EMU FISCAL RULES: A NEW ANSWER TO AN OLD QUESTION?

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1. Introduction

Fiscal sustainability is a central tenet of European Monetary Union (EMU); it is a precondition for financial and monetary stability. Budgetary flexibility is needed for stabilisation policy; it has become more important in EMU as member states can no longer rely on a monetary policy tailored on national needs nor on exchange rate adjustments. EMU fiscal rules have been designed with the goal to ensure that national policies keep a sound fiscal stance while allowing sufficient margins for budgetary flexibility in bad times[1].

The Stability and Growth Pact commits EMU member states to a medium term objective of budgetary position close to balance or in surplus. The main rationale for such a target is that its attainment will allow member states to deal with normal cyclical fluctuations while keeping the government deficit within the value of 3% of GDP set in the Treaty of Maastricht[2]. Compliance with this threshold, and with the 60 per cent ceiling for the debt to GDP ratio, will prevent the public finances of EMU member states from taking unsustainable paths.

In this paper we try to assess to what extent the issue facing the founders of EMU was a new one in the field of public finance and to what extent the solution chosen can be regarded as innovative. To this end, we review the literature on budgetary rules from its very beginning to the years immediately before the Treaty of Maastricht (section 2). The review is largely based on quotations drawn from economists and policy makers. On the basis of this review, in section 3 we argue that the bulk of EMU fiscal

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[1] The economic policy framework of EMU is extensively examined in Buti and Sapir (1998) and in Buti, Brunila and Franco (2001). The theory of fiscal sustainability and its links with EMU fiscal rules are reviewed in Balassone and Franco (2000a); see also the papers in Banca d'Italia (2000). On the flexibility allowed by EMU fiscal rules see Buti *et al*. (1997) and Balassone and Monacelli (2000).

[2] The actual definition of this medium term objective requires several factors to be taken into account; see section 3.1.

regulation does not qualify as innovative; however, the interaction between the multinational nature of EMU and the lack of a federal political authority (a truly innovative feature) shaped the solution chosen. The highly decentralised setting of fiscal policy in EMU gave prominence to moral hazard issues and EMU fiscal rules, while drawing heavily on ideas that are central to the long lasting debate on fiscal rules, are innovative in the way in which different approaches are blended and complemented by innovative and pragmatic choices.

2. The balanced budget rule and its amendments

Mankind has always displayed a certain degree of awareness of the potential negative effects of excessive borrowing. Exhortation to sound fiscal behaviour can be found as early as in the Bible: “And thou shalt lend unto many nations, but thou shalt not borrow” (Deuteronomy 15:6).

Several centuries later, as Hansen (1941) reminds us: “Scholastic theologicians, like Thomas Aquinas, were bitterly opposed to loans… Political philosophers of the early modern period continued to regard the prior accumulation of treasures as superior to borrowing… [For] Jean Bodin … emergencies should be met by accumulated hoards, and only war provided justification for extraordinary levies or loans. Thomas Hobbes was more realistic … [allowing] the monarch [to resort] occasionally even to the public credit… [but] Adam Smith reverted to the older tradition … Hume likewise wrote … [that] to mortgage the public revenues … [is] a practice that appears ruinous” (p. 110).

Burkhead (1954) notes that there is a common body of doctrine that may be characterised as the classical view of debt and deficits that goes from Smith to Mill. These writers recognised that there are productive uses to which borrowed resources may be put; however, they feared that unproductive use was more likely and strongly opposed deficit finance when giving policy advice. They noted that interest payments would pose a burden on future taxpayers, but their main concern was the loss of wealth borne when the deficit was incurred in the first place.

Smith opposed unbalanced budget on the ground that government borrowing would deprive society of resources which could be invested more productively. He also noted that beyond a certain threshold debt inevitably leads to national bankruptcy.

Say argued that the possibility of borrowing allows governments "… to conceive gigantic projects that lead sometimes to disgrace, sometimes to glory, but always to a state of financial exhaustion; to make war themselves and stir up others to do the like; to subsidize every mercenary agent and deal in the blood and the consciences of mankind; making capital which should be the fruit of industry and virtue, the prize of ambition, pride, and wickedness[3]".

Ricardo refers to the debt as "… one of the most terrible scourges which was ever invented to afflict a nation[4]", as "… a system which tends to make us less thrifty, to blind us to our real situation". He feared that the citizen initially "deludes himself with the belief, that he is as rich as before" and then, faced with the taxes levied to pay for the debt, is tempted "… to remove himself and his capital to another country, where he will be exempted from such burthens[5]".

In short, for a long time the only budgetary rule was that of a balanced budget. This rule was probably based on an analogy between government and family finance drawn when the budget of the State was the budget of a monarch and it was separate from the finances of his subjects. The precept was therefore to avoid living beyond one's means. "As Adam Smith put it, 'what is prudence in the conduct of every private family, can scarcely be folly in that of a great kingdom'"[6] or, following Dickens' Mr. Micawber: "… if a man had twenty pounds a year for his income, and spent nineteen pound nineteen shillings and sixpence, he would be happy, but … if he spent twenty pounds one he would be miserable[7]".

In the second part of the XIX century, the precept of a balanced budget still found a widespread endorsement. Ursula Hicks notes that "Gladstonian budgeting is inextricably bound up with the theory of the ever-balanced (or even over-balanced) budget" (1953, p. 25) and quotes the following statement by Lowe, a disciple of Gladstone, "I would define a Chancellor of the Exchequer as an animal who ought to have a surplus; if

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3 Say (1853), p. 483.

4 The Works and Correspondence of David Ricardo, P. Sraffa, ed., (1952-73), vol. IV, p. 197.

5 The Works and Correspondence of David Ricardo, P. Sraffa, ed., (1952-73), vol. IV, p. 247-8.

6 Premchand (1983), p.4.

7 Charles Dickens, *David Copperfield*.

under extraordinary conditions he has not a surplus he fails to fulfil the very end and object of his being" (p. 25)[8].

Deficit and debt drew less attention from economists. For instance, as Burkhead (1954) notes, Marshall's *Principles* devote no attention to these issues. Noticeably, Puviani (1903) devotes most of its analysis of fiscal illusion to public expenditure and revenue. While he notes that politicians may prefer borrowing to extraordinary levies because citizens underestimate future interest burdens, this argument remains relatively unimportant in his analysis of the methods employed by governments to influence citizens' perception of fiscal policy.

The consensus on the balanced budget is witnessed by Pigou's 1929 writing: "in normal times the main part of a government's revenue is required to meet regular expenditure that recurs year after year. There can be no question that in a well-ordered State all such expenditure will be provided for out of taxation, and not by borrowing. To meet it by borrowing … would involve an ever-growing government debt and a corresponding ever-growing obligation of interest. … The national credit would suffer heavy damage; ... This thesis is universally accepted" (1929, p. 233).

Even after the keynesian revolution the virtue of a balanced budget kept being praised. Truman's 1951 *Economic Report of the President* stated that "… we should make it the first principle of economic and fiscal policy in these times to maintain a balanced budget, and to finance the cost of national defence on a 'pay-as-we-go' basis".

As Schumacher noted in 1946, the precepts of sound public finance were grounded in the opinion that the economy is self-equilibrating[9]. "The logical corollary of orthodox economics is orthodox finance. If it is believed that all factors of production are normally and inevitably utilised by private business, it follows that the State can obtain the use of such factors only by preventing private business from using them. … From this it follows that the first principle of 'sound' public finance is that the budget should be balanced" (p. 86).

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8 U. Hicks relates this view to the objective of reducing the debt and taxation, to the prevailing favourable economic conditions and also to some difficulties in managing the budget. She notes the growth of administrative expertise in budgeting contributed to the development of a different approach in the 1930s.

9 Schumacher, while reporting these views, did not share them.

Almost seventy years later than Pigou, Buchanan echoes his words: "the first century and one-half of our national political history did, indeed, embody a norm of budget balance. This rule was not written in the constitution document, as such, but rather it was part of an accepted set of attitudes about how government should, and must, carry on its fiscal affairs" (1997, p. 119).

However, even in family finance borrowing is not necessarily evil. Even classical advocates of the balanced budget were aware of the necessity of allowing borrowing in certain circumstances and of its usefulness in others. Therefore economists have had a hard job in trying to specify under what circumstances exception to the balanced budget rule were to be allowed, caught between the Scylla of missed opportunities as a consequence of the constraint and the Charybdis of waste and instability caused by its removal.

The need for exceptions as well as the need for tight rules to deal with them was clearly recognised by Pigou (1929). He deemed it to be plain that when "non-remunerative government expenditures *on a wholly abnormal scale* have to be undertaken, as in combating the consequences of an earthquake or to meet an imminent threat of war … to collect what is required, and required at a very short notice in these conditions, through the machinery of taxation is politically and administratively impracticable" (p. 39; italics ours). He also argued that concerning "government expenditure devoted to producing capital equipment … *the fruits of which will subsequently be sold to purchasers for fees* … it is generally agreed that the required funds ought to be raised by loans. …Upon this matter … there is no room for controversy" (p. 36; italics ours). Finally, he notes that "…since changes in taxation always involve disturbance, to keep the rates of taxation as nearly as possible constant from year to year … it may be desirable … to arrange a budget so that good and bad years make up for one another, *a deficit in one balancing a surplus in another*" (p. 35; italics ours).

2.1 Ordinary vs. extraordinary finance

One first exception was thus found in the distinction between ordinary and extraordinary finance: the former dealt with recurrent expenditures, to be financed by recurrent revenues so as to avoid the depletion of non-renewable assets; the latter dealt with one-off outlays to be backed also by borrowed funds. Also the rationale for this exception was found by way of analogy to family finance. De Viti de Marco (1953) points out that "…if an individual has to face an expense which he reckons to exceed his annual income … he will either have to sell his assets or raise a loan" (p. 390, our translation) and applies the same line of reasoning to public finances[10].

De Viti de Marco is very much aware of classification problems as the extraordinariness of an outlay is a matter for subjective assessment both at the individual and at the collective level: "this subjective element does not allow to define a rigorous and objective rule that draws the line … between ordinary and extraordinary finance" (p. 390, our translation). Margins for moral hazard and opportunistic behaviour arise as "the distinction between 'ordinary' and 'extraordinary' receipts and expenditure is admittedly not clear-cut, depending ultimately on the judgement of the classifying authority as to whether the receipts and expenditure in question are to continue indefinitely in the future" (United Nations, 1951, p. 61).

While extreme cases were easily identified (on the one hand, interest outlays and salaries; on the other, the cost of a war), in some cases it is not straightforward to see what is ordinary and what is not. "It is impossible to define ex ante what is an extraordinary outlay. Building a school may be an extraordinary effort for a small town, an ordinary one for a big city" (Einaudi, 1948, p. 318; our translation). Ultimately, "there is no great technical difficulty in producing for a series of years budgets which are balanced at the end of the year to the nearest penny … Perhaps half a dozen financial writers in the country would understand from the published accounts what was happening, but I doubt if any one of the half dozen is capable of making the position clear to the public[11]".

National experiences did not differ much. "In the case of France, the extraordinary budget was proverbially the dumping place for all expenditures which could not be balanced by tax receipts" (Hansen, 1941, p. 199). In 1945 Keynes notes that in the United Kingdom "the present criterion leads to meaningless anomalies. A new G.P.O. is charged 'below', a new Somerset House 'above'. A Capital contribution to school buildings is 'above' in the Exchequer Accounts and is paid for out of Revenues, and is 'below' in the Local Authority Accounts and is paid for

10 De Viti de Marco goes on to justify deficit finance as a less painful alternative to extraordinary taxation which may penalise liquidity constrained taxpayers.

11 Sir F. Phillips, writing in 1936, quoted in Middleton (1985), p. 82.

out of loans. The cost of a road is ‘above’, of a railway ‘below’. And so on[12]”. “In Canada, although not always realised even by Canadians, a budgetary distinction between ordinary and capital expenditures has been made ever since the confederation in 1867. The official reports show surpluses in fifty of the sixty-six years following 1867; but if the accounting were made on the United States basis, surpluses would appear in only fifteen of the sixty-six years” (Hansen, 1941, p. 199)[13].

2.2 The double budget

The double budget is a refinement of the ordinary/extraordinary distinction which reduces the degree of arbitrariness of the decision concerning which expenditures can be deficit-financed. The budget is split into a current and a capital account. While the former must be balanced or in surplus, the latter can run a deficit (the so-called *golden rule*) and thus allows to spread the cost of durables over all the financial years in which they will be in use rather than charging it entirely on one year. It can be a powerful instrument in overcoming liquidity constraints and fostering economic development structurally.

Arguments along these lines can be found earlier than the dual budget debate per se. The productive character of a large part of public outlays was noted by German scholars in the second part of the XIX century. They also argued that government can borrow to finance undertakings that are expected to improve the income of future generations (Cohn, 1895). Bastable (1927) argues that “non-economic (i.e. non-remunerative) expenditure is primarily to be met out of income, and, unless it can be so dealt with, ought not to be incurred…[and] … that borrowing

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12 Memorandum by Keynes for the National Debt Enquiry, 21 June 1945, in D. Moggridge and A. Robinson, eds., (1971-89), vol. XXVII, pp. 406-7. On the UK experience, Clarke (1998) also notes that “in the best Gladstonian tradition …. On the expenditure side, what mattered was expenditure above the famous ‘line’ in the Exchequer accounts, dating from the Sinking Fund Act of 1875, broadly … distinguishing a revenue account from a capital account – but by no means unambiguously … Only an old Treasury hand could be expected to know the difference within this hybrid accounting framework …. therefore, the simple moral imperative of balancing the budget was in practice wrapped in the esoteric conventions of the public accounts” (p. 64).

13 In Italy, in the late 19th Century and the early 20th Century revenues and expenditures related to the construction of railways were included in a special balance sheet and separated from other ordinary and extra-ordinary items. Revenues were represented by the proceeds of the sale of bonds, expenditures by the outlays for investment projects (see Nitti, 1903). De facto, an item specific golden rule was implemented.

should hardly ever be adopted except for strictly economic expenditure, and then only when the extension of the State domain is clearly advisable" (pp. 670-1).

The usefulness of a dual budget has been long debated[14]. It is still an unsettled issue, which has been tackled in different ways in different countries and at different times. Sweden, introduced the dual budget in 1937 and suppressed it in 1980.

First of all, the distinction between current and capital items retains a certain degree of ambiguity which can be used opportunistically. "The classification procedures which are to be followed in separating "current" and "capital" transactions are among the most controversial and difficult questions in budgetary procedure, especially in view of the frequent abuses of so-called "capital budgets" in hiding deficits which otherwise would have become apparent" (United Nations, 1951, p. 11).

According to Lindbeck (1968), this distinction "facilitated tactical political manoeuvres and hampered the fiscal policy debate for many years [in Sweden] by focusing it on complicated bookkeeping issues understood by very few and of very little economic relevance" (p. 34).

In principle, one can distinguish between durable goods producing a direct revenue, durable goods producing an indirect revenue as, respectively, investments by publicly owned enterprises and public infrastructures that reduce the costs borne by private producers and/or consumers and durable goods with pure consumption functions. It may be argued that the latter should be excluded from the capital account as they do not affect growth and thus do not imply a future financial benefit for the public sector; therefore they worsen the sector's net worth.

In practice, however, the divide between the second and the third category is very unclear. In the case of infrastructures, for example, there is the issue of the treatment of expenditures determined by the attempt to reduce the impact on the environment. If the overall costs increase should these expenditures be considered as producing an indirect revenue or as pure consumption? If for this reason we include in the capital account all durables, we end up creating a distortion in allocation only based on duration, rather than on contribution to growth, thus "the analogy with

[14] See the accounts in Premchand (1983) and Poterba (1995). For a recent discussion in the context of EMU, see Balassone and Franco (2000b).

private accounting may be conductive to an irrational preference for capital expenditures over current expenditures" (Goode and Birnbaum, 1955, p. 1)[15].

Clearly there are current expenditures, such as those increasing human capital, that can give a relevant contribution to growth as "indirect revenue need not come through a durable good" (Steve, 1972, p. 164; our translation). If one is not careful about the expenditures to be included in the capital section, the dual budget may result "...in a preference for expenditures on physical assets rather than greater spending for intangibles such as health or education" (Colm and Wagner, 1963, p. 125). Thus, "the need for a return, either in the limited financial sense or in the broader context of the social return, is a view that needs to be applied over a wider spectrum of public expenditures and not confined to capital budget only" (Premchand, 1983, p. 296).

However, the inclusion in the capital account (which can be financed through debt) of all expenditures contributing to human capital would imply high levels of deficits and pose serious problems of classification[16]. One should also take into account that a part of expenditures replaces existing capital.

Furthermore, the possibility to borrow, without strict limits, in order to finance investments can lower the attention paid when evaluating the costs and benefits of each project. In a way with the double budget the analogy between government and private finance moves from the household to the business sector where the distinction between current and capital budget is customary. But the analogy between public sector accounts and those of private enterprises overlooks the absence of mechanisms that would penalise the public body investing in low revenue projects.

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[15] For a discussion along these lines see also Steve (1972; pp. 163-5). Steve also notes that drawing the line between durable goods with direct and indirect revenue would pose similar problems.

[16] Bastable (1927) already acknowledged the usefulness of non-remunerative expenditures such as those on education, improved housing and the like, however he also pointed out that there is a "… difficulty of application. The results of expenditure of the kind are hard to trace or measure, and any of statement respecting them must rest in a great degree of conjecture". (pp. 621-2).

2.3 Stabilisation policy

Another attempt at justifying deviations from the balanced budget rule came from Keynesian theory where the budget plays a crucial role in cushioning the effects of cyclical downswings in the economy compensating for insufficient private demand. Therefore a balanced budget was no longer to be achieved in each financial year but to be attained over the whole length of the economic cycle.

On April the 5th of 1933 Keynes wrote on The Times: "The next budget should be divided into two parts, one of which shall include those items of expenditure which it would be proper to treat as loan-expenditure in the present circumstances". Later he sharpens the distinction between the government's own current expenditure and a capital budget to provide for sufficient national investment. In 1942 he writes: "I should aim at having a surplus on the ordinary budget, which would be transferred to the Capital Budget, thus gradually replacing dead-weight debt by productive or semi-productive debt… I should not aim at attempting to compensate cyclical fluctuations by means of the ordinary budget, I should leave this duty to the capital budget[17]".

Fiscal policy in Sweden and in the USA moved along these lines[18]. In 1937 Sweden reformed its budget rules and abandoned the annual balancing. In Lindbeck's account, the Swedish reform was based on the idea that "in normal times the capital budget should be financed by loans whereas the current budget should be financed by taxes. In boom periods the current budget should, however, be overbalanced, hence part of the capital budget would be financed by taxes; in recession the current budget should be underbalanced, hence partly financed by loans" (1968, p. 33).

Hansen explains how in the USA, "President Roosevelt … divided federal expenditures into 'ordinary' and 'extraordinary'. The former relate to the 'operating expenditure for the normal and continuing functions of government' … [and] … should be met out of current revenues'… He expressed the hope that in times of prosperity current revenues would so

17 'Budgetary Policy', 15 May 1942, in D. Moggridge and A. Robinson, eds., (1971-89), vol. XXVII, pp. 277-8.

18 These developments reflected common problems but were to a large extent unrelated. On the relationship between Swedish fiscal policy and Keynesian theories see Lundberg (1996). He recalls that in 1929 Lindhal considered the use of fiscal policies to affect the level and composition of demand and that Myrdal was asked to write an appendix to the government budget proposal of January 1933 on the issue of the feasibility of active fiscal policies.

far exceed ordinary expenditures as to produce 'a surplus that can be applied against the public debt'… The extraordinary expenditures, which are concerned with loans, capital expenditure and relief of need, he deemed to be sufficiently flexible in character as to permit their contraction and expansion as a 'partial offset for the rise and fall in the national income" (1941, p. 219).

However, the idea of balancing the government accounts over the course of the business cycle had an exceptionally brief life span. Blinder and Solow (1974) point out that while it "… had considerable appeal… in the immediate post-Keynesian years, when the balanced budget was [still] influential, it is almost never discussed nowadays" (p. 37). It was the turn of functional finance to take the lead.

"Functional finance rejects completely the traditional doctrines of 'sound finance' and the principle of trying to balance the budget over the solar year or any other arbitrary period … government fiscal policy … shall all be undertaken with an eye only to the results of these actions on the economy" (Lerner, 1943, p. 41).

Hansen noted that "if one adopts wholeheartedly the principle that government financial operations should be regarded exclusively as instruments of economic and public policy, the concept of a balanced budget, however defined, can play no role in the determination of that policy" (1941, p. 188).

The way in which these ideas were first met is exemplified in the following passage by Chamberlain in 1933[19]: "If I were to pretend I could lay out a programme under which what I borrowed this year would be met by a surplus at the end of three years, everyone would soon perceive that I was only resorting to the rather transparent device of making an unbalanced budget look respectable[20]".

[19] Middleton (1985) reviews the debate about budgetary policy in the United Kingdom in the 1930s. In 1933 the Treasury stressed the risks related to unbalanced budgets: "Would not the ordinary taxpayer and the business man very soon begin to have a feeling of uneasiness and apprehension? After all people will realise that the bill must be paid if not this year next year or the year after. Uncertainty and apprehension about the future would very quickly cancel out any immediate psychological benefit which the reduction of taxation by unbalancing the Budget would promote" (1985, p. 88).

[20] Neville Chamberlain (Chancellor of the Exchequer), quoted in Sabine (1970, p. 15).

It was also pointed out that "the requirement of a balanced budget was and still is the simplest and clearest rule to impose 'fiscal discipline' and to hold government functions and expenditure to a minimum… Even an avowedly counter cyclical policy is believed to give rise to an upward trend in expenditures that might not otherwise occur. The expenditures undertaken to counteract a depression are unlikely to be discounted in the succeeding boom. If the boom is countered at all, the measures taken will be credit restriction or increased taxation" (Smithies, 1960).

The obstacles posed by politics to a symmetric and timely reaction of the budget to cyclical developments were stressed. Agreement over the appropriate budgetary items to use may take too long; it may prove difficult to reduce expenditures once they have been increased. Drees (1955) and Steve (1972) provide early discussions of the relevance of the balance of powers between the Parliament and the Government and of the relationship between the Government and its Parliamentary majority: budgetary rules cannot be evaluated per se but need to be set in the overall institutional context.

Among the remedies suggested to the political problem described, an enhanced reliance on automatic stabilisers and the so-called formula flexibility were suggested. The latter consisted in the introduction of a predetermined relationship between tax rates (or benefits levels) and the level of economic activity[21].

But support in favour of functional finance was strong. "Even if stability in the budget has something to recommend it, stability in the economy is surely better… Who makes the rule? Who decides when to abide to it and when to countermand it? Furthermore, within the framework of a political democracy, the case for taking stabilisation policy out of the hands of politicians is an uneasy one: into whose hands shall it be placed?… No budgetary rule can be provided with a solid intellectual foundation. This will hardly be new to economists. The best that can be said for rules is that some of them may be better than incompetently

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[21] Biehl, in summarising several papers on fiscal policy issues, notes that "It is strange to see that, e.g., the old-fashioned concept of the simple budget balance rule is still widely used in many countries and that …. the full employment budget concept, the structural margin of fiscal impact concept, and the concept of the cyclically adjusted neutral budget … are only known to a small circle of specialists." (1973, p. 6).

managed discretionary policy…" (Blinder and Solow, 1974, pp. 43 and 45). This view was broadly accepted in some public finance textbooks[22].

Along the same lines, though less aggressively, Steve (1972) notes that "budgetary policy cannot be reduced to simple rules, it should take into account the overall effects of the budget on private demand components and national income" (p. 170; our translation)[23].

The stagflation in the 70s; the difficulties concerning the estimate of the actual impact of budget changes on the economy; the risks of fine tuning given the lags between the decision to change the budget and its implementation; the development of theoretical models questioning the possibility for the Government to influence the level of government activity all contributed to a decline of interest in the theory of functional finance.

Advocates of the balanced budget regained the fore. "The balanced-budget principle played a crucial role in holding the pre-keynesian fiscal constitution together, and constraining the otherwise inherent biases of that system to over-expenditure and deficit finance. Once the balanced-budget had been bowled over by the Keynesian revolution, those biases were unleashed" (Buchanan, Wagner and Burton, 1978, p. 47)[24].

Politicians praised again the virtues of balanced budgets: "At one time, it was regarded as the hallmark of good government to maintain a balanced-budget; to ensure that, in time of peace, Government spending was fully financed by revenues from taxation, with no need for Government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded … And I have balanced the budget" (Nigel Lawson, Budget Statement, 1988).

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[22] See, for instance, Johansen (1965), in which the use of budgetary items for stabilisation policy is unquestioned, the focus of the analysis being on the choice of the most appropriate instruments.

[23] Steve stresses that the budget balance cannot be considered in isolation: the level and composition of public revenue and expenditure are extremely important.

[24] Keynes' own views about active fiscal policy were rather prudent. He stressed the need to control inflation and retain appropriate market incentives. In evaluating the UK budget in 1940, he noted "The importance of a war budget is not because it will 'finance' the war. The goods ordered by the supply department will be financed anyway. Its importance is *social*: to prevent the social evils of inflation now and later; to do this in a way which satisfies the popular sense of social justice; whilst maintaining adequate incentives to work and economy". ('Notes on the Budget', 21 September 1940, in Moggridge and Robinson, eds., 1971-89, vol. XXII, p. 218).

The recent policy debate has largely recognised that in normal circumstances automatic stabilisers ought to be allowed to operate freely[25]. On the contrary, discretionary fiscal action is generally considered problematic in view of irreversibility and timing problems and of the uncertainty about its effects[26].

3. EMU fiscal rules: a new answer to an old question?

European Monetary Union represents a new historical development. For the first time a number of sovereign countries adopt a common currency while retaining independent fiscal policies. The need for fiscal rules complementing monetary union has been at the core of the debate on EMU since the early nineties[27].

Some arguments were put forward against the introduction of fiscal rules at the European level. It was noted that fiscal rules may have costs in terms of stabilisation policies and may hamper the achievement of allocative and distributive objectives. It was also noted that excessively stringent rules may be counter-productive. If the Pact leads to an unduly tight fiscal stance in one or more countries, pressure may mount on the ECB to deliver a monetary offsetting[28]. Otherwise, the credibility of the Pact may be endangered[29].

However, the prevailing view in the policy debate was clearly in favour of the introduction of formal rules. It was argued that procedural or fiscal rules are necessary because the factors that in recent decades have

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25 The issue is extensively discussed in OECD (1999). OECD notes that "in the future governments should guard against the asymmetric use of automatic stabilisers, although this obviously does not preclude all discretionary action, particularly for structural reasons." (p. 145).

26 See European Commission (2001), Kilpatrick (2001), Taylor (2000) and Wren-Lewis (2000).

27 For a review of the justifications put forward for the Pact and for an analysis of its potential macroeconomic implications see European Commission (1997), Artis and Winkler (1997) and Eichengreen and Wyplosz (1998).

28 Canzoneri and Diba (2001).

29 It was also noted that the multiplicity of fiscal authorities does not provide strong arguments in favour of permanent constraints on the deficit as it may actually dilute the pressure on the central bank. According to Canzoneri and Diba (2001), a more relevant reason to have fiscal rules is to underpin the 'functional', as opposed to the 'legal', independence of the central bank. Without a credible deficit criterion ensuring government fiscal solvency, the central bank would not be able to keep control of the price level.

determined fiscal profligacy in several countries have not disappeared. Moreover, the multinational dimension of EMU is likely to increase the need for such rules.

Stark (2001) describes the genesis and the rationale of the Stability and Growth Pact[30]; he stresses how in Europe, up to the early nineties, lax fiscal policy "… occurred although it is indisputable that unsound fiscal policy practices have adverse effects on price stability, growth and employment: large deficits and large public debt place constraints on the ability of a country … to act during different stages of the business cycle…; the State's absorption of resources which would otherwise have found their way into private investments results in higher long term interest rates …; … a stifling government debt ratio impair(s) the overall efficiency of an economy and create(s) risks to price stability…; these problems are especially pronounced in monetary union since … the policy of a single country might have adverse consequences for all the other participating countries". These arguments combine the two main strands of opinion about the budgetary balance: the one stressing the importance of stabilisation policies and budgetary flexibility and the other maintaining that unbalanced budgets imply distortions in the allocation of resources[31].

It was also pointed out that, without strong rules, the legal independence of the European Central Bank (ECB) may turn out to be an empty shell because of pressure by high-debt countries for ex ante bail-out (refraining from raising interest rates in conditions of inflationary tensions) or ex post bail-out (debt relief through unanticipated inflation). EMU can induce unilateral fiscal expansions since governments may feel less inclined to preserve fiscal rectitude, as they individually face a less steep interest rate schedule in a monetary union than under flexible exchange rates.

The debate on fiscal rules in EMU was grounded on the wider debate that took place in the nineties about the role of fiscal institutions and procedures in shaping budgetary outcomes[32]. While certain political configurations, such as weak coalition governments, have been recognised as conducive to budgetary misbehaviour or to hampering attempts to

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30 See also Costello (2001).

31 See Buti *et al.* (1998).

32 See Kopits and Symansky (1998).

redress the budgetary situation[33], inadequate budgetary institutions and procedures may also contribute to a lack of fiscal discipline[34].

In this context, institutional reforms in the fiscal domain have been discussed and introduced in several countries. As noted by Beetsma (2001), these reforms come in two main categories: (a) the introduction of procedural rules conducive to a responsible fiscal behaviour and (b) the introduction of a fiscal rule, i.e. a permanent constraint on domestic fiscal policy in terms of an indicator of the overall fiscal performance (budget balance, borrowing, debt, reserves) of central and/or local government.

In national experiences, both types of measures have proved to be effective tools in containing political biases in fiscal policy-making and in achieving and sustaining fiscal discipline. In a multinational context, the adoption of harmonised tight budgetary procedures may lead to fundamental problems from the point of view of national sovereignty (Beetsma, 2001). Moreover, institutional reforms are more difficult to monitor centrally, compared to numerical targets. The latter are also simpler to evaluate and easier to grasp by public opinion and policy-makers. In the end a clear consensus emerged about the introduction of common numerical rules and an elaborated multilateral surveillance mechanism[35].

The fiscal framework of EMU was developed gradually. The Treaty of Maastricht in 1992 set the fiscal criteria to be met for joining Monetary Union. The Stability and Growth Pact (SGP), adopted by the European Council in Amsterdam in June 1997, developed these criteria with a view to permanently restraining deficit and debt levels while allowing room for fiscal stabilisation. The Pact also strengthened the monitoring procedures complementing the quantitative rules.

[33] See, e.g., Roubini and Sachs (1989), Alesina and Drazen (1991), Alt and Lowry (1994), Alesina and Perotti (1995) and Balassone and Giordano (2001).

[34] See, e.g., von Hagen and Harden (1994) and the essays in Strauch and von Hagen (2000).

[35] See Buti and Sapir (1998) and Stark (2001).

3.1 A description[36]

As we have anticipated in the introduction, EMU fiscal rules have been designed with the goal to ensure that national policies keep a sound fiscal stance while allowing sufficient margins for budgetary flexibility in bad times.

The Treaty of Maastricht stated that budget deficits cannot be larger than 3 per cent of GDP unless (a) under exceptional circumstances, such as deep recessions, (b) they remain close to 3 per cent, (c) the excess only lasts for a limited period of time[37]. If the deficit exceeds the 3 per cent limit when the above three conditions are not met, the deficit is deemed "excessive" and it sets off a procedure intended to force corrective measures by the deviating country. If such measures are not taken the Treaty foresees monetary sanctions which increase as situations of excessive deficit persist[38].

The Stability and Growth Pact specified what is meant by "exceptional" and "limited period" in the clauses allowing a deficit greater than 3 per cent of GDP not to be considered "excessive". A recession is considered exceptional if real GDP diminishes by 2 per cent. Milder recession (where the reduction in real GDP is of at least 0.75 per cent) may also be considered exceptional if, for example, they are abrupt. The excess above 3 per cent must be reabsorbed as soon as the "exceptional circumstances" allowing it are over.

The Pact also specified that each country should aim for a medium term objective of a budgetary position "close to balance or in surplus". According to the guidelines provided by the European Council[39], the choice of the medium term target should take into account both the budgetary risks of recessions and those linked to fluctuations of other economic factors (e.g. interest rates). Countries with debt ratios above 60 per cent of GDP should also take into account the need to decrease such ratio, at a satisfactory pace, towards the threshold. Moreover, an increase in the debt

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[36] A more detailed description of the rules is provided in Buti and Sapir (1997) and in Cabral (2001).

[37] The three conditions make the 3 per cent threshold extremely binding (see Buti *et al*., 1997).

[38] See Cabral (2001) for a description.

[39] Council Resolution on the Stabilty and Growth Pact, 17 June, 1997; Council Regulation n. 1466/97, 7 July 1997; Council Declaration, 1 May 1998; Opinion of the Monetary Committee, 12 October 1998 as approved by the Council.

ratio during recessions should be avoided[40]. Finally, other risk factors, such as the effects of demographic trends, ought to be taken into account[41].

According to the European Council, compliance with the Pact should be assessed considering the cyclical position of the economy. In practice, EMU fiscal rules require that each member state choose a budgetary target in cyclically adjusted terms and let automatic stabilisers or discretionary action operate symmetrically around it. The lower this budget balance with respect to the 3 per cent threshold, the wider the margins for counter cyclical policy without running the risk of an excessive deficit.

Each member state must submit its budgetary targets officially in multi-year budgetary documents (Stability Programmes); these documents are updated annually and are subject to a review by the European Commission aimed at assessing their consistency with EMU fiscal rules.

Overall, the approach taken by the EU can be characterised as less flexible than the solutions adopted in some federally structured countries[42]:

a) the rules are defined on the basis of established numerical parameters;
b) *ex post* compliance with the parameters is required each year; overshoots must be rapidly dealt with;
c) margins of flexibility are envisaged only in connection with exceptional cyclical events (established *ex ante* as a decline in GDP) or in any case events beyond the governments' control;
d) no special provision is made for investment expenditure[43];
e) monitoring procedures are envisaged, whereby peer pressure is strengthened by the European Council's power to make formal representations to governments of the need to adopt corrective measures during the year and by the application of pre-established monetary sanctions.

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[40] Art. 104C of the Treaty says that when the ratio is above 60 per cent of GDP it must "diminish sufficiently" and approach 60 per cent "at a satisfactory pace". If the ratio increases, the excessive deficit procedure begins. It should be noted that, while the Treaty allows exceptions to the 3 per cent deficit criterion, it does not for the criterion concerning the debt ratio See Balassone and Monacelli (2000).

[41] The choice of the medium term fiscal target is examined in Artis and Buti (2001, Dalgaard and de Serres (2001) and Barrel and Dury (2001).

[42] See Balassone and Franco (1999).

[43] No distinction is made in the Treaty between current and capital expenditure for the purposes of determining the deficit. The volume of capital expenditure is included only among the relevant factors to be borne in mind when deciding whether there is excessive debt.

3.2 A new answer to an old question?

With European Monetary Union for the first time the need for fiscal rules arises in a multinational context. The review in the previous section shows how the arrangements adopted are deeply embedded in the long-lasting debate on budgetary rules. The novel features of EMU guided the choice between alternative solutions and required the introduction of some innovations.

The need to reconcile fiscal soundness and budgetary flexibility led to combine different approaches:

a) setting a predetermined upper bound for the deficit is a new pragmatic solution[44];
b) balancing the budget over the cycle is a precept derived from the keynesian approach. In 1951 a report by the United Nations, commenting the 1937 Swedish reform, points out that "while counter – cyclical budgeting introduced an element of flexibility in the fiscal policy of Government, the concept of 'financial soundness' has been retained" (p. 69);
c) prudence when fixing the average target to be achieved over the cycle ("close to balance or in surplus") has a classical flavour. In 1927 Bastable argued that "the safest rule for practice is that which lays down the expedience of estimating for a moderate surplus, by which the possibility of a deficit will be reduced to a minimum" (p. 611).

The stress on fiscal soundness motivates the rejection of a dual budget approach and of any distinction between ordinary and extraordinary finance. However, pragmatism called for the allowance of margins for exceptional circumstances, this rests on the idea that "in some circumstances, indeed, a balanced budget is a pedantic luxury, which a community, hard pressed by sudden and exceptional misfortune, can ill afford" Dalton (1934, p. 12).

A broadly balanced budget, like that required by the SGP, may negatively affect the public investment level; this effect can be especially relevant during the transition to the low debt levels consistent with the chosen structural balance. The double burden determined by this transition

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[44] The deficit ceiling, although arbitrary, is reminiscent of the results obtained by Domar (1944) in the analysis of fiscal sustainability assuming a constant deficit. Perhaps conscious of the partial equilibrium nature of Domar's results, the introduction of a debt ceiling as well avoids convergence at high levels of debt. See Balassone and Franco (2000a).

can be assimilated to that arising from the transition from a pay-as-you-go to a funded pension system. However, besides the criticism to the double budget system examined in the previous sections, in the context of EMU the golden rule would be an obstacle to deficit and debt reduction. In particular, given the ratio of public investment as a percentage of GDP, the long-run equilibrium level of government debt could be very high, especially in an environment of low inflation. This could imply that the debt ratio would rise in low-debt countries, while in high-debt countries there would be a very slow pace of debt re-absorption. The golden rule would also meet with practical difficulties, such as the evaluation of amortisation, and would make the multilateral surveillance process more complex, by providing leeway for opportunistic behaviour. Governments would have an incentive to classify current expenditure as capital spending[45].

The asymmetry in EMU between the monetary regime, with the single currency and a single monetary authority, and the political landscape, lacking an authority of federal rank, gave prominence to moral hazard issues. It is probably at the roots of the rejection of both the dual budget and the distinction between ordinary and extra-ordinary finance. It motivated the adoption of a detailed multilateral surveillance procedure and the introduction of a predetermined limit for the annual deficit in a framework that envisages the targeting of a balanced budget over the cycle[46].

EMU may be termed a "radical federation", where in the absence of fiscal rules member states enjoy absolute autonomy in matters of public expenditure and taxation and recourse to debt. In this context, the stability of monetary and financial conditions represents a public good to which all local governments contribute by maintaining sustainable budget positions. There is an incentive for each local government to exploit the benefits accruing from the discipline of others without itself complying with the rules. This creates a double cost for the other entities: the free-rider's

[45] See Balassone and Franco (2000b).

[46] EMU fiscal rules are targeted at national governments while many EMU member states have a federal or highly decentralised structure. A free riding problem can re-emerge at national level. This problem is analysed in Balassone and Franco (1999).

excessive indebtedness can put pressure on interest rates to rise; it can also result in bankruptcies requiring bail-outs[47].

The need for monitoring was felt also in earlier days. For instance, Durrell (1917) argues that: "the public and the Parliament should be satisfied that … there is some authority which … will give timely warning if that expenditure or those obligations are either outrunning the revenue provided for the year or engaging the nation too deeply in the future" (p. 242). However the monitoring procedure adopted for EMU is novel with respect to its scale, complexity and tightness.

Until now the chosen mix of approaches has been successful in securing a reduction in budget deficits and debt across EMU member states. It remains to be seen whether it will also be successful in maintaining fiscal discipline once at regime. Unfavourable economic developments will put to test EMU's fiscal constitution and the issue of legitimacy of rules in a democracy pointed out by Blinder and Solow may come to the fore again.

Fiscal rules can be successfully implemented over a long period of time only if public opinion considers them a valuable contribution to policy making. In the words of Bastable (1927): "it but remains to again lay emphasis on the fact that good finance cannot be attained without intelligent care on the part of the citizens. The rules of budgetary legislation are serviceable in keeping administration within limits; but prudent expenditure, productive and equitable taxation, and due equilibrium between income and outlay will only be found where responsibility is enforced by the public opinion of an active and enlightened community (p. 761).

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47 The risks clearly increase if member states are asymmetric in some relevant respect (e.g. accumulated public debt). These considerations are likely to have motivated the inclusion of a "rule" concerning not only deficits but also debt.

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