COMMENTS ON SESSION II: EUROPEAN FISCAL RULES

Anne Brunila[*]

To ensure smooth functioning of EMU with a single monetary authority and multiple fiscal authorities, EU Member States opted for a fiscal policy framework that is essentially rule-based. The first step in introducing supranational fiscal rules were the Maastricht fiscal criteria for joining EMU and the Excessive Deficit Procedure (EDP) that restrain budget deficits to 3% of GDP and debt levels to 60% of GDP. The second step was the adoption of the Stability and Growth Pact (SGP) that complements and tightens the fiscal provisions set in the Maastricht Treaty.

The SGP sets the medium-term target for budgetary positions of close to balance or in surplus, steps up procedures for multilateral surveillance and specifies the type and scale of sanctions to be applied in the event of an excessive deficit. The basic motivation behind the strict deficit limit, 'close-to-balance' rule and sanctions for non-compliance was to make budgetary discipline watertight in EMU, while still allowing a certain degree of fiscal flexibility. At the minimum, the 'close-to-balance' rule requires that budgetary positions over the medium-term should be strong enough to let automatic stabilisers to operate fully without a risk to breach the 3% of GDP deficit limit during recessions. The SGP also allows a limited degree of state contingency by singling out exceptional circumstances such as severe recessions and natural disasters, under which the deficit limit can be temporarily exceeded without triggering an Excessive Deficit Procedure and possible sanctions.

A strict rule-based approach guaranteeing strong fiscal discipline in EMU was deemed necessary to prevent moral hazard and 'deficit bias' that could erode the credibility of the common monetary policy. Moreover, fiscal rules can be seen as a device to improve transparency and predictability of fiscal policy making at national and EU level.

The setting up of the Maastricht fiscal criteria and the SGP in a context of both historically high public debt and persistent budget deficits revitalised academic interest in rule-based fiscal policy. Recent analytical

[*] European Commission.

and empirical work on fiscal rules in the context of EMU has focused largely on the stringency of the SGP deficit limit. It has frequently been argued that it would prevent automatic stabilisers from properly working when they are most needed as countries are forced to discretionary fiscal tightening in recessions for not to breach the deficit limit and incur sanctions. The EMU framework of rule-based fiscal policy and independent central bank with rigorous price stability objective has also spurred academic interest in policy co-ordination and interactions between monetary and fiscal policies in a monetary union.

The papers in this session reflect well the recent interest in fiscal rules and policy co-ordination in EMU. All papers deal with numerical rules that set limits on fiscal variables. The paper by Ron Berndsen focuses on the functioning of nationally imposed fiscal rules in general and draws on the Dutch experience on a number of fiscal rules implemented over the past 50 years. Wolfgang Föttinger addresses incentive problems arising under a golden rule relative to a balanced budget rule, while Philippe Mills and Alain Quinet discuss problems related to the working of automatic stabilisers under medium-term close-to-balance rule. The paper by Marco Buti, Jan In't Veld and Werner Röger focus explicitly on the use of supranational fiscal rules in the context of a monetary union. They analyse fiscal and monetary policy co-ordination in a monetary union. In what follows I will discuss the issues raised in these papers from the point of view of the following questions: Does the SGP with its 'close-to-balance' rule make national fiscal rules redundant in EMU? Would the golden rule of deficit financing provide a feasible alternative to the 'close-to-balance' rule? Does the 'close-to-balance' rule hamper cyclical stabilisation? Does EMU need policy co-ordination beyond the SGP?

Does the SGP with its close-to-balance rule make national fiscal rules redundant in EMU?

What are desirable characteristics for national fiscal rules? For any rule to be successful in delivering desirable outcomes, it has to be credible. In practice, this requires operationally simple and transparent rules with efficient enforcement mechanisms and sanction systems. Moreover, monitoring of the compliance with the rules should be easy and carried out by an independent agent. These characteristics imply a trade-off between simplicity and transparency on the one hand, and flexibility and

contingency on the other: contingent rules can easily become less transparent and subject to manipulation.

The paper by Berndsen illustrates well the difficulty in defining fiscal rules that are operational (easy to calculate and monitor), transparent and efficient in delivering the desired outcome. The Dutch experience on various national budgetary rules (constant capital rule, cyclical deficit rule, structural budget rule, tax burden rule, actual financial deficit control, net expenditure rule) shows also clearly that when the government unilaterally declares a certain budgetary rule as an objective with no sanctions for non-compliance or enforcement mechanisms to prevent targets being reformulated or departed from, rules are likely to be abandoned or eroded over time. Berndsen finds basically two situations that are likely to result in the abandoning of national budgetary rules: worsening economic situation making harder to stick to the rules or a new government coming to power with new policy priorities. Problems in commitment can thus make nationally adopted rules rather short-lived and inefficient in preventing the existence of persistent deficits and high public debt.

For both types of commitment failures supranational fiscal rules, such as the SGP, can provide a clear remedy; internationally agreed rules with sanctions cannot be abandoned as easily as national rules. The SGP does not however necessarily imply that national fiscal rules in EMU are worthless. The medium-term 'close-to-balance' rule of the SGP concerns general government, not only the central or federal government. However, in most EU countries it is the central government that commits to the medium term budgetary targets on behalf of the whole general government without much involvement of regional and local governments in setting the targets. In countries where lower levels of government have substantial financial autonomy, national level budgetary rules can serve as a co-ordination device to improve accountability and commitment of other budgetary players to the set targets. To this end a number of Member States have introduced national level budgetary rules (stability pacts, medium-term expenditure ceilings) to supplement the SGP.

Besides the potential need to strengthen budgetary co-ordination at the national level, national budgetary rules that constrain fiscal policy along appropriate lines can be used to diminish the risk of pro-cyclical relaxation of fiscal policy in good times. The SGP is essentially focused on budgetary discipline during cyclical downturns and hence, may not provide enough incentives to be prudent and to run even sizeable budget surpluses during periods of high growth and positive output gaps.

Would the golden rule of deficit financing provide a feasible alternative to 'close-to-balance' rule?

A golden rule has been introduced in some countries as a device to control budgetary policy at the national, regional and/or local level. Could a golden rule have been a feasible alternative to 'close-to-balance' rule to ensure fiscal discipline in EMU?

Under the golden rule, governments can borrow only to finance public investment. The rationale behind this type of a rule is that as public investment results in the accumulation of government assets that yield return over an extended period, it should also be possible to allocate financing costs over time to those generations that benefit from investment.

Ideally fiscal rules should provide a set of incentives and/or constraints that make fiscal policy actions closer to 'desirable' outcomes. Earlier work analysing the impact of fiscal rules on government investment *inter alia* by Barro (1979) and Balassone and Franco (1999, 2000) have shown that the introduction of a deficit ceiling (balanced budget) can imply a reduction in public investment. From this viewpoint the golden rule could be a more desirable alternative. However, as suggested in the paper by Föttinger serious incentive problems (low-powered incentives, increasing possibility to opportunistic behaviour and complicated surveillance of outcomes and trends) related to the implementation of the golden rule would lead to overinvestment. Hence, once the agency-costs of overinvestment are taken into account balanced budget rule seems to be superior to the golden rule.

Basically, overinvestment under golden rule in a principal-agent framework discussed by Föttinger depends on the utility function of the agent: driving force for overinvestment is the assumption that government/politicians draw utility from investment expenditure, whatever their benefits to the society. Föttinger motivates this by public investment projects which have been undertaken in developing countries and former socialist economies despite small or no economic value to the society. One may however question the relevance of this kind of behaviour in the European context.

In general, part of the incentive problems related to the golden rule could be ameliorated by adopting constraints on public investment expenditure, such as the UK type constraint on government net debt.

Nevertheless, in EMU 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'. Governments would also have an incentive to classify current expenditure as capital spending.

Does 'close-to-balance' rule hamper cyclical stabilisation?

The overall set of fiscal rules in EMU puts emphasis on the working of automatic stabilisers as the main tool for fiscal stabilisation once Member States have achieved their medium-term fiscal positions close to balance or in surplus. In principle, this non-discretionary approach should guarantee that the behaviour of the actual budget balance is always counter-cyclical and hence, contributes to economic stability. Strict adherence to the medium-term orientation of the close-to-balance rule and symmetric working of the automatic stabilisers over the cycle are thus essential if deterioration of the underlying structural budget balance and pro-cyclical tendencies of the past fiscal policy are to be reversed in EMU countries.

An important challenge for this framework to function properly is related to the measurement of structural or cyclically adjusted balances. Without a 'correct' understanding of the size and sign of the changes in the structural budget balance, the monitoring of the compliance with 'close-to-balance' rule would become vague and could lead to wrong policy recommendations. Specifically, wrong assessment of the direction of the change in the structural budget balance would result in the tightening of discretionary policies during recessions and expansionary policies in booms if governments tried to keep structural balance unchanged on its estimated level.

Mills and Quinet discuss at length the well-known methodological problems in the cyclical adjustment methods used to estimate structural budget balances. These problems arise mainly for two reasons: firstly, output gap estimates might suffer from a procyclical assessment of potential GDP and secondly, insofar budget elasticities vary over the cycle, the cyclical adjustment of various revenue and expenditure categories based on average long term elasticities can produce biased results.

To avoid the methodological problems related to the operationalisation and surveillance of the 'close-to-balance' rule, the authors opt for a medium-term expenditure rule. However, giving spending rules preference over the 'close-to-balance' rule is not so clearcut. Much of the alleged advantages of spending rules depend, of course, on how they are formalised: as a fixed share of GDP, a fixed real/nominal growth rate, a fixed share of potential GDP, etc. Moreover, spending rules do not prevent governments from running pro-cyclical tax policies that offset the working of automatic stabilisers.

In more general terms, a fiscal strategy resting on expenditure control, while allowing the automatic stabilisers to operate freely on the revenue side, seems largely consistent with the rationale of the SGP and 'close-to-balance' rule. In fact, several EU countries have implemented various types of spending rules to complement the SGP at the national level. Constrained medium-term expenditure paths producing a gradual decrease in the government expenditure to GDP ratios could also be a useful instrument to create conditions for lasting reductions of tax burdens while safeguarding fiscal consolidation.

Does EMU need policy co-ordination beyond the SGP?

Possible credibility problems stemming from the lacking track record of the newly created central bank, too decentralised fiscal policies and insufficient policy co-ordination were frequently stressed in the literature before the launch of the euro (see e.g. Allsopp and Vines 1998, Artis and Winkler 1997). This was seen to lead to an unbalanced policy-mix with overly expansionary fiscal policy and too tight monetary policy resulting in higher interest rates, currency appreciation and lower growth than otherwise would be the case. Consequently, the maintenance of a balanced policy-mix, where national fiscal policies do not overburden the single monetary policy, is a crucial element for the success of EMU. Under

[1] Sanctions are designed to have a pre-emptive deterrent impact rather than to fall automatically without any preventive mechanisms and possibility to correct the situation early enough. Moreover, the incentive under the chosen sanction system is to keep the excessive deficit as small as possible and to implement corrective actions sooner rather than later: the smaller the excessive deficit, the smaller the sanction.

[2] Sanctions consist of a fixed and variable components based on the difference between the actual budget deficit and the 3% limit. Fixed component is 0.2% of GDP and the upper limit for sanctions is 0.5% of GDP.

which conditions this kind of balanced policy-mix is possible to achieve? Does it require policy co-ordination that goes beyond the fiscal rules set in the SGP?

In principle, supranational co-ordination of economic policies in a monetary union would be beneficial if there exist sizeable spillovers between countries or between governments and the single monetary authority. Significant financial spillovers could arise in case that fiscal policies are perceived to run against the objective of price stability. However, the adherence of fiscal authorities to 'close-to balance' rule should lessen the probability of policy conflicts in EMU significantly. 'Close-to-balance' rule allowing fiscal stabilisation via the working of automatic stabilisers implies thus a passive rule-based policy co-ordination.

The issue of policy co-ordination in EMU under various types of shocks is the focus of the paper by Buti, In't Veld and Röger. The authors build on a theoretical model that encompasses explicitly the main elements of the EMU policy framework: fiscal policy constrained by 'close-to-balance' rule and a deficit limit, and monetary policy geared to maintain area-wide price stability.

To keep the theoretical framework tractable, the authors have opted for an approach that essentially involves a single monetary and a single fiscal authority and thus abstracts away the problem of multiple fiscal authorities. Because of this simplification, the results and policy conclusions refer strictly speaking only to situations where the shocks hitting the monetary union are symmetric and the policy response of various national fiscal authorities are broadly the same. From the viewpoint of analysing policy interactions and co-ordination this simplification need not however be considered overly restrictive as only shocks that have area-wide implications are relevant for the single monetary policy and thus for policy co-ordination. By definition, asymmetric shocks with a negligible impact on area-wide price stability do not trigger monetary policy response and the issue of policy co-ordination does not arise.

The authors show that the type of shock hitting the monetary union as a whole is crucial for the need and incentives to co-ordinate monetary and fiscal policies. Under demand shocks, as inflation and output move in the same direction, fiscal and monetary stabilisation do not conflict each other and hence, incentives for policy co-ordination are scant. However, conflict as well as incentives for co-ordination arises under supply shocks, because output and inflation tend to react in the opposite way.

While the simple theoretical setup is useful for analysing policy interactions under various types of shocks, they are far from describing the complex economic relationships that are in play and relevant to policy evaluation. To perform a more comprehensive analysis the authors have run simulations by the Commission's QUEST model, which lend support for their theoretical predictions.

On the basis of the analysis provided in the paper one could make a tentative conclusion that under demand shocks fiscal authorities should let the automatic stabilisers operate fully and monetary authorities should seek to maintain price stability. However, in the event of supply shocks, fiscal authorities might find it advisable to limit the working of automatic stabilisers to soften the policy conflict so that the central bank 'can move less' than otherwise would be the case to maintain price stability.

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