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Fiscal rules in the Member States: principles, practice and implementation

Abstract:
Fiscal rules constitute a delicate governance challenge for the EU and its Member States, because they impinge on one of the core functions of the state and its relationship with citizens. Rules that restrict political judgements or preferences have, nevertheless, proliferated in recent years. They have consistently been advocated by international institutions, notably the IMF and the OECD, and have manifestly become central to the governance reforms intended to underpin EU economic and monetary union. Strengthening fiscal frameworks, in particular numerical fiscal rules, has emerged as a key response to the fiscal legacy of the euro crisis. Significant pressure has been exerted by EU institutions to adopt more extensive and intrusive fiscal rules, particularly in the euro area, but also in other EU Member States. This paper looks at the evolution of national fiscal rules in EU Member States and how they are functioning alongside EU-level rules. It draws extensively on the databases that have been compiled by DG Ecfin of the European Commission and the IMF on fiscal rules.

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Fiscal rules constitute a delicate governance challenge for the EU and its Member States, because they impinge on one of the core functions of the state and its relationship with citizens. Unlike competition policy or monetary policy, where delegation to an agency is the norm and can be defended on the grounds that the policies concerned require technical rather than political decision-making, fiscal policy is politically much more sensitive because it goes to the heart of distributive politics. It is, in short, one of the core functions of the state and, as such, is deemed to require democratic legitimation. Rules that restrict political judgements or preferences have, nevertheless, proliferated in recent years. They have consistently been advocated by international institutions, notably the IMF and the OECD, and have manifestly become central to the governance reforms intended to underpin EU economic and monetary union.

Strengthening fiscal frameworks, in particular numerical fiscal rules, has emerged as a key response to the fiscal legacy of the euro crisis. Significant pressure has been exerted by EU institutions to adopt more extensive and intrusive fiscal rules, particularly in the euro area, but also in other EU Member States. This paper looks at the evolution of national fiscal rules in EU Member States and how they are functioning alongside EU-level rules. It draws extensively on the databases that have been compiled by DG Ecfin of the European Commission and the IMF on fiscal rules.

This paper takes a broad look at the use of fiscal rules in the EU, starting with some background, then providing a series of descriptive empirical analyses. The third section assesses the practice of fiscal rules and draws attention to a number of reservations, then conclusions complete the paper.

1 The background

The best known EU fiscal rules are those embodied in the Stability and Growth Pact (SGP), the regulations governing the treaty provisions on excessive deficits. Already in the Maastricht Treaty, the nominal convergence criteria of a three percent of GDP ceiling for fiscal deficits and a sixty percent ceiling for public debt had become key points of reference for fiscal policy. Some countries had domestic fiscal rules, but others did not and were under no direct pressure to have them, even among the countries participating in the euro. Although there are provisions in the Treaty for coordination of economic policies 'as a matter of common concern' (Article 121 for the EU as a whole) and for the coordination and surveillance of their budgetary discipline (Article 136 for the Eurozone), they have relied on 'soft' policy coordination and are generally agreed to have had at most limited effect.

The first version of the SGP, adopted in 1997, persevered with the three percent nominal deficit limit, although it is more accurate to identify the expression 'close to balance or in surplus' as the rule the SGP sought to impose. In response to various criticisms, including weaknesses in its implementation and the critique that it was too prone to pro-cyclicality, the SGP was reformed (some say watered-down) in 2005, when the nominal target was changed to a structurally adjusted one. The Pact lacked any explicit debt rule, something only remedied when it was reformed for a second time in 2011. As part of the 'six-pack' of measures to reform economic governance, the EU also agreed a directive requiring Member States to introduce more stringent domestic national budgetary frameworks, consistent with stronger fiscal discipline. In part these

are about processes, data collection and institutional structures, but there is also a precise statement about fiscal rules, calling for:

> "numerical fiscal rules, which establish a permanent constraint on the conduct of fiscal policy expressed in terms of a summary indicator of budgetary performance, such as the government budget deficit, borrowing, debt, or a major component thereof"

The Fiscal Compact, agreed as part of the separate Treaty on Stability, Coordination and Governance (TSCG) in 2012, reaffirms the 'balanced or in surplus' rule for general government deficits (Art 3.1.a) and spells out how an excessive deficit or debt should be redressed. It also obliges signatories to embed these commitments in national law. According to article 16 of the TSCG, the necessary steps should be taken within five years for 'incorporating the substance of this Treaty into the legal framework of the European Union'. It remains to be seen whether and how this will happen, but it would be expected to reinforce the resort to rules.

Since the arrival in office of the Juncker Commission, with its avowed aim of being more political, the strictness of rules has been questioned, particularly by the governments of France and Italy. An outcome has been for the Commission (in its surveillance role) to grant certain countries more flexibility in the timing of adjustment, but perhaps more significantly, also to issue guidance about the terms under which adherence to the SGP rules can be more flexible. What this highlights is a key dimension of fiscal rules which is that in certain circumstances they may prescribe unhelpful policies.

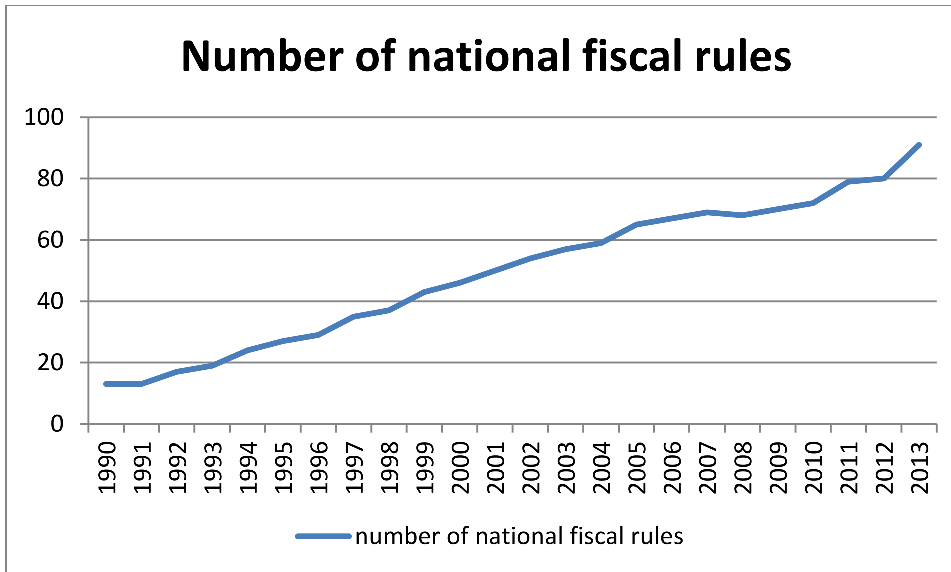
2 Evidence and analysis

The increased resort to rules, alongside other reforms to fiscal frameworks, has been one of the key fiscal governance trends of recent years. The trend predates the euro crisis, but has manifestly also been given further momentum by it.

2.1 Rules in aggregate in the EU

A first clear measure is shown in figure 1 which is a simple count of the number of fiscal rules applying since 1990. Despite a slight slowdown when the financial crisis erupted in 2008, the rise has been inexorable, such that by 2013, there was an average of more than three rules per Member State, compared with a total of just twelve in 1990.

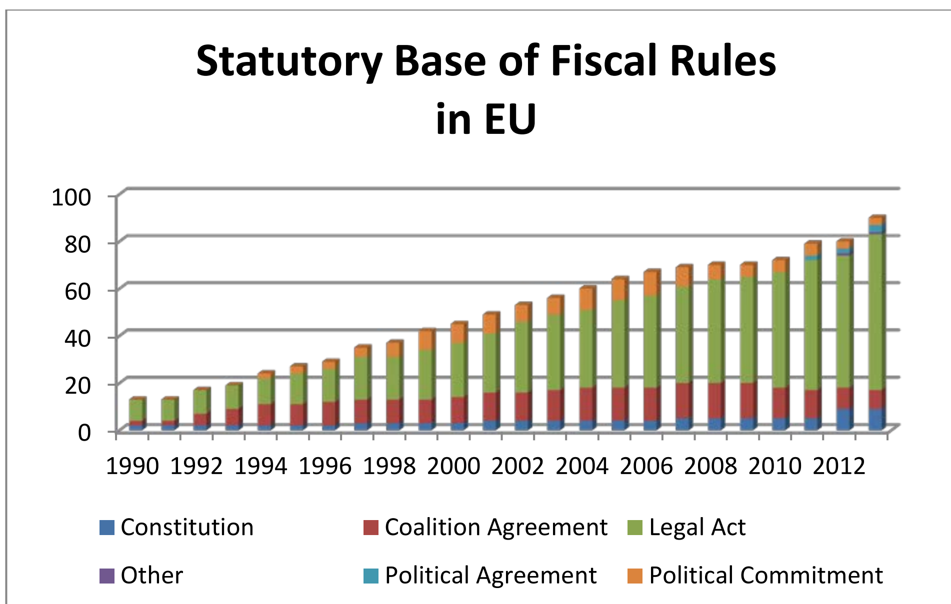
Figure 1



Source: DG Ecfin Fiscal rules database

The legal basis for rules is varied, although as figure 2 shows, the main basis is legal acts, whereas the number written into constitutions is smaller. The latter could, nevertheless, grow as countries face up to their obligations under the Fiscal Compact.

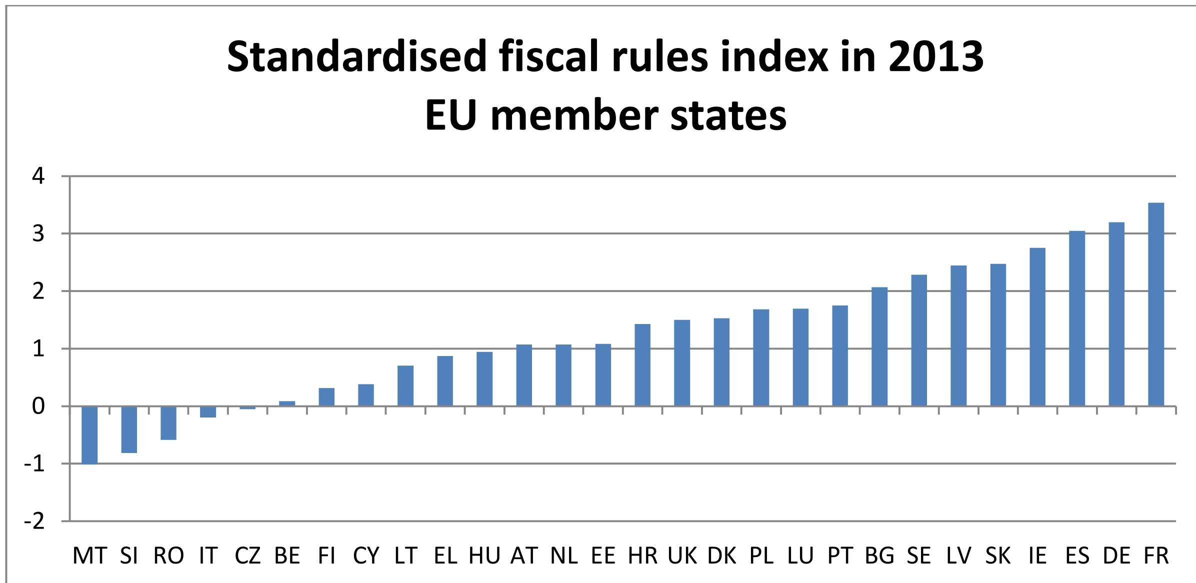
Figure 2



Source: DG Ecfin Fiscal rules database

The strength of rules, as measured by DG Ecfin showed considerable variation in 2013, but will also be subject to quite rapid change in the aftermath of recent governance reforms. Figure 3 reveals that some of the strongest rules are now in countries worst hit by crisis, reversing the previous position in which most of the countries in which crises arose had weak rules

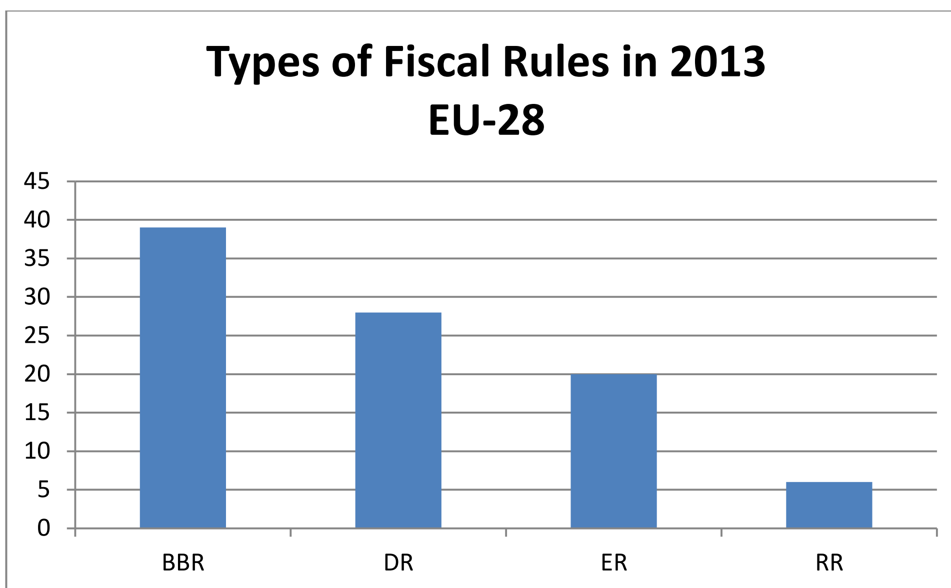
Figure 3



Source: DG Ecfin Fiscal rules database

Most rules in force relate to the current budget, pushing governments towards balancing the annual budgetary accounts, although as can be seen from figure 4, there are now many rules governing debt and expenditure. A much small number of rules prescribe how increases in revenue are to be used.

Figure 4



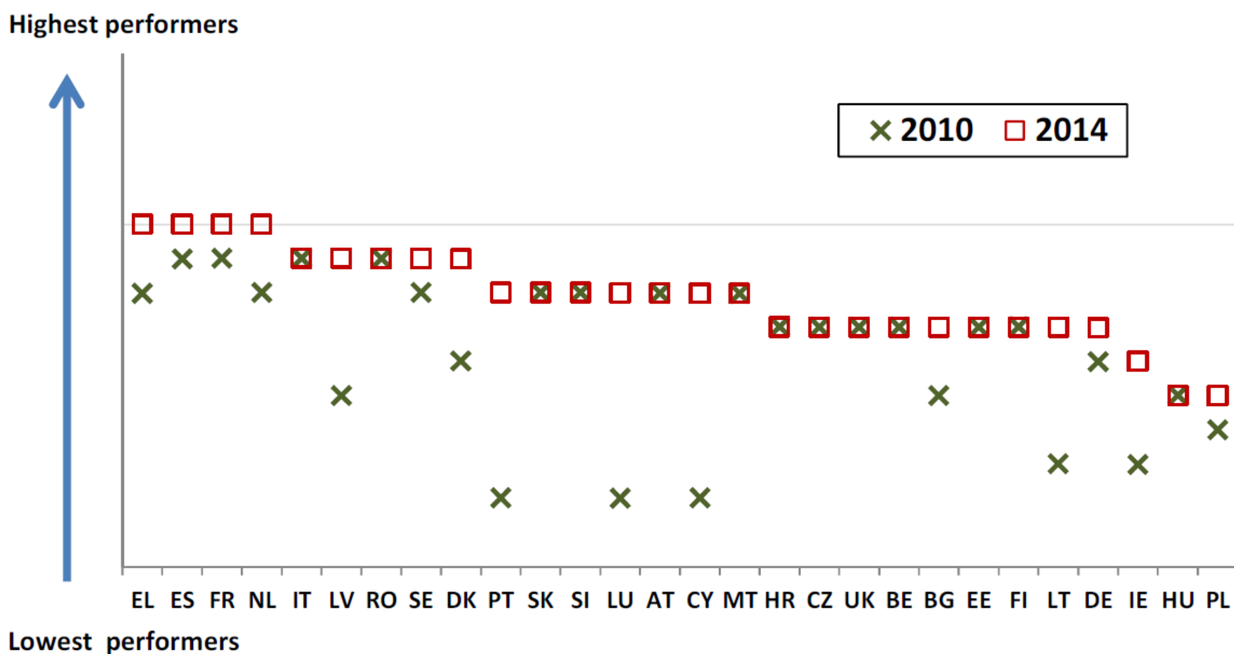
Key: BBR = balanced budget rule; DR = debt rule; ER = expenditure rule; RR = revenue rule

Source: DG Ecfin Fiscal rules database

2.2 Trends in fiscal governance

According to a Commission (2016) assessment of fiscal rules, all Member States either increased or maintained the strength of their medium-term fiscal framework between 2010 and 2014, which would be consistent with the new obligations under the Fiscal Compact (figure 5). What is striking about the index is there has been significant upward convergence and that some of the countries which have most strengthened their frameworks are among those that faced the most acute difficulties during the euro crisis. However, the identification of Greece and Spain as countries with strong frameworks shows that the mere fact of having a notionally robust framework is no guarantee of fiscal sustainability.

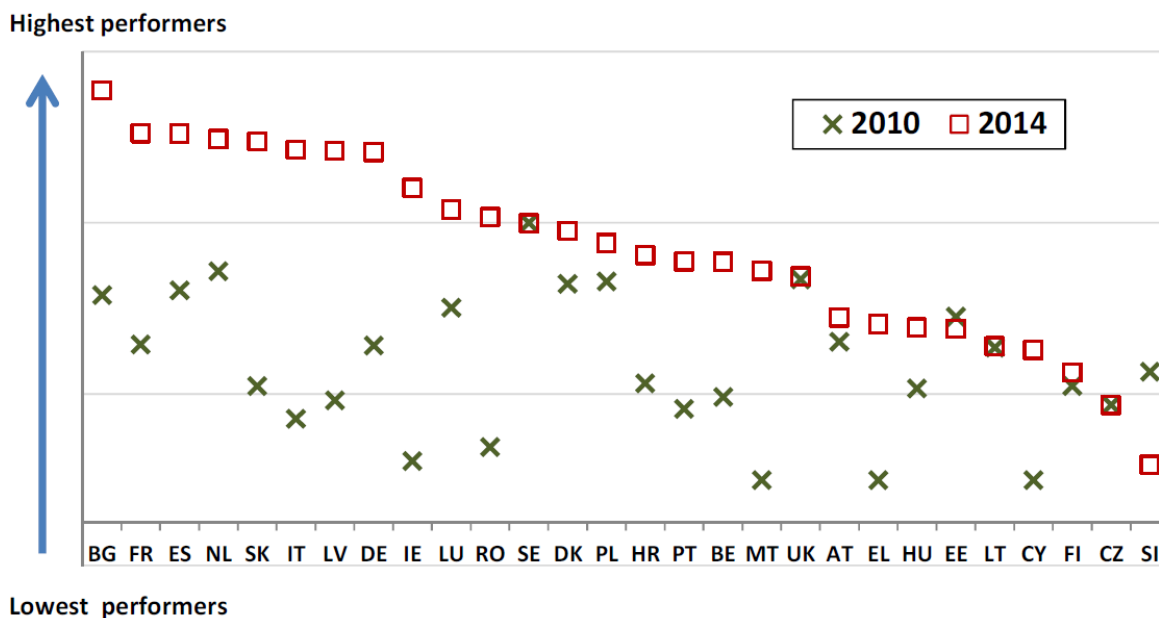
Figure 5 Strength of medium-term budgetary index, by Member State



Source: European Commission (2016)

A parallel assessment of the 'strength of the design of all fiscal rules' was undertaken. It finds that, with two exceptions (Estonia, very slightly and Slovenia), the rules have been strengthened – see figure 6. However, compared with fiscal frameworks, there is more diversity in the strength of rules, with some suggestions that there are distinct clusters of countries.

Figure 6 Strength of numerical fiscal rules index, by Member State



Source: European Commission (2016)

In the end it is compliance that matters for whether rules or frameworks are effective. But here there can be differences of interpretation. For example the Austrian Fiscal Council in its 2016 report notes that its own 'spring forecast – contrary to the federal government's current stability program – points to the risk of a significant deviation from the structural adjustment path under the preventive arm of the SGP that will persist over the entire forecast horizon.

2.3 Compliance with rules: do they work?

The simple, obvious question of whether fiscal rules are making a difference is surprisingly hard to answer. A rather negative verdict form Andrle et al. (2015) is that, despite the many reforms that have taken place in the governance of fiscal policy in the EU, compliance remains disappointing. They note that half of Eurozone members have missed the debt target more than half the time since 1999 and, while the record on the 3% deficit target is a little better, especially in the 'good times' between 1999 and 2007, Greece and Portugal have missed the target in most years.

In part, this is because the expansion of rules has occurred in such unusual times: in as fraught a period as the EU has just endured, compliance with rules is manifestly harder. The straightforward explanation is that meeting rules in periods of recession or stagnation is bound to be harder, because automatic stabilisers will tend to be more substantial in states with large public sectors – the norm in most EU countries. Taking a five year period from 2012 when the most acute phase of the successive crises ended, the lack of improvement in fiscal sustainability remains striking. Table 1 provides a summary of how each Member State has fared in the period since 2012, together with brief notes drawn from the 2016 country-specific recommendations (CSR) addressed to them as part of the annual governance cycle of the 'semester'. It is noteworthy, that in the Commission's own summary[1] of CSR's, only three countries do not receive any recommendations

[1] http://ec.europa.eu/europe2020/pdf/csr2016/csr2016-overview-table_en.pdf

under the heading on ‘fiscal policy & fiscal governance’: Estonia, Luxembourg and Sweden. The table reports how the position has changed in each Member State, using data from the latest (May 2016) European Commission forecasts as the source for the last data point.

It shows that deficits have come down in the great majority of Member States; and in the few cases where they have risen, there is room for manoeuvre: in all four, the rise in the deficit leaves it below the three percent SGP threshold. However, it is striking that just two countries are projected to have surpluses in 2016 (Germany and Luxembourg) and that four will still have deficits in excess of three percent (Greece, Spain, France and the UK). The unweighted average (used because the focus of interest is on individual performance, not the aggregate EU position) of deficits in 2016 was 1.83%., an average reduction between 2012 and 2016 of 1.99%. Even the highest projected 2016 deficit (Spain) is just under four percent of GDP. This led the Commission in July 2016 to castigate Spain[2] again, along with Portugal[3].

The debt picture is much less positive. In seventeen Member States the debt to GDP ratio increased between 2012 and 2016. The unweighted average of debt ratios rose by 3.6 percentage points between 2012 and 2016, with increases of 12 points or more in six countries (Greece, Spain, Croatia, Cyprus, Slovenia and Finland). At the other end of the spectrum, the debt ratio in Ireland fell by 31 points. The average debt level in 2016 is projected to be 72.3%, having been 68.7% in 2012 and 43% in 2007. Only eleven Member States are projected to have debt ratios in 2016 below the sixty percent threshold, six of them from central and eastern Europe, along with Denmark, Luxembourg and Sweden. Six countries will still have debt in excess of one hundred percent of GDP (Belgium, Greece, Spain, Italy, Cyprus and Portugal); and a further six will be in the range of eighty to one hundred percent (Ireland, France, Croatia, Austria, Slovenia and UK).

Four observations are worth making about these summary figures. First, and unsurprisingly, the Member States subject to formal macroeconomic adjustment programmes (including Spain which had a limited programme targeted at the banking sector) are generally the worst performers, although the extent of the improvement in Ireland invites caution about drawing too firm a conclusion. Second, the risks to fiscal sustainability are arguably greatest in a number of Eurozone countries, although the UK is a striking exception. Third, there is no clear indication of a richer/poorer Member State cleavage, nor of a systematic divide between creditor and debtor countries. On the basis of these indicators, the Czech Republic and Estonia are among the most fiscally sound countries, as is Luxembourg; Germany has made great strides in curbing its debt, but two countries often bracketed with it (the Netherlands and Austria) have not.

The fourth, more intriguing, finding is that three of the largest Member States (France, Italy and the UK) as well as Spain have vulnerable fiscal positions, while Germany and Poland look to be in better shape. One inference could be that larger Member States face less market pressure and are more able to exercise discretion when conditions warrant it. There has been some suggestion in

[2] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-08_commission/20160707_es_commission_recommendation_en.pdf
[3] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-08_commission/20160707_pt_commission_recommendation_en.pdf

the past that larger countries are less bound by EU rules (Buti and Pench, 2004), citing a range of explanations of a political economy nature. With the growth of domestic rules, it may also be that at least some of these states are more inclined to neglect new rules for broadly similar reasons.

Table 1

MEMBER STATE	General government debt		General government deficit		'Actions not sufficiently specified?'	Comment based on assessment in country-specific recommendations
	2016	2012-16 change	2016	2012-16 change		
Belgium	106.4	+2.3	-2.79	-1.42	Yes	Has deviated from MTO; action needed to forestall risks of non-compliance with debt rule; adjustment burden should be spread to sub-national level
Bulgaria	28.1	+11.3	-1.97	+1.66	Yes	Comfortable debt position, but concerns about deficit target
Czech Republic	41.3	-3.4	-0.72	-3.23		Current fiscal position satisfactory, but risk of deviation from MTO and of longer term age-related problems. Fiscal framework explicitly criticised as 'among the weakest in the EU', reforms approved by government, but await parliamentary ratification. A proposed fiscal council is not yet operational.
Denmark	38.7	-6.5	-2.46	-1.05		Nothing relevant on public finances
Germany	68.6	-11.0	0.19	-0.29		No specific problems of fiscal sustainability identified
Estonia	9.6	0.0	-0.12	-0.13		No problems; fiscal not even part of the bare two recommendations.
Ireland	89.1	-31.0	-1.12	-6.89	Yes	Unease about the MTO and clear message that some further measures are required
Greece	182.8	+23.3	-3.08	-5.75		No CSR
Spain	100.3	+14.9	-3.94	-6.50		Obvious risks are highlighted in the approach to both the deficit and the debt; macroeconomic scenario is adjudged to be optimistic, although the endorsement by the Independent fiscal institution is noted; implementation shortcomings in relation to fiscal framework
France	96.4	+6.8	-3.39	-1.42		Concern about high and increasing public debt with dangers of spillover to other Member States
Croatia	87.6	+17.0	-2.74	-2.57		Worries about the sustainability of public finances; Fiscal Council independence in doubt; national fiscal rules under revision and need to be better aligned with SGP; durable correction of deficit required
Italy	132.7	+9.4	-2.44	-0.51		Not meeting debt rule and progress towards the MTO is too slow and risky notwithstanding deviation; slow progress on reforming fiscal framework; privatisation vital for meeting rules
Cyprus	108.9	+29.6	-0.38	-5.42		Exited from MAP, but still adjusting (with some legislation still to be completed) and need for further measures; public sector wage bill a problem
Latvia	39.8	-1.6	-0.98	+0.16		Discussion of deviation from the MTO to support growth, but no great concern

Lithuania	41.1	+1.3	-1.06	-2.09	Yes	Limited deviation from MTO envisaged to deal with systemic pension reform, but otherwise compliant
Luxembourg	22.5	+0.5	1.01	-0.75		No evident problems
Hungary	74.3	-4.0	-1.99	-0.32	Yes	Medium-term outlook for public finances at risk
Malta	60.9	-6.6	-0.92	-+2.63		Doubts around the short run attainment of the MTO and especially about meeting longer run age-related challenges
Netherlands	64.9	-1.6	-1.71	-2.18		Gradual improvement and approaching MTO, but some further measures will be needed.
Austria	84.9	+3.2	-1.49	-0.68	Yes	Concern about deviation from the MTO and that it should be limited to the exception for costs of dealing with refugees
Poland	52.0	-1.9	-2.58	-1.12		Growing risk of breaching MTO and compromising fiscal sustainability. New expenditure rule first applied in 2015 but was amended, weakening its impact. The debt brake applies, but no independent fiscal council and thus weak fiscal framework; longer term risks from ageing.
Portugal	126.0	-0.2	-2.67	-2.99		**Wide-ranging concerns about sustainability and failure to meet the transitional debt rule; needs an expenditure review**
Romania	38.7	+1.3	-2.77	-0.92		Widening of the deficit ratio and risks that significant deviation will occur; sound fiscal framework in theory, 'but it is not applied effectively in practice'; fiscal council has limited scope to react and to influence; national fiscal framework being flouted in spending plans
Slovenia	80.2	+26.3	-2.36	-1.74	Yes	Long-term risks to fiscal sustainability; more needed to persevere with MTO not; fiscal council legislated but not yet operational; and fiscal rules act only partly operational
Slovakia	53.4	+1.0	-2.42	-1.88		Main challenge to fiscal sustainability is long-term costs of ageing; reference made to delays in adopting binding expenditure ceilings; some additional effort on MTO needed
Finland	65.2	+12.2	-2.55	+0.36		Public finances already under stress and significant risks identified for the medium and longer term. Short term effort needed to conform to MTO.
Sweden	41.3	+4.1	-0.36	-0.57		No evident problems or recommendations; CSRs say next to nothing of value
United Kingdom	89.7	+4.3	-3.36	-4.90		Continuing high deficit and debt noted, but not really criticised; debt reduction plan broadly on track (pre-Brexit vote), but weakened post-Brexit

Sources: European Commission Spring Forecasts, 2016; Country specific recommendations for individual Member States

2.4 National assessments

Further insights into the application of rules can be gleaned from examination of the reports of national fiscal councils, but also from the way in which institutional reform has proceeded. In Greece, for example, the national 'conversation' about fiscal rules is at an early stage[4] and, although a law establishing a fiscal council has been passed, it has yet to become active. By contrast, the Irish Fiscal Advisory Council, having been set up in interim form in 2011and given a statutory basis in 2012 has a prominent role in the fiscal policy framework (Jonung, Begg and Tutty, 2015).

Slovakia has rules derived from the *Fiscal Responsibility Act* and the *balanced budget rule* derived from the fiscal compact. According to the Slovak *Council for Budget Responsibility*, the government was not expected to respect the debt rule in 2015. The analysis shows that the country was in the 'second sanction zone' in which, in principle, the government is supposed to take steps to reduce the debt and reduce ministers' salaries. The Council[5] concludes that not enough is being done. It also finds that the government is not meeting the domestic balanced budget rule and that the risks of deviation from the rule are increasing.

A more stringent rule applies to local government, although the rule is only just being implemented in 2016. The Council also notes that, although the government formally meets the rules for transparency by publishing all the data it is obliged to, 'in terms of content, the information presented was not sufficiently explained and justified, which makes the evaluation and identification of potential risks more difficult'.

Germany is compliant with both EU and national rules according to the Finance Ministry[6] and this was confirmed by the Stability Council in a two-line formal statement from a meeting on 6th June 2016:

> 'The Stability Council determined that the upper limit for the general government structural deficit under section 51 subsection (2) of the Budgetary Principles Act was being complied with'

The Advisory Board of the Stability Council also finds that Germany has a margin for error, despite an expansionary fiscal stance, and that the already very good framework conditions for Germany's public finances will continue to be maintained

Portugal has recently emerged from its MAP, making it harder to assess where it stands in relation to[7] rules because, as with Ireland, the influence from outside of the 'Troika' was paramount. The Portuguese Fiscal Council is now becoming more active. It recently cast doubt on the viability of the government's plans for achieving its targets, noting in particular that: 'the lack of details

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[4] Based on a series of interviews in Athens conducted by the author with prominent experts on Greek fiscal policy
[5] http://www.rozpoctovarada.sk/download2/hodnoteniervs_2016_2018_eng_final.pdf
[6] http://www.stabilitaetsrat.de/SiteGlobals/Forms/Suche/EN/PdfSuche_solr_Formular.html#searchResult
[7] http://www.cfp.pt/wp-content/uploads/2016/05/CFP-REL-06-2016-PT.pdf

regarding a significant part of the fiscal consolidation measures places the achievement of the published projections at risk'. The report goes on to refer to risks that the macroeconomic scenario is too optimistic, referring in particular to reliance 'on factors that are beyond the MF's direct control'.

Experience in **Ireland** as it emerged from its macroeconomic adjustment programme is revealing. While the programme was running, under the supervision of the 'Troika', rules were essentially irrelevant. As recovery took hold, however, the governance of fiscal policy changed in character (Jonung et al., 2015). National rules became more binding than EU obligations and led to some friction with external assessors not just about the appropriate stance of fiscal policy or the credibility of government plans projections and budgetary plans, but also about the methodologies employed. Specifically, the Commission's preferred approach to measuring the output gap was questioned by both Irish government experts and the independent Irish Fiscal Advisory Council. A contentious issue for Ireland is how to accommodate the very substantial foreign owned business sector which has led the recovery. This highlights the unease about a one-size-fits-all technique being used.

2.5 Rules and debt positions

Comparison over time of the relationships between the strength of fiscal rules and the debt (see appendix figures for each of the Member States) show disparate patterns, although it is important to recognize that causality cannot necessarily be assumed. In the charts, the strength of rules up to 2013 is measured, thereby excluding significant changes that might have happened as the Fiscal Compact has been implemented. Moreover, in examining the national trajectories in these charts, it is important to be aware of the levels of debt as well as the change: a country with low debt can be more relaxed than one which is well over the sixty percent threshold. Despite these caveats, striking examples of countries where a strengthening of fiscal rules is associated with declining debt are:

- Bulgaria, where rules were greatly strengthened after 2002 and there has been a sharp reduction in the debt to GDP ratio
- Sweden, where strong rules, low and falling debt seem to coincide

By contrast, there are countries where there has been limited change in debt ratios and fiscal rules were not strengthened noticeably:

- In Belgium, for example, the slow improvement in the high debt ratio came to a halt after 2007 and the rules were relatively weak
- The Czech Republic, albeit from low levels, has seen debt rise steadily and has weak rules
- Italy has had consistently weak rules and has made little progress in reducing it high debt ratio.

The causality could run the other way, with signs that a strengthening of fiscal rules has been a reaction to spiralling in debt. France, for example might fit this model.

2.6 The preventive approach: advance scrutiny of budgets

For the Eurozone countries, an additional obligation came about in 2013 with the adoption of two regulations (known as the 'two-pack') under which draft national budgets have to be submitted to the Commission by mid-October for scrutiny. The Commission then assesses these plans and can recommend changes.

In the 2015 assessment (of the budget for 2016), five countries were deemed to be at risk of non-compliance with the SGP, seven broadly compliant and at risk of non-compliance five compliant, a slight improvement (at least as measured by the numbers in each category) compared with 2014 (table 2).

- The budgetary plans of five member states (Germany, Estonia, Luxembourg, the Netherlands and Slovakia) were in line with the obligations they face under the SGP.
- Seven further member states (Belgium, Ireland, France, Latvia, Malta, Slovenia and Finland) have budgetary positions broadly compliant with the SGP
- Among the remaining five (Spain, France, Italy, Malta, Austria and Portugal) the more damaging verdict was that they were at risk of non-compliance. Spain in particular is highlighted as being likely to fail being unlikely to achieve a 'durable correction'.

The 2014 assessment of the draft budgetary plans submitted to the Commission in mid-October (Greece and Cyprus, because they were still subject to adjustment programmes, were not assessed in this procedure) led to the conclusion from the Commission was that:

- The budgetary plans of five member states (Germany, Ireland, Luxembourg, the Netherlands and Slovakia) were in line with the obligations they face under the SGP. However, the Commission called on Germany to boost public investment, using its 'sizeable fiscal space', while asking Ireland to accelerate debt reduction.
- Four further member states (Estonia, Latvia, Slovenia and Finland) have budgetary positions broadly compliant with the SGP
- For the seven remaining countries (Belgium, Spain, France, Italy, Malta, Austria and Portugal) the more damaging verdict was that they were at risk of non-compliance.

In 2013, only two countries were deemed to be compliant (Estonia and Germany), while three others (France, the Netherlands and Slovenia) were 'found to be compliant, but without any margin for possible slippage, as this would put the correction of the excessive deficit at risk'. This second category was not used in 2014.Three countries (Belgium, Austria, Slovakia), were 'found to be broadly compliant' and considered to be 'on track to correct their excessive deficits by the 2013 deadline'. The remaining five countries (Spain, Italy, Luxembourg, Malta and Finland) were deemed, for differing reasons, to 'pose a risk of non-compliance'.

Table 2

Year Assessment	2013	2014	2015
Compliant	DE, EE	DE, IE, LU, NL, SK	DE, EE, LU, NL, SK
Broadly compliant or no margin for slippage (only used in 2013)	BE, FR, NL, OS, SI, SK	EE, LV, SI, FI	BE, IE, FR, LV, MT, SI, FI
At risk of non-compliance	ES, IT, LU, MT, SU	BE, ES, FR, IT, MT, OS, PT	ES, IT, LT, OS, PT
Subject to MAP Not in Euro	EL, IE, CY, PT LV, LT	EL, CY LT	EL, CY

Source: Own elaboration from Commission reports

Key: red text is a deterioration from the previous year; green is an improvement

It is, however, intriguing that for Slovakia in 2014, classed in the first group, the Commission states that it 'is of the opinion that Slovakia has made limited progress with regard to the structural part of the fiscal recommendations issued by the Council in the context of the 2014 European Semester and thus invites the authorities to accelerate implementation.' This is exactly the same wording as for France and Austria which fall into the third group, while several in the second and third group have made 'some progress', rather than 'limited progress'. A possible inference is that the Commission itself, in its monitoring role, may introduce elements of subjectivity and that its 'throughput' legitimacy may be debatable (Schmidt, 2012).

3 Interpreting the evidence

These findings have limitations in terms of validating the use of rules, not least because underlying determinants of nominal growth are bound to have had a powerful effect (as in Italy, where real growth has been by far the lowest in the EU since 1999), but are nevertheless suggestive of their influence. An intriguing finding from Reuter (2015) is that governments do, on the whole, adjust their budgetary positions in response to rules. Rather than general indicators of fiscal sustainability, Reuter looks at the specific indicator targeted by the rule and finds a generally stronger effect than revealed elsewhere in the literature. He also suggests that it is asymmetric in the sense that governments do react if they fail to comply with a rule by bringing the outcome closer to the rule He infers 'that introducing a fiscal rule does not shift the mean of the constrained variables, but changes the reaction of fiscal policy to non-compliance with fiscal rules' (Reuter, 2015: 74): where there is non-compliance, having a rule means a fifty percent higher policy reaction. A focus on sanctions, where the letter of the rule is breached, may therefore be unwarranted or even counter-productive.

In an interesting observation, he suggests that the effect may be higher in former transition countries and in non-Eurozone countries, something of a paradox given the concerns about spillovers inside the latter. In contrast to other work, his findings indicate that expenditure rules do not seem to have this constraining effect when there is non-compliance. Reuter also raises the question of whether the reaction in cases of non-compliance may be influenced by wider

macroeconomic developments. In this regard, the choice of indicators and the values assigned may have an influence.

The original SGP was subject to a range of criticisms and proposals for reform for varied reasons (see for example Jonung, 2006), some of which fed into the successive reforms. Similar criticisms are now surfacing about the current EU fiscal framework. These are summarised in this section under a number of headings. The post crisis approach is now subject to different sorts of criticisms. Claeys et al. (2016) consider it to be inefficient: on the one hand, they point to problems of measurement and quality of forecasting which complicate the formulation of appropriate recommendations; an implication of their argument is that wrong policy choices will either be advocated or made. On the other hand, they find that the various forms of flexibility make the process opaque and, by doing so, create divisions among Member States, exacerbating differences about how rules are applied; in this regard, an implication of their analysis is to bring resort to rules into disrepute.

3.1 The compliance-appropriateness dilemma

A fiscal rule makes sense if it enables governments to follow time consistent policies, but its application may give rise to policies with short term costs and may even be self-defeating at certain times. This dilemma has arisen repeatedly and has usually resulted in some form of political fudge or over-ride of the rules. When this happens, the de facto suspension of the rule may make good sense, economically as well as politically, but at the cost of undermining credibility in not just the specific rule, but also the principle of such rules as instruments of governance.

Three potential solutions might enable this dilemma to be resolved. The first is to design the rule flexibly enough. In the original version of the SGP, a recession of 2% of GDP or more allowed a Member State to breach the 3% deficit ceiling on the (reasonable) grounds that automatic stabilisers should then kick-in and help to mitigate the recession. So long as a shock is cyclical rather than structural, this latitude would be consistent with maintaining fiscal sustainability, but the obvious drawback is that the distinction between cyclical and structural will often be quite fuzzy. The appropriate threshold is also open to debate and it is instructive that one of the 2005 reforms of the SGP was to alter it from -2% to 0% growth.

Second, the metrics used for the rule can be made sensitive to the economic circumstances. Using a cyclically adjusted threshold (another of the SGP reforms) rather than actual GDP is one answer. While economically more meaningful insofar as an adjusted figure better reflects what is going on in the economy, the well-known drawback is that estimating the output gap is tricky. Although, from a technical perspective, there are tried and tested methods for doing so, what is much less well understood is how the economy adjusts to being away from the presumed equilibrium point.

Using political judgements to complement fiscal rules is the third option. Here, however, the challenge becomes even more awkward. At one extreme, a government or decision-maker able to suspend the rule, possibly even in a capricious manner or for electoral advantage, would mean the rule had no substance. At the other, heavily constrained discretion could, in practice, mean no

discretion at all. The middle-ground would entail discretion subject to boundaries: in other words, rules about when rules can be over-ridden. The Commission guidance on the circumstances in which obligations under the SGP can be relaxed is an 'in-between' position, but in giving dispensation for EFSI investments, there is an evident political agenda.

3.2 The dilemma of proliferation

When multiple rules are in place and when rules target a variety of variables, there is scope for confusion or ambiguity. This is especially so if rules are, or could be, in conflict with one another, for example by signalling that action is needed on the profile of debt rather than the deficit or aggregate spending. The consistency of budgetary arithmetic is a potential problem, given that the origins of the three percent deficit and sixty percent debt rules were in a period of five percent nominal growth that meant precise adherence to the rules is a steady state. With lower inflation, the nominal growth figure is also now much lower on average; yet the average always masked significant difference among Member States. Four percent, fifty percent and eight percent is also a steady state.

Andrle et. al (2015) point to the sheer number of constraints on national fiscal policy in the EU, citing evidence that in 13 federations, the federal level imposes an average of two constraints on sub-national governments, whereas the EU, which is well short of being a federation, imposes five. It is also an open question which rule is dominant at any time, raising questions about why some are still in place. Andrle et al (2015) argue that MTOs tend to be more binding than nominal targets. They also highlight differences between Member States in how the national rules required by the Fiscal Compact dovetail with the SGP. Although they identify a number of potential reforms in response to these concerns, they also recall that whether rules are simple or complex, compliance will remain a concern.

Jonung (2015) argues that the most important contribution to Sweden's fiscal sustainability has come from the expenditure ceiling, observing that it 'has the advantage of being simple to understand and communicate to parliament and the public. It serves much more as a binding constraint than the surplus target'. The latter is measured over the business cycle, a rule also adopted in the UK under 'New Labour', which introduces ambiguity about both the length of the cycle and how to monitor a potentially elusive concept; it plainly gives the government room for interpretation which detracts from transparency. Ayuso-i-Casals (2012) similarly, argues he case for expenditure rules, noting that they have the advantage of being most directly controlled by governments and are easiest to formulate and explain to other actors.

There seem to be different positions on how fiscal rules need to be designed in order to enhance fiscal discipline in terms of the statutory base of the rule, the monitoring and enforcement mechanisms, or the relevant fiscal aggregate that is targeted (e.g. debt rule vs. budget rule). Marco Buti, in a recent statement[8] summed up the dilemma of authority:

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[8] http://ec.europa.eu/dgs/economy_finance/buti/what_future_for_rules-based_fiscal_policy_en.pdf

> “What is important to note is that the two issues of complexity and insufficient authority are truly two faces of a single problem. Any rules-based setting, however smart in design, requires an authoritative enforcer to provide firm guidance and ultimately call the shots. However, if you suspect that you miss this authority, the temptation is to substitute with additional fine prints to the contract. Rules are complemented by sub-rules and sub-provisions in order to cater for all kinds of circumstances in the hope of increasing predictability and preventing risks of abuse”.

3.3 The asymmetric effects dilemma

A well-documented problem of fiscal rules is their tendency to bite hardest in periods of slow growth or recession, but to have little impact in periods of stronger growth: rules aimed at fixing the roof when the sun shines seem to be harder to frame. This tends to increase the likelihood of rules being pro-cyclical with two damaging consequences: first, they will be less effective economically; but a more insidious second effect could be to call their legitimacy into question if adherence to rules is perceived as being to blame for engendering sub-optimal outcomes.

Fiscal rules can increase fiscal discipline, but it may be that that this is only possible in conjunction with other factors, such as strong institutions, or a political consensus around the thrust of fiscal policy. Indeed, Kopits (2001) argues that ‘governments with a strong reputation of fiscal prudence do not need to be constrained by rules’ whereas rules can be helpful to governments with a poor reputation for discipline. There are, however, risks that an undue focus on rules can lead to targeting the rule for its own sake, resort to creative accounting, such as stock-flow adjustments, to disguise deficits. The tendency to substitute stock-flow adjustments for budget deficits is especially strong for the cyclical component of the deficit, as in times of recession the cost of reducing the deficit is particularly large. The upshot can become misconceived policy choices aimed at meeting the rule rather than politically-determined policy objectives.

Equally, an excessive zeal in implementing rules could have damaging spillover effects for partner countries, especially in the Eurozone, if conforming strictly resulted in an aggregate loss of demand. At the margin, the first order effect of a moderate fiscal tightening by a small state (accounting for, say, one percent of EU or Eurozone GDP) would barely register on the demand for exports from others. But a sizeable contraction from Spain or Italy, let alone France or Germany, would. Tacitly or not, this may be a factor in the reluctance of the larger states to comply, but also of the EU institutions to react too aggressively to breaches. There are evident ways for policy to evolve to counter some of these visible drawbacks, although despite repeated efforts, the EU has been unable to devise a satisfactory means of arriving at a collective fiscal stance.

3.4 Institutional considerations and the wider policy framework

Effective fiscal frameworks do not emerge overnight and this may, in itself, offer an explanation for the mixed evidence on the success of the reforms of recent years. As Jonung (2015) explains in detail, the Swedish model – developed in large part as a reaction to the crisis of the early 1990s – entailed a succession of reforms and saw evolution in numerical rules and the mandate of, for

example, the Fiscal Council. He is positive about how it developed, but also warns that new bodies such as Fiscal Councils are bound to make mistakes and cannot be expected to have an immediate impact. Much the same conclusion is likely to apply to fiscal rules, the more so when they constitute a radical transformation of the policy framework. A double paradox may well be that fiscal rules are most needed where the ground for their introduction is least fertile, and that countries in which the extent of reform of the fiscal framework is greatest may be those in which evidence of success is least immediate.

Rules are affected by the institutional setting in varied ways. For example, Bergman and Hutchison (2015) find that their effectiveness is contingent on government efficiency and their research suggests that the combination of rules and efficiency is what is needed to prevent, notably, pro-cyclicality. Yet as they point out, rules can quickly be abandoned, as in the UK in 2009, if economic conditions deteriorate. According to Debrun et al. (2009), part of the challenge is that constraints on fiscal autonomy are most needed in the countries where governance structure are least conducive to implementing them – suggesting something of a paradox, as well as highlighting a democratic dilemma.

The emphasis given to discipline in fiscal rules has had most resonance in pushing Member States to respect thresholds such as the three percent deficit limit, but has been less well attuned to qualitative objectives or to longer-run targets, prompting the question of how far rules can sensibly go in steering fiscal policy. Nor is it obvious whether or how rules should take account of what might be considered the externality of impact on other countries. Although the *Alert Mechanism Report* for 2016 – hereafter, ARM2016 – (Commission, 2016b) mentions the notion of 'countries with fiscal space' in the context of rebalancing demand across the Eurozone, a rule that could achieve this is not specified; in practice it would entail a country having a separate objective from the immediate national interest.

A link to structural reforms as the basis for achieving fiscal sustainability is also mentioned in ARM2016 in comments singling-out France and Italy. The reasoning here has echoes of conditionality, but without the difference of lacking the external influence of a bailout or similar. Rather, the message is to connect the fiscal and the structural. Against this backdrop, the terms on which adherence to rules can be eased is a matter of continuing controversy. The guidance issued by the Commission early in 2015 on making use of the flexibility in the SGP[9] has fuelled suspicions in fiscally hawkish Member States, such as Germany and the Netherlands, that discipline is being compromised. But, the stance of the Italian government on the need for flexibility highlights the need to pay more attention to appropriateness.

The optimal remedy proposed by Claeys et al. is to redesign the framework from scratch, although they concede that this is politically unrealistic and propose instead a range of incremental reforms. They include dropping the use of the structural balance indicator, and opting instead for an

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[9] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf

expenditure rule targeting the growth of nominal expenditure, alongside a debt-correction mechanism. They also call for the approach to be ‘transposed into national laws and monitored by national fiscal councils’, but for exception clauses to go. If their recommendation is followed it would mean a new directive.

4 Conclusions

Debates continue to rage about what caused the euro crisis and whether the gamut of policy responses and institutional reforms offers the right remedies to put the euro on a more secure footing. Plainly, the strengthening of fiscal frameworks and the insistence on fiscal rules are key elements of the recasting of macroeconomic governance and appear to be in line with ‘best-practice’ advice emanating from the main bodies charged with monitoring policy-making: the IMF, the OECD and (most directly) the European Commission in its capacity as custodian of the euro. Yet, according to Claeys et al. (2016) the current system, despite its flexibility, is not delivering an appropriate fiscal policy. As the evidence in section 2 of this paper demonstrates, fiscal discipline remains patchy and real economy outcomes are far from encouraging, as even a cursory look at growth and unemployment data shows.

The sheer extent of the fiscal governance change in the EU, especially the Eurozone, invites caution about how to analyse recent developments and how much to read into the track record of fiscal rules. On the one hand, new rules require time to bed-in and for the institutional machinery to adapt, requiring the recasting of relationships between ministers, external agencies and officials. Finance ministries may like to portray themselves as the custodians of fiscal orthodoxy and the antidote to spending ministers (who, in turn, have incentives to secure more money for their priorities), but as senior figures in most governments, Finance Ministers are bound also to have wider political objectives. Until they reach an accommodation with, notably, national fiscal councils and the Commission on procedural matters, including data exchange and timetables for meetings or release of forecasts, as well as policy discussions, there is a risk of misunderstanding or even of conflict. How to mediate when conflicts arise has to be part of the political economy of rules. Differences can arise in relation to the appropriateness-compliance dilemma, but also in relation judgements about uncertainty in the relevant data, methodologies for calculating key control variable (the output gap is a crucial one) or the accuracy of forecasts.

On the other hand, the last few years have been unusually turbulent and may not, consequently, be a fair test of systems of rules designed to foster long-term fiscal sustainability. The rules in place prior to the onset of the euro crisis manifestly did not hold, posing a question about whether such rules can only be effective in more benign times. Equally, the thrust of many of the rules, both at national level is preventative rather than corrective: their thrust should be to forestall problems, something they manifestly failed to do during the 2000s. Reuter’s (2015) finding that, even though rules are complied with barely half the time, they do have a moderating effect on behaviour is also important. The possible metaphor is that if the speed limit is 100 kph, drivers will exceed it by 10 or 20 kph, but not by dramatically more, suggesting that the better test of compliance is not whether the rule is strictly respected, but whether it modifies behaviour in the

desired direction. This could lead to gaming if a rule is then set at a lower level than makes economic sense, in the knowledge that it will be flouted.

A less persuasive element of the Claeys et al. proposal is for an independent European Fiscal Council 'to oversee the system and exercise the necessary discretion in unusual times', justified on the grounds that the very independence of such a body would enable it to avoid accusation of political bias. The inevitable difficulty with this is how to impose decisions on recalcitrant governments, whether it is to ease or tighten fiscal policy. But it would face a further legitimation challenge that whatever implicit model it adopted would, itself, be open to objections to its normative foundations. If, in addition, the deliberations were behind closed doors, the throughput legitimacy (Schmidt, 2013) of the process could be challenged.

In his introduction to the 2015 Commission report on EU Public Finances[10], Marco Buti (the Director-General for Economic and Financial Affairs) concedes 'that the fiscal rules have become very complex' and promises clarification of their operation and increased transparency. To this should be added the imperative of national ownership and commitment, without which any rule in danger of being compromised. Even the best-designed rules will fail if implementation falters, but fiscal rules face the added challenge that they are at the heart of the relationship between the citizen and the state and thus not as amenable to delegation to experts as monetary policy: in short, a fundamental democratic dilemma.

[10] http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip014_en.pdf

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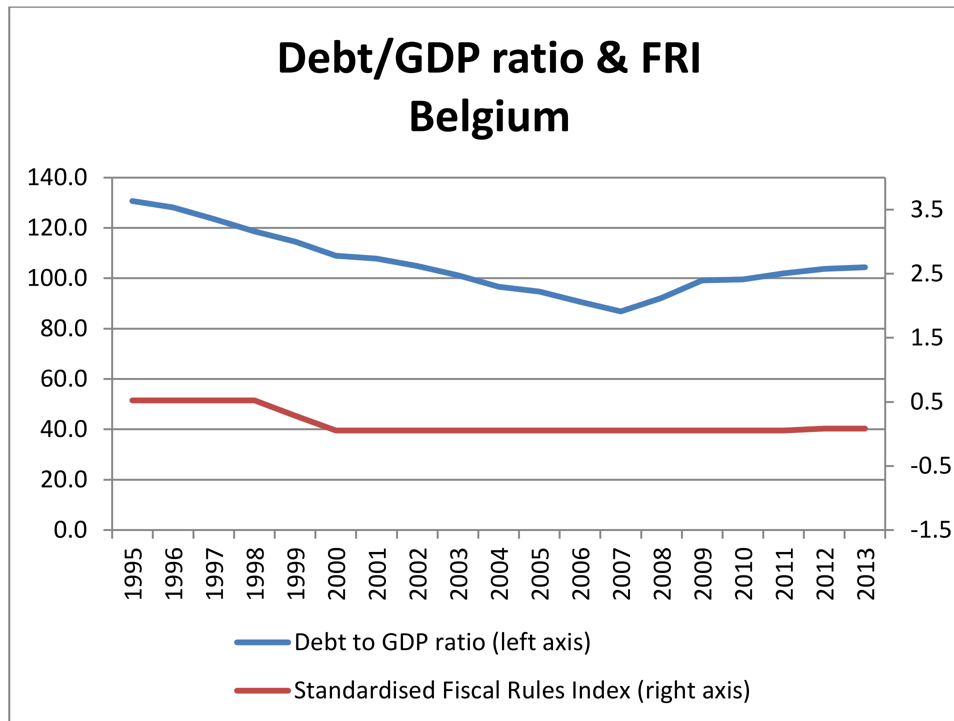
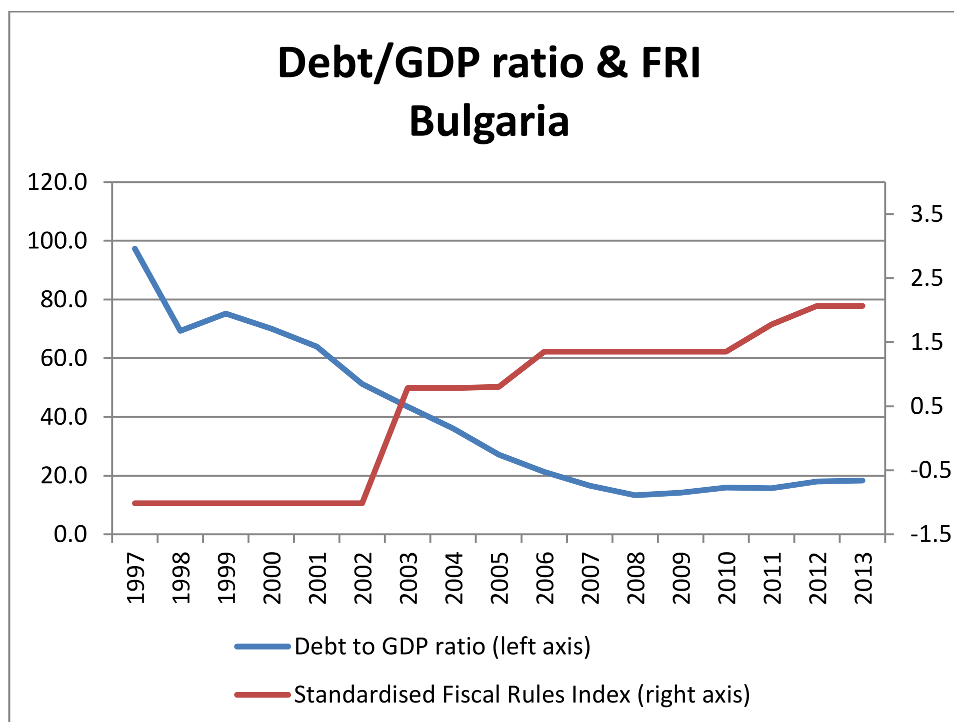
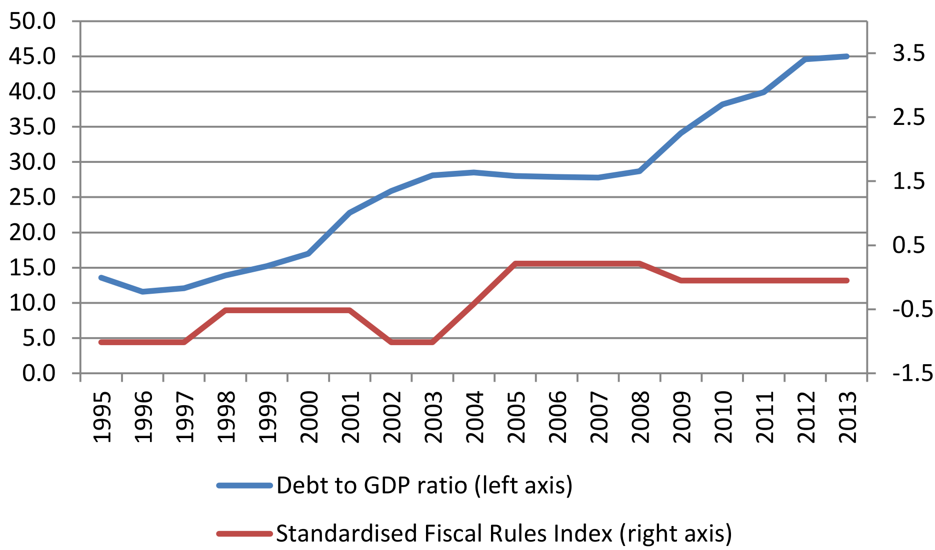
Appendix charts: trends in fiscal rules and debt ratios by Member State

The charts which follow are all based on the DG Ecfin fiscal rules database.






Debt/GDP ratio & FRI
Czech Republic
50.0
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
3.5
2.5
1.5
0.5
-0.5
-1.5
1995
1996
1997
1998
1999
2000
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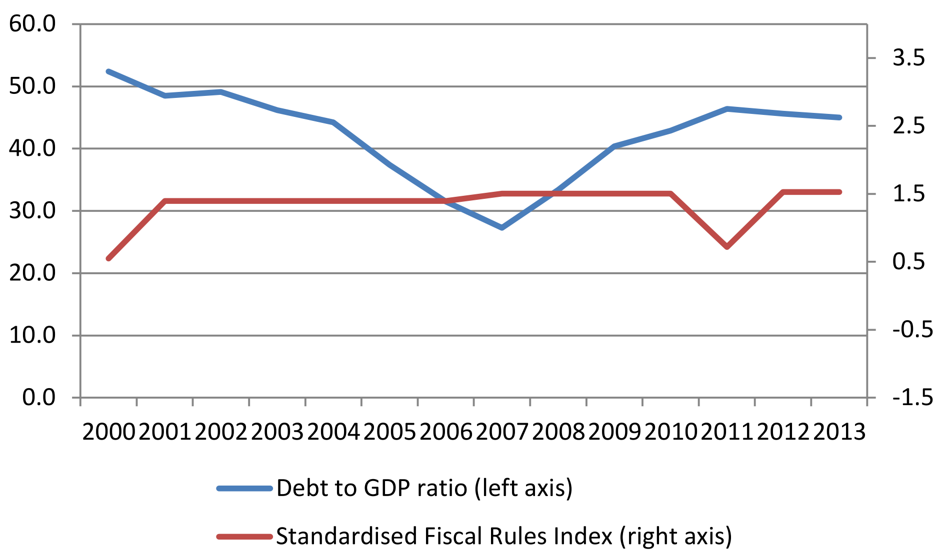
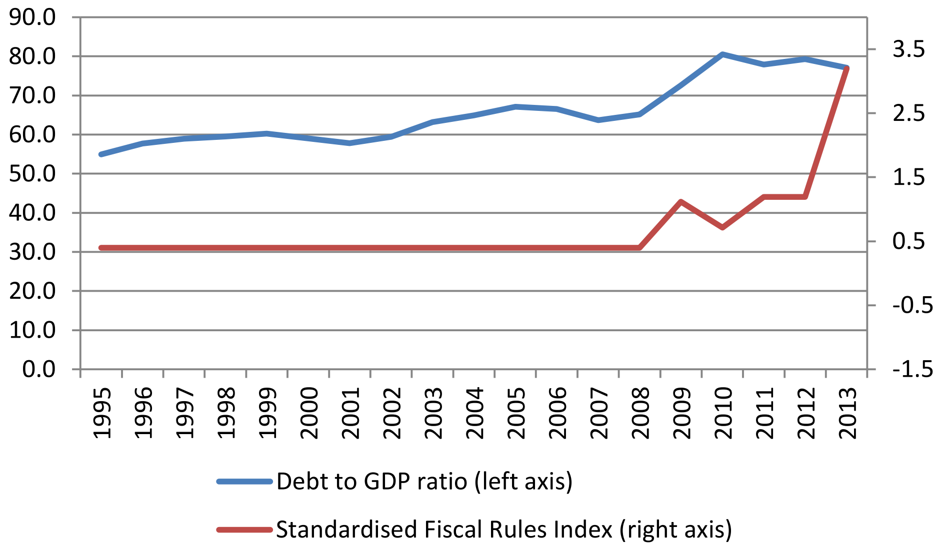
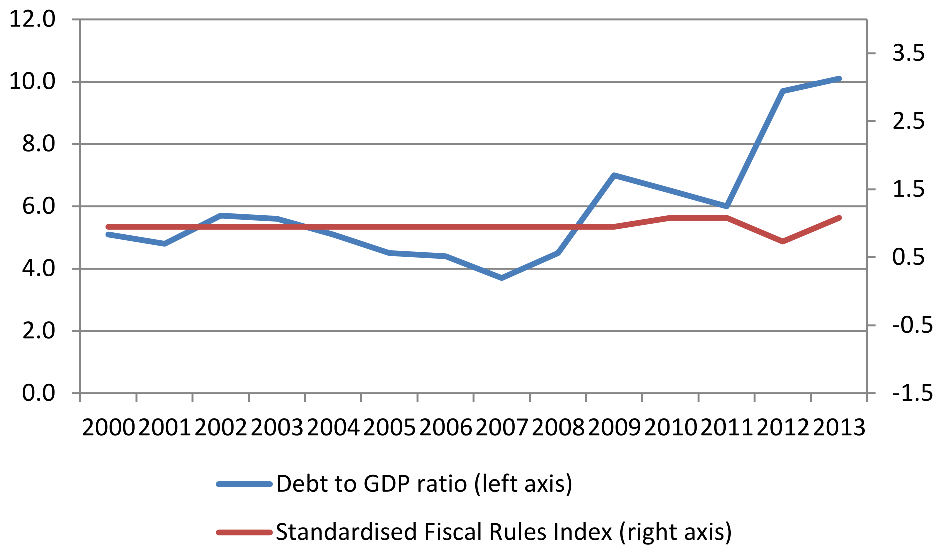
2011
2012
2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Denmark
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
2.5
1.5
0.5
-0.5
-1.5
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Germany
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
2.5
1.5
0.5
-0.5
-1.5
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Estonia
12.0
10.0
8.0
6.0
4.0
2.0
0.0
3.5
2.5
1.5
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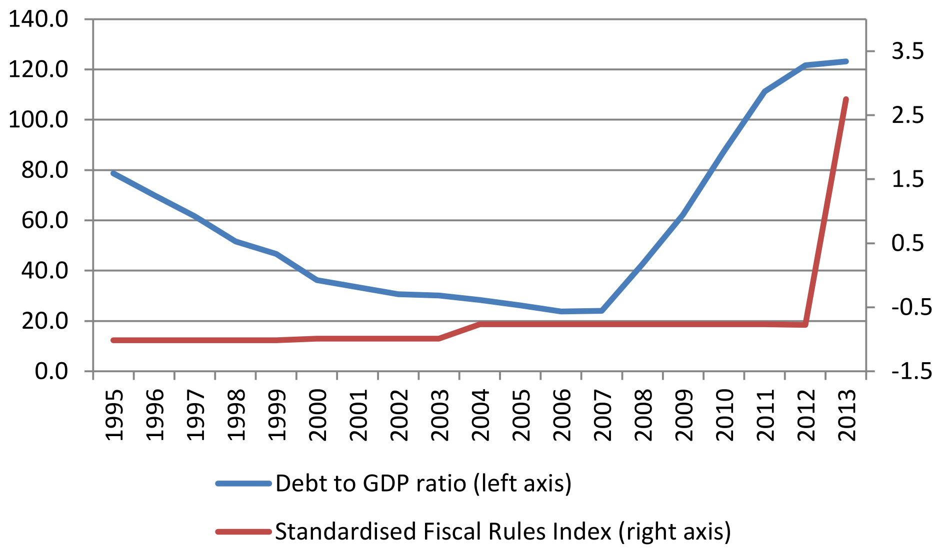
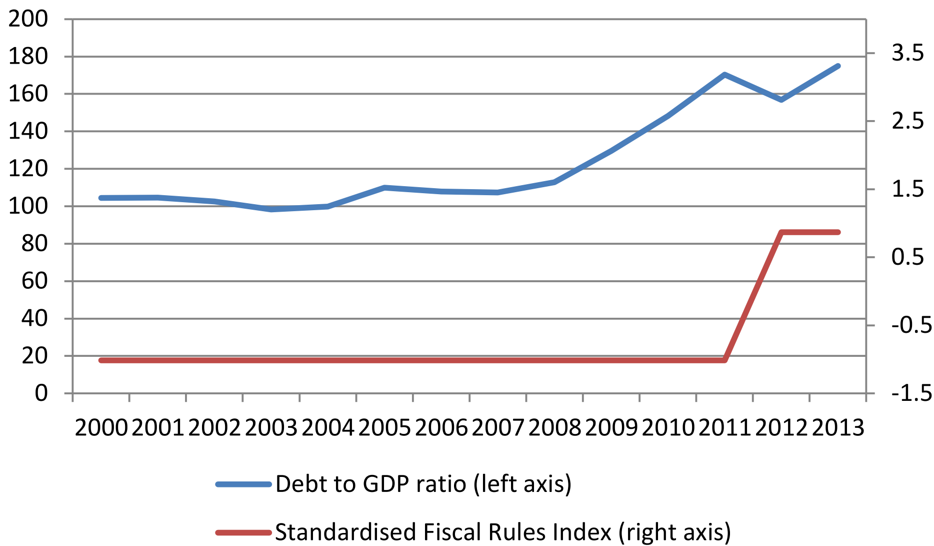
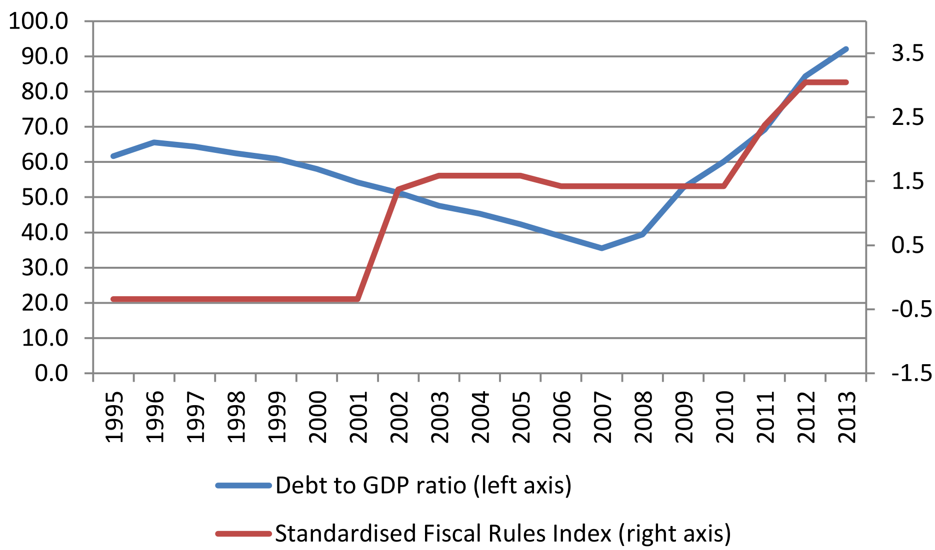
-0.5
-1.5
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)



Debt/GDP ratio & FRI
Ireland
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
3.5
2.5
1.5
0.5
-0.5
-1.5
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)



Debt/GDP ratio & FRI
Greece
200
180
160
140
120
100
80
60
40
20
0
3.5
2.5
1.5
0.5
-0.5
-1.5
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Spain
100.0
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
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-0.5
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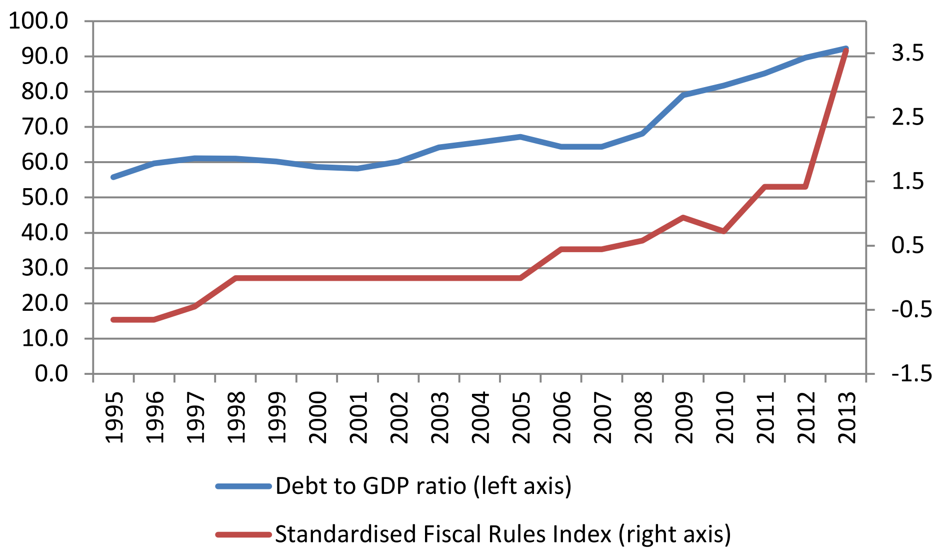
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
France
100.0
90.0
80.0
70.0
60.0
50.0
40.0
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10.0
0.0
3.5
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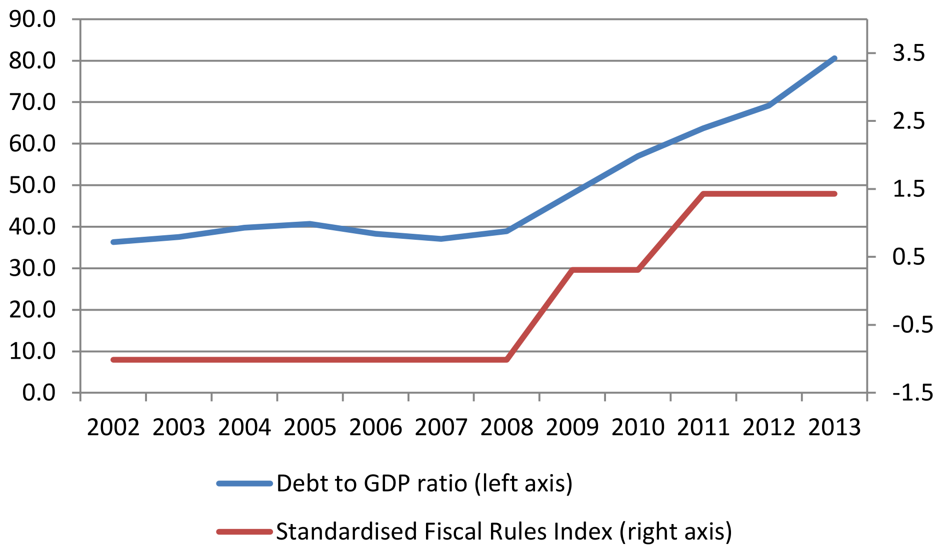
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Croatia
90.0
80.0
70.0
60.0
50.0
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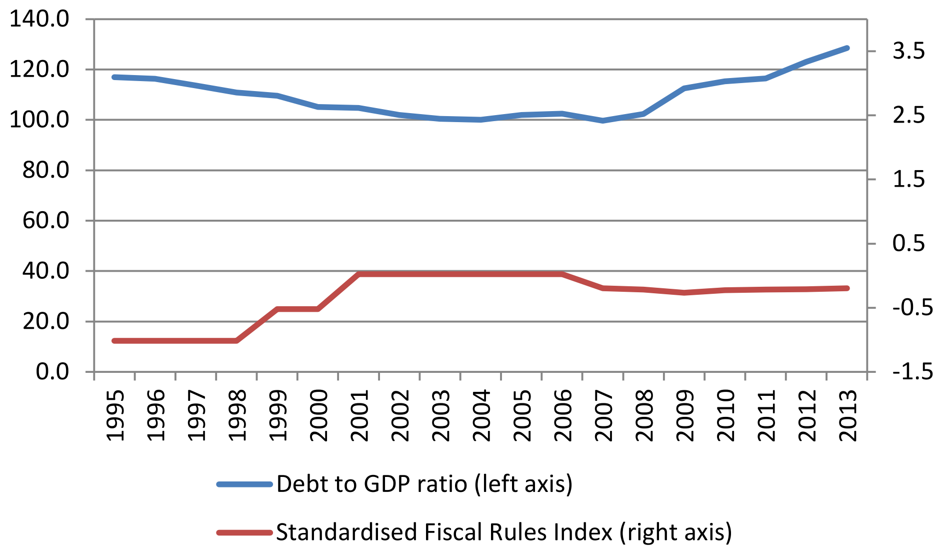
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Italy
140.0
120.0
100.0
80.0
60.0
40.0
20.0
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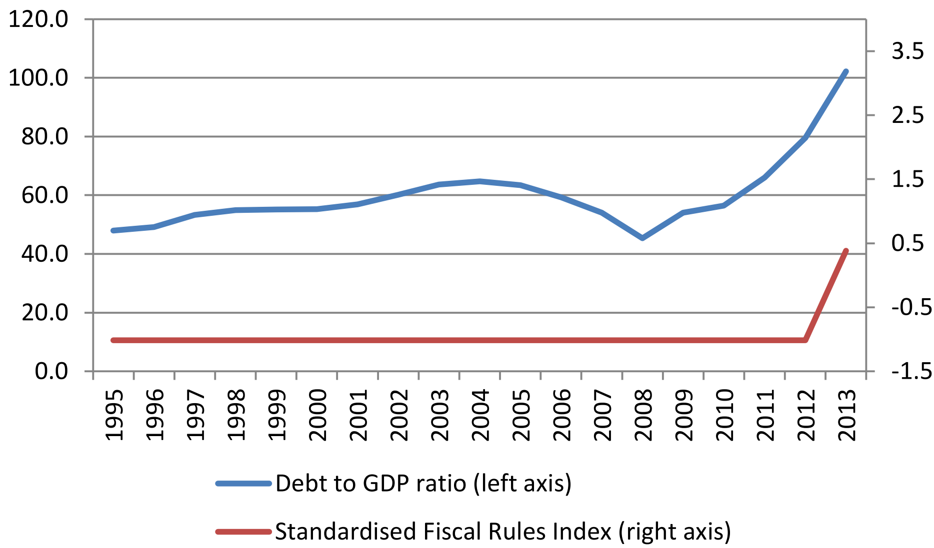
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Cyprus
120.0
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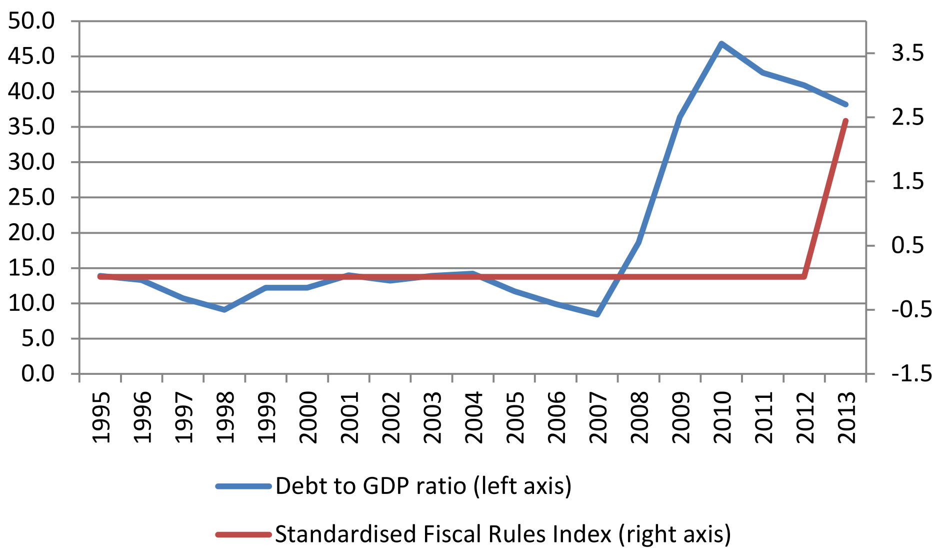
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Latvia
50.0
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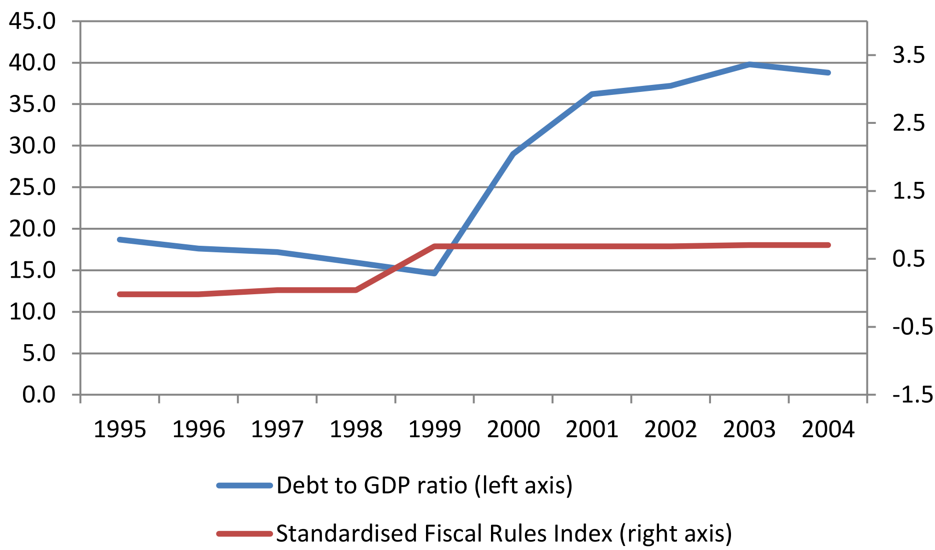
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Lithuania
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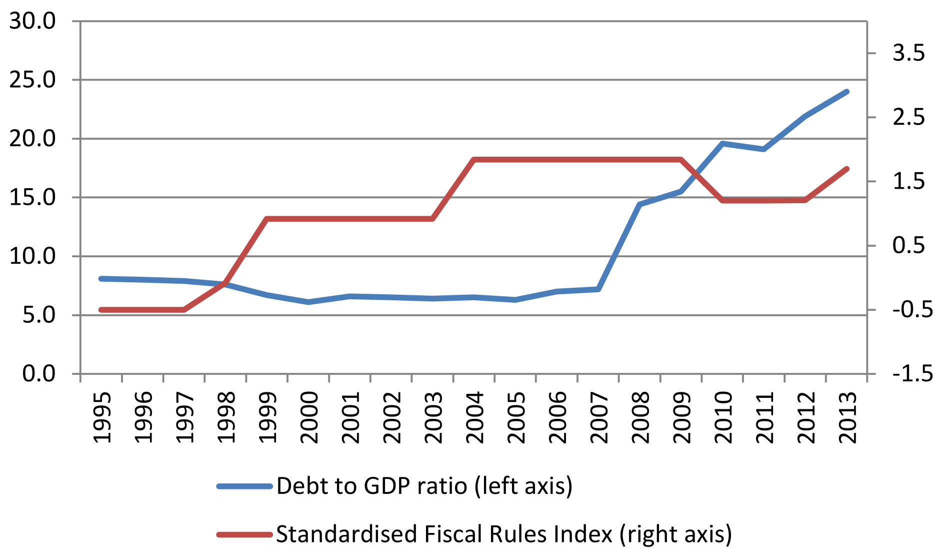
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Luxembourg
30.0
25.0
20.0
15.0
10.0
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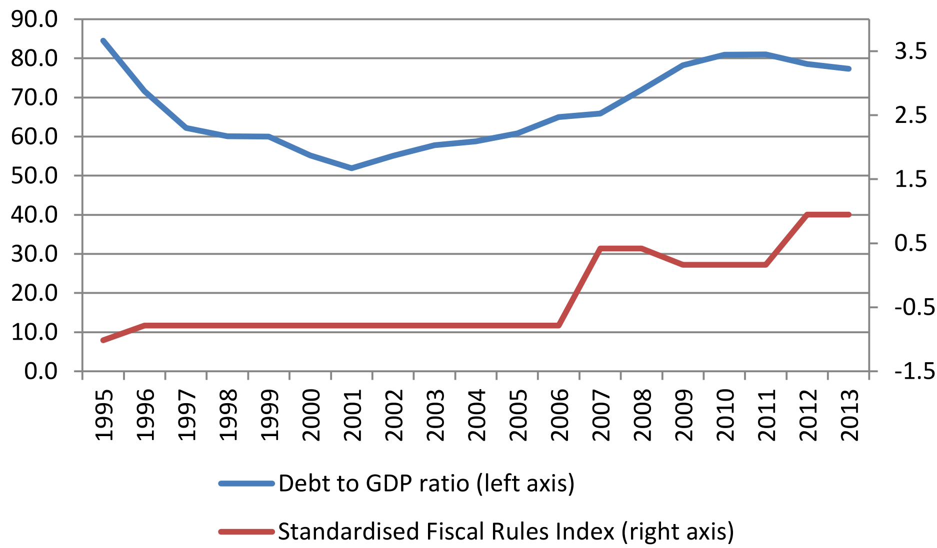
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Hungary
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
2.5
1.5
0.5
-0.5
-1.5
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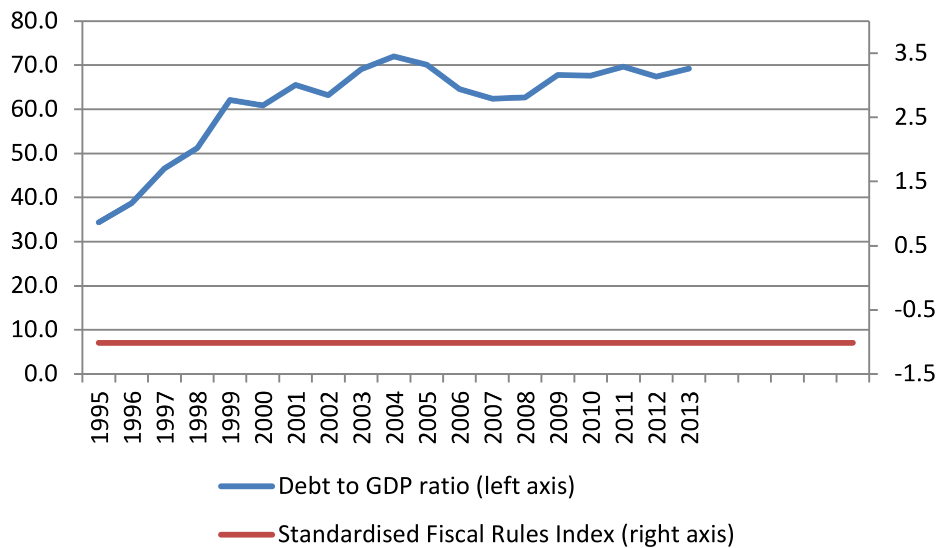
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Malta
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
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-1.5
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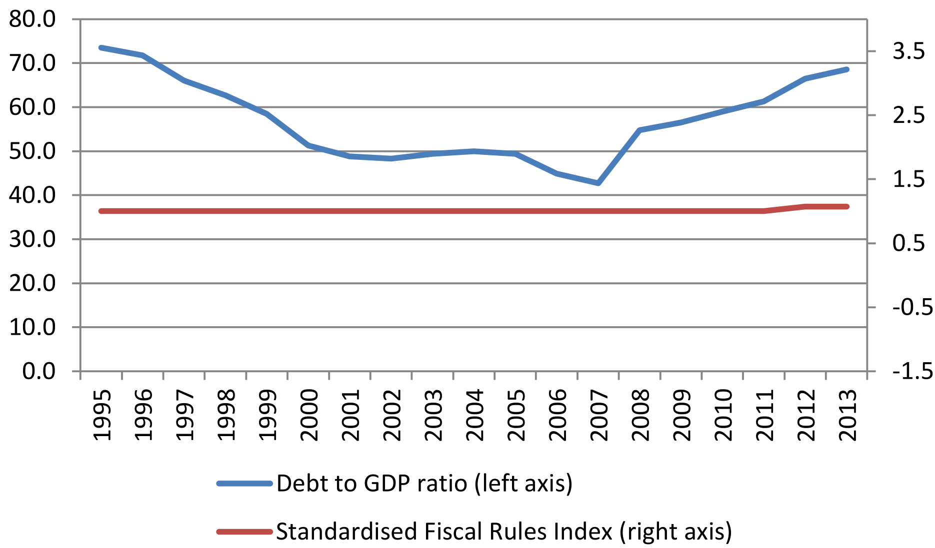
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Netherlands
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.5
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-0.5
-1.5
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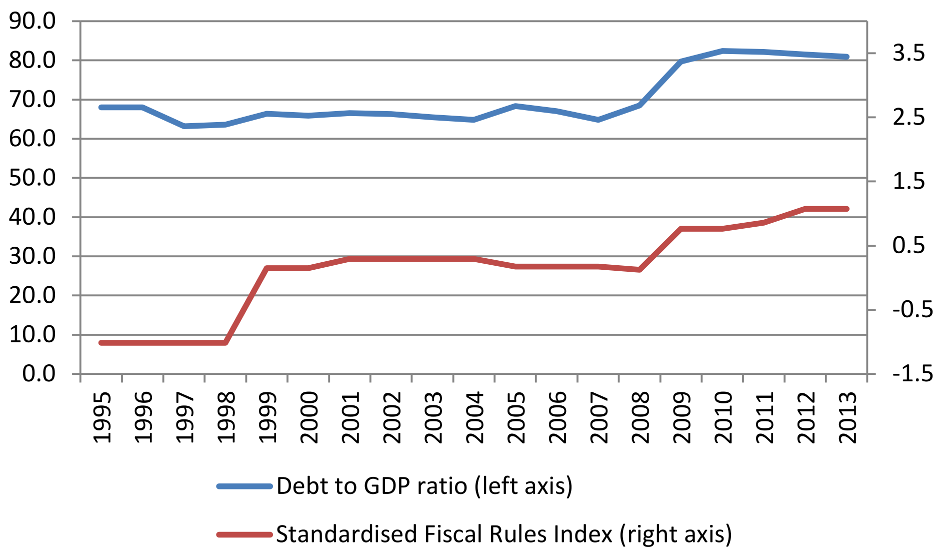
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Austria
90.0
80.0
70.0
60.0
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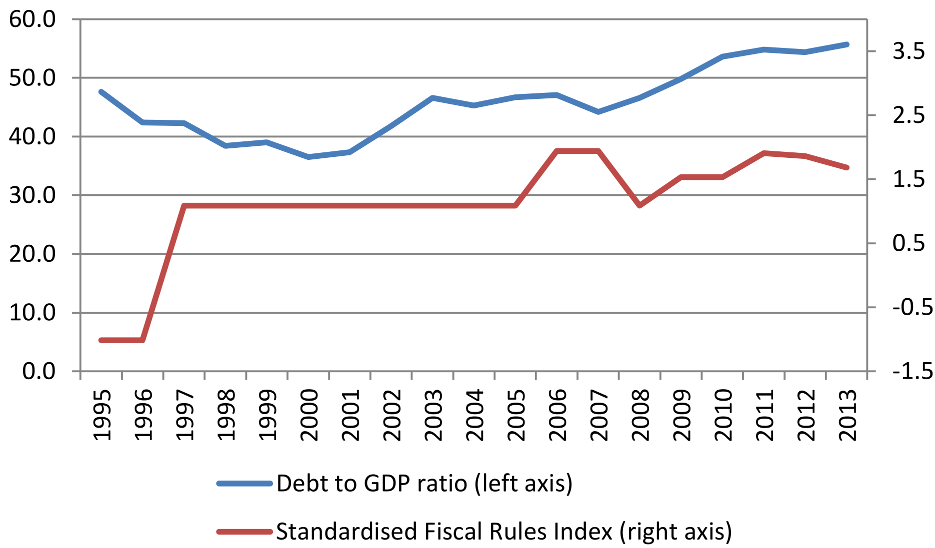
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Poland
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50.0
40.0
30.0
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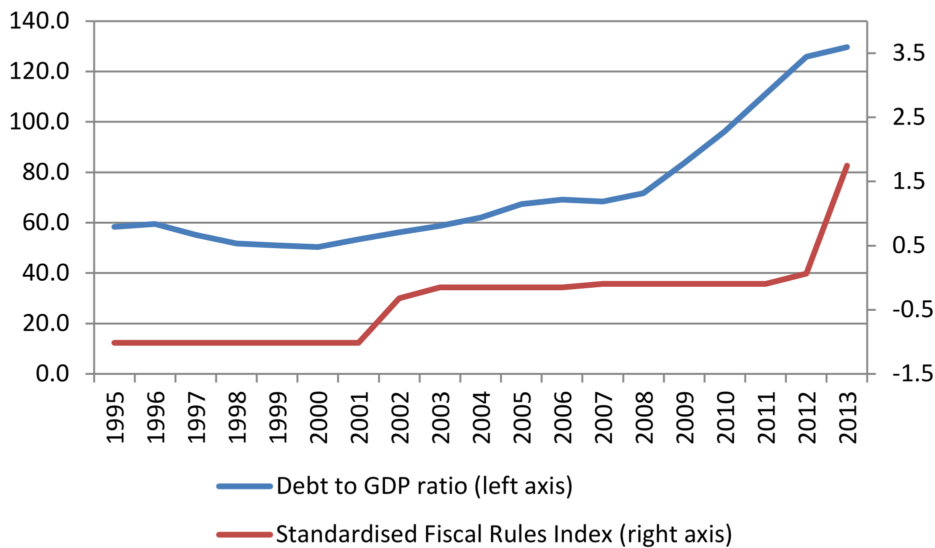
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Portugal
140.0
120.0
100.0
80.0
60.0
40.0
20.0
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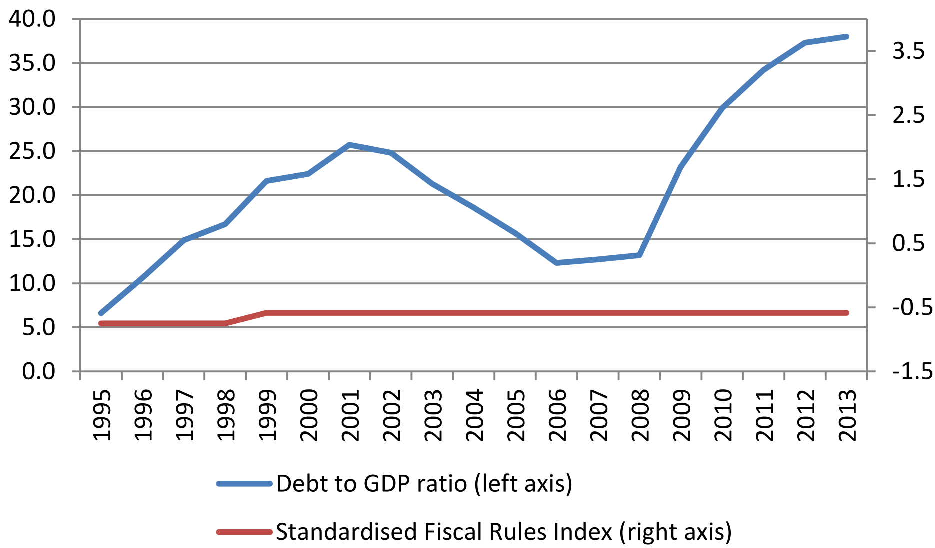
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Romania
40.0
35.0
30.0
25.0
20.0
15.0
10.0
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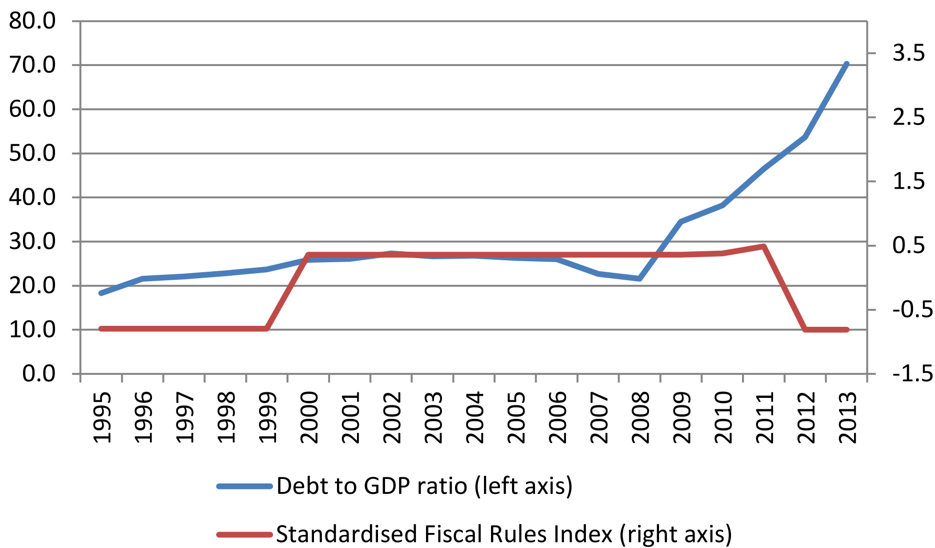
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Slovenia
80.0
70.0
60.0
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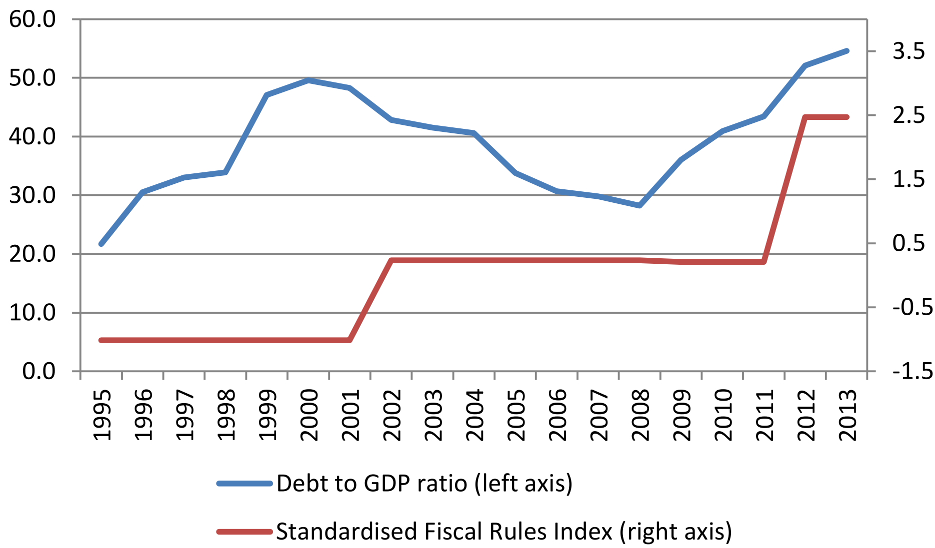
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Slovakia
60.0
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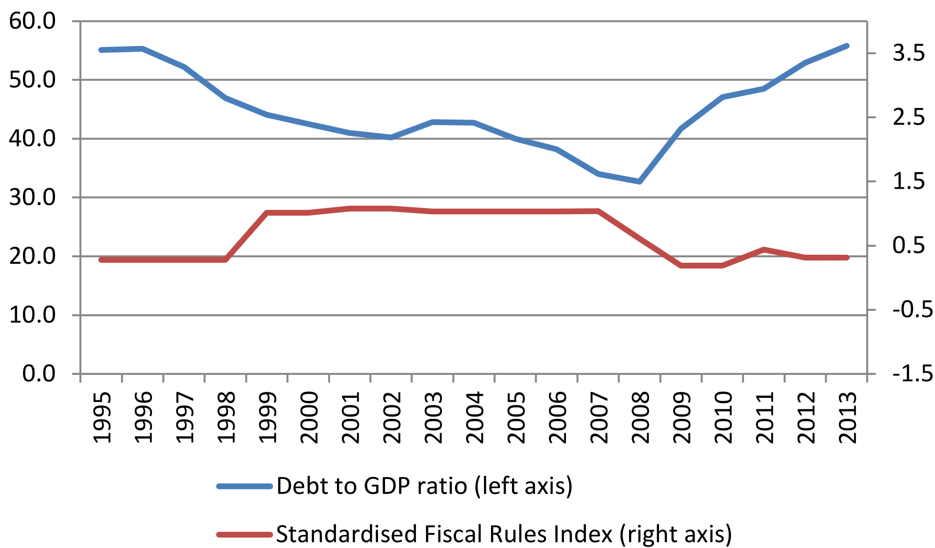
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
Finland
60.0
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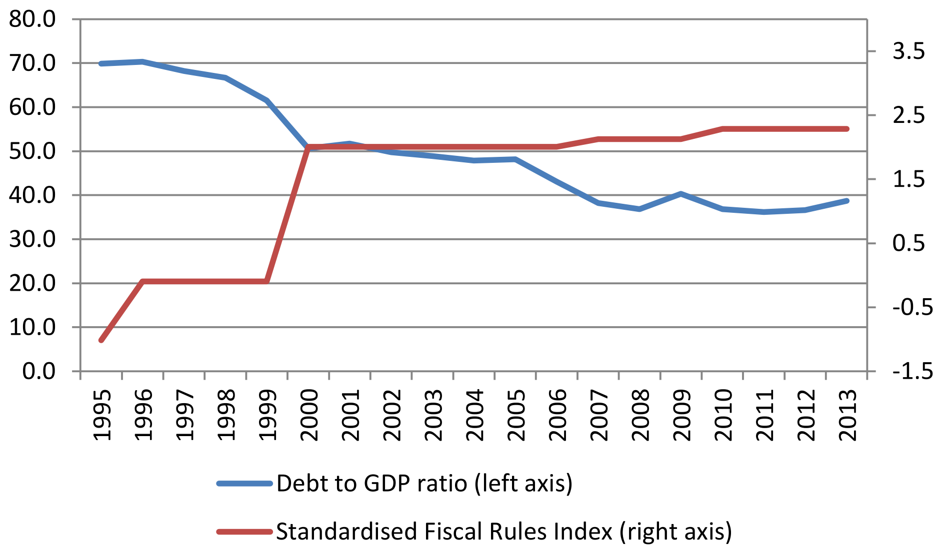
Debt/GDP ratio & FRI
Sweden
80.0
70.0
60.0
50.0
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30.0
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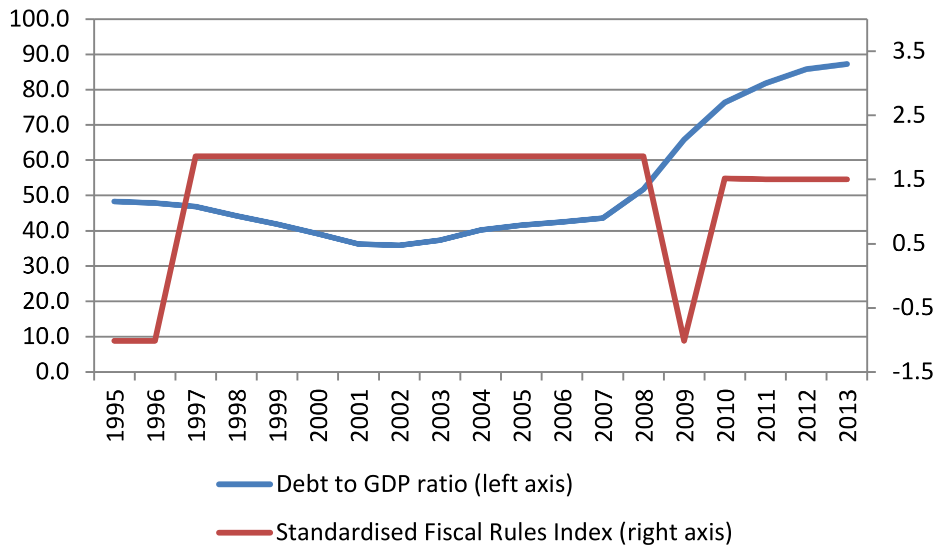
Debt to GDP ratio (left axis)
Standardised Fiscal Rules Index (right axis)


Debt/GDP ratio & FRI
United Kingdom
100.0
90.0
80.0
70.0
60.0
50.0
40.0
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Debt to GDP ratio (left axis)
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