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Policy Brief: Are fiscal rules an effective and suitable means of ensuring fiscal sustainability?

Note: This policy brief draws on a longer FIRSTRUN paper by Iain Begg (D6.2: "Fiscal rules in the Member States: principles, practice and implementation", available at http://www.firstrun.eu/files/2016/07/D6.2_Fiscal_rules.pdf)

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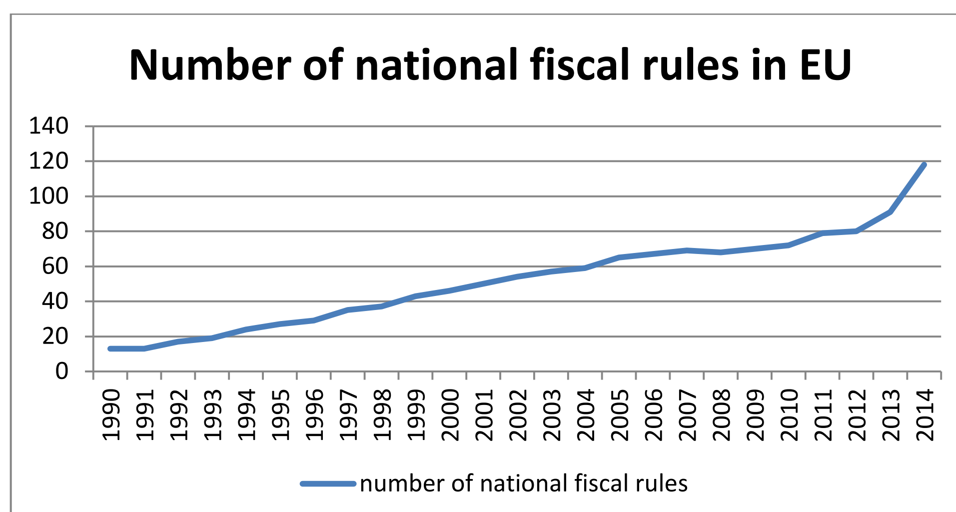
A key part of the response to the succession of EU economic crises since 2008 has been to strengthen fiscal frameworks, notably through more and stricter fiscal rules, together with closer scrutiny of government choices by independent bodies. Although fiscal rules have been encouraged by international agencies, especially the IMF and the OECD, and have feature prominently in the economic governance reforms enacted in the EU in recent years, they are politically delicate because fiscal policy is at the heart of distributive politics. It follows that there needs to be a compelling case for their imposition if citizens are to forgo, or have circumscribed, their right to choose what sorts of revenue and expenditure policies governments adopt.

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, yet evidence that they are succeeding is, at best, tentative. Although the EU level Stability and Growth Pact (SGP) has been –and remains – the most visible such rule, the terms of the EU's Fiscal Compact require signatories to put in place national rules with similar objectives. This policy brief provides an overview of what fiscal rules are achieving in the EU and highlights a number of dilemmas that have to be confronted in defending the increased resort to them in recent years.

The evidence

A figure 1 reveals, there has been a steady rise in the number of national fiscal rules in the EU, such that by 2014 there was an average of some four rules per Member State, compared with a total of just twelve in 1990. The particularly sharp increase in rules in 2013 and 2014 can be attributed to the new governance arrangement s put in place as part of the EU response to the euro crisis.

Figure 1



Source: European Commission fiscal rules database

Most rules target the current budgetary balance, but there is also a growing number of rules aimed at restraining debt and setting limits on government expenditure, as well as a few

prescribing how unanticipated increases in public revenue should be used. Most of the rules are enacted through legal acts, but some are written into national constitutions, while others are more informal, political arrangements of different sorts.

According to a Commission assessment of fiscal rules in 2016, all Member States either increased or maintained the strength of their medium-term fiscal framework between 2010 and 2014. Yet, if judged purely by the budgetary indicators of EU Member States today, the verdict on fiscal rules would be pretty negative, even making allowances for the difficult circumstances of recent years which were hardly conducive to strengthening budgetary sustainability. Looking at the period from 2012 to 2016, after the most acute phase of the successive crises ended, there is a mixed picture. Deficits have come down in the great majority of Member States; and in the few cases where they have risen, the governments have evident room for manoeuvre. However, the public deficits in two of the Eurozone's economies assisted during the euro crisis (Portugal and Spain) continue to worry the European Commission and vulnerabilities in several others have been highlighted in the annual country-specific recommendations issued as part of the 'semester' process. Scrutiny of budgetary plans by the Commission – another of the post-crisis reforms – also points to continuing unease about fiscal discipline in many Eurozone Member States.

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).

Over the long-term, work undertaken by the IMF shows that, despite the many reforms that have taken place in the governance of fiscal policy in the EU, compliance remains disappointing. The study notes 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. On a more positive note, research by Wolf Heinrich Reuter finds that even though rules have often not been met, there are indications that they may still have restrained governments more than if they had been absent. The implication is that too narrow a focus on exact compliance with the letter of the rule may be unwarranted or even counter-productive.

Four observations are worth making about these findings. 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.

Implications for the future of rules

The original SGP was subject to a range of criticisms, some of which fed into the successive reforms. Similar criticisms are now surfacing about the current EU fiscal framework, raising potentially awkward questions about the place of rules in the post-crisis fiscal framework, especially for the Eurozone. In parallel, policy-makers have to ponder how rules can best be legitimated in a context in which political antagonism to what are perceived as oppressive austerity policies has grown and is recognised to be an influence on the rise of populism.

At an operational level, there are several dilemmas around rules. A first is the sheer number of them and the attendant risks from this 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 if an expenditure rule bites, even though the underlying fiscal position is robust. A related concern is that a rule deriving from historical budgetary arithmetic may lose its rationale if key parameters change. For example, the enduring Maastricht rules of three percent deficit and sixty percent debt, both as a percentage of nominal GDP, ensure a steady state if nominal GDP grows at an annual rate of five percent. With inflation having fallen sharply since the 1990s when these figures were first adopted, nominal growth in GDP is generally much lower.

A second major dilemma can be characterised as between compliance and appropriateness. When rules are enshrined in law and, moreover, prescribe sanctions – whether on the decision-makers or on the country in breach – or a course of action that has to be followed to restore compliance with the rule, the effect can be to push policy-makers into actions consistent with achieving the rule, but potentially damaging to the economy. If the proposed solution is to introduce flexibility to the rule, it is likely to undermine its credibility. The issue can become still more thorny if the government notionally constrained by the rule is able to suspend the rule, possibly even in a capricious manner or for electoral advantage. Equally, 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.

An alternative solution of more complex metrics carries the danger of diminishing the transparency of the rule and thus the ease with which it can be explained to citizens. This concern will be exacerbated (as is the case with using structurally adjusted budget deficits, for instance,

given differing views on how best to measure the output gap) there are methodological doubts about the best approach. If, say, a national fiscal council disagrees with the European Commission on the approach the problem will be all the greater.

Many rules, including the SGP, have been criticised for pro-cyclicality, characterised by a lack of symmetry in which they are strictly enforced in bad times, but neglected in good times. This can have two damaging consequences: first, rules will be less effective in achieving a measured and sustainable fiscal policy; 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.

Concluding comments

The sheer extent of the fiscal governance change in the EU, especially in the Eurozone, invites caution about how much to read into the track record of fiscal rules. Even their most ardent supporters would, nevertheless, have to concede that they have yet to deliver systematic improvements in fiscal sustainability. Fiscal discipline remains patchy and real economy outcomes are far from encouraging, as even a cursory look at growth and unemployment data shows. Quite simple, a recent critique from the Bruegel think-tank argues that the current system, despite its flexibility, is not delivering an appropriate fiscal policy.

With so much having changed in fiscal governance, it may be that more time is needed not only for rules to take effect, but (perhaps more importantly) for the various actors involved (finance ministries, independent fiscal councils, the European Commission, let alone the media and citizens) to learn how to live with fiscal rules and for the institutional machinery to adapt. In addition, there may be something of a paradox around rules, namely that they are not really needed in countries in which institutions are strong enough to adopt sustainable fiscal policies, but do not work adequately where most needed because institutions are weak.

Fiscal rules face the challenge that policy decisions on tax and public spending are at the heart of the relationship between the citizen and the state. Complexity in rules is manifestly a problem, not just from a technical perspective, but also from a political economy standpoint. If the rules are opaque or appear not to be leading to better economic outcomes, citizens are bound to question them. If the rules are found wanting, either because they cannot easily be explained or appear to generate unpalatable outcomes, their legitimacy will suffer: in short, a fundamental democratic dilemma.