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What Future for Rules-Based Fiscal Policy?

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In this chapter, I wish to address the issue of rules-based fiscal policy. Specifically, the question I wish to put forward is, what is the future of rules-based fiscal policy?

Fiscal rules are now widespread, in both advanced and emerging economies (EMEs), which is a testament to their increasing popularity. Yet, as before in the monetary field, the growing experience with rules-based fiscal policy has illuminated potential pitfalls. And there has always been a view that rules are at best an "unnecessary ornament," if not positively harmful.

The reflection has been continually active with regard to the European set of rules, where a specific context is additionally created by the monetary union of member states that still enjoy fiscal sovereignty. The European rule book has been amended several times in response to problems that have been identified. This is a rich experience already.

The judgment over European fiscal rules is occasionally dismissive—as if the successive revisions, together with disappointing macroeconomic performance, sufficed to demonstrate an inherent failure. As one might expect, I will adopt a more nuanced and positive assessment. While not hiding the challenges of operating fiscal rules, including our present toolbox in Europe, I argue that there has been an impressive number of lessons learned, paving the way for smarter and more effective rules-based frameworks.

Let me outline the three specific take-home messages from my intervention:

1. From a purely macroeconomic perspective, the fiscal stance was at times too restrictive during the crisis, but this reflected more the

incompleteness of the architecture of the European Monetary Union (EMU) rather than inherent flaws in the EU's fiscal framework.

2. Fiscal rules should anchor public debt ratios to long-term prudent levels while helping to stabilize the economy. Achieving such a double act is even more important in a currency union than in independent jurisdictions. In the present juncture, in achieving this double act, a broadly neutral fiscal stance appears appropriate for the euro area as a whole, but its distribution is suboptimal. If an expansionary policy proves desirable, it would be better pursued at the central level than at the national level.
3. A prudent debt anchor and a stabilization goal are consistent with the present EU fiscal rules, but are "hidden" in a framework that is overly complicated and suffers from an "authority gap" at the center. The latter two features are two faces of the same coin and can be traced back to lack of trust.

As a final word of introduction, let me note the importance of this debate, especially from the perspective of Europeans. Deep fiscal union among members of the EMU might be on the long-term agenda, but the foreseeable future largely hinges on a stepped-up coordination of national fiscal entities. This coordination can hardly be organized without some elaborated underpinning framework. And one must also recognize, as a political reality, the attachment within influential constituencies to ordoliberal settings.

These joint contextual features have crucial implications. They point to the vital need to forge intellectual common ground, to a greater degree than currently obtains, with regard to the merits, limitations, and above all the proper attributes of rules-based fiscal frameworks. It is to this endeavor that I wish to contribute here. I would also like to add as a disclaimer that these views are my own.

An Existential Crisis: Fiscal Rules in an Incomplete EMU

The fiscal rules in Europe have been submitted to a severe "stress test" in recent years. Debt levels have risen to unprecedented levels in a depressed environment shaped by the balance sheet downturn combined with permanent stagnation features that predated the crisis. In this unusually challenging situation, it has been difficult to credibly apply fiscal rules all along in a sensible manner.

Have the EU fiscal rules made things better or worse? From a purely macroeconomic perspective, the fiscal stance was at times excessively tight and procyclical, especially at the height of the sovereign crisis, for example from mid-2011 to early 2013. For the euro area as a whole, structural balances improved by 1 percent of GDP per year in the three years 2011–2013, a significant contraction against large negative output gaps. There are indications that the underlying policy effort was in fact even a bit higher, given the significant revenue shortfalls compared with ordinary tax elasticities.

In some countries, mainly those under financial market pressure, the effort has been more impressive still. To take just one example, in Spain the underlying budgetary adjustment was about double the average in those years, although the stance has now been relaxed. At the same time, the few countries arguably benefiting from some fiscal space, such as Germany, advanced faster on consolidation than they might have, taking a macroeconomic perspective.

At the same time, one must stress that these developments occurred in the highly unusual economic environment that I mentioned above, doubled by the incomplete institutional setting of a monetary union still very much in the making:

- On the financial side, several EU member states were on the verge of or had effectively lost market access.
- Meanwhile, the institutional foundations that could have supported a more balanced fiscal strategy were not there ex ante. They had to be devised as the crisis developed.

In particular, the setting up of European firewalls (the European Financial Stability Facility and the European Financial Stabilisation Mechanism, and later the European Stability Mechanism), the decision to launch a banking union, and the crucial actions of the European Central Bank (ECB), including the announcement of Outright Monetary Transactions (OMT), were decisive in turning the corner of acute financial stress.

Once these elements were in place, a more gradual fiscal adjustment policy could effectively be deployed.

The take-away, from my perspective, is not that fiscal rules per se proved their inadequacy with the crisis. Rather, the main lesson is that fiscal rules operate in a certain institutional and political environment, which has to be conducive to sensible implementation. The fiscal rules *stricto sensu* could in fact have been applied in a less procyclical fashion.

In addition, the "excessive procyclicality" should not be overdone. Given very large initial sustainability gaps, most EU countries had to embark on sustained consolidation, if more gradual and better composed. Even Germany arguably faced dilemmas, as it also had to shoulder the credibility of the overall European framework much on its own.

That said, this difficult experience from the crisis has also led to renewed questions over the design of our fiscal rules. This is the topic to which I turn now.

Fiscal Rules: The "Double Act" of Anchoring Discipline while Helping Stabilization

There are several desirable features of fiscal rules. More than fifteen years ago an influential IMF paper (Kopits and Symansky 1998) encapsulated these in eight criteria, such as adequacy, simplicity, efficiency, and others. It was concurrently recognized that jointly fulfilling all the relevant criteria would be no easy feat, as there are apparent trade-offs between them.

While all criteria from Kopits and Symansky or similar grids deserve attention, there is one aspect that, although not absent, was not emphasized enough in the light of subsequent experience. This "focal point," which I wish to stress now, is the ability to preserve, or even to empower, the macroeconomic role of fiscal policy in stabilizing the economy, within the framework set by the rules.

I wish to emphasize the stabilization role of fiscal policy without forgetting, of course, the classic motivations for fiscal rules. Broadly speaking, fiscal rules are expected to discipline budgetary policymaking and confer credibility. A rich literature has expounded a ubiquitous deficit bias, from informational problems to electoral competition and the tragedy of the commons. Together with unprecedented levels of public indebtedness, this explains the attraction for rules bolstering the commitment to time-consistent policies.

However, while committing to long-run budgetary discipline is the key motivation for fiscal rules, my view is that allowing fiscal policy to help stabilize the economy in the short run is also important.

Achieving this "double act" is the central issue in designing a rules-based framework. Let me emphasize that this is symmetric: good times should be accompanied by tight policies in order to build buffers for the less good times.

There is a view that fiscal rules should only be about forcing fiscal discipline, that is, constraining the deficit bias that policymakers are prone to. This one-sided approach is vulnerable in practice to a double criticism, as we have learned. In real time, some observers will consider the rules too restrictive, while others argue that they are too lax. Indeed, this is precisely what we see in European discussions, where the European Commission's advice on an appropriate fiscal stance is typically met with skepticism running in opposite directions.

The way out of this double bind is to actively make the case that the rules deliver a sensible stance, if not optimal.

Integrating countercyclical properties in fiscal rules is all the more important in the EMU. Countries sharing the euro cannot benefit from tailored monetary policy and nominal exchange rate adjustments in response to asymmetric developments, with fiscal policy remaining the main macroeconomic tool at a national level. Besides, in a more general manner, the experience of the past years has inflected views on the effectiveness of fiscal policy, partially giving it back its earlier Keynesian legitimacy.

Another reason why we need cyclically friendly rules in the euro zone is to avoid putting an excessive burden on monetary policy for managing the overall *policy mix*. This concern has been illuminated in the recent past, when deflationary threats have led the president of the ECB himself (Draghi 2014) to call for a better consideration of the aggregate fiscal stance within the rules of the Stability and Growth Pact. In the absence of a central fiscal capacity, that equates with the sum of country policies.

The important implication is that rules for national budgets cannot be conceived as only forbidding profligate behavior. Again, rules should be conceived also to prescribe, not just proscribe.

In sum, fiscal rules in a currency union should ensure no overburdening of monetary policy both in the long run—thereby avoiding the unpleasant monetary arithmetic (Sargent and Wallace 1981)—and in the short run, by helping deliver an appropriate policy mix in good and bad times while catering for asymmetric shocks.

Prudent Public Debt Objectives as Long-Run Anchors

Expanding on matters of rules design, I wish to also stress the importance of the details. There as well we have learned and continue to learn.

When designing a rules-based fiscal framework, the first step is to establish an operational notion of sustainability that can serve as a long-run anchor.

From this perspective, there is an important discussion to be held on the effective limits to public indebtedness. This debate is being revived in a world presenting features of secular stagnation. That is because in principle, persistent excess private saving could be countered by persistent fiscal expansion, implying a growing stock of public debt that agents are only too happy to buy.

However, economists have generally agreed that keeping public debt at prudent levels is a sensible long-term objective. Indeed, high debt levels are empirically associated with risks of lower growth, intergenerational equity issues, and threats of reaching fiscal limits, as well as compromising the ability to use fiscal policy in downturns.

A significant prerequisite for devising fiscal rules is thus to pin down the order of magnitude of what constitutes prudent debt levels, and this is an important topic for empirical research.

Recent research, however, lends support to the view that several advanced economies have already exceeded the range of prudent indebtedness. This holds true in particular for members of the EMU, where, interestingly, the levels of prudent public indebtedness may be lower insofar as each individual member does not have a native central bank underpinning its public debt exposure (Fall et al. 2015).

Therefore, I think that moving toward moderate levels of public debt as a long-run objective remains a sensible approach for a country participating in the euro area. Accordingly, the achievement of prudent debt levels is and should remain a key anchor of a rules-based framework.

Designing Subtle Rules

We have encountered the issue that rules are exposed as being either too lax or too restrictive, or both, depending on circumstances. This circumstance has led to a quest for smarter rules. For example, the European Commission has recently introduced a matrix that differentiates fiscal policies according to the twin dimensions of sustainability needs and economic conditions (European Commission 2015).

Progress in designing "second-generation" rules also has occurred, if sometimes below the radar screen, though perceivable in experts' discussions. One thing we have learned something about is the choice of operational target, by which I mean a variable that is effectively targeted through annual budgets. Here, the experience is that both debt and deficit objectives raise questions.

Of course, public debt ratios should act as a long-run anchor, as I explained. However, they are too exposed to uncontrollable factors to serve as annual targets. We have seen this firsthand in Europe, where the so-called debt rule has become temporarily unrealistic in an environment of very low nominal GDP growth. This happened despite the sophisticated features embedded in the rule (such as three-year smoothing and cyclical correction).

Yet budget balance rules also suffer significant shortcomings in this regard. Headline balances usually reflect cyclical developments through the working of automatic stabilizers. In principle, the solution is to rely on cyclically adjusted balances, as has long been recognized in the EU framework. But structural deficits are weakened by large measurement uncertainties, especially in level terms, but also to some extent in first differences.

These methodological concerns are truly first-order problems in practice. One implication is that changes in the structural balances cannot be equated with policy-driven impulses. It has become evident, for example, that changes in structural balances have differed by more than 1.5 percent of GDP on average over the past decade in EU countries from a competing measure of the discretionary fiscal effort. These are major gaps when it comes to implementing continued surveillance. Correcting at least partly for these methodological problems is possible, and that is what we often do when implementing the Stability and Growth Pact (such as in the assessment of effective action in the context of the Excessive Deficit Procedure). However, such corrections make the system very complex (more on complexity below).

These empirical features also explain the attraction of rules that use as operational targets a quantum that is more evidently linked to government actions at the frequency of annual budgets, such as expenditure rules in conjunction with a bottom-up assessment of revenue measures.

Putting all these threads together, we see the broad contours of a robust and economically based rule. Such a rule would prescribe a proper notion of the fiscal effort, as just evoked, against the two objectives I have discussed, debt sustainability and cyclical stabilization (Carnot 2014). In practice, such an economically robust rule can be used as a benchmark to evaluate the fiscal stance. For example, it was used to show that in the conditions of a slow recovery and large debt legacy, a close to neutral stance struck an appropriate balance for the euro zone as a whole in 2015, although the distribution across countries could be improved (Buti and Carnot 2015).

Lack of Authority and Complexity Are Hampering a Sound Application of EU Fiscal Framework

Good Design Helps but Doesn't Guarantee Implementation

All this is very well, you might say, but the true weakness with fiscal rules does not lie so much with design as with effective implementation. It is commonly agreed that enforcing the rules is the Achilles' heel of EMU surveillance.

Before going into this issue in more depth, I wish to note that matters of "political ownership" and effective implementation are also partly connected to design issues. Good design, recognized as such, is more conducive to subsequent effective implementation. This is not only because the policy is better but also because it can be more legitimately enforced, by coercive means, if needed, since there is an ex ante broader acceptance by policymakers and the public at large. Conversely, an insufficiently adequate rule will not be implemented, not just because policymakers are sinners but simply because it would really be stupid to insist on it. *Lex mala, lex nulla*.

But while good design is necessary and conducive to implementation, it will not always be sufficient. This is where the topic of rules meets the question of institutions.

Lack of "Authority," Excessive Complexity

In this regard, it is fair to admit that the European fiscal framework suffers from two interlinked issues: an overly complicated set of rules and an insufficient "authority" from the center.

The complexity is most visible not so much in the subtlety of a given rule—that is partly necessary to meet the criterion of adequacy—as in the plurality of rules and subrules. While most federations impose limits on the borrowings of subgovernments, the EU is unique in the number of rules it imposes on member states and in the size of its rule book (Eyraud and Wu 2015).

At the same time, the incomplete authority is seen in the lingering doubts over the ability to effectively impose the discipline of agreed-on rules on recalcitrant member states.

In principle, the rules are enshrined in legal texts, which have to be enforced through a quasi-judicial approach, including with the possible use of financial sanctions. The legal apparatus has been strengthened in recent years as part of EU law, as well as by the Fiscal Compact, the intergovernmental agreement of quasi-constitutional provisions in national legislations.

Yet in practice, the implementation of the Stability and Growth Pact can be seen as closer to a political model of peer pressure. The decisions on fiscal policies essentially reflect a mix of circumstantial judgments and political compromises, far from the mechanical application of fixed norms. This system tends to foster a perception that the application of rules is exposed to a degree of arbitrariness or insufficient consistency of treatment. The perception is also there that the coercive means for enforcing the rules remain incomplete.

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 to call the shots. However, if you suspect that you miss this authority, the temptation is to substitute with additional fine print in the contract. Rules are complemented by subrules and subprovisions to try to take into account all kinds of circumstances, in the hope of increasing predictability and preventing risks of abuse.

This lack of trust, together with incomplete consensus over proper design, seems to be the driving force behind the growing complexity of the EU fiscal framework. An added factor is the incremental nature of changes over the past twenty years (whereby secondary legislation is gradually made "fatter" while primary legislation, enshrined in the Maastricht Treaty, stays unchanged).

However, the "complete contract" approach is far from an ideal or even a viable setting. This is most easily seen by drawing a comparison with modern monetary policy settings.

Reconciling Credibility with Flexibility: The Need for "Institutions"

In the monetary sphere, a double move was apparent some time ago. First the focus was put on rules to address the inflation bias; then the emphasis moved on to institutions.

This occurred as it became clear that even though simple rules, such as the Taylor rule, could offer a reasonably sensible benchmark (other early rules, such as monetary aggregates, were soon dismissed as inadequate), they might not be adequate in each and every circumstance. Institutions, specifically an independent central bank with a clear mandate, have taken the upper role.

Such an arrangement has been understood as a superior way of marrying flexibility and credibility. And indeed, in the fiscal realm too, the case has recently been made by the president of the ECB that fiscal institutions may ultimately offer a superior alternative to fiscal rules when it comes to the EMU governance architecture.

There are two complementary reasons why an institutional center carrying more authority would be useful in the European fiscal framework (Draghi 2015):

- One, as laid out before, is to ensure the full enforcement of the fiscal agreements. The current enforcement gap is what explains the attraction of an authority with the legitimacy and accountability to transcend the national polities.
- The other reason is to allow a move from purely proscribing rules to a more prescriptive approach, where the case is positively made that the recommended policies are economically sound.

Recent initiatives taken by the European Commission have to be seen in this double light. We can see that in particular in the Communication over making the best use of flexibility within the Stability and Growth Pact that the new commission issued earlier this year (European Commission 2015).

From a political angle, the Communication might be seen as a small step toward a more authoritative center. This should be kept in proportion, of course: the European Commission's formal powers remain unchanged. And significant changes toward stronger European institutions would require deep legal (i.e., treaty) changes and more political appetite than is currently encountered in national capitals.

In terms of substance, the Communication takes a number of small steps while not amending the legal rules: it charts a clear differentiation of the fiscal stance according to sustainability risks and cyclical conditions in the preventive arm of the pact. It also makes uses of the existing flexibility to foster investment and structural reforms. This is important to provide incentives for growth-oriented policies, without which public finances cannot be sustained in the long run.

Conclusion

The need for stronger institutions comes from two separate angles in the EMU. One is the possibility of enforcing the common rules; the other is the ability to exert the necessary discretion to depart from the quantitative parameters enshrined in the rules under specific circumstances.

It should be clear from what I have said, however, that I see a complementary relationship between rules and institutions, not a relation of substitutes.

In this regard, the limits to comparing monetary and fiscal settings must also be acknowledged. The sustainability objective cannot be defined as clearly as an inflation mandate. And while the macroeconomic direction of fiscal policy, as opposed to its composition, is not necessarily more redistributive than interest rate policy, parliamentary control of the public finances has always been at the heart of democratic arrangements.

These reasons make it less likely that fiscal policy can be delegated in the same manner as monetary policy has been.

They also mean that pure discretion is less appealing in the fiscal realm, even within a sound institutional framework. Pure discretion, where the policy is determined from scratch at the beginning of each period, would impose too great a risk that the discipline objective would be overlooked in favor of short-term results.

By contrast, a fiscal rule that is referred to on a steady basis will help underwrite consistent policies, even if there is some freedom to depart from the rule on occasions.

In fact, once the proper institutional framework is in place, one would be in a better position to use economically sensible rules as a broad compass. The EU member states could keep it simple by limiting the agreed-upon code to one "rule of thumb" reconciling smartness and simplicity.

I have outlined such a possible robust rule (prescribing a proper idea of the fiscal effort against the two objectives of debt sustainability and cyclical stabilization). This would give a useful benchmark for assessing the fiscal policies and frame the recommendations, while leaving room for judgment in their application.

In a nutshell, a fruitful long-term approach would involve a framework in which a simple and smart rule acts as the basis and permanent anchor for authoritative discretionary policymaking.

Note

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