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Simple Rules for Better Fiscal Policies in Europe

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Proposals to reform the euro area are on the agenda again. An overhaul of the complex set of European fiscal rules should be top priority on this agenda because the fiscal framework in place suffers from clearly identified problems: rules are complex (therefore difficult to internalize for policymakers), pro-cyclical (therefore potentially destabilizing), and noncompliance is the norm (therefore not credible).

THE CURRENT FISCAL FRAMEWORK SUFFERS FROM CLEARLY IDENTIFIED PROBLEMS

Either because countries did not abide by the rules or because the rules were not sufficiently stringent during good years, there was insufficient debt reduction in many countries in the 2000s, and this reduced fiscal capacity during bad years. Consequently, several countries experienced excessive fiscal austerity during the crisis, contributing to the aggravation and prolongment of its consequences. A major drawback of these rules lies in measurement problems. The structural budget balance (the budget balance cleaned from the impact of the economic cycle and one-time budget measures like bank rescue costs), which is the cornerstone of current rules, is a useful theoretical concept but it is not observable and its estimation is subject to massive errors. The typical annual revision in the change of the structural balance is larger than half a percent of GDP, while half a percent of GDP is the baseline fiscal adjustment requirement for countries in breach of EU fiscal rules. Alone, such huge revisions highlight that this indicator is not suitable for policymaking.

The policy mistakes generated by the fiscal rules also led to overburdening the ECB as the main remaining stabilization instrument. The fiscal framework has also put the European Commission in the difficult position of enforcing a highly complex, nontransparent, and error-prone system, exposing it to criticism from countries with both stronger and weaker fiscal fundamentals. The rules are used as a scapegoat by anti-European populists because they are seen as a centralized micro-management that infringes on national sovereignty.

However, in a monetary union like the euro area, arguments exist to justify the existence of fiscal rules and the adoption of a common framework. A specific issue in a monetary union is that governments may not fully internalize the risk of accumulating public debt. The reason is that they (and markets) may expect a bailout in case of difficulties to finance themselves. Indeed, a debt restructuring event accompanied by exit risk may generate financial disruption, contagion to other countries, and collateral damage so large that other members of the eurozone prefer a bailout. This implies that the no bailout rule is not fully credible in the eurozone (see Gourinchas, Martin, and Messer 2019) and this itself is a reason why a fiscal rule that binds all members of the monetary union is necessary.

In addition, expected bailouts may also have reduced market discipline in the sense that the cost of borrowing for some countries may have been too low in the period before the crisis. This may also have reduced the incentive for fiscal prudence, as was the case in Greece in the 2000s. Note, therefore, that debt sustainability, not public deficit per se, should be the core objective in the EMU. Note also that macroprudential rules that limit the vulnerability of financial institutions are a necessary complement to fiscal rules, as we have seen (for example in Ireland and Spain) that bank debts can rapidly be transformed into public debts.

Finally, because countries in a monetary union loose the monetary instrument to stabilize the economy against asymmetric shocks, the fiscal instrument is a key countercyclical policy tool. Hence, fiscal rules in the EMU, more than in countries with independent monetary policy, must play a countercyclical role.

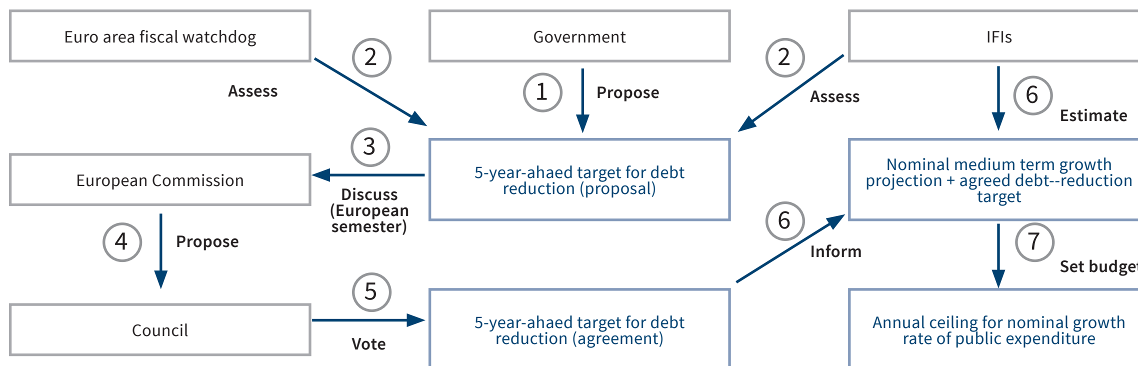
However, fiscal rules are not a silver bullet and cannot substitute the national democratic debate on fiscal choices and debt sustainability. Instead, they should help frame this debate. In particular, it is important that fiscal rules do not impose a low or high permanent level of public spending, or a low or high permanent level of taxation. This should be left to the democratic debate. However, the fiscal rules should be such that the levels of public spending and taxation are consistent and generate a sustainable level of public debt. If we agree on the necessity to change the rules, how should this be done?

HOW TO CHANGE THE RULES?

In a nutshell, fiscal rules should be as transparent as possible, set targets under the direct control of the government, allow countercyclical fiscal policy, and generate incentives to reduce excessive public debt.

The Stability and Growth Pact (SGP), put in place in 1997, clarified and complemented the fiscal criteria and in turn was reformed in 2005, in 2011 (by the so-called “Six-pack”), in 2012 (by the so-called “Fiscal compact”), and in 2013 (by the so-called “Two-pack”). Beyond these legislative acts, the European Commission regularly updates and extends a detailed Code of Conduct and a detailed Vade Mecum, which specify various aspects of the implementation of the fiscal rules. Moreover, academia has proposed a myriad of reforms to European fiscal rules. Budget federalism with “cycli-

Figure 1
Institutional Process of the Expenditure Rule



Source: Authors' illustration.

cal transfers" across states has long been put forward as an efficient way to stabilize the economy in Europe but remains hard to implement politically (see Italianer and Pisani-Ferry 1992). Other proposals include the golden rule for public finance (Truger 2015) inspired by the British rule, where the budget is balanced but leaves public investment to be financed through borrowing. This proposal is appealing because of its good cyclical properties, but opens up the Pandora's box that is the definition of public investment. Several proposals put public debt level as cardinal point for fiscal rules. The long-term target for the public debt level is already included in the European rules since if public debt is higher than 60 percent, it must decline annually by at least 5 percent of the gap between the actual debt level and the 60 percent reference value. However, the 60 percent reference point is ad hoc and should rather take into account country-specific characteristics, such as the initial level of public debt, and could be revised. As pointed out by Teulings (2018), this reference point might be incompatible with the aging population in big eurozone countries (Germany, Italy, Spain) that is likely to lead to higher savings and thus to low interest rates, deflation, and increasing level of public debt.

Contributing to this lively debate, we propose a major overhaul that builds on a recent report from the French Council of Economic Advisors (see Darvas et al. 2018). We recommend substituting the present numerous and complex rules with a new, simple rule focused on limiting the annual growth rate of expenditures. Other economists (Claeys et al. 2016; Benassy-Quéré et al. 2018; Feld et al. 2018) have made similar recommendations and international organizations – such as the IMF – have published positive analyses on such rules (Debrun et al. 2018).

Our expenditure rule requires that nominal expenditures do not grow faster than long-term nominal income, and that they grow at a slower pace in countries with excessive levels of debt. This translates into a two-pillar approach: (1) a long-term target debt level, such as 60 percent of GDP; and (2) an expenditure-based operational rule to achieve the anchor.

The expenditure rule could take the following form: the growth rate of nominal public spending (net of interest payments and of unemployment spending and after properly taking into account public investment) is the sum of real potential growth and expected inflation, minus a debt-brake term that takes into account the difference between the observed debt-to-GDP ratio and its long-term target (which we take to be 60 percent in line with the EU Treaty). The key parameter in this formulation is the speed at which the country converges to its long-term debt target (i.e., the debt-brake parameter). In our simulations of this formula, we found that a public spending rule with a constant and homogenous debt-brake parameter to reach the 60 percent target does not generate realistic fiscal policy recommendations for certain European countries. In countries with debt levels significantly higher than 60 percent of GDP, the necessary initial budgetary effort is unrealistically high if, for example, the debt-brake parameter is chosen to fit France or Germany. By recognizing this limitation, instead of a set-in-stone numerical formula, we recommend an expenditure rule based on a rolling five-year country-specific debt reduction target. Figure 1 illustrates what could be an ad hoc institutional process for the implementation of this rule.

Each year, the government proposes a rolling medium-term (e.g., five-year-ahead) target for reduction in the debt-to-GDP ratio. This could be part of the existing Stability Programme that member states provide each year to the European Commission. Both the national independent fiscal council and the euro area fiscal watchdog are consulted and provide a public assessment of the target in terms of both feasibility and ambition. A discussion follows with the European Commission. The discussion should be based on an economic analysis where the important parameters would be: (1) the gap between the actual debt-to-GDP ratio and the long-term target of 60 percent (the higher the gap, the more ambitious the adjustment); (2) a broader analysis of fiscal sustainability (in particular, to give credit to countries that undertake solvency-improving

entitlement reforms, or major reforms expected to raise potential growth); and (3) an economic analysis of the economic situation and the relevant path of debt reduction. The economic analysis could, for example, take into account the rate at which countries can borrow. As a result, the pace of medium-term debt reduction should not be determined by a formula. Subsequently, the Commission presents its conclusion for the debt reduction targets for each country to the council, which can vote against it by a reverse qualified majority.

The national fiscal council would prepare a medium-term nominal GDP growth projection based on expected potential output growth, expected inflation, and a possible cyclical correction in case initial conditions depart markedly from long-run equilibrium. Given the medium-term target on debt reduction, the national fiscal council provides a consistent medium-term nominal public expenditure path and uses it to set a nominal expenditure ceiling for the coming year for use in the preparation of the corresponding budget.

Nominal expenditures are calculated net of interest payments, of unemployment spending (except when these are due to discretionary changes to unemployment benefits), and of the estimated impact of any new discretionary revenue measures (changes in tax rates and tax bases). The first two adjustments allow for more counter-cyclicality, while excluding the effect of expenditure-increasing structural measures. The last adjustment is meant to preclude the manipulation of tax rules (for example, tax cuts ahead of an election) that are not compensated by offsetting expenditure measures. It also allows elected governments to make fiscal policy choices (implying different but consistent long-term levels of expenditures and taxes) that reflect political preferences.

Limited deviations between actual and budgeted spending could be absorbed by an "adjustment account" that would be credited if expenditures net of discretionary tax cuts run below the expenditure rule, and debited if they exceed it. These types of accounts exist in Germany and Switzerland. If a country passes a budget with no excessive spending, but realized spending is above the target, the overrun could be financed without breach of the rule, provided that the deficit in the adjustment account does not exceed a pre-determined threshold (for instance 1 percent of GDP). If the threshold has been breached, the country violates the fiscal rule.

We show (see also Claeys et al. 2016) that structural budget balance estimates are subject to large revisions, partly due to the uncertain estimates of the output gap. Based on that finding, one might argue that the medium-term potential growth estimates, which are the basis of our proposed expenditure rule, could be also subject to large revisions – but this is not the case. For example, for the EU15 core countries, the typical revision to the medium-term potential growth estimate is about 0.15 percentage points per year. A downward revision of 0.15 percentage points would imply that if in spring 2018 a country is allowed to increase expenditures by 3.0 percent, in spring 2019 the allowed growth rate of expenditures would be revised downward to 2.85 percent per year. Given that public expenditures amount to about half of GDP, a 0.15 percent revision in expenditures implies an impact of 0.075 percent of GDP on the budget balance, which is rather small and well below the impact of revisions in the structural balance!

HOW WOULD SUCH A RULE PERFORM?

We assess the consequences of an application of this expenditure rule through several quantitative simulations by the Observatoire français des conjonctures économiques (OFCE), based on French data (OFCE 2018). The rule itself should not be governed by a simple equation but of course simulations do require a rule to be specified that takes the form:

$$\hat{g}_{i,t} = \hat{y}_{i,t} + E\pi_{i,t} - \gamma_{i,t}\left(d_{i,t} - \bar{d}\right)$$

where the growth rate of government expenditures of country *i* in year *t* should be equal to the long-term growth rate of the economy (estimated in year *t*) *plus* expected inflation in year *t minus* the debt-brake term that takes into account the difference between the observed debt-to-GDP ratio at time t and its long-term target, which we take to be 60 percent. Note that the parameter is key and measures the level of ambition on the speed at which countries should converge the long-term debt-to-GDP ratio. This is itself determined by the 5-year target reduction of the debt-to-GDP ratio. It is easy to check that once the 5-year target reduction of the debt-to-GDP ratio is determined, the parameter is itself set. Once potential growth and expected inflation are determined, the rule-consistent growth rate of expenditures is defined.

Examples of OFCE's simulations of France's debt dynamics and real public expenditures growth rates under three objectives (a -2%, -4%, or -6% decrease in debt over GDP at a five-year horizon) suggest that, depending on the degree of ambition of the 5-year debt reduction target, an expenditure rule can generate debt-reduction dynamics that are similar or less stringent than the present rule. In all cases of the proposed expenditure, the real growth rate of expenditures for France would converge to a bit less than 1 percent (i.e., less than the potential growth rate assumed to be 1.1 percent) but with more front loading of the adjustment in the initial years.

Concerning countercyclical properties for unexpected demand shocks, our rule also performs better. First, the nominal growth rate of expenditures is not affected by the shock, and automatic stabilization is at work due to lower revenues and higher deficits. Second, a negative demand shock generates inflation below expectations. As the growth rate of nomi-

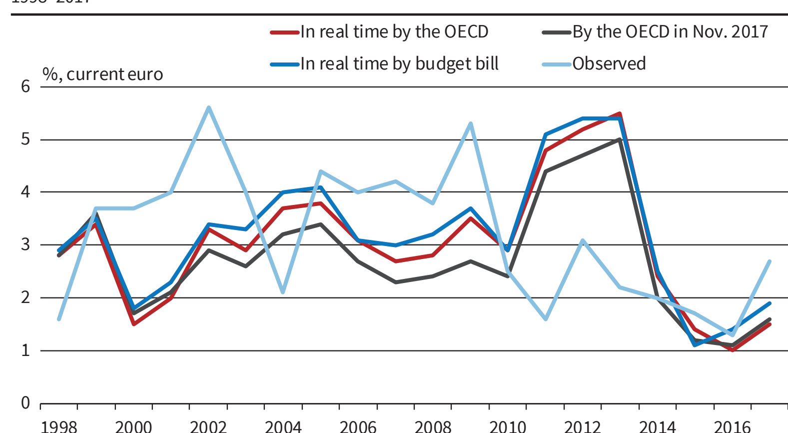
nal public spending is based on expected inflation, such a shock induces a higher real growth rate of public expenditure and therefore a positive fiscal impulse. Concerning supply shocks, such as oil price shocks generating a fall in output and an increase in inflation, the expenditure rule is still stabilizing because it induces a budget deficit, but the higher unexpected inflation slightly reduces its stabilizing properties (relative to the current rule). Overall, if, as is mostly believed, demand shocks are predominant in the euro area, we conclude that the expenditure rule has better cyclical properties than the current rule.

To illustrate the better countercyclical properties of the expenditure rule, Figures 2 and 3 show the observed growth rate of primary public spending in France (in black) and of the fiscal impulse and a counterfactual OFCE simulation of these two series (in color), as generated by an expenditure rule.

Both figures suggest that the rule would be more countercyclical than was observed in France. During good years, the growth rate of public expenditure as well as the fiscal impulse would have been lower; and vice versa, in the period 2011–2013 French fiscal policy would have been more expansionary. Note, however, that in 2009, the rule would have implied what we believe is insufficient fiscal stimulus and this is the reason why we advocate keeping an escape clause in case of exceptional circumstances. This escape clause should be decided at the eurozone level.

Figure 2

Growth Rate of Primary Public Spending in France
1998–2017



Note: Based on the expenditure rule with potential GDP.
Source: Ducoudré et al. (2018).
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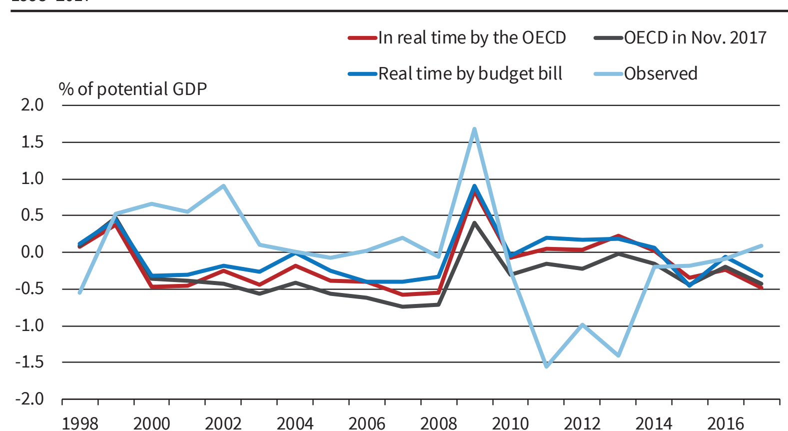
Figure 3

Fiscal Impulse in France
1998–2017



Note: Based on the expenditure rule with potential GDP.
Source: Ducoudré et al. (2018).
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FLEXIBILITY, SIMPLICITY, AND ENFORCEABILITY

Several studies have pointed out a three-dimensional trade-off faced by fiscal rules (Deroose et al. 2018 and Debrun et al. 2018). The three objectives at stake are flexibility, simplicity, and enforceability.

Regarding simplicity, the proposed rule itself is relatively simple with fewer indicators but de facto adds a layer of rules within the existing framework. As explained by Deroose et al. (2018) a large part of the SGP's complexity does not come from each of its provisions taken individually but rather from the sedimentation of rules. Those rules potentially contradict themselves, make it harder to know which rule is binding, and multiply the number of indicators to be measured and taken into account. It is therefore important to think about the compatibility of the expenditure rule with the existing framework and the potential adjustments to be made. For instance, the rule we propose to add does not necessarily comply with the 3 percent deficit threshold. Because we anticipate that the EU Treaty will not change soon, we exclude the first-best option of rewriting the whole set of rules. Alternatively, it is possible to change the Two-Packs and the Six-Packs with co-decision of the council and the European Parliament and to design a "light excessive deficit procedure" when the 3 percent deficit rule is violated but the expenditure rule is obeyed. This would de facto mitigate the importance of the 3 percent rule and limit the complexity linked with additional layers.

Regarding flexibility, the simulations of the expenditure rules show that a common debt target is unrealistic and can lead to bad economic effects (Darvas et al. 2018). Moreover, as explained by Teulings (2018), deeper country-specific heterogeneities (like demography) justify that indebtedness targets could differ from one country to another. This is why the target should be country-specific and commonly decided by the member state at the European level. Given the institutional framework proposed to supervise the rule (described above), this flexibility given to the rule does not imply much complexity and can add to the renationalization of the debate on fiscal rules and hence foster its understanding for the general public. Another dimension of flexibility that should be added to the rule is the introduction of an escape clause. Contrary to the German Council of Economic Experts (Feld et al. 2018), we think that the degree of complexity added by the introduction of an escape clause is justified by the need for fiscal stimulus in time of deep economic crisis, as experienced in 2009. To finish with, the absence of an escape clause risks violation of the rule in times of crisis, which would undermine the credibility of the rule. Thus, the escape clause would indirectly reinforce its enforceability.

Turning to the enforceability of the rule, the European experience suggests that enforcing compliance through penalties imposed by what is seen in many countries as bureaucracy from Brussels or political might from Berlin has major deficiencies. Instead, we advocate for a credible enforcement of fiscal rules, mixing several instruments pertaining to surveillance, positive incentives, market discipline, and increased political cost of non-compliance while renationalizing the debate. The Six-Pack reform in 2011 has formalized the role of Independent Fiscal Institutions (IFI) in the budget process for eurozone countries. Such institutions are central in the supervision of the rule.[1] Independent Fiscal Institutions should therefore see their mandate harmonized across European countries and, if needed, broadened in order to match the criteria pointed out by the OECD, namely, integration into the national budget process (including evaluation of medium-term sustainability of public finances and economic analysis), adequacy of resources with the mandate, access to relevant information, credible communication, impartial stance, and good collaboration with parliament.

One possibility is to relate the enforcement of fiscal rules to the creation of a fiscal capacity for the eurozone. In a sense, this also shifts the mechanism from using sticks to offering carrots. For example, the participation in a fiscal stabilization scheme that offers one-off transfers in case of large downturns could be made conditional on the compliance with fiscal rules. Market discipline should also be part of the package, even if it has not worked well in the past. In the 2000s, markets did not discipline countries that were running imprudent fiscal policies – or imprudent financial policies that generated excessive private leverage. And, during the euro crisis, market discipline overreacted with mechanisms of self-fulfilling expectations where the fear of default and exit were pushing the cost of several countries' financing to levels that were driving them towards default. Steps have already been taken to guide market discipline. For example, the introduction of collective action clauses to government bonds will likely help to avoid the pre-2007 market complacency. A further "stick" would be to increase the political cost of deviating from the fiscal rule, in line with the objective to renationalize the fiscal debates. For example, whenever the national fiscal council concludes that the rule is not respected, it should hold a press conference and the minister of finance should testify in front of the national parliament. When the European Fiscal Council concludes that the deviation from the rule is major, the minister of finance should also testify in front of the European Parliament.

[1] French government forecasts on growth one year ahead have been characterized by an optimistic bias on budget balances (0.36 percentage points of GDP on average between 1996 and 2003) and growth (0.57). Only 7 of these 20 countries have a more optimistic bias on the balance forecast than France. Since 2013 and the creation of the French High Council of Public Finance – Haut-Conseil des finances publiques (HCFP) – these biases have been drastically reduced: the budget balance bias forecast is 0.06 percentage points of GDP and the GDP growth bias forecast is at 0.05 percentage points of GDP. Although it is still too soon to fully assess the role of the French IFI on forecast bias, this suggests that the mere presence of HCFP reduced pressure by the government on the forecast unit of the Treasury to "massage" data so as to provide growth forecasts.

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