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National Fiscal Rules:

A New Paradigm of Fiscal Discipline in EMU

Vito Mosè Pierro

DEPARTMENT OF
EUROPEAN INTERDISCIPLINARY STUDIES

Natolin Best Master Thesis 03 / 2011

To my parents and to little Matteo.
With love.

College of Europe
Collège d'Europe

Brugge

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National Fiscal Rules:

A New Paradigm of Fiscal Discipline in EMU

Vito Mosè Pierro

Supervisor: Professor Benedicta Marzinotto

Thesis presented by Vito Mosè Pierro
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Vito Mosè Pierro

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List of Abbreviations

BBR	Budget Balance Rule
CG	Central Government
DR	Debt Rule
EC	European Commission
ECB	European Central Bank
EMU	Economic and Monetary Union
ER	Expenditure Rule
GG	General Government
LG	Local Government
MTO	Medium-Term Budgetary Objectives
RG	Regional Government
RR	Revenue Rule
SGP	Stability and Growth Pact
SS	Social Security

Abstract

This thesis focuses on the rationale for adopting numerical fiscal rules at the national level aimed to ensure fiscal discipline and foster compliance with European rules in EU Member States. It aims at giving a detailed analysis of the present debate and of the on-going reforms in the EU.

The adoption of numerical fiscal rules at the national level is a relatively recent practice both worldwide and in the context of the European Economic and Monetary Union. For this reason, the theoretical and empirical literature available on the subject remains limited. Nevertheless, it has attracted a growing interest in the aftermath of the recent economic crisis due to the need to restore sound public finances in many advanced economies. This thesis makes extensive use of official documents of the European Institutions and, in particular, of the database developed by the European Commission to map and monitor the existing national fiscal rules in the EU. It also draws on studies and reports of other international organisations, such as the OECD and the IMF. The relevant economic literature is reviewed and analysed to present the debate on the need for fiscal discipline and on the positive influence of numerical rules on countries' fiscal performance.

This thesis offers a general overview of the debate about the need for adopting national fiscal rules in EU Member States aimed to enhance fiscal discipline. It is structured as follows. Chapter 1 introduces the main economic arguments in favour of fiscal discipline and analyses the state of the current debate and of the on-going reforms at the European level. Chapter 2 focuses on the ideal characteristics of numerical fiscal rules. It also discusses whether and, if yes, under what conditions they are effective in improving countries' fiscal performance. Chapter 3 presents relevant data from the European Commission's database. In addition, it analyses the characteristics of the numerical fiscal rule adopted in Germany in 2009 and often proposed as a model for other EU Member States. It then presents some reasons for France to adopt a similar rule in the context of the on-going reform projects of French public finances.

In the aftermath of the recent economic crisis, sound public finances are essential to sustain the recovery and create a growth-friendly economic environment. There is a wide consensus that national fiscal rules effectively contribute to this aim. However, it is a standard assertion of the existing empirical literature that this greatly depends on the characteristics and the overall power of the fiscal rules. Moreover, strong political commitment to fiscal discipline remains a fundamental prerequisite to ensure compliance and avoid misbehaviour. Numerical fiscal rules can be used to bring European public finances onto a sustainable path. They can also strengthen national ownership of the Stability and Growth Pact. However, as their design necessarily involves trade-offs, they cannot be a substitute for political willingness and public opinion's support for maintaining sound budgetary frameworks.

Introduction: The Natolin Best Master Thesis

Prof. Georges Mink
Director of studies
College of Europe (EIS programme, Natolin Campus)
Directeur de Recherche au CNRS (France)

The College of Europe (CoE) was the world's first university institute of postgraduate studies and training specialised in European affairs. Its origins date back to the 1948 Hague Congress. Founded in Bruges (Belgium) in 1949 by leading European figures such as Salvador de Madariaga, Winston Churchill, Paul-Henri Spaak and Alcide de Gasperi, the idea was to establish an institute where university graduates from many different European countries could study and live together. The Natolin campus of the College of Europe in Natolin, Warsaw (Poland) was established in 1992 in response to the revolutions of 1989 and in anticipation of the European Union's 2004 and 2007 enlargements. The College of Europe now operates as 'one College - two campuses'.

The European Interdisciplinary Studies (EIS) programme at the Natolin campus invites students to view the process of European integration beyond disciplinary boundaries and offers them a well-rounded understanding of the European Union. Students are awarded a 'Master of Arts in European Interdisciplinary Studies'. This programme takes into account the idea that European integration goes beyond the limits of one academic discipline and is designed to respond to the increasing need for experts who have a more comprehensive understanding of the European integration process and European affairs.

The EIS programme is open not only to graduates in Economics, Law or Political Science, but also to graduates of History, Communication Studies, Languages, Philosophy, or Philology who are interested in pursuing a career in European institutions or European affairs in general. This academic programme and its professional dimension prepare graduates to enter the international, European and national public sectors as well as non-governmental and private sectors. For many, it also serves as a stepping stone towards doctoral studies. Recognised for its academic excellence in European studies, the Natolin campus of the College of Europe has endeavoured to enhance its research activities. A programme aimed at producing high-quality research on EU internal and external policies in line with the specificities of the EIS academic programme was designed in 2010. This has been joined by the recent creation of two Chairs; the European Parliament Bronislaw Geremek European Civilisation Chair and the European Neighbourhood Policy Chair.

Beyond research and policy-oriented workshops and conferences, a new series of Publications has been created. The first issues were published in 2011, including a series on the EU and the neighbourhood as well as the inaugural "Natolin Best Master Thesis" publications. In order to get their Masters degree all students are required to write a Thesis within the framework of one of the course they follow during the academic year. The research theme chosen by the student or proposed by the Professor supervising the Thesis must be original and linked to European policies and affairs. An interdisciplinary approach is also encouraged. Masters theses are written either in French or in English, the two official languages of the College of Europe, often not the native language of the students. A scientific committee selects the Best Masters Theses among more than 100 produced on the campus every year. By publishing them, we are proud to disseminate some of the most interesting research produced by our students throughout the wider European studies academic community.

Preface of the Master Thesis Supervisor

Dr. Benedicta Marzinotto
Part-time Professor
College of Europe, Natolin Campus, Warsaw

The thesis of Mr Vito Mosè Pierro deals with the role of national fiscal rules in the Economic and Monetary Union (EMU), where special attention is devoted to the context of the European debt crisis. As a matter of fact, whilst the EU has always been concerned with the relative strength of national fiscal frameworks, the European debt crisis that started in 2009-2010 reopened the debate about the need to create the conditions for fiscal discipline at home and not only at the EU level. Such a position followed from the evident demise of the Stability Pact in ensuring discipline across the euro area.

The debate on the pros and cons of different types of fiscal rules and the extent to which each of them contributes to fiscal discipline was still open at the time of writing, and still is. Moreover, the EU was still in the process of approving the new governance package known as six-pack, which contains a new directive on national fiscal frameworks. Since then, the EU has not only eventually approved the six-pack but also embraced the idea of a Fiscal Compact, for which the contracting parties are obliged to adopt a domestic balanced-budget rule, which needs have a strong statutory. Against this background, there is no doubt that this thesis deals with a research question that is relevant theoretically, empirically and also politically.

The first part of the report nicely summarises the economics and political economy literature that has looked at the role of fiscal policy in monetary unions providing a number of arguments in defense of the idea that fiscal discipline contributes to the proper functioning of EMU. This is followed by a review of the institutional context and of the fiscal governance reforms that were discussed in reaction to the debt crisis.

The second part describes national fiscal frameworks, a term used to indicate dimensions of fiscal institutions and regimes ranging from fiscal rules to the relative independence of fiscal institutions, the extent to which budgetary procedures are sound and transparent, and the existence and relative strength of medium-term budgetary frameworks (MTBFs). The thesis focuses specifically on national fiscal rules. It provides a useful classification of all the existing numerical fiscal rules from balanced budgets, to debt, expenditure and revenue rules and a discussion of their advanatages and disadavantages, based on an analysis of the existing literature.

There is scarce empirical evidence on the relationship between numerical fiscal rules and fiscal performance and the results are generally ambiguous. The central problem each rule faces is well summarised in the trade-off between credibility and flexibility. Strict rules that bind governments to fiscal discipline in the years to come tend to be more credible than softer rules, but do not allow for the degree of flexibility that is often required to make the best of a fiscal rule. An important disadvantage is the fact that the rule may act in a pro-cyclical fashion by imposing austerity in bad times – when budget outcomes always deteriorate due to the operation of the automatic stabilisers -, whilst not providing incentive for consolidation in good times. On the issue of the so-called the pro-cyclicality of fiscal rules, Mr Vito Mosè Pierro concludes: „*the rules with the more procyclical effects are overall balanced budget rules and debt rules. Cyclically adjusted …balance rules allow automatic stabilisers to function, but they limit discretionary fiscal policies. Over the cycle balance rules allow both automatic and discretionary interventions. Finally, primary balance rules do not require fiscal response to variations of the interest and exchange rates*".

Special attention is devoted to the balanced budget rule, which has always been part of the Stability Pact and is now at the core of the Fiscal Compact's provisions. The empirical literature suggests that the adoption of such a rule tends to be associated with long-lasting consolidation efforts, especially if it has particularly strong features, such as being part of a country's Constitution. At the same time, a rigid balanced budget rule with a strong legal base (i.e. constitutional legal basis) certainly suffers from a procyclical bias, as it was often demonstrated on the example of the Stability Pact.

Independently of the nature of the fiscal rule, the general consensus is however that the adoption of numerical targets tends to improve a country's fiscal performance, above and beyond the risks associated with procyclicality. Besides the advantage of being able to deliver fiscal discipline at home, a national fiscal rule has also the merit of augmenting national ownership of the EU Stability Pact. The author persuasively concludes that such rules cannot, in any case, be a substitute for political willingness and public support.

The third and final part of the thesis is devoted to an assessment of numerical fiscal rules in EMU. This section provides interesting data from the European Commission on the success of fiscal rules in Europe, which have rapidly increased from 1990 onwards. It also discusses in detail the most recent fiscal governance reforms in EU countries, specifying the type of rule adpted, the definition, and the level of government where it was applied. Special attention is devoted to the German „debt brake". This rule is de facto a balanced budget rule that adopts the idea of having a structural balance close to zero already contained in the Stability Pact. It benefits from some degree of flexibility as it foresees derogation under exceptional circumstances, which is a feature that the rule also shares with the Stability Pact including its latest six-pack version. On the other side, the rule targets the structural balance, which requires an assessment of the output gap, an exercise that is not free of potential problems and ambiguities. The German reform process is then compared with equivalent measures in France. The author recommends that France adopts a rule as similar as possible to the German one.

The thesis makes very interesting reading covering the economics of monetary unions, the role of institutions in macroeconomic management and the reform climate in the midst of the European debt crisis.

Introduction

'It is best to prepare for the days of necessity.'
Aesop, The ant and the grasshopper

Public finances in the EU have been strongly affected by the recent economic crisis. According to Eurostat, public deficit in the whole euro area increased from 0.7% of GDP in 2007 to 6.3% in 2009, while public debt increased from 66.2% to 79.3% over the same period. In 2010, the former amounted to 6%, while the latter further increased up to 85.1% of GDP.[1] [2] This is the result of the full operation of automatic stabilisers and of the extraordinary fiscal policy measures adopted during the crisis to sustain the economy and relieve the intense social strain caused by the recession. Indeed, the euro area aggregate GDP decreased by 5.3% during the crisis and the unemployment rate increased by 2 percentage points, amounting to 10% on average in 2010.[3]

Even though the European Economic Recovery Plan approved by the European Council in December 2008 represented an attempt at economic policy coordination at the European level, fiscal responses to the crisis varied according to the specific circumstances of the country concerned.[4] Consequently the fiscal performance of EU Member States varied widely, both throughout the crisis and in the ensuing recovery. According to Eurostat data, in 2010 the Swedish budget was in balance and Estonia even accumulated a slight surplus. On the other hand, countries like Luxembourg, Denmark and Finland recorded a deficit level between 2% or 3% in the same year, while Ireland, Greece, the UK, Spain and Portugal presented the highest deficit ratios. Greece, Italy, Belgium, Ireland and Portugal were the countries with the highest public debt.[5]

The negative consequences of the crisis and the past track record of poor growth, lack of structural reforms, mismanagement of public finances, as well as unsustainable imbalances in the private sector severely weakened the fiscal position of some countries in the aftermath of the crisis. As a result, continuous distress on financial markets since the end of 2009 pushed Greece, Ireland and Portugal so far as to ask for financial assistance.

---

1 Eurostat, *Euro area and EU27 government deficit at 6.0% and 6.4% of GDP respectively*, News release No. 60/2011, 26 April 2011. Available at: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF (Consulted on 30.04.2011).

2 EU27 government deficit amounted to 6.4% and public debt to 80% of GDP in 2010.

3 OECD, *OECD Economic Surveys: Euro Area 2010*, OECD Publishing, 2010.

4 EC, *Public Finances in EMU - 2010*, European Economy, No. 4, European Commission, Brussels, 2010.

5 Eurostat, *op. cit.*, note 1.

Meanwhile, projects to reform the present institutional architecture of the euro area have been intensively discussed at the European level in order to guarantee the sustainability of European public finances in the future, without harming the recovery.

Table 1 Public deficits and debts in EU countries in 2010 (% of GDP).

AT	BE	BG	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HU
-4.6	-4.1	-3,2	-5.3	-4.7	-3.3	-2.7	0.1	-10.5	-9.2	-2.5	-7.0	-4.2
72.3	96.8	16.2	60.8	38.5	83.2	43.6	6.6	142.8	60.1	38.4	81.7	80.2

IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK	UK
-32.4	-4.6	-7.1	-1.7	-7.7	-3.6	-5.4	-7.9	-9.1	-6.4	0.0	-5.6	-7.9	-10.4
96.2	119.0	38.2	18.4	44.7	68.0	62.7	55.0	93.0	30.8	39.8	38.0	41.0	80.0

Source: *Eurostat*.

The on-going reforms aim at strengthening the existing mechanisms, which have not properly functioned in the past, while at the same time new instruments are envisaged to tackle the problems highlighted by the crisis, to enhance economic policy coordination and enforce compliance with the European objectives. To this end, some of the initiatives devised at the European level include: the European Semester, a surveillance mechanism to monitor and detect potentially unsustainable macroeconomic imbalances, the reform of the Stability and Growth Pact, the Euro Plus Pact, as well as the Europe 2020 strategy, the launch of a new Single Market programme, the permanent establishment of the European Stability Mechanism and the reforms of the banking sector and its supervisory authorities.

In this context, the implementation of sound national fiscal frameworks has acquired further importance. The unsustainable path of European public finances calls for enhanced fiscal discipline, but simple strengthening the European mechanisms may prove insufficient to achieve this outcome as EU Member States remain largely sovereign in the fiscal domain. Stronger national ownership of the European rules is thus considered essential to foster compliance and implement virtuous fiscal behaviour.[6]

National fiscal frameworks as defined in European jargon include: national fiscal rules, independent fiscal institutions, sound and transparent budgetary procedures, and medium-term budgetary frameworks.[7] This thesis analyses the role of national fiscal rules in the present and future architecture of European economic governance. It aims at drawing a

6 Charles Wyplosz, 'The Eurozone's levitation', *voxeu.org*, 17 June 2010. Available at: http://www.voxeu.org/index.php?q=node/5178 (Consulted on 15.4.2011).

7 EC, *op. cit.*, note 4.

wide picture of the complex issues at stake. Indeed, on the one hand, there seems to be a broad political consensus on the fact that adopting strong fiscal rules at the national level helps countries to maintain sound and sustainable public finances. On the other hand, the economic debate in this domain remains limited, while supportive empirical evidence is fairly mixed. This thesis aims to explore this debate to better understand whether the on-going reforms to strengthen national fiscal frameworks, and in particular, fiscal rules adopted at the national level, have the potential to help EU Member States improve their public finances and restore a growth-friendly economic environment.

The thesis is structured as follows. Chapter 1 sets the ground for the analysis. It focuses on the need for fiscal discipline, presenting the main economic arguments debated in the literature. It then moves on to an analysis of the on-going reforms and of the different proposals discussed at the European level, in order to revise the state of play and foresee possible future developments. Chapter 2 focuses in more detail on the economics of national fiscal rules. It presents the relevant terminology, the ideal characteristics of fiscal rules and the debate on their effectiveness. Chapter 3 presents some data on the national fiscal rules presently in force in Europe. It also discusses, as a case study, the characteristics of the fiscal rule adopted in Germany in 2009 and possible reasons to adopt a similar rule in France.

Post Scriptum. Since the submission of this thesis in May 2011, the unfolding events of the sovereign debt crisis in the euro area have radically changed the political and economic scenario underpinning the debate about numerical fiscal rules at the national level. Major government changes in a significant number of EU Member States, the radicalisation of the debate 'fiscal discipline vs. growth-enhancing policies', the continued volatility in the financial markets and a fundamental questioning of the reasons and sense of the European project and the role of the Economic and Monetary Union, have shaped the policy response to the crisis both at the EU and the national level. A long series of policy initiatives have been adopted in recent months. At present, the EU seems to be slowly moving towards further economic and political integration, in spite of the need for reconciling the multiple centrifugal forces which this process entails. This renders the description of the institutional reforms in the following pages essentially outdated. An in-depth re-writing would be needed to take into account the recent political, economic and institutional developments. Nevertheless, it is the author's conviction that this exercise would not affect the fundamental conclusion of the analysis, namely that national fiscal rules are an effective tool to maintain sound public finances, but their design and implementation involve significant trade-offs. As a result, strong political commitment and wide public support for fiscal discipline are essential for numerical fiscal rules to fully deploy their effectiveness. (July 2012)

Chapter 1. Fiscal Discipline in EMU: Theory and Practice

The rationale for the adoption of numerical fiscal rules to constrain fiscal policy both within and outside a monetary union is closely linked to the economic debate about the enhanced effectiveness of macroeconomic policies subject to rules, as compared to discretionary policies. This has been a long-lasting debate in economics that assumed a renewed importance in the run up to EMU as regards the design of the institutional architecture of the European economic governance. The recent economic crisis has drawn further attention to this issue.

The aim of this chapter is to briefly discuss the main arguments in favour of fiscal discipline, as highlighted in the economic literature. We will then focus on the present institutional set-up and on the on-going reforms of the European economic governance to analyse when the idea to introduce numerical fiscal rules at the national level was first put forward and how it has gained consensus over time.

1.1 The need for fiscal discipline in EMU

The effectiveness of demand management policies and the need for fiscal discipline represent a classic object of debate in economic literature. The deterioration of public finances in developed countries starting from the early 1970's has highlighted the importance of rules and constraints to limit the discretionary powers of fiscal authorities.[8] In fact, high deficits and rising public debts showed that governments may demonstrate a 'deficit bias', as much as monetary policy authorities are inflation-biased. Consequently, there have been efforts to implement a consistent rules-based institutional framework for both monetary and fiscal policy. However, while the recognition of the Central Bank's independence and the adoption of inflation-targeting regimes have been successful in ensuring monetary discipline and reducing the inflation bias, this has been less feasible

8 Mahmohan S. Kumar and Teresa Ter-Minassian (eds), *Promoting fiscal discipline,* IMF, Washington DC, 2007.

for fiscal policy. There are in fact a number of important differences between these two instruments of political economy, both from an economic and political viewpoint. For example, fiscal policy is relatively less effective in stabilising the output than monetary policy, while it has stronger redistributive effects so that a more stringent democratic control is needed.[9]

Moreover, a traditional divide distinguishes economists in terms of how they analyse economic aggregates and suggest policy recommendations. While Keynesians believe that fiscal and monetary policy is essential to stabilise short-term fluctuations of the business cycle and bring the aggregate output to its long-run potential; neoclassical economists emphasise how this might be not only impossible, but also undesirable. In the following sections, we will briefly discuss some of these arguments.[10]

Firstly, the effectiveness of the fiscal policy response designed to face economic shocks may be negatively affected by a number of policy lags. This is also the case for monetary policy, but in a less evident way. Indeed, it takes time for policy-makers to correctly identify the shocks (recognition lag) and devise the policy response needed (decision lag). It takes even more time to implement it and make it produce the desired effects (implementation and effectiveness lags). As a result, macroeconomic policies may worsen the economic cycle and have pro-cyclical effects, instead of stabilising it. As this has adverse effects on savings and investments and it eventually harms economic growth, the monetarist view suggests that policy-makers should refrain from actively intervening in the economy and allow only automatic stabilisers to operate.[11]

Secondly, fiscal policy may be ineffective because of the Ricardian equivalence. If economic agents are rational, forward-looking and have unlimited access to credit, they internalise the public sector budget constraint: in other words, they recognise that when governments acquire additional financial resources via an increased public debt, this does not affect the country's overall wealth, as debt has to be financed by imposing higher taxes either today or tomorrow. If this is the case, an expansionary fiscal policy

9 Charles Wyplosz, 'Fiscal Policy: Institutions Versus Rules', in *National Institute Economic Review*, Vol. 191, No. 1, 2005, pp. 64-78.

10 It will appear evident that some of the arguments presented in this paragraph openly contradict each other as they make use of different assumptions and have different perspectives on the behaviour of economic agents and on the functioning of the economy along different time horizons. However, since the purpose here is to recall the theoretical framework justifying the need for fiscal discipline, we will only present the different existing theories, leaving the discussion on their validity and reciprocal consistency out.

11 Michael Burda and Charles Wyplosz, *Macroeconomics – A European Text* (5th edition), Oxford University Press, Oxford, 2009.

which reduces the tax rate fails to stimulate the economy, as private economic agents will not spend more, anticipating the need for financial resources to face the future higher taxation.[12] Although there is wide consensus that the underlying hypothesis of this theory is hard to verify in practise, empirical evidence shows that some offset effects can still occur and limit the effectiveness of discretionary policy.[13] A similar argument states that fiscal consolidation efforts do not necessarily depress the economy, as the so-called non-Keynesian effects are likely to occur. Bringing public finances on a sustainable path may in fact restore the confidence of private agents and push them to increase consumption.[14]

Moreover, if over expansionary fiscal policies push public debt onto an unsustainable trend, subsequent stabilisation efforts entail high costs both from an economic and political point of view. Indeed, given a certain GDP growth rate, there are no other ways to stabilise public debt than by reducing deficit or declaring default, either repudiating the debt vis-à-vis creditors (outright default) or reducing the value of the debt via surprise inflation and devaluation (implicit default).[15] In any case, these measures are very costly, in terms of political support, high and growth-damaging inflation, as well as reputation.[16] For example, it is difficult for politicians to make voters accept credible fiscal consolidation plans, which often require tough austerity measures. Moreover, countries may find it difficult to further borrow on the international markets after a default. In case of advanced financial integration, there may also be negative consequences for the stability of foreign banking sectors.[17]

For all these reasons, fiscal discipline should be preferred to the active use of fiscal policy. Moreover, rules are also invoked because policy-makers seem to be deficit-biased in the conduct of fiscal policy. Indeed, there is not only the risk that fiscal policy is ineffective, but that it is also misused. Governments in fact tend to over increase public spending

12 *Ibid.*

13 Oliver Röhn, 'New Evidence on the Private Saving Offset and Ricardian Equivalence', *OECD Economics Department Working Papers*, No. 762, OECD Publishing, 2010.

14 See for example: Alberto Alesina and Silvia Ardagna, 'Tales of Fiscal Adjustment', in *Economic Policy*, Vol. 13, Issue 27, 1998, pp. 487-545.

15 Paul De Grauwe, *Economics of Monetary Union* (8th edition), Oxford University Press, Oxford, 2009.

16 Michael Burda and Charles Wyplosz, *op. cit.*, note 11.

17 This is for example the main reason why debt restructuring in Ireland and Greece has been firmly opposed so far at the European level.
See: Charles Wyplosz, 'Et de trois ! Le Portugal suit le mouvement', *telos-eu.com*, 7 April 2011. Available at: http://www.telos-eu.com/fr/article/et-de-trois-le-portugal-suit-le-mouvement
(Consulted on 15.4.2011).

during recessions, while failing to retrench in good times. Political economists have identified two main arguments to explain this problem, both of which advocate the imposition of constraints on fiscal policy: governments' myopia and the common pool problem.

The first argument claims that governments are driven by short-term concerns, as they try to increase public support in the expectation of incoming elections. Thus, governments increase public spending or delay fiscal consolidation, because they disregard the consequences of their actions in the long run. Indeed, given the constraints imposed by the political cycle, this is an efficient strategy to grasp short-term political advantages and increase their chances to be re-elected, while imposing at the same time the costs of their actions on future governments.[18] Moving in the opposite direction from the Ricardian equivalence, the political business cycle theory thus suggests that voters fail to understand the inter-temporal public budget constraint and reward with their vote the governments that use public resources to their benefit.[19] Moreover, like all principal-agent relationships, there is also the risk that politicians use the budgetary powers they are endowed with in their own interests, rather than pursuing common public goals.[20]

A similar reasoning closely follows the argument explaining the inflation bias of monetary policy authorities and their time-inconsistent behaviour towards higher inflation. It has been argued in fact that if policy makers are left with a high margin of discretion in the conduct of fiscal policy, they have a strong incentive to divert from optimal policy paths agreed *ex ante*. For example, although there might be a general consensus on the need to put aside revenue windfalls collected in good times to use them in bad times, it is difficult for governments which face liquidity constraints to *ex post* resist the temptation of making use of these increased resources as soon as they become available.[21] Therefore, an effective way to reduce this risk is to externally constrain the behaviour of policy makers with the adoption of formal rules.

The second argument used to explain policy makers' deficit bias is a classic example of the externalities involved in the use of public goods. The common pool problem resides in the fact that those benefiting from public policies are only part of the wider

18 See for example: Alberto Alesina and Guido Tabellini, 'A Positive Theory of Fiscal Deficits and Government Debt', in *Review of Economic Studies*, Vol. 57, Issue 191, 1990, pp. 403-414.

19 Mahmohan S. Kumar and Teresa Ter-Minassian (eds), *op. cit.*, note 8.

20 Jürgen von Hagen, 'Fiscal Rules, Fiscal Institutions, and Fiscal Performance', in *The Economic and Social Review*, Vol. 33, No. 3, 2002, pp. 263-284.

21 See: Xavier Debrun, David Hauner and Manmohan S. Kumar, 'Independent Fiscal Agencies', in *Journal of Economic Surveys*, Vol. 23, No. 1, 2009, pp. 44-81.

and more dispersed group of taxpayers who finance them. Because politicians often represent the interests of these smaller but better organised groups and constituencies, they overestimate the benefits of their policies and disregard the costs which are spread on the whole society. Moreover, as the interests of future tax payers are generally not represented, the future costs of present policies are further underestimated. As a result, policy makers have a distorted incentive to increase public spending in a suboptimal fashion.[22] It has been also proven that the more dispersed and fragmented the society is, the bigger the common pool problem gets, and the more important the deficit bias becomes.[23]

Government's myopia and the common pool problem present two possible explanations for the tendency of policy makers to misuse fiscal policy. Further arguments in favour of fiscal discipline have been advanced in the EMU context, with the aim of avoiding eventual negative externalities. In fact, in a monetary union, countries with extremely high levels of public debt and poor fiscal records may negatively affect other Member States. The theory has identified two different ways in which these negative spillovers operate.

Firstly, according to the standard macroeconomic textbook model, increasing public spending in one country may drive the common interest rate upwards. However, this argument has been extensively criticised in the literature and is scarcely supported by the empirical evidence. In fact, the increase of the common interest rate is unlikely, provided that capital markets are efficient. Indeed, financial markets should be able to discriminate against borrowers and charge a higher risk premium only on the government bonds of the undisciplined country. On the contrary, those countries with a low risk profile will remain unaffected.[24] This is indeed exactly what has happened in Europe to interest rate differentials on long-term government bonds since 2008. According to their different risk profile, South European countries have been charged a different interest rate on their bonds compared to Germany, so that, for instance, the credit spreads on Greek bonds amounted to 9.52%, immediately before the approval of the EU-IMF financial assistance package on 9 May 2010.[25]

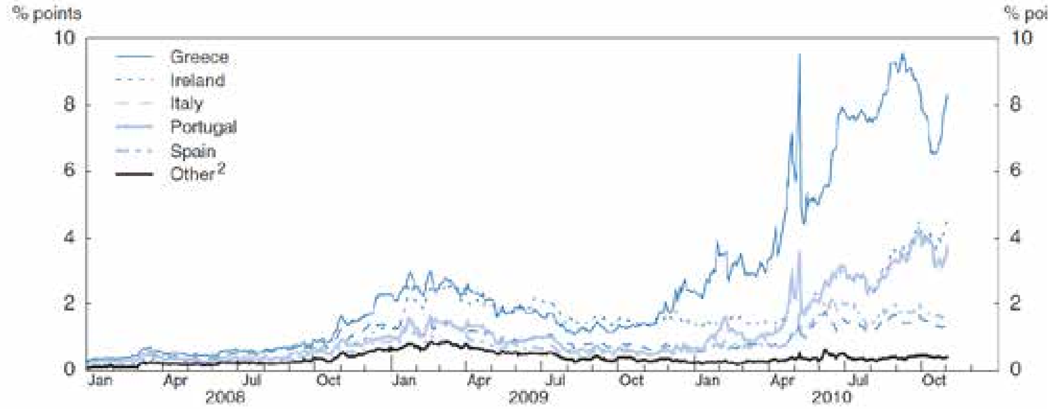
22 Jürgen von Hagen, *op. cit.*, note 20.

23 For an overview of the relevant literature on the topic, see for example: Xavier Debrun *et al.*, 'Tied to the mast? National fiscal rules in the European Union', in *Economic Policy*, Vol. 23, No. 54, 2008, pp. 297–362.

24 Charles Wyplosz, 'European Monetary Union: the Dark Sides of a Major Success', in *Economic Policy*, Vol. 21, Issue 46, 2006, pp. 207-261.

25 OECD, *op. cit.*, note 3.

Figure 1 Credit spreads[1] of some EU countries (2008-2010).



1. Benchmark bond 10-year over German bond yields.
2. Unweighted average of the spreads for Austria, Belgium, Finland, France and the Netherlands.

Source: OECD, *OECD Economic Surveys: Euro Area 2010*, OECD Publishing, p. 89.

Secondly, fiscal indiscipline may also become a source of inflation as it will increase the political pressure on the common central bank to accommodate monetary policy. As a result, it may threaten the independence of the ECB.[26] In any case, successfully constraining discretionary fiscal policies and ensuring fiscal discipline with the adoption of fiscal rules both contribute to the stability of the whole monetary union.

The need to impose fiscal discipline in a monetary union finally rests on a moral hazard argument. Joining a monetary union seems to reduce the incentive for discipline and thus requires the imposition of rules.[27] In fact, if a country defaults on its debt, there may be a risk of contagion. Thus, to avoid it, the other member countries of the currency union may agree to bail-out the undisciplined country in order to avoid further major negative consequences for their economies. The existence of this possibility distorts the incentives for discipline and encourages free-riding behaviours. Indeed, to avoid this, the Maastricht Treaty introduced a no bail-out clause (now article 125, TFUE), stating the principle of individual fiscal policy responsibility.[28] Nevertheless, both the credibility

26 Jürgen von Hagen and Charles Wyplosz, 'EMU's decentralized system of fiscal policy', in Marco Buti *et al.* (eds), *The Euro – The First Decade*, Cambridge University Press, Cambridge, 2010, pp. 415-444.

27 Indeed, this is highly controversial. On the one hand, as already explained, being part of a monetary union, countries may enjoy lower risk premia for default and devaluation. On the other hand, losing the possibility of creating money and autonomously financing debts, they also face harder budget constraints compared to the countries that keep full control over their currency and can influence their national central bank. Which of the two effects prevail in practice is unclear and arguments in both directions have been proposed.
See also: Paul De Grauwe, *op. cit.*, note 15.

28 '*The Union [...and] a Member State shall not be liable for or assume the commitments of central*

of this clause and its practical application remain questionable, especially in the light of the recent crisis and the establishment of European Stability Mechanism.[29]

1.2 Fiscal discipline in EMU: present institutional set-up and on-going reforms.

For all the different aforementioned reasons, there are valid arguments for countries within the EMU to maintain sound public finances, as fiscal profligacy entails high political and economic costs. The recent economic crisis in the euro area provides a further example substantiating such need. The adoption of fiscal rules could be an effective way to ensure discipline. In the following sections we will discuss how this problem was originally addressed in the EMU. It is not our aim to present here the institutional architecture of the European economic governance in detail. However, it might be useful to recall some of its features and the on-going reform projects. We will focus in particular on the proposals to introduce numerical fiscal rules at the national level in order to strengthen the European economic framework.

Fiscal policy in the EMU remains a national competence. However, article 121, TFUE provides for an overall framework of coordination at the European level, stating that '*Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council.*'[30] Economic policy coordination thus occurs via a wide array of instruments, ranging from the Stability and Growth Pact to the role played by the Eurogroup, and the Broad Economic Policy Guidelines.

The SGP represents the cornerstone of these mechanisms. It was signed in 1997 in response to German concerns with the aim to extend the validity of the convergence requirements laid down in the Maastricht Treaty (now article 126, TFUE and Protocol no. 12) after the entry into the third phase of the EMU. It consists of a series of Council regulations in two parts: a preventive arm aimed at strengthening the fiscal discipline at the national level via information exchanges and peer pressure at the European level;

governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.' (Article 125, TFUE).

29 Charles Wyplosz, 'European Stabilisation Mechanism: Promises, realities and principles', *voxeu.org*, 12 May 2010. Available at: http://www.voxeu.org/index.php?q=node/5031 (Consulted on 3.4.2011).

30 Article 121, TFUE.

and a corrective arm designed to put increasing pressure on the deviating country to return to discipline, up to the imposition of sanctions.[31]

The adoption of the SGP and the political and economic rationale for the deficit and debt limits it sets have become the object of a lively debate on its effectiveness and on the existence of possible drawbacks.[32] Notwithstanding the limits highlighted in this debate, the actual effectiveness of the SGP has also been questioned in practice. After the Irish opposition to the Council decision in 2001 and the decision not to fine France and Germany despite their non-compliance with the deficit limits in 2003, the SGP was reformed in 2005 following a judgement by the European Court of Justice.[33]

During this reform process, the need to strengthen the ownership of the European fiscal rules was first put forward in the *Sapir Report*.[34] The report stressed the importance of the macroeconomic policy frameworks at the national level. It thus proposed to improve budgetary coordination at the European level via the establishment of a European Semester, as well as to strengthen national fiscal responsibility and enhance transparency via the establishment of independent fiscal councils, i.e. Fiscal Auditing Boards in charge of monitoring and auditing national budgets.[35]

The importance of strengthening the domestic budgetary frameworks was further elaborated in the *Report on the SGP* approved by the European Council on 22 March 2005.[36] The report stressed the importance of national rules and institutions to enforce compliance with SGP targets, strengthen national ownership, enhance enforcement and foster coordination of economic policies in the EU.[37] Following these recommendations, the European Commission has conducted extensive research on the topic, preparing different surveys with the aim of evaluating national fiscal frameworks in EU Member

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31 See: Kenneth Dyson and Lucia Quaglia (eds), *European Economic Governance and Policies – Commentary on Key Policy Documents*, Volume II, Oxford University Press, Oxford, 2010.

32 See for example: Barry Eichengreen and Charles Wyplosz, 'The Stability Pact: more than a minor nuisance?', in *Economic Policy*, Vol. 13, Issue 26, 1998, pp. 65-104.

33 See for example: Dermot Hodson, 'Economic and Monetary Union', in Helen Wallace, Mark Pollack and Alasdair Young, *Policy-making in the European Union* (6th edition), Oxford University Press, Oxford, 2010, pp. 157-180.

34 André Sapir *et al.*, *An Agenda for a Growing Europe: Making the EU Economic System Deliver*, July 2003, p. 143. Available at: http://www.euractiv.com/ndbtext/innovation/sapirreport.pdf (Consulted on 10.4.2011).

35 *Ibid.*

36 European Council, *Conclusions of the European Council (22-23 March 2005)*, 7619/1/05 REV 1, 23 March 2005, p. 25.

37 *Ibid.*

States and of monitoring *inter alia* the existence and level of enforcement of numerical fiscal rules at the national level. Chapter 3 will present further details on the content and main results of these surveys.

The outbreak of the recent financial and economic crisis and the adoption of an extraordinarily large fiscal stimulus have refocused public attention on the solidity of public finances in the EU. Since the *Council conclusions on Fiscal exit strategy* adopted on 20 October 2009,[38] a renewed consensus has also emerged at the European level on the importance of strong and resilient domestic fiscal frameworks. National fiscal frameworks are considered essential to enhance the on-going fiscal consolidation efforts and guarantee the long-run sustainability of European public finances.[39]

Following the Greek crisis in the first half of 2010, the European Commission has proposed a series of reforms to strengthen the economic governance of the European Union. In particular, the European Commission adopted two communications on 12 May and 30 June 2010 on economic policy coordination and proposed a package of six legislative proposals on 29 September 2010.[40]

Communication No. 250 on *Reinforcing economic policy coordination* requires the reinforcement of the SGP, the full implementation of the Europe 2020 strategy to tackle macroeconomic imbalances, and further coordination of national budgetary procedures with the launch of the European Semester, as well as the implementation of the financial stability mechanism to provide the necessary liquidity to the countries with borrowing difficulties on the financial markets. Indeed, the Communication was issued after the adoption of the first measures for financial assistance to Greece. The Communication particularly focuses on the need for national fiscal frameworks to sustain compliance with the European fiscal targets and ensure discipline, making use of national legally binding instruments, to respect the obligations set out in Protocol 12.[41]

These elements are further elaborated in Communication No. 367 on *Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU*

38 Council of the EU, *Council Conclusions on Fiscal Exit Strategy*, 14765/09, 20 October 2009, p. 3

39 *Ibid.*

40 EC, DG Economic and Financial Affairs website. Available at: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm (Consulted on 15.4.2011).

41 EC, *Reinforcing economic policy coordination*, COM(2010) 250, 12 May 2010. See also: EC, *Mastering economic interdependence: Commission proposes reinforced economic governance in the EU*, Press Release, IP/10/561, 12 May 2010. Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/561 (Consulted on 3.4.2011)

economic governance.[42] The European Commission focuses again on the need for greater coordination via the European Semester, on the reforms needed to reinforce the SGP and on the establishment of a European mechanism to monitor macroeconomic imbalances.

The importance of sound national fiscal frameworks is reemphasised. Indeed, the European Council further underlined on 17 June 2010 the need for all Member States to have national fiscal rules.[43] Allowing for national differences, Communication No. 367 highlights the importance of adopting consistent and quality-proved accounting standards, of implementing multiannual budgetary procedures, and providing comprehensive budgets at all levels of government. It also states the need to adopt national fiscal rules in compliance with the obligations specified in the Treaties and the Medium-Term Budgetary Objectives. However, adoption and enforcement is left at the national level.[44]

Following these two Communications, the European Commission issued a legislative package of six directive proposals aimed at enhancing fiscal coordination and discipline (the first four directive proposals), as well as dealing with macroeconomic imbalances (the remaining two proposals).

Directive Proposal No. 523 specifically deals with budgetary frameworks at the national level. It acknowledges that '*the particular decentralised nature of fiscal policy-making in the EU and the general need for national ownership of EU rules make it essential that the objectives of the EMU budgetary coordination framework are reflected in the national budgetary frameworks*.'[45] Chapter 4 of the proposal particularly focuses on national fiscal rules. It requires Member States to adopt numerical rules to enhance compliance with the European and national fiscal targets (deficit and debt limits imposed in the Treaties and in the MTO). It also outlines the common features that numerical rules should be endowed with, whilst leaving Member States with wide discretionary margins: precise definition of the target and scope, monitoring requirements, sanctions in case of non-respect and escape clauses to provide the rules with the necessary flexibility. Moreover, it states that '*strong national fiscal rules that are consistent with the budgetary objectives*

42 *Ibid.*

43 European Council, *Conclusions of the European Council (17 June 2010)*, EUCO 13/10, 17 June 2010, §11.d, p. 5.

44 EC, *Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance*, COM(2010) 367/2, 30 June 2010.

45 EC, *Proposal for a Council Directive on requirements for budgetary frameworks of the Member States*, COM(2010) 523, p. 6.

at the level of the Union must be a cornerstone of the strengthened budgetary surveillance framework of the Union.'[46]

The Task Force to the European Council on Economic Governance has further stressed the need for adopting numerical fiscal rules at the national level. The report published on 21 October 2010 identifies national fiscal rules as an important instrument to reinforce fiscal discipline and strengthen national ownership. The Task Force particularly suggested the development of a two-tier mechanism composed of measures commonly agreed at the European level and further specified at the national level, while the European Commission and the Council should be empowered with the tasks of evaluating countries' compliance and the effectiveness of the rules. In also invoked action on these matters by 2013.[47]

The proposals of the European Commission following the changes introduced by the Lisbon Treaty are subject to the ordinary legislative procedure and require full engagement of two European legislators: the European Parliament and the Council of the EU. The procedure is thus complex, but a final agreement is expected to be reached by June 2011. Presently, in May 2011, the preliminary obligatory consultations have already taken place with the European Central Bank and the European Economic and Social Committee, while both the Economic and Financial Affairs Council and the Economic Committee of the European Parliament have already met once to agree on their own negotiation positions.[48]

In a note issued on 10 June 2010 on *Reinforcing Economic Governance in the Euro Area*, the European Central Bank had already advanced some proposals on how to strengthen fiscal policy and the competitiveness framework of the euro zone, as well as on the creation of a crisis management mechanism. In particular, the ECB suggested to enhance the national fiscal frameworks by embedding EU objectives in national law, namely at the constitutional level. This requirement, combined with the implementation of independent budget offices and monitoring institutions, would strengthen national budgetary procedures without raising sovereignty concerns.[49]

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46 *Ibid*., p. 9.

47 Task Force to the European Council, *Strengthening Economic Governance in the EU*, 21 October 2010.

48 The legislative procedure can be tracked on the European Parliament website. http://www.europarl.europa.eu/oeil/file.jsp?id=5876762 (Consulted on 15.4.2011).

49 ECB, *Reinforcing Economic Governance in the Euro Area*, 10 June 2010.

A further elaboration of these proposals is contained in an opinion issued on 16 February 2011.[50] The ECB raised concerns that the reforms contained in the proposals of the Commission might lack automatic mechanisms to enforce compliance, which could undermine their effectiveness. As for the chapter on national fiscal rules, the ECB suggested to amend the proposal in order to require that the envisaged national fiscal rules clearly specify the reputational, political and financial costs for non-compliance of Member States, [51] as well as more strictly define the circumstances in which the escape clause could be invoked.[52] These suggestions are thus intended to strengthen the profile of the fiscal rules to be adopted. The ECB also advocated in favour of a widespread implementation of the so-called delegation approach in national budgetary procedures, which reinforce the role of the Finance Ministry in the decision on the overall financial resources annually available in the national budget, before distributing them across ministries.[53] Consistently with the empirical evidence on the subject, this suggestion thus aims at keeping budget deficits under greater control.[54]

Finally, as of May 2011, the Commission's proposals have already been discussed once by both the Council and the European Parliament. On 15 March 2011 the Council of the EU restated the need for the national budgetary frameworks to reflect EU objectives and foster coordination. The national fiscal rules are thus envisaged to 'promote compliance with the deficit and debt thresholds'.[55] On 19 April 2011, the EP Economic Committee supported the legislative package, but tabled overall almost 2000 amendments with the aim of strengthening the mechanisms set out in the proposals and trying to support growth and job creation.[56] [57]

50 ECB, *Opinion on economic governance reform in the European Union*, CON/2011/13, 16 February 2011. Available at: http://www.ecb.int/ecb/legal/opinions/html/act_11239_amend.en.html (Consulted on 15.4.2011).

51 *Ibid.*, Amendment n. 3 to recital 12 of the proposed directive, p. 20.

52 *Ibid.*, p. 8.

53 *Ibid.*, Amendment n. 5 to recital 13 of the proposed directive, p. 21.

54 See for example: Jürgen von Hagen, *op. cit.*, note 20.

55 Council of the EU, *Council reaches agreement on measures to strengthen economic governance*, Press Release 7691/11, 15 March 2011, p. 3.

56 European Parliament, *Economic governance: MEPs demand tougher sanctions for excessive deficits*, 26 April 2011. Available at: http://www.europarl.europa.eu/en/headlines/content/20110324STO16434/html/Economic-governance-MEPs-demand-tougher-sanctions-for-excessive-deficits (Consulted on 30.4.2011).

57 For example, amendment No. 83 asks for costs of non-compliance with the numerical fiscal rules which are not only reputational (as stated in the original draft), but also political and financial. For the same part of the original draft, amendment No. 85 specifies the need to take into account national consideration and strengthen ownership at the national level. Furthermore, amendment

The importance of adopting national fiscal rules has been further recognised by the adoption during the European Council of the 24/25 March 2011 of *the Euro Plus Pact on Stronger Economic Policy Coordination and Competitiveness and Governance*.[58] The Pact is a result of lengthy negotiations following the Franco-German proposal of a Competitiveness Pact among Euro area Member States during the European Council of 4 March 2011.[59] The final version of the Pact contains a clause which remained throughout all the different drafts and which states that Member States commit themselves to adopt a national fiscal rule (either in their constitutions or in ordinary legislation) in order to enhance the sustainability of their public finances and to translate their European commitments at the national level. The envisaged rule follows the German model, as we will see in chapter 3. However, full freedom of choice is left to Member States as regards both the legal instrument to use and the exact formulation of the rule. Nevertheless, consultations with the Commission are envisaged to ensure consistent design of the rule.[60]

It is thus clear that there exists a broad consensus within the European Institutions that national fiscal rules represent an essential tool to strengthen Member States' fiscal performance, as well as the ownership and effectiveness of the rules established at the European level. National fiscal rules remain, however, only a limited, but nevertheless essential part of the multiple reforms proposed to improve national budgetary frameworks, such as the implementation of monitoring institutions or fiscal councils, more transparent data elaboration and multi-annual planning. None of the provisions under discussion at the European level specifies any details concerning the characteristics of the national fiscal rules to adopt. Member States are left with wide discretionary

No. 88 requires to specify and limit the number of exceptional circumstances where escape clauses can be invoked. See: European Parliament, Committee on Economic and Monetary Affairs, *Draft Report on the proposal for a Council directive on requirements for budgetary frameworks of the Member States*, 16 December 2010. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-454.691+01+DOC+PDF+V0//EN&language=EN (Consulted on 30.4.2011).

See also: European Parliament, Committee on Economic and Monetary Affairs, *Amendments 39-186 - Draft Report on the proposal for a Council directive on requirements for budgetary frameworks of the Member States*, 16 February 2011. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-458.663+02+DOC+PDF+V0//EN&language=EN (Consulted on 30.4.2011).

58 European Council, *Conclusions of the European Council (24/25 March 2011)*, EUCO 10/11, 25 March 2011.

59 See for example: Peter Muller, 'Merkel's Plan Could Transform the European Union', *Spiegel Online International*, 31 January 2011. Available at: http://www.spiegel.de/international/europe/0,1518,742565,00.html (Consulted on 15.4.2011). See also: The Economist, 'The Divisiveness Pact', 12-18 March 2011, p. 34.

60 European Council, *op. cit.*, note 58.

powers to implement these provisions in order to take into account their peculiarities and different national fiscal sensibilities on the subject. This notwithstanding, the SGP remains an overarching framework of fiscal discipline in the EU: thus, countries have still to comply with it in the design of their national fiscal institutions. In this sense, the role of national fiscal rules is instrumental for the observance of the SPG.

Chapter 2. Numerical fiscal rules

The adoption of numerical fiscal rules has significantly increased in the last two decades, both in advanced and emerging economies.[61] In fact, there is a widespread political consensus on the usefulness of this instrument to signal the government's commitment to fiscal discipline, strengthen its credibility and improve its fiscal performance. This consensus goes well beyond the empirical evidence concerning the effectiveness of the rules.

In this chapter we will analyse the economics of national fiscal rules. We will first define what a numerical fiscal rule is and then present the main typologies of the existing fiscal rules. We will also cover the debate and the evidence about the effectiveness of fiscal rules in enhancing fiscal discipline, as measured by different variables such as short-term fiscal performance, debt sustainability, and pro-cyclicality.

2.1 Definitions.

The adoption of formal constraints on fiscal policy is not a new practice in modern economies.[62] However, they have recently acquired renewed importance and widespread public attention. According to IMF data, while in 1990 only 7 countries had adopted a fiscal rule; in 2009, the number of countries reported to have a national or supranational fiscal rule in place was 80, including 21 advanced, 33 emerging and 26 low-income countries. In total, 53 countries had their own national fiscal rule; the rest were subject to fiscal rules agreed at the international level, mostly in the framework of a monetary union: the EMU, the West African Economic and Monetary Union (WAEMU); the Central African Economic and Monetary Community (CEMAC) or the Eastern Caribbean Currency Union (ECCU).[63]

61 IMF, *Fiscal rules - Anchoring expectations for sustainable public finances*, paper prepared by the Fiscal Affairs Department, 2009, mimeo.

62 George Kopits, 'Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?', *IMF Working Papers*, WP/01/145, 2001.

63 *Ibid.*

Originally, numerical fiscal rules have been used in federal countries, namely the US, to impose fiscal discipline on sub-national governments and guarantee a balanced development of public finances. Numerical fiscal rules aimed to signal to financial markets that individual states were committed to a sustainable debt path and to increase their access to capital.[64] After the Second World War, legal provisions imposing budget balance at the general and central government levels have also been introduced in several advanced economies (i.e. Germany, Italy, the Netherlands and Japan), but with not very successful results afterwards.[65]

While rules on fiscal policy may be interpreted in a broad sense, we refer here to those targets and ceilings imposed on fiscal aggregates, which are often expressed as a percentage of GDP and whose function and aim is to provide guidance and impose constraints on the definition and conduct of fiscal policy over a significant period of time.[66] Indeed, a widely-accepted definition of fiscal rules was proposed by Kopits and Symansky (1998). According to them, 'a fiscal policy rule is defined, in a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance.'[67]

Numerical fiscal rules may vary significantly according to the targets pursued or the legal instruments chosen to enforce them, but they display some common characteristics. Firstly, they are intended to last over time and guide government actions at present and in the foreseeable future, 'on a permanent basis'.[68] For this reason, then, not all targets of fiscal policy can be defined as fiscal rules. For instance, the multiannual deficit targets defined in the Stability and Convergence programmes prepared at the European level to foster compliance with the SGP cannot be properly qualified as fiscal rules.[69]

Other desirable features highlighted in the literature are the following:[70]

The statutory basis. Numerical fiscal rules should ideally have legal power to foster compliance. The statutory basis may vary according to different national circumstances:

64 Robert P. Inman, 'Do Balanced Budget Rules work? U.S: Experience and Possible Lessons for the EMU', *NBER Working Paper Series*, No. 5838, 1996.

65 George Kopits, *op. cit.*, note 62.

66 Xavier Debrun *et al.*, *op. cit.*, note 23.

67 George Kopits and Steven Symansky, 'Fiscal policy rules', *IMF Occasional Papers*, No. 162, 1998.

68 *Ibid.*, p. 2.

69 Xavier Debrun *et al.*, *op. cit.*, note 23.

70 The key elements listed here are based on the findings of the European Commission reports. See: EC, *op. cit.*, note 4.

numerical fiscal rules can be contained in constitutions, laws or international treaty obligations.[71] However, the more binding the statutory basis is for policy makers, the stronger the rule and the higher the chances of compliance become. Indeed, stronger fiscal rules impose higher costs on governments in case of misbehaviour.[72] Nevertheless, while constitutional rules are desirable, in some countries strong political agreements and wide public consensus may be sufficient to ensure fiscal discipline. Moreover, some drawbacks of constitutional fiscal rules also emerge at the procedural level, as in most EU Member States amending the constitution in order to include a numerical fiscal rule requires a special legislative procedure, often demanding a high consensus among political parties because of high majority thresholds. To write the rule in the Constitution also limits *ex-post* flexibility, as changes are eventually very difficult to implement, if needed.[73]

Monitoring. Compliance with numerical fiscal rules should be subject to constant and independent monitoring. In order to achieve this, it is essential to have updated and reliable statistical data, as well as to empower an independent body with monitoring tasks.[74] Moreover, the more public visibility and support a fiscal rule has, the higher the incentives for policy-makers to comply with it become, as visibility increases reputational costs and misbehaviour can be easily sanctioned by the public opinion. To this extent, the simplicity of the rule is essential, as it needs to be easily understood and widely discussed in the public arena.

Enforcement mechanisms. Fiscal rules are more effective if they foresee automatic mechanisms for correcting misbehaviour or if there is an independent body in charge of enforcing the rule and imposing sanctions in case of non-compliance.

Sanctions. Non-compliance should be appropriately sanctioned. The most important type of sanction for a government is the loss of reputation and credibility. However, this is not always sufficient to foster compliance. Sometimes, especially in developing countries, fiscal rules foresee personal penal liabilities for the elected or the appointed officials who are held responsible for the non-implementation of the rule.[75]

71 George Kopits, *op. cit.*, note 62.

72 Xavier Debrun *et al.*, *op. cit.*, note 23.

73 Edoardo Campanella, 'What constitutional fiscal rule for members of the EU?', *voxeu.org*, 20 February 2011. Available at: http://www.voxeu.org/index.php?q=node/6129 (Consulted on 20.3.2011).

74 EC, *op. cit.*, note 4.

75 George Kopits and Steven Symansky, *op. cit.*, note 67.

Flexibility. Numerical rules should have the necessary flexibility to face unexpected external shocks, such as natural disasters and economic recessions. The problem here is that when designing any fiscal rule, policy makers have to rely on their imperfect forecasts of the future.[76] Flexibility is necessary to give policy makers the adequate policy tools to respond to shocks, but at the same time too much flexibility may undermine the credibility of the rule. Because of this inherent trade-off, the way escape clauses are designed is essential to guarantee that non-compliance is only occasional and in each case justified. The circumstances under which the escape clause can be activated have to be precisely-defined and limited.[77]

76 Barry Anderson and Joseph J. Minarik, 'Design Choices for Fiscal Policy Rules', in *OECD Journal on Budgeting*, Vol. 5, Issue 4, No. 25, 2006, p.169.

77 EC, *op. cit.*, note 4.

2.2 Main typologies of numerical fiscal rules.

There exists a great variety of numerical fiscal rules. Fiscal rules adopted at the national level vary according to the fiscal aggregate targeted, to their level of stringency and to the different institutional bodies whose policies they are intended to constrain, like for example central or sub-national governments, or general government aggregates.[78] [79]

Budget balance or deficit rules (BBRs) aim at guaranteeing the sustainability of public finances in the long run. They may target the overall balance, the structural or cyclically adjusted balance, or the balance over the cycle, and try to ensure that revenues and expenditures match, using a reference value most often expressed in terms of GDP, but sometimes also in nominal terms.

The term BBR may refer to different definitions of budget balance. In particular, *cyclically adjusted balance rules* take into account the effects of cyclical fluctuations on fiscal policy, whilst *structural balance rules* also control for 'additional one-off factors and other non-discretionary changes in the budget unrelated to the cycle.'[80] Both types of rules refer to annually set targets, while '*over-the-cycle*' *rules* aim at nominal budget balance on average over the cycle. There are also *primary balance rules*, which by definition exclude interest payments, and the so-called '*golden rules*', which exclude investment expenditures.

Indeed, this last type of BBRs is designed to overcome the trade-off existing between specific and low deficit targets and the need for governments to make long-term investments and growth-driving expenditures, which would be otherwise prevented. Without these appropriate accounting corrections, BBRs may create distorted incentives for policy makers to cut essential types of expenditures, like those on education and R&D, and negatively affect potential output.[81] Therefore, it is essential to design BBRs in an appropriate way so that sensitive and important types of expenditure can be excluded from the calculation of the reference values. However, these different accounting methodologies introduce complexity and are also more difficult to operationalize and monitor. For these reasons, they can favour creative accounting and practices to circumvent the constraints imposed.[82]

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78 We refer here to the common definitions used for the different levels of government, as in the OECD Glossary of Statistical terms.

79 All the following definitions are consistent with those presented in: IMF, *op. cit.*, note 61.

80 *Ibid.*, p. 5.

81 EC, *Public Finances in EMU - 2006*, European Economy, No. 3, European Commission, Brussels, 2006, p. 149.

82 EC, *op. cit.*, note 4.

Debt rules (DRs) target a specific ceiling of public debt expressed as a percentage of GDP. The concern about the effect of BBRs on the quality of public spending equally applies to DRs, as they may also create incentives for government to cut those expenditures that are less politically sensitive, but essential to sustain economic growth.[83]

Expenditure rules (ERs) impose constraints on public spending with the aim to foster fiscal discipline. They may constrain total, primary or current public expenditures. However, regardless of the expenditure aggregates formally targeted, governments can only act on the expenditures under their direct control: thus, ERs should preferably not take interest payments into account.[84] Generally, they impose ex-ante constraints, as they limit discretionary fiscal policies before they are decided.[85]

Revenue rules (RRs) set ceilings or floors on the revenue side. While the primary goal of deficit and debt rules is enhance fiscal discipline, ERs and RRs may pursue different objectives, such as avoiding an excessive tax burden, defining specific tax revenue or spending trend, as well as avoiding procyclical effects of fiscal policies.[86] RRs may also constrain the use of more than expected revenues and allocate them to reduce public debt. This is the case in countries like France, Lithuania and the Netherlands.[87]

83 *Ibid.*, p.102

84 Xavier Debrun *et al.*, *op. cit.*, note 23.

85 Barry Anderson and Joseph J. Minarik, *op. cit.*, note 76.

86 Xavier Debrun *et al.*, *op. cit.*, note 23.

87 EC, *op. cit.*, note 4.

2.3 Fiscal rules and fiscal performance

Despite the emerging consensus on the importance of adopting numerical fiscal rules, some authors have advanced doubts on their effectiveness. On the one hand, numerical fiscal rules seem not to really address and correct the deficit bias of fiscal authorities: to this extent, comprehensive fiscal institutions may be more efficient in constraining governments' behaviour.[88] On the other hand, it has been also argued that fiscal rules are redundant while at the same time introducing unnecessary rigidities, if governments are credibly committed to fiscal discipline.[89] A further criticism, advanced in the framework of the debate about the reform of the SGP, highlights the risk that fiscal rules impoverish the quality of public expenditures, as they may favour current account spending against public investment.[90] They may also induce creative accounting practises and reduce transparency in budget reporting.[91]

The empirical evidence on the effectiveness of fiscal rules is however relatively scarce, as comprehensive data on a wide panel of countries and for a sufficiently long period of time are often not available.[92] Moreover, while supranational fiscal rules, like the SGP, have been widely debated, there is not very much literature on the impact of fiscal rules implemented at the national level. However, it is a standard outcome of the analyses performed in the existing literature that the effectiveness of fiscal rules strongly depends on their characteristics. For this reason, for example, the European Commission takes into account five criteria to calculate a fiscal rule strength index: 1. statutory basis of the rule; 2. nature of monitoring body; 3. nature of the enforcement body; 4. enforcement mechanisms; 5. media visibility. Empirical analysis suggests that, if these characteristics apply, the stronger the rule, the better the country's performance.[93]

Among other relevant contributions in the literature, Bohn and Inman (1996) report, for example, the wide consensus which emerged in the empirical analysis on the effectiveness

88 See for example: Charles Wyplosz, *op. cit.*, note 9 and Mark Hallerberg, Rolf Strauch and Jürgen von Hagen, 'The design of fiscal rules and forms of governance in European Union countries', *ECB Working Paper Series,* No. 419, 2004.

89 George Kopits, *op. cit.*, note 62.

90 Olivier Blanchard and Francesco Giavazzi, 'Improving the SGP Through a Proper Accounting of Public Investment', *CEPR Discussion Papers*, No. 4220, February 2004.

91 Jürgen von Hagen and Guntram B. Wolff, 'What do deficits tell us about debt? Empirical evidence on creative accounting with fiscal rules in the EU', in *Journal of Banking and Finance*, Vol. 30, Issue 12, 2006, pp. 3259-3279.

92 The dataset collected by the European Commission is therefore considered a valuable exception.

93 EC, *Public Finances in EMU - 2009*, European Economy, No. 5, European Commission, Brussels, 2009.

of BBRs in limiting public deficit, but also highlight the limited amount of available data used until then.[94] Enlarging the sample panel of their analysis, but with reference only to US states, they confirm the main results of previous studies: if well-defined and enforced, BBRs effectively limit government deficits. They also find that BBRs imposing *ex-post* compliance are more effective than *ex-ante* rules. The statutory basis of the rules as well as their judiciary enforcement also matter for their enhanced effectiveness.[95]

Inman (1996) further elaborates on those issues and identifies four sufficient conditions for an effective BBR: *ex-post* deficit accounting (compliance with the rule is valued at the end of the reference period: to this extent, *ex-post* BBRs are stronger than *ex-ante* BBRs), constitutional statutory basis (as the possibility to overturn the rules in case of necessity diminishes, the majority required for it increases), a politically independent agency responsible for its implementation (especially in case of non-compliance, across three dimensions: open or close access, partisan or independent agent, possibility to impose significant or minor sanctions), and high amendment costs.[96] Ideal rules are thus difficult to modify, are implemented by an independent body and foresee sanctions in case of non-compliance.

Kopits (2001) identifies as necessary the following characteristics for an effective numerical rule: its operational simplicity (easy to implement and monitor), flexibility (allowing adaptation to exogenous shocks) and growth-oriented. Transparency is also a key feature, as it decreases the risk of creative accounting.[97] Ayuso-i-Casals *et al.* (2009) confirm these findings, including in particular the importance of a mechanism to enforce the rule.[98]

Schuknecht (2004) further underlines that there exists a trade-off between complexity and enforceability.[99] Indeed, numerical fiscal rules have to be clear and at the same time to make economic sense. Rules are to be clear and understandable by the wider public to allow public monitoring, avoid any possibility of circumventing them, and make

94 Henning Bohn and Robert P. Inman, 'Balanced-budget rules and public deficits: evidence from the U.S. states', in *Carnegie-Rochester Conference Series on Public Policy*, Vol. 45, 1996, pp. 13-76.

95 *Ibid.*

96 Robert P. Inman, *op. cit.*, note 64.

97 George Kopits, *op. cit.*, note 62.

98 Joaquim Ayuso-i-Casals *et al.*, 'Beyond the SGP: Features and Effects of EU National-Level Fiscal Rules', in Joaquim Ayuso-i-Casals *et al.* (eds), *Policy Instruments for Sound Fiscal Policies – Fiscal Rules and Institutions*, Palgrave Macmillan, Houndmills, Basingstoke, Hampshire, 2009.

99 Ludger Schuknecht, 'EU Fiscal Rules: Issues and Lessons From Political Economy', *ECB Working Paper Series,* No. 421, 2004.

governments more accountable. This is especially the case when there is no specific institution in charge of monitoring the compliance with the rule, but the rule is left to the scrutiny of the public and of financial markets: for both these actors, simple and clear rules are easier to understand. However, the more the design of the rule corresponds to complex economic criteria, the more complex and difficult to handle the enforceability and monitoring become, unless there exists an appropriate and independent body in charge of it. 'When rules are not enforceable they must be very simple so that monitoring institutions with high transaction costs can put pressure on policy makers. At the other end of the spectrum, well-enforced law may require complex rules to enhance their acceptance.'[100]

Here we summarise the most important effects that fiscal rules have on fiscal performance, according to the specific type of rule.

a) Fiscal discipline

Analyses carried out by the European Commission prove that fiscal performance in EU countries generally improved after the introduction of a national fiscal rule, especially when the rules in question have particularly strong features.[101]

BBRs and DRs directly and positively affect a country's fiscal performance. These fiscal rules provide policy-makers with the right incentives to carry out sound fiscal policies, and accumulate larger surplus or lower the deficits.[102]

ERs also have positive effects in fostering fiscal discipline. However, while by definition BBRs directly affect budget balance, ERs do not. In fact, they only limit spending possibilities. However, as they target only the variables under the direct control of the government, ERs increase accountability and transparency. Furthermore, while there might not be a causal link between ERs and better fiscal performance, ERs are often introduced in support of fiscal consolidation efforts or soon after them to lock the expected results.[103] Practise thus suggests that ERs are adopted when there is a strong political consensus about the need for discipline.[104]

100 *Ibid.*, p. 21.

101 EC, *op. cit.*, note 81.

102 EC, *op. cit.*, note 4.

103 Peter Wiert, 'How do Expenditure Rules affect Fiscal Behaviour?', *DBN Working Papers*, No. 166, 2008, p. 13.

104 EC, *op. cit.*, note 4.

RRs show mixed evidence as they may constrain governments to collect a less-than-adequate amount of taxes to finance expenditures and thus may prove to be counterproductive. However, when RRs impose limits to the use of revenue windfalls in good times, they can be useful in enhancing fiscal discipline.

The effectiveness of numerical fiscal rules in strengthening budgetary discipline is further confirmed by their positive contribution in a number of recent fiscal consolidation episodes. On this issue, econometric evidence is not clear-cut. In fact, in several cases of large fiscal adjustments, fiscal rules have only played a supportive role and have been adopted when the consolidation efforts had already been undertaken.[105] However, there is also some evidence of the positive effects of fiscal rules. In particular, with reference to a wide panel of episodes, Guichard *et al.* (2007) find that BBRs in combination with ERs have significantly enhanced countries' ability to carry out large fiscal consolidation efforts for a prolonged period of time. This was especially the case in the run-up to the EMU for EU Member States with reference to the Maastricht criteria.[106] These results are further confirmed by Larch and Turrini (2008) who argue that the existence of numerical fiscal rules and sound budgetary procedures positively contribute to the long-lasting success of fiscal consolidation efforts. However, while deficit and debt rules are found to be important in this respect, this is not true for expenditure rules in isolation. As a possible explanation for this result the authors highlight the important contribution that deficit and debt rules make to a good budget planning and a balanced composition of the consolidation measures.[107]

b) Macroeconomic stabilisation and procyclicality

BBRs and DRs help enforcing fiscal discipline, but create constraints on the ability of the fiscal authorities to steer the business cycle and may have adverse procyclical effects in the conduct of fiscal policy.[108]

Indeed, fiscal performance in the countries that have adopted BBRs or DRs depends very much on the way these rules have been designed and on the previous budget situation of the country. When BBRs are defined in nominal terms or as a percentage of GDP, the risk is that they force governments to further contract their fiscal policy during recessions

105 IMF, *op. cit.*, note 61.

106 Stéphanie Guichard *et al.*, 'What Promotes Fiscal Consolidation: OECD Country Experiences', in *OECD Economics Department Working Papers*, No. 553, OECD Publishing, 2007.

107 Martin Larch and Alessandro Turrini, 'Received wisdom and beyond: Lessons from fiscal consolidations in the EU', in *European Economy Economic Papers*, No. 320, 2008, p.18.

108 Xavier Debrun *et al.*, *op. cit.*, note 23.

and do not provide enough incentives not to increase spending or cut taxes during expansion. Furthermore, the more undisciplined the country's performance has been in the past, the higher the procyclicality risk is. If the country's fiscal position is already sound, in case of negative shocks on the economy, the governments may have a larger room of manoeuvre and allow automatic stabilisers to work. However, if the budget position of the country is weak, this becomes more difficult. The same considerations apply in case of a positive shock: since the reference value of the GDP automatically increases with the expansion, governments have strong incentives to increase spending or cut taxes, within the framework allowed by the rule. If the country position had been far beyond the deficit target, the need for consolidation diminishes.[109] The same reasoning is true for DRs.

As BBRs and DRs may have procyclical effects, these rules are often designed in order to take into account the business cycle, so that the reference value is the potential output and not the current GDP, or a wider time horizon instead of a single year of reference. The existence of escape clauses further improves the design of the rule.[110] However, as already mentioned, introducing specification in the way the reference values are calculated carries an inherent trade-off, as it increases the costs of monitoring and the probability of creative accounting. Moreover, references to the business cycle and to the output gap are also difficult to operationalize as they convey uncertainties on the country's position in the cycle and on the value of the potential output itself.

In order to capture the procyclicality effect of fiscal rules, Debrun *at al.* (2008) have constructed a Fiscal Rule Cyclicality Index (FRCI) aimed at valuing the influence of fiscal rules on the procyclicality of fiscal policy, in each year and each country, given the different properties of fiscal rules. The higher the value of the index, the less procyclical impact fiscal policy has on the economy. Their estimations confirm that BBRs are more procyclical, but when those rules are designed taking into account cycle movements, countries perform in a less procyclical fashion. In other words, 'rules that, by type or design, are expected to be more cycle-friendly *a priori*, are also associated with a less pro-cyclical behaviour of fiscal authorities.'[111]

To sum up, overall BBRs and DRs are associated with more significant procyclical effects. Cyclically-adjusted and structural balance rules allow automatic stabilisers to function, but they limit discretionary fiscal policies. Over-the-cycle balance rules allow

109 Barry Anderson and Joseph J. Minarik, *op. cit.*, note 76.

110 Xavier Debrun *et al.*, *op. cit.*, note 23.

111 *Ibid.*, p. 342.

both automatic and discretionary interventions. Finally, primary balance rules do not require fiscal response to variations of the interest and exchange rates.[112]

ERs are not procyclical *per se*: they provide a cap on government spending regardless of all other economic variables and projections. They are also easy to communicate and monitor.[113] Moreover, on the one hand, ERs allow automatic stabilisers to work, both in the case of a downturn and in good times, when revenue windfalls are more important. On the other hand, they successfully limit discretionary policies. Wierts (2008) finds for example that ERs reduce the risk that the fiscal policy stance responds to fiscal shocks in a procyclical way. However, this is conditioned to the way the rule is designed and to its strength.[114] Countries with strong ERs make good use of revenue windfalls during expansion, so that they have larger room for manoeuvre during recessions. In contrast, if countries have weaker ERs, this positive effect is rather small: having failed to save financial resources when available, these countries are pressed to retrench during downturns.[115] It is also important how the spending ceiling is defined: if it is expressed as a percentage of GDP, ERs can also exhibit some procyclicality. This is not the case if the rule provides for a maximum expenditure growth rate or for a ceiling expressed in nominal terms.[116] During an expansion, indeed, they will still ensure fiscal responsibility, while tax collection increases.[117]

RR may also eventually have procyclical effects if they contain precise reference values of tax collection, as these targets may not be appropriate for the actual position of the country in the business cycle. On the contrary, the RRs that set conditions on the use of more than expected revenues do not have procyclicality effects.[118] Thus, while ERs allow discretionary tax reduction policies and limit the expenditure side; the contrary is true for RRs. For this reason, these rules are often used together.[119]

112 IMF, *op. cit.*, note 61, p.5.

113 Allen Schick, 'Post-Crisis Fiscal Rules: Stabilizing Public Finance while Responding to Economic Aftershocks', in *OECD Journal on Budgeting*, Vol. 10, Issue 2, No. 7, 2010.

114 Peter Wiert, *op. cit.*, note 103, p. 13.

115 *Ibid.*, p.14.

116 EC, *op. cit.*, note 4.

117 Xavier Debrun *et al.*, *op. cit.*, note 23, p. 337.

118 *Ibid.*

119 IMF, *op. cit.*, note 61.

c) Debt sustainability and government size

By definition, debt rules prevent debt levels from becoming unsustainable. However, since they do not affect *per se* the level of expenditures and revenues, they can hardly influence those variables (namely public deficits) that contribute to debt accumulation. It is thus a common practice to combine DRs with BBRs.

On the other hand, BBRs, ERs and RRs do not directly affect public debt, but can be supportive of sound fiscal policies aimed at putting debt on sustainable track. Indeed, this is especially the case when they prescribe that resources collected during periods of growth are dedicated to reducing public debt, before being allocated to new discretionary policies.

ERs limit the size of the government and can be used to modulate public spending according to the importance of the individual items.[120] RRs are also used to limit the size of the government. In contrast, there is no direct effect of BBRs and DRs on the size of the government.

d) Spreads on government bonds

There is also some evidence that fiscal rules positively affect a country's risk profile. Iara and Wolff (2010) find that those countries where strong fiscal rules are in place enjoy more favourable treatment on financial markets, as fiscal rules signal and reinforce government's commitment to discipline.[121] They are thus found to reduce risk premia and lower sovereign bond spreads. Indeed, confirming standard theoretical assumptions and empirical evidence on the negative correlation between the debt level and the interest rate demanded to service it,[122] numerical fiscal rules are found to lower the risk perceived by financial markets and make countries' access to credit easier. In particular, the stronger the fiscal rule with reference to its statutory base and enforcement mechanisms, the lower the interest rate demanded. 'National fiscal rules can thereby contain sovereign risk by

120 EC, *op. cit.*, note 81.

121 Anna Iara and Guntram B. Wolff, 'Rules and risk in the euro area: does rules-based national fiscal governance contain sovereign bond spreads?', in *European Economy Economic Papers*, No. 433, 2010, p. 24.

122 See for example: Kerstin Bernoth, Jürgen von Hagen and Ludger Schuknecht, 'Sovereign risk premia in the European government bond market', *ECB Working Paper Series*, No. 369, 2004. Mark Hallerberg and·Guntram B. Wolff, 'Fiscal institutions, fiscal policy and sovereign risk premia in EMU', *Public Choice*, No. 136, pp. 379–396.

increasing trust in the sustainability of public finances in addition to their contribution on better fiscal outcomes'[123]

In conclusion, 'no fiscal rules should be expected to do the impossible. No fiscal rule will achieve its desired budgetary results if and when the political will of policy makers is to the contrary. A legislature's procedural rules can be changed or waived, and restrictive laws can be amended or repealed.'[124] Fiscal rules introduce transparency and accountability in this process: deviations are always still possible, and according to the circumstances even welcomed, but as long as they occur following the procedures and are subject to scrutiny, policy makers are less tempted to deviate on a discretionary basis and are also made accountable for their choices.

123 Anna Iara and Guntram B. Wolff, *op. cit.*, note 121, p. 24.

124 Barry Anderson and Joseph J. Minarik, *op. cit.*, note 76, p. 179.

Chapter 3. National fiscal rules in EMU

As documented in chapter 1, there seems to be a wide consensus on the need to adopt national fiscal rules in the present debate to strengthen European economic governance. National fiscal rules are meant to sustain countries' efforts to maintain fiscal discipline and strengthen compliance with the European rules, without replacing them. Given the theoretical framework on numerical fiscal rules developed in chapter 2, we will now analyse the European situation in further detail.

This chapter aims at providing a general analysis of the national fiscal rules in force in the EU at present. We will first review the latest available data. We will then focus on the German constitutional rule, adopted in 2009 and often presented as a model for other EU Member States in the recent debate on the need to foster fiscal discipline in Europe. We will then elaborate on the need to adopt a similar national fiscal rule in France, as a case study.

3.1 National fiscal rules: an EU scenario.

As already mentioned in chapter 1, following the renewed attention to the importance of sound national fiscal frameworks which emerged during the reform process of the SGP in 2005, the European Commission has thereafter conducted a series of surveys on national fiscal rules, independent fiscal institutions and existing domestic medium-term budgetary frameworks, in the context of the activities of the Working Group on the Quality of Public Finances of the Economic Policy Committee.[125] The first survey on national fiscal rules dates back to 2005 and covered the period 1990-2005. A new survey in 2008 highlighted that there were no significant changes in the way national fiscal rules are designed in EU countries, but it also confirmed their constantly growing

125 The relevant information and dataset on fiscal governance can be found on the European Commission website, DG Economic and Financial Affairs. Available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm (Consulted on 15.4.2011). A description of the questionnaire used for the survey is contained in EC, *op. cit.*, note 81.

importance.[126] According to the Council's conclusions on the *Quality and Sustainability of Public Finances* in April 2009,[127] the European Commission is now in charge of the annual update of these data. However, the results from 2009 are not yet available to the public, thus the latest comprehensive data refer to 2008. Further information can also be found in the Stability and Convergence Programmes submitted to the European Commission in 2010.[128] However, many reforms in this domain are on-going as of May 2011. Thus, these data cannot be used to draw a comprehensive picture of the present situation, albeit disclosing important information on the increasing attention that numerical fiscal rules are receiving in Europe at present.

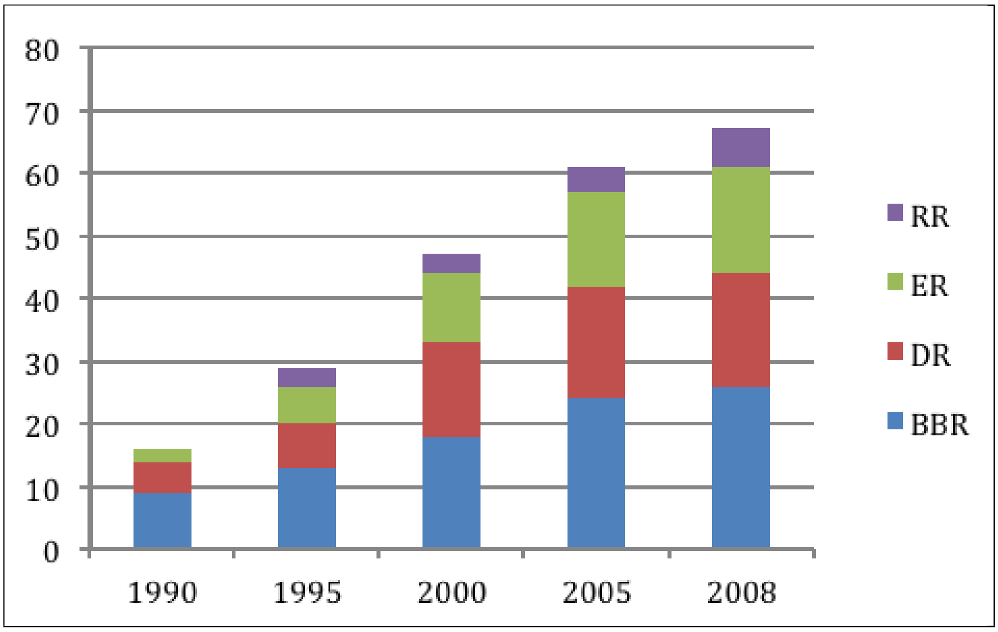
126 A detailed analysis on the findings of the two surveys and the differences between them could be found in the *Public Finances in EMU* reports, 2006 and 2010 editions, *op. cit.*, note 4 and 81.

127 Council of the EU, *Draft Council Conclusions on the Quality and Sustainability of Public Finances*, 8818/09, 29 April 2009.

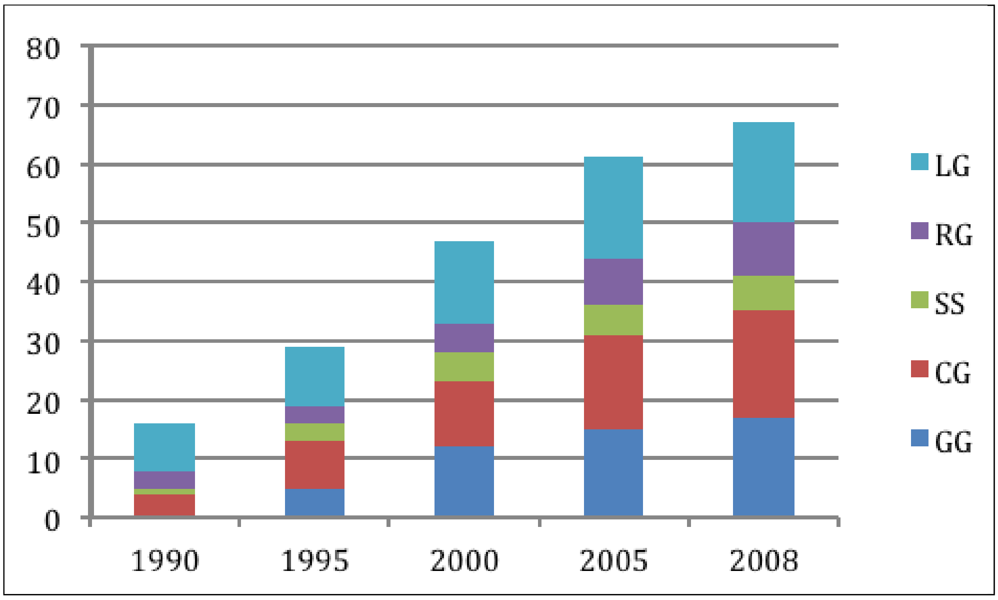
128 EC, *op. cit.*, note 4.

FIGURE 2. NATIONAL FISCAL RULES IN EU MEMBER STATES (1990-2008).

A. BY TYPE OF RULE



B. BY LEVEL OF GOVERNMENT



Source: *European Commission.*

There were 67 national fiscal rules in force in the EU in 2008, compared to 16 in 1990. At the beginning of the period concerned, national fiscal rules applied almost only to regional or local governments, but the number of rules concerning general or central governments nearly doubled over time. By category of rules, in 2008 there were 26 budget balance rules, 18 debt rules, 17 expenditure rules and only 6 revenue rules. Budget balance and debt rules were the most common at the regional and local level, while expenditure rules typically referred to central governments and social security systems. Revenue rules are not very widespread in the EU.[129]

Table 2. National fiscal rules by government sector and main characteristics (2008).

	GG	CG	SS	RG	LG	Rules applying to multiple government levels	Total
Type of rule							
BBR	6	3	2	4	9	2	26
DR	4	2	1	2	7	2	18
ER	3	8	2	-	-	4	17
RR	2	2	1	-	-	1	6
Time horizon							
Annual	2	7	2	4	15	4	34
Multiannual	13	8	4	2	1	5	33
Statutory basis							
Legal act or Constitution	6	9	3	4	14	7	43
Political commitment	9	6	3	2	2	2	24

Source: *European Commission*; Xavier Debrun *et al.* (2008).

In 2008, almost all countries in the EU adopted a fiscal rule at the national level, except for Cyprus, Greece and Malta. North-European countries such as the Netherlands, Denmark, Finland and Sweden, whose public finances have proved to be more resilient to the crisis, , have a tradition of expenditure rules adopted in combination with budget balance rules at the general government level. The United Kingdom also has had two rules in force since 1997. Among the new EU Member States, Poland had a constitutional debt rule establishing a 60% GDP ceiling for general government. [130]

Rules applying at the central and local government levels present very different characteristics. Generally speaking, sub-national governments are tied by stronger rules, enshrined in laws or constitutions, while rules for central governments are based on political agreements. They also differ in media visibility and enforcement mechanisms

129 EC, *op. cit.*, note 93.

130 *Ibid.*

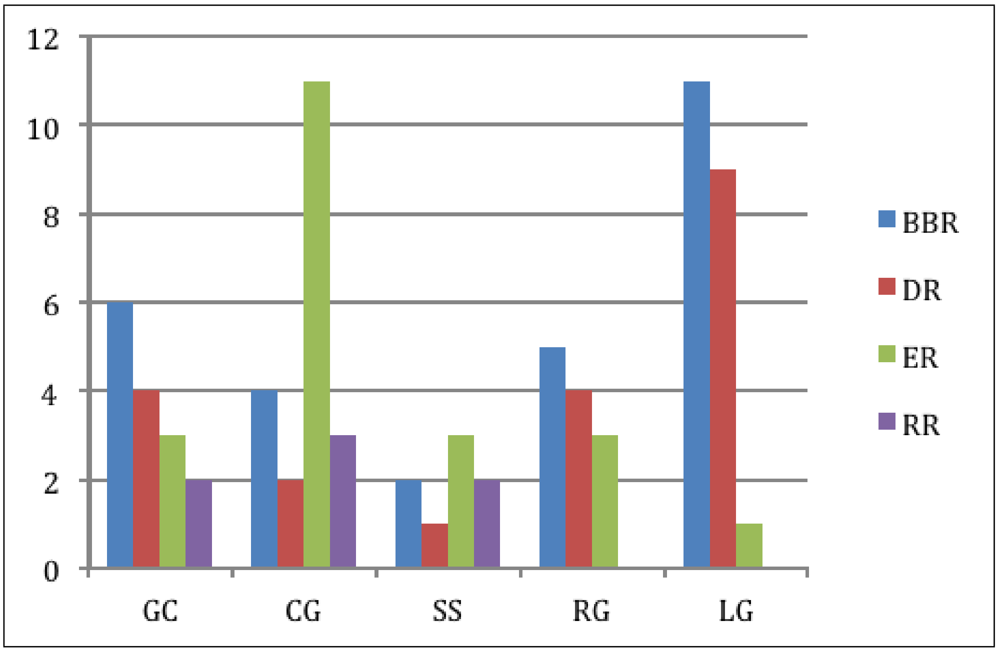
in case of non-compliance. Overall, however, most rules lack independent monitoring and appropriate enforcement mechanisms.[131]

Table 3. National fiscal rules by government sector. Main Characteristics.

Regional and local governments	Central and general governments
'hard' rules	political agreements
in case of non-compliance: automatic enforcement mechanisms	in case of non-compliance: no ex-ante defined rules
Low public visibility	High public visibility
Annual frameworks	Multi-annual frameworks

Source: based on EC, *Public Finances in EMU - 2009, op. cit.*

Figure 3. National fiscal rules by level of government and fiscal aggregate targeted (2008).



Source: *European Commission.*

According to the Stability and Convergence Programmes submitted to the European Commission, compared to the aforementioned data in 2010 EU Member States introduced 19 new rules, namely 8 ER, 6 BBR and 5 DR, while no new RR was adopted. Moreover, existing rules in Poland and Estonia were reformed.[132] The total number of national fiscal rules in the EU thus amounted to 86 in 2010.

131 *Ibid.*

132 EC, *op. cit.*, note 4.

Table 4. Target definition by type of rule (2008).

BBR	Golden rules	Balanced budget rules	Nominal ceiling	Ceiling as a % GDP	Rules in structural terms	Total
	5	10	7	1	3	26
DR	Debt ceiling in nominal terms	Debt ceiling as % GDP	Debt ceiling related to repayment capacity	Other		Total
	5	3	8	2		18
ER	Nominal expenditure ceiling	Real expenditure ceiling	Expenditure growth rate (nominal)	Expenditure growth rate	Other	Total
	5	2	4	3	3	17
RR	Tax burden as % GDP	Rule related to tax rates	Allocation of extra revenues	Other		Total
	0	1	4	1		6

Source: EC, *Public Finances in EMU - 2009*, *op. cit.*

However, as already mentioned, many reforms are still on-going and the situation in individual Member States varies considerably. In fact, some countries have long debated on the subject and have already introduced important reforms. This is for instance the case of Hungary and Germany. Hungary adopted a new fiscal responsibility framework in 2008, introducing both a debt and an expenditure rule on the central government, which will fully enter into force after a transitional period up to 2012.[133] Germany adopted in 2009 a cyclically adjusted budget balance rule tying both the federal government and *Länder*. In 2010 the UK also introduced important budget reforms, in the framework of an important consolidation plan. The 2010 budget established an Office for Budget Responsibility in charge of elaborating independent economic forecasts. It also replaced the 1997 rules with a five-year fiscal mandate, which aimed at achieving a cyclically-adjusted budget balance and a falling debt trend by 2015-16. Revisions will be possible at the end of this period, upon completion of the consolidation process.[134] In other countries, the reforms are still on-going. For instance, Poland has introduced stricter enforcement mechanism for its debt rule and four new rules, whose entry into force

133 Colin Forthun and Robert Hagemann, 'Sustaining the Momentum of Fiscal Reform in Hungary', *OECD Economics Department Working Papers*, No. 802, OECD Publishing. See also: OECD, *OECD Economic Surveys: Hungary 2010*, OECD Publishing, 2010.

134 HM Treasury, *Budget 2010*, 22 June 2010. Available at: http://cdn.hm-treasury.gov.uk/junebudget_complete.pdf (Consulted 30.4.2011). Further information can be found on the website of the newly established Office for Budget Responsibility, available at: http://budgetresponsibility.independent.gov.uk/ (Consulted 30.4.2011).

is established for 2011 and 2014.[135] Greece has also announced the introduction of a fiscal rule, but no further information is available at present. France presented in March 2011 a constitutional draft law to enhance the sustainability of its public finances. In the remaining part of this chapter, we will thus analyse as a case study the debt rule adopted in Germany and the on-going reforms in France.

Table 5. Reforms of numerical fiscal rules in EU countries (2010).

	Total	AT	BE	BG	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HU
Number of rules in 2008	67	1	4	2	-	2	5	3	2	-	4	4	5	2
Reform of existing rules	2								1					
New rules	19	1					1						1	1

	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK	UK
Number of rules in 2008	3	4	4	3	2	-	2	1	3	2	3	2	2	2
Reform of existing rules								1						
New rules		1					1	4	1	3		1	2	2

Source: EC, *Public Finances in EMU - 2010*, *op. cit.*

135 EC, *op. cit.*, note 4.

3.2 The German 'debt brake'.

German fiscal performance has considerably improved in recent years: before the crisis, public finances were almost in balance or registering a moderate surplus. In 2009 and 2010 public deficit was almost 3% of GDP, while public debt continued to accumulate, reaching 83.2% of GDP in 2010.[136]

After a long reform process following a ruling of the Federal Constitutional Court in 2007, Germany adopted a new fiscal rule at the constitutional level in May 2009. Ruling on the constitutionality of the 2004 federal budget, the Court had asked for a reinforcement of article 115 of the German Constitution, which had prohibited net government lending higher than gross investment spending since 1969.[137] To this aim, the Federalism Reform Commission II, after a first report in February 2008,[138] designed the characteristics of the new rule, building on a large consensus between the federal government and *Länder*.[139]

The new rule, also commonly referred to as 'debt brake', sets a requirement of zero net borrowing, thus a cyclically adjusted budget balance target, for *Länder*, while it allows the federal government budget to be in deficit up to a maximum of 0.35% of GDP. The rule is thus designed in order to directly comply with the targets of the SGP, requiring a budget position close to balance or in surplus.[140] Entering into force in 2011, the rule will become fully operative in 2016 for the federal government and only in 2020 for *Länder*. The rule also contains an escape clause in case of natural disasters or other unforeseeable events, as well as the possibility of amendments provided that a 2/3 majority exists in the Parliament.[141] A stability council, composed of the Minister of Finance, the Minister of the Economy and the finance ministers of *Länder*, will monitor compliance with the rule and eventually require additional consolidation measures in case of financial distress.[142]

136 Eurostat and OECD data.

137 OECD, *OECD Economic Surveys: Germany 2010*, OECD Publishing, 2010, p.65.

138 Christian Schiller, 'Germany: Fiscal Reform Commission II presents report', *IMF Public Financial Management Blog*, 30 June 2008. Available at: http://blog-pfm.imf.org/pfmblog/2008/06/germany-fiscal.html (Consulted on 15.4.2011).

139 Deutsche Bundesbank, *Monthly Report*, Vol. 61, No. 5, May 2009.

140 OECD, *op. cit.*, note 137.

141 Christian Schiller, 'Debt Brake for Germany--Could it be too Strict?', *IMF Public Financial Management Blog*, 23 February 2009. Available at: http://blog-pfm.imf.org/pfmblog/2009/02/debt-brake-for-germanytoo-strict.html (Consulted on 3.4.2011).

142 OECD, *op. cit.*, note 137.

The new rule contains a number of positive features. It introduces greater transparency and accountability, as it strongly relies on the European targets and accounting practises. Moreover, it properly signals German commitment to sustainability of public finances, despite the fact that German debt is constantly moving on an upward trend. Indeed, although Germany is enjoying low interest rates on financial markets, there is some concern that this might not last for long. The rule thus establishes the right framework to guarantee fiscal discipline.[143] Moreover, the rule contains a number of characteristics which enhance its flexibility: apart from the escape clause, it allows automatic stabilisers to fully operate and, as long as in good times the governments maintain a surplus position, it gives them enough room for manoeuvre to adopt discretionary policies in bad times.[144]

The German debt brake has also attracted some criticisms. Since it is based on the definition and measurement of the output gap, the rule's effectiveness may be negatively affected by the high uncertainty involved in the evaluation of the country's position in the business cycle. A further risk derives from the fact that governments may have an incentive to overestimate the value of the potential output and thus increase their margin of manoeuvre. In fact, under the new rule, the amount of resources which the government can borrow depends on the forecasts of potential GDP growth made at the moment of the budget approval. If these forecasts are systematically higher than verified *ex-post*, governments effectively increase their borrowing limits. Another weakness concerns the fact that the rule considers as definitive the estimates elaborated in the year following the adoption of the relevant annual budget. Therefore, subsequent revisions are not taken into consideration. Despite increasing certainty, this provision also introduces some flows in the rule as it has been proven that in Germany these forecasts have systematically underestimated the structural component of the fiscal deficit. If this continues to be the case, there is thus a potential risk of higher than expected debt accumulation. Another problem lies with the fact that the rule binds only *Länder* governments and does not concern municipalities at the sub-national level: it has thus been highlighted that necessary expenditures may be downgraded from *Länder* to municipalities in order to circumvent the limits imposed by the rule. Finally, the stability council lacks sufficient independence and binding authority, so that its ability to monitor

143 Jan Schnellenbach, 'Public Debt in Germany: Will the Debt Brake Change the Trend?', *IREF*, 10 December 2010. Available at: http://www.irefeurope.org/en/content/public-debt-germany-will-debt-brake-change-trend (Consulted on 15.4.2011).

144 Ashoka Mody and Sven Jari Stehn, 'Germany's new fiscal rule: A responsible approach to fiscal sustainability', *voxeu.org*, 11 August 2009. Available at: http://www.voxeu.org/index.php?q=node/3861 (Consulted on 10.4.2011).

and sanction fiscal indiscipline is actually put into question.[145] The mechanism set by the rule to sanction non-compliance remains also unclear.[146]

The new German fiscal rule has been further criticised as it imposes additional constraints on German public finances at a time when increased spending in a surplus country like Germany might help alleviate the burden of adjustment on deficit countries at the EU periphery. Indeed, as confirmed by OECD estimates, additional retrenchment measures are required in order to meet the targets set by the rule before it will definitively enter into force.[147] There exist however different points of view on whether these measures would be appropriate or not, in the context of the present fiscal crisis of some European countries. On the one hand, some argue that Germany should support the recovery in Europe by increasing its public spending and subsequently redress its current account position, favouring exports from the rest of the EU. On the other hand, others underline the importance of fiscal debt sustainability and the success of German reforms in boosting productivity and export-led growth. They believe that it does not make much sense to ask Germany to change its successful growth strategy and reduce the competitive advantage gained by its industries, increasing public expenditures and unnecessarily compromising public finances.[148]

Despite the potential drawbacks in its design and the debate on its political opportunity, the German debt brake is often presented as a model fiscal rule. It does in fact embody the German model of discipline, which has become so important in the present post-crisis scenario and which is proposed to all other European countries.[149] Indeed, the idea of adopting a national fiscal rule of the same type in other EU Member States has also been strongly advocated by Germany in the framework of the discussions about the so-called *Competitiveness Pact*, later *The Euro Plus Pact*, as recalled in chapter 1. The original draft of this Franco-German driven Pact contained a clause obliging Member States to include

145 Isabell Koske, 'After the Crisis – Bringing German Public Finances Back to a Sustainable Path', *OECD Economics Department Working Papers*, No. 766, OECD Publishing, 2010. See also: OECD, *op. cit.*, note 137.

146 Jan Schnellenbach, *op. cit.*, note 143.

147 OECD, *op. cit.*, note 137.

148 See for example: Alberto Alesina and Roberto Perotti, 'German spending is not the cure', *voxeu.org*, 17 June 2010. Available at: http://www.voxeu.org/index.php?q=node/5176 (Consulted on 1.2.2011). See also: Alberto Alesina and Roberto Perotti, 'Perchè è un errore sparare sulla Germania', *Il Sole 24 ore*, 26 June 2010. Roberto Perotti, 'Il gioco perverso di parlar male dei successi altrui', *Il Sole 24 ore*, 8 November 2010.

149 See for example: Jean Pisani-Ferry, 'The Eurozone according to Merkel', *Project Syndicate*, 15 February 2011. Available at: http://www.project-syndicate.org/commentary/pisaniferry9/English (Consulted on 15.4.2011).

in their own Constitutions 'a debt alert mechanism'.[150] The Euro Plus Pact is more vague in this respect. The text, which is results from lengthy and complex negotiations, because of the strong opposition encountered by the initial proposal, still commits Member States to adopt fiscal rules at the national level in order to successfully translate their European obligations into the national legal framework. However, the choice of the instruments and the actual design of this rule are now at their complete discretion.[151] Indeed, this proposal was less controversial than other provisions of the pact, but the new formulation still responds to the concerns advanced by some countries about the need to explicitly commit to a reform process of national Constitutions.[152]

The German constitutional rule reflects the importance that Germany attributes to fiscal discipline in EMU. The underlying idea is that adopting a fiscal rule based on the German model will help build momentum and maintain public support towards the on-going efforts to rebuild sound fiscal finances in Europe. The analysis of national fiscal rules in chapter 2 has highlighted that the way fiscal rules are designed is essential to foster compliance. Nevertheless, it is also a matter of balancing all the relevant trade-offs. Therefore, whether fiscal discipline will be the final outcome strongly depends on the degree of commitment that policy makers will be able to maintain. As previously shown, the German rule itself contains some flows and elements of flexibility which can be misused. Indeed, Schick (2010) warns about the tensions between the desire to rebuild a future economic order based on stricter fiscal rules than before on the one hand, and the existence of extraordinary economic circumstances which make obedience to the rules impossible on the other. Indeed, this is an irreconcilable opposition between two different periods of time: normal economic times and crises.[153] The widespread attention to fiscal rules recorded in Europe at present does not resolve this tension. Their design may reflect the present consensus on the need for fiscal discipline and attempt to make it last in the future. Indeed, the empirical evidence shows that the rules can effectively contribute to fiscal discipline. However, this does not provide a long-term assurance on their effectiveness. To this extent, the alternate fortunes of the SGP are a telling example. Whether national fiscal rules alone can achieve this objective remains an open question.

150 An unofficial version of the Pact for Competitiveness and its English translation are available at: http://www.euractiv.com/sites/all/euractiv/files/BRNEDA224_004512.pdf (Consulted on 11.4.2011).

151 European Council, *op. cit.*, note 58.

152 Leigh Philipps, 'Competitiveness Pact was never the blueprint people thought it was', *Euobserver.com*, 11 March 2011. Available at: http://euobserver.com/?aid=31967 (Consulted on 11.3.2011).

153 Allen Schick, *op. cit.*, note 113.

3.3 Enhancing fiscal discipline in France.

With the background analysis conducted so far, we will now move on to briefly discuss the case of the on-going reform process of the French public finances, started in 2010. In fact, making reference to the German experience, President Sarkozy announced in May 2010 that France would also amend its Constitution in order to oblige each new government to define at the beginning of the legislative mandate precise limits on public spending.[154] The proposal was made during the Second Conference on Public Deficit and somehow anticipated the existing political support to the results of the Camdessus Report on *Realising the constitutional objective of public finance balance*, released a month later.[155] The Commission chaired by Michel Camdessus and composed of prominent European economists was established in January 2010.[156] Following the indications of the Camdessus report, in March 2011 the Council of Ministers approved a draft law to be adopted by the Parliament to amend the French Constitution.[157]

The draft law introduces a new legal instrument to set a multiannual budget framework, which will have primacy over the annual budget laws and over the laws financing social security schemes. The so-called 'framework laws for public finances balance' aim at guaranteeing budget balance for a minimum period of three years. The draft law also requires that the budget law brings together all dispositions concerning financial and social revenues now dispersed across multiple legislative instruments. According to the new dispositions of the draft law, the French Parliament will also vote on the national stability programmes submitted to the European Commission and elaborated in the context of the new European Semester.[158]

Although inspired by the German debt brake, France does not properly follow its model. The draft law in fact only modifies the way budgetary laws are approved, although it reaffirms at the same time the importance of balanced public budgets. Nevertheless, it has been argued that this new framework may still be effective, provided that some other

154 Andrea Willis and Valentina Pop, 'Sarkozy proposes constitutional change to limit deficit', *Euobserver.com*, 20 May 2010. Available at: http://euobserver.com/?aid=30113 (Consulted on 15.4.2011).

155 Further information is available on the web page of the French Ministry of the Budget, at: http://www.budget.gouv.fr/actus/suite/100128_conference_deficit_01.htm (Consulted on 30.4.2011).

156 Michel Camdessus *et al.*, *Réaliser l'objectif constitutionnel d'équilibre des finances publiques*, 21 June 2010. Available at: http://www.budget.gouv.fr/directions_services/sircom/rapport_camdessus_2010.pdf (Consulted on 30.4.2011).

157 *Projet de loi constitutionnelle relatif à l'équilibre des finances publiques*, 17 Mars 2011. Available at: http://www.performance-publique.gouv.fr/accueil/detail-de-la-une.html?actu=59&cHash=96ab40d5e0 (Consulted on 15.4.2011).

158 *Ibid.*

conditions are met. In particular, Pisani-Ferry and Boone (2011) suggest three main improvements to the present draft law: to anchor the multiannual budgetary framework to the political cycle in order to foster political accountability, to create an equalisation account based on the German model in order to correct deviations from budget balance over time, and to establish a fiscal council with monitoring and sanctioning power to enhance compliance.[159]

On the other hand, it is also argued that introducing a fiscal rule based on the German model, in substitution for or combination with this reform, may guarantee more successful results. For instance, the OECD has recently suggested that adopting a new 'stable and effective budget rule' may provide the necessary incentives to restore fiscal discipline and sustain fiscal consolidation efforts also in the future.[160] To this extent, the on-going reforms will be important to foster compliance with this rule, but they will serve a different scope, namely specifying in the annual budget procedure how the targets set by the rule will be achieved.[161]

Indeed, adopting such a rule seems necessary as France's fiscal performance has been very poor in the past. Building on the long-term trend of constantly increasing public debt figures, the crisis has imposed further constraints on French finances. In fact, public deficits amounted to more than 7% both in 2009 and 2010 and public debt reached 81.7% of GDP in 2010.[162]

In the present post-crisis scenario, the need to restore sound public finances has become a widespread concern. Adopting a strong numerical fiscal rule may contribute to this aim. At present, there exist three legally-binding rules in France, whose strength is very low however, as proved by the negative track record of French fiscal performance: 1. a BBR on sub-national governments excluding investment expenditures; 2. a DR on social security, namely to guarantee proper finance of health care spending and 3. a RR on central government to reallocate higher-than expected revenues.[163] The OECD has thus suggested the adoption of a structural deficit rule for general government, whose characteristics are extensively based on the German debt brake model. It also acknowledges the importance of a strong political willingness to ensure that this rule

159 Jean Pisani-Ferry and Laurence Boone, 'Comment discipliner les finances publiques?', *telos-eu.com*, 17 April 2011. Available at: http://www.telos-eu.com/fr/article/comment-discipliner-les-finances-publiques (Consulted on 30.4.2011).

160 OECD, *OECD Economic Surveys: France 2011*, OECD Publishing, 2011, p. 55.

161 *Ibid.*

162 Eurostat and OECD data.

163 European Commission dataset on National fiscal rules. See: note 125.

properly functions, as well as of creating an independent fiscal council to strengthen the overall budgetary framework.[164]

Although the present draft law represents an important step towards the creation of a more sound budgetary framework, the adoption of a numerical rule may further enhance fiscal discipline. Compared to the present reform proposals, it would strengthen the transparency of the budgetary process and the accountability of policy-makers. In fact, a more precise fiscal target would receive a wider public visibility and facilitate monitoring by the electorate, thus increasing the reputational costs for undisciplined governments. It would also give policy makers a longer and more stable framework of reference to plan their policies and better adjust them to the actual development of the economic cycle. In any case, whether or not introducing such a rule is considered as a valid option in the on-going reform process, strong commitment to discipline is needed to restore the sustainability of French public finances. A numerical fiscal rule has the advantage to set the reference framework for sound fiscal policies in the future: a clear objective, the right incentives to reach them and sanctions in case of non-compliance.

164 OECD, *op. cit.*, note 160.

Conclusions

The adoption of numerical fiscal rules at the national level represents one of the many reforms that have been presently introduced to improve fiscal performance in EU countries and strengthen the stability of the euro area, after the recent economic crisis.

There is in fact a wide array of arguments justifying the need for ensuring fiscal discipline both within and outside a monetary union and imposing constraints on governments' behaviour. In chapter 1 some of these arguments have been recalled. In a long-lasting economic debate with Keynesians, monetarist economists have argued that discretionary policies are ineffective in stabilising the business cycle and can even be counterproductive. Moreover, in the context of a monetary union, unsustainable debt accumulation may generate negative spillovers of varied impact onto other Member States. The institutional mechanisms of the euro area have thus tried to ensure fiscal discipline, but with no successful results so far. The impact of the recent economic crisis has in fact further weakened the public finances of most European countries, which were already moving on an unsustainable path. The on-going reforms of the institutional set-up of the euro area aim at ensuring that compliance with the European rules guarantees long-term debt sustainability, at a time when most countries are making huge consolidation efforts and others face severe financial troubles. In this framework, adopting numerical fiscal rules at the national level may help countries maintain these efforts, comply with the renewed rules of the SGP and build an economic environment which favours growth, stability and well-being.

Chapter 2 focused on the economics of national fiscal rules. Although the empirical evidence of their effectiveness remains limited, fiscal rules certainly contribute in a positive way to the maintenance of sound public finances. However, this strongly depends on the characteristics of the rules. In fact, stronger rules increase the chances of compliance and have a higher impact on countries' fiscal performance. Nevertheless, the design of the rules also requires a balancing exercise, as many of the features highlighted in the literature as relevant to enhance the effectiveness of the rules involve trade-offs. Firstly, a strong fiscal rule is generally enshrined at the highest level of the legal system of the country concerned, in order to foster compliance. However, this reduces its flexibility, as the adoption of both the rule itself and of any later amendments thereto requires increasing political consensus, the higher the importance of the used legal instrument becomes. Secondly, numerical fiscal rules should be easy to implement and to monitor and enjoy a wide media visibility. This increases in fact the reputational costs of the government in case of misbehaviour. However, reputational costs alone could be insufficient to ensure discipline. Credible and effective enforcement mechanisms are necessary as well. Fiscal rules are thus stronger when an independent authority is endowed with the powers to monitor fiscal developments and impose sanctions in case of non-compliance. Finally, rules should also include some flexibility clauses in order to take into account unforeseeable future events. However, the more flexibility is introduced in the rule, the higher the incentives not to comply with it get. Indeed, the same happens with the definitions of the target and the scope of the rule. On the one hand, simplicity increases public awareness and understanding; on the other hand, the rule should be more nuanced to take into account different economic concerns. However, the more it becomes complex, the higher the incentives to circumvent it are. For all these reasons, national fiscal rules cannot be ultimately effective if they are not backed by a strong political commitment.

In the present post-crisis scenario, fiscal rules have been under the spotlight in EU countries. The need to consolidate and the threat of contagion from countries facing financial instability have brought to the public attention the benefit of constraining government's behaviour. The number of fiscal rules adopted in recent years has been on a continuously growing trend, signalling politicians' commitment and engagement to discipline. The constitutional rule adopted in Germany has also emerged as a model to follow, given its political and economic influence. Most EU Member States have in fact engaged themselves to adopt similar types of rule, while a directive proposal from the European Commission explicitly requires them to do so.

National fiscal rules are considered in the current debate as an effective tool to enforce discipline, strengthen ownership of the SGP and sustain the on-going consolidation efforts. Indeed, as the French case study has shown, this can really be the case. However, fiscal rules cannot be a substitute for the required political commitment to discipline. Whatever their design, this the involved trade-offs and leave some margin for misbehaviour and non-compliance. Fiscal rules can be essential to increase public attention to the issue and impose the ultimate sanctions on politicians to be outvoted in the following elections. However, they cannot resist the pressure if governments decide not to comply.

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