Rules-Based Fiscal Policy in EMU: Pros and Cons

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The Case for Fiscal Rules

- Political economy influences create expenditure pressure that leads to rising deficits and debt.
- Market discipline is too abrupt, penalizing only particularly poor fiscal policy choices.
- In a monetary union, high deficits and debt in one country can spill over to other countries.
- Rules signal a commitment to sound fiscal policy, and to macroeconomic stability.

Euro Area Fiscal Policy Framework

- Pre-Maastricht fiscal policy lacked discipline and was highly procyclical.
- The fiscal convergence criteria of the Maastricht Treaty provided a basis for monetary union.
- The regulations of the Stability and Growth Pact consolidated the improvement in fiscal positions and reduced procyclicality.
- However, the recent experience with the euro area fiscal policy framework points to limitations.

Fisical Policy in Bad Times

Fiscal Policy in Good Times

- The framework does not foster forward-looking fiscal policy management, and especially the running of fiscal surpluses during upswings (consistent with maintaining a fiscal position of close to balance or surplus over the medium term).
- A symmetric approach would provide more room for countercyclical fiscal policy in bad times, while respecting the 3 percent of GDP deficit limit.
- Expansionary fiscal policy is also likely to be more effective (i.e., fiscal multipliers will be larger) when the fiscal position is strong.

Some Other Claims

- Deficit targets and limits are not tailored to differences in debt levels across countries.
- The longer-term fiscal challenges posed by prospective population aging are not properly taken into account.
- Insufficient attention is paid to the structure of fiscal policy and longer-term growth; more specifically, there is a bias against public investment, especially during fiscal consolidations.

Reform Options

To address some of the perceived shortcomings in the design and application of the euro area fiscal policy framework, reforms to the fiscal rules have been suggested.

- Focus on debt rather than deficits, although countries with low debt already have more room for discretion.
- A golden rule would allow borrowing to finance public investment, but it does not ensure fiscal discipline.
- A cyclically adjusted balance rule would introduce symmetry as between good and bad times.

Targeting Cyclically Adjusted Balances

- One possibility is to adopt a year-to-year cyclically adjusted fiscal target.
  - Automatic stabilizers may not be optimal.
  - Cyclical adjustment is not a precise science.
  - The budget responds automatically to noncyclical factors.
  - There may be a conflict with structural reforms aimed at reducing the size of the welfare state and high marginal tax rates.
- Alternatively, a fiscal target can be met on average over the cycle, which provides more scope for discretionary policy.
  - The cyclical position of the economy is difficult to judge.
- Targeting cyclically adjusted balances would make the euro area fiscal framework more complex and less transparent, and increase the scope for opportunistic behavior.

Using Alternative Fiscal Indicators

- Reference can still be made to alternative fiscal indicators, including the cyclically adjusted balance, to gauge underlying fiscal positions, and the current balance, to promote and protect public investment.
- This is fully consistent with the discretion countries have at present over short-term fiscal policy. Alternative indicators can also be used more in surveillance.
- However, there is a need to improve estimates of cyclically-adjusted balances, and to ensure that current balances are properly measured.
- It should also be noted that a shift to accrual accounting could complicate the interpretation of fiscal indicators.

Medium-Term Fiscal Targets

Country specific “close to balance or surplus” targets could more explicitly take into account a number of factors.

- Debt positions.
- Unfunded pension costs.
- Structural reform priorities.
- Infrastructure needs.
- Contingent liabilities (e.g., associated with public-private partnerships).

Conclusions

- The SGP should remain a central pillar of EMU.
- A clearer rationale for medium-term fiscal targets should be provided.
- Multiple fiscal indicators can be used to assess fiscal policy in the short term.
- Allow more flexibility in assessing excessive deficits.
- Resolving the current procedural impasse will bolster credibility.

...and in particular

- “Reloading the fiscal cannon” in good times will prepare countries well to respond to bad times. This is a major challenge for surveillance, and for domestic policies and institutions.