

## National Expenditure Rules – Why, How and When

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The need to ensure fiscal consolidation across EU countries in order to revert the growing debt ratios stemming from the current crisis calls for an improvement of national fiscal governance. Institutional arrangements such as numerical fiscal rules may be instrumental in improving the conduct of fiscal policy domestically. In particular, expenditure rules present a number of features in terms of simplicity, transparency, monitoring and accountability that make them particularly appealing relative to other types of rules and may substantially contribute to an improved fiscal policy making. They also show an appropriate balance between budgetary discipline and macroeconomic stabilization. In turn, they have represented a cornerstone in the fiscal strategy adopted by some EU Member States to sustain successful episodes of fiscal consolidation over the last decades. More specifically, spending rules are featured by the following characteristics:

- They focus on the part of the budget most directly controlled by the government, reducing uncertainty for the attainment of the target and promoting accountability.
- They target the main source of the deficit bias, i.e. recurrent spending overruns.
- They hardly prevent automatic stabilizers from operating, particularly on the revenue side, and may limit spending pressures in good times.
- Their target formulation and monitoring are simpler than those of other rules (e.g. cyclically-adjusted budget balance or debt rules) and easy to communicate to the public and elected bodies, i.e. they are conducive to transparency and simplicity.
- They may improve expenditure composition by breaking down the overall spending ceiling into separate thresholds for each main expenditure area, which in turn requires the establishment of public spending priorities and provides policy guidelines for policy makers.
- Recent research and policy experiences suggest that expenditure rules are instrumental in supporting the functioning of budget balance rules and enhancing their effectiveness.

A number of design features of expenditure rules are critical to ensure their appropriate working. The following issues deserve particularly attention:

First, the choice between real and nominal spending targets is crucial and depends on the time horizon of the rule. In the short-term, a nominal expenditure is more appropriate to be used as an operational annual target during the budgetary execution (i.e. an annual real expenditure target might be difficult to meet and destabilising as it may imply significant adjustments in line with price developments complicating the annual budgetary execution

and its monitoring). In the medium-term, however, real targets are more sensible to properly decide what volume of goods and services the government may provide with reference to a medium-term real GDP growth (i.e. the pool of available resources) and according to its policy priorities. This suggests setting nominal targets as the annual policy objective and real targets in the medium-term when setting up the expenditure figures in the medium-term fiscal planning.

Secondly, in order to ensure a highest effectiveness, expenditure rules should adopt a multi-annual perspective. While a rule that only sets a target for one year is more prone to circumvention and creative accounting practices, a medium-term perspective allows setting expenditure targets consistent with macroeconomic and tax revenue prospects, sustainability issues and policy priorities. Additionally, expenditure rules incorporated into a medium-term budgetary framework (MTBF), as part of a comprehensive fiscal strategy, may better adapt to economic and country specific situations while making stabilisation and consolidation objectives more compatible.

Thirdly, spending rules should be accompanied by correction mechanisms containing pre-established measures in case of non-compliance, which are an important feature to ensure the credibility and effectiveness of the rule.

Next, exclusions of some budgetary items from the coverage of the rule may be justified to promote accountability and reinforce the counter-cyclical properties of spending norms. In this respect, policy experiences point to a relatively favourable assessment on excluding interest payments and cyclically sensitive items such as unemployment benefits, which are not under the direct control of the government in the short-term.

The coverage in terms of government layers is also an important design feature of the rule. Although an expenditure rule should ideally apply to all government layers, institutional and historical country-specific backgrounds and legal constraints may render a full coverage by a single rule unfeasible and inappropriate. In this respect, the existence of appropriate coordination mechanisms across government levels appear of utmost importance to effectively control public expenditure in all government sub-sectors, which in some countries has been pursued through the so-called Internal Stability Pacts.

Finally, since expenditure rules only focuses on the spending side of the budget they need to be complemented by other types of fiscal rules and arrangements to effectively promote discipline. A number of successful EU country policy experiences show a high complementarity between expenditure thresholds and budget balance and/or revenue rules to sustain fiscal consolidation.

In the EU context, consistency between domestic expenditure rules and the SGP provisions is crucial. Specifically, the design of national spending rules should ensure that government spending developments are in line with the expenditure benchmark included in the reformed SGP and effectively sustain the achievement of the MTOs.

Last but not least, similarly to other types of rules, strong political support and commitment to the respect of the rule is essential as well as a certain degree of social consensus on the need to conduct sound and sustainable fiscal policy with a particular emphasis on spending control.