What future for rules-based fiscal policy?

IMF Conference: Rethinking Macro Policy III: Progress or Confusion?

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1. Introduction

Today, I wish to talk about rules-based fiscal policy. Specifically, the question I wish to put forward and discuss is: 'what is the future of rules-based fiscal policy'? Some panellists have commented on the title of the conference. If I had to reformulate it from the standpoint of the debate on fiscal rules, I would change it into "Rethinking fiscal rules: progress <u>and</u> confusion".

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

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

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

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

* I would like to thank Nicolas Carnot for his contribution in the preparation of this intervention.

1) From a purely macroeconomic perspective, the fiscal stance was at times too restrictive during the crisis, but this reflected more the incompleteness of EMU's architecture rather than inherent flaws of the EU's fiscal framework.

2) Fiscal rules should anchor public debt ratios to long-term prudent levels whilst helping to stabilise the economy. Achieving such a double act is even more important in a currency union than in independent jurisdictions.

3) In the present juncture, in achieving this double act, a broadly neutral fiscal stance appears appropriate for the euro area as a whole, but its distribution is suboptimal. If an expansionary policy proves desirable, it would be better pursued at the central than at the national level.

4) A prudent debt anchor and a stabilisation goal are consistent with the present EU fiscal rules, but are 'hidden' into a framework which is overly complicated and suffers from an 'authority gap' from the centre. The latter two features are two faces of the same coin and can be traced back to lack of trust.

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

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

2. An existential crisis: fiscal rules in an incomplete EMU

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

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

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

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

- On the financial side, several Member States were on the verge of or had effectively lost market access.

- Meanwhile the institutional foundations that could have supported a more balanced fiscal strategy were not there ex ante. They had to be devised as the crisis developed.

In particular, the setting up of European firewalls (the EFSF and EFSM, and later the ESM), the decision to launch a banking union, and the crucial actions of the European central bank (ECB), including the announcement of Outright Monetary Transactions (OMT), were decisive in turning the corner of acute financial stress.

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

The take-away, from my perspective, is not that fiscal rules *per se* proved their inadequacy with the crisis.

The main lesson is that fiscal rules operate in a certain institutional and political environment which has to be conducive to sensible implementation. The fiscal rules *stricto sensu* could in fact have been applied in a less pro-cyclical fashion.

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

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

3. Fiscal rules: the 'double act' of anchoring discipline while helping stabilisation

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

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

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

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

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

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

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

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

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

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

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

Prudent public debt objectives as long-run anchors

Expanding on matters of rules design, I wish to also stress the importance of the details. Also there we have learnt and continue to learn.

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

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

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

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

Recent research including from international organisations, however, lends support to the view that many advanced economies have already exceeded the range of prudent indebtedness. This holds true in particular for members of the European Monetary Union where, interestingly, the levels of prudent public indebtedness may be lower given the fact that each individual member does not have a native central bank underpinning its public debt exposure.

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

Designing subtle rules

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

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

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

Yet, budget balance rules also suffer significant shortcomings in this regard. Headline balances are usually better left off accommodating economic fluctuations. In principle, the solution is to rely on cyclically-adjusted balances, as has long been recognized in the EU framework. But structural deficits are weakened by large measurement uncertainties, especially in level terms, but also to some extent in first differences.

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

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

Overall and putting the threads together, we see the broad contours of a robust and economically-based rule. This would prescribe a proper notion of the fiscal effort, as just evoked, against the two objectives that I have discussed, debt sustainability and cyclical stabilisation (Carnot, 2014).

4. Broadly neutral stance appropriate at the current EU juncture, though distribution could be improved

How does the current EU fiscal stance compare with such an economically-robust rule? I have provided a recent assessment in a VOX column together with my colleague Nicolas Carnot (Buti and Carnot, 2015).

At the current juncture, the aggregate stance for the Eurozone is close to neutral. This appears to strike a reasonable balance between the considerations of sustainability – bearing in mind unprecedented levels of debt as compared with what the recent research would suggest as 'safe levels' – and the current economic conditions of a slow momentum.

Specifically, the Eurozone still retains a fiscal gap of about 2% of GDP compared with what would be needed for a smooth reduction of debt in the long run (though this gap has been already significantly reduced in past years). On the other hand, while not as acutely dramatic as in the Great Recession of 2009, animal spirits remain clearly downbeat, albeit with recent green-shoots.

At the same time this overall stance should remain differentiated with country conditions. We see in particular scope for moderate expansion, e.g. focused on supply-side enhancing investments, in the few countries with arguably fiscal scape and large private saving. Instead, moderate consolidation should be pursued according to our rule of thumb in both France and Spain (reflecting still very large primary gaps). The case of Italy is more in-between, given the relatively smaller fiscal gap and the still very depressed environment (in contrast to better momentum in Spain).

In all countries, the composition of fiscal policies also needs to be further improved, both on the tax structure and the quality of public spending.

5. Lack of authority and complexity are hampering a sound application of EU fiscal framework

Good design helps but doesn't guarantee implementation

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

Before getting further into this, I wish however to note that matters of 'political ownership' and effective implementation are also partly connected to design issues. Good design – and importantly, recognized as such – is more conducive to subsequent effective implementation.

This is not only because the policy is better but also as it can be more legitimately enforced by coercive means if needed, since there is an *ex ante* broader acceptance by policy-makers and the public at large. Conversely, an insufficiently adequate rule will not be implemented not just because policy-makers are sinners, but simply because it would really be 'stupid' to insist on it. *Lex mala, lex nulla*.

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

Lack of 'authority' and complexity

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

The complexity is most visible not so much in the subtlety of a given rule – that is partly necessary to meet the criterion of adequacy – as in the plurality of rules and sub-rules. It has been noted that while most federations impose limits on borrowings of sub-governments, the EU is unique in the number of rules it imposes on Member States and in the size of its rule book (Eyraud and Wu, 2015).

At the same time, the incomplete authority is seen in the lingering doubts over the ability to effectively impose the discipline of agreed rules to recalcitrant Member States.

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

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

What is important to note is that the two issues of complexity and insufficient authority are truly two faces of a single problem. Any rules-based setting, however smart in design, requires an authoritative enforcer to provide firm guidance and ultimately call the shots. However, if you suspect that you miss this authority, the temptation is to substitute with additional fine prints to the contract. Rules are complemented by sub-rules and sub-provisions in order to cater for all kinds of circumstances in the hope of increasing predictability and preventing risks of abuse.

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

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

Reconciling credibility with flexibility: the need for 'institutions'

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

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

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

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

- One, as laid out before, is to ensure the full enforcement of the fiscal agreements. The current enforcement gap is what explains the attraction for an authority with the legitimacy and accountability to transcend the national polities.

- The other reason is to allow a move from purely proscribing rules to a more prescriptive approach, where the case is positively made that the recommended policies are economically sound.

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

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

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

6. Conclusion

So overall, the need for stronger institutions comes from both angles in the European Monetary Union. One is to ultimately have the possibility to enforce the common rules; the other is to exert the necessary discretion to depart from the quantitative parameters enshrined in the rules under specific circumstances.

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

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

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

They also mean that pure discretion is less appealing in the fiscal realm, even within a sound institutional framework. Pure discretion, where the policy is determined from scratch at each period, would leave too much of a risk that the discipline objective is overlooked at the expense of the short term.

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

In fact, once you have the proper institutional framework, you would be in a better position to use economically-sensible rules as a broad compass. You could keep it simple by limiting the agreed code to one 'rule of thumb' reconciling smartness and simplicity.

I have already sketched the outline of such possible robust rule (prescribing a proper notion of the fiscal effort against the two objectives of debt sustainability and cyclical stabilisation). This would give a useful benchmark to assess the fiscal policies and frame the recommendations, while keeping amount of judgment in the application.

In a nutshell, a fruitful long-term avenue would therefore involve a framework where a simple and smart rule acts as the basis and permanent anchor for authoritative discretionary policy-making.

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