NUMERICAL FISCAL RULES FOR FISCAL DISCIPLINE

Mihaela Göndör, Assoc. Prof., PhD, ”Petru Maior” University of Tîrgu Mureș

Abstract : This study focuses on fiscal governance from the perspective of numerical fiscal rules as main elements for strengthen the fiscal discipline. The study defines the numerical fiscal rules, compares their types, design, properties and objectives in EU countries, analyses the key features and their reform in responding to the contemporary crisis. The paper uses official data from EU fiscal rules database, Eurostat, IMF and national authorities (at least central government), regarding both national and supranational rules, between 1990 and 2012. The main objective of this paper is to provide policy guidelines related to the appropriate and desirable institutional reforms so as to ensure fiscal responsibility and debt sustainability at national level.

Keywords : Fiscal Rules, Fiscal Policy, Fiscal Discipline, National Fiscal Framework.

Introduction

The contemporary economic crisis highlighted the importance of fiscal policy as a macroeconomic tool for dampening the output shock. The crisis has resulted in the adoption of a large number of fiscal measures expenditures and revenues side, e.g. tax measures both upwards and downwards or/and cut public spending, revenue-raising measures based on direct taxes or indirect taxes or both of them or/and measures aimed at granting companies the possibility to defer tax payments, including VAT. The impact of fiscal measures in response to the economic and financial crisis widely differs across the European Member States. While some EU members faced the crises, a number of them continue to experience severe fiscal crises and the sustainability of their public finances is in doubt. These differences reflect the national design of discretionary/non-discretionary fiscal policy, based on social policy choices such as public or private provision of services, the size of Automatic Fiscal Stabilizer, or technical factors such as the level of the tax-to-GDP ratios, the government size, the efficiency of tax administration and the domestic fiscal frameworks. The crisis revealed that the mistakes in fiscal policy can have severe economic and social consequences with high recovering costs. According our previous research, unstable and unpredictable fiscal policies have worsened the economic and social system in Romania, thus reducing the government credibility (Göndör and Özpençe, 2013; Göndör, 2013; Göndör and Neag, 2012). The unpredictability, the lock of transparence and the arbitrariness of fiscal rules drastically reduced the government’s credibility, leading to tax avoidance, tax evasion and corruption. Thus becomes increasingly clear that the fiscal policy do needs rules for controlling possible excesses in the management of public finances, because of the dangers of populism and fiscal irresponsibility that may involves a discretionary fiscal measure.

Given the importance of the public sector in contemporary economies, understanding the fiscal policy as a factor underlying the cyclical dynamics of macroeconomic aggregates can make a valuable contribution to the design of stabilization program. In this perspective, the paper intends to explore the numerical fiscal rules from the perspective of fiscal governance, in order to provide some empirical basis for the argument that fiscal rules sustain fiscal discipline. The main objective of this paper is to define, characterize, explain, compare and promote the numerical fiscal rules as elements for strengthen the fiscal discipline to avoid repeating past policy mistakes.

Based on the scientific literature and empirical evidence on the domestic fiscal framework, particularly on existing fiscal rules, the present paper firstly study the existing evidence and then develop the theory's implications for these evidence. The paper uses official data from EU fiscal rules database, IMF and national authorities, regarding both national and supranational rules, between 1990 and 2012.

The paper is structured as follows: Section 1 presents a brief literature review regarding the numerical fiscal rules for fiscal discipline. Section 2 provides a brief characterization of Numerical Fiscal Rules for Fiscal Discipline in EU Member States, using IMF and EU statistical data. Section 3 focuses on the results of the study and the last section concludes.

1. Numerical Fiscal Rules for Fiscal Discipline in the Scientific Literature

As Wyplosz (2013) points out, the domestic demand shocks occurred in some countries in contemporary crisis time, may have different causes but, the common feature is the fiscal discipline. Fiscal rules are found to be important tools of fiscal consolidations (Larch and Turrini (2008)) and in fulfilling medium-term fiscal objectives and plans (von Hagen (2010).)

Defining the fiscal indiscipline as "the tendency to run deficits year in-year out", Wyplosz (2013) concludes about the ambiguity of the theoretical literature, despite the fact "this is a very general issue" and states that it is caused by "common problems" as "the need for democratic governments to spend to cater to pressure groups while avoiding to upset taxpayers".

The scientific literature reveals that the number of countries using fiscal rules as a fiscal policy device has increased rapidly since the mid-1990s, initially confined to advanced economies and rapidly outnumbered by developing economies (Schaechter et al., 2012).

According to Symansky and Kopits (1998), a fiscal rule is "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance such as the government budget deficit, borrowing, debt or a major component". According to European Commission, fiscal policy rules set numerical targets for budgetary aggregates which pose a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal outcomes, such as the government budget balance, debt, expenditure, or revenue developments, in order to enhance budgetary discipline and foster policy coordination between different levels of government. Additionally, fiscal rules may further contribute to the reduction of uncertainty about future fiscal policy developments. (European Commission, 2014).

As it regards the impact of fiscal rules on pro-cyclicality, the literature reveals some divergent views, facing empirical limitations. As suggested by Kopits and Symansky (1998), IMF (2012), Bova et al. (2014), etc., fiscal rules are generally established as part of a broad reform of the fiscal framework that seeks to support fiscal credibility and discipline, containing pressures to overspend, especially in good times. Bova et al. (2014) find that in contrast with advanced economies, the adoption of fiscal rules in developing countries has not been associated with more counter-cyclical fiscal policies and conclude that having a fiscal rule does not shield developing economies from pro-cyclicality. Debrun et al. (2008) find that fiscal rules tend to encourage higher cyclically-adjusted primary balances in the EU and may reduce pro-cyclicality. On the other hand, Manase (2005) claims that fiscal rules tend to limit the ability of fiscal authorities to react to business cycle fluctuations, thus potentially exacerbating volatility.

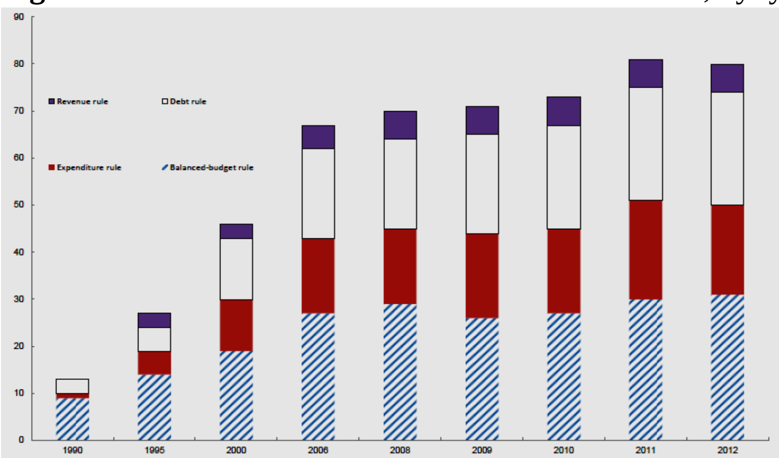
More recent economic literature (European Commission, 2011) and country-specific policy experiences provide evidence that well-designed numerical fiscal rules (NFR) significantly enhance fiscal discipline together with independent fiscal institutions (Debrun (2007).

2. Numerical Fiscal Rules for Fiscal Discipline in EU Member States

2.1. NFR in EU - The empirical evidence

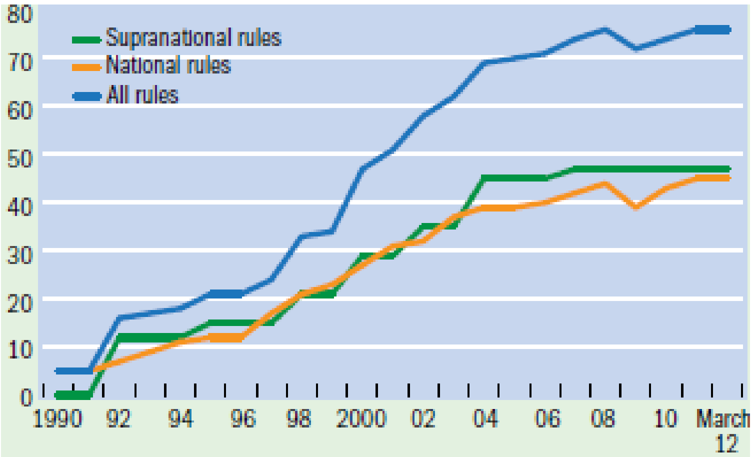
The official data reveals the increasing number of numerical fiscal rules (NFR) used by EU Member States as fiscal device since 1990s, as shown in Figure 1 and 2. The main types of NFR in EU Member States are Balanced Budget Rule (BBR), Debt Rule (DR), Expenditure Rule (ER) and Revenue Rule (RR). In 2008, there were 67 rules in place in EU Member States, of which more than one third were budget balance rules; debt and expenditure rules represented about one quarter each and revenue rules accounted for less than 10%.(European Commission, 2014)

Figure 1 Number of NFR in force in the EU Countries, by type, 1990–2012



Source: European Commission

Figure 2 Number of national and supranational NFR, 1990-2012

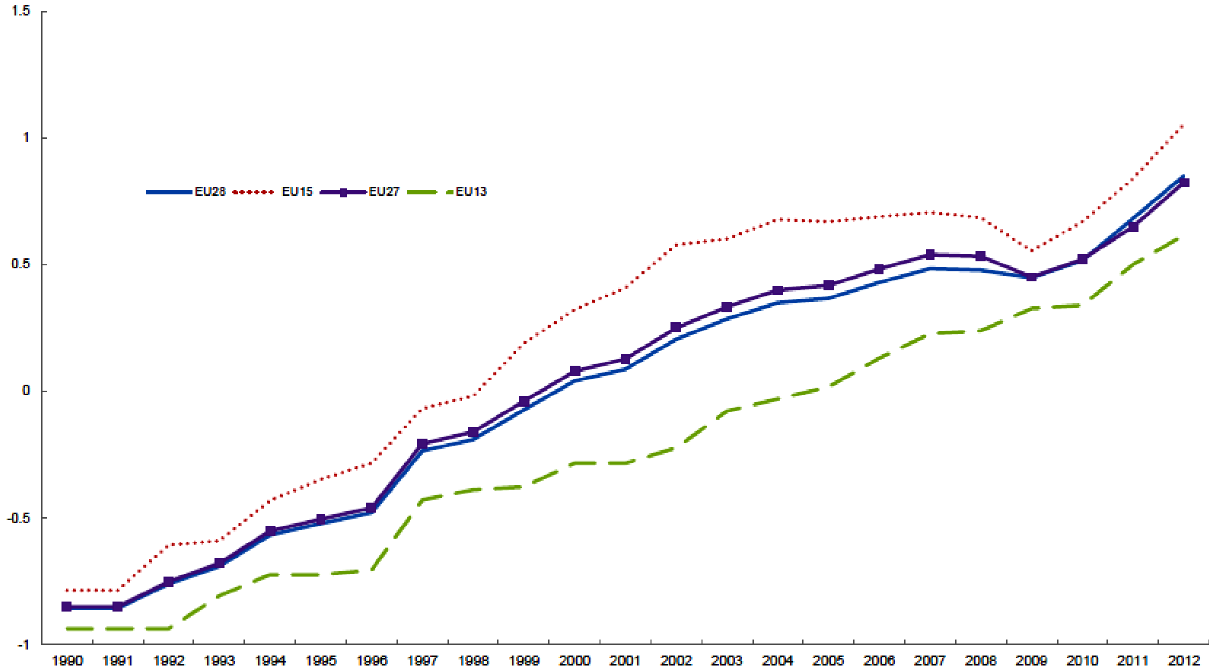


Source: IMF Fiscal Rules Database

To capture the influence of the characteristics within the institutional framework of fiscal policy, DG ECFIN has constructed an index of strength of fiscal rules (SFRI), using information on (i) the statutory base of the rule, (ii) room for setting or revising its objectives, (iii) the body in charge of monitoring respect and enforcement of the rule, (iv) the enforcement mechanisms relating to the rule, and (v) the media visibility of the rule. Based on the SFRI for each rule, a comprehensive time-varying fiscal rule index for each Member State was constructed by summing up all SFRI in force in that Member State weighted by the coverage of general government finances of the respective rule (i.e. public expenditure of the government sub sector(s) concerned by the rule over total general government expenditure). In the presence of more than one rule covering the same government sub-sector, the second, third and fourth rules obtain weights ½, ⅓, and ¼, to reflect decreasing marginal benefit of multiple rules applying to the same sub-sector. The assigned weights are mainly determined by the fiscal strength of the rule and its coverage. (European Commission)

The fiscal rules database contains the time series for the fiscal rule index 1990-2012 as shown in Figure 3 and 4. This corresponds to the quality of rules-based fiscal governance in EU Member States.

Figure 3 The FR Index (FRI) in the EU and selected groups of Member States, 1990 to 2012

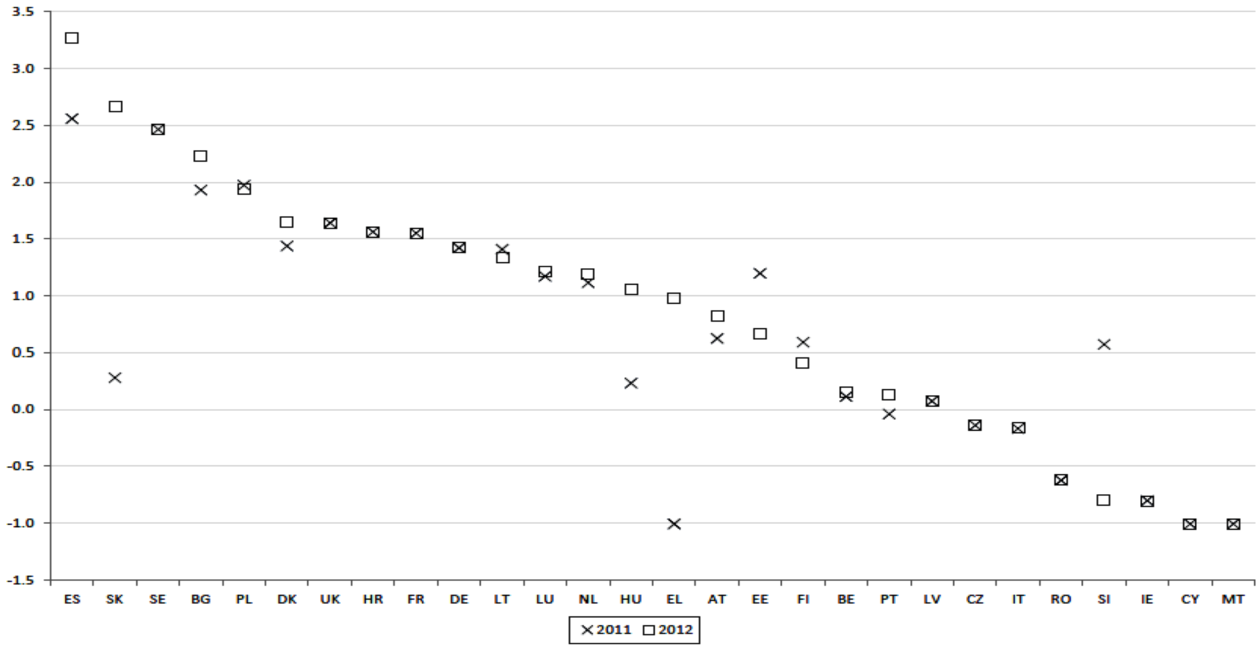


Source: European Commission

An improvement of the index is achieved by strengthening one or several existing numerical fiscal rules along either of the above dimensions, by introducing new numerical fiscal rules, or by extending the coverage of general government by existing or new rules. The average quality of fiscal governance in the EU-27 has improved during 1990 and 2012, although 2009 marks a decline in the quality of fiscal governance in several EU countries.

As shown in Figure 4, countries with above-average standards of rules based fiscal governance include the Netherlands, Estonia, Denmark, Sweden, Luxembourg, Poland, Germany and Belgium; Bulgaria, Spain and France have joined this group by strengthening their rules-based framework in the time period under review. Slovenia, Hungary, Slovakia, Italy, Latvia, Romania, Austria, Ireland and Portugal have maintained rules-based fiscal governance frameworks with lower than average quality. The Czech Republic, Finland and the United Kingdom have a tradition of sound rules-based fiscal governance in contrast with Cyprus, Greece and Malta, continuously characterized by the absence of numerical fiscal rules.

Figure 4 The fiscal rule index (FRI) in the EU-28 by country, 2011 and 2012



Source: European Commission

A more direct indication of a systematic relationship between the quality of fiscal governance and the price of debt – that is determined by the risk of default – can be obtained by looking at the risk of default in groups of countries distinguished by their fiscal governance directly. (Table 1)

Table 1 Credit ratings of Moody's of EU Member States grouped by their strength of rules-based fiscal governance, mid-2009

Rating	Fiscal rule index			
	below average		above average	
Aaa	AT	(2.2)	DE	(6.9)
	FI	(4.6)	DK	(9.4)
	IE	(2.2)	ES	(9.5)
	IT	(3.7)	FR	(6.9)
	UK	(0.0)	LU	(8.3)
			NL	(9.4)
			SE	(9.1)
			BE	(5.3)
Aa2	PT	(1.7)		
Aa2	SI	(5.1)		
Aa3	CY	(0.0)		
A1	CZ	(5.2)		
	EL	(0.0)		
	MT	(0.0)		
	SK	(3.8)		
A2				
A3			LT	(9.5)
Baa1	HU	(5.1)		
Baa2				
Baa3	LV	(3.6)	BG	(10.7)
	RO	(2.3)		

Source: *Moody's (credit ratings), Commission services (fiscal rule index)*

Table 1 provides some support for the relation between sound fiscal governance and the cost of public debt.

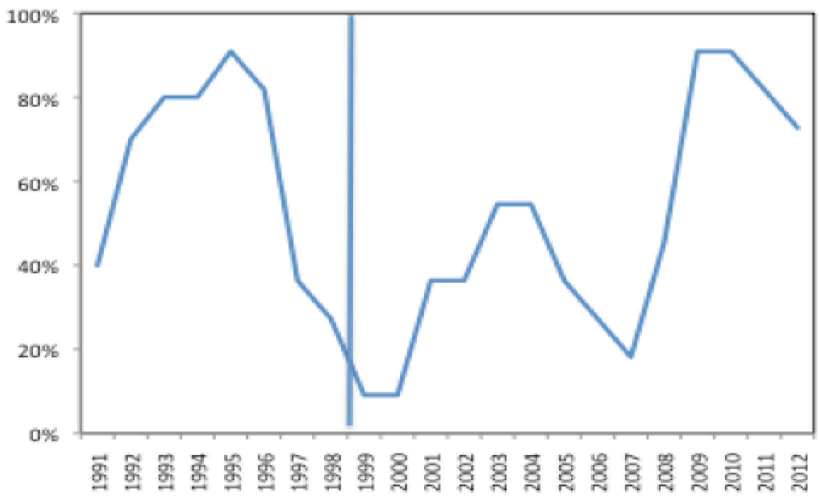
In the Maastricht Treaty, fiscal discipline rests mainly on the excessive deficit procedure which led to the Stability and Growth Pact (SGP). The EU fiscal framework, as laid down by the SGP, aims at ensuring fiscal discipline through two main requirements: (i)

Member States are required to avoid excessive government deficit and debt positions, less than 3% and 60% of GDP, respectively; (ii) Member States are required by the preventive part of the SGP to achieve and maintain their medium term budgetary objectives (MTO), which are cyclically adjusted targets for the budget balance.

The 2005's version of the pact strengthens the "preventive arm" by requiring that budgets be significantly improved during boom years in order to leave enough room for deterioration in slow-growth years not to result in a breach of the 3% limit. The revised pact also specifies that the Commission would base its recommendations on cyclically adjusted budget measures.

The very existence of a public deficit crises doubled by the sovereign debt crisis in the EU is just the latest available proof that the European model has failed to establish and enforce fiscal discipline. The 3% and 60% ceilings proved their inefficiency as NFR (shown in Figure 4 and Figure 5).

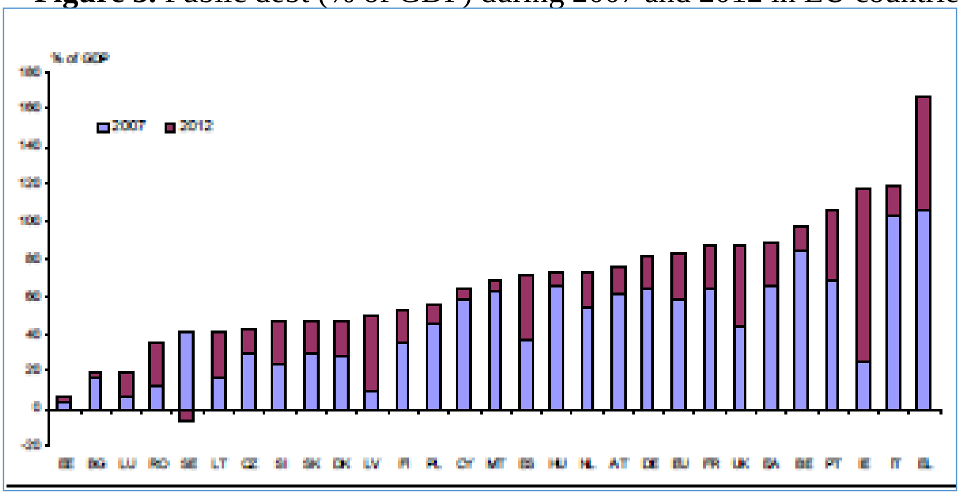
Figure 4. Percent of EU countries with deficits above 3% of GDP



Source: European Commission

According to the Commission services' 2011 Spring forecasts, the government deficit exceeded 3% of GDP in twenty-two Member States in 2010. According to the Commission services' 2014, the public debt exceeded 60% of GDP in 16 Member States in 2012 (as shown in Figure 5).

Figure 5. Public debt (% of GDP) during 2007 and 2012 in EU countries

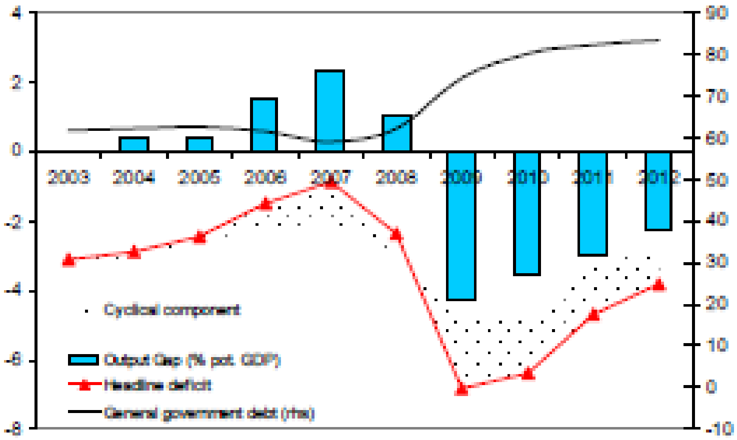


Source: European Commission

The empirical evidence shows that many governments did not adopt countercyclical policies before the onset of the crisis and as a consequence, the 3% ceiling rule forced fiscal policy to turn pro-cyclical during the crisis. Moreover, the enforcement mechanism proved to be too weak to exert sufficient pressure on national governments.

Figure 6 shows the cyclicality in EU and indicates the weakness of public finances related to the crisis.

Figure 6. Public Deficit, Public Debt and Output Gap (% of GDP) in UE



Source: European Commission

These deteriorations in the public finances clearly have difficult political and economic consequences and for some countries these are particularly acute. An obvious lesson learnt from the crisis is thus that the SGP was not able to ensure sound public finances throughout the EU.

2.2. NFR in EU – from SGP to TSCG

From an empirical perspective, lessons learnt from the actual crisis revealed the need to complement the fiscal rules enshrined in the EU Treaty and SGP with national fiscal rules. As a consequence, the Treaty on Stability, Coordination and Governance (TSCG or the Fiscal Compact), seen as a way of strengthening the Stability and Growth Pact, introduces a key element of fiscal discipline, which is now every national government's own legal obligation. It involves the adoption of a clever fiscal rule, based on the cyclically adjusted budget which cannot exceed 0.5%-1% of GDP, depending on the share of public debt in GDP, together with the 3% ceiling. Thus the Fiscal Compact represents a further centralization of fiscal discipline enforcement (2011). It states that, "if possible", the rule should require that the cyclically adjusted primary budget be in balance and should be written into the national Constitution. As states Wyplosz (2013), it is more modern since, instead of involving nominal debt, spending or deficit ceilings, it focuses on cyclically adjusted figures.

In focusing on national institutions and processes, the Two Pack builds on an approach that underlies the Directive on national budgetary frameworks, which was introduced as part of the Six Pack in 2011. This directive recognized the importance of the role that national policy-makers have in countries' ability to comply with the European requirements under the SGP and sets certain minimum criteria for national budgetary frameworks that countries should comply with. These criteria concern accounting and statistics, forecasts, numerical fiscal rules, the need to rely on medium-term budgetary frameworks,

coordination arrangements and transparency.

3. **Reforming NFR in EU**

The findings of this research suggest the key features of NFR as follows: (i) the statutory basis of the rule, (ii) the monitoring of budgetary developments against the fiscal targets and (iii) the existence of corrective mechanisms in case of non-compliance. Monitoring and enforcement could be carried out by an independent body and the actions to be taken in case of non-compliance should always be defined ex-ante so as to make the rule credible and enforceable. Otherwise, the cost of non-compliance would be only reputational. The sanctions must include personal sanctions as dismissal procedures, obligations to resign, fines, or lower wages.

There are important elements to take into account in the design of NFR in order to enhance their influence on fiscal policy. The influence of fiscal rules on fiscal outcomes can be seen under two angles i.e. budgetary discipline and macroeconomic stabilization, as a consequence, an appropriate balance between these two objectives needs to be sought.

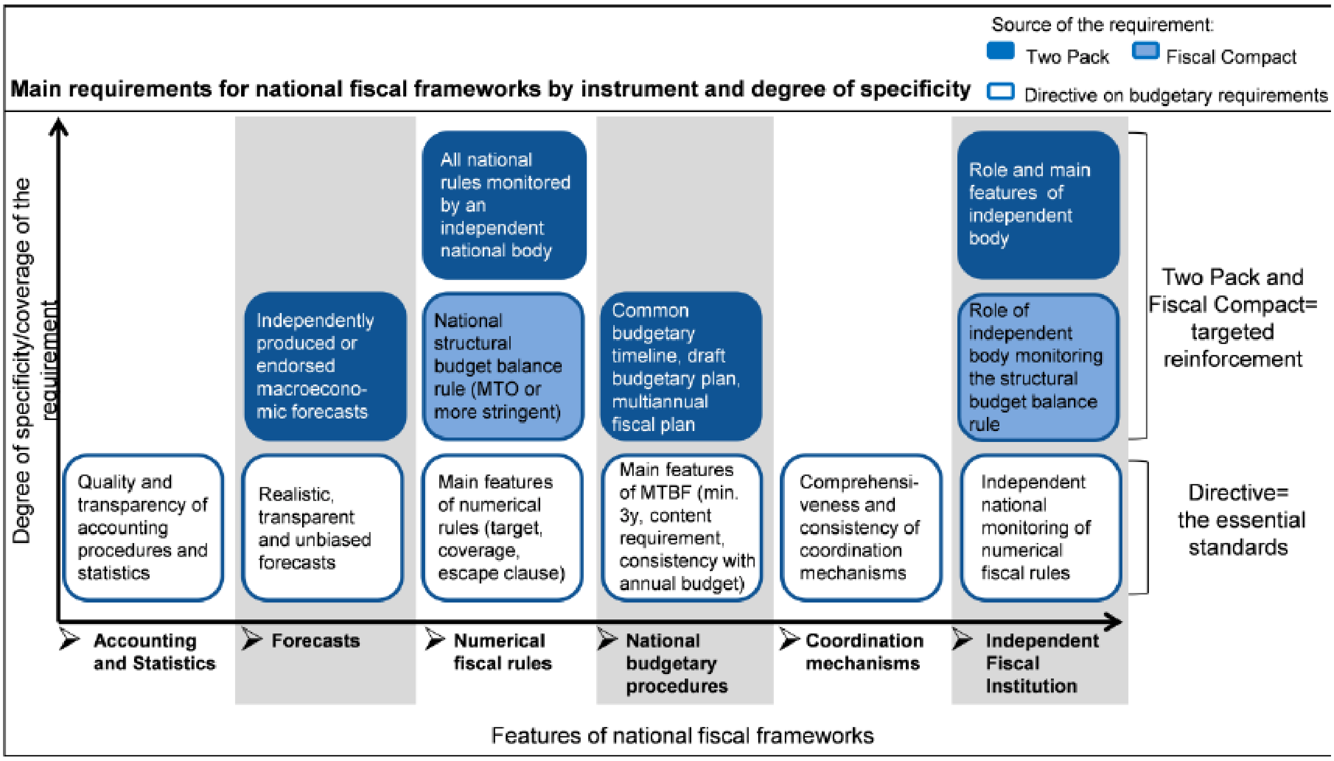
As it regards the NFR by type, the findings of this research suggest as follows: (i) Budget balance rules (BBR) are by far the most widespread fiscal rules in force across the EU Member States (Figure 1). They are defined in nominal terms with annual time horizons. A major criticism of budget balance rules concerns the risk of pro-cyclicality. BBR should be based on a medium-term perspective. Rules embedded into a medium term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances; (ii) Debt rules (DR) suffer the same limit as BBR, i.e. the risk of pro-cyclicality. DR should be embedded in a medium-term framework in order to limit their potential pro-cyclical bias; (iii) Expenditure rules (ER) represent around one third of all fiscal rules and predominantly concern central governments and social security spending. Most of these rules are embedded into a medium-term budgetary framework (European Commission, 2010). As suggested by Kopits (2007), binding spending ceilings can play a crucial role in the functioning of the whole fiscal framework. The main limit of ER is the risk of negative effect on the quality of public expenditure; (iv) Revenue rules (RR) are not common rules in the EU. According to European Commission (2012), in 2008, only six EU Member States had such rules.

The main weakness of NFR in EU countries are, in our opinion, the absence of independent monitoring and regular reporting, together with the absence of corrective mechanisms. All these shortcomings should be addressed in order to increase the effectiveness of NFR.

Given the variety of national situations and institutions, a one-size-fits all policy would not have been warranted. The large specificity of institutional environment, fiscal policy and economic development across the EU Member states requires specific adapted design features; it means more flexible numerical fiscal rule adapted to the practical reasons of member states, but defined at EU level. Effective and timely monitoring of the rules by independent bodies must be ensured. Overall Member States must transpose the fiscal rules into their national legal order as to strengthen the enforcement mechanism. This requires that Member States adhere to certain minimum standards for domestic fiscal frameworks. Research has shown that the best performing countries meet certain minimum standards. (European Commission, 2011) The use of a directive rather than a regulation is in recognition of the fact that the optimal procedural and institutional set-up for fiscal policy- making will depend on the different characteristics of Member States, meaning that there is no one model that can or should be applied in all cases.

The interaction and mutually reinforcing provisions of EU fiscal rules on national budgetary frameworks (NFF) are presented in Figure 7.

Figure 7. Main requirements for NFF by legal instrument and degree of specificity



Source: European Commission

By requiring that all Member States adhere to them in their specific way, the quality of national fiscal policy can be enhanced even for the worst performers. It is true that fiscal policy is supervised at European level, but it is set at national level. As the total fiscal harmonization remains an impossible goal at EU level, by adhering to certain minimum standards for domestic fiscal frameworks can also foster policy coordination between different levels of government depending on their institutional coverage. Additionally, fiscal rules may further contribute to the reduction of uncertainty about future fiscal policy developments. However, fiscal rules can only yield these benefits if appropriate institutions for monitoring and enforcement mechanisms are in place, or if they are supported by strong political commitment.

4. Concluding Remarks

The traditional domestic fiscal framework based on simple numerical fiscal rules is discussed in the recent literature in relation to its limitations when used as a measure to strengthen the fiscal discipline. Proposals in the literature go in the direction of using more complex approach for numerical fiscal rules, together with stronger enforcement mechanisms.

Based on the literature review and empirical evidence, the present paper suggests that compliance with a well-designed fiscal framework contributes to the policy credibility, to boost economic growth and to dampening the output volatility. More complex and flexible rules, multiannual medium term national fiscal framework and more supportive institutional arrangements could help reduce the pro-cyclical bias associated with rules. Such flexible rules also call for higher-quality institutional arrangements that strengthen monitoring and enforcement mechanisms.

Reaching these ends will require improvements along the whole gamut of the fiscal framework.

The need to minimize and enhance the government intervention into the economy and the need to ensure fiscal discipline imply that the public policies of adjustment become more non-discretionary, which requires reducing the weight of discretionary macroeconomic adjustment and introduction of fiscal rules. Numerical fiscal rules together with monitoring and enforcement mechanisms provide non-discretionary government intervention with the lowest public cost and highest effectiveness. Sufficient and necessary attributes of NFR identified in the study could help design comprehensive, coherent and consistent NFR to be taken for the institutional structure of national tax policies at national level.

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