Fiscal Discipline in EMU: Rules or Institutions?

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This version: April 2002

Paper prepared for the April 16, 2002 meeting of the Group of Economic Analysis of the European Commission. I have benefited from comments by André Sapir. It draws extensively on previous work prepared for the Swedish Government’s Committee on Stabilization Policy in the EMU for which I acknowledge with thanks useful comments received from Marco Buti, Hans Genberg, Francesco Giavazzi, Jacques Melitz and Jürgen von Hagen.
1. Introduction

Three years after the launch of EMU, the Growth and Stability Pact – which implements the EDP – is even more controversial than when it was announced. Official and academic criticism is strengthened by the controversies which have arisen and which have confirmed key weaknesses of the Pact: arbitrary ceilings, political implementation, asymmetric effect over the cycle. Other previously identified weaknesses have not yet come to the fore, but will eventually do. The conflict with subsidiarity has been muted mainly because the Pact has generally been ignored during the national process. The political impossibility of imposing fines has not yet been tested.

As we search for ways of improving fiscal discipline in Europe, two paths are possible. The first one calls for refining the GSP, the second one urges a paradigm shift. Fixing up the GSP may seem as the practical approach, maybe the only feasible one. Feasibility here refers to perceived political constraints, not to economic effectiveness; the rules approach (quantified targets), backed by peer pressure (the BEPG), is unlikely ever to work satisfactorily. Europe has many other unsatisfactory arrangements which, over time, become sacred cows, so this is one chance to avoid enshrining the GSP, a basically flawed concept. This note argues that institutions work better, and explains how fiscal discipline can be achieved through appropriate reform.

The next section briefly reviews the output stabilization record of fiscal policy. Section 3 takes stock of our understanding of how fiscal policy works, and how it compares to monetary policy. It draws lessons for reviving an instrument that has been vilified for the wrong reasons. Section 4 compares rules-based with institution-based fiscal discipline, strongly supporting the latter over the former. Section 5 examines how institution-based fiscal discipline could be implemented. How this would work in EMU is the object of Section 6. The conclusions are presented in Section 7.

2. Fiscal Policies: The Stabilizing Record

Fiscal policy is criticized for being inefficient. In particular, it is claimed, the combination of lags (recognition, decision and implementation) and economically-misguided political motives often result in actions that exacerbate business cycles instead of dampening them. The European Commission (2001) – see also Buti at al. (1997) – claims that fiscal policies in Europe have been characterized by “pro-cyclical activism”. This conclusion is based on a graphical analysis where the 1990s play an important role. Melitz (2000) finds instead that they are counter-cyclical, but to a much smaller extent than previously believed. This section examines the record by

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1 On reasons why governments may not be deeply committed to the common public good, see Buchanan and Tullock (1962), Drazen, 2000 and Persson and Tabellini (2000).

2 A well-known “0.5 rule of thumb”, mostly derived from OECD estimates, asserts that for any 1 percentage point decline in GDP, the deficit increases by 0.5% of GDP (see Eichengreen and Wyplosz, 1993 and the review of the literature in Melitz, 2000). Melitz (2000), in line with Wyplosz (1999), finds instead a coefficient of 0.1-0.2. This may be an effect of the extension of the sample period to
estimating the statistical linkage between fiscal policy and business cycles in four countries: the US, France, Germany and Italy. The record is important because if policy has indeed been countercyclical, forfeiting discretionary action and relying solely on the automatic stabilizers would already represent a significant improvement.

In order to detect the cyclical characteristics of fiscal policies, three budgetary indicators – public spending, public revenue and the budget balance (revenue less spending) – are regressed against their own lags as well as the output gap (actual less potential GDP as estimated by the OECD). If fiscal policy is counter-cyclical we expect that, when the output gap increases, spending declines, revenue increases, and therefore the budget balance increases too.

The results shown in Table 1 also test two frequently suggested hypotheses:

- First, it is asserted that fiscal policy is asymmetric over the cycle, being more relaxed in downswings than it is tightened in upswings. This can be tested by allowing the output gap to enter separately in years when it is declining (the gap is interacted with a dummy variable which takes the value of 1 when the gap declines, 0 when it increases). A stronger counter-cyclical reaction in downswings would correspond to the interacted gap variable appearing with a coefficient of the same sign as the gap itself.

- Second, it examines formally the claim that, over the 1990s, to meet the Maastricht convergence criteria until 1998 and then the Stability Pact requirement, debt stabilization has led to a lesser counter-cyclical use of fiscal policy, possibly even to fiscal policy becoming pro-cyclical. To test for this possibility, the output gap is also interacted with a dummy variable that takes the value 1 over the period 1992-2001, 0 otherwise. Pro-cyclicality would require the corresponding coefficients to be of the opposite signs and larger than those obtained for the output gap alone. If the coefficients are smaller but of the same sign, we would conclude that fiscal policy remains counter-cyclical, but weaker. It could also be expected that during 1999-2001 fiscal policy has been less smooth. This is tested by checking whether the coefficient of the lagged dependent variable is negative when interacted with the same dummy.

Fiscal policy is also criticized for lacking discipline, which explains the spectacular buildup of public debts over the last three decades. A proper conduct of fiscal policy,

\[\text{\textsuperscript{3}}\text{To account for lags, and to avoid the endogeneity problem, the lagged output gap could be used. The results thus obtained are not different from those presented here.}\]

\[\text{\textsuperscript{4}}\text{Following the political economic literature, e.g. Alesina and Perotti (1997), it would be desirable to add a number of political variables. The existing database, however, ends in 1995, which would preclude a meaningful study of the 1990s.}\]
### Table 1. Cyclical Behavior of Fiscal Policy

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instead, would avoid long-run debt buildup and, if it arises, would then call for
subsequent adjustment. In order to test for the debt-stabilization motive, the lagged
debt-to-GDP ratio is added on the right hand-side. If fiscal policy is systematically
adjusted to reduce the public debt when it has risen, we expect to see a negative
coefficient in the spending regression, a positive sign in the revenue regression, and a
positive sign in the budget balance regression.

On a technical level, it can be objected that the variables used are not statistically
stationary. In order to meet this objection, for each of the three policy indicators,
Table 1 displays two regressions: in the first one all variables are used in level, in the
second one they are all – including the gap – first-differenced.

2.1. Budgets are (moderately) counter-cyclical

The evidence shows that the budget balance is systematically counter-cyclical in Italy
and the US - where a 1 percentage point decrease in GDP is met in the short run with
a decline in the deficit of 0.4% to 0.5% of GDP. The effect is weaker (about 0.2) and
very imprecisely estimated for France. It is negligible for Germany where, however,
the response is found to be asymmetric, with a relatively strong counter-cyclical
reaction in downswings, but at best a weak correction in upswings.

2.2. Public spending is counter-cyclical and revenues are pro-cyclical

Spending is counter-cyclical, and revenues are either acyclical (Italy, US) or pro-
cyclical (France, Germany). This may come as surprise, since taxes are thought to be
the main channel for the automatic stabilizers. As Melitz (2000) observes, some taxes
may indeed be sensitive to cyclical conditions, but when all public revenues are put
together, the automatic stabilizers may be systematically thwarted by discrete policy
actions on other taxes. The combination of counter-cyclical spending and pro-cyclical
revenues explains why the overall stance of fiscal policy is, at most, weakly counter-
cyclical.

2.3. No asymmetry over the cycle

There is no clear evidence of an asymmetry over the cycle. For the budget balance
indicator, the estimated coefficients of the gap interacted with the downswing dummy
suggest more counter-cyclical during downswings, but they are never statistically
significant. The exception is Germany where procyclicality during the downswing
cannot be ruled out, and can be traced back to public revenues.

2.4. Limited changes in the 1990s

There is no general pattern of changing cyclical behavior over the 1990s. German
fiscal policy remains moderately pro-cyclical. In France spending and the overall
budget, has become asymmetric, reacting counter-cyclically to downswings and pro-
cyclically to upswings. In Italy, spending is more counter-cyclical and taxation pro-
cyclical during downswings, with no net effect on the budget balance. In the US, the

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5 This stands in contrast to the view of the European Commis sion (Buti, 2001; Buti, Franco and
Ongera, 1997) which claims that fiscal policy has turned procyclical in the 1990s and concludes that
deficit seems to have become considerably more counter-cyclical, although the
evidence is not clear cut. This could be the coincidental result of the two “Clinton
miracles”: unusually fast growth and the end of the era of large federal deficits.

2.5. Debt exercises a disciplinary effect

In France and Italy, the public debt exerts a significant disciplinary effect on the size
of the deficit. Except for the US (where the evidence is conflicting), spending declines
when the debt rises. Germany, again, is the odd man out: both spending and revenues
decline when the debt rises, with no significant effect on the overall budget balance.

3. Is There Any Future for Fiscal Policy?

3.1. Fiscal Policy Effectiveness

Can fiscal policy be used as a macroeconomic instrument without necessarily
bringing about deficits and a growing debt? In theory, the answer is obviously
positive: deficits can be balanced over the cycle while being as strongly counter-
cyclical as appropriate. The record is less sanguine, as exemplified in the previous
section. In spite of the automatic stabilizers, overall policy is weakly counter-cyclical,
which suggests that discretionary policy is often pro-cyclical.

That discretionary policy has tended to be used at cross-purpose is not necessarily a
fatal flaw, however. Current wisdom would ban discretionary action altogether
relying solely on the automatic stabilizers. In most instances, that may prove to be
sufficient, indeed better than over the recent past. But there will inevitably be
circumstances where discretionary actions will be needed and could be effective, so
current wisdom suffers from “GSP-type myopia”, in reference to the GSP’s escape
clause that allows for so exceptional circumstances that it is effectively useless. What
is needed is an enforcement mechanism that allows for some discretionary action only
when needed.

Many countries, and the Eurozone, have established rules which do not rule out
discretionary policy but binds it with rules. The problem with rules is that they tend to
be rigid and artificial (arbitrary debt or deficit limits, golden rules based on thin air
and falsifiable accounts), which makes them ultimately impossible to defend in the
face of public opinions. A better response is to build institutions which create the
proper incentives to achieve both short and long-term objectives.

3.2. Fiscal and Monetary Policies: A Fundamental Similarity

The challenge for fiscal policy, therefore, is to credibly combine long term
commitments with short term flexibility. This challenge is not specific to fiscal policy.
Monetary policy faces the same dual concern: it aims at delivering price stability in
the long run, but it can help stabilize output in the short run. There is little today that

the Stability and Growth Pact will improve things by making fiscal policy at least neutral and possibly
countercyclical when the automatic stabilizers are allowed to operate.
monetary policy is an important and effective instrument. And yet, that has not always been the case. The crucial change that has rehabilitated monetary policy has been the move from rule design to institutional reform.

Back in the 1970s, the gradually dominating view was that the best way of running monetary policy is to follow a Friedman-type growth rule. The Bundesbank, among many other central banks, adopted this strategy and met early success. As time went by, however, flaws emerged and rules have fallen in disrepute. The modern approach to central banking is to replace rules with adequate institutions. Following the lead of New Zealand, an increasing number of countries have delegated monetary policy to independent Monetary Policy Committees (MPCs), which are assigned a clear task, that of maintaining price stability, while seeing to it that economic conditions are otherwise adequate.

Fiscal policy is following similar lines, with a lag. Currently, rules dominate. Several countries have adopted rules: multiannual limits on spending have been introduced in the Netherlands, New Zealand, Sweden, the UK and the US, debt rules have been introduced in New Zealand and Poland. EMU member countries are subject to the Growth and Stability Pact.

3.3. Fiscal and Monetary Policies: Important Differences

In comparison with monetary policy, fiscal policy is relatively ineffective. Its impact rather slow and (too) long lasting, and it is also uncertain (Blanchard and Perotti, 2000). The debate on Ricardian equivalence underlines that much depends on how economic agents perceive fiscal policy actions. Temporary tax measures are understood to be largely ineffective, for agents adjust their saving behavior. “Permanent” tax measures are of limited credibility. Spending actions raise the question of how they are to be financed, which may elicit partially offsetting private reactions. In the extreme case where the debt path is seen as unsustainable, restrictive fiscal policies have been observed to exert an expansionary effect if they are seen as stabilizing an otherwise explosive public debt (Giavazzi, Jappelli and Pagano, 2000).

A complicating factor for fiscal policy is that assessing the budget constraint is not easy. Governments are held accountable to deliver both explicit and implicit entitlements such as welfare payments and the retirement of future generations. This complexity cannot be fully eliminated, but the effectiveness of fiscal policy can be enhanced by improving the visibility of implicit commitments and by eliminating off-budget items.

A further complicating factor is that fiscal policy is subject to democratic oversight. Every action has to be approved by the parliament. The result is a high degree of politicization which naturally involves differences of opinion but also open the door

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6 These flaws are not just bad luck or technological advances in banking. The unwritten yet ever wise Goodhart Law is that any measure that becomes subject to a rule soon changes behavior. This has been true for monetary aggregates and will also affect deficits or debts.

7 For a survey of the changing world of central banking, see Blinder et al. (2001).
to lobbying by a myriad of interest groups that care little for the common public good.\footnote{See von Hagen and Harden (1994).}

### 3.4. Lessons From Monetary Policy

**Lesson No.1: less activism.**
Fiscal policy is a less good instrument than monetary policy. Whenever monetary policy alone can deal with the situation, fiscal policy should remain inactive, relying only on the automatic stabilizers, certainly avoiding to become pro-cyclical.

**Lesson No.2: long term debt sustainability ought to be a binding constraint.**
Most modern central banks are given a clear, explicit mandate to aim at price stability. The equivalent long-term concern for fiscal policy is debt sustainability, and it ought to be made explicit.

**Lesson No.3: qualified freedom over the business cycle.**
Like monetary policy, once its long-term constraint is set and serves as an anchor, fiscal policy can be used as a counter-cyclical tool whenever it can make a contribution to economic (price and output) stability.

**Lesson No.4: an ability to respond in real time.**
Part of the advantage of monetary over fiscal policy is its speed of reaction. The counter-cyclical use of fiscal policy requires that the automatic stabilizers be powerful enough and, for discretionary actions, that the decision and implementation lags be sharply reduced.

**Lesson No.5: long term commitments must be backed up by specific legal and/or operational arrangements.**
Monetary policy is now typically subject to a clear long-term mandate via legal arrangements. The debt sustainability imperative of fiscal sustainability is rarely backed by a similar legal mandate. Europe’s Stability and Growth Pact is quite unique in this respect.

### 4. Two Approaches to Debt Sustainability

A new fiscal policy framework must combine a credible commitment to long-run debt sustainability with sufficient short-run flexibility for fiscal policy to operate as a counter-cyclical instrument. To that effect, two steps need to be taken: (1) defining long-run debt sustainability and short-run flexibility; (2) adopting a framework that supports this aim.

#### 4.1. The Debt Sustainability Objective

Long-term debt sustainability requires that the debt level not increase as a percent of GDP. Where it is high, the objective is more demanding: the debt-to-GDP ratio ought to decline.
There is no clear definition of what is a reasonable public debt level. The 60% Maastricht convergence criterion, for example, is an accident of history, the average debt level in Europe on the day the Maastricht Treaty was finalized. Is zero debt desirable? In principle, because taxes are distortionary, the lowest possible debt level allows to reduce the tax burden. In practice, there is no indication that the tax burden is lower where debt is smaller. In the OECD area, for instance, the partial correlation coefficient is negative (-0.03) and insignificant (t-statistics = 0.42). Another view is that the government borrows on behalf of credit-constrained citizens, which implies that some positive debt level is welfare-enhancing. Similarly, with standards of living likely to continue to rise over the foreseeable future, intergenerational equity calls for some negative transfers to richer future generations.

The only reasonable conclusion is that a moderate debt level is desirable, but “moderate” cannot be precisely pinned down. We simply have to rely on good judgment. “Judgment” is the crucial word here. It means that human thinking, guided by clear principles, is a superior alternative to binding rules.

Long-run constraints are notoriously hard to enforce because of the time inconsistency problem: there will always exist circumstances where giving up a commitment is actually welfare improving, although as seen from the current perspective it is highly undesirable. The challenge, therefore, is to provide incentives for the authorities to abide by past commitments. Two main approaches are examined: rules and institutions.

4.2. Rules

Rules specify what is acceptable behavior. To be effective, they must include sanctions to be applied in the event of non-compliance. To be operative, the rules must be precisely set. Typically they are intangible, but they can be decided on a case by case basis.

Fiscal rules are on the rise. In a way, fiscal rules have been around for a long time: IMF programs typically include quantified fiscal objectives, with an explicit sanction in case of noncompliance, the suspension of the loan program. The Stability and Growth Pact is a prominent and innovative example of recently adopted fiscal rules. Like IMF programs, it is monitored and implemented externally, and it includes sanctions. It also sets quantified limits to budget deficits, but these limits are universal while the IMF decides on them on a case by case basis. Other recently-adopted fiscal

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9 See Perotti et al. (1998) for a discussion of sustainability as well as for useful references. They consider fiscal policy to be sustainable when there is no need for sharp adjustments. These authors conclude that, because sustainability cannot be appropriately defined and measured, attention should shift to controllability. In a sense, this is the view adopted here too, as the focus shifts to institutions which are likely to deliver a debt that remains under control, independently of its size.

10 It can be objected that the three Scandinavian countries and Japan are outliers. Without these four countries, the partial correlation coefficient is positive (0.13) and significant (t-statistics = 2.27), but it is not clear why these countries should be excluded. The Scandinavian countries illustrate the main point that a low debt level may be intentionally accompanied by a large tax burden, while Japan shows that small governments can run unsustainable fiscal policies.
rules also rely on quantified limits but, instead of sanctions, they simply make it illegal to breach the limits. Fines allow for some flexibility because they offer a trade-off and can be “negotiated”, while legal bounds are stricter. This is why legal bounds are typically made less strict by allowing an averaging over the length of a business cycle (the UK and Sweden), or by allowing for a cyclical adjustment (Switzerland). Doing so injects an important degree of imprecision (how to assess the timing of cycles or the allowed cyclical correction?), which may ultimately undermine the rule.

This brief description illustrates some important difficulties inherent to rules. First, explicit limits to deficits (or debts) must be specified. Because economic conditions change, these limits may become ill-chosen and prevent the short-run counter-cyclical use of fiscal policy. The solution is to allow for some flexibility. The IMF often renegotiates its programs. The GSP has recently faced a lenient political interpretation of the rule.\textsuperscript{11} Averaging over, or accounting for, the cycle, is the most popular way-out but the implementation of this approach will be tricky given our poor ability to measure and foresee cycles, and to estimate the effects of cyclical fluctuations on the budget. The unavoidably large margin of error may prove to be the Achilles’ heel of such rules.

Second these limits must be enforced. Experience with external enforcement by the IMF warns us that the political fallout may be lethal, and the experience so far with the GSP does not assuage such fears. Loan program suspension in the case of the IMF, and fines in the case of the GSP, only exacerbates the budgetary problem at the worst possible time.

Third, the main advantage of rules is that they appear as set in concrete. This implies that judgmental evaluation is ruled out. Yet, the desirability of policy action varies depending on time and circumstances. That rules are impervious to short-term expediency is their strength, but also their weakness. Judgment is superior if it can be relied upon.

4.3. Institutions

Institutions rely on the delegation mechanism: a principal entrusts an agent to deliver a particular task. The question is which agent, which task, and which control. In these respects, much has been learnt from the experience of central banks.

In both cases, the principal is the same – the people – except that monetary policy is vastly simpler than fiscal policy. Monetary policy deals mainly with macroeconomic issues, inflation, growth, employment, the exchange rate. Fiscal policy includes deeply redistributive functions that cannot be delegated to a single agent: all democratic countries delegate such choices to their parliamentary institutions which, by construction, embody the various diverging interests.

It is essential to realize that fiscal policy fulfills two very different tasks. The first task is structural and redistributive: the size and aims of various spending items and the structure of the tax system. Redistributive decisions cannot be delegated to an agent.

\textsuperscript{11}The escape clause – a deep recession – is far too restrictive to be of practical use, see Eichengreen and Wyplosz (1974).
The second task is macroeconomic and is largely subsumed by the budget balance. That task does not fundamentally differ from monetary policy and, to a first order of approximation, it can be designed independently from the first one. As such it can be delegated to an agent.

The key aspect of monetary policy is that the agent, the central bank, is given a clear constitutional mandate, and is made independent. These combined attributes sharply reduce the probability that the central bank will renege on its commitments. This feature make the agent (nearly) as good as a rule. The key advantage is that the agent can exercise judgment. Monetary rules have been largely discarded for that precise reason. Today’s good central bankers deliver both long-run price stability and extensive short-run stabilization. This feature lies at the roots of other cases of delegation, such as anti-trust or financial regulation. There is no reason why it would not work for the macroeconomic aspect of fiscal policy making.

5. Rules-Based Fiscal Discipline

5.1. Fiscal Policy Committees

In each country, responsibility for setting the budget balance would be delegated to a new institution, the Fiscal Policy Committee (FPC). Like the central banks’ Monetary Policy Committees (MPC), the FPC would include a small number of qualified persons appointed for long, non-renewable terms of office. FPC members could not be removed from office unless they violate their mandates and they would not be allowed to seek or receive instructions from governments, members of parliaments or any outside person or group. The FPC would be supported by a staff that would produce its own forecasts of economic conditions and budgetary figures.

The FPC would be given an explicit mandate, that of ensuring debt sustainability over the appropriate horizon. The specification of debt sustainability is presented in Section 5.2 below. Over the short run this would leave the FPC free to choose deficits and surpluses, as justified by its analysis of current and future conditions.

The power of the FPC would be limited to set annual deficit figures (say, in percent of planned GDP) ahead of the government budgetary cycle. Its decision would have the force of law, and impose itself on both the government and the parliament. The FPC would have no authority regarding the size of the budget, the tax structure and the allocation of public spending. All these matters would remain as in the currently existing political process.

12 The macroeconomic effects of spending items and taxes differ, but these differences can be safely taken as second order of magnitude.

13 A step in this direction has been adopted in Italy in the early 1990s. The deficit is decided by the government in the summer, and it takes the form a law. When the rest of the budget (size, spending, taxation) is set by the government and discussed by the parliament in the fall, the budget law cannot be modified anymore. von Hagen and Harden (1994) convincingly argue that this step has been crucial in Italy’s successful efforts at stabilizing and reducing its public debt. Another related development is the increased power of the Belgian High Council for Finances which can issue recommendations regarding the size of deficits at the federal and sub-federal levels, see von Hagen (2001).
The budget bill, including spending and revenue projections, would require FPC approval before it becoming law. Any budget that does not comply with the FPC’s balance decision would either be void – and would have to be redrawn – or, alternatively, would activate an automatic procedure to bring the budget in line. As an example of the latter, spending and/or tax revenues would be adjusted pro-rata.

In the event of abrupt change in economic conditions, the FPC would mandate a change in the budget law. This could take the form of a new deficit figure, leaving again the government and the parliament with the task on adjusting spending and/or revenues. Eichengreen, Haussmann and von Hagen (1999) provide an excellent discussion of the relative merits of fixed review dates vs. discretionary interventions.

Finally, exceptional circumstances – unforecastable, by definition – may warrant a suspension of the debt sustainability obligation. This is what lies behind the over-ride provision discussed in the case of monetary policy (see, e.g., Roll et al., 1993). Such a procedure must be exceptional: for instance, it could require a parliamentary vote with a super-majority.

**5.2. The Debt Sustainability Mandate**

Debt sustainability can be defined in two alternative ways:

- It can be an obligation to achieve budget balance on average over a number of years. The number of years should be of the same order as the length of ordinary business cycles (4 to 6 years). It should not be fixed *ex ante* since two cycles are never alike. A possibility is to delegate to another, independent institution – like the NBER in the US – the task of identifying cyclical peaks and troughs, and require *ex post* that the budget be at least balanced over each cycle.

- It can be an obligation to stabilize the debt-to-GDP ratio over the long-run, i.e. cycle after cycle. Countries which start with a high debt, or which face large future commitments (due to an ageing population, for example) could aim at a given reduction of the debt-to-GDP ratio over a given horizon tailored to the length of the business cycles.

Such an arrangement sets the incentives right. The authorities know *ex ante* that any budget relaxation will have to be clawed back in the not-too-distant future. As a result, they are likely to adopt a debt-increasing stance only if they think that it will be efficient, not only in the short run but intertemporally, i.e. if today’s gains outweigh tomorrow’s costs. Similarly, they will take advantage from favorable conditions to garner room for maneuver in anticipation of future adverse shocks.

An important aspect of these principles is that they eschew any numerical target for the debt level. As noted above, there is no optimal target level for public debts. Setting quantified targets inevitably elicits criticism, to which the response is to create an artificial “holly cow” which may be difficult to change later on. In addition, as
made abundantly clear by the Maastricht convergence process, artificial targets can be easily flouted precisely because they lack a solid enough basis to be adhered to.\textsuperscript{14}

5.3. Democratic Accountability

The present proposal may be seen as a technocratic encroachment on a fundamental aspect of democracy. This is not the case, for three distinct reasons.

**Macro vs. microeconomics**

The reason why fiscal policy is everywhere under direct parliamentary control is that it powerfully redistribute income. This aspect almost entirely originates in choices regarding the size of government, public spending programs and the structure of taxation. In contrast, budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play not part in democratic control.\textsuperscript{15} Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit. Taking the deficit and the debt out of the standard democratic process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is not different from that of monetary policy. In fact, the similarity between monetary policy and setting the budget deficit can serve as a guide to the procedure of democratic accountability to be applied to a FPC.\textsuperscript{16}

**Parliamentary oversight**

The FPC would be accountable to a national elected body. The FPC will not be goal-independent, it will be instrument-independent, since the goal will be set either in its mandate (balanced budget over completed cycles) or by the government (debt target for the length of the legislature). Accountability requires both \textit{ex ante} and \textit{ex post} oversight.

- \textit{Ex ante} oversight takes the form of regular testimony by the FPC President and the timely publications of the minutes of the FPC’s policy setting meetings, including the votes of individual committee members, who could also be called to testify to the parliament. The FPC would be bound to publish its analysis, backed by all the technical material and data that may be used.

- \textit{Ex post}, the FPC would be held accountable of its record. In the event that the goal is not achieved, the parliament could take a number of actions: a reprimand to the committee, or to some of its members on the basis of

\textsuperscript{14} A common problem with quantified constraints, which also applies to balanced-budget laws, is that they can be escaped through creative accounting, including off-budget spending or the creation of separate government agencies exempt from the constraints, see von Hagen (1992).

\textsuperscript{15} It could even be argued that the current generation is ill-suited to provide a fair treatment of future generations.

\textsuperscript{16} As I was formulating the present proposal I came upon a nearly identical one by Eichengreen, Hausmann and von Hagen (1999). They go in considerably more details regarding the design and functioning of their proposed National Fiscal Councils.
published minutes and votes; the dis-appointment of the FPC, or some of its members, in case of serious failure.

6. Compatibility with EMU Institutions

6.1. The Excessive Deficit Procedure

The Treaty of the European Union mandates each member of the Eurozone to subject itself to the Excessive Deficit Procedure whose aims are exactly the same as those considered here: long-term debt sustainability with some short-run flexibility to conduct counter-cyclical policies. The guiding principle is peer pressure and, if need be, peer-imposed sanctions. As noted above, this raises serious issues of accountability and sovereignty, and it injects a heavy dose of politics in an otherwise desirable undertaking. Setting up FPCs would deliver the goals of the Excessive Deficit Procedure without these important difficulties.

There would be no European-level FPC and the responsibility for enforcing fiscal discipline would be given back to the states. What would be required would be a change in the protocol that mandates the 3% and 60% limits. This section of the treaty would have to be replaced by provisions for establishing national FPCs which meet some common principles. This would follow the precedent set for national central bank statutes, which have to be compatible with the Statute of the ESCB (art. 109). Thus, each country would be requested to adopt statutes for its FPC that are compatible with agreed-upon norms: the objective (deficits, debts), the pre-eminence of FPC decisions in setting the deficit, and limits to deviations from the objective.17

A key advantage of this approach would be to restore an important element of sovereignty to national parliaments, along the principle of subsidiarity currently mistreated by the GSP. Far from increasing the technocratic level of the Union, joint FPCs would enhance the quality of national debates on fiscal policy by removing the “Brussels excuse”.

6.2. Policy Coordination in EMU

The practice of policy coordination in EMU is currently perceived as unsettled. Some argue that there is no need for explicit coordination, others call for an “economic government of Europe”. This is not the place to review in detail this debate, but a few observations are in order to examine how rule-based fiscal discipline would affect the situation.

Coordination covers two different aspects:

- The aggregate policy stance and policy mix. It is sometimes asserted that national governments ought to agree on an aggregate fiscal policy stance, both among themselves and with the ECB. The argument is that the policy mix

17 High-debt countries need to have different goals from low-debt countries. Furthermore, over time, the goal may change in any particular country. This implies that the treaty only need to specify the nature of the objective – debt or deficit – and allow each country to specify the goal.
affects the interest and exchange rate, and that the aggregate fiscal policy stance elicits reactions from the ECB. There is zero evidence that interest rates are affected by public borrowing, which is to be expected from globalized financial markets. The policy mix, on the other hand, is bound to affect the exchange rate but it is fair to say that our understanding, both theoretical and empirical, of this link is extremely limited. Attempts at influencing the exchange rate indirectly through monetary and/or fiscal policies will fail in the future as they have failed in the past.

- National fiscal stances. National fiscal policies obviously spill-over from one country to another. This effect is obviously stronger for actions emanating from the large countries. The logic would seem to be that national fiscal policies would have to be coordinated, especially among the large countries. While correct in theory, the logic fails to account for two crucial facts. First, it seems politically impossible to subject national fiscal policies to foreign oversight. This objection is enhanced by the fact that fiscal policy is now the only macroeconomic tool available at the national level. Whatever the merits of coordination, they pale in comparison with the political need to keep a free hand at home. Second, it is equally politically unacceptable that large countries be treated differently from smaller ones.

It is fair to conclude that formal coordination of fiscal policies is unlikely to be agreed upon in the foreseeable future. Informal exchanges, on the other side, are highly desirable as they may help avoid the most grievous mistakes. Such an informal approach would be much easier to organize among independent, non-political FPCs than it currently is among Finance Ministers.

The coordination between national governments and the ECB has not been satisfactory so far, largely because the ECB insists on keeping governments at arm’s length. Here again, it can be expected that the ECB will find it less threatening to entertain informal contacts with like-minded, independent FPCs.

6.3. Peer pressure in EMU

There is one area where some formal coordination would be required under rule-based fiscal discipline. It concerns the national determination of the goal set by the national authorities for deficits or debts. As noted above, the goal will have to differ from country to country and over time for each country. Obviously, one must make it sure that these definitions are compatible with the spirit of fiscal discipline. This calls for peer pressure.

The natural solution is to use the BEPG. Each country’s goal would be the object of an evaluation. In fact, it is entirely possible to retain the SGP procedure and apply it to the goals set for national FPCs.

7. Conclusion: Fix It or Change It?

The GSP is proving difficult to implement. One approach is to look for ways to improving it. Another is to seek a different concept that allows to achieve the same
Delegating fiscal policy to independent experts opens the way to the institutional approach, which has proved successful in various areas where judgment is called for. The alternative to attempt to fix the GSP.

Much of current discussion looks to ways of making the GSP less asymmetric over the duration of a business cycles. The perception that underlies such efforts, fed by the unexpected turn of events over 2001, is that the automatic stabilizers ought to be allowed to run their full course when the economy is away from its potential GDP. Indeed, one weakness of the GSP is that it is based on commitments based on assumptions which can quickly be proven wrong. This perception leads to two logical "solutions".

The first idea is to apply the deficit ceiling to the cyclically-corrected budget. This is the approach recently adopted in Switzerland. Theoretically, this would go a long way towards allowing the automatic stabilizers to be fully utilized, even if the initial deficit is close to the ceiling. The devil lays in the details: how to measure the cyclically-corrected budget? This requires estimating the potential GDP to determine the output gap, and then estimating how the gap affects spending and tax receipts. A large literature has been devoted to this question and a number of cyclically-corrected measures have been produced. These measures are useful tools to form a judgment on fiscal policy stances, but they are far too imprecise to become the focus of a contractual arrangement with profound political ramifications.

The second idea is to evaluate fiscal performance over a completed business cycle, as in Australia, New Zealand and the UK, all of which mandate a budget balance target and/or a debt target. It is both theoretically sound and, in contrast with cyclical adjustments, implementable in practice. This is identical to the target suggested above for FPCs, the only difference being that there is no delegation to an independent panel. In the British case, for example, the incentive to abide by the fiscal code rests entirely on the transparency of the budget process and the belief that the government will not allow its credibility to be jeopardized by flouting its own rule. This may be a workable approach in some countries, but it is easy to see how the process can go wrong. First, the government can always invoke special circumstances and receive the Parliament’s blessing. Second, the length of a legislature is unlikely to coincide with a completed cycle. This opens up the door to manipulation, for instance blaming the predecessor’s legacy or letting deficits swell in the run up to an election. More fundamentally, it amounts to giving the jail’s key to the convict: the main reason for seeking rules is the repeated observation that governments, supported by their parliamentary majorities, are prone to fiscal indiscipline.

Competent and dedicated policymakers are better able than quantitative ceilings and rules to exercise good judgment and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from the temptation and pressures that are part of political life. This is the approach that has been adopted for monetary policy by an increasing number of countries, so far successfully. Fiscal policy has not yet benefitted from a similar treatment because of both traditions and the perception that fiscal policy belongs exclusively to the political sphere. Traditions too were once invoked to keep central banks under the thumb of politicians, but the recent changes show that traditions can be relatively easily shaken. The additional challenge for fiscal policy is the confusion between its structural and redistributive
function, belongs to the political sphere, and its macroeconomic role, which can be delegated. There is no reason why FPCs should be less successful than the MPCs.

A major advantage of replacing the GSP with FPCs is that the subsidiarity principle would be applied where it should. With a common currency, national fiscal policy is more needed than ever. Many of the difficulties encountered so far by the GSP are directly related to a conflict with sovereignty, an additional instance when external enforcement of policy discipline fails.
References


