

# Do we need fiscal rules?

Catherine Mathieu and Henri Sterdyniak (OFCE)

*Preliminary draft (not for quotation)*

## Section 1. Introduction

The 2007-2011 (?) crisis is a first of all a banking and financial crisis. The crisis was due to hazardous and unregulated financial innovations, in a context of financial liberalisation and globalisation. Markets were greedy, blind, and volatile. The crisis is also due to the huge increase in capital flows coming from neo-mercantilist economies, raw material exporting economies, emerging economies, pension funds, or the wealthiest in emerging and advanced economies, tracking the most profitable financial opportunities. Monetary policies allowed the rise in private debts, financial and housing bubbles which supported output growth without higher wages or social incomes. Last, but not least, the world economy became more fragile due to the strategies run by mercantilist countries (like China and other Asian emerging economies, Germany, and other Northern Europe economies) pursuing competitiveness gains and cumulating external surpluses (see Mathieu and Sterdyniak, 2011).

But the crisis is not due to the rise in public debts and deficits. At the end of 2007, general government borrowing for the OECD as a whole was amounting to 1.3% of GDP only, below the level ensuring debt stability. Net public debt amounted to 39% of GDP only.

The crisis led to a huge rise in government debts and deficits. Initially this rise in debts and deficits was due to government measures taken to support banks, later to the automatic fall in tax revenues resulting from lower output growth, and finally to measures taken to support output. Starting from mid-2009, markets pretended to have doubts about public finance sustainability. They requested higher risk premia on government bonds issued by some euro area countries.

According to financial markets, international institutions, and even to many economists, it is now of first importance to tackle the issue of public deficits and debts, and no more the instability and lack of control of the world economy generated by financial liberalisation. Proposals aiming at imposing either fiscal policy rules or independent fiscal policy committees on governments are back to the forefront. This issue is acute in the euro area, where fiscal policy rules did not work, and where member states having abandoned their monetary sovereignty are directly under market pressure. Some countries having agreed to guarantee Southern countries' debts wish more binding fiscal policy constraints on Member States as a counterpart.

As concerns monetary policy, the Central Bank's objective is quite clear: ensuring low and stable inflation rates, the natural unemployment rate theory ensuring that this monetary policy will lead to the optimal employment level. The fiscal policy objective is less obvious: should

fiscal policy target full employment or public finances equilibrium, and how to define the latter? What is an optimal fiscal policy? Can rules be defined so that fiscal policy is always optimal?

The paper has three parts. Section 2 deals with the justifications for fiscal policy rules, either in a classical or in a Keynesian framework. In this section we try to make a link between the justifications and the currently proposed rules. Section 3 provides in analysis of some fiscal rules experimentations. Section 4 discusses recent academic proposals and European projects. Section 5 concludes.

## **Section 2. Justifications for fiscal rules and their specifications**

### **The neo-classical point of view**

For those in favour in fiscal rules, the latter are necessary because governments are not benevolent<sup>1</sup>. Governments do not aim at optimising citizens' welfare but aim at being re-elected. Each generation is selfish and does not care about the situation for future generations. Last, financial markets need to be reassured on the ability of governments to service debt. Each of these goals induces a specific rule.

According the Leviathan-State theory, each social group asks for benefiting from higher public spending without considering that this will imply higher taxes. In a non-cooperative equilibrium public expenditure are excessive. Governments are inclined to spend too much in order to please their voters, without increasing taxes as a counterpart. They use fiscal policy for electoral purposes and not for stabilisation purposes. They do not make the appropriate budgetary efforts in good economic times. The social choice between public expenditure and taxes is biased because governments can increase public debt. Each government agency sets the objective of increasing the number of civil servants and means at their disposal, without accounting for efficiency and productivity. No social or economic mechanism can ensure an optimal level of government debt or deficit. Thus public deficits are always excessive and this leads to excessive public debts.

Public deficits are therefore an autonomous cause of macroeconomic unbalances. According to the 'crowding-out' effect theory, public deficits generate excessive demand, which induces higher interest rates and crowds-out private spending. Public deficits reduce savings available for investment. The current deficit level leads financial markets to expect large deficits to persist and hence further increases in government debts. This raises long-term rates which crowds-out private investment. Public deficits are detrimental to capital accumulation and therefore to future growth.

Two objections can be made to this reasoning. The first objection is theoretical. The described mechanisms will not play if households are Ricardian. On the one hand, Ricardian households are aware that a deficit is equivalent to taxes: they cannot be fooled by the government strategy and they have a preference for governments who do not spend much. On the other hand, Ricardian households increase their savings in order to offset higher public deficits; public debt has no specific unfavourable effect: financing public expenditure through taxation or higher indebtedness will be similarly detrimental for output growth.

---

<sup>1</sup> See, for instance, Alesina and Perotti (1995), Alesina and Tabellini (1990), Drazen (2004), Wyplosz (2011).

The second objection is empirical. These mechanisms of higher interest rates and crowding-out effects have hardly been observed in reality. From 2002 to 2005 both short and long-term interest rates were historically low despite the rise in government deficits in Europe, like in the US and Japan. This has been also the case since 2008. Large economies run large government deficits and high public debts with low interest rates at the same time. The rise in government debts did not have any impact on interest rate levels or on inflation expectations. In 2009, long-term interest rates stood at 1.4% in Japan, 3.3% in Germany and the US, 3.6% in the UK, 3.7% in France, i.e. were similar to expected potential output growth (and were even clearly below it for the US). It is difficult to assess that such interest rates levels are detrimental to investment.

This theory does not explain why all governments would have suddenly become demagogic and increased too much their expenditure in 2002 or in 2009. In the recent past, the rise in government deficits has been due to fiscal stabilisation rather than to a spontaneous rise in expenditure or a spontaneous decrease in tax revenues. It is not obvious that OECD countries were characterized, in the recent period, by fiscal indiscipline (such as Debrun and Kumar (2007), and Wyplosz (2111) say). The reason why public debts are higher than ever in peace time, even though, according to the IMF (2009), many countries have adopted fiscal rules, needs to be explained.

This theory omits that governments do not care only about median voters but also about leading classes asking primarily lower taxation for companies or for themselves and trying to promote public spending cuts strategies.

In any case, this theory advocates the implementation of a ‘Golden rule of public finances’ so as to reduce the governments’ bias for running excessive deficits: current expenditure must be financed through taxation; while investment which will benefit future generations may be financed through borrowing.<sup>2</sup>

This rule can be more precisely defined. Let us assume that a country wishes to maintain a public debt level equal its public capital stock. Public debt in real terms will vary as:  $D = D_{-1}(1+r-\pi) - S_p$ , where  $r-\pi$ , stands for the real interest rate and  $S_p$  is the primary government balance. The public capital stock level varies as:  $K = K_{-1} + I - \delta K_{-1}$ . The equality between debt and capital stock requires:  $S = S_p - rD_{-1} = -(I - \delta K_{-1} + \pi D_{-1})$ . Government borrowing should equal net public investment plus debt depreciation due to inflation.

It is however difficult to measure investment. How to account for education or research expenditure, even more as we have to measure net investment? Besides, it is fair to smooth over all generations exceptional public spending and tax revenues. Despite these limitations, the rule according to the classical theory must be the golden rule and not the balanced-budget rule.

The second argument is intergenerational fairness. A given generation should not consume too much at the expense of future generations. But it is difficult to assess this ‘excessive consumption’, while accounting both for demographic developments, productivity growth, natural resources and environmental constraints. It is difficult to compare the well-being of successive generations. Moreover, in this approach, the criterion cannot bear only on the public deficit; private savings needs also to be taken into account. According to the ‘golden

---

<sup>2</sup> This view was developed at the end of the 19<sup>th</sup> century by Von Stein (1885), Leroy-Beaulieu (1891) and Jèze (1896). It can also be found for instance in Musgrave (1939) or Eisner (1989).

rule of economic growth', *per capita* consumption is maximised in a permanent regime if the interest rate equals GDP growth. As long as the interest rate does not exceed GDP growth, there is no evidence that fairness is not ensured. Intergenerational fairness may thus require a fiscal surplus (if the savings ratio is spontaneously too low) or a deficit (if the savings ratio is too high).

The third argument is public debt sustainability. Markets should not believe that a country may be a situation where sovereign default is the more profitable outcome. Let  $s_p$  stand for the primary balance-to-GDP ratio,  $\tilde{r}$ , the interest rate on debt corrected from GDP growth,  $h$  the debt-to-GDP ratio. At a given debt ratio,  $s_p = \tilde{r}h$ . One should avoid that  $d$  exceeds a critical value, i.e. the value where the primary balance would be unbearable for populations. The difficulty is that  $\tilde{r}$  depends itself on sustainability perceived by markets. Countries like Greece, Italy, or Belgium, have been able to run primary surpluses of 4 percentage points of GDP. If  $\tilde{r} = 1\%$ , then the limit for  $h$  is 400%. If  $\tilde{r} = 5\%$ , then the limit comes down to 80%. An indebted country is at risk of being trapped in a self-fulfilling spiral. This pleads for a debt ceiling, but at which level?

Moreover, it is necessary to make a difference between countries with monetary sovereignty, who borrow in their own currency and can ask for central bank financing, and non-sovereign countries, who borrow in foreign currency and cannot benefit from central bank financing (like euro area countries). The latter do not control their interest rate; they may have to pay risk premia; they may default; sustainability is a crucial issue for them. The first group of countries can run very low nominal interest rates and cannot be insolvent since the Central Bank can provide funding to the government.

### **A Keynesian perspective**

From a Keynesian perspective, a certain level of debt and deficit are necessary to ensure that demand equals potential output. Public debts and deficits result from the macroeconomic situation and are not at the origin of this situation. In times of economic uncertainty or entrepreneurs' pessimism, private demand may be insufficient to maintain full employment. The optimal policy consists in cutting the interest rate until demand is sufficiently boosted. The advantage of this policy is that it does not increase public debt, it helps capital accumulation and lowers the profit rate requested by companies to invest. However, it may lead to excessive private companies' or households' debt accumulation. It may generate financial or housing bubbles. Conversely interest rates cuts may be inefficient in times of strong economic depression, when private agents are reluctant to borrow. It may be insufficient, especially because there is a floor to nominal and consequently real interest rates: at the end of the 1990's, the daily interest rate was set at 0 in Japan, which led to a base rate of around 3% for commercial banks and to a real credit interest rate of 4.5% (accounting for a fall in prices of around 1.5% per year). It may not be implementable in the euro area where the common interest rate cannot adjust the different business cycle situations in the 17 Member States. So the sharp rise in public debts must be related to the lower inflation and growth (which prevent the authorities to reduce the real interest rate adjusted for growth) and to the introduction of the Euro.

In order to obtain a satisfactory demand level, the government must then accept some government borrowing.

If  $y = g + d + cy - \sigma r + kh$ , this implies that in the short-run:  $g = -d + \sigma r$

Let us note that if this policy is implemented and if stabilisation is perfect, then there is no link *ex post* between the deficit and the output gap.  $g$ , government borrowing, is considered as structural according to the OECD or the EC methods, which makes no sense.

In the long run,  $g=0$  and  $h = -(d - \sigma r) / k$

The long-term public debt level is not arbitrary, but depends on private agents' wishes: debt must equal desired debt at the optimal interest rate, i.e. the rate equal to growth rate. This simple model shows that a fiscal rule like:  $g = g_0 - \lambda y - \mu(h - \bar{h})$  cannot be proposed, since it would not allow for entire stabilisation and since the government cannot set a debt target regardless of private agents saving behaviour. The public debt level desired by private agents has probably increased during the crisis as households wish to hold less risky financial assets and businesses want to be less leveraged. Structurally, the ageing of populations induces that safe public assets are increasingly desired.

Such a deficit necessary to support activity will not crowd out private spending: it will not raise interest rates, since by definition the interest rate is as low as possible. It does not raise sustainability issues: if the rise in public debt leads private agents to increase their spending, then the government will be able to cut its deficit accordingly. The government must be ready to cut its deficit when private demands resumes. This may require that some public expenditure or some revenues cuts are explicitly defined as temporary.

This idyllic scheme requires that the government cuts the public deficit when the economy comes close to full employment. The rule should be: the public deficit must be reduced when demand tends to become excessive, therefore when inflation tends to accelerate or when the central bank has to raise its interest rate above the output growth rate in order to slowdown inflation.

### 1. A Keynesian fiscal policy rule?

Can a Keynesian fiscal rule be designed? Net public investment (NPI) must be financed through borrowing; public deficit should be corrected of debt depreciation induced by inflation (at least for a 2% inflation target and a 60% debt target); fiscal policy should be countercyclical: a 1% output gap justifies a 0.75% of GDP public deficit, i.e. the automatic effect and slightly more; fiscal policy should be restrictive when monetary policy is restrictive too (a fiscal surplus is needed when the interest rate set by the ECB exceeds 4%, the growth 'golden rule' rate, according to Phelps). Therefore:

$$S = -NPI - 1.2\% + 0.75 \text{ output gap} + 0.5(i - 4)$$

According to this reasonable fiscal rule, which ensures that public debt does not exceed public capital stock in the long-term, and using the OECD output gap, the French public deficit should amount in 2011 to:  $1.2 + 0.75 * 3.3 + 1.25 = 6.2\%$  of GDP. The French public deficit is actually around 5.7% of GDP.

But this rule does not allow full stabilisation and does not take in consideration the fact that the output gap depends on fiscal policy.

According to this approach, the rise in public debts is a macroeconomic phenomenon with two causes: insufficient private demand and too high interest rates. Demand weakness may be interpreted as a desire of households to own more financial assets combined with a denial of companies to invest.

Peter is 50 and worries about his retirement pension. He decides to raise its savings by 1,000 euro per month in order to accumulate 120,000 euro when he is 60. He thus generates a demand deficit. If interest rates cannot be cut, then the government needs to increase government borrowing by 12,000 euro per year and government debt by 120,000 euro after 10 years. Will this debt be a burden for James, Peter's son? The answer is no, if Peter bequeaths 120,000 euro to James. The answer is also no, if Peter spends this money, while Paul, Peter's cousin who is 10-year younger makes savings over this time period. These 120,000 euro are a desired public debt. In this situation, it is normal that the government allows public debt to increase (if interest rates cannot be lowered): the government stabilises the economy in providing the desired public debt. Public deficits increase demand directly and also indirectly in raising public debt, owned by households, which tends to increase their consumption. Public debt is not a burden for future generations since it has a counterpart in terms of assets owned by households. Public debt is only a way to make the economy more liquid. Households' saving has a counterpart in terms in public debt and deficit. One may of course regret that it has no counterpart in terms of private firms' investment and debt, but in the context we are considering, companies do not wish to borrow.

This scheme may come to a halt if households become Ricardian or if markets request inappropriate risk premia (see Ben Amar and Sterdyniak, 2011). Let us assume for instance, that households increase their savings' ratios because as they get older they wish to own more public debt. The government thus increases public debt, but households expect future tax increases (they are wrong, of course): they increase their savings further, which obliges the government to increase its deficit further. Another example: households increase their savings ratio; the government has to increase its deficit to stabilise output, but markets request risk premia to offset the debt rise. Here also, the economy may enter into an infernal spiral: higher interest rates requested by markets will lead the government to increase its debt to maintain full-employment, which will worry markets and increase the debt again. In both cases, output cannot be stabilised. In both cases, private agents' defiance towards public debt is a self-fulfilling prophecy.

Thus public debt can be reduced only through higher companies' or households' borrowing or lower savings (owing to reduced uncertainty about the future). Public debt reduction requests interest rates to be kept at lowest levels. When government borrowing is of a Keynesian type, it makes no sense to advocate a strong cut in government borrowing without explaining how the resulting demand deficit will be offset.

Hence, there are two views on public debts and deficits, like on the need for fiscal rules. The fiscal rules proponents may blame Keynesians for opening a Pandora's box. How to avoid demagogic choices, once it is recognised that debts and deficits are allowed? The opponents of fiscal rules may reply that fiscal policy adequacy criterion lies on the employment level, inflation, interest rates, and not on *a priori* public debt or deficit levels. They may request rules consistent with the macroeconomic stabilisation objective.

For neo-classical economists, the rise in deficits and public debts in recent years shows that rules are needed to avoid this drift. For Keynesians, this rise was necessary and fiscal rules would be harmful if they prevent fiscal policy to play.

Therefore the fundamental question is: why are large public deficits necessary today at the world level in order to support demand? Prior to the crisis, four factors contributed to insufficient world demand:

- Many countries implemented neo-mercantilist strategies targeting current account surpluses accumulation: Asian countries learnt the lesson from the 1997 crisis and wish to be free of financial markets pressure; China has a growth model based on exports; some countries wish to anticipate the implications of the ageing of their populations (Japan, Germany, Austria, the Netherlands, Nordic countries). These surpluses add to oil exporting countries' surpluses.

- Trade globalisation increases the weight of international competitiveness. Each country has an incentive to put downward pressure on their wages so as to raise their competitiveness. Countries like Germany, the Netherlands and Austria have succeeded in lowering substantially the wage share in value added since 2000. Consequently consumption has decreased as a share of GDP in these countries. Accounting for globalisation and for the interests of leading classes no country implements the relevant strategy: supporting output through higher wages and social benefits<sup>3</sup>.

- Anglo-Saxon economies have chosen a growth strategy based on wage and incomes stagnation for households as a whole and the rise in inequalities. This implies a declining consumption trend which was offset by higher households' borrowing and financial and housing bubbles, allowed by real interest rates maintained at low levels. When households borrowing reach a paroxysm and when bubbles implode, public debt has to support demand.

- The debt rise in France and in many countries does not result from rising public spending, since on the contrary these expenditure have decreased as a share of GDP (by 1.4 percentage point for the euro area and 0.8 for France between 1997 and 2007), but from lower tax receipts (by 1.5 percentage point in the euro area like in France) due to the tax counter-revolution implemented by most governments since 25 years. In the name of free movement of people and capital, EU institutions have forbidden countries to implement measures needed to protect their tax policies. Hence EU governments have used tax competition. Tax and contributions cuts have been intensified (on corporate taxation, on higher-income households, on wealth, employers' contributions etc...) with no positive impact on growth. These tax policies have therefore increased social inequalities and public deficits. Simultaneously these tax cuts policies were chosen by EU institutions, right-wing governments and leading classes with a view to cut tax revenues, and pretend afterwards that because of the resulting deficit public expenditure need to be cut.

### **Section 3. Fiscal rules already implemented, an assessment**

A fiscal rule<sup>4</sup> may be defined as: 'a fiscal policy constraint which limits the level of some variables like deficit, debt or expenditure, either in absolute terms or depending on some economic variables'. The implementation of fiscal rules has been strongly advocated by the IMF, fiscal rules facilitating domestic fiscal policies surveillance by the IMF (see IMF, 2009).

In fact, there are different types of rules according to several criteria:

- Some rules set permanently what fiscal policy should be: for instance, the structural deficit should be nil or equal to net public investment. Other rules set a limit: public deficit

---

<sup>3</sup> Strangely, the European Commission and economists in the industrial economies recommend this strategy ...but for China.

<sup>4</sup> This paper considers national rules only and does not discuss rules imposed on local government.

should not exceed 3% of GDP; debt should not exceed 60% of GDP. Such rules play asymmetrically and episodically.

In the first case, it is difficult to design a rule able to account for all situations. In the second case, the rule bites in times of crisis, precisely when output needs to be supported by fiscal policy, and not in good times, when running fiscal consolidation would possibly not be detrimental to growth. The ceiling is generally arbitrary.

- Rules can apply to government borrowing, structural balance, debt, expenditure or taxes. But government borrowing depends on the cyclical situation; the structural balance is difficult to measure. The debt criterion is difficult to handle (see box 2). Should a rigid rule constrain the social choice between public and private expenditure? This has hardly any long-term justification. Expenditure rules generate incentives to introduce tax expenditure. The rule in terms of tax revenues is often counter-productive. It leads governments to increase borrowing rather than raise taxes.

#### **Box 2. The public debt criterion in the short term**

Let us consider an economy in a Keynesian situation. Demand determines output, according to:  $y = g + c(1-t)y$ . Debt varies as:  $h = h_0 + g - ty$ . If  $g$  declines by 1, this leads  $y$  to fall by  $1/(1-c(1-t))$ . A restrictive fiscal policy will lead the debt to GDP ratio to rise if:  $h_0 / y_0 > (1-c)(1-t)$

For instance: if  $c=0.5$  and  $t=0.5$ ,  $h_0 = y_0 = 100$ , cutting the deficit by 1 leads output to fall by 1.33 (from 100 to 98.68), *ex post* the deficit will fall by 0.33. Debt will decrease to 99.67. The debt-to-GDP ratio rises from 100% to 101%. In the short run, a restrictive policy cannot cut the debt-to-GDP ratio.

- Rules can be annual, medium-term (to set a debt target or a deficit target at a five-year horizon) or long-term (ensuring public finance sustainability). But an annual rule often comes into conflict with the economic situation, a medium-term rule allows to postpone efforts and may lack credibility, a long-term rule is not very useful: even if a country anticipates a strong increase in its pension expenditures, an immediate increase in social contributions is counterproductive in a period of insufficient demand.

- They may consist in a simple objective set by the government. They may be supervised by an external authority (Committees of independent experts, Parliament, Constitutional court, EU Commission), which may be entitled to give advices only. This external authority may be entitled to impose the fulfilment of the rules. Rules may be written in the Law or in the Constitution.

The first case has the advantage of being soft: the government may change its objective or may not fulfil it (sometimes with the only obligation to explain why). In the second case, the question of the supervising authority is raised: is fiscal policy a technical question or a political one. The supervising authority may be given the mandate to give advices, to dialogue with the government. Going beyond that, the third case is hardly consistent with democratic principles. The fourth case is difficult to implement because all possible events cannot be written in the law. If the text is too vague (for instance: fiscal policy should target a balanced-budget) it may be ineffective. If the text is too precise (for instance, the structural balance should be at the equilibrium), it is unenforceable.



- How should the position of the economy in the business cycle be accounted for? Should the fiscal rule apply on to the structural balance (knowing all measurement difficulties)? Should discretionary fiscal policy be forbidden? What should a government do after a major depressive shock: give up the fiscal rule in order to support growth or try to meet the rule at the risk of slowing down recovery?

- The non fulfilment of the rule may lead to no sanction (except by the general public), may be subject to fines (in the case of international commitments), may be impossible (if the surveillance authority is entitled to constrain the government or if the law is automatic).

The last cases raise feasibility and democratic issues. In the event of a deep depression, a rule may be unenforceable or produce disastrous consequences. For what reasons could a group of experts constrain an elected government to run a given policy? The difficulties we have just mentioned plead for a vague rule, with a large flexibility. This is how rules worked until recently.

### **National rules**

Many countries have introduced in their constitution rules which did not have a real impact. They are either vague and not really binding, or they are abandoned when they become binding.

The US has no fiscal rule. There is a public debt ceiling, which can be risen when needed, and this may be the opportunity to make medium-term fiscal commitments. Since 1974, the CBO has played a significant role in producing reports on the medium-term fiscal outlook and on fiscal policy costs. But it does not have any power. The situation is similar in the Netherlands, where the CPB plays an important expertise role, in Sweden (with a Fiscal Policy Council), in Belgium (High Council of Finance) and in Denmark (Economic Council).

In Germany, according to the National Stability Pact, governments are not allowed to run deficits exceeding the amount of their investments; they should target budgetary positions in balance.

In Spain, the Fiscal stability law from 2004 states that ‘all levels of government should aim at budgetary positions in balance’.

In the UK, the new-Labour government submitted to a vote in the Parliament in 1998 a ‘Code for fiscal stability’, embedding two rules: the golden rule for public finances: the government should be allowed to borrow only to invest over an economic cycle; the sustainable investment rule: net public debt should remain at a stable and prudent level, set at 40% of GDP.

The golden rule has an economic justification since it ensures in theory that public expenditure are financed by the generations which benefit from it. It is appropriate from a cyclical view point: in times of recession, government borrowing can increase both under the automatic deficit and under discretionary measures, as long as this increased borrowing is offset in good economic times. It allows governments to borrow to invest, which is particularly necessary for countries lagging behind in terms of public investment. The rule prevents governments from reducing their deficits through lower investment, which is detrimental to growth. But this rule opens a Pandora’s box on public investment definition: should the rule stick to the National accounts’ concept or should all expenditure preparing for the future be included, like education and research? The rule involves a risk of excessive public investment in bad economic times.

This golden rule is probably one of the best fiscal rules. However it has three drawbacks: it is difficult to implement because it assumes that there is a ‘regular’ economic cycle. What should be done if the economic cycle turns out to be irregular? The government has an incentive to change the business cycle dating in order to have rooms for manoeuvre. The British golden rule is too strict, since we have seen that the appropriate rule is that government borrowing equals net public investment augmented by debt depreciation.

Should we offer as an appropriate golden rule that the structural balance less net public investment and debt depreciation be at least in balance? Balassone and Franco (2002) rejected this rule in the name of measurement difficulties. The rule implies that statisticians are able to estimate the cyclical part of government borrowing (therefore the output gap and its impact on public finances), public investment and public capital stock depreciation, in other words four questionable measures. But is not it better to use a fair rule, estimated with some lack of precision than to follow a wrong rule, estimated with precision?

A more fundamental criticism is that this rule defines fiscal policy neutrality, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equals public investment). But a government may choose not to be neutral. It may wish to run an expansionary fiscal policy in times of subdued activity or a restrictive policy in a period a high inflation. It may wish to implement structural measures if it judges that saving is too high *ex ante* (which would require a too low interest rate) or too low (in the light of demographic developments). The rule confuses a neutrality criterion with an economic policy norm. Nothing guarantees that the fiscal policy needed to reach a satisfying output level in a country which does not control its interest rate matches the golden rule.

The 40% limit for the debt ratio has no justification (net debt stood at 33% of GDP in 1998 in the UK). The golden rule ensures on its own that net public debt stands below public capital stock.

No mechanism forces the government to fulfil the Code; the government simply needs to explain why it did not fulfil it and how he will stick to it. The rule allowed the government to increase substantially public investment spending starting from 2002, which was needed both for structural (public equipment was insufficient) and cyclical (to counterbalance lower private demand after the burst of the internet bubble) reasons.

In November 2008, in view of public finance deterioration, the UK government abandoned the Code for fiscal stability, announcing that it would restore public finances once the economy would recover. Government borrowing rose rapidly, together with net government debt (which reached 62.6% GDP in September 2011, excluding financial interventions). This shows clearly that fiscal rules cannot be set as a rules ‘for all seasons’, and that they cannot be fulfilled in times of huge crisis as we have since early 2008.

Formally, France already has a fiscal rule. Since July 2008, the Article 34 of the Constitution states that: ‘The public finance multiannual guidelines are defined by programming laws. They are part of the target of public finances in balance’. This article has had very little influence on fiscal policy implemented since then. In times of crisis, multiannual guidelines rapidly lose any influence (Table 1). This was the case in 2002 and 2009. Moreover, the target of public finances in balance is excessive: we know that the golden rule allows in the medium term a deficit of around 2.5% of GDP.

### 1. Public balance targets according to the Stability programmes submitted by France

	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13
J99	-2.9	-2.3			-1.2											
J00		-2.1	-1.7			-0.5										
J01				-1.0	-0.6	-0.4	0.2									
J02					-1.4	-1.3	-0.5	0.0								
J03					-2.8	-2.6	-2.1	-1.6	-1.0							
J04						-4.0	-3.5	-2.9	-2.2	-1.5						
J05								-2.9	-2.2	-1.6	-0.9					
J06								-3.0	-2.9	-2.6	-1.9	-1.0				
J07									-2.7	-2.5	-1.8	-0.9	0.0			
J08										-2.4	-2.3	-1.7	-1.2	-0.6	0.0	
J09											-2.9	-3.9	-2.7	-1.9	-1.1	
J10												-7.9	-8.2	-6.0	-4.6	-3.0
J11													-7.0	-5.7	-4.6	-3.0
	-2.6	-1.8	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.3	-2.7	-3.3	-7.5	-7.0	-5.6		

### The Stability and Growth Pact

Euro area countries are committed to the SGP. This is an example of a fiscal rule enshrined in an international Treaty, which raises a delicate question: can a Treaty resulting from a political compromise contain binding economic constraints, constraints which come in contradiction with economic theory.

The Pact was based on the assumption that MS domestic fiscal policies could have a negative impact on partner countries. But only the risk of an over-expansionary policy was taken into consideration, and not the risk of too restrictive policies. The Pact was marginally revised in 2005, but its initial basic principles remain unchanged. MS should not run higher than 3% of GDP public deficits and higher than 60% of GDP public debts. MS are requested to produce Stability programmes showing 4-year projections for public finances, bringing medium-term budgetary positions in balance (a 1% of GDP deficit is allowed for MS with high potential growth and low public debt). The budgetary effort must be at least 0.5% of GDP per year (measured in terms of primary structural balance, as estimated by the Commission). If debt exceeds 60% of GDP, bringing back the debt to this value must be undertaken at a satisfactory pace. Once the objective of the structural balance in equilibrium is reached then it must be maintained. Only the automatic stabilizers are allowed to play, the calculation of the structural balance being made by the Commission's method. The European Commission initiates an Excessive Deficit Procedure (EDP) when a country exceeds the 3% deficit (unless this excess is temporary) and sets a deadline for the country to bring its deficit below 3% of GDP. Fines can apply in principle if countries do not fulfill their commitments in an EDP but they have never been implemented.

The SGP drawbacks have often been analysed (see, for instance Mathieu and Sterdyniak, 2003):

1. The 3% limit makes no sense in times of economic depression. A country particularly hit by a recession may need a higher than 3% of GDP deficit to counterbalance a large fall in private demand. *A priori* it will induce no negative effect on his partners since it avoids that its domestic demand fall spills-over. In 2002, there was a public deficit of 3.5% of GDP in Germany but the inflation rate stood at 1.4% only and the current account surplus at 1.9% of GDP: we cannot see how the German deficit could have a negative impact on his partners.

2. The Pact is blind for two reasons. It can operate only at the trough of the cycle. But restrictive measures should be taken only when the economy is at the peak of the cycle. The Pact does not bite for too virtuous countries. The Pact does not take into account the issues of external balance, competitiveness, private debt, financial or real estate bubbles.
3. The Pact should allow sanctions for countries running excessive public deficits, inducing inflationary pressures and excessive deficits, which require the ECB to raise interest rates. In fact, countries under an EDP are often countries with low growth and low inflation, and which need public deficits to support their growth. Conversely, countries like Spain and Ireland have enjoyed strong growth, with inflation, and without any public deficit.
4. The rationale for a medium-term budget in balance has no clear economic justification. A country where private savings are spontaneously too low (high) may need some budget surplus (deficit). It is also reasonable to finance public investment through government borrowing and therefore some public deficit is justified. In a situation of relatively low private demand, running a government budget in balance may require such a low interest rate level that the objective will be out of reach. A deficit kept in permanence at 0% of GDP would lead nominal public debt to be stable and constantly declining as a percentage of GDP. The debt would reach 0% of GDP at some point. But savers, in particular pension funds, need to own public assets, because these are long-term, liquid and safe assets.
5. In good times, the SGP aims at structural borrowing cuts, but cannot put pressure on governments to do so. The 1999-2002 episode showed that the concept of a good economic situation is problematic: MS refused to accept the structural unemployment rate floor as calculated by the Commission. In a depression, the rule becomes totally unenforceable. Moreover, the distinction between a structural and cyclical balance is questionable: where should stimulus measures be placed? What about the large revenue falls due to the overreaction of corporate and income taxation? Nothing justifies the prohibition of discretionary fiscal policies.
6. Since there is a single interest rate which does not fit the specific situation of each country, each MS should be allowed to use fiscal policy to achieve a satisfactory level of output (corresponding to the natural rate of unemployment). If we summarise the EMU functioning by:  $y_i = d_i + g_i - \sigma r$ , where  $y_i$  is the output gap,  $d_i$  private demand and  $g_i$  public spending (assumed to be equal to the public deficit),  $r$  is the common interest rate. We should have:  $g_i = -d_i + \sigma r$ . On the contrary, imposing  $g_i = 0$  produces an unsatisfactory output level.
7. The SGP implementation relies crucially on the potential output growth estimate, which is problematic in the crisis. According to the Commission method, potential output deviates relatively little from actual output, so the deficit is estimated to be mostly structural.

As Table 2 shows, the 2009 crisis led the Commission to revise substantially its estimates of potential output before the crisis. For 2007, the structural deficit increased by 1.2 percentage points at the euro area level. For 2007, the structural deficit rose from 0.4% of GDP to 1.2% of GDP for Germany, from 2.6 to 3.7 for France, from 1.7 to 3.0 for Italy, from -0.3 to 1.0 for

the Netherlands, from -0.2 to 1.6 for Ireland. In 2010, was the requested effort to return to the structural balance equilibrium of 5.1 or 2.2 percentage points of GDP?

## 2. Euro area structural balance estimates, by the Commission

	2005	2006	2007	2008	2009	2010	2011
GDP	1,7	3,0	2,8	0,6	-4,1	0,9	1,5
Public balance	-2.5	-1.3	-0.6	-2.0	-6.3	-6.6	-6.1
Potential growth*	1,6	1,5	1,5	1,3	0,8	0,8	1,0
**	1,9	2,0	2,1	2,0	1,9		
Output gap*	0.0	1.4	2.5	1.8	-3.1	-3.1	-2.6
**	-0.9	-0.2	0.2	-1.2	-7.3	-8.4	-8.9
Structural balance*	-2.5	-2.0	-1.9	-2.9	-4.8	-5.1	-4.8
**	-2.0	-1.2	-0.7	-1.4	-2.6	-2,2	-1,7

\* Spring 2010 estimate; \*\* Spring 2008 estimate.

The SGP implementation led to strong tensions within the area (Tables 3 and 4). In 1999-2000, the largest countries refused to run restrictive policies, despite strong growth, because they did not want to undermine growth while domestic unemployment was still high. So, in the 2003-2004 economic downturn, deficits rose above the 3% of GDP limit and governments refused to undertake restrictive policies which would have deepened the recession. This led to a crisis between the Commission and the Council in November 2003. From 2004 to 2007, fiscal positions improved thanks to the recovery and to consolidation policies undertaken in Portugal, Germany and Italy, but these countries experienced sluggish growth in that period. In mid-2008, no country was under an EDP. However, six countries had public debts exceeding 60% of GDP: countries cannot meet *a priori* fiscal rules.

## 3. Excessive deficit procedures (EDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Portugal	24/9	EDP	11/5	22/6	EDP	EDP	3/6	07/10	EDP
France		2/4	EDP	EDP	EDP	30/1		18/2	EDP
Germany	19/11	EDP	EDP	EDP	EDP	16/5		07/10	EDP
The Netherlands			28/4	7/6				07/10	EDP
Greece			19/5	EDP	EDP	16/5		18/2	EDP
Italy				16/6	EDP	EDP	3/6	07/10	EDP
Spain								18/2	EDP
Ireland								18/2	EDP
Belgium								07/10	EDP
Austria								07/10	EDP
Finland									12/5

## 4. MS not fulfilling the rules

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Portugal	4.3		3.1	3.4	5.9/63	4.1/64	3.2/68	3.6/72	10.1/83	9.2/93	5.9/108
France		3.2	4.1/63	3.6/65	3.0/66	/64	/64	3.3/68	7.5/78	7.0/82	5.6/85
Germany		3.6/60	4.0/64	3.8/66	3.3/68	/68	/65	/66	3.0/73	3.3/83	/84
Neth.			3.2						5.5/61	5.3/63	3.7/66
Greece	4.4/104	4.8/102	5.7/97	7.4/99	5.3/103	6.0/106	6.7/105	9.8/111	15.6/127	10.4/143	7.5/153
Italy	3.1/109	3.0/106	3.6/104	4.4/104	3.3/106	/106	/104	/106	5.3/116	4.5/119	3.9/121
Spain								4.2	11.1	9.2/60	5.9/68
Ireland								7.3	14.3/66	32.4/96	10.1/114
Belgium	/107	/103	/98	/94	/92	/88	/84	/90	6.0/96	4.2/97	3.6/97
Austria	/67	/66	/66	/65	/64	/62	/61	/64	4.2/70	4.6/72	3.7/74

## 5. Euro area public finances

	GDP growth, %	Government balance	Interest payments	Cyclical component	Primary structural balance
1998	2.8	-2.3	4.2	-0.3	2.2
1999	2.9	-1.4	3.7	0.0	2.3
2000	4.0	-1.1	3.5	0.9	1.5
2001	1.9	-1.9	3.3	0.8	0.6
2002	1.0	-2.6	3.1	-0.3	0.8
2003	0.8	-3.1	2.9	-1.0	0.4
2004	1.9	-3.0	2.8	-1.1	0.9
2005	1.8	-2.6	2.7	-1.3	1.4
2006	3.2	-1.4	2.6	-0.7	1.9
2007	2.8	-0.7	2.6	-0.3	2.1
2008	0.3	-2.1	2.6	-1.2	1.5
2009	-4.1	-6.3	2.5	-4.3	0.5
2010	1.7	-6.0	2.4	-4.4	0.8
2011	1.8	-4.2	2.6	-4.5	2.3

From 1997 to 2007, structural balances improved in the euro area due to lower interest payments and primary public expenditures (table 6), and despite lower tax revenues. There was a lack of tax harmonisation strategy in the EU, which would have prevented tax competition.

## 6. Public finances developments between 1997 à 2007 (data corrected from the cycle)

	Revenues	Interest payments	Primary expenditures	Government balance
Euro area	-1.5	-1.6	-1.4	+1.5
Germany	-2.5	-0.5	-3.7	+1.7
France	-1.6	-0.6	-0.8	-0.2
Italy	-1.0	-3.9	+2.2	-0.7
Spain	+2.2	-3.1	+0.3	+5.1
Netherlands	0.0	-2.6	+0.8	+1.7
Belgium	-0.5	-3.4	+2.3	+1.7
Greece	-0.8	-4.1	+1.5	+1.9
Austria	-4.6	-1.2	-5.0	+1.5
Portugal	+3.8	-1.0	3.5	+1.2
Finland	-2.4	-2.4	-6.4	+6.4

## Lessons from the crisis

In 2007, public debt was sustainable in all euro area MS (except for France, see table 7). The gap between the observed debt level and the stable debt level was negative for the UK, the US, and even more for Japan. The impact of the Pact is therefore ambiguous. The Pact has imposed some degree of fiscal discipline, but not as strong as it was implying.

## 7. State of public finances in 2007 (% of GDP)

	Government borrowing	Primary public balance	Net Public Debt	Real interest rate – GDP growth	Gap/Debt stability	Change in debt 2007/1997
Germany	0.2	2.6	42.9	1.6	1.9	+10
France	-2.7	-0.2	34.0	0.2	-0.3	-8
Italy	-1.7	3.0	89.6	0.9	2.2	-18
Spain	1.9	3.0	18.7	-3.2	3.6	-35
Netherlands	0.2	1.8	28.0	0.3	1.7	-20
Belgium	-0.2	3.5	73.4	-0.2	3.6	-28
Austria	-0.7	1.3	30.7	-0.3	1.4	-6
Greece	-6.7	-2.3	80.4	-2.9	0.0	+4
Portugal	-2.3	0.6	44.1	0.6	0.3	+17
Finland	5.2	4.6	-71.1	-0.3	4.4	-67
Ireland	0.2	0.9	-0.3	-3.4	0.8	-42
Euro area	-0.6	2.0	43.3	0.1	2.0	-10
UK	-2.7	-0.7	28.8	-0.3	-0.6	-2
US	-2.8	-0.8	47.2	-1.1	-0.3	-6
Japan	-2.5	-1.9	80.4	0.7	-2.6	+45

Fiscal policy rules were not helpful during the crisis. The crisis destroyed the reliability of structural balance estimates (see table 2); it appeared that governments were not controlling their deficit levels, due to the over-reaction revenues. Governments implemented discretionary policies; the Commission had to accept them and even to pretend to co-ordinate them, forgetting its speeches on their inefficiency. The structural balance objective was entirely lost. Government deficits rose, both in their structural and cyclical parts: the Stability Pact had to be put aside.

It appeared that public finances deteriorate in times of crisis when fiscal rules can no more be applied and are necessarily 'forgotten'. Should fiscal rules be implemented to prevent the fiscal policy which was implemented in 2008-2010? Do we need temporary fiscal rules to help the economies to recover from the budgetary crisis? But how would these rules make a trade-off between the GDP growth objective and public finance objectives? Should everything be done to bring deficits below 3% of GDP and debts below 60% of GDP? Should everything be done to support economic recovery?

Public finance deterioration during the crisis is not due to over-expansionary policies before the crisis (except for Greece). It results from the depth of the recession (which raises the issue of economic instability induced by financial globalisation), by banks' recapitalisation in some countries (Ireland), by the length of the crisis (which raises the issue of exit strategies), by the bad functioning of the euro area which means that financial markets bet against Ireland, Portugal, Italy and Belgium, where situations are not worse than in the US.

The size of the effort to be done depends substantially on the estimates of cyclical balance and on the deficit target (table 8). The effort is nil at the euro area level according to us (since the primary structural balance is already positive); it amounts to 4.4% of GDP for the Commission (which wants the structural balance to be brought down to 0).

In terms of fiscal rules, the SGP assessment is therefore negative. The rules of the Pact were not met before the crisis; the Pact created useless tensions among MS; it did not allow to define a strategy during the crisis; it does not allow to define a strategy an exit strategy.

## 8. Three euro area structural balance estimates in 2010

	OECD	EC	OFCE
Public balance	-6.0	-6.0	-6.0
Interest payments	2.4	2.8	2.4
Cyclical balance	-2.1	-1.6	-4.4
Primary structural balance	-1.5	-1.6	0.8

## Section 4. Fiscal rules Proposals

Although the rise in deficits and debts was not due to a drift in public finances, many economists and international institutions suggest exit strategies based on fiscal rules, aiming at bringing budgetary positions in balance. This raises two issues: how to define this new equilibrium? How to ensure that these rules are consistent with macroeconomic balance?

Even if the crisis has shown that active fiscal policies are necessary, some countries blame inappropriate fiscal policies for current difficulties. Therefore, they wish more binding fiscal policy constraints. Should EU governments deprive themselves of weapons which were helpful during the crisis?

In the euro area, the strengthening of the rules is demanded by Germany, the Netherlands, and Finland, as a counterpart of the increased fiscal solidarity needed in face of speculation against public debts. The issue is also to *re-assure* financial markets who have understood that public debts in the euro area have become risky assets. But any rule raises credibility issues. Too rigid rules implemented simultaneously in Europe will reduce GDP growth which will have vicious effects: lower output growth will generate lower tax receipts, will increase the debt-to-GDP ratio, government balance targets will not be reached; the rise in unemployment and political and social tensions will raise the fear that the country does not stick to the rule.

### Proposals from academics

#### *Fiscal policy committees*

Wyplosz (2002) proposed to establish a fiscal policy committee of independent experts in each Member State (but how would these experts be chosen?). This Committee would be in charge of fiscal policy regulation, i.e. would set the level of government borrowing, while public spending and receipts would remain under the responsibility of national governments and parliaments. After the ECB's independence, this proposal is a new step towards leaving economic policy entirely under the responsibility of a technocracy. The Committee's mandate would be to ensure public debt long-run sustainability, while the objective of output stabilisation will come in second.

Unfortunately, the author has difficulty in defining debt sustainability. He makes two suggestions: a balanced budget over the economic cycle (which implies a public debt at 0% of GDP in the long run), or the stabilisation of the debt-to-GDP ratio in the medium run (i.e. excluding cyclical effects), but the author admits that it is impossible to set the appropriate level for this ratio.

As concerns monetary policy, the central Bank's objective is rather clear<sup>5</sup>: ensuring low and stable inflation rates, the equilibrium unemployment rate theory ensuring that monetary policy

---

<sup>5</sup> Although this objective has become less clear with the financial crisis' developments. Should the Central Bank ensure financial and banking system stability? Should the Central Bank save the financial and banking system?



will lead to the optimal employment level. The fiscal policy objective is less obvious: should fiscal policy target full employment or public finances in balance, and how to define the latter? Should public debt reduction be the target or is public debt needed to ensure macroeconomic equilibrium? This is a political choice which belongs to voters and not to experts (we here are along the same lines as Murray and Wilkes, 2009). Wyplosz (2011) recognises that these committees should be based on rules, but it does not describe them: will they apply only to fiscal variables or will they take account of the macroeconomic situation?

The effective budget is never equal to the budget voted due to economic developments: the Committee would therefore have to control government policies in permanence and possibly to ask governments to change taxes. What government would agree?

Why would citizens be asked to vote for political parties' representatives if fiscal decisions are in fact made by non-elected independent experts? Can the choice of macroeconomic strategy be taken out of the democratic debate? The crisis has clearly shown that fiscal policy cannot follow rules and must be run by determined and brave governments, which will not be the case for experts' committees. Can we imagine that a group of experts would have agreed to stop banks' financial support or active stabilisation policies in 2008-2009?

Other authors, like Fatas *et al.* (2003) propose a Sustainability Council, i.e. an independent panel of experts, who would assess national fiscal policies according to sustainability criteria. Their judgment would be made public, so as inform financial markets and the general public. The problem is that sustainability is a vague concept, which makes sense as a long term constraint only. This means it is difficult to use it to make a judgment on fiscal policy run in a given year. It would require judgements on the output gap level, on optimal debt, on the need for discretionary fiscal measures. Why would these experts be more qualified than others to have an opinion on so difficult issues? The risk is that these experts lead markets to have a single opinion and that they exert an excessive influence.

Other academics simply suggest an independent fiscal policy committee who would be in charge of assessing macroeconomic projections' credibility and whether fiscal assessments are realistic. Why not? But should there be a single and official Committee? Would not this paralyse the democratic debate? But one should not engage in the vicious circle: lower than expected output growth, therefore a higher than forecast deficit and therefore a more restrictive fiscal policy.

### ***Automatic rules***

Some authors suggest more or less automatic fiscal policy rules. Generally, these rules are based on magical numbers (like budget in balance) which are unrelated with macroeconomic equilibrium constraints. Some authors advocate bringing government borrowing to 0. But such a criterion has no economic justification once it is recognised that some level of public debt is needed (because private agents wish to be able to own a safe asset). Besides, it makes sense to finance public investment through borrowing. Let us assume, for instance, that households wish to own a public debt of 60% of GDP, at a 4% interest rate, and a 4% output growth. The equilibrium public balance is 2.4%. It makes no sense to target a borrowing balance at 0, which would require an interest rate below GDP growth. Some authors recommend a debt ratio target of below 60% of GDP. But this level is also arbitrary.

For instance, the German Council of Economic Experts suggested in 2009 that MS make commitments to bring their structural deficit in balance. Any deviation from the path would

be corrected through an automatic rise in taxes. But this would prevent any stabilisation fiscal policy, this implies that the structural balance can be available in real time, and that the structural balance equilibrium matches the macroeconomic equilibrium.

A large number of economists at the IMF and at the OECD suggest to run fiscal policy at two horizons: in the short-run, expansionary fiscal policies would continue to be implemented; in the long-term rigid rules would be implemented, and announcements like future pensions reforms would be made to reassure financial markets (see for example, Schick, 2010). But this is likely to be an illusion. What would be the credibility of such policies?

### **Recently implemented rules**

#### ***Germany: The debt brake***

Germany has introduced a ‘debt brake’ in its Constitution, which forbids any higher than 0.35% of GDP structural deficit from 2016. The cyclical deficit is estimated according to the Commission’s method, and we have seen that this method is fragile. According to that estimate, Germany would have run an excessive structural deficit (above 0.35% of GDP) each year since 1974 (except in 1985 and 1989). But how can we consider that a country running a higher than 6.5% of GDP current account surplus in 2005-2007 and a 1.5% inflation rate was running excessive public deficits. In fact, the debt brake is not more rigid than the SGP rules. But Germany was not fulfilling the SGP.

Derogations can take place, in case of ‘natural disaster or exceptional economic circumstances’. They should be agreed in a Parliament vote, with a 2/3 majority.

The law creates a ‘notional adjustment account’, where the excess over the 0.35% rule (due to cyclical developments or poor execution of the budget) are written. These excesses will have to be amortized either thanks to good economic times, or to discretionary policies. The amount of this account cannot exceed 1.5% of GDP.

This rule is satisfactory neither in the short nor in the long term. In the short-term the definition of ‘exceptional situations’ will be crucial. In the event of growth deceleration, the fiscal policy constraint will depend strongly on the potential output estimate. In 2010, the German government deficit stood at 3.3% of GDP. The structural deficit amounted to 2.2% of GDP according to the Commission and the OECD, to 0.5% of GDP according to us.

In the long-term, if one considers that Germany may have a potential growth rate of 3% per year in nominal terms, then running a 0.35% of GDP deficit would lead the public debt down towards 12% of GDP in the long-term. Is this realistic? With Germany having imposed on itself such a rule, the other EU countries are under market pressure to be as virtuous as Germany.

#### ***A French-type rule?***

In March 2010, a Commission was appointed with the mandate of recommending rule of public finances in balance. The report was released in June (see Camdessus, 2010).

From the beginning, the Commission chose not to consider wise rules like the ‘golden rule’ or the stabilisation of the debt-to-GDP ratio, and suggested instead an unenforceable rule: the equilibrium of the structural balance, which forbids discretionary measures and imposes a too strong constraint in the medium term. There was however no macroeconomist among the members of the Commission, and stabilisation issues were forgotten.

The Commission suggested that each new government commits himself by law on a programme reducing structural deficits and on a date at which the structural balance would be reached.

In March 2011, the French government proposed a complicated Constitutional law project. Each Government will have to commit himself in a multiannual public finances Law, which should cover 3 years at least and would include, year by year, a public spending ceiling and an amount of new measures in terms of receipts (independently of the conjuncture). Higher than announced spending would be allowed only if combined with a similar rise in receipts. The government would have to commit initially on a fixed scenario including each year cuts in the structural deficit (public expenditure less receipts corrected from the conjuncture). The government would have to give a date at which the structural balance would reach 0. The Constitutional Council would be entitled to amend a finance law if the latter was not in conformity with this multiannual public finance law, i.e. if it involved a lower fiscal effort.

This project raises several difficulties:

- It commits future governments to target public finances in balance.
- It continues to be based implicitly on a potential output growth path, needed to estimate the effort in terms of expenditure and of the trend in receipts.
- It requests the Constitutional Council to assess whether the fiscal effort matches well the multiannual public finance law, whereas the measurement of this effort depends on arguable assessments of potential growth, on the impact of output level on tax revenues, on the impact of the new measures.
- What will happen if output growth is much weaker than planned in the ‘multiannual law’? In principle, the government should not be entitled to implement discretionary stabilisation measures. The Law would then constrain fiscal policy to let automatic stabilisers play only. But the latter alone cannot stabilise the economy. Let us assume that the tax-to-GDP ratio is 50% and propensity to consume is 1. Then the multiplier equals 2. If private spending falls by 10 *ex ante*, this will lead output to fall by 20 in the absence of any fiscal policy response, and public deficits will rise by 10. If a fiscal expansion increases public expenditure by 10, this will induce the same rise in deficit but will prevent output from falling. Such a policy would be forbidden according to the law proposal. The proposal is based on an implicit and wrong theory: automatic stabilisers should be allowed to work, but discretionary stabilisation fiscal policies should be forbidden. At the end of 2008, the IMF, the G20 and the European Commission requested countries to implement such policies. Should these policies be forbidden two years later?

In fact, the Constitutional project is written in such a way that the government will have the possibility ask the parliament to vote a new ‘multiannual law’ before voting the budget law. The risk is that it complicates further the budgetary process, even more if the multiannual law comes in addition but does not replace the Stability programme that France has to send to EU authorities each year.

The experience of the SGP has shown that it is useless to ask MS to announce a trajectory for public finances independently of the cyclical situation. In November 2007, the French government announced that the structural deficit would be cut down to 0.6% of GDP in 2011. In January 2010, the structural deficit target had moved to 6% of GDP. Obviously, this rise in deficit was needed in the crisis. But what would have happened if the budget had been

constrained by a ‘multiannual law’ passed in 2008? Does the French government consider it was wrong to support output in 2009, and not to be constrained to remain inactive?

Some economists (like Boone and Pisani-Ferry, 2011) think that France should make more budgetary efforts: they request that the ‘multiannual law’ at the beginning of the Parliament legislature, determines ‘the fiscal policy main parameters over a five-year period’, as if a rigid economic policy could be run without accounting for cyclical or structural developments. They request the ‘correction of past deviations’: in 2013 or 2014, excessive deficits from 2009 or 2010 should be corrected without accounting for the effective cyclical circumstances these years. An ‘independent public finance council’ should be settled, and would be in charge of evaluating the fiscal policy implemented. But according to which criteria would these experts make their assessment?

This project was adopted by the French National Assembly and the Senate, but did not obtain a sufficient majority. It will not be voted by the Congress.

However, the French government has made a clear commitment to meet from now on the deficit public reduction path enshrined in the budget law (6% of GDP in 2011, 4.6% in 2012 and 3% in 2013), independently of the cyclical developments. Hence, the announcement of a GDP growth 1 percentage point lower than anticipated a few months ago for 2012 should translate into austerity measures amounting to 0.5% of GDP which should dampen output growth further. On the whole, accounting for a 0.5 sensitivity of government borrowing to GDP and a multiplier equal to 1, the additional austerity measures should amount to 1 percentage point of GDP and GDP should fall by 2%.

### ***UK: an independent office***

In 2010, the UK introduced an independent *Office for Budget Responsibility*, in charge of producing the macroeconomic and fiscal forecasts and of assessing the government patrimonial accounts. In 2011, the government set the objective of bringing the structural current government borrowing in balance in a five-year period, i.e. the golden rule with the problems mentioned earlier. The OBR has to assess if the fiscal policy implemented will reach this objective (with a higher than 50% of GDP probability). What will the government do if an active fiscal policy is needed in 2016? He will fortunately not be constrained by the 2011 programme. Hence, the medium-term commitment is not so binding.

### ***A strong EU pressure***

The EC’s legislative proposals on strengthening the SGP and the ‘Euro Plus Pact’ aim at constraining all euro MS to introduce binding fiscal rules in their constitution. The EU authorities did not learn the lessons from the disastrous euro area management before the crisis. This management was focusing on rigid fiscal rules and not on a precise coordination of macroeconomic strategies, and this has increased disparities in the EU in a poor growth context (see Mathieu and Sterdyniak, 2011).

The debt crisis strengthened the weight of proponents of automatic and without economic rationale fiscal rules. These proponents can now rely on financial markets’ threat, on the need to reassure financial markets, on Germany’s weight, which wishes a price to be paid for increased EU solidarity through strengthened SGP rules. The Greek crisis is way to hide the financial crisis under the carpet.

The proponents of strict rules point to the threat of financial markets and rating agencies. If a country did not include such rules in their constitution they would lose their precious AAA. Financial markets would lend at reasonable rates only to countries committing not to have to borrow. On the one hand, countries cumulating huge currency reserves (like China, and oil producing countries), pension funds, and insurance companies wish to own huge public assets amounts. On the other hand, they refuse to lend to countries which need to borrow, at least without high risk premia. They refuse that their accumulation of liquid assets has a counterpart in terms of debt. Such contradictory demands can only paralyse the world economy.

In 2011, most euro area economies appear to be close to primary structural balance, in other words their debt would remain stable if they were borrowing at an interest rate equal to output growth (table 9). This is not the case for Japan, the US and the UK. Besides, euro area countries suffer from a much higher interest rate than countries outside the euro area, with smaller imbalances. There is a specific cost for euro area countries.

### 9. Countries' situation in 2011

	Current account % of GDP	Gov. balance % of GDP	Public deficit % of GDP	Average growth, 2011 and 12	Grade, over 20	Primary structural balance % of GDP	10-year interest rate
Finland	8.2	-1.4	54	2.5	20	0.5	2.7
The Netherlands	7.2	-3.8	66	1.25	16	-1.3	2.6
Germany	5.5	-1.7	84	1.9	13.5	0.0	2.2
Belgium	1.0	-3.8	97	1.7	13.1	0.3	4.4
France	-2.6	-5.8	85	1.2	11.9	-1.4	3.1
Japan	2.6	-8.3	236	0.9	11.1	-4.9	1.0
Spain	-2.9	-6.5	68	0.5	10.8	-0.9	5.2
UK	-1.5	-8.8	86	1.15	9.6	-4.4	2.6
US	-3.7	-9.1	98	1.75	8.8	-6.8	2.25
Italy	-4.1	-3.7	121	0.3	8.1	2.3	5.8
Ireland	3.7	-11.3	114	0.0	6.9	-2.2	8.2
Portugal	-7.8	-6.8	101	-1.5	5.7	0.6	11.6
Greece	-8.6	-8.2	153	-4.2	3.5	2.6	23.9

On 29 September 2010, the Commission proposed a set of six legislative proposals aiming at strengthening economic governance:

- The proposals keep the 3% of GDP limit for deficits, the medium term objective of budgetary positions in balance, and the constraint for countries running a structural deficit to cut it by at least 0.5% of GDP per year. No lesson is drawn from past experience.
- Countries will face sanctions if public spending increases more rapidly than the prudent GDP growth (unless this is offset by a rise in expenditure or if the country runs a budgetary surplus). This would forbid support measures through higher public spending. In times of economic depression, do we really need prudence? What would happen if, by prudence, households stopped consuming and companies stopped investing?
- Countries will face sanctions if they do not cut their structural deficit by 0.5 percentage point per year.

- Countries running a higher than 60% of GDP debt ratio will be under an excessive deficit procedure if the debt ratio does not fall by 1/20 per year of the gap between the effective debt and the 60% reference value. But it is almost impossible to prevent the debt ratio to rise in times of economic slowdowns. This new rule is pro-cyclical: it strengthens the constraint on deficits in slow growth periods. For a country having a debt of 90% of GDP and a 2% annual inflation rate, the public deficit will have to be below 2% of GDP if GDP grows by 2%; the deficit will need to be below 1% if GDP grows by 1% only.
- Guilty countries (countries with public spending rising too rapidly, countries not reducing their structural deficit, or not complying with an EDP) will have to make a deposit of between 0.2% and 0.5% of GDP, which will possibly be converted into a fine if requested measures are not implemented).
- The Commission wishes to impose countries to introduce EU rules in the fiscal frameworks (the 3% and 60% limits, the medium-term target of budgetary positions in balance) and to implement a surveillance of these rules by an 'independent budgetary institution'.
- The qualified majority will now be needed to oppose measures and sanctions recommended by the Commission, this being expected to ensure the automaticity of sanctions.

The Commission's proposals undermine MS autonomy, and force them to fulfil rules lacking rationale; they reduce their ability to stabilise their economies. It will increase further the tensions between the Commission and the MS. Expert Committees are given the mandate of monitoring fiscal policy, although the crisis has clearly shown that strong and determined policy responses are needed.

The proposal (the 6 directives) was voted by the European Parliament while media remained silent and the citizens entirely uninterested. The Parliament worsened the text: the Commission can sanction automatically a country not fulfilling the forecast path for deficit reduction.

According to the Euro plus pact, each MS should introduce in their budgetary framework or their Constitution a fiscal rule similar to the SGP, the Commission being in charge of verifying this equivalence.

In October 2011, the ECOFIN council specified that MS under an EDP, i.e. currently almost all euro area countries, will have to meet their budgetary targets independently of economic circumstances. Last, some economists and even ministers in Germany or the Netherlands requested that a country not fulfilling the SGP may be condemned by the European Court of Justice. We therefore observe the implementation of binding and absurd fiscal rules, inconsistent with the needs of macroeconomic governance.

### ***Fiscal rules and markets***

For euro area countries these constraints come on top of financial markets constraints. Since 1945, no industrial country defaulted on its public debt. Public debt was a safe asset, since governments were borrowing in their own currency and could always ask for central bank financing. Industrial countries benefited from 'monetary sovereignty'. This is always the case today for Japan (which can borrow at 1% for 10-year bonds despite a 210% of GDP debt), the UK (with 10-year government interest rates at 2.5% while the public debt stands at around

86% of GDP). It is basically absurd that rating agencies rate governments with monetary sovereignty, as if they could possibly default. Countries with monetary sovereignty should abandon their AAA: by nature, their debt has no risk since it is guaranteed by the monetary power of their Central banks.

Euro area have lost their 'monetary sovereignty': according the EU Treaty, the ECB is not allowed to finance governments; there is no solidarity between MS. Financial markets spotted this in mid-2009. From that time, an out-of-control speculation started on the more fragile countries: Greece, Portugal, Ireland, and then by a domino effect, Italy, Spain, and even Belgium. Today, Belgium has to pay an interest rate of 3.8%, Spain 5.2%, Italy 5.6%, as compared to 2.6% for France and even 1.8% for Germany. Greece, Ireland and Portugal are brought back to a situation of developing economies in the past: their debts have become risky assets, facing substantial risk premia; they have to obey the Caudine Forks of the IMF.

This financial markets game may entirely paralyse fiscal policy. When a country has monetary sovereignty, the Central Bank may cut its interest rate down to the lowest level and be committed to keep it durably low. The government increases its deficit, but the low level of interest rates avoids public debt to increase under a 'snowball effect'; it leads the exchange rate to fall, which supports output. The debt guarantees through monetary creation implies that there is no default risk, hence no reason for being obliged to reassure markets in permanence. The central bank will keep interest rates low in times of depression and this will ensure fiscal policy effectiveness. Fiscal policy does not have to care about markets. This is still the strategy of the US.

In the euro area the risk is that a country may be unable to increase its deficit under the fear that rating agencies will downgrade its rate and that interest rates increase. Countries have therefore no choice but beauty contests, in order to appear as virtuous as Germany in the markets' eyes. Their fiscal policy becomes ineffective and hence their cyclical situation out of control. Public debt becomes a permanent risk factor, since governments are at the mercy of markets' animal spirits. Any economic policy would have to be assessed while accounting for markets' opinion. But markets do not have any particular macroeconomic skills. They impose austerity measures in depressed times and afterwards complain about the insufficient growth. This is what they do nowadays for the euro area in general, for Italy and Greece in particular. They favour free-market reforms, such as reducing social protection or the number of teachers. The default risk must be nil for countries so that they can keep their ability to run economic policies.

The euro area therefore has to choose between disappearing or getting reformed in order to guarantee MS government debts; governments would find their 'monetary sovereignty' again. EU public debts should become safe assets again, with low interest rates but entirely guaranteed (by EU solidarity and fundamentally by the ECB). This is the only way to maintain fiscal autonomy, which is necessary due to disparities in Europe and to the loss of the monetary instrument and of the exchange rate for each MS.

The euro area framework was not appropriately designed initially, especially as concerns the trade off between 'fiscal policy autonomy/single currency/monetary sovereignty'. The joint guarantee creates a moral hazard problem, since each country may increase its debt with no limit, but the absence of guarantee leaves the door open to financial markets who are always ready to bet against some countries. The guarantee cannot be restricted to countries fulfilling the automatic fiscal rules (lacking rationale and not enforceable). It should be automatic and

total. In order to avoid moral hazard, the EU Treaty should include a scheme for a country that would implement effectively an unsustainable policy; in this case, the new debt of the country would not be guaranteed, but this should never occur.

Euro area countries not having to reassure markets anymore, could implement differentiated but coordinated strategies, setting themselves a main target of bringing their economy to a satisfactory employment level, consistent with a stable inflation.

## **Section 5. Conclusion**

Due to the crisis, there is probably a need for a more transparent fiscal policy management: governments should state clearly their output growth target, temporary expansionary measures should be clearly announced as such, the structural account should not include temporary expansionary measures; the public deficit target should be explicit, but this target can only be the golden rule and should be assessed accounting for the macroeconomic context.

Fiscal rules proponents forget that fiscal policy cannot be managed on its own, under arbitrary criteria. Fiscal policy should set itself the objective of maintaining (or reaching) a satisfactory employment level albeit enabling inflation and interest rates to remain at satisfactory levels. Government deficit and debt should derive from this objective.

The emergency today is not increase public finance discipline in reducing blindly deficits but to question economic developments (financial globalisation, the wish of many countries to accumulate surpluses, the change in incomes distribution), which make these deficits necessary to support output (Mathieu and Sterdyniak, 2011).

If the rise in public debts and deficits in advanced economies is the answer to the increase in world imbalances, then one cannot reduce these deficits without handling these imbalances. The world economy would be in better shape if countries running surpluses based their growth on domestic demand and if their capitals would take the risk of direct investment. In Anglo-Saxon economies, higher increases in wages and social incomes, lower income inequalities would mean that a rise in financial bubbles, households' and public debts would be less necessary.

The euro area needs to find the 8 percentage point of GDP lost due to the crisis.<sup>6</sup> Instead of focusing on public deficits, the EU authorities should implement an exit strategy, based on demand, consumption like public spending and investment for the future. This strategy should involve maintaining low interest rates and public deficits, as long as they are necessary to support output.

Fiscal policies should be given back more rooms for manoeuvre, through implementing strong measures at the EU and world levels, fighting against tax evasion, abolishing tax heavens, and restoring the ability of countries to tax multinational companies' benefits, high incomes and wealth. Financial globalisation should step back, because it is a source of economic instability and of excessive misappropriation by the finance sector. This implies that public financial circuits are developed to use households long term savings to finance and guide companies productive investment towards innovative sectors, and in the green economy, so as to support activity without rising public debt.

---

<sup>6</sup> When comparing in 2010 the observed GDP level with the level it would have reached under the pre-crisis trend growth rates.



## References

- ALESINA A. and R. PEROTTI, 1995: “The Political Economy of Budget Deficits”, *IMF Staff Papers*, March.
- ALESINA A. and G. TABELLINI, 1990: “A Positive Theory of Fiscal Deficit and Government Debt”, *Review of Economic Studies*, vol 57.
- ANDERSON B. and J. J. MINARIK, 2006: “Design choices for Fiscal Policy Rules”, OECD journal of Budgeting, Vol 5, N°4.
- BALASSONE F. and D. FRANCO, 2001: “The SGP and the ‘Golden Rule’”, in Brunila A., M. BUTI M. and D. FRANCO, eds., 2001: *The Stability and Growth Pact*, Palgrave.
- BEN AMAR A. and H. STERDYNIK, 2011: “Politique budgétaire et stabilisation macroéconomique”, *OFCE Working Paper*.
- BOONE L. and PISANI-FERRY J. : Comment discipliner les finances publiques, *Telos*, 17 avril 2011.
- CAMDESSUS M., 2010: *Réaliser l’objectif constitutionnel d’équilibre des finances publiques*, Rapport au Premier ministre, La Documentation française, juin.
- DEBRUN X. and M.S. KUMER, 2007: “Fiscal rules, fiscal councils and all that: commitment devices, signalling tools or smokescreens”, in Banca d’Italia (eds.), *Fiscal Policy: Current Issues and Challenges*.
- DELPLA J., 2010 : *Réduire la dette grâce à la Constitution : créer une règle budgétaire en France*, Fondapol.
- DRAZEN A., 2004: “Fiscal Rules From A Political Economy Perspective” in G. Kopits (ed.), *Rules-Based Fiscal Policy in Emerging Markets*, New York: Palgrave Macmillan, 2004.
- EISNER, R., 1989: “Budget deficits: rhetoric and reality”, *The Journal of Economic Perspectives*, volume 3, No. 2, Spring.
- EUROPEAN COMMISSION, 2010: *Reinforcing economic policy coordination*, May.
- EUROPEAN COMMISSION, DG Ecofin, 2009: *Domestic Fiscal Frameworks*, October.
- EUROPEAN COMMISSION, DG Ecofin, 2010: *Public finances in EMU-2010*.
- FATÁS, A., H. HALLETT, A., SIBERT, A., STRAUCH, R. and VON HAGEN, J., 2003: “ *Stability and Growth in Europe: Towards a Better Pact*, CEPR.
- GERMAN COUNCIL OF ECONOMIC EXPERTS, 2009: *Annual Report*.
- IMF, 2009: “Fiscal Rules—Anchoring Expectations for Sustainable Public Finances”, *mimeo*, December.
- JEZE G. and BOUCARD M., 1896: *Cours de la science des finances et de la législation financière*, Paris: V. Giard et E. Brière.
- LEROY-BEAULIEU P., 1891: *Traité de la science des finances*, Paris: Guillaumin et C<sup>ie</sup>.
- MATHIEU C. and H. STERDYNIK, 2003: “Réformer le Pacte de stabilité : l’état du débat”, *Revue de l’OFCE*, n° 84, January. In English: “Reforming the Stability and Growth Pact”, *Document de travail de l’OFCE*, May.
- MATHIEU C. and H. STERDYNIK, 2006: “A European Fiscal Framework designed for stability or growth?”, in: *European Economic Policies - Alternatives to Orthodox Analysis and Policy Concepts*, Metropolis-Verlag.
- MATHIEU C. and H. STERDYNIK, 2010: “La globalisation financière en crise”, *Revue de l’OFCE*, n° 110, October.
- MATHIEU C. and H. STERDYNIK, 2011: “Finances publiques, sorties de crise”, *Revue de l’OFCE*, n° 116, January.
- MURRAY A. and G. Wilkes, 2009: *Fiscal Rules, OK ?*, Centre Forum.

- MUSGRAVE R., 1939: "The nature of the budgetary balance and the case for a capital budget", *American Economic Review*, 29.
- SCHICK A., 2010: "Post crises Fiscal Rules: stabilising Public Finance while Responding to Economic Aftershocks", *OECD Journal on Budgeting*.
- VON STEIN L., 1885: *Lehrbuch der Finanzwissenschaft*, Leipzig, F.A.Brockhaus.
- WREN-LEWIS S., 2011: 'Lessons from failure: fiscal policy, indulgence and ideology', *NIESR Review*, July.
- WYPLOSZ C., 2002: 'Fiscal discipline in EMU: rules or institutions?', *mimeo*, April.
- WYPLOSZ C., 2011: 'Fiscal discipline: rules rather than institutions?', *NIESR Review*, July.