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Fiscal Rules and the Scope for Risk Sharing

The trade-off between risk reduction and risk sharing has been at the heart of debates concerning EU economic governance over the last five years, but there are few signs as yet of a solution being reached. Despite this, there is scope for an obvious grand bargain. Those concerned about irresponsible policy choices, especially where the structure of incentives is open to moral hazard, will want more binding arrangements to tie the hands of the profligate, while those concerned about the adverse impact of restrictive macroeconomic policies want to escape from low-growth traps.

Sequencing matters. Proponents of risk reduction argue that the first courses of action must be to strengthen functions such as prudential supervision and bank resolution, and to reduce the exposure of banks to sovereign risks. Only then can steps to introduce "sharing" mechanisms, such as common deposit insurance or supplementary fiscal resources, be considered. By contrast, those who advocate the sharing of risk believe that failure to act promptly could lead to a vicious cycle of worsening problems and accentuated risks; hence, the priority should be to establish mechanisms for sharing and only then to strengthen risk controls.

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Significant pressure has been exerted by EU institutions to adopt more extensive and intrusive fiscal rules, particularly in the euro area, yet evidence that they are succeeding is tentative at best. This article examines the contribution of rules, focusing particularly on implementation shortcomings.

The role of rules

Fiscal rules have proliferated across the EU, and there are lively arguments about their design, consistency and credibility. Rules can play an important part in curbing risks, but they can also have perverse side effects, especially if they entrench pro-cyclical or otherwise inappropriate policies. The effect is also likely to be asymmetric, potentially triggering a downward spiral during an economic slowdown – akin to excessive austerity. Although the EU-level Stability and Growth Pact (SGP) has been – and remains – the most visible such rule, the EU's Fiscal Compact requires signatories to put in place national rules with similar objectives.

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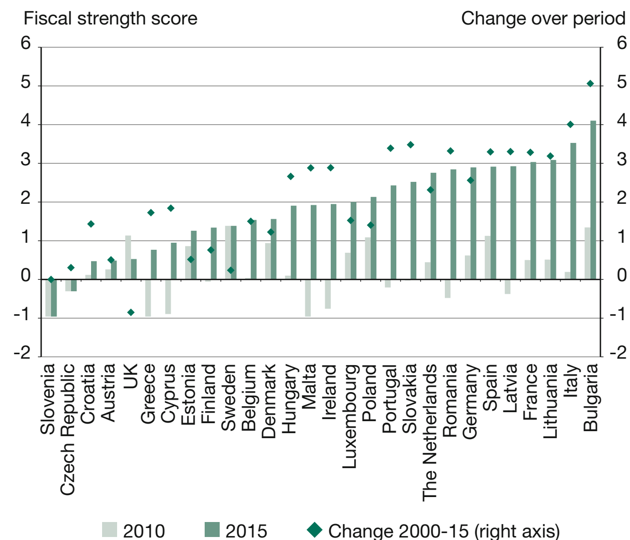
Figure 1
Strength of fiscal rules, 2010-15



Note: For an explanation of how the fiscal rule strength is determined, see source.

Source: European Commission: Numerical fiscal rules in EU member countries, available at http://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/numerical-fiscal-rules-eu-member-countries_en.

A database compiled by the Directorate General for Economic and Financial Affairs (DG ECFIN) of the European Commission lists some 120 numerical fiscal rules among the EU28.[1] According to the database, the rules have become stronger over the last 15 years in every country other than the UK (see Figure 1). More recently, several EU member states, including many of those which experienced acute pressures on their public finances during the crisis years, have replaced their weak rules with strong ones. The bars in Figure 1 show the fiscal rule index values for 2010 and 2015, based on DG ECFIN's methodology.[2] Cyprus, Greece and Ireland all shifted from weak to comparatively strong rules, while Portugal now has rules on par with those countries with the highest index values. Hungary, Romania, Italy and Spain also significantly strengthened their fiscal rules.

A fiscal framework has to be understood as being broader than mere numerical rules, because there are many institutional influences that determine whether or not it is effective. Among other recent innovations is the espousal by nearly all member states of independent fiscal councils to strengthen scrutiny of the policy choices made by governments. In addition, beginning with the draft 2014 budgets, eurozone countries are now obliged to submit draft national budgets to the European Commission for scrutiny.

The establishment of the macroeconomic imbalances procedure (MIP), reflecting the causes of the crises in Ireland and Spain (both of which had solid fiscal positions), can also be understood as a form of rules-based governance intended to control risks other than from fiscal policy. The regulations behind the MIP have much in common with the SGP, namely preventative and corrective arms, combined with the possibility of financial sanctions. Member states are first assessed on a range of indicators, then given an "in-depth review" (IDR) if there is evidence of a macroeconomic imbalance. The Commission subsequently publishes its verdicts for those subject to an IDR on whether there are imbalances and, if so, how severe they are.

Dilemmas can be observed relating to several characteristics of rules-based governance. Their proliferation has consequences for how governments set priorities, notably where different rules from different directives risk being in conflict with one another, alongside the profusion of channels for monitoring national performance. According to Andrle et al., the number of rules in the EU is well above what is found in other federations.[3] Given their role in policy coordination, both within and between countries, a lack of consistency among the rules can be problematic, because it is not always obvious which rule is dominant at any time. An example is how the national rules required by the Fiscal Compact interact with the SGP. In addition, a dilemma associated with granting some exceptions to rules is that doing so encourages governments to attempt to use further excuses to avoid complying with rules that they find onerous. This raises a fundamental issue: can rules be interpreted flexibly without undermining their essential logic? Institutional settings have to be conducive to using rules successfully, and transparency is an important facet here.

There are also increasing doubts about the economics underlying fiscal rules, with a widespread sense that fiscal policy has been tighter than was warranted at a time of enduring economic stagnation, casting doubt on the appropriateness of rules (and minimising the stigma of a lack of compliance). As a result, support for rules has become more grudging, although as Buti stresses, the economic

1 European Commission: Numerical fiscal rules in EU member countries, available at http://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/numerical-fiscal-rules-eu-member-countries_en.

2 Ibid.

3 M. Andrle, J. Bluedorn, L. Eyraud, T. Kinda, P. Koeva-Brooks, G. Schwartz, A. Weber: Reforming Fiscal Governance in the European Union, IMF Staff Discussion Note 15/09, 2015.

environment was highly unusual and the political reality of divergent national standpoints was a considerable obstacle to alternative approaches at the EU level.[4] Among the concerns the highlights are the continuing bias of the rules towards pro-cyclicality, the absence of incentives for tighter fiscal policies in good times that would be capable of building buffers against future downturns and the lack of emphasis on public investment.

Compliance with rules

A perennial difficulty has been in ensuring that mechanisms of governance function effectively in enforcing rules, so as to assure compliance with the underlying objectives. The eurozone countries' record on compliance with rules is revealing. The SGP is widely misunderstood as requiring deficits to be kept under three per cent of GDP, but from the outset its rule has been to maintain public finances "close to balance or in surplus" over the medium term, and it is only since 2011 that a debt criterion was added, despite the fact that the Lisbon Treaty refers to a 60% debt-to-GDP ratio. Half of the eurozone members have exceeded that debt threshold for the majority of the time since 1999. While the countries' records on the three per cent deficit limit is a little better, especially in the "good times" between 1999 and 2007, Greece and Portugal have missed it in most years.[5]

Looking at two of the major post-crisis governance innovations – scrutiny of draft budget plans and the macroeconomic imbalances procedure (MIP) – it is not at all evident that the new mechanisms have unambiguously elicited greater compliance. Scrutiny of draft budget plans aims to prevent the adoption of budgets which are likely to compromise compliance with the SGP and associated fiscal disciplines. Based on examination of four rounds of this scrutiny, the risks of non-compliance do not seem to have diminished much (Table 1). Indeed, it is noteworthy that the assessments seemed to have coalesced into one group of compliant eurozone members and another group persistently at risk of non-compliance.

This *ex ante* risk of non-compliance should be a source of worry in the light of research by Eyraud et al. which finds that the main culprit for non-compliance is what they describe as poor execution, as opposed to budgetary plans.[6] For example, they show that planned reductions in debt (over three years) by member states exceeding the 60% threshold averaged ten percentage points, but out-turns (i.e. execution) revealed no improvements in the ratios. However, the findings by Reuter that fiscal rules do have a restraining effect on public finances, even if the letter of the rules is not complied with, are intriguing.[7]

Table 1
Commission assessments of draft budget plans for following fiscal year

Assessment	2013	2014	2015	2016
Compliant	DE, EE	DE, IE, LU, NL, SK	DE, EE, LU, NL, SK	DE, EE, LU, NL, SK
Broadly compliant (or "no margin for slippage" – only used in 2013)	BE, FR, NL, AT, SI, SK	EE, LV, SI, FI	BE, IE, FR, LV, MT, SI, FI	IE, LV, MT, AT, {FR}
At risk of non-compliance	ES, IT, LU, MT, FI	BE, ES, FR, IT, MT, AT, PT	ES, IT, LT, AT, PT	BE, IT, CY, LT, SI, FI, {ES, PT}
Subject to adjustment programme	EL, IE, CY, PT	EL, CY, LT	EL, CY	EL
Not in eurozone	LV, LT			

Note: The three member states in curly brackets are subject to the corrective arm of the SGP.

Source: Own elaboration from European Commission reports.

The results of the last four annual assessments of macroeconomic imbalances, summarised in Table 2, show how the number of countries subject to an IDR has fallen, especially in 2017. However, the list of countries still deemed to have excessive imbalances is stable, and some of the judgements must be considered questionable. For example, looking at the indicators in the 2017 Alert Mechanism Report,[8] it is difficult to see why the UK has gone from having imbalances in 2015 to no imbalances in 2016 to not even an IDR in 2017, despite having alerts "flashing" because of its large current account deficit, the rate of house price increases and the ratio of consumer credit to national income.

Other high profile instances of fudging – such as over the excessive deficits of France and Germany in 2002-03, or the 2016 decisions on Portugal and Spain – damaged the

4 M. Buti: What future for rules-based fiscal policy?, Speech at IMF Conference on Rethinking Macro Policy III: progress or confusion?, Washington DC, 15-16 April 2016, available at https://ec.europa.eu/info/sites/info/files/what_future_for_rules-based_fiscal_policy_en.pdf.

5 M. Andrle et al., op. cit.

6 L. Eyraud, V. Gaspar, T. Poghosyan: Fiscal Politics in the Euro Area, IMF Working Paper No. 17/18, 2017.

7 W.H. Reuter: National numerical fiscal rules: Not complied with, but still effective?, in: European Journal of Political Economy, Vol. 39, 2015, pp. 67-81.

8 European Commission: Alert mechanism report 2017, COM(2016) 728 final, Brussels, 16 November 2016.

Table 2
Commission assessments of macroeconomic imbalances in member states, following in-depth reviews

	2014	2015	2016	2017
Excessive imbalances with corrective action plan	None	None	None	None
Excessive imbalances which require specific monitoring and continuing strong/decisive policy action	SI			
Excessive imbalances which require specific monitoring and strong/decisive policy action	HR, IT	BG, FR, HR, IT, PT	BG, CY, FR, HR, IT, PT	BG, CY, FR, HR, IT, PT
Imbalances which require specific monitoring and strong/decisive policy action	IE, ES, FR	IE, ES, SI		
Imbalances requiring monitoring and strong/decisive policy action	HU	DE, HU		
Imbalances requiring monitoring and policy action	BE, BG, DE, NL, FI, SE, UK	BE, NL, RO, FI, SE, UK	DE, IE, ES, NL, SI, FI, SE	DE, IE, ES, NL, SI, SE
No imbalances			AT, BE, EE, HU, RO, UK	FI
In adjustment or Balance of Payments programme (hence no in-depth review)	CY, EL, PT, RO	CY, EL	EL	EL

Source: Own elaboration from European Commission reports.

credibility of fiscal rules.[9] The latter episode illustrates just how tricky enforcement can be. Both member states were found to have done too little to rein in their excessive deficits and should, consequently, have been fined under the rules of the SGP. Yet, as the headline of a press release from the Council of Ministers put it, the "Council agrees to zero fines and new deadlines for Portugal and Spain".[10] For Spain, the Council found that "exceptional economic circumstances that would warrant a reduction of the amount of the fine do not exist".[11] Instead, Spain's efforts to transform its economy were deemed to justify cancellation of the fine.

Four case studies: selected findings

The experience with rules was examined recently in case studies of four EU member states, undertaken as part of the EU FIRSTRUN (Fiscal Rules and Strategies under Externalities and Uncertainties) project. Their purpose was to investigate how fiscal and other macroeconomic rules are working in practice in Italy, Poland, Slovakia and the UK, drawing on documents and interviews with experts and practitioners.[12]

Italy

In line with its commitments under the Fiscal Compact, Italy undertook a significant strengthening of its fiscal framework in 2012 through Law 243/2012, which provided for much stronger national fiscal rules and the establishment of a fiscal council – the *Ufficio Parlamentare di Bilancio* (UPB). Having exited the excessive deficit procedure only at the end of 2012, Italy was subject to a transitional arrangement on debt reduction for 2013-2015. While it has kept its deficit in check, helped by the balanced budget rule inserted into the constitution, the country has made scant progress on debt reduction, partly because GDP itself has been so sluggish.

Italy illustrates how issues of interpretation can make it difficult to render judgements regarding compliance with rules, particularly where a country seeks relief from the terms of the SGP by making use of the "guidance" issued by the Commission.[13] For 2017 and 2018, the UPB nevertheless concludes that budget plans "do not represent an

9 I. Begg: Fiscal and Other Rules in EU Economic Governance: Helpful, Largely Irrelevant or Unenforceable?, in: National Institute Economic Review, Vol. 239, No. 1, 2017, pp. R3-R13.
10 European Council: Excessive deficit procedure: Council agrees to zero fines and new deadlines for Portugal and Spain, Press release, 8 August 2016, available at http://www.consilium.europa.eu/en/press/press-releases/2016/08/08-excessive-deficit-portugal-spain/.
11 Ibid.
12 See FIRSTRUN: Fiscal rules and other rule-based mechanisms in practice: introduction to case studies of four Member States, 12 April 2017, available at http://www.firstrun.eu/2017/04/12/fiscal-rules-and-other-rule-based-mechanisms-in-practice-introduction-to-case-studies-of-four-member-states/.
13 European Commission: Stability and Growth Pact, available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf.

adjustment path towards the MTO [Medium-Term Budgetary Objectives] that is consistent with the current interpretive framework of the European fiscal rules as transposed in Italian law".[14] A common view heard from Italian interviewees was that countries hit hardest by recession are most penalised by EU rules.

Poland

With a constitutional provision adopted in 1999, limiting debt to 55% of GDP (as measured by national methods, not those used at the EU level), Poland was an early proponent of strong debt rules. The 1999 measure, which has escalating sanctions, has not been transgressed so far and is considered to be much more binding on Poland's policy-makers than either a secondary debt rule with a softer legal base or other more complex rules on expenditure. However, as a country outside the eurozone, Poland does not have a balanced budget rule or any revenue rules.

Poland has not established a fiscal council yet, although the case study found that other governmental institutions provide equivalent scrutiny. Unsurprisingly, given that there has been no in-depth review, the MIP has little visibility in Poland. There is also scepticism about the usefulness of the European Semester or the country-specific recommendations. However, the macroeconomic conditionality associated with cohesion policy is one dimension of EU economic governance seen as more relevant for Poland.

Slovakia

Since the adoption of the Fiscal Responsibility Act in 2011, Slovakia has had a strong rule limiting the country's debt-to-GDP ratio. The act also envisages a progressive lowering of the limit (from the current level of 60%). The rule includes graduated sanctions if different debt thresholds are breached, such as a freeze on the salaries of cabinet members once the debt-to-GDP ratio passes 53%, a selective freeze on spending once the ratio exceeds 55% and a vote of confidence in Parliament if the ratio rises to 60%. The law also led to the establishment of the independent Council for Budget Responsibility. National rules are still a work in progress, though, as plans for an expenditure ceiling have not yet been realised.

Although generally compliant with the fiscal rules, Slovakia triggered the limited sanctions for breaching the first debt thresholds in both 2014 and 2015. There have also been differences between the fiscal council and the government in their interpretation of the prospects for achieving the MTO, with the former claiming significant deviation from the prescribed path and the latter demurring. The Slovak case study found that national rules have the greatest influence, and rules matter in particular for a small open economy like Slovakia, because they help to contain market pressures on bond spreads by instilling certainty. Similarly, adherence to rules is considered to be helpful in attracting foreign investment. Even so, there are demands for a less binding debt rule, notably to allow more latitude for investment.

The MIP does not seem to have much effect on policy-making and lacks visibility in the public debate; instead, domestic incentives seem to matter in dealing with imbalances. An interesting point contained in the case study, and one which also applies to Italy, is that the EU governance process has stimulated improvement in the quality of public administration. The Slovak case study also finds that EU rules and priorities work best when they coincide with the national interest.

The United Kingdom

Fiscal rules of different sorts have been part of UK economic governance since the late 1970s, but they have something of a chequered history. Expenditure rules were supposed to guide fiscal commitments during the 1980s and 1990s, but they often proved to be non-binding. The Labour government in power from 1997 implemented two explicit fiscal rules. The first is described as the "golden rule", which stipulated that government borrowing should only be used for public investment, while public consumption should be in balance or in surplus. This rule was applied over the economic cycle, a potential source of uncertainty because the cycle itself was of unpredictable duration. Second, there was a "sustainable investment" rule concerned with keeping public debt at the end of each financial year at a stable and prudent level, deemed to be 40% of GDP.

These rules were suspended when the financial crisis struck in 2008, and the evolution since has been away from firm numerical rules. Instead, the UK now has target dates for returning public finances to balance and reducing the debt ratio, as part of a broader fiscal framework. Initially, the aim was to achieve these reductions by the end of the 2010-15 Parliament, but the target date was repeatedly pushed further into the future. There is also a partial expenditure rule, intended to cap the level of welfare spending, but its impact has, so far, been limited, and independent analysis suggests actual spending will

14 Ufficio Parlamentare di Balancio: 2016 Budgetary Planning Report, 2016, p. 65, available at http://en.upbilancio.it/2016-budgetary-planning-report/.

exceed the target by seven percentage points by 2020. Crawford et al. leave open the question of whether "this condemns the cap to irrelevance and failure in the longer term", but their scepticism is evident.[15] It is also instructive that the European Commission database of fiscal rules does not record the cap as a fiscal rule.

EU rules and processes were found to have no real influence on UK policy-making. Even interviewees directly involved as practitioners paid little heed to, for example, the UK being within the excessive deficit procedure (EDP) from 2009 onwards, and there is no awareness in UK public debate of the European Semester. Tellingly, in his 2017 budget speech, Philip Hammond, the Chancellor of the Exchequer, summed up the UK attitude in a contemptuous joke about the likely exit from the EDP in the current financial year:

> And for those who care about such things, it means we are forecast to meet our 3% EU Stability and Growth Pact target this year for the first time in almost a decade. But I won't hold my breath for my congratulatory letter from Jean-Claude Juncker![16]

Discussion and conclusions

Rules-based economic governance has a strong appeal where governments struggle to adopt time-consistent policies, but it cannot be a panacea. If judged purely by the budgetary indicators of EU member states, the verdict on fiscal rules would be pretty negative, even allowing for the difficulties of recent years. Portes and Wren-Lewis identify the absence of what they call an "implementation incentive" in some applications of rules, because there is no real penalty for missing targets.[17] They also put forward the concept of a "realizable target" which can lead to different problems, especially if optimal adjustment is slow.

The evidence suggests that a recurring difficulty with EU governance mechanisms has been in ensuring that implementation lives up to expectations. Larch argues things might have been worse without rules, but "when push comes to shove, adherence to and enforcement of the commonly agreed EU fiscal rules remains imperfect at best".[18] Plainly, instances of fudging, such as the "fines" of zero euros on Portugal and Spain, damaged the credibility of these rules.[19] The case study findings also suggest more insidious political economy concerns, namely the perception that enforcement is avoided when it becomes politically inconvenient, possibly to the selective advantage of favoured member states. As the Italian and UK cases demonstrate, repeated resort to escape clauses, manipulation of what is often technically complex data (aggravating a lack of transparency) or frequent amendment of rules can become the norm rather than the exception.

What can be inferred about patterns of non-compliance? Unsurprisingly, the member states subject to formal macroeconomic adjustment programmes are generally the worst performers, though Ireland's recovery invites caution about drawing too firm a conclusion. Risks to fiscal sustainability are arguably greatest in a number of eurozone countries, although the UK is a striking exception. There is no indication of a richer/poorer member state cleavage, nor of a systematic divide between creditor and debtor countries. From the case studies, constitutionally embedded national rules appear to be more effective in fostering compliance, especially (as in Poland and Slovakia) where they prescribe sanctions on policy actors. It is less clear whether they lead to optimal policy actions, unless the priority is to instil a commitment to sustainable public finances and not to deal with shorter-term challenges.

In assessing the prospects for rules, it is important to consider the interactions between the short run and the longer run, and also between normal times and the exit from the abnormal times of recent years. A particular recent "abnormality" is the exceptional monetary policy stance, with interest rates effectively at the zero lower bound and general recognition of the diminishing returns from unconventional policies (notably quantitative easing). In response, the UK has arguably suspended its fiscal rules in favour of a fiscal framework with much looser (and manifestly flexible) targets instead of numerical rules. Intriguingly, the UK has not reduced its debt ratio, but its looser fiscal policy may well have helped to maintain growth. However, other member states have gone the other way by imposing more binding rules, albeit with questionable compliance in some cases.

These findings suggest that existing provisions for controlling macroeconomic risks, particularly if thought of as preconditions for more extensive risk-sharing in EU (and, more

15 R. Crawford, C. Emmerson, T. Pope, G. Tetlow: Fiscal targets: committing to a path of budget responsibility?, in: C. Emmerson, P. Johnson, R. Joyce (eds.): IFS Green Budget 2016, London 2016, Institute for Fiscal Studies, pp. 49-77, here p. 74.

16 P. Hammond: Spring Budget 2017: Philip Hammond's speech, 8 March 2017, available at https://www.gov.uk/government/speeches/spring-budget-2017-philip-hammonds-speech.

17 J. Portes, S. Wren-Lewis: Issues in the Design of Fiscal Policy Rules, in: The Manchester School, Vol. 83, No. S3, 2015, pp. 56-86.

18 M. Larch: Independent Fiscal Councils: Neglected Siblings of Independent Central Banks, Directorate General for Economic and Financial Affairs, European Commission, 2016, p. 4.

19 I. Begg, op. cit.

so, eurozone) economic governance, have to pay much more attention to implementation. Remedies, however, are not obvious. Financial sanctions may look intimidating on paper, but if the institutional process consistently balks at applying them, they will remain toothless. The alternative is policies at the national level, where domestic sanctions, such as those in Poland and Slovakia, do appear to bite. There is a growing recognition of the need for a fiscal framework to encompass political economy factors, perhaps even more so than improving the design of rules. Eyraud et al. note that "the current fiscal framework is heavily tilted toward negative incentives in the form of sanctions and corrective actions".[20] By comparison, the positive side of the incentive structure is underdeveloped.

Fundamentally, the EU faces the dilemma that reliance on fiscal and other rules is not enough to assure sustainable macroeconomic stability in a context in which politicians are not only adept at circumventing them but garner popular support for doing so. Rules-based governance in the EU may, therefore, have reached its limits, implying something more, or perhaps something different, is needed.

20 L. Eyraud et al., op. cit., p. 27.