# Fiscal Rules for Europe

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## Fiscal Discipline in the Eurozone: Don't Fix It, Change It

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### INTRODUCTION

After twenty years, the conclusion is unescapable: the Stability and Growth Pact has failed. This failure was predictable and now widely acknowledged.[1] Even such insiders as the former Chair of the Eurogroup admits that "the present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors." (Wieser 2018). Beyond this near-consensus, opinions about reforms greatly diverge. Some propose to streamline the pact, others to focus on a different rule or set of rules, while others again seek a greater role for market discipline through the issuance of various types of eurobonds.

Yet, these proposals fail in five crucial aspects. First, they ignore the inconsistency of the Treaty on the Functioning of the European Union (TFEU). On the one hand, the treaties establish that national budgets are an exclusive competence of member states. On the other hand, they assert that national budgets are of common interest (Art. 121–1). Second, while they set out to provide a simplification, most proposals formulate complicated rules replete with exceptions and sophisticated procedures that citizens cannot comprehend. Third, rules have become an end unto themselves, deviating from the underlying economic logic. Fourth, numerical targets cannot be rigorously justified and the justifications provided are time-dependent and therefore bound to become outdated. Fifth, the proposals that seek to promote market discipline fail to recognize that it can be weak as an early signal, violent when it is triggered, and possibly arbitrary in the presence of self-fulfilling prophecies.

This paper adopts a different approach. It argues that no fiscal discipline framework will be effective unless it recognizes that national budgets are intrinsic to Western democracies. It therefore proposes to decentralize the responsibility for fiscal discipline to the national level. It also seeks to ground the rules to sound economic principles. This leads to establish long-term debt as the only target and to use the annual budget balance as the instrument. It recognizes that fiscal policy can be a useful instrument to stabilize income and employment when discipline is established. This means that annual budgets must be seen as steps toward achieving the long-run target, which allows for fluctuations when needed. This, in turn, entails judgments that can be made only by independent fiscal councils that are properly equipped with adequate resources. Finally, it shows how the "common interest" can be preserved in a decentralized approach by subjecting national rules, and their implementation, to a European certification process that respects national sovereignty regarding budgetary decisions.

### ECONOMIC PRINCIPLES I: WHAT IS FISCAL DISCIPLINE?

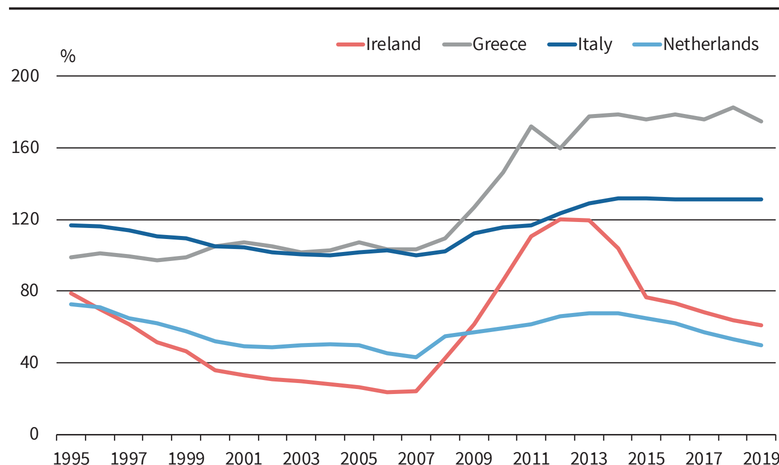
No economic principle justifies capping the budget deficit at 3 percent year after year. The 3 percent ceiling is neither necessary nor sufficient to achieve fiscal discipline. In fact, most existing rules include various obligations that are not justified. More importantly, fiscal discipline often remains shrouded in normative misconceptions. This matters a great deal because, for a rule to be enforced, ultimately citizens must be convinced that it makes sense.

Fiscal discipline is best understood as the obligation imposed by the budget constraint. The difficulty is that the budget constraint is intertemporal. It says that in the infinity of time, the public debt must be negative or nil. Infinity, of course, must be made practical, which means looking at the very long run. But then the debt does not have to strictly be negative or nil, just "not too big". Of course, "not too big" is highly subjective. How then to operationalize "not too big in the very long run"? The proposed solution is the eyeball test, illustrated in Figure 1, which displays the ratio of public debt to GDP for selected countries. The Netherlands passes the eyeball test: the debt ratio never seems to drift endlessly upward. Ireland lost control of its public debt during its banking crisis in 2008–2010, then recovered it. Italy never managed to significantly bring its debt ratio down, although it was "too big". Greece lost control in the early 2000s, although the debt ratio was

[1] The literature has become too voluminous to quote. A few examples are Eichengreen and Wyplosz (1998); Ioannou and Stracca (2011); Christofzik et al. (2018); European Fiscal Board (2018); and the survey in Eyraud et al. (2018).

Figure 1

Debt-to-GDP Ratios




Source: European Commission, AMECO online (UDGG).

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already big, and has not yet managed to bring it down. Note that the test allows for different starting positions, which fixed numerical targets do not.

This definition may seem vague. In fact, it is sufficient to distinguish fiscal discipline from indiscipline. Applying the eyeball test to Italy and Greece at any point from the 1990s onward would have issued the correct signal. In the case of the Netherlands over the period 2007–2014, the test would not have called for immediate correction, given the ongoing recession. In the case of Ireland, the post-2018 slippage could not have been missed. The "soft" eyeball test is, in fact, far more precise than rules that focus on tenths of percentage point deviations.

## ECONOMIC PRINCIPLES II: ONE TARGET AND ONE INSTRUMENT

The eyeball test requires making projections of the likely evolution of the debt ratio over the long run, defined as a few decades, and passing judgement. It can be argued that this is impossible, but it is not. The evolution of the public debt ratio is driven by three variables: the growth rate of GDP, the interest rate, and the annual budget balances. Long-run growth is commonly estimated, as is the interest rate. The precision of these projections is limited, of course, but probabilities can be assigned to derive fan charts or scenarios. The advantage of fan charts and scenarios is precisely to bring to the fore the uncertainty of projections, which should warn against sanguine statements and policy recommendations. It also serves as an important reminder that precise numerical targets are unrealistic and possibly misleading.

Regarding the path of future budget balances, the procedure is to inverse the reasoning. Instead of attempting to forecast the evolution of the debt, it asks whether the evolution of the debt predicted by various assumed paths of budget balances is compatible with fiscal discipline. This allows to immediately distinguish acceptable budget balance paths from unacceptable ones. The procedure has three key advantages. First, it clarifies that the debt is the target and the budget is the instrument, an important distinction that is lost in most rules. Second, it allows for an unlimited number of feasible budget paths, thus fully preserving the right of governments to make intrinsically political decisions. Third, it makes it clear that a few years of large deficits have a negligible impact on the long-run evolution of the debt ratio provided that they are corrected, which allows for the countercyclical use of fiscal policy while preserving fiscal discipline.

It is worth emphasizing that the rule is not numerical. There is no set debt target. The eyeball test merely considers the long-run evolution of the debt ratio. Countries that start with a high debt level must aim at a declining trend. Countries that start with a low debt level can choose to keep it where it is, to bring it down, or even to let it rise (a bit) if there is a good reason to do so. Theory has not identified any optimal public debt level. Empirical work suggests that debt ratios in excess of, say, 90 percent of GDP can lead to instability and impose a growth-reducing burden of taxation.[2] This can be taken as an indication of what "too big" is, bearing in mind that some safety margin is needed to cope with unforeseeable events.

## ECONOMIC PRINCIPLES III: TIME CONSISTENCY

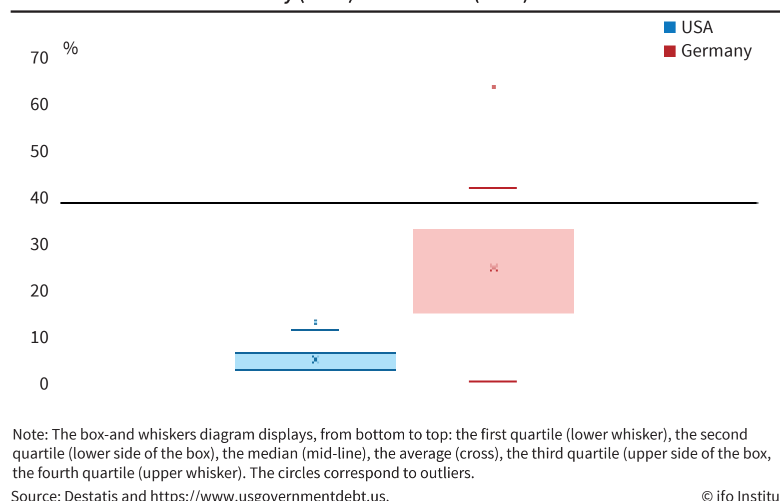
An important issue is that the current government cannot tie future governments down to its own commitments. This is not what the proposed rule attempts to do, but it must deal with the associated time inconsistency. The natural solution is to explicitly introduce and define fiscal discipline in the constitution. Doing so does not reduce government autonomy, as is sometimes claimed. It merely recognizes the fact that no country can escape the budget constraint and that the constraint creates a time inconsistency problem. As for the definition, it ought to link fiscal discipline to the internal budget constraint. As argued above, the proper statement should be based on the long-run path of the debt ratio, in effect the eyeball test. Finally, if it is not already the case, the constitution must unambiguously assign responsibility for upholding this obligation to the parliament in its role of voting on the budget.

[2] The classic (and controversial) reference is Reinhart and Rogoff (2010) but other studies deliver similar limits. Precision, again, is illusory.

In practice, the procedure requires that the government in place announces publicly its planned long-run debt target and the associated budget balance path. The next government can change the debt and budget paths, but it must do so publicly. It is then up to the parliament to ensure that any change satisfies the constitutional requirement. The constitutional court may intervene if it considers that fiscal discipline is not upheld. The precise implementation may vary from country to country according to existing institutions and traditions.

Figure 2

Debt-to-GDP Ratios in Germany (2017) and the USA (2018)




Note: The box-and whiskers diagram displays, from bottom to top: the first quartile (lower whisker), the second quartile (lower side of the box), the median (mid-line), the average (cross), the third quartile (upper side of the box, the fourth quartile (upper whisker). The circles correspond to outliers.

Source: Destatis and https://www.usgovernmentdebt.us.

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## INDEPENDENT FISCAL COUNCILS

The main advantage of the proposed approach is that it leaves the government, the parliament and the constitutional court with a wide margin of appreciation. It obviously opens up the possibility that this margin will be exploited to avoid the rule. Somehow, during the budgetary process, someone must tell the truth, evaluating the economic situation and assessing the rule's inherent uncertainty. The solution calls for an independent fiscal council that is nonpartisan and whose expertise is beyond doubt.

The Fiscal Compact already requires every eurozone member country to establish an independent fiscal council, but this requirement is imprecise and has been diversely implemented from country to country. The proposed rule requires a modification of the Fiscal Compact. Three requirements are in order.

First, the council must be in charge of translating the government's budgetary decisions into numbers – both the budget and the public debt path. This is already the case in some countries, for example in the Netherlands but, in many others, this task in conducted by the Ministry of Finance, which is not independent.[3] One solution is for the Ministry to entirely devolve the task to the independent fiscal council, another solution is to provide the council with the resources and information required to perform the task on its own, independently of the Treasury.

Second, the council must be tasked to determine whether the government's choices are compatible with fiscal discipline, as defined in the constitution. This requires professional, nonpartisan judgment. The council's view must be taken into account by the parliament when it votes on the budget. In the event that the constitutional court is called upon, its own judgment must acknowledge the council's opinion.

Third, the competence of the council must be beyond doubt. To that effect, its members – or its manager – must be chosen on the basis of explicit criteria that focus exclusively on competence and nonpartisanship. In addition to the Netherlands, several countries (for example, Sweden, the UK, and Spain in Europe, or Chile and the US Congressional Budget Office) provide useful examples.

## IMPLEMENTATION AND EUROPEAN OVERSIGHT

Obviously, there is no guarantee that each eurozone member country will adopt and adequately enforce the proposed rule. The logic of the Stability and Growth Pact is to rely on centralized enforcement, involving the Commission and the European Council, but that did not work out satisfactorily. One reason is politicization. The European Council is a political institution and, as such, not inclined to blindly follow technical rules. This was made clear by the 2005 decision to put the pact in abeyance when the two largest countries, France and Germany, faced the possibility of sanctions. More generally, no country was ever sanctioned in spite of repeated challenges to the pact. Neither is the Commission free from political interference.

Anther reason is the internal inconsistency of the treaties, as noted in Section . This problem is vastly underestimated. It arises even in federal countries. The case of Germany, whose experience inspired the Stability and Growth Pact, is telling. The fiscal autonomy of the Länder (federal states) is more limited than that of the eurozone's member states. Even though the federal government has the power to intervene, some Länder have accumulated rather large debts: Bremen's debt ratio stands at 65 percent of its GDP, Berlin's at 43 percent and Saarland's at 41 percent. In contrast, in the US, the states are fully autonomous, as the federal government has no authority to intervene. Yet the largest state debt – in Rhode Island – amounts to 15 percent of

[3] Interestingly, the New Zealand Treasury is fully independent.

its GDP. More generally, Figure 2 shows that fiscal discipline is far better achieved in the US than in Germany.

How can this surprising result be explained? In the US, each state (save Vermont) has adopted a constitutional rule. The rules vary from state to state but they are variants of a budget balance rule. The reason why these rules have been adopted, and why Vermont is fiscally disciplined, is that the federal Congress created a jurisprudence in the 1840s that bans bailouts. In contrast, in Germany, the Constitutional Court has imposed on the Federal Government the obligation to bail out Länder that face financial difficulties. The unmistakable lesson is that a solid no-bailout rule provides sub-federal governments with the incentive to adopt fiscal discipline constitutional rules and to respect them. Restoring and guaranteeing the European no-bailout rule is essential.

Even so, the treaty's declaration that national budgets are of common interest recognizes an important externality that must be dealt with. In the proposed framework, it means that the European level should have a say on the arrangements adopted by member countries. This concerns the constitutional provisions, the associated rule, the budgetary process and the independent council. These arrangements do not have to be the same in each country, but they should be certified before they are adopted. The detailed requirements would be specified ex ante. The certification could be delegated to the Commission or to the European Fiscal Board. This would go a long way toward resolving the internal contradictions of the treaties: each country would retain full sovereignty in budgetary matters but the budgetary process would have to comply with European-wide norms, pretty much as is already the case in a variety of cases ranging from human rights to democracy.

In the same spirit, the implementation of fiscal discipline would be subject to the European Court of Justice. The Court should be given the mandate to verify that each member country abides by its own constitutional commitments. In contrast with the sanctions envisaged by the Stability and Growth Pact, this is a decision that is inherently nonpolitical. While it is impossible to have an iron-clad guarantee that a member state would always respect fiscal discipline, the prospect of a condemnation by the European Court of Justice would provide a powerful incentive. For the process to be effective, it is essential that the requirements be very precisely stated. The experience with the no-bailout clause is a reminder of the risks that apparently clear legal obligations can be circumvented.

## CONCLUSIONS

Fiscal discipline is a necessary condition for the smooth functioning of the euro. It is a sad accident of history that the solution adopted to fulfil this condition has been the Stability and Growth Pact. When the limitations of the pact started to become evident, the response has been to try and "improve" it, sometimes by making it more flexible, at other times by closing loopholes or by trying to enhance national ownership, always by making it more complex. Even though this logic has failed repeatedly, it remains the order of the day. Further improvements and refinements will fail to be effective because fiscal policy will remain a national competence, as it is even in tighter federal systems.

This paper proposes a different approach. It aims at combining national competences and the collective interest. National competence in budgetary matters must come with national responsibility for fiscal discipline. The collective interest is to be served by requiring that adequate national budgetary processes be inscribed in the national constitutions of member states.

Another distinctive characteristic of the proposed framework is to align the definition of fiscal discipline with economic principles. Fiscal discipline is not about year-by-year budget balances nor about numerical targets that do not have solid foundations. Following the successful experience with inflation targeting in monetary policy, it is suggested to adopt the long-run evolution of the debt-to-GDP ratio as a target and annual budget balances as the instrument. This allows for the countercyclical use of fiscal policy while constraining the path of the debt ratio. Importantly, the path of the debt ratio is not encased in a priori numerical targets, rather it is subjected to an "eyeball test" that checks whether current and future budget balances deliver a prudent long-run evolution of the debt.

Substituting for numerical targets, the eyeball test requires a professional and nonpolitical judgment. To that effect, independent fiscal councils must be empowered to compute the long-term evolution of the debt and to determine whether fiscal discipline is respected. Their conclusions must fit in the budgetary process and guide parliaments as they vote on annual budgets subject to the constitutional obligation to enforce fiscal discipline.

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