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Fiscal consolidation through fiscal rules?

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Abstract. *Following the financial crisis, the budget deficits and public debt have recorded levels that no one would have considered a few years ago. Therefore, efforts are needed to achieve fiscal consolidation. Both in academic debates and policy many believe that fiscal rules should be the central element of a successful strategy, idea argued by the fact that a rule would restrict the discretionary actions of the government, thus strengthening the fiscal consolidation. However, there are differences when it comes to precisely specifying a rule.*
Therefore, in this article we want to analyze how much policy makers can rely on fiscal rules, factors necessary to achieve a high degree of effectiveness of fiscal rules, if a fiscal rule should be based on the budget balance level or the debt balance level and we will analyze whether the restrictions imposed ex-ante to the fiscal policy are superior to the ex-post penalties.

Keywords: fiscal consolidation, fiscal rules, credibility, budgetary deficit, public debt.

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REL Classification: 8K.

The sovereign debt crisis in the euro area is a bad memory of the fact that no country can ignore the requirements of a fiscal discipline. The crisis has shown, moreover, how slow the fiscal discipline can rise. Fiscal discipline consists of three clear implications. First, it is not a concept which changes from year to year, but a characteristic that involves a medium to long term, which may allow significant temporary deviations with surpluses to compensate them. Then a solid budgetary framework is necessary but it is not a sufficient condition because private debts may become public debts in crisis situations. Third, the issue of political domination is a concern that no central bank can avoid, no matter how independent it is (Wyplosz, 2012).

When we consider fiscal discipline, this translates into two types of processes: ***fiscal rules and fiscal institutions.***

Fiscal rules are of different forms, but all have the same characteristic, namely the imposition of numerical rules. These standards can take into account the budget balance, public expenses or budgetary revenues. In other words, the fiscal rules are legal agreements that promote the fiscal discipline "tying the hands" of policy makers in order to constrain the decisions regarding the scheduling of the budgetary revenues and expenditures (Bergman, 2013).

Fiscal rules may vary from country to country, some rules apply from year to year, others define boundaries over many years, sometimes for an entire business cycle. Some are national, others supranational (such as those related to the fiscal Compact).

In theory, if properly implemented, the fiscal rules can eliminate government's deviations from deficit targets ("deficit bias"). There are, however, several limitations of the rules.

First, a rule is vulnerable to *inconsistency in time*. A simple to avoid rule is often useless and a strict rule may not be followed in certain situations (such as periods of economic turbulence). In general, when unexpected situations appear the easiest solution is to draw up derogatory clauses. They cannot be entirely accidental because too many relevant events are unpredictable, and certain foreseeable events can guarantee predictable rule adjustments without affecting the disciplinary effect (case of cyclical fluctuations). The practice of derogatory clauses is unlikely to be effective as policy makers generally choose to be fiscally undisciplined choosing to pass the debt burden to the account of future generations. As long as the political costs of ignoring tax compliance requirements are smaller than the political benefits of allowing public debt growth, the latter option will be chosen over the other. Rules are useful as long as the political costs of fiscal indiscipline are extremely high. Thus, it appears the need to incorporate them into institutional arrangements. Legal sanctions require the law to be written in terms strong enough to face the challenges, being also against the principle of simplicity. Otherwise, a government that wants to practice deviations from deficit targets can quite easily convince public opinion that the current circumstances are exceptional and technocratic arrangements should not stand in front of serving the interests of the population.

Another limitation concerns the *aging population*. In a system such as "pay as you go" the present generation supports the previous generation, and the present generation is supported by the future one. Given the fact that there is a demographic reduction (as it is, in fact, in the present), the burden on future generations regarding pension payments is much higher. According to a European Commission (2009) report, 20 countries in the European Union will have annual pension costs higher by more than 2% of GDP by 2060. The additional cost for these countries is estimated at 5.8% of GDP. In order to reduce the burden the measures would mean that the present generation should agree to pay more taxes, receiving lower benefits or a longer work program. All these measures can be seen as numerical rules that affect specific elements of the state budget.

For the rules to have a high degree of efficiency, they should depend on four main factors (Bernanke, 2010):

- To be transparent;
- To be addressed to the basic problem;
- To be focused on variables that can be directly controlled by policy makers;
- Not to be substituted to the political will.

In case a rule is transparent, then it serves the clarifications made by policy makers, it facilitates a dialogue with the general public and encourages policy makers to recognize the more extended fiscal consequences of their decisions. Transparency is certainly strengthened when there are also fiscal councils (Calmfors and Wren-Lewis, 2011). Then, a rule should be ambitious enough to address a core problem. Thus, incomes and future expenses (such as social security charges) should be forecasted. Even if such forecasts are complicated and generate uncertainties, a number of studies highlight the benefits of conducting fiscal projections, such as increasing fiscal sustainability (Anderson and Sheppard, 2009).

To be effective, the rules should be focused on a set of variables that can be controlled directly by decision makers (such as the budgetary deficit which depends on the decisions made for expenditure and budgetary revenues) because in case the targets are missed to be easier to assume responsibility. So constraints regarding the cyclically adjusted budget deficit are welcome. Measuring the output gap is a complicated task, but can be achieved more easily by including a fiscal council in government fiscal policy. Moreover, fiscal rules cannot be substituted to the political desire, which means that understanding and support from business agents are welcome.

In Romania, the principles underlying fiscal-budgetary policy, according to the Fiscal-Budgetary Responsibility Law 69/2010, are:

- The principle of *transparency* regarding fiscal-budgetary goal setting and implementation of fiscal and budgetary policy;
- The principle of *stability*, the Government having the obligation to conduct fiscal-budgetary policy in a manner that ensures predictability for a medium term, in order to maintain macroeconomic stability;
- The principle of *fiscal responsibility*, the Government having the obligation to conduct fiscal-budgetary policy prudently and manage resources and budgetary obligations, as well as fiscal risks in a manner that ensures sustainability of the fiscal position on medium and long term;
- The principle of *equity*, the Government implementing fiscal-budgetary policy taking into account the potential financial impact on future generations and the impact on economic development on medium and long term;
- The principle of *efficiency*, the fiscal-budgetary policy of the Government being based on the efficient use of scarce public resources;
- The principle of *effective management of expenses* with the personnel paid from public funds.

Regarding *fiscal institutions*, they generally translate into fiscal councils. Their powers vary from an objective analysis of fiscal-budgetary policy decisions to actual decisions on the budgetary balance. In the first case, the intention is to have a "watchdog", receiving official recognition.

Most times, they realize both **ex-ante** fiscal surveillance – through the analysis and drafting of opinions and recommendations on the official macroeconomic and budgetary forecasts, the fiscal strategy, annual budget laws, budgetary adjustments, other legislative initiatives that may impact the volume of budgetary expenditures - and **ex-post** by making annual reports containing the assessment of objectives, targets and indicators set by fiscal-budgetary strategy and annual budget, Government's performance evaluation and how the principles and rules provided by the present law have been followed, opinions and recommendations of the Fiscal Council to improve fiscal-budgetary policy.

Some of the fiscal rules verified by the Fiscal Council in Romania are, according to the fiscal-budgetary responsibility Law no. 69/2010, the following:

- general consolidated budget balance and personal expenses of the general consolidated budget, as a percentage of GDP, cannot exceed the annual limits set in the fiscal-budgetary frame from the fiscal-budgetary strategy for the first two years covered by it;
- the total general consolidated budget expenditures, excluding financial assistance from the European Union and other donors and personnel costs, taking into account the state budget, the state social insurance budget, local budgets, the budgets of self-financing institutions, special funds and other component budgets, shall not exceed the limit specified in the fiscal-budgetary frame from the fiscal-budgetary strategy for the next fiscal year;
- for each of the three years covered by fiscal-budgetary strategy, the annual growth rate of total expenditures of the general consolidated budget will be maintained below the annual nominal growth rate of GDP projected for the respective budgetary year, until preliminary balance of the general consolidated budget has recorded a surplus in the year previous to the year for which the budget project is drafted.

Thus, in most of the cases fiscal councils have advisory role, and governments are exposed to reputational risk and may lose credibility if they choose to disregard their opinions and recommendations without thoroughly explaining the reasons thereof.

As the rules are rigid and exceptionally they cannot even be met, in the current period, due to the economic turmoil manifested in the European Union, there are simultaneously conducted both fiscal rules and fiscal councils. This is recommended this because when we use the derogatory clauses of the fiscal rules, *governments lose their credibility if independent and competent institutions authorize such deviations*.

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