

Box 9

DOMESTIC FISCAL RULES AND INSTITUTIONS AS A COMPLEMENT TO THE EU FISCAL FRAMEWORK

The Treaty establishing the European Community and the Stability and Growth Pact provide the legal and institutional framework for achieving and maintaining sound public finances in the EU; they should thus also guide Member States' fiscal exit and consolidation strategies aimed at reversing fiscal stimulus measures and swiftly correcting excessive deficits.¹ As highlighted by a large body of literature, domestic fiscal rules could usefully complement the EU fiscal framework for strengthening fiscal discipline and ensuring the sustainability of public finances in the euro area.²

Domestic fiscal rules naturally align with national sovereignty, are subject to national parliamentary approval and their implementation may be monitored by independent national

1 For a brief overview of the main provisions of the Treaty and the Stability and Growth Pact, see the box entitled "The legal framework for ensuring sound fiscal policies in EMU" in the March 2009 issue of the Monthly Bulletin. An extensive description and assessment of the EU fiscal rules is provided by R. Morris, H. Ongena and L. Schuknecht, "The reform and implementation of the Stability and Growth Pact", ECB Occasional Paper No 47, 2006.

2 See, for example, L. Schuknecht "EU fiscal rules: issues and lessons from political economy", ECB Working Paper No 421, 2004, and M. Buti, S. Eijffinger and D. Franco, "Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?", CEPR Discussion Paper No 3692, 2003.

bodies. This allows governments to reinforce their commitments to budgetary prudence by adopting credible and ambitious fiscal rules, which may be backed by stringent enforcement mechanisms.³ Thus, while the deficit and debt ceilings of the Treaty and the Stability and Growth Pact, as well as the medium-term budgetary objectives, establish common and consistent benchmarks for fiscal prudence across Member States, national fiscal rules and institutions may reinforce compliance with these EU-wide provisions.

Recent empirical evidence for EU countries suggests that strong domestic fiscal rules do indeed encourage governments to adopt a more prudent fiscal stance.⁴ In particular, a broad consensus has emerged that rules-based restrictions on government spending are suitable tools to induce fiscal prudence at the domestic level, since political pressure to deviate from budgetary discipline tends to be especially pronounced on the expenditure side.⁵ As a consequence, countries with enforced national expenditure rules should, *ceteris paribus*, be expected to show stronger compliance with the EU fiscal framework than other EU countries.

In addition to strengthening the budgetary discipline of central governments, domestic fiscal rules are a useful instrument to coordinate fiscal policy between different layers of government: most Member States are characterised by substantial fiscal autonomy at the sub-national government level. This federal structure can give rise to a “common pool” problem, since the consequences of fiscal indiscipline of a sub-national government often spill over to other jurisdictions and affect the general government sector as a whole. Hence, restricting sub-national fiscal policy via domestic rules helps to induce budgetary prudence across layers of government, which is needed to meet the budgetary targets for general government set by the EU fiscal framework.

The overall institutional environment needs to support the implementation of domestic fiscal rules. In particular, the assessment of governments’ compliance with the rules may need to be carried out by independent and impartial institutions. Moreover, the power of fiscal rules rests to a large extent on the fact that compliance can be monitored by the public. This calls for simple and quantifiable norms and requires accurate and timely reporting of fiscal plans and developments by governments.

The recent surge in government debt ratios points to another important area in which domestic rules and institutions might provide a useful complement to the EU fiscal framework. In particular, a commitment to explicit targets for debt developments at the domestic level would further strengthen the disciplining role of deficit-oriented fiscal frameworks for two reasons. First, such targets would be highly transparent for voters and thus provide a forceful benchmark against which a government’s debt reduction effort can be measured. Second, targeting both deficit and debt would reduce the political incentive to shift activities “off-budget” in order to meet the budgetary constraints imposed by the EU fiscal framework.^{6,7}

3 See A. Fatás, J. von Hagen, A. Hughes Hallett, R. Strauch and A. Sibert, “Stability and Growth in Europe: Towards a Better Pact”, *Monitoring European Integration 13*, ZEI/CEPR, Bonn/London, 2003.

4 See, for example, X. Debrun, L. Moulin, A. Turrini, J. Ayuso-i-Casals and M. Kumar, “Tied to the mast? National fiscal rules in the European Union”, *Economic Policy*, Vol. 23 (4), pp. 297-362, 2008.

5 See, for example, “Public Finances in EMU”, European Commission, 2003, 2005 and 2006, and G. Ljungman, “Expenditure Ceilings – A Survey”, IMF Working Paper No 282, 2008.

6 For details on the use of stock-flow adjustments as an instrument to meet the restrictions of the EU fiscal framework, see J. von Hagen and G. Wolff, “What do deficits tell us about debt? Empirical evidence on creative accounting with fiscal rules in the EU”, *Journal of Banking and Finance*, Vol. 30, pp. 3259-79, 2006.

7 The view that governments should commit to ambitious debt reduction efforts is also reflected in the IMF staff report for the 2009 Article IV consultation on euro area policies concluded on 17 July 2009.

A “quick fix” should not be expected for the challenges faced by public finances in the current environment, in particular given the uncertainty concerning the pace of recovery. However, both theoretical considerations and experience in individual countries suggest that a rigorous implementation of, and adherence to, rules-based fiscal frameworks will be useful in directing fiscal policy towards a sustainable path for public finances.