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Anne Brunila
Economics Department
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Fiscal policy: Coordination, discipline and stabilisation

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Fiscal policy: Coordination, discipline and stabilisation

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Abstract

The framework for fiscal policy coordination in EMU has been in effect for three years. The experience gained shows that the rule-based approach provides in principle a feasible solution for policy coordination among a large number of heterogeneous countries whose joint interest is to safeguard the credibility of the common monetary policy and smooth functioning of the EMU. At the same time, the experience indicates that the current set of rules and procedures laid down in the Maastricht Treaty and Stability and Growth Pact (SGP) suffer from complexity, lack of transparency and asymmetric incentives. The paper discusses the rationale for fiscal policy coordination in the monetary union in general and emphasises the role of fiscal rules and multilateral surveillance in ensuring discipline and long-term sustainability of public finances. The paper also considers incentive problems arising from the asymmetric nature of the SGP and weak interaction between national policy-making and EU-level policy commitments. As a possible remedy, the paper proposes complementing the SGP with medium-term expenditure rules for central governments and balanced budget requirements for lower levels of government.

Key words: fiscal policy coordination, expenditure rules, Stability and Growth Pact

Finanssipolitiikan koordinointi, kurinalaisuus ja suhdannevaihteluiden tasaaminen

Suomen Pankin keskustelualoitteita 7/2002

Anne Brunila
Kansantalousosasto

Tiivistelmä

Finanssipolitiikan koordinointia ohjaava ns. EMU-kehikko on ollut toiminnassa kolme vuotta. Saatu kokemus osoittaa, että finanssipolitiikalle asetettuihin sääntöihin perustuva lähestymistapa on toimiva ratkaisu, kun politiikkaa koordinoivat useat erilaiset maat, joiden tavoitteena on turvata yhteisen rahapolitiikan uskottavuus ja rahaliiton vakaa toiminta. Samalla on tullut kuitenkin ilmeiseksi, että Maastrichtin sopimuksessa ja vakaus- ja kasvusopimuksessa sovitut säännöt ja menettelytavat ovat osin monimutkaisia, niiden läpinäkyvyys on heikko ja politiikkaa ohjaavat kannustimet epäsymmetrisiä. Tässä keskustelualoitteessa arvioidaan finanssipolitiikan koordinaation taustalla olevia yleisiä perusteita ja korostetaan finanssipolitiikan sääntöjen ja monenkeskisen valvonnan merkitystä kurinalaisen politiikan ja julkisen talouden pitkän aikavälin kestävyyden turvaamisessa. Työssä analysoidaan myös vakaus- ja kasvusopimuksen epäsymmetrisyydestä sekä kansallisen politiikan ja EU-tason sitoumusten heikosta yhteensovittamisesta johtuvia kannustinongelmia. Mahdollisena ratkaisuna näihin ongelmiin ehdotetaan vakaus- ja kasvusopimuksen täydentämistä kansallisesti laadituilla keskipitkän aikavälin menokehyksillä (valtiontalous) ja tasapainoisen budjetin vaatimuksilla (kuntatalous).

Asiasanat: finanssipolitiikan koordinaatio, menosäännöt, vakaus- ja kasvusopimus

Contents

1 The basic set-up

"…we must avoid investing the concept of economic coordination with more that it can deliver. That was a trap that we fell into with the concept of political union. Some people claimed that monetary union could work only when there was political union. There is no political union, yet we have monetary union and it is working. That was a mistake confusing both markets and electorates."
Sir Nigel Wicks 2001

The EMU framework for policy coordination relies on the assignment principle: the ECB is responsible for the single monetary policy, while other economic polices are carried out by governments under subsidiarity principle respecting the rules and procedures laid down in the Maastricht Treaty and the Stability and Growth Pact (SGP). The policy assignment and institutional arrangements of EMU underline the importance of economic and monetary stability as a precondition for a smooth functioning of the monetary union. As the ECB's primary objective is to maintain price stability in the euro area as a whole, the maintenance of economic stability at the national level falls to fiscal and structural policies. Given this set-up, the key question is whether the agreed coordination procedures and rules guiding fiscal policies are such that contribute to the achievement of economic stability at the national and euro area level.

The maintenance of fiscal discipline is crucial for the credibility of the single monetary policy and sustained economic growth in the context of price stability. The fiscal framework of EMU seeks to combine discipline and flexibility through two requirements: firstly, budgetary position should be "close to balance or in surplus" over the medium term as required by the SGP and secondly, the Maastricht Treaty requires that general government deficit remains below 3% of GDP except in the event of exceptional circumstances. The two requirements complement each other as adherence to "close to balance" requirement restores flexibility to the conduct of national fiscal policies by ensuring the necessary room for manoeuvre for cyclical stabilisation and the deficit limit secures discipline and sustainability of public finances.

After three years of EMU there is still confusion on how fiscal policy and policy coordination should be conducted in the euro area. As the functioning and objectives of the adopted framework are not well understood, criticism towards it has occasionally been relatively severe. Also the seemingly slow progress to live up to the policy recommendations and budgetary objectives commonly agreed within the EMU coordination framework has contributed to this. The situation has not been helped by the fact that fiscal positions of several Member States at the start of EMU were still close to the 3% of GDP deficit ceiling. Consequently, the need to fulfil the SGP's "close to balance" requirement has implied additional constraints for fiscal policies in the early years of EMU. This in turn has contributed to a widely held perception that the SGP rules out any sensible fiscal stabilisation by imposing a straightjacket upon euro area economies which does not allow for cyclical breathing space in public finances. The risk is that the longer the transition period to "close to balance" position, the more obscure and less credible the framework.

The rest of the paper is organised as follows. Section 2 discusses the rationale for fiscal policy coordination in a monetary union in general while section 3 focuses on the rule-based vs discretionary coordination of decentralised fiscal policies. The issue of coordination and fiscal stabilisation is addressed in section 4. Section 5 outlines the problems in the current policy coordination framework and section 6 discusses the procyclical bias in the SGP and ways to reduce it. Section 7 considers introduction of expenditure rules and balanced budget rules as complements to the SGP while section 8 discusses the implementation of such rules within the current policy framework and institutional arrangements. Coordination of structural policies is beyond the scope of the paper.

2 Rationale for fiscal policy coordination in EMU

The scope for fiscal policy coordination in the monetary union arises from the recognition that budgetary policies of individual member countries may have a significant impact not only on their own economy but on the area-wide stability as well. According to the textbook case expansionary fiscal policy in a country affects the economies of other EMU members through three basic transmission channels: firstly, through intra-EMU trade flows, secondly, through area-wide interest rates and finally, through the common exchange rate. Neglecting these spillover effects would lead to inefficient policy outcomes and hence, it pays off to coordinate fiscal policies.

Theoretically, the sign of spillover effects of budgetary expansions is ambiguous, as it depends on the relative magnitude of the direct trade effect and the impact on the common interest and exchange rate. Although empirical evidence on the magnitude of spillovers is scant,[1] negative impact of a substatial fiscal laxity on the part of individual countries via common interest and exchange

[1] Global macroeconomic model simulations suggest that spillovers between countries are negligible (see eg Buiter, Corsetti and Roubini 1993, Buti and Sapir 1998, Gros and Thygesen 1998, Hobza 2001). Since most of these simulations focus on trade linkages leaving aside financial market spillovers, the outcome is not surprising.

rate on all other participating countries can be substantial in a monetary union. Potentially significant spillovers through financial markets form thus one of the main justifications for supranational fiscal policy coordination, the aim of which is to ensure the maintenance of fiscal discipline in all member countries (see eg, Beetsma 2001, Korkman 2001).

Reflecting these underpinnings, the reason for policy coordination in the monetary union is reiterated in the Luxembourg Resolution on Economic Policy Coordination of December 1997 as follows:

– To the extent that national economic developments have an impact on inflation prospects in the euro area, they will influence monetary conditions in that area. It is for this basic reason that the move to a single currency will require closer Community surveillance and coordination of economic policies.

In the area of policy coordination the Resolution also stresses the subsidiarity principle of the Treaty:

– Enhanced policy coordination must adhere to the Treaty principle of subsidiarity, respect the prerogatives of national governments in determining their structural and budgetary policies, subject to the provisions of the Treaty and the Stability and Growth Pact.

The SGP together with the Broad Economic Policy Guidelines (BEPGs) form the basic devices for fiscal policy coordination at the EU-level. In the context of the SGP euro area member countries submit annually Stability Programmes where they commit to achieve and maintain budgetary positions of "close to balance or in surplus" over the medium term. The annual BEPGs spell out the appropriate macro policies and recommendations for structural reforms in product, labour and capital markets. Issues dealt with range form budgetary discipline to quality and sustainability of public finances.

The practical coordination encompasses a host of modalities: information exchange, policy analysis and dialogue, multilateral surveillance of common rules and procedures, peer pressure, open method of coordination, formal recommendations and sanctions. Apart from budget deficits, which are limited by the deficit ceiling and sanction mechanisms, the coordination of fiscal policies relies essentially on "soft" forms, which have no binding force.

The main actors responsible for policy coordination are the European Commission, ECOFIN Council, the Euro group, the Economic and Financial Committee and the Economic Policy Committee. The role of the Commission in the field of coordination is *inter alia* to monitor and analyse macroeconomic and budgetary developments in member countries, carry out multilateral surveillance, assess Stability Programmes and make initiatives and policy recommendations.

The hard core of coordination is confined to the Council: it endorses BEPGs, makes formal decisions on recommendations, gives its opinion on Stability Programmes, decides on the existence of excessive deficit and the application of sanctions. Policy coordination in the Euro group and the Committees draws on "soft" forms: monitoring, information exchange, policy dialogue and peer pressure.

3 Are decentralised fiscal policies in a monetary union a threat to economic stability and policy credibility?

It is hard enough to manage a national economy. But collective management of the economies of twelve Member States in the euro area would be a daunting task.
Sir Nigel Wicks 2001

In the absence of any policy coordination decentralised fiscal policies in the monetary union could result in overly expansionary fiscal policies that could jeopardise the area-wide price stability and lead to a more restrictive monetary policy, higher interest rates and lower growth than otherwise would be the case.[2] As a result, the credibility of the stability oriented policy framework would suffer and the effectiveness of monetary policy weaken (see eg Allsopp and Vines 1998, Artis and Winkler 1997).

In economic theory policy coordination is usually understood as joint adjustment of policy parameters (Bryant 1995). The EMU fiscal framework relies on implicit policy coordination by restricting national policies through rules and procedures rather than explicit coordination of discretionary policy measures in the form of joint decision making. Supranational fiscal rules, such as the SGP, are considered effective in preventing political distortions (deficit bias, moral hazard, free riding), that could lead to negative financial market spillovers and erode the credibility of the common monetary policy (see Buiter, Corsetti and Roubini 1993, Beetsma and Uhlig, 1999). Supranational fiscal rules can thus work as a commitment technology in a monetary union.

Several commentators however tend to think that the combination of the single monetary policy and decentralised fiscal policies that are not backed by

[2] Ie, the incentive for a single EMU member to overexpand by assuming that its own effect on area-wide inflation is small. For a survey on political biases leading to excessive deficits, see Alesina and Perotti 1995.

joint decision making is a serious fault in design, which will sooner or later end up in insurmountable difficulties, policy failures and tensions between Member States. The obvious remedy for EMU to function properly would then be strengthened policy coordination beyond the current provisions of the Treaty and the SGP and a further shift of policy competences from the national to the supranational (euro area) level.

At the same time opposite views stress that supranational monetary policy not only can but should go hand in hand with decentralised fiscal and other policies to allow nationally tailored responses to country specific shocks and structural problems. An efficient initial assignment of objectives and responsibilities of various policy actors in the euro area will largely substitute the need for discretionary coordination later on (see eg, Issing 2000, Korkman 2001). If applied strictly, monetary union *per se* does not call for additional coordination instruments nor procedures: the SGP and policy recommendations of the BEPGs, if adhered to, ensure fiscal discipline and long-term sustainability of public finances, which are essential in the context of monetary union. Hence, explicit policy coordination beyond the SGP is not necessary and should in any case be non-binding.

Coordination sceptics have also emphasised the limits of discretionary policy coordination: enormous information requirements and risk of confusing responsibilities which imply well-known decision and implementation lags in policy-making, distorted incentives and reduced accountability of individual policy-makers (see eg, Issing 2000, Virén 2001). Furthermore, calls for deeper policy coordination disregard the political-economy context of practical policy-making, ie, lack of appropriate enforcement mechanisms, which could contain free-riding behaviour by national policy-makers.

A balance lies probably between the two extreme views. The rule-based coordination of decentralised fiscal policies provides a feasible solution for a large number of heterogeneous countries whose joint interest is to safeguard the credibility of common monetary policy and smooth functioning of EMU. As this type of policy coordination means essentially agreeing on and committing to common policy rules and procedures as well as their multilateral surveillance, the overall framework can be developed and strengthened without a necessity to transfer policy competencies from the national to the supranational (euro area) level.

4 Coordination and stabilisation

The policy assignment and institutional arrangements of EMU are based on a widespread consensus that smoothing asymmetric shocks and divergent cyclical conditions falls to national fiscal policy as the single monetary policy responds only to area-wide price developments. Contrary to the serious doubts raised against discretionary stabilisation, there seems to be a broadly based agreement that automatic stabilisers are useful and should be used to smooth out cyclical fluctuations.[3] The advantage of automatic stabilisers over discretionary actions lie in their very nature: they are reversible, information requirements are small, they operate practically with no decision making or implementation lags and by definition, they do not require supranational fiscal policy coordination beyond the adopted rule-based framework.

The unpopularity of fiscal activism among academics and policy makers as well reflects not only the developments in macroeconomic theory over the past decades,[4] but other reasons as well. Discretionary fiscal actions resulting in persistent and high budget deficits, unsustainable debt positions and procyclicality in the 1970s and 1980s contributed significantly to the general disillusionment on the desirability of discretionary stabilisation policy. Due to long decision and implementation lags and irreversibility, it became conventional wisdom that discretionary fiscal policy is too rigid to be effective in responding to changing macroeconomic conditions. Informational and analytical requirements for active stabilisation policy are enormous and relative to these requirements very little is known. Moreover, the recognition of "deficit bias" inherent in the political decision making process and institutions made the successful use of discretionary policies for short-term stabilisation even more doubtful.

Even if discretionary stabilisation policy were considered effective, a rule-based coordination relying on the working of automatic stabilisers has several advantages over explicit coordination of discretionary policy actions in maintaining economic stability in the euro area. High variance of economic

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[3] The non-discretionary approach to fiscal stabilisation does not however imply that the degree of stabilisation provided by the prevailing set of automatic stabilisers is sufficient or appropriate with respect to national and area-wide needs in the euro area. Automatic stabilisers have not in general been designed for cyclical stabilisation purposes and certainly not in view of the monetary union but on the ground of political preferences over income redistribution and welfare systems. Hence, if higher degree of fiscal stabilisation is deemed necessary in EMU compared to a situation with independent monetary policies, prevailing tax and expenditure systems should be redesigned so as to increase their responsiveness to the cycle. This however may imply increased economic distortions and efficiency losses. Alternatively, the need for traditional fiscal stabilisation could be diminished by structural reforms that improve the overall flexibility and functioning of the economy.

[4] See f. ex., the survey by Persson and Tabellini (1995).

structures, institutions and economic situations across member countries would make coordination of discretionary fiscal policy actions extremely complex.

Moreover, given the heterogeneity of the participating countries, harmonised policy responses or structural measures would not even be desirable.[5] A large number of players multiplies the challenges and problems, imposes high transaction costs and increases the overall inefficiency of discretionary coordination.[6] Discretionary coordination would also reduce transparency compared to a rule-based framework by making fiscal policy less predictable at the EU and national level. Moreover, the risk and cost of coordination failures could be large suggesting a relatively cautious approach towards coordinating discretionary policy actions.

Furthermore, the need for elaborate coordination of discretionary fiscal policy actions should be very limited in EMU and confined to exceptional situations. In case of asymmetric shocks automatic stabilisers can work subject to the 3% of GDP deficit ceiling without triggering significant negative spillovers to other member countries to justify discretionary policy coordination. The individual country concerned can – if it deems necessary and if it has adequate room for manoeuvre – supplement the working of automatic stabilisers by discretionary measures within the EMU fiscal framework. Under symmetric and area-wide (demand) shocks the single monetary policy by maintaining the area-wide price stability provides output stabilisation as well, which limits the need for discretionary fiscal actions and policy coordination.[7]

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[5] This refers basically to macro- and structural policies aimed at improving the functioning of labour and product markets and not to coordination designed to promote the functioning of internal market, eg the issue of minimum harmonisation of taxation on savings.

[6] With a view of the EU enlargement the importance of transaction costs would magnify. Efficiency and timeliness in fiscal policy making in the presence of a large number of participating countries speaks clearly in favour of rule-based approach to fiscal policy coordination. The framework should be such that it can easily encompass the EU enlargement.

[7] Coordination of significant discretionary policies to foster structural reforms in public finances could however pay off if a coordinated strategy increases the incentives of individual countries to implement tax and expenditure reforms that are politically difficult due to short-term adjustment costs. The rationale for coordination in this particular case comes from the expected response of monetary authorities as countries might count on supportive monetary response to the extent that reforms reduce inflationary pressures for the euro area as a whole by improving efficiency and productivity.

5 Problems with the current framework

What are desirable characteristics for fiscal rules? Ideally fiscal rules should provide a set of incentives and/or constraints that make fiscal policy actions closer to "desirable" outcomes. For any rule to be successful in delivering desirable outcomes, it has to be credible. In practice, this requires operationally simple and transparent rules with efficient enforcement mechanisms and sanction systems (see Kopits and Symansky 1998). Moreover, monitoring of the compliance with the rules should be easy and carried out by an independent agent.

In principle the SGP contains the basic ingredients for a successful rule-based approach to fiscal discipline. Nevertheless, it is perceived to suffer from complexity, lacking transparency and substantial discretionary powers of the ECOFIN Council. All these factors weaken the role of the Commission as the "guardian" of the Treaty and the SGP, the power of the enforcement mechanisms (the early warning system of the SGP and the issuance of policy recommendations)[8] and the potential applicability of the sanctions in case of excessive deficits.

In a recent paper, Hodson and Maher (2000) describe the current state of affairs as follows: "The fragmentation of responsibilities within economic policy is problematic as coordination is characterised by diffuse responsibility, an opaque institutional structure and a consequent lack of transparency with a large number of supranational and national players operating at different levels and interlinked through a complex web of transnational and supranational initiatives. Such features raise questions as to the legitimacy of the emerging coordination process."

These critics highlight well the problems of coordination in general. On the hand, the question is about incentives and effective enforcement mechanisms and on the other hand about transparency and legitimacy. Even a well-designed framework can deliver desired results only if it is clearly understood and supported by policy-makers as well as the public at large. To translate the common objectives into actions at the national level would require *inter alia* increased transparency, reinforced incentive structures and enforcement mechanisms.

[8] See European Council Resolution on the Stability and Growth Pact, OJ C 236, 2.8.1997, pp 1 and 2.

6 Procyclical bias

Even the best-intentioned finance ministers are subject to extensive political constraints: electoral concern, the necessity to strike deals with opposition parties, or to favour certain constituencies such as public sector unions. The complex political game that leads to the formulation of fiscal policy often brings about departures from optimal and prudent policies.
(Alesina-Blanchard-Gali-Giavazzi-Uhlig 2001).

In what follows, possible ways ahead are sought by asking, how well the current fiscal framework functions in contributing to economic stability at the national and euro area level. This is done by addressing a traditional friction in fiscal policy that creates risk to economic stability namely, pronounced procyclicality in the short-term fiscal policy making, which in the longer term may lead to debt accumulation and jeopardise long-term sustainability of public finances.

Is the SGP efficient in eliminating procyclical bias in policy-making? The tendency for procyclical bias in the conduct of discretionary fiscal policies has been a typical characteristic of European policy-making (Brunila and Martinez-Mongay 2002, IMF 2001a). The SGP is not however well equipped to rein in procyclical tendencies due to its asymmetry: it is essentially focused on budgetary discipline during cyclical downturns rather than during upswings. While an excessive deficit is sanctioned, there are no effective enforcement mechanisms to ensure appropriate budgetary behaviour and to run even sizeable budget surpluses during cyclical peaks. Specifically, the SGP does not foresee any restraints to political temptation to spend the automatic fruit of higher growth, which lies at the heart of the political deficit bias. To avoid excessive deficit during a downturn would in turn imply procyclical fiscal tightening. This potential flaw in the SGP was recognised already from the very beginning.[9]

At the euro area level pro-cyclical fiscal relaxation will put pressure on monetary policy and call higher interest rates to contain acceleration in the area-wide inflation. The result would be an unbalanced policy-mix, which is

[9] Charles Bean (1998) pointed out in his comment to Eichengreen and Wyplosz (1998) that the problem with the SGP as presently framed is that it is all stick and no carrot; rewarding good fiscal behaviour in booms rather than, or in addition to, punishing bad behaviour in slumps would surely make better sense. In Bean's view the Pact's architects believe that countries will be sufficiently far-sighted and will run surpluses in good times, so as to give room for the automatic fiscal stabilisers, and other discretionary action, in bad times. As a remedy for this he suggested that payments to the EU budget or the distribution of euro seigniorage to fiscal positions should be used as carrots for good behaviour in good times.

detrimental for sustained economic growth and employment for the area as a whole.

Overall, one reason why the SGP tends to work asymmetrically and does not necessarily improve the incentives for disciplinary fiscal behaviour during good times is the confusion surrounding the appropriate interpretation of the medium-term objective of "close to balance or in surplus". Despite extensive discussions and efforts to define the medium-term target clearly and to make it operational,[10] it remains relatively opaque. Specifically, there is controversy regarding the actual vs structural interpretation of the budget balance.

A number of policy actors and commentators tend to think that the "close to balance" objective is met if the general government budget is broadly in balance in actual terms by the end of the horizon covered by annual Stability Programmes. This makes the objective as a rolling target, which will never be necessary to meet literally. However, the rolling objective of reaching an actual balance sometime in the future may bring about unpleasant surprises if cyclical conditions weaken suddenly as the actual figures mask the potential weaknesses in the underlying budgetary position. Defining the medium-term objective in terms of actual figures especially during times of high growth does not provide strong enough incentives to run cyclical surpluses, which are necessary for the symmetrical working of the SGP and fiscal discipline.

The Commission has been active in promoting the definition of "close to balance" objective in terms of underlying or cyclically adjusted budget balances (see European Commission 2001). Notwithstanding the measurement problems involved, this kind of an approach would improve incentives to be prudent also in good times. However, being a highly technical concept, the cyclically adjusted budget balance as a rule for fiscal policy does not render itself easily understood by a broader audience. This is an important concern for transparency, credibility, accountability and enforcement of the "close to balance" rule.

Another important issue concerning transparency, accountability and enforcement of the EMU fiscal rules is related to the role of national budgetary institutions. Although the medium-term "close-to-balance or in surplus" requirement of the SGP applies to general government, in most EU countries it is the central government that commits to the medium-term budgetary objectives on behalf of the whole general government without much involvement of lower levels of government. Lacking coordination, commitment and enforcement mechanisms at the national level tying the hands of sub-central governments can become an important obstacle for the achievement of government set objectives. This applies specifically to countries where regional/state and local governments have substantial financial autonomy. Moreover, decentralised revenue and

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[10] See eg, the new Code of Conduct on the content and format of stability and convergence programmes adopted by the ECOFIN Council in July 2001.

expenditure responsibilities at the national level may aggravate the political deficit bias and strengthen procyclical tendencies in fiscal policy (see Pisauro 2001).

The Maastricht Treaty[11] includes a specific provision, which calls for the governments of the Member States to ensure that their national budgetary procedures and institutions enable them to comply with the obligation to maintain sound and sustainable public finances. To this end a number of EMU countries have adjusted their budgetary procedures to some extent in recent years, but in most countries there is still a lot of scope for improvement. The risk of fiscal profligacy and pro-cyclical tendencies could be diminished if the SGP were complemented by rules and procedures setting constraints and incentives for all national budgetary players to behave in accordance with the EMU fiscal framework (see Alesina and Perotti 1996, Corsetti and Roubini 1994, von Hagen 1992, von Hagen and Harden 1994, 1996, von Hagen et al 2001). In this respect the endorsement of Stability Programmes by the national parliaments would be a step towards better integration of national budgetary processes and policy objectives agreed at the EU level.

7 What types of complementary rules?

Expenditure rules that constrain the growth in public spending could be a useful complement to the medium-term "close to balance" objective of the SGP. By making fiscal policy more predictable and stable, they could also reduce fiscal policy shocks to aggregate demand and create room for lasting tax reforms. Expenditure rules in general raise less measurement and surveillance problems and are better understood by budgetary players and the public at large than eg a balanced budget in structural terms. They also make governments accountable for what they can control most directly, which is not necessarily the case of tax receipts as they are more sensitive to cyclical fluctuations than expenditures (see IMF 2001b). More importantly, by highlighting possible spending overruns expenditure rules tackle deficit bias by addressing the principal source of fiscal profligacy: political and institutional temptation to raise expenditures in good times.

Designing an effective expenditure rule is not however straightforward and several questions need to be addressed: Should the rule be defined in nominal or real terms? How comprehensive the rule should be? What time span should the rule cover? How does it work in a decentralised system where decisions on public finances are done independently by various sub-sectors of general government? What enforcement mechanisms ensure that the rule is not circumvented?

[11] Art. 2 of the Protocol on the Excessive Deficit Procedure.

Research on fiscal policy rules emphasises (see Kopits and Symansky 1998, Banca d'Italia 2001) that rules will be successful if they are operationally simple, their enforcement and surveillance mechanisms are effective, they are binding across terms of government, they are easy for the public to understand and they are widely supported across the society.

In conceptual terms, the difference between real and nominal expenditure rule is significant only if the underlying projection for the public sector price deflators is erroneous. Since an expenditure rule defined in real terms does not depend on the rate of inflation, nominal public expenditures and deficits may turn out higher than intended should inflation be higher than projected. Nominal expenditure ceilings, on the other hand, force the adjustment of real expenditures as inflation accelerates and help to stabilise the economy, especially when a pickup in inflation is caused by growth in domestic demand. Similarly, under a permanent negative supply shock, lower real government expenditure would help absorb the shock and stabilise the ratio of expenditure to GDP. Moreover, nominal expenditure rules are transparent and adherence is easier to monitor than is the case for real expenditure rules, the compliance of which depends on the particular price deflator applied.

To be effective, the rule should define clearly the expenditure aggregate to be kept under control and specify an adjustment mechanism to rein in deviations from the rule. Comprehensive expenditure rules covering all expenditure items would be simple and transparent. At the same time they could however impose undue rigidity in fiscal policy and might not necessarily reduce the procyclical bias. When growth exceeds forecast and cyclically-sensitive expenditures decline, rigid expenditure rules enable bloating of other expenditures, which often are difficult to reverse when times go bad. On the other hand, when growth slows and unemployment increases, adhering to original expenditure rules requires the financing of cyclically-induced expenditures via cuts in other expenditure items. Rigid expenditure ceilings, which ignore cyclically-induced changes, can thus lead to a pro-cyclical discretionary policy that offsets the impact of automatic stabilisers on the expenditure side.

Increasing flexibility and state-contingency tends to reduce transparency and thus the effectiveness of rules to deliver desired results. A practical way of achieving fiscal flexibility to deal with cyclical fluctuations without compromising transparency too much would be the application of the rule only on expenditures that are unresponsive to cyclical conditions. This means in essence excluding unemployment-related expenditures from the rule. Alternative way of introducing some flexibility to expenditure rules covering also cyclically sensitive spending items could be a limited contingency fund that covers expenditure overruns resulting from purely cyclical fluctuations.[12]

Another expenditure item that should be excluded from the rule is interest payments on government debt. Interest payments are shrinking because government debt is generally on the decline decreasing thus automatically the share of public expenditures to GDP. As this room for manoeuvre could automatically set in motion increases in other spending, it would be better to exclude interest payments from the rule. The extra room for manoeuvre created should be used to strengthen longer-term sustainability of public finances given the looming demographic shock and spending pressures due to population ageing.

With these long term challenges and the sustainability of public finances in mind, expenditure rules should not be formulated only short-term disciplinary considerations in mind but taking also a due account of long-term expenditure pressures and how they can realistically be contained to safeguard long-term sustainability. To this end expenditure rules should be reviewed regularly and assessed on the basis of their appropriateness in terms of fiscal discipline and longer term financing constraints.

Expenditure rules can be effective in limiting the growth of public spending only if they cover a substantial part of the general government. General government in several euro area countries comprises of financially highly autonomous local/regional/state governments. Application of expenditure rules to all sub-central governments, however, is not a realistic option because of the large number and heterogeneous tasks of such governments. Moreover, compliance monitoring would also be particularly difficult. An alternative solution would be a combination of binding expenditure rule for the central and state governments and a balanced budget requirement for local governments.

This kind of an arrangement promotes the aims of the SGP but does not guarantee consistent national fiscal policy (taxation and expenditure allocations) because budget balancing at sub-central government level can be achieved via tax increases and/or spending cuts. On the other hand, an increase in exceptional (cyclical) tax revenue could result in procyclical expenditure increases by sub-central governments as well, which may jeopardise their budget balance in times of slower growth.[13] To alleviate procyclical spending bias at the local government level, transfers from the central government could be designed to minimise cyclical influences from the revenue side. This may however be complicated in practise and require an extensive reform to sub-central financing practises. The basic trade-off between a rule that is easy to implement (balanced budget rule)

[12] These types of contingency funds are used in the Netherlands, and currently under consideration in Spain.

[13] This procyclical tendency constitutes the main criticism towards balanced budget rules, see Alesina and Perotti 1999.

and one that avoids procyclicality (expenditure rule) is difficult to avoid completely when choosing an appropriate rule for a large number of sub-central government entities.

8 Implementation and enforcement of complementary rules

Even though the Article 99 of the Treaty states that policy coordination in EU should confine to issues of "common concern", each Member State retains freedom to decide its level and structure of taxation and government expenditure. To comply with the existing rules and institutional arrangements, the introduction of complementary rules and procedures – such as expenditure rules and balanced budget objectives for lower levels of the government – as a part of the multilateral budgetary surveillance and coordination mechanisms at the EU level is not straightforward. In any case these types of complementary rules should be country-specific and set by national governments/parliaments to respect the subsidiarity principle of the Treaty.

Experience with national fiscal policy rules in different countries indicate that, without an effective enforcement and sanction systems, rules often turn out to be short-lived and thus ineffective in constraining expenditure growth or preventing deficits and expanding indebtedness. The temptation of government to one-sidedly break its own rules ex post is especially strong in election years, in times of economic slowdown and in the throes of a change of government. Hence, to be effective expenditure rules should in general be enshrined in law, which restricts the ability of government, parliament and other budgetary actors to obviate them. Concerning ex post compliance, the obligation to specify how ex post deviations from the rule will be adjusted in the following years would be crucial.

Currently a number of EU Member States apply a variety of expenditure frameworks to central government finances and balanced budget targets for lower levels of government.[14] The frameworks applied differ substantially with respect to coverage, comprehensiveness and their statutory nature. In general, expenditure targets are normally set by a particular government and extend over the length of its term. As they are not usually enshrined in law, nor do they entail automatic adjustment mechanisms or sanctions against expenditure overruns, the status of the targets is closer to medium-term goals of government than binding rules.

[14] Expenditure ceilings or targets are used in Finland, France, Germany, the Netherlands, Spain and Sweden. So called Internal Stability Pacts or balanced budget rules and golden rules are used in Austria, Belgium, Finland, France, Germany, Italy, Spain, Sweden and the UK. See Brunila and Kinnunen 2002.

Neither do expenditure limits tie the hands of the parliament, which can change the government's budget proposal and obviate expenditure targets. Consequently, their success in reining in government spending has varied across countries and across time.

Given that various fiscal rules are widely applied, the idea to complement the SGP with expenditure rules for central/federal and state governments and balanced budget requirements for local governments is not a novelty and does not provide a panacea for fiscal policy coordination in the EMU. However, credibility, transparency and enforcement of such nationally introduced arrangements would improve markedly if they were coordinated and monitored at the EU/euro area level as part of the multilateral surveillance mechanism of the SGP. In particular, a common agreement on the guiding principles how to formulate and implement complementary fiscal rules at the national level would be a step towards enhanced policy coordination and the overall transparency of the EMU fiscal framework. Agreeing on general principles and coordinating the procedures at the EU level would also help to clarify the interaction between national policy-making and EU-level policy commitments.

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