

FISCAL DISCIPLINE: RULES RATHER THAN INSTITUTIONS

Charles Wyplosz*

The lack of fiscal discipline is a natural and pervasive implication of the perceived separation between the benefits from public spending and the taxes that individuals and interest groups receive and pay, respectively. The implication is that budget preparation, decision and execution must be constrained. The challenge is that the policymakers who need to be constrained are those who must decide the constraints. Two broad classes of solutions are possible: institutions that shape the budgetary process and quantitative rules that set limits. The mounting experience with both institutions and rules is disappointing, for reasons that are often complementary. Examining the reasons for this state of affairs, this article argues that institutions and rules ought to be combined and associated with advisory fiscal councils.

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“Responsibility for the application of fiscal alchemy in policymaking falls squarely on governments and legislatures who, for many years, have refused to invest in the intellectual capital that could lead to more economically sound policy decisions. Political leaders much prefer the discretion that alchemy offers over the discipline that science imposes. Resistance of policymakers to adopting rules to guide their fiscal decisions is a key example of this revealed preference.”
Leeper (2010).

I. Introduction

In Wyplosz (2005) I presented the case for fiscal discipline institutions.¹ The logic is rooted in the rules *vs* discretion debate augmented to account for political failures. In such a situation, neither rules nor discretion can be optimal in the presence of unforeseeable contingencies. This is precisely the kind of reasoning that led to granting central banks independence and the adoption of the flexible inflation targeting strategy (see, e.g. Svensson, 2005).

The similarity between price stability and fiscal discipline is deep, indeed. In both cases, the objective is to be achieved in the long run, but short-term slippages

may be desirable in the face of unexpected shocks. Letting inflation move away from the target can be an acceptable trade-off as long as long-run price stability is not jeopardised. In the same way, temporary deviations from fiscal discipline may be justified if an eventual stabilisation is guaranteed. Furthermore, in both cases, judgement is involved: whether slippage is justified or not and, if so, how much and for how long, requires trading-off conflicting objectives. This means that any rule, which cannot be fully contingent, is bound to be counterproductive under some conditions while total discretion can lead to unwise decisions by policymakers who operate under difficult constraints.

What are those constraints? In both cases, there is a well-established tendency to discount the future excessively because governments are never sure to be re-elected. Other political motivations, including the timing of elections, may also come into play. In the area of fiscal policy, in addition, the common pool problem implies that governments are subject to pressure by interest groups that want more spending or less taxes for themselves; they fail to internalise the fact that the budget constraint will force others to suffer from spending cutbacks or tax increases (von Hagen and Harden, 1994, Krogstrup and Wyplosz, 2006). These

*The Graduate Institute, Geneva, and CEPR. e-mail: charles.wyplosz@graduateinstitute.ch.

constraints betray the fact that well-performing democracies are subject to political failures, with the implication that we cannot rely on real-life politicians to act as welfare-maximising agents.

Correcting these political failures is the issue. One way or another, it implies constraining democratically elected politicians, not an easy proposition. Viewed this way, it may look like a miracle that the problem has been reasonably well solved in the area of monetary policy. In fact, it was not a miracle. Monetary policy changed in the wake of the high inflation rates of the 1970s and the high costs of disinflation in the 1990s in the developed countries. These episodes, along with the memory of dramatic hyperinflation episodes in the interwar period, made two points: the political failures are real and widespread, and the consequences are costly. This is why the spread of central bank independence in the 1990s, coupled with the adoption of price stability as the primary objective of monetary policy, has proceeded quite swiftly among the developed countries and has reached numerous emerging market and developing countries.

In the area of fiscal policy, we now face a similar situation. The relentless increase of public debt in many countries has evidenced an important political failure. So far, few governments have shown any willingness to acknowledge their failings and adopt arrangements that restrict their power, but changes have occurred and more are likely to follow. The present paper starts with an analysis of possible responses to the widespread deficit bias to conclude that none of them alone is likely to solve the problem, at least in politically acceptable forms. It argues that the best hope is to combine advisory independent fiscal institutions and rules that include escape clauses. Section 3 then focuses on the Euro Area, where a sovereign debt crisis is raging. It examines the reasons for this crisis and offers a proposal based on a decentralisation of the Stability and Growth Pact, along with the re-establishment of the no-bailout rule and the abandonment of the European Financial Stability Fund and its successor, the European Stability Mechanism.

2. Fiscal arrangements

2.1 Sources of fiscal indiscipline

In contrast with monetary policy, the literature on fiscal policy is relatively underdeveloped. One reason is that, from a macroeconomic viewpoint, the theory of how fiscal policy affects demand remains highly

controversial, as it hinges on the existence of market failures – borrowing constraints – that create a justification for public interventions. From a microeconomic viewpoint, fiscal policy deals with functions such as the provision of public services, public investment and income redistribution. These functions also involve complex and controversial considerations. As a result, there is nothing like an optimal fiscal policy.

Absent clear and non-controversial criteria, fiscal policy decisions are bound to be arbitrary. Because they are inherently collective, these decisions can easily be subject to political manipulation and the list of potential political failures is long. It includes intertemporal inconsistency, interest group externalities, political games between government and parliament, not to mention outright corruption at various levels.

Intertemporal consistency is a widespread phenomenon that occurs when decisions taken previously are no longer desirable given that the passage of time has changed incentives. The most obvious example is a commitment to operate balanced budgets. If the commitment is made under crisis conditions and is upheld, a few years later the situation will be healthier and the commitment may be abandoned without dire consequences, and maybe even for good reasons. Improved conditions, therefore, make it possible to renew with fiscal indiscipline, with problems likely to appear a few years down the road.

Yet, this interpretation must still explain why it could be desirable to give up discipline when the consequences are not to be faced immediately. A first justification is that the current government has an incentive to please its electorate and to pass the bill to future governments.² A similar argument is that the current generation is passing a debt burden to future generations.

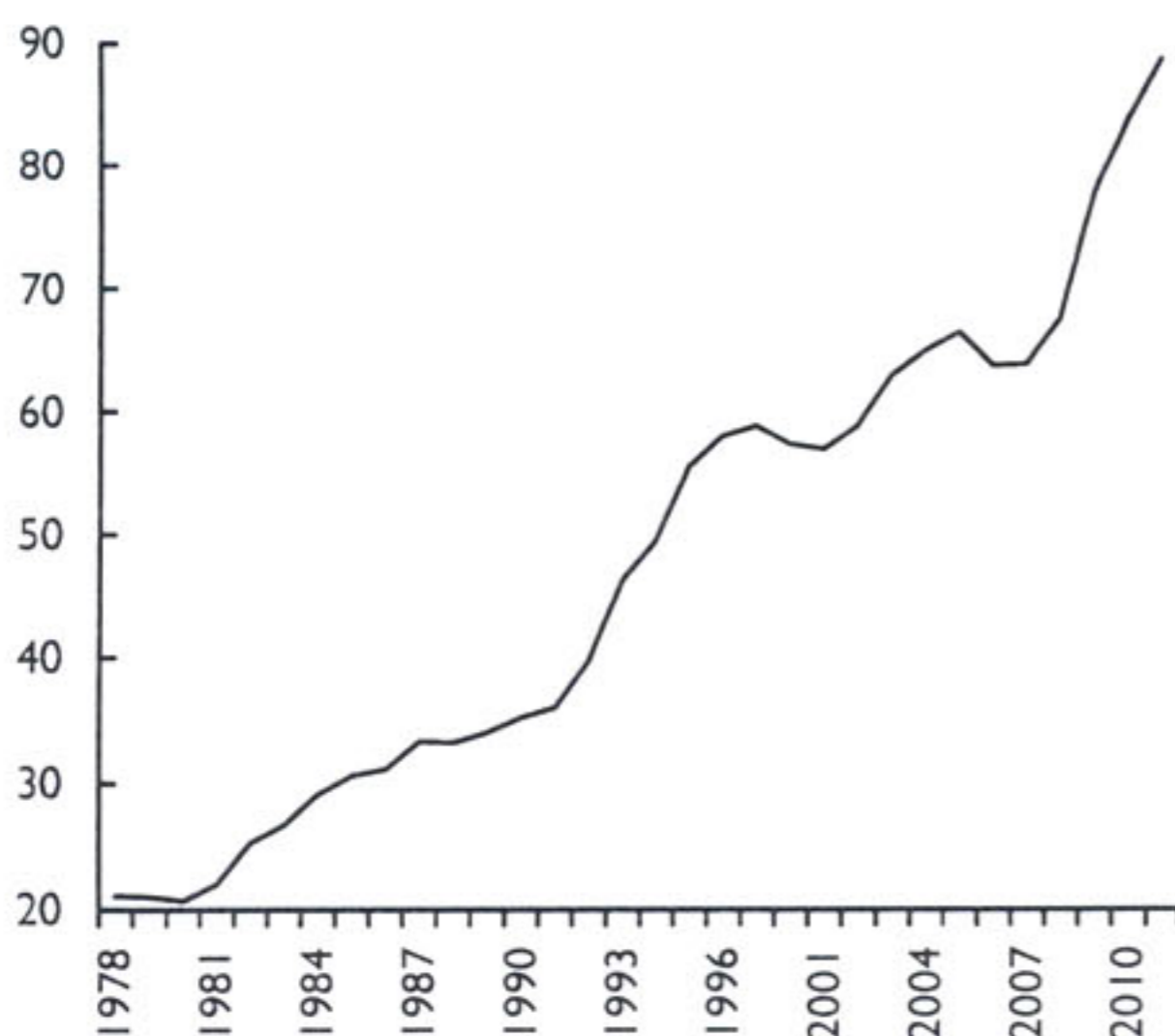
These are but examples of a generic interpretation, known as the common pool problem (von Hagen and Harden, 1994). The problem arises whenever those who benefit from public spending consider that they will not face the corresponding costs, because the costs are spread across all taxpayers. Even though they may end up facing the costs, the belief that they will not provides them with an incentive to lobby forever more spending. Of course, enlightened governments would not give in to such pressure, but real-life governments need to be elected and to please their voters. One outcome of this situation is the emergence of a deficit bias. Even though the outcome is *ex post* inefficient it may be the only

politically viable one *ex ante*. Of course, passing on a debt burden is just one case of attempts by interest groups to get benefits without paying for them.

The common pool problem also explains the tendency of parliaments to increase spending and reduce taxes when they approve the government proposal. Each Member of Parliament has an incentive to please his constituency with measures whose costs will be shared by all voters. The constituency may be an electoral district, corporations located in the district, or wider-purpose lobbies.

The deficit bias is a general phenomenon, the manifestation of an externality that emerges spontaneously whenever governments tax and spend. It follows not only that some spending may be inefficient or that taxes are ill designed, but also that budget deficits may arise for bad reasons, leading to unjustified build-up of public debts. As an example, figure 1 below plots the evolution of the debt to GDP ratio in France since 1978. The increase following the 2008 financial crisis is spectacular but, at least, it represents efforts to prevent a Great Depression and to keep the banking sector afloat. The increase during the 1990s, following a slow grinding build-up in the 1980s, is no less spectacular, in fact it was larger. Yet, there is no good explanation why it happened.

Figure 1. Gross public debt in France (% of GDP)



Source: AMECO, European Commission.

Could one explanation be purely economic errors and miscalculations, unavoidable given our state of knowledge? Because errors have no reason to be systemically asymmetric, they cannot explain debt build-ups. Even rare events cannot always be considered as pure, asymmetric errors. For instance, in most developed countries, the financial crisis has led to sharp increases in public debts. The crisis is indeed a rare event, say one that occurs every two or three generations. Still, arguably, it is the consequence of poor bank regulation and inadequate supervision. The result has been a classic common pool outcome whereby private debts have been socialised.³

The conclusion is that the relentless increases in public debts observed across a wide spectrum of countries cannot be explained as the result of unfortunate and unintentional policy mistakes. The responsibility for debt build-ups rests squarely with the politics of fiscal policymaking. Stopping and then reversing the rise in public debt will require either changing the incentives of policymakers or restricting their ability to carry out deficit-biased policies. Various solutions have been proposed and experimented with. The following sections review these experiments.⁴

2.2 Process-based arrangements⁵

A first category of arrangements aims at directly containing the common pool effect by internalising at least some of the externality. The general principle is that each stage of budgetary procedure is open to externalities that are the source of a deficit bias. Over the years, a number of countries have experimented with various arrangements designed to promote fiscal discipline. Setting aside fiscal rules, which are examined in the next section, such arrangements can concern a large variety of arrangements.

Budgets are commonly prepared in several stages that may start one year before implementation and the execution itself lasts over the whole fiscal year. The four main steps are:

- Budget preparation within governments.
- Budget approval by parliaments.
- Execution following approval.
- Control of the accuracy of public accounts.

The budget preparation process occurs within the government. Spending ministries are the channel through which the externalities emerge while the finance

minister is customarily the one who attempts to internalise competing claims. A number of arrangements can mitigate the deficit bias:

- Setting *ex ante* unbreakable ceilings for each ministry budget.
- Setting *ex ante* total spending or the overall budget balance, before collecting bids from the spending ministries, who must then negotiate among themselves to meet the set target.
- Giving last say to the finance minister.

Parliamentary approval is often a delicate stage as the number of actors is large, which means that the internalisation of an unbounded list of competing claims is challenging. Solutions include limiting the ability of parliaments to introduce additional spending or cutting taxes without compensating revenues or, in some cases, preventing any change in the budget balance.

The execution of budget laws is never trivial. Each unexpected event opens up the possibility of ‘adjusting’ the budget, and the deficit bias implies that such adjustments tend systematically to worsen the balance. Here again, the finance ministry is pitted against spending ministers and against parliamentarians. Arrangements that deal with unexpected events include rainy day funds, i.e. resources set aside to meet urgent needs, which must be replenished as part of the normal budgeting process.

Finally, the accuracy of public accounts should never be taken for granted. The stricter are the arrangements to combat the deficit bias, the more frequent and imaginative are attempts to doctor the accounts. Beyond outright ‘playing’ with the numbers, the temptation to shift spending to external entities often proves to be irresistible. Here again, a strong financial ministry offers some protection, especially when it is coupled with independent auditing.

The literature does not seem to offer statistical estimates of the effectiveness of these various arrangements. The perception is that the political process can easily undermine formal arrangements. In particular, von Hagen (1995) suggests that the best-designed framework may fail to deliver its expected results if the political situation is sufficiently dysfunctional. These two aspects are inextricably associated. They explain the diversity of institutions put in place around the world but they also help understand why the evidence of the effectiveness of fiscal institutions is unimpressive.⁶

Three gaps often undermine existing arrangements. The first one is the proliferation of special budgets, for example those covering various social programmes, which have become large. A similar channel for the deficit bias is the existence of sub-central government authorities, each of which is subject to the same externalities but, also, to the possibility of explicit or implicit (bailout) financing by the central government.

The second gap is the tendency to adopt laws that mandate policies without simultaneously appropriating their costs. This can include spending programmes or tax shelters. The result is that the budget must then take on board these laws that are totally externalised in the process. Plugging the hole can prove to be particularly challenging since none of the various players (spending ministries, interest groups) feels responsible for the resulting deficit bias.

The third gap goes to the heart of fiscal discipline. Fiscal discipline is fundamentally an intertemporal characteristic; it cannot be achieved in a particular year but it must be respected year after year over the indefinite future. Under funding pressure, governments may resort to temporary measures presented as an emergency response to a specific situation. The response to this problem has been the widespread adoption of ‘medium-term budgeting’ whereby governments set their annual budgets within a multi-year framework that mandates that slippages be corrected over the planning horizon.

These various gaps, along with the unavoidable reliance on political systems to adopt and then respect fiscal arrangements, reflect a fundamental contradiction presented in Section 2.5. They explain the tendency observed over past years to adopt more constraining arrangements in the form of rules or to seek to delegate to independent council the task of combating the deficit bias.

2.3 Rules-based solutions

Fiscal policy may be subject to numerical rules. IMF (2009) reports that 80 countries have adopted one sort or another, and often several fiscal rules. Such rules come in a bewilderingly wide range of types. The most frequent ones stipulate upper limits on the budget balance, or on the debt, or on spending, or lower limits on tax revenues. Combinations of the limits are frequent as well. Some rules apply year by year, others define limits over several years, sometimes over the entire

business cycle or over the duration of a government. Some are national while the European Monetary Union's Stability and Growth Pact is supranational.⁷ Rules may be seen as the definitive but rugged solution to endemic fiscal discipline. By putting the budgetary process in a straightjacket, fiscal rules impose a desirable outcome. This view is deeply misleading for several reasons.

First, as the old debate on rules *vs* discretion has long shown, rules can be counterproductive. By limiting the range of possibilities, contingencies may arise that would make any rule very costly. The financial crisis, which has led to debt increases of some 30 per cent of GDP, is a case in point.

Second, any rule must include escape clauses to deal with unforeseeable contingencies. As a consequence, the precise design of rules becomes of the utmost importance. The presumption is that rules should be simple in order to be understood by policymakers and citizens alike, but flexibility is bound to come at the expense of simplicity. A good example is the case of a balanced budget rule. Strictly applied, the rule has a procyclical bias. In order to avoid procyclicality, and possibly to encourage countercyclicality, the rule must target the budget over a whole cycle or be stated in terms of a cyclically adjusted measure. Since business cycles cannot be predicted, the rule can lose much of its meaning, although solutions have been proposed, as discussed below. Cyclical correction is more art than science and is not easily comprehended by the public at large.

Third, any rule can be manipulated. Budgets are forward-looking and rest therefore on assumptions about economic and financial conditions over the next fiscal year. In addition, data come from the government, the agent that the rule seeks to constrain.

Fourth, the democratic legitimacy of the fiscal rule can easily be challenged. A government can fairly easily convince public opinion that today's circumstances are special and that technocratic arrangements should stand in the way of serving people's interests. The experience so far includes countless examples of rules that were easily set aside when they were effectively constraining the government as they should. One example is the US Gramm-Rudman-Hollings deficit reduction law of 1985. The annual deficit targets were raised in 1987 when they proved too difficult to meet. Another example is the Stability and Growth Pact, which was put in abeyance in 2004 when it affected the Euro Area's two largest countries, France and Germany.

Fifth, rules only work if noncompliance is sanctioned with a high degree of uncertainty. In democracies, however, only voters can sanction their governments, unless they violate the law. But then the law must be written in precise enough terms to face powerful challenges, which runs against the simplicity principle. Worse, laws can always be changed.

This all implies that fiscal rules are unlikely to be a panacea and this is indeed what the evidence suggests. This is a key message from Kopits (2001), Guichard *et al.* (2007) and IMF (2009). Debrun and Kumar (2007) estimate the impact on fiscal rules on the primary budget balance and report some evidence that they are effective, although the evidence is not overwhelming. This may be because rules differ widely in their details. It may also reflect that the political and institutional context matters, much as is the case with the arrangements discussed in the previous section. Another interpretation, suggested by Debrun and Kumar (2007), is that the evidence may suffer from reverse causality, namely that disciplined governments may wish to adopt rules as a way of signalling their determination.

2.4 Independent fiscal policy councils

Fiscal policy councils – sometimes called fiscal councils or agencies – are a particular case of fiscal institutions. Their mission is to internalise the conflicting claims of interest groups. Their remits can vary from just 'telling the truth' to deciding on the budget balance. In the earlier case, the council is intended to call public attention to potentially misleading information about the budget. Its role is then to be an official watchdog, at the same time benefitting from official recognition and providing unbiased views. Their usefulness is entirely dependent on the influence that they can exert on policymakers and, upstream, on interest groups who can feel restrained. In the latter case, councils are intended to fully solve the common pool problem, but decide on the budget balance before policymakers set the remaining parameters of the budget: the level and composition of public spending, and the level and composition of tax revenues. Intermediate arrangements are possible. For example, the councils may be formally consulted to evaluate government forecasts of spending and income, which are based on forecasts of variables such as GDP growth, inflation, the interest and exchange rates, and so on. Their own forecasts may be for mandatory use budget planning or simply produced for advisory purposes.

In order to deal with the deficit bias, fiscal policy councils must be effectively free from influence by the interest groups at the source of the common pool problem. They must also be independent from governments and parliamentarians who may not be free from such influence. They must also have enough competence and credibility to disagree with governments that have at their disposal large staffs of highly qualified budget specialists. Their competence is based on the council members, or on the professional staff, preferably both. Obviously, they must have full access to all the information relevant to the budget process.

Until now, there has not existed any fiscal policy council with the power to decide on the budget balance. As discussed in Wyplosz (2008), the idea faces considerable resistance from policymakers who consider that democratic principles mandate that only elected officials can decide all aspects of fiscal policy. Similar arguments used to be opposed to proposals that central banks ought to be independent institutions. Quite clearly, only elected officials can take decisions that imply a redistribution of income or wealth, and this includes first and foremost public spending and taxation. The budget balance, in and of itself, is no more redistributive than monetary policy, which affects inflation, interest and exchange rates, all of which have (limited) redistributive effects. At any rate, the rejection of fiscal policy councils with decision power is universal and determined.

On the other hand, councils with advisory roles have become frequent in recent years. Calmfors and Wren-Lewis (2011) list eleven independent councils with advisory or non-binding control roles in developed countries.⁸ Debrun *et al.* (2009) report that similar councils have been set up in other developed or emerging-market countries (Japan, Chile, Indonesia, Jordan, Korea, Mexico). Several international institutions, including the IMF, the OECD and the European Commission, have recommended the establishment of such councils.

The literature on the design and effectiveness of fiscal policy councils has become sizeable recently, providing a reasonably clear picture of the experience so far. Country studies, for example Calmfors (2010), IMF (2005) and Debrun *et al.* (2009), suggest that these councils can have a favourable impact, but only if they are allowed to make normative, quantified statements. This, in turn, depends on the willingness of

policymakers to allow for such statements to be made publicly and, when this is the case, to follow the advice. One lesson from past experience is that the political costs of not heeding such advice are very limited.⁹ It should also be noted that fiscal policy councils are usually established as part of a broader effort at dealing with fiscal discipline; as a result, it is often not possible to disentangle their specific contributions to fiscal discipline. In addition, because most fiscal policy councils have been established recently, or because they differ considerably in terms of remits, means and make-up, the empirical evidence on their effectiveness remains tentative.

A fair conclusion is that advisory fiscal policy councils have made a tangible contribution to fiscal discipline in countries where policymakers have shown a willingness to listen to them, which is why they created them in the first place. Elsewhere, the councils provide useful analyses and viewpoints but their recommendations are frequently ignored.¹⁰ Like fiscal rules, advisory fiscal policy councils are not a panacea.

2.5 A fundamental contradiction

In many ways, the foregoing analysis is depressing. The deficit bias is an inherent feature of most democratic systems. Solutions exist but they have only limited effects and the reasons why they sometimes work and often fail remain murky. At the same time, the European debt crisis shows that complacency is both commonplace and lethal. The measures taken since May 2010 have clearly failed to stop the rot and may have contributed to worsening the situation.

There is a good reason why it has proved so difficult to deal with the common pool problem; solving the problem requires that those primarily responsible for it will also willingly remove it. Policymakers that see it in their best interests to give in to the myriads of special interests that do not wish to pay for what they receive are reluctant to change the game. Solving the problem requires constraining policymakers to the point where they no longer provide the favours that they are asked to grant, or that they raise taxes to pay for those favours, both of which options they believe will cost them (re)election. Under strong market pressure, governments may develop the will to internalise the common pool externalities but members of parliaments do not have the cohesion that (some) governments may work out. Quite logically too, interest groups that have organised themselves in order to benefit successfully from state largesse have no incentive to unravel the situation.

This contradiction implies that it will take unusual circumstances to trigger the adoption of solutions. Most of the time, this will be acute market pressure, often leading to the need to apply to the IMF for a rescue. In Europe, the adoption of a common currency could have played a positive role, and it did lead to the adoption of the Stability and Growth Pact. Unfortunately, the Pact's design is flawed (see von Hagen and Wyplosz, 2008) and the successive efforts at improving it have failed to come to grips with the original flaws.

While crises offer unique opportunities to undertake politically difficult reforms, the chance is often lost. Part of the reason is that the measures adopted in the midst of a crisis are of an emergency nature, seeking immediate results – typically, cutting the budget deficit – dealing with the symptoms – the deficits – rather the deeper cause – common pool externalities. Even though the IMF has now championed the use of rules and institutions, its emergency programmes are ill designed to promote structural reforms. Even when governments seize the opportunity of a crisis, they often push through solutions that are incomplete and bound to fail. The reason is probably that they are loath to challenge the interest groups and hope that limited changes are acceptable to them. In fact, as previously noted, most of the successful adoptions of adequate solutions occur after debt stabilisation, when governments want to solidify their reputations as deficit-fighters and pass their determination on to succeeding governments.

The current situation offers a glimmer of hope. The slowly spreading contagion in the Euro Area is instilling fear into many a government. The step increases in public indebtedness make it clear that the years of complacency are over. Whether this will be enough to overcome the contradiction remains to be seen. But the opportunity should not be wasted by adopting solutions that will not work.

2.6 Rules and institutions

The main conclusion reached in Section 2.4 is that independent fiscal councils are unlikely to be the solution. They could be highly effective if they are given the power to set the budget balance, mimicking the role of independent central banks in setting and reaching the inflation target, but policymakers have displayed acute aversion towards this approach. Advisory councils have been established in several countries and they typically provide important and high-quality information. Yet they seem mainly to convince the faithful and can be overlooked when they are politically convenient.

The key advantage of councils is that they can exercise judgement and aim at outcomes that make sense. Their task is the complicated one of combining long-run discipline with short-run responsiveness to ever changing conditions. This is a difficult task that necessarily involves trading-off conflicting objectives. As a consequence, fiscal policy is more art than science, which means that the recommendations are always controversial. Those who do not like the recommendations will always find ways of undermining them, and the institution's credibility. The only possible response is to make it clear that the policy recommendations follow clear principles. Here again the parallel with monetary policy comes to mind. Central banks frame their actions within sets of principles that, even if they do not command unanimity, come to be seen as valid and acceptable guides. The logic of principles-based guidelines naturally links up with rules.

Rules are useful precisely because they describe what should be done – or should not be done – in precisely described situations. However, a message from Section 2.3 is that rules cannot be absolute and must include safety clauses. Because these clauses cannot be fully contingent, there will always be unforeseeable instances where the rules are ill conceived. In such an event, the rules must be adapted or softened, but adjustments in the midst of unusual circumstances stand to undermine the rule itself. It would then greatly help if agents who cannot be suspected of being influenced by interest groups give their blessings to rule adjustments. Rules naturally link up with independent councils.

It thus follows that the choice may not be between institutions (i.e. fiscal councils) and rules. Each arrangement stands to benefit from the other. Independent councils clearly need to be seen as guided by rules set by law, but they should have the authority to bend the rules in unusual and unforeseen circumstances. In principle, rules should be based on as many contingencies as possible but simplicity is a key ingredient in order to make rules broadly understood and accepted. Deferring to independent councils to re-interpret rules when needed allows a combination of simplicity and flexibility. Independent councils are unlikely to overstep their prerogatives with too frequent or controversial rule adjustment because they stand to lose their credibility, which is their *raison d'être*.

The remaining question is whether combining rules and institutions stands a chance of being effective. Hallerberg

et al. (2004) argue that fiscal rules and independent councils are a form of delegation and that delegation only works when the government is run by a coalition of parties. The argument is that delegation is part of the agreement (implicitly or publicly) worked out by the parties so that renegeing is likely to lead to a breakup of the coalition. A single party government, on the other hand, can easily decide to push aside politically inconvenient constraints. The question is, then, whether it would be as easy to dispense with an arrangement that is written into law, possibly in the constitution. In the absence of experimentation and empirical evidence, it is easy to be sceptical and observe that some countries have a tendency to elect governments that are serial debtors. Given the absence of any better alternative, experimentation is clearly desirable.

3. The case of the Euro Area

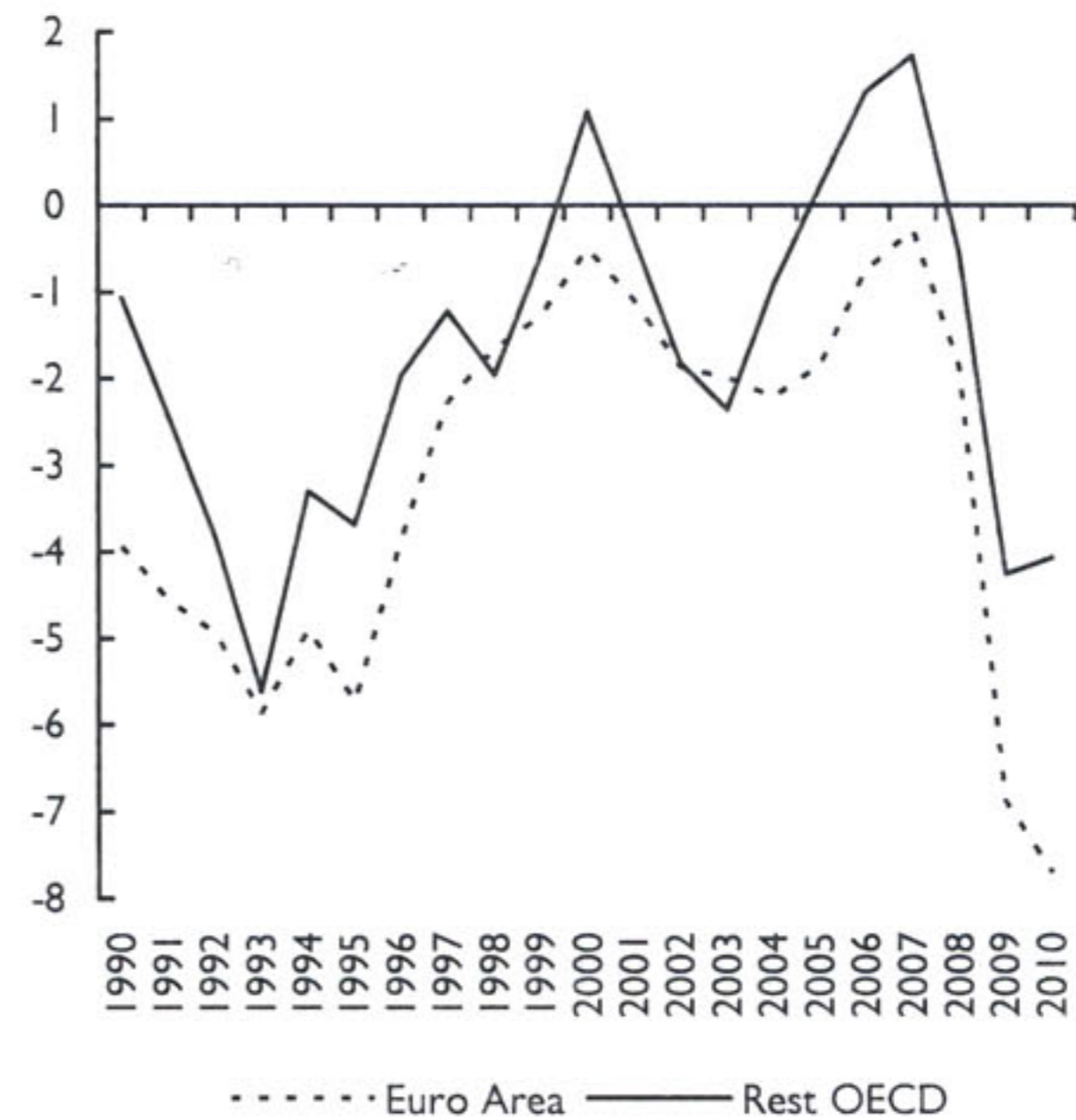
3.1 The additional contradiction

As far as fiscal discipline is concerned, the Euro Area is not doing well. Figure 2 shows that since 1990, on average, budget outcomes have been worse in the countries that are currently members of the Euro Area than amongst the other OECD countries. Strikingly this is even true during the 'convergence period' 1996–8 when each country had to pass the Maastricht entry criterion of a deficit of less than 3 per cent of GDP (the 60 per cent debt target was in effect not actively considered). Somehow, on average, the Euro Area member country fiscal arrangements are not effective at dealing with the common pool problem. Evidently, the collective solution, the Stability and Growth Pact, has not made a significant contribution either; after 1999, average deficits are higher in the Euro Area than in the rest of the OECD.

The contradiction outlined in Section 2.5 suggests that it will not be easy to lessen the deficit bias in the Euro Area. This may be the reason why the post-financial crisis sovereign debt crisis has started in the Euro Area and, so far, has remained contained therein. It may also be that the financial markets are concerned with another contradiction, which is specific to the Euro Area. The European Treaties declare national fiscal discipline as a matter of common concern (art. 121) but they also recognise that fiscal policy is not a shared competence, so that it remains a matter of national sovereignty.

The approach of the Stability and Growth Pact has been to ignore the second contradiction and use collective

Figure 2. Budget balances (per cent of GDP)



Source: OECD, *Economic Outlook*.

Notes: Unweighted averages of national budget balances.

peer pressure as an antidote to domestic interest group pressure. This may have had some effect in some smaller countries where external pressure is perceived as important, but it has largely failed in the larger countries and in a number of smaller countries. The simple fact is that the Stability and Growth Pact cannot override decisions made by independent states. It can impose sanctions, but member governments may choose to pay fines – if they ever get imposed – and ignore the pact's injunctions. This is the main, quite possibly the only, reason why the Stability and Growth Pact has not worked.¹¹ Furthermore, the creation of the European Financial Stability Fund (EFSF) further implies that, when faced with the consequences of fiscal indiscipline, a delinquent country may expect a bailout whose value may well exceed the cost of the fine.¹²

In fact, the demise of the no-bailout clause amounts to creating a second common pool problem, this time among member countries which can bet on passing some of their debt burden on to other countries (Krogstrup and Wyplosz, 2006). Strengthening the pact by extending its remit and making sanctions more likely can be seen as a response to the additional common pool problem but, at least as currently planned, the response ignores the second contradiction and is therefore unlikely to achieve its aims.

3.2 Externalities: myths and reality

It is often taken for granted that membership of the Euro Area necessarily entails restrictions on national fiscal policies. The Treaty is highly ambiguous on this issue; in fact it is self-contradicting as explained in the previous section. The view that fiscal policies must be coordinated, or even shared, must be backed up by the existence of externalities whereby one country's indiscipline has detrimental effects on some other countries. Given the sensitivity of the issue, these externalities must be sizeable. There seem to be two valid and two unconvincing (or small) arguments.

The first unconvincing externality concerns the interest rate. One view is that rising public borrowing leads to interest rate increases; in a monetary union, this affects all other countries. The empirical literature notoriously fails to report a significant impact of fiscal policy on domestic interest rates, especially in small and financially integrated countries.¹³ The textbook explanation for the lack of evidence is simple; a small country takes the foreign interest rate as given or, to put it differently, a small open economy is unlikely to affect the world interest rate. Quite clearly, the Euro Area is well integrated in the world financial markets and its member countries are probably all too small for their borrowings to have a noticeable impact on international interest rates. If it exists at all, this externality is most likely too small to matter and this is why it goes undetected. It may well be that a particular country's interest rate rises because of market concern about a default risk (or an exchange rate risk outside of a monetary union), but then this is not an externality.

The second and more cautious, but still unconvincing view, focuses on a situation of market concern. At crisis time, this channel implies the risk of a contagion. Indeed, we have seen contagion within the Euro Area since early 2009, but the reason is not yet ascertained. It could be a European version of the Tequila effect, the spread of the Mexican crisis to many Latin American countries in the 1980s, or from Thailand to other East Asian countries in 1997–8. This is a case of multiple equilibria, whereby countries that share similar vulnerabilities can be lumped together by highly concerned markets. If that is the case, the second best answer is the elimination of the vulnerability, in Europe's case the deficit bias. Another interpretation is that markets came to see the absence of exchange rate as a highly complicating factor that concerned all Euro Area countries with large debts. However, interest rates

did not rise for all national debts of Euro Area member countries. As previously noted, the only countries that were affected were those perceived to have a most serious deficit bias problem; solving this problem is therefore the best policy response.

A more convincing externality is the setting-up of the EFSF. The resulting removal of the no-bailout clause has established a link among Euro Area member countries. This is the second common pool problem already described in Section 3.1. This externality can and should be removed by re-establishing the no-bailout clause (assuming that it can be done credibly, see below).

The last externality concerns the common monetary policy. Obviously, any impact of deficits and debts on the monetary policy is an externality. Because the ECB's independence is an essential element of the agreement to share a common currency, any threat to this independence must be considered as a critical requirement. Indeed, the need to shield the ECB from government pressure has been very clearly and explicitly stated in the Treaty. This is why it has been commonly considered that the ECB is "the most independent central bank in the world". The sovereign debt crisis is challenging this conclusion.

The channel for this challenge is the familiar policy dominance issue, whether at the end of it all fiscal policy can constrain monetary policy – the case of fiscal policy dominance – or whether central banks can always remain free of interferences from the budget – the monetary policy dominance case.¹⁴ The importance and depth of this issue is easily overlooked. Formally, it arises from the consolidated intertemporal budget constraint of the public sector, which combines the constraints of the government and of the central bank. As a part of the public sector, the central bank cannot fully extricate itself from potential violations of the budget constraint because the inflation tax is one way through which markets may bring into line the real value of the public debt and the government's ability to service it.

This is a fairly abstract concept and it may seem irrelevant in a monetary union. Indeed, one country's debt crisis is unlikely to be the source of Euro Area-wide inflation. Yet, we have seen the ECB undertake to buy troubled debts outright, pretty much against its practice and, it would seem, its initial intentions. The ECB bowed to pressure from its member governments, ostensibly to avoid contagion and a financial meltdown.

It is very likely that such events would have led to a depreciation of the euro and, therefore, to inflation pressure within the entire Euro Area. If this interpretation is correct, then fiscal policy can dominate monetary policy even in monetary union. This possibility may explain why the ECB has always been so sensitive to fiscal indiscipline among member states.

In conclusion, the interest and contagion externalities are fairly convincing and, if anything, the response is fiscal discipline. The removal of the no-bailout clause may have created a new externality in the form of an international common pool problem within the Euro Area. Threats to the ECB independence may be exaggerated but they are ominous. Establishing fiscal discipline must be an essential ingredient of the Euro Area.

3.3 *The decentralisation solution*

The collective need for state-level fiscal discipline is often seen as implying a centralised control of member state budgets, hence the Stability and Growth Pact. This is not a logical imperative. Measures to counterbalance the deficit bias can, in principle, be achieved either through a transfer of competence to the collective level or equally well directly through the member states themselves. This choice is ignored in policy debates although decentralisation of fiscal policy and the associated responsibility for discipline are natural in federal systems. This is so even though Europe is not even a federal system. At best, the sharing of the common currency can be seen as a step towards a federal arrangement, but certainly not a centrally controlled arrangement. The most natural outcome would seem to be first to operate a loose federal arrangement, which of course can evolve over time toward more centralisation as all federal systems do.

A centralised solution to the deficit bias would represent a major change, one that would bring the European Union a step closer to a political union. It is worth recalling that a political union was explicitly identified as an objective in the Maastricht Treaty. It would require devolving some effective authority to the European Commission or another institution in controlling national budgets. One question is whether governments and public opinion are ready for such a step. There is no evidence that this is the case. Even though many of the decisions taken since the bailout of Greece in May 2010 can only be understood as an attempt to move in that direction, using the crisis as a

tool to pry open a door that has been tightly locked so far, but public opinion in many countries is displaying opposition to this evolution.¹⁵

Another question is who would exercise the power to be transferred. The European Commission would be a natural recipient but a number of hurdles arise. First, the arguments presented in the previous section indicate that collective fiscal discipline is a requirement for the Euro Area, not for the European Union as a whole. As long as a significant number of EU states are not in the Euro Area, it would be difficult to give the latter authority over the budgetary matters of the former. Since we would also need some parliamentary oversight, the European Parliament would be equally ill designed for the task.

In contrast, decentralising the task of dealing with the deficit bias seems more natural and more feasible. It accepts the fact that fiscal policy is and will remain for a long while an element of national sovereignty. It does not require the creation of new institutions at the Euro Area level. On the other hand, it rests on the ability of individual countries to adopt arrangements that stand to deliver fiscal discipline. The next section develops a few concrete suggestions.

4. A proposal

The decentralised solution must meet three requirements: 1) the solution to the national common pool problem calls for robust and well-adapted national arrangements; 2) each country must be held responsible for achieving fiscal discipline and therefore bear the consequences for failing to do so; 3) the international common pool problem justifies some collective oversight of national solutions. The first implication means that the Stability and Growth Pact must become a decentralised system. The second implication requires that the European Financial Stability Fund and its successor, the European Stability Mechanism, be scrapped. The third implication means that member states must seek collective approval of their arrangements.

The key step involves the adoption by each Euro Area member country of budgetary arrangements designed to deliver fiscal discipline on a permanent basis. The national arrangements are expected to differ to enhance adequacy to each country's history and political institutions. Still, there can be some generic features. The arguments presented above support the idea of

combining rules and independent fiscal councils. The details of the rules as well as the composition of the councils can be left to each country's preference. However, the rule must guarantee that public debts will be rolled back steadily over the foreseeable future, until debt ratios are reduced to, say, less than 60 per cent. The independence of the fiscal councils must also be guaranteed by adequate high-level legislation.

The second step involves the formal reaffirmation of the no-bailout clause. The current wording sounds explicit, but apparently not explicit enough to stand in the way of the May 2010 bail-out to Greece and the creation of the EFSF, now expected to be replaced by a permanent EMS. The plan to create the EMS must be scrapped and the EFSF should be allowed to stop functioning as initially planned.

The third step concerns the collective oversight of national arrangements. If every country achieves fiscal discipline by solving its own common pool problem, the international common pool problem will be solved *ipso facto*. This creates a strong reason for an effective oversight arrangement. Of course, given the restoration of full national sovereignty, a decentralised solution cannot be imposed from outside. The solution must rest instead on incentives, first concerning the adoption of national arrangements and then the supervision of the functioning of these national arrangements.

Each country would submit to the Commission the proposed legislation concerning its fiscal rule and the establishment of its independent fiscal council. The Commission would then examine the proposal and decide whether to validate it. In addition, a European independent fiscal council would be established. Its remit would be to follow the work of the national fiscal councils. The European council could censure national councils that fail to operate with sufficient precision. It could also, and this is likely to be the most frequent occurrence, relay critical observations made by national councils regarding fiscal policy. Failure by a country to have its proposal validated by the Commission would entail the refusal by the ECB to accept as collateral bonds issued by the government. The same sanction would be imposed when the Commission, acting on a report by the European independent fiscal council, determined that a country was not abiding by its commitment. Such a decision would probably significantly raise the cost of borrowing for the delinquent country. Jointly with the reaffirmation of the no-bailout clause, this would provide strong incentives for prompt remedial action.

NOTES

- 1 Previous contributions making a similar argument are von Hagen and Harden (1994), Wren-Lewis (1996, 2003), Eichengreen *et al.* (1999), Wyplosz (2001) and Calmfors (2003).
- 2 See Persson *et al.* (1987).
- 3 Among the developed countries, bank crises have occurred in the Nordic countries in the early 1990s, but not again in 2007–8, as a lesson had been learnt (Jonung *et al.*, 2009). The US underwent the Savings and Loan crisis in the 1980s and, of course, the Subprime Mortgage crisis in 2007, showing that the lesson had not been learnt.
- 4 A recent survey of recent changes is IMF (2009).
- 5 For a somewhat dated survey of existing arrangements, see OCED Economic Outlook 72.
- 6 See, among others, Alesina and Perotti (1999), Auerbach (2008), Fabrizio and Mody (2006) and Hallerberg *et al.* (2004). Note that this ambiguity does not extend to the level and composition of public spending and taxation, see Kontopoulos and Perotti (1999) or to risk premia, see Hallerberg and Wolff (2006).
- 7 Both African monetary unions and the East Caribbean monetary union also operate supranational fiscal rules.
- 8 These committees are in Austria (Government Debt Committee established in 1997), Belgium (High Council of Finance, 1989), Canada (Parliamentary Budget Office, 2008), Denmark (Economic Council, 1962), Germany (Council of Economic Experts, 1962), Hungary (Fiscal Council, 2008), Netherlands (Central Planning Bureau, 1947), Slovenia (Fiscal Council, 2010), Sweden (Fiscal Policy Council, 2007), the UK (Office for Budget Responsibility, 2010) and the US (Congressional Budget Office, 1975).
- 9 More worrisome in the case of Hungary where a fiscal policy committee was set up in 2008 only to be all but dismantled a couple of years later when a new government came to power. Note that the new government has such a majority that it could have achieved its aims even if the details of the committee's remit and means were cast in hard law.
- 10 In 2011, the newly elected Hungarian government has effectively dismissed the committee set up by its predecessor.
- 11 See Ayuso-Casals *et al.* (2007).
- 12 Officials argue that the interest rates charged by the EFSF are penalty rates. In fact, they are much lower than the market rates on the secondary market. Countries resort to borrowing from official sources (the IMF, the EFSF) when they cannot borrow from financial markets, which means that the market interest rate is quasi-infinite. And an official loan is therefore a subsidy, in the sense that the interest rate is below the market rate.
- 13 A recent study is Aisen and Hauner (2008).
- 14 A classic reference is Canzoneri *et al.* (2001).
- 15 There is a huge difference between a temporary loss of sovereignty and a permanent one. When a country is under an IMF programme, arguably many policy decisions are no longer taken exclusively locally. Once the programme is over, however, sovereignty is fully restored. The Stability and Growth Pact, on the other hand, is a permanent regime that aims at constraining national decisions.

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