FISCAL RULES: REASONS AND EVOLUTION

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Abstract

The fiscal rules' framework is presented in a simple and logical manner, considering the reasons for their implementation from different perspectives. Thoughtfully analysing the specific literature, the importance of an appropriate design for fiscal rules is underlined, and the arguments for rule compliance are identified. The current situation of fiscal rules practice and application is mentioned and analysed.

Keywords: economic policies, deficits, fiscal reform

JEL Classification: E62, H30, H6, H87

1. Introduction

The main body of specific economic literature suggests that fiscal rules may constrain the policy makers' behaviour, resulting in better management of deficit and debt. While fiscal rules framework is different across countries, it brings into attention the costs for monitoring and the issue of asymmetric information, the relation between the policy makers and voters and markets.

Expansionary policies before elections and unappropriated allocation for spending can produce deficit and debt prejudice. The issue of economic policies manipulation before the elections and the evolution of electoral business cycles and lately fiscal cycles are presented in Ciumara and Lupu (2015).

Linked or not with the electoral cycle, the time inconsistency issues are producing shortcomings for fiscal imbalances improvement (the promised adjustments are not respected due to different economic or political circumstances). Another example of reasons that induce deficit and debt issues is the distribution of costs and benefits among groups of interest and generations (Alesina and Drazen, 1991; Cukierman and Meltzer, 1989).

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In the specific case of a monetary union, the deficit and debt issue of one member country can endanger the entire union by adding supplementary costs for financing and instability (Detken et al., 2004).

Considering these premises, the article continues the analysis of fiscal rules, and mentions the reasons for adopting fiscal rules in section 2 and identifies the types of fiscal rules and will describe their trends in section 3. The sections 4 addresses the subject of fiscal rules design, while the section 5 presents the final remarks.

2. The reasons for introducing fiscal rules

The general explanation for introducing fiscal rules is that by doing this, the governments' behaviour is restricted, assuring the public and the markets that future policies will conduct to sound public finances. The sustainable and stabilizing fiscal rules should limit the discretionary measures and also decrease the uncertainty about future policies.

After the recent economic crises, appeared numerous budgetary problems, including fiscal deficits and public debt increases and as a result, a commonly agreed solution appears at the international level – short and long term fiscal measures. In the last years were discussed and implemented numerous fiscal and financial policies intended to help the economic recovery and protect against contagion (a presentation of the theoretical perspective of contagion is presented by Lupu, 2012).

While fiscal rule are increasingly in fashion, their efficiency is not yet addressed in many papers (Bergman and Hutchison, 2014). More research in this area will help to identify mistakes in designing fiscal rules and introduce another generation of rules, smarter and more adequate, combining the discipline with flexibility.

The deficit bias is fathomed in the literature, Persson and Tabellini (2000) offering a large presentation and Wren-Lewis (2011) suggesting the reasons for their existence. Wyplosz (2011) underlines the two main reasons – proclivity towards impelling the fiscal burden to future administrations or generations and the interface between democracy and interest groups actions. The "common pool" issue is often discussed, including here the problem of moving the debt burden for the future and spending more than revenues, in a context with heterogeneous voters.

Another reason for introducing fiscal rules is to avoid the pro-cyclicality. As presented by Cespedes and Velasco (2014), in emerging and developing countries, we find more pro-cyclical fiscal policies, although in the last years many emerging countries succeeded to step out form this category (Frankel et al., 2011). Bergman and Hutchison (2014), after analysing 81 economies over the period 1985-2012, concluded that the introduction of fiscal rules, together with government efficiency may decrease the pro-cyclicality, and, at particular extent may even entail counter-cyclical reactions.

3. Types of fiscal rules and their evolution

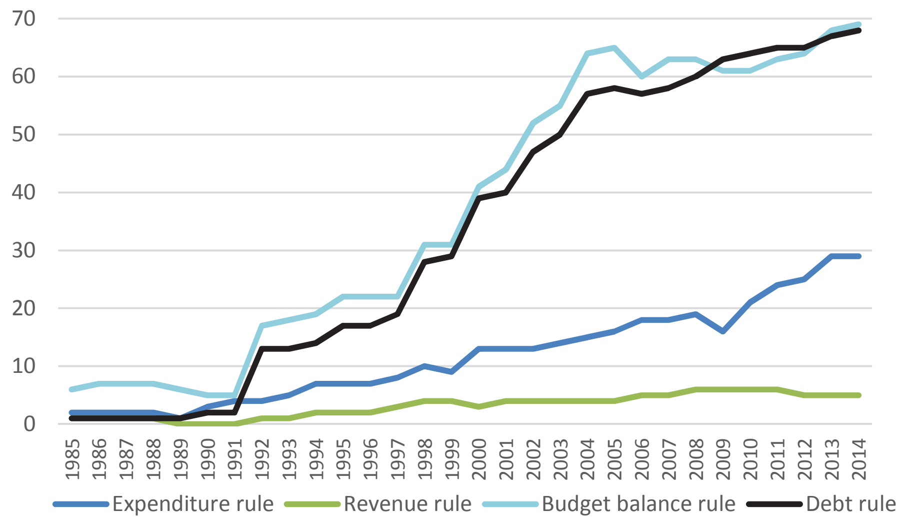
The forms that fiscal rules can take are various, starting with numerical rules or procedural rules for the budget process, budget balance, and public spending or revenues. The numerical fiscal rules, including ceilings and targets for budgetary aggregates, usually impose some long term (at least three years) obligations for the fiscal policy.

The numerical fiscal rules can target a debt limit or a budget deficit limit, including structural budget balance. As presented by Schaechter et al. (2012), in a simple form, these rules are facile to communicate and easy to monitor, usually with explicit medium and long term guidance, but with the possibility to support pro-cyclicality. From another perspective, the numerical limitation can set targets for expenditure or revenue (volume, intervals or percent of other economic indicators). Although these types of rules have positive influence on the economy, they do not directly support the debt sustainability, and the revenue rules can conduct to pro-cyclicality

In time, the number of countries using numerical fiscal rules has been rising continuously. From a total of 89 countries taken into analysis (using IMF Fiscal Rules Dataset, 2015), at the end of 1980's there were only few countries (considerable less than 10 for each type of rule) using numerical limits for fiscal policies. In 1985 (the first year for which data is available) there were six countries using budget balance rules (Australia, Germany, Indonesia, Japan, Malaysia and Singapore), two countries using expenditure rules (Australia and Germany), one country using revenue rules (Australia) and one debt rule (Malaysia). It is worth to mention that Australia (that had in 1985 three types of rules in place and four types in 2014) had a period between 1989 and 1997 with no type of numerical rule in place.

Figure 1

Number of countries using different types of national and supranational numerical fiscal rules, 1985-2014



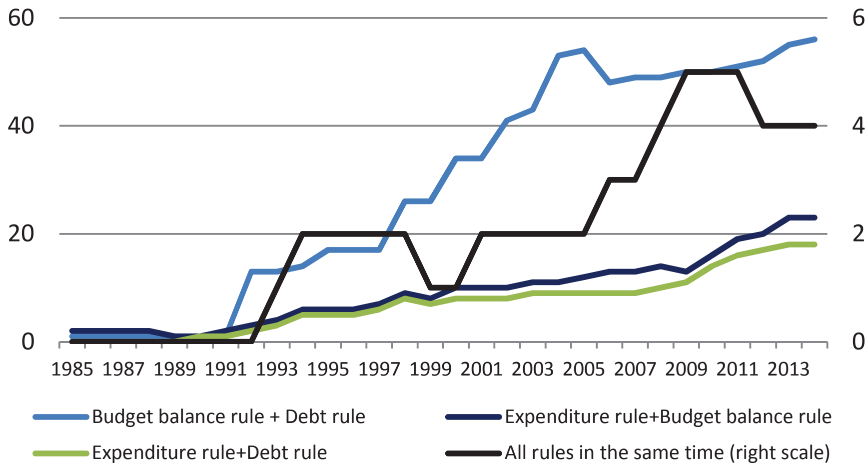
Source: author's calculations, using IMF Fiscal Rules Dataset, 2015.

In 1992 is noticeable a strong increase of the number representing countries that use fiscal rules, especially the number of countries using budget balance rule (from 5 in 1991 to 17 in 1992) and debt rule (from 2 in 1991 to 13 in 1992). From then, the increase was intense, at least for these two types of numerical fiscal rules, the number of countries that introduced at least one of these fiscal rules being 69 for budget balance rule and 68 for debt rule. The number of countries using revenue rule is a modest one, remaining even in 2014 lower than 10 (5 countries were using this type of rule in 2014, while the maximum number of countries was 6).

The numerical rules are used quite often in combination, with the intention to reduce the negative effects of a specific rule; on the other side, multiple targets raise the complexity of the fiscal policy and sometimes are even incompatible one with each other. The most used combination of rules is the budget balance rule with debt rule (56 countries using it in 2014). The expenditure rule is often used together with budget balance rule (23 countries having it in 2014) or with the debt rule (18 countries in 2014). The revenue rule (a rule that is not so frequent as previously showed) is mostly used with all other rules together; between 2009 and 2011, 5 countries used all the rules in the same time (Australia, Denmark, France, Lithuania, Netherlands), this being the maximum number in the analysed period. Between 2012 and 2014 the number of countries that applied all 4 rule in the same time decreased to 4, Denmark renouncing to use the revenue rule.

Figure 2

Number of countries using at least two types of national and supranational numerical fiscal rules in the same time, 1985-2014



Source: Source: author's calculations, using IMF Fiscal Rules Dataset, 2015

Knowing the limitations of the numerical rules (Kydland and Prescott, 1977) that may be arbitrary or suboptimal, another option for improving the fiscal policy is the introduction of a well-designed fiscal institutions type of rule (or procedural fiscal rules). This category of fiscal rules may refer to an increasing transparency of fiscal policies, by creating conditions for a better monitoring that may be imposed through a Fiscal Responsibility Law.

4. Designing fiscal rules. The need for simple and clear fiscal rules and rule compliance

The issue of choosing between simple and more complex fiscal rules is also discussed in the literature. While simple fiscal rules are facile to monitor, their compliance is followed by market and public that may evaluate and sanction the deviations.

In order to have the public support and power for enforcement, the fiscal rule should be credible and fair from the economic point of view, existing in the specific literature pros and cons for what to include or exclude from the targets. A broad economic coverage is desired for countries where are many quasi-fiscal activities that can put additional pressure on sustainability of the fiscal policies. Besides this, the quality of the fiscal policy may be influenced by a proper design of the fiscal rules, respecting the specific needs of the countries.

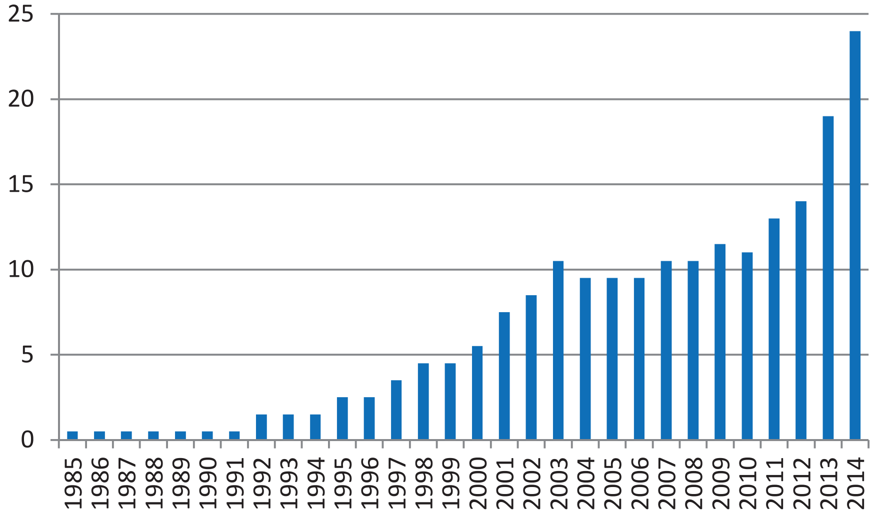
There is another debate in literature sustaining the idea that “soft lows” enhance transparency (diminishing the political transaction costs) and became “self-enforcing” if they are appropriately projected, helping to avert from large policy deviations (Schuknecht, 2004). Moreover, is it considered to be a first step in a learning process, before implementing a “hard law”.

The implementation of the fiscal rules may be impaired by the commitment’s deficiency or the use of non-reliable data and frequent forecast errors. As already mentioned, some rule may lead to pro-cyclicality. The cyclicality issue was addressed in some countries (or economic unions) by adopting some fiscal rules that provide for cyclically adjusted targets, including here structural or cyclically adjusted budget balance targets.

According to IMF Fiscal Rules Dataset, the European Nordic countries are using this type of rule that allow to account for cyclicality starting from 1990’s and until now, Denmark introducing it in 1992 and Finland in 1995 (with a short period between 2011 and 2012 without cyclically adjusted rules). Sweden and Norway inserted such rules in 2000, respectively 2001, and United Kingdom in 1997. A special case is Germany that is accounted in the IMF fiscal dataset with 0.5 rules for the period 1985-2009 because it was in force an escape clause for situations that affect the macroeconomic equilibrium, but starting with 2011 it was introduced at the national level a fiscal rule accounting for the cycle. Most of the countries that use this category of rules are European, the number of countries using them increasing after 2010, when the European sovereign debt crisis started. Among countries that introduced cyclically adjusted fiscal rule we find few from South America: Chile (from 2001), Colombia (from 2011), and Peru (from 2014).

Figure 3

Number of countries using fiscal rules that allow for cycle adjustments at national level, 1985-2014



Source: author's calculations, using IMF Fiscal Rules Dataset, 2015

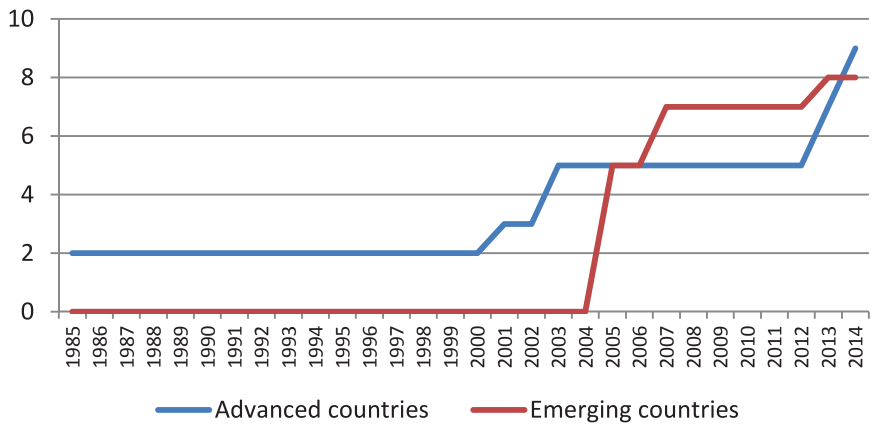
There are authors that consider the need for more complex rules, the level of complexity depending on countries' specific economic and institutional features. These more complex rules should consider particular situations or differences for good and bad periods from the economic point of view.

Another way to adapt the fiscal policy to specific or exceptional cases is to accept different exceptions for rule compliance. While in some extraordinary cases like natural disasters, economic recessions or other situations outside the government control, the escape clauses are generally accepted in the literature (with clear definitions of such situations, voting process and guidance for interpretations and adjustment towards the normal), there are some censurable forms like change in government or in budget coverage.

At least at national level, the countries that usually apply escape clauses are especially advanced economies; the number of emerging economies that introduced escape clauses increased after 2004.

Figure 4

Number of countries with well specified escape clauses at national level, 1985-2014



Source: author's calculations, using IMF Fiscal Rules Dataset, 2015

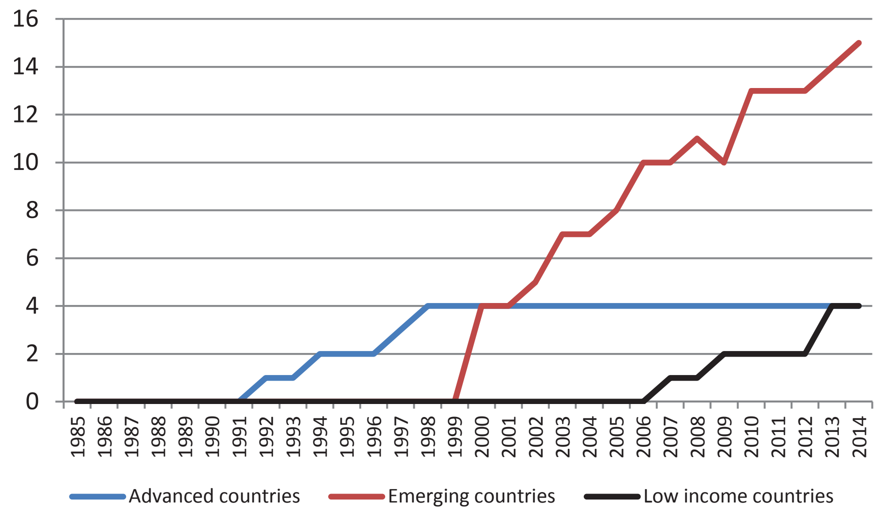
A proper and timely reporting regarding the budget process is essential for a better external monitoring of rules' compliance. In this sense, starting with 1990's, it was mentioned in the literature the suggestion to create at national (and European Union) level independent fiscal councils with the role of independent assessment of fiscal performance, constraining the rules compliance (von Hagen and Harden, 1994; Wyplosz, 2002; Fatas et al., 2003).

Even in some countries the fiscal countries had only an advisory role, the reputational cost may affect policymakers when the fiscal policy does not comply with the rules. This action is visible and brings some constraint.

In some countries, the need to assure the implementation of the fiscal rules or procedures was supported by introducing Fiscal Responsibilities Laws that are more frequent in emerging countries than in the advanced economies. The reasons for less attractiveness of these regulations in the advanced countries are represented by the existence of good legislations for the budget process that are appropriate and effective and also the already introduced supranational rules, especially in the case of European Union.

Figure 5

Number of countries with Fiscal Responsibility Laws by economy type, 1985-2014



Source: author's calculations, using IMF Fiscal Rules Dataset, 2015

As observed by Lienert (2010), many countries from Latin America have adopted Fiscal Responsibility Laws, but in general they are not directly targeting fiscal transparency. Fiscal stability and fiscal rules are the main subjects of this kind of law in this region.

Although the rules imposed by the law support a stabile fiscal framework for a longer period of time and are not facile to change, they are adopted harder and are not always effective if not sustained by enforcement mechanisms and institutional responsibility.

5. Final remarks

The evolution of fiscal rules and their current distributions and special features accounts for the fact that every country needs a specific design, based on country's economy and institutional settings. The design of the rules for one specific country or union should reflect the objectives that are intended to be achieved, in a well-established flexible or inflexible manner based on exceptional events or cyclical adjustment, and in line with the other macroeconomic policies.

In order to obtain a good result, the rules should be accompanied by procedures and responsible fiscal institutions, while assessments made by independent monitoring bodies can improve transparency and credibility.

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