Fiscal Spending Rules in Europe

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A workshop on Fiscal Spending Rules hosted by the Austrian Government Debt Committee in cooperation with the Oesterreichische Nationalbank (OeNB) on September 29, 2005, explored two major issues: First, whether national fiscal rules that tie in with the EU fiscal framework can help sustain sound fiscal policies in Europe, and second, what aspects must be taken into consideration when designing such spending rules. Additionally, contributors presented two proposals for the implementation of fiscal spending rules in Austria.

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Interest in rule-based fiscal policies aimed at sustaining sound budgets and curbing debt growth has steadily increased in recent years, as *Josef Christl (OeNB)* pointed out in his introductory statement. For the EU Member States, fiscal rules were first established by the Maastricht Treaty in 1992 and subsequently substantiated and strengthened by the Stability and Growth Pact (SGP). The EU-wide fiscal framework has established reference values for the government deficit (3% of GDP) and debt (60% of GDP). While the legal framework of the EU does not explicitly provide for any numerical budget commitments at the national level, empirical experience from several OECD countries would support the introduction of national rules along these lines (above all for capping public expenditure). Medium-term statutory spending caps at the national level would appear to be a workable solution for compensating free-rider and moral hazard problems that weaken the disciplining effect of fiscal policies in the euro area, and for counteracting the inherent tendency of policymakers to run up higher deficits. Given the weakening fiscal discipline of EU Member States, all measures to strengthen compliance with the EU's Stability and Growth Pact and the credibility of European fiscal policy are to be welcomed.

National Fiscal Spending Rules in the Context of the EU's Fiscal Policy Framework

The first session dealt with the effectiveness of, and the design requirements for, national expenditure rules that supplement the EU-wide fiscal framework.

Peter Wierts (European Commission) presented an empirical study he produced with coauthors on "National Expenditure Rules and Expenditure Outcomes: Empirical Evidence for EU Member States," which examined the effectiveness of such rules in EU countries with descriptive and statistical means. Wierts recalled that in recent years increasing budget deficits and spending overruns had characterized budgetary developments in EU countries. The national stability program updates that EU countries have to submit annually to the European Commission with data indicating the budgetary development of the current year and targets for the three years ahead show that actual public expenditure deviated significantly more from projected figures than public revenues. Hence, one might ask whether stricter controls of public expenditure in the form of national spending rules might not improve compliance with the stability programs – in other words, whether national spending tools might not be effective tools.

Wierts and his coauthors compiled a questionnaire to collect data about the tools individual countries use to

control public expenditure and developed a strength index on the basis of responses. In a next step, panel regressions were run to estimate the impact of these national fiscal rules on public expenditure growth and deviations from the spending projections of the stability programs. The questionnaire covered design principles (target, concept, coverage and time horizon of the fiscal rule), the institutional framework (legal force, enforcement and surveillance mechanism, competences of the finance minister, degree of independence of the controlling authority) and public awareness of the fiscal rule. The data collected were used to generate a strength index for fiscal spending rules. The authors found the United Kingdom and Sweden to have the highest score on this index, followed by the Netherlands, Finland and Denmark. The United Kingdom and Sweden have adopted numerical statutory targets; these targets impose binding annual public expenditure volumes for a medium-term horizon, are monitored by independent institutions and are endowed with correction mechanisms in the case of spending overruns. By contrast, multiyear spending targets that are not binding (like those set by Germany or France) were identified as "weak" fiscal rules.

According to Wierts, the results of the strength index corresponded to national experience with the effectiveness of spending rules. Countries with a low index typically considered their spending rules to have little impact on actual spending performance, whereas countries with a comparatively high score tended to qualify their rules as effective. Empirical analyses of the impact of medium-term budget rules on deviations from spending projections published in the stability programs or on actual spending also confirm that medium-term national spending rules typically contribute to dampening spending dynamics, and that these rules tend to be more effective the stricter the fiscal rules are. In concluding, Wierts stressed that non-compliance with the spending paths projected in the stability programs is not attributable to the weaker than expected economic performance in recent years. The negative regression coefficients for economic growth disprove the argument put forth by EU Member States that downward revisions of forecasts had necessitated higher spending.

In his comment, *Peter Mooslechner (OeNB)* noted that the numerous academic papers on this issue as well as practical experience with rule-based fiscal policies have produced highly mixed results. Furthermore, political economy and monetary policy teach us that the institutional framework is the determinant of effectiveness. While the authors had chosen innovative and impressive approaches to analyze the effectiveness of fiscal policy rules, the results were not conclusive. The econometric estimates clearly show that the impact of fiscal spending rules on the development of public expenditure and on the extent of budget overruns (compared with stability program targets) was very limited. Further weak points included the low significance of the estimates and the short observation horizon (1998 to 2003). Finally, the actual budget outcomes in the EU in fact discredit the effectiveness of fiscal spending rules: almost 60% of all EU Member States that apply such rules according to this study reported budget deficits of 3% or more of GDP in 2004 and 2005 – but of those EU countries that do not

apply fiscal spending rules less than 40% exceeded the budget limit of 3% of GDP.

Jürgen von Hagen (Center for European Integration Studies) focused on political economy aspects in his presentation on the effectiveness of fiscal spending rules. In his view, political and institutional structures or processes determine the fiscal stance more strongly than numerical rules. At the same time, the effectiveness of fiscal rules very much depends on the institutional framework. Spending caps as such are no guarantee for sustainable, sound budget policies. They can only be effective and promote fiscal discipline if they are integrated in an effective institutional framework.

Common pool models of public budgeting, to which von Hagen referred, presume that vested interests dominate the political process in a democracy. In pushing through their plans, vested interest groups consider only the costs and benefits for their own group but neglect the impact or external effects on other social actors. The common pool problem is thus a problem of coordination, and it arises in fiscal policymaking. While public spending programs benefit specific groups, they are tax-financed by the entire population. As the interest groups bear only part of the cost, they have a great incentive to place excessive demands on the budget. To be able to internalize such external effects, multiparty governments might be well advised, according to von Hagen, to adopt an approach that strengthens the political will to pursue sound budget policies, the fiscal contract approach. This political economy approach focuses on the budget process and underlines the importance of negotiating the budget with all cabinet ministers. The only way to arrive at a comprehensive economic view of fiscal policy measures is through negotiations. The effectiveness of the fiscal contract model hinges on the following factors: a binding commitment to the negotiation results (binding numerical spending caps for every minister), widespread competence of the finance minister with regard to budget implementation, a system of strong parliamentary surveillance, and a high degree of transparency. To conclude, von Hagen noted that empirical studies confirm the impact of a process-oriented institutional framework of budget preparation on fiscal discipline. Calculations analyzing the relationship between budget balances and the institutional framework (Index of Budgetary Institutions) have produced significant results with correlation coefficients of around 0.4.

In his comment, *Daniele Franco (Banca d'Italia)* focused on two areas: first, on empirical findings on the effectiveness of the fiscal contract approach and the Index of Budgetary Institutions developed by von Hagen, and second on conceptual issues of fiscal rules. Franco questioned the validity of von Hagen's country ranking based on institutional framework conditions, criticizing that it makes assessing the effectiveness of the fiscal contract more difficult. The construction of the index meant to measure the strength of a country's institutional framework was based on arbitrary valuation approaches. Any resulting country ranking thus strongly reflected the underlying methodology. Furthermore, the results did not imply a straightforward relationship between a country's institutional strength and its fiscal policy. Countries with a strong institutional framework according to the index, such as France, Germany or Greece, had repeatedly breached

the Maastricht deficit limit of 3% of GDP in recent years, whereas countries with low index values, such as Denmark or Finland, showed above-average budget discipline. Overall, the budget performance of EU Member States is likely to reflect above all the economic policy and, of course, country-specific factors. Franco also recalled that the European Commission had qualified fiscal spending rules as not very effective in its report "Public Finances in EMU" of 2003. In addition, Franco underlined that national fiscal spending rules were unsuitable as a substitute for the EU's fiscal policy framework. Fiscal rules embedded in a specific institutional framework tailored to national needs and subject to different forms of self-commitment (nominal or real upper limits, general government or regional government commitments) are not adequate for use as EU-wide targets, concluded Franco.

Fiscal Spending Rules for Austria

The focus of the second session was on two specific proposals for the implementation of fiscal spending rules in Austria.

Helmut Frisch (Austrian Government Debt Committee) presented a proposition developed with coauthors for a general government fiscal spending rule for Austria, namely a so-called debt brake based on a Swiss model; its purpose is to balance the budget over the business cycle. The rule provides for an annual spending cap which equals the sum of public revenues adjusted for a cyclical factor. Accordingly, public spending may exceed public revenues in economic downtimes, while it should be lower than revenues when the economy thrives. In other words, boom periods are meant to produce budget surpluses, while budget deficits are acceptable during recessions. This interaction contributes to stabilizing cyclical developments and the nominal debt, and to reducing the debt-to-GDP ratio over the business cycle. Such an approach makes it possible to distinguish between the cyclical component of the budget deficit (which is evened out over the budget cycle) and the structural component. The latter remains unaffected by cyclical developments and represents a permanent increase in debt.

Structural budget deficits or surpluses resulting from overspending or underspending as well as revenue forecasting errors are to be recorded in a balancing account. The structural deficit recorded in the balancing account must be cut back once it has reached a specific limit. The authors recommend the adoption of targets established by the EU as an upper limit. For Austria, this would imply an annual upper limit on the structural budget deficit of approximately 2% of GDP. Exceptional events (natural disasters, severe recessions) will not be taken into account for the debt brake calculations and should affect neither the spending cap of the debt brake nor the balancing account. Here, too, the proposal mirrors the concept of the EU's Stability and Growth Pact.

In his comment, *Peter Siegenthaler (Swiss Federal Finance Administration)* underlined above all the importance of fiscal spending rules for the consolidation success of Switzerland's general government. He briefly described the fiscal policy conditions that had led to the introduction of a debt brake in Switzerland in 2003 and emphasized the need for strict fiscal discipline. Given the burdens that demographic developments are anticipated to put on the budget in the foreseeable future demand, it is critical to ensure

adequate fiscal leeway. The big advantage a debt brake has over deficit rules is that it removes (consolidation) pressure from the revenue side and puts the focus on expenditure-side consolidation. To allow automatic stabilizers to take effect not only on the revenue but also on the expenditure side, it would appear advisable to exclude cyclically sensitive public expenditure, such as unemployment benefits, from the spending cap of the debt brake. The real challenge of the debt brake proposal for Austria, according to Siegenthaler, was its application to all levels of government. In Switzerland, the success of fiscal federalism hinged primarily on location and tax competition between individual cantons. Moreover, several cantons had put in place their own fiscal rules to ensure that sound public finances are established and maintained.

In assessing the expediency of implementing medium-term fiscal spending rules in Austria, *Gerhard Steger (Austrian Federal Ministry of Finance)* favored implementing a spending rule meant to complement the existing fiscal rules (EU fiscal rules including the SGP and the Austrian Stability Pact). Steger argued that the spending pressure inherent in the traditional budgeting process would necessitate a rule-based approach to spending decisions. This spending pressure reflects the friction between having to limit spending to clearly defined (groups of) recipients and having to tax a broad base to generate the required revenues, and also reflects the incrementalism prevailing in fiscal decision-making and the high significance of rigid spending categories that can be changed only at great political cost.

Steger presented a new fiscal policy framework for the federal government's budget, developed by a group of experts of all political parties represented in parliament, the Federal Ministry of Finance, the Federal Chancellery and the Court of Audit, which is scheduled to be enshrined in law with a federal constitutional act. This concept envisages a four-year fiscal framework that is binding for budget preparation and execution. The fiscal framework covers the major policy areas in which expenditures arise. The spending caps reflect both fixed targets and – in the case of cyclically sensitive expenditure – flexible, indicator-based targets subject to annual reviews and, if necessary, adaptations. Individual areas will receive more or fewer funds in line with broadly based targets (sustaining public finances, ensuring macroeconomic balance and gender mainstreaming). In the interest of an efficient use of public funds, not only the appropriation of public funds but also the envisaged outcome and efficiency of measures (performance budgeting) should be subjected to the parliamentary decision-making process. Linking input and output (or outcome) and using a flexible global resource framework has led to very positive results in pilot projects and should, as Steger sees it, considerably enhance the quality of public finances.

In commenting on this contribution, *Bruno Rossmann (Federal Chamber of Labor)* argued that spending rules should be given preference over fiscal rules based on the budget balance (deficit). Spending rules with a medium-term horizon left room for improving fiscal discipline in good economic times, allowed deficits in bad economic times (automatic stabilizers), and strengthened the credibility of fiscal policy. The weaknesses of deficit rules become manifest in the implementation of the EU's fiscal framework (convergence criteria, SGP): They lack

coordination mechanisms to counter asymmetric shocks and cause uncertainty about fiscal requirements in economic upturns (which leads to the promotion of a procyclical fiscal policy). Moreover, the EU had failed to integrate its Lisbon strategy in its fiscal framework. At the same time, Rossmann cautioned that spending rules may also have deficiencies. For instance, rules cast into stone might promote the procyclical behavior of fiscal policymakers and overly limit cyclically sensitive or investment expenditure. Steger's concept of a medium-term expenditure framework for the Austrian federal government did not extend to tangible methods for determining the spending paths. Indeed, economic experience did not provide for any clear-cut approach. Yet the economic assumptions underlying the growth path and the method used to set upper limits were of paramount importance for the success of such rules, i.e. for the effective control of budgetary expenditure.

The Relevance of Fiscal Rules for EU Budget Policymaking

The workshop concluded with a panel discussion on "EU Budget Policymaking: Do Sustainable Sound Fiscal Policies Require National Fiscal Rules?", following introductory remarks by *Klaus Liebscher (OeNB Governor)*. He noted that national und stability-oriented fiscal rules could contribute decisively to achieving sound public finances and complying with the SGP. Such rules would, moreover, enhance the credibility of fiscal policies in the euro area. From a monetary policy perspective, clear statutory fiscal targets at the national level that are in line with the SGP and above all call for budget consolidation when the economy thrives are highly welcome.

Karl-Heinz Grasser (Austrian Federal Minister of Finance) viewed national fiscal rules complementing existing EU rules as an indispensable tool for sustaining sound public finances. Grasser described the Austrian Stability Pact as a successful example of national budget coordination. At a broader level, though, it would take a comprehensive fiscal framework, based on top-down budgeting, balancing the budget over the business cycle and strict budget execution, to keep Austria's fiscal policymaking a success. At the time of the workshop, the finance ministry was in the midst of preparing a budget law reform meant to support a sustained, stability-oriented fiscal policy by focusing on expenditure targets. These reform efforts were aimed at a multi-year orientation of the budget, determining binding spending limits and stepping up performance budgeting.

Sepp Rieder (Vice Mayor of Vienna) discussed the government's challenge of meeting the rising need for funds (e.g. investment) while stabilizing the budget. Apart from the basic commitment to sound budget policies, Rieder recalled the need to remain flexible in the execution of budget plans to be able to respond adequately to cyclical developments. To this end, the fiscal framework must allow the required room for maneuver whenever the need arises without violating medium-term targets. Specifically, Rieder saw a need for extending the horizon of the Austrian Stability Pact. The stability targets should apply to the whole reference period so as not to limit the annual leeway from the outset. Such an approach should enable decision-makers to pursue a growth-oriented budget policy and not to limit fiscal

policymaking to a search for loopholes in the Maastricht budget framework.

Peter Siegenthaler (Swiss Federal Finance Administration) considered Switzerland's rule-based fiscal policy a necessary (but insufficient) precondition for sustainable fiscal policies. The introduction of the debt brake, with an approval rating of 85% established by referendum, was triggered by two fiscal asymmetries – the revenue intake is governed by the constitution, while all expenditure decisions only require simple majorities in parliament; cyclical revenue increases are spent rather than used to bring down the budget deficit. In combination with short-term and sustained spending cuts, this spending rule contributed to a rapid reduction of the structural deficit. Siegenthaler underlined the need for further structural reforms in dynamic spending areas (e.g. welfare and retirement provision) with a view to improving the quality of the budget and stabilizing the budget in the long run. The shift in the spending structure observed in the past two decades toward transfer payments (pensions, healthcare, other social benefits) and interest payments on outstanding debt came at the cost of growth-enhancing spending categories (capital formation, education). Rule-based fiscal policies are expected to retain the existing room for maneuver with a view to ensuring funding for the highly necessary comprehensive reform and growth agenda.

In the view of *Gerhard Schwödiauer (Otto-von-Guericke-Universität of Magdeburg)* the SGP supports an anticyclical budget policy by requiring Member States not to exceed a zero deficit over the medium term. He termed concerns that the SGP was an obstacle to adequate fiscal stabilization policies unwarranted. Compliance with the SGP ensured that deficits amassed during economic downturns would be offset by surpluses accumulated during economic upturns. Germany, however, had failed to achieve sufficient budget surpluses from 1998 to 2000 when the German economy was strong, thus laying the foundation for Germany's current fiscal troubles. The deficit rule underlying the SGP may create the wrong incentives, in the opinion of Schwödiauer. Both theoretical and empirical evidence tell us that anticyclical changes to taxes (tax cuts in economic downswings, tax increases in economic upswings) reduce welfare and growth. Consequently, fiscal policies on the revenue side should limit themselves to letting the automatic stabilizers of the tax system work but on the expenditure side should include anticyclical stabilizing measures that go beyond the in-built stabilizers. National spending rules could contribute significantly to implementing the requirements of the SGP, provided they were credible and binding. To be able to stop the debt spiral, Germany needs to implement fiscal adjustments, and most of all it needs to cut public consumption and social transfers (taking into account growth and employment effects).