

Under Threat Rules-Based Fiscal Policy **and** How to Preserve it

Xavier DEBRUN and Lars JONUNG | DG ECFIN Workshop:
Fiscal Rules in Europe: Design and Enforcement

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Disclaimer

The views in the paper are those of the authors and do not necessarily represent those of the National Bank of Belgium.

This paper

- ❑ Frustration with design and enforcement of fiscal rules:
 - ❑ FR unloved because... too complicated, too rigid, too flexible, noncredible, not enforced, unenforceable, unable to curb rising public debts... → RBFP under threat!
 - ❑ But are FR unlovable?
- ❑ Position paper (no theory, no empirics) guided by one question:
 - ❑ Can we escape current frustration with FR?
- ❑ Our answer: Yes we can (make rules great again)!
 - ❑ Culprit: presumption that rules must be enforced like a speed limit.
 - ❑ De-emphasize enforcement, leverage reputation (independent fiscal institutions).

Flow

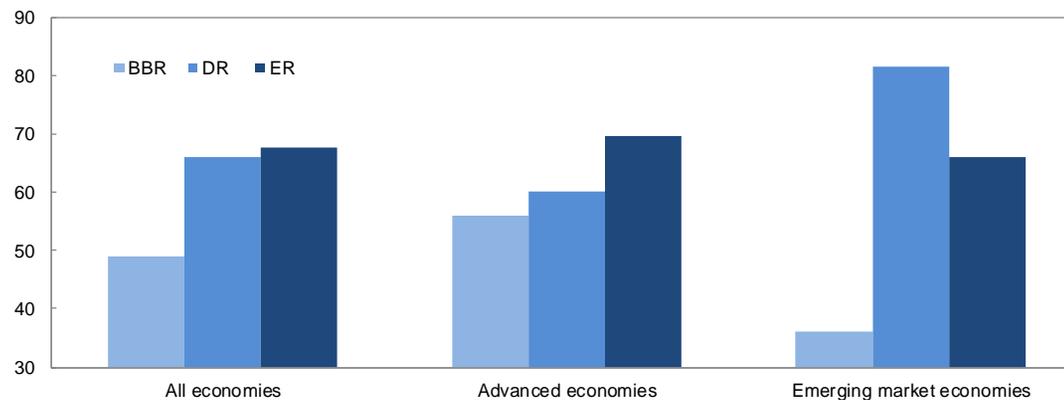
- ◆ Enforcement, compliance and effectiveness.
- ◆ Designing fiscal rules is hard → A trilemma → frustration
- ◆ Frustration → Specific threats to RBFP.
- ◆ No single rule is right all the time and everywhere:
 - ◇ Pick the rule that can work for you... and the menu is richer than you think, if only you let IFIs play a key role.
 - ◇ Have regularly scheduled reviews of rules.

Enforcement, compliance and effectiveness: Basic

- ◆ Rules vs discretion?
- ◆ In practice: no mechanical adjustment → constrained discretion.
- ◆ Concrete problem:
 - ◇ Find the optimal state-contingent rule? NO
 - ◇ Find practical arrangement taming the dark side of discretion while preserving the bright side of it.
- ◆ The paradigm so far: speed limit → caps must bind → enforcement (= act of compelling observance of or compliance with a law, a rule, or obligation.)
- ◆ Issues:
 - ◇ Who compels a sovereign? No cop.
 - ◇ $\Pr(\text{rule is stupid}) > 0 \rightarrow$ Optimal compliance $< 100\% \rightarrow$ flexible implementation of rigid rules.
 - ◇ More flexible rule requires stricter enforcement (Beetsma and Debrun, 2007).

Enforcement, compliance and effectiveness: Lessons

- ◆ Extreme enforcement options (fines, sanctions...) not credible, and unhelpful for sinners.
- ◆ Low formal compliance rates despite evidence of effectiveness.



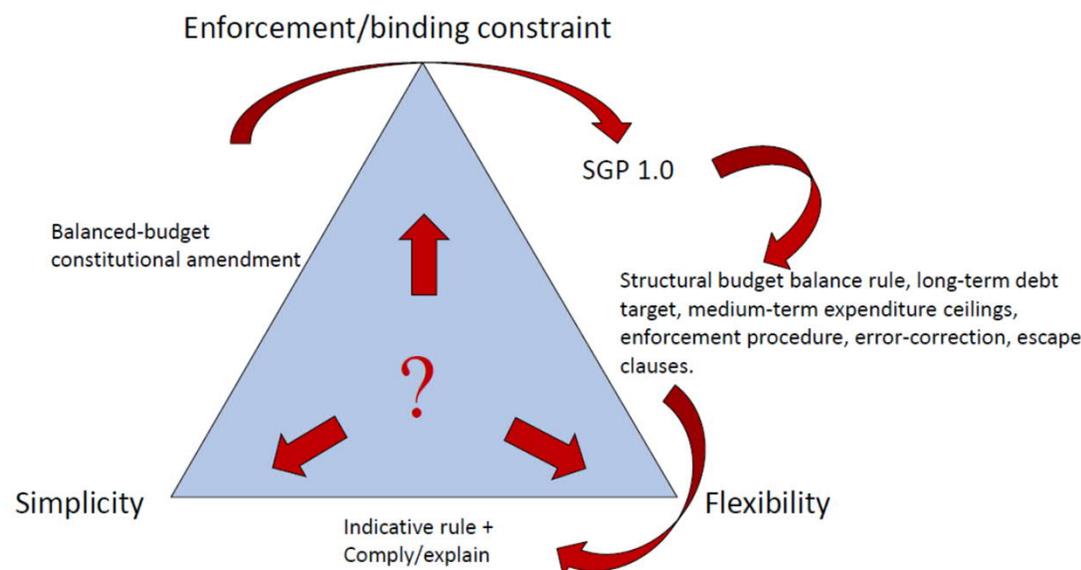
- ◆ Flexibility-enforcement nexus: reforms to make rules more flexible AND to strengthen enforcement.

Designing fiscal rules is hard

- ◆ Core Kopits-Symansky (1998) criteria for a good rule:
 - ◇ **Enforceable**: speed limit view (see also Buiters's [2004] Ten Commandments).
 - ◇ **Flexible**: contingent enough not to conflict with other policy objectives.
 - ◇ **Simple**: credibility requires clear guidance about future fiscal policy (=shape expectations).
- ◆ This is a **trilemma**: only two of three properties can be met simultaneously:
 - ◇ **Enforceable and simple**: Constitutional balanced-budget amendment.
 - ◇ **Enforceable and flexible**: The quest of the SGP in Europe.
 - ◇ **Simple and flexible**: indicative rules → Fiscal Taylor rules (Taylor [2000]).

Designing fiscal rules is hard

- ◆ Frustrating **struggle** with trilemma.
- ◆ Sedimentation process (**partial** reforms).
- ◆ Alchemy (Leeper, 2010) used to characterize exercise of fiscal discretion, now it describes the rules supposed to constrain it.
- ◆ Lesson from past experience: cannot get the rule right AND enforce it.
- ◆ Lessons for the future:
 - ◇ Try harder: internalize trade-offs better (IMF, 2018).
 - ◇ Consider uncharted territory if politics allow → FTR + IFI.



RBFP is under threat

◆ Interest rates at ELB:

- ◇ Public debt looks free → profligacy is in, prudence is out.
- ◇ Focus on BBR implies ELB dividends can be spent, including on non-reversible items.

◆ Low nominal growth:

- ◇ Secular stagnation story → Government must invest.
- ◇ Calibration of deficit caps must be revised.

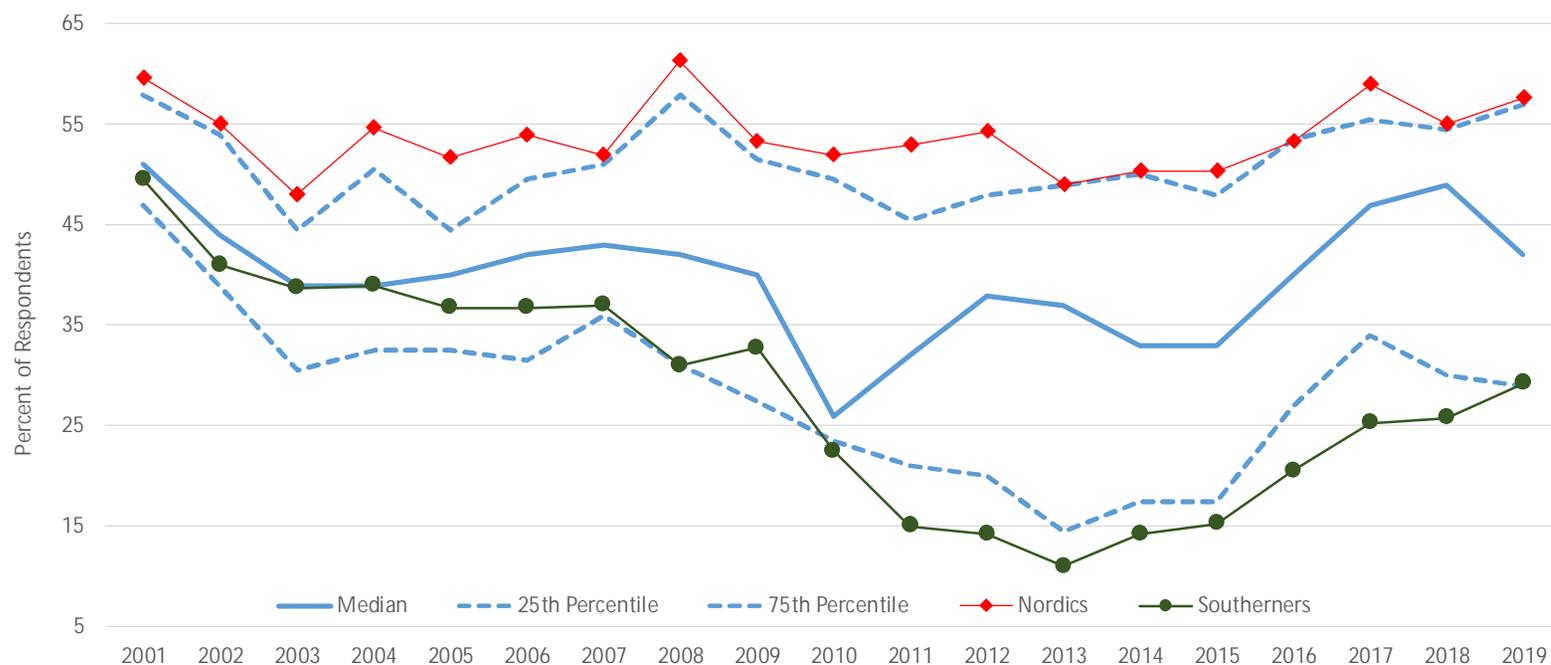
◆ Ricardian policy is out of favor → FP must do it all!

◆ Public fatigue with austerity → fading memory of crisis and misperception (rule means austerity).

◆ Deep factors (culture,...) → Institutional ecosystem unsupportive of enforcement.

Zoom in: Deep factors

- ◆ Country-specific attitudes vis-à-vis rules and compliance with them:
 - ◇ Trust in government's capacity to design and implement good rules → very persistent gaps across countries!

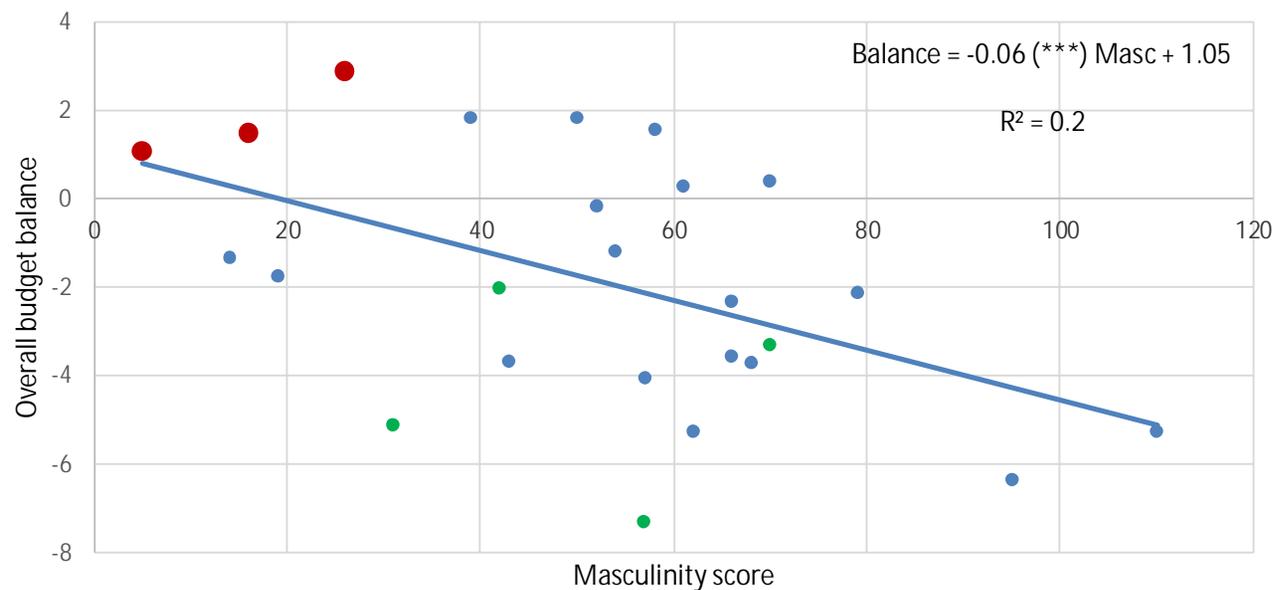


Source(s): Eurobarometer.

Countries Included: Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, The Netherlands, Austria, Portugal, Finland, Sweden, UK

Zoom in: Deep factors

- ◆ Why such persistence in trust?
- ◆ Does culture shape institutional soundness, trust in the integrity and effectiveness of government, and thus the likelihood of RBFP survival?
- ◆ Correlate average budget balances (2000-2010) with Hofstede et al.'s « Masculinity » scores (low score = society prefers cooperation and consensus building over assertiveness and individual competition).



Preserving RBFP

- ◆ In sum:
 - ◇ Rules have become complex and opaque → little guidance, difficult communication → credibility?
 - ◇ Challenging to design and calibrate.
 - ◇ Acceptance of constraint requires broad public support for the framework.
- ◆ Small reputational/political costs for governments to give up on rules or make them irrelevant.
- ◆ Way forward:
 - ◇ Assess the value of sticking to the enforcement (speed limit) paradigm → enforcement can leverage market discipline.
 - ◇ **If speed limit OK, then** holistic reform ameliorating trade-offs (IMF, 2018).
 - ◇ **If not:** strong IFI + indicative rule → maximize reputation effects and checks-balances.

What indicative rule?

- ◆ Emulate Taylor rule (broad description of appropriate policy patterns).
- ◆ Taylor (2000) proposes (again based on some rough empirics):

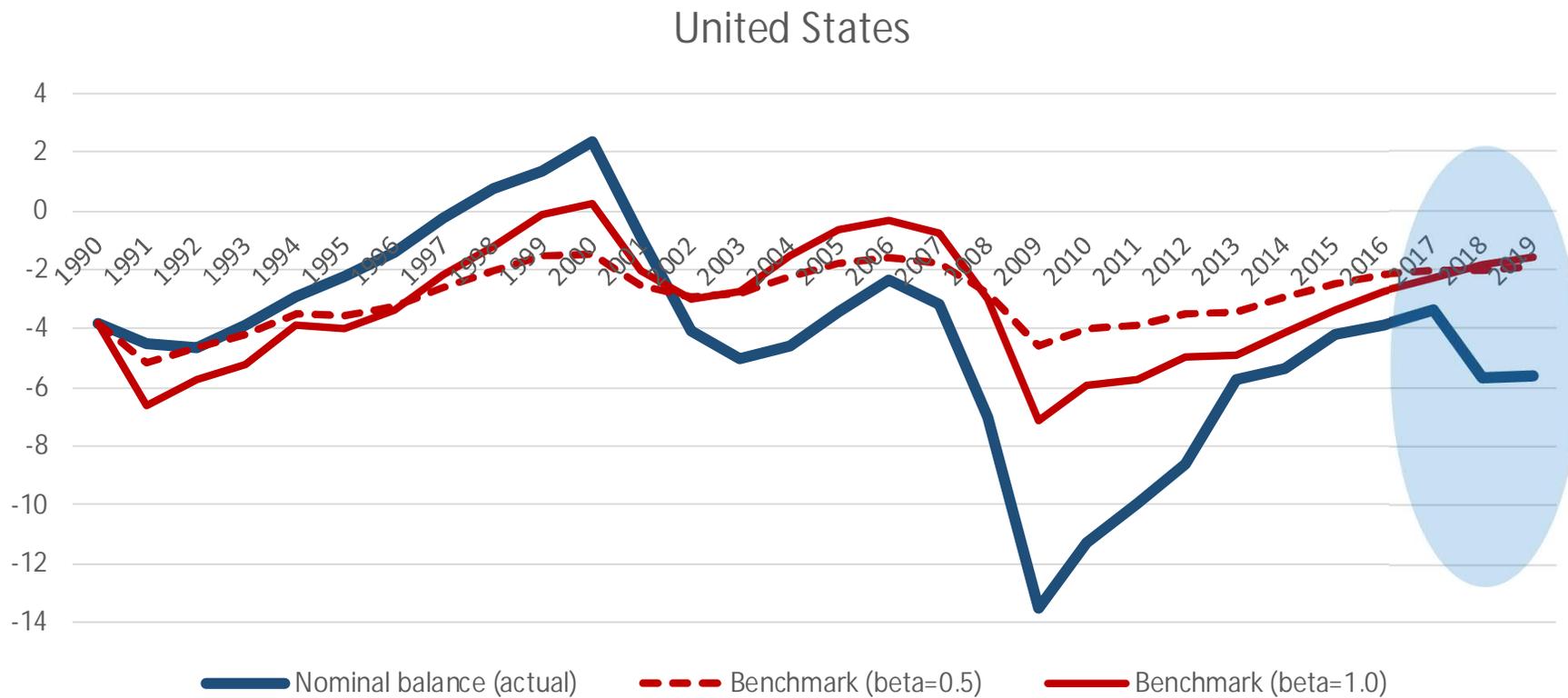
$$b_t = 0.5y_t$$

- ◆ We suggest:

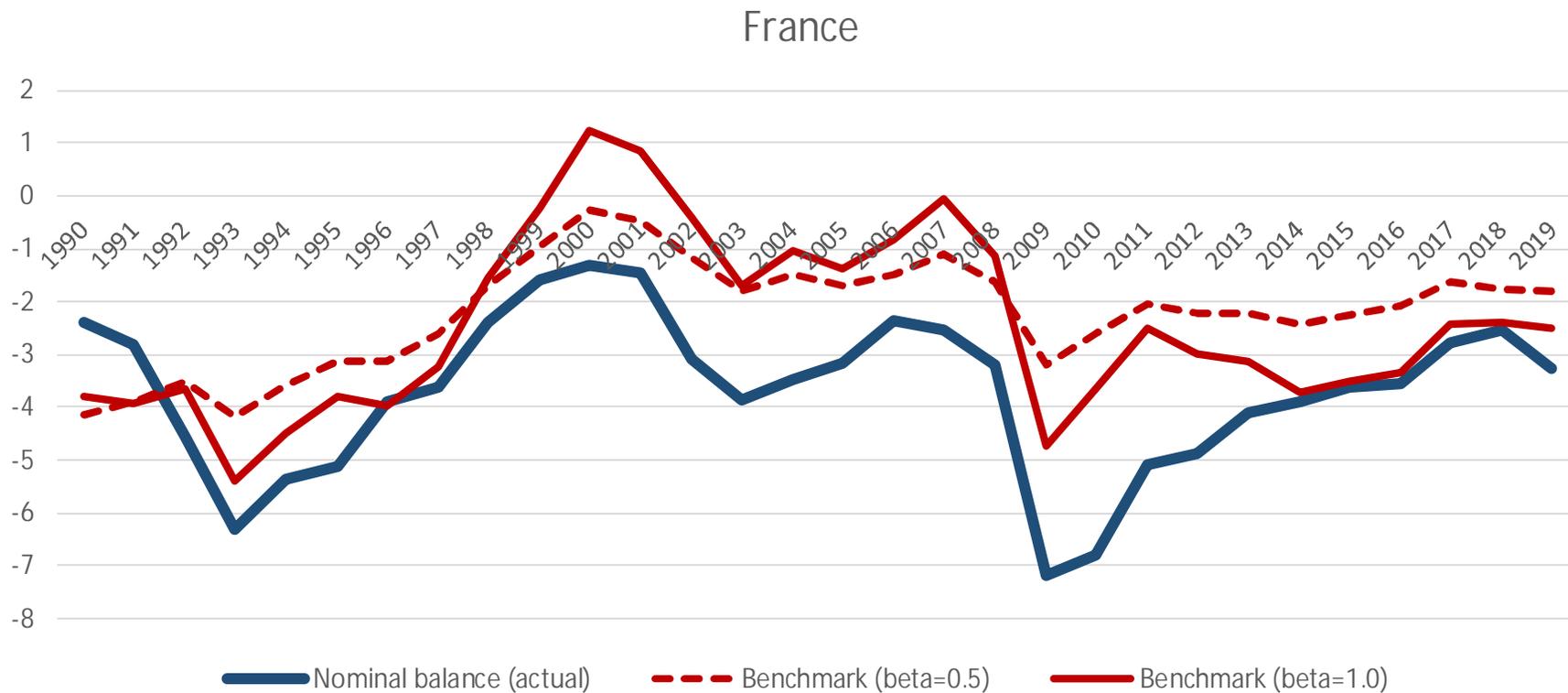
$$b_t = \bar{b}_t + \beta y_t$$

- ◆ The rule combines the debt and the macro stabilization objectives such that if \bar{b}_t is maintained in steady state, debt converges to 60 percent of GDP.
- ◆ Two options: ex-post vs real-time deviations from the benchmark.

Ex-post deviations: US

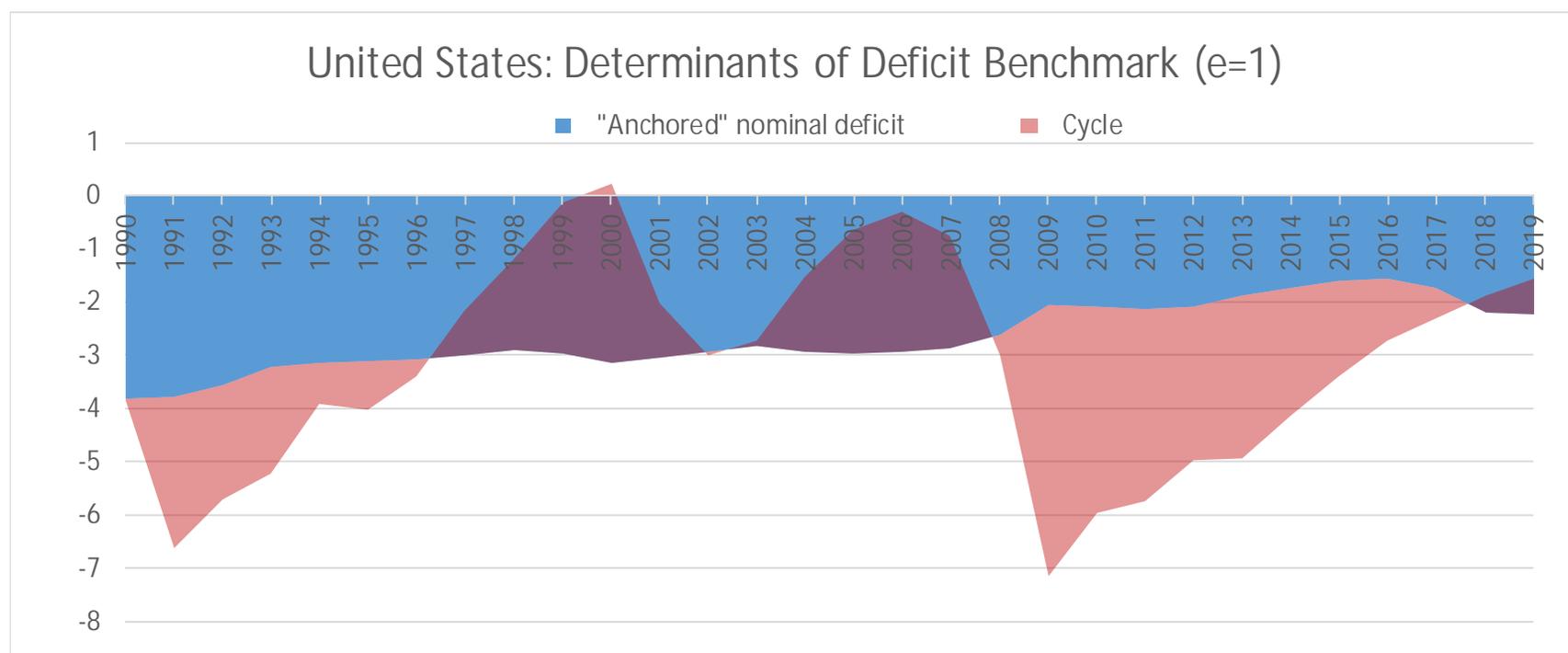


Ex-post deviations: France



Determinants of benchmarks

- ◆ Lower nominal growth and cycle.



Framework with FTR

- ◆ FTR can identify episodes of misaligned fiscal policies compared to explicit debt and macro stabilization objectives.
- ◆ Mandate IFI to define (and periodically review) benchmarks consistent with official policy objectives.
- ◆ IFI to publicly report on policy alignment with official policy objectives based on deviations from FTR.
- ◆ IFI given full independence to maximize reputational/political costs through public debate, and other stakeholders (parliament, civil society).
- ◆ Other FTR-styled proposals (e.g. Carnot [2014]: benchmark complementing existing rules); MTOs have the flavor of an FTR, but buried in a Pandemonium of indicators.
- ◆ In the end, constraints on discretion is always a mix of rules and institutions. They complement each other and they should both be well-designed and fully-owned. (Wyplosz, 2018)

Conclusions

- ◆ RBFP is under threat. Existential.
- ◆ Culprit is the speed-limit paradigm, which requires enforcement.
- ◆ Enforcement is:
 - ◇ Questionable (sovereign),
 - ◇ Leading to partial reforms and intractable complexity → loss of credibility → getting rid of RBFP is tempting.
- ◆ Make rules great again:
 - ◇ Holistic reforms improving on better known trade-offs (enforceability-flexibility, flexibility-simplicity,...) → IMF's 2nd generation mantra.
 - ◇ If enforcement is a problem, explore the uncharted waters of FTR cum IFI.