Fiscal Rules Versus Fiscal Discretions

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Summary:

This paper studies the fiscal rules and fiscal discretions in the context of fiscal stabilization policy. The study supports the need for complementarity of discretionary fiscal measures and the operation of automatic budget stabilizers. The last global economic crisis provides the necessary conditions for the empirical verification of this complementarity in EU member states. Analysis suggests that old EU member states employ stronger countercyclical discretionary fiscal measures at lower levels of automatic budget stabilizers. New EU member states, on the other hand, witness weaker countercyclical and even procyclical fiscal measures when automatic budget stabilizers are weak.

Key words: fiscal rules, fiscal discretions, automatic budget stabilizers

JEL Classification: E62, E61, E63, E32

1. Introduction

The rules versus discretion dilemma has been the object of increasing interest in the academia. The normative and empirical debates around the idea of rational expectations, the Ricardian equivalence hypothesis, and the expansionary fiscal consolidations spur considerable skepticism regarding the use of discretionary fiscal policy for macroeconomic stabilization. Moreover, the serious budget deficits and rapidly increasing government debt in many countries put the issue of fiscal sustainability in the foreground among political and economic circles. In this respect, various fiscal rules play an important role in managing public finances. Instead of presenting a general analysis of the fiscal rules, this paper concentrates more specifically on the fiscal rules related to the free operation of automatic stabilizers. The proponents of rule-based fiscal policy place the focus on automatic budget stabilizers as the principal means of mitigating cyclical fluctuations in aggregate economic activity and on the need of ensuring fiscal discipline.

In the wake of the last global economic crisis and the occurrence of substantial recessionary GDP gaps, however, the fiscal authorities in many countries implement temporary discretionary fiscal measures in the form of various fiscal incentives that aim at increasing macroeconomic activity. This raises the question of flexibility of fiscal policy and the interaction of fiscal discretionary measures and automatic budget stabilizers.

2. Fiscal discretions and procyclicality of fiscal policy

The mixed results of fiscal policy implementation and the relevant recognition, decision, implementation, and impact lags determine the dominant role of automatic budget stabilizers versus the limited role of fiscal discretions. Moreover, the presence of such lags raises the question: When the policy takes effect, will there still be the need for such impact?

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There are a number of problems with the politically-motivated fiscal actions. The literature on the subject is quite extensive and enjoys considerable interest. A good starting point is the work of Nordhaus (1975) on the political business cycle that has been later on embraced and further developed by other authors. While earlier studies in that field were primarily aimed at analyzing the opportunistic behavior with respect to the election cycle, the newer literature on political economy also takes into account the effects of various characteristics of the political system on the implementation of fiscal policy. The following are the main conclusions that can be drawn from the theoretical and empirical literature on politically-motivated fiscal actions:

- Opportunistic behavior assumes pre-electoral fiscal manipulations;
- The uncertainty of electoral results is related to the implementation of short term horizon policy;
- Most empirical studies demonstrate that before elections taxes decrease, while budget spending increases;
- Governments are more likely to pursue countercyclical fiscal policies in times of economic recession, rather than in times of economic boom;
- Electoral rules define fiscal behavior - plurality elections imply a greater fiscal focus on target programs, while proportional elections are associated with prevalence of broader programs.

All of the considerations above not only limit the ability of fiscal discretions to act as a tool for limiting macroeconomic fluctuations but also lead to procyclicality in fiscal policy. Empirical evidence shows that there are procyclical fiscal actions in a number of countries, particularly in times of economic surge - growth in discretionary spending, accompanied by reduction in taxes. This prevents accumulation of public resources in favorable economic times and limits the potential for countercyclical fiscal policy in the event of recessionary gaps due to problems with the sustainability of public finances. In this respect, procyclical fiscal policy in times of economic expansion leads to an increase in government debt during economic downturn when deficit increase is not offset by accumulated budget surpluses. The rapidly increasing budget deficit and public debt lead to substantially negative macroeconomic consequences - increasing interest rates, national currency depreciation, capital flight, pessimistic expectations, slowdown in economic growth, and subsequent turmoil in public finances.

3. Fiscal rules to prevent procyclicality

In order to avoid procyclical fiscal actions and to promote fiscal discipline, a number of countries introduce fiscal constraints. Some fiscal frameworks are predominantly associated with procedural rules for budget implementation, while others focus on fiscal rules based on exact numerical constraints on the budget. The two types of rules are generally considered complementary with procedural rules being a necessary condition for imposing numerical fiscal rules.

Fiscal restrictions allow for implementing discretionary policy measures as opposed to rejecting them. At the same time they set the requirement for fiscal discipline, thereby avoiding time inconsistency and lack of transparency of government policy. In that sense, the fiscal frameworks on the one hand lead to fiscal discipline, while on the other hand allow for flexibility under certain circumstances. This raises the question of how rigid the adopted fiscal rules should be and what characteristics they should have to ensure both efficient operation of automatic budget stabilizers and the necessary fiscal discretion when conditions for their implementation arise.

A number of economists outline different criteria to assess the "quality" of good fiscal rules. Most cited are the criteria proposed by Kopits and Symansky (1998). According to them, the optimal fiscal rules should be:

- clearly defined – in terms of the relevant indicators, institutional arrangements, and specific escape clauses, in order to avoid ambiguities and inefficiencies in their application;
- transparent – an essential characteristic that implies clear and overt government operations, including reports, forecasts, and institutional plans to limit the misrepresentation of facts and to increase "popular support";
- simple – fully and clearly understood by the public;
- flexible – adaptable to external shocks;
- adequate – in terms of the objectives pursued;
- enforceable – in that sense, they should be legally established, which implies certain sanctions for their violation and clearly defined authorities for their implementation;
- consistent – both with each other (internal consistency) and with other macroeconomic policies and policy rules;
- efficient – accompanied by effective political actions thereby stimulating fiscal reforms that ensure the sustainability of public finances.

These characteristics of fiscal rules represent a mix of economic and political criteria. Requirements 1,2,3, and 6 are to a greater degree political, while the remaining 4,5,7, and 8 are economic. It is difficult for each fiscal rules compilation to meet all requirements. There is also the possibility of some contradictions between them. Ultimately, some should be prioritized over others, establishing a certain balance.

Most economists agree that the fiscal restrictions should take into account the specific economic and political conditions in each country. The presence or absence of certain circumstances makes the implementation of one type of fiscal rule more appropriate than another. Fiscal restrictions should also comply with internationally accepted good practices in that field. This explains the wide range of fiscal rules applied in different countries and communities.[1] The fiscal frameworks include rules that target the level of actual or structural budget deficit, place ceilings on government debt, aim at balancing the budget over the cycle, and limit government spending and/or revenues. Some fiscal frameworks are unilateral and ensure the countercyclicality of fiscal policy only in times of economic recession, while others are bilateral and operate both in times of economic boom and recession. Moreover, in some countries there are specialized institutions that monitor, supervise, and assist with compliance to fiscal rules. In some cases, fiscal frameworks include rules not only at national, but also at sub-national and community levels.

Overall empirical results show that the fiscal rules are an important tool that contributes to fiscal discipline and improving the state of public finances. However, introducing fiscal constraints that ensure countercyclical fiscal policy is not an easy task. International studies show that fiscal rules based on numerical deficit ceilings have played little role in adjusting procyclical actions in times of economic expansion. Therefore unilateral fiscal frameworks are not a particularly effective tool for limiting the tendency towards deficits in the absence of political commitment to avoid procyclical fiscal policy during economic boom. This is why a number of studies demonstrate the need for bilateral fiscal rules.

[1] For a detailed description of the fiscal rules in different countries, see European Commission, Public Finances in EMU, European Economy 3, 2001; Kopits, G., Fiscal Responsibility Framework: International Experience and Implications for Hungary, MNB Occasional Papers 62, 2007

Many authors recommend that fiscal constraints be complemented by the establishment of specialized institutions. Their task is to draw independent macroeconomic forecasts that would serve as the basis for government budget development, assess the budget impact of policy measures, make fiscal policy recommendations, and ensure long-term fiscal sustainability and time consistency. Moreover, they assist in the accumulation of funds (primarily tax revenue surplus from cyclical expansionary phases) for financing any future countercyclical growth of budget spending to offset recessionary GDP gaps. In this way, these institutions support the countercyclical fiscal policy by avoiding growth of government debt. The success of such institutions depends on their transparency, independence, and credibility which are essential to avoid the risk of economically inappropriate use of the relevant funds.

The establishment of specialized institutions and the introduction of fiscal rules related to budget revenues have the potential to reinforce government commitment to saving additional revenue generated during phases of economic uplift. However, the implementation of budget revenue fiscal constraints is relatively less emphasized in institutional fiscal frameworks, while government spending restrictions are much more pronounced. Placing restrictions on the growth of budget expenditures is an effective means to prevent procyclicality of fiscal policy during expansionary phases and allows for a free operation of automatic budget stabilizers. Strong empirical evidence suggests that countries that have introduced budget spending constraints witness a more gradual growth of government expenditures, especially during phases of economic boom. In addition to restrictions on the maximum budget spending, there are also restrictions on the various types of spending. This allows prioritization of the different types with respect to their economic and social impact.

Scientific literature on fiscal rules also stresses the importance of implementing subnational rules. They are strongly recommended when a country faces the need for considerable fiscal adjustment that is impossible to achieve at central government level only and when there is lack of fiscal discipline of decentralized fiscal authorities. The necessity for implementation of subnational rules increases with the increase in fiscal decentralization. Subnational fiscal constraints should provide flexibility to asymmetric shocks in different regions.

Fiscal frameworks often include escape clauses. They allow for countercyclical action in times of weak economic growth or recession. Examples are the escape clauses envisioned by the institutional fiscal framework of the EU. Escape clauses, however, contribute to a more difficult implementation of fiscal rules and could undermine the credibility of the fiscal policy.

All of this demonstrates that the introduction of various fiscal rules aims at preventing fiscal policy procyclicality and at ensuring the sustainability of public finances. In this respect, the emphasis is on the need for guaranteeing fiscal discipline in the context of stabilization-oriented institutional framework. Therefore, proponents of rules-based fiscal policy call for moderate implementation of discretionary fiscal measures and prioritizing the role of automatic budget stabilizers.

The automatic budget stabilizers are a set of preconceived and established mechanisms to mitigate the output volatility over the economic cycle, which do not require any direct and explicit government intervention. They include all state budget components which automatically moderate fluctuations in macroeconomic activity by tax cuts and increased government spending during economic downturn and increased taxes and reduced government spending during economic boom. The automatic stabilizers are related to both business and personal taxes on the one hand and social transfers as unemployment benefits on the other. Considering the fact that they do not suffer from the recognition, decision, and implementation lags that often impair the timeliness and relevance of discretionary policy actions, policymakers that lean in the direction of fiscal rules rely predominantly on automatic stabilizers to counteract output volatility. In this regard, it is emphasized that the institutional fiscal framework should allow for the free operation of the automatic budget stabilizers.

4. Complementarity of fiscal discretions and the operation of automatic budget stabilizers

The adequacy of automatic budget stabilizers in exceptional circumstances has been questioned. While automatic budget stabilizers can provide the necessary countercyclical response in "normal" times, their capabilities are quite limited in the presence of strong recessionary gaps. The last global economic crisis is a striking example. It is the reason why a number of countries introduced discretionary measures in the form of various fiscal incentives to counter recessionary downturn and speed up economic recovery. Due to different macroeconomic conditions and priorities, individual countries used fiscal incentives packages that were different in terms of both size and types of measures. Regardless of the diversity of fiscal measures, the tendency is to strengthen the role of fiscal policy to overcome economic instability.

This demonstrates that discretionary fiscal measures and the operation of automatic budget stabilizers should be seen as complementary, suggesting a more pronounced role of discretionary fiscal policy at lower automatic budget stabilizers, and vice versa. To empirically verify this complementarity, the relationship between the strength of the automatic budget stabilizers and the change in the structural component of budget spending as a percentage of the GDP of EU member states, grouped by old (EU-15) and new (EU-13) member states, should be examined (see fig. 1).[2] A positive value of the change in the structural component is interpreted as expansionary fiscal policy, i.e. as indicative of the presence of fiscal incentives, while a negative value demonstrates a restrictive fiscal policy, i.e. lack of fiscal incentives.

The greatest positive changes in the structural component of budget spending are observed in Ireland, Denmark, Spain, Cyprus, Luxembourg, the Netherlands, Portugal, and Finland. Negative changes, on the other hand, are seen in Bulgaria, Czech Republic, Estonia, Greece, Latvia, Lithuania, Hungary, Malta, Romania, and Sweden. It is worth noting that expansionary fiscal measures on spending prevail and are more pronounced in old member states as compared to new member states. The average change in structural component of budget spending in old member states has a positive value at 1,4 p.p., while in new member states it has a negative value at -0,5 p.p. This indicates that, in general, fiscal policies in old member states are of expansionary nature, while fiscal policies in new member states are of restrictive nature.

With regards to the value of automatic budget stabilizers, the highest levels are seen in Belgium, France, the Netherlands, the United Kingdom and the Scandinavian countries, while the lowest levels are observed in Bulgaria, Latvia, Lithuania, Romania, and Slovakia. The data shows that the automatic budget stabilizers have relatively low values in new member states. The reason is that the strength of the automatic budget stabilizers depends on the progressivity of the tax system and the scale

[2] The strength of the automatic budget stabilizers is determined by the cyclical sensitivity of budget balance which in turn depends on budget revenue elasticity and budget spending elasticity versus GDP gap.

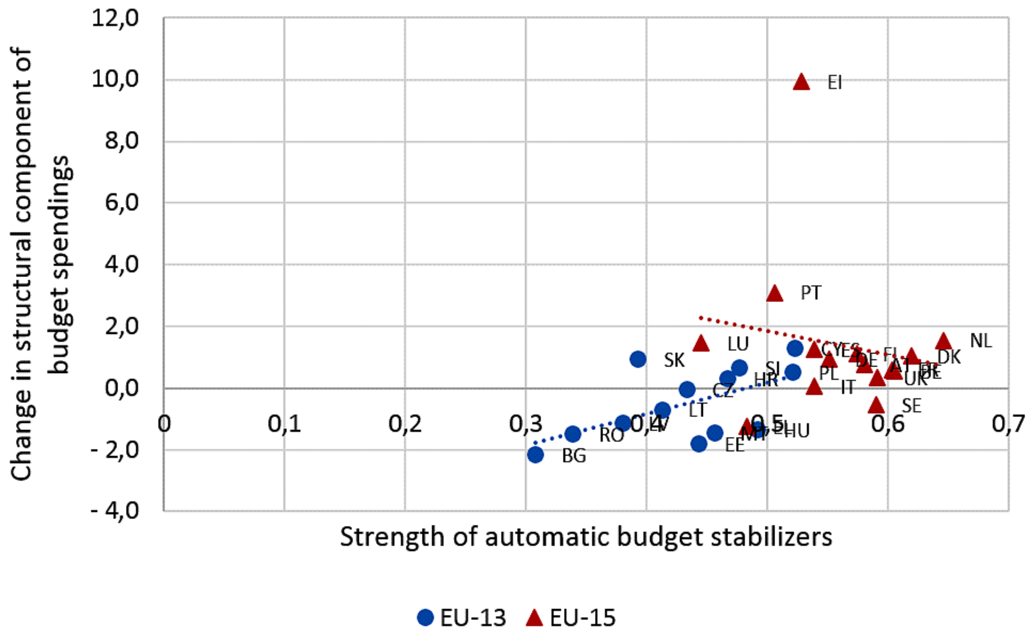

Fig. 1. Change in structural component of budget spending and strength of automatic budget stabilizers in EU-15 and EU-13 states, 2009-2010

**Averaged values for 2009-2010 period*

Source: Author`s calculations based on: European Commission, Cyclical Adjustment of Budget Balances, 2013, http://ec.europa.eu; Mourre, G., Astarita, C, Princen, S., Adusting the Budget Balance for the Business Cycle: the EU Methodology, European Economy, Economic Papers 536, 2014

of social assistance and transfer programs. A number of new EU member states employ flat tax systems which reduces the strength of the automatic budget stabilization.

The studied complementarity of fiscal discretions and automatic budget stabilizers implies greater fiscal incentives during economic downturn following the global economic crisis in countries with weaker automatic budget stabilizers. This is evidenced in the old, but not in the new member states. In the EU-13, procyclical restrictive fiscal measures are seen in countries with strength of automatic fiscal stabilizers below the EU average, with the largest fiscal restrictions observed in Bulgaria where the automatic fiscal stabilizers are the weakest (1.6 times weaker than the EU average). This shows that fiscal discretions counter the effects of the weak automatic fiscal stabilizers and do not contribute to overcoming the recessionary trends.

Unlike the EU-13 group, the EU-15 group shows a negative relationship between the change in the structural component of budget spending and the strength of automatic budget stabilizers. In general, the old EU member states display expansionary fiscal measures, with Greece and Sweden being the only exceptions. In the case of Greece, this is explained by the presence of significant fiscal problems arising from high levels of budget deficit and government debt. In Sweden, fiscal authorities rely on the operation of strong automatic budget stabilizers related to the progressive taxation and the comprehensive social policies.

Conclusions

Fiscal discretions and automatic budget stabilizers should not be seen as competing and mutually exclusive. On the contrary, they must be to a much greater degree recognized as complementary which would lead to strengthening the countercyclical effects of fiscal policy. In that respect, if automatic budget stabilization is supported by skillful discretionary intervention when necessary, the overall fiscal stabilization policy would gain a substantially stronger momentum. This implies that the fiscal rules should ensure the necessary flexibility of fiscal policy.

The complementarity of fiscal discretions and the operation of automatic budget stabilizers is empirically verified during the last global economic crisis and it is exemplified in the new, but not in the old EU member states. This indicates that unlike in the EU-15, discretionary fiscal policy in the EU-13 in general does not show the necessary flexibility with respect to the strength of automatic budget stabilizers and does not contribute to promoting macroeconomic activity and overcoming the economic downturn. Considering the prevailing relatively weak automatic stabilizers in the new EU member states, the fiscal discretions in these countries should demonstrate a more pronounced countercyclicality with respect to macroeconomic dynamics which in turn implies strengthening the stabilization role of fiscal policy.

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