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# ZEW policy brief

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## Better Fiscal Rules for Europe: Reflections Based on New Empirical Evidence



### Introduction

Over the past five years, the euro area's fiscal rules have been reformed and extended. It is not clear, however, whether these changes have been effective at boosting fiscal prudence, and whether they go far enough. This policy paper summarises recent research findings from a Spanish-German-American team led by ZEW. The study considers the general effectiveness of fiscal rules in the past and the interactions between rules, political factors and fiscal equalization. One key recommendation is that fiscal governance should pay more attention to budgetary developments in the seemingly good times, explicitly addressing the use of windfall revenues and the build-up of large bureaucracies.

One uncontroversial conclusion from five years of debt crisis in Europe is that a general overhaul of fiscal governance is needed. The prolonged crisis testifies to clear shortcomings in the Maastricht approach. Neither the institutional surveillance mechanisms provided for by the Maastricht Treaty nor the capital markets were able to prevent ever rising levels of public debt. This unsustainably high debt has driven Europe's economic woes and eroded confidence in the institutional framework of the European Union.

The Maastricht model for budgetary prudence was founded on two pillars (Dolls et al., 2015): market discipline and fiscal regulation. Market discipline was supposed to be assured by the no-bailout clause (Art. 125 Treaty on the Functioning of the EU, TFEU), the prohibition on monetary budget financing (Art. 123 TFEU) and the ban on privileged loan access (Art. 124 TFEU). Fiscal rules were designed to have a double function: provide an entry condition to the European Monetary Union (EMU) based on convergence criteria (Art. 140 TFEU) and prevent excessive deficits in EMU member states (stipulated in the Stability and Growth Pact, SGP).

Recent emergency measures and permanent reforms have brought considerable changes to the initial two-pillar-framework. In particular when it comes to the first pillar – market discipline –, implementation and enforcement seem to have softened substantially.

First, the no-bailout clause has always had a credibility problem. In the first decade of the euro, the euro government bond market showed almost a complete absence of risk premia. With the exception of the private sector involvement in Greek debt restructuring in 2012, the crisis and the responses to it have largely proven those investors right who did not believe that the no-bailout

**Crisis shows the  
weakness of the  
Maastricht model**

**The credibility  
problem of  
EU policies**

clause will be strictly enforced. Since 2010, countries have gained access to loans guaranteed by other Euro-member countries (EFSF, ESM), the European Union (EFSM) or the IMF, via institutions created ad hoc. Initially, emergency loan facilities were intended to be available only temporarily. But they have now become a permanent institution in the form of the ESM (an amendment of the TFEU (Art. 136 (3)) grounded the ESM in primary EU law). Moreover, access to loan facilities has not been confined to countries with short-lived liquidity problems. In the case of Greece, significant support was given to a country whose public financing was unsustainable.

Second, the ECB's heavy involvement in government bond markets has undermined the credibility of the monetary financing ban. The Securities Markets Programme (SMP) activated in 2010 and the Outright Monetary Transactions (OMT) Programme established in 2012 enable the ECB to selectively buy government bonds from highly indebted countries in secondary markets. Though the Public Sector Purchase Programme (PSPP), started in March 2015 as part of the ECB's quantitative easing, is non-selective, it has significantly increased the ECB's role as a buyer on the euro government bond market. At least according to the ruling by the European Court of Justice, the ECB's involvement in the bond market via the OMT programme is consistent with Art. 123 of the TFEU. From an economic perspective, however, such programmes in effect allow market investors to base their investment calculus on the ECB's (conditional) willingness to buy bonds on the secondary market.

Third, the ban on privileged loan access for governments also lost credibility, since all the new loan facilities offer substantial privileges for market access. What is more, the reforms on banking regulation since the financial crisis omit zero weighting for euro government bonds in banking capital requirements.

The weakening of market discipline has been accompanied by attempts to make the second pillar of budgetary discipline – fiscal regulation – more effective (for a concise summary on all reforms see European Commission, 2014). Two comprehensive legislative packages (the “six pack” and the “two pack”) have strengthened the surveillance, prevention and enforcement dimension of the SGP. On surveillance, the debt criterion has become more influential. For countries with debt levels in excess of 60 per cent of GDP, a numerical benchmark has been defined for the required annual reduction in the debt ratio – one twentieth of the gap to the reference value. On prevention, the SGP now includes a benchmark for acceptable increases of government expenditures. On enforcement, financial sanctions are to be decided earlier on and with a reversed majority. That is to say, a sanction proposed by the Commission can only be averted through a qualified Council majority. These new rules are grounded in the so-called “European Semester”, which details the coordination of national budgets with feedback loops from Brussels throughout the year. Finally, the Treaty on Stability, Coordination and Governance in the EMU (“Fiscal Compact”) commits the 25 signatory states to introduce deficit ceilings in binding national laws. As a consequence, national enforcement (e.g., through national constitutional courts) will supplement the enforcement provided by supranational law.

In sum, over the course of the economic crisis a far-reaching overhaul of the Maastricht approach to fiscal prudence has taken shape. In particular, measures have been introduced to tighten existing regulation, acting as a partial counterbalance to the weakened market incentives associated with the new support from the ESM and ECB.

However, any reform regarding rules must be based on a sound understanding of the (fiscal) origins of the current crisis and the impact of various fiscal institutions. In addressing several key issues, this policy paper contributes to an understanding of how to improve the design of fiscal governance institutions in the EU. It focuses on the role of business cycles and their adverse effects on public finances; on the impact of fiscal transfers on budget deficits and the implications regarding the design of such transfers; and on the effectiveness of numerical fiscal rules in constraining budgetary decisions.

## Effectiveness of Fiscal Rules

The basic premise in the euro area has been that governments can avoid excessive spending and borrowing by adopting credible commitments on future governmental behaviour, and do so often through numerical fiscal rules. However, without additional provisions, it is not at all certain whether these rules will effectively constrain politicians in their budgetary decision making. Laws can be rewritten or overturned, as in the United States, where balanced budget and expenditure rules in the 1980s and 90s were phased out or abandoned. But even if rules are not modified formally, there is often ample room for circumvention strategies.

In Germany, for example, the debt brake limits the deficit of the states but not that of municipalities. Anecdotal evidence suggests that, in response, fiscal burden shifts to the municipal level, which increasingly relies on short-run loans. Alternatively, supranational deficit caps can simply be exceeded. In the European Union, for instance, more than half of member states currently exceed the three per cent maximum budget deficit specified in the Stability and Growth Pact without fearing any timely or significant consequences from sanctioning mechanisms. The empirical question is, thus, whether fiscal rules could and should be employed to constrain government spending.

A key methodological challenge in measuring the impact of fiscal rules on deficits and debt is “endogeneity”. Rules may have no causal impact on fiscal performance; instead they may just be a symptom of an underlying fiscal preference. Countries with fiscally conservative populations could have low deficits and strict rules with both elements driven by an underlying fiscal prudence. Correlation between strict rules and low deficits, therefore, does not necessarily indicate that rules make a difference.

Our research uses several instruments to cope with this difficulty. Relying on a meta-regression analysis, one part examines the growing empirical literature that tests for the effectiveness of numerical fiscal rules in different contexts (Heinemann, Moessinger and Yeter, 2015). Testing for endogeneity has received significant attention. Existing studies have been grouped into various categories: those that account for underlying fiscal preferences and those that do not; and those that apply appropriate identification tools and those that do not. Two results have emerged from this exercise: First, the literature overwhelmingly indicates that rules indeed make a difference and effectively constrain fiscal policy makers. And second, this finding stands up to proper identification approaches. In this sense, European policy makers can be confident that the imposition of new rules will have a disciplining effect on fiscal decisions. The meta-regression analysis also provides insights about the design of rules. For instance, fiscal rules targeting the state level rather than the national level seem to be less effective in limiting public debt. In contrast, the type of rule does not seem to matter: expenditure or revenue rules are neither more effective nor less effective than deficit rules, which are the most prevalent type.

Another element of our research, also related to the endogeneity problem, draws on a large sample of countries in identifying which types of countries have chosen fiscal rules in the past (Asatryan, Castellon and Stratmann, 2015). It finds that the adoption of fiscal rules does not only depend on economic factors like high unemployment and high levels of debt, as is commonly thought, but also on deeper issues related to the design and structure of government institutions that promote irresponsible fiscal policy making.

More specifically, the research shows that parliamentary systems, commonly characterised by weaker separation of powers than presidential systems, more frequently rely on numerical rules to constrain fiscal policies, since existing institutions of checks and balances are not always sufficiently vigorous. This is particularly relevant for European countries not only because fiscal rules are popular, but also because the vast majority of European countries have a parliamentary system.

**Enforcement of fiscal rules**

**The endogeneity problem**

Empirical tests for electoral cycles in the adoption of fiscal rules re-enforce this finding. They show that the legislative branch adopts fiscal rules whenever a new executive is elected into office. In the absence of other, perhaps better, more flexible and more inclusive institutions to constrain government borrowing, fiscal rules may be a suitable mechanism to force fiscal discipline on a new administration.

## Mistakes in the Good Times

Our research has found evidence that economic and fiscal crises promote reforms in different policy areas. This is typical of the political economy of reforms. While spikes in the number of reforms taken in times of crises are somewhat expected, no prior expectations are made with respect to the willingness to reform during booms.

The recent crisis has had a severely negative impact on the public finances of many European countries, most notably those of Portugal, Ireland, Greece and Spain. There is both anecdotal and empirical evidence that the resulting crisis stimulated politically costly fiscal adjustments and other economic reforms. However, in Ireland and Spain – as in the US – the roots of the crisis go back to pre-crisis bubbles that might have been prevented with better economic policies.

### The role of windfall revenues

Using sub-national government data from Spain, the project studies how revenue windfalls in economically good times adversely affect public finances when a crisis hits (Solé-Ollé, Viladecans and Pasidis, 2015). The analysis shows that the extraordinary revenues obtained by property transaction taxes and other construction-related sources of revenues during the 1995–2007 housing bubble vanished between 2008 and 2011. Owing to the failure of budgetary and political institutions, just a tiny portion of the windfall obtained during the boom was saved for “rainy days”, while nearly all of them were spent on capital and current projects – often on inefficient ones – and were not used to finance tax cuts. During the bust term (2008–11) all the windfalls turned into shortfalls and around one fifth of them became deficits. Our research found that the situation was much more worrisome in municipalities with bad governance (corruption and lack of electoral competition). Municipalities with good governance saved half of their windfalls, did not increase current spending and did not cut taxes, while ones with bad governance spent their windfalls, raised current spending (not just investments) and cut taxes. This behaviour had consequences during the crisis: half the shortfalls turned into deficits in municipalities with bad governance; moreover, these municipalities were not able to cut current spending and had to raise taxes and/or adjust investment to even lower levels.

### Efficiency of public administration

Another part of the project studies the political economy of public administration reforms (Asatryan, Heinemann and Pitlik, 2015). The findings here point to an additional difficulty with the political constraints associated with post-crisis policies. Booms help build large bureaucracies that may or may not be inefficient in their own right. But when a crisis hits, large public administrations and inflated government wage bills not only represent additional pressures for the budget that are hard to reduce, but also – as shown by empirical analysis of EU countries – strengthen the relative power of special interests in the bureaucracy. This opposition is often effective in constraining efficiency-enhancing public administration reforms. Therefore, it cannot be assumed that a deep crisis alone will prepare the way for overcoming institutional deficiencies. The findings show that when bureaucracies are large and powerful, the link between crisis and reforms of the public administration is absent.

What can be learned from these findings, and, perhaps with a little bit of boldness, how do we extend what we learn to Europe’s current problems? Politicians’ inability to deal with budget vol-

atilities seems to be a crucial point that needs to be addressed. Increased government accountability may be one of the answers. This argument is also supported by the Spanish case, where the results point to much lower savings from windfalls when turnout at local elections is low. European supra-national bodies also have a role to play. Recently, many regulations have been applied in this regard, such as numerical fiscal rules capping some budget items (more below) or the use of some type of stabilisation or “rainy day” funds where windfall revenues should be allocated. Another aspect that can be improved is how windfalls and shortfalls from asset booms or other booms are taken into account when computing cyclically-adjusted deficits. Of course, one complexity is that on the national level windfalls may be harder to define.

## The Potential of Smart Fiscal Equalization

What about the role of fiscal transfers? On the one hand, these are known to have the potential of creating moral hazard problems. On the other, transfers are an integral part of any economic union for obvious reasons. The research from both EU-wide country-level analysis outlined above and a second study using Spanish sub-national data helps build several arguments.

In the context of public administration reforms, the role played by the different types of EU transfers is revealing. The research findings show that the EU’s many structural funds – preoccupied as they are with physical infrastructure – seem to neglect the bottleneck of deficient administrative capacities in recipient countries (Asatryan, Heinemann and Pitlik, 2015). Cohesion spending, a tiny but better targeted item involving technical assistance to member states, appears to significantly increase the likelihood of efficiency-enhancing reforms in public administrations. One lesson to take from this is that designing a well targeted programme is crucial.

Let us now turn to transfers during crises. Here revenues from national or sub-national governments decline due to the economic shock, but an additional stress may be created by the reduction of fiscal transfers from higher levels whenever the revenue sharing arrangement is also negatively affected (a likely scenario). A good example is the case of Spanish municipalities, where the funds allocated through revenue sharing fell by a third during the post-crisis years (Foremny and Solé-Ollé, 2015). The research shows that while spending stayed the same after the shock, moderate efforts were made to raise revenues for the most indebted municipalities. Hence, transfer cuts from the Spanish central government almost always meant higher deficits for an average municipality. This might be due to the transitory nature of the shock and shows that these events do not create incentives for local jurisdictions to increase fiscal efforts or cut expenditures. Those jurisdictions that could not absorb the shock by issuing debt responded by increasing their fiscal efforts.

Another potentially informative tool inherent in the Spanish revenue sharing system is cash advancement. This feature was introduced due to technical reasons rather than due to an intentional policy designed to ward off future crises. Nevertheless, it delayed the loss of revenue by about two years, saving many regions from a total crash. This suggests that similar stabilisation mechanisms in the design of transfer formulas may create a smoother adjustment process with less severe and immediate cuts. However, a careful design should – through early warning mechanisms, say – take into account the costs related to possible delays in necessary fiscal adjustments.

Viewed collectively, these arguments suggest that a well-designed transfer formula, perhaps accompanied by strictly enforced fiscal rules and no-bailout clauses, must not necessarily create a moral hazard problem. Indeed, they may help recipients to smooth fiscal adjustments and even to push for more reforms.

**Well-designed and targeted transfers make a difference**

### Five hints for better European fiscal rules

## Conclusions

In part, these research findings are encouraging for current institutional reforms. Regulation makes a difference and can provide effective constraints with a measurable impact on fiscal outcomes, including the level of structural deficits. Nevertheless, the findings also point towards several issues that have not received sufficient attention in current reforms:

- ▶ Fiscal rules are generally effective, but they should apply in good times as well. In particular, rules must be more explicit in addressing windfall revenues and exceptional savings. For example, the current record low yields on euro area government bonds – several countries even have negative yields for medium-term bonds – generate massive savings on interest payments. Nevertheless, there are no demands for additional deficit reductions from countries with exceptionally low financing costs.
- ▶ Although rules significantly reduce deficits, the empirical evidence shows that there is room to improve their performance, particularly when targeting the state and local levels. This finding underlines the difficulties in setting effective country-wide rules on federal environments.
- ▶ The findings on bureaucracy size and reform point to the importance of quality in public finances. It is crucial to have a thorough understanding of the structural developments in the public sector, which are often hidden behind aggregate headline data on fiscal deficits. Clearly, the reforms of the SGP have brought progress in this regard. What is missing, however, is a more explicit consideration of growth or decline in bureaucracy size. This lack turns out to be a potential impediment for reform in crisis-ridden countries.
- ▶ Fiscal equalization is regularly discussed as a stabilising element in times of shocks. Our findings indicate that revenue sharing systems could have precarious or even destabilising effects due to sharp declines in vertical grants. Therefore, more attention must be paid to smoothing vertical grants over time. Such smoothing can cushion the impact of the business cycle on effective payments from higher jurisdictions to lower jurisdictions.
- ▶ Fiscal equalization schemes should also set stronger incentives for the quality of spending projects. The findings on the impact of cohesion spending indicate that it may not be the size of transfers that is crucial for success, but the precision of grant earmarking. Given that the size and efficiency of public administrations have proven to be a bottleneck for development in many euro area crisis countries, EU spending should rely more on grants tied to the modernisation of administrations in recipient jurisdictions.

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