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DO WE NEED FISCAL RULES?¹

Catherine Mathieu and Henri Sterdyniak

OFCE

The public finances crisis has brought binding fiscal rules proposals back to the forefront. The paper analyses their justifications and specifications, either in a classical or in a Keynesian framework. In the recent period there is no evidence that public deficits were caused by fiscal indiscipline and induced too high interest rates; there is no evidence that economically relevant rules can be designed. The paper provides an analysis of fiscal rules implemented either at country level (like the UK golden rule), or at the EU level (the Stability and Growth Pact). The paper shows that fiscal rules did not work before and during the crisis. The paper discusses the EU project, the “Fiscal Pact”, which risks to paralyse fiscal policies and to prevent economic stabilisation. The priority today is not to strengthen public finance discipline but to question economic developments which make public deficits necessary to support output.

Keywords: Fiscal policy, Fiscal rules.

In memory of Henner Will

The 2007-2012 crisis is first of all a banking and financial crisis, due to hazardous and unregulated financial innovations, in a context of financial liberalisation and globalisation. Markets

1. Preliminary versions of this paper were presented at the OFCE conference: “Public finances in the crisis”, Paris, May 2010, at the 15th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM), Berlin, October 2011, and at the 9th EUROFRAME Conference, Kiel, June 2012. We would like to thank participants at the three Conferences and more especially Achim Truger for their comments and suggestions. A shorter version of an earlier draft was released in “From crisis to growth?, The challenge of debt and imbalances, *Series of the Research Network Macroeconomics and Macroeconomic Policies*, Vol. 15, H. Herr, T. Niechoj, C. Thomasberger, A. Truger and T. van Treeck (eds), Metropolis-Verlag, Marburg 2012. All remaining errors are ours.

were greedy, blind, and volatile. The crisis is also due to the huge increase in capital stocks coming from neo-mercantilist economies, raw material exporting economies, pension funds, or the wealthiest in emerging and advanced economies, tracking the most profitable financial opportunities. Monetary policies allowed private debts to rise, financial and housing bubbles, which supported output growth without higher wages or social incomes. Last but not least, the world economy became more fragile due to the strategies run by mercantilist countries (like China and other Asian emerging economies, Germany, and other Northern Europe economies) pursuing competitiveness gains and cumulating external surpluses (Mathieu and Sterdyniak, 2011).

But the crisis is not due to the rise in public debts and deficits. At the end of 2007, the public deficit for the OECD as a whole amounted to 1.3% of GDP only and was therefore below the level ensuring debt stability. Net public debt amounted to 39% of GDP only.

The crisis led to a huge rise in government debts and deficits. Initially this rise in debts and deficits was due to government measures implemented to support banks, later to the automatic fall in tax revenues resulting from lower output growth, and finally to measures implemented to support output. Starting from mid-2009, markets pretended to have doubts about public finance sustainability. They requested higher risk premia on government bonds issued by some euro area countries. Proposals aiming at imposing governments either fiscal policy rules or independent Councils in charge of assessing or even setting fiscal policies are back to the forefront.

The issue is especially acute in the euro area, where existing rules did not work (especially the Stability and Growth Pact, SGP), and where Member States (MS) having lost monetary sovereignty are under direct financial market pressure, where the Greek crisis has shown the implicit solidarity linking all euro area MS. The ECB and some of the countries having agreed to help Southern countries wish in counterpart the strengthening of binding rules on domestic fiscal policies.

The objective of monetary policy is rather clear: maintaining low and stable inflation, the equilibrium unemployment rate

theory ensuring that monetary policy will lead to the highest employment level. The issue is more delicate for fiscal policy: should it target full employment or the equilibrium of public finances, and how to define the latter? What is an optimal fiscal policy? Can rules allowing to run an optimal fiscal policy in permanence be defined?

The paper has four parts. Section 1 deals with the justifications for fiscal policy rules, either in a classical or in a Keynesian framework, trying to make a link between the justifications and the proposed rules. Section 2 describes different kinds of rules that may be implemented. Section 3 provides an analysis of fiscal rules experiences. Section 4 discusses recent EU proposals. Section 5 concludes.

1. Fiscal rules, from justifications to specifications

1.1. The classical model

Fiscal rules proponents argue that governments are not benevolent². Governments do not aim at optimising citizens' welfare but aim at being re-elected. Besides, each generation is selfish and does not care about the situation for future generations. Last, financial markets need to be reassured on the ability of governments to service debt. Each of these goals induces a specific rule.

According to the Leviathan-State theory or the Public Choice theory, each social group seeks to benefit from higher public spending without considering that this will imply higher taxes. In a non-cooperative equilibrium public expenditure are excessive. Each government agency aims at increasing the number of civil servants and means at their disposal, without accounting for efficiency and productivity. Governments tend to spend too much in order to please their voters, without correspondingly increasing taxes. They use fiscal policy for electoral purposes and not for stabilisation purposes. They do not make the appropriate budgetary efforts in good economic times. The social choice between public expenditure and taxes is biased because governments can run defi-

2. See, for instance, Alesina and Perotti (1995), Alesina and Tabellini (1990), Drazen (2004), Wyplasz (2011).

cits. No social or economic mechanism can ensure an optimal level of government debt or deficit. Thus public deficits are always excessive and this leads to excessive public debts.

Public deficits are therefore an autonomous cause of macroeconomic unbalances. According to the “crowding-out” effect theory, public deficits generate excessive demand, which induces higher interest rates and crowds-out private spending. Public deficits reduce savings available for investment. The current deficit level leads financial markets to expect large deficits to persist and hence further increases in government debts. Markets anticipate high future long-term interest rates, which immediately increases interest rates, and crowds-out private investment (Ducoudré, 2005). Public deficits are detrimental to capital accumulation and therefore to future growth.

Three objections can be made to this reasoning. The first objection is theoretical. The described mechanisms will not play if households are Ricardian. On the one hand, Ricardian households are aware that a deficit is equivalent to taxes: they cannot be fooled by the government strategy and they have a preference for governments who do not spend much. On the other hand, Ricardian households increase their savings in order to offset higher public deficits; public debt has no specific unfavourable effect: financing public expenditure through taxation or higher indebtedness will be similarly detrimental to output growth.

The second objection is empirical. Such mechanisms of higher interest rates and crowding-out effects have hardly been observed in reality. From 2002 to 2005 both short and long-term interest rates were historically low despite the rise in government deficits in Europe, like in the US and Japan. This has also been the case since 2008: large economies have run large government deficits and high public debts with low interest rates at the same time. The rise in government debts did not have any impact on interest rate levels or on inflation expectations. In 2009, long-term interest rates stood at 1.4% in Japan, 3.3% in Germany and the US, 3.6% in the UK, 3.7% in France, *i.e.* were similar to expected potential output growth (and were even clearly below it for the US). It is difficult to assert that such interest rates levels are detrimental to investment.

Last, this theory does not explain why all governments would have suddenly become demagogic and increased their deficits in 2002 or in 2009. In the recent past, the rise in government deficits was due to fiscal stabilisation rather than to a spontaneous rise in expenditure or a spontaneous decrease in tax revenues. It is not obvious that the OECD countries were characterized, in the recent period, by fiscal indiscipline (contrary to what Debrun and Kumar, 2007; and Wyplosz, 2011, 2012 pretend).

This theory omits that governments do not care only about median voters but also about leading classes requesting primarily lower taxation for companies or for themselves and trying to promote public spending cuts strategies.

In any case, this theory advocates the implementation of a “Golden rule of public finances” in order to reduce the governments’ bias for running excessive deficits: current expenditure must be financed through taxation, while investment which will benefit future generations may be financed through borrowing.³

It is however difficult to measure investment. How to account for education or research expenditure, even more since we have to measure net investment? Besides, it is fair to smooth exceptional public spending and tax revenues over all generations. Despite these limits, the rule, according to the classical theory, should be a golden rule and not a balanced budget rule.

This rule can be more precisely defined. Let us assume that a country wishes to maintain a public debt level equal to its public capital stock. Public debt in real terms varies as: $D = D_{-1}(1 + r - \pi) - S_p$, where $r - \pi$ stands for the real interest rate and S_p is the primary government balance. The public capital stock level varies as: $K = K_{-1} + I - \delta K_{-1}$. The equality between debt and capital stock requires that: $S = S_p - rD_{-1} = -(I - \delta K_{-1} + \pi D_{-1})$. Government borrowing should equal net public investment plus debt depreciation due to inflation.

The second argument is intergenerational fairness. A given generation should not consume too much at the expense of future generations. But such an “excessive consumption” is difficult to

3. This view was developed at the end of the 19th century by Von Stein (1885), Leroy-Beaulieu (1891) and Jèze (1896). It can also be found for instance in Musgrave (1939) or Eisner (1989).

assess, while accounting both for demographic developments, productivity growth, natural resources and environmental constraints. It is difficult to compare the well-being of successive generations. In this approach, the criterion cannot bear exclusively on the public deficit; private savings need also to be taken into account. According to the “golden rule of economic growth”, *per capita* consumption is maximised in a permanent regime if the interest rate equals GDP growth. As long as the interest rate does not exceed GDP growth, there is no evidence that fairness is not ensured. Intergenerational fairness may thus require a fiscal surplus (if the savings ratio is spontaneously too low) or a deficit (if the savings ratio is too high).

The third argument is public debt sustainability. Financial markets should not believe that a country may be a situation where sovereign default is the more profitable outcome. Let s_p stand for the primary government balance-to-GDP ratio, $\tilde{r}$, the interest rate on debt corrected from GDP growth, h , the debt-to-GDP ratio. At a given debt ratio, $s_p = \tilde{r}h$, one should avoid that h exceeds a critical value where the primary balance would be unbearable for the population. The difficulty is that $\tilde{r}$ depends itself on sustainability perceived by markets. Countries like Greece, Italy, or Belgium, have been able to run primary surpluses of 5 percentage points of GDP. If $\tilde{r} = 1\%$, the limit for h is 500%. If $\tilde{r} = 5\%$, the limit comes down to 100%. An indebted country is at risk of being trapped in a self-fulfilling spiral if financial markets require high interest rates to offset an unsustainability risk.

Moreover, it is necessary to make a difference between countries with monetary sovereignty, borrowing in their own currency and able to ask for central bank financing (Nersisyan and Wray, 2011), and non-sovereign countries, borrowing in foreign currency or not able to benefit from central bank financing, like euro area countries.

The latter do not control their interest rate; they may have to pay risk premia; they may default. These countries may be trapped in a spiral: financial markets' doubts $\rightarrow$ increases in interest rates $\rightarrow$ unsustainable debt $\rightarrow$ financial markets' doubts. Debt sustainability is a crucial issue for these countries.

The former may run very low interest rates and are not in danger of being insolvent since the Central Bank can provide

funding to the government. Coordination between fiscal and monetary policies can maintain full employment after a negative demand shock. The risk is that over-expansionary fiscal policies lead the central bank to raise interest rates to stabilise inflation, which may lead public debt to be unsustainable, or to abandon its inflation target (Sargent and Wallace, 1981, Leeper, 1991, Sterdyaniak and Villa, 1994). This cannot occur with the following rule: fiscal policy must maintain a satisfactory employment level, while enabling the interest rate not to be higher than the nominal growth rate, with stable inflation at a satisfactory level.

1.2. The Keynesian model

From a Keynesian perspective, a certain level of public debt and deficit is necessary to ensure that demand equals potential output. Public deficits result from the macroeconomic situation and are not at the origin of this situation. In times of economic uncertainty or entrepreneurs' pessimism, private demand may be insufficient to maintain full employment. The optimal policy consists in cutting the interest rate until the demand level is satisfactory. The advantage of this policy is that it does not increase public debt, it helps capital accumulation and lowers the profit rate requested by companies to invest. However, it may lead to excessive private companies' or households' debt accumulation. It may generate financial or housing bubbles. Conversely interest rates cuts may be inefficient in times of strong economic depression, when private agents are reluctant to borrow. It may be insufficient, especially because there is a floor to nominal and consequently to real interest rates: at the end of the 1990's, the daily interest rate was set at 0 in Japan, which led to a base rate of around 3% for commercial banks and to a real credit interest rate of 4.5% (accounting for a price deflation of around 1.5% per year). It may not be implementable in the euro area where the common interest rate cannot adjust to the different business cycle situations in the 17 MS. So the sharp rise in public debts must be related to decelerating inflation and growth (which prevents the authorities to cut sufficiently the real interest rate adjusted for growth) and to the introduction of the euro (which does not allow anymore MS to run appropriate interest rates and exchange rates).

In order to obtain a satisfactory demand level, the government must then accept some public deficit. Let us note y , the output gap, d , private demand, g public demand, r the interest rate, and h public debt-to-GDP ratio,

If $y = g + d + cy - \sigma r + kh$, the stabilisation fiscal policy is:
 $g = -d + \sigma r$

If this policy is implemented and if stabilisation is perfect, then there is no link *ex post* between the deficit and the output gap. g , government borrowing, is considered as structural according to the OECD or the EC methods, which makes no sense.

In the long run, $g = 0$ and $h = -(d - \sigma r) / k$.

The long-term public debt level is not arbitrary, but depends on private agents' wishes: debt must equal desired debt at the optimal interest rate, *i.e.* the rate equal to the growth rate.

This simple model shows that a fiscal rule like: $g = g_0 - \lambda y - \mu(h - \bar{h})$ should not be recommended, since it would not allow for full stabilisation and since the government cannot set a debt target regardless of private agents' saving behaviour. The public debt level desired by private agents has probably increased during the crisis since households wish to hold less risky financial assets and companies want to deleverage. In structural terms, the ageing of populations implies that safe public assets are increasingly desired.

Such a deficit necessary to support activity will not crowd out private spending: it will not raise the interest rate, since by definition the interest rate is as low as possible. It does not raise sustainability issues *a priori*: if the rise in public debt leads agents to increase their spending, the government will be able to cut its deficit accordingly. The government must be ready to cut its deficit when private demand resumes. This may require that some public expenditure or some tax cuts are explicitly defined as temporary.

This ideal scheme requires that the government cuts the public deficit when the economy comes close to full employment. The rule should be: the public deficit must be reduced when demand tends to become excessive, therefore when inflation tends to accelerate or when the central bank has to raise its interest rate above the output growth rate in order to slowdown inflation.

Box 1. A Keynesian fiscal policy rule?

Can a Keynesian fiscal rule be designed? Net public investment (NPI) must be financed through borrowing; public deficit should be corrected of debt depreciation induced by inflation (at least for a 2% inflation target and a 60% debt target); fiscal policy should be countercyclical: a 1% output gap justifies a 0.75% of GDP public deficit, *i.e.* slightly more than the automatic effect; fiscal policy should be restrictive when monetary policy is restrictive (a fiscal surplus is needed when the interest rate set by the ECB exceeds 4%, the “golden-rule” growth rate, according to Phelps). Therefore:

$$S = -NPI - 1.2\% + 0.75 \text{ output gap} + 0.5 (i - 4)$$

According to this sensible fiscal rule, which ensures that public debt does not exceed public capital stock in the long-term, and using the OECD output gap, the French public deficit should have amounted in 2011 to:

$1.2 + 1.2 + 0.75 \times 3.3 + 1.25 = 6.2\%$ of GDP. The French public deficit amounted in fact to 5.2% of GDP.

But this rule does not allow for full stabilisation and does not take into consideration the link between the output gap and fiscal policy.

According to this approach, the rise in public debts is a macroeconomic phenomenon with two causes: insufficient private demand and too high interest rates. Weak demand may mirror households' desire to own more financial assets combined with companies refusing to increase their borrowing.

Pierre is 50 year-old and worries about his future pension. He decides to save 1,000 euros per month so as to have cumulated 120,000 euros at the age of 60. Hence he generates a demand deficit. If interest rates cannot be cut, the government must increase its deficit by 12,000 euros per year and the public debt by 120,000 euros after 10 years. Will this debt be a burden for Antoine, Pierre's son? The answer is no if Pierre donates 120,000 euros to his son. The answer is also no if Pierre spends this amount while Paul, Peter's cousin and 10 years younger saves money over this period. The 120,000 euros are a desired additional debt. In such a situation, government should allow public debt to rise. The government stabilises the economy through providing the desired public debt. Public deficits increase demand directly but also indirectly by raising public debt, owned by households, which tends to

increase their consumption. Public debt is not a burden for future generations since it has a counterpart in terms of assets owned by households. Public debt is only a way to make the economy more liquid. Households' savings have a counterpart in terms in public debt and deficit. One may of course regret that it has no counterpart in terms of private companies' investment and debt, but in the context we are considering, companies do not wish to borrow.

This scheme may come to a halt if households become Ricardian, if markets request risk premia, or if the government sets a public debt target (for simulations, see Ben Amar and Sterdyniak, 2011). Let us assume that households increase their savings' ratios because they wish to own more public debt as they get older. The government thus increases public debt, but households expect future tax increases (they are wrong, of course): they increase their savings further, which obliges the government to increase its deficit further. Another example is: households increase their savings ratio; the government has to increase its deficit to stabilise output, but markets request risk premia to offset the debt rise. Here also, the economy may enter into an infernal spiral: higher interest rates requested by markets will lead the government to increase its debt to maintain full-employment, which will worry markets, and increase debt again. In both cases, private agents' defiance towards public debt is a self-fulfilling prophecy; output cannot be stabilised (see Box 2).

Thus public debt can be cut only through higher companies' or households' borrowing or lower savings (owing to reduced uncertainty about the future). Public debt reduction requests interest rates to be kept as low as possible. When government borrowing is of a Keynesian type, it makes no sense to advocate a strong cut in government borrowing without explaining how the resulting demand deficit will be offset.

Hence, there are two views on public debts and deficits, like on the need for fiscal rules. Fiscal rules proponents may blame Keynesians for opening a Pandora's box. How to avoid government's demagogic choices, once debts and deficits are allowed? Fiscal rules opponents may reply that the fiscal policy adequacy criterion lies on both the employment level, inflation, and interest rates. They may request rules consistent with the macroeconomic stabilisation objective.

Box 2. Fiscal rules and multiplier

Let us consider the simplest model.

Public balance is: $s = ty - g$, where g stands for discretionary policy.

GDP is: $y = d + g + c(1-t)y + ny^* - ny$ where d is a private demand shock.

Let us assume that $t=0.5$; $c=0.5$; $n=0.25$.

The multiplier equals 1 for a specific shock; 1.33 for a EU wide shock. The public balance stabilisation constraint increases it to 2 for a specific shock, 4 for a EU wide shock. The economy is more unstable under a balanced budget constraint.

	Specific shock		EU shock	
	y	s	y	s
Full stabilisation of y	0	-1	0	-1
Automatic stabiliser	-1	-0.5	-1.33	-0.67
s stabilisation	-2	0	-4	0
Cost of reducing deficits	-2	-1	-4	-1

Let us now assume that households are Ricardian or that financial markets request risk premia for public deficits. This will translate through $(-hs)$ in the equation determining output: $y = d + g + c(1-t)y + ny^* - ny - hs$, where $h = 0.5$. Then fiscal policy is less efficient. The economy is here also more unstable in the event of a negative demand shock. It cannot be stabilised if h becomes equal to or higher than 1.

	Specific shock		EU shock	
	y	s	y	s
Full stabilisation of y	0	-1	0	-2
Automatic stabiliser	-1.33	-0.67	-2	-1
s stabilisation	-2	0	-1	0
Cost of reducing deficits	-0,667	-1	-1	-1

For neo-classical economists, the rise in deficits and public debts in recent years shows that rules are needed to avoid this drift. For Keynesians, this rise was necessary and fiscal rules are harmful if they prevent fiscal policy to play.

However, the fundamental question is: why are large public deficits necessary today at the world level in order to support demand? Prior to the crisis, four factors contributed to insufficient world demand:

— Many countries implemented neo-mercantilist strategies aiming at building current account surpluses: Asian countries

learnt the lesson from the 1997 crisis and wish to be free of financial markets' pressure; China's rapid growth model is based on exports; some countries wish to anticipate the implications of their ageing populations (Japan, Germany, Austria, the Netherlands, and Nordic countries). These surpluses add to oil exporting countries' surpluses.

— Trade globalisation increases the weight of international competitiveness. Each country has an incentive to exert downward pressure on their wages so as to raise domestic competitiveness. Countries like Germany, the Netherlands and Austria have succeeded in lowering substantially the wage share in value added since 2000. Consequently consumption has decreased as a share of GDP in these countries. Accounting for globalisation and for the interests of leading classes no country implements the relevant strategy: supporting output growth through higher wages and social benefits⁴.

— Anglo-Saxon economies have chosen a growth strategy based on wages and incomes stagnation for households as a whole and a rise in inequalities. This implies a declining consumption trend which was offset by higher households' borrowing and financial and housing bubbles, allowed by real interest rates maintained at low levels. When households' borrowing reaches a paroxysm and when bubbles burst, public debt has to support demand.

— The rise in public debt in France and in many countries does not result from rising public expenditure, since on the contrary the latter have decreased as a share of GDP (by 1.4 percentage point in the euro area between 1997 and 2007, 0.8 percentage point in France), but from lower tax receipts (by 1.5 percentage point in the euro area as in France over the same period) due to the tax counter-revolution implemented by most governments for 25 years. In the name of free movement of people and capital, EU institutions have forbidden countries to implement measures needed to protect their tax policies. Hence EU governments have used tax competition. Tax and contributions cuts have been intensified (on corporate taxation, higher-income households, wealth, employers'

4. Strangely, the European Commission and economists in the industrial economies recommend this strategy ... but for China.

contributions, etc...) with no positive growth impact. These tax policies have increased social inequalities and public deficits. Simultaneously the tax counter-revolution was a choice of EU institutions, liberal governments and leading classes as a way to cut tax revenues, and pretend afterwards that in view of the resulting deficit, public expenditure need to be cut.

2. Fiscal rules: lessons from experience

2.1. A typology for fiscal rules

A fiscal rule⁵ may be defined as a fiscal policy constraint which imposes limits on variables like deficit, public debt or public expenditure, either in absolute terms or depending on some economic variables. The introduction of fiscal rules has been strongly advocated by the IMF, in order to facilitate domestic fiscal policies discipline or surveillance by the IMF (see IMF, 2009).

There are different types of rules according to several criteria (see also EC, 2010):

— Some rules set permanently what fiscal policy should be: for instance, the structural deficit should be nil or equal to net public investment. Other rules set a ceiling: public deficit should not exceed 3% of GDP; debt should not exceed 60% of GDP. Such rules play in an asymmetrical and episodic way.

In the first case, the difficulty is how to design a rule able to account for all situations. Generally, these rules are based on magic numbers (like budgetary positions in balance), unrelated with macroeconomic equilibrium constraints. The balanced government budget rule for instance has no economic justification once it is recognised that a certain level of public debt is necessary (because public debt is desired by private agents who wish to own safe assets), and that besides, it is justified to finance public investment through borrowing. Let us assume for instance that households wish to own public debt at 60% of GDP under a 4% interest rate and a 4% nominal growth. The equilibrium govern-

5. This paper addresses national rules only and does not discuss rules imposed on local governments.

ment deficit is 2.4%. It makes no sense to request a deficit at 0%, which could require an interest rate at below GDP growth.

In the second case, the rule bites in times of crisis, precisely when output needs fiscal policy support, and not in good times, when fiscal consolidation would possibly not be detrimental to growth. The ceiling is here also generally arbitrary.

— Rules can apply to government borrowing, structural balance, public debt, expenditure or taxes. But government borrowing depends on the cyclical situation: a norm on government borrowing is necessarily pro-cyclical. The structural balance is difficult to measure. The debt criterion is difficult to fulfil as, in the short run, a restrictive policy can increase the debt-ratio (see Box 3). Should a rigid rule constrain the social choice between public and private expenditure? This is not justified from a democratic point of view. Expenditure rules generate incentives to introduce tax expenditure. The rule in terms of tax revenues is often counter-productive: it leads governments to increase borrowing rather than raise taxes.

Box 3. The public debt criterion in the short term

Let us consider an economy in a Keynesian situation. Demand determines output, according to: $y = g + c(1-t)y$. Debt varies as: $h = h_0 + g - ty$. If g declines by 1, this leads y to fall by $1/(1-c(1-t))$. A restrictive fiscal policy will lead the debt-to-GDP ratio to rise if: $h_0 / y_0 > (1-c)(1-t)$

For instance: if $c=0.5$ and $t=0.5$, $h_0 = y_0 = 100$, cutting the deficit by 1 leads output to fall by 1.33 (from 100 to 98.67), *ex post* the deficit will fall by 0.33. Debt will decrease to 99.67. The debt-to-GDP ratio rises from 100% to 101%. In the short run, a restrictive policy cannot cut the debt-to-GDP ratio.

— Rules can have annual, medium-term (debt or deficit targets set at a five-year horizon) or long-term (ensuring public finance sustainability) horizons. But an annual rule often comes into conflict with the short-term economic context. A medium-term rule allows postponing efforts and may lack credibility; it implies commitments for the future while ignoring the future short-term situation. A long-term rule is not very useful: even if a country

anticipates a strong increase in its future pension expenditures, an immediate increase in social contributions is counterproductive when demand is insufficient.

Some economists recommend fiscal policy to be run at two horizons: in the short-run, expansionary fiscal policies would be allowed; in the longer-term the implementation of rigid fiscal rules or announcements of future pensions or health reforms would reassure financial markets (see for instance Schick, 2010). But this is probably an illusion: What is the credibility of such policies?

— Rules may consist in a simple objective set out by the government. This case has the advantage of being soft: the government may amend its objective or may not fulfil it if needed, possibly explaining why.

Rules may be supervised by an external authority (Committees of experts, Parliament, Constitutional court, EU Commission), which may be entitled to give advice only or to impose the fulfilment of the rule. But how should this authority be appointed: is fiscal policy a technical or a political issue? The supervising authority may be given the mandate to give advice, to dialogue with the government. Going beyond this is hardly consistent with democratic principles.

— Rules may be written into Law or into the Constitution. But all possible events cannot be written into the law. If the text is too vague (for instance: fiscal policy should target a balanced budget) it may be ineffective. If the text is too precise (for instance: a balanced structural balance), it is unenforceable.

Wyplosz (2002) proposed establishing a national fiscal policy committee of independent experts (how would they be appointed?). This Committee would have to regulate fiscal policy, *i.e.* to set the public deficit level, while public spending and receipts would remain under the responsibility of national governments and parliaments. After the ECB's independence, it would be a new step towards leaving economic policy entirely in the hands of a technocracy. The Committee's mandate would be to ensure public debt long-run sustainability, while output stabilisation would come in second.

But Wyplosz has difficulty in defining debt sustainability. He makes two suggestions: a balanced budget over the economic cycle

(which implies a public debt at 0% of GDP in the long run), or the stabilisation of the debt-to-GDP ratio in the medium run (*i.e.* cyclically adjusted), but he admits that it is impossible to set an appropriate level for this ratio.

As concerns monetary policy, the central Bank's objective is rather clear⁶: ensuring low and stable inflation rates, the equilibrium unemployment rate theory ensuring that monetary policy will lead to the maximal employment level. The fiscal policy objective is less obvious: should fiscal policy target full employment or public finances in balance, and how to define the latter? Should public debt be reimbursed or is public debt necessary for the macroeconomic equilibrium? This is a political choice which belongs to voters and not to experts (Murray and Wilkes, 2009). Wyplosz (2011) recognises that this committee should follow rules, but he does not define them: will rules bear only on public finance variables or will they account for the macroeconomic context?

Economic developments lead effective budget to differ from budget plans. The Committee would therefore have to control in permanence government policy measures and oblige the government to change taxes. What government would accept this?

Why would citizens be asked to vote for political parties' representatives if fiscal decisions are made by non elected independent experts? Can economic policy choices be made independently of a macroeconomic strategy and without democratic debate?

The crisis has clearly shown that fiscal policy cannot obey rules and must be run by determined and brave governments, which will never be the case with experts' committees. Can we imagine that a group of experts would have opposed to banks' financial support or to active stabilisation policies in 2008-2009 in the name of public finance sustainability?

Fatas *et al.* (2003) proposed a Sustainability Council, who would assess fiscal policies according to sustainability criteria. Their judgment would be made public, so as inform financial markets and the general public. The problem is that sustainability is a vague concept, which makes sense as a long-term constraint only. This

6. Although this objective has become less clear under the financial crisis' developments. Should the Central Bank ensure financial and banking system stability, supervise it, or rescue it?

means that it is difficult to use it to make a judgment on fiscal policy run in a given year. It would require judgements on the output gap level, on optimal debt, on the need for discretionary fiscal measures. Why would these experts be more qualified than others to have an opinion on so difficult issues? The risk is that these experts help markets to have a single opinion and that they exert excessive influence.

Calmfors and Wren-Lewis (2011) consider that a fiscal council could fight the deficit bias of governments. They recognise that fiscal rules are often too rigid. The fiscal council should induce governments to fulfil rules, but would also allow for flexibility and for possibly not fulfilling them. However, the fiscal council would have a consultative role only.

Others simply suggest setting an independent fiscal policy committee in charge of assessing macroeconomic projections' credibility and whether fiscal assessments are realistic. This is already the case in many countries. But should there be a single and official Committee? Would not this paralyse the democratic debate? There is a risk that such a Committee initiates a vicious circle: lower expected output growth and hence a higher deficit and hence a more restrictive fiscal policy in order to meet the deficit target at any cost, at the price of a further fall in output growth.

— How should the position of the economy in the business cycle be accounted for? Should the fiscal rule apply only to the structural balance (knowing all measurement difficulties)? Should discretionary fiscal policy be forbidden? What should a government do after a major depressive shock: give up the fiscal rule in order to support growth or try to meet the rule at the risk of slowing down the recovery?

— The non fulfilment of the rule may lead to no sanction (except by the general public), may be subject to fines (in the case of international commitments), may be impossible (if the surveillance authority is entitled to constrain the government or if the rule is automatic).

The last two cases raise feasibility and democratic issues. In the event of a deep depression, a rule may be unenforceable or may have disastrous macroeconomic consequences. Why could a group of experts oblige an elected government to run a given policy?

The German Council of Economic Experts suggested in 2009 that euro area Member States make commitments to bring their structural deficit in balance and thereafter maintain it in balance. Any deviation from the path would be corrected through an automatic rise in taxes. But this would prevent any stabilisation fiscal policy; this supposes that the structural balance can be available in real time, and that the structural balance equilibrium matches macroeconomic equilibrium.

Delpla (2010) suggests that the balanced budget rule is written into the Constitution. The rule would apply to the structural balance. An independent fiscal Committee (IFC) would be settled and requested to assess the structural balance. The rule would apply from 2018 only. Until then, the structural deficit, estimated at 8% of GDP in 2010, would have to be cut by 1 percent of GDP per year without accounting for the business cycle situation.

In a permanent regime, deficits (due to a deviation between effective and voted budgets) would be cumulated in a notional account and would have to be amortised in seven years. If the finance law project (PLF) deviates from this rule, it will be judged not in conformity with the Constitution by the Constitutional Council. In case of recession (to be defined by the IFC), the rule would be put aside for N years, but cumulated deficits would have to be offset in the following years. The rule would not be applied in case of exceptional circumstances, voted by the Parliament.

In case of structural reforms (raising output growth or reducing implicit debt) the IFC could allow for a certain level of deficit. This would open the door to drifts: 2% of deficit for the introduction of the “*Contrat Première embauche*” (Scheme for young employment), 5% for the abolition of the minimum wage, etc...

Thus, the rule would only apply when net public debt is higher than 40% of GDP. In France, it would have been applied only from 1996 to 1998, and since 2008.

This proposal lies on strong assumptions, lacking evidence:

1. The optimal level of net public debt is 40% of GDP.
2. Any level of deficit may be run, private demand or interest rates will adjust.
3. Discretionary deficits should be forbidden.
4. Structural government balances may be assessed in real time.

The difficulties mentioned above imply a need for a vague rule, with high flexibility. This is how rules worked until recently.

2.2. National rules

Many countries have introduced in their constitution rules with no real impact, either because these rules are vague and not really binding, or because they are abandoned when they become binding.

There is no fiscal rule **in the US**. There is a public debt ceiling, which can be raised when needed, which may be the opportunity to make medium-term fiscal commitments. Since 1974, the Congressional Budget Office (CBO) has played a significant role in producing reports on the medium-term fiscal outlook and on fiscal policy costs. The situation is similar in the Netherlands, where the Centraal Planbureau (CPB) plays an important expertise role, in Sweden (with a Fiscal Policy Council), in Belgium (High Council of Finance) and in Denmark (Economic Council).

In Germany under the Stability National Pact, the central and local governments are not allowed to run deficits exceeding the amount of their investments. They should target a budgetary position in balance.

In Spain, the Fiscal Stability Law from 2004 states that “all levels of government should aim at budgetary positions in balance”.

In the UK, the New Labour government introduced in 1998 a “Code for fiscal stability”, embedding two rules. The golden rule for public finances states that the government shall be allowed to borrow only to invest over an economic cycle. The sustainable investment rule states that net public debt should remain at a stable and prudent level, set at 40% of GDP.

The golden rule has an economic justification since it ensures in theory that public expenditure are financed by the generations which benefit from it. It is appropriate from a cyclical view point: in times of recession, government borrowing can increase both under the automatic deficit and under discretionary measures, as long as this higher borrowing is offset in good economic times. It allows governments to borrow to invest, which is particularly necessary for countries lagging behind in terms of public investment. The rule prevents governments from reducing their deficits

through lower investment, which is detrimental to growth. But this rule opens a Pandora's box on public investment definition: should the rule stick to the national accounts' concept or should all expenditure preparing for the future be included, like education and research expenditure? The rule implies a risk of excessive public investment in bad economic times.

The golden rule is probably one of the best fiscal rules. However it has three drawbacks: it is difficult to implement because it assumes that there is a "regular" economic cycle. What should be done if the economic cycle turns out to be irregular? The government has an incentive to change business cycle dating in order to have rooms for manoeuvre.

The UK golden rule is slightly too strict, since we have seen that the appropriate rule is that government borrowing equals net public investment augmented by debt depreciation.

Should we recommend the implementation of a *golden rule* correctly designed as structural government borrowing excluding net public investment and debt depreciation? Balassone and Franco (2002) reject this rule in the name of measurement difficulties. The rule requires in fact statisticians to assess the cyclical part of government borrowing (therefore the output gap and its impact on public finances), public investment and public capital stock depreciation, in other words four debatable measures. But is not it better to use a fair rule, estimated with some lack of precision than to follow a wrong rule, estimated with precision?

A more fundamental criticism is that this rule defines fiscal policy neutrality, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equals public investment). But a government may choose not to be neutral. It may wish to run an expansionary fiscal policy (in times of deep recession) or a restrictive policy (in times of high inflation). It may wish to implement structural measures if it judges that savings are too high *ex ante* (which would require a too low interest rate) or too low (for instance in the light of demographic developments). The rule confuses a neutrality criterion with an economic policy norm. Nothing guarantees that the fiscal policy needed to reach a satisfying output level in a country which does not control its interest rate matches the golden rule.

The 40% limit for the debt ratio has no justification. The golden rule ensures on its own that net public debt stands below public capital stock.

No mechanism forces the UK government to fulfil the Code; the government simply needs to explain why he did not fulfil it and how he will fulfil it. The rule allowed the government to increase substantially public investment spending starting from 2002, which was necessary both for structural (public infrastructure was insufficient) and cyclical (to counterbalance the fall in private demand after the burst of the internet bubble) reasons.

In November 2008, in view of public finance deterioration, the UK government abandoned the Code for fiscal stability, announcing that it would restore public finances once the economy would recover. Government borrowing rose rapidly, together with net public debt (which reached 60.5% GDP in March 2011). This shows clearly that fiscal rules cannot be set as rules “for all seasons”.

Formally, **France** is already committed to a fiscal rule. Since July 2008, the Article 34 of the Constitution states that: “The public finance multiannual guidelines are defined by programming laws. They are part of the target of public finances in balance”. This article has had very little influence on fiscal policy implementation since then. In times of crisis, multiannual guidelines rapidly lose any influence (Table 1). This was the case in 2002 and 2009.

Table 1. Public balance targets according to the French stability programmes

In % of GDP	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13
J 99	-2.9	-2.3			-1.2											
J 00		-2.1	-1.7			-0.5										
J 01				-1.0	-0.6	-0.4	0.2									
J 02					-1.4	-1.3	-0.5	0.0								
J 03					-2.8	-2.6	-2.1	-1.6	-1.0							
J 04						-4.0	-3.5	-2.9	-2.2	-1.5						
J 05								-2.9	-2.2	-1.6	-0.9					
J 06								-3.0	-2.9	-2.6	-1.9	-1.0				
J 07									-2.7	-2.5	-1.8	-0.9	0.0			
J 08										-2.4	-2.3	-1.7	-1.2	-0.6	0.0	
J 09											-2.9	-3.9	-2.7	-1.9	-1.1	
J 10												-7.9	-8.2	-6.0	-4.6	-3.0
J 11													-7.0	-5.7	-4.6	-3.0
Obs.	-2.6	-1.8	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.3	-2.7	-3.3	-7.5	-7.0	-5.2		

Source: Stability programmes, Updates (1999-2011).

Moreover, the target of public finances in balance is excessive, as the golden rule allows in the medium term a deficit of around 2.5% of GDP.

2.3. The Stability and Growth Pact

Euro area countries are committed to the SGP. This is a unique example of a fiscal rule enshrined in an international Treaty, which raises a delicate issue: can a Treaty resulting from a political compromise, necessarily with simple specifications, contain binding economic constraints which may come in contradiction with economic principles, and with the needs of relevant fiscal policy?

The Pact was based on the assumption that MS domestic fiscal policies could have negative impacts on partner countries. But only the risk of an over-expansionary policy was taken into consideration, and not the risk of too restrictive policies. The Pact was marginally revised in 2005, but its basic principles remained unchanged. MS should not run higher than 3% of GDP public deficits and higher than 60% of GDP public debts. MS must produce Stability programmes showing 4-year projections for public finances, bringing medium-term budgetary positions in balance (a 1% of GDP deficit is allowed for MS with high growth and low public debt). Budgetary efforts must reach at least 0.5% of GDP per year (measured in terms of primary structural balance, as estimated by the Commission). If debt exceeds 60% of GDP, debt should be brought down to this value at a satisfactory pace. Once the objective of the structural balance in equilibrium is reached then it must be maintained. Only automatic stabilisers are allowed to play, the structural balance being estimated by the Commission's method. The European Commission initiates an Excessive Deficit Procedure (EDP) when a country breaches the 3% of GDP limit for deficits (unless this excess is temporary) and sets a deadline for the country to bring its deficit below 3% of GDP. MS not fulfilling their commitments under an EDP may be subject to fines, but this has never been implemented.

The SGP drawbacks have often been analysed (see, for instance Mathieu and Sterdyniak, 2003, 2006):

1. The 3% limit makes no sense in times of economic depression. A country hit by a specific recession may need a higher than 3% of GDP deficit to counterbalance a large fall in domestic private demand. *A priori* this will have no negative impact on euro area inflation. Such a deficit will have a positive impact on partner countries since it will prevent spill-over effects of a fall in demand. In 2002, Germany was running a 3.5% of GDP public deficit but inflation was growing by 1.4% only and there was a 1.9% of GDP current account surplus: one cannot see how the German deficit could then have had a negative impact on his partners.
2. The Pact is blind for two reasons. It bites only at the trough of the cycle. But restrictive measures should be taken only when the economy is at the peak of the cycle. The Pact cannot bite for too virtuous countries (who induce other countries to be “sinner” countries).
3. The Pact does not take account for issues such as external imbalances, competitiveness, private indebtedness, financial or housing bubbles.
4. The Pact should allow sanctions for countries running excessive public deficits, inducing inflationary pressures and excessive deficits, which require the ECB to raise interest rates. In fact, countries under an EDP are often countries with low growth and low inflation, and which need public deficits to support their growth. Conversely, a country like Spain could enjoy strong and inflationary growth without any public deficit but with a large current account deficit.
5. The rationale for a medium-term budget in balance has no economic justification. It is tighter than the golden rule or debt stability. In a situation of weak private demand and interest rates already at a floor, a government budget in balance is inconsistent with a satisfactory demand level. A deficit kept in permanence at 0% of GDP would lead nominal public debt to be stable in level and declining as a percentage of GDP. Public debt would reach 0% of GDP at some point. But savers, in particular pension funds, need to own long-term, liquid and safe assets, in other words public assets.
6. In good economic times, the SGP induces cuts in structural government borrowing, but cannot exert pressure on

governments to do so. The 1999-2002 episode showed that the concept of a good economic situation is problematic: MS refused to accept the structural unemployment rate floor as calculated by the Commission. In times of depression, the rule becomes totally unenforceable. Besides, the distinction between a structural and cyclical balance is questionable: where should stimulus measures be placed? What about the large revenue falls due to the overreaction of corporate and income taxation? There is no justification for prohibiting discretionary fiscal policies.

7. Since the single interest rate cannot fit all domestic specific situations, each MS should be allowed to run fiscal policy in order to reach a satisfactory output level (corresponding to the natural rate of unemployment). Let us summarise the EMU functioning by: $y_i = d_i + g_i - \sigma r$, where y_i is the output gap, d_i : private demand and g_i : public spending (assumed to be equal to the public deficit), r is the common interest rate. Then we should have: $g_i = -d_i + \sigma r$. On the contrary, imposing $g_i = 0$ leads to an unsatisfactory output level.
8. The SGP implementation relies crucially on the potential output growth estimate. This is problematic in times of crisis. According to the Commission method, potential output deviates relatively little from observed output, so the deficit is estimated to be mostly structural.

As Table 2 shows, the 2009 crisis led the Commission to revise substantially its estimates of potential output before the crisis. For 2007, the structural deficit increased by 1.2 percentage points at the euro area level. The reduction in the deficit between 2006 and 2007 was revised downwards from 0.5 to 0.1 percentage point. In 2011, was the effort needed to bring the structural deficit back to 0 amounting to 3% or 0% of GDP?

The SGP implementation led to strong tensions within the area (Tables 3 and 4). In 1999-2000, the largest countries refused to run restrictive policies, despite strong growth, because they did not want to undermine growth while domestic unemployment was still high. Thus, in the 2003-2004 economic downturn, deficits rose above the 3% of GDP limit and governments refused to undertake restrictive policies which would have deepened the recession. This led to an open crisis between the Commission and the Council in

November 2003. From 2004 to 2007, fiscal positions improved thanks to the recovery and to consolidation policies undertaken in Portugal, Germany and Italy. In mid-2008, no country was under an EDP. However, six countries ran public debts exceeding 60% of GDP: countries cannot meet *a priori* fiscal rules. There are still economists however (see for instance, Calmfors 2012) who blame countries for not having strictly conformed with the rules of the Pact, as if these rules have any economic justification.

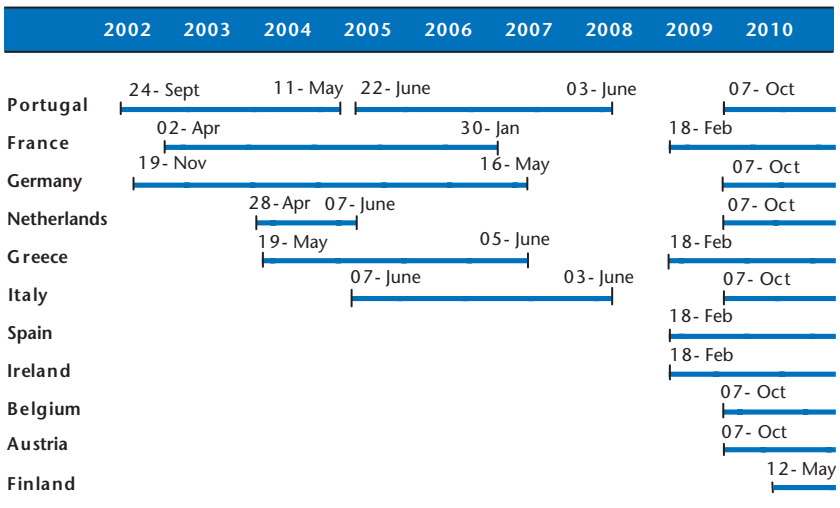
Table 2. Revision of the European Commission's structural balance estimates, 2005-2011

In % of GDP	2005	2006	2007	2008	2009	2010	2011
GDP growth, %	1.8	3.2	2.8	0.3	-4.2	1.9	1.5
Public balance	-2.5	-1.3	-0.7	-2.1	-6.4	-6.2	-4.1
Potential growth*	1.6	1.8	1.7	1.4	0.9	0.8	1.1
**	1.9	2.0	2.1	2.0	1.9		
Output gap*	0.0	1.4	2.5	1.4	-3.7	-2.6	-2.2
**	-0.9	-0.2	0.2	-1.2	-7.3	-7.3	-7.7
Structural balance*	-2.5	-2.0	-1.9	-2.8	-4.6	-5.0	-3.2
**	-2.0	-1.2	-0.7	-1.4	-2.6	-2.5	-0.1

* Autumn 2011 estimate; ** Spring 2008 estimate.

Source: European Commission (2008, 2011).

Table 3. Excessive deficit procedures



Source: European Commission.

Table 4. MS not fulfilling the rules

Public deficit/Public debt in % of GDP

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
PRT	4.3		3.1	3.4	5.9/63	4.1/64	3.2/68	3.6/72	10.1/83	9.2/93	5.9/108
FRA		3.2	4.1/63	3.6/65	3.0/66	/64	/64	3.3/68	7.5/78	7.0/82	5.6/85
DEU		3.6/60	4.0/64	3.8/66	3.3/68	/68	/65	/66	3.0/73	3.3/83	/84
NLD			3.2						5.5/61	5.3/63	3.7/66
GRC	4.4/104	4.8/102	5.7/97	7.4/99	5.3/103	6.0/106	6.7/105	9.8/111	15.6/ 127	10.4/ 143	7.5/153
ITA	3.1/109	3.0/106	3.6/104	4.4/104	3.3/106	/106	/104	/106	5.3/116	4.5/119	3.9/121
ESP								4.2	11.1	9.2/60	5.9/68
IRL								7.3	14.3/66	32.4/96	10.1/ 114
BEL	/107	/103	/98	/94	/92	/88	/84	/90	6.0/96	4.2/97	3.6/97
AUT	/67	/66	/66	/65	/64	/62	/61	/64	4.2/70	4.6/72	3.7/74

Source : European Commission (2011).

Over 1998-2007 the euro area government balance was however in surplus according to the OECD estimates (Table 5). From 1997 to 2007 the improvement in the structural euro area balance is due to decreasing interest payments and public expenditure (Table 6). Conversely it was limited due to lower tax revenues. The implementation of a tax harmonisation strategy in Europe would have prevented tax competition.

In 2007, debt was sustainable in all euro area countries (except in Greece and France, see Table 7). The gap was negative for the UK, the US, and even more for Japan. From a purely fiscal perspective, the assessment of the Pact is therefore mitigated. The Pact was probably binding, but less strongly that it intended.

Fiscal policy rules were not helpful during the crisis. The crisis destroyed the reliability of structural balance estimates (see Table 2); it appeared that governments were not controlling their deficit levels, due to the over-reaction of revenues (corporate taxation, income taxation, inheritance and transfers tax). Governments implemented discretionary policies; the Commission had to accept the latter and even pretend to co-ordinate them, forgetting its discourses on their inefficiency. The objective of structural budget in balance was entirely put aside. Government deficits rose, both in their structural and cyclical components: the Stability Pact had to be put aside.

Table 5. Euro area public finances

	GDP growth, %	Government balance, % of GDP	Interest pay- ments, % of GDP	Cyclical component*, % of GDP	Primary structural balance*, % of GDP
1998	2.7	-2.3	4.1	-0.2/-1.3	2.1/3.2
1999	2.8	-1.5	3.6	0.1/-0.8	2.3/3.2
2000	3.9	-1.1	3.5	0.8/0.0	0.7/1.5
2001	2.0	-2.0	3.3	0.6 /0.0	0.9/1.5
2002	0.9	-2.7	3.1	-0.1/-0.5	0.4/0.8
2003	0.7	-3.1	3.0	-0.6/-1.2	-0.1/0.5
2004	2.0	-2.9	2.8	-0.4/-1.2	0.3/1.1
2005	1.8	-2.5	2.7	-0.3/-1.3	0.4/1.4
2006	3.3	-1.4	2.6	0.6/-0.6	0.9/2.1
2007	3.0	-0.7	2.6	1.3/-0.1	0.9/2.3
2008	0.3	-2.1	2.6	0.6 /-1.0	-0.1/1.5
2009	-4.2	-6.4	2.5	-2.0/-4.1	-2.3/-0.2
2010	1.8	-6.3	2.5	-1.5/-4.2	-1.7/1.0
2011	1.6	-4.0	2.6	-1.3/-4.3	-0.3/2.7
2012	0.2	-2.9	2.8	-1.8/-5.2	1.3/4.7

*OECD estimate / OFCE estimate.

Source : OECD, *Economic Outlook*, May 2012.

Table 6. Public finances from 1997 to 2007 (cyclically adjusted)

Change, in % of GDP

	Revenues	Interest payments	Primary expenditure	Government balance
Euro area	-1.5	-1.6	-1.4	+1.5
Germany	-2.5	-0.5	-3.7	+1.7
France	-1.6	-0.6	-0.8	-0.2
Italy	-1.0	-3.9	+2.2	-0.7
Spain	+2.2	-3.1	+0.3	+5.1
Netherlands	0.0	-2.6	+0.8	+1.7
Belgium	-0.5	-3.4	+2.3	+1.7
Greece	+1.0	-3.1	+6.5	+2.4
Austria	-4.6	-1.2	-5.0	+1.5
Portugal	+3.8	-1.0	3.5	+1.2
Finland	-2.4	-2.4	-6.4	+6.4

Source : OECD, *Economic Outlook*, May 2012.

Table 7. Public finances in 2007

In % of GDP

	Government balance	Primary public balance	Net debt	Real interest rate corrected from growth	Debt stability gap	Change in debt, 2007/1997
Germany	0.2	2.6	42.9	1.6	1.9	+10
France	-2.7	0.2	34.0	0.2	-0.3	-8
Italy	-1.7	3.0	89.6	0.9	2.2	-18
Spain	1.9	3.0	18,7	-3.2	3.6	-35
Netherlands	0.2	1.8	28.0	0.3	1.7	-20
Belgium	-0.2	3.5	73.4	-0.2	3.6	-28
Austria	-0.7	1.3	30.7	-0.3	1.4	-6
Greece	-6.7	-3.0	80.4	-2.9	-0.7	+4
Portugal	-2.3	0.6	44.1	0.6	0.3	+17
Finland	5.2	4.6	-71.1	-0.3	4.4	-67
Ireland	0.2	0.9	-0.3	-3.4	0.8	-42
Euro area	-0.6	2.0	43.3	0.1	2.0	-10
United Kingdom	-2.7	-0.7	28.8	-0.3	-0.6	-2
USA	-2.8	-0.8	47.2	-1.1	-0.3	-6
Japan	-2.5	-1.9	80.4	0.7	-2.6	+45

Source : OECD, *Economic Outlook*, November 2011.

Public finances deteriorate in times of crisis when fiscal rules can no more play and are necessarily “forgotten”. Should fiscal rules be implemented, although they would not have allowed the policies run in 2008-2010? Is there a need for temporary fiscal rules to bring the economy out of the crisis? But how would such temporary rules make a trade-off between growth and public finances objectives? Between doing everything to bring deficits below 3% of GDP and debts below 60% of GDP and doing everything to support growth?

The strong deterioration of public finances during the crisis is not due to over-expansionary policies before the crisis (except for Greece). It results from the depth of the recession (which raises the issue of economic instability induced by financial globalisation), by banks’ recapitalisation in some countries (Ireland, which raises the issue of the regulation and supervision of the banking system), by the length of the crisis (which raises the issue of crisis exit strategies), by the bad functioning of the euro area which leads financial

markets to bet against Ireland, Portugal, Italy and Spain, where the situation of public finances is not worse than in the US.

The requested budgetary effort depends strongly on the estimate of the cyclical component of government borrowing; in 2011 it was nil at the euro area level according to us (since the primary structural balance was already in surplus), and amounted to 3% of GDP according to the European Commission (which aims at bringing structural deficits in balance).

As a fiscal rule, the SGP Pact therefore has a negative assessment. It was not met prior the crisis. It generated useless tensions. It did not allow to design an economic strategy before and during the crisis. It does not allow to define a crisis exit strategy.

3. Fiscal rules proposals

Although the rise in deficits and debts since the beginning of the financial crisis was not due to a drift in public finances, many economists and international institutions advocate exit strategies based on implementing fiscal rules in order to bring budgetary positions in balance. This raises two issues: how to define this new equilibrium? How to ensure that fiscal rules are consistent with macroeconomic equilibrium requirements?

Even if the crisis has shown the need for active fiscal policies, some countries blame inappropriate fiscal policies for current difficulties. Therefore, they wish more binding fiscal policy constraints. Should EU governments deprive themselves of weapons which were helpful during the crisis?

In the euro area, Germany, the Netherlands, and Finland demand more binding rules as a counterpart of the increased fiscal solidarity needed in face of speculation against public debts. The objective is also to *re-assure* financial markets who have understood that public debts in the euro area have become risky assets. But any rule raises credibility issues. Too rigid rules implemented simultaneously in Europe will reduce GDP growth which will have vicious effects: falling output growth generates lower tax receipts, and raises the debt-to-GDP ratio, public finance targets will not be reached; rising unemployment and political and social tensions will increase the fears that the country defaults and even leaves the euro area.

3.1. Domestic rules

3.1.1. *Germany: The debt brake*

Germany introduced a “debt brake” in its Constitution, which forbids higher than 0.35% of GDP structural deficits from 2016. The cyclical deficit is estimated according to the fragile Commission’s method. According to that estimate, Germany would have run excessive structural deficits (*i.e.* above 0.35% of GDP) each year since 1974 (except in 1985 and 1989). But can we consider that a country with higher than 6.5% of GDP current account surpluses in 2005-2007 and a 1.5% inflation rate was running excessive public deficits? In fact, the debt brake is not more rigid than the SGP rules. But Germany did not fulfil the SGP.

Deviations from the rule may be allowed in case of “natural disaster or exceptional economic circumstances”. They should be passed in a Parliament vote, with a 2/3 majority.

The law introduces a “notional adjustment account”, where deficits over the 0.35% ceiling (due to cyclical developments or a bad implementation of the budget) are recorded. These deficits will have to be cut either thanks to good economic times or to discretionary policies. The amount of this account cannot exceed 1.5% of GDP.

This rule is satisfactory neither in the short nor in the long term. In the short-term the definition of “exceptional situations” will be crucial. If growth decelerates, the fiscal policy constraint will depend strongly on the potential output estimate. In 2010, the German government deficit amounted to 4.3% of GDP. The structural deficit amounted to 3.5% of GDP according to the Commission or the OECD, to 1.3 % of GDP according to us.

In the long-term, if German potential output is assumed to grow by 3% per year in nominal terms, running a 0.35% of GDP deficit would bring the public debt down to 12% of GDP. Is this realistic?

With Germany having imposed on itself such a rule, the other EU countries are under market pressure to be as virtuous as Germany.

3.1.2. The UK: an independent office

In 2010, the UK introduced an independent *Office for Budget Responsibility* (OBR), in charge of producing macroeconomic and fiscal forecasts and of assessing the government patrimonial accounts. In 2011, the government set the objective of bringing the structural current government borrowing in balance in five years, *i.e.* to apply the golden rule with the problems we mentioned earlier. The OBR has to assess if the fiscal policy implemented will reach this objective (with a higher than 50% probability). What will the government do if active fiscal policy is needed in 2016? Fortunately, it will not be constrained by the 2011 programme. Hence, the medium-term commitment is not so binding.

3.1.3. A French-type rule?

In March 2010, a Commission was appointed with the mandate of recommending a rule for public finances in balance (see Camdessus, 2010). From the beginning, the Commission chose to exclude wise rules like the true golden rule or the stabilisation of the debt-to-GDP ratio, and suggested instead a rule of a structural budget in balance, which forbids discretionary measures and imposes a too strong constraint in the medium term. There was however no macroeconomist among the members of the Commission, and stabilisation issues were forgotten. The Commission suggested that each new government commits themselves by law on a programme of structural deficit cuts and on a date at which the structural balance will be reached.

The French government had proposed a complicated constitutional law project. Each government had to commit themselves in a multiannual public finance law⁷, which should cover at least 3 years and include, year by year, a public spending ceiling and an amount of new measures in terms of revenues (independently of the conjuncture). Higher than planned spending would be allowed only if associated with a similar rise in receipts. The government would have to commit initially on a fixed intangible scenario including each year structural deficits (public expenditure less receipts corrected from the conjuncture) cuts. The government

7. With a content to be specified in an Organic law.

would have to set a date at which the structural balance would be reached. The Constitutional Council would be entitled to amend a finance law if the latter was not in conformity with this multiannual public finance law, *i.e.* if it involved a lower than planned fiscal effort.

The experience of the SGP had however shown that it is useless to ask governments to announce a public finance trajectory independently of the cyclical context. In November 2007, the French government announced that the structural deficit would be cut down to 0.6% of GDP in 2011. In January 2010, the structural deficit target for 2011 had moved to 4% of GDP. Obviously, this rise in deficit was needed accounting for the crisis. But what would have happened if the budget had been constrained by a multiannual law passed in 2008? Does the French government consider it was wrong to support the economy in 2009, and that it should have been constrained to remain inactive?

Some economists (like Boone and Pisani-Ferry, 2011) were requesting France to make more budgetary efforts: they requested that the multiannual law passed at the beginning of the Parliament, sets “the fiscal policy main parameters over a five-year period”, as if a rigid economic policy could be run without accounting for cyclical or structural developments. They requested the “correction of past deviations”: in 2013 or 2014, excessive deficits from 2009 or 2010 should be corrected without accounting for the effective cyclical circumstances over these years. An “independent public finance council” should be settled, and would be in charge of evaluating implemented fiscal policy. But who would appoint these experts? What would be the judgement criteria of these experts?

This project was approved by a vote in the French National Assembly and the Senate, but not with a sufficiently large majority. It was therefore not adopted.

However, the French government had from then clearly committed to follow the deficit public reduction path enshrined in the budget law (6% of GDP in 2011, 4.6% in 2012 and 3% in 2013), independently of cyclical developments. Hence, the announcement of GDP growth 1 percentage point lower than anticipated for 2012 induces austerity measures which dampen GDP growth

further. As shown in Box 2, each time French GDP growth is 1 percentage point lower than anticipated, the government must implement measures amounting to 1 percentage point of GDP if it wishes to meet the *a priori* set target, which reduces *ex post* GDP growth by 2%.

3.2. The EU proposals

The European Commission's legislative proposals on the SGP strengthening and the "Euro Plus Pact" aim at constraining all euro area MS to introduce binding fiscal rules in their constitution. The EU authorities did not learn the lessons from the disastrous euro area management before the crisis. This management was focusing on rigid public finance rules and not on a precise coordination of macroeconomic strategies, which increased disparities in Europe in a weak growth context (Mathieu and Sterdyniak, 2011).

The debt crisis strengthened the weight of proponents of automatic and without economic rationale fiscal rules. These proponents can now rely on financial markets' threat, on the need to reassure financial markets, on the weight of Germany, which wishes increased EU solidarity to be paid by strengthened SGP rules. The Greek crisis is way to hide the financial crisis under the carpet.

The proponents of strict rules point to the threat of financial markets and rating agencies. If a country does not include such rules in their constitution they will lose their precious AAA. Financial markets would lend at reasonable rates only to countries committing not to have to borrow. On the one hand, countries cumulating huge foreign currency reserves (like China, and oil producing countries), pension funds, and insurance companies wish to own huge public assets amounts. On the other hand, they refuse to lend to countries which need to borrow, at least without high risk premia. They refuse to accept that their accumulation of liquid assets has a counterpart in terms of debt. Such contradictory demands can only paralyse the world economy.

On 29 September 2010, the Commission proposed a set of six legislative proposals aiming at "strengthening economic governance":

- The proposals keep the 3% of GDP limit for deficits, the medium term objective of budgetary positions in balance, and the constraint for countries running a structural deficit to cut it by at least 0.5% of GDP per year. No lesson is drawn from past experience.
- Countries will face sanctions if public spending increases more rapidly than *prudent* GDP growth (unless this is offset by a rise in taxation or if the country runs a fiscal surplus). This will prevent economic stabilisation through increased public spending. In times of economic depression, do we really need prudence? What would happen if by prudence households stop consuming or companies stop investing?
- Countries will face sanctions if they do not cut their structural deficit by at least 0.5 percentage point per year.
- Countries running a higher than 60% of GDP debt ratio will be under an excessive deficit procedure if the debt ratio does not fall by 1/20th per year of the gap between the effective debt and the 60% reference value. But it is almost impossible to prevent the debt ratio to rise in times of economic slowdowns. This new rule is pro-cyclical: it strengthens the constraint on deficits in slow growth periods. A country with a 90% debt-to GDP ratio and a 2% annual inflation rate, will have to keep a public deficit at below or 2% of GDP if domestic GDP grows by 2%; the deficit will need to be below or at 1% if GDP grows by 1% only.
- Guilty countries (countries with *too* rapid rises in public spending, countries not cutting their structural deficit, or not complying with an EDP) will have to make a deposit of between 0.2% and 0.5% of GDP, which will possibly be converted into a fine if the requested measures are not implemented.
- MS will have to introduce EU rules in their domestic fiscal frameworks (the 3% and 60% limits, the medium-term target of budgetary positions in balance) and to implement a surveillance of the fulfilment of these rules by an “independent budgetary institution”.
- A qualified majority will now be needed for the Council to oppose measures and sanctions recommended by the

Commission, this being expected to ensure the automaticity of sanctions.

The Commission's proposal undermines MS autonomy; forces them to fulfil strictly rules without economic rationale, and reduces their ability to stabilise their economies. It will increase further tensions between the Commission and the MS. Expert Committees are given the mandate of monitoring fiscal policy, although the crisis has clearly shown that strong and determined policy responses are needed.

The proposal was passed by the European Parliament while media remained silent and hence citizens entirely indifferent. The Parliament worsened the text: the Commission will be able sanction automatically a country not fulfilling the forecast path for deficits.

According to the Euro plus pact adopted in March 2011, each MS must introduce in their fiscal framework or their Constitution a fiscal rule similar to the SGP, the Commission being in charge of verifying this similarity.

In October 2011, the ECOFIN council specified that MS under an EDP, *i.e.* currently almost all euro area countries, will have to meet their budgetary targets independently of economic circumstances, in other words to implement pro-cyclical fiscal policies.

On 9 December 2011, the European Council proposed a "fiscal pact", which merely repeats the already adopted framework. It became the Treaty on Stability, Coordination and Governance (TSCG) and was signed on 2 March 2012. This text only recalls the six directives. Each country is requested to include in its Constitution a rule limiting the structural public deficit to 0.5% of GDP. It will have to converge rapidly towards this objective, according to a schedule given by the Commission. An automatic correction mechanism will have to be implemented in case of a deviation from this path. The EU Court of Justice will verify that the rule complies with the European rules. Countries will have to cut their deficit, according to a schedule proposed by the Commission. Countries under an EDP have to submit their budgets and structural reform programmes to the Commission and the Council, which will make recommendations and monitor budget implementation. A qualified majority of euro area governments will be

required to oppose sanctions decided by the Commission against countries breaching the 3% ceiling or not complying with instructions given by the Commission. MS will have to introduce independent fiscal committees in charge of verifying that the balanced budget rule is met and the adjustment path.

This project is dangerous from an economic point of view because it imposes an arbitrary public deficit rule; it imposes quasi-automatic fiscal policies; it prohibits any discretionary policy to support activity. But discretionary policies are needed to stabilise the economy. Let us assume that the tax-to-GDP ratio is 50% and propensity to consume is 1. Then the multiplier equals 2. If private spending falls by 10 *ex ante*, this will lead output to fall by 20 in the absence of any fiscal policy response, and the public deficit will rise by 10. Fiscal expansion raising public expenditure by 10 will lead to the same rise in deficit but will prevent output from falling. Such a policy would be forbidden according to the law proposal. The proposal is based on an implicit and wrong theory: automatic stabilisers should be allowed to work, but discretionary stabilisation fiscal policies should be forbidden. At the end of 2008, the IMF, the G20 and the European Commission requested countries to implement such discretionary policies. Should these policies have been abandoned two years later?

MS will lose fiscal autonomy. Implementing this Pact would be a serious setback for democracy in Europe.

In fact, the aim is to impose strong commitments to MS in order to convince Germany and the other Northern countries to accept more financial solidarity in Europe, to persuade the ECB to intervene more strongly by buying public debts, and more importantly to announce its intention to do it as long as necessary. But so far Germany and the ECB are not convinced that they should follow this strategy.

Last, some economists and even ministers in Germany or the Netherlands requested that a country not fulfilling the SGP may be condemned by the European Court of Justice. Fiscal policy would be submitted to the judiciary power. Jean-Claude Trichet, the then ECB President, and Wolfgang Schäuble, the German minister for finance, proposed that a Commissioner be responsible for euro area MS public finances, be allowed to supervise MS budgets, and

even have a veto right. The risk is that binding and absurd fiscal rules, inconsistent with macroeconomic governance needs are implemented. This is the ambiguity of current European construction: better economic policies coordination is needed, but a strictly numerical control of public deficits levels is neither economic policy coordination, nor an optimal rule.

3.2.1. A French-type rule? Bis

In October 2012, the French government has had the Parliament enact an “Organic law relating to the planning and governance of public finances” (*loi organique relative à la programmation et à la gouvernance des finances publiques, LPFP*), which translates into French law the European Fiscal pact (the TSCG). In fact, the government chose to take account *ad minima* of the Treaty, since the new fiscal procedure is not included in the constitution.

Article 1 of the Organic Law stipulates that: “In accordance with the objective of running government accounts in balance as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in Article 3 of the TSCG.” But how can a Programming law “set a target” when the target derives from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of below 0.5% of GDP and that an adjustment path to ensure a rapid convergence towards equilibrium will be proposed by the European Commission? The ambiguity of this article reflects an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France’s commitment to follow the recommendations of the Commission.

The programming law will cover 4 to 5 years, but will be voted again by the Parliament each year and so the constraint will possibly be amended with the vote of a new programming law, as this has been the case in France since the SGP was introduced. Thus the programming law as such does not introduce additional constraints to those already required by European treaties.

The organic law establishes a High Council of Public Finances, which will give advice on the macroeconomic forecasts underlying the finance law project, on the Stability programme which France has to submit to EU authorities, on the LPFP. The High Council

will verify that the Finance Law project is consistent with the trajectory announced in the LPFP. He will give his opinion on the existence of “exceptional circumstances”.

The High Council will be chaired by the President of the *Cour des comptes* (Court of audit) and will consist of 4 members of the *Cour des comptes* and four members appointed due to their expertise in public finances by the Presidents of the French National Assembly, the Senate and two Finance Commissions. The *Cour des comptes* will have a prevailing role, which is problematic. The *Cour des comptes'* judicial officers are not *a priori* macroeconomic experts, and because of their job position are often more concerned with public finances in balance than with output growth and employment. The latest *Cour des Comptes'* Reports have for instance underestimated the size of the output gap, they support the thesis according to which the fiscal multiplier is close to 0 and that public expenditure cuts are more relevant than increases in taxes. We would like to be sure that the *Cour des Comptes'* judicial officers will express their own views in full independence, and that the High Council's Reports will reflect a diversity of opinions; which is not currently the case in the *Cour des Comptes'* Reports.

More fundamentally, one may wonder whether there will be some flexibility in the High Council's assessments. Will the High Council be entitled to conclude that the adjustment path is too restrictive, and that the medium-term target is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore public finances?

Finally, a question needs to be raised: what will be the legitimacy of this High Council? Fiscal policy choices must be subject to democratic procedures. Economic policy assessment is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other hand?

The High Council will only give advice, which neither the government nor the Parliament are obliged to follow, but the risk is great that these recommendations influence financial markets

and the Commission and that it would be risky for the government not to fulfill them strictly.

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the spirit of the negotiators from Northern European countries and from the Commission, this mechanism should stipulate that in the event of 1% of GDP deviation in year *N*, the Constitution ensures that, automatically, some taxes (e.g. VAT) are raised by 0.5 percentage point of GDP and some expenditures (e.g. social benefits) are cut by 0.5 percentage point of GDP. As a matter of fact, Chapter 3 of France's Organic Law provides that the High Council reports such a deviation, that the government explains the reasons for this deviation and then takes them into account when elaborating the next finance law. Parliament's rights are respected, but fortunately the automaticity of the correcting mechanism is not guaranteed.

In the spirit of its founders, the fiscal treaty should put an end to the possibility of autonomous domestic fiscal policies. Fiscal policies should become automatic. Fiscal policy should aim at budgets in balance, just as monetary policy must be to prevent inflation; growth and employment shall be sought through free market structural reforms. The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implements it only reluctantly. It's a safe bet that, as with the Stability Pact, there will be great tensions in the euro area between those who demand the strict enforcement of the Treaty and those who do not want to sacrifice growth to it.

3.3. Fiscal rules and markets

In 2011, most euro area economies ran close to primary structural balances, in other words their debt ratio would be stable if they could borrow at interest rates equal to output growth (Table 8). This is not the case for Japan, the US, and the UK. Besides, euro area countries suffer from a much higher interest rate than countries outside the euro area, although they have smaller imbalances. There is a specific cost for euro area countries.

Table 8. Selected indicators for countries' economic situation in 2011

	Current account, % of GDP	Public deficit, % of GDP	Public debt, % of GDP	Average growth, 2011 and 2012	Grade, Over 20*	Primary structural balance, % of GDP	10-year interest rate, 2011Q4
FIN	-0.6	-0.9	49	1.9	17.5	-0.7	2.5
DEU	5.7	-1.0	81	2.2	17.5	1.0	1.9
AUT	1.9	-2.6	72	1.9	16.1	0.1	3.1
NLD	9.2	-4.6	65	0.4	15.4	-2.4	2.4
BEL	-0.8	-3.9	98	1.2	12.5	-0.6	4.4
FRA	-2.1	-5.2	86	1.2	10.7	-1.6	3.2
US	-3.1	-9.7	103	2.1	9.6	-5.7	2.0
UK	-1.9	-8.4	83	0.6	9.6	-4.2	2.3
SPN	-3.5	-8.5	69	-0.5	8.6	-3.7	5.7
JPN	2.6	-9.5	206	0.7	8.2	-7.4	1.0
IRL	0.1	-13.0	108	0.7	7.5	-2.0	8.7
ITA	-3.1	-3.8	120	-0.6	7.5	1.4	6.6
PRT	-6.4	-4.2	108	-2.4	6.4	-1.5	12.2
GRC	-9.8	-9.2	165	-6.1	2.9	1.1	19.0

* This grade is the average of each country's rank according to four criteria: current account, public deficit, public debt and output growth.

Source: OECD, *Economic Outlook*, May 2012. Authors' calculations.

For euro area countries, these constraints come in addition to financial markets constraints. Since 1945, no industrial country defaulted on its public debt. Public debt was a safe asset, since governments were borrowing in their own currency and could always ask for central bank financing. Industrial countries benefited from “monetary sovereignty”. This is always the case today for Japan (where 10-year government bonds interest rates are at 1%, despite a government debt of 205% of GDP), the US (where 10-year government bonds interest rates are at 2%, despite a government debt of 100% of GDP) and the UK (where interest rates are also at 2% with a debt of 85% of GDP). It is a nonsense that rating agencies rate governments having monetary sovereignty, as if the latter could possibly default. Countries with monetary sovereignty should abandon their AAA: by nature, their debt is safe since it is guaranteed by the monetary power of their central bank.

Euro area countries have lost their “monetary sovereignty”: according the EU Treaty, the ECB is not allowed to finance governments; there is no solidarity between MS. Financial markets

realised this in mid-2009. Since then, an out-of-control speculation started on the more fragile euro area countries: Greece, Portugal, Ireland, and then by a domino effect, Italy, Spain, and even Belgium. In December 2011, Belgium had to pay an interest rate at 4.3%, Spain at 5.3% and Italy at 6.6% against 3.1% for France and 1.85% for Germany. Greece, Ireland and Portugal are brought back to a situation of developing economies in the past: their debts have become risky assets, facing substantial risk premia; they have to obey the caudine forks of the IMF.

Thus, fiscal policy may be entirely paralysed. In a country with monetary sovereignty, in times of recession the central bank may cut its interest rate down to the lowest level and be committed to keep it durably low; the government increases its deficit, but the low level of interest rates avoids public debt to increase under a “snowball effect”; this leads the exchange rate to fall, which supports output. The debt guarantees by the central bank implies that there is no default risk, hence no reason for being obliged to reassure markets in permanence. The central bank will keep interest rates low in times of depression and this will ensure fiscal policy effectiveness. Fiscal policy does not have to care about markets. This is still the strategy of the US.

In the euro area the risk is that a country may be unable to increase its deficit under the fear that government debt will be downgraded by rating agencies and that interest rates increase strongly. Countries have therefore no choice but to engage in beauty contests, in order to appear as virtuous as Germany in the markets’ eyes. Their fiscal policy becomes ineffective and hence their cyclical position cannot be stabilised. Public debt becomes a permanent risk factor, since governments are at the mercy of markets’ animal spirits. Any economic policy would have to be assessed accounting for markets’ opinion. But markets do not have any particular macroeconomic expertise. They demand austerity measures in depressed times and afterwards complain about insufficient output growth. This is how they proceed nowadays for the euro area in general, for Italy and Greece in particular. They favour free-market reforms, such as reducing social protection or the number of teachers. The default risk must be inexistent for countries to remain able to stabilise their economy.

The euro area therefore has to choose between disappearing or getting reformed in order to guarantee MS government debts; MS would find their “monetary sovereignty” again. EU public debts should become safe assets again, with low interest rates but fully guaranteed (by EU solidarity and fundamentally by the ECB). This is the only way to maintain domestic fiscal autonomy, which is necessary due to disparities in Europe and to the loss of the monetary instrument and of the exchange rate .

The euro area framework was not appropriately designed initially, especially as concerns the trade off between “fiscal policy autonomy/single currency/monetary sovereignty”. The joint guarantee creates a moral hazard problem, since each country may increase its debt with no limit, but the absence of guarantee leaves the door open to financial markets always ready to bet against some countries. The guarantee cannot be restricted to countries fulfilling the automatic fiscal rules of the SGP or the fiscal pact, which lack economic rationale. It cannot be restricted to countries committed to follow a pre-defined trajectory for public deficits, without accounting for the cyclical situation (as propose Doluca *et al.*, 2013). Such a commitment would oblige countries to implement simultaneously restrictive policies in times of economic slowdown, multiplying by almost 4 the size of the shock *ex ante* (see Box 2).

Contrary to what several economists propose (and among them even de Grauwe, 2012), this guarantee cannot be limited to 60% of GDP. The 60% of GDP figure is arbitrary, and does not fit with the needs of macroeconomic equilibrium. The non-guaranteed debt would be considered as highly risky and markets would require high interest rates. Since almost all euro area countries run government debts of more than 60% of GDP, they would have to borrow at high interest rates. The interest rate spread between the two types of debt would allow financial markets to speculate in permanence.

Euro area countries would not have to reassure markets anymore. They could implement differentiated but coordinated strategies, setting themselves a main target of bringing their economy to a satisfactory employment level, consistent with moderate inflation.

4. Conclusion

Due to the crisis, there is probably a need for a more transparent fiscal policy management: governments should set out clearly their output growth target, temporary expansionary measures should be clearly announced as such, the structural balance should not include temporary expansionary measures; the public deficit target should be explicit, but this target can only be the true golden rule and should be assessed accounting for the macroeconomic context.

But fiscal rules proponents forget that fiscal policy cannot be managed on its own, under arbitrary criteria. Fiscal policy should set itself the objective of maintaining (or reaching) a satisfactory employment level albeit allowing inflation and interest rates to remain at satisfactory levels. Government deficit and debt should be derived from this objective.

The emergency today is not to strengthen public finance discipline by cutting deficits blindly but to question economic developments (financial globalisation, the wish of many countries to build surpluses, the change in incomes distribution), which make these deficits necessary to support output (Mathieu and Sterdyniak, 2011).

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