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Document de travail

DO WE NEED FISCAL RULES?

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Do we need fiscal rules?*

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In memory of Henner Will

Abstract: 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 in 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 “New 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.

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Section 1. Introduction

The 2007-2011 crisis is a first of all a banking and financial crisis. The crisis was due to hazardous and unregulated financial innovations, in a context of financial liberalisation and globalisation. Markets 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, public deficit for the OECD as a whole was amounting to 1.3% of GDP only, 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 taken 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.

According to financial markets, international institutions, and many mainstream economists, it is now of first importance to tackle the issue of public deficits and debts. The problems due to the instability and lack of control of the world economy generated by financial globalisation have been forgotten.

Proposals aiming at imposing fiscal policy rules are back to the forefront. But there is no evidence that economically relevant rules can be set. The issue is especially acute in the euro area, where the Stability and Growth Pact (SGP) did not work, and where Member States (MS) are under financial market pressure. The ECB and the Northern countries have agreed to help Southern countries but wish, as a counterpart, to impose a “New Fiscal Pact”, which risks to paralyse fiscal policies and to prevent economic stabilisation.

The paper has three parts. Section 2 deals with the justifications and specifications for fiscal policy rules, either in a classical or in a Keynesian framework. Section 3 provides an analysis of fiscal rules experiences. Section 4 discusses EU projects. Section 5 concludes.

Section 2. Fiscal rules justifications and specifications

The neo-classical viewpoint

Fiscal rules proponents argue that governments are not benevolent¹. Governments do not aim at optimising citizens' welfare but aim at being re-elected. 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.

¹ See, for instance, Alesina and Perotti (1995), Alesina and Tabellini (1990), Drazen (2004), Wyplosz (2011).

According to the Leviathan-State theory or the Public Choice theory, each social group asks for benefiting from higher public spending without considering that this will imply higher taxes. In a non-cooperative equilibrium public expenditure is excessive. Each government agency sets the objective of 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 increasing taxes as a counterpart. 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 increase public debt. 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. This raises long-term rates which crowds-out private investment. 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. These 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 assess that such interest rate levels are detrimental to investment.

This theory does not explain why all governments would have suddenly become demagogic and increased too much their expenditure 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 OECD countries were characterized, in the recent period, by fiscal indiscipline (contrary to what Debrun and Kumar (2007), and Wyplosz (2011) 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’ so as 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.²

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.

This rule can be more precisely defined. Let us assume that a country wishes to maintain a public debt level equal its public capital stock. Public debt in real terms will vary 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: $S = S_p - rD_{-1} = -(I - \delta K_{-1} + \pi D_{-1})$. 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 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. Moreover, 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. 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 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 populations. 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, where financial markets require high interest rates which leads growth to fall and debts to be unsustainable. This pleads for a debt ceiling, but at which level?

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; sustainability is a crucial issue for them. The former cannot be insolvent since the Central Bank can provide funding to the government. Coordination between fiscal and monetary policies can maintain full

² 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).

employment after a negative demand shock. The risk is that a too expansionary fiscal policy obliges the central bank to raise interest rates to stabilise inflation, which could make public debt unsustainable (Sargent and Wallace 1981, Leeper 1991, Sterdyniak and Villa 1994). This cannot occur with the rule: fiscal policy must maintain a satisfactory employment level, while enabling the interest rate to be below the nominal growth rate.

A Keynesian perspective

From a Keynesian perspective, a certain level of debt and deficit are necessary to ensure that demand equals potential output. Public debts and 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 demand is sufficiently boosted. 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 fall in prices of around 1.5% per year). It may not be implementable in the euro area where the common interest rate cannot adjust the different business cycle situations in the 17 Member States. So the sharp rise in public debts must be related to the lower inflation and growth (which prevent the authorities to reduce the real interest rate adjusted for growth) and to the introduction of the euro.

In order to obtain a satisfactory demand level, the government must then accept some public deficit.

If $y = g + d + cy - \sigma r + kh$, this implies that in the short-run: $g = -d + \sigma r$

Let us note that if this policy is implemented and if stabilisation is perfect, then there is no link *ex post* between the deficit and the output gap. Let us note also that, 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 growth rate.

This simple model shows that a fiscal rule like: $g = g_0 - \lambda y - \mu(h - \bar{h})$ cannot be proposed, since it would not allow for entire 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 as households wish to hold less risky financial assets and businesses want to be less leveraged. Structurally, 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: if the rise in public debt leads private agents to increase their spending,

then the government will be able to cut its deficit accordingly. The government must be ready to cut its deficit when private demands resumes. This may require that some public expenditure or some revenues 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. the automatic effect and slightly more; fiscal policy should be restrictive when monetary policy is restrictive too (a fiscal surplus is needed when the interest rate set by the ECB exceeds 4%, the growth 'golden rule' rate, according to Phelps). Therefore:

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

According to this reasonable 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 amount in 2011 to: $1.3 + 1.2 + 0.75 \times 3.3 + 1.25 = 6.2\%$ of GDP. The French public deficit is actually around 5.7% of GDP.

But this rule does not allow for full stabilisation and does not take in consideration the fact that the output gap depends on 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. Demand weakness may be interpreted as a desire of households to own more financial assets combined with a denial of companies to invest. In this situation, it is normal that the government allows public debt to increase (if interest rates cannot be lowered): the government stabilises the economy in providing the desired public debt. Public deficits increase demand directly and also indirectly in 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' saving has a counterpart in terms in public debt and deficit. One may of course regret that it has no counterpart in terms of private firms' 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 or if markets request inappropriate risk premia (Ben Amar and Sterdyniak, 2011). Let us assume for instance, that households increase their savings' ratios because as they get older they wish to own more public debt. 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: 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 the debt again. In both cases, output cannot be stabilised. In both cases, private agents' defiance towards public debt is a self-fulfilling prophecy.

Thus public debt can be reduced 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 at lowest levels. 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 demagogic choices, once it is recognised that debts and deficits are allowed? Fiscal rules opponents may reply that the fiscal policy adequacy criterion lies on the employment level, inflation, interest rates, and not on *a priori* public debt or deficit levels. They may request rules consistent with the macroeconomic stabilisation objective.

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 would be harmful if they prevent fiscal policy to play.

Therefore 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 current account surpluses accumulation: Asian countries learnt the lesson from the 1997 crisis and wish to be free of financial markets pressure; China's 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 put downward pressure on their wages so as to raise their 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 through higher wages and social benefits³.
- 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 reach a paroxysm and when bubbles implode, public debt has to support demand.
- The debt rise does not result from rising public spending, since on the contrary these expenditure have decreased as a share of GDP (by 1.4 percentage point for the euro area between 1997 and 2007), but from lower tax receipts (by 1.5 percentage point in the euro

³ Strangely, the European Commission and economists in the industrial economies recommend this strategy ...but for China.

area) due to the tax counter-revolution implemented by most governments since 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' contributions etc...) with no positive growth impact. These tax policies have therefore increased social inequalities and public deficits. Simultaneously these tax cuts policies were chosen by EU institutions, right-wing governments and leading classes with a view to cut tax revenues, and pretend afterwards that because of the resulting deficit, public expenditure need to be cut.

Section 3. Fiscal rules experiences

A fiscal rule⁴ may be defined as: 'a fiscal policy constraint which limits the level of some variables like deficit, debt or expenditure, either in absolute terms or depending on some economic variables'. The implementation of fiscal rules has been strongly advocated by the IMF, fiscal rules facilitating fiscal policies surveillance by the IMF (see IMF, 2009).

In fact, there are different types of rules according to several criteria:

1. 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 limit: public deficit should not exceed 3% of GDP; debt should not exceed 60% of GDP. Such rules play asymmetrically and episodically.

In the first case, it is difficult to design a rule able to account for all situations. In the second case, the rule bites in times of crisis, precisely when output needs to be supported by fiscal policy, and not in good times, when running fiscal consolidation would possibly not be detrimental to growth. The ceiling is generally arbitrary.

Some authors suggest automatic fiscal policy rules. Generally, these rules are based on magical numbers, unrelated with macroeconomic equilibrium justification (like the target of bringing public balance in equilibrium). Some authors recommend to target the debt ratio; but how to determine the appropriate level?

2. Rules can apply to government borrowing, structural balance, debt, expenditure or taxes. But government borrowing depends on the cyclical situation; 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 2). Should a rigid rule constrain the social choice between public and private expenditure? This has hardly any long-term justification. 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.

⁴ This paper considers national rules only and does not discuss rules imposed on local government.

Box 2. 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 98.68), *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.

3. Rules can be annual, medium-term (debt or deficit targets set at a five-year horizon) or long-term (ensuring public finance sustainability). But an annual rule often comes into conflict with the economic situation, a medium-term rule allows to postpone efforts and may lack credibility, a long-term rule is not very useful: even if a country anticipates a strong increase in its pension expenditures, an immediate increase in social contributions is counterproductive in a period of insufficient demand.

Some economists suggest fiscal policy should be run at two horizons: in the short-run, expansionary fiscal policies would be allowed; in the longer-term rigid rules would be implemented, and announcements like pensions reforms would be made to reassure financial markets (Schick, 2010). What would be the credibility of such policies?

4. Rules may consist in a simple objective set by the government. They may be supervised by an external authority (Committees of independent experts, Parliament, Constitutional court, EU Commission), which may be entitled to give advices only. This external authority may be entitled to impose the fulfilment of the rules. Rules may be written in the Law or in the Constitution.

The first case has the advantage of being soft: the government may change its objective or may not fulfil it (sometimes with the only obligation of explaining why). The second case raises the issue of the supervising authority: is fiscal policy a technical or a political issue? The supervising authority may be given the mandate to give advices, to dialogue with the government. Going beyond that, the third case is hardly consistent with democratic principles. The fourth case is difficult to implement because all possible events cannot be written in 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, the structural balance should be at the equilibrium), it is unenforceable.

Wyplosz (2002) proposed to establish a national fiscal policy committee of independent experts. This Committee would 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 under the responsibility of a technocracy. The Committee's mandate would be to ensure public debt long-run sustainability, while the output stabilisation objective would come in second. Unfortunately, the author 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, but he admits that it is impossible to set the appropriate level for this ratio.

As concerns monetary policy, the central Bank's objective is rather clear⁵ : ensuring low and stable inflation rates, the equilibrium unemployment rate theory ensuring that monetary policy will lead to the optimal 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? This is a political choice which belongs to voters and not to experts (Murray and Wilkes, 2009). Wyplosz (2011) recognises that these committees should be based on rules, but it does not describe them: will they depend only of fiscal variables or will they take account of the macroeconomic situation? The crisis has clearly shown that fiscal policy cannot follow rules and must be run by determined and brave governments, which will not be the case for experts' committees. Can we imagine that a group of experts would oppose to banks' financial support or active stabilisation policies in 2008-2009?

Other authors, like Fatas *et al.* (2003) propose a Sustainability Council, i.e. an independent panel of experts, who would assess national 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 senses as a long term constraint only. This means 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 lead markets to have a single opinion and that they exert an excessive influence.

Other academics simply suggest setting an independent fiscal policy committee in charge of assessing macroeconomic projections' credibility and whether fiscal assessments are realistic. Why not? But should there be a single and official Committee? Would not this paralyse the democratic debate? One should not engage in a vicious circle: lower than expected output growth, therefore a higher than forecast deficit and therefore a more restrictive fiscal policy.

5. How should the position of the economy in the business cycle be accounted for? Should the fiscal rule apply 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?
6. 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 law is automatic). The last cases raise feasibility and democratic issues. In the event of a deep depression, a rule may be unenforceable or generate disastrous consequences. For what reasons could a group of experts constrain 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. Any deviation from the path would be corrected through an automatic rise in taxes. But this would prevent any

⁵ Although this objective has become less clear with the financial crisis' developments. Should the Central Bank ensure financial and banking system stability? Should the Central Bank save the financial and banking system?

stabilisation fiscal policy; this supposes that the structural balance can be available in real time, and that the structural balance equilibrium matches the macroeconomic equilibrium.

The difficulties we have just mentioned plead for a vague rule, with large flexibility. This is how rules worked until recently.

National rules

Many countries have introduced in their constitution rules which did not have a real impact. Either these rules are vague and not really binding, or they are abandoned when they become binding.

The US has no fiscal rule. There is a public debt ceiling, which can be risen when needed, and this may be the opportunity to make medium-term fiscal commitments. Since 1974, the CBO has played a significant role in producing reports on the medium-term fiscal outlook and on fiscal policy costs. But it does not have any power. The situation is similar in the Netherlands, where the 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, according to the National Stability Pact, governments are not allowed to run deficits exceeding the amount of their investments; they should target budgetary positions in balance.

In Spain, the Fiscal stability law from 2004 states that ‘all levels of government should aim at budgetary positions in balance’.

Formally, France already has 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. 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.

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

	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13
J99	-2.9	-2.3			-1.2											
J00		-2.1	-1.7			-0.5										
J01				-1.0	-0.6	-0.4	0.2									
J02					-1.4	-1.3	-0.5	0.0								
J03					-2.8	-2.6	-2.1	-1.6	-1.0							
J04						-4.0	-3.5	-2.9	-2.2	-1.5						
J05								-2.9	-2.2	-1.6	-0.9					
J06								-3.0	-2.9	-2.6	-1.9	-1.0				
J07									-2.7	-2.5	-1.8	-0.9	0.0			
J08										-2.4	-2.3	-1.7	-1.2	-0.6	0.0	
J09											-2.9	-3.9	-2.7	-1.9	-1.1	
J10												-7.9	-8.2	-6.0	-4.6	-3.0
J11													-7.0	-5.7	-4.6	-3.0
	-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	-5.6		

In the UK, the New Labour government submitted to a vote in the Parliament in 1998 a ‘Code for fiscal stability’, embedding two rules: the golden rule for public finances: the government

shall be allowed to borrow only to invest over an economic cycle; the sustainable investment rule: 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? The rule involves a risk of excessive public investment in bad economic times.

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

Balassone and Franco (2002) rejected the Golden rule in the name of measurement difficulties. The rule implies that statisticians are able to estimate 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 questionable 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 subdued activity or a restrictive policy in a period a high inflation. It may wish to implement structural measures if it judges that saving is too high *ex ante* (which would require a too low interest rate) or too low (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 (net debt stood at 33% of GDP in 1998 in the UK). The golden rule ensures on its own that net public debt stands below public capital stock.

No mechanism forces the government to fulfil the Code; the government simply needs to explain why it did not fulfil it and how he will stick to it. The rule allowed the government to increase substantially public investment spending starting from 2002, which was needed both for structural (public equipment was insufficient) and cyclical (to counterbalance lower 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 government debt (which reached 62.6% GDP in September 2011, excluding financial interventions). This

shows clearly that fiscal rules cannot be set as rules ‘for all seasons’, and that they cannot be met in times of huge crisis such as the one which started in 2008.

The Stability and Growth Pact

Euro area countries are committed to the SGP. This is an example of a fiscal rule enshrined in an international Treaty, which raises a delicate issue: can a Treaty resulting from a political compromise contain binding economic constraints which are in contradiction with economic theory?

The Pact was based on the assumption that MS domestic fiscal policies could have a negative impact 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 initial basic principles remain unchanged. MS should not run higher than 3% of GDP public deficits and higher than 60% of GDP public debts. MS are requested to release 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 potential growth and low public debt). The budgetary effort must be 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, it 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 the automatic stabilizers are allowed to play, the calculation of the structural balance being made by the Commission’s method. The European Commission initiates an Excessive Deficit Procedure (EDP) when a country exceeds the 3% of GDP deficit (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):

1. The 3% limit makes no sense in times of economic depression. A country particularly hit by a recession may need a higher than 3% of GDP deficit to counterbalance a large fall in private demand. *A priori* this will have no negative impact on partner countries since it will prevent spill-over effects of a fall in domestic demand. In 2002, Germany was running a 3.5% of GDP public deficit but the inflation rate stood at 1.4% only and the current account surplus at 1.9% of GDP: we cannot see how the German deficit could have a negative impact on his partners.
2. The Pact is blind for two reasons. It can operate 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 does not bite for too virtuous countries. The Pact does not take into account the issues of external balance, competitiveness, private debt, financial or real estate bubbles.
3. 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, countries like Spain and Ireland have enjoyed strong growth, with inflation, and without any public deficit.
4. The rationale for a medium-term budget in balance has no clear economic justification. A country where private savings are spontaneously too low (high) may need some budget

surplus (deficit). It is also reasonable to finance public investment through government borrowing and therefore some public deficit is justified. In a situation of relatively low private demand, running a government budget in balance may require such a low interest rate level that the objective will be out of reach. A deficit kept in permanence at 0% of GDP would lead nominal public debt to be stable and constantly declining as a percentage of GDP. The debt would reach 0% of GDP at some point. But savers, in particular pension funds, need to own public assets, because these are long-term, liquid and safe assets.

5. In good times, the SGP aims at structural borrowing cuts, but cannot put 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 a depression, the rule becomes totally unenforceable. Moreover, 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? Nothing justifies the prohibition of discretionary fiscal policies. The SGP constrains fiscal policy to let automatic stabilisers play only. But the latter alone cannot 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 public deficits will rise by 10. If fiscal expansion increases public expenditure by 10, this will induce the same rise in deficit but will prevent output from falling. Such a policy would be forbidden according to the SGP, based on an implicit and wrong theory: automatic stabilisers should be allowed to work, but discretionary stabilisation fiscal policies should be forbidden.
6. Since there is a single interest rate which does not fit domestic specific situations, each MS should be allowed to use fiscal policy to achieve a satisfactory output level (corresponding to the natural rate of unemployment). If we 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 $g_i = 0$ produces an unsatisfactory output level.
7. The SGP implementation relies crucially on the potential output growth estimate, which is problematic in the crisis. According to the Commission method, potential output deviates relatively little from actual 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. In 2010, was the requested effort to return to the structural balance equilibrium of 5.0 or 2.5 percentage points of GDP? If the target is a primary structural position in balance, this was already reached in 2010, if we consider the 2008 estimates of potential growth.

The SGP implementation led to strong tensions within the area (Table 3). 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. So, 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 a 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, but these countries experienced sluggish growth in that period. 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.

Table 2. Euro area structural balance estimates, according to the Commission

	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.

Table 3. MS not fulfilling the rules: public deficit/public debt in % of GDP

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Portugal	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
France		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
Germany		3.6/60	4.0/64	3.8/66	3.3/68	/68	/65	/66	3.0/73	3.3/83	/84
Neth.			3.2						5.5/61	5.3/63	3.7/66
Greece	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
Italy	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
Spain								4.2	11.1	9.2/60	5.9/68
Ireland								7.3	14.3/66	32.4/96	10.1/114
Belgium	/107	/103	/98	/94	/92	/88	/84	/90	6.0/96	4.2/97	3.6/97
Austria	/67	/66	/66	/65	/64	/62	/61	/64	4.2/70	4.6/72	3.7/74

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. Governments implemented discretionary policies; the Commission had to accept them and even to pretend to co-ordinate them, forgetting its speeches on their inefficiency. The structural balance objective was entirely lost. Government deficits rose, both in their structural and cyclical components: the Stability Pact had to be put aside.

It appeared that public finances deteriorate in times of crisis when fiscal rules can no more be applied and are necessarily ‘forgotten’. Public finance deterioration 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), by the length of the crisis (which raises the issue of exit strategies), by the bad functioning of the euro area which means that financial markets bet against Ireland, Portugal, Italy and Belgium, where situations are not worse than in the US.

Section 4. Fiscal rules proposals

Although the rise in deficits and debts was not due to a drift in public finances, many economists and international institutions suggest exit strategies based on fiscal rules, aiming at bringing budgetary positions in balance. This raises two issues: how to define this new equilibrium? How to ensure that these rules are consistent with macroeconomic requirements?

Even if the crisis has shown that active fiscal policies are necessary, 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, the strengthening of the rules is demanded by the ECB, Germany, the Netherlands, and Finland, 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: lower output growth will generate lower tax receipts, will increase the debt-to-GDP ratio, government balance targets will not be reached; rising unemployment and political and social tensions will increase the fear that the country does not stick to the rule and even leaves the euro area.

Germany: The debt brake

Germany has introduced a 'debt brake' in its Constitution, which forbids any higher than 0.35% of GDP structural deficit 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 (above 0.35% of GDP) each year since 1974 (except in 1985 and 1989). But how can we consider that a country running 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 was not fulfilling the SGP.

Derogations can take place, in case of 'natural disaster or exceptional economic circumstances'. They should be agreed in a Parliament vote, with a 2/3 majority. The law creates a 'notional adjustment account', where the excess over the 0.35% rule (due to cyclical developments or poor execution of the budget) are recorded. These excesses will have to be amortised 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. In the event of growth deceleration, the fiscal policy constraint will depend strongly on the potential output estimate. In 2010, the German government deficit stood at 4.3% of GDP. The structural deficit amounted to 3.5% of GDP according to the Commission, to 3.3% according to the OECD, to 1.3 % of GDP according to us.

In the long-term, if one considers that Germany may have a potential growth rate of 3% per year in nominal terms, then running a 0.35% of GDP deficit would lead the public debt down to 12% of GDP in the long-term. 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.

Austria, Spain and Italy

In 2011, the Austrian government tried to introduce the same ‘debt brake’, but did not obtain the agreement of enough political parties.

In Italy, a constitutional amendment requiring a balanced general government budget, starting from 2014, was voted in December 2011 and still needs two votes by June 2012.

In Spain, a reform of the Constitution incorporating deficits and debt limits required at the EU level was approved in September 2011. An organic law, setting precisely the rules, should be approved by the Parliament before 30 June 2012. From 2020, the structural deficit should be limited to 0.4% of GDP (0.26 for the State, 0.14 for regional governments). Hernandez de Cos (2011) writes: “The target variable is the structural deficit, but currently the project does not say how it would be defined. The problem of measuring the structural deficit for Spain has always been very acute”.

UK: an independent office

In 2010, the UK introduced an independent *Office for Budget Responsibility*, in charge of producing the 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 a five-year period, i.e. the golden rule with the problems 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? He will fortunately not be constrained by the 2011 programme. Hence, the medium-term commitment is not so binding.

A French-type rule?

In March 2010, a Commission was appointed with the mandate of recommending a public finances rule. The report was released in June (see Camdessus, 2010).

From the beginning, the Commission chose not to consider wise rules like the ‘golden rule’ or the stabilisation of the debt-to-GDP ratio, and suggested instead an unenforceable rule: the equilibrium of the structural 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 himself by law on a programme reducing structural deficits and on a date at which the structural balance would be reached.

In March 2011, the French government proposed a complicated Constitutional law project. Each government will have to commit themselves in a multiannual public finance law, which should cover 3 years at least and would include, year by year, a public spending ceiling and an amount of new measures in terms of receipts (independently of the conjuncture). Higher than announced spending would be allowed only if combined with a similar rise in receipts. The government would have to commit initially on a fixed scenario including each year cuts in the structural deficit (public expenditure less receipts corrected from the conjuncture). The government 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 fiscal effort.

This project raises several difficulties:

- It commits future governments to target public finances in balance.
- It continues to be based implicitly on a potential output growth path, needed to estimate the effort in terms of expenditure and of the trend in receipts.
- It requests the Constitutional Council to assess whether the fiscal effort matches well the multiannual public finance law, whereas the measurement of this effort depends on arguable assessments of potential growth, on the impact of output level on tax revenues, on the impact of the new measures.
- What will happen if output growth is much weaker than planned in the ‘multiannual law’? In principle, the government should not be entitled to implement discretionary stabilisation measures. The Law would then constrain fiscal policy to let automatic stabilisers play only. But the latter alone cannot 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 public deficits will rise by 10. If a fiscal expansion increases public expenditure by 10, this will induce 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 policies. Should these policies be two years later?

In fact, the Constitutional project is written in such a way that the government will have the possibility ask the parliament to vote a new ‘multiannual law’ before voting the budget law. The risk is that it complicates further the budgetary process, even more if the multiannual law comes in addition but does not replace the Stability programme that France has to send to EU authorities each year.

The experience of the SGP has shown that it is useless to ask MS to announce a trajectory for public finances independently of the cyclical situation. 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 had moved to 6% of GDP. Obviously, this rise in deficit was needed in 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 output in 2009, and not to be constrained to remain inactive?

Some mainstream economists (like Boone and Pisani-Ferry, 2011) think that France should make more budgetary efforts: they request that the ‘multiannual law’ at the beginning of the Parliament legislature, determines ‘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 request 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 these years. An ‘independent public finance council’ should be settled, and would be in charge of evaluating the fiscal policy implemented.

This project was adopted by the French National Assembly and the Senate, but did not obtain a sufficient majority. It will not be voted by the Congress.

However, the French government has made a clear commitment to meet from now on 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, announcing that GDP growth will in 2012 be 1 percentage point lower than anticipated a few months ago should translate into austerity measures amounting to 0.5% of GDP which should dampen output growth further. On the whole, accounting for a 0.5 sensitivity of government borrowing to GDP and a multiplier equal to 1, the additional austerity measures should amount to 1 percentage point of GDP and GDP should fall by 2%.

A strong EU pressure

The EC's legislative proposals on strengthening the SGP, the 'Euro Plus Pact' and the 'new fiscal rule' aim at constraining all euro 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 fiscal rules and not on a precise coordination of macroeconomic strategies, and this has increased disparities within the EU 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 Germany's weight, which wishes to be paid for increased EU solidarity through 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 did not include such rules in their constitution they would 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 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 that their liquid assets accumulation has a counterpart in terms of debt. Such contradictory demands will 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 budgetary surplus).
- Countries will face sanctions if they do not cut their structural deficit by 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 1/20 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. For a country having a debt of 90% of

GDP and a 2% annual inflation rate, the public deficit will have to be below 2% of GDP if GDP grows by 2%; the deficit will need to be below 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 requested measures are not implemented.
- The Commission wishes to impose countries to introduce EU rules in the fiscal frameworks (the 3% and 60% limits, the medium-term target of budgetary positions in balance) and to implement a surveillance of these rules by an 'independent budgetary institution'.
- The qualified majority will now be needed to oppose measures and sanctions recommended by the Commission, this being expected to ensure the automaticity of sanctions.

The Commission's proposals undermine MS autonomy, and force them to fulfil rules lacking rationale; they reduce 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 (the six-packs) was voted by the European Parliament while media remained silent and citizens entirely uninterested. The Parliament worsened the text: the Commission can sanction automatically a country not fulfilling the forecast path for deficit reduction.

According to the Euro plus pact, each MS should introduce in their budgetary framework or their Constitution a fiscal rule similar to the SGP, the Commission being in charge of verifying this equivalence.

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 December 9th 2011, the European Council, under Angela Merkel and Nicolas Sarkozy leadership, proposed a 'new fiscal compact', which merely repeats the already adopted framework. Each country should include in its Constitution a rule limiting the structural public deficit to 0.5% of GDP and providing a mechanism for automatic correction, if the ceiling is breached. The EU Court of Justice will verify that the rule complies with the European rules. Countries should reduce their deficit, according to a schedule proposed by the Commission. Countries under an EDP should submit their budgets and structural reform programmes to the Commission and the Council, which will give their advice and monitor budget implementation. A qualified majority of euro area governments will be required to oppose the sanctions for countries breaching the 3% ceiling or not complying with instructions given by the Commission. This project is dangerous in economic terms as it imposes an arbitrary public deficit rule; it imposes quasi-automatic fiscal policies; it prohibits any discretionary policy to support activity. MS will lose their fiscal autonomy. Implementing this Pact would be a serious setback for democracy in Europe.

In fact, the aim is to impose strong commitments to convince Germany and other Northern countries to accept more financial solidarity in Europe, to persuade the ECB to intervene more

strongly by buying public debts. But until now Germany and the ECB are not convinced they should engage in 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. The ECB President proposes that a Commissioner be responsible for euro area MS public finances and be allowed to control MS budgets. We therefore observe the implementation of binding and absurd fiscal rules, inconsistent with macroeconomic governance needs. This is a failure in the current EU framework: better economic policies coordination is essential, but a numerical control of public deficits levels is neither economic policy coordination, nor an optimal rule.

Fiscal rules and markets

In 2011, most euro area economies appear to be close to primary structural balance, in other words their debt would remain stable if they were borrowing at an interest rate equal to output growth (Table 4). 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, with smaller imbalances. There is a specific cost for euro area countries.

Table 4. Countries' situation in 2011

	Current account, % of GDP	Public deficit, % of GDP	Public debt, % of GDP	Average growth, 2011 and 12	Grade, over 20	Primary structural balance, % of GDP	10-year interest rate, December
Finland	3.0	-1.4	54	2.5	18.6	0.5	2.7
Germany	5.5	-1.7	84	1.9	17.1	0.0	2.15
Austria	3.1	-3.6	74	2.2	16.8	-0.4	3.2
The Netherlands	7.2	-3.8	66	1.25	15.9	-1.3	2.55
Belgium	1.0	-3.8	97	1.7	12.3	0.3	4.55
France	-2.6	-5.8	85	1.2	11.1	-1.4	3.3
Spain	-2.9	-6.5	68	0.5	10.7	-0.9	5.75
UK	-1.5	-8.8	86	1.15	8.9	-4.4	2.15
US	-3.7	-9.1	98	1.75	8.2	-6.8	2.05
Italy	-4.1	-3.7	121	0.3	7.5	2.3	6.35
Japan	2.6	-8.3	236	0.9	7.1	-4.9	1.0
Ireland	3.7	-11.3	114	0.0	7.1	-2.2	8.2
Portugal	-7.8	-6.8	101	-1.5	5.4	0.6	13.0
Greece	-8.6	-8.2	153	-4.2	3.2	2.6	34.5

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, US and UK (table 5). It is basically absurd that rating agencies rate governments with monetary sovereignty, as if they could possibly default. Countries with monetary sovereignty should abandon their AAA: by nature, their debt has no risk since it is guaranteed by the monetary power of their Central banks.

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 spotted this in mid-2009. Since then, an out-of-control speculation started on the more fragile countries: Greece, Portugal, Ireland, and then by a domino effect, Italy, Spain, and even Belgium. 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.

This financial markets' game may entirely paralyse fiscal policy. When a country has monetary sovereignty, 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'; it leads the exchange rate to fall, which supports output. The debt guarantees through monetary creation 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. Countries have therefore no choice but beauty contests, in order to appear as virtuous as Germany in the markets' eyes. Their fiscal policy becomes ineffective and hence their cyclical situation out of control. 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 while accounting for markets' opinion. But markets do not have any particular macroeconomic skills. They impose 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 nil for countries so that they can keep their ability to run economic policies. The euro area therefore has to choose between disappearing or getting reformed in order to guarantee MS government debts; governments would find their 'monetary sovereignty' again. EU public debts should become safe assets again, with low interest rates but entirely guaranteed (by EU solidarity and fundamentally by the ECB). This is the only way to maintain fiscal autonomy, which is necessary due to disparities in Europe and to the loss of the monetary instrument and of the exchange rate for each MS.

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 speculate against some countries. The guarantee cannot be restricted to countries fulfilling the automatic fiscal rules (lacking rationale and not enforceable); it should be automatic and total. The compromise would be that debts are totally guaranteed for countries agreeing to submit domestic fiscal policies to a coordination process. Such coordination should aim at reaching full-employment. The coordination process should reach unanimity. The Treaty should include a scheme for a country that would implement an unsustainable policy, incompatible with the coordination decision; in this case, the new debt of the country would not be

guaranteed, but this should never occur. Euro area countries not having to reassure markets anymore, could implement differentiated but coordinated strategies, setting themselves a main target of bringing their economy to a satisfactory employment level, consistent with a stable inflation.

Section 5. Conclusion

Due to the crisis, there is probably a need for a more transparent fiscal policy management: governments should state 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 golden rule and should be assessed accounting for the macroeconomic context.

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 increase public finance discipline by cutting blindly deficits but to question economic developments (financial globalisation, the wish of many countries to accumulate surpluses, the change in incomes distribution), which make these deficits necessary to support output (Mathieu and Sterdyniak, 2011).

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