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Chapter Author(s): Lucio R. Pench

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Comment Lucio R. Pench

The chapter by Charles Wyplosz provides a fairly comprehensive, clearly written, and overall balanced overview of the role of fiscal rules and institutions in helping ensure fiscal discipline. I agree with its main conclusions, which I read as follows: fiscal policy is affected by a serious deficit bias, the dangers of which have been exposed by the financial crisis; fiscal rules and institutions, while no panacea, are complementary instruments toward correcting deficit bias; in binding policies and their makers, rules and institutions are themselves subject to time-consistency problems, which can be mitigated by careful design exploiting their complementarity. My discussion is organized as follows: after touching on the technical issue of the empirical definition of fiscal discipline, I briefly review the broad concept of fiscal governance, which includes but is not limited to the dichotomy rules versus institutions, and in this connection I briefly elaborate on the complementarity between the different elements of fiscal governance; I then point to recent findings that lend support to the effectiveness of fiscal rules. Some considerations on the state of the play in the euro area conclude.

At the outset the chapter defines fiscal discipline in terms of the "[debt] ratio [being] stationary over a sustained period" and presents for a number of industrial countries the result of two methodologies testing the null hypothesis of, respectively, nonstationarity and stationarity. My basic point is that such tests are a way of helping one read the corresponding tie series, but not too much should be read into them. This is illustrated by the profile of the corresponding debt ratios over the period considered (figure 12C.1).

With most profiles exhibiting a hump-shaped pattern, with the debt ratio typically peaking in the late 1980s and early 1990s (before resuming an upward trend since the start of the explosion of the financial crisis in 2008), it is not surprising that the tests tend to reject stationary but rarely, if ever, reject nonstationarity. Moreover, if a trend is nonstationary, its mirror image must be equally nonstationary: this is the reason why Norway, where the debt has been in overall decline since the early 1980s, is classified as nonstationary, while few would probably argue that the country has a fiscal discipline problem.

Stationarity tests, moreover, do not take into account the level around which stationarity is tested, while clearly this matters for overall perception of sustainability of a country's fiscal policies, a point underscored by the recent strand of empirical literature finding significant threshold effects in

Lucio R. Pench is director of fiscal policy in the Directorate-General for Economic and Financial Affairs at the European Commission.

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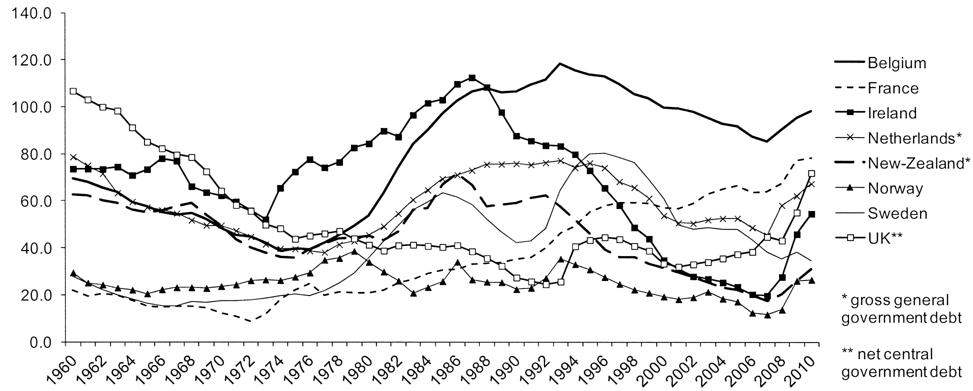

Fig. 12C.1 Evolution of gross central government debt levels (in percent of GDP) in selected countries (1960–2010)

the relationship between government debt and growth (Reinhart and Rogoff 2010; Kumar and Woo 2012).

The chapter focuses on the dichotomy rules versus institutions. I broadly agree with the definitions that are given of fiscal rules and fiscal councils (a particular type of institution), but I think that the discussion would gain from integrating other elements. For example, the chapter highlights the role of a "better budgetary process" in improving budgetary discipline, but does not elaborate on the dimensions conducive to a better quality of the budgetary process. Likewise, it mentions the time dimension of fiscal rules but does not discuss the role of medium-term budgetary frameworks; namely, the fiscal arrangements whereby the horizon of fiscal planning is extended beyond the annual calendar. Taking into account these different elements it may be preferable to elaborate the different institutional dimensions of fiscal policy under the encompassing concept of fiscal governance rather than in terms of rules versus institutions. This would include four main dimensions: numerical fiscal rules, independent fiscal medium-term budgetary frameworks, and budgetary procedures (European Commission 2010). In the same vein, while I fully agree that fiscal rules and institutions should be seen as complements rather than substitutes to each other, I would carry the argument further so as to encompass the four dimensions and their interconnections: for example, a budget balance rule is best seen as providing a medium-term objective, which needs to be operationalized through binding expenditure ceilings based on a multiannual expenditure rule; in turn, to be effective, expenditure ceilings need to be supported by top-down budgeting and the expenditure rule needs to be inscribed in a medium-term framework constraining the annual budgetary process.

The chapter stresses that the outcomes associated with fiscal rules are often disappointing and acknowledges that the econometric evidence on their impact on budgetary discipline is not overwhelming. While I certainly agree with the first proposition and could not contest the second, I would like to point to a couple of recent empirical studies that strengthen the case for an independent effect of fiscal rules on budgetary discipline. Using a unique data set for the EU summarizing the quality of numerical fiscal rules and medium-term budgetary frameworks, Iara and Wolff (2010) estimate the impact of enhancing the quality of the budgetary framework in a structural model of sovereign spreads in the presence of different level of risk aversion: after controlling for the effects of debt and deficit and fixed countries effects, the time-varying fiscal governance quality is found to have a significant effect on risk premia, which is greater depending on the overall level of risk aversion and deficit and debt level (owing to the log-linear specification of the model). The main argument against the evidence on the effect of fiscal rule revolves around reverse causality; that is, a high-quality fiscal framework may be simply a characteristic of polities that care about fiscal discipline and do not have an independent effect on it. An interesting testing field in this respect is provided by the experience of Swiss cantons, which is studied by Feld et al. (2011): while sharing common institutional and cultural characteristics, Swiss cantons differ remarkably in terms of presence and strength of fiscal rules, and these are shown to contribute significantly to cantonal spreads; moreover, the "natural experiment" of a 2003 court decision relieving cantons from responsibilities toward lower municipal entities in financial distress—equivalent to the establishment of a credible no-bailout rule—is shown to have been effective in severing the link between cantonal risk premia and municipal financial situations.

Perhaps not surprisingly, I find the section on the fiscal arrangements in the euro area to be the least satisfying. My dissatisfaction is not so much with the employment of usual and dubious shortcuts (i.e., "[t]he European Commission can be seen as the equivalent of a central government"), which do not do justice to the admittedly complex and unique nature of the European Union. Nor would I contest that the Stability and Growth Pact has been less effective than its early proponents perhaps naively believed (Stark 2001). Rather, I would to have seen a better recognition of the evolving nature of fiscal governance in the euro area and the EU and the acceleration imparted by this evolution of the financial crisis. While this is not the place for even summarily charting the course of the reform of fiscal governance (see European Commission 2011, 2012), I would simply like to stress that one criticism that the chapter, not without some reason, levels at the European fiscal surveillance arrangements—namely, that they are "neither supported by hard legislation nor endorsed by the political system"—arguably no longer holds true. Acknowledging the complementarity between supra-national and domestic arrangements, and the necessity of political ownership of the former through some form of incorporation in the latter, the reform of economic governance that has entered into force at the end of 2012 (so-called "Six-Pack") includes for the first time a European directive setting out standards for domestic budgetary frameworks in a number of key areas, to ensure minimum quality as well as consistency with the European framework. This trend has received a further decisive impulsion with the signing early in 2012 of the Treaty on Stability, Coordination and Governance, which obliges its parties to incorporate in their constitution or in other legislation binding the budgetary process the medium-term objectives of the Stability and Growth Pact, including provision for corrective mechanism in case of deviations and for independent fiscal institutions for monitoring observance of the rules. While it is clearly too early to pass judgement on the effect of these far-reaching reforms, they attest to the euro area ability to learn from its experience with fiscal rules.

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