Fiscal policy under rules and restrictions

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Chapter 5

Conclusion

With more and more countries world-wide adopting fiscal rules and restrictions, the analysis of the economic effects of such restrictions becomes a key macroeconomic issue. This thesis, therefore, has investigated some of these effects. In particular, the focus of this research has been on restrictions similar to those imposed by Europe's Maastricht Treaty and the Stability and Growth Pact, which are probably the most prominent examples of fiscal rules.

The introduction has presented an overview of the main motivations proposed by the economic literature to explicitly restrict the ability of public authorities (governments) in creating or increasing public deficits. It has shown that fiscal rules and restrictions are used in general to: (i) guarantee fiscal solvency; (ii) reduce the volatility and procyclicality of discretionary fiscal policy; (iii) promote intergenerational fairness and equity; and, especially, (iv) curb excessive deficits. The predominant types of fiscal restrictions, such as numerical rules and procedural restrictions, as well as some of the main issues involving their implementation (flexibility, credibility and enforcement) have also been discussed in Chapter 1. That analysis has shown in particular that fiscal rules should be well defined, transparent, simple, and enforceable. In addition, that chapter has described some of the main rules and restrictions in practice in developed and developing countries around the world, demonstrating the scope and importance of the topic.

Chapter 2 has examined the welfare differences of imposing primary deficit-based sanctions on myopic governments rather than sanctions based on the debt level. As the analysis has shown, both types of sanctions discipline impatient partisan governments and reduce the political deficit bias. The analysis has also shown that economies with debt-based sanctions feature higher social welfare than economies with primary deficit-based sanctions. This finding is reinforced when (i) government myopia is stronger, (ii) the interest rate is higher and (iii) the income shocks have higher variance and are more persistent. Debt-based constraints imply better smoothing of public spending after an income shock. Further, the appropriate debt constraint is more robust against changes in the interest rate than is the appropriate deficit constraint. This suggests that the former type of constraint might be easier to implement in practice, in view of the fact that it would be politically difficult to make frequent and large adjustments to the constraints. These results support the greater emphasis that the SGP puts on debt after its reform.

Chapter 3 has analyzed the incentives of a government facing electoral uncertainty to implement structural reforms in the presence of a deficit that reduces the scope for providing short-run compensation to the losers from the reform. The analysis has shown that in designing a reform package, the government faces a trade-off between enhancing its electoral chances by providing compensation to private individuals and the cost of violating a deficit restriction. While the deficit restriction is effective in restraining the actual public deficit, it reduces the likelihood of structural reform by forcing a reduction in compensation spending for the losers from the reform. As a result, social welfare may be negatively affected because the future reform benefits are more likely to be foregone. That chapter has in addition evinced that more individual income uncertainty reduces the likelihood of reform, indicating that the political feasibility of reforms is enhanced by making the deficit restriction contingent on the business cycle and also on compensation. While one needs to be careful in translating this analysis into the context of the Europe's SGP, the results suggest that the recent reform of the pact went into the right direction by including explicitly in its corrective arm the possibility to exceed the 3% deficit norm in the case of expenses related to the implementation of structural reforms.

The fourth chapter has focused particularly on the European fiscal restrictions and assessed the effectiveness of the Maastricht Treaty and of the Stability and Growth Pact in disciplining fiscal policy in the Euro zone. The results have shown that indeed those restrictions induced a fiscal tightening in response to *excessive deficits*. However, if the reduction of total average deficits and/or the change of fiscal policy to countercyclical are also considered as measures of effectiveness of the EU fiscal framework, then that evaluation becomes less positive. Furthermore, the MT during the period preceding EMU seems to have been more stringent than the SGP, although the fiscal contractions in the EU that preceded the start of EMU were also observed in other "industrialized" countries (also those not subject to fiscal constraints). Therefore, Chapter 4 has called for improvements in the SGP. A reformed Pact should include incentives to produce lower deficits (or higher surpluses) during boom phases of the business cycle and more flexibility in the application of sanctions during recessions, especially if the enforcement of countercyclical fiscal policies in the Euro zone is seen as an objective of the SGP. This is again in line with the recent revision of the Pact in 2005, even though that reform can also undermine the enforceability of the restrictions, making its success strongly dependent of the political will of European fiscal authorities to enforce the Pact.

All in all, this thesis has demonstrated that fiscal rules and restrictions can be an effective instrument in curbing excessive deficits and to guarantee fiscal sustainability. Nevertheless, their design must receive a careful attention in order to avoid providing the wrong incentives to policymakers and to avoid negative spillovers to the economy, which would consequently reduce social welfare. In particular, those restrictions should be flexible enough to accommodate exogenous shocks and to allow the implementation of policies aiming at economic growth (structural reforms and public investment, among others). At the same time, they should be credible and enforceable, and therefore, simple and backed by appropriate legal norms. Chapter 2 has also suggested that debt-based sanctions are preferable to restrictions on the primary deficit.

Regarding Europe's fiscal restrictions, this thesis has evinced that they have been relevant to reduce deficits in the Eurozone during the last fifteen years. Moreover, given all analyses, we conclude that the recent reform of the SGP, even though raising concerns about its enforceability, has increased its flexibility and has given more room for the implementation of the so-needed structural reforms in Europe. Nonetheless, additional measures should be taken to promote the adoption of countercyclical fiscal policies by European fiscal authorities under the new SGP.

This thesis offers various possibilities for further research. While Chapter 2 goes in that direction, the analysis of optimal fiscal rules and their welfare effects could be extended. In particular, the derivation of optimal fiscal rules and restrictions should take into consideration households' optimizing behavior and the interactions between fiscal and monetary policy. Another gap that we identify in the literature is the analysis of the credibility and enforcement of fiscal restrictions. As far as the theoretical side is concerned, more advanced game theoretic frameworks and, as far as the empirical side is concerned, new databases (such as real time data), could be used to tackle such issues and help in designing more credible and easily enforceable restrictions. At last, the analysis of fiscal restrictions and economic growth should also be further researched. A better understanding of how fiscal restrictions affect public investment and productivity, for example, is crucial for their optimal design.