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RULES-BASED FISCAL RESPONSIBILITY FRAMEWORKS

Discours prononcé par Jacques de Larosière
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sur le thème de
« La responsabilité en matière budgétaire »

I am particularly grateful to the State Audit Office and to the National Bank of Hungary for having invited me to touch on the "potential usefulness of a rules-based fiscal responsibility framework for Hungary".

In dealing with this subject, I shall refer to international practices.

I shall touch briefly on three points :

1. Countries that show a tendency to accumulate fiscal deficits and public indebtedness over the years should, in my view, consider adopting rules-based policies ;
2. A number of countries who have adopted such rules have been successful, but some have not ;
3. What lessons can we draw from this experience ?

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I. Countries that tend to accumulate fiscal deficits and public indebtedness over the years should consider adopting a rules-based set of policies :

1. Fiscal slippages become more frequent and prolonged :

There are still perhaps some countries who follow "naturally" disciplined fiscal policies.

Under the old tradition, budgets were normally voted in balanced terms, except in the case of wars. The deficits incurred during recessions were offset by the surpluses generated by years of expansion. Public debt, in such countries, tended to be contained within moderate limits.

But over the last two to three decades, we have seen most countries deviate from this traditional pattern.

Indeed, structural evolutions have tended to increase public spending. The greater role of the State in the field of social welfare has been, in this regard, an essential factor. In most cases, higher taxes have been unable to keep up with the increase in public expenditures. Thus, repeated and structural deficits have appeared generating swelling public indebtedness.

The case of Europe illustrates this trend. Countries like France, Germany, Italy have seen a profound deterioration in their public finances. For example, in France, public debt represented only 20 % of GDP in 1980. It has reached 66 % in 2005. This is because France has accumulated fiscal deficits year after year over the last twenty five years (the yearly average of French fiscal positions since 1980 has been a deficit of 3,5 % of GDP).

The case of Hungary is also a manifestation of this evolution. From 2001 to 2004, the cumulated fiscal deficits (general government) amount to almost 23 % of Hungary's GDP (entailing a rise in public debt of 5,4 points of GDP to a level of 58 %).

2 The need for a constraining framework seems clear :

In such countries, it is clear that "normal" budgeting processes do not work properly. The reasons can be manifold : excessive politicisation of fiscal policy in electoral periods, belief by the general public that throwing money at problems makes sense, low spreads and low interest rates creating the illusion that "borrowing one's way out" is a cheap option….

Be it as it may, such countries cannot rely on the "normal" annual budgetary procedures. They need a framework that can help them to establish a medium term fiscal strategy.

As the horizon of politicians is, often, limited to the next elections, it is difficult for them to conceive and enforce a medium term fiscal strategy. Cutting back public expenditure is never popular, because it reduces, by definition, the benefits and entitlements of a number of citizens (electors) even if it leads to a global betterment for the community at large. Reducing, year after year, public expenditure is obviously politically difficult.

This reality has led a growing number of democracies to resort to "rules-based" fiscal policies. Such rules are meant to better contain deficits and public expenditure over the medium term and to stabilize or, if needed, reduce public indebtedness.

The common thread of the many legislations that have been voted in this field is that fiscal discipline -once it has been laid out by Parliament in a medium term framework- is easier to enforce steadily. Or course, new majorities can always undo what has been established earlier on. But experience shows that it is easier politically to reach "bi-partisan" agreements on fiscal codes of conduct, than to obtain year after year new austerity measures.

II. A number of countries who have adopted such rules have been successful. Some have not :

1. The European paradox :

The paradox is that the most heralded rules-based fiscal framework, the one that covers the largest number of countries -I am referring to the European Stability and Growth Pact- is the one that has known the most significant failures precisely since the creation of the euro in 1999.

This is all the more distressing that there is an additional justification for a fiscal framework in a monetary zone where there is no central fiscal power. Indeed, as monetary policy is, by definition, common to all members of the Union, and run by an independent Central Bank, national fiscal policies must be consistent. If some members were allowed to run high deficits, this would entail consequences for the whole Union, all the more so if the slippages came from countries carrying a significant economic weight. Systematic deficit spending eventually leads to higher prices and interest rates, to a loss of competitiveness and therefore distorts economic and financial conditions in the Union.

2. But a number of countries have adopted national rules-based fiscal frameworks which have proved successful :

This is the case of countries like Australia, New Zeeland, Canada, Chile, Sweden, Netherlands, Switzerland[1]… These countries have adopted medium term budgetary frameworks that have reined in or prevented the overexpansion of public spending while not damaging their medium-term economic outlook. On the contrary, such fiscal action has favored growth in the interested countries.

I shall not dwell on these national successful experiences because some of them -in particular the cases of Chile and Sweden- have been presented in detail this morning.

Let me just draw on a few common characteristics of those systems :

- They are national (even for a country like the Netherlands who is a member of the EU and of the EMU) :
- They are medium term oriented ;
- They aim to avoid structural imbalances ;
- They, therefore, address the question of the economic cycle and its influence on cash budgets and tend to avoid or reduce the possible pro-cyclical consequences of fiscal policies while allowing the automatic stabilizers to work both ways;
- They combine quantitative and structural objectives (reining in public expenditure at large, prioritizing and reallocating expenses, avoiding over taxation…) ;
- They have led to spectacular results. For example :

  - in Australia, the fiscal position has shifted from a deficit of 4 % in 1992-93 to a surplus of close to 2 % in 2003 (average of + 1,5 % for the years 2003-2005) ;
  - in New Zeeland (where fiscal structural surpluses have persisted over the last decade at an average level of 3 % of GDP ; +5% in 2005), the public debt (74 % of GDP in 1987 has been halved) ;
  - in Canada, the budgetary position shifted from a deficit of 5 % in 1992 to a surplus of close to 3 % in 2000 and 1,5 % in 2005. Public debt was brought down from 70 % of GDP in 1994, to 52 % in 2000 and 26 % in 2005.

  And I could do on…

3. It is true that some countries have been less successful :

In the UK, the fiscal framework established in 1997 has three pillars : the "golden rule" (only borrow for investment purposes) ; the current budget is to be in balance or surplus on average

[1] See International Monetary Fund (Occasional Paper n° 225) : "Rules-based fiscal policy in France, Germany, Italy and Spain", by Teresa Daban, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti et Steven Symansky, Washington 2003.

over the business cycle ; and a limit of 40 % of GDP on net debt of the public sector has been set.

This medium-term strategy was successful in the first years. But, the fiscal position has deteriorated since 2002-2003, when expenditures rose, revenues increased less rapidly than the government had projected and the deficits grew (more than 3 % of GDP on a yearly average since 2003). Adjustment measures are now needed to bring the fiscal position back in line with the golden rule over the cycle.

I could also add that the US adopted for some time rules-based fiscal policies destined to reduce public deficits and to control the increase in public debt. The most publicized of these laws was the "Gramm-Rudman-Hollings Act" of 1985.

The US experience was not successful. Mandatory spending reductions imposed by the Act were ruled unconstitutional with regard to the separation of powers. In 1990, because of the war with Iraq, the President and Congress agreed to postpone balancing the budget (as prescribed in Gramm-Rudman-Hollings II). The 1990 Budget Enforcement Act has focused on nominal caps on discretionary spending over the period 1990-95. In fact, the improvement of US fiscal accounts from 1997 to 2001 was largely the reflection of the upswing in the economy. But spending limits established under the Budget Enforcement Act were systematically circumvented. And the fiscal position is now in serious deficit (more than 4 % of GDP as a yearly average from 2002 to 2005).

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III. What lessons can be drawn for these experiences ?

Regarding the Stability and Growth Pact, which is of particular relevance for Hungary, I would stress the following issues :

1. The fiscal rules :

We know the norms of the Maastricht Treaty (signed in 1992) : fiscal deficits must not exceed a limit of 3 % of GDP and public debt should not exceed 60 % of GDP. Those norms, internally consistent, were basically destined to assist the convergence process for the accession countries of the time.

The Stability and Growth Pact (June-July 1997) -which lays out the procedure of "excessive deficits"- should be understood in a different perspective. Its objective is not intended to establish accession criteria but to determine the rules which, in the medium term, will ensure that member-states fiscal discipline will be pursued after the accession and the creation of the euro. It is in this context that the Pact prescribes that member-states must reach a balanced fiscal position over the cycle.

2. Why didn’t the system work well ?

It is not, in my opinion, because it contained a fundamental flaw.
Requiring European States to ensure a fiscal balance over the cycle, seems, indeed, a prudent rule. Some could object, nonetheless, that such a rule would tend to lead in the very long run to an elimination of public indebtedness (because of the positive trend for GDP growth),

which would have an unnecessary restrictive effect on the economy and would hamper an optimal allocation of savings. To this argument -that has some validity in theory- one can object, however, that European countries fiscal horizon has so deteriorated and is so clouded by the consequences of demographic changes on long term public commitments that it is only prudent to try and build some margins for future, inevitable, increases in indebtedness. In this respect, requiring an "over-the-cycle fiscal balance", as laid out by the Pact, especially for countries whose public debt exceeds 40 to 50 % of GDP is, for the future, a good house-keeping measure[2]. We have seen that many are the countries who, outside EMU, abide by such rules.

But if it is not the basic concept that was at fault, it was the application of the rules that was the source of the problems which, following the "excessive deficits " procedures for France and Germany, led to the stalemate and the crisis of 2004.

I believe that five factors explain this failure.

a) Automatic stabilizers should operate both ways :

It is normal that, within certain limits (and in this respect, the 3 % reference is an acceptable order of magnitude, even if it implies an inevitable element of arbitrariness), fiscal deficits deteriorate when the economy slows down. But what is not normal, is that in periods of growth, the additional revenues are not used to reduce deficits significantly more than has been the case in the past for a number of member states.

This has been the case of many countries and notably France and Germany. The more virtuous example of Spain helps to understand how the cycle can be used, in fiscal terms, without endangering economic growth (see annex).

The experience described above shows that the 3 % Maastricht criteria has been misinterpreted. Far from being a target, at which governments would feel comfortable, the limit should only operate "in bad weather". It is during periods of growth that EMU member-states should -better than has been achieved in the past-, reduce deficits well below 3 % or generate surpluses. Letting the automatic stabilizers operate both ways should become an obligation (see, for example, the case of the Netherlands).

b) Structural deficits should be reduced :

At the end of 2002, the Commission has given more importance to the cycle in its proposals to adapt the Pact. It has stressed the need to let the stabilizers operate symmetrically. In this respect, it has proposed an annual target to reduce structural deficits, which is indeed the only proper way to implement the medium term stability objective. Statistics show that, except for Japan and the United States (6,8 % and 3,5 % of GDP respectively), Germany, the UK, Italy and France are the large countries of the OECD who run the highest structural deficits (respectively 3,2 %, 3 %, 2,9 % and 2,6 % of GDP in 2004[3]). It is therefore indispensable for Europe to engage in a policy geared to the reduction of those deficits. This is of the essence, not only for the sake of the Pact, but for the future of the public finances of the interested countries and their ability to face the challenges for growth and employment in a open and non-inflationary environment.

[2] On the fiscal impact of aging populations , see Peter S. Heller :"Who will pay ?" (IMF 2003).
[3] IMF : World Economic Outlook, September 2005.

c) It is necessary to better adapt fiscal policies to the nature and the sources of the problems experienced by different member-states :

This “case by case” adaptation is, in principle, taken into account in the national stability programs. But the endeavor should be more systematically followed up by the Union. The recommended fiscal adjustments should be more "tailor-made" and influenced by factors like the level of public debt or the burden of public spending (current versus investment) of individual member-countries.

Thus, a country like France which is characterized, as I have shown, by a very high level of public spending and taxation, should decisively engage in reducing public expenditures and improve the efficiency of public administration.

Countries like Italy, Belgium, Greece who have very high levels of public debt (respectively in 2004 : 105,8 %, 95,6 % and 110,5 % of GDP) well beyond the European average, should also be required to carry out a more significant reduction of their structural deficits.

d) One should shape the fiscal strategy in a longer term demographic perspective :

The aging of European populations is bound to increase the burden of pensions and healthcare. These impacts and their timing vary from country to country. For example, Ecofin projections show that in the "heaviest" year of the central scenario -2030 for France and Italy, 2040 for Germany, 2050 for Spain- the public expenditure "overruns" vis a vis 2000 stemming from pensions alone, will be, on average, of a magnitude of 4,5 % of GDP for that group of countries (4 % for France, 5 % for Germany)….

If structural reforms (lengthening of retirement age, reductions in entitlements, pension schemes…) cannot, by themselves, resolve all the problems, it is prudent to consider that the public finances of those countries will have to make some additional contribution. This means that it is imperative to "mend" fiscal policies well ahead of the most critical years, so that, when times come, debt sustainability is not put in jeopardy.

Therefore, taking into account -as countries like Australia, New Zealand and United Kingdom do systematically- the demographic evolutions on the long run is an indispensable exercise. This would perhaps facilitate the educational process aimed at getting public opinions better aware of the need for medium term fiscal discipline.

e) Lastly, european budgetary discussions should be "depoliticized" :

On several occasions, the Commission has, without success, recommended to the Council of Ministers to trigger early warning or excessive deficits procedures.

The events have shown that the Commission had been right but that, because of the more "political" stance of the Council, fiscal situations had been allowed to deteriorate. Had the Commission been followed, fiscal corrective actions might have been taken earlier and the Pact would have been better observed.

With hindsight, it appears also that member-states have often based their budgetary projections on too optimistic growth assumptions. This bias affects the European procedures.

One should pay much more attention to this issue. A "rule of prudence" should be established and followed up meticulously (perhaps by a group of independent experts as is done in the case of Chile for determining the key assumptions underlying the trend GDP growth and the long term copper prices).

Lastly, member-states should not consider the Stability and Growth Pact as a sort of external imposition. They have all approved the Pact and should, therefore, feel responsible of its implementation. A number of democratic states abide, on a voluntary basis, by similar (and generally stricter) rules. It is time that governments and parliaments make those rules really "theirs" and, if needed, adapt them to their own situations as long as this "personalization" doesn't weaken the Pact (see, for example, the case of the Netherlands where rules are stricter than those of the Pact).

<u>3. The softenings introduced in the Stability and Growth Pact, in March, 2005, do not guarantee a greater efficiency for the future.</u>

Some adjustments introduce more realism and flexibility into the rules. Thus, the Council has made a distinction between countries with low debt but with high growth potential and countries with high debt ratios or with low growth potential.

For the former ones, the medium-term deficit can reach one percentage point of GDP, whilst for the latter the accounts should be in balance or in surplus. This modification is justified[4], notably for the countries of Central Europe whose potential growth is strong and who have high needs of catching up in infrastructure.

But what seems questionable is the way the 3 % criterion was watered down. Henceforth, member states can depart from this criterion in case of stagnation (and not, as previously, in case of a recession). Besides, the Commission will have to «assess if the deficit is higher than the public investment » (but, we know that the definition of public investment is elastic) and will have to take into account "all other relevant factors" among which feature the spending on research, development and education -which amount to 5 % of GDP in the euro zone !- as well as the budgetary efforts for “aid, international solidarity and the unification of Europe”. The "relevant factors" will thus easily allow to exceed the 3 % criterion. Besides, the time frame for correcting actions is doubled, moving from one to two years.

The most important measure, in my opinion, namely, to take binding provisions to enforce a symmetric application of the Pact (i.e. to get States accumulate surpluses or at least fiscal improvements in the upper parts of the cycle) was not taken. The Council only indicated that the adjustment efforts should be more marked in periods of strong growth, but this appears as a pious wish.

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To conclude, I would suggest the following points:

1. Fiscal derailments, when they reach the size and the proportions I have alluded to must be considered by the political authorities as a major national issue. When you prolong the deviations we have been witnessing in some countries, you realize that the cost of inaction is

[4] See Philippe d’Arvisenet : Le Pacte de Stabilité et de Croissance, Sociétal, June 2005.

absolutely destructive (public debt trajectories, if unchanged, would lead in 2050 to orders of magnitude of 400 % of GDP !) ;

2. Therefore governments should urgently undertake to explain the situation and propose to their Parliaments rules and measures that would, overtime, change the present trends and lead to substantial improvements ;

3. These rules should be inspired by he numerous medium term oriented models and schemes that have shown their validity and have been tested by experience ; they can be adapted to each case ;

4. This process must be national. Imposing rules contained in a multilateral pact has shown its limits. Peer pressure leads to peer concessions and arrangements more than to sanctions. The problem is to get governments act in their own interest -within the framework of the pact- basically because the countries understand that it is <u>their</u> own future that is at stake.

5. Ideally, this should be done on a bipartisan basis. It may not always be possible, but explanation to the general public should be widely organized.

I have, in this respect, an example to share with you. It is the case of my own country. I have not minced my words, to say how concerning is the fiscal situation in France. But there is a sign of hope. Last July, the Minister of Finance commissioned a study on the issue of France's public debt and on the ways and means to correct the situation. A committee, chaired by Mr. Michel Pébereau, the Chairman of BNP Paribas, worked on the subject for six months. The Committee was composed of some 20 academics, parliamentarians, entrepreneurs, trade unions, journalists, researchers… from different political persuasions. The report, issued unanimously, recommends strong and in depth measures (like restoring balance in the budget over the coming 4 to 5 years by capping public expenditures in nominal terms, and by pursuing this policy over 10 years so that the debt of the State would come down from 53 % to 45 % of GDP…..). This report still remains to be implemented, but, at least, the diagnosis is transparent, structurally oriented measures have been proposed and described in detail and public opinion starts to understand the gravity of the issues at stake.

So, I am convinced that these types of changes and reforms, if they are based on a clear and undisputable basis, can offer decision makers an opportunity to act.

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Just a final work.

Markets are going through new turbulences these days. Interest rates are moving upwards in the US and in other industrialized countries, making short term inventors less eager to put their funds in emerging economies at present spreads. This increases the vulnerabilities of indebted countries.

In such circumstances, fiscal and monetary stability are essential : they are the only factors that give the right signal to more volatile markets.

They reassure investors that budgetary deficits, public indebtedness and inflation are not going to swell out of control.

Annexes

		1998	1999	2000	2001	2002	2003	2004 (est.)
France	GDP growth	3,5 %	3 %	3,4 %	2 %	1,1 %	0,5 %	2,4 %
	Public deficit/ GDP	- 2,6 %	- 1,8 %	- 1, 4 %	- 1,5 %	- 3,1 %	- 4,2 %	- 3,7 %
	Structural deficit/ GDP	- 1,6 %	- 1,2 %	- 1,6 %	- 1,7 %	-3,0 %	- 3,0 %	- 2,5 %
Germany	GDP growth	2 %	1,8 %	3 %	0,8 %	0,1 %	- 0,1 %	1 %
	Public deficit/ GDP	- 2,2 %	- 1,5 %	- 1,4 %	- 2,8 %	- 3,6 %	- 3,8 %	- 3,7 %
	Structural deficit/ GDP	- 1,4 %	- 0,9 %	- 1,4 %	- 2,6 %	- 2,6 %	- 2,3 %	- 1,9 %

		1998	1999	2000	2001	2002	2003	2004
Spain	GDP growth	4,3 %	4 %	4,1 %	2,7 %	2 %	2,4 %	2,7 %
	Fiscal balances	- 0,6 %	- 1,2 %	- 0,8 %	- 0,1 %	- 0,3 %	+ 0,3 %	- 0,3 %
	Structural positions	- 2,3 %	- 1,0 %	- 1,3 %	- 0,5 %	+ 0,3 %	+ 0,3 %	+ 0,4 %