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Promoting sustainable public finances in the European Union: The role of fiscal rules and government efficiency

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ABSTRACT

New indices of fiscal rule strength are constructed and, using a dynamic panel econometric model for 27 EU countries over the period 1990–2012, we assess whether national fiscal rules alone help to promote sustainable public finances in the EU or whether they must be supported by good governance in order to be effective. We find that fiscal rules are effective in reducing structural primary deficits at all levels of government efficiency. However, the effect is smaller as government efficiency increases, indicating that fiscal rules and government efficiency are institutional substitutes in terms of promoting fiscal sustainability. We also find that balanced budget rules are the most effective form of fiscal rules. Multiple fiscal rules are found to enhance fiscal solvency. Other institutional features that enhance the effectiveness of fiscal rules are transparency of policies and commitment to implementation of fiscal programs. Supranational rules, however, do not affect the effectiveness of national fiscal rules in reducing the deficit bias. Our results are robust to alternative estimation methods and endogeneity assumptions.

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1. Introduction

The fiscal crisis in the European Union (EU) has spurred a renewed emphasis on designing and implementing stronger fiscal rules and institutions. The best known fiscal rules in Europe, as embodied in the EU's Stability and Growth Pact (SGP), did not adequately promote sustainable public finances in the region prior to the Global Financial Crisis (Hughes Hallett and Jensen, 2012; Schuknecht et al., 2011). In an attempt to address this problem, the Fiscal Compact, part of the March 2012 Treaty on Stability, Coordination and Governance (TSCG), introduces new rules on public finances which signatories to the Treaty agreed to implement into their national legislation.

It is not obvious, however, whether legislated national rules in the EU are likely to impose greater fiscal discipline than the SGP supranational rules. Nonetheless, several European countries have apparently found national fiscal rules to be helpful in achieving greater budgetary discipline.[1] And previous research finds evidence that sustainable public finances in Europe may be associated with strong fiscal rules (Debrun et al., 2008; Wierts, 2008; Afonso and Hauptmeier, 2009; Dahan and Strawczynski, 2010; Holm-Hadulla et al., 2012; Nerlich and Reuter, 2013; Foremny, 2014; Afonso and Guimarães, 2014). Moreover, strong fiscal rules are

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[1] For example, Sweden, Finland and the Netherlands all realized improvements in their fiscal situations after adopting rules that limit spending (Ayuso-i-Casals, 2012).

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associated with lower risk premia on national debt (Iara and Wolff, 2014) and output stabilization of discretionary fiscal policy (Sacchi and Salotti, 2015).[2]

This literature, however, has not fully addressed the interaction of national fiscal rules with broader government institutional arrangements. Good governance and the efficiency of government institutions have been shown to be helpful in promoting sustainable public finances in various contexts (Albuquerque, 2011; Bergman and Hutchison, 2015; Calderón et al., 2012; Frankel et al., 2013; Hallerberg et al., 2007; von Hagen and Harden, 1995). This is an interesting question for the EU also as indicators of government efficiency vary widely across the member states.

In addition, we investigate which specific types of fiscal rules (balanced budget rules, debt rules, expenditure rules or revenue rules) are most effective in promoting fiscal solvency. This analysis directly relates to the debate in Europe over the optimal design of fiscal rules and, in particular, whether the constraints embodied in the Fiscal Compact are likely to be effective.

The main contributions of our study are threefold. First, we construct a new aggregate index of fiscal rule strength and four new sub-aggregate indices of the strength of specific types of fiscal constraints (expenditure rules, balanced budget rules, revenue rules and debt rules). These five new refined measures of the strength of fiscal rules, varying across countries and over time, are based on the specific characteristics of various types of fiscal constraints using the IMF FAD data base (Schaechter et al., 2012).

Second, we combine the fiscal rule and governance literatures to determine whether national fiscal rules alone help to promote sustainable public finances in Europe or whether they must be supported by good governance in order to be effective. For this evaluation we employ a dynamic panel econometric model for 27 EU countries over the period 1990–2012. The interaction of fiscal rules with governance is assessed using the World Bank "efficiency of government bureaucracy" index.[3] This index is part of the World Bank "Worldwide Governance Indicators, 2013 Update" (WGI) project research dataset. This indicator measures perceptions of the efficiency of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. We also consider alternative measures of institutional quality, including policy transparency and commitment to fiscal program implementation.

Third, we investigate which specific type of fiscal rules — balance budget, expenditure, revenue or debt rules — are most effective in promoting fiscal solvency. In all cases, we focus on the interaction of fiscal rules and good governance in promoting sustainable fiscal finances in Europe.

The road map of the paper is as follows. Section 2 presents a brief review of the literature that provides a theoretical motivation for our empirical hypotheses. Section 3 presents the empirical model and methodology. Section 4 discusses the data and construction of our fiscal strength indices. Section 5 presents the empirical results and consists of summary statistics, tests of the baseline model (fiscal rule strength and fiscal solvency, interacted with government efficiency) and tests of the effectiveness of specific types of rules. Section 6 presents extensions and robustness tests. Section 7 concludes.

2. Fiscal rules: theory, literature and model

Fiscal rules are generally legislative agreements intended to mitigate "deficit bias" and promote fiscal discipline by "tying the hands" of policy makers in order to constrain decisions about spending and revenue programs. The main causes of deficit bias cited in the literature are governments' "short-sightedness" and the "common pool" problem, although the "time inconsistency" problem and many other political and economic factors have been suggested. Short-sightedness may be attributable to several reasons, including governments running excessive deficits in anticipation of being replaced by another political party in future (Persson and Svensson, 1989; Alesina and Tabellini, 1990). Deficit bias may also arise because spending measures tend to be targeted at specific interest groups but financed by general taxation. This creates the potential for free-riding problems emphasized by the common pool explanation for deficit bias (Velasco, 2000; Weingast et al., 1981). Time inconsistency may create a problem for governments to commit to fiscal discipline, leading to excessive deficits, as these commitments may not be credible in the face of the incentive to simulate short-run aggregate demand (Persson and Persson, 1987; Persson et al., 2006).

In the literature, a myriad of solutions have been proposed to reduce deficit bias, including fiscal rules. Debrun et al. (2008), for example, identifies four broad categories of solutions to the deficit bias problem: (1) fiscal policy-makers may be held more accountable for their actions (Corbacho and Schwartz, 2007); (2) improved budgetary procedures that govern the preparation, approval and implementation of annual budget laws (von Hagen and Harden, 1995); (3) delegating fiscal policy or aspects of fiscal policy to institutions that are insulated from short-term political pressures (Wyplosz, 2005); and (4) curtailing discretion of fiscal authorities by *ex ante* fiscal rules for numerical targets or ceilings for fiscal aggregates or set benchmarks for the conduct of fiscal policy (Krogstrup and Wyplosz, 2010).[4]

[2] Iara and Wolff (2014) find that stronger fiscal rules in euro area members reduce sovereign risk premia during times of market stress. Using the EC data set of rules-based fiscal governance in EU member states, they estimate a model of sovereign spreads that are determined by the probability of default in interaction with the level of risk aversion. They find that the legal base of the rules and their enforcement mechanisms are the most important dimensions of rules-based fiscal governance. Sacchi and Salotti (2015) study the relationship between discretionary fiscal policy and macroeconomic stability in 21 OECD countries over the 1985–2012 period. They find that strict fiscal rules induce discretionary policy to become output-stabilizing rather than destabilizing. They find that this result can be more easily achieved by rules on balanced budgets, rather than on expenditures, revenues, or debt.

[3] Charron et al. (2010) find in their comparison of alternative measures of quality of government that the World Bank data are both empirically and conceptually superior and provide the best measurement for reliable and meaningful comparisons of quality of government in the EU.

[4] Lavigne (2011) empirically investigates the role of political and institutional factors in determining why countries get into fiscal distress, why some are able to fiscally consolidate when required, and why others are unable to adjust despite an evident need to do so. For advanced countries, he finds that fiscal rules contribute to avoiding situations of fiscal distress, and fiscal performance management systems improve the odds of implementing adjustments.

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