

Do we need Fiscal Rules ?

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Needed at all?

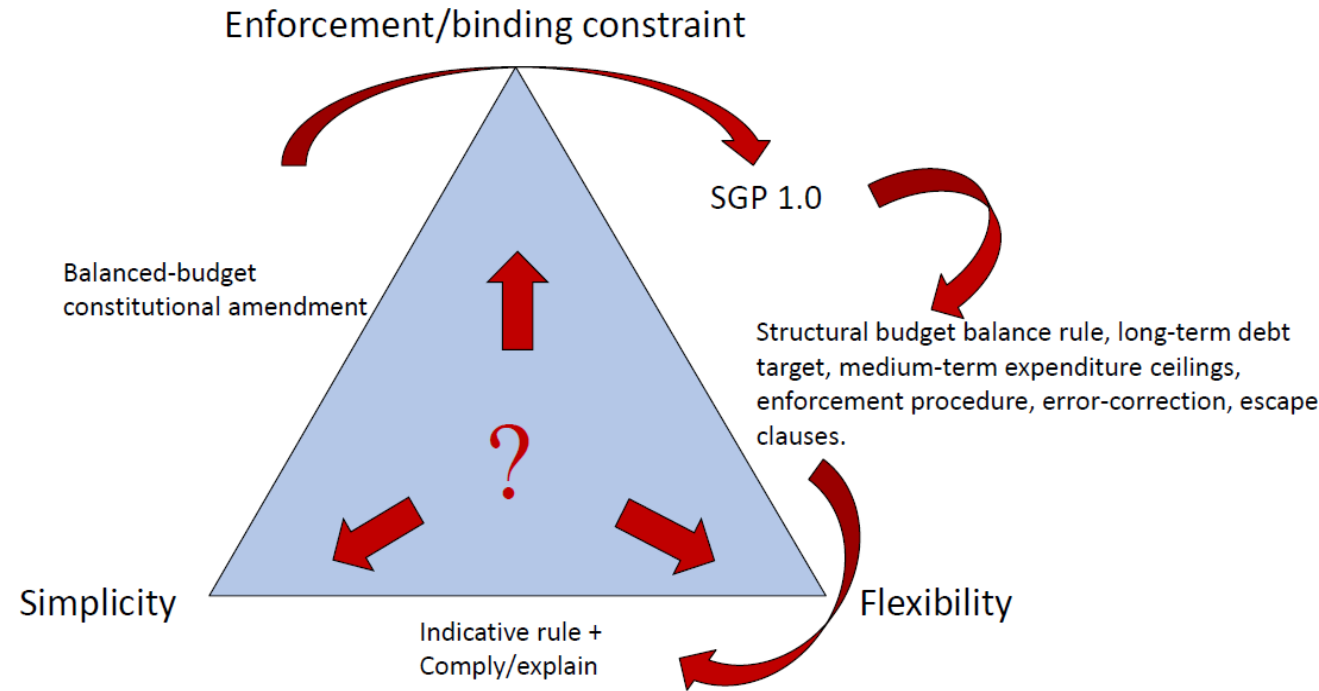
- Discretion = ability to adapt policy at any time to respond to changing needs, priorities and circumstances.
- If discretion is enabling optimal policies, no need for rules.
- In a democracy, democratic accountability should be enough.
- As James Madison said: “If Men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; **and the next place, oblige it to control itself.**”
- But Madison warns: “A dependence on the people is, no doubt, the primary control on the government; but experience has taught mankind the necessity of **auxiliary precautions.**” → **democratic accountability is NOT enough!**
- Auxiliary precautions = **constraints on elected politicians’ discretion** (Madison has in mind independent justice system).

Constrained discretion is optimal

- Rules vs. discretion literature (Kydland and Prescott, 1977)
 - Rules are to be preferred (but only because they mimic social optimum in the model: perfectly state contingent and all-encompassing.)
- In practice:
 - No such rule exist (imperfect and incomplete information).
 - Discretion is constrained by **a mix of independent institutions and simple rules** (almost rules of thumb, with all the arbitrariness that comes with them).
- Problem with unconstrained discretion: rising public debts.
- Monetary policy: from rules to independent institutions.
- Fiscal policy: rules (no fiscal delegation).

Designing fiscal rules is hard

- Frustrating **struggle** with trilemma.
- Sedimentation process (**partial** reforms).
- Alchemy (Leeper, 2010) used to characterize exercise of fiscal discretion, now it describes the rules supposed to constrain it.
- Lesson from past experience: cannot get the rule right AND enforce it.
- Yet, even if not complied with, rules are effective (Δ fiscal behavior)
- Lessons for the future:
 - Try harder: internalize trade-offs better (IMF, 2018).
 - Consider uncharted territory if politics allow \rightarrow FTR + IFI.



Rules are needed and useful, but keep in mind key principles

- Ownership / legitimacy is needed (FP is political!):
 - in EU more tailoring (EFB proposal) or role for national rules (2010 reform).
- Keep your eyes on the ball: rule must be connected to the violated objective (sustainability) → keep it simple
- and (not too) stupid! → Minimize risk that sticking to rule is the wrong thing to do (e.g. procyclicality, slash public investment).
- Make sure rule truly guide your budget process (link to procedures and processes is essential).