

RULE-BASED VERSUS DISCRETIONARY FISCAL POLICY

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A b s t r a c t

Fiscal policy can be of a discretionary or rule-based nature. This article discusses selected examples of fiscal rules as well as presents the advantages and disadvantages of following them. The aim of the article is to solve dilemmas about the positive and negative consequences of strict regulations of contemporary fiscal policy. Therefore, a hypothesis is tested concerning whether the following of rules in macroeconomic policy is a more beneficial solution than carrying out a discretionary policy. The hypothesis was not clearly verified. On the one hand, it was stated that it is usually more beneficial to follow standard rules due to higher reliability for markets. On the other hand, that entails lower flexibility, which may be especially disadvantageous during a crisis.

REGUŁY A UZNANIOWOŚĆ W POLITYCE FISKALNEJ

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A b s t r a c t

Polityka fiskalna może mieć charakter uznaniowy lub oparty na regule. W opracowaniu zaprezentowano wybrane przykłady reguł polityki fiskalnej oraz przedstawiono koszty i korzyści związane z ich stosowaniem. Za cel artykułu przyjęto rozstrzygnięcie dylematów związanych z pozytywnymi i negatywnymi konsekwencjami ścisłych regulacji dotyczących współczesnej polityki fiskalnej. W związku z tym weryfikacji poddano hipotezę, zgodnie z którą stosowanie reguł w polityce

makroekonomicznej jest rozwiązaniem korzystniejszym niż uznaniowość. Hipoteza ta nie została jednoznacznie zweryfikowana. Stwierdzono wprawdzie, że zazwyczaj stosowanie reguł jest korzystniejsze z uwagi na większą wiarygodność dla rynku. Należy jednak dodać, że wiąże się ono z mniejszą elastycznością, co szczególnie niekorzystne okazać się może podczas kryzysu.

Introduction

Fiscal policy may be discretionary or based on rules. In the former case, decision-makers freely evaluate the current and predicted future economic situation. Based on that evaluation, they apply instruments being solely founded on their own opinions and decisions, guided by their own knowledge and conscience. For example, a national government can explain themselves to the public, without presenting relevant calculations, that they increased the budget deficit since it was required by *e.g.* a difficult economic situation.

An alternative to discretionary policy is policy based on rules. As for fiscal policy, such a rule can be, for instance, striving not to exceed the upper limits established by the budget deficit or public debt, or a certain limit on an annual rise in budget expenditures.

The aim of this article is to attempt to resolve dilemmas over the positive and negative consequences of strict regulations concerning contemporary fiscal policy. Therefore, a hypothesis will be initially examined wherein the application of rules in fiscal policy is a more advantageous solution than discretionary policy.

The study is theoretical in nature, although numerical data and examples of economic reality are provided in some cases. The article is composed of this introduction (Point 1), three main parts and a summary. The first main part (Point 2) presents examples of selected fiscal policy rules. The second main part (Point 3) shows the costs and benefits of applying rules and following discretionary policy. In the final part (Point 4), the application of both types of policy in the economic practice of EU countries in recent years is shown using specific examples. The article ends with a summary containing final conclusions.

Exemplary Fiscal Policy Rules

The simplest variant of fiscal policy rules are upper limits of public debt or budget deficit. They are often enshrined in treaties, constitutions or statutes. In such a case, various sanctions can be imposed if a set limit is exceeded. Typically, limits are not expressed in monetary terms but in the form of indices – usually as a percentage of GDP. It was in that way that reference values were

formulated for the EU countries in the Maastricht Treaty. They were set at the levels of 60% of GDP for public debt and 3% of GDP for budget deficit respectively (*Treaty on European Union* 1992, p. 27, 183).

The application of rules related to public finance in the entire community is connected with policy aimed at maintaining price stability in the euro zone. In order to implement the assumption of a strong common European currency, it is necessary to maintain economic balance in the member and candidate states of the Economic and Monetary Union. Therefore, certain conditions are imposed on the countries to be met even prior to joining the euro zone.

Along with the above-mentioned criteria officially enshrined in the law and concerning the two most common fiscal measures, *i.e.* debt and deficit, another category of fiscal rules is sometimes taken into account. Budget expenditures can also be regarded. The simplest version of such rules assumes that governments are obliged not to exceed an appropriate limit imposed on those expenditures with relation to GDP.

A typical spending rule may also presume that state expenditures can increase by not more than a certain marginal value. The value may be set, for example, at a level equal to the long-term rate of economic growth. According to a more complicated version of the rule, the rate of a rise in expenditures ought not to exceed a certain moving average of the future rates of an increase in revenues.

It is also worth mentioning the so called golden fiscal rule applied in some countries, where under current revenues can be used to cover not all but solely current expenditures. The other expenditures, *i.e.* those associated with investment, may generate a certain level of deficit (KELL 2001, p. 3).

It should be emphasised that fiscal policy rules may serve, among others, to evaluate how restrictive a policy is. The simplest way to examine that scenario is to compare the actual budget deficit and public debt ratios with provisions concerning reference values in the constitution, statutes or treaties. In such a case, rules play an important application role as the fact of adhering to or breaching the rules by a country can be a central argument, for instance, when qualifying for the euro zone.

Fiscal criteria established at the above-mentioned levels are justified by practice. Nevertheless, treating them as optimal fiscal policy rules attracts considerable criticism. This particularly concerns the public debt limit. There has been a discussion in the specialist literature on an optimal debt ratio level. The level may depend on many factors, for example: the relationship between growth and interest rates, demographic trends, the distortionary effects of different taxes, the degree of aversion to risk and inequality across generations, the type and extent of market failures, the degree to which consumers are forward-looking, the size and distribution of shocks, and whether government expenditure is either permanent or structural (KELL 2001, p. 14).

That issue aside, attention should be paid to the fact that such a rule can be appropriate only when the set debt limit equals approximately the initial debt-GDP ratio. Otherwise, when the initially established debt limit is significantly higher than the current one, fiscal policy may tend to be excessively expansionary due to the fact that, despite the increasing indebtedness, the debt limit still seems to be relatively “safe” (DZIAŁO 2009, p. 184).

In such a case, a better rule appears to be, for instance, the requirement to reduce or stabilise the debt ratio to or at the level of the base year. The budget balance should then be set at a level preventing relative public indebtedness (as a proportion of GDP) from growing (KOPITS 2001, p. 10).

In that context, it is worth directing attention to the fact that all of the above-mentioned rules may be unsuitable for countries not regarded as developed ones since they are not sufficiently saturated with infrastructure yet (KOPITS 2001, p. 23). The high investment needs of such countries may require the so called modified golden rule according to which budget deficit should be maintained at such a level so that the ratio of net public assets to GDP remains unchanged. In other words, a rise in relative public debt may be allowable in such cases, although it ought not to exceed an increase in the public-capital-to-GDP ratio (MACKIEWICZ 2006, p. 55, 58).

It may also turn out to be very useful in analysing fiscal policy, the isolation of the total budget balance from the cyclical (connected with output gap) and structural portions. The latter should be regarded as an approximate figure that enables determining the budget balance value if the economy works at full capacity. Moreover, the division of the budget balance into the two portions allows distinguishing between discretionary actions and automatic stabilisers as the former mainly affect the structural portion, while the latter – the cyclical portion of the budget balance (TAYLOR 2000, p. 31).

Taking into account the division of the budget balance into two components, a fiscal rule can be assumed that, for instance, requires solely the structural budget rather than the total budget to be balanced. Alternatively for some countries, the rule can presume not a zero, but a relatively low, structural deficit. It is in that way that the medium-term fiscal policy target is set in convergence programmes recommended by the European Commission for particular countries¹.

Yet another rule may be associated with isolating, from the total budget balance, the primary balance. The primary balance is calculated as a difference

¹ For instance, for the Visegrad Group countries, the target was established at the level of: 0.5% of GDP for Slovakia, 1.0% of GDP for Poland and the Czech Republic, 1.7% of GDP for Hungary (*Convergence Programme of the Czech Republic*, 2015, p. 2; *Convergence Programme of Hungary 2014–2017*, 2014, p. 31; *Convergence Programme. 2014 update*, 2014, p. 8; *Stability Programme of the Slovak Republic for 2014–2017*, 2014, p. 23).

between budget revenues and expenditures minus interest payments on public debt. Then, the rule can provide for the requirement of the balanced primary budget, for example.

It is worth highlighting that such a rule would, to some extent, be contrary to the relative debt stability rule, since the primary balance values safe for maintaining the public debt ratio stability vary considerably among countries. In order to stabilise the debt-GDP ratio in some countries, a primary budget surplus proportionate to the difference between the interest rate and nominal GDP growth rate would be necessary. If, however, the latter rate is higher, the debt ratio can be stabilised even at a certain level of primary deficit². In such a case, the fiscal policy rule enables controlling the effects of interest rates and the GDP growth rate changing over time on the deficit component connected with public debt servicing (FAVERO, MONACELLI 2005, p. 3).

It should be emphasised that fiscal policy rules are mostly target rules. Although maintaining appropriate structural or primary balances can be considered an instrument of maintaining *e.g.* unchanged relative debt, it would be more accurate to regard those as targets as well (indirect and at the same time essential for meeting the main objective). If we assume fiscal policy instruments to be mostly expenditures and taxes, an instrument-related rule should be considered, in principle, to concern solely the limits on the level of or changes in expenditures (absolute or relative). On the other hand, expenditure rules can also be categorised as target rules, given their common main task of helping to maintain appropriate deficit and debt levels. Therefore, the boundary between target rules and instrument rules is sometimes quite fluid.

Costs and Benefits of Rule-Based and Discretionary Fiscal Policy

An attempt at verifying the hypothesis put forward in the introduction, whether discretionary or rule-based policy is more beneficial for the economy, can be made on the basis of several criteria. Those include, among others: **credibility** and **flexibility**, which are shown in Table 1. Furthermore, in the case of the former, attention will be devoted to two aspects associated with it: **market uncertainty** and the **temptation of abuse**.

² Applying values in real terms, the debt ratio can be stabilised even at a certain level of primary deficit if the economic growth rate (real GDP) exceeds the difference between the nominal interest rate and inflation rate.

Table 1

Rule-based versus Discretionary Fiscal Policy

Characteristic	Discretionary Fiscal Policy	Rule-based Fiscal Policy
(1) Credibility	lower	higher
– Market uncertainty	higher	lower
– Temptation of abuse	higher	lower
(2) Flexibility	higher	lower

Source: own work.

Credibility of Fiscal Policy

The presence of rules enhances the accountability of decision-makers since, if rules are violated, they owe an explanation of the causes of such an action to public opinion. Moreover, consistent adherence to policy rules increases its **credibility**, and hence will usually improve its effectiveness as well.

It is the presence of invariably obeyed rules in the consciousness of market participants that allows them to predict future macroeconomic policy decisions, eliminating, to a certain extent, the negative consequences of **market uncertainty**. Discretionary policy, in turn, increases that uncertainty.

Credibility is strictly connected with the issue of **temptation of abuse** as the absence of clear rules increases the decision-makers' tendency to make decisions more advantageous to themselves but often less than optimal for the economy in the long run, particularly taking into account the unrepresentativeness of public officials in conjunction with relatively short election cycles. At that point, attention should be directed to the fact that a rise in deficit may be advantageous to authorities from the point of view of future parliamentary elections. Even when the likelihood of election defeat and loss of power is high, it may also be more advantageous for the government to increase the deficit as the costs of that excessive deficit will be borne by the next government – who will be forced to limit expenditures during the next term. Thus, in that model, the higher the risk of loss of power by the ruling party and the higher the political polarisation is, the higher the budget deficit becomes (ALESINA, TABELLINI 1990, p. 22).

On the grounds of a balanced budgetary position over the entire economic cycle rather than in a given fiscal year, it is sometimes called for in the economic literature (KELL 2001, p. 3) that fiscal policy ought to be counter-cyclical. This means that when the economy is doing well, the government should reduce expenditures as a result of higher revenues from taxes and lower welfare expenditures connected with unemployment benefits, for example. However, remarkably often it appears that due to, among others, the prefer-

ences of voters who decide the outcome of elections, fiscal policy is pro-cyclical, which means that government expenditures grow even in an economic boom (ALESINA, TABELLINI 1990, p. 23–24).

Flexibility of Fiscal Policy

Despite many possible adverse consequences of increasing deficit and debt for economic growth in the case of discretionary policy, it should be kept in mind that discretionary policy can be more beneficial for the economy in some circumstances. Sometimes governments may face various, often quite dramatic situations such as wars, surges in oil prices or deep stock-market slumps. In such exceptional situations, rules would not be capable of taking into account those extraordinary circumstances. Then the freedom of action by fiscal authorities could prove a valuable asset (MANKIW, TAYLOR 2009, p. 455). Thus, in economic crisis conditions many countries pursue expansionary fiscal policy, which is meant to boost the economy and bring about multiplier effects in global demand.

Strict adherence to rules could blunt such effects, hence also contributing to long-term negative consequences in the labour market since, according to the neo-Keynesian view, along with short-term actual unemployment increases, crises may also lead to a long-term rise in natural unemployment. This results from, among others, the hysteresis concept according to which, if the actual unemployment rate is higher than the natural rate of the previous period, the latter will automatically rise as a consequence. What is more, the increase is not a one-off but is rather long-term in nature. That means that the labour market situation deteriorating due to a recession leaves a permanent “scar” behind and thus, even after negative shocks stop affecting the economy, the natural rate will not return to its previous lower level (BALL, MANKIW 2002, p. 9).

Therefore, it can be concluded that **flexibility** is decidedly a stronger point of discretionary policy. All the more so as fiscal target rules may sometimes contribute to very nervous actions of decision-makers determined not to exceed upper deficit or debt levels, not infrequently even resorting to creative accounting practices (KOPITS 2001, p. 7). Thus, it is worth drawing attention in that context to the fact that, if rules already apply, their essential characteristic should be transparency in governmental operations, including accounting, forecasting and institutional arrangements (KOPITS, SYMANSKY 1998, p. 18).

On the other hand, it ought to be highlighted that the abandonment of already applicable rules (through, for example, exceeding an upper debt ratio limit) could lead to even worse consequences for the economy associated with

the total loss of the credibility of authorities. However, that in fact depends, among others, on possible external sanctions for the breach.

Discretionary versus Ruled-Based Fiscal Policy in the EU Countries' Economic Practice

Many fiscal rules described in Point 1 can be applied in particular EU countries on a certain voluntary basis. That means that, although they are recommended by the European Commission (*e.g.* the rule regarding the achievement of an appropriate structural deficit level), they act as a medium-term target with no practical consequences of noncompliance. Even more freedom of application concerns such rules as: not increasing the debt ratio (when the reference value has not yet been exceeded), limits on primary deficit or increases in governmental expenditures, as well as different variants of the golden fiscal rule. In the above cases, a decision to apply or not to apply a given rule is usually made by governments of sovereign countries rather than by EU authorities.

A slightly different approach characterises the issue of reference values of public debt and total budget deficit as all the EU member states are obliged to respect them pursuant to the Maastricht Treaty. What is more, a fine of up to 0.1% of GDP may be imposed on countries failing to follow those rules (*Information Note on the EU Fiscal Compact Treaty* 2012, p. 11). Such an approach would be consistent with the view promoted by Taylor, among others. According to him, even in economic crisis conditions, government interventions involving fiscal laxity could do more harm than good, resulting in deviations from what has worked well before, without a significant boost to GDP. In such a case, due to the adverse long-term consequences of deficit and debt, the government should always, irrespective of the condition of the economy, strive to reduce indebtedness, especially if the target rule in the form of a set convergence criterion has been exceeded or is close to being exceeded (TAYLOR 2010, p. 175).

Interestingly in that context, against commonly held opinions, governments which pursue fiscal tightening often win the next election. According to research carried out by A. Alesina and S. Ardagna, out of nine analysed countries which implemented restrictive fiscal policy programmes in the 1980s and 1990s, election defeat after fiscal tightening occurred only in Greece and Denmark as well as in Ireland during the first analysed period. This was not the case in: Australia, Belgium, Canada, Italy, the Netherlands and Sweden as well, although only in the second analysed period, in Ireland (ALESINA, ARDAGNA 1998, p. 32–57).

On the other hand, it ought to be remembered that inflexible adherence to rules may sometimes result in undesirable nervous actions on the part of authorities. That is exemplified by actions of the Greek government before their accession to the euro zone, which understated the official debt statistics as compared to the actual debt and, recently, the reaction of the Polish government to the risk of exceeding the constitutional and treaty threshold of 60% public debt. When public debt reached 57% of GDP, it was decided to transfer money from Open Pension Funds to the budget (*Convergence Report 2014*, p. 163–165).

Nevertheless, decision-makers do not take such nervous steps very often, permitting the exceeding of allowable limits. Figure 1 indicates that as many as 17 EU-28 countries (Greece, Italy, Portugal, Cyprus, Ireland, Belgium, Spain, France, the United Kingdom, Croatia, Austria, Slovenia, Hungary, Germany, Malta, the Netherlands and Finland) exceeded the public debt ratio convergence criterion in 2015. For comparison, that was the case for only 9 EU-28 countries (Greece, Italy, Portugal, Belgium, France, Austria, Hungary, Germany and Malta) in 2008. That means that 8 countries (Cyprus, Ireland, Spain, the United Kingdom, Croatia, Slovenia, the Netherlands and Finland) exceeded the required level in recent years. What is more, Figure 1 indicates that 9 countries, which exceeded the 60% level as early as in 2008, not only did not near the required reference value but got even further away from it, regularly increasing their debt ratios over the last seven years. That is not changed by the fact that, over the last three years (from 2012 to 2015), 10 EU-28 countries (the Czech Republic, Denmark, Germany, Ireland, Lithuania, Luxembourg, Hungary, Malta, the Netherlands and Poland) managed to reverse the negative trend by slightly reducing their public debt ratios (<http://epp.eurostat.ec.europa.eu> – Code: tsdde410) – accessed on 31 May 2016).

Similar conclusions can be drawn based on the analysis of the budget deficit ratio. Figure 2 indicates that the 2009–2011 budget balance deteriorated compared to the preceding three-year period in all countries except Hungary. Some of them managed to improve the said balance in the following three years but it usually remained worse than in the 2006–2008 period. Therefore, considering the average three-year values, the deficit level required by the Maastricht Treaty was exceeded in as many as 21 countries (all apart from Denmark, Germany, Estonia, Luxembourg, Malta, Finland and Sweden) in the years 2009–2011 and 12 countries (Belgium, Ireland, Greece, Spain, France, Croatia, Cyprus, Poland, Slovenia, Slovakia and the United Kingdom) in the years 2012–2014. For comparison, that convergence criterion was not met by only 5 countries (Greece, Hungary, Portugal, Romania and the UK) in the 2006–2008 period.

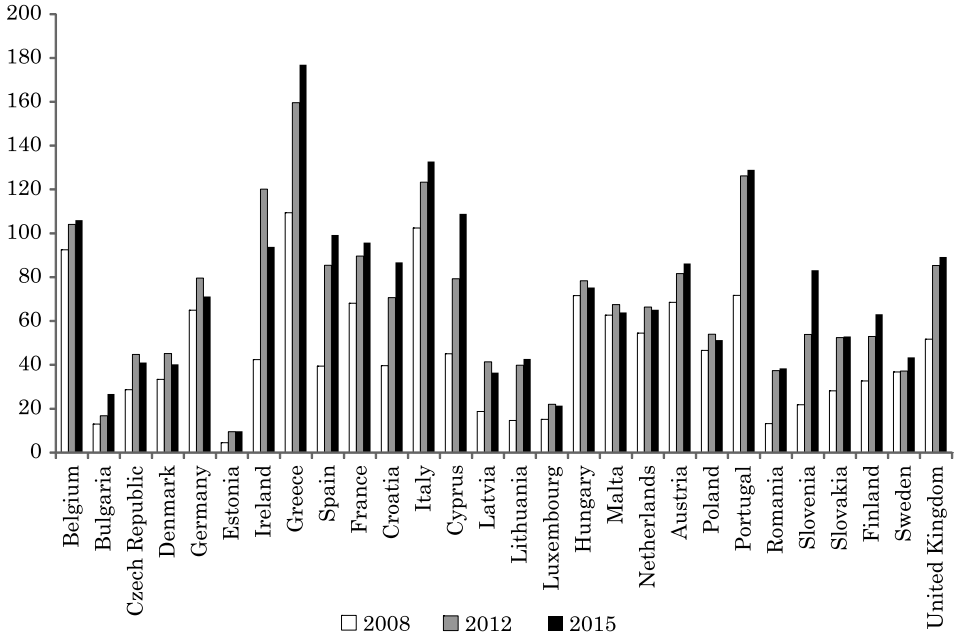


Fig. 1. Public debt ratios in EU countries in 2008, 2012 and 2015

Source: <http://epp.eurostat.ec.europa.eu> (Code: tsdde410) – access: 31.05.2016.

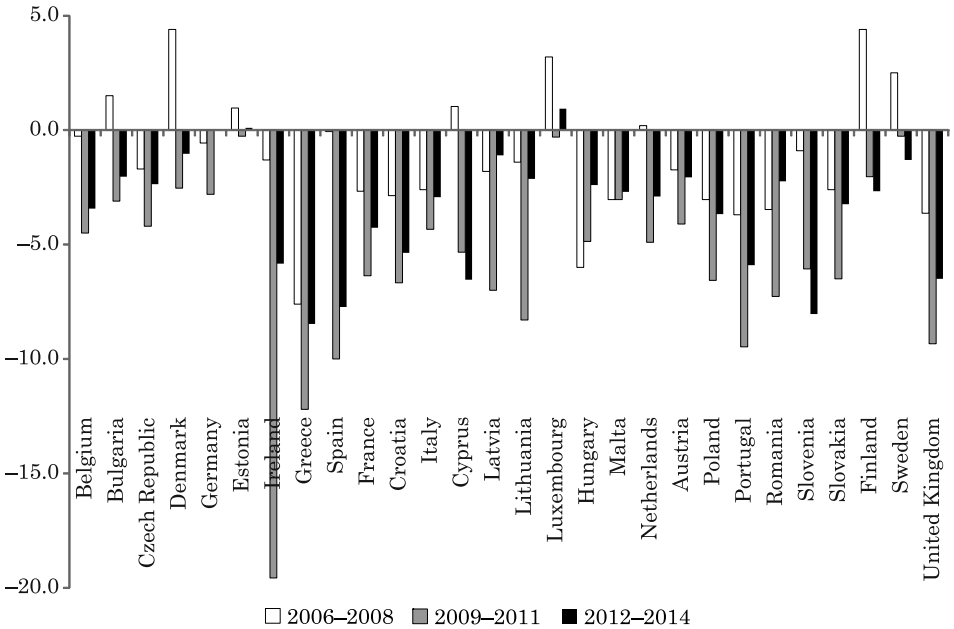


Fig. 2. Average budget balance ratios in EU countries in the years 2006–2008, 2009–2011 and 2012–2014

Source: <http://epp.eurostat.ec.europa.eu> (Code: tec00127) – access: 31.05.2016.

Taking into account the fact that the economic crisis widely manifested itself in 2009, the growing debt and deficit may indicate that in order to stimulate global demand, particular countries' governments applied very expansionary fiscal policy, ignoring the applicable Maastricht Treaty provisions.

In that context, it can be assumed that the model actually applicable in the EU is to a large degree a compromise solution and exceeding the prescribed limits does not usually entail any sanctions in practice, apart from possibly not being qualified to join the euro zone. Moreover, the Stability and Growth Pact contains a provision stating that the European Commission may not even instigate disciplinary procedures at all, if it decides that rules have been violated due to an extraordinary, transient situation (DZIAŁO 2009, p. 117). On the one hand, such an approach significantly reduces the long-term benefits of applying and obeying the rules. On the other hand, as presented in the theoretical analysis, it increases the flexibility of fiscal policy sometimes needed in the economy in the recession phases of an economic cycle.

Conclusion

The conducted analysis allows the drawing of several fundamental conclusions.

1. National governments face a dilemma about whether to follow a fully discretionary fiscal policy or a fiscal policy based on certain rules. Fiscal rules are, first and foremost, target rules. They mostly concern limits of maintaining public debt and budget deficit at appropriate levels in relation to GDP. They are enshrined in the law and their violation may sometimes entail sanctions. Furthermore, there may be more such rules as they may also apply to budget expenditures, structural deficit and primary deficit.

2. If rules apply, fiscal policy is more credible (apart from the nervous actions of authorities when a variable approaches the maximum allowable level). All the more so as the presence of rules is connected with lower market uncertainty and lower temptation of abuse. On the other hand, rule-based policy is decidedly less flexible, especially in extraordinary situations such as wars, stock-market crashes or economic crises.

3. Therefore, **the hypothesis put forward at the beginning cannot be unambiguously proved or rejected.** Nevertheless, based solely on the conducted theoretical analysis, a statement can be attempted that rules are more advantageous in normal conditions, whereas in exceptional situations discretionary policy can be better for the economy thanks to its higher flexibility. The lack of sanctions against countries not adhering to rules in the EU seems to prove that similar conclusions have also been drawn by EU

decision-makers. It should, however, be emphasised that the above hypothesis cannot be fully verified based on the mainly theoretical deliberations and thus the analysed issue requires detailed empirical studies for particular regions or countries.

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