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Evaluation of Fiscal Rules in the Euro Area and in the United Kingdom[1]

*Ondřej SANKOT – Barbora HRONEŠOVÁ**

Abstract

This paper deals with fiscal regulation in the EU and the UK, analysing the Stability and Growth Pact (SGP) after the Six-pack reform and the recent introduction of British fiscal rules. The main aim of the first section of this paper is to compare the SGP before and after the Six-pack reform in order to determine whether the reform has contributed to conformity of the SGP with theoretical requirements on fiscal rules, as defined by Kopits and Symansky (1998). According to our analysis, it could be concluded that the Six-pack reform has contributed to better fiscal regulation in the EU compared with theoretical requirements. Enforceability in real conditions, nonetheless, still depends on political will. The second section deals with the two recent British fiscal rules, which are also analysed using the Kopits and Symansky framework. The analysis of Eurozone and British fiscal rules aims at contributing to the current discussions about the economic consequences of Brexit.

Keywords: *European Union, United Kingdom, EU governance, fiscal regulation, fiscal rule, Six-pack, Stability and Growth Pact*

JEL Classification: E62, E63, H30, H87

Introduction

The European Monetary Union is in many aspects unique. It is a special arrangement among particular states that are at the same time subject to a wider governance framework, the EU. Monetary policy is unified, and fully delegated to common monetary authority; however, fiscal policies remain to be set independently at national level.

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Even before the Eurozone was founded, policymakers, especially from countries preferring currency stability, feared fiscal indiscipline inside the single currency area. German finance minister Theo Waigel proposed in 1995 a fiscal rule to restrain the national public deficits and debts of Eurozone members. The Stability and Growth Pact (SGP) should have prevented fiscally undisciplined states from taking advantage of common monetary policy, where they could enjoy lower interest rates on their sovereign debt. However, the emergence of the European Sovereign Debt Crisis in 2009 proved that the SGP failed to ensure financial stability across the Eurozone and the EU. Non-Eurozone EU members were also influenced by the SGP, especially when setting their own fiscal rules. The UK implemented its own fiscal rule in the same period, aiming at very similar objectives.

In the current literature, we can find a comparison of the fiscal rules in the EU and the UK before 2010 (British fiscal rules reform) and 2011 (the second SGP reform) (e.g. Buiter, 2003). In this paper, the effect of the Six-pack reform on overall fiscal regulation in the EU together with the current British fiscal rules will be analysed.

The main goal of the paper is to determine whether both the Six-pack reforms and British fiscal rules contributed to the introduction of better fiscal regulation compared with the model fiscal rule. As a theoretical underpinning the concept introduced by Kopits and Symansky in 1998 is used.

The first chapter initially describes fiscal regulation from the theoretical point of view. Reasons for the introduction of a fiscal rule, its definition and the main goals of a fiscal rule are depicted in general terms and subsequently in brief also for the Eurozone as a specific case. In the second part, the specific aspects of the model fiscal rule are described. This model fiscal rule serves then as the benchmark for analysis of the Six-pack reforms and the British last two fiscal rules.

The second chapter deals with the reasons for the Six-pack introduction and the impact of the Six-pack on the overall quality of budgetary control in the European Union.

The last chapter deals with the applied fiscal rules within the economic governance of the UK. This paper should contribute to the understanding of three topics – the strengths and weaknesses of the current SGP, principles of fiscal regulation in the EU related to the SGP, and EU economic governance related to member state budgetary policies.

The analysis of Eurozone and British fiscal rules aims also at contributing to current discussions about the economic consequences of Brexit. Nonetheless, we do not expect a very high impact of Brexit on both British and Eurozone countries' fiscal policies.

1. Fiscal Regulation and Fiscal Rules

1.1. Fiscal Regulation

Historically, public budgets had only one function – to allocate resources and to finance state expenditures. Public expenditure's debt financing was connected mostly with military conflicts. During the 19^{th} century, social aspects began to be taken into account and public budgets gained their second function, the redistribution of income (Jain, 1983). Keynesianism theoretically justified short-term state deficit financing as a tool of macroeconomic stabilization (Keynes, 1936). After World War II, developed states in Western Europe focused on fiscal policy in accordance with the Keynesian approach (Buti and van der Noord, 2004). Despite the fact that the emphasis on an active anti-cyclical fiscal policy decreased after the neoliberal turn in the 1980s, the national governments of developed OECD economies have utilized the opportunity to accumulate debts – in some cases exceeding 100% of their GDP (Danninger, 2002; Eurostat, 2017. The long-term focus on deficit financing as a post-war phenomenon could be explained by Public Choice Theory. For further detail, see Buchanan and Wagner (1977) or Schuknecht (2004).

Public debt accumulation could be dangerous in the long run, causing potential instability and precluding future economic growth. Despite the fact that empirical studies (e.g. Paniza and Presbitero, 2013; or IMF, 2012) fail to deliver exact figures about what level of public debt is perilous, the necessity for fiscal discipline remains a part of the current economic consensus (Kumar and Ter--Minassian, 2007). Governments therefore conduct steps to ensure that public debts do not rise unrestrictedly (European Commission, 2003).

For that purpose, especially since the 1980s, fiscal rules aiming at public finance consolidation are being introduced. Between 1990 and 2012, the number of countries having fiscal rules in place increased from 5 to 76 (Frankel and Schreger, 2012). Kopits and Symansky (1998) define a fiscal rule as a: *permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. The rules under consideration cover summary fiscal indicators such as the government budget deficit, borrowing, debt or major components thereof – often expressed as a numerical ceiling or target in proportion to gross domestic product (GDP).* We could distinguish three major types of fiscal policy rules: a balanced budget or deficit rules, borrowing rules, and debt or reserve rules (Kopits and Symansky, 1998).

Many reasons could be found for the introduction of fiscal rules that in fact limit state authority. Kopits and Symansky (1998) describe the following rationale – in general, fiscal rules are meant to moderate inflation, interest rates, contribute to investments, and most of all, to limit a built-in bias of democratic governments towards deficit spending (Buchanan and Wagner, 1977; Persson and Tabellini, 1990). The need for fiscal rules in a single currency area, like the Eurozone (Schuknecht, 2004; Willet, 1999; Wyplosz, 2002), is partially specific and mostly connected with the avoidance of negative spill-over effects. In a single currency area with unrestricted autonomous fiscal policies conducted by national governments, an excessively indebted country could avoid consequences in the form of rising interest rates due to the obligations of other countries resulting from the common currency. Moreover, excessive public spending would have an impact on price levels in a particular country. This would rule out setting a proper common monetary policy for the whole currency area, resulting in possible bubbles in local asset markets (Stockhammer and Köhler, 2015). The existence of the single currency area in the EU also has specific consequences for the economic policies of other EU members, whose markets are interconnected with the Eurozone. The pre-Brexit UK with its financial market has been a special case showing very high correlation with the Eurozone's interest rates since pre-crisis 2007.[2]

1.2. Requirements for Fiscal Rules

Fiscal rules could be based at different frameworks. In this paper, the framework set up by Kopits and Symansky (1998), used also by Creel (2003) and Buti and Giudice (2002), will be used. Kopits and Symansky (1998) laid down the following eight requirements for model fiscal rules. Such rules should be well-defined, transparent, adequate, consistent, simple, flexible, enforceable, and supported by efficient policy actions.

In order to be enforceable, a fiscal rule has to be well-defined first. This means a choice of appropriate indicator, institutional coverage and potential escape clauses. It is desirable to monitor rather the overall balance than the current balance. The balance should incorporate the whole public sector to avoid creative accounting practices as defined by Koen and van der Noord (2005). As von Hagen and Wolff (2006) argue, creative accounting practices tend to take place particularly during recessions, since the likelihood rises that the fiscal rule will be broken. Transparency in government operations is the second attribute of a fiscal rule. It includes accounting, forecasting and institutional arrangements (Kopits and Craig, 1998). Lack of transparency is likely to subvert popular support for a fiscal rule, necessary for its implementation and application. Best practices

[2] According to the dataset of annual money market interest rates from Eurostat ranging from 2007 to 2016/2014. When calculating correlations in day-to-day interest rates between the Eurozone and the particular non-Eurozone members, the UK according to our expectations, based on the existence of the strong financial market, gained the highest number: 0.91, followed by Bulgaria (0.88), the Czech Republic (0.87), Romania (0.71), Hungary (0.64) and Poland (0.63).

for budget transparency have been introduced by the OECD (2015), while further standards related to fiscal transparency are defined by the IMF (2015). The adequacy of a fiscal rule should be related to its main purpose. Related tools and indicators should correspond to the main goal. The goals of fiscal rules can vary from inflation control, across external debt limitation, towards the size of the public debt as a whole. A fiscal rule has to be consistent internally with other macroeconomic policies and rules and consistent in time. It is necessary to take the exchange rate system and preferences regarding debt structure into account. Fiscal rule in the EMU has to conform with other rules of the European Union and the European Economic Area. A simple legal definition and comprehensibility to the public are further desirable aspects of a fiscal rule. Only understandably defined rules could raise the confidence of citizens and other external actors. In order to retain the ability to cope with exogenous shocks, a fiscal policy rule has to be flexible. Flexibility could be gained using escape clauses defined well and in advance. One of the more simple escape clauses is to define a fiscal rule over the medium-term, or the escape clause may be related to structural balance or a cyclically adjusted budget. Under certain circumstances, governments could also be granted loans from central banks.

A critical element of any fiscal rule is its enforceability, without which any fiscal rule remains meaningless. Fiscal rule supervision can be entrusted to a newly created or existing authority; however, such an authority has to be independent from the national government. The consequences of non-compliance with a fiscal rule could be reputational, financial or juridical. All the procedures connected with a breach of a fiscal rule have to be clearly defined and guaranteed by a supervision authority, which not only monitors compliance with a fiscal rule itself, but also related accounting and procedural standards.

Each fiscal policy rule has to be complemented by efficient policy actions. For some time, a balanced budget can be ensured by one-off measures. *However, these should be regarded only as temporary stopgap measures, allowing time for preparation and implementation of more fundamental reforms to ensure continued adherence to the rule in the future* (Kopits and Symansky, 1998). From this point of view, long-term sustainability is anyway achievable only by addressing crucial fiscal issues and continuously conducting essential reforms. Only if this condition is fulfilled will a fiscal rule be durable. The above-mentioned attributes of a model fiscal rule are not achievable simultaneously as there are inevitable trade-offs among them. The most severe trade-offs can be seen between simplicity and adequacy, flexibility and enforceability, and simplicity and flexibility (Kell, 2001). On the other hand, some attributes complement one another, such as transparency and enforceability. Some attributes overlap, such as efficiency and enforceability.

2. The Six-pack Reforms and their Impact on Fiscal Regulation in the EU

2.1. The Purpose of the Six-pack Reforms

After the Economic and Monetary Union (EMU) was established, monetary policy was shifted to the common monetary authority and fiscal policy, which remained in the competence of nation states and gained a specific significance. In order to avoid potential discrepancies between fiscal and monetary policies, the EMU is in theoretical perspective built on strong fiscal discipline foundations (Buti and van der Noord, 2004). Before a country is allowed to join the EMU, it should fulfil criteria laid down by the Maastricht Treaty. Regarding fiscal limitations, a deficit of public budgets exceeding 3% of GDP and public debt exceeding 60% of GDP (unless decreasing to the reference level) are not allowed (Baldwin and Wyplosz, 2013). The Maastricht Criteria were in 1999 nevertheless used in an arbitrary way to pursue political objectives with little regard for the economic situation in accession countries (De Grauwe, 2009). The approach of relaxed interpretation and insufficient enforcement has turned out to be the fate of subsequent fiscal rules as well.

In order to maintain fiscal stability after accession to the EMU, the Stability and Growth Pact, implementing the same fiscal criteria as the Maastricht treaty, was suggested by Germany and approved in 1997. By that time, it was believed that compliance would be strictly enforced. However, as each country had a right to determine its own fiscal policy, the final decision on potential sanctions was entrusted to the Economic and Finance Affairs Council (ECOFIN), comprising of EU finance ministers, who represent the interests of nation states (Baldwin and Wyplosz, 2013). This clearly collides with the prerequisite of a fiscal rule, which demands an enforcing institution to be independent from the national government executing the fiscal policy. In 2002, the SGP was breached by Germany and a year later by France. According to the SGP, the European Commission started an excessive deficit procedure, issued a recommendation for the Council, and proposed a notice to adopt corresponding measures. The ECOFIN was, however, reluctant to issue a legally binding decision (Wyplosz, 2013; Council Decision, 2003) and both Germany and France were not forced to reduce their public deficits. Due to this fact, the European Commission took legal action against the Council through the European Court of Justice. The Court of Justice decided that ECOFIN had failed to fulfil its duties; nevertheless, it was not able to make the ECOFIN issue a decision (Bacho, 2009; ECJ, 2004). *The action of the ECJ was only censored on legal technicalities that required a rewording of the decision. The court did not consider the economic merit – or demerit – of this action* (Wyplosz, 2013).

Based on these troubles, the European Commission proposed the first SGP reform, stressing long-term fiscal sustainability. The basic rules of the SGP were not changed, but many exceptions were issued, in order to promote flexibility to overcome short-term fiscal difficulties (Council Regulation, 2005). In fact, fiscal rules were relaxed and the time to issue sanctions was extended (Kunesova and Cihelkova, 2006).

In 2009, when the European Sovereign Debt Crisis emerged, 15 out of the then 17 Eurozone members were subjects of an excessive deficit procedure (Baldwin and Wyplosz, 2013). Figure 1 depicts the development of public debts in selected EU countries from 1997, when the SGP was introduced, over 2007 and 2013, to demonstrate the effect of the European Debt Crisis, till the present. Countries were selected from the group of 11 Eurozone founding members, where the SGP rules are applicable for the longest time period – Italy being currently the most indebted and Luxembourg the least indebted. Ireland demonstrated the largest increase in public debt during the debt crisis, while in Germany the increase during the crisis was the lowest.

F i g u r e 1

General Government Consolidated Gross Debt (% of GDP)

Source: Eurostat (2017).

As shown in figure 1, despite the fact that identical SGP fiscal restraints were applicable to all the Eurozone countries without exceptions, particular nation states demonstrate very different results with respect to the development of public debt. Köhler and König (2015) argue that the SGP to some extent contributed to reducing public indebtedness in the Eurozone. Nevertheless, the SGP failed to fulfil the main aim of its existence to ensure fiscal stability in the Eurozone.

Generally, non-compliance with set fiscal rules could, according to Wijsman and Crombez (2017), stem either from government short-sightedness (Alesina and Tabellini, 1990), common pool resource problems (Roubini and Sachs, 1989), or electoral cycles (Alesina and Sachs, 1988). Buti and Carnot (2012) identify three particular reasons for the failure of the SGP. First, the 3% ceiling was incorrectly interpreted as a target, not a limit. Second, due to the 3% ceiling, fiscal policy became pro-cyclical during economic slowdowns. Finally, and most importantly, enforcement power was weak as sanctions did not act as a deterrent and the introduction mechanism was not reliable. In fact, financial sanctions for non-compliance have so far never been imposed. All in all, national governments were not under sufficient pressure to behave in a fiscally responsible manner.

The irresponsible fiscal behaviour of some Eurozone members is seen by some economists as an even more important driver of the European sovereign debt crisis than differences in competitiveness and resulting macroeconomic imbalances (Wyplosz, 2013). That is why the fiscal governance of the Eurozone had to undergo serious amendments. During the debt crisis, many measures have been taken to prevent such a crisis from happening again. DeGrauwe (2007) argues that the SGP did not work well because national governments are primarily responsible to national electorates, not to the EU institutions. National governments therefore prefer to accept sanctions arising from a violation of a fiscal rule to risking defeat in elections. That is why all the reforms of fiscal governance do have one common denominator – the centralization of power on the supranational level.

Nonetheless, this part focuses exclusively on the Six-pack and its effects on fiscal regulation in the EU. Besides the introduction of the so-called Macroeconomic Imbalance Procedure, a warning and correction mechanism for macroeconomic imbalances, the Six-pack[3] represents foremost a comprehensive reform of the SGP. Both the preventive and corrective parts of the SGP were reformed.

It is important to highlight that in general, the SGP is obligatory for all EU members. However, some of its parts, notably sanctions, are valid for Eurozone members only. Although the UK, until Brexit the non-Eurozone member *par excellence*, is generally subject to the SGP,[4] it holds a unique position regarding excessive deficits. Whereas other member states *shall avoid excessive government deficits*, the UK is obliged to *endeavour to avoid* it (Protocol 15, Article 139 of the TFEU; in Gov.uk, 2014). The endeavour to avoid an excessive deficit is nevertheless very clear in the UK; however, both the endeavour and the excessive

[3] Regulation EU No. 1175/2011; Regulation EU No. 1177/2011; Regulation EU No. 1173/2011; Directive No. 2011/85/EU; Regulation EU No. 1176/2011; Regulation EU No. 1174/2011.

[4] As of August 2017, when the post-Brexit arrangement is not clear yet.

deficit may have a different definition in the UK than in the Eurozone. As indicated above, there is a risk stemming from lack of political ownership of the policy in the UK, so imposing fiscal rules in the country seems to be rather motivated by its own approach than overall compliance with the Eurozone rules. Based on this pre-Brexit arrangement, it could be expected that there will be no significant change in the British attitude to excessive deficits in the future and these will be still be dealt with according to the actual state of the British economy. Further analysis is provided in the following sections.

2.2. The Impact of the Six-pack on Fiscal Regulation in the EU

The SGP represents the primary fiscal regulation tool in the EU. The attributes of the original SGP, approved in 1997, have already been compared in the economic literature with model fiscal rule defined by Kopits and Symansky (1998). According to Buti et al. (2003), simplicity was the main strength of the original SGP, while enforceability and efficiency were among its weaknesses. Creel (2003) considers simplicity to be the only strength of the original SGP, whereas enforceability, consistency and efficiency were its weak aspects.

In the following part, the Six-pack reforms of the SGP in the context of model fiscal rule defined by Kopits and Symansky (1998) will be evaluated.

Regarding the first aspect, is the SGP better defined now? The Six-pack reform contributed to clarification of the crucial term, serious non-compliance with the medium term budgetary objective. Moreover, sanction rules for non-compliance with both the Preventive and Corrective Arms of the SGP were specified. The definition of minimal budgetary framework requirements also contributes to improvement in this field. On the other hand, many possible exceptions were provided to the Commission and Council so that sanctions could be mitigated or not imposed at all. Both European bodies have enough flexibility as those exceptions are defined only poorly. Nevertheless, as many poorly defined exceptions were introduced already in previous SGP versions, it could be concluded that the Six-pack reform contributed to a better definition of SGP rules.

Due to the better definition of serious non-compliance with the medium-term budgetary objective, the Six-pack clearly defines when the Commission is obliged to start the excessive deficit procedure, leaving less room for its own interpretation. Despite many applicable exceptions, the Commission has to at least objectively and consistently evaluate compliance or non-compliance with set budgetary objectives. Transparency as a model fiscal rule aspect was for that reason improved. Minimal requirements on budgetary frameworks of member states further support this conclusion.

More precise definitions and more aspects to be taken into consideration when deciding about the consequences of non-compliance significantly aggravated the simplicity of the original SGP (Prammer and Reiss, 2016). This was however one of the necessary trade-offs if better definitions and adequacy were to be introduced. Continual enlargements of the EMU also contributed to lower simplicity. Country diversification in the Eurozone implies a reduction of fiscal rule flexibility, as Buti and van der Noord (2004) and Buti et al. (2003) suggest.

Evaluating the development of flexibility is a challenging task. The European Commission still has to consider many aspects when deciding about the consequences of non-compliance, and escape clauses remain part of the rule. However, the room to decide whether a specific case constitutes non-compliance, or not does not exist anymore. Moreover, even excusatory reasons for the mitigation of non-compliance consequences have been defined more precisely in comparison to the previous versions of the SGP, regardless of exactly defined sanctions to be imposed when specific parts of the SGP are violated. For those reasons, the flexibility of the fiscal rule could be considered reduced.

In terms of enforcing fiscal discipline, the SGP has from the theoretical point of view always been quite adequate. In practice, on the other hand, the SGP failed to secure the goal it was designed for. This, however, is not an issue of definition, but enforcement. For that reason, it is hard to determine whether the Six-pack reform contributed to a higher or lower adequacy of the SGP.

Enforceability remains the major weakness of the SGP. Nation states do not seem to be impressed by reputational sanctions connected with the introduction of the excessive deficit procedure and financial sanctions have never been imposed. According to the Six-pack, the European Commission still has the right only to propose sanctions, which have to be finally confirmed by the Council. The main modification consists in the introduction of reverse qualified majority voting on sanctions in the Council. Proposed sanctions are approved unless a qualified majority of states votes against them. A qualified majority in the Council (on a proposal by the Commission) is reached if 55% of member states, i.e. 16 out of 28, representing at least 65% of the total EU population, vote against the proposed sanctions (European Council, 2016; European Commission, 2012). This should theoretically increase the chance of a sanction being approved. However, the political will in the Commission and Council still remains the crucial element. Wijsman and Crombez (2017) claim that governments represented in the Council tend to behave opportunistically and hinder imposing fines on others when breaching the rules themselves, as was the case of Germany and France in 2003, when four out of the six countries voting against fines had excessive deficits themselves, whereas none of the eight member states in favour of sanctions had a deficit exceeding 3%. This moral hazard could be resolved by transferring the deciding authority completely to an independent supranational body, i.e. by completing the fiscal union (Eyraud and Wu, 2015). On the other hand, the Commission itself was also quite restrained when enforcing valid fiscal rules, not acting as an independent body without its own political goals and motivation. In 2016, the missing political will proved to be still the most serious weakness of fiscal regulation in the EU, as both the Council and the Commission agreed not to impose fines on Spain and Portugal (mainly in order to prevent reputational damage to the EU in times of increasing Euroscepticism), despite the fact that the Council had found that there had been no effective action taken to reduce the excessive deficit of both countries (European Council, 2016). This setback could have been prevented if sanctions had been triggered automatically, which would, however, further decrease the flexibility of the fiscal rule. Beetsma and Debrun (2007) argue that rigid fiscal rules could discourage states from conducting necessary structural reforms, such as those related to the ageing population or limited labour market flexibility. Moreover, the automatic imposition of sanctions turned out not to be politically acceptable. The real effect of the Six-pack reform on enforceability therefore effectively remains dependent on the appraisal of the Commission and the Council.

The SGP is quite consistent in referring to the limits it imposes on the public deficit or public debt and the Six-pack does not bring any fundamental change. The criticism in this field (Creel, 2003) applies mainly to the relation of fiscal and monetary policies in the EMU. As the Six-pack does not deal with the coordination of fiscal and monetary policies, the consistency of the SGP is not affected.

The SGP efficiency depends mostly on policy actions taken in relation to fiscal discipline. Neither the previous versions of the SGP nor Six-pack reforms deal with actual policy actions related to the insurance of fiscal sustainability in the long-run. This remains within the competence of nation states. However, under the assumption that the Six-pack promotes the enforceability of the SGP, its efficiency to ensure deserved budget limitations, at least in the short-run, should be increased. A brief summary of the Six-pack reform effects on fiscal regulation in the EU is depicted in Table 1.

The Brexit vote will not have any direct effect on fiscal regulation in the Eurozone. Nevertheless, it is going to remove a determined opponent of further European integration. This could clear the way for completing the Fiscal Union, as the Five Presidents' Report sets out (European Commission, 2015). Limiting the powers of nation states represented in the Council in favour of a politically independent supranational body could contribute to addressing the most serious weakness of the SGP, i.e. its enforceability.

T a b l e 1

Six-pack Reform Compared with Model Fiscal Rule by Kopits and Symansky (1998)

Aspect	Six-pack impact
Well-defined	+
Transparency	+
Simplicity	–
Flexibility	–
Adequacy	?
Enforceability	+
Consistency	?
Efficiency	+

Note: + stands for improvement; – stands for deterioration; ? stands for no or contradictory effect.

Source: Author´s summary.

3. British Fiscal Regulation and Its Ties to the SGP and Its Reforms

Fiscal policy relevance in the UK has risen due to ineffective monetary measures established to deal with the crisis consequences (Becker et al., 2015; Emmot 2016). In particular, decreasing the interest rate to 0.5% in 2009 did not lead to the expected results and motivated the British government to focus on fiscal policy. This led to increased government spending with public sector net borrowing (PSNB) peaking at 10.2% of GDP in 2010. Since there is currently no general fiscal rule established by the British government[5] (OBR, 2015a, p. 20), the analysis will be based rather on the actual execution of fiscal policy by the Office for Budget Responsibility (OBR) and its EU fiscal rules compliance, with a historical excursion into the previous fiscal rules from 1997.[6]

3.1. Fiscal Regulation in the UK – from "Labourite" to "Conservative" Fiscal Rules

In the long-term perspective, the government sets fiscal targets annually through public sector net debt[7] (PSND) and PSNB. The latter is a key indicator of the British fiscal position and it represents the year-to-year difference between total public sector receipts and expenditure on an accrued basis.

[5] There is rather a fiscal regime which is based on medium-term fiscal objectives defined on a yearly basis in successive government budgets. However, the precise specification can be and is frequently subject to change.

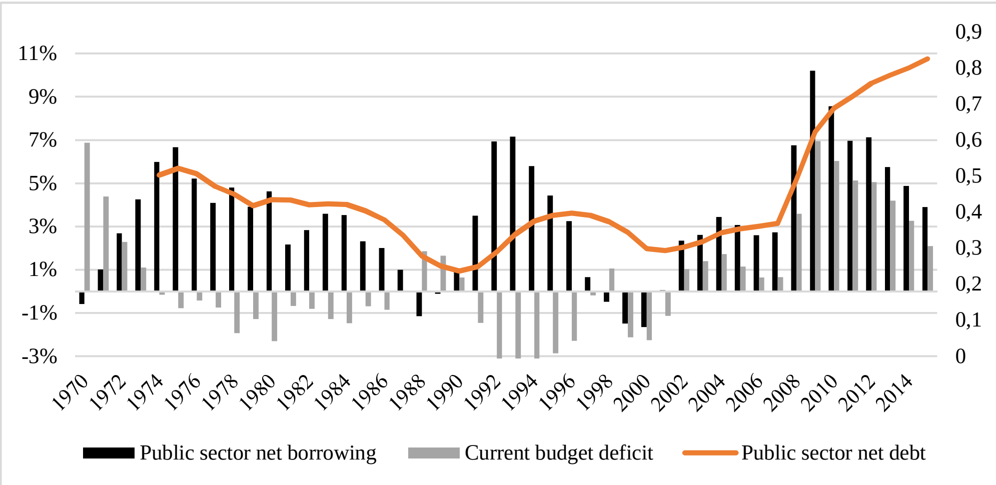
[6] These developments bolstered scientific research on the assessment of British fiscal rules, such as Kell (2001) and Frayne and Love (2001). Murray and Wilkes (2009), Sawyer (2011) and Dupont and Kwarteng (2012) followed these works by focusing on the coalition and Conservative Cameron´s Conservative government´s fiscal rules assessment.

[7] PSND represents "a stock measure of the public sector's net liability position i.e. its liabilities minus its liquid assets (…). It is also the fiscal measure used for the Government's supplementary fiscal target. PSND is the key measure of the country's overall debt." (OBR, 2015a).

Figure 2 shows the development of the fiscal targets and compares them with the current budget deficit. Apart from that, British governments have tried many times to set general rules for sustainable fiscal policy. This dimension, however, moves us from technocratic fiscal rules definition to purely political issues. According to Murray and Wilkes (2009), both Labourites and Conservatives made efforts to divert voters´ attention from the expected consequences of expansionary fiscal policies, either by setting the so-called ‘golden rule’ in 1997 or by establishing the OBR in 2010.

Figure 2

UK Fiscal Targets – PSNB (left axis) and PSND (right axis), and Current Budget Deficit (left axis), in % of GDP, 1970 – 2015



Source: OBR (2015a).

In 1997, the new Labour government took steps to reach its goal of “high and sustainable levels of growth and employment” (HM Treasury, 2008). Overall, five fiscal management principles were set, theoretically partly compatible with the model fiscal rule by Kopits and Symansky (1998), as depicted in Table 2. However, some aspects were not even included theoretically, above all the simplicity of the fiscal rule and its flexibility.

The motivation to introduce these principles stemmed from previous periods of increasing PSNB as well as indebtedness, as apparent in Figure 2. Whereas in the fiscal year 1988 – 1989 the British public sector demonstrated a slight surplus, afterwards this measure kept rising until reaching the level of 7.2% of GDP in 1993/94. PSND later rose from the level of 23.6% of GDP in 1990 – 1991 to almost 40% in 1997/98, when Labour started its first term. Furthermore, the government pointed out that there had been a substantially low level of investments funded by Conservative governments in the previous periods. Figure 3 shows the decreasing trend of public sector gross investment in the periods prior to 1997, in comparison with public sector current expenditure. Kell (2001, p. 5) adds that the government gross investments as a share of GDP were at the lowest level among the G-7 countries.

Table 2

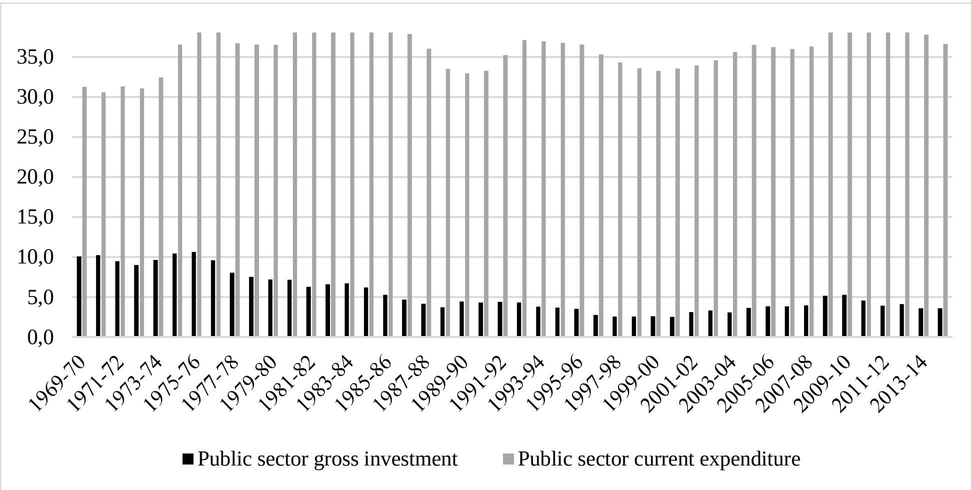
Labour's five Principles of Fiscal Management Compared with the Model Fiscal Rule by Kopits and Symansky

Model by Kopits and Symansky (1998)	Labour's five principles of fiscal management (1998)
Well-defined	?
Transparency	Transparency
Simplicity	–
Flexibility	Fairness
Adequacy	Responsibility
Enforceability	–
Consistency	Stability
Efficiency	Efficiency

Source: Author´s summary.

Figure 3

Public Sector Gross Investment and Public Sector Current Expenditure (as percentage of GDP), 1969 – 2015



Source: OBR (2016a).

Moreover, these principles were included in the subsequent Finance Act as well as the Code for fiscal stability in 1998. Two basic fiscal rules were codified: the golden rule and the sustainable investment rule. The golden rule aimed at committing the government to borrow only in order to invest over the economic cycle, and not to secure current spending. The sustainable investment rule suggested that PSND should be assessed on the basis of the economic cycle. The stable level of PSND related to GDP was set at 40% (Emmerson et al., 2006, pp. 2 – 3).

As indicated above, these fiscal rules lacked even according to governmental declaration some aspects defined by Kopits and Symansky (1998), especially simplicity and enforceability. The problem with simplicity lay in the proper definition of the economic cycle, the central point of the golden rule, which had to be based on Treasury estimates. These generally tended to be rather over-optimistic (Dupont and Kwarteng, 2012, p. 13). According to Murray and Wilkes (2009, p. 5), this could have led to the fact "that an adjustment [to the dating of the cycle] might have been made for reasons of political expediency." Enforceability became a crucial point of the rule, as it was dependent on its creators and came to an end as soon as the Labour government was removed in 2010. Although indicated by the Treasury, the sustainable investment rule lacked flexibility, since the highest possible level of public sector debt had been clearly set. On the other hand, too much flexibility was given to politicians, so they did not have any motivation to reduce budget deficits in the growth period after 2002 (Dupont and Kwarteng, 2012).

Real fiscal rule functioning has been criticised by many researchers. These criticisms aim at the lack of "clarity and enforceability, a failure to ensure sustainability and intergenerational fairness, the risk that they will undermine fiscal discipline by creating the incentive to reclassify expenditure, and insufficient constraint on discretionary loosening of policy" (Kell, 2001, p. 3). Those objections were even strengthened by the fact that the years after establishing the rules were marked by strong economic growth. The general trend among developed countries showed a broad reduction of indebtedness. Nevertheless, this was not the case of the UK (Murray and Wilkes, 2009, pp. 2 – 3). As depicted in Figure 3, public sector current expenditure rose steadily in 1999 – 2005. The period was extremely stable and brought a low level of inflation and interest rates, public revenues were much higher than expected, and the government gained significant budget surpluses (Emmerson et al., 2006, pp. 3 – 8). In the golden rule logic, however, this enabled the government to rely on future budget deficits that happened after 2002. Nevertheless, decisions to spend more during the rising phase of the economic cycle were highly political and led in the end to the rules being relaxed and their abandonment as soon as the financial crisis began.

The Labourite fiscal rules were relaxed in 2008 by the Labour Chancellor Alistair Darling, to enable the planned increases in spending in the time of the emerging economic crisis. The Coalition agreement (2010) between the Conservatives and Liberal Democrats stated that the rising deficit reduction was "the most urgent issue facing Britain" (Cabinet Office, 2010).

The coalition government of 2010 – 2015 abandoned the Labourite fiscal rules completely, as it became clear that they were not credible enough during the period of accelerating public indebtedness. In an attempt to return some order to public finances, i.e. to set its own kind of fiscal rules, the government launched the Office of Budget Responsibility, as well as the so-called temporary operating rule. Simply said, this rule meant a return to year-to-year adjustment of fiscal policy according to the actual economic situation of the country (Sawyer, 2012). A related measure, the Fiscal Responsibility Act (2010), aimed at fiscal tightening in the period 2010 to 2015. As shown in Table 3, the plan was not fulfilled in either of the indicators. This was anticipated by several researchers, above all based on the fact that reduction in potential output stemming from austerity fiscal policy is usually interconnected with falling aggregate demand and supply potential (Sawyer, 2012).

T a b l e 3

The Fiscal Responsibility Act Tightening Plan Compared to Actual Development (as percentage of GD

Period	Cyclically adjusted current budget deficit (planned)	Cyclically adjusted current budget deficit (actual)	Public sector net borrowing (planned)	Public sector net borrowing (actual)
2009/2010	–	4.8	–	10.2
2013/2014	1.8	2.6	3.1	5.7
2014/2015	1.3	2.5	2.5	4.9

Source: OBR (2016a); Sawyer (2012).

The actual fiscal consolidation began within the fiscal year 2010 – 2011 by applying spending cuts and several increases in indirect taxes. Additional austerity measures were planned to be implemented on a yearly basis until 2017 – 2018[8] (Tetlow, 2013). Since July 2015, the new Conservative government followed in this austerity approach by setting two new medium-term fiscal targets. First, the UK should achieve a budget surplus by 2019 – 2020, which was in compliance with the 2010 fiscal consolidation plan, and then maintain the surplus except for eminent deviation in an economic cycle. Second, the PSND proportion to GDP should be reduced step-by-step each fiscal year until 2019 – 2020[9] (OBR, 2015a).

[8] The procedures announced after 2008 were expected to reduce public borrowing by 9.1% of national income by 2017 – 2018 (Tetlow, 2013).

[9] In 2015, government borrowing reached GBP 75.3 bn, approximately 5% of GDP. The accumulated debt reached 82.5% of GDP. In 2016, the fiscal consolidation was assessed as quite successful by HM Treasury: "The public finances would be in a much worse position had the government not undertaken the fiscal consolidation that has occurred since 2010 […] The government is maintaining a balanced pace of deficit reduction, with public sector net borrowing forecast to fall as a share of GDP at the same average annual rate over 2015 – 2016 to 2019 – 2020 as was achieved over 2010 – 2011 to 2014 – 2015" (HM Treasury, 2016, pp. 20 – 22).

An essential part of the Conservative fiscal consolidation has been the establishment of a fiscal sustainability body, the Office for Budget Responsibility in 2010. This was motivated above all by one major flaw of the Labourite fiscal rule – the constant overestimating of economic prospects, which led to increased current spending based on the belief that the debt would be easily repaid in the future (Dupont and Kwarteng, 2012, p. 21). Institutionally, the OBR belongs to the network of national fiscal regulation bodies (or so-called fiscal councils) established under the IMF and supported by the EU. Overall 29 such bodies operate in the world,[10] out of which 17 (together with the OBR) focus on monitoring fiscal rules (Debrun and Kinda, 2014, p. 16). Although this British fiscal policy arrangement is interconnected with the EU, it is rather rooted in the IMF framework and thus Brexit is expected not to cause any change regarding this issue.

The IMF definition complies with the governmental motivation to establish the OBR. According to the OBR Charter, it regularly judges whether the Government is able to meet its fiscal targets, i.e. serves as a fiscal policy watchdog. The several-times revised document defines targets for borrowing, debt and welfare spending, assessed each year before the publication of the budget. Moreover, the wider governmental goals are observed and evaluated on a regular basis, above all the government fiscal goal, which requires a surplus of PSNB from the end of the fiscal year 2019 – 2020. Also, PSND is being assessed according to the goal that its ratio to GDP should shrink each year until 2019 – 2020. The welfare cap is tracked, too, setting a limit on welfare spending at levels set out by the Treasury each year according to current economic prospects (OBR, 2016b, pp. 22; 189 – 190).

Interconnectedness between the forecasts and actual governmental fiscal targets seems to be more limited than in the previous period. Nevertheless, it is higher than in other similar European bodies, even operating under the SGP (Calmfors, Wren-Lewis, 2011, p. 38). According to the OBR, "when our underlying forecast revisions have worsened the outlook for the public finances, the Government has tended to respond by using policy to offset part of those changes over the forecast period […]. When our underlying forecast revisions have improved the outlook for the public finances, the Government has responded either by banking the improvement (as in 2013) or by reducing the squeeze on spending that had been pencilled in at previous fiscal events (as in 2015)" (OBR, 2016b, pp. 22 – 23).

[10] By the IMF definition, such a body should be an independent public institution(s) aimed at strengthening commitments to sustainable public finances through various functions, including public assessments of fiscal plans and performance, and the evaluation or provision of macroeconomic and budgetary forecasts (IMF, 2016).

Table 4

British Fiscal Policy Rules Compared with the Model Fiscal Rule by Kopits and Symansky (1998)

Aspect by Kopits and Symansky (1998)	Conservative fiscal policy assessment (2010; 2015)
Well-defined	+
Transparency	–
Simplicity	–
Flexibility	+
Adequacy	+
Enforceability	–
Consistency	–
Efficiency	?

Note: + stands for fulfilment; – stands for default; ? stands for no or contradictory effect.

Source: Author´s summary.

To sum up, contemporary British fiscal policy is based on an evaluation of several indicators, for which passable levels are to be set individually by the government according to the economic situation of the country. This policy is further assessed and underpinned by the independent body. Regarding the first aspect defined by Kopits and Symansky (1998) that a fiscal rule has to be well--defined, we could find similar characteristics with the above-assessed SGP reform. Both the measures are now aiming more precisely at medium-term prospects rather than year-to-year fulfilment of a certain tightly-set indicator and both the rules are defined more precisely, which could affect their adequacy for the current economic situation. This, however, challenges the rule´s simplicity. The aspect is strengthened in the UK by the existence of the OBR, which regularly assesses its database. On the other hand, whereas the SGP clearly defined what happens if the rule is not fulfilled (however, with many exceptions) the British fiscal rule lacks this component completely, as it is tightly interconnected with the serving government. The same flaw was to be found in the previous Labourite fiscal rule, too. The aspects of transparency and consistency seem to be problematic in the UK in the long-term, given the dependency of the rules on politicians. This could be seen as very problematic, compared to the SGP's prospects. Nonetheless, the British fiscal rule brings much more flexibility than the SGP, because there is much greater space for adjustment of the fiscal goals based on the actual state of the economy. Enforceability remained the major weakness of the SGP. However, it is also a crucial questionable point of British fiscal rule, since there is no other enforceability mechanism than the government's responsibility to its voters, stemming from the rules' dependency on current governmental policy. As seen many times in the past, this fact could not be regarded as underpinning the enforceability of any measure of a single government. Last but not least, the rule efficiency is quite difficult to assess, since the British economy has still not completely overcome the consequences of both economic and political crises. Although we do not expect many changes in British fiscal policy caused directly by Brexit, it still brings uncertainty both into British and Eurozone economies and the final outcome is unclear. The rule itself does not consider subsequent policy actions that are vital for the enforcement of rules, which leaves this aspect to a fate completely dependent on the government. This feature is also a crucial point of the SGP; however, it is softened by the existence of enforceability rules in the Eurozone.

3.2. British Fiscal Regulation and the SGP in the Perspective of Brexit

The ties of British fiscal policy to the SGP were never very tight. However, in our opinion there were several important bonds, which will definitely not disappear quickly in the perspective of ongoing Brexit. The SGP has never been fully applied in all of its aspects in the UK due to the negotiated opt-outs. The reformed Six-pack sanction provisions have not been applied to the UK, as well as Articles 5 to 7 of Directive 2011/85/EU dealing with requirements for Member States' budgetary frameworks.[11] That indicates that the UK did not have to comply with numerical fiscal rules promoting compliance with the excessive deficit procedure reference values. Nor was the UK obliged to keep up with the multiannual objectives within the medium-term budgetary framework. Despite the above-stated issues, the UK has been involved in the EU surveillance and fiscal policies mechanisms, apart from the SGP in the related measures arising from the European Semester (Gov.uk, 2014, pp. 44 – 45). Since 2011, when the European Semester was launched, the UK became a subject of the preventive arm of the Macroeconomic imbalances procedure (MIP) five times, due to its macroeconomic imbalances defined by the monitoring process within MIP in-debt reviews[12] (European Commission, 2016). This is expected to be a final number due to Brexit being in progress.

Concerning the OBR, it could be understood as a part (however a very independent one), of the EU Independent Fiscal Institutions Network in the perspective of the EU fiscal governance framework. The framework was strengthened by both the Six-pack and Two-pack reforms, and the corresponding measures came into effect in September 2015. The Two-pack introduced a requirement

[11] The Directive specifically stresses that these SGP measures (in Protocol 12 of the treaties) "are not directly binding on the UK" (Gov.uk, 2014, p. 45).

[12] In the MIP process, there are four (or alternatively five) stages of macroeconomic imbalance. The UK has been subject to the second level, imbalance. The first level is no imbalance, the third excessive imbalance and the most serious one is a stage when a country becomes a subject of an excessive imbalance procedure, as defined by the SGP. This special category constitutes of countries that are included in recovery programmes, like the ESM.

for Euro Area countries to set up an independent body (such as a fiscal council), responsible for monitoring compliance with the SGP fiscal rules. The independent bodies are required to conduct macroeconomic forecasts as well (ECB, 2016; Debrun and Kinda, 2014).

Since the referendum on the British EU membership in June 2016 resulted in the decision for the country to leave, we have performed a content analysis of the major OBR regular study, Economic and Fiscal Outlook, to find out how the British fiscal policy could be affected by this political issue. The analysis covered the reports since March 2013.[13] In the six reports dated from March 2013 to November 2015 there was no appearance of the term "Brexit" or "referendum" (OBR, 2013a; 2013b; 2014a; 2014b; 2015b; 2015c). We have noticed a slow change since the report from March 2016, issued just three months before the actual Brexit vote on June 23rd 2016. In that report, "Brexit" was mentioned 11 times and "referendum" 7 times. No analysis of a possible Brexit scenario was included. As stated in the report: "Parliament has told us to prepare our forecasts on the basis of the current policy of the current Government and not to consider alternatives. So it is not for us to judge at this stage what the impact of 'Brexit' might be on the economy and the public finances" (OBR, 2016b, p. 84). In the subsequent post-referendum report from November 2016, "Brexit" was mentioned 20 times, and more importantly, "referendum" appeared 142 times. However, it was admitted in the text that "we have been given no information regarding the Government's goals or expectations for the negotiations that is not already in the public domain" (OBR, 2016c, p. 6). In the report from March 2017,[14] the number of occurrences of "Brexit" decreased to 8, and "referendum" to 21. The impact of the referendum on British fiscal policy was assessed as unclear, given the fact that the Brexit negotiation had not started yet (OBR, 2017). Based on the above-stated considerations, it could be concluded that the impact of Brexit on British fiscal policy is unclear or rather small.

Conclusions

In this article, the latest reform of the SGP and current fiscal rules in the UK were compared and evaluated. The model fiscal rule, serving as a benchmark in this paper, should be, according to Kopits and Symansky (1998), well-defined, transparent, adequate, consistent, simple, flexible, enforceable and supported by efficient policy actions. Such a rule is, however, out of reach, due to trade-offs

[13] The first issue of the outlook after the Bloomberg speech of the prime minister David Cameron, when the intention to hold a referendum about leaving the EU was announced.

[14] The last available at the time of revising this paper (August 2017).

between some aspects, for instance between simplicity and adequacy, flexibility and enforceability, and simplicity and flexibility. That is why regulation-setting bodies have to prefer some aspects to others.

The part of the Six-pack related to the amendment of fiscal economic governance in the EU brought especially more precise definitions of serious non-compliance with medium-term budgetary objectives, requirements for budgetary frameworks of the member states, and the simplification of financial sanctions imposition for breaches of SGP rules.

The final decision on sanctions will currently be approved unless rejected by a qualified majority in the Council (reversed qualified majority voting), promoting the chances to authorize a sanction proposed by the Commission. The triggering of the applicable sanction, however, still remains dependent on the political will in the Commission and the Council, as the case of remitted fines to Spain and Portugal in 2016 demonstrated.

Compared to the model fiscal rule, the Six-pack in general contributed to improvement of the following fiscal rule aspects: definition, transparency, enforceability and efficiency. The simplicity and flexibility of fiscal regulation in the EU was aggravated due to the Six-pack reform, and the impact on adequacy and consistency is ambiguous.

More precise definitions of terms, sanctions and procedures of the SGP, as well as reverse qualified majority voting on sanction issuance, helped to improve the framework for fiscal regulation in the EU. Nonetheless, the main issue of budgetary control was not addressed as sanctions for non-compliance are still not imposed automatically. The lack of political will to enforce rules hence remains the main threat to efficient fiscal regulation as well as to fiscal sustainability and long-term stability in the EU. This issue could be addressed by completing the fiscal union and transferring the enforcing authority to an independent supranational body. However, the move towards deeper integration was strongly rejected in the UK. In this regard, the Brexit vote could indirectly contribute to improving the enforceability of the Eurozone fiscal rules in the future.

Individual British fiscal rules also demonstrate shortages in compliance with the model fiscal rules, often in similar aspects as the reformed SGP, especially concerning enforceability. There are similarities found in Labourite fiscal rules, the current Conservative fiscal policy and the SGP. Moreover, further similarities were based on differences between the official borrowing forecast of (in most cases) independent budgetary bodies, and the actual deficits. According to Frankel's study (2011), the greater the uncertainty, the more governments tend to overestimate its prospects. The UK was a shining example of this phenomenon; however, the Eurozone was even worse.

Concerning the ongoing political issues regarding the British no-vote on staying in the EU, we expect that British fiscal policy will not be very affected, based on the fact that the institution dealing with fiscal policy, the Office for Budget Responsibility, reflected Brexit just in a very low manner. Moreover, the principles of British fiscal policy have never been deeply rooted in the EU framework, as they are rather based on the IMF framework.

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