NUMERICAL FISCAL RULES PRECURSOR OF FISCAL PERFORMANCE

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Abstract
Tax rules and other institutional and economic factors can, in principle, either exacerbate or mitigate the pro-cyclicality of tax policy. In the wake of the global financial crisis, the sustainability of public finances has become one of the most important issues in Europe. Diverging fiscal circumstances in European countries reflect the outcome of their economic performance and fiscal institutions. In the past decades, many European countries have introduced fiscal rules and set up independent fiscal agencies to strengthen their budget, process and improve their fiscal performance. (Roch et al., 2021). However, the design and features of the rules varied significantly across countries. A growing number of countries have improved the legal basis of their national tax rules (statutory level or above) and many of them have also introduced formal enforcement mechanisms. At the same time, over the last decade, the share of countries with cyclically adjusted tax rules has declined, probably reflecting significant operational challenges.

Keywords: *Tax rules, sustainability, performance, flexibility, costs.*

Clasificare JEL : *E60, E62, F30.*

1. Introduction and context of the study

A fiscal rule is a long-run coercion on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules usually aim at correcting distortionary incentives and limiting pressures for overspending, especially in good times, to ensure fiscal responsibility and debt sustainability. During the pandemic, fiscal frameworks have been put to the test. The widespread use of bailout clauses was one of the novelties of this crisis, which helped provide space to policies for responding to the health crisis. Evidence shows that fiscal rules, in general, have been flexible during crises, but have not prevented a large and persistent build-up of debt over time. Experience shows that deviations from debt limits have been very difficult to reverse.

2. Numerical fiscal rules as a precursor to fiscal performance

A fiscal rule is a long-term coercion on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules usually aim at correcting distortionary incentives and limiting pressures for overspending, especially in good times, to ensure fiscal responsibility and debt sustainability. During the pandemic, fiscal frameworks have been put to the test. The widespread use of bailout clauses was one of the novelties of this crisis, which helped provide policy space to respond to the health crisis. Evidence shows that fiscal rules in general have been flexible during crises, but have not prevented a large and persistent build-up of debt over time. Experience shows that deviations from debt limits have been very difficult to reverse.

Kopits and Symansky (1998), define a fiscal rule as a permanent coercion on fiscal policy by simple numerical limits on fiscal performance indicators. It is preferable to focus on rules that impose specific, binding coercions on government policy choices. These rules can be set by legislation or by political agreement, as is usually the case at the national level. However, at regional and international level, rules are backed by a treaty.

In terms of coverage, we focus on rules that cover at least central government. Thus, subnational rules are not included. Accordingly, the main fiscal rules include four types (IMF, 2009; Kopits and Symansky, 1998; Schaechter et al., 2012): balanced budget rules (BBR), debt rules (DR), expenditure rules (CR) and revenue rules (RV), which apply to the central government, the general government or the public sector.

- (REB) Budget balance rules are usually specified as rules for either the overall balance, the structural balance or the cyclically adjusted balance, or the "over-cycle" balance.

Set as a percentage of GDP, these rules (excepting the primary balance and the golden rule) aim to ensure debt sustainability.

- (RD) Debt rules limit government borrowing and set explicit targets for government debt-to-GDP ratios.

- (CR) Expenditure rules set persistent limits on total, primary or current expenditure in absolute terms, growth rates or as a percentage of GDP. When mixed with debt or balanced budget rules, expenditure rules can be used as operational guidelines for fiscal consolidation.

- Revenue rules are designed to encourage revenue collection or prevent an excessive tax burden and therefore set revenue caps or limits.

There are various features of rules such as their legal basis, coverage, avoidance clauses, stabilising properties, and enforcement procedures. It is necessary to balance sheet of the key supporting features that are in place, including independent monitoring bodies and fiscal responsibility laws. On the other hand, numerical rules could be soft rules, based only on political declarations and essentially on non-binding agreement among political actors. These rules can also help to establish budgetary discipline, but are usually considered to have less power. There is also a sceptical view of numerical fiscal rules. Wyplosz (2002) suggests that very strict rules can hinder the conduct of fiscal in such a way that they become counterproductive.

Von Hagen and Wolff (2004) have addressed the issue of the level to which rules are implementable and effective, drawing attention to „creative" accounting that can effectively circumvent rules. The right balance has to be found. One issue is the consistency of rules over time because a situation can always arise where rule implementation is very costly for political leaders. It is also a trade-off between flexibility on the one hand and whether the rule is simple and understandable to ordinary citizens on the other. For example, the complete ban on deficits is very clear and precise, but it not only limits discretion but also directly imposes a pro-cyclical fiscal policy.

Economic and Monetary Union (EMU) is based on strong foundations of fiscal discipline. The budgetary autonomy of euro area members is subject to the numerical coercionss of the Maastricht Treaty and the Stability and Growth Pact (SGP). The Treaty stipulates that budget deficits should not exceed 3% of GDP unless exceptional circumstances arise and even then the excess should remain limited and temporary. Government debt must not exceed 60% of GDP or, if necessary, should be kept on a downward trend. While the numerical parameters of the Treaty were seen as a sorting device to select euro area members, the aim of the SGP, which sets medium-term, close-to-balance targets for EU member states, was to make fiscal discipline a permanent feature of EMU. Such rules triggered strong fiscal adjustment in the run-up to EMU. However, a dark side to the fiscal rules quickly emerged. Accounting tricks, one-offs, exotic transactions and legally dubious data manipulation became common to cheat on deficit and debt coercions. The political incentives used to circumvent real adjustment were recognised from the early days of the new Treaty: „Maastricht encourages financial engineering to avoid the underlying fiscal adjustment. Even when privatisation is desirable for efficiency reasons, doing the right (structural) thing for the wrong (financing) reasons is bad economic policy”. (Buiter et al., 1993) In recent years, EU member states have decided to significantly strengthen their national and supranational fiscal frameworks. This has been especially true for the "so-called" Six-pack and Two-pack regulations at the EU level, as well as the Fiscal Compact at the national level, which introduced new measures designed to lead to greater fiscal sustainability. Key elements of this EU fiscal framework are numerical fiscal rules, restricting the discretion of governments at national level.

The new initiatives have shifted the optimal design of tax rules and their effects to the centre of public and academic debate. The theoretical rationale for the introduction of fiscal rules is well established and based on the deficit bias theory of deficits and governments (e.g. Wyplosz, 2012 or Debrun et al., 2008 for an overview). In empirical studies, the general effects of fiscal rules on public finances seem widely accepted. Various papers show that the introduction of fiscal rules leads, among other factors, to lower fiscal deficits (e.g. Heinemann et al., 2016), lower sovereign interest rate spreads (e.g. Heinemann et al., 2014; Iara and Wol, 2014), lower output volatility (e.g. Fatas and Mihov, 2006) or more fiscal space (e.g. Nerlich and Reuter, 2015). These and similar studies examine the effects of introducing or tightening fiscal rules (depending on various features of those rules) on fiscal and macroeconomic variables independently of countries' compliance with fiscal rules.

Although, as Reuter (2015) points out, actual compliance with tax rules may not necessarily be a necessity for their economic effects, analysis of the determinants of compliance can highlight the optimal framework and design of tax rules. When tax rules are assumed to have been introduced for good reasons (e.g., to overcome government deficit bias or to reduce the indirect costs of excessive fiscal deficits) and numerical limits have been set at optimal levels, then tax rule compliance becomes an important issue.

A number of governments around the world have adopted fiscal policy rules, particularly against the background of worsening fiscal performance and rising debt levels. Recently, in the wake of the crisis, fiscal rules have been advocated to support fiscal consolidation efforts and ensure the long-term sustainability of government finances.

However, Chowdhury and Islam (2012) express concern that rule-based policymaking can pose a risk to both democracy and development. They fear that by removing politicians' discretion, fiscal rules could undermine accountability, especially in new democracies, making them question whether credibility should be an issue for financial markets rather than the electorate. A key concern addressed in the literature is whether fiscal rules are actually effective. There is a general concern that the rules could reduce the flexibility of fiscal policy. For example, they tend to create incentives for artificial targeting through the adoption of dubious accounting practices, thereby reducing the transparency of government budgets (Milesi-Ferretti, 2000; von Hagen and Wolff, 2006; Larch and Turini, 2011; Basdevant, 2012). As Irwin (2012) argues, governments under pressure to reduce fiscal deficits may be tempted to replace spending cuts or tax increases with accounting devices that give the illusion of change without substance or that make a change appear larger than the actual situation. In any case, however much accounting creativity emerges, the reputational cost to government and the economic cost of adhering to the rule would depend on it (von Hagen and Wolff, 2006).

Effectiveness is enhanced when rules have regulations or political support (Wyplosz, 2012). Given the above limitations, there is a renewed focus among policy makers and researchers on design and monitoring issues. IMF (2009) notes that fiscal rules are only effective when there is a credible penalty for non-compliance. In the US context, Bernanke

(2010) proposes that an effective rule must be ambitious enough to address the underlying problem. It should focus on variables that the legislature can directly control and should have widespread political commitment and broad public support. In the context of the European Union, Marneffe et al. (2011) propose that the effectiveness of rules can be improved when framed within a medium-term economic management framework.

Other key support requirements include adequate fiscal institutions, independent fiscal councils and fiscal responsibility laws. This is a recognition that tax rules by themselves are not the solution to ensuring fiscal discipline. Indeed, Wyplosz (2012, 2005) and the European Commission, (2006) argue that rules and institutions should not be seen as substitutes, but rather complementary. In particular, Wyplosz (2012) notes that both fiscal rules and institutions can never be sufficiently contingent - in the face of a contingency, rules are often too rigid, while fiscal institutions can be too flexible. The belief is this: independent tax councils could enhance the credibility of tax rules by monitoring their implementation.

However, in the absence of formal rules, fiscal frameworks could ensure fiscal discipline provided they have credible and transparent strategies supported by appropriate fiscal institutions. While recognizing that it is virtually impossible to have a fiscal rule that possesses all desirable features, we also consider Kopits and Symansky's (1998) recommendations for the features of an ideal fiscal rule. Some studies have argued that an ideal tax rule is one that is transparent, flexible and implementable (Guichard et al., 2007; Price, 2010). In addition, Ahrend, Catte and Price (2006), argue that institutional adequacy as well as rules are essential.

Table no. 1. Desirable characteristics of a fiscal rule

1.	A fiscal rule should be well defined to avoid ambiguity and inefficient implementation. This requires clarity on the indicator that is constrained, institutional coverage and specific avoidance clauses, if any.
2.	It should be transparent in relation to government fiscal operations, including accounting, forecasting and institutional arrangements. It should avoid misrepresenting the magnitude and timing of future tax liabilities, especially contingent liabilities.
3.	It should be appropriate in relation to the specified proximate objective. For example, debt sustainability would require a rule expressing debt as a non-decreasing percentage of GDP or a minimum primary balance as a percentage of GDP.
4.	A fiscal rule should be internally consistent with other existing fiscal rules as well as with other macroeconomic policies. For example, a fixed nominal exchange rate anchor should be accompanied by an explicit restriction on the monetisation of budget deficits.
5.	It should be simple to implement. This enhances the understanding of the general public and parliament and therefore attracts broad consensus.
6.	A fiscal rule should be flexible to cope with exogenous shocks. An example is when central banks down payments to the government are subject to specified limits and repayment in full during the year. Lately, escape clauses provide a certain level of flexibility to respond to uncertainties related to a recession, adverse economic development, banking system bailout and natural disaster.
7.	It should be enforceable by including penalties for non-compliance and authorities for enforcement. Consequences of non-compliance - judicial, financial and reputational - should be agreed by all parties involved. Implementation should be under government control. An independent fiscal council has been proposed to

	monitor compliance.
8.	A rule should be backed up by effective policy action, including engaging in more fundamental tax reforms to restore public finances to sustainable levels.

Source: Kopits and Symansky (1998).

The adoption of fiscal rules and fiscal advice has continued to grow globally over the past decades based on two new global datasets. During the pandemic fiscal frameworks have been put to the test. The widespread use of bailout clauses was one of the novelties of this crisis, which helped provide policy space to respond to the health crisis. But the unprecedented fiscal actions led to large and widespread deviations. Evidence shows that fiscal rules in general have been flexible during crises, but have not prevented a large and persistent build-up of debt over time. Experience shows that deviations from debt limits have been very difficult to reverse. All of this highlights difficult policy choices that need to continue to be improved. (Hamid R. Davoodi; Paul Elger et al., 2022).

Countries have increasingly adopted fiscal rules and fiscal councils to help strengthen their fiscal frameworks, promote debt sustainability and increase the credibility of fiscal policy. Fiscal rules are long-standing coercions on fiscal policy through numerical limits on broad budget aggregates.

Fiscal councils - independent non-partisan agencies with a formal mandate to assess fiscal policy, plans and compliance - have often been tasked with providing fiscal surveillance, including monitoring fiscal rules and assessing the credibility of budgets and the quality of public policies (IMF, 2013). While advanced economies have been leaders in adopting fiscal rules, they have also become increasingly common among emerging market and developing economies (EMDEs). Most countries have several fiscal rules covering different components of the budget to achieve fiscal objectives. The most common combinations are a debt ceiling or debt anchor supported by other operational rules such as expenditure or budget balance. A key trend has been greater flexibility in the rules, including through bailout clauses. The number of fiscal councils has doubled in the last decade. Many have been set up to monitor new fiscal rules or in response to external pressures after big shocks. The pandemic has been a massive test for rules-based fiscal frameworks. It led to widespread activation of escape clauses to temporarily suspend rule limits in the tax framework, allowing flexibility to adopt extraordinary fiscal support for households and firms. Other countries, without escape clauses, have had to resort to ad hoc suspensions or changes to the rules or even introduce new tax rules. Fiscal councils also played an important role during the pandemic in assessing governments' responses and the use of bail-out clauses.

Some have borne the cost of emergency measures and analysed the impact of the crisis on public finances. Deficits and public debt in many countries rose during the pandemic, leading to large deviations from fiscal rules.

According to Hamid R. Davoodi et al. (2022) about 90% of countries had deficits above the rule limits in 2020, while public debt exceeded the limits or anchor levels in more than half of the countries, adding to already large deviations before COVID-19. Experience suggests that it will be difficult to return to debt limits. The number and design of fiscal rules have evolved. The most common form has been a combination of a debt rule and operational limits on expenditure and budget balance. Based on a new index of the strength of fiscal rules, they appear to have improved over time, with stronger enforcement and oversight. Many countries have introduced flexibility provisions in their fiscal rules, notably through bailout clauses. Before the pandemic, two thirds of countries with fiscal rules had escape clauses. An increasing number of countries have improved the legal basis of their national tax rules (state level or above) and many have also introduced formal enforcement mechanisms. At the same time, over the last decade, the share of countries with cyclically adjusted fiscal rules has declined, probably reflecting significant operational challenges. However, the design of rules has varied significantly across countries. Several countries have seen frequent amendments, and the increasing complexity of the rules may undermine the transparency and credibility of the frameworks.

There have also been improvements in the independence and capacity of fiscal councils, although challenges remain. Many have legal access to timely information to provide a relevant assessment. However, ensuring the operational independence of fiscal councils and adequate budgetary safeguards remain a challenge in many countries. The rules-based fiscal framework came under pressure during the COVID-19 pandemic. In particular, the widespread activation of escape clauses has shown how fiscal rules can have great flexibility during large shocks within a well-defined rules-based framework. Fiscal councils played an important role during the pandemic, including analysing the impact of COVID-19, monitoring the use of escape clauses and determining the costs of pandemic-related fiscal measures. Many fiscal councils stressed the need for transparency in fiscal responses to COVID-19. Fiscal rules enabled a strong response to the pandemic, addressing concerns that the rules were rigid in constraining governments' response in bad times. However, fiscal rules have not prevented persistent debt accumulation over time.

Fiscal rules and other institutional and economic factors can, in principle, either exacerbate or mitigate the pro-cyclicality of tax policy. For example, simple balanced budgets or spending rules that do not take cyclical conditions into account could induce fiscal contractions during economic downturns. On the other hand, different fiscal rules may allow governments more pro-cyclical discretionary actions to the extent that they lead to greater long-term fiscal sustainability with lower debt levels and stronger budgetary positions. In the wake of the global financial crisis, sustainability of public finances has become one of the most important issues in Europe. Diverging fiscal circumstances in European countries reflect the outcome of their economic performance and fiscal institutions. In recent decades, many European countries have introduced fiscal rules and set up independent fiscal agencies to strengthen their budget, process and improve their fiscal performance. (Roch et al., 2021).

Działo and Guziejewska (2017) state that economic unions often implement fiscal rules with a common debt limit. However, the complexity of finding an appropriate common debt limit has led to proposals to abandon numerical fiscal rules for country unions. Debt levels that may be appropriate or sustainable for some EU countries may be the opposite for others (Blanchard et al., 2021; Martin et al., 2021). The inability to find an appropriate common debt limit for an economic union is not surprising. Fiscal rules are intended to mitigate sovereign risk and mapping from sovereign debt levels to sovereign risk, often referred to as debt intolerance, varies widely across countries and over time (Reinhart et al., 2003; Reinhart et al., 2015). In fact, the use of debt limits in fiscal rules has been criticized even for single countries.

One of the most important factors affecting the effectiveness of tax policy in a country is the right choice of tax rules. Meeting this condition is particularly important during an economic crisis, manifested, among other things, in a drastic deterioration in the state of the public finance sector. The economic crisis has highlighted the need to reform the previous binding fiscal rules and the need to strengthen their enforceability in order to transform the rules into an instrument that, on the one hand, is an instrument to ensure fiscal stability and, on the other hand, an instrument to support economic growth.

Tax rules can be introduced for several reasons. One reason is to ensure macroeconomic stability in the economy and to maintain a stable fiscal policy in the long term. The rules also aim to reduce the negative externalities of the pursuit of an independent fiscal policy by EU countries. However, during an economic crisis, the main objective of fiscal rules is to reduce excessive deficit and debt levels and to improve the credibility of fiscal policy. The fiscal rules laid down in the Maastricht Treaty have proven to be quite effective and have led to a visible decrease in deficit and debt levels in many EU countries.

According to Działo and Guziejewska (2017) effective fiscal rules should combine the following two criteria: they should stabilize public finances and should not inhibit economic growth. For this to be effective, the structural deficit should be relatively low. Effective enforcement of the rules is also made possible by the universality and inevitability of sanctions and by ensuring that a control mechanism is used. In addition, a strong legal basis for fiscal rules is important.

3. Conclusions

One of the most important factors affecting the effectiveness of tax policy in a country is the right choice of tax rules. This is particularly important during an economic crisis, manifested, among other things, in a drastic deterioration of the public finance sector in a state. The economic crisis has highlighted the need to reform the previous binding fiscal rules and the need to strengthen their enforceability in order to transform the rules into an instrument that, on one hand, is an instrument to ensure fiscal stability and, on the other hand, an instrument to support economic growth. Tax rules can be introduced for several reasons. One reason is to ensure macroeconomic stability in the economy and another reason is to maintain a stable fiscal policy in the long term. The rules also aim to reduce the negative externalities of the pursuit of an independent fiscal policy by EU countries. However, during an economic crisis, the main objective of fiscal rules is to reduce excessive deficit and debt levels and also to improve the credibility of fiscal policy.

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