

Preferences for Fiscal Rules or Discretion:

A Case Study on Germany and France

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Abstract

We study the signals that fiscal policies and institutional reforms give about underlying preferences for policy conduct in Germany and France. Results for a wide range of indicators mostly - but not always - confirm a first intuition that preferences are tilted towards rules in Germany, and towards discretion in France. At the same time, our case study also suggests that preferences are not fixed, and that fiscal policies and institutions may change as a result. In recent years, ongoing unsustainable debt developments seem to have inspired the introduction of stricter national fiscal rules both in Germany and France. It remains to be seen how constraining recent innovations in national fiscal rules will turn out to be in the course of the fiscal exit.

* The views expressed in this paper are those of the author and do not necessarily reflect the views of De Nederlandsche Bank.

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1. Introduction

Germany and France form roughly half of the euro area economy.¹ Ever since the creation of the Stability and Growth Pact (SGP), these countries have led the debate concerning its design and implementation. In recent months, it has been widely recognised that positions taken by Germany and France will be crucial for the fiscal exit during the next years. Experience suggests that recommendations from the European Commission and the Council on the consolidation path can only be fully effective if they match the preferences in the country itself (i.e. if there is national ownership). Given the relevance of fiscal policies of Germany and France for the euro area as a whole, this paper contains a case study on fiscal policies in these two countries. We take a specific perspective that will be elaborated on in the next paragraph: the focus is on the *preferences* of the fiscal policy makers for implementing specific fiscal policies and institutions. Studying these preferences may add to our understanding as to why the countries follow *similar* or *different* fiscal strategies. As a by-product, this paper brings together a wealth of fiscal and institutional data on Germany and France.

The rest of this paper is organised as follows. Section 2 motivates the specific perspective from which we look at fiscal policy and institutions in Germany and France. Section 3 starts our actual case study, by analysing differences and similarities in ex post fiscal indicators and real time data. Section 4 looks at fiscal rules. Section 4.1 investigates positions taken regarding the debate at EU level on the design and implementation of the SGP. Section 4.2 looks at national fiscal rules in Germany and France. Section 5 concludes.

2. Motivation and approach

During the past years, several studies have concluded that tighter national fiscal rules coincide with a higher budget balance², more ambitious fiscal planning, and better implementation.³ As a result, international organisations such as the European Commission and the IMF now regularly advise countries to improve their national institutions as part of wider programs to improve fiscal discipline. The advice to improve national fiscal governance appears especially relevant in the current situation, where many countries face unsustainable debt dynamics due to the economic crisis. However, if institutional reforms provide such an obvious way of improving fiscal discipline, one may wonder why actual reforms in fiscal governance have progressed relatively slowly inside the euro area.⁴ This apparent paradox provides the motivation for this paper. Why are we not seeing more cases of reforms in countries that are in urgent need of improving fiscal discipline? Or, put differently, why is it that the

¹ The latest figure is 48% of euro area GDP.

² E.g. EC (2006), Debrun et al. (2008).

³ Beetsma et al. (2009).

⁴ EC (2006) and EC (2009) report that since 1990 the number of national fiscal rules has increased steadily. However, since 2006, in the Euro area only France introduced a new rule applying to social security. Moreover, only France introduced significant changes to its MTBF.

often cited cases of countries with stronger types of fiscal rules (the Nordics, the Netherlands, the new constitutional rule in Germany) seem to be from countries with a stability-oriented culture? Would it even be possible for fiscal rules to be effective in countries where there is no stability oriented culture of fiscal discipline?

The literature on the causal effect of fiscal rules and institutions on fiscal outcomes is full of disclaimers that both fiscal rules and fiscal outcomes may ultimately driven by a third variable of underlying preferences of fiscal policy makers.⁵ After all, the same fiscal policy makers that decide on the fiscal stance also have the power to modify the institutional setting within which fiscal policy is conducted. In this context, it has been argued that disciplined governments may be more likely to adopt strict institutions. Moreover, ultimately policies and institutions can only be maintained if they reflect deeper social preferences.⁶ If there is some merit in these arguments, then actual policies and institutions provide signals on underlying preferences of fiscal policy makers. Studying these signals about preferences may add to our understanding as to why some countries follow different fiscal strategies than others. Once we now more about preferences, we can ask whether these preferences can change over time, over even be influenced. To our knowledge, the very basic question whether we can to some extent *observe* underlying preferences for fiscal rules versus discretion has not yet been addressed.

Our approach requires that we study both the fiscal policy stance *and* institutional reforms, and ask what signals they provide. This would require looking at a broad range of indicators. Obviously, this limits the scope of our research, hence the focus on Germany and France only. New datasets that have become available over the past years may play a useful role here. First, datasets of fiscal policy in real time are particularly useful, given that the true fiscal policy effort needs to be assessed on the basis of the information as it was available to policy makers at the time when they made their decisions. Second, datasets on the evolution of national fiscal rules have become available on the basis of EC questionnaires since 2005. Third, the debate on the EU fiscal rules provides a wealth of information on positions taken by different countries regarding the direction of the EU fiscal rules. In this paper, we will use indicators from these datasets, and see whether this would give a consistent message about the underlying preferences that may (at least partly) drive both fiscal outcomes and institutional reform. The main focus in this paper is on the period 1998-now (i.e. the period since the start of the SGP). When focusing on broad fiscal trends in Germany and France on the basis of ex post indicators we will however also look at longer time intervals.

⁵ See for example Poterba (1996), de Haan et al. (1999), or IMF (2009).

⁶ Debrun and Kumar (2007).

3. Fiscal indicators

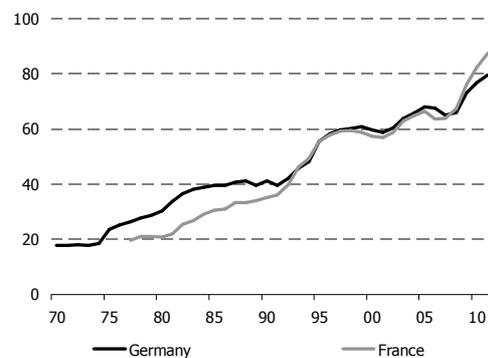
3.1 Ex post data

Before looking at real time data, we first want to get an overview of fiscal trends in Germany and France on the basis of ex post data. In principle, similar trends in both countries may reflect endogenous effects of correlations in economic variables (mainly GDP growth), or similarities in policy effort. Differences in fiscal trends may reflect economic drivers, and differences in preferences, the institutional set up and history of each country. In principle, we want to put more weight on indicators of policy effort.

As an introduction to fiscal developments in Germany and France, we start by looking at traditional indicators of debt, deficits, expenditure and revenue over a longer time period. Figure 1 shows developments in gross debt. In both countries, debt has been on a continuous upward path, which seems to stabilise in economic good times (e.g. around 2000, 2006/07), and accelerates upward in bad times. This upward drift is especially strong in recent years due to the economic crisis. Debt developments in Germany and France are also highly correlated, especially since the early 1990s. In the current period, including the projections up to 2011, debt in France increases more quickly than debt in Germany, and has moved from being 11.5% GDP lower than in Germany in 1983 to an expected 8% GDP higher in 2010.

Figure 1. Gross debt

Percentage GDP



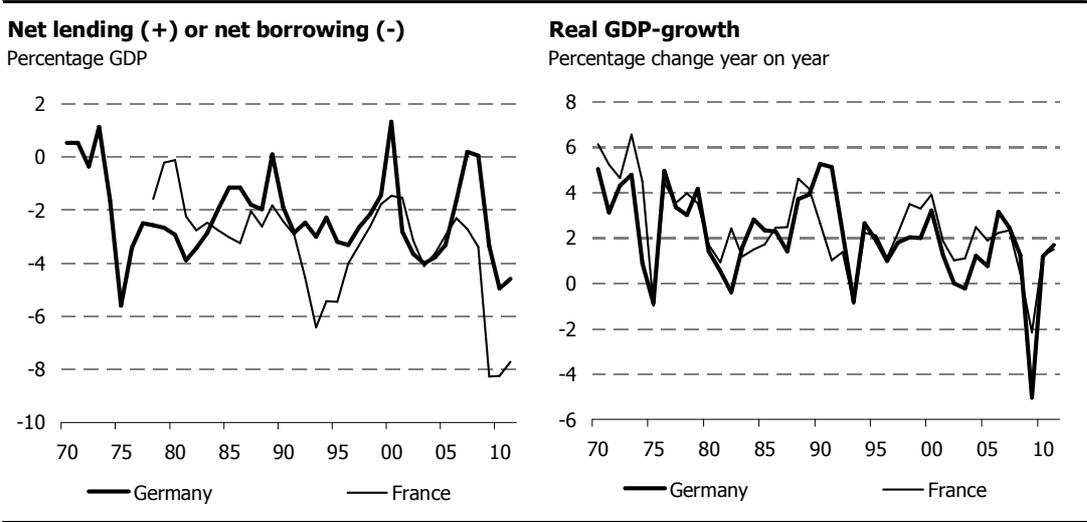
Source: European Commission/Ameco database, Autumn Forecasts 2009.

Figure 2 shows the budget balance in Germany and France. In line with the build up in debt, we see sizeable deficits in both countries, increasing to very high levels in the current period, thereby leading to unsustainable debt trends. It is noticeable that German re-unification, which led to a fiscal expansion due to large fiscal transfers from West to East Germany⁷, does not show up in larger deficits

⁷ See Heileman and Rappen (1997). Through 1991-1997, fiscal transfers amounted to approximately 6% of West German GDP. Less than 20% of the transfers were financed by spending cuts. With shares of about 40% each, debts and tax increases played much larger roles.

in Germany vis-à-vis France. In Germany, the fiscal expansion of the first half of the 1990s was offset later on by fiscal consolidation in the run-up to EMU. In France, we see a much larger increase in deficits during the downturn of 1992-1993, also followed by a fiscal correction in the run-up to EMU. Overall, deficits have been larger in France than in Germany. However the fact that real growth – which has been on a long term decline in both countries – mostly has been lower in Germany since the end of the 1990s (right hand panel of Figure 3) explains why debt developments have been rather similar up to 2006.

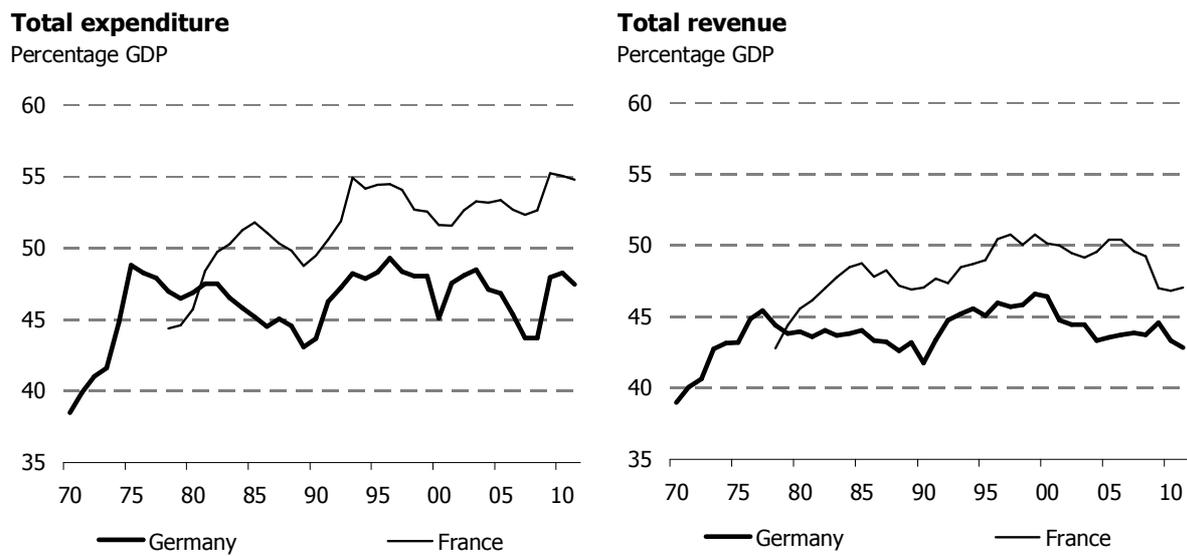
Figure 2. Net lending and GDP-growth



Source: European Commission/Ameco database, Autumn Forecasts 2009.

Figure 3 shows total expenditure and total revenue in Germany and France. Overall, total public expenditure has been fluctuating in the range of 45% GDP to 50% GDP in Germany during the last two decades. In France, it has increased from 45% GDP to over 55% GDP over the same period. Hence, whereas at the beginning of the sample period, the size of the public sector is smaller in France than in Germany, this reverses after 1980, while the difference increases. Looking at the past decade since 1999, total expenditure first falls in Germany, and then increases when the economic crisis hits. In France, it remains constant around a higher level, and then also increases with the economic crisis. By 2008, public expenditure in France was 9.0% GDP higher than in Germany, and total revenue was 5.5% of GDP higher than in Germany.

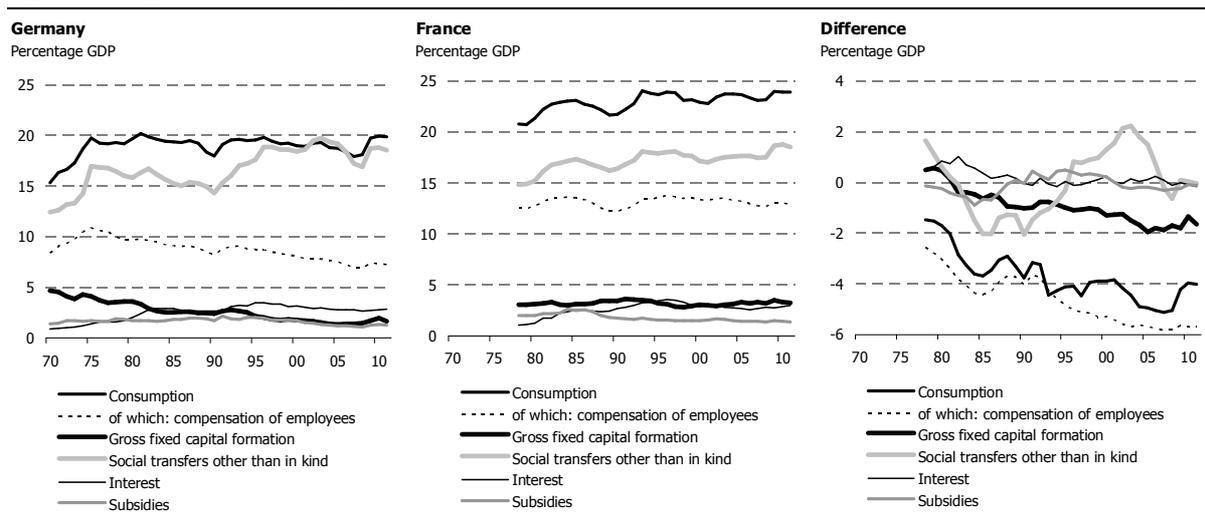
Figure 3. Total expenditure and total revenue



Source: European Commission/Ameco database, Autumn Forecasts 2009.

In order to investigate where the difference in the size of the public sector comes from, Figure 4 compares the development in the main components of public expenditure in Germany and France. The right hand side of Figure 4 subtracts them, where a negative number indicates that expenditure over GDP is lower in Germany than it is in France. As can be seen, the increasing difference in total expenditure is to some extent driven by lower public investment in Germany, while by far the main difference is in government consumption. A further look at consumption shows that the main difference is in the public wage bill (compensation of employees). Whereas the public wage bill has decreased in Germany from almost 9% GDP in the mid 1990s to 7% GDP in 2008, it has started from a higher level in France and decreased much less during the same period, from almost 14% GDP to just below 13% GDP. Moreover, according to OECD (2009), employment in general government as a percentage of the labour force decreased from 12.2% to 10.4% in Germany between 1995 and 2005, while it increased in France from 21.6% to 21.9% during the same period. Using the OECD labour force statistics as the denominator, this implies a decrease from 4.7 to 4.2 million employees in Germany, or a decrease of 10.5%. For France, it implies an increase from 5.4 to 6.0 million employees during the same period, or an increase of 11.1%.

Figure 4. Components of total expenditure



Source: European Commission/Ameco database, Autumn Forecasts 2009.

Given that the main focus in this paper is on the period since 1999 (start monetary union and entry into force of SGP), Table 1 below summarises key indicators for that period. First, real growth has been lower in Germany than in France, implying less fiscal room for manoeuvre.⁸ In Germany, real expenditure growth has been slower than real GDP growth, implying a decrease in the size of the public sector. France has just been on the other side of the coin, with expenditure growth slightly higher than real GDP growth, implying an upward drift in the size of the public sector. Overall, real expenditure growth has been substantially higher in France than in Germany.

Table 1. Key indicators 1999-2008

Percentage change

	Germany	France
Real growth	1.5	2.1
Real primary expenditure growth	0.7	2.2
Real revenue growth	1.0	1.9

Source: European Commission/Ameco database, Autumn Forecasts 2009.

Obviously, these data also raise the question as to why growth was lower in Germany than in France (so that there was less fiscal room for manoeuvre), and whether differences in fiscal policies have played a role here. A full exploration of this issue is outside the scope of this paper. Nevertheless, it should be noted that studies on Germany's growth performance generally do not point to fiscal policy as a main contributing factor. Rather, they point to rigidities in the labour market which interacted with factors related to re-unification. At the same time, it has been argued that the composition of

⁸ Over very long periods, both expenditure and revenue are expected to grow in line with GDP. See Alfonso and Turrini (2008) on long term expenditure elasticities and Afonso and Rault (2007) on the cointegration of expenditure and revenues.

expenditure cuts probably played a small role through cuts in the level of government employment and investment (EC, 2002).

So what signals could these data potentially give about preferences for fiscal policy conduct? In Germany, the data seem to tell that fiscal preferences have been in favour of keeping expenditure growth in check in a growth unfriendly environment. The fiscal expansion of re-unification was offset by consolidation in the run-up to EMU. In France, preferences seem to have been towards maintaining the size of the public sector, which increased to its highest level over the sample period when the economic crisis hit. Moreover, deficits increase substantially during the downturn of 1992-1993 and during the current downturn, suggesting a greater role for countercyclical discretionary fiscal policy. Even if in both countries, debt has risen to unprecedented levels, the rise is faster in recent times in France. Both countries face a need to counter an unsustainable fiscal trend, but France more so than Germany.

3.2 Real time fiscal data

In recent years, real time fiscal data have increasingly been used for making inferences about the behaviour of fiscal policy makers.⁹ The idea is that in studying actual behaviour, the information set should be used as it was available to the fiscal policy makers when they made their decisions. When data revisions to ex post data have been large, using these data may lead to potentially wrong inferences about the actual behaviour of fiscal policy makers. Bluhm (2009) illustrates the relevance of this issue in actual practice. Comparing fiscal plans to fiscal outcomes in *real time*, he finds results in line with Moulin and Wiertz (2006) and Beetsma et al. (2009) that attribute recurrent fiscal slippages under the EU fiscal rules to the *expenditure* side of the budget. Comparing fiscal plans with *ex post data*, his results are in line with von Hagen (2008) who attributes fiscal slippages to the *revenue side* of the budget. His decomposition analysis then shows that data revisions indeed explain the differences between both studies.

Real time data may be especially suitable for the purposes of this study, given that they closely resemble the actual policy effort of fiscal policy makers. Moreover, real time data from the main stages of the budget process - i.e. fiscal planning and its subsequent implementation – may signal different pieces of information about the underlying preferences of fiscal policy makers. Put briefly, fiscal planning may signal how disciplined a government may want to appear, while implementation provides information on the extent to which it feels constrained by its own fiscal plans.

⁹ E.g. Forni and Momigliano (2004), Cimadomo (2007) and Giuliadori and Beetsma (2008).

Table 2 therefore starts from planned fiscal changes in France and Germany, using the data set of Beetsma et al (2009).¹⁰ On average, both countries present back-loaded fiscal consolidation strategies, as the planned improvement in the budget balance increases in each of the years of the medium term forecast horizon. In both countries, the consolidation strategy is also expenditure based, with expenditure cuts outweighing planned reductions in the revenue ratio. The main difference is that planned expenditure cuts are larger in Germany than in France, while Germany also plans to reduce the revenue ratio. As such, Germany has signalled an (even) stronger ambition than France in reducing both public expenditure and the revenue ratio. Finally, projected GDP growth is somewhat higher in France than in Germany.

Table 2. Summary statistics for planned fiscal changes, 1998-2008.

	Surplus change		Spending change		Revenues change		GDP growth	
	Germany	France	Germany	France	Germany	France	Germany	France
1 year ahead	0.03	0.19	-0.54	-0.42	-0.50	-0.21	1.45	2.27
2 years ahead	0.41	0.52	-0.91	-0.71	-0.50	-0.21	1.96	2.41
3 years ahead	0.55	0.58	-0.95	-0.65	-0.41	-0.06	2.03	2.45

Source: updated from Beetsma et al. (2009)

Table 3 summarizes the implementation stage in both countries (i.e. the difference between planned and observed fiscal changes in real time, as in Beetsma et al., 2009, for the EU average; a negative number implies that implementation falls short of plan). For both countries, the implementation error in the one year ahead fiscal plan is large, and even outweighs the planned fiscal consolidation. This result is in line with the observed increase in deficits in ex post data (see section 3.1). Moreover, GDP growth was projected too high, a finding that is in line with previous papers.¹¹ The main difference between Germany and France is on the expenditure side. In Germany, average overspending of 0.36% of GDP for the one year ahead forecast implies that one third of the planned expenditure cuts of -0.54% GDP (as in Table 2) has been implemented, while revenue almost went down as planned. In France, however, the implementation error on the expenditure side outweighs planned expenditure cuts (implying an upward drift in the expenditure to GDP ratio, in line with ex post indicators in Table 1), while also planned decreases in revenue are not implemented.

¹⁰ As updated until the 2008/09 round of stability and convergence programmes.

¹¹ E.g. Jonung and Larch (2006).

Table 3. Summary statistics for real time implementation errors

In changes, as a % of GDP

	Surplus change		Spending change		Revenues change		GDP growth	
	Germany	France	Germany	France	Germany	France	Germany	France
1 year ahead	-0.21 (0.93)	-0.35 (0.53)*	0.36 (0.81)	0.66 (0.77)**	0.16 (0.84)	0.31 (0.63)	-0.41 (0.98)	-0.52 (0.89)*
2 years ahead	-0.44 (0.97)	-0.51 (0.55)**	0.47 (0.82)	0.70 (0.70)**	0.03 (0.64)	0.18 (0.39)	-0.69 (1.27)	-0.59 (0.82)*
3 years ahead	-0.41 (0.93)	-0.68 (0.61)**	0.35 (0.73)	0.72 (0.66)**	-0.06 (0.87)	0.04 (0.41)	-0.99 (1.05)**	-0.78 (0.69)**

Source: updated from Beetsma et al. (2009)

Note: results from two-sided t-test. ***, **, *, denote statistical significance at 10, 5, and 1 % level.

In order to investigate in more detail the policy effort that is behind these data, we can show a further decomposition. In its Macro Financial Assessment of the Stability and Convergence Programmes, the European Commission decomposes differences between fiscal plans and outcomes for each individual year into (i) a base effect (reflecting revisions in the fiscal outcome of the previous year); (ii) nominal expenditure/revenue growth being different from plan; (iii) a denominator effect due to nominal GDP growth being different from plan (where lower growth than projected increases the ratio), and (iv) a small residual effect. Bluhm (2009) applies this decomposition to the whole of our sample period 1998-2008, in real time and for the one year ahead implementation error.¹² The underlying database is the same as in Tables 3, so that the results are fully aligned. In Table 4, subtracting the base effect from the level error exactly gives the real-time implementation errors in changes of Table 3. This occurs since focusing on fiscal changes instead of levels corrects for data revisions across different vintages.¹³

Table 4. Decomposition of fiscal forecast errors

		Error in changes	Level error	Base effect	Exp/rev. growth effect	Denominator effect	Residual
		(1)=(2)-(3)	(2)=(3)+(4)-(5)+(6)	(3)	(4)	(5)	(6)
Germany	BB	-0.21	-0.09	0.12	-0.18	0.01	-0.01
	Exp	0.36	0.37	0.01	0.07	-0.29*	0.01
	Rev	0.16	0.29	0.13*	-0.12	-0.27*	0.00
France	BB	-0.35*	-0.33	0.02	-0.33**	0.01	-0.01
	Exp	0.66**	0.38	-0.28	0.40*	-0.23*	0.02
	Rev	0.31	0.05	-0.26	0.08	-0.22*	0.01

¹² Moulin and Wierds (2006) apply a similar decomposition, but without including the base effect. Moreover, they compare plans to ex post fiscal data.

¹³ In mathematical terms, the error in changes of the decomposition in Beetsma et al. (2009) can be divided into an error in levels and a base effect.

Source: Bluhm (2009), and updated from Beetsma et al. (2009)

Note: standard errors and brackets; ***, **, *, denote statistical significance at 10, 5, and 1 % level in a two-sided t-test.

This decomposition reveals interesting differences between Germany and France on the expenditure side of the budget. In Germany, yearly nominal expenditure growth (the numerator) has been only slightly higher than planned (0.07 % GDP). Disappointing growth however largely explains why expenditure was off target (denominator effect of -0.29% GDP, which increases the expenditure ratio). In France, however, nominal yearly spending growth has been 0.40% GDP higher than what was planned on average, while the denominator effect explains an additional 0.23% of GDP of the overall error. Moreover, note that downward revisions of past expenditure data (negative base effects) have limited expenditure overruns in terms of levels in France.

Overall, while section 3.1 suggested preferences for larger size of the government in France relative to Germany, the real time data of this section could be indicative of differences in preferences regarding fiscal discretion. While Germany shows some degree of commitment towards implementing its own plans, preferences in France seem to have been towards maintaining discretion during the implementation phase of the budget.

4. Institutional data

4.1. EU fiscal rules

Apart from actual policy conduct, underlying preferences may also shine through in positions taken in debates on the EU fiscal rules. We look briefly at the important events in its history: the design of the SGP, its reform, and the response to the crisis.

Designing the SGP (1995-1997)

Especially the negotiation process that led to the creation of the SGP has been very well documented, and thus provides a wealth of information. As described in detail in Stark (2001, p. 85), the original proposal by Germany on a complement to the Treaty provisions rested on two considerations:

- Ensuring that the deficit ceiling of 3 per cent of GDP was not violated during any stage of the business cycle;
- Including stringent, automatic sanctions to add ‘teeth’ to the agreement in case the rules would be violated.

Especially the proposal for automatic sanctions could be seen as indicative of preferences for a strong rules based approach during the mid 1990s. Stark (2001) also addresses the deeper social preferences that could have inspired the policy makers to take such a position. In sum, the German experience of

two hyperinflations in one century had provided a strong motivation for its policy efforts aimed at ensuring the monetary union would be a stability union. See also Costello (2001, p 107), who notes that late 1995 was a period when the future of the EMU project depended on the German government being able to convince a sceptical public that the euro would be as stable as the D-mark. Even though the German idea of a ‘Stability Pact’ was broadly welcomed during the negotiations, the idea of automatic sanctions was countered by insistence on the French side on the Council’s *discretionary* powers. Eventually, a compromise was therefore reached on a quasi-automatic time path for speeding up the excessive deficit procedure. Moreover, in June 1996 the then newly elected French government added the word Growth to the Stability Pact, so that an agreement could be reached.

Reforming the SGP (2003-2005)

In 2003, Germany and France clashed with the European Commission over a next step in the EDP procedures towards sanctions for breaking the 3% limit. This provided the starting point for the reform of the SGP, with agreement on a more flexible Pact reached in 2005. If anything, this episode seems indicative of a shift in preferences towards more fiscal discretion in Germany. How to explain this? Does it represent a genuine change in policy preferences or could it perhaps be explained by the special circumstances of the time? As we have seen in the previous sections, expenditure growth had been rather subdued in Germany, but nevertheless it broke the SGP rules largely due to low economic growth. We therefore speculate that after largely delivering on policy effort, German policy makers felt that there was no other escape route than to break out of what they perceived as the straight jacket of the rules. With both Germany and France pleading for more flexibility, agreement on the revised rules could be reached relatively easily.

The crisis period (2008-2009)

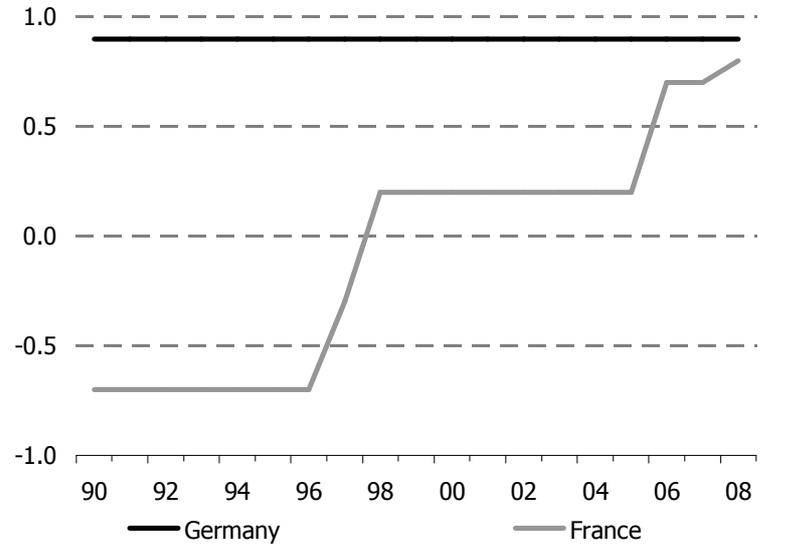
Updated information on policy preferences can again be found in the latest period when the economic crisis hit. In late 2008, the French presidency took a strong lead in bringing about a concerted European response to the economic crisis (see Pisany-Ferry and Sapir, 2009, for details on the subsequent summits and the conclusions that they reached). While the creation of the SGP can perhaps be seen as the heyday of German initiative in promoting a rules-based approach, the European Economic Recovery Plan of December 2008 owes much to French leadership in bringing about a discretionary response to the unprecedented downturn of 2008-2009. Interestingly, and in line with its perceived underlying preferences towards rules over discretion, Germany had at first resisted the idea of a stimulus package¹⁴, but then showed receptivity when international political consensus went into the direction of a concerted policy effort.

¹⁴ See FT 8 december 2008, ‘VAT cut is “crass Keynesianism”’: The latest view from the German government.

3.2 National fiscal rules and institutions

If preferences determine both fiscal rules and fiscal outcomes, then fiscal rules may provide signals regarding underlying preferences. With this hypothesis in mind, we now investigate national fiscal rules in Germany and France. EC (2006) provides a time varying aggregate indicator that combines the coverage of national fiscal rules with its institutional ‘strictness’, which has been updated in 2008. Figure 5 shows the overall results for Germany and France.¹⁵ The new German constitutional rule has not yet been taken into account in these data.

Figure 5. Fiscal rules in Germany and France



Source: EC (2009).

Results show that whereas national fiscal rules in Germany have been rather constant over the sample, there have been increases in the index for France in 1998 and again in recent years. At the beginning of the sample period, combined strictness and coverage in France is well below the European average, but it then increases to the stricter end of the range in recent years. We first discuss the institutional changes that are behind this development for France, and then briefly discuss the evolution of national fiscal rules in Germany. Data on the evolution of national fiscal rules are from the EC database on fiscal governance.

France

Before 1998, national fiscal rules in France applied to the local government sector only. The golden rule applied. Voted budgets had to be in balance, and ex post deficits could not exceed 5% of current

¹⁵ Note that the index was standardised so that the average over the sample of all countries and years (1998-2008) is zero and the standard deviation is one.

revenues (10% for small municipalities). In 1997 an expenditure rule for health care was introduced,¹⁶ and in 1998 an expenditure rule for the central government was introduced, which targeted an increase of central government expenditure in real terms. In practice, real expenditure was planned to increase more slowly than real GDP. Experience with this expenditure rule has however been disappointing. See Moulin (2004): the rule was not enforced, initial targets were missed by a wide margin and the objective of consolidating public finances through a structural decline in the expenditure to GDP ratio was not achieved. This pattern is in line with the data on fiscal performance in sections 2 and 3 of this paper. In 2006 the strictness of the expenditure rule increased however slightly, as the ministry of finance became responsible for enforcing the rule (even if still no actions were prescribed in case of non compliance). Moreover, the overall fiscal rules index of France increased further in 2006 due to the introduction of a revenue rule for the central government. According to this rule, the central government has to define ex ante how higher than expected tax revenues are to be used. Moreover, in 2008 a new debt rule came into force that applies to social security. The rule prescribes that each increase in the social security debt has to be matched by an increase in revenues. Thus, the repayment of the social security debt should not be prolonged to the future. Finally, according to EC (2009, p. 95), France has also strengthened its Medium Term Budgetary Framework (MTBF). Even though the fiscal targets are not legally binding, the reformed MTBF implies to set a fixed path for fiscal targets, which should not be revised during the time horizon of the framework unless major changes in the underlying macroeconomic assumptions materialize.

Overall, institutional reforms in France seem to have made the fiscal process more rules based. The reforms suggest awareness of the problem of slippages relative to national targets, and attempts of addressing it. It should also be noted, however, that most targets as set out by the rules are still not legally binding, while monitoring and enforcement actions remain relatively soft. It therefore remains to be seen whether these institutional reforms really represent a regime shift, where national targets and plans become truly constraining. So far, a first assessment has been complicated by the economic crisis, and the discretionary policies that have been pursued in response. The fiscal exit will now provide new information as to whether or not preferences are indeed shifting to some extent towards self imposed constraints and addressing unsustainable debt trends.

Germany

For Germany, the level of the fiscal rules index in Figure 5 suggests that the combined strictness and coverage has been above the average for the EU countries. This is in line with the idea of relatively strong preferences for a rules based approach. Second, the index is constant, suggesting that there have not been major reforms in national fiscal rules until the new constitutional deficit rule passed

¹⁶ Based on an annual vote of the Parliament on the national ceiling for health expenditure.

Parliament in the summer of 2009. See Kastrop et al. (2009) for a detailed description of the provisions of the new constitutional rule, and the reasons for the new rule. The new constitutional rule is to replace the golden rule for the central and regional governments, according to which public borrowing was only allowed if it did not exceed public investment. The starting point of Kastrop and his team in motivating the new rule is that the existing rules had not prevented an unsustainable rise in debt. Hence, a more restraining rule was needed for countering the fiscal trend (also in the light of increasing future fiscal pressures due to ageing).¹⁷ As in the case of France, this suggests that unsustainable fiscal trends may gradually have shifted preferences towards addressing the unsustainable trend. Obviously, also in this case the jury is still out whether or not the fiscal exit will show a credible consolidation path. As with national fiscal planning in the context of the SGP (see Table 3 in section 3.2), the consolidation path is back-loaded: a transition phase until 2015 was agreed for complying with the central target of a cyclically-adjusted budget deficit of at most 0.35% of GDP.

Apart from the golden rule for the central government and the regions, several other national fiscal rules have been in place in Germany, which together add up to the relatively high overall fiscal rules index score. An expenditure rule aims at limiting nominal expenditure growth for the central government and the regions to a maximum of 1% on average. However, no predefined action applied in case of non compliance. Moreover, a balanced budget rule applies to local governments. Sanctions in case of violation are imposed by the communal supervisory agency, including the possibility to refuse to authorise the budget, impose consolidation programmes or take over the administration of the commune. Moreover, a debt ceiling in nominal terms applies to local governments. Raising credits by the communes requires authorisation by the supervisory agencies and must only be used to finance investments.

5. Conclusion

In this paper, we have investigated the signals that national fiscal policies and institutions give about underlying preferences for the conduct of fiscal policy. If anything, ex post fiscal data seem to signal a stronger preference for constraining expenditure growth in Germany than in France, and stronger preferences for discretionary countercyclical policy in France. Real time data suggest that national fiscal plans have been more constraining in Germany than in France. Positions taken regarding the EU fiscal rules indicate preferences for a rules-based approach in Germany (except during the revision of the SGP in 2003-2005), and preferences towards discretion in France. We therefore conclude that

¹⁷ According to Kastrop et al. (2009), the drawbacks of the golden rule include: (i) the distinction between investment and consumption, which is difficult to make in practice; (ii) too many exceptions were allowed; (iii) the rule worked asymmetrically over the business cycle, and (iv) there was no mechanism that ensuring compliance.

results for most of the indicators confirm a first intuition that preferences are tilted more towards a rules-based approach in Germany, and towards discretion in France.

Our results however also suggest that preferences are not fixed, and that fiscal policies and institutions may change as a result. In Germany, ongoing unsustainable debt trends led to preferences for and agreement on a stronger national constitutional rule. But also in France, actual fiscal developments seem to have inspired reforms in the national institutional setting, making the system somewhat more rules based. As a result, we could argue that there is merit in the argument that disciplined countries introduce stricter rules, but that it is not the whole story. In addition, unsustainable fiscal developments may lead to an evolution of preferences towards addressing the unsustainable trend, and stronger rules in response.¹⁸ At the same time, it remains to be seen how constraining recent innovations in fiscal rules will turn out to be in the course of the fiscal exit.

In recent months, it has sometimes been argued that differences in approach in Germany and France regarding the fiscal exit could jeopardise the credibility of both the fiscal exit and the SGP. We are more inclined to give a positive interpretation, however. Thanks to their differences in approach, Germany and France have played complementary roles at EU level, and acted in different ways: Germany by taking the lead in introducing the EU fiscal rules, and France by taking the lead in organising a discretionary response to the economic crisis. Moreover, in cases where German proposals tilted too much towards rules, or French proposals too much towards discretion, there was always the need to compromise with each other and strike a balance. We like to think that, in a world of uncertainty, differences in approach, learning from each other, as well as learning from experience can over time only lead to better policies.

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¹⁸ On these issues, Wierds (2008, p. 257-258) points to additional cases where during a period of biased outcomes and unsustainable fiscal trends, preferences may have evolved towards addressing the unsustainable trend, and stronger rules may have been introduced as a result. The EU fiscal rules had been introduced after a period of steady increase in the debt ratio, while countries with higher expenditure to GDP ratios subsequently introduced tighter expenditure rules.

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