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A Fiscal Rule that Has Teeth: A Suggestion for a Fiscal Sustainability Council Underpinned by the Financial Markets

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Abstract: In this paper, we set out to examine an efficient fiscal-policy framework for a monetary union. We illustrate that fiscal policy's bias toward budget deficit only temporarily ceased at the end of the 20th century as European countries endeavored to qualify for euro-zone membership, which compelled strict limits on budgetary deficits. We then explore which mechanisms might instill a sense of fiscal discipline in governments. We find that most mechanisms suffer from the incentive-incompatible setup whereby governments restrict their own fiscal-policy freedom. We argue that even multilateral fiscal rules, such as the EU's Stability and Growth Pact, suffer from the same endogeneity flaw. Consequently, we argue that a fiscal rule must incorporate an external authority that would impartially assess fiscal-policy developments. Using U.S. debt and bond-market data at the state level, we show that financial markets represent a good candidate as, vis-à-vis the American states, they do differentiate state debt according to the level of debt. We thus argue for a fiscal institution – what we call the Fiscal Sustainability Council– that would actively bring financial markets into the fiscal-policy process, and we explain the technique whereby this could be effected.

JEL classification: E6, H6, H87

Keywords: fiscal policy, European Union, sustainability

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