МИРОВАЯ ЭКОНОМИКА И МЕЖДУНАРОДНЫЕ ОТНОШЕНИЯ, 2024, том 68, № 2, сс. 5-15
WORLD ECONOMY AND INTERNATIONAL RELATIONS, 2024, vol. 68, no. 2, pp. 5-15

THE WORLD AT THE BEGINNING OF MILLENNIUM

DOI: 10.20542/0131-2227-2024-68-2-5-15 **EDN:** XCMIDG

FISCAL POLICY OF ADVANCED ECONOMIES: PLAYING BY THE RULES?

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Received 29.09.2023. Revised 09.10.2023. Accepted 09.11.2023.

Abstract. The article examines the reasons for the adoption of fiscal rules in advanced economies, their main types, evolution and results of application. In the practice of fiscal policy over the past decades, there has been a steady trend towards budget deficits. There are two main reasons that explain this widespread deficit bias phenomenon: the tendency to push out the financial discipline burden to future governments or even to future generations and the interplay of political processes and interest group activities (common pool effect). Chronic budget deficits and growing public debts have prompted many countries to adopt certain national and supranational (in the EU) fiscal rules – long-lasting constraints on fiscal policy through numerical limits on main budgetary aggregates: budget balance, debt, expenditure or revenue. Fiscal rules can promote financial discipline and reduce the deficit bias in several ways. This influence on fiscal behavior arises from their capacity to "tie the hands" of policymakers and to be a useful signaling tool, helping to reduce the asymmetry of information between policymakers and voters. But the compliance track record with fiscal rules is relatively poor. They have failed to provide sufficient fiscal discipline: the deficit bias persists and the debtto-GDP ratio in most advanced economies continues to grow. The adopted budget rules are periodically suspended, they are subject to revision, sometimes formally implemented by applying the creative accounting, policymakers use them as a tool of political bargaining. Ultimately, fiscal discipline does not depend on the existence of rules, but on the willingness of politicians to comply with this discipline.

Keywords: fiscal policy, budget deficit, fiscal rules, government debt.

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БЮДЖЕТНАЯ ПОЛИТИКА РАЗВИТЫХ СТРАН: ИГРА ПО ПРАВИЛАМ?

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Статья поступила 29.09.2023. После доработки 09.10.2023. Принята к печати 09.11.2023.

Аннотация. За последние десятилетия в развитых странах сложилась практика регулярного принятия дефицитных бюджетов, что ведет к постоянному возрастанию государственного долга и ставит под угрозу стабильность финансовой системы. В этих условиях многие правительства пошли по пути принятия различных бюджетных правил – количественных пределов для основных бюджетных агрегатов: доходов, расходов, сальдо бюджета или уровня государственного долга. Практика применения таких правил указывает на их слабую эффективность: действие принятых правил часто приостанавливается, сами они пересматриваются, выполняются формально или используются как инструмент политического торга.

Ключевые слова: бюджетная политика, дефицит бюджета, бюджетные правила, государственный долг.

The problem of fiscal rules, which restrict the actions of governments in the budgetary sphere, is currently in the spotlight for both politicians and experts. The COVID-19 pandemic led to an unprecedented increase in government spending, especially in developed countries, which suspended

previously established budget rules to ensure flexibility for large-scale anti-crisis measures. After overcoming the pandemic, governments now face additional challenges: record levels of public debt and rising interest rates in response to increasing inflation rates. This situation necessitates a significant tightening of budget policy. As IMF experts emphasize, “uncertainty around the future course of fiscal policy can be particularly problematic at present, given the combination of high debt and high inflation” [1, p. 2].

STATE BUDGET DEFICIT AS A TREND

It would seem that the need for governments to observe financial discipline is obvious. However, awareness of this truth spreads slowly, especially in countries with developed financial markets that allow large-scale borrowing. A government may run a budget deficit for a number of years, even decades, before encountering serious financing difficulties and, therefore, a real risk of default.

The question arises: what should be understood by reasonable financial discipline? In macroeconomic theory, aiming for a balanced budget every year is seen as an example of unsuccessful fiscal policy, since it is likely to destabilize the economy. Revenues to the state budget largely depend on the country’s total income, which fluctuates noticeably within the economic cycle, increasing during an upturn and decreasing during a downturn. The expenditure side of the budget, on the contrary, does not have such an automatic connection with fluctuations in GDP levels. As a result, fiscal policy aimed at maintaining a balanced budget in all phases of the economic cycle would be pro-cyclical, inevitably leading to an increase in the amplitude of cyclical economic fluctuations.

Thus, budget discipline is not a concept designed to be implemented annually; rather, it is a medium- and long-term characteristic of fiscal policy, which involves maintaining a balanced state budget over fairly long intervals, at least over the economic cycle as a whole. In other words, budget deficits that arise during recessions must be compensated by surpluses during economic expansion. Using a simplified approach, one would expect that in a country with a disciplined government, the number of years in which the government budget runs a deficit would be about half of some fairly long period.

However, such a view is not supported by actual data; over the past six decades (1960–2020), only three of the 38 OECD member countries more or less met the criterion of financial discipline: Denmark, New Zealand, and Sweden. Norway and Finland experienced a significant predominance of years with budget surpluses (more than 80%), while in all other cases, the opposite occurred – budget deficits prevailed for eight years out of ten (or even more frequently). Italy set a kind of anti-record with a deficit budget in 100% of cases [2, p. 496; source 1].

Notably, a number of large countries have not adopted a budget surplus for a long time. In the UK, this last occurred in 2001, in the USA in 2000, in Japan in 1992, and in France in 1974. Significant budget deficits during recessions are in full accordance with the provisions of macroeconomic theory. However, they persist during economic recoveries, albeit at a smaller scale (Fig. 1). The conclusion is that in modern conditions, the state budget deficit, with rare exceptions, can be maintained for a long period if the country has a sovereign credit rating of AAA or close to it, which allows borrowing from financial markets without problems.

Since the regular adoption of deficit budgets is widespread in developed countries, the term “deficit bias” has appeared in the economic literature. Researchers offer various theoretical explanations for this phenomenon: from incomplete information leading to incorrect budget decisions to the concept of hyperbolic discounting, popular within the framework of modern behavioral economic theory, which explains the features of intertemporal choice that politicians make when adopting a budget [3].

Two dominant explanations for deficit bias are highlighted. The first is the tendency to shift

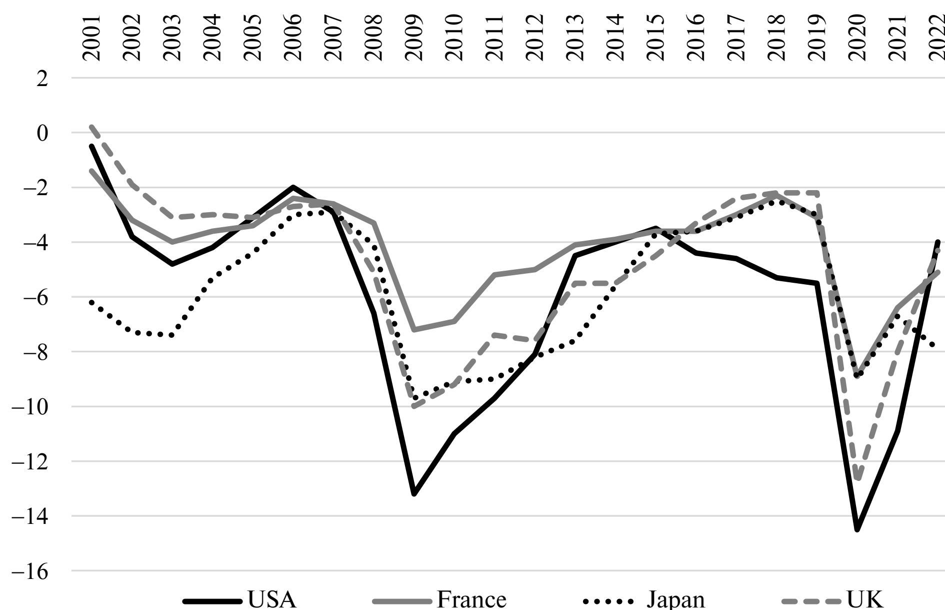

Fig. 1. State budget balances of the USA, France, Japan, and Great Britain, 2001–2022, ratio to GDP, %

Built according to: [source 2].

the burden of fiscal discipline onto future governments or even generations. Governments in modern conditions are typically short-term – from elections to elections, usually lasting four years, or even less in cases of political instability[1]. Consequently, economic policy as a whole, including the state budget, is developed by each government primarily based on the immediate tasks it faces; however, its responsibility is also limited in time. "The benefits for the politician of cutting taxes or increasing spending may be immediate, whereas the costs in servicing higher debt can be put off into the longer term" [4, p. 9].

The second explanation involves the relationship between political processes within representative democracies and the actions of interest groups. Politicians increase their likelihood of election (or re-election) by pleasing interest groups and demonstrating governmental largesse at the expense of future taxpayers. Even when there is awareness of the dangers of rising government debt, finding the political courage and support to reduce the deficit can be extremely difficult[2].

In this context, the so-called "common pool" effect appears, where interest groups compete to gain access to budget resources, based on the assumption that taxes will be paid mainly by others. Notably, in relation to fiscal policy, this effect also manifests at the interregional level: local authorities adopt deficit budgets, reasonably expecting to receive financial transfers from the central government.

A similar situation arises in interstate relations, when the government of a country that is part of an integration group violates financial discipline expecting to receive external financing either as part of regular transfers or as financial assistance. The European Union can serve as an example here; the Treaty on the Functioning of the EU contains a provision on the refusal of direct financial assistance to countries experiencing budgetary difficulties (Article 125) [source 4]. However, this was actually ignored: during the

[1] Thus, in Italy, in 1980–2022, prime ministers changed 26 times (average period – 1 year and 7 months), in Japan 23 times, and in France 18 times.

[2] Former head of the European Commission Jean-Claude Juncker, being Prime Minister of Luxembourg, once said, discussing the political difficulties in pursuing stabilization policies: "We all know what to do, we just don't know how to get re-elected after we've done it." [source 3].

years of the debt crisis in the Eurozone, such financial assistance was provided to Greece, Ireland, and Portugal.

TYPES OF BUDGET RULES AND THEIR EVOLUTION

Chronic budget deficits and the escalating scale of public debt have prompted numerous countries to adopt certain restrictions (rules) for fiscal policy; these are diverse but united by clear quantitative limits for the main budget aggregates[3]. Compliance with such limits is intended to help avoid costly means of restoring fiscal sustainability, including sovereign default and inflation. In this sense, fiscal rules are designed to reassure investors and society as a whole that government finances will remain stable.

Four main types of budget rules can be singled out:

1. Rules establishing a ceiling on government debt, usually expressed as a percentage of GDP. However, its level is influenced by factors that are not fully controlled by governments (for example, the dynamics of the exchange rate and interest rates). Therefore, rules regarding public debt do not provide short-term guidance for fiscal policy, especially when its level is below the maximum.

2. Fiscal balance rules establish restrictions on the overall budget balance, the primary balance, the structural budget balance, or the cyclically adjusted budget balance. They help ensure clear operational budget management and an acceptable level of public debt. However, restrictions on the actual budget balance, as already noted, can have a pro-cyclical effect on the economy, and restrictions on the structural deficit require an assessment of the so-called GDP gap (the deviation of actual GDP from its potential value), which makes budget rules less transparent and complicates monitoring of their implementation.

3. The rules of budget expenditures imply restrictions on general, primary, or current government expenditures. They are usually set in absolute terms or growth rates, and sometimes as a percentage of GDP, with a time horizon often ranging from three to five years. Such rules are not directly related to ensuring an acceptable level of debt, since they do not limit the revenue side of the budget. However, they can help slow down the growth of government spending when the increase in budget revenues is temporary (for example, in case conditions in world commodity markets change).

4. Budget revenue rules establish maximum or minimum levels of income and aim to increase tax collection (which is typical for low-income developing countries) or, conversely, to prevent excessive tax burdens (which is more typical for developed countries). Such rules are not directly related to maintaining an acceptable level of debt, since they do not limit the expenditure side of the budget. In addition, they can be combined with procyclical tax policy, since minimum (or ceiling) levels of taxation, as a rule, will not take into account the role of the tax system as an automatic stabilizer during a recession (rise) of the economy[4].

Over the past three decades, the number of countries that adopted rules-based constraints on fiscal policy increased dramatically. According to the IMF, in 1985, fiscal rules were in effect in only six countries (Australia, Germany, Indonesia, Malaysia, Singapore, and Japan). In 2000, they were in effect in 48 countries, and in 2022, 104 countries adopted at least one fiscal rule (34 developed and 70 developing). Only four economies classified as developed by the IMF do not currently use fiscal rules: Canada, South Korea, Puerto Rico, and Taiwan. In 53 countries (including 22 developed ones), along with national ones, supranational budget rules also apply[5] [source 6].

[3] In addition to quantitative budget rules, governments can also establish procedural restrictions on budget (procedural rules) to increase predictability and improve transparency in preparing, adopting, and executing budgets.

[4] The specific content and quantitative parameters of fiscal rules vary significantly between countries. A complete list of such rules by country is provided in the IMF Periodic Review *Fiscal Rules at a Glance* [source 5].

[5] Supranational rules apply in the European Union, the Eastern Caribbean Currency Union (ECCU), the Economic

Таблица. Бюджетные правила в странах *G7* по типам и периодам применения

Country	Type of rules[1]	Debt rule	Budget balance rule	Expenditure rule	Revenue rule
UK	*a*	1987–present	1997–present		
	b	1992–2019	1992–2019	2012–2019	
Germany	*a*		1969–present	1982–present	
	b	1992–present	1992–present	2012–present	
Italy	*a*		2014–present		
	b	1992–present	1992–present	2012–present	
Canada	*a*	1998–2005	1998–2005	1998–2005	
USA	*a*		1986–1989	1990–2002 2011–present	
France	*a*		2012–present	1998–present	2006–present
	b	1992–present	1992–present	2012–present	
Japan	*a*		1947–present	2006–2009 2010–2013 2015–2018	

[1] *a* – national, *b* – supranational.

Compiled from: [sources 5, 6].

In general, 85 countries in the world use debt rules, 93 budget balance rules, 55 expenditure rules, and 17 revenue rules. However, often several types of rules are combined, therefore states, including leading world economies, use three different fiscal rules on average (see Table 1).

To make the picture more complete, in addition to budget rules, so-called fiscal councils were created in 49 countries, including 28 developed ones [source 7], which are independent institutions given a formal mandate to evaluate budget policy and oversee compliance with budget rules[6].

Modern economic literature customarily distinguishes budget rules of two generations. The first generation includes budget rules adopted before the so-called Great Recession (the global financial and economic crisis of 2008–2009). At that time, the rules themselves were characterized by relative simplicity yet by insufficient elaboration of the compliance mechanism.

During the Great Recession, most countries relaxed or even suspended fiscal rules to accommodate the necessary scale of countercyclical fiscal stimulus. After the acute phase, the pre-crisis rules in most cases were not restored, but new or significantly revised ones were introduced[7]. This gave grounds to talk about the transition to a new (second) generation of budget rules [5], although there is no established definition of them. As IMF experts emphasize, "although the term 'second generation' may suggest a paradigm shift related to the crisis, these rules are generally an evolution of existing rules, trying to address their shortcomings and strengthening some of their key features" [6, p. 10].

In general terms, the second-generation rules are characterized as more feasible, flexible, and operational. In particular, more than 60% of countries using fiscal rules have introduced a so-called escape clause, which provides for the possibility of exemption from all or part of the rules under certain circumstances. It became the cornerstone of the second-generation rules [7, p. 8].

and Monetary Community of Central Africa (CEMAC), the West African Economic and Monetary Union (WAEMU), and the East African Monetary Union (EAMU).

[6] The Fiscal Council is a general name used to describe various bodies with own names in different countries: Congressional Budget Office in the USA, Office for Budget Responsibility in the UK, High Council of Public Finance in France, Bureau for Economic Policy Analysis in the Netherlands, etc.

[7] In 2010–2012 only, the following developed countries changed their budget rules: Austria, Great Britain, Israel, Spain, Italy, Portugal, Slovakia, the USA, and Japan. As an exception, Germany did not revise its rules, since its Constitution fixed the upper limit of the structural deficit of the federal government at 0.35% of GDP.

The COVID-19 pandemic and the associated global economic crisis led to numerous states suspending budget rules or changing their targets, and on an even larger scale. The total number of countries that suspended fiscal rules in 2020–2021 was twice as large as in 2008–2010.

As noted in the latest issue of the IMF's Fiscal Monitor, "now countries need to decide whether to return to fiscal rules and, if so, how fast and which ones." [source 8, p. 21]. The discussion in the expert community and among politicians about the directions for revising budget rules indicates that in the near future, one can expect a transition to third-generation rules. The general consensus is that using second-generation rules over the past decade showed that "these innovations have made the systems of rules more complicated to operate, while compliance has not improved" [6, p. 4].

Moreover, supranational budget rules in the European Union also underwent significant evolution. The Stability and Growth Pact, adopted in 1997, fixed the following rules for EU members: ceilings (3% of GDP for the overall budget deficit and 60% of GDP for public debt) and the requirement that medium-term budget positions were "close to balance or surplus." From 2005 to 2015, the European budget rules system underwent several stages of reform. The number of rules reached six, and during the pandemic, their operation was suspended. Ways to revise EU fiscal rules are currently being actively discussed, as "it is difficult to avoid the conclusion that – notwithstanding several reform attempts – the rules have failed in their most basic objective, namely, preserving fiscal sustainability and preventing debt crises" [8, p. 4].

BUDGET RULES: GOALS AND RESULTS

Fiscal rules can promote fiscal discipline and reduce deficit bias in several ways. First, and most obviously, fiscal rules act as a mechanism for making commitments, tying the hands of politicians and limiting their freedom in pursuing fiscal policy, primarily restraining their tendency to increase government spending.

Second, rules help reduce information asymmetries between politicians and voters. It is considered one of the factors contributing to the deficit bias because it increases political instability and short-sightedness in budget decisions. Accordingly, the rules can perform a kind of signaling function, making fiscal policy more transparent and increasing confidence in it on the part of investors and society as a whole [9].

Third, rules can serve a political function by facilitating the formation and stability of governments based on a coalition of political parties. As experts note, "countries with ideologically dispersed coalitions will not be as willing to delegate power to a finance minister representing only one of the parties in government. Instead, it is more likely that coalition governments opt for multi-year expenditure targets, which they can credibly fix in their coalition agreement for their electoral period" [10, p. 8][8].

Ultimately, the point of fiscal rules is to prevent government debt from growing to levels that threaten the country's financial stability. Certainly, the ability to service and repay the existing debt depends not only on its size but also on the scale of the economy. Therefore, when assessing the financial stability of a country and, accordingly, the effectiveness of fiscal rules, the ratio of debt to GDP is taken into account first of all. In general, fiscal discipline can be said to exist when the debt-to-GDP ratio is at least stable over the long term, and fiscal rules should support this.

From this point of view, the experience of applying budget rules in the countries under consideration can hardly be considered successful. There are examples where governments, before the start of the pandemic, managed to adopt surplus budgets, maintain the ratio of public debt to GDP at a stable level (Sweden, Switzerland), and even achieve a noticeable reduction in this indicator (Germany). However, they are not numerous; the deficit bias in most developed countries cannot be overcome, and the scale of

[8] For example, after the Great Recession in several European countries (Belgium, Luxembourg, the Netherlands, Finland, Sweden), ruling parties included multi-year budget spending caps in their coalition agreements.

public debt is increasing both in absolute terms and in relation to GDP. In developed countries as a whole, this figure increased from 70% in 2001 to 112% in 2022, and in the G7 countries to 128% [source 2]. The prevailing opinion among experts is that "despite their proliferation, the compliance track record with fiscal rules is relatively poor. In particular, in the EU, breaching fiscal rules has been more the norm than the exception" [11, p. 3].

If one takes the stabilization of the debt-to-GDP ratio as a minimum indicator of the effectiveness of fiscal rules, what conditions must be met for this to happen? If G is the current expenditures of the state budget, T is the current revenues, D is the amount of public debt, and r is the interest paid on government bonds, then the change in the total amount of debt will depend on the level of the current budget deficit (surplus) and debt servicing costs:

$$\Delta D = (G - T) + rD. \quad (1)$$

Dividing both sides of the equation by the value of GDP (Y), one can obtain the ratio of the change in debt to GDP:

$$\Delta D/Y = (G - T)/Y + rD/Y. \quad (2)$$

The overall change in the debt-to-GDP ratio can be represented as

$$\Delta(D/Y) = \Delta D/Y - \Delta Y/Y \times D/Y. \quad (3)$$

Since $\Delta Y/Y$ is the growth rate of GDP, substituting (2) into (3), one can get:

$$\Delta(D/Y) = (G - T)/Y + (r - g)\, D/Y. \quad (4)$$

From the above equation, it follows that the debt-to-GDP ratio can be maintained at a relatively stable level even in case of an insignificant primary budget deficit ($G > T$), if $g > r$, since GDP in this case will increase faster than debt. If the interest rate exceeds the growth rate of GDP, adopting a budget with a primary surplus will be necessary to stabilize the debt-to-GDP ratio.

Thus, the level of interest rates on government debt is an important indicator for assessing the prospects for maintaining the financial stability of the state. Fig. 2 shows that the yield on government bonds in leading countries was steadily declining since 1990. In recent years before the pandemic, it was close to zero and even became negative; this allowed politicians to calmly deal with constant budget deficits, since their financ-

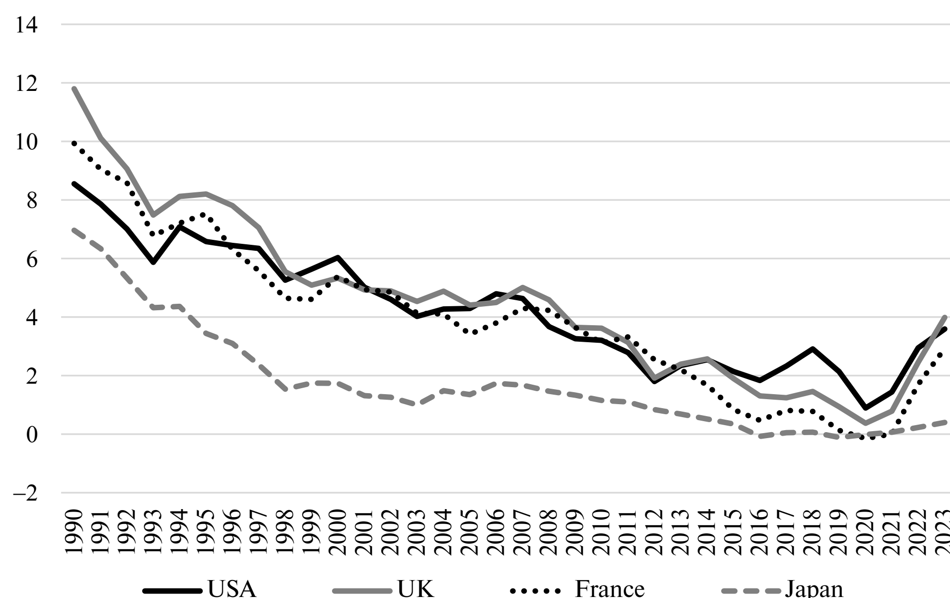

Fig. 2. Yield of 10-year government bonds of the USA, Great Britain, France, and Japan, 1990–2023, %

Compiled from: [source 1].

ing turned out to be not very burdensome, and in some periods it was even free.

The inflation surge in 2022–2023 changed the situation: a significant increase in interest rates exacerbated the problem of maintaining budget discipline. Thus, in 2020, the yield on 10-year US government bonds was only 0.89%, although even then servicing the huge debt cost the budget a considerable amount – about $300 billion a year. In December 2023, the yield increased to 4.23%, which in itself sharply increased the burden on the federal budget. Moreover, the yield on government bonds began to exceed the growth rate of GDP: in 2022, the US economy grew by 2.1%, and in 2023 and 2024, according to the IMF forecast, growth will be even less – 2.0 and 1.5%, respectively [source 2].

In such conditions, budget rules become especially relevant, yet they only yield results when, first, they are observed and, second, their violation entails responsibility. However, budget rules, being a way to overcome the so-called time inconsistency problem, become its manifestation themselves.

The first-generation rules were criticized for insufficient strictness: a rule easy to evade becomes, in fact, useless. The second-generation rules became more stringent yet at the same time supplemented with the escape clause already noted above. Various kinds of unforeseen events provide a convenient reason for politicians to take advantage of the situation and break even the strictest rule. “A government subject to the deficit bias can fairly easily convince its public opinion that today’s circumstances are special and that technocratic arrangements should not stand in the way of serving people’s interests” [2, p. 507]. Thus, the government actually relieves itself of responsibility for violating budget rules.

Even when the rules are formally observed, this does not always mean that budget discipline is maintained. The evolution of fiscal rules made them much more complex and difficult to implement, monitor, and communicate to the public. Research shows that governments often circumvent budget rules using so-called creative accounting techniques[9]. In this case, “fiscal institutions could indeed end up being used as counterproductive smokescreens” [12, p. 480]. The more complex the budget rules, the easier it is to interpret them in the right aspect and even to mislead public opinion, and the second-generation rules contribute to this.

Hagen and Wolff provide evidence of creative accounting methods used by a number of EU countries to bypass the 3% budget deficit limit and show that adjustments with their help existed even before the introduction of the euro. However, after the introduction of budget rules within the framework of the Stability and Growth Pact, their use to manipulate deficit indicators became systematic [13]. In addition, frequent changes to fiscal rules (e. g. in the EU) create the illusion that rules can be changed at any time, which undermines confidence in the system as a whole.

Reviewing experience with budget rules, analysts point out that “the key element of these rules is that they determine a threat point in budget negotiations and, thus, allow the opposition to use them as ‘bargaining chips’” [14, p. 2441]. During the bargaining, its participants (the government, parliament, and political parties) try to extract some political benefits for themselves, and the normalization of public finances sometimes looks more like a pretext.

Thus, in the United States, the growing national debt hits the established ceiling almost annually; during bargaining between the presidential administration and the opposition in Congress, each side seeks concessions from opponents on various political issues while the debt continues to grow. Over the past 20 years alone, the official debt ceiling was raised 18 times and increased from 6.4 trillion USD to 31.4 trillion. In addition, the ceiling was suspended six times, once again in June 2023. As a result, by the end of 2023, the actual level of the US national debt was close to 34 trillion USD.

[9] A set of accounting operations aimed to present the financial position of a company or of the state budget in the desired form. Such transactions often fall outside the scope of current accounting rules.

Leading international rating agencies have started to pay attention to this situation. Fitch in August 2023 downgraded the US rating from AAA to AA+, justifying its decision as follows: "The rating downgrade of the United States reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions" [source 9].

RESULTS AND CONCLUSIONS

Most developed countries have been using various budget rules, including supranational ones, for many years, improving them and even creating independent structures to improve the implementation of these rules. Assessments of the Fiscal Rules Strength Index conducted by IMF experts show that in the 10 years after the Great Recession, its level in developed countries increased significantly, that is, the rules became more stringent [7, p. 36][10]. However, they are periodically suspended, revised, or sometimes followed formally using creative accounting methods, and used as a tool of political bargaining. It is unlikely that such budget policy can be qualified as playing by the rules, especially since public debt reached record levels. Existing rules in numerous cases appear only as a kind of declaration of intent, yet to promise does not mean to fulfill.

Evidently, fiscal rules can help maintain fiscal discipline, yet in themselves, these are neither a necessary nor a sufficient condition. Ultimately, fiscal discipline depends not on the existence of rules but on the willingness of politicians to comply with them. To reduce deficit bias, the rules must impose strict restrictions on preparing, adopting, and executing the budget, and therefore on the actions of those who make budget decisions. To do this, the costs for violating the rules are to be significantly increased. However, the task of developing and adopting such rules seems difficult to solve, since it is those who have incentives to allow a budget deficit that should be asked to take measures to reduce these incentives. It is quite natural that politicians want to avoid restrictions on their freedom of action.

The modest results that compliance with fiscal rules yields are largely due to the fact that although the debt-to-GDP ratio cannot grow indefinitely, there is no magic number that would determine its optimal value. Macroeconomic theory does not define a clear threshold above which public debt can become especially dangerous for economic growth and financial stability of the country. Therefore, politicians in developed countries are relatively calm about constant budget deficits, believing that the critical level of debt is still far away. Yet, as the French economist Charles Wyplosz rightly notes, "years and decades of lenient appraisal by the financial markets and rating agencies can come to a surprisingly abrupt end. (...) Debts can grow unnoticed until they get noticed. They represent the kind of vulnerability that gives rise to self-fulfilling crises" [2, p. 496].

[10] The Fiscal Rules Strength Index was compiled by the European Commission based on five criteria: legal framework, regulatory authorities, adjustment mechanism, flexibility, and resistance to external shocks [source 10].

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