Fiscal Rules and Effective Fiscal Policy

Abstract

This article examines and assesses the influence of political factors on the effectiveness of pursuing fiscal policy. These factors usually cause and maintain a high budget deficit and public debt. Moreover, the problems of influence of fiscal rules on increased effectiveness of the pursued fiscal policy have been discussed. The fiscal rules are to assure macroeconomic stability in economy and improve credibility of the pursued fiscal policy by reducing the deficit, government spending, and public debt. Examples of applicable fiscal rules in the EU and Poland are presented and an attempt is made to evaluate the effectiveness of these rules in the process of consolidation of public finances.

1. Introduction

In recent years one can observe an increasing interest of economic literature in fiscal policy and its impact on the economic activity. One of the main reasons for this interest is the fact that indicators of public debt-to-GDP ratio, caused by a long-lasting budgetary deficit have increased over the last several decades in many developed countries. In recent years this situation has dramatically deteriorated due to the global financial crisis, which turned out to be acute for the economies of many countries. Currently, deterioration of public finances seems to be the biggest threat to global finance.

It seems that one of the reasons for this state of affairs is the fact that many countries fail to pursue responsible fiscal policy. The responsible policy is

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one that stabilizes public finances in the medium and long run, by correcting inconsistent budget policy over time and by reducing predisposition to create deficit resulting from the influence of external factors on fiscal policy. The responsible fiscal policy results in increased reliability and transparency of fiscal policy and consequently increased macroeconomic stability and long-term fiscal stability which in turn improves investors’ confidence in the economy and promotes economic growth (European Commission 2010).

It should be emphasized that the difficulties in implementing responsible fiscal policy may result not only from economic factors (e.g., economic recession), but may also result from political reasons. It is believed that politicians tend to use the power they exercise in order to pursue their own interests. In order to achieve their goals they use fiscal policy, thereby it often becomes irresponsible. This paper aims to analyze and assess political factors which hinder the efficiency of fiscal policy and generate high and permanent budget deficit and public debt. Moreover, the issue of the impact of fiscal rules on the increase in the effectiveness of fiscal policy has been mentioned. The paper ends with conclusions.

2. Factors impeding the pursuance of effective fiscal policy

Liquidity constraints and polarization of social preferences

One of the factors that may induce pro-cyclicality of fiscal policy may be the access to external financing sources under different economic conditions. This is especially true in the case of developing countries, whose liquidity during stagnation/recession is significantly smaller due to lower reliability of these countries (as compared to the developed and economically stable countries), or these countries are offered high-interest loans. Consequently, the developing countries must reduce spending and cannot excessively increase the budget deficit. The situation changes during booms when it is easier to borrow money, resulting in increased borrowing and increased spending. Therefore, as a result of limited access to international financial markets in times of recession, the developing countries are somehow forced to conduct pro-cyclical fiscal policy (Gavin, Perotti, 1997; Catao, Sutton, 2002; Kaminsky, Reinhard, Vegh, 2004).

One of the latest hypotheses explaining the reasons of pro-cyclical fiscal policy is a hypothesis about the social polarization of preferences resulting from social income inequality (Woo 2006). The strong polarization of social preferences can make it hard for politicians to pursue and implement optimal economic policy on the grounds that they represent the interests of different
social groups. The tendency of different social groups to put pressure on politicians is particularly strong in the period of economic expansion, when increased budget revenues increase the likelihood of meeting the specific demands. In this case, the pressure exerted by various social groups on politicians is such that they will make political decisions which are rational from the perspective of one social group, but inefficient in terms of economy and society as a whole.

**Conflict of interests (budget deficit as a strategic variable)**

In a situation of conflict of interest between political parties, politicians use budget deficit as an instrument of their strategy aimed at preventing or at least impeding the takeover of power by political parties with different preferences in regard to shape of fiscal policy. The ruling parties may tend to use the deficit as a tool with which potential successor will encounter limitations and difficulties in pursuing economic policy. This argument is based on the fact that the current budget deficit causes future costs in the form of lower spending and/or higher tax burden.

Alesina and Tabellini (1990) present a model in which politicians have different preferences as to the structure of budget expenditure. The ruling party which fears losing power to the opposition tends to maintain excessive budget deficit and to make such expenses, that they prefer. If the party actually loses power, the costs of the budget deficit in the form of future spending cuts will affect its successors in the sense that they will have to spend less on objectives they prefer, and which had not been preferred by the party which lost power. In this model, the budget deficit grows when the probability of losing power by the ruling party increases. Moreover, the deficit increases along with polarization of political parties, because the higher the polarization, the more disparate are the objectives and preferences of each party.

**A common-pool resource problem**

An important factor that makes it difficult to pursue a good fiscal policy is a common pool problem. A lot of public spending is targeted to specific groups of voters, while it is financed by all voters (taxes). So we are dealing with redistribution of financial resources, because often those who benefit from certain government spending are not those who pay for. In addition, a group of people who pay (all taxpayers) is larger than the group of beneficiaries. Consequently, there is a difference between the benefit of a group of beneficiaries and the benefit of general public. Politicians tend to over-estimate the social benefits of a particular fiscal policy because they see general benefits for the social groups whose interests they represent, and only a part of the costs in the form of taxes paid by these groups. The result is a common pool problem,
which leads to an increase in budgetary expenditures, especially those which provide local benefits (Von Hagen 2005b).

Therefore, the varied interests of different groups of voters may become a cause of excessive spending and consequently, of excessive budget deficit. The problem arises when politicians who are making decisions regarding the budget represent different regions of the country and want to truly represent the interests of their constituents. In such a situation the politicians will be interested in the implementation of these projects financed by the budget, whose benefits accrue to the region, but the costs are incurred by all the voters (taxpayers). Consequently, the particular region of the country absorbs all the benefits of the expenditure incurred by the budget, but only part of the costs. Subsequently, there is a “surplus supply” of government projects directed to those regions whose interests are most strongly represented by political parties. Therefore, the increase in spending and, consequently, in deficit is the greater, the more regions of the country are represented in the parliament (the government), and thus the greater is the geographical fragmentation (polarization) of the government (Dzialo 2009).

The agency problem and asymmetry of information

The agency problem occurs when one entity (the principal) hires another (agent or contractor) to pursue a specific task assigned by the principal. As a rule, however, the agent who implements assigned tasks, is not only guided by the good of the principal, but pursues his own interests, often different from the interests of the principal.

In the context of fiscal policy, the voters are principals and politicians are contractors, but only the latter have full information about activities they perform. As a result, fiscal policy becomes sub-optimal, since the decisions taken by politicians often do not have a direct relation with the economy and are intended to “please” voters.

Voters do not have full information about the activities of politicians, but are aware that government officials are corrupt to some degree and appropriate part of tax revenues to pay the so-called political rent, i.e. that is to finance their private interests. Therefore, during booms, the voters demand greater utility for themselves (e.g. in the form of lower taxes or higher quality and / or more public goods). This in turn forces the government to increase government spending to finance the production of public goods. In this way, voters are somehow forcing the government to pursue pro-cyclical fiscal policy, demonstrated by lowering taxes, increasing budget expenditure, and increasing the public debt when the economy is in the boom (Alesina, Tabellini, 2005).
3. The main types of fiscal rules

To constrain the freedom of politicians in shaping fiscal policy, fiscal rules are often introduced, that is, quantitative constraints of the deficit, government spending, and public debt, which are usually legitimated by constitutional regulations or related acts of law. Consequently, the fiscal rules are to ensure macroeconomic stability in the economy and improve the credibility of fiscal policy and reduce excessive government deficits. The purpose of the rules is also to maintain the stability of adopted fiscal policy in the long run, as well as to reduce the negative externalities of independent fiscal policies pursued by the countries belonging to a specific federation of countries (e.g., EU countries).

Fiscal rules are usually classified in three groups:

- Deficit rules
- Expenditure rules
- Public debt rules

The deficit rules are in the form of limits, which the deficit cannot exceed in the fiscal year. A special type of deficit rule is a balanced budget rule, which for a long time has been the most popular and in fact the only applicable rule of fiscal policy. As set out by his rule, the total state budget revenues in a given fiscal period must be equal to the total expenditure, while the fiscal period need not be identical with the calendar year (since it can be longer). This rule may also allow for a temporary deficit due to unusual circumstances (a strong recession, natural disasters, war).

One of the modifications of the described deficit rule is the so-called golden rule. Application of the golden rule allows for the deficit only to finance investment spending, while balancing current expenditure. Public debt is a financial source of investment spending. According to advocates of the golden rule, it provides a proper distribution of wealth between generations. Investment expenditures create assets, which will greatly benefit future generations, so it is appropriate in this case, to burden these generations with costs in the form of public debt repayment. It should also be noted that it is important to precisely

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3. C. Cottarelli (approved), Fiscal Rules-Anchoring Expectations for Sustainable Public Finances, IMF, the Fiscal Affairs Department, November 11, 2009.
define the current and investment expenditure in order to prevent possible abuses of the fiscal authorities, who may try to treat the part of current expenditures as investment (Działo 2009).

One of the varieties of sustainable budget rule are also deficit limits. Frequently, they take a form of a regulation that over a certain time (fiscal period); the budget deficit should not exceed a certain fixed, border value, expressed as a percentage of GDP. An example of such a rule is the deficit limit enshrined in the Maastricht Treaty, according to which the deficit in the Member States should not exceed 3% of GDP.

The expenditure rules make take various forms due to the considerable diversity of budget expenditure categories. The vast majority of these rules, however, concern the aggregate expenditure. Probably the most popular are spending growth limits, according to which government spending is to grow at a specified rate, regardless of the changes taking place on the revenue side of the budget. Expenditure rules may also concern particular types of expenditure and usually take the form of long-term limits imposed on various parts of budget spending.

The public debt expenditure rules are fairly uniform and practically not subject to modification. They are based on imposition of limits on the total level of public debt as a ratio of debt to GDP. The best-known public debt rule is the one included in the Maastricht Treaty and repeated in the Stability and Growth Pact according to which the public debt of EU Member States must not exceed 60% of GDP. A similar rule can be found in Poland and is enshrined in the Constitution. The ratio of public debt to GDP should not be higher than 60% of GDP.

4. Advantages and disadvantages of fiscal rules - effective fiscal rules

Each of the existing fiscal rules has advantages and disadvantages. In this context it is important to select rules used in a given country in such a way so as to use their advantages to the greatest extent and at the same time to try to minimize their disadvantages. The basic advantages of the fiscal rules include:

- The rules help reduce the tendency for the deficit and improve the condition of public finance sector, especially when they have strong legitimacy and are supported by mechanisms enforcing their adherence to the rules;
- The rules provide a market signal which increases the credibility of macroeconomic policy;
The rules can help reduce the cost of raising capital through lower interest rates on bonds (which is the indirect effect of higher credibility of macroeconomic policy).

The fiscal rules have also the following disadvantages:

- Some rules result in reduced flexibility of fiscal policy (e.g. the budget deficit rules and public debt rules);
- The rules can lead to reduction of budget expenditures at the expense of capital expenditure;
- The rules may cause aspiration to “bypass” the rules by the so-called creative accounting, or development of extra-budgetary units to which budgetary funds would be transferred in order to spend these funds outside the central budget, etc.\(^5\).

However, the rules usually combine the advantages and disadvantages; there is no rule that would be optimal. For example, the deficit rule based on the structural balance is flexible, sensitive to economic fluctuations, but complicated and not transparent (flexibility for the price of simplicity). The public debt rule is simple, transparent, but it is not enough sensitive to economic fluctuations and may contribute to the pro-cyclicality of fiscal policy\(^6\).

Therefore, it is extremely important to select fiscal rules that would help to implement effectively the objectives set. In this context, it seems that an effective fiscal rules should have the following characteristics:

- The rules should be properly defined (a specific fiscal indicator, precise definition, rules of wide coverage with no exclusions which would reduce their effectiveness);
- The rules should be characterized by simplicity and transparency;
- The rules should be flexible (on the one hand sensitive to economic fluctuations but should also include escape clauses which allow actors to temporarily opt-out of the rule without leaving the rule entirely e.g. in the case of natural disasters;
- The rules should be the most suitable for the objective it serves;
- Conditions for enforcement of rules should be ensured;
- The rules should be supported by a consensus.

\(^5\) IMF Annual Report 2009.
\(^6\) IMF Annual Report 2010.
5. International fiscal rules (European Union)

Joining the Economic and Monetary Union required from the EU countries to fulfill fiscal criteria enshrined in the Protocol on the excessive deficits procedure, annexed to the Treaty on European Union (Maastricht Treaty), signed in 1992. The first criterion assumes that the budget deficit should not exceed 3% of GDP. Since this rule provides some exceptions, e.g. when a high deficit is being reduced in a permanent way and is clearly approaching the designated limit. It is allowed to exceed the limit when it was caused by a strong economic recession. The second criterion refers to the level of public debt and shows that the debt to GDP ratio should not exceed 60%. Also in this case there are exceptions, as long as the rate of debt reduction is strong. Fiscal rules enshrined in the Maastricht Treaty were quite effective and in many EU countries resulted in a significant decrease in the deficit and debt. In 1993, the average deficit in the candidate countries to the euro zone was 5.5% of GDP, while in 1997 the average deficit amounted to only 2% of GDP. In 1999, all countries met the required criteria.

It was only the global economic crisis that caused a sharp deterioration of budget balances in EU countries. However, many countries (including the four largest: Germany, France, Spain, and Italy) maintained budget deficits close to or higher than 3% of GDP even during relatively good economic conditions (before the financial crisis).

Since the Maastricht Treaty has not defined what fiscal policy should be pursued by the EU countries belonging to the Monetary Union, in 1997, new fiscal rules were adopted, enshrined in the Stability and Growth Pact. The Pact imposed on euro area countries the obligation to prepare annual stability plans and convergence programmes for countries outside the Eurozone. The programs include scenarios of changes in public finances for several years, and the so-called medium-term budgetary objective (MTO). According to the objective, the target structural balance should be zero or positive (surplus or structural budget balance) and the EU Council is required to monitor programs and make recommendations to take corrective measures in case of discrepancies between the actual state and the MTO.

The growing budget deficits and debt in many countries, resulting from the recent economic crisis, led the European Commission to strengthen fiscal discipline by introducing changes to the Stability and Growth Pact and in the

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8 Structural budget balance is a hypothetical value of the budget balance with potential economic growth.
national fiscal framework. The definition of “prudent fiscal policy,” was introduced, that is the policy when nominal growth rate of spending does not exceed or is less than the nominal rate of economic growth from the period of several years. A provision was also added that countries with high levels of debt or excessive economic imbalance should improve structural balance by more than 0.5% of GDP annually and the “minimum acceptable rate of public debt reduction to 60% of GDP” was defined. In relation to countries which do not comply with the applicable rules, the sanctions were introduced in the form of non-interest-bearing deposit of 0.2% of GDP, which is then after two years upgraded to a fine if the country at that time did not follow the rules. There is also a threat to suspend access to funds from the Cohesion Fund. The Commission also proposed to introduce the so-called European semester, the review and evaluation of the budgets of countries and their plans for fiscal reform ex ante, prior to their implementation, which will not only foster a better coordination of fiscal policy, but also establish a more effective supervision.

6. Fiscal rules used in Poland

In Poland, the fiscal rules have been applied since 1997, when a provision on public debt appeared in the Constitution. According to the provision, “it is not permitted to contract loans nor provide guarantees and financial sureties, following which the public debt exceeds 3/5 of annual gross domestic product”\(^\text{10}\). The fiscal rule enshrined in the Polish Constitution, has the highest rank in the Polish legal system. This ensures a high efficiency of the rule, because even if the parliament adopts the budget law incompatible with a constitutional provision, such law will be put into question by the Constitutional Court\(^\text{11}\).

Since 2004, Poland as a member of the European Union, is obliged to obey the rules enshrined in the Maastricht Treaty\(^\text{12}\). The legal status of these constraints is high, because they are superior to national law and very difficult

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9 Reinforcing economic policy coordination, European Commission, 12\(^\text{th}\) May 2010.
11 In addition, compliance with the rule is to be achieved by applying the “Prudential and Reform Procedures”, enshrined in the Public Finance Act. However, the provisions forbid (both central government and local government budgets) to borrow when the ratio of public debt to GDP exceeds the thresholds of 50%, 55% and 60% of GDP. These solutions are additional, next to constitutional provisions, fiscal rules, preventing violations of the constitutional public debt rule. See. The Act of 27 August, 2009, on public finances, Journal of Laws No. 157 item 1240.
(almost impossible) to amend. This implies a potentially high effectiveness of fiscal rules enshrined in the framework of the EU law. In addition, it also implies the adoption of a widely used ESA’95 system of official statistics and the need to recognize the decisions of external entity (Eurostat) on controversial issues. In this way, the use of the so-called “creative accounting” is greatly limited which increases the effectiveness of internal fiscal rules, such as the constitutional rule.

However, the rules of the deficit and debt may lead to pro-cyclical policy, especially when the indicator underlying the rule has not been adjusted for fluctuations in the business cycle. First, because the nominal debt growth depends on the size of the deficit, the deficit increases during the economic slowdown/recession following the operation of automatic stabilizers. Therefore, when the economy is growing at a slower pace, in nominal terms, the debt is growing faster. Second, in the case of the debt limit in relation to GDP, the pro-cyclical effect results also from the operation of the denominator (the relation of public debt to GDP, mentioned above): with slower growth of GDP the same debt increase in nominal terms leads to a relatively high ratio of debt to GDP. Initially, when the debt level is lower than the limit, the restriction is almost imperceptible, which makes it possible to pursue a fairly expansive policy and may lead to an increased debt level. When due to the excessive deficit the debt will reach the debt limit, the fulfillment of the requirements of the rule results in the rapid increase of restrictiveness of fiscal policy. It is likely that this moment will fall in a phase of recession because then, the debt increase is the fastest. In such a case there is a need to reduce the deficit at a time when a more expansionary policy would be desirable. Therefore, the fiscal policy becomes pro-cyclical.

With effect from 1 January 2011, a new expenditure rule, the so-called discipline rule entered into force, by which the state budget expenditure is to increase every year up to the inflation rate plus 1 percentage point. The rule will not, however, cover the so-called rigid budget expenditures, i.e. the expenditures enshrined in the Acts (today rigid expenditures account for 74% of the total expenditure), if these expenditures had been incurred before the expenditure rule was introduced. This applies also to the so-called general

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13 To eliminate the problem of pro-cyclicality, attempts are made to use rules based on measures of the structural deficit, i.e., adjusted for cyclical fluctuations. Such is the situation, for example in Chile, where in 2000 a rule was introduced to maintain a structural surplus of 1% of GDP. However, due to the uncertainty associated with the assessment of the cyclical economy situation, which leads to frequent changes in the estimations of the budget structural balance, this approach complicates the enforcement of the fiscal rule and reduces its transparency.

subsidy paid from the budget to local governments or expenditures on defense, as well as pension and health contributions paid for those on parental and maternity leaves as well as for persons with disabilities (the new rigid expenditures will be covered by the rule). The restriction will not cover expenses, which are difficult to predict, such as public debt servicing costs, contributions to the EU budget and international organizations, expenses reimbursed from the EU budget. With the rule of expenditure, the budget is to save PLN 3 billion in 2011 and PLN 5.5 billion in 2012. Were the rule of expenditure in force until 2015, the total budget savings achieved by reducing the increase of expenditure would reach PLN 45 billion. This rule is applicable until Poland is exempted from the so-called excessive deficit procedure\textsuperscript{15}.

It seems that in Polish conditions, the rule of expenditure has the most advantages because of its simplicity and clarity, and also because it does not contribute to an increase in pro-cyclical fiscal policy.

7. Conclusions

The considerations carried out in this article permit to draw the following conclusions:

- In many countries, the fiscal policy is largely pro-cyclical. One reason for this situation may be a difficult access to external funding, especially in developing countries. During the period of stagnation/recession the developing countries have limited liquidity because of their relatively low reliability. As a result, they are usually forced to reduce spending and cannot excessively increase the budget deficit. Therefore, in times of recession, developing countries are in a sense forced to conduct pro-cyclical fiscal policy.

- Another cause for pro-cyclical fiscal policy may be polarization of social preferences, resulting from unequal income distribution in society. Politicians represent various social groups, and the pressure exerted by various social groups on politicians may cause that they would make political decisions rational from the perspective of one social group, but inefficient in terms of economy and society as a whole. The pressure exerted on politicians is particularly strong during the period of economic expansion, when growing budget revenues increase the likelihood of implementing the requests of individual social groups.

\textsuperscript{15} Gazeta prawna.pl, 4 January 2011.
• Conflicting interests between politicians of diverse preferences may give rise to excessive government deficits. When such a conflict exists between political parties, the politicians use the budget deficit as an instrument for their strategy aimed at preventing or at least impeding the acquisition of power by political parties which have different preferences with regard to the shape of fiscal policy. There may also be a common pool problem where the different groups of politicians/voters fighting for the use of budgetary funds induce the increase of the deficit.

• Diversification of interests of particular groups of voters and the politicians representing them is an important reason for the emergence of excessive government deficit. Politicians tend to use a common pool (taxes) to finance the needs of their own (local) voters. As a result, the particular region of the country receives great benefits from budget expenditure, but bears only part of the cost. There is pressure to direct public resources to those regions that are most strongly represented by political parties. The increase in spending and the deficit are the bigger; the more regions of the country are represented in the government (parliament).

• An important reason for pro-cyclical fiscal policy and excessive budget deficit is asymmetry of information and the agency problem. If voters do not believe politicians, suspecting them of corruption and grabbing political rent, they demand higher spending or tax cuts when the economy enters a phase of expansion. Otherwise, voters would be afraid that the profits from the healthy economy would end up mainly in the pockets of politicians. For the same reason voters do not allow for accumulation of financial assets generated during the period of expansion, they would rather have the government generate debt, which would force the government to use its funds to pay off the interest, instead of grabbing the political rent. This causes excessive growth of the budget deficit, public debt and the procyclicality of fiscal policy.

• Many countries have quantitative fiscal rules mainly to improve the reliability of the pursued fiscal policy and reduce excessive government deficit. The most commonly used fiscal rules include the budget deficit, public debt, and expenditure rules.

• Fiscal rules, if properly applied, can be an effective tool for fiscal consolidation. The effectiveness of the rules is largely dependent on the practical possibility of their non-compliance (“by-pass”). One can specify the conditions under which fiscal rules should demonstrate higher efficiency. Precisely formulated rules relating to the actual condition of the state budget and not to its predictions, and those that are legally authorized (enshrined in
the constitution) give a better chance for effective action in the form of lower budget expenditures and lower deficit.

• The weakness of the rules is the fact that they constrain the flexibility of fiscal policy (in the case of the budget deficit and public debt rules) as well as certain possibilities of avoiding the rules by creation of extra-budgetary entities (e.g. earmarked funds) which spend public funds by bypassing the central budget.

• The budget deficit and public debt rules used in Poland are simple and transparent, which can be regarded as their advantage. They have also high legal status. On the other hand, however, the major weakness of the rules is that they can lead to pro-cyclical fiscal policy.

• The expenditure rule, introduced in 2011, seems to be a good solution for the Polish public finances. It is also simple and transparent, like the fiscal rules, but does not have the drawbacks of the fiscal rules: the expenditure rule does not promote pro-cyclicality of fiscal policy. Consequently, the expenditure rule may be one of the instruments giving rise to the gradual reduction of budget deficit and public debt.

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**Streszczenie**

REGUŁY FISKALNE A EFEKTYWNA POLITYKA FISKALNA

Artykuł poddaje analizie i ocenie wpływ czynników politycznych na efektywność prowadzenia polityki fiskalnej. Czynniki te z reguł przyczyniają się do powstawania i utrzywiania wysokiego deficytu budżetowego i długu publicznego. Ponadto, poruszone zostały problemy wpływa reguł fiskalnych na zwiększenie skuteczności prowadzonej polityki fiskalnej. Reguły fiskalne poprzez ilościowe ograniczenie poziomu deficytu, wydatków rządowych lub długu publicznego mają zapewnić stabilność makroekonomiczną w gospodarce oraz poprawić wiarygodność prowadzonej polityki fiskalnej i redukcję nadmiernego deficytu budżetowego. Zaprezentowane zostały przykłady stosowanych reguł fiskalnych w UE i w Polsce oraz podjęta została próba oceny skuteczności tych reguł w procesie konsolidacji finansów publicznych.