COMMENTS ON SESSION 3:
PUBLIC SPENDING AND FISCAL POLICY MANAGEMENT

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My comments cover recent or ongoing fiscal adjustment episodes in India, Sweden, Bulgaria, Portugal and Japan, discussed in the chapters by Pattnaik, Bose, Bhattacharyya and Chander, Hansson-Brusewitz and Lindh, Nenova-Amar, Braz and Cunha, and Miyazaki, respectively. The authors provide informative and competent analysis of these episodes, with enough food for policymakers. Instead of a detailed critique of each chapter, I shall attempt to give a broad comparative assessment.

Apart from the fact that these case studies are intrinsically interesting, I welcome them because of their potential relevance for the new EU members in Central Europe (mainly Czech Republic, Hungary, Poland), currently engaged in indulgent fiscal behavior[1] though aspiring to join the euro area by the end of the decade. From this perspective, I would like to explore the lessons that can be drawn from these five episodes mainly for the new EU members in their convergence to the fiscal reference value to qualify for the euro.

The episodes under consideration, while displaying some common characteristics, offer in fact a rich and diverse experience. Whereas their level of economic and institutional development ranges from a developing stage (India) to an advanced stage (Sweden and Japan), all experienced similar initial conditions: a deficit bias and a major sustainability problem. At the outset, all countries faced considerable structural weaknesses and expenditure rigidities; an added structural impediment to adjustment was India's highly decentralized federal fiscal system. In all five countries, we can find the necessary technical capacity – financial literacy, information system, etc. – to design and implement a fiscal adjustment program.

There has been fairly widespread recognition of the need for structural reform, involving mainly rationalization of social entitlements and other current expenditure programs, instead of merely relying on one-off across-the-board expenditure cuts. But not all countries were equally successful in pruning primary current expenditure; in particular, India thus far opted in part for reducing capital outlays. Besides restraining expenditure, Japan had also raised the value-added tax rate, given its relatively low ratio of government outlays and revenue to GDP.

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[1] See G. Kopits and I. Szekely (2003), "Fiscal Policy Challenges of EU Accession for the Baltics and Central Europe," in G. Tumpel-Gugerell and P. Mooslechner (eds.), *Structural Challenges for Europe*, Cheltentham, Edward Elgar, on the fiscal laxity in the new members in Central Europe, as distinct from the fiscal discipline in the Baltics. For an analysis see H. Berger, G. Kopits and I. Szekely (2004), "Fiscal Indulgence in Central Europe: Loss of the External Anchor?", IMF, Working Paper, WP/04/62, April.

The framework of adjustment differed across countries. Aside from Japan, which had in fact abandoned its current-balance rule, all countries relied to a greater or lesser extent, formally or informally, on a rules-based framework. Both Sweden and Bulgaria established a binding constraint on the overall balance in the mid-Nineties, following severe currency and banking crises. In Sweden, the government is legally required to maintain a structural budget surplus and to abide by a limit on primary expenditure set over a rolling medium-term horizon – both rules being stricter than the applicable EU Stability and Growth Pact (SGP). In Bulgaria, consistent with a currency board arrangement established in the wake of the crisis, the government has been bound by an informal balanced-budget rule.[2] To facilitate compliance with these rules, both countries undertook an in-depth reform of their welfare programs, which broadened the scope for discretionary spending. In sum, combination of the fiscal framework and a coherent monetary framework has made a major contribution to macroeconomic stability and growth.

As a participant in the euro area, in principle, Portugal's adjustment effort was intended to meet the annual targets specified in convergence programs under the excess deficit procedure pursuant to the SGP. However, the annual targets were barely met (or not met at all) through one-off expenditure cuts (albeit including reduction in subsidies) or application of creative accounting practices. Recently, having learned from this experience, the authorities have embarked on a more credible adjustment effort, with the support of structural reform steps.

Of all the countries under scrutiny, India faces the greatest challenge in the period ahead. As the most fiscally decentralized economy in the group and with a very large public sector deficit and indebtedness for an emerging-market economy, it intends to liberalize its external trade and payment systems. To tackle this task, the authorities have enacted a rules-based fiscal responsibility legislation at the federal level, to be emulated over time by most state governments. This initiative is seen as promising, but its success will require major reform in a number of fiscal areas.

Japan stands alone in several respects. The track record shows continuous application of discretionary demand management – to cool the economy in the Eighties and then to stimulate it since the Nineties – that for the most part has been met with very limited success. Besides difficulties in fine-tuning the fiscal adjustment, unlike in the other countries, these efforts have been offset by what appears to be a case of Ricardian equivalence in action. As high public indebtedness and recurrent deficits seem to be compensated by high saving propensity in the household sector, perhaps Japan's intertemporal budget constraint will always be satisfied and its sustainability problem soleved – not much of a benchmark for most other countries.

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[2] This stands in stark contrast with Argentina's currency board arrangement in the Nineties when, on average, the externally-financed actual public sector deficit had exceeded 4 per cent of GDP yearly, which – not surprisingly – contributed to the ensuing currency crisis. See M. Teijeiro (2001), "Una vez más la politica fiscal…," in M. Lascano (ed.), *La Economia Argentina Hoy*, Buenos Aires, Centro de Estudios Públicos.

Overall, our comparative review of the above episodes suggests that Sweden and Bulgaria experienced the most successful fiscal adjustment, in terms of its durability and contribution to sustained growth. The track record in Portugal and Japan has been rather mixed, while in India the adjustment has barely begun. In these last three cases, however, recognition of past mistakes and likely correction holds out the promise of future success.

A number of important lessons, particularly useful for the new Central European EU members, can be distilled from the collective experience of these five countries. First, a rules-based policy framework is superior to a discretionary approach. In particular, a balanced-budget rule plus a ceiling on primary outlays are key elements of such a framework. The balanced-budget rule should possibly be defined in cyclically-adjusted or structural terms, so as to allow for the operation of automatic stabilizers.

Second, the framework should provide for a rolling medium-term budget plan, quantifying major expenditure priorities. The reduction in primary outlays can be complemented with nondistortionary revenue-enhancing measures – with emphasis on broadening the effective tax bases rather than raising statutory rates – in countries characterized by a relative low tax yield.

Third, instead of reduction in productive infrastructure investment or of one-off across-the-board spending cuts, the bulk of the adjustment should consist of structural reform measures – including in areas such as civil service and social security. Reform steps do not always result in immediate budgetary savings, but they serve to relax expenditure rigidities, to ease fiscal stress in the medium run, and to ensure fiscal sustainability in the long run.

Fourth, sustained political support for the adjustment is essential. Unfortunately, support can be mobilized much easier in a crisis situation (Sweden and Bulgaria) than in tranquil times (Portugal). In general it is the responsibility of party leaders to join forces in generating the necessary support by alerting voters as to the costs of postponing much-needed adjustment in the face of a looming sustainability problem.