

COMMENTS ON SESSION 3: PUBLIC SPENDING AND FISCAL POLICY MANAGEMENT

*Balázs Romhányi**

Three of the papers in this session are covered in my comments. First I'll talk about each of them separately and then I'll raise two broad issues, which are connected – to some extent – to the first two of them.

The main message of the Fedelino and Hemming's paper (FH) is that any fiscal indicator has to be analyzed from an incentive point of view, before using it as a policy target in any specific situation.

It is clear that once investments are excluded from the targeted category of fiscal deficit (especially when the target is set by outside actors, e.g. the IMF), there is a strong incentive for the government to classify public consumption as investment and, in many cases, this is not very difficult due to practical problems of the separation but, in my view, the statistical classification problems are no excuse for washing away the conceptual difference between consumption and investment. The key question is whether expenditure finances itself in the form of enhanced economic growth (in corporate finance language, the net present value is positive of the project). In this sense, education or health expenditures are candidates for being classified as investment into human capital. It is true that no single expenditure item in the standard fiscal reports seems to be immune to the problem of classification or, put in another way, there are no so-called growth-enhancing expenditure items (not even R&D is a safe bet).

The problem from an economic policy point of view is that even a project with a highly positive net present value can cause problems in the aggregate demand management.

According to FH, "Irrespective of the accounting principles applied and the fiscal balances targeted, public investment needs to be financed from public resources, and it contributes to demand pressures just like other government spending."

As it is already cited (from Vito Tanzi) in the paper, "... a range of fiscal indicators should be used". Here we have to raise the question: What do we want to measure by the deficit? There are at least three different concepts:

- long-term sustainability (net change of government wealth);
- government liquidity (net change of financial assets);
- inflationary pressure (short-term aggregate demand).

* Ministry of Finance, Hungary.

It is not completely obvious that demand pressure is always the most important from society's or even economic policy's point of view. It might well be true that in cases where the IMF steps in to assist in handling or preventing macroeconomic crises, short-term demand is usually the main concern, but (fortunately) this is not always the case. FH acknowledges that "...where macroeconomic stability and debt sustainability are not pressing concerns for fiscal policy, a supplementary target for the current balance can limit the government's ability to utilize any scope it has for additional borrowing to finance tax cuts or increased current spending".

This leads us to the next question: what do we want to use the deficit indicator for? Here again we have several options, e.g.:

- economic modeling;
- have a simple "early warning system" for the society about fiscal affairs;
- justify (peer) pressure on malevolent politicians.

The above citation shows that the authors are sympathetic with the third view, but (unfortunately) come to the conclusion that "there is no magic bullet when it comes to safeguarding public investment".

My personal conclusion is somewhat different: if we want to use the deficit indicator "against politicians", then institutional arbitrage has to be excluded (e.g., the arbitrary distinction between *real* and *financial* assets) and hence private sector accounting standards should rather be used as much as possible (e.g., depreciation should be substituted for investment, that is now *de facto* solved in the form of PPP availability fees). The informational asymmetry problem due to the separation of ownership (principal/citizens) and management (agent/politicians) has been a well-known problem for several hundreds of years. To a large extent, the development of private sector accounting practices is an answer to the problem of institutional arbitrage. Hence the main message is that any fiscal indicator has to be analyzed from an incentive point of view before using it as a policy target in any specific situation.

The central finding of the Paternostro, Rajaram and Tiongson's paper (PRT) is that to maximize efficiency of international donations or any other form of assistance to fight poverty, the receiver side has to be adequately analyzed. The key sentence is: "There is, however, growing concern regarding the wisdom of relying so heavily on social sector spending to promote poverty reduction. The OED finds that a different balance between social and other sectors, particularly infrastructure and rural development, may be warranted for mobilizing investment to promote growth, a necessary condition for sustainable poverty reduction".

The effect of fiscal policy (or, in a narrower sense, government expenditure) on poverty is, hence, partly related to its effect on long-term growth. Unfortunately, private sector investment doesn't show up in the framework proposed, though crowding in and crowding out is an important issue from this point of view.

On one hand, PRT claim that “The paper sketches out such a framework as the first step in what will have to be a longer-term research agenda to provide theoretically and empirically robust and verifiable guidance to public spending policy”. On the other hand, however (in the section about application of the proposed tax-and-transfer scheme), they acknowledge that “...the impact on Y [output] in the longer-run is an empirical question”. On the whole, we can only conclude that first we need a flexible enough theoretical model, but its parameters have to be estimated or calibrated on a case-by-case basis. For this second step, the receiver side has to be analyzed adequately.

The main point of the Giordano, Momigliano, Neri and Perotti’s paper (GMNP) is that the type of government expenditure matters a lot.

I have a few minor question marks from a technical point of view. First, it is not completely convincing that empirical results of an open-economy VAR model cannot be affected by the inclusion of some “international” variables such as exchange rates or foreign interest rates. My suspicion is somewhat supported by the result that, according to GMNP, “The largest negative shocks to purchases take place in the third quarter of 1992 and in the last quarter of 1997”: two periods when “international” variables did change a lot. Especially 1992Q3 is also a candidate for introducing a structural break into the series.

The private real GDP is free from the government-output and efficiency-measurement problem, but can be a poor proxy for our preferences. Modeling the interaction between private and public output will be needed before using the results for policy advice.

The model only distinguishes wage and non-wage expenditures, but the composition of the wage shock should matter as well. Based on the identity that:

$$\text{Wage bill} = \frac{\text{wage}}{\text{hour}} \times \frac{\text{hour}}{\text{employee}} \times \text{number of employees}$$

we should expect different effects of an increase in government wage rates (per hour), changes in regulation (e.g., 38-hour work week) and increase in government employment, since they imply completely different effects on the private sector. The core statement that “the type of government expenditure matters a lot” could be amended: the way of spending the money matters as well.

Finally, based on these papers, I’d like to mention briefly two broad issues for further debate.

1. The concept of fiscal deficit

By accepting some corrections of the Maastricht deficit indicator when using it for the purpose of the Stability and Growth Pact, the positive and normative concept of the fiscal deficit is officially separated. In the future we might see the development of an array of fiscal indicators tailor-made for different purposes

(effect on long-term growth, short-term demand or poverty), analogous to the development of quantity of money concepts (M1, M2, etc.) in the Seventies and Eighties.

2. When applied to fiscal policy, the mainstream neoclassical framework of economic policy analysis has to be amended by behavioral, institutional and transactions costs effects

PRT point out that "... unlike tax policy, where the theory of optimal taxation was developed, there is not a comparable theory of optimal expenditure policy that provides comparably well-defined rules for expenditure allocation". In my view, the "neglected middle ground between the disciplines of public economics policy and the theory of economic growth", as they call it, might not exist. Solid micro-foundation (allowing for behavioral, institutional and transactions costs effects) might be a better starting point.

FH state that "Public investment should naturally decline over time as the public capital stock is built up". In my opinion, the demand for public capital stock is a matter of technology and preferences. It depends on the (1) capital intensity, (2) public or private nature and (3) the scope for public or private provision of newly-developed goods and services. One of the key variables in technologies are transactions costs (in a broad sense). There is no clear theoretical reason for assuming a constant demand for public goods while the demand for private goods increases. Whether public goods (e.g., airport safety) can be supplied by private producers (e.g., privatized airports), which are formed from private fixed capital, is a matter regarding institutions, transaction costs (can we efficiently control private airports?) and behavior (is an official policeman more deterring than a private bodyguard?).

PRT cite Duncan and Pollard (2002): "... have identified the building blocks necessary – such as social order, good governance, and functioning markets – prior to any government investment for poverty reduction". This sort of ordering doesn't seem to be very helpful in achieving policy goals. I rather prefer the approach of Merton and Bodie (2004) in "The Design of Financial Systems: Towards a Synthesis of Function and Structure" (NBER, Working Paper, No. 10620): institutions are invented and evolving over time in order to get closer to the ideal world of neoclassical general equilibrium. Evolution of markets and institutions is complementary.