COMMENTS ON SESSION 3
FISCAL POLICY AND FISCAL RULES

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1 Introductory remarks

Fiscal policy needs rules. This is because policy makers (and their voters and advisers) tend to accept high deficits and debt "in the short term" in the pursuit of various worthy goals, while leaving the task of achieving sustainable public finances for the future. Excessively high debt is the consequence, which eventually limits the room to manoeuvre in terms of fiscal policy. As the financial market crisis and the rapid swings in confidence in public finances in some countries have shown, there is a need for both effective rules for ordinary times and appropriate exemption clauses for exceptional circumstances. A key challenge when designing an exemption clause is to provide some flexibility while at the same time preventing the exemption from becoming the rule and ultimately subverting the objective of the original rule. The discussion about fiscal stabilisation measures in the context of the crisis and about how to exit from them underscores the difficulty in this regard as it shows that there is no consensus about the exact nature of an "extraordinary event" (as distinct, for example, from an unpleasant event) and the appropriate policy response.

An important aim of fiscal rules for ordinary times is to support a sustainable fiscal policy by curbing the deficit bias. As a side product, this helps to ensure that public finances are in good shape when an emergency arises. A major difficulty for fiscal rules in crisis as well as ordinary times is the significant uncertainty when forecasting public finances and the difficulty defining (conceptually and in practice) appropriate indicators and quantitative thresholds to mechanically assess the state of public finances. Here, an independent fiscal agency or another monitoring arrangement that provides policy makers and the public with information on public finance developments and prospects, and evaluates specific fiscal policy measures can play an important role. However, since there is often no consensus about the state of public finances and the best policy measures, responsibility ultimately lies with elected parliaments and governments (or sometimes, where the issue is compliance with legislation, with the courts). At the same time, the large degree of uncertainty suggests the advisability of prudent fiscal planning and an adequate adjustment mechanism, which implies a smooth (preferably non-cyclical or anti-cyclical) and efficient correction after unintended deviations from fiscal plans. Another issue is enforcement in case of intentional rule-breaking. Besides political economy aspects, enforcement is complicated since plausible reasons will often be put forward to justify a violation of the rule. If the rule includes smooth adjustment mechanisms for cases of truly unexpected developments, enforcement can be more rigorous, however.

The two interesting contributions "Fiscal Institutions in New Zealand and the Question of a Spending Cap" by Tracy Mears, Gary Blick, Tim Hampton and John Janssen, and "Impact of the Global Crisis on Sub-national Governments' Finances" by Teresa Ter-Minassian and Annalisa Fedelino highlight important aspects relating to fiscal institutions, fiscal rules and fiscal stabilisation policy. The discussion in the following sections partly draws on the observations outlined above.

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The views expressed here are those of the author and do not necessarily reflect those of the Deutsche Bundesbank.

2 Comments on "Fiscal Institutions in New Zealand and the Question of a Spending Cap" by Tracy Mears, Gary Blick, Tim Hampton and John Janssen

The paper starts by describing fiscal developments and the performance of the fiscal policy framework in New Zealand over the past decade. Generally, the authors attest a good performance regarding net debt. This raises the question of how the institutions would have performed in bad times and how reliable net debt, which is difficult to measure, is as an indicator. As a crucial problem within the current fiscal framework the authors identify that it did not prevent the strong rise in government spending in relation to GDP after 2004-05. Even though the expenditure ratio is still relatively low by international standards, the increase is problematic if it is related to the spending of temporary revenue windfalls and reflects a suboptimal rise in spending in good times. To the extent that spending was too high because of a lack of timely information on the true state of the economy and public finances – which is probably the case at the current junction, but may not have been the problem in the first years after 2004 – one would not necessarily speak of a failure of institutions, but rather rethink the quality of budgetary forecasts and the set of fiscal indicators employed. However, taking into account the known forecast uncertainties and considerable forecast errors, which complicate public finance analysis,[1] it also seems warranted to consider additional thresholds or limits that can support a sustainable fiscal policy with a medium-term orientation.[2]

Against this backdrop, the authors propose a spending cap as an additional element of fiscal institutions in New Zealand. Several general caveats apply to spending rules. For example, the delineation is often unclear, in particular in terms of tax expenditures, outsourcing activities or price effects. Furthermore, an increasing expenditure ratio might not be due to a spending bias and therefore be suboptimal. Instead it might be the consequence of evolving preferences over time (e.g., increasing preference for social security). Keeping these caveats in mind, the proposed spending cap can help to prevent unexpectedly high revenue from being spent immediately (as would be possible within the confines of the current deficit rule). It has to be noted, however, that the proposed cap is relatively complex. *Inter alia*, several budgetary items are excluded from the cap, which might aggravate the problem of delineation. With regard to unemployment expenditure, it seems to be more straightforward to adjust this item for cyclical factors than to exclude also its structural development from the cap. Generally, one might consider defining the cap in terms of cyclically-adjusted expenditure and to take (expected) developments of trend nominal GDP – as a reference line for a neutral expenditure path – into account.

As an alternative to the spending cap that would avoid some of the problems with spending rules outlined above and address more directly the problem that unsustainable revenue windfalls might be spent under a deficit rule, one might consider capping fiscal loosening after unexpectedly favourable developments in terms of cyclically adjusted tax revenue. This forms part of the proposals by Kremer and Stegarescu (2009).[3] It – as similarly in Mears *et al.* – also addresses the problem that overly strict rules might be procyclical in case of negative revenue surprises (which often coincide with bad times). To this end, it is proposed to combine a target for the cyclically adjusted deficit ratio with a symmetric and gradual adjustment mechanism to return to the target after an unexpected revision of the forecast for cyclically adjusted tax revenue. Furthermore, the

[1] See, e.g., Morris *et al.* (2009), "Explaining Government Revenue Windfalls and Shortfalls: An Analysis for Selected EU Countries", ECB, Working Paper, No. 1114, regarding the problem of measuring the "underlying fiscal position".

[2] In addition, it might be worthwhile further investigating the role of the distinction between formula-driven indexed items and others in the current framework. Ex ante indexation might be particularly problematic in times of negative growth surprises. Furthermore, with stricter rules – as for example with an additional spending cap – the issues of transparency, bypassing and enforcement of rules might become more relevant.

[3] Kremer, J. and D. Stegarescu (2009), "Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik", Wirtschaftsdienst 09/2009, pp. 630-36 (English version available).

need for and adequate size of safety margins – which is also an issue in the proposal of Mears *et al.* – are discussed.

3 Comments on "Impact of the Global Crisis on Sub-national Governments' Finances" by Teresa Ter-Minassian and Annalisa Fedelino

Against the backdrop of the recent experiences, Ter-Minassian and Fedelino address problems that arise if cyclical conditions and economic shocks differ between regions and if fiscal policy is not adequately coordinated between different government levels. In this case, the policy pursued in one region or government level may offset the (discretionary or automatic) fiscal impulse of another region or level. Furthermore, spillover effects or the specific assignment of competences mean discretionary fiscal stimulus may be more effective if coordinated between regions and levels. In addition, achieving sustainable public finances is a common task for all government levels. Generally, these observations demonstrate that the design of fiscal rules at all government levels should be consistent with the overall fiscal policy aims and highlight, in particular, the importance of sub-national fiscal rules – where details naturally depend on country-specific federal structures.

In this context, the distinction between the rules for ordinary times (e.g., ordinary economic cycles) and exemptions for extraordinary events (e.g., current crisis) appears highly relevant. Generally, the recent experiences in times of crisis do not seem to suggest a fundamental review of discretionary stabilisation policy and fiscal federalism issues in ordinary times. Given the familiar problems of regular economic fine-tuning, a discretionary stabilisation policy during ordinary economic cycles does not appear advisable – be it coordinated or uncoordinated between different government levels and regions. In terms of major obstacles, namely the lack of suitable methods to assess economic conditions in real time (where scepticism has grown rather recently) and the asymmetry of fiscal policy interventions owing to the political debt bias, the fine-tuning of fiscal policy to specific regional developments is most likely even more error-prone than stabilisation policy at the national level.

On the other hand, reforms that allow a smoother working of automatic stabilisers in federal states, for example a better alignment of the fiscal rules at specific government levels and improvements to the degree of volatility of the respective budgets, could be addressed more seriously. In this context, shifting cyclical budgetary fluctuations to higher (central or state) government levels by providing regional levels – in accordance with mainly exogenous expenditures and balanced budget rules – with stable revenue (via transfers from higher to regional level) and a moderate fiscal equalisation system among regions to dampen asymmetric regional shocks on public finances seems relevant. In addition, the crisis underscored the need to design exemption clauses for "extraordinary events" more carefully. An important task here is to prevent over-fulfilment in the sense that overly broad exemption clauses might undermine fiscal policy aims in ordinary times. With a view to federal structures, some shortcomings in dealing with extraordinary events were revealed during the recent crisis. In particular, for the timely and efficient implementation of discretionary stabilisation measures in the case of an extraordinary, self-reinforcing economic downturn (e.g., speedy increases in government investment by regions that might face binding budget constraints), the demands placed on a fiscal federation in terms of coordination and monitoring might be higher than in ordinary times.