COMMENTS ON SESSION 1
NATIONAL FISCAL FRAMEWORKS: THE EXPERIENCE

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Discussion of "Laws for Fiscal Responsibility for Subnational Discipline: International Experience" by Lili Liu and Steven B. Webb and of "Towards (More) Appropriate Fiscal Policy in Slovenia" by Slaven Mićković

The two papers presented here offer different, complementary, perspectives on fiscal rules and institutions. Liu and Webb offer an analysis of tools that governments adopt to keep themselves from the brink of "excess," by which I meant unsustainable, or otherwise undesirable, levels of public indebtedness. An important part of this exercise is a cross-national examination of restrictions placed on the liabilities of subnational governments. Rules of the sort that Liu and Webb discuss are *ex ante* commitment devices, restricting the public sector's ability to expand public debt, thus avoiding rapid, unplanned changes in fiscal policy. Mićković's analysis discusses a particular form of this kind of rule, primarily in the context of the Slovenian central government. This, at least, is a partial interpretation of the concept of Budgeting with Impact (BwI). BwI, with its emphasis on the interaction between fiscal decisions and macroeconomic outcomes, chooses meeting macroeconomic targets as an *ex ante* way of guiding fiscal choices and ensuring that they remain consistent with public objectives.

Mićković also explores the more dire situation faced periodically by governments, and many today, wherein existing *ex ante* restrictions have failed to restrain deficits sufficiently, and a fiscal crisis, or at least outcomes incompatible with broader fiscal stability, loom. Medium-term Objective setting (MtO) is intended to bring public budgets into alignment with fiscal rules imposed from higher-level authorities, in this case those imposed by the EU's Stability and Growth Pact.

Before discussing the effectiveness of the particular kinds of rules presented here, it is worth putting them in the broader context the need for and mechanisms for achieving fiscal discipline. Both papers start from the premise that fiscal rules are necessary – that is, we cannot rely on the voluntary actions of policy makers – either individually or collectively – to restrain spending sufficiently to achieve socially optimal outcomes. In the current context, with governments around the world and especially in Europe experiencing the costs of excessive deficits, this seems natural. But in evaluating the effectiveness of various kinds of fiscal rules, it is useful to remind ourselves of the features of public budgeting that make such rules necessary. For we do not insist on specific rules for private companies' actions with respect to their borrowing, rather we insist on transparency as to what debts are, and the mechanisms by which they are to be repaid. Why, then, do we single out the public sector for especially strict regulation?

Three principal differences between public and private sector borrowing strike me as relevant. First, public sector decision makers are short-lived relative to their private sector counterparts, and thus face incentives to reap the benefits of excellent public services (*i.e.*, high spending) today, while leaving the bills to be paid by the next generation of officials (through debt finance paid for by compulsory taxes levied on future generations). This *time inconsistency* problem is disciplined in the private sector by the fact that the long run value of the firm will

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incorporate the decisions made by today's decision makers, meaning that today's shareholders face incentives to ensure that the firm's borrowing does not result in reductions in firm value. The concept of public sector ownership is much more diffuse, and for many governments there is no analogue to this concept of ownership, since it is far less easy to exit "ownership" of a particular government than it is a particular private sector firm. Indeed, the latter requires a call to one's stock broker, while the former requires establishing residence in a different country. (In the case of subnational governments, of course, things are less obvious, and I return to this setting shortly.)

A second important difference between the two sectors has to do with their objectives. In the private sector, owners agree that maximization of profits – and thus the value of the firm – is the principal goal of the enterprise, and all decisions may be judged against that rubric. In the public sector, objectives are almost as numerous as constituents, and, even in a democracy, the government in power may not share the objectives of a significant part of its citizenry. This means that some decisions that lead, for example, to a reduction in long run economic growth may be chosen because they have distributional consequences deemed favourable by the ruling party. The difficulties of collective decision making are well known, and while by no means absent in the private sector, are likely more likely to cause difficulties in the public sector.

A final important difference between public and private sectors is the sheer complexity and magnitude of the budgets involved. Governments provide a multiplicity of services, often financed with earmarked taxes or fees. Sometimes these fees are intended to exactly cover the costs that the government incurs in providing the service, but other times they intentionally fall short, producing an implicit subsidy, or provide a surplus that can diverted to other uses. General-purpose revenues come in many different forms – excise taxes, income taxes, value-aded taxes – and may fund a very wide variety of public services ranging from ones that arguably increase future incomes (and tax bases) like education and infrastructure investment, to ones that likely increase consumption in the near term, like transfer payments to needy individuals. In addition, many of today's fiscal decisions create contingent liabilities of uncertain value, like public pension plans. Keeping track of the details of all these funding sources and expenditure objects and their implications for the future is extremely difficult when reporting is well-designed and transparent. When it is not, the ability of ordinary citizens to effectively monitor public sector liabilities is non-existent.

Each of these three features of public finances creates problems for ensuring that budgets remain consistent with a country's long-term economic objectives. Can the private market overcome these obstacles? One natural mechanism to consider is the bond market. Don't bond investors – or bond rating agencies – have an incentive to ensure the sustainability of public finances and the means to invest in gathering the required information? Yes, but only to a limited degree. Like many other constituencies, bond investors care about only one part of the total problem faced by the citizenry – in this case, whether debts will be repaid in a timely manner. This is, of course, a matter of substantial importance, but does not provide citizens with the comprehensive view of budget impacts that they require. As recent activity in Greece indicates, sovereigns typically place a high priority on debt repayment, even when avoiding default requires wrenching macroeconomic adjustments that citizens would much prefer to avoid.

At the subnational level, a substantial literature implies that a well-informed citizenry may face exit costs that are low enough to discipline fiscal policy making. In this case, we would expect to observe negative capitalization of subnational debts (net of assets) into local asset values – particularly land and housing – without the need for strict regulation. The key problem here is, however, the information requirement. Calculating the net present value of *all* subnational governments' fiscal positions is necessary for asset values to accurately reflect the relevant variation, and there is little consistent evidence in the literature that capitalization goes much beyond current tax rates and school quality. Full, consistent, transparent reporting of fiscal positions might allow the combination of mobility and capitalization to send the appropriate market

signals to citizens and their governments, but we are a long way from that situation at present. In addition, the potential for central government bailouts of wayward subnational governments further undermines the ability of mobility and capitalization to provide needed discipline.

We are thus left with the need to regulate, even at the subnational level, and the real substance of these two works. Mićković's discussion of BwI may initially seem an uncomfortable fit for a volume on fiscal rules, since it is focused on what has become known in the US as "dynamic scoring". In essence, the idea is for policymakers to evaluate the long run impact of macroeconomic outcomes on fiscal variables – this part oi standard – and vice versa – and this part is much more controversial. Budget forecasts are often made, and the costs of policy changes are evaluated, in a static framework. For example, a permanent one hundred basis point cut in income taxes would be calculated as 1 per cent of baseline income each year. Advocates of dynamic scoring, however, might argue that reducing taxes in this way will stimulate income growth by increasing capital investment and labor supply, and the final cost will be much less than static scoring would imply – income growth induced by the change in tax policy will offset much, or perhaps all, of the effect of rate reductions.

But how is this debate over scoring policy changes related to fiscal rules? At the heart of the Mićković concept of BwI, in my view, is to make determinations about various macroeconomic targets – the level of aggregate income in the previous example – and design fiscal policy in such a way as to come as close as possible to these targets, with "close" defined in a reasonably rigorous way. The particular form of targeting proposed here is to minimize the sum of squared deviations of realizations from targets. A couple of issues arise, some minor, some major. On the minor side, it is important to make the units consistent so that two objectives may be balanced on an equal basis – otherwise Euro-denominated GDP deviations would swamp unemployment deviations. Also, what is the correct timeframe for this analysis? Shorter timeframes raise the problem of time consistency described above, while longer ones lead to the introduction of considerable uncertainty.

More major issues are related: what macro outcomes are to be included in the list, and how are they to be weighted? Who is to provide the estimates of the general equilibrium model that is required? How are exogenous, non-fiscal, shocks to be accommodated? In the US, questions like these have made the concept of dynamic scoring difficult to implement even as a way of evaluating the impacts of a particular policy initiative. Making hard and fast *rules* on such a basis makes the stakes even higher, and may lead to significant controversy along all of these dimensions and likely many others I have not mentioned. Thus while the feedbacks between fiscal decisions and private macroeconomic outcomes are extremely important, and are in some sense the fundamental driver of fiscal rules, formalizing them is complex, and requires many necessarily subjective elements.

Many of the fiscal rules summarized in the very fine international compendium provided by Liu and Webb share the intent of BwI: ensuring that fiscal choices are compatible with desired macroeconomic outcomes. But most of the rules actually in place require much less information than BwI, and may be thought of as shorthand, readily implementable versions of that concept. As noted above, the subnational governments are more complex in some ways than their national counterparts, since citizens at the regional level have additional mechanisms by which they can externalize their debts: by defaulting (shifting the cost to bondholders), by emigrating (shifting the cost to future residents) or by receiving a central government bailout (shifting the cost onto residents of other regions). Given the difficulties of other forms of discipline, described above, strict regulation may be useful in these cases.

Liu and Webb describe the effectiveness of the rules they catalog in constraining the borrowing of these governments. If this is the full purpose of these rules, then the discussion is complete, although as the authors note it is difficult to convincingly identify the partial effect of the rules themselves. But as Mićković notes, we want to hold fiscal policy to a much higher standard

than low debt. Rather, we want rules that encourage fiscal policies that foster good outcomes in the private economy. Consider the fact that some borrowing by regional governments is likely a good thing – borrowing to finance long-lived capital projects, for example, is a good way to ensure that benefits are paid for by those that receive them. So in my view, a more complete analysis of these rules and their benefits would take a broader view. Do they provide for better economic outcomes? Do they protect against significant disruptions in public service delivery, or variability in tax rates? Do they reduce the probability of central government bailouts and reductions in national economic well-being?

The juxtaposition of these two works provides insight into the difficulty in designing welfare-enhancing fiscal rules. The ideal approach is reflected in a generalized version of Mićković: set fiscal rules that foster achievement of the desired level of key macroeconomic outcomes. But implementable rules are quite a bit simpler than this, and are frequently evaluated against a much more restrictive set of criteria. In the end, rules may help, but we cannot completely rely on them to achieve the outcomes we desire.