COMMENTS ON SESSION 4
NATIONAL FISCAL FRAMEWORKS: THE WAY FORWARD

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As the last discussant of this workshop, let me on behalf of all participants thank our host for the excellent organisation of this event and for the lavish supply of food for thought and discussion, as well as for our stomachs. The variety of insights presented and the breadth of items discussed have provided an intellectually enriching atmosphere for all of us.

European fiscal policy is guided by the European fiscal policy framework – a framework which was created with the intention of guaranteeing sound fiscal policies. Yet ever since these rules were first introduced, they have been subject to criticism, generating discussions about their usefulness and the lack of a theoretical foundation, about the carrots-and-sticks problem and the problem of missing national ownership and, thus, about their effectiveness. Indeed, the rules have not been able to prevent fiscal policy from being pro-cyclical, in particular in good times. Thus, it should not have come as a surprise after the outbreak of the great recession that there was rather limited room for manoeuvre to stabilise the real economy.

In all likelihood, the EU fiscal framework would be more effective if it were fully reflected in the national institutional settings, *i.e.*, if adequate accompanying fiscal frameworks were in place at the national level. One issue in the current EU policy debate on reinforcing economic governance in the euro area is the idea of implementing specific minimum requirements for national fiscal frameworks, including binding proposals for budget preparation, requirements for medium-term fiscal planning, budget monitoring and numerical fiscal rules. The empirical literature supports these ambitions: empirical findings have highlighted that strong fiscal institutions in countries can foster budget discipline. In other words, well-defined numerical fiscal rules, the centralisation of the budget process, top-down budgeting approaches or the presence of medium-term fiscal frameworks tend to improve fiscal outcomes. What is also relevant, though, is the share of government finances that are actually covered by those rules, whether compliance is monitored adequately and, whether there are effective sanctioning mechanisms.

This year's workshop focuses on rules and institutions for sound fiscal policy after the crisis. The first session discussed past experiences with given national frameworks, followed by the second session about fiscal rules and institutions in the European Union. Whereas the third session kept an eye on new developments with respect to independent authorities and expenditure rules, the last session was devoted to the topic "National fiscal frameworks: the way forward" and thus on the discussion of concrete suggestions for improving the effectiveness of specific countries' fiscal frameworks such as the one for Slovakia and New Zealand, two countries with very different economic history and economic policy backgrounds. In terms of institutional constraints we have got one country (Slovakia, as a member of EMU) that is committed to the European fiscal framework, pitched against a country that is not. In terms of conceptual differences underlying the stimulating papers, the rather complex proposal for Slovakia is aimed above all at improving the long-term sustainability of public finances, whereas the New Zealand paper essentially focuses on the question of how to enhance the stability function of fiscal policy.

Slovakia's fiscal policy still "suffers" from chronic deficits, pro-cyclicality and a steadily rising debt, strong expenditure pressures and an unsustainable pension and health system; moreover, creative accounting, off-budgetary operations and sales of assets as well as the depletion

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of natural resources and the ignorance of environmental damage aggravate the overall state of the public sector; hence, the rules of the Stability and Growth Pact (SGP) together with the national fiscal framework failed to eliminate the deficit bias and place public finances on a sustainable footing. Against this backdrop, the paper makes the case for rules which encompass the broader public sector rather than the general government sector alone and which refer not only to explicit liabilities but also to implicit as well as contingent liabilities. In other words, it advocates switching to a rather complex and highly comprehensive fiscal framework designed to guarantee fiscal sustainability in the future.

Essentially, the Slovakian paper suggests replacing the flow-based concept (which is in compliance with the EU fiscal framework) with a stock-based net worth concept, consisting of a constitutional debt limit, expenditure ceilings, rules for municipalities, transparency procedures and, above all, a newly installed independent fiscal council. Since the author is fully aware of the string of valuation and data problems that come with a net worth approach, his proposal is to use the *change* in net worth as a major building block for determining the concrete expenditure ceilings rather than define an operational target based on a comprehensive net worth approach.

At the heart of the proposal is the idea to replace the conventional budget balance targets with medium-term expenditure ceilings. The expenditure ceilings should be defined in nominal terms and they should exclude interest payments and cyclically sensitive items. The actual ceilings or the specific expenditure path should be derived from the *change* in the net worth. This means that a government would face more generous expenditure ceilings if it implemented reforms that improve the long-term sustainability of public finances (and vice versa). However, neither the net worth per se nor the change in net worth is straightforward to measure. Hence the recommendation to measure the change in net worth with a new indicator, called GAP – which is very similar to the S2 indicator but broader as it includes also non-age-related implicit liabilities and financial wealth of state companies and the central bank.

While replacing the current flow-based concept with a stock-based fiscal rule may have its merits from a theoretical point, the proposal also means abandoning the comparatively simple rules in the European fiscal framework tradition for a rather complex rule. This contradicts the "common understanding" that fiscal rules should be simple, understandable, enforceable and easy to control.

Partly this replacement is based on the "scepticism" about headline budget balance targets and structural budget balance targets – in the first instance mainly because of the cyclical influence on headline budget balances; in the second instance mainly because of the problem of correctly estimating potential growth and, thus, the output gap. However, the proposal cannot circumvent this methodological problem: potential growth is after all a necessary ingredient for determining the expenditure ceilings in the proposal at hand. The paper suggests to use the GAP indicator as the ultimate sustainability target which needs to be based on a measure of potential growth since it is identified within the intertemporal budget constraint. Furthermore, in order to calculate GAP one also needs a methodology to calculate cyclical and structural revenues and expenditures. Thus, from a methodological point of view the proposal doesn't offer a way out of the problems surrounding the estimation of potential growth and output gaps. Besides, the proposal suffers from non-negligible valuation and data problems connected to the calculation of the *change* in net worth since it is based on the assessment of certain assets such as state-owned companies. The value of an asset is equivalent to the net present value of the revenues that may be generated with that asset from now on into the future and is therefore generally difficult to precisely assess.

As sustainability analyses based on the intertemporal budget constraint might have an analytical value in the economic policy discussion, one should be aware of the weaknesses of policy target choices on the basis of sustainability indicators.

Judging from the problems that underlie current fiscal policy-making in Slovakia, such as the common pool problem, information asymmetry, political cycles and creative accounting, the question arises whether the new proposal would indeed be a remedy. With respect to the common pool problem, an expenditure rule might be helpful in preventing overspending in good times in particular. However, it would need to be twinned with a deficit anchor in order to keep the evolution of the tax/revenue side under control as well. As regards the debt rule that would accompany the expenditure rule, strict debt rules may be fraught with problems of their own. In the short run, negative macroeconomic shocks might have a much bigger impact on the evolution of the debt ratio through taxes and via the denominator effect than "bad policies" such as expenditure overruns. Moreover, a strict debt rule per se might be an incentive for bad policies, such as asset sales at low prices or pro-cyclical fiscal policies.

Furthermore, it is questionable whether the new and more complex framework would in fact reduce the asymmetric information problem – even if the suggested new independent fiscal body were to work effectively. Moreover, a more complex rule may perhaps open up more opportunities for creative accounting measures. After all, policy-makers do not resort to creative accounting in response to a specific rule; much rather creative accounting is fueled by a behavioural attitude which is against the spirit of sound and transparent fiscal policy-making.

My comments on the paper on New Zealand's fiscal framework will be more limited and straightforward. As argued by the author, New Zealand has been successful in putting its fiscal policy on a sustainable footing. At the same point, fiscal policy-making in New Zealand has got its weaknesses, too. Essentially, its insufficiency rests with the short-term stabilisation function, as the author has detailed in her interesting paper. The study would, however, benefit from concentrating simply on the main question – namely on how to improve the short-term stabilisation function of fiscal policy, *i.e.*, on how to prevent pro-cyclical fiscal policy or spending of surpluses in good times. In particular the chapter on a "Rule for more activist (countercyclical) tax policy" could be cut since firstly it doesn't offer any option for action and secondly, the analysis is highly disputable from a tax theory perspective.

A great part of the paper is devoted to the discussion of the methodological problems and difficulties in assessing the economic cycle – yet without offering solutions to this problem. The analysis shows that the New Zealand government followed a countercyclical policy in the period 2001-05. Subsequently, however, fiscal policy turned rather pro-cyclical, partly misguided by an inaccurate assessment of the economic cycle. Given a wrong assessment of structural growth, New Zealand's policy-makers were unable to accurately gauge the stage of the economic cycle in the period 2005-08. The overoptimistic assessment of structural revenue developments accompanied by overspending implied a pro-cyclical stimulus to the already overheated economy. The outbreak of the economic crisis in 2009 led to a tremendous revision of structural figures.

The author discusses different options to make fiscal policy more stabilising. One of these options would appear to be particularly promising, namely the introduction of a "stabilisation fund". The idea is to fill this fund with revenue windfalls in good times and to draw down money in periods of negative output gap. Such a stabilisation fund may have the capacity to limit pro-cyclical fiscal policies in good times – in particular for virtuous countries (see Balassone *et al.*, 2007). At the same time, it must be said that the effectiveness of such a tool also rests on an accurate assessment of the economic cycle.

To sum it up: both papers have got their merits and their drawbacks – and the solutions they propose have yet to live up to reality. Nevertheless, they can serve as excellent starting points for further research and policy debate.