COMMENTS ON SESSION 3
NEW DEVELOPMENTS: INDEPENDENT AUTHORITIES AND EXPENDITURE RULES

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1 Horizontal issues

Setting *ex ante* public expenditure ceilings – so that a top-down budgeting approach is enforced – turns out to be crucial for the efficient design of the expenditure budget and the adherence to pre-determined expenditure and/or public deficit targets, in particular in times of fiscal adjustment. Now, expenditure limits have to be determined by some means. The most recent literature in the field tends to favor the determination of these ceilings or limits by means of expenditure rules, in contrast to the practice of following discretion and political bargaining at the beginning of the budgetary process. Beyond the *ex ante* constraint on public spending, an expenditure rule is typically deemed to be a pre-emptive arm designed to avoid spending *ex post* higher-than-expected revenues (sometimes in the form of the so-called *revenue windfalls*) in good times.

The *ex ante* and *ex post* restraint on public expenditure embedded in that type of rules is increasingly seen by the academic literature on fiscal frameworks as well as the most recent policy developments in the field (like the EU review of national fiscal frameworks conducted over 2011) as a key ingredient of any effective fiscal framework. Why is that the case? As signaled by the authors, the objective is to build up appropriate margins of maneuver for bad times. Thus, the discussion on expenditure rules should necessarily be connected to a debate on country-specific targeted levels of debt (given its role as shock absorber) and its determinants, like the volatility of government revenues. I will come back to these issues in the course of the discussion, because in my opinion the recent policy discussion on expenditures rules has to some extent overlooked this relevant aspect.

In addition, from a horizontal point of view, after considering the three papers of this session it is clear that the design of a expenditure rule has to pay due attention to at least some of the following issues:

- Should the annual expenditure ceiling/limit be set *ex ante* as a residual from the application of a deficit rule and a given revenue projection? Should it rather be fixed in an independent manner by looking at certain macroeconomic indicators?
- Should the expenditure ceiling/limit be firm or flexible (thus hinging on *ex post* adjustment rather than on-the-run adjustments)?
- On the coverage of the expenditure ceiling/limit: (i) Institutional coverage: should it be applied to the central government only or should it rather encompass additional ceilings for local and regional governments?; (ii) Functional coverage; (ii) Exclusions: should it leave out interest payments? Should it leave out spending on unemployment benefits?
- Practicalities: should the limit be defined in public accounts or National Accounts terms?
- Horizon: should the expenditure ceiling/limit be designed for one year (standard budgetary horizon) or should it be designed to apply to more than one year in a row (multi-annual)?
- It is crucial to consider the derived impact on the quality of public expenditure and the link to considerations related to the efficient provision of public goods and services.

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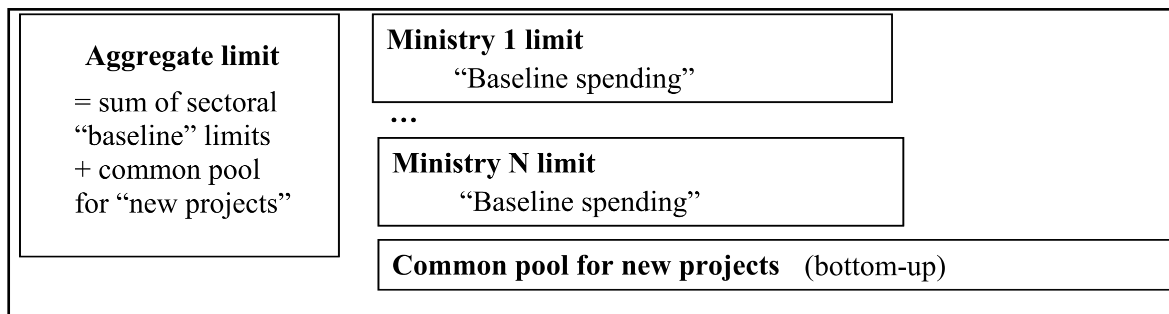
Figure 1

Outline of the Expenditure Ceiling Proposal



- Which is the relevant base-year expenditure level that has to be considered? Which is the potential of rules focused on the growth rates of expenditure items to curb the persistence in existing spending plans? (*i.e.*, how to define the baseline or time zero level).

The consideration of all these issues may indicate that the one-design-fits-all, aggregate approach taken in the European context might not have been the optimal one, even though it may have been a "second best" resulting from necessity.

2 Expenditure ceilings

"Keeping the Lid on Aggregate Expenditure During Budget Preparation: Enforcing Aggregate Expenditure Ceilings while Preserving Allocative Flexibility" by Robinson represents an excellent discussion on the role and design of expenditure ceilings. The type of discussion and messages of the paper has not been present to the extent that, in my opinion, would have been needed in the EU-wide discussion on expenditure rules. The paper outlines certain budget preparation techniques which can ensure that ministry allocations do not in total exceed the aggregate ceiling while at the same time preserving and enhancing flexibility in the reallocation of resources between ministries. It challenges the traditional approach that the ministry-level limits (that aggregate to the overall spending limit) should encompass "baseline spending" plus ministry-specific proposals for new project's spending. The paper proposes, in turn, a scheme that could be summarized as in Figure 1.

The proposal is extremely interesting in that it may help improving efficiency. Nevertheless, some considerations can be done to fine-tune the proposed scheme:

i) The distinction between "baseline" and "new" spending might not be that evident in certain circumstances, thus creating problems in the design and monitoring of the relevant spending; in addition, it is not obvious which should be the relevant level at which the decision/design of the common pool of new projects has to be done (within each Ministry or by the Ministry of Finance).

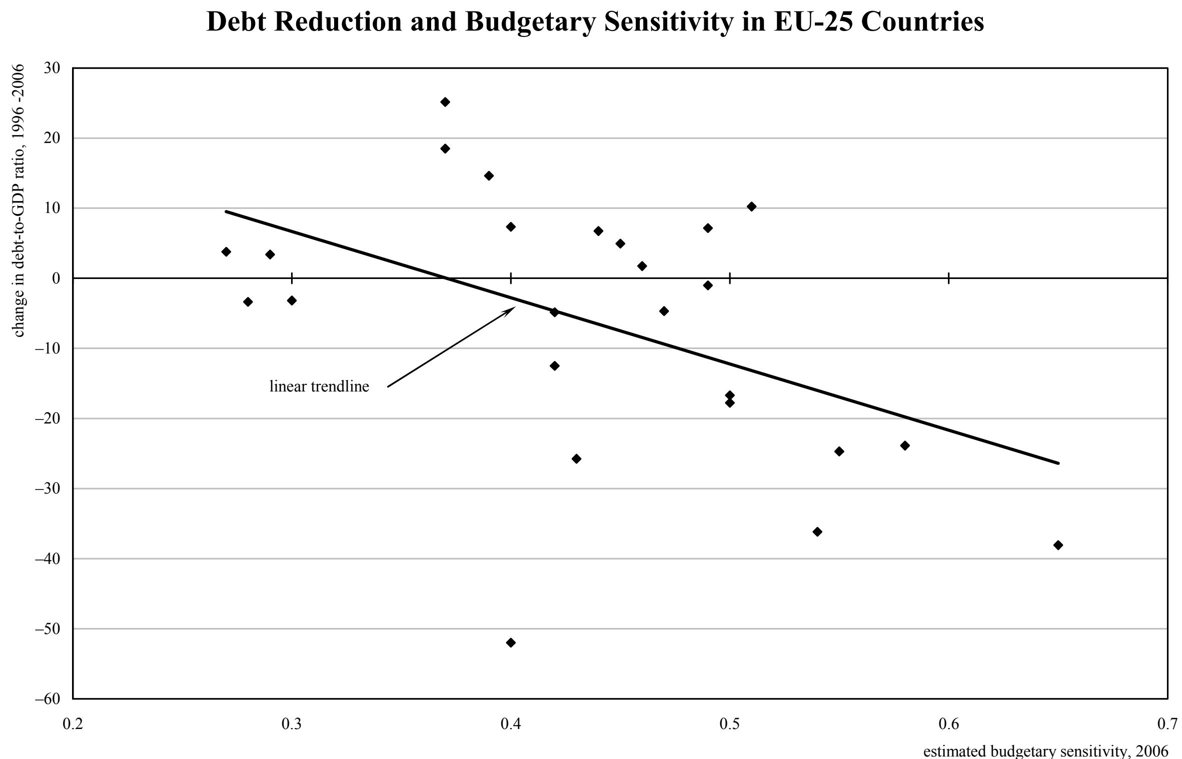
ii) The design of the common pool might be constrained by "political priorities". Would a zero-based budget guarantee full allocative efficiency?

iii) Potential problem: in the limit, the argument of allocative efficiency and "new spending needs" vs. discipline applies to the overall expenditure ceiling.

In this respect it is crucial to clarify which is the objective function of the "spending unit" (Ministry): (i) first case: is it a rational policy-maker/minister that aims at maximizing its own

Figure 2

Debt Reduction and Budgetary Sensitivity in EU-25 Countries



budget? (for good or for bad reasons, it doesn't matter); (ii) second case: is it a benevolent planner ready to compromise with fellow ministers? The political economy literature suggests that in the first case overall aggregate and sectoral ceilings would force an optimal reallocation between "baseline" and "new" spending.

3 Fiscal rules and "fiscal sanity"

"Towards Expenditure Rules and Fiscal Sanity in the Euro Area" by Hauptmeier, Sánchez-Fuentes and Schuknecht presents a number of useful and policy relevant exercises on public spending dynamics. The counterfactual exercises shown in the paper are well designed and exemplify the damage that expenditure overruns had on the deterioration of public finance headline variables (deficit and debt) over the EMU period. Nevertheless, closely linked to the focus of the paper there are two broader relevant issues that are not fully tackled by the authors.

The first consideration is related to the fact that the decision on letting spending grow more or less in a given moment of time should not be just linked to a certain indicator (like potential output growth) but rather be linked to the determination of the buffer that should be built against an adverse fiscal situation in bad times. For instance, which is the size of the shock a government has to be insured against? As an example, the level of public debt as a percent of GDP was below 30 per cent in Ireland in 2007. The succession of adverse shocks has made public debt explode but, *ex ante*, should it have been reasonable for Irish authorities to build up a buffer amounting to some negative debt position? Another example is the case of Spain; public debt was also low, below 40 per cent of GDP, in 2007. Since the start-up of the economic crisis some 50 per cent of the huge deterioration on public finances witnessed between 2007 and 2010 was linked to the revenue side

of the budget, with a major part of the deterioration linked to so-called revenue shortfalls. Would this advice for indicators of potential/neutral spending growth taking into account revenue volatility? In fact, as shown in Figure 2, in the two decades prior to the current crisis there seemed to be an inverse relationship between public debt reduction and the cyclical sensitivity of the budget.[1]

The second consideration, on which I am not going to go very much in detail, is that the focus on expenditure growth contains an implicit message on the optimal size of expenditure/GDP that is not properly addressed in the paper. Take the following example: what if Germany decided to downsize public spending over GDP not because of "virtue" (as implicitly argued by the authors) but because the high level of public debt as a percent of GDP observed in the specific time period considered in the paper was not deemed to be sustainable enough by German authorities?

By exploiting the link between the discussion of the paper on "sane expenditure growth" and the related issues of "optimal/target" public debt and level of public expenditure, the authors could enrich the discussion (by making it much more balanced) and improve the already substantial relevance of the study. The latter is particularly so as regards the selection of countries, the somewhat biased view of expenditure policies as the root of much of the current significant fiscal imbalances, the lack of analysis of revenue developments as the other side of the same coin, and the definition of "neutral" expenditure policies.

4 Fiscal rules and fiscal targets

"Achilles Catches Up with the Tortoise: An Expenditure Rule to Bridge the Gap Between Fiscal Outturns and Targets" by Balassone, Franco and Zotteri provides an excellent overview and summary of all the relevant arguments that advocate that public spending rules are a necessary element in a country's fiscal framework. The authors suggest the adoption of a properly designed expenditure rule in the case of Italy. This is the case because, as shown by the authors, failure to meet fiscal targets was mainly due to higher-than-planned expenditure. In particular, the authors argue that the introduction of multi-year expenditure ceilings.

While agreeing with the main message of the paper, some remarks can be made on specific issues. First, which could be the gains in terms of improved fiscal targets of applying such an expenditure rule in the case of Italy? A preliminary assessment can be made by looking at the simulations of Haupmeier, Sánchez-Fuentes and Schuknecht (the paper included in this volume). If their baseline spending-neutral rules would have been applied over the EMU period (1999-2009), Italian public debt in 2009 would have been situated in the range of 90-110 per cent of GDP. Would this safety margin be considered as safe enough? This level would not have been too far from actual levels, so not much would have been saved with the use of this family of "prudent expenditure rules" over the 1999-2009 period.

This first consideration would call for taking into account some additional elements when designing an expenditure rule for a high-debt country like Italy: (i) would this evidence call for the inclusion of interest expenditure in the rule in a transition period?; (ii) would this evidence call for a spending rule of the type of the one recently suggested by the government of Slovenia? As regards the latter, in addition to prescribing that public expenditure grows with some type of prudent reference growth rate (like potential output), the proposal of Slovenia incorporates some type of additional effort of expenditure reduction while public debt is above some reference value and/or the primary budget balance is below a reference value. This would imply that some type of

[1] For further details on this line of argumentation see Hiebert, P., J.J. Pérez and M. Rostagno (2009), "The Trade-off Between Debt Reduction and Automatic Stabilisation", *Economic Modelling*, No. 26, pp. 464-72.

reaction function should apply over a transition period, until public debt reaches a certain prudent target value.

In relation to the best practice cases some countries are typically mentioned, namely Finland, the Netherlands or Sweden. In this regards, it is relevant to mention that expenditure ceilings on those cases do not have a legal status. Would this framework be of application to the case of countries like Italy or Spain? In the latter respect, given the reasons for deviations with respect to public deficit targets reported by the authors in the case of Italy, all issues of design related to the *ex ante* determination, the real-time monitoring and the *ex post* control of expenditure developments, seem to be of special relevance, over and above the minimum denominator standards set up in the recent EU-wide decisions.