COMMENTS ON SESSION I: THE PROS AND CONS OF FISCAL RULES

Geert Langenus[*]

I would like to start this discussion by congratulating the contributors to this session for their excellent papers and presentations. At the same time, I want to apologise to them for not discussing the individual papers in great detail - time being probably too short for that - and therefore not giving them the attention they deserve. What I would like to do instead, is focus on a few general issues and try to summarise and put into perspective what we have heard in the various presentations.

In my opinion, the two main questions in this session are the following: 1) do we need fiscal rules (or are they, to quote George Kopits, an unnecessary ornament)?; and 2) if so, how should these rules be designed and implemented?

Starting with the first question, I understand that the majority view of the different speakers is that fiscal rules are indeed useful although there are some qualifications. Perez Garcia and Hiebert look at rules as a way to simply understand policy in a model-based approach rather than to actually govern it. Kopits argues that rules can be an unnecessary nuisance for governments which already enjoy a sound fiscal reputation. Finally, Peach is rather sceptical about the role played by the regulatory framework in consolidating the US federal budget.

With respect to the usefulness of fiscal rules, one could also turn to the empirical literature, an aspect which was a bit neglected in the presentations. In the Kilpatrick paper it is argued that this issue has received surprisingly little attention in the empirical literature, the rules-vs.-discretion debate having almost exclusively focused on monetary rather than fiscal policy - although there are obvious parallels to be drawn. I fully agree with Kilpatrick: the existing empirical literature on this issue is probably neither very rich nor convincing. Most studies look at State finances in the US and try to establish a link between fiscal rules and fiscal outcomes (usually a simple numerical indicator such as the overall budget balance or the evolution of public debt). On average, they tend to find a

[*] Nationale Bank van België / Banque Nationale de la Belgique.

strong positive relationship which leads them to conclude that the existence of fiscal rules is some sort of guarantee for a satisfying fiscal outcome. Obviously, nearly all of these studies suffer from the endogeneity problem described by Poterba (1996) which I believe can be quite damaging. Perceived causality might very well be mere coexistence because of voter preferences. Indeed, if the electorate is averse to sloppy fiscal policy, it will probably tend to elect a government favouring strict fiscal discipline while at the same time additionally constraining the government by adopting clear fiscal rules. Both the rule and the outcome can simply reflect voter preferences: there needn't be any causal relationship between them.

Bearing this caveat in mind, the existing literature nevertheless *suggests* that fiscal rules do seem to have a favourable impact on fiscal outcomes. This is not sufficient, however, to advocate their use. Even if they are shown to be a good drug against fiscal diseases, one should make sure that they do not have any harmful side-effects. They do put constraints on fiscal flexibility and hence limit the scope for tax smoothing or active anti-cyclical policy. In the latter respect, the backward-looking sections in the Kilpatrick paper are very enlightening. The UK fiscal stance *before* the adoption of the new regulatory framework is clearly shown to be procyclical rather than the opposite. In the year 2000 Annual Report of the Belgian National Bank similar evidence is presented for Belgium and the euro area. This suggests that, if governments face no constraints whatsoever, they seem to use this freedom in potentially destabilising ways which might enhance cyclical fluctuations. On this issue one can also refer to the work by Alesina and Bayoumi (1996) analysing the link between fiscal rules and output variability at the State level in the US and concluding that the latter is actually smaller in States with stronger fiscal rules. Obviously, State finances might only have a very weak impact on State output and the correlation reported by Alesina and Bayoumi might to some extent be spurious but, on the other hand, their results could confirm that fiscal rules effctively limit the scope for destabilising fiscal policy. All in all, there seems to be some evidence - albeit not entirely convincing -that fiscal rules not only provide for better fiscal outcomes in the purely accounting sense (higher budget balances, lower public debt) but also for better fiscal policy in the broader macroeconomic sense.

As to *why* fiscal rules are appropriate, the basic explanation that was echoed in the presentations is related to the dynamic inconsistency of voter preferences: voters always tend to prefer a larger deficit in the current year than they had preferred for this current year earlier. In this respect, I am not fully convinced that Kopits's view of rules not being necessary for governments that already enjoy a sound reputation is correct. In my view, reputation is a very asymmetrical feature: it takes a lot of time to build but can be lost quite rapidly. I would also like to add a simpler argument of my own concerning the reasons why rules can be useful: the mere existence of fiscal rules can lead to an increased media attention and coverage of fiscal policy. Indeed, the media generally like to report more extensively on fiscal outcomes when they can compare them to pre-fixed targets. In Europe, for instance, public finances have received unprecedented media attention since the Maastricht criteria have been agreed upon. Because of this, public awareness about public finance issues grows and this is obviously beneficial.

If the answer to first question - do we need fiscal rules? - is by and large yes, there is far less unanimity on the second question with respect to the exact design and implementation of these rules. Kilpatrick describes two lines of thinking although the distinction is probably more a matter of emphasis than of anything else. One approach emphasises accountability and transparency (the typical example being the UK budgetary framework) whereas the other one is blunter in a way and relies more on simple yardsticks for numerical budgetary indicators (the deficit criterion of the Treaty on European Union is one of the best-known examples). This distinction between procedural rules and numerical ones was also alluded to by the Chairman in his opening remarks.

If one focuses for the time being on the numerical rules, the literature, e.g. the papers by Inman (1996) and Bohn and Inman (1996), provide a number of characteristics of 'good' rules. They should be simple, concern ex-post government accounts, be enforced by a non-partisan agency which can effectively inflict penalties and be costly to amend. If I stop here, then this list of desired characteristics reads to a certain extent as a blueprint for the Maastricht deficit criterion for instance. In several presentations a few other characteristics have been highlighted however. The rules should ideally be growth-oriented, take into account the generational balance - if not actually target generational equity - and explicitly refer to trend economic growth. I very much agree with the importance of the latter criteria and what I would like to stress is that, in my view, they conflict to a certain extent with the more traditional criteria of 'good' fiscal rules, most notably the call for simplicity and the need for penalties.

Obviously, from an optimality point of view, rules should target actual fiscal policies rather than fiscal outcomes. In practice, one generally assumes, however, that the latter are adequate proxies for the former and rules typically apply to outcomes. Nevertheless, one should be aware of the fact that these outcomes are co-determined by a number of exogenous elements that fall outside the government's direct control. Predominant among them is obviously the business cycle. Thus, ideally, the influence of the cycle should be wiped out and the rule should be based on a cyclically-adjusted indicator. In addition, to a certain extent, the government can always shift revenue and expenditure from one period to another so an ideal rule should consider some indicator of long-term sustainability. Currently, generational accounting measures are already routinely used in the budgeting process in a number of countries. Finally, if rules should ideally support economic growth, then at the very least one should distinguish between current and capital spending and consider rules of the golden type. We all know, however, that this distinction is not sufficient: investment in human capital in the form of expenditure on education, tax incentives for private investment, etc. can enhance growth in the same way as government investment in physical capital.

If rules take into account all of these refinements, however, - as I believe they should in order to allow for a richer policy analysis - then one obviously loses in terms of simplicity and, probably, enforceability. In addition, these issues, cyclical adjustment, generational accounting and the impact of public finances on growth, are very controversial and rules that try to take them into account might prove difficult to sell.

Summing up and coming back to the Chairman's distinction between procedural and numerical rules, I believe that the former might in the end be more important. I would argue that we should to some extent move away from what Kopits dubbed the 'eurocentric' view of bluntly comparing actual fiscal balances with simple numerical yardsticks and focus attention rather on issues such as transparency. Meanwhile, the profession should spend even more time and energy on developing true or at least better indicators of actual fiscal policy - taking into account, as Van den Noord and Atkinson argue, the impact of that policy on private-sector behaviour. Once a consensus about methodological issues has been reached and we feel confident enough to use these indicators, we might move one step further and consider numerical rules actually targeting these indicators rather than simple accounting balances. Even if a lot of progress has been made already (e.g. concerning cyclically-adjusted balances) this final goal is probably still a (large) number of workshops away.

REFERENCES

Alesina, A. and T. Bayoumi (1996), "The costs and benefits of fiscal rules: evidence from U.S. States", NBER, Working Paper, No. 5614.

Bohn, H. and R. P. Inman (1996), "Balanced-budget rules and public deficits: evidence from the U.S. States", *Carnegie-Rochester Conference Series on Public Policy*, Vol. 45, pp. 13-76.

National Bank of Belgium (2001), “2000 Report”.

Inman, R. P. (1996), "Do balanced budget rules work? U.S. experience and possible lessons for the EMU", NBER, Working Paper No. 5838.

Poterba, J. (1996), "Do budget rules work?", NBER, Working Paper, No. 5550.