PROMOTING FISCAL RESPONSIBILITY: TRANSPARENCY, RULES AND INDEPENDENT FISCAL AUTHORITIES

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1. Introduction

The period from the mid-1970s through the early- to mid-1990s witnessed persistently large fiscal deficits in many OECD countries, together with a continuous run up in government debt which in several countries reached very high levels. This contrasts with much of the 1990s, which has been characterized by sizable fiscal adjustment in almost every OECD country, with the notable exception of Japan. Fiscal deficits have been lowered, and in the many countries where fiscal deficits have given way to fiscal surpluses, government debt is being paid down.

At various times during the 1990s, a number of OECD countries have also overhauled their fiscal policy frameworks with a view to promoting fiscal responsibility. Australia, New Zealand, and the United Kingdom have established new frameworks in legislation which place a heavy emphasis on achieving fiscal transparency. Several countries have adopted fiscal rules, including the deficit and debt limits set out in the Maastricht Treaty and Stability and Growth Pact, and the golden rule and the sustainable investment rule in the United Kingdom. There has also been an increased emphasis on setting multi-year deficit and debt targets (e.g., Australia, Canada, New Zealand, Sweden, Switzerland, and the United States), and on procedural rules limiting expenditure (e.g., in Sweden, the Netherlands, Finland, and the United States).

This paper discusses the way in which such changes in fiscal policy frameworks can and have contributed to aggregate fiscal discipline. It also looks briefly at proposals for more radical institutional reform, namely the creation of independent fiscal authorities, analogous to independent central banks, with some power to set fiscal policy independent of government.

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2. Background

Two decades of large deficits cannot be explained by traditional economic models alone. The usual arguments—which emphasize either the need for tax smoothing[1] or for fiscal policy to play a macroeconomic stabilization role—provide a rationale for temporarily rather than permanently large deficits. Different models are needed to explain the deficit bias that became a characteristic of fiscal policy between the mid-1970s and mid-1990s.

Alesina and Perotti (1995) provide an overview of possible models that are suggested by the extensive literature on political and institutional aspects of fiscal policy. Such models emphasize: fiscal illusion because voters do not understand that governments face an intertemporal budget constraint and therefore do not penalize unsustainable fiscal policies accordingly; the under-representation in the political process of future generations who have to bear the costs of fiscal policy decisions benefiting current generations; the use of debt as a strategic variable which is used by governments to constrain the actions of future governments; the distributional conflict between different groups in fragmented political systems which pushes fiscal adjustment into the future; the tendency for local constituencies to overestimate the benefits they receive from public expenditure relative to the costs which are shared nationally; and the ineffectiveness of budget institutions, including procedures for budget formulation, approval, and implementation.

While these models offer plausible explanations of deficit bias in general, to the extent that the political and institutional structures they deal with have been in place a long time, they cannot explain why deficit and debt problems emerged when they did. The best they can do is explain why deficits and debt became a problem in some countries and not others by reference to differences in these structures across countries, and this is where the related empirical studies are most convincing, especially as regards the role of budget institutions (von Hagen and Harden, 1994).

The literature suggests four possible approaches to addressing deficit bias.

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1 By allowing the deficit to change in response to temporary changes in public expenditure, tax rates are smoothed, and the distortionary effects of taxation are reduced.

- Improving fiscal transparency with a view to increasing the accountability of policymakers.
- Adopting fiscal rules or binding fiscal targets.
- Implementing traditional institutional reform, for example, by strengthening the powers of the finance minister over spending ministries or requiring a binding vote on the size of the overall deficit at the start of the annual budget round.
- Undertaking radical institutional reform by creating an independent fiscal authority.

In view of the extensive literature on the third of these approaches, traditional institutional reform, this paper focuses on the other three[2]. It should be kept in mind, however, that actual measures do not always fall neatly into one of the above categories. For example, setting expenditure ceilings could be classified as a fiscal rule or as an institutional reform. Also, the different approaches are not mutually exclusive, and could indeed reinforce each other.

3. Improving Fiscal Transparency

Fiscal transparency can be defined as being open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts, and fiscal projections (Kopits and Craig, 1998). Such openness is essential if discipline is to be imposed on governments by making policymakers accountable for the design and implementation of fiscal policy. Transparency should then lead to better, more credible policies, to a less uncertain policy environment, to an earlier and smoother fiscal policy response to emerging economic problems, and ultimately to improved economic performance.

Alesina and Perotti (1995 and 1999) provide some specific examples of nontransparency from OECD countries, including budgets that are based on overestimates of growth and revenue which allow larger deficits to be attributed to unanticipated macroeconomic developments, unreasonably

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2 For further discussion of traditional institutional reform, see von Hagen and Harden (1994) and Alesina and Perotti (1999).

optimistic expectations about the impact of new budget measures, limited coverage of the budget, the strategic use of budget baselines to overstate fiscal adjustment, and relying on multiyear budgets to delay adjustment.

New Zealand pioneered the approach to fiscal management which places an explicit emphasis on improving fiscal transparency. The 1994 Fiscal Responsibility Act requires that the government should: be clear about the objectives and consequences of its policies; take an aggregate and a long-term view; and provide for parliamentary and public assessments of fiscal policy, most notably by strengthening reporting requirements. The Act also stipulates that the government should be judged against its ability to: reduce debt to prudent levels by achieving operating surpluses each year; ensure that, over a reasonable period of time, total operating expenses do not exceed total operating revenues; achieve appropriate levels of government net worth; manage risks prudently; and maintain predictable and stable tax rates. While the government is required to set out its broad strategic priorities for the budget and for the next three years, and its long-term fiscal policy objectives, details are not included in the Act. However, targets are specified elsewhere (see section IV for details).

Australia and the United Kingdom have since adopted a similar approach to fiscal management. In Australia, the Charter for Budget Honesty enacted in 1998 requires the government to prepare an annual fiscal strategy statement which states long-term fiscal policy objectives and sets specific fiscal targets for the following three years. This statement, and the government's performance against the objectives and targets it contains, are subject to public scrutiny. As in New Zealand, targets are specified elsewhere. The 1998 Finance Act in the United Kingdom introduced a Code for Fiscal Stability which requires that fiscal policy is conducted with a view to achieving transparency, stability, responsibility, fairness, and efficiency. The Code specifies principles that should govern the formulation and implementation of fiscal policy, and strengthened reporting requirements. Not included in the Code, but closely associated with it, are two fiscal rules against which fiscal performance is to be judged[3]. The golden rule requires that the government should borrow only to finance investment, and the sustainable investment rule requires that public sector net debt as a proportion of GDP should be held at a stable and prudent level.

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3 These rules were first set out in the 1997/98 budget.

These frameworks share certain common elements. In particular, they have an explicit legal basis, they combine guiding principles for fiscal policy with a requirement that objectives are clearly stated, they emphasize the need for a longer-term focus to fiscal policy, and they set demanding requirements for fiscal reporting to the public. As such, they are widely seen to represent the state of the art as far as fiscal transparency is concerned, and more generally provide an approach to fiscal management that has become a model which some non-OECD countries (e.g., Argentina, Brazil, Peru, and India) are following.

These reforms have generally been viewed positively, although Alesina and Perotti (1999) argue that a legislative approach to improving transparency is inappropriate, because the inherent complexity of legislation creates room for ambiguity and obfuscation. This is certainly true of legislation, or rules and regulations, that are overloaded with detail. However, a feature of the laws in Australia, New Zealand, and the United Kingdom is that they focus on guiding principles which are fairly robust and whose credibility should not be undermined by short-term considerations. Specific objectives are provided outside the law, because they may be required to vary over time as circumstances change. Moreover, a legislative approach may be essential where discretionary fiscal policy has suffered from time inconsistency problems and credibility has to be established, in particular because it increases the cost to governments that abandon or even weaken their commitment to transparency.

The frameworks of New Zealand, Australia, and the United Kingdom have provided the motivation for a more general effort to improve fiscal transparency, and in particular provided the starting point for work that resulted in the IMF *Code of Good Practices on Fiscal Transparency*[4]. The Code provides a benchmark for assessing fiscal transparency, and as such represents a standard of fiscal transparency to which all countries should aspire. The Code is organized around four general principles that reflect essential elements of fiscal transparency and a number of specific principles that expand upon each of the general principles. These principles are provided in Box 1. The Code also contains detailed good practices of fiscal management. These good practices do not reflect what happens in Australia, New Zealand, and the United Kingdom, where the fiscal frameworks are examples of best practice and do not

4 The original Code was published in 1998. A revised version was published in May 2001.

Box 1. Principles of Fiscal Transparency

Clarity of roles and responsibilities

The government sector should be clearly distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

There should be a clear legal and administrative framework for fiscal management.

Public availability of information

The public should be provided with full information on the past, current, and projected fiscal activity of government.

A commitment should be made to the timely publication of fiscal information.

Open budget preparation, execution, and reporting

The budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

Budget information should be presented in a way that facilitates policy analysis and promotes accountability.

Procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified.

There should be regular fiscal reporting to the legislature and the public.

Assurances of integrity

Fiscal data should meet accepted data quality standards.

Fiscal information should be subjected to independent scrutiny.

represent a standard that is appropriate for all countries (especially developing countries)[5].

While the Code largely addresses the sources of nontransparency identified by Alesina and Perotti, it goes further in the direction of providing the public with the information needed to understand the structure and functions of government, to be clear about the government's fiscal policy objectives, to appreciate the range of possible fiscal outcomes, and to assess the government's performance in implementing fiscal policy. To these ends, the Code has the following characteristics.

- It extends beyond the general government budget, and covers: extrabudgetary activities; quasi-fiscal activities undertaken by the central bank, public financial institutions, and nonfinancial public enterprises; and regulation of the private sector. All of these have proved to be important means through which governments exert an influence over the rest of the economy without being constrained by formal budget procedures.

- It places the budget in a broader fiscal policy and macroeconomic context, and calls for major risks to the budget to be identified and where possible quantified. These fiscal risks include variations in the forecasting assumptions underlying the budget, contingent liabilities (e.g., guarantees that may be called), the uncertain costs of specific expenditure commitments, and new commitments that may have to be made.

- And it says that the objectives to be achieved by major government programs should be indicated, and performance relative to these objectives assessed and reported.

In contrast to Alesina and Perotti, who call for less emphasis on multiyear budgets and more focus on the year ahead, the Code emphasizes a forward-looking approach to budget formulation. While their argument—that multiyear budgets allow fiscal adjustment to be pushed into the future, and that budgets for later years can then be reformulated so as not to deliver the required adjustment—is correct, multiyear budgets have a number of advantages from a transparency standpoint. They help to

5 Best practices are discussed in the IMF *Manual on Fiscal Transparency*, a revised version of which was also published in May 2001. The OECD has also produced best practice guidelines for budget transparency (OECD, 2000).

prioritize spending in a situation where some activities have to be delayed because of inadequate funding; current and capital spending can be properly coordinated; spending ministries are provided with a more certain planning environment; and spending pressures can be identified ahead of time. Moreover, with full transparency, governments will find it difficult to recast future budgets other than for legitimate reasons, and to move revenue and expenditure between different years to window dress outcomes, without incurring a political cost.

While the Code is motivated by legislative approaches to increasing fiscal transparency, it is also consistent with other approaches. For example, fiscal management in the United States is characterized by a high degree of fiscal transparency, but this results from competition between the legislative and executive branches (and their respective budget agencies) and a long tradition of open government. It should also be noted that the Code is grounded firmly in an approach to economic and financial management that recognizes the importance of adhering to international standards as a means of strengthening policies, reducing vulnerabilities, and providing for more effective crisis prevention and management. In this connection, the IMF publishes assessments against various standards and codes in Reports on the Observance of Standards and Codes (ROSCs) which allow judgments to be passed on the transparency and other aspects of economic and financial policies by a wide range of outsiders, but most notably by financial markets. Participation in the ROSC process is voluntary.

4. Adopting Fiscal Rules

Two arguments are usually used to justify fiscal rules. The first and more general argument emphasizes the political and institutional factors described earlier that give rise to deficit bias, and the use of fiscal rules to strengthen credibility given the time inconsistency of discretionary policy. The second and more specific argument emphasizes spillover effects within a currency area or a federation, and the use of fiscal rules to constrain the deficits of member/subnational governments, and thus prevent lax fiscal policy in one jurisdiction from being transmitted to other jurisdictions or to a higher level of government. However, defining a fiscal rule is not straightforward. Kopits and Symansky (1998) view a fiscal rule as a permanent constraint on fiscal policy, usually specified in terms of an indicator of overall fiscal performance. This is quite a narrow definition which would exclude targets specified over a preannounced period of time. This paper uses a broader definition which includes some time-bound targets, as well as some procedural rules used to ensure the execution of either discretionary or rules-based fiscal policies. Three categories of fiscal rule are discussed: deficit rules, debt rules, and expenditure rules.

4.1 Deficit rules

The 3 percent of GDP limit on general government deficits under the Maastricht Treaty and the 'close to balance' requirement under the Stability and Growth Pact are the most notable examples of rules relating to the overall deficit. The latter requires medium-term fiscal positions that are close to balance or in surplus, with a view to ensuring that the 3 percent of GDP deficit limit can be respected during normal cyclical downturns[6]. The close to balance requirement has been interpreted by the European Union to refer to 'close to cyclically adjusted balance[7]'.

A number of countries have overall deficit targets. The 2000 Budget Policy Statement for New Zealand indicates that an operating surplus should be maintained over the cycle; the 2000 Budget Strategy and Outlook Report in Australia says that the aim is to achieve budget balance over the cycle; and the government in Sweden announced in 1997 that it is aiming for a fiscal surplus of 2 percent of GDP over the cycle, and set numerical targets for the next three years. In Switzerland, a constitutional amendment in 1998 required the federal government budget to attain budget balance by 2001. Once this has been achieved, a new constitutional amendment will establish a ceiling on the level of central government expenditure every year, with the aim of ensuring budget balance over the cycle. In addition, the 1997 Balanced Budget Act in the United States requires a balanced budget by 2002, and the federal government in Canada is committed to balanced budgets or better for 2000–01 and 2001–02[8].

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6 See Artis and Buti (2000) for further discussion.

7 Some Euro area countries also have internal stability pacts to ensure that the finances of subnational governments are consistent with commitments under the Stability and Growth Pact. Austria distributes the permissible deficit to the Länder on the basis of population; Belgium establishes deficits for regions and local governments; Italy sets targets for reductions in local government deficits distributed according to levels of primary current spending; and Spain applies borrowing restraints to regions.

8 All but two U.S. states have laws requiring the submission, passing, or signing of balanced budgets. Most states are also prevented from carrying fiscal deficits for more than one or two (continues)

Other countries have established rules for current budget balance, that is the golden rule which limits the deficit to the amount of government investment. This is the deficit rule in the United Kingdom, and it too applies over the cycle. The German constitution has incorporated a golden rule for the federal government since 1969, and some state constitutions have a similar provision. Japan for many years operated a golden rule, only allowing a deficit for public works financed by construction bonds. This practice was abandoned in 1975 when the government began to issue deficit-financing bonds.

As noted by Alesina and Perotti (1999), a problem with balanced budget rules is that they are inflexible. In particular, they are inconsistent with the use of fiscal policy to stabilize output; indeed, they tend to be procyclical. That is why most recent deficit rules apply over the cycle, thus allowing the operation of automatic stabilizers and providing some room for discretionary policy (with the proviso that any discretionary loosening or tightening is fully offset over the cycle). However, the increased flexibility this provides comes at a cost in that the benchmark against which fiscal performance is to be judged is made less clear, which potentially reduces the enforceability and credibility of the rules.

The problem is clear. If a rule is to apply on average over the cycle, it is necessary to define the cycle for the purpose of applying the rule, and then when designing fiscal policy a view has to be formed on the cyclical position of the economy. While the latter can be done to an approximate degree, the risk is that as the end of the cycle approaches the focus will be on predicting where the end may be, and making corrections to fiscal policy to meet a rule, rather than on tailoring fiscal policy to macroeconomic requirements. Indeed, it is possible to envisage a rule demanding a totally inappropriate fiscal policy response. Targeting cyclically-adjusted balance each year is one solution. This boils down to letting automatic stabilizers work. However, cyclical adjustment is a technical, and highly imperfect, exercise. There should also be no pretence that automatic stabilizers will be optimal from the perspective of macroeconomic stabilization, since they are determined by structural

years, and they therefore build up reserves (rainy day funds) in good years to cover deficits. The ability of states to issue debt is limited. Nine provinces and territories in Canada have fiscal rules. In all but one case, balanced budgets are required. Most provinces allow surpluses to offset deficits over specified periods, and there are usually exceptions to cover emergencies. Several provinces also have debt reduction plans. In Australia, all states and territories specify fiscal objectives (such as maintaining a budget surplus, keeping taxes low, or reducing debt) and many have introduced fiscal responsibility legislation to underpin these objectives.

features of the tax and benefit system which were designed with other objectives in mind. In addition, estimates of the size of fiscal multipliers are very impressive.

There are important considerations in operationalizing the Maastricht/SGP framework. The European Union and others have calculated individual country benchmarks under the “close to balance” requirement which reflect the size of automatic stabilizers, the possible need for discretionary measures, and other factors that should influence fiscal policy (e.g., the level of debt). For most countries, small cyclically adjusted deficits would in general be consistent with a 3 percent of GDP deficit limit. But there remains a risk that such a limit may not provide sufficient room under all circumstances for an appropriate response to cyclical downturns, and financial sanctions may be applied unjustifiably. Moreover, such an approach could certainly be strained if there is a significant downturn before benchmark deficit levels have been achieved.

The trade-off between the flexibility and the credibility of fiscal rules can be relaxed through increased transparency. Thus Australia, New Zealand, and the United Kingdom could rely on the transparency provisions of their fiscal frameworks to avoid being constrained by fiscal rules or targets when it would be counterproductive to stick to them. They have the option of designing fiscal policies which are generally consistent with the rules, but of departing from them at the implementation stage as long as they explain why and how this is being done. If the reasons for such a departure are legitimate, and in particular if they are subject to independent verification, there should be no reputational cost of failing to meet a rule.

Another way of responding to the trade off between flexibility and credibility is to use cautious projections for trend growth to reduce the risk of being overly optimistic in adjusting for the cycle. However, while this approach may be helpful in establishing the credibility of a new rules-based regime, its effectiveness will diminish over time as markets and voters learn to discount the deliberate margin for caution. Moreover, persistently cautious projections can result in the build-up of considerable room for maneuver, thereby limiting the credibility gains from a rule.

Finally, there is the standard criticism of deficit rules that they encourage creative accounting and other practices detrimental to transparency[9]. Steps taken to address this potential concern include the use of uniform accounting and classification standards, for example, the adoption of an internationally agreed definition of investment in specifying a golden rule, and an emphasis on explicit reporting requirements (e.g., to parliament) as a means of encouraging independent scrutiny.

4.2 Debt rules

The 60 percent of GDP debt target under the Maastricht Treaty and the United Kingdom's sustainable investment rule, which requires that public sector net debt should be held at a stable and prudent level over the cycle (currently defined as 40 percent of GDP), are the clearest examples of debt rules. However, an increasing number of countries have debt targets. One of the principles of responsible fiscal management in New Zealand is that debt should be kept at prudent levels (which is left to the government of the day to define). The current government has a long-term objective of keeping gross debt below 30 percent of GDP, and net debt below 20 percent of GDP, both over the cycle, and increasing government net worth. The original objective in Australia was to halve the ratio of general government net debt to GDP by the end of 1999, which was met, and the objective now is to improve the general government net asset position over the medium to longer term. Canada is committed under the 1998 Debt Repayment Plan to keeping the debt-to-GDP ratio on a permanent downward track. In Sweden, the key target of a 2 percent of GDP fiscal surplus over the medium term is consistent with eliminating net debt by 2015.

A general problem with debt rules and targets is that it is difficult to decide what is the optimal level of debt, and therefore what the target should be. The literature is not very helpful in providing conclusions about optimal debt levels. Tax smoothing models suggest only that the debt ratio should be constant (Barro, 1979). Dynamic optimal tax models with exogenous growth suggest that the debt should decline over time to levels determined by initial conditions (Judd, 1985 and Chamley, 1986), while in models with endogenous growth debt should be negative in the long term so that distortionary taxes are not needed (Milesi-Ferretti and

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9 See, for example, Gramlich (1990) and Reischauer (1990) on the effects of the Gramm-Rudman-Hollings deficit reduction legislation in the United States; and Eurostat (1998) on the creative accounting prompted by the need to meet the Maastricht criteria.

Roubini, 1998). Intergenerational models of fiscal policy also provide guidance on the optimal level of debt, although the results are sensitive to parameter values (Aiyagari and McGrattan, 1998). In the final analysis, debt reduction has been driven not by concerns about nonoptimality but rather by concerns with nonsustainability, and the need to lower risk premia on interest rates; the circumstances of individual countries have thus been an important influence on judgments about appropriate debt rules and targets[10].

Given that an optimal debt ratio is difficult to determine, and that fluctuations in debt are to some extent welfare-enhancing (according to both neoclassical and Keynesian approaches), a debt ceiling may make more sense than a point-target. However, if debt is well below the ceiling, there is little restraint on short-term fiscal policy. Thus the combination of a path and a ceiling probably has greater merit in terms of providing an appropriate combination of flexibility and credibility, although the path is probably better specified in terms of a deficit target (or expenditure ceiling—see below). And while even a loose debt target or rule can emphasize the need to focus on the longer term sustainability of fiscal policy, the specification should not be too loose. OECD (1999a) argues that the absence of a credible and specific timeframe for the target debt ratio in New Zealand is one explanation of slippages in fiscal adjustment in late 1990s.

The choice of debt measure is also an issue. Gross debt has the advantage that it is a well-understood measure that is broadly comparable across countries, and it is the relevant concept from a financial policy perspective. But it can be a misleading indicator of sustainability. Net debt is better in this regard, although what to include on the financial asset side and the valuation of some assets are both problematic. Net worth is the best indicator of solvency, but presents enormous measurement difficulties.

4.3 Expenditure rules

Several OECD countries have adopted as the centerpiece of their fiscal framework a form of rule that imposes ceilings or similar

[10] The current net debt target of 40 percent of GDP for the United Kingdom is a level that "balances the need to undertake worthwhile public investment and fund this in a fair way, against the requirement that debt remains prudent, and at levels that do not impose a burden on the economy, or future generations." (H.M. Treasury, 1998.)

requirements on specific areas of expenditure. The four main examples are the following.

The United States. The 1997 Balanced Budget Act requires that the balanced budget target for 2002 be achieved through the application of spending limits, as originally set out in the 1990 Budget Enforcement Act. The latter applies only to on-budget accounts (social security and Medicare are excluded), and sets nominal expenditure ceilings for discretionary spending, requires that new expenditure and revenue measures impose no net cost (i.e., that they be financed on a pay-as-you-go, or PAYGO, basis), and includes sequestration procedures which are triggered if these requirements are not met.

Sweden. The government sets a ceiling for total government expenditure (consistent with achieving the medium objective of a surplus of 2 percent of GDP) for the coming three years. This is debated and approved by parliament, and operationalized by setting nominal ceilings in 27 expenditure areas (including social security but excluding interest costs). Cost overruns in one program have to be financed either by drawing from other programs in the same area or by finding savings in the same area in the following two years.

The Netherlands. The 1998 Coalition Agreement, supported by subsequent budget memoranda, sets ceilings in real terms for central government expenditure, social security and health, over the period 1999–2002. In the context of each annual Budget, the projected GDP deflator is used to convert the real targets into nominal ceilings. An expenditure reserve is also included, to cover any public sector wage bill overruns.

Finland. Expenditure ceilings were introduced in the early 1990s, and have been the mainstay of fiscal adjustment efforts since. The ceilings cover all central government expenditure, including debt service costs and unemployment benefits. They are set to keep total central government expenditure at 1999 levels in real terms, deliver a structural surplus, and reduce the debt-to-GDP ratio below 50 percent by 2003. The expenditure ceilings are binding only for the budget year ahead, but are set out, in constant prices, for the following three years. They are subsequently converted into nominal ceilings using specific cost and price deflators (so that adjustments for wage and salary increases are automatic).

Some other OECD countries have also adopted expenditure ceilings—such as the objective of keeping operating expenditures below

35 percent of GDP in New Zealand, or the detailed medium-term expenditure targets for discretionary expenditure in the United Kingdom—but these are not the central focus of the respective fiscal policy frameworks.

The principal advantage of expenditure rules is that they tackle deficit bias at its source, that is the pressure for excessive expenditure, by forcing participants in the budget process to internalize budget constraints. Governments are made accountable for what they can control most directly, which is not the case with deficits given that they are highly dependent on economic developments. Related to this, there is now a large body of evidence suggesting that expenditure-based fiscal adjustments tend to be more successful than tax-based adjustments (see, for example, Alesina and Perotti, 1997 and von Hagen, Hughes Hallett, and Strausch, 2000). The second advantage is that expenditure rules are conceptually simple, and the objective of expenditure restraint is well understood by players in the budget process and by the wider public. Moreover, expenditure ceilings or targets are easier to monitor than cyclically adjusted measures of the deficit. Thirdly, in principle, expenditure rules can maintain fiscal discipline while also allowing the operation of automatic stabilizers. This is clearly the case on the revenue side, but is also possible on the expenditure side, either by building a margin into the expenditure ceiling to accommodate higher spending related to cyclical downturns, or by excluding cyclically sensitive spending.

However, there are indications that the scope for automatic stabilizers to operate has been undermined by a tendency for discretionary spending to absorb the budget margins (in the case of Sweden) and for spending to be set equal to the ceilings even in favorable cyclical conditions (in the case of the Netherlands). Expenditure rules could also encourage the kind of creative accounting practices that have dogged some deficit targets, but this type of problem does not seem to have arisen in the Netherlands, Finland, or the United States, and only marginally in Sweden. Other potential criticisms of expenditure rules are that they do not provide a long-term anchor for fiscal policy, and may not be sufficient to secure nominal surpluses during economic upswings. Thus the discretionary spending caps in the United States have been exceeded since 1998, coinciding with the emergence of a budget surplus. In general, however, the use of expenditure ceilings and rules is generally judged to have significantly enhanced fiscal discipline in the countries that have adopted them.

5. Transparency, Rules, and Fiscal Adjustment

As noted at the outset, since the early- to mid-1990s fiscal adjustment has occurred in most OECD countries. Indeed, fiscal developments before then also had a large common element. This is illustrated in Chart 1, which distinguishes three subperiods of the 1980s and 1990s for the OECD area as a whole: a period of revenue-based fiscal adjustment during 1982–89; a period of expenditure-led fiscal expansion during 1989–93; and a period of expenditure-based adjustment during 1993–99.

Looking at Australia, New Zealand, and the United Kingdom, countries which have most emphasized transparency, and the Euro area countries, with the strongest rules-based approach to fiscal policy, it is clear that fiscal developments have a very similar pattern to that for the OECD area as a whole. The same is true for Canada and the United States—the latter placing more emphasis on procedural rules and both controlling the finances of provinces and states—although the earlier periods showed less extreme changes. But the recent fiscal adjustment period is very similar. By not contributing to the recent fiscal adjustment, Japan is a clear outlier, but it shared the general pattern of fiscal developments during the earlier periods. Finally, other OECD countries (Denmark, Iceland, Greece, Norway, Sweden, and Switzerland), including some that have not been recognized as making as strong a commitment to transparency and fiscal rules as others, have mirrored the experience of OECD countries more broadly.

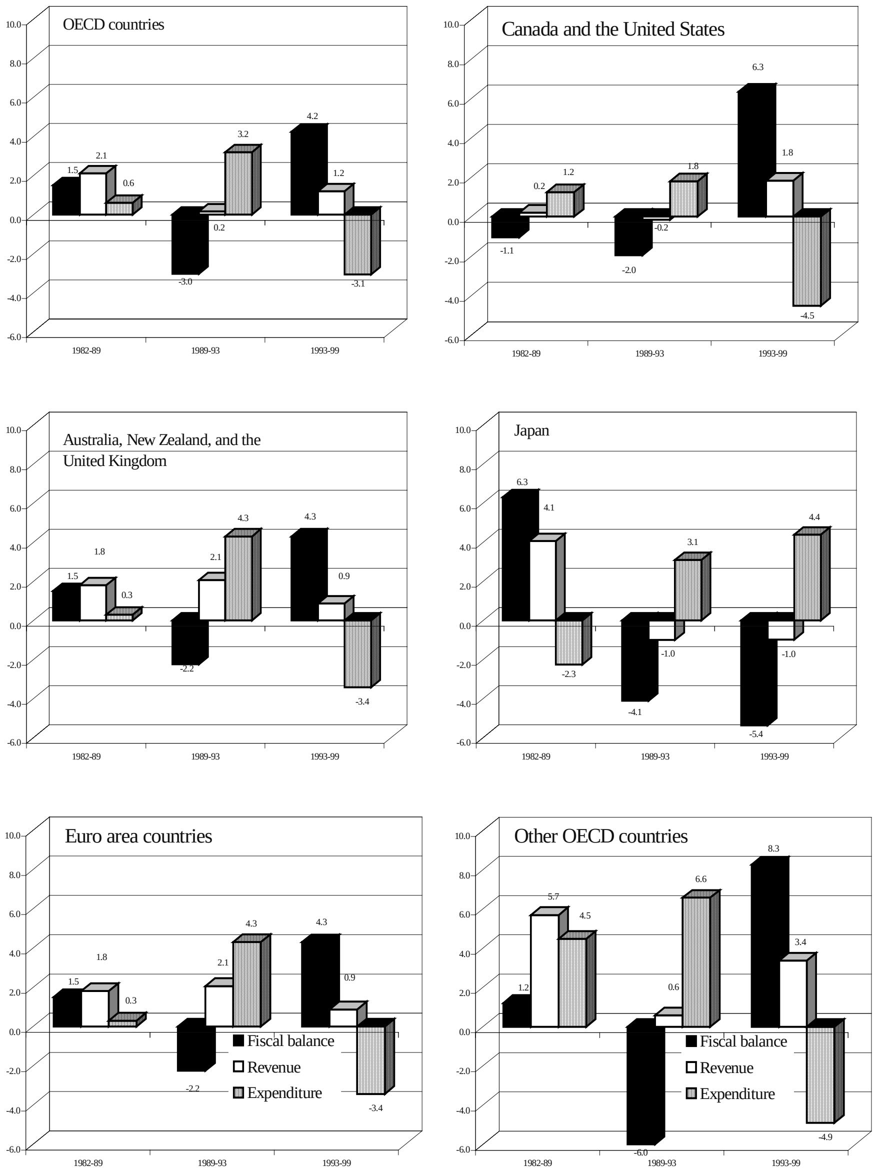
Given the near universal picture of recent fiscal adjustment it presents, Chart 1 could be taken to suggest that transparency and rules have not contributed in any obvious way to fiscal adjustment. But it could equally be argued that they have been very important. Clearly, part of what has happened recently could be cyclical, but Chart 1 looks very similar in cyclically adjusted terms. Nor does there appear to be any significant structural growth effect, other than in the United States[11]. Part of the

[11] There have been upward revisions to estimated potential output for the United States. This contrasts with downward revisions for the Euro area.

Chart 1

Fiscal Developments in OECD Countries, 1982-99

(changes in percent of GDP)



Source: OECD.

problem, of course, is that it is difficult to provide clear conclusions about the role of transparency and rules in the absence of a counterfactual. For example, could New Zealand, where there had been a history of poor fiscal performance, have undertaken a sustained fiscal adjustment without its new fiscal framework? Or could European countries with very high debt ratios by the mid-1990s (such as Italy) have adjusted without the discipline imposed by the Maastricht Treaty?

Table 1 provides information on some of the OECD countries that have adjusted the most during the 1990s.

Greece, Italy, and Belgium. These three countries were operating under the constraints of the Maastricht convergence criteria. While this may be viewed as evidence of the effectiveness of strict quantitative targets, it could be argued that the underlying political commitment to qualifying for EMU, combined with very high debt levels in these countries, were the real motivating factors behind the large fiscal adjustment that occurred during the 1990s. But in the case of Italy, where a lack of transparency was a recognized obstacle to imposing fiscal discipline (Tanzi, 1994), it does indeed seem unlikely that fiscal adjustment could have been achieved in the absence of a major institutional change[12].

Sweden. While the strong fiscal adjustment that began in 1994 predates the introduction of expenditure rules in 1996, there is evidence that the new fiscal framework has worked well and contributed to the improved fiscal performance (OECD, 1999b).

New Zealand. The Fiscal Responsibility Act was introduced towards the end of the period of adjustment, but a case can be made that the Act did help to lock in fiscal adjustment for several years during the mid-1990s and prevented the unwinding of previous reforms. However, it did not prevent the recent slippage relative to long-term fiscal goals; OECD (1999a) suggests that this casts some doubt as to whether transparency by itself is sufficient to promote fiscal responsibility.

Canada. Adjustment was driven primarily by cuts in discretionary expenditure, which were based on radical expenditure reviews across government, to identify specific areas where permanent cuts would be

[12] Chiorazzo and Spaventa (1999) argue that the unexpected but successful large adjustment in 1997, to meet the 3 percent deficit criterion, allowed Italy to switch into a “good equilibrium” of rising confidence, falling risk premia, and a declining deficit.

Table 1

Fiscal Adjustment in Selected OECD Countries

(in percent of potential GDP)

	Period of adjustment (1)	Change in structural balance (2)	Change in structural expenditure	Change in structural revenue
Greece	1990–99	+15.7	-5.1	+10.6
Sweden	1994–98	+11.4	-7.2	+4.2
Italy	1990–99	+11.0	-6.9	+4.1
New Zealand	1986–94	+10.6	-14.0	-3.4
Belgium	1992–99	+9.3	-6.0	+3.3
Canada	1992–99	+8.9	-8.6	+0.3
Netherlands	1990–99	+7.8	-7.9	-0.1
United Kingdom	1993–99	+7.0	-4.3	+2.7
United States	1992–99	+6.0	-3.7	+2.3

Source: OECD.
1) Starting point defined by highest level of deficit; end point defined by lowest level; 1999 is the latest available observation.
2) For general government.

feasible, and reforms to the expenditure management system. Canada, unlike most OECD countries, has not relied on medium-term deficit-reduction targets, preferring instead rolling two-year targets; this, according to the Canadian government, increases accountability and the chances of successful adjustment.

The Netherlands. While EMU considerations were important, the switch to a fiscal framework emphasizing expenditure ceilings in 1994 has been judged to be particularly successful, and to have contributed significantly to the improvement in the fiscal position (OECD, 1998, and van Ewijk and Reininga, 1999).

United Kingdom. A large part of the recent fiscal adjustment was achieved prior to the introduction of the Code for Fiscal Stability and the two fiscal rules. But, unlike New Zealand, the adjustment process has continued strongly since then, and it seems that recent reforms played a role in bolstering fiscal policy credibility. However, the use of deliberately prudent forecasting assumptions has now created a large amount of room for maneuver within the fiscal framework, to the point where the rules will likely improve with effective constraint on fiscal policy over the next few years; the role of transparency in sustaining the credibility of fiscal policy will therefore become more important.

United States. Several studies (Poterba 1997, OECD 1999c, Schick, 2000) have concluded that the specific expenditure ceilings embodied in the Budget Enforcement Act have played a significant role in reducing expenditure, and that this approach was better suited to the U.S. budget process than deficit reduction targets of the preceding Gramm-Rudman-Hollings approach, where sensitivity to economic and technical factors implied sequestrations of such a large size that the approach was not credible.

There is some econometric evidence on transparency and rules, particularly for European Union countries. In particular, von Hagen and Harden (1994) find that countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s, while von Hagen, Hughes Hallett, and Strausch (2000) note that fiscal policy has been associated with stronger fiscal performance, and has been less reactive to cyclical fluctuations and monetary policy changes, in the 1990s than in a baseline period 1973–89. This is attributed in part to the

Maastricht Treaty[13]. But the results of these studies should be regarded cautiously. The results relating to the impact of transparency are for a period preceding recent fiscal adjustment and before efforts were made to increase transparency. However, extending the data period raises potential endogeneity problems given that transparency has increased in response to poor fiscal performance. The limited aspects of transparency that are included is also a concern[14]. The conclusion relating to the impact of rules derives from an indirect test that is suggestive rather than definitive, although it is difficult to pinpoint why the conclusion could be wrong. But the more general problem with these studies is that the effectiveness of both transparency and fiscal rules, and especially rules given that the majority are supposed to apply over the cycle, can only be assessed over an extended period, and preferably using both cross-section and time-series data[15].

6. Creating an Independent Fiscal Authority

As noted at the outset, the success with granting independence to central banks in conducting monetary policy has naturally suggested to some that a similar idea—namely, the creation of an independent fiscal authority (IFA) with the power to set or constrain some fiscal variable(s)—can be extended to fiscal policy with similar benefits. IFA proposals are of two main types[16].

- Ball (1997) and Gruen (1997) propose giving statutorily appointed fiscal officials, independent of the government, some responsibility to make small across the board adjustments to tax rates. The intention is that this would increase the scope for discretionary fiscal policy and increase its effectiveness because making fiscal decisions less political

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[13] While there is a large literature on U.S. states which is supportive of the role of balanced budget rules in influencing fiscal outcomes (see Poterba, 1996, 1997 for a review), Alt (2000) fails to observe such a relationship between transparency and fiscal deficits for the mid-1980s to the mid-1990s.

[14] Quantification based on assessments against the requirements of the *Code of Good Practices on Fiscal Transparency* could support more thorough empirical investigation.

[15] The latter requires that changes in transparency can be measured, which is an especially demanding requirement.

[16] Blinder (1997) proposes that the design of complex tax reform be given over to an independent body which would be better placed than the executive and legislative branches of government to concentrate on the long-term effects of reform.

would reduce implementation lags and increase fiscal policy credibility; at the same time, dependence on monetary policy for demand management purposes could be reduced.

- Von Hagen and Harden (1994) proposed a National Debt Board for European Union countries as a means of enhancing fiscal discipline in the run-up to EMU. The Board would be independent of government, and would decide at the beginning of the budget process the maximum change in debt over the budget year[17].

While there are some similarities between monetary and fiscal policy, the arguments for independent central banks do not carry over automatically to IFAs because fiscal policy differs from monetary policy in fundamental ways. First, monetary policy in most cases has a single objective, the control of inflation, while fiscal policy has multiple objectives in the general areas of improving allocative efficiency and promoting distributional equity, in addition to its macroeconomic stabilization function. Second, monetary policy typically pursues its single objective with one basic instrument, a short-term interest rate, which can be easily and quickly adjusted; fiscal policy, in contrast, uses various tax and expenditure instruments with complicated interrelationships between them and typically long implementation lags. Third, the highly visible and immediate distributional consequences of fiscal policy also make it more political than monetary policy. Fiscal policy decisions create tensions within the executive branch, between the executive and legislative branches, and between central and subnational governments.

Proponents of IFAs do recognize these factors to some extent, and do not advocate that all aspects of fiscal policy be handed over to an IFA; rather, IFAs would control one fiscal variable (namely, the change in the tax ratio or the budget balance). The overall size of government and the broad distributional effects of fiscal policy would be determined by traditional fiscal institutions. However, there is also much in the detail of the IFA proposals that would need to be worked out if they were to be seriously considered for implementation. What exact variable(s) would the IFA target? If it is the tax ratio, would it be with a parameter that adjusts all taxes or just some taxes? Which taxes would these be? If the budget

[17] Eichengreen, Hausmann, and von Hagen (1999) propose something very similar in a Latin American context, the main difference being that their National Fiscal Council would have more scope to change fiscal policy within the budget period in response to changing economic conditions.

balance is targeted, would it be cyclically adjusted? Should the IFA have an eye to broader macroeconomic objectives (such as meeting an inflation target or minimizing variability of output)? What would be the time horizon of the IFA? It could focus only on short-term fiscal policy, or it could take account of longer-term fiscal sustainability. When would the IFA make changes to fiscal policy? This could be decided according to a regular schedule, or as the need arises. Should the IFA worry about the microeconomic and distributional effects of fiscal policy? Finally, there are management and control issues to address. How would the performance of the IFA be assessed? To whom would it be accountable? And what incentives and sanctions would be put in place for the IFA officials?

Many of these implementation issues are not addressed by the Ball/Gruen proposal. It also has to be recognized that some of the alleged benefits of the Ball/Gruen proposal—shorter implementation lags, increased credibility—could be achieved through other means. One option would be to enhance the automatic stabilizers inherent in the existing fiscal policy framework. Although this might imply higher marginal tax rates, such an approach would be less controversial, and would arguably create less uncertainty. Another option would be to introduce a fiscal rule and, emphasizing transparency as well, provide the means by which the private sector can monitor the government's performance against the rule.

The von Hagen and Harden proposal is not subject to all of the same criticisms in that the objective is clearer (the National Debt Board would set the target for the fiscal balance); all tax and spending decisions are left to government (subject to the fiscal balance constraint) so there are fewer microeconomic issues raised; and many of the other implementation aspects have been thought through. However, the proposal does not address how the fiscal balance target should be set. And other, less radical, ways exist to impose binding macroeconomic constraints on the budget process, such as increasing the power of the finance ministry relative to the spending ministries, or again by introducing a fiscal rule.

6. Conclusion

Three approaches to promoting fiscal responsibility have been discussed. Of these, transparency is undoubtedly the most important, both in its own right and as a precondition for the other two approaches to be effective. Legislating transparency has clearly increased the coherence and credibility of fiscal policy in Australia, New Zealand, and the United Kingdom. However, while such an approach has set the benchmark for fiscal frameworks, legislation is not the only way to ensure transparency, and "one size fits all" policy prescriptions are generally inappropriate given the diversity of fiscal institutions and experience. This is where the *Code of Good Practices on Fiscal Transparency* comes in, since its requirements can be met in a variety of institutional settings. Any government with a modicum of fiscal policy credibility will send a strong signal about its commitment to fiscal transparency in particular, and responsible fiscal management more generally, if it meets or says it will meet the requirements of the Code. However, in those cases where past experience raises doubts about credibility, there may be a case for confirming a commitment to transparency by legislating for it.

Where credibility is clearly a problem, fiscal rules may serve to bolster the beneficial effects of transparency. Moreover, in the recent implementation of fiscal rules there has been some learning from past mistakes, with steps taken to reduce the risk of rules resulting in procyclical policies (either by applying rules over the cycle or by targeting expenditure while letting revenue vary with the cycle), and to reduce risk of "cheating," by using deliberately cautious economic assumptions and forecasts, by setting tighter definitions (e.g., of investment spending under the golden rule), and by enhancing transparency and monitoring. In addition to bolstering credibility, rules can also be put in place to meet specific fiscal policy objectives. Hence the golden rule in the United Kingdom is intended primarily to increase public investment and share its costs equitably across generations. Moreover, rules may be helpful in ensuring that recent fiscal adjustment is secured for the longer term. Given the biggest risk is that recent efforts to control expenditure will be reversed, the combination of expenditure ceilings to constrain short-term fiscal policy and a medium-term debt ceiling to ensure sustainability probably offers the best solution in most cases.

In principle, IFAs offer the benefits of rules but with more flexibility. But their introduction would be controversial, and only where credibility is completely compromised are the gains from introducing an IFA likely to be sufficient to offset the upheaval involved. OECD countries for the most part have alternative means of promoting fiscal responsibility.

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