COMMENTS ON SESSION III: FISCAL RULES AND BUDGETARY PROCEDURES

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1. Introduction

I have read the papers with great pleasure and I much enjoyed (and agreed on) many of the ideas and suggestions. It is not an easy task to make comments on so many interesting and different papers; therefore, I will focus only on some aspects dealt with and, after reviewing briefly some common results of the theoretical literature, I will focus on some specific aspects of fiscal rules and budgetary procedure.

The papers raise some interesting issues: just to quote some of them:

a) Are fiscal rules really effective in promoting fiscal consolidation?

b) If so, what are the most effective procedures and rules to promote fiscal stability?

c) Is fiscal transparency sufficient to attain fiscal responsibility?

d) What are the advantages of building an Independent Fiscal Authority (IFA)?

2. What Do We Know on Fiscal Rules and Budget Deficit?

Earlier works on fiscal rules and budget deficits (see, for example, von Hagen, Alesina and Perotti, Poterba[1], etc.,) have shown the major political and institutional influences on fiscal policy outcomes, budget deficits and debts. Budgetary institutions are defined as all the rules and regulations according to which budget are prepared, approved and implemented. As previous works pointed out, since these rules vary greatly across countries, and to a lesser extent, over time, they can quite well explain cross country differences in fiscal policy outcomes, cross country

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[1] Von Hagen (1992), Alesina-Perotti (1994), Alesina-Perotti (1996a) and (1996b), Poterba (1994), (1996a) and (1996b).

variations in deficits and debts; they can be a part of the explanation, although not exclusive.

Moreover, these works find that several related indices of budgetary institutions are significant explanatory variables for cross country differences in the debt/GNP ratio and budget deficits in the eighties and nineties in the EU[2]. To put it simply, budgetary institutions matter, they affect heavily fiscal policies.

We can distinguish between two types of budget institutions: a) laws that prescribe quantitative targets on the budget, such as balanced budget laws and b) procedural rules[3].

The introduction of a balanced budget law would raises the issue of its optimality. The standard Keynesian stabilization policies and especially the tax smoothing theory of budget deficits (see Barro (1979)) clearly suggest that this kind of laws is suboptimal: with a rigid balanced budget, governments would be unable to use deficits and surpluses as a buffer to smooth the distortionary cost of taxation. Moreover, these laws could reveal themselves to be unnecessary and harmful when applied to a non transparent budget process. They can generate incentives for creative budgeting, unfortunately a widespread practice in some countries in the past. Instead, appropriate procedures may not require numerical targets, so that one may maintain flexibility on the budget balance front (to implement tax smoothing policies) without giving up fiscal discipline.

Procedural rules can be set and implemented with regard to three distinct aspects of the budget process: a) the formulation of a budget proposal (within the executive); b) the presentation and approval of the budget (in the legislature); c) the implementation of the budget.

We can distinguish between "*authoritarian*" and "*collegial*"[4] procedures (institutions). The first type limits in some way the democratic accountability of the budget process. A classical example of these procedures are to give strong prerogative to the Prime (Finance) Minister to overrule spending ministers within intergovernmental negotiations on

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2 See von Hagen (1992).

3 See Alesina, Marè and Perotti (1995).

4 We label, for lack of a better word, the two procedures as "authoritarian" and "democratic". See the discussion in Alesina-Marè-Perotti (1995).

the formulation of the budget or to bind the capacity of the legislature to amend the budget proposed. The second type of procedures has the opposite features and emphasizes the democratic rule at every stage, like the prerogative of spending ministers within the government and that of the legislature *vis à vis* the government.

These procedures create a relevant trade-off. Authoritarian institutions are more likely to enforce fiscal restraints, to be successful in avoiding fiscal deficits and in accomplishing fiscal adjustments more promptly; however, they will be less democratic, less respectful of the rights of the minority[5]. On the other hand, collegial institutions have opposite features: they tend to favor consensus building in the budget formation process.

The procedures leading to the formulation of the budget are also very important. In the same way, the process of legislative approval of the budget plays a key role and is crucial for fiscal responsibility. Procedures that limit the type of amendments, prescribe at the beginning a vote on the size of total spending (or total deficit) and then a discussion on specific items, are more likely to limit deficits[6]. Conflicts within the government, amongst spending ministers, at the stage of budget formulation, that tend to happen in coalition governments, weaken the enforcement of fiscal responsibility. The proposal to have a strong prime minister (or finance minister), a minister with a veto power on other players (ministers) in budget formation, tends to influence budget outcomes and to produce fiscal discipline and responsibility.

For example, in a paper of 1992, von Hagen shows that:
"budget procedures lead to greater fiscal discipline if they give strong prerogative to the prime minister or the finance minister, if they limit universalism, reciprocity and parliamentary amendments and facilitate strict execution of the budget law".

Moreover, the formulation of a budget proposal should be as simple and transparent as possible. Simplicity and transparency are values *per se*. Unfortunately, the budget of modern economies tends to be very complex and certainly in Italy it is still too complex. Politicians tend to hide the real

5 These institutions are also more likely to generate budgets heavily tilted in favour of the interests of the majority.

6 See Alesina-Perotti (1994).

balance – to hide taxes, overemphasize the benefits of spending, and hide future liabilities – and have little incentive to produce simple and transparent budgets[7].

Ambiguity can offer some benefits to policymakers: by creating confusion and by making unclear how policies translate into outcomes, policymakers can retain a strategic advantage versus rational, but not fully informed voters. At least up to a point, the less the electorate knows and understands the budget process, the more the politicians can act strategically and use fiscal deficits and spending to pursue egoistic goals. The informational and strategic advantage would disappear with transparent procedures – it would be more difficult for policymakers to hide overspending and deficits.

Following the recommendations of these lines of research, during the last years many reforms have been adopted and implemented in the right direction, as recalled by Hemming and Kell and by von Hagen and Strauch (in this volume). For example:

- new frameworks in legislation have been introduced aiming at increasing fiscal transparency;
- the introduction of balanced budget laws or rules which limit the discretionality of each government in running deficits;
- the setting of multi-year deficit and debt targets;
- explicit procedural rules limiting spending quantitatively;
- Last, but not least, the use of external bodies, with the benefits that fiscal policy could obtain from independent fiscal authorities.

3. Quid Agendum?

I want to end off my remarks by giving some comments in open order.

[7] Here there are two theoretical arguments: first, the concept of fiscal illusion, first proposed by an Italian economist, Amilcare Puviani in 1903 and then developed by Buchanan and Wagner (1977). Second, the ambiguity of policymakers. See Alesina-Cukierman (1990).

a) The role of multiyear budget

I am quite sceptical about the ability of multiyear budgets to promote fiscal responsibility. Italy is the best example of how shifting on the years ahead the burden of the adjustment can be a way of doing nothing. Of course, we all know that this depends on the strength of governments, on their duration and on the nature of coalitions formation.

But I have to admit that in countries with more stable governments, multiyear budgets can be a useful tool; they have a number of advantages for the governments, as shown by the paper of Heeringa and Lindh on the experience of Netherlands and Sweden (in this volume). This is especially true if, for example, a structure of credible sanctions enforceable by the legislative power exists. However, this remedy has to be adapted to the conditions of various countries. To believe that it can be optimal in any situation seems too optimistic to me. In the end, the Italian case showed that governments can recast future budgets without incurring excessive political costs.

b) Fiscal transparency

I want to stress again the argument of fiscal transparency. I strongly believe that fiscal transparency plays a crucial role in budgetary procedures and in obtaining good fiscal outcomes. In my opinion, the importance of a high level of transparency in budget formation will never be too stressed.

I agree with Hemming and Kell (in this volume) when they say that the experience of New Zealand, where fiscal transparency has been deeply improved, while the fiscal adjustment has instead decelerated (especially in the last three years), should suggest that transparency by itself is not sufficient to promote fiscal responsibility.

Transparency is crucial in promoting fiscal responsibility; but it is often a precondition to a coherent fiscal policy for which other instruments are needed, such as fiscal rules and frameworks and quantitative ceilings. However, ”one size fits all” prescriptions are not a good solution given the diversity of budget institutions and experiences, the different legislations in various countries and the different institutional settings, and given the different political economic environments.

c) Balanced budget rules

We have to take seriously the doubts raised by some authors on the effectiveness of fiscal rules, especially with regard to balanced budget rules. It is true, as Alesina and Perotti wrote, that balanced budget rules are not flexible; that they tend to be procyclical and inconsistent with the use of fiscal policy to stabilize output (and with the theory of tax smoothing) and they tend to stimulate creative accounting.

However, balanced budget rules can be useful. The Italian case makes this point very clear. I am quite sure that the success of my country in accomplishing the impressive fiscal adjustment of nineties would not have been achieved without quantitative fiscal rules, such as those envisaged by the Maastricht Treaty and the Stability and Growth Pact.

d) The composition of the effort of fiscal adjustment

Chart 1 by Hemming and Kell (in this volume) suggests that transparency and fiscal rules have been important and that they have maybe contributed to fiscal adjustment in the same direction.

I suspect that some interesting hints could be found by looking more into the details of the fiscal adjustments occurred in most OECD countries (as described by Hemming and Kell on page 436 and on Chart 1). The pattern of the efforts seems much the same but I guess that the composition of the effort is not. The mix of tax increases and expenditure reductions, I suspect, should reveal some significant differences among this group of countries.

e) Use of independent bodies

Another important point is to reduce the risks of cheating by the governments. In many countries (and also in Italy, for example) too many times economic and budget forecasts have missed the target, too many times baseline scenarios have been optimistic to justify non ambitious fiscal policy measures. The use of external and independent bodies could be a good solution not only to make fiscal forecasts but also to monitor outcomes of the implemented fiscal policies.

f) Are budgetary institutions endogenous?

A last interesting issue could be to try to understand whether budgetary institutions are endogenous. They could be expressions of other socio-political and historical variables, which may affect institutions and fiscal outcomes, or simply, unsatisfactory fiscal outcomes may produce a change in these institutions. However, budgetary institutions are changed relatively infrequently, since they are costly and complex to change, therefore one can assume that at least in the short and medium run they are exogenous. Nevertheless, the dynamics of budget institutions reforms is an excellent subject for future research.

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