COMMENTS ON SESSION III: FISCAL RULES AND BUDGETARY PROCEDURES

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These papers provide much valuable insight about fiscal rules and the different country experiences.

1. Hemming and Kell

This is a very interesting paper with a pragmatic focus and it provides several interesting and relevant points. The paper makes a good case for transparency, although it is not as convincing on the contribution of fiscal rules to fiscal performance. The point that there is a trade-off between flexibility and credibility is, in my view, very well done. In addition, the paper states convincingly that countries that could benefit from enhanced credibility would benefit the most from fiscal rules. Lastly, the paper seems to favour the case that rules should apply over the cycle as opposed to being applied on a year-by-year basis.

The authors conclude that countries that have a credibility problem may be best to legislate a commitment to transparency, and may also benefit from adopting fiscal rules. However, they do not discuss whether fiscal rules should be legislated or not, which is an important area of debate.

The remedy for a country that has a credibility problem would be to legislate transparency rules (and possibly to adopt other rules) where the cost of non-compliance would be a political one. Do the authors think that penalties consisting only of reputational costs are sufficient to ensure that countries will adhere to the spirit of transparency rules? It is quite possible that, if these countries already have a credibility problem, they have already endured political costs for failing to live up to their targets.

The view of Hemming and Kell on the contribution of transparency is clear, but an assessment of the contribution of fiscal rules to fiscal

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discipline would represent a natural extension of their analysis. Although they say it is very hard to judge in the absence of counterfactual evidence, the authors then present evidence from a number of countries. The link between the two statements could be improved.

On page 429, the paper states that the effectiveness of using "cautious projections", used in order to reduce the risk of being overly optimistic in adjusting for the cycle, might wear off "as markets and voters learn to discount the deliberate margin for caution". This does not seem to be the lesson learned from the Canadian experience. "Moreover, persistently cautious projections can result in the build-up of considerable room for maneuver (sic), thereby limiting the credibility gains from the rule." Again, this statement does not fit the Canadian experience .

The paper by Delorme, Kennedy and Robbins (2001) presented at this conference yesterday deals with 4 main issues:

1) the reasons for adopting fiscal rules;
2) fiscal rules in practice;
3) an analysis of fiscal outcomes in countries with and without fiscal rules; and
4) an overview of recent research on fiscal rules.

Andrew Kilpatrick's presentation on the United Kingdom case struck me because of the similarity between the UK and the Canadian cases. One way to understand Canada's experience is to take Andrew's paper and perform the following substitutions:

1) "United Kingdom" = "Canada";
2) "Chancellor" = "Minister of Finance";
3) "Caution" = "Prudence"; and
4) "Fiscal errors" = " One-time budgetary adjustments".

These substitutions allow one to get a good representation of Canada's situation, which of course, is very similar to the UK case.

Despite the seemingly common points with respect to the process, the ultimate conclusion is very different. In the UK, the analysis led to the "UK Code for Fiscal Stability". In Canada, at the federal level, we ended up with no set of explicit legislated fiscal rules whatsoever. The situation is very different at the sub-national level, a point on which I shall return below.

The reason why we ended up with a different conclusion in Canada (at the federal level), has a lot to do with the nature of the political process. For the last six years, we've had a Finance Minister that has a strong influence over Cabinet decisions, whose government has earned a highly credible and sound reputation related to the management of public finances.

It may be argued that such a reputation could be rapidly lost and that this is the reason why we need fiscal rules. In that context, the favorable economic conditions we've benefited from in the recent years may have contributed to render fiscal rules temporarily unnecessary. But, in my view, the real "acid test" has yet to come with a future economic slowdown and the related impact on cyclically-sensitive components of the budget.

As we all know, automatic stabilisers are unlikely to be optimal. An eventual recession is therefore likely to require discretionary fiscal measures and, a test of the rules will be the success in reversing these measures when the economy recovers.

At the federal level in Canada, we looked at the different country experiences and we tried to adapt them to the Canadian reality:

- The Canadian federal government introduced a number of *non*-legislated policy rules, which played a major role in the dramatic improvement in Canada's finances in the 1990s.
- In 1994, the government began basing its budget plans on economic assumptions toward the low end of the range of private sector forecasts, in order to avoid making inappropriate policy decisions due to internal overly-optimistic economic assumptions.
- In addition, the government began setting two-year rolling deficit targets, with an ultimate goal of a balanced budget.
- In 1995, the government began the practice of including a Contingency Reserve in its budget planning, to protect against adverse changes in the economy or forecasting errors. If not needed, the reserves were applied to deficit reduction.
- As a result of prudent economic planning assumptions and credible, short-term fiscal targets, along with a firm commitment from the government to meet these targets, the federal government was able to move from a deficit to a surplus position.

- Since running a surplus, the government has continued the practice of setting aside a Contingency Reserve, which is now applied to debt reduction, if it is not needed.

Canada provides a good example of a situation where legislated rules were not necessary to implement a fiscal turnaround. There are more stringent legislated rules at the sub-national level as mentioned by Wolfgang Foettinger yesterday, encompassing either the budget balance, expenditure and/or debt levels. These cases are reviewed in the Delorme, Kennedy and Robbins paper.

In some provinces, the impact of not meeting the rules can be as costly as having Cabinet ministers experiencing salary cuts ranging from 20 to 40 per cent in the first year and even more if the rules are not met for a second consecutive year.

In my view, the Canadian experience at the sub-national level brings about a dimension that could be further discussed in the context of our exchanges, that is, the issue of enforcement (and consequent penalties) and politicians' accountability. Again, given the favourable conditions Canada has experienced in the recent years, meeting the requirements of the rules has been relatively easy.

However, with the less optimistic economic perspectives we are now facing, we might be on the verge of witnessing the real test of fiscal rules in Canada (but also elsewhere), should the slowdown turn out to be more persistent.

A last issue, this whole issue of fiscal rules might have substantial implications for fiscal federalism, an area of research on which we are devoting resources and an issue that we will be discussing tomorrow morning.

One dimension that could be explicitly explored in the Hemming and Kell paper is the issue of the longer-term assessment of fiscal policy that contributes to enhance transparency.

The US represents a good case. In a recent paper, Auerbach and Gale (2001)[1] demonstrate that although the outlook for the next ten years is

[1] Auerbach, Alan J. and William G. Gale (2001), "Tax Cuts and the Budget," The Brookings Institution.

favourable for the US, when the long-term liabilities of Social Security are taken into consideration, fiscal policy is in fact on an unsustainable path. Moreover, they show that the degree of long-term fiscal imbalance increases significantly when a tax cut of a magnitude similar to that proposed by President Bush is included in the model. These long-term considerations have also been raised in a number of other US studies[2]. As for the Canadian perspective, we have applied Auerbach and Gale's framework to the federal and social security sectors in Canada and found that, in contrast with the US situation, Canadian fiscal policy is on a sustainable path.

It would be interesting for the reader to know (perhaps through a short annex) how the cyclically-adjusted variables were calculated. CABBs are only one part of the story (Fiscal stance). "Fiscal Conditions" are perhaps a better indicator.

Using the CABB to attribute the role of discretionary actions in the fiscal adjustment is problematic if the measurement of the CABB neglects to address the simultaneity between the fiscal and economic variables; whereby changes in government revenue and spending affect output and vice versa. Failure to address this issue of simultaneity tends to bias the cyclical component of the budgetary balance downwards, and thereby, overstates the contribution of discretionary actions to the fiscal adjustment.

We are currently developing a new indicator of Fiscal Policy Stance (FiPS) that jointly estimates two indicators: the effect of the economic cycle on the budget balance (or CABB) and the impact of government revenues and spending on economic activity (or fiscal stance). The advantage of this methodology is that it addresses the issue of simultaneity between the economic and fiscal variables, yielding estimates that are statistically unbiased.

Moreover, the CABB should not be used to determine the fiscal stance of government policies because it places homogeneous demand elasticities across the budgetary components and it excludes the impact of the automatic stabilizers on economic activity. The FiPS addresses both of these issues.

[2] See, for example: Congressional Budget Office (2000), "The Long-Term Budget Outlook"; General Accounting Office (2000), "Budget Issues: July 2000 Update of GAO's Long-Term Fiscal Simulations", GAO/AIMD-00-272R.

2. Von Hagen and Strauch

This paper is an important and innovative contribution to the empirical literature as it is very interesting to have a study that separates the effects of the centralization of budgetary procedures from legislated rules.

Since there are relatively few empirical studies, it would be useful if Von Hagen and Strauch provided more information on the methodology in their paper, (e.g., do the indices they construct vary over time or are they just cross-sectional?). This would help the reader to make his own conclusions about the robustness of the results.

The paper states that "the results presented in Table 2 confirm the importance of annual effects". It is not clear what the authors mean by this assertion and more background information would be warranted. Besides, annual effects are not reported in Table 2. Moreover, what is the reasoning for the time period chosen? (1987 to 1992)? Were other periods tested and are the results time-sensitive? The discussion is structured in terms of the long run, but the results only cover 1987 to 1992.

It seems difficult to consider expenditures without revenues and vice versa. Couldn't this this lead to an "omitted variable" problem and hence, bias the results? The regressions using the primary deficit or deficit seem more useful. In order to separate the effects on spending and revenues, maybe they should be examined together e.g., in a VAR or some simultaneous equation model.

3. Janssen

The discussion about the evolution of New Zealand's framework is exhaustive and very interesting, especially the decision that transparency alone was not enough and that legislating principles for sound fiscal management was necessary.

It is also interesting to read about the reasons justifying the rejection of mandatory targets. These echo the concerns raised in other papers presented at this conference: e.g., in practice, it is difficult to evaluate targets defined in cyclically-adjusted terms.

The paper points out a distinction that does not figure prominently in empirical studies: the effect of legislating principles as opposed to rules.

The discussion on sustainability and long-term issues is very interesting. Canada is also using long-term instruments such as generational accounting and the fiscal gap concept (à la Auerbach) to gauge the long-term sustainability of fiscal policy.

4. Reininga

This is a very interesting paper as, for some reason, the Dutch case is rarely mentioned in the literature. To my knowledge, this is the only case where revenues are explicitly separated from expenditures and not considered together (at least until the Kok II administration, which included references to deficit levels).

The reader would benefit from additional information: How were expenditure ceilings determined under the Kok I administration? Were they set so as to reduce spending as a share of GDP or to keep spending growing at the estimated trend rate? (section 3). In the discussion about the Kok II administration, what is the agreement on how to treat higher than expected tax revenues? The discussion of expenditures states that windfall gains are not to be spent. Does this mean that the anticipated excessive tax revenues will be applied to debt reduction? Overall, Ted Reininga produced a very useful paper.