Session 3

FISCAL RULES AND BUDGETARY PROCEDURES

NATIONAL AND EU BUDGETARY RULES AND PROCEDURES: AN EVOLVING INTERACTION

Jonas Fischer[*]

1. Introduction

The EU approach for budgetary policy surveillance to achieve fiscal discipline and improve co-ordination and transparency is to use rules and procedures. The Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP) introduce a supranational budgetary surveillance and co-ordination framework at the EU-level. The rules in the form of numerical targets allow the monitoring of budgetary aggregates against a common standard. These numerical targets focus on the avoidance of excessive deficits, the achievement of sustainable debt levels and the attainment of budgetary positions that are "close to balance or in surplus". Budgetary positions are monitored on a "Maastricht accounting basis", compiled according to the EU system of economic accounting rules (the ESA) which ensures comparability and equal treatment. Member States must regularly report budgetary data and submit Stability and Convergence programmes where they present and explain their budgetary strategies leading to the attainment of the set objectives and targets. Plans are discussed and assessed in different Council formations (the Ecofin and the euro-group) and EU committees forcing Member States to face the peer pressure of their colleagues.

The budgetary rules and procedures at the EU-level interface with the rules and procedures at national level, in particular through the elaboration and treatment of the stability and convergence programmes. In compliance with the subsidiarity principle, the EU framework does not give any indication on the set-up of national budgetary institutions. In fact, the EU legislation[1] makes it clear that at EU level: 1) governments are responsible for the general government deficit, and 2) Member States must

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[*] European Commission. The author works at the Directorate General of Economic and Financial Affairs at the European Commission. The views expressed in this article are those of the author only and in no way reflect those of the European Commission. The author would like to thank especially E. Reitano for her contribution and also A. Brunila, M. Buti and G. Giudice for their valuable comments.

[1] This is made explicit in Article 3 in the Protocol on the Excessive Deficit Procedure annexed to the Treaty.

make sure that national budgetary institutions and procedures allow them to meet their obligations. Therefore, it is the responsibility of each Member State to arrange its domestic procedures on budgetary matters in the way it deems appropriate, in order to ensure that the government can fulfil the Member State's obligations at EU level effectively.

While the traditional national framework focuses on the annual budget cycle of central government, the SGP/EDP package encompasses the whole general government sector in a forward-looking medium-term setting. Indeed, sector coverage and budgeting horizon are the two main areas where some streamlining between the EU and the national level budget frameworks can be expected.

The purpose of this paper is to present a broad overview on, firstly, the extent to which national rules and procedures are at present compatible with the EU framework, in the sense that they operate smoothly together towards the same overriding targets (discipline, control and co-ordination of budgetary policies). Secondly, to investigate what are the areas of "friction" and if we can already, despite the youth of the Pact, observe changes introduced to reduce these. Moreover, we can observe some strategic behaviour by Member States when setting their budgetary targets that reduce the disciplinary power of the peer pressure.

Section 2 explains the EU budgetary surveillance framework. Section 3 focuses on how Member States have adapted national frameworks to the medium term framework of the SGP as well as some strategic behaviour facing peer pressure. Section 4 looks at the co-ordination of budgetary positions over the general government sector. Finally, in section 5 there are some final remarks.

2. The EU framework for budgetary surveillance

2.1 The procedural setting

The EU procedures of budgetary surveillance and fiscal co-ordination centre on: (1) the Excessive Deficit Procedure (EDP)[2]; (2) the

[2] Art. 104 of the Treaty, the Protocol on the Excessive Deficit Procedure annexed thereto and Council Regulation no 1467/97 of 7 July 1997 on the speeding up and clarifying of the Excessive Deficit Procedure.

provisions of the Stability and Growth Pact[3]; and (3) the broad guidelines of the economic policies (BEPG) of the Member States and the Community[4]. Member States are committed to provide information to the European Commission and to implement any policy recommendations the Council may make following the Commission's assessment.

Institutionally, the implementation of the EU procedural framework revolves around the interaction of the Member State with three EU-level actors: the European Commission, the Economic and Financial Committee (EFC), and the Ecofin Council (complemented by the euro-group for the members of EMU). The Commission is involved in the monitoring and evaluation of the budgetary process and policies, preparing assessments, reports and recommendations to the Council. The Council (Ecofin), where the finance or economic ministers of all Member States are members, is responsible for the decision-making, and acts through opinions, recommendations, decisions and, if need be, the application of sanctions upon recommendations/ proposals from the Commission. The euro-group, consisting of finance ministers from the euro-area countries, has no formal decision power but discuss economic policy issues relating to the euro area. The EFC prepares the Ecofin Council and the euro-group meetings and is the framework for dialogue between the Council and the European Central Bank. The members of the EFC are senior officials of the Commission, of the European Central Bank and of the Member States' economic ministries and national central banks, "selected from among experts possessing outstanding competence in the economic and financial field". The Committee therefore also constitutes a framework for dialogue between the Member States and the EU institutions and amongst the Member States, playing a crucial role in developing and engraving a mechanism of peer review and peer pressure.

The Member States are required to report to the Commission twice-yearly their planned and actual deficits and the levels of their debt under the EDP as part of the early warning mechanism under the EDP. In addition to providing this information, the Member States are required to

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3 Resolution of the European Council of 17 June 1997, and Council regulations 1466/97 and 1467/97 of 7 July 1997.

4 Art. 99 of the Treaty.

submit regularly each year stability and convergence programmes, on which the Council formulates an opinion[5].

The stability and convergence programmes and their annual updates are the key instrument of the EU budgetary surveillance and fiscal policy co-ordination framework. They establish a medium-term objective for the general government balance and for the reduction in the government debt ratio, delineate a path to reach the objective and contain a description of the main economic assumptions underlying the fiscal framework and of the budgetary and economic policies to achieve the objectives, as well as an analysis of how changes in the economic assumptions could affect the fiscal aggregates. The informational content and the format of the programmes is clarified by a Code of Conduct drafted by the Monetary Committee (now replaced by the EFC) and approved by the Council in late 1998. The Code of Conduct is aimed at ensuring greater standardisation and maximum comparability of the programmes.

The Ecofin Council is responsible for the examination of the stability and convergence programmes. Based on the Commission's assessments of the programmes and its recommendations for a Council opinion, which are followed by a discussion in the EFC, the Council formulates an opinion on each programme. Updated programmes could be examined under a lighter procedure, without the direct involvement of the Council. If deemed sufficient, the assessment could be based only on the EFC examination. However, given the relative youth of the Stability and Growth Pact and the need to build the credibility of the overall framework, so far the updated programmes have been evaluated following the standard procedure, i.e. they have been examined by the Council which has released a formal opinion.

The Council must assess whether the medium-term budgetary objectives provide sufficient room for manoeuvre to avoid excessive deficits, whether the economic assumptions underpinning the programme are realistic and whether the fiscal measures announced/described in the programmes are sufficient to reach the targets. The Council must also examine whether the economic policies in the programme are consistent with Broad Economic Policy Guidelines and whether the content of the programme "facilitates closer co-ordination of economic policies".

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[5] Council Regulation no 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies.

2.2 The budgetary numerical rules at the EU-level

Framing a discussion on numerical rules at EU (below) and national level (section 3.2), there are a number of aspects identified in the literature that should be taken into account.

First there is the issue of what is the definition of a rule. A critical feature of a budgetary rule is that it is intended for application on a permanent basis by successive governments (Kopits and Symanski, 1998). A rule should also have an ex-post dimension and be followed up. Needless to say, not all policy targets that guide national budgetary policies qualify as "rules", even if they also serve the purpose of being commitment devices. Therefore, self-proclaimed "targets" by a government should rather be labelled as "guidelines", as they are useful as commitment and transparency devices for the current government's policies, but do not commit successive governments, nor create any legal restraints on their policies.

The credibility of a rule is built over time by reputation and/or by ex-post enforcement mechanisms and sanction systems. Only a credible rule gives ex-ante knowledge about future budgetary policies and can influence agents' expectations. The design of a rule also involves many features. Compliance should be easy to survey, preferably by an independent agent. In this respect, there is a trade-off between simplicity and transparency on the one hand, and flexibility and contingency on the other. In principle, the ideal rule should be state-contingent, but if rules are too contingent they may lose in terms of transparency and become excessively flexible and subject to manipulation. It is then difficult to read what is the real commitment involved. This supports the argument in favour of simplicity.

There is also a trade-off between externally and internally imposed rules. While external rules may help guide "weak" governments in the right direction, they may also be regarded as forced constraints with low social acceptance. The degree of severity of a rule depends on which part of the government sector is covered, on the budgetary indicator chosen and on the threshold targeted.

The EU budgetary numerical rules is set up as a device to promote a low deficit culture with a high degree of budgetary control (3% deficit ceiling), sustainability of budgetary positions (60% debt ratio target) and to ensure that planned budgetary positions contain underlying safety margins

so that the budget can respond to economic shocks without the actual deficit surpassing the 3% ceiling (close to balance target).

To ensure comparability and equal treatment across Member States. Therefore, the ESA economic accounts (the European System of Economic Accounts[6]) have been chosen as the accounting framework for the budgetary surveillance at EU level. The sector coverage encompasses the whole general government, defined as central government, state and regional government and social security funds. Importantly, the general government definition is based on a functional basis rather than on an institutional basis, thus including also "off-budget" items. Only units that produce non-market services (administrative services) are included. Publicly owned units dealing with commercial operations are excluded, such as most public enterprises.

- *The 3% of GDP ceiling on general government net borrowing*

The general government deficit, or net borrowing, is defined in the ESA and refers to the excess of all current and capital expenditure over the corresponding receipts. Importantly, all financial transactions[7] are excluded. Net borrowing must not be confused with the borrowing requirement drawn from the public accounts and used as reference in budget laws. Contrary to the analytical focus of economic accounts, the borrowing requirement focuses on the financing of the State budget. The two concepts are different both in terms of coverage and the recording concepts used. In particular, contrary to the ESA definition, the borrowing requirement normally includes many financial transactions and covers usually only the central government and could include public corporations. Overall, the 3% deficit ceiling is the "anchor" among the EU rules and has the advantage of being simple and transparent to monitor while, being formulated in actual terms, a drawback could be its relative inflexibility over changing economic conditions.

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6 Council Regulation 2223/96 of 25 June 1996.

7 A financial transaction is the sale and purchase of financial assets, such as gold, currency deposits, loans, equity and bonds. Financial transactions must not be confused with capital transactions which cover capital formation (investments) and capital transfers (such as investment grants and capital taxes). Capital transactions influence net borrowing.

- *The "close to balance or in surplus" target*

The "close to balance or in surplus" target in the Stability and Growth Pact relates to medium term budgetary positions as expressed in the Stability and Convergence programmes. There is no precise definition of "close to balance or in surplus" and of how to monitor compliance to the rule. At a minimum, such a position should allow the automatic stabilisers to play freely[8]. To this end, the Commission made a first quantification effort by calculating a set of "minimum benchmarks"[9].

As the target should be read in cyclically adjusted or underlying terms, it becomes less transparent and more difficult to monitor than the actual deficit ceiling. The ESA does not identify underlying budget balances and the the cyclical position of the economy is unobservable and therefore needs to be estimated. Accordingly, any estimate of cyclically adjusted budget balance is surrounded with a large amount of uncertainty. Hence, while this rule suffers from monitoring difficulties it has the advantage of being insulated from changing economic circumstances.

- *The 60% of gross government debt to GDP ratio target*

The gross debt ratio target is probably the most straight-forward of the EU numerical rules, but maybe at the same time the least targetted. The debt rule in the EDP says that the general government gross debt ratio to GDP should be below or approach the 60% of GDP reference target level at a "satisfactory pace". The actual implementation of the debt rule so far seems to suggest that a reduction in the debt ratio is sufficient to qualify as satisfactory[10].

Gross debt is not defined in the ESA but in the Treaty protocol on the excessive deficit procedure annexed to the Treaty. However, the financial assets to be taken into account are defined in ESA terms. The precise definition is: total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general

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8 Resolution of the European Council on the Stability and Growth Pact, 17 June 1997, OJ C 236, 2.8.1997.

9 For a elaboration on this issue see part III in « Public finances in EMU-2000 », the Commission 2000.

10 See the 1998 convergence report « Euro 1999 » published by the Commission.

government[11]. The "consolidation" means that the only assets taken into account are holdings of general government debt within general government[12]. "Contingent" liabilities, such as PAYG pension liabilities, are not recognised in the ESA and are therefore not included in the debt definition. This is of course a limitation because the gross debt is used as a signal of sustainability although it may neglect the long-term financing pressures.

3. Expenditure control and medium-term budgeting

3.1 Overview of the expenditure control mechanisms at national level

The EU framework promotes budgetary discipline and puts public finances in a medium term setting. In this context, medium term expenditure control mechanisms contribute to increase the transparency of the budgetary process by an early identification of overruns and by making the budgetary choices involved more explicit. Member States have various expenditure control mechanisms to help them meet these medium-term commitments.

Moreover, a fiscal strategy resting on expenditure control, while allowing for the automatic stabilisers to operate freely on the revenue side seems largely consistent with the rationale of the EU framework approach emphasising the role of budgetary discipline and national automatic stabilisers. Constrained medium-term expenditure paths producing a gradual decrease in the government expenditure to GDP ratios could also be a useful instrument to produce space for reductions of high tax burdens while continuing and safeguarding fiscal consolidation.

Table 1 gives an overview of the different rules, objectives and guidelines, currently used in some Member States to direct the evolution of public expenditure in the medium-term. Even if the overall aims are similar, the details differ substantially. A number of Member States now apply extensive multi-annual budgeting frameworks including "hard"

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[11] This definition is further specified in the Council Regulation 3605/93 as amended by CR 475/2000 where the debt instruments that should be included are listed: currency and deposits, bills and short-term bonds, long-term bonds, other short-term loans and other medium and short-term loans. Note that government guarantees and contingent liabilities are not included.

[12] While the debt criterion is on a gross basis, the deficit criterion is on a net basis. This implies that there is a discrepency between the change in the debt ratio and the deficit mainly due to the building up/down of financial assets. This is labelled the « stock-flow » adjustment.

expenditure ceilings, while others operate with less formal expenditure growth targets or guidelines.

One of the most encompassing medium-term budgeting framework is in *the Netherlands*. It is based on the coalition agreement of the ruling Dutch government and covers the full period of office[13]. The cornerstone is real expenditure targets. Under the current coalition agreement, real expenditure is allowed to grow by 1 1/2% a year on average. The real expenditure guidelines are translated into actual figures on an annual basis using the GDP deflator. The real expenditure targets are set on the basis of deliberately cautious growth scenarios. Should expenditure overruns occur, then they must in principle be compensated for in the same year. A key feature is the clear separation of the expenditure and revenue sides of the budget, since windfalls in revenues may in principle not be used for financing additional expenditure. As revenues almost always come in higher than assumed (given the cautious growth scenario assumptions), recent years have seen growth dividends relative to plan. The framework stipulates rules how to distribute such "growth dividends" between the alleviation of the tax burden and the reduction of debt[14].

In *Italy*, the government presents a medium-term budget-planning document (DPEF[15]) to Parliament in June each year for a vote. The DPEF contains a four-year budget framework of the main aggregates including budget balances and expenditure and revenue ratios for the general government. The DPEF gives government targets and estimated outcomes based on trend projections, indicating the expected amount of discretionary budget measures necessary. The autumn budget then implements the DPEF for the first year of the plan. Overall, the DPEF does not directly constrain public expenditure, but rather is a framework that reveals the government's medium-term objectives.

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13 The current cabinet period ends in 2002. It is likely that the current system will be modified after the elections.

14 In the case of a positive growth dividend on the revenue side, if the EMU deficit is smaller than 0.75% of GDP, the allocation of additional revenues are split 50/50 between lower taxes and improving the deficit. If the deficit is higher than 0.75% of GDP, 75% goes to improve the deficit. In the case of a negative growth dividend, if the EMU deficit is above 2.25% of GDP 50% of revenue losses are covered by borrowing and 50% by tax increases. If the deficit is below 2.25%, 75% is covered by borrowing and 25% by higher taxes.

15 Documento di Programmazione Economico-Finanziaria.

Table 1

General government medium term budgeting frameworks used in Member States

	Multi-annual budgeting framework	Multi-annual spending targets/ guidelines/ objectives	Additional budget rules and targets
B	-	Annual CG+SS exp. Growth 1.5% in real terms over medium term.	Primary balance objective
DK	-	Annual GG consumption growth of 1% in real terms over medium term.	Average GG budget surplus of 2-3% of GDP. Reduce debt levels.
D	-	Annual GG 2% expenditure growth in real terms	Golden rule for federal government
F	-	GG exp. 4.5% real growth target over 3 years (2002-2004). Growth target set to be below potential growth of economy.	
IRL	Three year departmental «envelopes».	-	
IT	DPEF and multi-annual budget presented to Parliament	-	
NL	CG commitment to expenditure framework over 1999-2002 office period.	CG+SS to grow 9% in real terms over 1999-2002.	Rules on how to deal with growth dividends on the revenue side
FIN	Four-year expenditure set by CG and presented to Parliament.	CG expenditures constant at 1999 real level over 2001-2004 period.	CG budget in surplus in structural and ESA terms
SW	Three-year nominal expenditure ceilings approved by Parliament.	CG exp. growth not higher than projected nominal GDP.	GG 2% surplus over the cycle.
UK	Three-year spending limits for department's covers mainly discretionary expenditures.	-	-Golden rule for public sector -Sustainable investment rule (40% net debt)

Source: 2000/2001 updated SCP and Commission services.

Note (1): GG: general government, CG: central government and SS: social security.

Note (2): Member States not mentioned in the Table do not yet apply a national medium term budgeting framework/mechanism.

In *Finland* and *Sweden*, more explicit multi-year expenditure frameworks are used in the budget process. In Sweden, the Parliament enacts four-year nominal expenditure ceilings for central government spending including pensions but excluding interest costs. These ceilings are fixed in the spring and are the starting point for the budget that is presented during autumn. The ceilings are set so that they are in accordance with the government aim to keep the budget balance at a 2% of GDP surplus over the cycle (see section 2.2). In Finland the system is similar using five-year expenditure ceilings for the central government, which are presented in the spring and updated annually. However, in Finland it is the government that sets the ceilings while the Parliament is only informed. The current government set the ceilings that aim to keep real expenditures at the 1999 level when it took office and provide for a central government surplus in structural terms.

The *UK* and *Ireland* use similar systems with three-year departmental expenditure envelopes. The UK the system is more elaborated, having three year departmental envelopes for discretionary expenditures (not including social security benefits and debt interest) decided in the bi-annual "*Comprehensive spending review*" and subject to approval of government and Parliament. Current government guidelines are set using a cautious 2.25% of GDP trend growth assumption. The envelopes are set to be in accordance with the "golden rule" and the "sustainable investment rule" which form part of the budgetary framework (see section 2.2). In Ireland, the three-year departmental envelopes are set by the government and operate more as guidelines to improve medium-term planning.

Several of the governments in other countries use targets for medium-term expenditure growth developments. These objectives are set by the government as a guide for fiscal policy, but are not part of a multi-annual budgeting system as such. In *France,* the government uses three-year rolling growth targets for real general government expenditures. The target is to be applied on average over the three-year period and is updated and rolled over on a yearly basis. Growth targets are set below potential GDP growth estimates, thus aiming at gradually lowering the share of public expenditures to GDP. In *Belgium,* the government has set an annual 1.5% growth target for real primary expenditure for the federal government and social security ("Entity I"). To this end, a cautious 2.5% trend growth

assumption has been used and growth dividends[16] are to be used to reduce debt. In *Germany*, the federal government has presented a 2% nominal expenditure growth objective to be applied for the whole general government sector over the medium term.

In both *Spain* and *Portugal* there are currently plans to introduce more extensive medium-term budgeting frameworks.

- *Common features across Member States*

While the frameworks described above share common features, they are also quite different in several institutional aspects. Firstly, their status differs. Only the frameworks enacted by law, such as in Sweden or the UK, or vested with an important amount of political capital can be regarded as "rules" that provide an external constraint to guide budgetary choices. In addition these frameworks also include enforcement mechanisms in the event of expenditure overruns. Where the government unilaterally declares a certain expenditure growth path as an objective, there is no enforcement mechanism within the system to prevent targets being reformulated or departed from. In these cases, credibility is established over time and the potential loss of built up credibility provides the incentives to stick to set plans.

Secondly, there is a trade-off between flexibility and credibility. The simplest and most focused frameworks are the most operational and transparent. But they also risk becoming inflexible in changing economic conditions creating costs from an economic efficiency point of view. Such inflexibility can imply that the resulting fiscal stance becomes pro-cyclical (see below), or that the frameworks no longer meet the specific concern for which they were designed. Pressures to modify the parameters of the existing framework can build, or indeed for a complete redesign of the overall framework. Both in Sweden and the Netherlands, the frameworks described above have been created at a time when budget deficits were high mainly due to increasing expenditures. Therefore, fiscal consolidation and expenditure control was key. However, in the current circumstances when growth is higher and budget positions are in surplus, there will be pressure for some, at least parametric, change. The benefits of such changes have of course to be weighed against the potential loss of

[16] Growth dividends stemming from the 2.5% to 2.7% interval could be allocated for other purposes.

credibility. Frameworks with a lot of flexibility may end up being less binding. For example in France, the three-year average growth objective given in the 1999 update of 4% over the 2000-2002 period has been increased to 4.5% for the 2001-2003[17].

Third, the sectoral coverage of the expenditure frameworks varies across countries. In general, frameworks aimed to be more directly operational tend to have a relatively narrow coverage encompassing mainly central government expenditures and in some cases also include social security). This is natural as this is under the direct control of the central government. However, expenditure growth guidelines tend to apply to the whole general government sector in order to give guidance to other parts of general government and to act indirectly as a co-ordination instrument. In these cases there tends to be no "hard enforcement" mechanism beyond domestic peer-pressure to respect the guidelines.

Four, there is the aspect of built in pro-cyclicality to be considered when expenditure ceilings are strict and based on cautious growth assumptions. Using cautious growth assumptions can be beneficial to the extent that the costs of not meeting budgetary targets tend to be higher than the benefits of overachieving them. Many countries assume cautious growth assumptions when setting budgetary targets/ceilings, and there is a tendency for growth to turn out higher than assumed. If so, "growth dividends" are likely to materialise on the revenue side. Several of the frameworks contain some guidelines on how to deal with these. For example, in Belgium the government is committed to use growth dividends to reduce the high debt levels that would allow automatic stabilisers to operate fully on the revenue side. However, in countries with lower debt levels it may be deemed more important to reduce high tax burdens than to further reduce debt levels. This could introduce a trade-off between efficiency concerns (i.e. a lower tax burden) and stabilisation concerns (i.e. cutting short the working of the automatic stabilisers in the process). As already said above, in the Dutch framework growth dividends on the revenue side, contingent on the level of the deficit, are in principle to be allocated to tax reductions. In this case, these tax reductions risk being pro-cyclical as taxes are reduced when growth is high. In Sweden, growth dividends leading to budget surpluses above the structural 2% surplus target are earmarked to be returned to the household sector. However it is

[17] Indeed, in the Council opinion on the French update the Council specifically noted this increase in the expenditure norm relative to last year and found that a lower increase would be desirable.

not specified what form this will take place (higher transfers or reduced taxes).

3.2 The use of numerical rules at the national level

Some countries complement expenditure control frameworks with numerical budgetary rules. In fact the numerical rules could sometimes be seen as having a higher status, with the expenditure frameworks being viewed as means to ensure they are met.

Sweden applies a budgetary rule that incorporates the SGP approach of concentrating on cyclically-adjusted budget balances. To lower the debt burden to prepare public finances for future recessions and the budgetary impact of ageing populations, the government has set an objective of a 2% of GDP budget surplus on average over the business cycle. This could accordingly be considered as a "cyclically-adjusted" budget balance target. In fact, a structural target at a 2% surplus level is more ambitious than the SGP "close to balance or in surplus" objective[18]. Whereas the strength of this type of rule is its flexibility in light of changing economic conditions, the monitoring of compliance is complicated. To translate the "average over the business cycle" target into an operational annual target, it is necessary to identify the position in the business cycle. As a view on the output gap is necessary in this framework, compliance with the target on an annual basis is difficult to assess.

Another interesting is the application of a current account balance requirement, the so-called "golden" rule of deficit financing. The UK and Germany apply a golden rule in their national budgetary framework that is codified by law. In the UK, the golden rule is part of the "fiscal code of conduct[19]" and is framed in a medium term context: over the economic cycle the current budget should be in balance or surplus. The investment concept used relates to net investment; thus borrowing is only allowed for investment that contributes to increasing the capital stock. In Germany, the golden rule applies to the federal budget on an annual basis and is enshrined in the constitution[20]. The definition of physical investment used

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18 The "minimal benchmark" for Sweden discussed in chapter 1 is +0.8% of GDP.

19 These principles were enshrined in the Finance Act 1998 and the Code for Fiscal Stability, approved by the House of Commons in December 1998. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice.

20 Article 115 in the «Grundgesetz».

also includes investment in human capital and therefore does not follow strictly the national account definition.

The pros and cons of targeting the overall or the current budget balance have been debated extensively in the literature[21]:, the concern here is the compatibility with the EU rules which do not treat investment expenditures differently from other expenditure[22]. An increase in borrowing to finance higher capital investment could be in conflict with SGP requirement of achieving a budget balance target of close to balance or in surplus.

The consolidation effort in the run-up to EMU has to some extent (relatively small) been based on restricting the growth of government expenditures[23]. Therefore, in the context of meeting the SGP budgetary targets, an application of the golden rule has generally led to any conflicts. Furthermore, the initial years of EMU, favourable growth has meant that the automatic stabilisers have contributed to improve overall actual budgetary position. However, different circumstances may arise in the future if growth conditions worsen and investment levels need to increase. The targets set in the 2000 UK convergence programme provided an indication in this direction. Table 2 shows the UK current budget targets and the compatible ESA budget balance targets as presented in the updated programme. While the national golden rule requirements are clearly overachieved, the planned budget balance deteriorates sharply as a result of increasing investment levels. Obviously, these developments are difficult to reconcile with the "close to balance or in surplus" requirement of the SGP, even though this would be of more concern in countries with higher debt levels or debt still above the 60% of GDP reference value. This development was noted in the Council opinion on the UK convergence programme update (see country section in Part V). Moreover, this type of "target inconsistency" may become more relevant in relation to applicant Member States where there is an evident need for high government investment levels.

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21 See for example Balassone and Franco, 2000, and Buiter, 2000.

22 However, the Treaty article 104 on the EDP specifies that the Commission should take investment expenditures into account when assessing excessive deficits.

23 See European Commission, 2000, Part I, chapter 3 on the budgetary adjustment in the 1990s.

Table 2

Budgetary outlook in the UK according to the 2000 updated UK CP

% of GDP	1999/ 2000	2000/ 2001	2001/ 2002	2002/ 2003	2003/ 2004	2004/ 2005	2005/ 2006
Current budget	+2.1	+1.7	+1.6	+1.3	+0.7	+0.7	+0.7
ESA balance	+1.8	+1.1	+0.6	-0.1	-0.9	-1.0	-1.1

A further example of a numerical rule is that of national targets for primary balances, which seem to be a useful complement to the actual balance target, especially in high debt countries. For instance, Belgium over several years has referred to a commitment to keep the primary budget balance over the 6% of GDP level in the medium term so as to bring down public debt at a fast pace. An explicit reference to a figure is no longer made in the stability programme update, mainly because primary balances are kept comfortably above the 6% of GDP level and in fact are closer to 7%.

Several countries use different guidelines for targeting debt levels, but these are generally fully compatible with the EU framework. Only the UK has a numerical rule codified by law (through the "fiscal code of conduct"), which states that the net debt should be below 40% of GDP over the business cycle[24]. In the current situation this ambition is not binding in a policy perspective, as the net debt is already below the 40% of GDP level. Moreover, in practice this is a tighter objective than meeting the 60% of GDP gross debt reference value. In theory the same type of conflict with the EU framework as is the case with the golden rule may arise since the gross, rather than net, debt is targeted.

[24] This is a sustainable investment rule, by virtue of which public sector net debt as a proportion of GDP should be held over the economic cycle at a stable and prudent level and where, other things equal, a reduction in public sector net debt to below 40 per cent of GDP over the economic cycle is deemed desirable.

3.3 Strategic behaviour to limit the discipline of peer pressure

The EU framework builds largely on the effectiveness of peer pressure as a disciplinary device to reach set targets and avoiding policy co-ordination failures. While a government could find external peer pressure a useful support when implementing difficult measures domestically, there are also incentives to reduce the discipline of peer pressure in other cases and maintain a maximum freedom of manoeuvre.

In the EU framework, peer pressure can be exerted both ex-ante and ex-post. *Ex-ante peer pressure* can be exerted if budgetary plans are presented and discussed at EU level before they are implemented or decided nationally. Such a discussion could lead to EU-level incentives to enact specific policies. For example, a country might plan to substantially cut taxes with an implication for the overall policy-mix and EU partners may have views on whether this is optimal given the current cyclical conditions. *Ex-post peer pressure* relates to the attainment of set targets. A Member State may have committed itself to reach a certain budgetary target and when it later appears that the target is not going to be reached there could be peer pressure from EU level to take corrective action.

Looking at the implementation of the Pact so far there are instances of behaviour on the part of Member States that could be read as a way to avoid both ex-ante discussions on budgetary plans and ex-post discussions on the attainment of set targets. An example of the former could be the observed strategy of submitting stability and convergence at a very late stage in the national budgetary process. This is discussed in more detail section 4.1 below. An example of the latter is the use of overly cautious underlying assumptions when setting budgetary targets. This is discussed below.

- *The use of cautious assumptions when setting budget targets*

A relevant issue in the assessment of compliance with programme's objectives is the tendency of many Member States to be overly cautious in their underlying assumptions. While in the run-up to EMU Member States may have had incentives to be overly optimistic, showing quick progress in their consolidation efforts, now, once in EMU, the incentives have diametrically changed, with cautious growth assumptions paying several forms of "dividends" to governments.

If assumptions are overly cautious and budgetary "growth dividends" systematically materialise, targets are generally overachieved giving the false impression that governments are over-performing (in actual terms). Also, an implicit "room for manoeuvre" is built up which can be used for 'ad hoc' discretionary budgetary measures without being restricted by the actual targets set in the programmes. Finally, in the case of surplus countries, cautious targets may help to avoid domestic political pressure to "spend" the surpluses. It should be recognised that there is a general asymmetry of costs and benefits when designing budgetary plans which calls for systematic caution: in general higher deficits than targeted are more damaging than the good-will gained when targets are surpassed.

Even so, biased underlying assumptions contribute negatively to the transparency of budgetary policies and constitutes a less useful basis for policy co-ordination and the actual surveillance of the attainment of SGP targets in this context is problematic. Partially this is because the question whether budgetary positions should be evaluated in actual or in cyclically adjusted terms is still partially open. While the Commission strongly supports the view that emphasis should be on underlying developments, not all Member States agree, mainly because of the uncertainties in the calculation of cyclically adjusted figures. Clearly, if "peer pressure" were on cyclically adjusted targets, then the cautious attitude of Member States would not create big problems for the assessment. Indeed, as higher-than-assumed growth outcome would imply a smaller deficit/higher surplus in actual terms, Member States would automatically be required, in order to respect their original commitment in the underlying terms, to attain better actual budget positions than envisaged in the programmes.

To illustrate the cautious approach by Member States it is possible to adjust the actual budgetary targets in the programmes by the expected growth dividends and outdated starting positions. This is done in Table 3[25] below, where the first two columns show the deficit targets for 1999 and 2002 as announced in the 1999/2000 updates. The change in the budget deficit from 1999 to 2002, in column 3, is the "committed effort" over the period. Column 4 shows the starting position adjustment for 1999, while in

[25] The starting position is calculated as the difference between budget balance outcome figures for 1999 used in the programmes and in the latest Commission forecast. The growth dividends are calculated as the difference in GDP growth assumptions in the programmes and the latest Commission forecast times the Commission budget sensitivities to growth (around 0.5 on average, see report «Public finances in EMU-2000» for more details).

Table 3

Deficit targets from the 1999/2000 round of updates, adjusted to take into account changes in the starting position and expected budgetary growth dividend

% of GDP	SP/CP deficit target 1999	**SP/CP deficit Target 2002**	SP/CP "effort"	Starting position 1999	Growth divi-dend 2000	Growth divi-dend 2001	Growth divi-dend 2002	Starting and growth dividends	Adjusted "effort" 99/02	**Adjusted deficit target 2002**
	1	2	3 = 2-1	4	5	6	7	8= 4 to 7	9 = 3 + 8	10 = 1 + 9
B	1.1	**0.0**	-1.1	-0.4	-0.8	-0.6	-0.5	-2.2	-3.4	**-2.3**
DK	-2.9	**-2.3**	-0.6	0.1	-0.7	-0.2	-0.1	-0.9	-0.3	**-3.2**
D	1.2	**1.0**	-0.2	0.2	-0.3	-0.2	-0.0	-0.3	-0.5	**0.7**
EL	-1.5	**-0.2**	-1.7	0.3	-0.1	-0.1	-0.2	-0.1	-1.8	**-0.3**
E	1.3	**-0.1**	-1.4	-0.2	-0.2	-0.0	-0.0	-0.4	-1.8	**-0.5**
F	2.1	**0.9**	-1.2	-0.3	-0.2	-0.2	-0.1	-0.8	-2.0	**0.1**
IRL	-1.4	**-2.6**	-1.2	-0.5	-1.2	-0.7	-0.5	-3.1	-4.3	**-5.7**
IT	2.0	**0.6**	-1.4	-0.1	-0.3	-0.1	-0.0	-0.5	-1.9	**0.1**
L	-2.3	**-2.9**	-0.6	-0.1	-0.4	-0.4	-0.3	-1.2	-1.8	**-4.1**
NL	0.6	**1.1**	0.5	-1.6	-1.3	-0.8	-0.6	-4.3	-3.8	**-3.2**
AT	2.0	**1.4**	-0.6	0.1	-0.2	-0.0	-0.1	-0.2	-0.8	**1.2**
P	2.0	**0.7**	-1.3	0.1	-0.1	0.3	0.3	0.8	-0.5	**1.5**
FI	-3.1	**-4.6**	-1.5	1.2	-0.7	-0.8	-0.8	-1.1	-2.6	**-5.7**
SW	-1.7	**-2.0**	-0.3	-0.2	-0.7	-1.1	-0.8	-2.8	-3.1	**-4.8**
UK	-0.4	**0.0**	0.4	-0.9	-0.5	-0.3	-0.3	-2.0	-1.6	**-2.0**

Source: Fischer and Giudice (2001).
Note: a minus sign for the targets indicates a budget surplus.

columns 5-7 is indicated the expected growth dividends over the 2000-2002 period on the basis of the Commission autumn 2000 forecast. Column 10 indicates the "new" targets in actual terms. From the table it is obvious that, if the 2002 targets are assessed only in actual terms (column 3), they are not very ambitious at all in comparison to the adjustments effort Member States have (implicitly) committed to (column 10). In other words, an assessment only in actual terms can be very misleading and become non-binding in a high-growth environment.

Interestingly, a new strategy from Member States seems to have emerged in the 2000 round of programmes. Several Member States (B, I, NL, SW) now make a separate in the programmes between budget balance "forecasts/ projections" and "targets", where the targets are generally less ambitious. A distinction is therefore made between the "hard commitments" which is the target, and the possible "room for manoeuvre" building up through cyclical developments and measured by the difference to the "target". How to allocate this "state contingent budgetary margin" is generally not committed to in a hard way. It can be used for other policy purposes, such as tax cuts or investment, or to reduce deficit and debt sometimes conditioned on policy-mix concerns. The positive in this trend is that what is the "hard commitment" is made explicit rather than implicit as is the case when using overly cautious growth assumptions. In fact the incentives to use cautious growth assumptions are reduced, while at the same time the "hard commitments" are easier to assess and monitor. Accordingly, this creates a better basis for policy co-ordination discussions. It will be up to the Commission to evaluate the appropriateness of the targets and the quality of the plans for the "budgetary margin".

4. Co-ordination of general government positions at the national level

The budgetary commitments of Member States set down in Treaty and the SGP concern the general government sector and not only central government. At the national level, several players other than the central government are involved in determining the overall budgetary stance, and consequently influence Member States' decisions regarding their EU commitments. In particular, national Parliaments are actively involved in the elaboration of SGP targets and programmes. Within the general government, lower levels of governments make up an important part,

especially on the spending side. How the central government interacts with these other national budgetary players on issues relevant for the SGP are examined below.

4.1 Stability and convergence programmes: the involvement of Parliament and the interaction with the national budget procedure

Whereas governments interact directly with the Parliament in the annual budgetary process, they operate with a large degree of autonomy when deciding the medium-term targets and commitments in their stability and convergence programmes, At present, national Parliaments are not formally involved in the process leading to the submission of the stability/convergence programmes (Table II.5)[26]. In fact, no Member State's Parliament formally endorses the programme before it is submitted to the EU and in most case the Parliaments are informed about the programmes at the same time or after they have been submitted to the EU.

However, a form of indirect Parliamentary endorsement of the contents and the commitments of the programmes exists to the extent that the programmes mirror documents, which have already received, or are due to receive, Parliamentary endorsement. Therefore, the timing of submission of programmes as compared to the national budget cycle and the stage in the parliamentary process is important.

The SGP (regulation 1466/97) required that the first set of stability and convergence programmes be submitted before 1 March 1999, a deadline that was synchronised with the first reporting of data on deficits and debt for use in the Excessive Deficit Procedure. Since then they have submitted updated programmes around the end of the year, in some cases as early as September or as late as March.

In most Member States the annual budget cycle runs during the autumn months, with Parliament adopting the final budget towards the end of the year or early the following year. The submission of updated programmes to the EU therefore takes place at different stages in the

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[26] Formal involvement implies a voting procedure, a debate followed by a resolution or some form of official endorsement of the programme.

Table 4

Involvement of Parliament in the 2000 round of updates

	Time of programme submission	Stage in budget process	Parliament informed relative to submission	Possible parliamentary treatment
B	12/2000	Budget adopted by Parliament	Same time	
DK	12/2000	Budget adopted by Parliament	Same time	
D	10/2000	Parliamentary debate underway	Same time	
EL	12/2000	Parliamentary debate underway	Same time	
E	01/2001	Budget adopted by Parliament	Same time	
F	12/2000	Budget adopted by Parliament	Before	Presented by Gov. and discussed in Parliament
IRL	12/2000	Budget submitted to Parliament	Same time	Parliament can discuss
I	12/2000	Budget adopted by Parliament	Same time	
L	12/2000	Budget adopted by Parliament	Same time	Relevant Parliament committee debate
NL	09/2000	Budget submitted to Parliament	Same time	Parliament can discuss and can vote on resolution
A	12/2000	Parliamentary debate underway	Same time	
P	01/2001	Budget adopted by Parliament	Same time	
FIN	09/2000	Budget submitted to Parliament	Same time	Presented by Gov. and discussed in Parliament
S	11/2000	Parliamentary debate underway	Before	
UK	12/2000	Start of consultation phase leading to draft budget	Same time	

national budgetary procedure across Member States[27].

It can be argued that the submission of the programmes after the parliamentary adoption of the budget means that they better reflect the outcome of the national budgetary process. However, a late submission could also be a way to avoid a parallel discussion at EU and at national level, and could mitigate concerns on national sovereignty that debate at EU level might pre-empt national political discussion.

However, If the programmes are submitted before the start of the annual budget process (i.e. ahead of the government presentation of the draft budget to the national Parliament), this could enhance the commitment of Parliaments to the main budgetary aggregates, and moreover provide an opportunity for the concerns expressed at EU level to be taken into account in setting national budgets.

For similar reasons, there could also be a deliberate intention to submit programmes very early in relation to an upcoming sensitive national policy discussion. In both cases, the programmes risk quickly becoming outdated, reducing their value importantly and affecting the transparency of the whole process. Overall, given that draft budgets are usually very close to final budgets, an early submission would seem to be more in line with the rationale of the SGP, allowing the EU discussions to feed back into the national discussions.

A low degree of formal involvement does not fully reflect the real degree of parliamentary involvement in the SGP process. As regards the short-term commitments, the degree of indirect endorsement of the programmes is in fact quite high, as generally there is a strong link between the programme targets and the annual budget for all Member States except the UK[28]).

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[27] Over the past three years, a number of Member States (Belgium, Spain, France, Italy, and Portugal) have consistently submitted the programmes after the adoption of the final budget by the Parliament. In a few cases (Ireland, Finland), the submission has taken place around the moment of the presentation of the draft budget to Parliament, while in others (Austria, Sweden) it has always taken place before the conclusion of the parliamentary debate on the budget. Only in the case of the UK, due to the fact that the budget is not presented until the Spring, does the submission of the programme take place during the preparation of the draft budget. Beyond the regular pattern of submission dates that emerges for the majority of the Member States, it can be observed that in some countries (notably Denmark, Germany and the Netherlands) the date of submission has not been constant in time.

[28] This is because the budget is not run a calendar year basis. The UK figures are based on the mid financial year autumn statement.

However, the implicit endorsement by Parliament of the medium-term target is much more tenuous. The medium-term target and adjustment path set down in stability and convergence programmes are not a budget proposal or on an existing budget, and thus signal ambitions rather than plans. In most Member States, the medium term objectives are merely based on a government forecast, or a forecast made by an independent planning bureau and thus remains exclusively the government's responsibility.

The situation is qualitatively different in the limited number of countries in which there is a medium-term framework based on parliamentary decisions. In Finland and Sweden (see section 3), multi-annual expenditure ceilings are agreed or discussed by Parliament in the spring, and thus constrain the major aggregates ahead of the adoption of the annual budget in the autumn. The objectives presented in the programmes by the government must be consistent with the expenditure ceilings implying that the medium term targets are endorsed by Parliament. In Italy, Parliamentary involvement goes even further as the DPEF is adopted by a vote of Parliament. The Italian stability programme is based on the budget law and the DPEF and if the programme objectives deviate from the DPEF the Parliament must be informed.

4.2 Setting the general government targets: local and regional government involvement

- *The contribution of each level of government to the general government balance*

Under the SGP, the central government undertakes commitments on behalf of the general government as a whole. While the central government is responsible for observing the Treaty and the SPG requirements, regional and local authorities may play a significant role in determining aggregate budgetary developments. Therefore the arrangements (or lack thereof) which oversee the relationship between the central and decentralised government could be an issue to the extent that the SGP requirements impact on state or local government finances.

Table 5 shows the general government budget balance for 2000 as reported in the March 2001 with a break down by government sector level. The figures indicate that local governments on average run roughly

Table 5

Budget balance, general government and government sub-sectors as reported in the March 2001 EDP reporting

2000, percent of GDP	General government	Central government	State government	Local government	Social security
B	0.0	-0.7	0.1	0.1	0.5
DK	2.5	1.4	-	-0.2	1.3
D	1.3	1.4	-0.5	0.3	0.1
EL	-0.9	-3.3	-	0.1	2.4
E	-0.3	-0.6	-0.3	0.0	0.5
F	-1.3	-2.2	-	0.3	0.6
IRL	4.5	4.2	-	0.0	0.4
I	-0.3	n.a	n.a	n.a	n.a
L	5.3	2.8	-	0.6	1.9
NL	2.0	0.3	-	0.2	1.5
A	-1.1	-1.4	0.2	0.1	-0.1
P	-1.4	-1.4	-	0.0	0.0
FIN	6.7	3.3	-	0.1	3.3
S	4.0	1.3	-	0.1	2.7
UK	2.1	2.0	-	0.1	-

Note: The EDP figures include UMTS receipts.

balanced budgets, and in any case do not inflict major deficits in national account terms. However, this does not mean that local governments do not run operating deficits as budget balances does not tell how much of expenditures are covered through transfers from central government. Planned operational deficits must generally be covered by transfers to balance the budget. However, higher than budgeted operational deficits must find additional financing, either through increased revenues (typically additional central government transfers implying higher central government expenditures) or by additional borrowing (implying a local government deficit).

- *Differing degrees of budgetary autonomy*

In most Member States, an important share of general government spending is carried out at local government level while the majority of taxes are raised at central government level. While depending on central government transfers, local and regional government are still autonomous to different degrees and can have an important impact on the general government budget position if operational deficits are channelled through to central government.

Therefore, the "financial significance[29]" of sub-national governments in an SGP context depends upon the part of total general government expenditure they account, and the existence of independent powers of borrowing and the possibility to claim transfers from the central government to cover financial shortfalls. A higher level of financial autonomy on the revenue side (defined in terms of the level of own receipts, including shares in centrally collected taxes, relative to expenditure), could reduce the "financial significance" of decentralised government as they would be able to find own financing in case of expenditure overruns. If, on the other hand, financial significance is high then the central government faces the problem of achieving a degree of control, be it through a mechanism of consultation and co-ordination or through a credible system of budgetary co-ordination rules.

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[29] The term "financial significance" is used here to describe to what degree the development of local government finances needs to be controlled as they pose a risk for the general government budgetary position.

The Member States with the highest levels of financial autonomy are federal states such as Belgium, Germany[30], Spain and the Nordic Member States (where local governments traditionally have a high degree of autonomy). Also, Italy is going through a process of decentralisation. Member States that could be said to have a low degree of sub-national financial autonomy are France, the Netherlands, Ireland and the UK. In terms of the part of total expenditure which is accounted for by sub-national government, it would seem that Germany, Spain and the Nordic countries are at the higher end of the spectrum, while Ireland, the Netherlands and Portugal are at the lower end.

- *How central governments guide general government public finances*

Given these differences it is not surprising that Member States have different frameworks to guide general government finances. In countries where lower levels of government have a substantial financial autonomy, their inclusion in the elaboration of and responsibility for stability and convergence programme objectives may be an important issue. In other countries, borrowing by lower levels of government is firmly restricted and to the extent that these arrangements are reliable and effective, the need for a direct involvement of local government in the elaboration of the programmes is reduced. In general, the relative autonomy of local and regional governments is acknowledged and spending decisions and budgets can be made without interference from the central government. However, the central government keeps overall control by restricting lower levels of governments power to tax or change tax rates complemented by restrictions on borrowing possibilities.

In practice, as a pre-emptive co-ordination device, the central government in practically all Member States puts a boundary of some sort on lower level's finances. In a majority of Member States, local governments are only allowed to borrow to cover for investment expenditures, thus a "golden rule" applies. In addition, it is not uncommon that borrowing has to be directly sanctioned by the Ministry of Finance. A more radical form of arrangement is the adoption of a direct balanced budget constraint. Such a rule exists in Sweden local governments since

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[30] Although in the case of Germany it may be questioned whether the degree of autonomy enjoyed by the Länder in setting revenue levels is really so high, given the important level of equalisation transfers.

1.1.2000, and requires local authorities to balance their budgets in every year (if they fail to comply, the situation must be corrected within two years). The Spanish government is also planning to introduce a similar law.

In addition to the possibility to restrict borrowing there may also be more explicit co-ordination frameworks. In federal states (Belgium, Germany, Spain and Austria) or Member States with strongly regionalised structure (Italy), this tends to be more important than in highly centralised countries.

In Belgium, the High Finance Council sets budgetary objectives for lower levels of government and the central government concludes agreements with communities and regions. In Germany, representatives from the federal government, the Bundesbank and Länder governments meet in Finance Planning Council ("Finanzplanungsrat") to discuss overall budgetary developments and plans. In Spain, central government and individual regions meet in the Fiscal and Financial Council to discuss budgetary matters and establishing the indebtedness limits for each region. A consultation system also exists in Denmark where there are negotiated agreements between central and local government. These normally encompass overall financial ceilings, a guideline for the overall development of expenditures and revenues. It is important to underline that these agreements are not legally binding, but rather a type of gentlemen's agreements.

A few countries have gone further and established so called "internal stability pacts" which are arrangements among the different levels of government aiming to clarify division of responsibility for budget discipline. This relates more directly to the requirements on general government finances introduced in the SGP. In such internal pacts, negotiations between the different levels of government can revolve around four axes: setting the objectives, ensuring their respect, identifying the responsibility for taking corrective action and sharing possible pecuniary sanctions in case of an excessive deficit. The internal pact can also contain a set of rules, which establishes the part of responsibility of local and regional authorities for the general government deficit. The pacts often set up joint committees to monitor budgetary developments at sub-national level and require sub-national governments to submit annual and multi-annual plans for their debt. Some agreements go so far as specifying the procedure to be followed in case of sanctions being applied at EU level for a breach of the excessive deficit procedure.

In Germany, the Länder have agreed that it is a common task of all levels of government to ensure the respect of the deficit target. Agreements of this sort can take the form of a joint declaration on the willingness to consolidate the budget balance. In Austria, each government entity is to pay a proportion of the sanction, in relation to its share of excessive deficit (in turn this depends to a large extent on the share of population living the territory). In Italy, the DPEF establishes budgetary targets for lower levels of government. Should Italy have an excessive deficit then "guilty" regions have to contribute to the potential fine. In addition, there are positive financial incentives to meet the targets also when the general government is not in excessive deficit.

Overall, of course the credibility of the internal pacts depends on the enforceability of the commitments, which in turn requires mechanisms such as a supervisory authority, conditionality of central government transfers or borrowing restrictions*)*. The jury is still out on the effectiveness of these domestic arrangements in ensuring that the goal of budgetary discipline is fully embodied in the political priorities of all government levels.

5. Concluding remarks

The discussion in this paper indicates budgetary procedures at the national level have allowed Member States to meet SGP requirements to date. National procedures have developed to improve their interaction with the EU multilateral surveillance framework. This particularly relates to developing medium term budgeting mechanisms and improving the co-ordination of national budgetary positions of the general government. Both these aspects are currently evolving.

Institutional change takes time and in general existing systems are only adapted when new demands create friction. In EMU, focus starts to shift away from pure budgetary consolidation towards aspects relating the "quality and sustainability" of public finances, that is, new issues come to the fore. Also, focus is turning towards the co-ordination of economic policies in the euro area and the role of how to integrate the BEPG in this context. There are currently ideas floating to streamline the submission dates of programmes and improve feed back mechanisms as well as creating a proper ex ante dimension in the EU surveillance process.

Against this background there could be pressure for additional institutional change at country level in the future, both from external and internal sources. Externally from the EU level as the EU framework is elaborated creating new demands. Domestically to the extent that budgetary players outside the central government become more directly affected by the commitments made at EU level making it more in their direct interest to become more involved.

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PROMOTING FISCAL RESPONSIBILITY: TRANSPARENCY, RULES AND INDEPENDENT FISCAL AUTHORITIES

Richard Hemming and Michael Kell[*]

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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[*] International Monetary Fund. The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the IMF.

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

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[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

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[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.

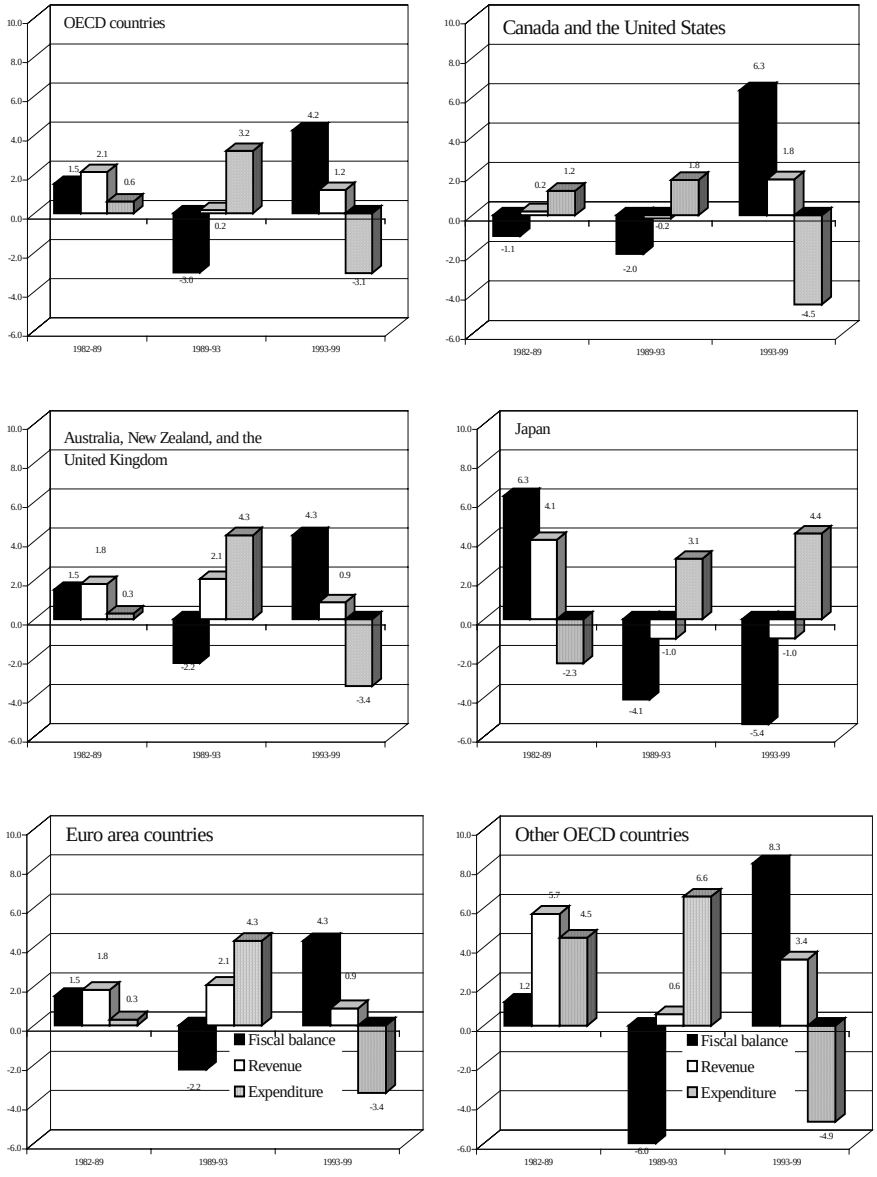
Given the near universal picture of recent fiscal adjustment it presents, Chart 1 could be taken to suggest that transparency and rules have not contributed in any obvious way to fiscal adjustment. But it could equally be argued that they have been very important. Clearly, part of what has happened recently 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

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[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

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[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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FORMAL FISCAL RESTRAINTS AND BUDGET PROCESSES AS SOLUTIONS TO A DEFICIT AND SPENDING BIAS IN PUBLIC FINANCES: US EXPERIENCE AND POSSIBLE LESSONS FOR EMU

Rolf Strauch[*] *and Jürgen von Hagen*[**]

Introduction

The process of European integration that culminated in European monetary union was based on the belief that fiscal discipline is a necessary precondition for a functioning monetary union. This belief has been enshrined in the fiscal criteria of the Maastricht Treaty setting deficit and debt limits for EMU member states. The Stability and Growth Pact (SGP) is in keeping with the general thrust of the Treaty insofar as it attempts to establish an enduring regime that will circumscribe fiscal policy choices. The SGP specifies the deficit limit over the business-cycle, details monitoring procedures and names sanctions for incurring an excessive deficit. Policy-makers thus have clearly relied on formal fiscal restraints as mechanism to safeguard public discipline. Until now, they have largely refrained from incorporating regulations which try to preclude a unsustainable development of public finances through the allocation of decision-making authority and structuring of budgetary processes.

During the immediate run-up to EMU the Maastricht fiscal restraints apparently were quite effective in re-aligning public finances in Member states showing a large excessive deficit. However, there are some objections concerning this initial sign of institutional effectiveness. First, the restraining effect is much less apparent in the early stages of the post-1992 for some bigger countries, where the deficit actually increased rather than decreased. Second, most countries consolidated their public finances later on until 1997, but empirical evidence indicates that they probably would have done this even without the Maastricht fiscal criteria, given their debt level and the macro-economic environment at the time. Although some countries, like Italy and Austria, certainly made an 'extra' effort to

[*] European Central Bank.

[**] University of Bonn.

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comply with the convergence criteria. Finally, the disciplining thrust of the SGP seems already to be vanishing in the current juncture. The fiscal policy stance of most governments in the euro area is becoming more expansionary, although some of them have not yet achieved the medium term position close to balance or in surplus as envisaged by the SGP or still suffer from a high debt burden.

In most member states the consolidation achieved prior to 1997 was at least partly, or in Portugal and Greece almost exclusively, based on revenue increases. Conversely, the current expansionary tendency is largely caused by governments' desire to finally reverse the steady enlargement of the fiscal burden characterising the 1970s and 1980s, by cutting taxes on income. These cuts, however, are not sufficiently matched by expenditure reductions to continue the consolidation process. Overall, there were only two EU countries, Ireland and Finland, where governments pursued a persistent consolidation strategy characterised by expenditure and tax reductions after the mid-1990s. These characteristics of consolidation experiences during the Maastricht convergence process suggests that there are still some important questions to be answered concerning the long-run impact of the deficit and debt limits: How effective can we expect this formal fiscal restraint to be in the long-run? Will the existence of a deficit limit lead to a larger public burden or can a sustainable position be achieved through expenditure reductions? Finally, are there other, complementary institutional arrangements which may underpin fiscal dicipline and what is their effect on public revenues and spending?

Fortunately, there is a rich and relatively extensive literature on legal budget restraints in the US states, which offer an empirical testing ground for the effectiveness of institutional regulations. The political economy literature also provides theoretical models for the "spending and deficit biases" inherent in public finance decisions and points to institutional solutions. This literature indicates that the structure of the budget process is a major determinant of public deficits and expenditures. We will be treating the different strands in the literature in the following order: The first two sections describe the deficit and spending bias originating in the common pool resource (CPR) property of public finance and reviews the institutional solutions that have been proposed in response to this problem. International empirical evidence on the impact of budget processes clearly indicates that the centralization of the budget process leads to lower public expenditures, deficits, and debt. The third section presents evidence on the

effectiveness of balanced budget requirements, tax and expenditure limits. The aim of our presentation is to identify the specific elements underpinning the effectiveness of these institutions and to compare these elements with the regulations of the Stability and Growth Pact. This section will show that fiscal rules are effective if they a) apply to actual instead of planned budgets and include clear target values, b) avoid loopholes and substitution effects, c) are enforced by external agents, and d) are difficult to amend. In the fourth section an analysis of the Maastricht Treaty and the Stability and Growth Pact in terms of these criteria shows that it performs well on the budget outcome and comprehensiveness criteria. The effectiveness of amendment and enforcement mechanisms will largely depend of the future development of regularities in their application. Moreover, the evidence presented in this section indicates that balanced budget requirements are not associated with a tendency to raise taxes.

1. The Common Pool Problem as a Source of Spending and Deficit Biases in Public Finance

Public spending is a story of some people spending other people's money. On this score, a fundamental aspect of public finance is in the distinction between general public goods, such as defense or home justice, which benefit all citizens (tax payers) alike, and targeted public policies, such as local public goods, sectoral policies or transfers targeted at subgroups of citizens (taxpayers) in society. The largest part of public budgets produce rather targeted than general benefits. As a consequence of this incongruence between spending and taxation, each policy-maker misperceives the costs of spending and demands an "excessive" amount, since he takes into account all the benefits while paying only attenion to that share of the taxes which falls on his constituency. This is most obvious when policy-makers represent specific geographical constituencies as is the case with members of the US Congress and of state legislatures. It also applies, however, to political systems in which representation is based on functional groups or on social strata rather than on geographical areas. If this tendency prevails in the budget process, the incomplete internalization of social costs leads to an aggregate level of government expenditures that exceeds the socially optimal amount. Moreover, if governments are allowed to finance these expenditures through public debt, this problem, also known in the context of natural resource usage as the Common Pool Resource (CPR) problem, will apply straightforwardly to the budget

balance; policy-makers will tend to approve fiscal measures implying a higher than optimal deficit[1].

2. Budget Processes as Institutional Solutions to the Fiscal Biases – Theory and Evidence

Budget institutions are a set of formal or informal rules which shape the decision-making process and which lead to a budget's formulation, its approval and implementation[2]. The principal constitutional function of the budget process is to resolve the conflict between competing social and political claims on public finances and to ensure that resource flows correspond to the approved budget. Thus budget processes provide a solution to the problem of allocating spending and revenues and, at the same time, determine the main fiscal aggregates - such as total expenditures, revenues, and budget balance.

2.1 Models of Budget Processes

Earlier formal treatments of budget processes using the CPR approach were strongly influenced by the US Congress and state legislatures. Weingast *et al.* (1981) were among the first to formalize the CPR idea using this setting. They assumed a rather "collegial" approach, where a group of legislators bargains and votes on the distribution of benefits. For the authors, the seriousness of a particular CPR problem depends solely on the number of decision-makers involved since this determines the share of taxes which his or her constituency will have to bear. Since decision-making in legislatures perpetuates a rule of "reciprocity", where everyone gets what he wants, the individual demands add up to an excessive budget. This bottom-up approach to aggregation, where the sum of total expenditures is determined as a residual, has been contrasted with a top-down approach, where policy-makers first decide on the total budget and then allocate shares of the budget. Ferejohn and Krebiel (1987), however, show that under a top-down approach the budget

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1 See, for example, von Hagen & Harden (1996) and Velasco (1997) for two- or multi-period models of fiscal decision-making.

2 The following paragraph relies heavily on von Hagen (1998).

is smaller only when the agents are assigned certain preference constellations.

In a series of papers, Baron (1989, 1991) and Baron and Ferejohn (1989) model a more elaborate institutional structure. They consider the effect that different amendment rules have on the legislators' choice of how benefits are allocated and on the efficiency of fiscal policies[3]. In a closed rule procedure, a proposal made by a legislator is immediately approved or voted down. If the proposal fails, a new legislator is called upon in the next session to submit a proposal. An open rule procedure allows members to call for a vote on the original proposal or to put forward an amendment. In the latter case, the proposal and the amendment are put up to a vote, and the winner becomes the new proposal on the floor in the next session. The main results of their model are that a closed rule generally leads to the approval of more inefficient budgets, to the allocation of benefits to a minimum winning coalition, and to a strong "first-mover" advantage to the legislator who proposed the budget. An open rule yields a more egalitarian distribution of resources and may result in delayed approval of the budget. The driving force behind these findings is that policy-makers have to take subsequent steps of the budget process into account when making a proposal.

Baron and Ferejohn continue to model budget processes assuming a collegial environment and concentrate on the proposal power of legislators. Strauch (1999) extends their framework to a bargaining process between leaders, such as the governor and the legislative leadership, and members. The two types of agent bargain about the size of the budget because the leaders take the social costs of the entire budget into account while the members focus on special constituencies and, therefore, demand higher spending. In addition, Strauch (1999) considers the *ex post* veto power of the executive. The distinction between two types of agent has been proposed by von Hagen (1992) and von Hagen and Harden (1996) for the European context. The model yields two main results: first, endowing the leadership with strong proposal and particularly *ex post* veto authority offers a powerful tool for curtailing the budget. Second, the constellation of rules matters. While the open rule procedure with veto authority of the

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[3] The overall efficiency of the budget, according to Baron (1991), can be defined as the benefit to tax ratio for all programs. In principle this decision can be translated into a decision about the total size of the budget, provided one make some assumptions concerning the available set of programs. However, since the approach does not offer any theoretically guided assumption about these factors, any empirical validation of the argument is extremely difficult.

leader produces lower budgets than would a simple open rule without the executive veto option, a closed procedure may yield lower expenditures than an open procedure with veto authority. In other words, the entire constellation of institutional rules is important when explaining the final budget decision.

Hallerberg and von Hagen (1999), and Hallerberg (1999), presenting a richer model of European government systems, arrive at similar results. They identify two centralization mechanisms at the government stage: delegation and commitment to a fiscal contract. Under the delegation approach, governments transfer or “delegate” authority to a "fiscal entrepreneur" who has an encompassing interest in the budget and whose function is to ensure the continuing cooperation of the other policy-makers throughout the process. To be effective, this entrepreneur must be able to monitor others, have selective incentives at his disposal, and be willing to bear the costs of monitoring. In European governments, the entrepreneur is typically the finance minister. He has the power to shape the final budget outcome, provided he effectively sets the agenda in cabinet negotiations and is authorised to constrain amendments. Under the contract approach, the government agrees to a set of fiscal targets negotiated on a collective basis at the start of the budget process. Here the emphasis is on the multilateral negotiations involved in the bargaining process, on identifying the externalities involved in budget decisions, and on the binding nature of the fiscal targets.

The authors show that there are several reasons why the two models should be closely linked to the electoral system. First, the delegation approach is easier to implement in the case of one-party governments because members of the same political party are more likely to have similar political preferences with regard to basic spending priorities than are members of different political parties. In a one-party government, the different ministers responsible for expenditures can be fairly sure that the finance minister shares more or less the same spending priorities and will use the power delegated to him solely to solve the CPR problem. By contrast, cabinet members in a multi-party coalition government may have substantially different views on basic spending needs. In this case the delegation of power to the finance minister entails the risk of not being able to get some of these priorities on the agenda, and thus a fiscal contract including all parties is the proper approach. Second, the punishment mechanism is important. In a one-party government, it is easy to punish a spending minister for defection by dismissal. A fiscal contract, however,

would not be credible in the case of a one-party government since the government could easily change its original goal at any point in time without incurring punishment. In a coalition government, a defecting minister cannot simply be removed from office by the prime minister if the coalition partner supports its ministers. The most important punishment mechanism here is the threat to break up the coalition if a minister reneges on the budget agreement. Thus, punishment leads to the fall of the government rather than to the dismissal of a single individual.

The authors elaborate on the adequacy of different institutional solutions only insofar as they bear on the structure of the budget process in its relation to the electoral system. However, this kind of consideration also applies to other fundamental organizational principles governing state and state-society relations, such as federalism or corporatist interaction. In addition, international actors may arrive on the scene and can in principle assume the same function as national budgetary institutions. Thus, although the framework may appear to be rather specific, it is open to a series of empirical amplifications.

2.2 Empirical Evidence

This part will review the available empirical evidence on the disciplining effect of budget institutions. The first problem posed by the empirical validation of these theories is how the centralization of the budget process is to be conceptualized, i.e. whether in terms of a delegation or a contract regime. For a variety of methodological reasons[4], von Hagen (1992) and von Hagen and Harden (1996) began by using an aggregate institutional index to measure the degree of centralization. This empirical approach was adopted in subsequent studies.

The budget process, as conceptualized by von Hagen (1992) and von Hagen and Harden (1996) with respect to European countries, consists of a series of elements corresponding to different stages. The budget preparation stage may be termed “fragmented” or “decentralized”, if there are no broad budget targets, i.e. if the finance minister only collects bids, and distributional conflicts are eventually resolved by the entire cabinet. It is “centralized” if the finance minister sets fiscal targets, coordinates and

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[4] See von Hagen and Harden (1996) and Strauch (1999) for these reasons and related considerations on the aggregation method.

approves bids, and helps to resolve final conflicts. Alternatively, under the contract approach, targets are negotiated *ex ante*, bids are monitored by the finance minister, and conflicts resolved by senior cabinet ministers or party leaders. The legislative approval stage is "decentralized" if the legislature is essentially unrestricted in its decisions and committees have weak monitoring power. It is centralized if the scope of amendments is at least moderately restricted, the government can determine voting procedures, committees have strong monitoring power under the contract approach, and the upper chamber has no budget authority which would enable it to avoid the kind of lengthy and pain-staking debates that might result in an expansion of the budget. Finally, in a centralized budget process, as mentioned above, a deviation from set targets may lead to the government's downfall. The implementation stage can be termed "centralized" if the finance minister has strong control over spending flows, the transfer of appropriations is under the control of the finance minister or otherwise restricted, and supplementary budgets are rare. The opposite holds for decentralized processes. In addition, von Hagen and Harden include informational elements in order to assess the transparency of the budget process.

With the help of this conceptualization, they analyze the fiscal impact of budget institutions on national debt and deficits for the period 1981-1994. More specifically, they use five or ten year averages to assess the long-term fiscal impact. Non-parametric as well as parametric tests confirm a disciplining impact of centralization. In later studies, they vary the initial conceptualization by multiplying the indicators for the different budget stages. This conceptualization closely reflects the interaction of institutions. Bivariate regressions indicate that not only the additive but also the multiplicative index is significantly associated with lower debt levels and deficits. Moreover, de Haan (1994) and von Hagen (1998) report a similar result for the additive index relating to the growth rate of debt, when they control for a number of economic and political variables, such as economic growth, party constellation in government, or party ideology. Finally, von Hagen (1998) presents evidence that the delegation regime is associated with a stronger anti-cyclical reaction during economic downturns than either a fragmented, decentralized budget process or the contract regime.

In a study on budget processes in the US states, Strauch (1999) constructs a centralization index to analyze the impact of decision-making structures on public deficits and spending. During the budget preparation

stage, the governor is endowed with strong agenda-setting power if he directly appoints the department and agency heads in the most relevant spending areas, unilaterally determines the revenue estimate guiding budget negotiations, and imposes tough budget targets on spending departments. Conversely, the budget proposal may be said to reflect the governors' preferences to a lesser extent, if department and agency heads dominate the process and are able to push their ideal budget proposals through the legislature.

In the legislature, the legislative leadership effectively sets the agenda, if leaders can present their own proposals, if referral and debate in the committee system is rather centralized and if party discipline can be invoked. The distributive thrust varies with the majority requirements for legislative approval and with the opportunities for arranging package deals. Here, the leadership has a stronger position if it does not have to distribute resources to everyone and it can preclude package deals. Time preferences are conducive to budget discipline if the consequences of non-decision at the beginning of the new fiscal year are severe, such as a shut-down of the government apparatus. The leadership is not likely to prevail, if it cannot present its own budget draft, if the committee system is extensive and decentralized, if there are large majority requirements, and if non-decision automatically places last year's budget in default. The governor's most important direct instrument for influencing and restricting legislative decision-making is his veto authority. The stronger the governor's veto authority and the stronger the majority requirement needed to override the governor's decision, the more he can do to indicate which expenditures he wants to see reduced.

Finally, the leverage which the governor has over expenditures during the implementation stage and the flexibility of budget execution is determined, first, by the governors' authority to cut the budget, which may be restricted to maximum amounts or across-the-board cuts. Second, unrestricted opportunities for agency heads to transfer funds between departments and programs may provide opportunities to spend a surplus in one item for another purpose; it may also induce agency heads to overspend their appropriations in the expectation of an *ex post* augmentation of their means.

In addition to the budget process, Strauch (1999) includes measures for the stringency of BBRs and takes into account the existence of tax and expenditure limits. The time-invariant structure of the variables, however, only allows one to use the structural index and the stringency index as

independent institutional sets[5]. Based on fiscal data from 1982 to 1992 for 47 US states, the empirical evidence presented indicates that centralized budget processes are significantly related to lower deficits as well as to lower spending and taxation[6]. This result holds for different expenditure and deficit concepts, i.e. primary expenditures and deficits as well as per capita figures and the ratio of spending or deficits to gross state income. For revenues, the effect can be found for revenues per capita but not for the share of the state in the economy. This result holds even if we control for the impact of balanced budget requirements and for tax and expenditure limits.

Additional evidence on the impact of centralization exists for Latin America and Asia. Alesina *et al.* (1995) as well as Stein *et al.* (1999) analyze the fiscal policy of twenty Latin American countries and Loa-Araya (1997) for eleven Asian countries. These studies use a combined aggregated index for the centralization and transparency of the budget process as well as for the stringency of budget rules. The studies on Latin America show that countries with centralized, transparent budget processes and strict formal or informal constraints have lower deficits and debt levels. Loa-Araya (1997) corroborates this finding because parametric and non-parametric tests produce a similar result for fiscal deficits, her main dependent variable. Unfortunately, the high level of aggregation does not allow the above mentioned authors to unravel the individual effects of the budget process structure and the budget constraint and to specify the extent of their potential interaction. This may partly explain the Latin American study's finding that governments with a centralized budget process tend to engage in a pro-cyclical fiscal policy. Finally, Jones *et al.* (1999) consider the development of public expenditures in the Argentinean provinces. Analyzing per capita expenditures during the second half of the 80s, they find that centralized budget processes, hard legal constraints for provinces and local authorities, the system of tax distribution, independent auditors and constitutional rules for subsidies lead to fewer expenditures. In short, there is considerable evidence that adequate budget processes help to solve the "deficit bias" as well as the "spending bias" in fiscal policy-making in Europe and overseas.

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[5] In fact, an analysis of their interaction does not yield any sensible results, probably due to the high degree of multi-collinearity resulting from the interactive term.

[6] Using data drawn from the gubernatorial budget drafts, the appropriation acts, and the final budget at the end of the fiscal year, he was able to trace budget decisions throughout the budget process. The findings are in line with predictions for a prospective agenda-setting strategy of agents.

3. The effectiveness of legal restraints

The benefits of legal restraints in maintaining fiscal discipline are obvious. If enforced, legal restraints eliminate "excessive" deficits and spending[7]. However, strict fiscal rules are not necessarily optimal for two reasons. First, they prevent the budget from reacting to the business cycle or exogenous shocks in an anti-cyclical manner, a reaction which would be adequate according to Keynesian considerations as well as the classical "tax-smoothing" hypothesis. In an inter-temporal setting, the latter argument more properly applies to the budget balance because the crucial aspect here is the convex costs of tax changes. Unlike a spending limit, a balanced-budget requirement might result in a sub-optimal volatility of tax rates. Second, legal restraints provide incentives for avoidance strategies. Such strategies include reducing the transparency of the budget, which in turn, gives rise to accounting gimmickry. Even worse, the restraint may have allocative effects if decision-makers decide to shift resources to unrestricted funds. The following paragraph will briefly discuss the existing empirical evidence on the effectiveness and potential negative side-effects of legal restraints in order to derive some conclusions concerning an "optimal" institutional design[8].

The appeal to empirical evidence presupposes, first, that the data relating to the fiscal rule of interest exhibit sufficient variation. This presupposes either a long time series with numerous changes in the fiscal rule or a large cross-section of diverse institutions. Second, the fiscal rule must be exogenous to the fiscal decision. If large deficits were one of the reasons for the adoption of a budget rule, then the analysis would underestimate the true effect of rules on deficit constraints. Third, all potentially important independent variables likely to determine the path of deficit behavior must be controlled for to avoid an omitted variables bias, i.e. an overestimation of the effect. This can be done either by explicitly including economic and social control variables or by selecting cases with a common macro-economic environment. In the light of these considerations, it seems particularly advantageous to examine the experience of the US states, since the deficits of all states, with the exception of Vermont, are subject to size constraints and the public debt of

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7 This paragraph follows the arguments presented in Alesina and Perotti's overview (1996:401-402).

8 The criteria mentioned in the following (except for that governing the comprehensiveness of the fiscal rule) as well as the introductory methodological remarks are taken from Inman's (1997) analysis of BBRs.

several states are subject to constraints as well. These legal restraints are characterized by varying degrees of strictness and enforceability, which allow us to consider the US states as a natural laboratory for different institutional regulations.

A detailed description of the balanced-budget requirements (BBRs) can be found elsewhere (ACIR 1987, Bohn and Inman 1996, Strauch 1999). Roughly speaking, they vary, first, depending on the stage of the budget process to which they apply. Some states require only that the governor submit a balanced budget proposal; others prescribe that the appropriation bill be balanced at the time of approval. Finally, several state governments are required to balance the budget at the end of the year, whereas others may roll over a deficit into the next fiscal year. By contrast, states with a no-carry-over provision have to accommodate fiscal shocks within the current fiscal year. Second, BBRs vary depending on the type of funds to which they apply. In most cases, they apply to general funds, but the actual law - or at least the letter of the law as interpreted by budget officers - may also cover other funds, such as capital as well as special revenue funds (see Strauch 1999). Third, four US states allow the legislature to override the state's BBR for general funds under special circumstances or to suspend the BBR temporarily by vote of a simple majority. Moreover, states may permit either statutory or constitutional amendments to the BBR, depending on the legal character of the rule. Statutory amendments usually require only the approval of a legislative majority. Constitutional amendments typically require a majority of 2/3 in a state-wide referendum. Amendments may be placed on the ballot either by the state legislature or upon citizen petition (Bohn & Inman 1996:10, 11, 15). Fourth, Bohn and Inman (1996) stress the role of external enforcement. Ultimately, state supreme courts serve as supervisory institutions because every taxpayer can bring the government to court for violating the law. Therefore, the mechanism for selecting judges may be of importance in distinguishing among different types of BBR. Judges are either appointed by the government or the legislature or they are independently elected, in which case they are able to adopt a more autonomous stance.

Much evidence exists indicating that the stringency of the rule affects its disciplining impact. Bohn and Inman (1996) find that no-carry-over rules lead to higher surpluses, while *ex ante* requirements, which oblige the governor or the legislature to submit a balanced budget, are not effective. The higher surplus is primarily the result of lower public

expenditures and not of higher taxes. This is in keeping with Poterba's (1994) results. Looking at within-year adjustment of the budget to unexpected fiscal shocks, the latter finds that governments in states with a strict BBR cut expenditures by more than twice the amount of states restrained by weak BBRs. Both studies, however, do not control properly for the structure of the budget process. The ACIR (1987) and Strauch's (1999) study on state institutions use institutional indices and come to the conclusion that the impact of the BBR increases with the degree of stringency. In the latter study the index relates only to the stage of the budget to which the requirement applies, thus indicating that end-of-fiscal year constraints are more effective for the budget balance. Controlling for the structure of the budget process, no significant impact of the BBRs on public expenditures could be found. The ACIR index also includes an indicator for the legal status of the BBR and thus raises the suspension or amendment issue. The ACIR's result, which demonstrates the importance of constitutional rules, is consistent with that of Crain and Muris (1995), who find constitutional no-carry-over rules to be more disciplining than statutory ones. In addition, Bohn and Inman (*op. cit.*) argue that the independence of the monitoring entity contributes to the stringency of the rule. Accordingly, states with strict BBRs and independently elected supreme courts have higher surpluses in their sample than do states with supreme courts appointed by the governor or legislature. However, this study also presents a qualification to this finding, because it looks at different deficit measures. The results reveal that BBRs are effective for deficits, which is the budgetary measure they regulate, but not for primary deficits. Although no substitution effect among different funds could be found owing to the nature of these concepts, the finding gives a first hint that legal restraints may not lead to fiscal discipline in general, but only regulate the resource flow for which they have been formulated.

The substitution effect as well as the role of amendment options has been explored in more depth by authors focusing on debt limits. The ACIR (1987) study finds that debt limits reduce fully guaranteed and long-term debt, but no statistically robust effect is evident for non-guaranteed debt. Von Hagen (1991) reports a somewhat stronger result. He argues that the difference between states with and without a formal debt limit is simply a higher share of non-guaranteed debt. An analysis of frequency distributions, however, confirms that debt limits are associated with a greater likelihood of having low debt levels and large shares of non-guaranteed debt. This result does not hold for absolute values on account of some extreme observations. Kiewiet and Szakaly (1996) distinguish debt

limits along two dimensions: first, whether a public referendum or only a legislative supermajority is necessary to issue fully guaranteed public debt; second, whether the debt limit regulates the absolute value or includes a revenue-based formula. Descriptive statistics and econometric tests suggest that legal restraints prohibiting guaranteed debt above a certain value or requiring a referendum for approval of issuance are associated with less guaranteed debt than are those requiring only a supermajority or those with a revenue-based limitation. In fact, states with a supermajority requirement tend to issue more debt than others, indicating that the majority requirements provide an incentive to encompass log-rolls. While Kiewiet and Szakaly (*ibid.*) cannot find any evidence that states circumvent debt limits by issuing non-guaranteed debt, their findings confirm the thesis that restrictive provisions at the state level result in the devolution of debt issuance to the local level.

In addition to deficit and debt restraints, several US states implemented tax and expenditure limits from the late 70s onwards. In some of the better known cases, these legal restraints were the result of public referenda, but state legislatures actually initiated and approved most tax and expenditure restraints. The assumption of exogeneity is not warranted for these rules, as it is for BBRs, on account of their relatively brief time span. Therefore, thorough empirical studies which attempt to unravel the fiscal impact of these institutions must address the endogeneity problem. Indeed, the empirical evidence is mixed in the case of those studies that do not take account of the potential endogeneity of tax and expenditure limitations, some finding a disciplining impact and others not (see Knight and Levinson 1999 for an overview). Rueben (1995), on the other hand, recognizing the endogeneity problem, uses tow measures of voter power, direct legislation and recall, as instruments for measuring legal restraint. Direct legislation, or public referenda, allow voters to bypass the legislature and to enact constitutional or statutory amendments directly. Recall procedures allow voters to remove elected officials from office. Reuben's estimation using instrumental variables indicates that tax and expenditure limitations reduce states' general expenditures as a percent of personal income by two percentage points. In addition, she finds that this reduction is partially offset by higher local expenditures, again providing evidence of a substitution effect.

Knight (1998) pursues a similar strategy with regard to supermajority requirements for the approval of tax increases or new taxes. He uses the access of voters to direct legislation, the supermajority

requirement for state constitutional amendments and the number of legislative sessions required to amend the state constitution as instruments, because these institutions facilitate or hinder the promulgation of a supermajority requirement for taxation legislation. Using these instruments, he finds that supermajority requirements have a large, negative impact on state taxes. Knight also examines the interaction between supermajority requirements and BBRs. One might expect states with taxes subject to strict BBRs and supermajority requirements to experience stronger reductions in expenditures. He finds little evidence for such an interactive effect, although the small number of observations in the two samples of states with and without strict balanced-budget rules may have contributed to this result.

4. Implications for the EMU fiscal regime

The Stability and Growth Pact generally elaborates on the regulations of the Maastricht Treaty, as confirmed in the Amsterdam Treaty. If not otherwise specified, procedures apply, as a rule, to all EU member states, with the exception of those pecuniary sanctions to be imposed when a country has an "excessive deficit" and fails to take corrective action. A synopsis of the regulations in the Maastricht Treaty and the Stability and Growth Pact is presented in Table 1.

What can be said about the effectiveness of the Maastricht Treaty and the Stability and Growth Pact in the light of these empirical findings? The prospects of arriving at a definitive conclusion concerning the strictness of the fiscal criteria are rather mixed. On the one hand, the fiscal reference values are comprehensive and strict insofar as they relate to the general government’s end-of-year surplus. Although the accounting principles used to determine the size of the deficit may contain some loopholes, the application of the rule to the entire government sector precludes the existence of broad-based substitution effects between different layers of government or between types of funds, such as those found in the US states. On the other hand, the relatively clear-cut reference values mentioned in the Treaty have been diluted by qualifying conditions. The weakening of the disciplining effect that was brought about by qualifications in the Treaty became obvious during the decisions governing

Table 1

Institutional characteristics of the Maastricht Treaty and the SGP

	Maastricht Treaty	**Stability and Growth Pact**
Fiscal criteria	3 percent general government deficit to GDP ratio; 60 percent general government gross debt to GDP ratio. An exceptional violation of the 3 percent deficit limit is possible, if the deficit remains close to the threshold, is due to exceptional circumstances and promptly drops below the reference value as soon as the causes vanish; downward-sloping trajectory is required if the debt level is above the 60 percent limit.	General government deficit "close to balance or in surplus" in the medium term to ensure that the 3 percent reference value will not be breached. 3 percent reference value may be breached if the annual fall of GDP exceeds 2 percent or if the downturn is less than 2 percent (but at least 0.75 percent) and further supporting evidence exists (in particular, if evidence for the abruptness of the downturn or for deviation from trend output is provided).
Enforcement	Monitoring by the Council and the European Commission. Council decision on the existence of an excessive deficit, including recommendations for corrective action. Publication of Council recommendations if no	Monitoring by Council and the European Commission based on annual national stability programs. Council decides on excessive deficit based on Commission report and makes recommendations for corrective action. The Council can decide to

	corrective action is taken. If the government still does not follow the recommendations, the Council may declare a delay and set a deadline for adequate fiscal adjustments; as long as the state does not change ist budget policy, the Council may decide to impose one or several of the following sanctions: bond issuance must be published; request that the EIB reassess its borrowing policy toward that country; demand a non-interest-paying deposit; demand a fine.	impose sanctions on EMU member states if the deadline for taking effective action to adjust the deficit, as recommended by the Council is breached. Sanctions take the following form: government is required to maintain a non-interest-bearing deficit of 0.2 percent of GDP plus one-tenth of the excess deficit; in each subsequent year only the variable component will be paid; the maximum deposit is 0.5% of GDP; the deposit is converted into a fine if the excessive deficit persists two years after the deposit has been made.
Amendment condition	Approval of all EU member states in accordance with national law.	The Council regulation on surveillance of the budgetary position may be modified by the Council but a qualified majority is needed for amendment approval. The regulation on the excessive deficit procedure, where most of the above mentioned rules are specified, can be modified by a Council decision but amendment requires unanimous approval.

accession to EMU, when it was felt that the debt criterion could be largely neglected owing to a reduction of the debt level in recent years[9].

The medium-term BBR mentioned in the Stability and Growth Pact is even more susceptible to diverse interpretation. The most telling indication of the difficulties associated with this fiscal rule may be found in the literature devoted to settling the issue of how the adequate fiscal position is to be defined and the exact surplus values pinpointed (see, among others, Buti et al. 1998, Banca d'Italia 1999).

The escape clauses in the event of an economic downturn of less than two percent further undermine the clarity of the legal restraint. Although the future will have to show how strictly the Council intends to interpret the Pact – at which time it will have to decide whether an excessive deficit exists.

The enforcement mechanism is also quite different from US institutions. In the US states, enforcement is closely linked to the existence of independent outside agents who are able to monitor public finances and overturn fiscal decisions or sanction policy-makers. None of the agents mentioned in these studies, such as the court or the public, are included in the formal procedures specified by the Treaty or the Pact. Indeed, the Treaty explicitly rules out the possibility of appealing to the European Court, although this does not preclude the possibility that national institutions, such as the German Constitutional Court[10], may define and enforce standards for public finance.

Since external enforcement agents do not exist at the international level, the proper functioning of the Stability and Growth Pact will depend crucially on the "evolution" of the Council's decision-making rules. Here, the experience of US state legislatures with supermajority requirements for issuing public debt presents a strong warning signal concerning the undesirable effects of a cooperative stance, in which a "reciprocity of favors" prevails. Still, if each of the participating members views himself as an independent, outside monitor of fiscal developments in other

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[9] Note that Germany actually breached the 60 % limit and was witness to a persistent rise in its debt level until 1997. In this case, it not only violated the reference value but also violated the Treaty even with its qualifying conditions.

[10] The Federal Constitutional Court issued several rulings on the constitutional limits of public finance. One example is the Court ruling on the Golden rule and the requirement that the economy of April 1989 be stabilized (see Andel 1992). For the role of the German Constitutional Court as an "enforcement agent" of the Maastricht Treaty, see Daniel Gros' comment on Inman's (1997) paper.

countries, the Council may prove to be very effective in reinforcing the disciplining thrust of formal fiscal restraints. The "track record" of the pre-1997 period indicates that the Commission and the Council were willing, under normal circumstances, to declare a deficit excessive, if there was a sustained impression of a misalignment in public finances.

Furthermore, it will depend on how sensitive states are to soft and hard sanctions imposed in response to a violation of the rule. The initial years of the post-Maastricht convergence process leave some doubt as to whether the soft reputational or political incentives associated with the declaration of an excessive deficit will always work. Many governments, particularly in "big states", widened their deficits and concomitantly incurred higher debt levels until the mid-1990s. At the same time, one may assume that public policy-makers abroad as well as international capital market participants will be more attentive to such political signals and react more forcefully in a monetary union, which certainly would raise the costs of defection[11]. Some academics[12] have maintained that "hard" sanctions are unlikely to be invoked. However, if the Council works effectively and that sanctions are imposed, nothing speaks against the assumption that the deposits or the fine specified in the Pact will provide a sufficiently strong incentive to induce the respective government to take corrective action.

Very different conclusions concerning the amendment condition can be derived for the Treaty and the Pact. Any amendment to the Maastricht Treaty and its Protocols which would establish the legal basis for the excessive deficit procedure and the reference values must be approved by all member states in accordance with national laws regulating the ratification of international treaties. Usually, the approval of parliament is needed to convert international into national law. This procedure tends to make any re-negotiation of the Treaty quite protracted, difficult, and rather unlikely. The Stability and Growth Pact is much easier to modify. The Council regulation embodying the "close to balance or in surplus" standard can be changed by a decision of the Council, assuming it has the support of a qualified majority. The regulation on "speeding up and clarifying the implementation of the excessive deficit procedure", where most of the

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[11] Note in this context that the effectiveness of budget restraints in US states evidently hinges on the costs of bringing fiscal policy issues to the attention of the public and letting people decide on these issues. This phenomenon cannot be attributed entirely to fiscal conservatism, which Peltzman (1992) ascribes to US states, since comparable institutions characteristic of direct democracy yield a similar result for Switzerland (Feld and Kirchgässner 1999).

[12] See, in particular, Eichengreen and Wyplosz (1998).

deficit criteria and sanctions are specified, requires a unanimous decision on the part of the Council. These majority requirements are obviously easier to fulfil than are the requirements for an amendment of the Treaty. Like the enforcement mechanism itself, the obstacles they present to an easing of the fiscal constraint will strongly depend on the fiscal stance of the Council.

5. Conclusion

The first major result emerging from the preceding sections is that formal fiscal restraints may yield an effective instrument for avoiding excessive deficits and spending, provided they incorporate certain institutional features: the fiscal target must be clear-cut and comprehensive, enforcement should rely on independent agents, and the formal restraints involved should be difficult to amend. If the Maastricht Treaty and the Stability and Growth Pact are examined with respect to these institutional characteristics, some weaknesses become apparent insofar as the effectiveness of these formal restraints are seen to depend strongly on the future evolution of "behavioural" decision-making and sanctioning rule. As for the interaction and macroeconomic effects of fiscal restraints, studies on US institutions suggest that no conflict exists between the need to reduce the overall tax burden and a strict balanced budget requirement since no evidence for an systematic increase of tax rates could be found. If anything, budget adjustments tend to be made on the expenditure side.

The second major result is that budget processes are effective instruments for solving the problem posed by a "deficit and spending bias" in public finance. This result holds even if strict fiscal rules already exist. Unfortunately, the available empirical evidence does not suffice to define the interaction between budget processes and fiscal rules more precisely, i.e. in a manner that would go beyond the above statement, which implies a substitutive relationship. If budget rules prove to be ineffective in maintaining fiscal discipline, this relationship suggests that budget processes may be needed to yield the desired effect. Given the above assessment of the Maastricht reference values and of the Stability and Growth Pact, more attention should clearly be paid to the budgeting institutions in EMU member states. If countries are characterized by weak budget institutions, adequate solutions will, of course, have to be adapted to national requirements. The adequacy of the delegation vis-à-vis the contract approach for different electoral systems is one important aspect

currently being analyzed. A federal system may, however, require a different solution, such as an 'internal stability pact', which would integrate the different levels of government[13].

[13] The Belgian High Council of Finance represents, in this respect, an important paradigm case for European states. See Stienlet (1999) and Hallerberg (1999) for an account of how the Council functions.

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DUTCH VERSUS SWEDISH BUDGETARY RULES: A COMPARISON

Willem Heeringa[*] *and Yngve Lindh*[**]

1. Introduction

After the negative development of public finances in many European countries in the 1980s and the early 1990s, some countries introduced reforms of their budget processes. So did for instance the Netherlands and Sweden. The Netherlands adopted a trend-based budgetary policy in 1994, after a period of budgetary consolidation which had started in the early 1980s. Sweden implemented new budgetary procedures in 1997, after having suffered the most severe fiscal crises of the 20th century. In both countries, the introduction of multiyear expenditure ceilings were important features of the reforms. In the Netherlands, these ceilings are formulated in real terms, while in Sweden they are nominal. Real-expenditure ceilings, together with a cautious macroeconomic scenario and income reference levels, constitute the pillars of the current budgetary framework in the Netherlands. In Sweden, a medium-term target for the budget surplus has also been adopted as part of the system.

The new budgetary rules have now been in use for some years in both countries and at least some tentative conclusions can be drawn about their qualities and effects on economic development. This paper focuses on the interaction between the two systems of budgetary rules and the macroeconomic development. Have the systems been helpful in supporting macroeconomic and budgetary developments? To what extent do the budgetary rules allow the budget to act as an automatic stabiliser? How do they cope with different types of shocks? For that purpose, this paper starts in Chapter two with a short presentation of the two systems, their history and their main properties. In the third Chapter a descriptive analysis is given of recent macroeconomic and budgetary developments in the two countries. The fourth Chapter sheds light on some specific problems of

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[*] De Nederlandsche Bank.

[**] Ministry of Finance - Sweden.

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both systems. In the Dutch case, the consequences of the use of a cautious macroeconomic base scenario and the problems related to the use of the GDP deflator to transform real ceilings into nominal equivalents are discussed. In the Swedish case soft uncertainty margins are the main problem. The fifth Chapter provides an assessment of the stabilising properties of the current Dutch and Swedish budgetary rules. Especially tendencies towards pro-cyclical behaviour are analysed. The sixth Chapter concludes with a comparison between the two systems of budgetary rules.

2. Budgetary rules in the Netherlands and Sweden

2.1 Current Dutch budgetary rules

The current Dutch budgetary framework has been introduced in 1994, when the first, so-termed "purple" coalition cabinet of Social Democrats (PvdA), Liberals (VVD) and Democrats (D66) took office. By introducing a trend-based budgetary policy, the Minister of Finance followed the advice of the 9th Study Group on Budgetary Margin[1]. In its second term (from 1998), the purple coalition has – apart from some minor modifications – basically maintained this budgetary framework. The current trend-based budgetary policy rests on three pillars: a cautious macroeconomic scenario, real net expenditure ceilings and (since 1998) real income reference levels combined with a formula stipulating how windfalls and shortfalls are to be treated. The revenue and expenditure sides of the budget are strictly separated in this budgetary framework. This implies that decisions concerning expenditures and revenues should in principle be made independently and should not interfere with each other.

2.1.1 Cautious macroeconomic scenario

The coalition agreement is based on a cautious baseline macroeconomic scenario for four years in advance. The adoption of a cautious scenario implies *inter alia* that economic growth underlying the budgetary projections in the coalition agreement is assumed to be 2 per cent per year. In order to capture the favourable economic effects of sound

[1] This group ("Studiegroep Begrotingsruimte") consists of the highest-ranking civil servants of the financial and economic ministries, an executive director of the central bank and the director of the Netherlands Bureau for Economic Policy Analysis (CPB). See Studiegroep Begrotingsruimte (1993).

budgetary and economic policy, another ¼ percentage points of economic growth were added in the past and current cabinet term, resulting in an assumed 2¼ per cent economic growth per year. This is about ¼ percentage points below the trend economic growth calculated as the average over the past 20 years. Economic and budgetary developments in this cautious scenario are calculated by the independent Netherlands Bureau for Economic Policy Analysis (CPB). CPB's calculations of the *ex ante* budgetary room for the cabinet term play a pivotal role in the set-up of the coalition agreement. Obviously, the adoption of cautious macroeconomic assumptions implies that *ex ante* the new budgetary room created by the endogenous growth of revenues is rather limited. The adoption of the cautious macroeconomic scenario does not only assume relatively low economic growth, but also relatively moderate wage increases and low interest rates. However, this is offset by a relatively unfavourable development of the number of social security benefit recipients in the cautious scenario. All in all, autonomous growth in expenditures in the cautious scenario is not very different from a more favourable scenario[2].

The cautious assumptions imply an asymmetry in unexpected budgetary developments: the probability of budgetary windfalls is in theory greater than the probability of setbacks. This is especially the case for government revenues. The asymmetry reduces the need for additional measures during the cabinet term once the coalition agreement has been settled. It also facilitates an orderly execution of the budget. From an administrative point of view, this gives the Minister of Finance a comfortable and strong position in the cabinet. However, from an economic point of view, it could be argued that a true *trend*-based budgetary policy should be based on *trend* economic growth. Obviously, every trend estimate is surrounded by significant uncertainties, especially for an open economy like the Netherlands. Apparently, the two purple cabinets have chosen to minimise the chance of unexpected negative economic and budgetary developments by taking the lower range of expected economic growth as the baseline scenario. This choice was mainly motivated by a desired reduction of the government deficit and debt rate.

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[2] CPB (1997).

2.1.2 Real fixed net expenditure ceilings

Expenditure ceilings form the second pillar of the trend-based budgetary policy framework. The ceilings apply to net expenditures i.e. gross expenditures minus most non-tax revenues (for example, gas revenues). They are defined in real terms, i.e. in constant prices and set for four years in advance in the coalition agreement. In the spring of every budgetary year, they are transformed into nominal ceilings by multiplying them with the most recent estimate of the GDP deflator. Separate ceilings exist for three budgetary sectors: the central government, social security and health care. Any overspending of the ceilings must in principle be compensated immediately within the sector in which the overspending occurs. General compensation by transfers from any other budget to the budget under consideration can only be decided by the cabinet. The budgetary rules allow for a limited carry-over facility: ministries can advance or postpone 0.25 per cent of the total budget to the current or following year. When the second purple coalition took office in 1998, it was agreed that expenditure windfalls stemming from a favourable macroeconomic development should be set apart to compensate for possible terms-of-trade losses. Furthermore, it was agreed that these expenditure windfalls could be used to offset setbacks in other sectors. Although officially not allowed in the first cabinet term, in actual practice it had happened already quite often. At the same time, an overall expenditure reserve of approximately € 0.1 billion per year was created for unforeseen expenditures. The main reason for the introduction of these ceilings seemed to be a desired reduction in government expenditures (measured as a percentage of GDP). Furthermore, the ceilings give the Minister of Finance a strong position from a political point of view as they provide him with a control device over the development of government expenditures. Thus, from an administrative point of view, real-expenditure ceilings are the cornerstone of the trend-based budgetary policy. The 11th Studiegroep (2001) advised to maintain the system of real net expenditure ceilings for the next cabinet term with some minor modifications (see Chapter 4.1).

2.1.3 Real income reference levels

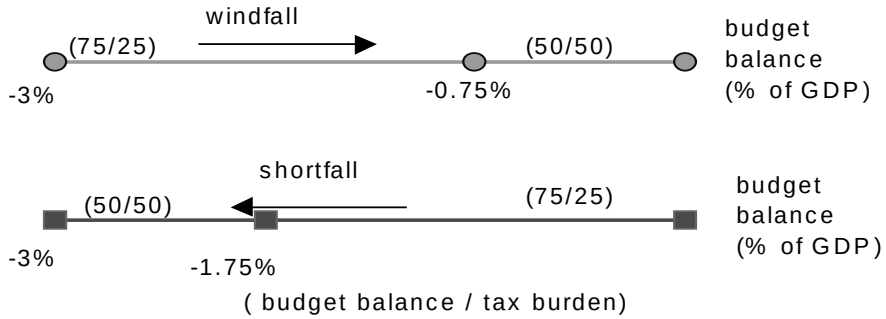
The real income reference levels as introduced in 1998 form the third pillar of the current trend-based budgetary policy. The real reference levels are projected for four years in advance in the coalition agreement and, just like the expenditure ceilings, are based on the cautious

macroeconomic scenario. In order to be transformed into nominal equivalents, they are annually multiplied with the expected GDP deflator for year t. This is done in September of year t-1 when the Budget Memorandum for year t is presented to Parliament. The main function of the reference levels is to estimate expected income windfalls or setbacks. More specifically, these are determined by comparing the projection of nominal government revenues for year t with the nominal reference levels for year t. This takes place in August of year t-1, when the Budget Memorandum for the next year is drafted. Thus, the determination of the revenue windfalls or setbacks is forward-looking by nature. Under the first purple coalition (1994-1998) it was already agreed that expected windfalls should be used for either a reduction of the deficit or a reduction of the tax burden, but not for extra expenditures, reflecting the disconnection of the revenue and spending side of the budget. However, as it was not exactly specified how windfalls should be distributed over the deficit and the tax burden, this was a rather loose agreement. In practice, this led to a bias to tax reduction in the first purple cabinet term. The coalition agreement of the second purple cabinet stipulated exactly how windfalls and setbacks on the revenue side were to be treated. The strict rule was maintained that revenue windfalls were not be used for extra expenditures and that revenue setbacks must not compel additional cutbacks. As for income shortfalls and windfalls, it was decided that three-quarters of any *expected* revenue windfall would be absorbed by the budget balance and one quarter by tax changes, as long as the budget balance would be less than -0.75 per cent of GDP. Windfalls are distributed equally among the deficit and the tax burden, if the budget balance exceeds -0.75 per cent of GDP. *Expected* revenue setbacks are absorbed for three-quarters by the budget balance and for one quarter by additional taxes, as long as the budget balance is not lower than -1.75 per cent of GDP. The distribution is adjusted to 50/50, if the budget deficit is more than -1.75 per cent of GDP (see Figure 1).

Moreover, it was also agreed that the rule would not be applied if the deficit were to surpass the 3 per cent limit. The tax changes resulting from this income windfall/shortfall formula come on top of the relief of the tax burden already agreed by the coalition agreement (*ex ante*). However, any *unexpected* additional deviation from the reference levels occurring *during* the budgetary year, but not foreseen in the budget memorandum, is absorbed in the budget balance and does not lead to tax changes. Thus, the income side of the budget is allowed to operate fully as an automatic stabiliser only during the budgetary year. Obviously, the windfall/shortfall-formula *ex ante* restricts the functioning of the budget as an automatic

Figure 1

Distribution of revenue windfalls and shortfalls between budget balance and tax burden



stabiliser: windfalls are partly returned to taxpayers, while shortfalls are partly offset by tax increases (see also Chapter 5). Hence, the formula is a compromise between a desire for budgetary macroeconomic stabilisation, on the one hand, and the desire to reduce the deficit or to lower the tax burden on the other. Apparently, the second purple coalition considers tax reduction more important and automatic stabilisation less important the more the deficit is reduced. In addition to interfering with the operation of automatic stabilisers, it should also be noted that the formula is at variance with Barro's tax smoothing theorem[3]. According to this theorem, the distortionary impact of taxes is minimised when tax rates are held constant over time, which is not the case under the windfall/shortfall-formula.

2.2 Current Swedish budgetary rules[4]

After the pronounced weakening of the Swedish public finances both in the early 1980s and in the early 1990s, with the latter episode witnessing the most severe fiscal crisis in the country during the whole 20th century, reforms of the budget process were introduced. The Swedish authorities believed that the earlier, rather loose process, was one of the factors behind

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[3] See Van Ewijk en Reininga (1999).

[4] The description of the budget process is based on Molander (2000), OECD (1998), and the Swedish Ministry of Finance (1999).

the crises. Central features of the new budget process, implemented in January 1997, are a ”top-down” budgetary process, multiyear expenditure ceilings and a medium-term target for general government’s net lending**.**

Parliament has endorsed the government’s medium-term goal of a surplus in general government net lending corresponding to an average of 2 per cent of GDP over the business cycle. The general government includes the central government, the local governments (counties and municipalities) and the old age pension system. According to the *Budget Bill for the year 2000*[5]*,* the targets, after a phase-in period, came into effect in the year 2000 and the targets for 2001 and 2002 were to remain unchanged at 2 percent of GDP[6]. However, it was underlined that, if for cyclical reasons growth were to be significantly stronger or weaker than expected, an equivalent deviation for general government net lending would be tolerated. In the *Budget Bill for the year 2001*[7] the *medium-term goal* is still 2 percent of GDP. However, a short-term target for the year 2001 was announced and set to 2½ per cent of GDP with the motivation that the economy approaches a situation of full utilisation of productive resources and that there is some risk of unduly high wage increases in 2001. As has been pointed out by Fischer and Reitano (2001) a potential problem with medium-term surplus target is monitoring. Structural indicators are notorious difficult to measure and the Swedish authorities have earlier been reluctant to publish such a measure. In connection to the Spring Bill 2001 a first step is taken to develop a comprehensive framework for analyses of fiscal policy including a measure of structural surpluses.

The ”top-down” budgetary process assigns a clearer role to the Ministry of Finance in drawing up the budget compared to the earlier process. In the first phase it is the Ministry’s responsibility to update the multiyear framework. This update contains forecasts for the current budget year and calculations of key macroeconomic figures related to the trend development of GDP for the two next years[8]. Parallel to these macro figures, forecasts of the consolidated governments revenues under current

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5 Swedish Ministry of Finance (1999).

6 *Ex ante,* the targets were set to –3.0 in 1997, 0.0 in 1998, 0.5 in 1999 and 2,5 in 2000. *Ex post,* the outcomes were –1.6, 2.1, 1.7 and 4.1.

7 Swedish Ministry of Finance, (2000).

8 In the Spring Bill for 2001 presented in April 2001 forecasts applies to the years 2001 and 2002 and projections to the years 2003 and 2004.

tax rules are carried out. The three-year framework also includes *nominal expenditure ceilings* for the coming three years. For the years t+1 and t+2 these ceilings are already laid down in decisions of earlier years. The ceilings are guideline decisions. However, there is a strong commitment to maintain previously agreed levels unless overriding reasons justify a change. So far, earlier ceilings have been maintained with a few exceptions for purely technical reasons, i.e. typically necessary adjustments dependent on internal transaction changes in the public sector. For the year t+3, the decision is taken on the basis of the revenue forecast for the year t+3 and the necessary surplus fulfilling the medium-term target. Hence, the surplus target can in a sense be seen as being superior to the expenditure ceilings and the ceilings can be seen as operative complements to the surplus target which are more easy to monitor. However, the ceilings also have the independent aim of restricting tax and expenditure ratios.

At a cabinet meeting in March every year the macro and revenue forecasts and nominal expenditure ceilings are laid down. In cabinet meetings, the expenditure ceiling for year t+3 and indicative levels of expenditures for 27 different expenditure areas are also set. These cabinet decisions are based on recommendations by the Ministry of Finance. The sum of these levels of expenditures in the 27 different areas is less than that of the ceilings for total expenditures. The difference constitutes *the budget margin* (*contingency reserve)*, which forms a buffer against forecasting errors and unspecified room for reforms[9]. Thereafter, the allocation between appropriations within each expenditure area is carried out. Thereafter, the framework is discussed and approved by Parliament during its spring session. Opposition parties can propose alternative expenditure ceilings, but the probability that parties of different backgrounds unite over such proposals is low. Hence, the government's position is strong and definitely stronger than under the system before 1997. The new framework constitutes a binding framework for the further budget processes and has probably improved budgetary discipline.

The binding nominal tri-annual expenditure ceilings include central government expenditures and old age pension costs, but not interest costs. The ceilings cover approximately two-thirds of total expenditures and roughly 50 per cent are transfers to households and 20 per cent public consumption and investment. Cyclically sensitive expenditures, such as

[9] When the expenditure ceilings were first set in the Budget Bill for 1997 the margins were set to 1.5, 2.0 and 2.5 per cent of total expenditures for the years 1997 through 1999.

expenditures on active labour market programmes, unemployment benefits and social security are included. The choice of nominal expenditure ceilings implies that inflation is treated as all other factors effecting expenditures without any automatic adjustments. Interest costs of central government are excluded on the argument that they are exogenous factors, unable to be influenced in the short run by the government.

Local government's expenditures are excluded with the motivation of the autonomy of this level of government from central government, for instance in terms of local taxation[10]. For local governments a balanced budget restriction was imposed as of the year 2000. If deficits occur they should be covered within two years. In the aggregate this target was fulfilled with a surplus in 2000[11].

What happens if there are expenditure overruns in any of the expenditure areas? In the system, so-called flexible appropriations would be used for rule-driven expenditures. A limited borrowing possibility is at hand with conditional carry-over to the following budget year. If agencies use the borrowing possibility the credit is automatically deducted from next year's budget appropriation. This possibility has so far not been used in practice.

What are the implications of the new framework? The tri-annual expenditure ceilings seem to impose a kind of inertia in nominal expenditure increases. At each annual decision about the ceiling it is only possible to freely set the level for the last of the three years without political costs. The levels for the first and second years are restricted by earlier decisions. This mechanism seems to have strengthened the current minority government in its budget negotiations with supporting parties and the process is felt to have increased long-term thinking in budget policy.

A full evaluation of the system is not possible after only four years of experience. However, the new budget process with its rules has so far, by and large, worked well. The expenditure to GDP ratio has steadily fallen from 62.6 per cent of GDP in 1996 to 55.4 per cent in 2000 and is in *the Spring Bill for the year 2001* projected to fall to about 53 per cent in 2004.

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[10] However, ceilings are computed also for this sector and consequently it is possible to calculate ceilings for the total public sector.

[11] Swedish Ministry of Finance (2001).

A few problems with the system have so far been revealed. A first problem is that budget margins (contingency reserves) have been rather small, usually less than 1 per cent of the ceiling for the next year. Originally, in the Spring Budget Bill for 1996, these margins were set to approximately 1.5 per cent of total expenditures for the budget year, and 2.0 and 2.5 per cent for the subsequent years. However, although the ceilings have not been exceeded, in practice the margins have to a large extent been used for discretionary expenditure increases. This problem will be further illuminated in Chapter 4.2. Secondly, there has been a lack of high-quality forecasts in some expenditure areas. The most obvious example has been the forecasts for sick-leave insurance costs. Finally, there has been some vagueness about how to interpret the medium-term surplus target in terms of annual targets. So far, a transparent structural measure has not been forthcoming. In connection with the Spring Bill for year 2001 an indicator for structural balances was introduced along with an indicator for fiscal impact.

Table 1 gives an overview of the main characteristics of the current Dutch and Swedish budgetary rules, as discussed above.

3. Macroeconomic and budgetary developments in the Netherlands and Sweden

3.1 Recent macroeconomic and budgetary developments in the Netherlands

Table 2a provides an overview of the economic and budgetary developments in the Netherlands under the trend-based budgetary policy pursued in the previous and current cabinet terms. For both periods, the first column denotes the development of the variable under consideration in the cautious scenario (i.e. *ex ante*). The second column gives the (expected) realisation (i.e. *ex post*). In general, in both periods, economic development (so far) turned out more favourable than assumed in the cautious scenario. Consequently, budgetary developments were also much more favourable in both periods. In the first period, especially lower interest rates and lower unemployment contributed much to a favourable development of Dutch public finances. However, oil prices were lower than expected and, consequently, gas revenues fell short of expectations. As a rule of thumb, a decrease in the oil price of one dollar per barrel means a revenue loss of approximately € 0.3 billion (0.07% of GDP) for the Dutch government.

Table 1

Main characteristics of Dutch and Swedish budgetary rules

	Netherlands	Sweden
Multi-annual budgetary framework		
Length in years	4	3
Coverage	Central government, social security and health sectors	Central government plus old age pensions
Commitment	Political	Legal
Base economic scenario	Cautious	Realistic (t+1) and trend (t+2) and (t+3)
Budget balance target	No	Surplus 2 per cent of GDP on average over the cycle
Revenues		
Targets	No, reference values	No
Revenue windfall	T+1: Partly budget balance, partly reduction tax burden T: budget balance	Ad hoc
Revenue shortfall	T+1: Partly budget balance, partly increase tax burden T: budget balance	Ad hoc
Expenditures		
Ceiling	Real	Nominal
Transformation real -> nominal	GDP deflator	-
Subdivision	Central government, social security and health sectors	Central, local and old age pension system, 27 expenditure areas
Expenditure windfall	Extra expenditures	Ad hoc
Expenditure setback	Cutbacks if ceiling is surpassed	Laid down by law
- due to inflationary differences	Compensation by expenditure reserve and cutbacks	

Wage developments in the market sector were more or less in line with the cautious scenario in the first cabinet term. Contractual wages are an important variable for government expenditures, since social security benefits are as a rule linked to contractual wages. Overall, the general government budget deficit was much lower, while the tax burden had been reduced more than envisaged in the coalition agreement. Due to the favourable economic and budgetary developments, government debt decreased more than expected in the first period.

Table 2a
Economic and budgetary developments in the Netherlands under the trend-based budgetary policy

	1994-1998		1998-2001	
	Ex ante	Ex post	Ex ante	Ex post*
Economic growth (in %, annual average)	2¼	3.2	2¼	3.7
Long-term interest rate (in %)	7	5	6	5.0
Unemployment (change in 000)	23	-182	-23	-32
Oil price ($ per barrel)	17	15	14	23.8
Dollar/euro exchange rate	1.10	1.22	1.07	0.90
Contract wages (average increase in %)	2¼	2.1	1½	3.3
Gen. govt. balance (end of period, % of GDP)	-2.1	-0.7	-1.1	0.5
Gen. govt. debt (end of period, % of GDP)	80¾	66.6	65½	51.8
Reduction of tax burden (billion)	2.0	7.7	1.9	3.6
Net extra expenditures (billion)	-5.5	-5.5	1.7	6.4

* Expected realisations 1999-2001 based on Spring Budget Bill 2001.
Source: Coalition agreements, Budget Memoranda, CPB (1998) and Brits and De Vor (1998).

Up to now, the second period has been characterised by buoyant economic growth, low unemployment rates and high oil prices. Moreover, the higher than expected exchange rate of the dollar has had a positive effect on gas revenues. On the other hand, wage developments have so far been less favourable than initially expected. This has an upward pressure on government expenditures as social security benefits are linked to wage developments in the market sector. Overall, the Netherlands currently has a budget surplus instead of an expected deficit due to the favourable macroeconomic development. As a consequence, government debt rate will in 2001 already undershoot the level expected in the coalition agreement for 2002. Moreover, the tax burden has been decreased more than expected while windfalls due to lower interest rates and lower unemployment rates allowed for extra expenditures under the expenditure ceiling.

3.2 Recent macroeconomic and budgetary developments in Sweden

The deep recession in the early 1990s resulted in substantial deficits in general government finances. In 1993 the deficit in the general government sector amounted to 11 per cent of GDP and general government debt grew rapidly to 78 per cent of GDP in 1994, the same year the new budgetary process was introduced. The sharp increase in unemployment led to a significant expansion in general government expenditures. In the period from 1995 to 1998 the aim of budgetary policy was to eliminate the deficit. By means of a consolidation programme, general government finances improved and reached a surplus of 4.1 per cent of GDP in 2000 with an even stronger cyclical adjusted surplus.

In the period 1998 to 2000 the Swedish economy developed favourably, and more favourably than expected at the beginning of the period. Generally, the new economic policy framework, with the inflation target and the stable general government finances, has both internationally and in Sweden been assessed to have contributed to this favourable development.

From 1998 through 2000 growth moved within a range 3.0 to 4.1 per cent annually. Employment was up and open unemployment was almost halved between 1996 and 2000 and it has been possible to reduce the volume of labour market programmes (see Table 2b). This development has been reinforced by favourable international economic conditions which have contributed to robust growth in Swedish exports.

Inflation, measured alternatively as changes in CPI or in the Riksbank's underlying measure UND1X, has constantly been below the target of 2 percent since 1996. In the March 2001 forecast by the Riksbank, it would stay slightly below target in 2001 and 2002 as well, although with some risk of higher inflation. Wages have also developed favourably in recent years. After high increases of hourly wages both in private and public sectors in 1996, in total around 6 per cent, hourly wages have in the period thereafter developed in line with the inflation target and with productivity improvements taken into account, i.e. in the range of 3.5 to 4 per cent annually. *Ex post,* due to low inflation, real wages have grown steadily. For the coming years, wage increases following wage negotiations in 2001 are seen as the single most important domestic risk to the favourable inflation prospects.

Table 2b

Economic and budgetary developments in Sweden under the new budgetary process

	1998-2000*		2001	2002-2003
	Ex ante (1)	Ex post	Ex ante (2)	Ex ante (3)
Economic growth (in %)	2.9	3.9	3.5	2.1
Open unemployment plus labour market programmes (annual change, pp) (4)	-3.9+0.1	-3.8-1.7	-0.8-0.0	0.2-0.6
Long-term interest rate	6.2	5.1	5.4	5.3
SEK, TCW-index (5)	119.2	123.7	121.9	120.0
Wages (average increase in %)	3.5	3.6	3.5	3.5
Inflation, CPI	1.8	0.7	1.7	2.0
Gen. govt. balance (end of period, % of GDP)	1.5	3.4	3.5	4.0
Gen. govt. debt (end of period, % of GDP)	67	59	53	48
Tax rate (end of period, % of GDP)	51.8	52.0	50.9	50.3
Expenditures (end of period, % of GDP)	58.4	55.5	53.7	52.9

* Expected realisations for 2000 in the Budget Bill for 2001.
(1) Forecasts in the Budget Bill for 1998, September 1997.
(2) Forecasts for 2001 in the Budget Bill for 2001, September 2000.
(3) Projections for 2002 and 2003 under the assumption of potential growth and unchanged policy.
(4) Change (per cent) of labour force. Annual average 1997 to annual average 2000 are used.
(5) Trade Weighted Index. A lower value measures a stronger exchange rate.

Sources: Budget Bills for 1998 and 2001. Konjunkturinstitutets analysunderlag, (National Institute of Economic Research: Analytical Support), November 2000.

The more favourable than expected developments in growth, consumption, employment and prices have resulted in higher than expected tax receipts[12]. Lower than expected costs for unemployment and labour market programmes and lower inflation have led to lower than expected expenditures for unemployment related costs. Together, these factors have resulted in larger surpluses and a faster amortisation of the consolidated gross debt compared to what was planned in the 1998 Convergence Programme. The general government's net lending was marginally below 2 per cent of GDP in 1998 and 1999, while the targets were *ex ante* set to 0 and 0.5 per cent of GDP, respectively. In 2000 net lending was 4.1 percent of GDP while the target was 2.0 per cent of GDP. Gross debt was 72 per cent of GDP in 1998 and decreased to below 60 per cent in 2000 and is calculated to fall to about 48 per cent in 2003[13]. The tax ratio fell from 52.7 per cent of GDP in 1998 to 52.0 per cent in 2000 and is projected to fall to around 50 per cent of GDP in 2003. The expenditure ratio fell during the same period from 58.7 to 55.5 per cent of GDP and is calculated to fall to around 53 percent of GDP in 2003.

4. Some specific problems

4.1 Current Dutch budgetary rules - some problems

4.1.1 Windfalls and shortfalls: asymmetric probability for revenues and expenditures and intertemporal pattern

From an administrative point of view, the disconnection of the revenue and the expenditure side forms a key element in the current Dutch budgetary strategy. Under this separation, revenue windfalls are not allowed to be used for extra expenditures. Thus, in principle, the separation facilitates the free operation of automatic stabilisers. However, the probability of overall windfalls and shortfalls is not the same for the revenue and expenditure side, respectively. On the revenue side, positive real and nominal shocks tend to reinforce each other, while on the expenditure side they tend to be offsetting[14]. For instance, if real economic growth and inflation are higher than expected, this has a positive effect on

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12 In recent years tax receipts on capital gains realisation has increased substantially.

13 The fast fall in the gross debt ratio is partly due to the fact that privatisation receipts have been used for amortisation.

14 CPB (2000).

nominal revenues. However, on the expenditure side higher real economic growth and higher wages and inflation have opposite effects on nominal expenditure. This asymmetry is especially relevant when starting from a cautious scenario with relatively low assumptions concerning growth and inflation, as in the Dutch case. This asymmetry is also relevant from an intertemporal point of view in conjunction with the business cycle. Suppose that the upturn of the business cycle follows its typical textbook pattern: increasing real GDP growth in the first stage and higher inflation in the second. This means that nominal revenues tend to rise over time in conjunction with an upturn of the business cycle, initially mainly due to real economic growth, later in the cycle due to nominal growth. However, on the expenditure side, windfalls occur in the first stage of the upturn due to *inter alia* lower social security expenditures, while setbacks due to higher wages and nominal interest rates materialise in the second stage.

The current Dutch budgetary framework has three provisions to deal with the aforementioned asymmetric and intertemporal pattern of windfalls and shortfalls. First of all, inflationary shocks are in principle absorbed since both the revenue reference values and the expenditure ceilings are set in real terms and transformed into nominal equivalents by means of the actual GDP deflator. Secondly, it was decided in the second coalition agreement to initially reserve expenditure windfalls stemming from more favourable macroeconomic conditions. This "savings" facility could in principle be used to overcome the intertemporal pattern of nominal and real shocks in relation to the business cycle. However, despite this agreement, in the past years expenditure windfalls stemming from a favourable macroeconomic development were mainly used for new expenditures (see Table 2a). Thirdly, the expenditure reserve can be used for specific inflationary shocks. However, this reserve is currently fairly small in size (approximately 0.25 per cent of the overall budget in 2002) and thus not a very effective provision to absorb specific price shocks under the ceiling.

4.1.2 Dealing with inflationary shocks: economy wide versus government specific shocks

As mentioned above, the government is compensated for economy wide inflationary shocks due to the use of the GDP deflator to transform real ceilings into nominal ceilings. Real-expenditure ceilings can thus be considered as a compromise between volume ceilings on the one hand and nominal ceilings on the other hand. The advantage of *volume* expenditure

ceilings is that specific price increases in government expenditures are compensated for by a parallel increase in the nominal ceiling. This contributes to an orderly execution of the budget. However, this has the disadvantage that nominal expenditures (and thereby the deficit) can fluctuate quite heavily, which makes it difficult for example to adhere to a deficit target. Moreover, there is no incentive for the government to limit increases in government wages and prices (moral hazard). The advantage of *nominal* expenditure ceilings is that government expenditures are fixed in nominal terms and hence do not fluctuate. They are simple to understand and not easy to manipulate. Moreover, the government has a strong interest in limiting increases in government wages and prices. The disadvantage is that nominal ceilings may call for cutbacks whenever the price of government expenditures is higher than initially expected. From an administrative point of view, this does not contribute to a smooth execution of the budget. *Real* ceilings are somewhere in the middle on a scale with nominal and volume ceilings as extremes. Government expenditures share in the overall nominal economic development due to the use of the GDP deflator as price deflator. However, it also implies a terms-of-trade loss for the government if the price development of certain government expenditures exceeds the overall price development of the economy, for example, if government wages increase faster than the GDP deflator. These terms-of-trade losses are not compensated for and can thus call for additional cutbacks if the ceilings are about to be exceeded. From an administrative point of view, this is clearly a disadvantage of the system of real-expenditure ceilings. On the other hand, terms-of-trade gains allow for extra expenditures under the ceilings, which can fuel inflationary developments even more. This is clearly a disadvantage of the system of real-expenditure ceilings from a macroeconomic point of view. Donders et al. (1999) have proposed to combine a volume ceiling with an alternative deflator. This deflator would be a weighted average of wage increases in the market sector (70 per cent weight) and the deflator for private consumption (30 per cent weight). The authors claim that this combination would reduce the probability of terms-of-trade losses for the government and thus the probability of required cutbacks. The disadvantage is that external terms-of-trade losses are reflected in the GDP deflator but not necessarily in the alternative one. Hence, under the alternative system, the government does not always share in unfavourable terms-of-trade shocks, which are relevant for an open economy such as the Netherlands. Moreover, one could argue that the administrative problem of terms-of-trade losses can easily be dealt with by increasing the expenditure reserve under the expenditure ceiling. This would solve the problem of terms-of-

trade losses within the existing budgetary framework. The 11th Studiegroep Begrotingsruimte (2001) advises to maintain the system of real-expenditure ceilings in the next cabinet term (2003-2006), but to replace the GDP deflator by the deflator for national expenditures. The latter would be less vulnerable to forecasting errors.

4.2 Macroeconomic shocks and the Swedish system – some problems

4.2.1 An unusually favourable macro shock: Higher growth and lower inflation than expected

In the period 1998 to 2000, immediately after the new budget process was introduced, Sweden experienced an unusually favourable macroeconomic shock. In this period, GDP grew 1.0 per cent faster per annum compared to what was expected in the *Budget Bill for 1998.* Employment increased more rapidly than expected and inflation turned out 1.3 per cent lower per annum. All together, the economic development affected revenues positively, and they grew faster than expected. As a consequence, the medium-term target of 2 per cent surplus over the cycle was approached faster than expected and was exceeded in 2000.

In this period the budget process must by and large be assessed to have worked well. Expenditure to GDP ratios decreased steadily: from 60.3 per cent in 1997 to 55.2 per cent in 2000 and the expenditure ceilings were met. The tax ratio started to diminish in 1999. However, after having implemented a reasonably large uncertainty margin to the ceiling in 1997, in later years the margins decreased substantially and were forecast to be smaller than 0.1 per cent of GDP in 2001. Expenditures have exceeded expectations since 1998. Also the *ex ante* budget margins for 2002 and 2003 are smaller than safe margins for uncertainty.

Since automatic changes in expenditures are negative in situations with larger than expected GDP growth and lower than expected inflation, it is clear that discretionary changes in expenditures were fairly substantial in the period 1998 to 2000 and larger than the "expenditure room" given by unexpected favourable macroeconomic developments[15]. For instance, this was obviously the case in 1999 when positive forecast errors automatically

[15] However, the output gap was negative during the period according to the government's assessments.

decreased expenditures, but still the budget margin was small. Hence, discretionary increases were larger than the windfall.

How can the behaviour as described above be explained? One interpretation is that the budget margin is a weak part of the new budget system in the sense that it is not sufficiently safeguarded by law and hence vulnerable to political pressure. When growth and inflation develop more favourably than expected, higher than expected revenues and surpluses infuse a sense of extra room for further expenditures, behaviour which is typical of "good times". This mechanism also strengthens the pro-cyclical tendency already at hand with a nominal ceiling when inflation is lower than expected.

A Commission given the task to evaluate the budget process has pointed out this weakness of the system[16]. The Commission recommends "that the expenditure ceiling should be supplemented by an expenditure target, which would be set lower than the expenditure ceiling. The level for the expenditure target should be set so that changes in the expenditure ratio, tax ratio and the balance should fall within the targets set for economic policy in the medium-to-long term[17]." Further, the Commission recommends "that the concept budget margin should be replaced by two concepts – contingency reserve and planning reserve. The contingency reserve is the margin between the ceiling and the target and should be around 3 per cent of expenditures, to allow for consequences of any short-term deviation in economic fluctuations from the longer-term trend." No decisions about changes in the status of the budget margin have so far been taken (in April 2001) but it seems necessary to somehow improve the robustness of the margins to strengthen the budget process and to diminish the embedded tendency to pro-cyclicality.

4.2.2 A stagflation scenario

So far the new Swedish system has not been tested in a recession or in a stagflation scenario when GDP growth is low and inflation is relatively high. Such a situation could be the result of an international raw material (commodity) shock or a domestically induced wage cost shock, typical of

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16 Swedish Ministry of Finance, "Utvärdering och vidareutveckling av budgetprocessen". Stockholm (2000b).

17 Swedish Ministry of Finance (2000b), p. 14.

Sweden in the 1970s and 1980s. A recession or stagflation seems to be a potential threat to the expenditure ceilings.

Under the assumption that GDP growth is lower than expected, inflation higher than expected and that budget margins are smaller than what is needed for this type of combined shock, the expenditure ceilings could come under pressure. Price-indexed expenditure items and cyclically sensitive expenditures such as unemployment insurance, costs for labour market measures and other social security costs would increase automatically. In order to maintain the ceilings, it would be necessary to reduce these or other types of expenditures. This would again strengthen the pro-cyclical tendency in the system. In situations when the budget margin is insufficiently large, necessary adjustments to maintain the ceilings tend to counteract automatic stabilisers. To hamper stabilisers at supply shocks could be supportive to monetary policy by somewhat mitigating the inflation pressure[18], but could be politically problematic, especially in a recession. Again, this example demonstrates the need to reform the system to secure the robustness of the uncertainty margins.

5. The stabilising properties of the Dutch and Swedish budgetary rules

The theory on optimum currency areas considers budgetary policy as one of the main instruments to compensate for the loss of the exchange rate and monetary policy autonomy in case of the creation of a monetary union. According to this theory, the adoption of a single currency and a uniform monetary policy would potentially increase the need for a stabilising budgetary policy in countries like the Netherlands and Sweden, especially in the form of freely working automatic stabilisers. The stabilising features of budgetary policy form an important element of the underlying philosophy of the Stability and Growth Pact. Adherence to the medium-term goal of a budgetary position close to balance or in surplus over the cycle should allow for the operating of the automatic stabilisers without surpassing the 3 per cent of GPD reference value for the deficit provided for by the Treaty of Maastricht. How should the stabilising features of the

[18] This is a mechanism that potentially could be of importance as long as Sweden has it's own monetary policy. With Sweden inside the monetary union the mechanism could be neglected because of the small size of the Swedish economy relative to the whole union.

current Dutch and Swedish budgetary rules as described above be assessed?

5.1 Budgetary stabilisation under the Dutch trend-based budgetary policy

A few general observations can be made about the stabilising features of the current Dutch budgetary rules. Obviously, the working of the automatic stabilisers on the revenue side is on the whole hindered by the windfall and shortfall formula. By devoting part of an expected revenue windfall for tax cuts or by compensating part of an expected shortfall by tax increases, budgetary policy in general has a pro-cyclical impact. This pro-cyclical impact is biased due to the application of cautious macroeconomic assumptions for the base scenario. Being in the lower range of the expected macroeconomic development, this scenario has a bias to windfalls. However, it could also be argued that using windfalls for new expenditures or additional tax reductions is not pro-cyclical as long as the economy operates below its trend growth rate. Although this seems a matter of definition, it can have important policy implications. On the expenditure side of the budget, real-expenditure ceilings restrict the working of the automatic stabilisers in principle to windfalls, as setbacks have to be compensated for. Moreover, as the ceilings tend to be filled to the maximum even in good times, in practice the expenditure side does not act as an automatic stabiliser at all. Both mechanisms suggest that the trend-based budgetary policy is not as anti-cyclical as it may be in theory. However, in practice, one can make some differentiations concerning the operating of the automatic stabilisers on the revenue side. First of all, the formula is applied to the *expected* windfall or shortfall. Although this expectation is based on the most likely economic development, it is still subject to forecasting errors. For 1999 and 2000, the government significantly underestimated revenues in the Budget Memoranda for those years. As a consequence, the extra tax reduction on top of the tax cuts agreed in the coalition agreement has been limited so far (see table 2a) and hence, budgetary policy has been less pro-cyclical than might be expected at first glance. Secondly, the government decided by discretion last year not to apply the formula for 2001, although a windfall of € 10 billion was expected in the Budget Memorandum for 2001. As a result, only 6 per cent of the (expected) revenue windfalls in the period 1999-2001 have so far been used for extra tax cuts.

The 11th Studiegroep Begrotingsruimte (2001) advised to adopt a cautious trend-based economic scenario for the next cabinet term. This would imply an exogenous economic growth of 2¼ per year, i.e. a ¼ percentage point above the previous two cabinet terms. Hence, the bias towards windfalls would in principle become smaller. Moreover, the 11th Studiegroep advised to abolish the system of real income reference levels and the windfall and shortfall formula. This would allow the automatic stabilisers to work freely on the revenue side of the budget. This would reduce the pro-cyclicality of the current system of budgetary rules.

5.2 Automatic stabilisers and the Swedish system

Given that the Swedish system is equipped with reasonably large margins for purely "normal"[19] GDP-shocks and that unexpected "room" for expenditures is not used, the system would support freely moving automatic stabilisers both on the expenditure and the tax sides and as a consequence of both negative and positive shocks. Such a system would have the properties related to a medium-term target for the budget, in which a structural budget balance is the proper short-term target[20]. At larger shocks than "normal" the system is asymmetric in the sense that automatic stabilisers will be hampered on the expenditure side but not on the income side. In deep recessions, pro-cyclical expenditure cuts may have to be taken to save the targets, which could be politically problematic. However, this mechanism could be mitigated if, at the same time, inflation is falling.

At unexpected inflation shocks, automatic stabilisers could also move freely under the condition that unexpected "room" for expenditures is not used. For instance, lower than expected inflation boosts real incomes and demand and expenditures fall. Again, large positive inflation shocks could induce asymmetric stabilisers.

However, as soon as some part of the unexpected windfall, referred to in the examples above, is used, the system's pro-cyclicality increases. As described in Chapter 4.2, this has in practise been the case in the years 1998 through 2000. Such behaviour also increases the risk for asymmetric

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[19] "Normal" GDP shock could be interpreted parallel to how it is interpreted in connection with the SGP.

[20] In connection with the Spring Bill 2001 a measure of structural surpluses has been calculated.

stabilisers at negative real shocks and positive price shocks. Furthermore, the budget margins have proved themselves to be soft impediments to expenditure increases which has strengthened the asymmetric property of the system.

6. Comparison and conclusions

Both the Netherlands and Sweden are relatively small open economies vulnerable to negative external economic developments. Recent budgetary developments in the Netherlands and Sweden show strong similarities. Both countries were hit by severe negative economic and budgetary shocks in the early 1980s (Netherlands and Sweden) and early 1990s (Sweden). After a period of budgetary consolidation to adjust for the distortions, both countries introduced a set of more-or-less binding budgetary rules with the aim to strengthen budgetary discipline. In the Netherlands, the budgetary rules are based on political agreements, while in Sweden they are partly founded in the Budget law, which must be seen as a long-term commitment. In both countries, the nature of the political system gives rise to a rules-based budgetary policy as coalition and minority governments have for a long period been typical in both countries, cases where in theory the position of the Minister of Finance could be relatively weak[21]. Currently, the Netherlands has a coalition government and Sweden a minority government with supporting parties. The adoption of budgetary rules could potentially strengthen the position of the Minister of Finance.

In both countries, the introduction of budgetary rules has contributed significantly to the recent favourable budgetary developments. Long-term thinking has been strengthened which has contributed to disciplined expenditure developments. Expenditure ceilings form the cornerstone of the budgetary framework of both countries at the moment. In Sweden, these ceilings are complemented by a medium-term surplus target, in the Netherlands by a cautious macroeconomic base scenario and income reference levels. In the Netherlands, the ceilings are defined in real terms whereas in Sweden they are nominal. The main characteristic of a system of *real-expenditure* ceilings is that the government shares in the overall nominal economic development. The resulting terms-of-trade losses can

[21] Hallerberg et al. (2001).

call for ad hoc cutbacks, which is a disadvantage from an administrative point of view. On the other hand, terms-of-trade gains allow for extra expenditures under the ceilings, which can fuel inflationary developments. The main advantage of *nominal* expenditure ceilings is that government expenditures do not fluctuate, which is a valuable support to the budget process. Moreover, nominal ceilings are easy to understand and are transparent. Finally, the government has an incentive to limit increases in government wages and prices. The disadvantage is that real shocks can necessitate pro-cyclical cutbacks. Both the Swedish and Dutch systems belong to a small group of countries in the EU-area where the medium-term expenditure framework is an explicit part of the multi-annual framework and the budgetary process. Such a framework could be positive for the credibility of fiscal policy[22].

Two differences stand out when we compare the Dutch and Swedish systems of budgetary rules. The first difference is that the Swedish system seems in a narrow sense more closely compatible with the Stability and Growth Pact due to the inclusion of an explicit quantitative medium-term surplus target. The Swedish medium-term surplus target is clearly in line with the latter part of the "close to balance or in surplus" provision. In the Dutch case, adherence to the medium-term target of the Stability and Growth Pact has so far been a more implicit goal of the system of budgetary rules. However, the 11th Studiegroep Begrotingsruimte advises the next cabinet to strive to a budget surplus of 1¼-1¾% of GPD, with an eye on the upcoming fiscal burden of ageing populations. A second difference is that the Swedish system with its two types of quantitative targets seems less flexible than the Dutch system in case of economic shocks. Especially positive inflationary shocks can be more easily dealt with in the Dutch system with its real-expenditure ceilings from a *budgetary* point of view.

Some problems of pro-cyclical behaviour have been revealed for both systems of budgetary rules. In the Netherlands, the application of a cautious macroeconomic base scenario creates a bias to unexpected positive real and price shocks. On the *revenue* side of the budget, such shocks tend to reinforce each other, thus creating a bias towards revenue windfalls. These windfalls are partly used for additional tax cuts according to the windfall formula, which gives budgetary policy a pro-cyclical bias. On the *expenditure* side of the budget, such shocks tend to mitigate each

[22] Fisher and Reitano (2001), p. 11.

other: positive real shocks lead to lower expenditures, while positive price shocks induce higher expenditures. However, under the system of real-expenditure ceilings, positive price shocks are partly compensated for by a higher GDP-deflator. Hence, all in all, the adoption of a cautious macro-economic base scenario usually creates scope for extra expenditures under the ceilings, thus giving budgetary policy another pro-cyclical bias. The same happens in Sweden when the uncertainty margin is more or less used for new expenditures. However, as long as the contingency margin is maintained, there is only a risk for pro-cyclical policies in case of large negative real shocks or large positive price shocks, the latter with a low probability to occur. However, as was described in section 4.2 the contingency reserves in Sweden have recently to a large extent been used for expenditure increases, even in, or because of, a situation of unexpected buoyant growth and lower than expected inflation. This makes the Swedish system vulnerable even to normal negative real shocks which must be compensated by pro-cyclical policy. However, in textbook cases when normally negative real shocks are correlated to weak price developments, the problem is somewhat mitigated. On the other hand, in a situation of stagflation the problem will be even more aggravated. Hence, in the Swedish case, positive real shocks combined with negative price shocks seem to induce a pro-cyclical behaviour which later may compel the government to introduce pro-cyclical adjustments at negative real shocks.

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NEW ZEALAND'S FISCAL POLICY FRAMEWORK: EXPERIENCE AND EVOLUTION

John Janssen[*]

1. Introduction

The focus of this workshop is on fiscal rules. Over the past 15 years New Zealand has been paying considerable attention to the "rules of the game" for monetary, fiscal and regulatory policies. This new focus has been an integral part of New Zealand's economic reforms that have been well documented elsewhere and which have received considerable international attention[1].

Prior to 1985, New Zealand labour and product markets were extensively regulated, effective tax rates were high and variable, and production of a narrow range of traded products left the economy vulnerable to shifts in world demand and shocks to commodity prices. A sustained period of fiscal deficits had seen a build-up in public debt, the current account deficit was close to 9% of Gross Domestic Product (GDP) in 1986, and inflation and inflationary expectations were high.

Institutional changes have separated and clarified the roles and responsibilities for monetary and fiscal policy. The Reserve Bank of New Zealand Act 1989 stipulates that the Bank is to formulate and implement monetary policy directed to the objective of achieving and maintaining stability in the general level of prices. The Fiscal Responsibility Act 1994 aims to improve fiscal performance and management and to bring a long-term focus to budgeting.

This paper discusses New Zealand's fiscal policy framework, experience and evolution. The paper is set out as follows:

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[*] New Zealand Treasury. Thanks to Michele Lloyd, Iain Rennie, Andrew Crisp, Bob Buckle, Struan Little, Renee Lister and Brian McCulloch for comments on earlier drafts. Any remaining errors or omissions are the responsibility of the author. The views are those of the author and do not necessarily reflect the views of the New Zealand Treasury. The author would also like to acknowledge Brendon Riches for background material used in drafting Section 2.2, and Angela Barnes and Steve Leith, whose earlier work forms the base for Section 6 and parts of Section 7 (see Barnes and Leith, 2000).

[1] For example, see Bollard and Buckle (1987), Evans, Grimes and Wilkinson with Teece (1996), Silverstone, Bollard and Lattimore (1996). The latest IMF Article IV Staff Report and OECD Economic Survey provide further assessments, including recent policy developments.

- Section 2 provides a brief fiscal history and details the various factors influencing the development of the fiscal policy framework. These factors include lessons from New Zealand's fiscal history and broader public sector reform.
- Section 3 outlines the key institutional change, namely the Fiscal Responsibility Act 1994.
- Section 4 compares the "fiscal rules" implied within New Zealand's framework with those used internationally.
- Section 5 sets out the experience with the framework. It includes a comparison of fiscal outcomes with fiscal objectives and sets out three key policy themes.
- Section 6 describes the current fiscal processes that evolved as refinements to the Budget process.
- Section 7 summarises some of the challenges facing New Zealand's fiscal policy framework and Section 8 concludes.

2. Background

A series of reforms between 1984 and 1994 saw significant changes to the institutional arrangements governing fiscal policy in New Zealand[2]. At a "macro" level, the Fiscal Responsibility Act (FRA) 1994 reflected a change in the focus of overall fiscal policy. The FRA needs to be set in the context of earlier "micro" reforms that altered the arrangements for management and decision-making in public sector organisations. Analysis of New Zealand's fiscal history helps identify some of the key influences behind the institutional change.

2.1 Fiscal history

New Zealand's fiscal history is documented elsewhere, especially as a sub-set of the broader economic reform process (see for example Wells, 1987; 1996). Some of the key themes include:

[2] See "Putting it Together – An Explanatory Guide to the New Zealand Public Sector Financial Management System" (August, 1996) available at www.treasury.govt.nz.

- Government expenditure on final goods and services, benefit transfers and debt servicing was below 30% of GDP in the 1960s and early 1970s. By the early 1990s the ratio had increased to around 40% of GDP[3]. Average tax rates increased, but tax receipts lagged spending growth during the 1970s and 1980s. The rise in spending during the 1970s and 1980s primarily reflected rising benefit expenditures and higher debt servicing caused by persistent fiscal deficits.
- Gross public debt increased from around 40% of GDP in 1974 to a peak of 78% in 1987. Net public debt was just below 5% of GDP in 1974, increasing to 52% of GDP in 1992. The net public debt ratio declined in some years as privatisation proceeds were largely used to repay debt (see Section 5.1 below). This reduction in the debt ratio from asset sales did not reflect a matching improvement in net worth.
- New Zealand's sovereign credit rating was downgraded through the 1980s and early 1990s. The Standard and Poor's rating of triple A was removed in 1983 and was AA– by 1991.
- In the 1970s and early 1980s New Zealand was a relatively active user of discretionary fiscal policy. Over the period 1973 to 1984 New Zealand's structural deficit increased by an average of 0.5% of GDP per year. The standard deviation of New Zealand's structural deficit was the fourth highest in a sample of 19 OECD countries (Wheeler, 1991).

In his assessment of New Zealand fiscal policy during the 1970s and 1980s, Wheeler (1991) concluded that:

- Extensive use of fiscal policy in a demand management role did not produce sustainable growth.
- Expansionary fiscal policy led to a rapid deterioration in the net debt position[4].

By the early 1990s, policy advice was oriented toward fiscal consolidation and a medium-term focus (see Treasury, 1990; Wheeler, 1991).

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[3] See the discussion of historical expenditure trends in the 1997 Budget Policy Statement. Fiscal information over this period is cash based. This information, together with all other data on fiscal outcomes reported in the text, is effectively for "central government" only.

[4] For a further discussion on the role of discretionary fiscal policy in New Zealand see Deane and Smith (1980) and Scott (1994).

2.2 Public sector management reform

Public sector management reform provided Ministers with new tools for the examination of spending priorities amongst departments and for reviewing departmental efficiency (Treasury, 1990). Two distinctive but overlapping sets of ideas influenced this reform. One derived from management theory, the other from institutional economics (the principal-agent issue)[5].

Management reform was grounded on the principle that for public sector managers to be held responsible for results, they needed the freedom to allocate resources within a given budget and run their organisations without external *ex ante* control (subject to delivering the required quantity and quality of goods and services).

Institutional economics suggested that the manager's (or agent's) interest might diverge from the owner's (or principal's) interest resulting in poor and inefficient outcomes. To facilitate appropriate behaviour, *ex-ante* performance criteria for managers were specified with performance evaluation contingent on delivery.

Three Acts cover the legislative framework underpinning the public sector management reforms.

2.2.1 The State-owned Enterprises (SOE) Act 1986

Where government services could be managed along commercial lines, the SOE Act allowed the Government to provide these services through organisational forms similar to private sector enterprises. The SOE Act embodies principles of management autonomy, clarity of objectives and transparency of process. Previously, SOEs had multiple and often conflicting objectives.

2.2.2 The State Sector Act 1988 (SSA)

The SSA established the accountability relationship between departmental chief executives and their Ministers. Departmental chief executives were placed on renewable contracts. These contracts made

[5] Clark and Sinclair (1986), Treasury (1987) and Holland and Boston (1990) provide further discussion of these ideas.

provision for annual performance agreements and made chief executives responsible for employing staff and determining their remuneration.

2.2.3 The Public Finance Act 1989 (PFA)

The PFA set out the way Parliament appropriates funds and gave chief executives powers and responsibilities in relation to financial management. The Act imposed budgeting and reporting requirements for departments and the government as a whole. It also changed the basis of appropriation from inputs to outputs or services, and from a cash basis to an accrual basis.

2.3 Fiscal policy reform

The public sector management reforms altered institutional arrangements at a "micro" level with the intention of achieving a more efficient and accountable provision of government services. The fiscal policy experience discussed in Section 2.1 above highlighted a number of broader fiscal policy lessons.

First, the impact of fiscal policy on economic activity in the short-term was difficult to predict and New Zealand's practical experience had not been positive. In normal circumstances it was considered not desirable to make fiscal decisions with a view to managing real aggregate demand (Treasury, 1987).

Second, the presence of some overarching target or ceiling was seen as a way of improving the control of public expenditure (Treasury, 1990). For example, an overarching target could strengthen the incentives on Ministers to co-operate in setting priorities and to follow an agreed fiscal strategy. However, it was recognised that such targets usually had no strong analytical basis and had disadvantages if interpreted mechanically (e.g., policy inflexibility).

Third, better fiscal outcomes would require mechanisms for more regular information to the public on the medium-term fiscal outlook and the decisions that underpinned that outlook (Treasury, 1990).

Although there are differences, notably in the ability to assign the implementation of monetary policy to an independent authority, some of the ideas that influenced the Reserve Bank Act 1989 also influenced the

design of institutional arrangements surrounding fiscal policy[6]. These ideas included the importance of transparency and credibility, and the need for institutional design to take into account the time consistency problem[7].

2.3.1 The Fiscal Responsibility Act 1994 (FRA)

The FRA became effective from 1 July 1994 and reflected the lessons and thinking discussed above. Importantly, the Act also codified a number of developments that had evolved in previous years, especially on the reporting and transparency side. These developments included the shift to Generally Accepted Accounting Practice (GAAP) together with the publication of regular short-term fiscal forecasts and a pre-election economic and fiscal update. The final form of the Act was shaped by the views of a committee of Government and opposition members of parliament (see Report of the Finance and Expenditure Committee, 1994).

As introduced, the Finance and Expenditure Committee saw the Fiscal Responsibility bill as neutral with respect to the fiscal stance that a government might choose to adopt. However, the Government would be required to provide a fiscal strategy report that would set out overall fiscal objectives and ten-year (minimum) fiscal projections.

The Committee determined that the weight of evidence presented to it supported the view that transparency alone was insufficient and recommended that the bill be strengthened in three ways:

- Inclusion of legislated principles of responsible fiscal management.
- Publication of a Budget Policy Statement.
- Providing for the Budget Policy Statement and other reports required under the legislation to be referred to a parliamentary committee.

Although the Committee considered the role of mandatory targets, the then Government rejected them, giving the following reasons (see Report of the Finance and Expenditure Committee, 1994, pp.13-4):

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[6] The Reserve Bank Act 1989 sets out the objective of price stability. The precise target of monetary policy and the definition of price stability are set out in the Policy Targets Agreement (PTA). The PTA is an agreement between the Reserve Bank and the Minister of Finance. The Bank has "instrument independence" and its Governor is accountable for achieving the targets set out in the PTA. See Reddell (1999) for a discussion of how the public sector management reforms discussed in Section 2.2 influenced the formulation of institutional arrangements for monetary policy.

[7] See for example, Chari, Kehoe and Prescott (1988).

- There is no solid theoretical justification for any particular fiscal target that can be maintained over a period of time. Judgements on the appropriate level of fiscal aggregates vary over time and depend on the economic circumstances currently prevailing.
- Other countries' experience of legislated targets suggests that there are substantial risks attached to their use. In particular, rigid adherence can seriously distort decision-making and, unless carefully handled, minor variations from target can result in significant but unnecessary damage to credibility.
- Their inherent inflexibility makes it difficult for fiscal policy to respond appropriately to the inevitable volatility of economic circumstances. While targets in principle could be expressed in cyclically-adjusted terms, in practice these are difficult to measure effectively.
- Despite the advances made in terms of the availability and transparency of fiscal information, human ingenuity has yet to find a way of specifying fiscal targets that cannot be effectively and often comprehensively evaded. Furthermore, without the political will to achieve targets, ways are inevitably found to avoid them.

The Committee considered that legislated principles provided a number of advantages over mandatory targets. These included the encouragement of a medium to long-term perspective with recognition that governments may have to depart from the principles, but requiring this to be justified. It was also considered important that institutional change designed to improve fiscal performance should be sufficiently "flexible" to endure through the shift to a Mixed Member Proportional (MMP) electoral system[8].

The FRA does not prescribe fiscal targets in legislation. However, it does require Governments to set short-term fiscal intentions and long-term fiscal objectives (see Section 3.2 below). Short-term fiscal intentions for key aggregates still create issues when interpreting results given cyclical changes and valuation changes. These issues explain further evolution of the framework, including the role of the fiscal provisions as a key anchor in the short-term (see Section 6).

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[8] The New Zealand electoral system changed from First Past the Post to MMP in 1995, following a referendum in 1993. The 1996 election was the first to be held under MMP.

3. The Fiscal Responsibility Act 1994

The FRA aims to improve fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirements[9].

3.1 Principles of responsible fiscal management

Governments are required to follow a legislated set of principles and publicly assess their fiscal policies against these principles. Governments may depart temporarily from the principles but must do so publicly, explain why they have departed, and indicate how and when they intend to conform to the principles. The five principles of responsible fiscal management are:

(a) Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.

(b) Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.

(c) Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future.

(d) Managing prudently the fiscal risks facing the Crown.

(e) Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Definitions such as "prudent" level of debt, or "reasonable" degree of predictability are not specified in the Act. It is left to the Government of the day to interpret the relevant fiscal terms.

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[9] See "Fiscal Responsibility Act 1994 – An Explanation" (September, 1995) available at www.treasury.govt.nz.

3.2 Reporting requirements

Governments must publish a Budget Policy Statement (BPS) before the annual Budget and a Fiscal Strategy Report (FSR) at the time of the Budget (see Box 1). These publications must demonstrate the consistency of the Government's short-term fiscal intentions and long-term fiscal objectives with the principles of responsible fiscal management (Table 1 provides more detail). The Act requires the FSR to include fiscal projections (the "Progress Outlooks") covering a minimum of 10 years for the variables specified as long-term fiscal objectives[10].

The Treasury is required to prepare regular economic and fiscal forecasts (see Box 1). Having the timing and broad nature of the overall forecasts specified in legislation raises their credibility.

Under the FRA, all financial statements included in reports required by the Act are prepared under Generally Accepted Accounting Practice (GAAP). Fiscal reporting follows a set of consistent accounting rules established independently by the Accounting Standards Review Board (which sets accounting standards that are mandatory for both the public and private sector). The use of accrual accounts means that the full cost of policy must be disclosed, including non-cash items like depreciation and changes to government employee pension rights[11].

GAAP provides externally set and audited standards and helps avoid some of the boundary problems that affected previous fiscal forecasts (e.g., the treatment of forestry cutting rights in the early 1990s).

The economic and fiscal forecasts are based on the Treasury's best professional judgement about the impact of policy, rather than relying on the judgement of the Government. The FRA requires the Minister of Finance to communicate all of the Government's policy decisions to the Treasury. The fiscal forecasts are also required to disclose contingent liabilities and other specific fiscal risks.

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[10] The BPS and FSR are Government documents. The Progress Outlooks contained in the FSR use economic assumptions determined by the Treasury and fiscal assumptions agreed by the Government. The first years of the Progress Outlooks are the short-term fiscal forecasts. Beyond the forecast horizon, the Outlooks ignore cyclical effects and so the projected fiscal position is structural.

[11] In addition to a range of other financial statements, the Crown produces a statement of financial performance (operating statement), a statement of financial position (balance sheet), a statement of cash flows and a statement of borrowing.

Table 1

Short-term fiscal intentions, long-term fiscal objectives, and principles of responsible fiscal management

	Short-term fiscal intentions Expenses, revenues, operating balance, debt, net worth	**Long-term fiscal objectives** Expenses, revenues, operating balance, debt, net worth	**Principles of responsible fiscal management** (a) to (e) in text
Set by	Current Government	Current Government	Specified in Act, Section 4(2)
Time horizon	Three-years	Not specified	Not specified*
Required reporting	Fiscal forecasts	Progress Outlooks (10-year minimum fiscal projections)	Specified in Act
Other reporting	Cyclically-adjusted operating balance	"What if?" long-term fiscal scenarios (typically 50-years)	
Control target	Fiscal provisions (see Section 6 in text)		

* As a set, the principles endure with the Act. However, individual principles do not contain explicit time horizons.

Finally, all reports required under the Act are referred to a parliamentary select committee that comprises representatives from the Government and opposition parties.

3.3 The credibility of fiscal policy

Setting long-term fiscal objectives and ensuring consistency of short-term intentions with these makes governments consider the long-term consequences of their decisions, including longer-term sustainability.

Overall, the FRA approaches the time consistency issue from the interaction of the long-term fiscal objectives, the short-term fiscal intentions and the longer-term fiscal projections. The credibility of fiscal policy will be undermined by:

- fiscal outcomes that consistently deviate from the stated path,

or:

- fiscal projections indicating objectives will not be met over a reasonable period of time given plausible economic and policy assumptions.

4. International Developments on Fiscal Policy Frameworks

The 1990s saw the development of a variety of fiscal policy frameworks internationally, including the Code for Fiscal Stability in the United Kingdom and the Australian Charter of Budget Honesty. The Maastricht Treaty imposes a deficit ceiling and a debt limit. The Stability and Growth Pact specifies particular circumstances where a deficit can be regarded as excessive.

In terms of reconciling short-run movements in deficits and debt ratios with long-term commitments, the OECD (1998) examines the potential role for limits such the "golden rule" and "deficit or debt ceilings". The following sections compare and contrast some of these mechanisms with those implied in New Zealand's fiscal policy framework.

Box 1
Key reports required under the Fiscal Responsibility Act 1994

The Budget Policy Statement is published by the end of March and is required to set out:

- Long-term fiscal objectives for Crown operating expenses, revenues and balance, debt and net worth.
- Short-term fiscal intentions for the above variables for the Budget year and the following two financial years (Fiscal years begin 1 July and the Budget must be presented by the end of July each year).
- Broad strategic priorities for the coming Budget.

The Fiscal Strategy Report is tabled with the Budget and must include:

- A comparison of the fiscal forecasts in the Budget Economic and Fiscal Update with the short-term fiscal intentions in the BPS.
- Progress Outlook projections for ten or more years of the variables specified for the long-term fiscal objectives.
- Assessment of the Progress Outlooks with the long-term fiscal objectives in the BPS.

Inconsistencies between the BPS and/or the FSR and the immediately preceding Statement or Report must be explained and justified by the Government.

The Treasury is required to prepare:

- An Economic and Fiscal Update at the time of the Budget and each December.
- A Pre-election Economic and Fiscal Update before each general election.

The Updates provide short-term forecasts for variables such as GDP, consumer price inflation, unemployment and the current account of the balance of payments. Fiscal information includes forecasts of the Crown financial statements.

4.1 The golden rule

The golden rule links increases in debt to public investment. For example, the United Kingdom's golden rule requires current receipts to equal current expenditure over the economic cycle so that over a cycle the government borrows only for (net) investment[12]. The OECD (1998) suggests that although a golden rule may offer benefits through tax-smoothing, it requires a clear definition of public capital formation and strong public financial accounting standards.

The FRA principles of responsible fiscal management reflect a golden rule approach. Principle (b) requires balance between operating revenues and expenses (which are inclusive of depreciation) over a "reasonable period of time". This can, and has been interpreted as implying that the economic cycle is the appropriate period over which to balance the budget (see Wells, 1996). In practice, there are difficulties in measuring the economic cycle and the underlying fiscal position. Principle (e), pursuing policies consistent with a reasonable degree of predictability about the level and stability of tax rates, also acknowledges tax-smoothing arguments.

4.2 Deficit ceilings

Specific deficit ceilings are a feature of the Maastricht Treaty. Dalsgaard and de Serres (1999) have estimated "safe" budget balances for a group of European Union countries. These "safe" budgets are the target needed to ensure, at a given level of probability, that the three percent deficit limit required by the Maastricht Treaty is not breached over a particular time horizon. The estimated safe budgets are based on model estimates of the effect of disturbances on the fiscal position.

Under the FRA, short-term fiscal intentions are set by the current Government and must be consistent with objectives and principles. In some cases, the short-term intentions have been expressed in terms of specific numerical targets. For example, "achieving fiscal surpluses of at least 3% of GDP" to provide a cushion for adverse events (see the 1996 BPS). More recently, the short-term fiscal intentions have tended to reflect the fiscal forecasts.

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[12] Buiter (1999) provides further analysis of the UK golden rule. Note that both the UK and New Zealand have debt goals.

Along similar lines to the Dalsgaard and de Serres study, preliminary work by Buckle, Kim and Tam (2000) develops a procedure for identifying the *ex ante* fiscal balance required to achieve, with a given probability, a desired *ex post* budget balance for alternative time horizons[13]. The analysis indicates that to avoid a budget deficit at a 95% confidence interval, the (average) annual *ex ante* budget balance for New Zealand should be set at a surplus of 1.5% of GDP if the fiscal planning horizon is one year. This target rises to 1.8% and 2% of GDP for horizons of two and three years respectively as the probability of adverse shocks increases and the propagation process becomes more pronounced.

4.3 Debt ceilings

Unlike the Maastricht Treaty, the FRA does not prescribe numerical targets for debt. The "prudent" level of debt is not specified in the legislation and it is left up to the Government of the day to interpret the relevant level. The Act (implicitly) accepts that a range of factors will influence prudent debt levels, including the nature of likely shocks, structural features of the economy, the nature of the Crown's balance sheet and future developments affecting spending and taxes.

CS First Boston (1995) analyse the "optimal debt" question given the key characteristics of the New Zealand economy (i.e., small, open, presence of distorting taxes, openness to world capital markets, emigration and local demographics). In a deterministic setting they conclude that current and capital spending plans should be determined independently of the debt decision. Optimal tax policy would plan for a constant average tax rate through all future periods.

However, the judgement in the mid-1990s was that New Zealand's debt levels were imposing significant economic costs and debt reduction was a policy priority. One of the practical considerations influencing the specification of long-term stock objectives into the future is the approach taken to the fiscal consequences of population ageing (see Section 7.8 below).

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[13] A structural vector auto-regression is estimated over the period 1971 to 1999 and includes real GDP, the fiscal balance-to-GDP ratio, the sum of real private consumption and real private investment, and the GDP deflator. Due to data limitations, the fiscal variable uses net cash flows from operations rather than the operating balance. The *ex ante* targets cited here are based on their simulations where fiscal policy shocks are "switched off".

4.4 Conservative assumptions

Prudent or conservative economic assumptions have been used in a number of countries to avoid the problem of overestimating the strength of the fiscal position[14]. Canada provides an example where fiscal targets have been set with projections based on "conservative" economic assumptions and a contingency reserve. For the purposes of projecting the public finances on a "cautious and prudent basis", the United Kingdom has assumed trend rates of economic growth that differ from what might be considered the neutral estimate.

Although such assumptions may generate initial credibility benefits, once credibility is established financial markets are likely to adjust their expectations. They could therefore incorporate the degree of conservative bias and assess governments relative to this bias-adjusted outlook. Similarly, spending Ministers and departments are also likely to adjust their actions through time to offset the bias. The FRA requires short-term forecast and medium-term projection assumptions, and hence any safety margins, to be published.

5. Experience with New Zealand's Fiscal Policy Framework

Fiscal outcomes over the 1990s provide insights into the strengths and weaknesses of the fiscal policy framework.

5.1 Fiscal outcomes

New Zealand's fiscal position improved substantially during the first half of the 1990s. To gauge the extent to which the economic cycle influenced the fiscal position, Figure 1 provides an estimate of the cyclically-adjusted, or structural balance.

With revenue remaining broadly stable as a share of GDP, the change in the fiscal balance was achieved largely through the expense side.

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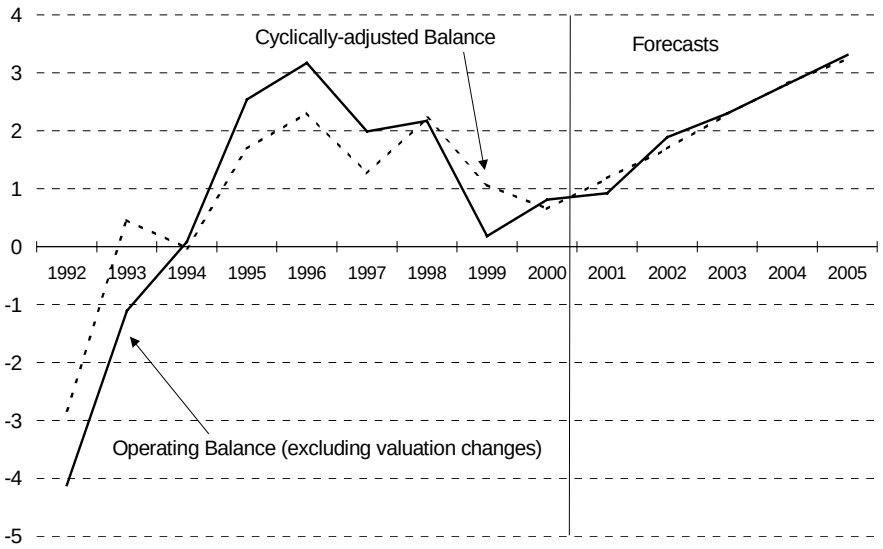
[14] OECD (1998, Annex 2).

Figure 1

Operating balance and cyclically-adjusted operating balance: estimate and forecasts

(June years, percent of GDP)



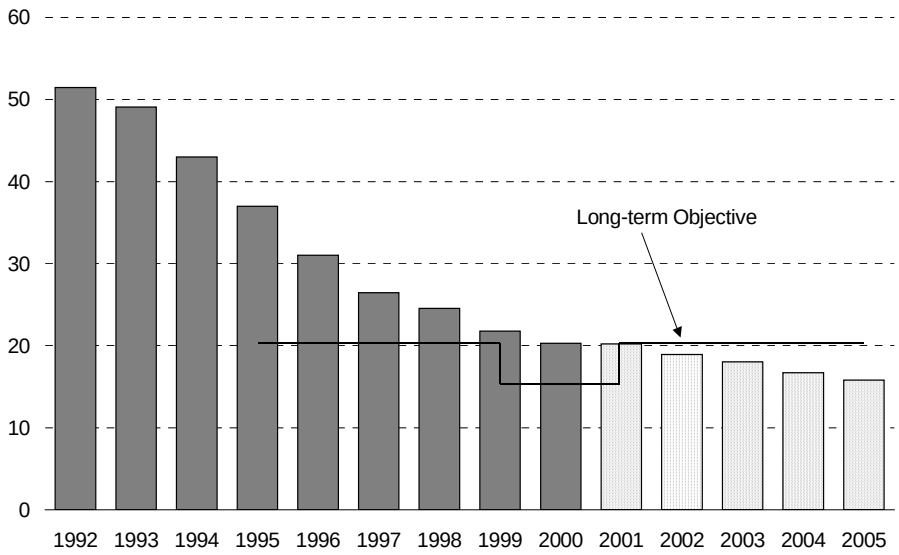
Source: The Treasury, December Economic and Fiscal Update, 2000.
Notes: This analysis removes the effect of valuation changes (including changes to the liability of the pension scheme for government employees, the liability of the accident compensation scheme, and losses/gains on sale of assets) and foreign exchange gains/losses. The estimate requires assumptions about potential output and the responsiveness of revenues and unemployment expenses to output. These assumptions are based on, and are sensitive to the latest available information. The estimate of potential output is derived using a Hodrick-Prescott filter.

The decline in expenses partly reflects lower finance costs as interest rates fell and fiscal surpluses and asset sales reduced the level of debt. Approximately NZ$19.2 billion was raised from the sale of government businesses and other assets between 1987 and 1999. Proceeds contributed to the repayment public debt, and a zero net-foreign currency debt goal was reached in 1996. Progress against stated long-term objectives for net debt is given in Figure 2[15].

[15] The 1994 FSR expressed the long-term objective for net debt as between 20% and 30% of GDP. This was changed to 20% of GDP in the 1995 BPS and to 15% of GDP in the 1998 FSR. The current formulation of the net debt objective is 20% of GDP (excluding assets accumulated for the purpose of funding future public pension expenses). An objective for gross debt was first introduced in the 1997 BPS and is currently 30% of GDP.

Figure 2

Net Crown debt: Actual and forecasts
(June years, percent of GDP)



Source: The Treasury, December Economic and Fiscal Update, 2000.

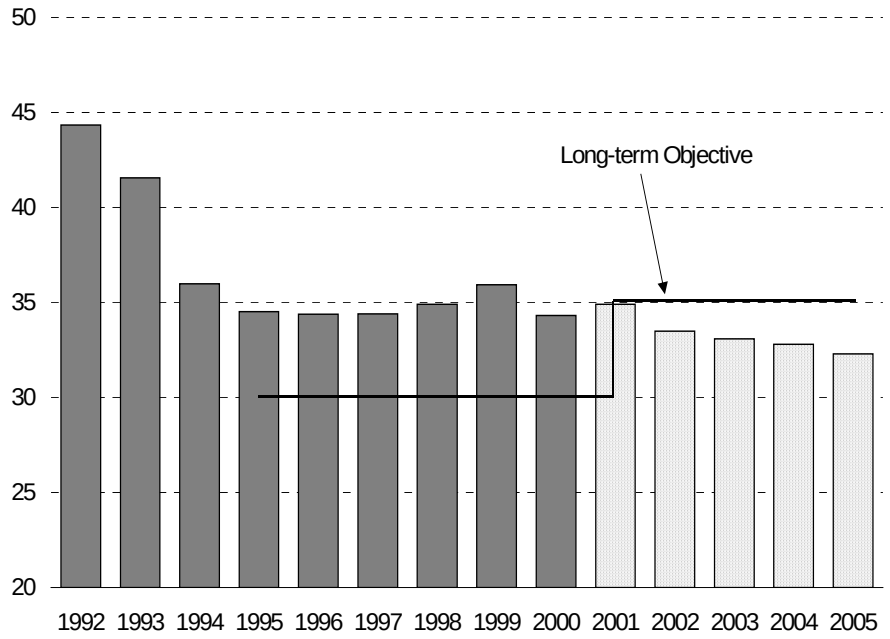
Although significant progress was made in reducing operating expenses as a share of GDP from the levels evident in the early 1990s, progress against the stated long-term objective stalled during the mid- to late-1990s (see Figure 3)[16].

In addition to the decline in finance costs, the decline in expenses through the 1990s also partly reflects the economic upswing and the associated fall in unemployment benefit expenses. The increase in the age of eligibility for New Zealand Superannuation (NZS) and fiscal discipline in the core public sector also contributed to the decline in expenses-to-GDP. Changes in the profile of the major components of total expenses (by functional classification) are illustrated in Figure 4.

[16] The long-term objective for expenses was changed in the 2000 BPS to "Expenses around current levels of 35% of GDP".

Figure 3

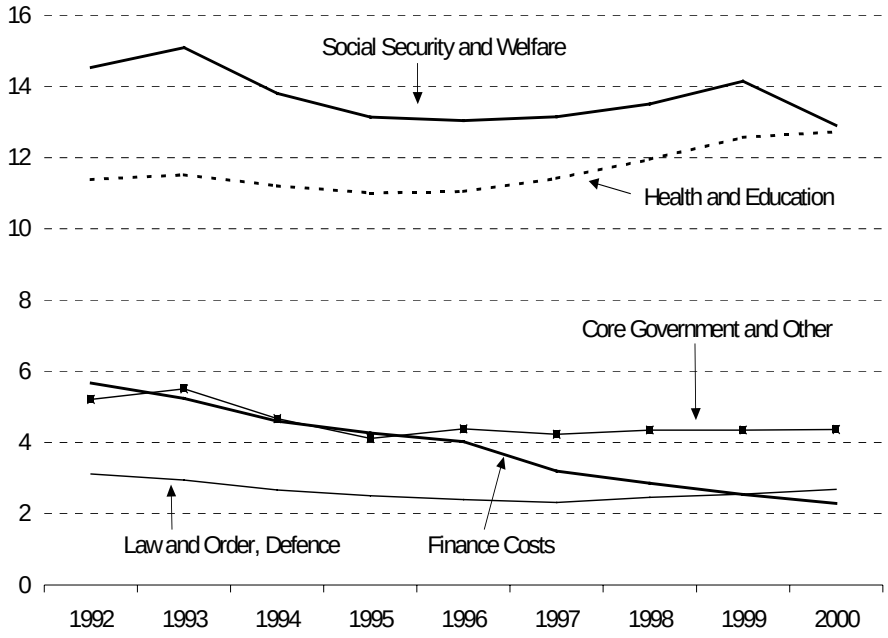
Expenses: Actual and forecasts
(June years, percent of GDP)



Longer-term (10-year) fiscal projections in the mid-1990s suggested rapid progress toward the then long-term fiscal objectives. For example, the baseline projection in the 1996 FSR indicated the elimination of net debt by 2001/02. This degree of debt reduction (and eventual asset accumulation) represented a higher level of government saving than the then Government thought desirable. A "structural correction" aimed at longer-term economic and social objectives became an option. Personal income tax reductions and additional spending plans were announced in early 1996. This structural correction was predicated on relatively strong assumptions regarding expenditure control that are discussed below and in Section 6.2.

Figure 4

Expenses: Functional components
(June years, percent of GDP)



Source: The Treasury.

5.2 Key themes from the experience of the 1990s

Three key themes emerge from the experience with the fiscal framework during the 1990s.

5.2.1 Setting and achieving long-term fiscal objectives

The FRA does not specify the timeframe for the long-term fiscal objectives and in practice the implicit timeframes for the objectives were

different[17]. For example, when debt was at relatively high levels in the early 1990s, the focus was on the debt and operating balance objectives rather than the expense objective. Debt and operating balance objectives could be met with a range of possible revenue and expense tracks.

As noted above, progress against the stated expense objective slowed during the mid- to late-1990s. Indeed, even if the 30% of GDP objective had been reached it was not clear that it could be sustained given the projected demographic changes that would begin to emerge after around 2010.

The implicit timeframes associated with the long-term fiscal objectives during the 1990s reflect an over-specification issue within the FRA (the requirement to specify long-term objectives for expenses, revenues, the operating balance, debt, and net worth). The FRA does not specify which variable is the binding constraint nor does it require governments to explicitly state a preference ranking.

5.2.2 A focus on longer-term fiscal issues

The second half of the 1990s saw an increasing focus on longer-term fiscal issues. This change in focus was assisted by the shift to a more sustainable fiscal position and more information on the implications of demographic change, in particular, the consequences of population ageing for public pensions and health spending.

Further detail is provided in Section 7.8, but examples of this longer-term focus include:

- The inclusion of longer-term (50-year) fiscal scenarios in Fiscal Strategy Reports.
- Reports on retirement income policy (e.g., Periodic Report Group, 1997). The 1997 Report reviewed the framework for private and public provision and included long-term projections of NZS costs.
- The 1997 referendum on a compulsory Retirement Savings Scheme (RSS).

[17] The framework does not preclude a government from specifying a particular time frame or convergence path toward long-term objectives.

- A comparison of alternative financing methods in the 1999 Fiscal Strategy Report ("tax-smoothing" versus "balanced budgets").
- The establishment of a Superannuation Task Force in late 1999 (disestablished in 2000).
- The proposed New Zealand Superannuation Fund, which is giving effect to a tax-smoothing approach for a part of future public pension expenses[18].

5.2.3 Setting short-term fiscal policy

Changes to fiscal policy settings in the mid-1990s involved some difficult judgements about short-term pressures on aggregate demand, the size of supply-side responses (primarily through labour supply) and likely spending increases.

The size and timing of tax reductions depended on a number of conditions being met. These included net debt being under 30% of GDP and no risk of a return to fiscal deficits in the foreseeable future. The conditions also included the avoidance of balance of payments and inflationary pressures (see FSR 1995).

The Treasury and Reserve Bank assessments were that the outlook for aggregate demand was such that tax reductions could be accommodated without causing significant inflationary pressures. However, the economy evolved differently from the initial assessment with aggregate demand stronger than expected in 1996[19]. The episode provides an example of the complex issues involved when adjusting fiscal policy in an environment of uncertainty about the evolving nature of the economy.

Furthermore, pre-1997 forecasting assumptions for expenses involved a tension between setting appropriate assumptions for macroeconomic management purposes (e.g., impact on aggregate demand) and the political economy of incorporating a specific amount for new spending (e.g., an explicit amount might set a "floor" rather than a "ceiling" on spending demands).

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[18] Details are available at www.treasury.govt.nz/release/super.

[19] See the Reserve Bank of New Zealand submission to the Independent Review of the Operation of Monetary Policy, supporting document on "Fiscal and monetary coordination" (www.rbnz.govt.nz/monpol/review).

Valuation changes and cyclical movements also complicated the interpretation of short-term intentions for fiscal aggregates against outcomes. In particular, the pension scheme for government employees and the outstanding claims liability of the accident compensation scheme fluctuate from year to year due to changes in long-term financial assumptions and other factors. For example, movements to the liability valuations for these two items boosted the operating balance in 1999/2000 by around $700 million (the actual operating balance was $1.5 billion or 1.4% of GDP).

By the late 1990s, debt-to-GDP ratios were significantly lower and there was increased scope to allow for the operation of automatic fiscal stabilisers. Policy-makers were in a better position to assess the nature and likely duration of economic shocks[20]. Nonetheless, the maintenance of operating surpluses was seen as important given the size of New Zealand's current account deficit and net external liabilities. For example, the Asian financial crisis saw the then Government make incremental adjustments to short-term fiscal plans during 1998 as new information emerged.

By the time of the 1999 BPS (published in December 1998), longer-term fiscal projections indicated four years of fiscal deficits. Although the fiscal position was projected to eventually move into surplus, there was a limited "buffer" against further adverse events and the achievement of longer-term debt and expense objectives was pushed out. The "Policies for Progress" programme included steps to improve the medium-term economic and fiscal outlook.

6. Current Fiscal Processes

In response to the experience with the framework in the mid-1990s, there have been refinements to Budget and forecasting processes. The following description on the top-down management of government spending is drawn from Barnes and Leith (2000). The two key tools for ensuring overall fiscal control and effectiveness are fixed nominal baselines for departmental spending and the fiscal provisions framework.

[20] See Fowlie (1999) for a discussion on the operation of automatic fiscal stabilisers and their relationship with the FRA.

6.1 Fixed nominal baselines

The early 1990s saw a change whereby Government spending could be characterised as being split into two tracks: "formula-driven" (i.e. indexed) and "fixed" (i.e. no change to nominal baseline amounts). Previously, departmental funding was split into three main input-based streams: personnel, operating costs and capital. Personnel costs were regularly adjusted for movements in wages, and the other two streams were generally adjusted annually to reflect expected cost movements. The Public Finance Act was enabling of a baseline approach.

Formula driven annual indexation applies to non-departmental spending on benefits (e.g., inflation indexation of unemployment payments) and to New Zealand Superannuation. Health and education spending are adjusted through formulas that take into account demographic change. A specific policy decision is required to change the amount spent on non-indexed spending.

6.2 Forecasting assumptions

A key issue to emerge from these changes was the relationship between fixed nominal baselines and the short-term fiscal forecasts. Three-year budget forecasts prepared under GAAP between 1994 and 1996 would include increases in government spending only for those areas affected by automatic indexation. All other spending was assumed to remain constant over time.

This approach provided what might be described as a "policy neutral" forecast and reflected a current policy assumption. However, because the fiscal forecasts did not allow for increased spending in future Budgets, they understated the likely spending profiles. An example of this "forecast bias" is illustrated in Table 2 below. The left-hand column sets out the forecasts for the 1997/98 financial year operating balance at different points in time, starting from the first time it was forecast through to the actual result. The right-hand column decomposes the change into its forecasting and policy components. The "forecasting" component includes

changes attributable to different macroeconomic conditions than forecast, and revised tax and welfare bases[21].

The analysis indicates that there was significant policy change ($3.7 billion) with respect to the current policy forecast assumption. This "slippage" against forecast reflects the tension mentioned in Section 5.2.3 – between setting realistic assumptions and the political economy of incorporating a specific amount for new spending.

The approach resulted in optimistic projections of progress towards the long-term fiscal objectives[22]. This created a number of issues, including those mentioned previously around macroeconomic management as well as discipline on the annual Budget process. Further, the approach raised credibility problems about likely progress towards long-term fiscal goals (see for example, OECD, 1999).

On the political side, there were also pressures to find a better way to represent spending intentions. For example, New Zealand's first coalition government sought a mechanism to demonstrate fiscal prudence and reduce the possibility that portfolio Ministers from different coalition parties would bid up spending in their sector.

The response was a statement incorporated into the Coalition Agreement committing to a $5 billion cap on new spending over a three-year term of government to 1999/2000. Importantly, this cap was on top of changes already included in the forecasts (i.e. on top of the formula-driven items). The cap evolved into a mechanism now known as the "fiscal provisions".

6.3 Fiscal provisions

The experience of the mid-1990s indicated the need to have a short-term anchor for fiscal policy, that while consistent with longer-term objectives, avoided the fluctuations caused by cyclical and valuation changes.

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[21] Some of the forecasting change may reflect changes in fiscal policy and so could arguably be allocated to the policy change component. The decomposition used does not allow for these effects.

[22] The Progress Outlooks in Fiscal Strategy Reports did include higher spending scenarios and so provided some indication of alternative paths towards stated long-term fiscal objectives.

Table 2

Operating balance for 1997/98: forecast and policy changes

Forecast 1997/98 operating balance ($billion)		Policy and Forecast changes from 1994 DEFU to actual result ($billion)*	
1994 DEFU	7.6	Revenue: Policy	– 1.0
1995 Budget	7.8	Revenue: Forecasting	– 1.1
1996 Budget	3.3	Expenses: Policy	– 2.7
1997 Budget	1.5	Expenses: Forecasting	– 0.6
1998 Budget	2.8	SOE/CE surplus: Policy	–
1998 Actual	2.5	SOE/CE surplus: Forecasting	0.2
		Total: Policy	– 3.7
		Total: Forecasting	– 1.5
Actual less DEFU forecast	– 5.1		– 5.2

Source: Adapted from Table 1.4, OECD (1999).
Notes: * Change is expressed in terms of the impact on the operating balance. DEFU refers to December Economic and Fiscal Update. CE refers to Crown entity. Totals do not sum due to rounding.

The fiscal provisions were introduced into the forecasts during the 1997 Budget. The provisions framework consists of a pre-determined fiscal limit across the parliamentary cycle (three years), and a set of rules for "counting" against that limit. The provisions are recorded in the Statement of Financial Performance as expenses. However, they are available for decisions that relate to changes in revenue, expenses or the surpluses of state-owned enterprise and Crown entities.

6.3.1 Operating balance focus

The provisions focus on the operating balance impact of changes to existing policy (including cost increases) or the introduction of new policy.

The framework focuses on decision-making and, therefore, only discrete policy decisions[23]. The focus on discrete policy changes builds on and extends the past practice of having fixed nominal baselines for most departmental spending, while allowing forecasting changes to fluctuate with the state of the economy.

A key aspect of the counting principles is that they include all policy decisions that affect the operating balance. In the past, tax policy decisions and policy decisions affecting state-owned enterprises and Crown entity surpluses had tended to be made in isolation of "spending" budget decisions.

The fiscal provisions require principles that determine which items will be treated as forecast changes, and which would be treated as specific policy decisions that "count" against the provisions. The development of the principles has evolved considerably since the framework was introduced (for details, see Barnes and Leith, 2000).

The fiscal provisions are not a direct mechanism to control the operating balance in the short-term. For example, under accrual accounting there are fluctuations due to liability valuations.

The effects of the economic cycle are also beyond the immediate control of the Government. The general approach taken is that as forecasts change through time, the fiscal provision limit is unaltered. This allows other fiscal variables to change as the automatic fiscal stabilisers operate through the cycle. Analysis for New Zealand indicates that cyclical effects operate mainly through the revenue side. Unemployment is the major cyclical expense.

Beyond the three-year parliamentary cycle, the fiscal forecasts have included "technical provision/s" to represent potential future policy decisions to be made as part of future Budgets[24].

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[23] For example, an increase in benefit payments due to higher unemployment would not impact on the provisions. In contrast, a decision to increase the amount of the benefit payment (over and above any automatic inflation indexation) would impact on the provisions.

[24] In the current Progress Outlooks the amount assumed beyond the fiscal forecast horizon is termed a "fiscal allowance" and provides a broad indication of fiscal flexibility rather than a specific policy commitment.

6.3.2 The current fiscal provisions

The current Government's fiscal provisions have been set at $5.9 billion (inclusive of Goods and Services Tax, GST). The provision is defined as a cumulative, three-year total. For example, a decision taken to increase a department's baseline in 2000/01 will generally represent a permanent increase (i.e., annual increases "roll out" into the following years).

The provision is phased across the three years in accordance with the expected profile of policy decisions. (The $5.9 billion provision covers four years as the election was held in November 1999, and the new Government undertook a number of initiatives in the 1999/2000 year.) Figure 5 provides a graphical representation and Table 3 details the dollar amounts. (Spending intentions beyond the current parliamentary term will be reviewed this year and the technical provision will then be replaced by an indicative Government policy commitment – see 2001 BPS).

Figure 5
Fiscal provision allocation as at December Economic and Fiscal Update, 2000
(June years, $ millions)

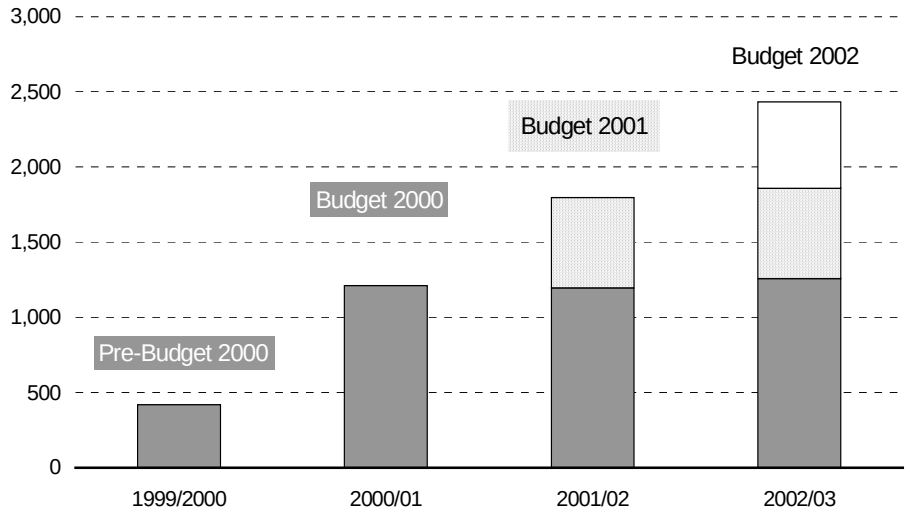

Table 3

Fiscal provisions as at December Economic and Fiscal Update, 2000

Operating provisions ($million, GST inclusive)	1999/00	2000/01	2001/02	2002/03	Total
Budget 2000 decisions	420	1,050	1,060	1,120	3,650
Inter-Budget contingency*	–	161	136	138	435
Budget 2001 provision	–	–	600	600	1,200
Budget 2002 provision	–	–	–	575	575
Total	**420**	**1,211**	**1,796**	**2,433**	**5,860**

Source: The Treasury.
Notes: * Within Budget 2000, the Government committed $3.65 billion of the $5.9 billion fiscal provision. It also set aside a contingency for further initiatives over three years. Approximately $240 million of this has been committed.

7. Challenges facing New Zealand's Fiscal Policy Framework

Challenges and ongoing developments can be grouped into short-term fiscal policy (primarily the provisions) and longer-term issues associated with population ageing.

7.1 Rolling out the provisions beyond the parliamentary term

The provisions framework is established for the three-year parliamentary term. However the fiscal forecasts extend beyond the parliamentary term, more so as the term progresses. Technical provisions are included to ensure a realistic expense profile is maintained.

However, the technical provisions present issues about the transition to the next three-year provision, for example, when a government makes decisions that impact beyond the horizon of its fiscal provisions. If the decisions are rising in cost, then these are not "counted" against any

technical provisions. This is termed the "bow wave" effect (effectively expenditure creep). In addition, the transition beyond the three-year term may result in large changes in provisions as they are finalised.

7.2 Capital provision

A capital provision, which links to the Government's debt objectives, exists alongside the fiscal (operating) provisions. The capital provision covers both physical assets and financial assets (e.g., loans). The provision generally provides for new investments or where maintaining current operations cannot be funded from accumulated depreciation on balance sheets. The provision also covers capital savings, including capital withdrawals (special dividends) from state-owned enterprises and Crown entities.

Currently the capital provision is largely based on a bottom-up assessment of likely capital requirements and is set at $3.2 billion over the years 1999/2000 to 2002/03. Uncertainty around long-term investment needs has led to changes in the provision as specific needs emerged. The "sanctions" around the capital provision are less transparent than those around the fiscal (operating) provisions. The Government is currently addressing the need for a more comprehensive framework that will guide capital investment decisions within sectors and across the whole of government.

7.3 Decisions at the margin

The fiscal provisions focus on the margins of new activity rather than existing spending. This may provide weaker incentives on overall spending control depending on whether existing programmes are subject to the same degree of scrutiny as proposals under the new initiatives spending limit. These issues are linked to the more generic issue of budget management in a surplus environment.

7.4 Institutionalising the fiscal provisions framework

The provisions provide the Government with an opportunity to credibly demonstrate that it is following through on its short-term fiscal

intentions. The operating balance is subject to a number of other factors in the short-term and the provisions provide a controllable operational target.

However, the provisions framework is an informal control mechanism. For example, in 1999 it was uncertain whether the incoming Coalition Government would agree to continue to use the fiscal provisions framework. Further institutionalisation would help maintain continuity of the framework from one term of government to the next.

Given the "forecast bias" discussed in Section 6.2, the provisions framework has enhanced the credibility of short-term fiscal forecasts. However, in contrast to GAAP, which is externally monitored, the provisions framework is internal to the Government and the Treasury. This creates the potential that increases in spending pressure could be met through non-transparent changes in the definition of the provision rather than transparent changes in the quantum. The credibility of the framework may be enhanced by an external monitoring mechanism.

7.5 Allowing for uncertainty

Establishing fiscal provisions requires a Government to consider its long-term objectives for the operating balance, debt reduction/asset accumulation, and future expense pressures. The current fiscal provision was based on the Government's broad fiscal goals and the most recent set of fiscal forecasts (those in the Pre-Election Economic and Fiscal Update, October 1999).

Setting the provisions with reference to the "central" forecast does not adequately allow for the inherent uncertainty associated with those forecasts. The experience of the Asian financial crisis demonstrates that while a reaction function can be used to adjust the provisions *ex post*, there may be benefits in allowing for some uncertainty *ex ante*.

The *ex ante* budget target framework developed by Buckle *et. al.* (2000) may provide an additional guide to setting both the level and phasing of the fiscal provisions. Buckle *et. al.* caution that the degree of certainty surrounding the *ex ante* targets is based on the frequency and magnitude of past shocks to the economy. The FRA and current budgetary frameworks may have altered the nature of the fiscal response and shock generation mechanisms. Nonetheless, some reference to historical shocks

would augment the current forecast scenarios, which are largely based on judgements about situation specific conditions.

7.6 Short-term fiscal policy

Managing within the provisions requires the Government to more explicitly develop a policy approach that looks beyond each year's Budget, so reducing the likelihood of pro-cyclical fiscal policy. The general approach is to allow automatic stabilisers to operate and alter the provisions on the basis of what are judged to be longer-lasting changes.

7.6.1 The role of the economic cycle

Fiscal reporting in New Zealand does not require the preparation of cyclically-adjusted information (unlike the United Kingdom), although cyclically-adjusted balances are published. The broad similarity of alternative measures of New Zealand's potential output over the 1990s has provided somewhat more confidence in the use of cyclically-adjusted fiscal balances[25]. Nonetheless, history and overseas evidence suggests that caution is required in the assessing the underlying fiscal position.

There has been increased international interest in the role of automatic stabilisers in cushioning shifts in private sector demand (in the US context, see Cohen and Follete, 2000; Auerbach and Feenburg, 2000). For OECD economies, van den Noord (2000) assesses the extent to which components of government budgets affected by the macroeconomic situation operate to smooth the business cycle.

For the United States economy, Taylor (2000) concludes that… "Given the more transparent and systematic approach to monetary policy that has been followed in recent years, it is more important than ever for fiscal policy to be clearly stated and systematic". Taylor acknowledges the role of cyclical stabilisers and suggests the discretionary focus of fiscal policy should be on longer-term issues (e.g., marginal tax rates, population ageing).

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[25] For a review of alternative measures of New Zealand's potential output see Claus, Conway and Scott (2000).

7.6.2 Fiscal and monetary policy

It would not be unreasonable to suggest that the approach suggested by Taylor broadly holds in the New Zealand context. In the case of the mid-1990s tax reductions there was active consultation between monetary and fiscal authorities. But, formal co-ordination between monetary and fiscal authorities does not take the form of the authorities acting to pursue joint objectives[26].

New Zealand's experience with discretionary fiscal policy during the 1970s and 1980s had a significant influence on the formulation of current institutional frameworks and the operation of fiscal policy through the 1990s.

Currently, "discretionary" fiscal policy changes are signalled via the three-year fiscal provisions and this is seen as assisting the task of setting monetary policy. In turn, the fiscal provisions are set with some reference to the implications for aggregate demand and hence monetary policy (see BPS 2000).

Nonetheless, a better understanding of how fiscal policy settings affect the economy may be warranted given recent studies investigating the dynamic effects of changes in government spending and taxes (for example, see Blanchard and Perotti, 1999).

7.7 Balance sheet issues and changes to financial reporting

The preparation of a balance sheet and use of GAAP present a number of issues for both the reporting of fiscal information and the setting of fiscal policy.

7.7.1 The Crown balance sheet and net worth

The Crown's balance sheet includes a range of assets and liabilities. For example, for the year ending June 2000, the unfunded liability of the defined benefit pension scheme for government employees was $8.3 billion (compared to gross Crown debt at $36 billion).

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[26] See the Reserve Bank of New Zealand submission to the Independent Review of the Operation of Monetary Policy, supporting document on "Fiscal and monetary coordination" (www.rbnz.govt.nz/monpol/review). The supporting document also explores some of the institutional issues surrounding coordination.

With lower levels of debt, there is increasing focus on the management of the Crown's balance sheet, including the Crown's attitude to risk. The emphasis on the balance sheet is likely to increase under the proposed NZS Fund, which will involve a build-up of financial assets that are currently excluded from the long-term net debt objective (net debt is the value of selected financial liabilities less selected financial assets).

A number of issues point to an increased focus on gross debt as opposed to net debt. These include the proposed build-up of NZS Fund assets plus the role of gross debt as an indicator of the amount of funding the government requires from capital markets.

In order to capture the changes in the composition of the balance sheet, there may need to be clearer specification of the long-term objective for net worth (e.g., whether an increase in net worth reflects higher assets or lower debt).Greater use of the net worth indicator will be assisted by the resolution of establishment issues that arose when the Crown's balance sheet was first prepared in 1992. Examples of establishment issues include liability recognition for the accident compensation scheme (1999), Public Trust reserves asset recognition (1999) and urban state highways asset recognition (the only remaining issue, to be resolved in 2001). Establishment issues have led to significant changes in the level of net worth and their resolution should facilitate an easier analysis of trends[27].

7.7.2 Changes to financial reporting

Ongoing GAAP developments are likely to see the introduction of greater potential for fluctuations resulting from fair value assessments of assets and liabilities altering through time.

In accordance with GAAP, full line-by-line consolidation is due to be introduced in the 2002 Budget. Under full line-by-line consolidation, "Crown" will include state-owned enterprises and Crown entities. This will not affect reported net worth and the operating balance, but individual assets and liabilities will be recorded in the balance sheet (with individual revenues and expenses in the operating statement). This has implications for reporting and the specification of some of the long-term fiscal

[27] For example, initial recognition of the outstanding claims obligation for the accident compensation scheme had a negative impact on Crown net worth of around $7 billion.

objectives (debt and expenses). A technical discussion document on the issues will be released this year.

7.8 Time horizons and demographic changes

Falling debt ratios across the OECD are ushering in a series of new challenges around fiscal management in a surplus environment. The New Zealand experience highlights the search for appropriate fiscal anchors and the challenges created by projected demographic change.

The Fiscal Responsibility Act does not define the time horizon for the long-term fiscal objectives. However, the Progress Outlooks covering a minimum of ten years require projections of the variables specified as long-term objectives.

Longer-term projections of the fiscal position are subject to considerable uncertainty. There is uncertainty regarding demographic trends, technological change, behavioural responses and the role of future governments. Nonetheless, population ageing is projected to generate a change in the growth of government expenses (see Polackova, 1997). Although not required by the FRA, longer-term fiscal scenarios over time periods long enough to capture demographic changes (e.g., 50-years) have been a feature of fiscal strategy documents.

In terms of long-term fiscal indicators, generational accounting estimates for New Zealand suggest the burden on future generations is projected to fall slightly below that on current newborns (Baker, 1999)[28]. However, the lack of focus on existing generations and the complexity of the methodology means the estimates have had limited impact on policy decisions. The FSR 2000 signalled ongoing investigation into long-term fiscal indicators, including the "fiscal gap" calculated by Auerbach (1994) and the Congressional Budget Office (1999).

The approach taken to funding a "given" future spending path will influence the setting over time of long-term fiscal objectives. For instance, a decision to tax-smooth may imply running substantial operating surpluses, followed by an extended period of operating deficits. This would require changes to the long-term operating balance, debt and expense objectives. A balanced budget approach, which entails changes to taxes

[28] These estimates are based on 1996 fiscal forecasts with adjustments for higher spending.

and/or spending, would require modifications to the long-term objective for expenses.

These considerations may require Government's to signal specific time periods over which their long-term fiscal objectives are to hold, or that objectives may need to be adjusted as future expense pressures become clearer.

8. Conclusions

Fiscal policy in New Zealand has seen a consolidation of the Government's position and significant changes to the institutional framework, in particular, the introduction of the Fiscal Responsibility Act 1994.

New Zealand's fiscal policy framework is a function of both historical experience and wider public sector reforms. The framework differs from that used elsewhere, especially in its use of legislated "principles of responsible fiscal management" as opposed to mandatory targets. However, the Fiscal Responsibility Act does require Governments to set short-term fiscal intentions and long-term fiscal objectives for a range of fiscal aggregates.

The 1990s saw a shift to structural surplus and declining debt-to-GDP ratios. Progress toward stated long-term expense objectives, however, has been more problematic. The experience of the 1990s highlights three key themes; the tensions created by "timeless" long-term objectives with no clear binding constraint; the uncertainties and tensions in adjusting short-term fiscal policy settings; and the emergence of longer-term fiscal issues associated with future demographic changes. With regard to the last of these, the FRA framework has increasingly been used to illustrate a range of fiscal issues that are broader than those that influenced its original formulation (e.g., fiscal consolidation and stabilisation).

The direct contribution of institutional change such as the FRA to the fiscal outcomes of the 1990s is unclear. The Act codified a number of earlier developments that may have improved fiscal policy regardless (e.g., through increased transparency). Nonetheless, by requiring Governments to be explicit about their short-term intentions and long-term objectives the FRA establishes a framework for annual Budget decisions.

More recently, the experience of the 1990s has seen the evolution of specific operational targets (the fiscal provisions). The fiscal provisions provide a short-term anchor that avoids fluctuations caused by the economic cycle and valuation changes. Cyclical and valuation changes complicated the interpretation of outcomes against short-term fiscal intentions.

New Zealand's fiscal policy framework faces a number of challenges and is subject to ongoing developments. For example, the provisions may benefit from a more explicit institutional framework. Although the framework has "opened up" longer term fiscal issues, these will present ongoing challenges to the formulation of fiscal policy.

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COALITION GOVERNMENTS AND FISCAL POLICY IN THE NETHERLANDS

Ted Reininga[*]

1. Introduction

In 1994, when public finances appeared to be under control again, the Dutch government introduced a trend-based budgetary policy. This policy regime features medium term ceilings for government expenditures and - to some extent - tax smoothing on the revenue side. It aims at structural reduction of the share of government expenditure in GDP, a transparent and orderly budget process, and automatic stabilisation with regard to the business cycle. The new Kok administration that took office in the summer of 1998 continues this fiscal policy regime, with a few modifications. Despite some features of the system that may be sub optimal, the policy regime has been very successful in terms of lowering budget deficits and government debt since 1994. In this paper we will discuss various features of the fiscal policy regime of the Kok administrations in a historical perspective of Dutch fiscal policy after 1945. In particular, a comparison is made with an earlier version of trend based fiscal policy.

Overlooking the post War period, an important turning point in the orientation of Dutch fiscal policy is the introduction of a policy of fiscal consolidation in 1982. Prior to 1982 fiscal policy was predominantly directed towards macroeconomic demand management. Two more or less conflicting explanations of this change in fiscal policy emerge in the literature.

On the one hand it seems likely that the urgency of consolidating public finances reduced disagreement among political parties in the Netherlands over priorities in public finance. Consequently, this enabled the first Lubbers administration (1982-1986) to embark on a tighter fiscal policy than its predecessors, aiming at a considerable drop in the budget deficit. This explanation can be based on the assumption that in “normal” times a bias exists in favour of politically motivated excessive budget

[*] Centraal Planbureau – The Netherlands.

deficits[1] that can only be redressed by a crises in public finances that necessitates fiscal consolidation. This theory is in accordance with the simultaneous shift to similar policies in other OECD countries facing sharp increases of deficits (OECD, 1988). However, it fails to explain why a gradual build-up of deficits has not re-emerged after the financial crises was averted.

On the other hand there is the view that underlines the relevance of socio-political institutions and concomitant budgetary rules for the explanation of both evolution and inter-country differences of public deficits[2]. Dur and Swank (1998) and Dur (2000) have made an interesting contribution to this literature that seeks to explain the change in Dutch fiscal policy after 1982. They claim that the increased significance of coalition agreements as a commitment device for participating political parties has facilitated the forming of coalition governments with a programme targeted at deficit reduction. A weak point of this line of thought is that no coinciding changes in socio-political institutions in other countries can be identified that might account for the simultaneity of the change in politics in OECD countries mentioned above.

This paper presents a synthesis of both views that can explain both the simultaneous appearance of a shift in fiscal policy in favour of sound public finances in the Netherlands in the early Eighties and the continuance of such policies after the deficit returned to more sustainable levels. It is beyond the scope of this paper to assess the extent to which the synthesis presented here can also contribute to an understanding of similar patterns in other OECD countries.

2. Structural Dutch Fiscal Policy after 1945

In the 1961 Budget, finance minister Zijlstra tried to circumvent the problems of Keynesian fiscal activism that prevailed during parts of the 50's by introducing his so-called structural fiscal policy[3]. The 1961 type of

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1 This policy can be explained by a majority of myopic voters that "normally" favours an increase of the budget deficit over an increase in taxes to finance additional spending.

2 See e.g. Alesina and Perotti (1995) and Grilli, Masciandaro and Tabellini (1991).

3 In terms of it's stabilizing effect on the economy, this policy showed a number of drawbacks, including (i) inflexibility of a large part of public outlays in the short run (especially downwards), (ii) problems in assessing the timing of cyclical upturns and downturns, and (iii) (irregular) time

(continues)

structural fiscal policy is characterised by two main features[4]. First, the so-called structural government budget deficit is introduced. This concept is related to cyclical neutrality. In its fourth report the Study Group on the Budget Margin (Studiegroep Begrotingsruimte)[5] explicitly related the size of the structural government budget deficit to the structural current account position. The Study Group argued that, in absence of cyclical disturbances, the current account should show a small structural surplus enabling the donation of capital transfers to developing countries. Applying the well-known macroeconomic identity the size of the structural budget deficit can be related to the cyclically neutral savings balance of the private sector and the desired current account surplus.

The second feature of the structural fiscal policy in the 60's was the extrapolation of government revenues on the basis of the structural or trend growth rate of the economy, rather than the actual growth rate anticipated. Moreover, as the structural deficit was considered constant relative to GDP, the absolute size of the deficit was also allowed to increase proportionally to the trend growth rate. The increase in next year's government expenditure, including spending on lower tax rates, was set equal to growth of both revenues and the absolute size of the structural deficit. As tax revenues were allowed to reflect actual rather than trend growth rates, the budget deficit acted as a built-in stabilizer. In this way, structural fiscal policy managed to circumvent the timing problem that encountered the activist Keynesian policy in the 50's. Moreover, the trend based growth rate of both revenues and the absolute size of the structural deficit enabled the estimation of the total means available for spending in future years. Consequently, structural fiscal policy also provided for a multi year framework to assess budgetary proposals.

By and large the system performed rather well until the Seventies. The economic slowdown that occurred in the early 70's was considered to be temporary. Because the trend growth rate of the economy was not adjusted, the extrapolation of structural tax revenues based on illusory

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lags between the implementation of fiscal policy and the desired outcome in terms of aggregate output and employment. Moreover, in strongly emphasizing the use of fiscal policy in stabilizing the macro economy, interest in the allocative aspects of the budget is lacking.

4 This part is primarily based on Sterks, 1982 , pp. 148-213.

5 The Study Group on the Budget Margin (*Studiegroep Begrotingsruimte*) is an advisory council of high-level civil servants. Among the members of the Study Group is a director of the Dutch central bank and CPB's managing director.

high growth rates resulted in steadily increasing budget deficits. Moreover, as estimation of the cyclical component of unemployment became indefinite as the economy entered a period of considerable turbulence , the procedure used by the Study Group to assess the size of the structural deficit became rather hazardous.

2.1 Intermezzo: 1982-1994

In the early Eighties the "old" structural fiscal policy was abandoned. By then, fiscal policy had got seriously out of hand and priority was given to the reduction of the actual budget deficit of general government that amounted to almost 7% of GDP in 1982[6]. The focus on the evolution of the actual budget deficit was motivated in particular by imminent adverse debt dynamics resulting from interest rates in excess of GDP growth rates. However, the new direction of fiscal policy necessitated by exploding deficits had a number of drawbacks. One serious complication was the pro cyclical nature. In order to meet deficit goals, the government had to make additional budget cuts in cyclical downturns. Moreover, it lacked the multi year quantitative framework for fiscal policy that was the implied gain of structural fiscal policy. By the time the deficit had reached a more sustainable level, a return to a type of structural fiscal policy that successfully disposed of the problems of the old regime was widely considered desirable.

2.2 Structural Fiscal Policy after 1994

The structural fiscal policy adopted by the first Kok administration in 1994 differed from the former type in a number of ways. First, the size of the structural deficit was no longer related to the assumed structural savings surplus of the private sector. As we will argue below, this partly reflected an important change in the underlying considerations derived from economic theory. Secondly, the new fiscal policy tried to overcome the problem of the assessment of the structural growth rate of the economy by relying deliberately on a cautious economic scenario. In this way, the

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6 The deficit concept used here is the so-called EMU deficit that is referred to in the Maastricht Treaty. It excludes financial transactions of governments. Actual net borrowing of government, at that time a politically more relevant concept, amounted to 9.5% of GDP in 1982 and was expected to rise even further.

risk of exploding deficits as a result of too high estimates of structural economic growth rates was minimized.

As has been argued above, the 1961 type of structural fiscal policy was strongly rooted in the belief that high public deficits had to offset notorious low private expenditure. This conclusion accounted partly for the traditional Keynesian flavour of the 1961 structural fiscal policy. At present it is widely recognized that economic theory cannot offer a normative conclusion on the size of the budget deficit. In fact, it is implicitly denied that only a particular size of the budget deficit of government can be reconciled with cyclical neutrality in the medium run.

The new fiscal policy rules reflect this changing view. Therefore, it tries to identify normative restrictions on the size of the budget deficit that are not derived from economic theory. Here, we will discuss two limitations on the structural fiscal position of Dutch government that are widely recognized[7].

One restriction results from the 3% EMU upper ceiling for the fiscal deficit that is included in the Maastricht Treaty. As cyclical fluctuations affect the fiscal deficit, the actual deficit must be lower in order to minimize the risk of a violation of the ceiling. Another normative implication for the budget deficit is derived from the prospect of an ageing population. Sustainability of present arrangements for the elderly can be established by smoothing overall public expenditure in future decades. According to recent CPB research this implies that the present deficit has to turn into a surplus in the course of the coming decade[8]. The resulting reduction of interest payments creates room for higher expenditure due to ageing.

In the next subsection we will deal in rather more detail with fiscal policy in the Netherlands after 1994. In particular we will address some changes in the fiscal policy of the Kok II administration compared to the rules that prevailed under the Kok I administration.

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7 See tenth report of the Study Group on the Budget Margin (*Studiegroep Begrotingsruimte*), 1997.

8 See H.J.M ter Rele, 1997, p. 21.

3. Trend based fiscal policy of the Kok administrations: some more detail

The Kok I administration (1994-1998), based on a coalition of Social Democrats (PvdA), Liberals (VVD) and Left Liberals (D66), adopted a trend based fiscal policy. To allow for tax smoothing and automatic stabilisation, the spending side was disconnected from the revenue side of the budget. For expenditure fixed numerical ceilings were set for the period 1994-1998 for the three main categories of public expenditure: social security, health care and the central government budget. As a rule, expenditure overruns had to be redressed by budget cuts within the category in which excess spending occurred. Lower expenditure levels than allowed by the ceilings would feed into a lower deficit or lower tax rates. Irregular revenues from selling state owned enterprises and (part of) natural gas were excluded[9]. A considerable part of these latter revenues was used to fund investment in economic infrastructure. Public investment outlays funded in this way were also not included.

The fiscal deficit was allowed to absorb temporary tax revenue fluctuations due to cyclical factors, subject to a pre-set fixed ceiling. Consequently, the system provided for fluctuations of tax revenues as a built-in stabilising factor.

3.1 Fiscal policy 1994-1998

Fiscal policy of the first Kok administration has contributed strongly to the consolidation of Dutch public finances in the 1994-1998 period[10]. However, it must be recognised that the new rules met with favourable conditions. The budget projections and expenditure ceilings were based on a cautious economic scenario, which assumed a moderate growth of only just over 2%. Actual growth in the 1994-1998 period amounted to 3.25%. Thanks to this favourable macroeconomic performance, and supported by social security reforms, the number of social benefits paid to people under 65 dropped from 2.1 million in 1994 to 1.9 million in 1998. This together with the sharp fall in interest rates - and therefore debt service - enabled

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9 The expenditure ceilings are defined in net terms, e.g. gross outlays minus non-tax revenues.

10 See “Consolidating Public Finances: the Dutch Experience”, CPB Report 1996/3 and “Towards Sustainable Public Finances”, CPB Report 1997/3.

the previous administration to accommodate notorious spending overruns in health care. Also expenditure on education and crime prevention was increased and social benefits improved. Even then expenditure stayed below the ceilings, except for 1998. Next to accelerating the reduction of the deficit, the favourable budget realisations have been used for an additional reduction of tax rates. So, also on the revenue side the government did not live up rigidly to its own rules. Tax smoothing was only partially adhered to.

The favourable macroeconomic conditions enabled a further consolidation of Dutch public finances than envisaged in the budget outlook made at the start of the coalition government in 1994 (see table 2)[11].

Table 1

Aggregate overrun of spending ceiling 1995-1998
(current prices, billions)

	1995	1996	1997	1998
Total	- € 0.9	- € 2.0	- € 0.2	€ 0.2

Source: Macroeconomic outlook 1999, CPB

3.2 Fiscal policy of the present government

The new administration, based on the same coalition that took office in 1998 by and large continued the successful fiscal policy of the previous administration. However, some modifications have been made. In 1998 the Kok II administration introduced, next to ceilings for public expenditure, also reference levels for public revenues (taxes)[12]. To avoid intricate

[11] The remarkable fall in public debt (% GDP) is partly due to consolidation of social security funds in the public debt.

[12] Here taxes are considered to include social security premiums.

Table 2

Consolidating Dutch Public Finances 1994-1998
(percent of GDP)

	1994	1998 estimate in 1994	1998 outcome
a. Net Government Outlays	50.2	47.2	39.8
b. Taxes and Social Security Premiums	46.0	44.3	40.5
c. Government Deficit[13]	4.3	2.3	0.7
d. Government Debt	80.5	81.0	66.6

Sources: Macroeconomic outlook 1995 and 2001, CPB

political discussions in later stages, it was already lead down in the coalition agreement, what should be done with deviations in tax revenues from this reference path. As long as the budget deficit is within the range of 0.75-1.75% of GDP, it was agreed that 75% of the deviation will be absorbed by the deficit. The complementary 25% will be covered by a change in tax rates[14]. Outside this range the deficit will absorb only 50% of the deviation; the rest must be accommodated by a change in taxes. The rules only apply to a state in which the actual deficit does not exceed the EMU deficit ceiling of 3%.

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[13] The government deficit presented here reflects the so-called EMU definition of the deficit. In compliance to the latter definition, a number of outlays and revenues that are part of net government outlays are excluded (e.g. revenues of the sale of publicly owned shares). Also in compliance with the EMU-definition is a different registration of taxes and social security premiums than presented in the table under b. As a result, the government deficit cannot be computed straightforward using the data on net public outlays and revenues from taxes and social security premiums.

[14] The range is set symmetrically around the deficit of 1.25% of GDP in 2002 that was anticipated in the budget outlook underlying that coalition agreement of the summer of 1998.

The fixed expenditure rules have been generally maintained. A novelty concerns the treatment of so-called macroeconomic shocks. This is to allow for particular sensitivity of some types of spending for changes macroeconomic variables like wages and interest rates. For instance, the health care sector is known to be very sensitive to wage increases. On the other hand, lower interest rates almost exclusively benefit central government. Therefore, it was decided in the event of such macroeconomic shocks to allow compensation of spending overruns in one sector by lower spending of another sector.

Moreover, the spending limits that prevail during the period 1998-2002 enclose a total spending margin increasing to 1 billion guilders in 2002. This margin is considered to accommodate small spending overruns that otherwise necessitate instantaneous political debates on spending cuts. Finally, it has been decided not to spend windfall gains resulting from favourable macroeconomic conditions the early years of the 1998-2002 period. They are considered an extra spending margin to counter possible adverse economic conditions.

In the first two years of the new government economic conditions again turned out to be favourable in comparison to the cautious reference path. As a result, in the spring of 2000 it was envisaged that spending would remain markedly below the spending limits for 2000 and 2001 (see CPB 2000b, p. 30). Subsequently, the cabinet has agreed on additional spending on (notably) education and health care *vis à vis* spending levels intended in the coalition agreement 1998-2002[15]. Also tax revenues develop favourably; they are expected to arrive at € 11 billion in excess of the reference path in 2001 (CPB 2000a, p. 151). Despite the obvious success of the budget rules there are a couple of points which give rise to discussion and are worth considering in more detail. We will deal with some of these issues in the text box below.

[15] This decision is not without risk. Although favourable economic conditions tend to mitigate real spending growth initially (notably through lower interest outlays and unemployment benefits), increased real wage growth due to lower unemployment levels might subsequently lead to increased real government spending growth (notably due to the link between wages and social security benefits in the government sector with wage growth in the private sector). (For an analysis along these lines see CPB, 1997b).

Some points for discussion

Van Ewijk and Reininga (2000) discuss a number of drawbacks of the present fiscal policy regime that have been pointed at. First, it has been claimed that the regime fostered only a modest reduction of the structural deficit in the recent past (see e.g. OECD 1999, p. 223). *It has to be underlined, however, that the assessment of the structural fiscal position is a rather hazardous task. In CPB (2000b, p. 33) estimates of the cyclical component of the budget balance in 2001 range from 0.5% to 2.5% of GDP. Therefore, it was concluded (CPB 2000b, p. 33) that, given an expected actual surplus of 0.8% of GDP in 2001 by then, an unambiguous assessment of the structural fiscal position was not possible.*

Another drawback of the present regime includes the limited effectiveness of built-in automatic stabilizers, as the rules with respect to deviations of revenues from the reference levels discussed above imply possible pro cyclical adjustments of tax rates. Next, the use of a cautious scenario has caused credibility problems as the economy shows considerably higher growth rates in 1999-2001. Two of the participating parties (Social Democrats en Left Liberals) express increasing dissatisfaction with the prevailing regime, which leads – in their view unnecessarily –to only limited budgets to cope with the challenges in health care and education. Finally, the use of real expenditure ceilings implies the possibility of a violation of a smooth and orderly budgetary process aimed for by disruptive price shocks to the public sector constitutes another drawback of the present system. To illustrate: in the spring of 1999 CPB's macroeconomic forecasts implied a negative price shock to the public sector for the budget year 2000 of € 1,75 billion (1.2% of the overall budget), which would have necessitated substantial spending cuts. Only a few months later, a revision of the macroeconomic projections implied only a negative price shock of € 0,75 billion. After successive projections, the final estimate of the price shock showed a favourable price shock of € 0.2 billion.

4. Continued consolidating of public finances in the Netherlands and the coalition agreement

The period of office of the first Lubbers administration (1982-1986) marks a major reorientation of Dutch economic policy. Broadly speaking, the "new" economic policy featured a shift from the emphasis on macro economic demand management towards a more market based orientation. By then, the majority of policymakers considered the steady increase in unemployment rates since 1972 not primarily as reflecting weak demand conditions. Rather, structural imbalances in the Dutch economy were considered to be at the heart of unfavourable economic conditions. The reorientation included a policy of fiscal consolidation aimed at a recovery of sound public finances.

Of course, the severe depression of 1980-1982 constituted an important trigger for the Lubbers administration to embark on a new course. In 1982, the coalition government of Christian democrats and liberals found the economy on an unsustainable path with sharply rising unemployment levels and high and rising budget deficits, despite the relatively high tax burden[16]. High nominal interest rates, together with the already high level of public sector debt, contributed to expectations of adverse debt dynamics leading to unprecedented levels of public deficits.

By now, it is widely recognized that the continuation of the market oriented approach, has contributed strongly to the marked improvement in labour market performance. To illustrate, in the nineties average annual employment growth reached 2¼%, well above the growth rate in the EU. Moreover, participation rates went up from 62% in 1990 to an expected 74% in 2001 and unemployment has reached very low levels that are reminiscent of the golden "sixties"(see CPB, 2000a, pp. 206-207). The concomitant policy of consolidating public finances has also been successful: in 1999 - for the first time in 25 years - the fiscal balance showed a surplus of 1% of GDP. Besides, public debt as a percentage of GDP dropped from an all-time high 81.3% in 1993 to an expected 52.0% in 2001. Finally, labour market performance is thought to benefit from a

[16] Unemployment rates more than doubled in 1979-1982: from 5.4% in 1979 to 11.4% in 1982 (OECD standardized measure). In 1982 an all-time high EMU-deficit (net lending of the public sector) emerged: 6.6% of GDP. By 1982, the borrowing requirement of central government was expected to rise to 12% of GDP in 1983, despite the relatively very high burden of taxes and social premiums (OECD, 1988).

drop in the tax burden from 48.8% of GDP in 1988 to an expected 39.5% in 2001 (CPB, 2000a, p. 130).

In the rest of this section we will focus on the reorientation of fiscal policy. It has to be underlined, however, that the policy of fiscal consolidation introduced in 1982, although initially aimed primarily at preventing public finances getting out of hand, constituted a natural part of the market-oriented economic policy. As the latter approach emphasizes the cost of government intervention in terms of reduced private economic activities (dead-weight loss), it follows quite naturally that the relatively large size of the government sector in the Netherlands was considered a core obstacle for economic recovery. In particular, increasing average tax rates, relatively already at a very high level, were considered detrimental to economic performance, as they would contribute to high real wage growth and concomitant low investment and employment growth. In turn, poor economic performance would lead to tax revenues falling short, necessitating a further increase on tax rates. As we will see, the slow adaptation by policymakers and the general public of this view of the interrelationship between worsening labour market performance and deteriorating public finances was at the heart of the rather late change in course of economic policy.

Although the change in fiscal policy can thus not be separated from the shift to a more market-oriented approach, still two questions arise almost inevitably from the history of Dutch fiscal policy in 1980-1982. First, why did it take until 1982 for fiscal policy to change course, while indicators of unsustainable public finances were available well before 1982? Second, why did a situation of high public deficits and sharply increasing public debt not reoccur after 1982?

4.1 Why was the change in fiscal policy delayed?

Looking back at the late Seventies and early Eighties it is hard to understand why a redirection of fiscal policy was delayed as public finances deteriorated strongly in the early Eighties. In 1982 the borrowing requirement of central government increased sharply to 8.3% of GDP, and was estimated in September 1982 to rise to 12% next year. (In fact, the borrowing requirement in 1983 turned out to be 8.9% of GDP.) The sluggish policy response is all the more remarkable, as early indicators of

an unsustainable continuation of poor economic performance and corresponding increasing public deficits were available.

As early as 1974, analysis of the Netherlands Bureau for Economic Policy Analysis (CPB) showed that increased real labour costs are detrimental to business investment and structural employment (CPB, 1975). Despite this warning, government continued to foster rising real labour costs by the "inexorable rise in the size of government share in the economy and the corresponding tax burden" (OECD, 1988, p. 92). As a result net operating surplus of manufacturing dropped to unprecedented levels by 1982. Still, the detrimental effects of this evolution to employment seemed almost absent at the surface, as private sector employment dropped only slowly due to government regulations concerning labour shedding and the simultaneous increase in public sector employment. This constituted an important factor that fostered the delay of the adaptation of economic policy.

The fact that the interaction of rising taxes, increasing real labour costs and deceased profits was unsustainable emerged not until the 1980-1982 period, as unemployment increased markedly in the aftermath of the second oil crisis (1979). Again, at least initially, a policy response was delayed. Two related explanations can be given:

1. The trend based fiscal policy that was developed in the early sixties was considered to have contributed to the relatively favourable economic conditions prior to the second oil crises. This view reflected the prevalence of a strong trust in Keynesian fiscal policy, with its fixation on negative macroeconomic demand shocks that are supposed to be at the heart of most economic problems. Consequently, at the time, no undisputed alternative macroeconomic view was available can could underpin a shift from Keynesian demand management towards a more market-oriented approach[17].

[17] Toirkens (1998, pp. 53-58) shows that members of the first Van Agt government (1977-1981) - like the Lubbers administration a coalition of Christian democrats and liberals - differed markedly on the appropriate course of fiscal policy. In particular, the ministers of Social Affairs (Albeda) and Education (Pais) opposed a policy of fiscal consolidation, as it would be detrimental to employment. Still, as the administration did embark on a policy of stabilizing the tax burden and reducing the relative size of the public sector, some authors (e.g. Knoester, 1989) do consider the first Van Agt administration as a pioneer of the market-oriented approach of the Eighties. However, due to lack of full political support within the coalition parties, the Van Agt administration did not succeed in fiscal consolidation.

2. There was a lack of a political majority in favour of such a reorientation in fiscal policy. The *ex ante* uncertainty concerning the identity of winners and losers of such a shift that prevailed at the time constituted an important determinant of inadequate political support[18]. Toirkens (1988, chapter 4) provides ample evidence that ministers of the first Van Agt administration (1977-1981) were worried about the possible detrimental effects of a policy of fiscal consolidation to particular groups in society (e.g. households on welfare).

Not until 1982, when exploding deficits and concomitant fears of adverse debt dynamics made a continuation of the fiscal policy that was in place intolerable, a reorientation of fiscal policy towards fiscal consolidation was introduced. The precarious situation at the time fostered political support for such a policy. As underlined above, the redirection of fiscal policy is part of a shift from the macro-oriented economic policy of the Seventies to a more market-oriented approach.

4.2 Why did high public deficits not reoccur?

After the successful completion of the policy of fiscal consolidation in many OECD countries in the nineties, there seem to be no indications that high deficits will reoccur in the near future. With the notable exception of Japan, OECD countries have sound fiscal positions, in the neighbourhood of fiscal balance (CPB, 2000a). Although, the present period of favourable economic conditions may obscure the incidence of still high structural fiscal unbalances, it seems unlikely, given the initial fiscal positions, that the next economic downturn will show marked increasing deficits reminiscent of the early Eighties. Here, we focus on the Dutch case.

A natural starting point to explain the persistence of fiscal consolidation would be to analyse the institutional setting of the budgetary process to identify possible changes in the budgetary institutions that might explain that high deficits have not reoccurred in the nineties. To this end, the analysis of Hallerberg and Von Hagen (1998) provides a general framework in which different electoral systems and concomitant features

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[18] See Fernandez and Rodrik (1991) on the issue of the *ex ante* uncertainty of the distribution of future benefits resulting from a reorientation of (fiscal) policy and political deadlock. See also Dur (2000) and Dur and Swank (1998).

of government (coalition government or single party government) interplay with budgetary institutions and outcomes. They argue that - given an electoral system - the government is restricted in choosing an appropriate institutional framework for the budgetary process. In particular, they argue, the desired centralisation of the budget process – witch enhances a proper evaluation of the expected benefits of extra government *vis à vis* the extra funding needed (either extra taxes or debt financing) – can be accomplished by using either of two institutional designs of the budget process. First, in countries with single party governments the institutional solution to budgetary "free riding" is the delegation of strong powers with respect to all stages of the budgetary process (design, determination and execution) to the finance minister (delegation model). In countries with multiparty governments a "strong" minister of finance is not an attainable solution, as it would imply strong powers of the minister of finance of a particular party over the ministers of other parties. In that case, the authors show, the proper institutional arrangement to foster budgetary discipline is a commitment to fiscal targets agreed upon by the coalition parties (commitment model).

For the Netherlands, with its coalition governments and a commitment model, Dur (2000) and Dur and Swank have pointed at the role of the coalition agreement in breaking political deadlock that has prevented the reoccurrence of unsustainable fiscal positions. Their analysis builds both on studies that underline the negative effect of fragmented party systems on political support in favour of fiscal consolidation (Alesina and Drazen (1991), Grilli, Masciandaro and Tabellini (1991)) and the work of Fernandez and Rodrik (1991) on the potential failure of governments to adopt policies that are generally seen as Pareto-efficient. The latter analysis rests on the *ex ante* uncertainty about the consequences of political reform at the individual (voters) level. As promises to compensate losers from the reform are not time consistent, *ex ante* uncertainty on the distribution of gains and losses might lead to political deadlock.

Dur and Swank introduce the Fernandez-Rodrik argument into a multiparty framework. In this setting the *ex ante* uncertainty about the distribution of winners and losers of a policy proposal over the voters of political parties may block agreement on the implementation of the proposal under consideration. Again, it is assumed that the policy proposal is welfare improving *ex post* and that compensation of losers by the

winners is not credible. The authors suggest that proposals for structural reform in the late Seventies and early Eighties very likely lacked majority support in parliament for this reason. We agree with the conclusion of Dur and Swank in this respect. Proposals for tax reform and reforms in social security and health care are bound to have effects on income distribution that are both very uncertain at the individual level and a very sensitive topic in politics. Therefore, it seems likely that political parties were very hesitant to adopt such reforms and, consequently, an undesirable bias towards *status quo* prevailed.

Dur and Swank continue by showing that voting on a package of political reforms reduces the likelihood of such a political deadlock. Intuitively, this results stems from the fact that the adoption of a reform that *ex ante* harms the voters of coalition party A and benefits the voters of coalition party B (although *ex post* Pareto-efficient) might still be approved by party A if it is compensated by the adoption of another reform that has *ex ante* the opposite distribution of benefits and losses. More formally the argument can be stated as follows:

- given a three party system (A,B,C);
- A and B form a coalition government, both A and B have 40 percent of the votes, C has the remaining 20 percent of the votes;
- parliament is assumed to mirror the electorate;
- the government proposes a policy reform to parliament that is welfare improving *ex post,* with the following *ex ante* effects on income distribution:
- the project yields a certain benefit of β to the constituents of party A;
- the project yields a certain loss of λ to the constituents of party C;
- the constituents of party B do not now *ex ante* whether they will end op being losers or winners. Each constituent faces a probability of ρ of gaining β and a probability of $(1-\rho)$ of losing λ.
- it is shown that *ex ante* support for the proposal is only warranted if:

$$\frac{\lambda}{\beta} < \frac{\rho}{(1-\rho)}$$

This condition states that the proposal is accepted by parliament if the expected gain of the proposal for the voters of B exceeds the expected

loss. Given the model, this means that the reform is excepted if all voters of B will be in favour of the proposal. Otherwise, all constituents of B will be against the reform and the proposal is rejected. Dur and Swank show that the condition for *ex ante* support for a package of two proposals – with the second proposal featuring symmetric opposite *ex ante* effects on income distribution with respect to the constituents of party A and B – can be shown to be:

$$\frac{\lambda}{\beta} < \frac{(1+\rho)}{(1-\rho)}$$

The latter condition is clearly less restrictive than the condition if only one reform is proposed. Not surprisingly, the possibility of compensating an expected loss of one project by the (certain) gain from the other project increases the probability to agree upon the package. Generalising this result, Dur and Swank conclude that the condition for *ex ante* approval will be less restrictive the larger the number of proposals.

The Dur and Swank argument can explain the inclination of Social Democrats and Left Liberals in the Netherlands to stick to fiscal consolidation laid down in subsequent coalition agreements. Although, fiscal consolidation – at least in the short run (!) – is at odds with their pronounced pleas in favour of increasing budgets for education and health care, apparently they are afraid of putting parts of the agreement which they favour at risk if they do not stick to the rules agreed upon.

However, it is not at all clear, as Dur and Swank claim, that the particular role of the coalition agreement also might explain the delay in the fiscal response in the early Eighties. Their argument critically depends on the implied assumption that coalition agreements in the Netherlands prior to 1982 – as opposed to the 1982 agreement and after - lacked certain necessary features to break political deadlock. In my opinion, Dur and Swank do not give a well-founded explanation for this dichotomy.

Contrary to the Dur and Swank argument, to me the most fundamental explanation of the prevailing view that fiscal consolidation should be continued, is the wide adaptation of a market-oriented approach. The concomitant emphasis on economic incentives and potentially damaging government intervention on private economic performance leads quite naturally to an inclination of downsizing the public sector. Besides, no longer the fear of immanent low spending of the private sector leads to

a call for countervailing public sector deficits. The success of the market-oriented approach in terms of employment and GDP growth and the consolidation of the fiscal position of the government can explain this broad support, including almost the entire political spectrum in parliament. Again, the Fernandez/Rodrik argument can be used to explain the support for the present *status quo* of fiscal policy.

This is not to say, that the changes with respect to the institutional setting of the budget process since 1994 documented above have had no impact on budgetary outcomes. As has been discussed, new structural fiscal policy adopted since 1994 had beneficial effects on the fiscal position. Only, the underlying force that fostered this outcome is the gradual change from old-fashioned Keynesian views that eventually contributed to unsustainable fiscal positions towards the adaptation of a more neo-classical framework. In the words of the master (Keynes, 1936, p. 384): "..But soon or late, it is ideas, not vested interests, which are dangerous for good or evil…".

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COMMENTS ON SESSION III: FISCAL RULES AND BUDGETARY PROCEDURES

António José Cabral[*]

I would like to start by saying that, as far as fiscal consolidation is concerned, the EU can be considered as a success story since 1995. Unfortunately this is a little disregarded when, in events like this workshop, fiscal policy and fiscal developments are discussed. And the success owes a lot to fiscal rules and budgetary procedures! Of course, there is no room for complacency and budgetary procedures - the topic of this session – can be clearly improved but the truth is that in 2000 the fiscal position of the EU was unambiguously better than five years earlier. This is the result of many factors on which I am not going to elaborate here. Let me just say that the scheme of incentives is by and large proving to be right. Of course, up to 1997 the incentive – the single currency – was very explicit. But we have to accept that fiscal consolidation did not stop there: we can argue that it could have been faster and of better quality, but we cannot deny that fiscal consolidation was not reversed.

Of course, *fiscal rules and budgetary procedures* played a role. Let me tell you my views on this issue, guided by the papers under discussion. As a starting point I think we should separate, as regards the EU countries, also in analytical terms, the *rules and procedures* (R & P) at national level and at the EU level, in particular at the euro-group level. I will argue that, while R & P at national level are in general *weak*, they are *strong* at the EU (euro-group) level. The overall balance, however, tilts towards the *strong* as evidenced by the good budgetary results achieved in 1995-2000. Which seems to suggest that, provided the R & P are adequately set at the EU (euro-group) level it is rather indifferent how the R & P are set at national level. Let me be very clear: of course that R & P must be improved at national level but such an improvement/setting is not a condition *sine qua non* for good fiscal behaviour, provided that at EU (euro-group) level *rules and procedures* are appropriately set and implemented.

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[*] European Commission. The views expressed here are the author's only.

Where does the *strength* of R & P at EU (euro-group) level come from? First, R & P at EU (euro-group) level are transparent in the sense that the rules of the game are known to players and the public in general; these are in the Treaty and the Stability and Growth Pact (SGP), which consists of legal texts. One of the criteria identified by Hemming and Kell seems therefore fulfilled. The first two years of implementation of the SGP provide clear evidence on transparency: stability/convergence programmes were made public annually by the Member State concerned (the Regulation obliges the Member State to make them public!) and the Council gave an Opinion on each of them, which was also made public (and published in the Official Journal); the implementation of the Pact is now in its third year which has allowed the building-up of a Commission/Council *doctrine* on each of the programmes thus constituting a kind of benchmark against which each Member State knows he is going to be judged. This means that we have now available, for each Member State, three programmes (more precisely, one programme rolled-over twice) and three Council Opinions. And all this is public. This is a non-negligible amount of information about budgetary intentions/outcomes of each Member State. Can we find another example of such transparency elsewhere?

Secondly, the intentions of the players are not only public but they consist of a multiannual budgetary programme. The importance of disposing of a multiannual framework for the government finances is emphasised in the papers presented to this session. Member States have, in general adhered to the budgetary projections presented in the programmes. Let me give an example: the table below displays the budgetary targets for 2001 as presented in the initial programme (submitted at least two years ago) and in the most recent updates. In all Member States the target for the actual deficit in 2001 is *better* than in the initial programme, in some cases with a wide margin; the only exception is Germany where the target remains unchanged. Of course we cannot conclude that the current targets for 2001 are those that would be achieved with the same *fiscal effort* as implicit in the initial programmes; probably not, if the method presented by Reitano and Fischer in their paper is correct. But the point I want to make is that no Member State significantly departed from the commitments they made publicly; more importantly, no u-turn was made. This provides evidence, in my view, that the stability/convergence programmes do matter for the budgetary process at national level.

Budgetary targets for 2001
(Government balance in % of GDP)

	Initial programme[1]	Latest update[2]
Euro area		
Belgium	-0.7	0.2
Germany	-1.5	-1.5
Greece	-0.8	0.5
Spain	-0.4	0.0
France	-1.6	-1.0
Ireland	1.6	4.3
Italy	-1.0	-0.8
Luxembourg	1.3	2.6
Netherlands	n.a.	0.7
Austria	-1.5	-0.75
Portugal	-1.2	-1.1
Finland	2.1	4.7
Non euro area		
Denmark	2.6	2.8
Sweden	2.5	3.5
United Kingdom	-0.1	0.6

[1] Submitted late in 1998/early 1999.

[2] Submitted late in 2000/early 2001.

Thirdly, the R & P at the EU level provide for a sort of an Independent Fiscal Authority (IFA) which is the European Commission. Hemming and Kell argue that the existence of an IFA can be very helpful to ensure fiscal discipline. In the framework of the institutional balance provided by the Treaty, the Commission has a unique role to play. I was already convinced of this, *et pour cause*… but I was definitely convinced when reading the papers presented to this session. In fact, in none of the R&P analysed in the papers one can find an institution like the Commission, although some would like to have one… I would just recall

that the Commission is an independent body, someway between the Member States and the Council and that (i) the Council acts upon recommendations/proposals from the Commission; for example, the Council Opinions on the programmes were all based on Commission's recommendations, which in turn were based on the Commission assessments of the programmes (ii) the public finance data are provided by the Commission, as regards the excessive deficit procedure and (iii) the Commission has the power to change the public finance data reported by Member States.

Last, the R & P include a sanction element, *strictu sensu* in the occurrence of an excessive deficit in the framework of the SGP or in the simpler form of a rebuke from the Council.

Of course, for the R & P at EU level to be efficient, Member States have to play the game right. And here the R & P at national level do matter. It goes without saying that stronger R&P at national level contribute to stronger R&P at EU level. Let me say a word about the fiscal rules in NL and SW in the light of the paper by Heering and Lindh. The NL have a very good record as far as budgetary outcomes are concerned. The budgetary results have been good, usually much better that expected. This is a positive aspect of the Dutch fiscal rule. But the Dutch fiscal rule is not very helpful as regards assessing ex-ante what are the intentions of the government and to assess compliance with the Stability and Growth Pact. This was expressed by the Council in its opinion on the 1999 updated stability programme: "*The Council considers that the Dutch method of using cautious growth assumptions and expenditure targeting and control has been instrumental in achieving the good results registered until now. However, this method also tends to make it more difficult to assess whether the medium-term outcome of the deficit is compatible with the requirements of the Stability and Growth Pact*"[1]. In addition the fiscal rule does not take into account, ex-ante, the cyclical position of the Dutch economy which, in phases of expansion, may lead to a wrong appreciation of the budgetary stance. As important as achieving better than planned results is to allow the other participants, in particular the eurogroup members, to understand if the fiscal stance will be appropriate. The fiscal rule in Sweden is from this

[1] Official Journal C 60, 2.3.2000, p. 1.

point of view clearer: in the budgetary bill for year t+1 the government (in September of year t) states how it will use the margin (if any) above the 2% of GDP surplus target, which is to be achieved over the cycle. For example in September 2000 the Swedish authorities stated that they would accept a surplus of 3.5% of GDP in 2001, clearly above target, but made possible by high projected growth and to avoid risks of overheating. In both countries the rules have so far worked well, but the test of *bad times* was not yet passed (hopefully there will never be a need for that!).

A final comment on Hemming and Kell's paper, where following Alesina and Perotti, they argue that a problem with the (balance budget) deficit rules is that they are inflexible, in particular because they are inconsistent with the use of fiscal policy to stabilise output. They might be right, but this criticism does not apply to the SGP, the fiscal rule of which is defined in terms of underlying budgetary position or structural balance. Indeed, the SGP objective of a "medium-term budgetary position of close to balance or in surplus" is to be interpreted in terms of structural, or cyclically-adjusted, budgetary balance. Once such a structural balance has been reached fiscal policy can (again!) play a stability role through the operation of the automatic stabilisers; this, in normal cyclical fluctuations, should not lead the government deficit to breach the 3% of GDP threshold. These have been the views of the Commission and the Council; to give just an example, in the Council opinion on the 2000 update of the stability programme for Finland it can be read *"The underlying budgetary position corresponding to the 4.5%* [of GDP] *expected surplus for 2000 will allow Finland to continue to fulfil the requirements of the Stability and Growth Pact"*[2].

[2] Official Journal C 374 of 28.12.2000, p. 5.

COMMENTS ON SESSION III: FISCAL RULES AND BUDGETARY PROCEDURES

Mauro Marè[*]

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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[*] University of Rome "La Sapienza".

[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

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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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COMMENTS ON SESSION III: FISCAL RULES AND BUDGETARY PROCEDURES

François Delorme[*]

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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[*] Ministry of Finance / Ministère des Finances, Canada. I benefited from the contribution of Suzanne Kennedy who kindly accepted to share her comments on the different papers as well as the input of Janine Robbins on the FIPS indicator.

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.

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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.