# COMMENTS ON SECTION IV: FISCAL POLICY ISSUES IN ECONOMIC AREAS AND COUNTRIES

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The extremely insightful papers included in this session span a broad set of highly topical issues. For the sake of both concision and effectiveness, this discussion will be organized around a limited number of selected themes.

## 1. The role of fiscal rules

The issue is addressed in both the Robinson and the Lindh and Ohlsson papers. While many of the related issues had already been dealt with in the previous Bank of Italy conference, there some new aspects to the discussion.

### *The choice between a golden rule versus a balanced budget rule*

Robinson's paper makes a strong plea in favour of the former, on the ground mainly of intergenerational equity and of the embedded bias against public investment in the budgetary process, particularly during a period of fiscal stringency. This may well be true, but a number of additional factors should be considered:

1. The definition of public investment is still largely arbitrary. Hence, excluding such item from the budgetary target would greatly increase the temptation to resort to creative public sector finance.
2. It cannot be excluded that the shift to a golden rule set-up may, somewhat perversely, induce an increase in current rather in capital spending. This may sound paradoxical, but is not so, when we recall that capital spending is difficult to expand, particularly in the short to medium run, and that most countries in Europe run a surplus on their current budget. With the golden rule set-up, however, the current

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budget would only need to balance. The new budgetary framework therefore would either lead to a boost in current spending or, at best, to a cut in taxes with little visible impact on public investment.

3. Last but not least, there is little evidence that those countries that have resorted to a golden rule framework for fiscal policy have been better able to protect public investment against unwarranted cuts. In the UK, for instance, public investment still accounts for one of the lowest, if not the lowest, proportion of GDP among OECD countries.

On balance, therefore, I remain quite sceptical about the wisdom of shifting from a balanced budget to the so-called golden rule. At the very least, the golden rule should be combined with a debt sustainability rule – as it is indeed done in the UK – to ensure that low productivity deficit financed public investment does not lead to an unsustainable debt accumulation. Equally crucially, the shift toward the golden rule should only be implemented if rigorous and transparent public investment evaluation procedures are in place.

*The role of fiscal rules in a currency union*

1. Fiscal rules in a currency union are typically designed with a view to preventing opportunistic behaviour by high debt countries who otherwise may impose negative externalities on other members. In particular, the pursuit of unsustainable fiscal policies by high debt countries may force more virtuous members to bear the cost of a fiscal bail out.
2. However, suppose bails out are ruled out. There is indeed no evidence, on current policies, of unsustainable debt dynamics in any EU country. Then, opposite to the existing wisdom, high debt countries would benefit relatively more from broad based fiscal discipline across the union as a whole, to the extent that fiscal rectitude is associated with lower interest rates. This key factor was explicitly acknowledged in Italy's 2001 Stability Program.

*The inherent weaknesses in fiscal rules*

First, fiscal rules can always be changed, albeit at some credibility costs. Second, and perhaps more crucially, existing fiscal rules are typically unsuited to prevent a long run deterioration in the fiscal position of the public sector due a significant change in long run entitlements. For instance, for an assessment of a pension reform to be sufficiently reliable, projections would need to be made over a at least a 50 year horizon. Unfortunately, this is rarely required by existing budgetary procedures. In Italy, for instance, pension reforms must be assessed over a 10 year period, a clearly inadequately short period to evaluate the impact of this kind of reforms.

## 2. Measuring fiscal adjustment

Balassone, Franco, Momigliano and Monacelli provide an insightful account of Italy's fiscal consolidation during the Nineties. The authors acknowledge that the size of the fiscal adjustment was indeed remarkable, with the general government net borrowing falling from around 12 percent of GDP in 1990 to close to 1.5 per cent in 2000. However, their argument goes, this "adjustment relied on significant tax increases, capital spending reductions and the rationing of transfers to local governments". Reductions in current spending were conspicuously absent. According to this view, the Italian economy still suffers from this biased pattern of adjustment, stifled by high taxes and inadequate public infrastructures. This interpretation is not without merits, but should be complemented by at least two observations:

1) First, the choice of the relevant period matters. It is true that from 1989 to 2001 current primary spending in Italy declined from 37.9 per cent to 37.6 per cent of GDP, a somewhat less than remarkable achievement. However, if we take 1993 as the starting point of our analysis (a well advised choice, I believe, given that 1993 marks the first determined attempt to address Italy's fiscal imbalances) we find that current primary spending fell substantially from 40.3 per cent to 37.6 percent of GDP, thereby providing a significant contribution to the fiscal consolidation effort. Moreover, much of the decline in current primary spending came from the downsizing of the public employment wage bill. Alesina and Perotti would certainly include such a pattern among the episodes of virtuous fiscal retrenchment.

2) Second, the counterfactual also matters. A simple comparison of say fiscal spending after and before the adjustment can be highly misleading. Suppose for instance that public spending is on an unsustainable trend, because of large and rapidly rising pension entitlements. Suppose now that the government takes effective

measures to stop first and then modestly reverse such trend. The data would only show a limited fall in the level of pension spending. Should we then conclude that restrictions in current spending did not play a role in the process of fiscal consolidation? The answer should obviously be no. In the case of Italy, in particular, the dramatic fall in pension wealth attendant on the 1993 reform was instrumental in prompting an unprecedented decline in consumers spending. Interestingly enough, the next consolidation episode four years later in 1997 had a significantly more muted effect on household behaviour, presumably because it was interpreted as signalling the end of increasing fiscal austerity once Italy had joined the European monetary union. To conclude, it cannot be overlooked that in the absence of the two pension reforms in 1992 and in 1997, pension spending would be substantially higher today, by more than 5 percentage points of GDP.

To sum up, it is difficult to accept the view that Italy's fiscal consolidation during the Nineties was achieved by a combination of rising taxes and falling interest payments, with primary spending contributing modestly to fiscal adjustment. This view neglects the fact that substantive measures were designed to curb an otherwise explosive path of public spending. While such measures do not show up in a standard before-after comparison they did however have a profound impact on the economy and should be included in any reliable measures of the fiscal effort.

## 3. The tools of stabilization policy

The Lindh and Ohlsson paper focuses on the key question of how the framework for fiscal policy should be adapted following the participation into a currency union. The paper covers a lot of ground. In trying to be selective, two questions spring to mind. First, is it true that a strengthening of fiscal stabilizers is called for after a country has lost its ability to run an independent monetary policy? At first blush, the answer may seem yes, until however we recall that such a strengthening of fiscal stabilizers would require an increase in the progressivity of the tax system and an expansion in the generosity of unemployment benefits. It is doubtful whether there is much appetite in Sweden and elsewhere for such kind of reforms, despite their well intentioned objective of enhancing the counter cyclical role of fiscal policy. Second, should the role of discretionary fiscal policy be strengthened? Again, there are many reasons for scepticism. First, payroll and income taxes are not particularly effective as an anti-cyclical tool. Second, while temporary changes in consumption and/or corporate taxes are potentially more effective, they face a number of severe hurdles, namely the need to predict with sufficient accuracy the turning points of the cycle. Mistakes here can be very costly as highlighted by the premature withdrawal of the fiscal stimulus in Japan in 1997.

## REFERENCES

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