COMMENTS ON SESSION 4: THE ROLE OF INDICATORS IN FISCAL POLICY

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When I saw the agenda, I initially felt slightly uncomfortable to be the final contributor to the workshop. But then, of course, I realised that Daniele had made the perfect choice. Germany, with Michael Schumacher, might seem to be a natural candidate for pole position, but in a conference on economic and fiscal issues – at least given our recent performance – we could well deserve to start last on the grid.

Moreover, I am more than recompensed for any inconvenience by the two very interesting papers I have to comment on. In order to keep you awake at this point of the workshop, I shall try to be as unfair and nasty as possible.

Comments on "From Deficits to Debt and Back: Political Incentives under Numerical Fiscal Rules" by Marco Buti, João Nogueira Martins and Alessandro Turrini

First, I shall discuss the paper by Marco Buti, Joao Nogueira Martins and Alessandro Turrini, which tackles the issue of European fiscal rules and creative accounting from a monitoring and (as commissioner Almunia stated) "police" perspective. Second, I shall focus on the paper by Robert Woods on fiscal rules/fiscal indicators in a national context, namely the UK. This approaches the subject from the policymaker or (as commissioner Almunia may have thought) "criminal" perspective.

"Creative accounting" has played a prominent role in the discussion on fiscal surveillance in Europe in the past few years. However, it is very difficult to analyse these measures systematically. Buti *et al.* make an important contribution to this issue and, therefore, also to this workshop on fiscal indicators. I shall begin with a brief discussion of stock flow adjustment (SFA), followed by the model and, finally, the results.

As suggested by von Hagen and Wolff, the authors take s*tock flow adjustments* as a measure of creative accounting. However, in my view, the disaggregated treatment of stock flow adjustments represents a significant improvement on von Hagen/Wolff. The disaggregated approach is very productive given the very different economic nature of these measures. It is particularly important to separate privatisation receipts and portfolio investments from other stock flows. The following extensions of the analysis may be worth considering:

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- "Reclassifications" may be included in the measure of "hidden deficits" because they are natural candidates for creative accounting (for example, in the case of debt assumptions from public corporations).
- It would be very interesting to show a table with the results for the "extended definition" of hidden deficits by country and year. However, the reason why the authors are not very explicit may be that some of the data used are confidential.
- Taking real-time data from spring 2005 appears somewhat arbitrary. It would be interesting to see real-real time data for all years (probably not available) and the result of the analysis with current data.

The *model* which is presented in the paper is, in my view, quite intuitive. One important political recommendation which is derived from the model is that one should try to reduce the incentive for creative accounting. There may be two ways of doing this:

- The right way would be to reduce the incentive by raising the costs – the political costs – of window dressing. In this context, transparency, auditing by Eurostat, and also papers focusing on creative accounting are important. However, Buti *et al.* seem to be very cautious about increasing such costs. In footnote 7, they state very prudently that "We are not necessarily suggesting that any country reported wrong or inconsistent data on purpose. However, governments may have an interest in keeping low quality statistical systems if this results in a minimisation of their deficits."
- By contrast, the wrong way to reduce the incentive for creative accounting is, of course, to weaken the rules: Weakening the rules reduces the incentive to manipulate the data. Unlike the authors, I think that we have gone some way down that road in Europe.

The *econometric results* are, in my view, not ultimately convincing and only partly prove the authors' conclusions.

While, in the model, an increase of the true deficit is expected to lead to an increase in the SFA, the problem in the econometric analysis is that the Maastricht deficit is reduced by significant SFA in order to fall below 3 per cent and is, therefore, affected by the SFA (simultaneity problem). It would be conceivable to use the Maastricht deficit plus the "hidden deficit" to obtain the "true deficit". This would seem to be particularly appropriate, because Buti *et al.* could overcome the von Hagen/Wolff problem of not being in a position to separate privatisations and hidden deficits.

Looking at the data intuitively, I would not focus on EU 25.

- First, I would expect huge statistical problems, at least in the new member states in the early years.
- Second, I would not expect a major creative accounting incentive for the non-euro-area countries with respect to the European rules – at least in the early years. Therefore, for the deficit, I would concentrate on the euro zone and on countries with true deficits above 3 per cent (Germany, France, Italy, Portugal,

Greece, the Netherlands, and additionally – known as a "specialist" in creative accounting – Austria). The results shown in Table 1 seem to confirm that these are the candidates for creative accounting.

The econometric results seem to conflict with the authors' conclusions in some cases.

- The results for the SGP framework (which, in my view, is the most relevant case) indicate that deficits have a mostly negative impact on SFA. This means that the positive effect, which the authors claim, comes from countries outside the euro area.
- The dummy "overshooting the 3 per cent" has an important and significant negative impact on the hidden deficit in euro-area countries. This contradicts the authors' conclusions, but is probably a result of the fact that countries which are characterised by large hidden deficits are precisely those countries which respected the 3 per cent limit.

Overall, the paper by Buti *et al.* is a major contribution to the discussion on fiscal indicators. It explains creative accounting from the spring 2005 perspective for the period 1995 to 2004. However, this specific approach focusing on stock flow adjustments may no longer be appropriate to tackling the issue of creative accounting in the future because the "virus" will have mutated: stock flow adjustments may disappear, but substituted by even more dangerous mutations. I would expect measures which reduce debt and deficit simultaneously (outside government transactions, securitisations, assumptions of pension liabilities). Moreover, temporary measures may be used to shape the deficits over time, thereby circumventing the rules.

An important conclusion of the paper is that, in the end, every rule is expected to be circumvented. Therefore, transparency has to be improved, and institutions must be in place to defend the rules, to control for creative actions, and to increase the costs of window dressing. However, making the rules more complicated and complex, introducing more room for discretionary decisions, interpretation and more country-specific analysis may also lower the incentive for creative accounting, but it does not foster fiscal sustainability.

Comments on "The Role of Fiscal Indicators in Setting Fiscal Policy in the UK" by Robert Woods

In his very interesting and impressive paper, Robert Woods discusses the fiscal indicators used by the UK treasury. He explains in detail the sophisticated and elaborate fiscal framework, which seems to match the cited criteria for appropriate fiscal rules:

- Transparency, openness, accountability for external scrutiny of fiscal policy is one of the key messages.
- Nine key indicators address short-term, medium-term and longer-term aspects (although showing the Maastricht criteria is probably no more than an example

of British humour, because the criteria do not really seem to be at the core of fiscal policy targets in the UK).

- Forecast evaluation is done and careful assumptions should underlie fiscal planning.
- Compliance with the rules is explicitly checked and communicated.
- The focus is on aggregated figures rather than on the details in order to convey the most relevant aspects to the general public.

The framework presented in the paper contrasts markedly with what we find in Germany, where transparency, in my view, can significantly improve and where the – much weaker – national fiscal golden rule is widely circumvented. But the situation may be always more complicated if you have a strongly decentralised federal system.

All in all, it seems to me that the UK is a fiscal policy framework paradise. However, after having read the Buti *et al.* paper, I am, of course, very suspicious and I wonder: What is wrong with the British? Why they are less susceptible to cheating with fiscal rules?

My first guess was that they respect the rules because of their tradition of "fair play". (In Britain, people queue up at the bus stop but British teams do not usually win the World Cup.) My second guess was that maybe fiscal policy window dressing is a specific feature of EMU members and affects countries which do not want to introduce the euro to a lesser extent.

But then I read a Times article from 31 December 2005:

"Mr Brown gained credibility, beyond actual performance by adopting his "golden rule" on current state spending. That credit melted away as the golden rule was reduced to a comedy club joke. In future the eyes of those who finance higher-than-forecast deficits will focus on the bare numbers".

Or, to put it more politely, like the IMF:

"However, the current form of the golden rule requires a precise dating of the cycle. Not only is this difficult, but the adjustments in the definition of the cycle have proved an unhelpful distraction from the more important considerations of what a sustainable fiscal policy is and how it should be achieved".

Having read this, I gained the vague impression that, in the fiscal framework paradise of the UK, someone may have found the apple.

At present, the relatively new comprehensive fiscal framework in the UK seems to be undergoing a stress test.

- These quotations suggest that some window dressing operations may have taken place with respect to the assessment of the cycle in order to just meet the rule of balancing the primary budget over the cycle.
- The current forecast is judged in the press to be quite optimistic.

- The debt ratio is expected to be not far away from the upper bound of 40 per cent.
- Fiscal policy has been significantly relaxed during the past four years (unlike monetary policy, which has been tightened overall).
- One can probably detect a certain expansionary pre-election effect before last year's parliamentary elections.

Hence, the strength of the fiscal rules in the UK will be put to the test in the next few years. It will be very interesting to see whether the UK government – unlike in earlier years – will implement a fiscal policy in the medium term that will significantly improve the cyclically adjusted primary balance in order to comply with the current fiscal framework. Therefore, I am looking forward to reading Robert's paper on the UK's experience of fiscal rules in the future.