COMMENTS ON SESSION 3
FISCAL POLICY AND BUDGETARY INSTITUTIONS

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Fiscal rules and budgetary institutions have been the subject of keen political interest in Europe and elsewhere and given rise in the past several years to a growing economic literature. The papers I comment on ask three fundamental questions:

1) Do fiscal rules really help to enhance budgetary discipline? (paper by Xavier Debrun and Manmohan S. Kumar);
2) What triggers the introduction of a fiscal rule? (paper by Stefania Fabrizio and Ashoka Mody);
3) How to design a robust fiscal rule? (paper by Barry Anderson and Joseph J. Minarik).

I will comment on the three papers in turn.

1 "Fiscal Rules, Fiscal Councils and All That: Commitment Devices, Signaling Tools or Smokescreens?" by Xavier Debrun and Manmohan S. Kumar

The paper shows by means of a simple theoretical model that in a context of asymmetric information between policy makers and voters, electoral uncertainty is a key source of deficit bias. Specifically, voters are assumed to be rational and only re-elect the incumbent government under certain conditions: namely, re-elections depends on the ability of the current administration to deliver a quantity of public goods that is deemed "fair" by voters in terms of taxes paid. However, policy makers themselves face uncertainty as to whether their actions will be successful in delivering enough public goods, which in turn leads to a deficit bias in the conduct of fiscal policy.

According to the model, a balanced budget rule with strong enforcement mechanisms could discourage policymakers to run deficits. In the model, this is possible because rational voters are assumed to hold policymakers accountable for sticking to the rule since this rule is expected to deliver an optimal policy: an appropriate balance between public goods (expenditure) and taxes to finance them (revenues). Thus, if voters can perfectly observe budgetary outcomes – which means that there is perfect transparency – compliance with the budgetary rule is rewarded by a re-election, which in turn eliminates electoral uncertainty and any incentive to deviate from the rule. In this context, the credibility of the rule stems from the existence of high political costs in case of non-respect, which are possible due to the

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existence of transparency and accountability in the budgetary and political process. These two elements allow rational voters to "punish" incompetent governments.

However, voters' rationality can be blurred by fiscal opacity related to budgetary developments. The paper emphasises that the lack of budgetary transparency is an obvious obstacle for the final effectiveness of fiscal rules and institutions. In this case, the paper argues that under incomplete budgetary transparency, accountable governments may also use institutions as a signal of competence to increase their re-elections chances, which in turn helps limit the deficit bias. Governments acting in this way will be those more pre-committed with fiscal stability.

The main conclusions and policy implications stemming from the development of this model may be summarised as follows:

1) The model shows how electoral uncertainty may be a key source of deficit bias due to the perceived risk by policy makers of not being re-elected.
2) According to the model, a balanced budget rule can suffice to tackle the deficit bias stemming from electoral uncertainty; effective enforcement mechanisms are key for the rule's credibility.
3) Transparency and democratic accountability play an important role in the existence of reputational costs. If transparency and accountability are complemented by fiscal rules reflecting social consensus on what constitutes an optimal fiscal policy, then these rules may be used by voters to assess government's fiscal conduct and to decide whether this government is re-elected or not.
4) The model accounts for the possible existence of reverse causality between fiscal rules and institutions and budgetary outcomes (*i.e.* the causality runs from budgetary developments to fiscal rules rather in the other way round).

The main objective of this empirical research is to assess the reverse causality running from budgetary results to fiscal rules. The reverse causality is tested by applying panel data econometrics and using standard fiscal reaction functions augmented by the fiscal rule indexes of the European Commission's database on budgetary institutions. Some evidence of reverse causality is found on the basis of the Durbin-Hu-Hausman test that indicates that fiscal rules could indeed be endogenous. In the same line, the author finds a significant correlation between the lagged cyclically-adjusted primary balance (CAPB) and the fiscal rules indexes, which is interpreted as evidence of the reverse causality running from fiscal outcomes to stricter fiscal rules. This potential simultaneity bias could weaken significantly the estimated impact of fiscal rules on budgetary outcomes.

The paper tackles the issue of the interplay between fiscal behaviour and political incentives in an innovative and insightful way. It covers a wide a range of issues. A narrower coverage would have helped the reader to better understand the links between the underlying theoretical model, the empirical findings and the policy conclusions.

The model is based on a number of assumptions that narrow its empirical and policy relevance. First, voters are rational and punish those governments that do not respect fiscal rules. Policy experiences suggest that voters may suffer very often from fiscal illusion (or what George Kopits called "fiscal alcoholism"). Second, the only source of the deficit bias is electoral uncertainty, and therefore, other usual sources of deficit bias (e.g. the common pool problem) are not considered in the model, which obviously restricts the validity of some of the conclusions to a particular case. Finally, the assumption that voters perfectly observe budgetary outcomes and have full ownership of the rule in force (since it incorporates the optimal fiscal policy) appears particularly restrictive.

The empirical analysis aims at checking whether political instability is associated to higher deficits. Whilst the results are intuitively appealing, they provide only limited and weak evidence of reverse causality between fiscal outcomes and fiscal rules. First, the descriptive analysis based on the median values of primary balances and debt ratios showing that these variables had already improved before the implementation of fiscal rules is far from being robust. For instance, if instead of the median and the primary balance, one uses the average and the cyclically-adjusted primary balance, the conclusion obtained is the opposite: in the period preceding the setting up of fiscal rules the CAPB barely changes, while after the implementation of rules it increases. Second, the econometric evidence supporting the possible existence of reverse causality is limited and far from being conclusive. While reverse causality cannot be excluded, it is clear that further econometric research is needed to reach more robust conclusions.

2 "The Value and Reform of Budget Institutions" by Stefania Fabrizio and Ashoka Mody

This very interesting paper examines the conditions under which fiscal rules are introduced or budget institutions are improved. The analysis is based on empirical analysis looking at the determinants of an index measuring the quality of national budget institutions. The construction of the index is well explained in a previous paper by the same authors: "Can Budget Institutions Counteract Political Indiscipline?" (*Economic Policy*, 2006). In fact what is meant by "budgetary institutions" is mainly the budgetary process. The three main steps of budgeting are taken into account in the index: (i) the preparation stage; (ii) the authorization stage; (iii) the implementation phase. The methodology used in constructing the index is close to the initial studies by von Hagen (1992) which had considered the stages of: (i) budget formulation (restrictions on the budget and the relative position of the Minister of Finance *vis-à-vis* the spending ministers) (ii) budget approval (degree to which amendments in Parliament may increase the size of the budget) and (iii) budget implementation. The construction of the index on the quality of the budgetary process takes into account a large number of variables. A total of 15 sub-dimensions are considered, which is more than in most other studies of the same type. The time-varying feature of the index allows putting in relation fiscal and

economic variables with developments in the features of the budgetary process in a meaningful way.

Much in line with the findings of reverse causality of the Debrun-Kumar paper, the main conclusion of the paper is that fiscal deficits are not conducive to institutional reforms. To the contrary, the larger the deficit, the lower is the likelihood of reforms. It is as if large deficits imply strong claims on the budget and hence create unwillingness to compromise. A consequence of this result is that countries seem to tend to move to two outcomes: low fiscal deficits and good institutions or high deficits and weak institutions. Economic shocks (higher unemployment rates and inflation, larger current account deficits) can help build a constituency for improving budget institutions. However, there is considerable inertia in institutions. Therefore strong political leadership is necessary to impose reforms and enter a virtuous cycle.

The paper carries out a sound econometric analysis. The authors control for a large number of variables (not only economic but also political) and conclusions appear robust. A number of improvements could nevertheless be considered. First, the standard EU dummies (Maastricht and the Stability and Growth Pact, SGP) are absent from the analysis. This could be an important missing variable. Analysis on numerical fiscal rules carried out by the European Commission (see the *Public Finance Report*, 2006) find that the EU and SGP seem to have acted as a catalyst for the introduction of numerical fiscal rules at national level. It would be interesting to see if these variables have the same influence on budget institutions (procedures). Second, the study looks at the influence of the quality of the budgetary process (*central government*) on developments in *general government* finances. Arrangements and rules in force in local governments or social security sectors (most of the time not covered – or less directly covered – by the budgetary process) are not taken into account in the analysis. This limitation also applies to most of von Hagen's school papers. This could be solved easily in adding dummies capturing the existence of fiscal constraints applying to lower levels of governments. Third, in the analysis, the deficit bias implicitly only stems from the common pool problem. Time inconsistency is not mentioned as a cause for the deficit bias. It would be interesting to add variables capturing time-inconsistency effects in the relations (e.g. elections dummies). This would also allow answering the question: do reforms of fiscal institutions come after/before elections? Finally, in the construction of the indexes, only legal constraints on deficits or government borrowing are taken into account. In practice, there are many other soft constraints (internal pacts, contracts, coalition agreements, etc.) that can also be considered "institutions" and that may have an impact on the conduct of fiscal policy. Taking into account these elements would however mean considerable further work.

3 "Design Choices for Fiscal Policy Rules" by Barry Anderson and Joseph J. Minarik

The *leitmotiv* of the paper is that expenditure rules are good while deficit rules are bad. Deficit rules that set a maximum limit on the deficit might encourage countries to run the largest deficits permitted; spending rules on the contrary provide firm guidance to policy makers whether the economy and the budget are strong or weak. With respect to stabilisation, deficit-based rules provide no incentive for counter-cyclical policy in strong economies, and can limit even the operation of automatic stabilisers in the budget in weak economies; in contrast, spending rules allow stabilisers to work fully. While expenditure rules are easier to monitor, non-compliance with a deficit rule, including either a reference deficit limit or required progress toward close-to-balance can be hidden behind optimistic economic assumptions or unlikely plans for future spending and revenue discipline. Spending rules make the availability of resources more predictable for pubic managers, notably with respect to annually appropriated funding for those core functions of government. Finally, funding for public investment can be protected under a spending rule whilst tends to be the first victim in case of adjustment under a deficit rule.

In general the paper would gain from taking a more balanced approach. This is not to deny that expenditure rules are very useful in several circumstances. Actually, the paper ignores (or is very short on) two additional advantages of expenditure rules: (i) they ensure a high degree of accountability of fiscal authorities, as expenditure is the part of government finances that is the most under the control of the government; (ii) they can be instrumental in limiting the size of the government and improving the composition and efficiency of government expenditure.

The paper argues that expenditure rules should be implemented at EU level, possibly substituting the current EU fiscal rules. While agreeing that expenditure rules can contribute to sound fiscal policies, there are good arguments to consider that such rules should not substitute current EU rules based on debt and deficits.

First, the use of expenditure rules in a multinational context can be problematic. *De facto*, introducing spending limits in all EU countries would carry the risk to impose homogeneous (or quasi-homogeneous) social preferences to all EU countries. As reflected in the large differences and fluctuations of the expenditure-to-GDP ratio among Member States, EU countries have different and time-varying preferences as regards the role and the appropriate size of the government. Second, implementing expenditure rules at EU level could be inconsistent with the principle of subsidiarity between EU institutions and Member States (*i.e.* level and composition of public expenditure are issues of national responsibility). Finally, in the euro area, there is a need for a fiscal policy framework that ensures that excessive budget deficits are avoided over the medium term and that national fiscal policies are effectively coordinated. The problem with expenditure norms is that they do not refer to the fiscal variable which can entail

negative externalities across countries and between fiscal and monetary policies. While a rising deficit or debt level in one country can create area-wide problems, a rising expenditure level as such does not have "first order" negative repercussions on other countries or on the common monetary policy, if it is matched by a corresponding increase in taxes.

The paper expresses a number of criticisms concerning the SGP and its implementation. It argues that deficit rules like those of the SGP do not provide sufficient guidance to Member States which are respecting the deficit reference value of 3 per cent of GDP. The paper also maintains that deficit rules hamper the stabilisation function of fiscal policy and that, in good times, they encourage a softening of fiscal policy.

The authors' assessment of the past performance under the SGP is very negative. It is true that the SGP was not successful in preventing the occurrence of excessive deficits in several EU countries. However, budgetary developments in the recent economic downturn compare favourably to the large and persistent deficits observed in similar episodes of low growth in the 1980s and the 1990s.

The paper argues that the SGP does not provide sufficient guidance/provisions for countries below 3 per cent of GDP. This may have been the case for the SGP "Mark I", but the 2005 reform introduced very clear provisions for Member States which have not yet reached their MTO. Member States of the euro area or participating to ERM-II not yet at MTO have to pursue an annual improvement in their cyclically-adjusted balance, net of one-off and temporary measures by at least 0.5 per cent of GDP as a benchmark. In addition, they committed to make additional efforts in good times. The fact that a number of countries introduced rules pre-defining the allocation of extra-revenues/tax windfalls, is a potentially important development triggered by a deficit rule such as the SGP.

The paper argues that the SGP rules hamper the stabilisation function of fiscal policy. This may be the case in a transition phase, but respect of the medium-term objectives by the Member States is consistent with a high cyclical smoothing while safeguarding the 3 per cent deficit ceiling. Moreover, at the time of the SGP reform governments committed to pursue active consolidation of the budget when the economic conditions are favourable, *i.e.* in "good times", and to use windfall revenues for the reduction of government deficit and debt.