COMMENTS ON SESSION 2
FISCAL CONSOLIDATION

WHAT IS NEEDED, WHAT IS (SOMEWHAT) USEFUL AND WHAT IS NOT NEEDED: LESSONS FROM THREE NON-OCDE COUNTRIES

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I am very grateful to the Banca d'Italia and Daniele Franco for giving me the opportunity to discuss the three papers devoted to cases of fiscal consolidation, which took place in Israel, Brazil and Uruguay over the recent decades. I use a loose definition of fiscal consolidation: fiscal consolidation refers here to a medium- to long-term reduction in public deficits and a stabilisation or a reduction in the public debt to GDP ratio. A more precise definition of fiscal consolidation is given by Guichard *et al.* (2007).[1]

I would first like to emphasise the salient features of these three processes.

1. In the case of Israel, the process of fiscal consolidation has been lengthy, unruly and at times ineffective. It started in 1985. The result has been mixed. The effectiveness of a drive toward a reduction in fiscal deficits rests on the capacity of a government to impose current sacrifices. On the contrary, the strategy of constraining future governments and fooling public opinion with promises is ineffective. "Talking" cannot be confounded with "doing".
2. The Brazilian consolidation process may be qualified as irregular and unbalanced. The process started in 1990. It has been pursued until 2006.[2] A relaxing of the fiscal effort happened in the subperiod 1995-99. Most of the adjustment has been made through increased taxes, rather than expenditure cuts. These cuts mainly targeted investment expenditures. Interestingly, this process has encountered a crisis which proved to be the acid test for its viability. In 2002, year of a presidential election, a typical "confidence" crisis occurred, with runs

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[1] Guichard *et al.* (2007) define a fiscal consolidation episode as follows. A fiscal consolidation episode:
- *starts* if the cyclically adjusted primary balance (CAPB) improves by at least one percentage point of potential GDP in one year or in two consecutive years with at least ½ percentage point improvement occurring in the first of the two years;
- *continues* as long as the CAPB improves. An interruption is allowed without terminating the episode as long at the deterioration of the CAPB does not exceed 0.3 per cent of GDP and is more than offset in the following year (by an improvement of at least 0.5 per cent of GDP);
- *terminates* if the CAPB stops increasing or if the CAPB improves by less than 0.2 per cent of GDP in one year and then deteriorates.

As the methodologies followed in the three papers are quite different, it appears suitable to use a more vague definition.

[2] History will tell us whether the Brazilian fiscal policies are firmly grounded on sound principles.

on mutual funds, increasing spreads and depreciation of the currency. It has been stopped when all candidates including the newly elected president endorsed the principles of sound fiscal policies.

3. Finally, the Uruguayan process has proved to be original in the following sense. Given the fiscal profligacies of the seventies and eighties, the Uruguayan authorities were gradually unable to use the inflation tax as an adjusting tool for deficit, as more and more agents reduced their exposure to the national currency. A fiscal consolidation was de facto taking place through the dollarization of the economy. It implied the disappearance of the basis for the inflation tax. Now through effective fiscal consolidation, a reconstruction process of peso-isation is under way. It may prove fragile.

Which lessons can we draw from these three fiscal consolidation experiences?

The received view on fiscal consolidation in developed economies, as recently expressed by OECD's experts (see *OECD Economic Outlook 2007*, and Guichard *et al.*, 2007) can be summarized as follows:

1. bad circumstances (high or increasing deficits, high interest rates) tend to trigger episodes of fiscal consolidation;
2. episodes of fiscal consolidation tend to be brief and of limited success;
3. successful episodes tend to rely more on cuts in expenditures and in particular, expenditures on social transfers and programmes;
4. fiscal rules tend to be correlated with successful fiscal consolidation. However the causal link is disputable. In addition their capacity to accommodate cyclical evolutions has to be high.

Actually, our three cases partly concur with this view, but also differ quite markedly from it in some important aspects. This is likely to be due to the fact that these countries do not belong to the set of advanced countries represented by OECD, either because they are too poor, or their situation is peculiar (e.g., Israel facing difficult times due to the Middle-East crisis). According to me, there are four features which are common to the three cases.

1. In the three countries, fiscal consolidation has been linked with institutional reforms, although they took place at different stages of the process. Structural changes in the spending and taxing process have taken place. The process in Brazil has been a bit chaotic since the end of the military regime created huge expectations about social programmes. In 1999, a "Fiscal Responsibility Law" was adopted and the Central Bank was able to adopt an inflation-targeting framework. Israel adopted a ban on government borrowing from the central bank in 1985. Finally, Uruguay adopted in 1995 a law drastically reducing the capacity of the Central Bank to finance public deficit. This confirms the need to adapt the institutional/legal frame to a policy of sound public finance. However a unique list of requested items for fiscal soundness does not exist. As the authors of the OECD's Economic Outlook study justly remark, the legal environment must be

adapted to the institutions and the political systems in place in each country.[3] This feature is congruent to the OECD countries.

2. The end of fiscal dominance appears a key element for fiscal consolidation. In the three countries, in the past, fiscal authorities could rely on the central bank's help to finance their deficits: the central bank was pressured by the Treasury.[4] This facility has been curtailed in the three countries, as we have just seen. The case of Brazil is not so clear-cut as the Central Bank does not possess a high degree of independence,[5] and may still be obliged to lend to the Brazilian Treasury, but the actual monetary financing of public debt steadily decreases, and the switch to inflation targeting is a sign that the facilities of the inflation tax are largely (but maybe temporarily) reduced.
3. Any progress toward fiscal consolidation is temporary and can easily be derailed. In the three countries under study, the succession of governments has led to reversals in fiscal policies and sudden increases in public deficits. Moreover, in their paper Licandro Ferrando and Vicente express the fear that the rebirth of a national currency effectively used in Uruguay could tempt Uruguayan governments to use again the inflation tax as a way to balance public budgets: in this country the end of fiscal dominance cannot yet be taken for granted. However the fragility of a process of fiscal consolidation is also common to any OECD country, as the cases of Germany and the US in the first years of the 21st century make clear. Vigilance can never be eased or weakened.
4. This explains why a successful process has to be backed by political consensus so as to survive the succession of governments. This feature is particularly evident in the case of Brazil and the episode of 2002: the pledge by the newly elected president to support fiscal consolidation has been critical in its continuation and eventual success. A fiscal consolidation programme proves credible and thus can (more easily) be enforced when a broad consensus covering a large part of the political spectrum supports it. It was the case in Israel in 1985 and also in 2003 when the Sharon government faced a weakened and not too restive opposition. Finally the decrease in seignorage income in Uruguay has been steady, and endorsed by the various governments, including in the last period. It is important thus that a consensus be built to rule out "manifest errors" in fiscal policy.

What then do these experiences tell us about the conduct of fiscal policy? I would like to comment on two items currently hotly debated, fiscal rules and fiscal stabilization councils.

First, do we need fiscal rules? Probably yes, but we should discriminate between them as their efficiencies markedly differ. The effectiveness of a fiscal rule depends:

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3 See OECD (2007), p. 242.

4 How past is the past depends on each country, of course.

5 See Jacome (2001).

a) negatively on the ability of policymakers and taxpayers to circumvent it,

b) positively on its ability to adjust to cyclical evolutions. A fiscal rule, constraining the ability to spend or tax by a government can be overcome by various means: through tax evasion, factor mobility, creative accounting, or last but not least, absence of commitment. The case of Israel is quite telling: just the wording of a fiscal rule is not enough. The revision of the Stability and Growth Pact in Europe is also an example of the difficulty to tailor an adequate fiscal rule.

From the evidence drawn from our three countries, but also from many other cases, the most useful fiscal rule is a no seignorage rule. Balanced budget rules are less convincing. Altogether, continuous political will matters, more than rules.

Second, do we need fiscal stabilization councils? Fiscal stabilization councils are advocated by some economists as a way to stop public deficits. Their utility depends on three things. First, the existence of deficits is due to the presence of a deficit bias, that is on a time-inconsistency problem; second, the members of a fiscal stabilization council should be so wise and clever as never to make any error in the diagnosis on the current macroeconomic situation, so that their own credibility as policymakers is not ruined; third, the politicians in charge of the government do not have their own agenda, and find no way nor any desire to circumvent more or less openly the programme defined by the fiscal council. Needless to say, by no means these assumptions can be taken as certified facts. It can even be feared that fiscal stabilization councils could be used to obscure the unwillingness of a government to serious tackle a strongly degraded fiscal situation and make more complex and cumbersome the highly political process of fiscal adjustments. In our three cases, no such fiscal stabilization council was created.

In brief, we can draw some lessons from these three stories about fiscal events in three non-OECD countries:[6]

1. What is needed for a successful fiscal consolidation: first, a broad political consensus; second, the elimination of fiscal dominance. We have seen that both features have been critical in our three countries.
2. What is useful: some fiscal rules, adapted to local circumstances and institutional framework. A sensible consolidation programme should predominantly target the expenditure side, and rather consumption expenditures rather than investment ones. Fiscal rules may be helpful, but probably more as a signal of the will to redress public accounts, than as a proper straightjacket constraining governments.
3. What are not needed: discourses about future efforts when they are not linked to immediate curtailments in public deficits and expenditures. From this perspective, fiscal stabilization councils are likely to be just another variety of smokescreen device.

6 Admittedly, this generalization has no econometric-like value: the evidence is a bit insufficient to properly draw clear-cut “lessons”, with a high degree of generality. I use the word in a thought-provoking turn of mind.

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