



INSTITUT UNIVERSITAIRE DE HAUTES ETUDES INTERNATIONALES
THE GRADUATE INSTITUTE OF INTERNATIONAL STUDIES, GENEVA

HEI Working Paper No: 03/2002

Fiscal Policy: Institutions vs. Rules

Charles Wyplosz

Graduate Institute of International Studies

© The Author.

All rights reserved. No part of this
paper may be reproduced without
the permission of the authors.

Fiscal Policy: Institutions vs. Rules

Charles Wyplosz

Graduate Institute for International Studies, Geneva and CEPR

December 2001

Report prepared for the Swedish Government's Committee on Stabilization Policy in the EMU. Without implicating them, I acknowledge with thanks the useful comments received from Marco Buti, Hans Genberg, Francesco Giavazzi, Jacques Melitz and Jürgen von Hagen.

1. Introduction

Faith in the ability of macroeconomic policies to effectively erase business cycles and foster growth has long been oscillating, and it is now at a low point. During the last decade policy activism has been rejected, increasingly replaced by rules of various kinds.¹ Most central banks now only accept responsibility for price stability and most governments put budget balance at the forefront of their concerns.

This impressive change from the trigger-happy 1970s can be traced back to both facts and academic research. Double-digit inflation and record levels of public debts in peace time have exposed the excesses of unconstrained policy-making. Academic research has analyzed the limits of discretion and, in the field of fiscal policy, given respectability to the principle of Ricardian equivalence which denies any stabilizing role to discretionary actions. Work on the political economy has shaken the view, already challenged long ago by Buchanan and Tullock (1962), that government is good as long as it is subject to democratic control (Drazen, 2000; Persson and Tabellini, 2000). In the presence of government failures, policies justified by the existence of market failures may do more harm than good. The not-so-new conventional wisdom seems to be that governments can help, a little, and if properly constrained.

Nowhere is this wisdom seen more at work than in the world of central banking. Central banks have been made independent and given a very precise mandate, price stability. The result has been a much reduced ability to make wide-ranging policy choices. Now central bank are increasingly required to be transparent and accountable.² Views on fiscal policy are following similar lines, with a lag. The active counter-cyclical use of fiscal policy, ‘fine tuning’ as it is often referred to, is almost universally frowned upon for being at worst inefficient and quite possibly misguided. Big government is generally seen as bad, largely driven by political interest aiming at chosen segments of the electorate.

¹ See the Symposium on Keynesian Economics Today in the Winter 1993 issue of the *Journal of Economic Perspectives*.

² For a survey of the changing world of central banking, see Blinder et al. (2001).

Formal changes, so far, have been less dramatic in the area of fiscal policy than in the area of monetary policy, but the tendency is clear. Rules have been adopted in several countries. In the OECD area, multiannual limits on spending have been introduced in the Netherlands, New Zealand, Sweden, the UK and the US. Debt rules have been introduced in New Zealand and Poland. Perhaps the most daring innovation has been the adoption by EMU member countries of the Growth and Stability Pact. The Pact, which formalizes the excessive deficit procedure specified in the Maastricht Treaty, aims at a balanced budget and relies on a combination of gentle peer pressure and aggressive fines. How effective it will be, and how judicious it is, remains to be seen and is discussed below.

The paper looks only at the OECD countries, with Europe closely in mind. The evolution in macroeconomic policies is reviewed in the next section. Section 3 analyses the particular difficulties faced when trying to reform fiscal policy-making. Section 4 develops a number of principles to be considered for any wide-ranging reform. Four arrangements are developed in Section 5, and the conclusions are presented in Section 6.

2. The Broad Facts: Fiscal Policies Then and Now

Since the early to mid 1980s, most OECD countries have reduced their deficits and many have started to cut down the size of government. At the same time, the counter-cyclical use of both fiscal and monetary policies is said to have declined. This section checks and documents these trends.

2.1. Rising and Receding Public Debts

Starting in the late 1970s in Europe, and the early 1980s in the US, debt levels have started to rise quickly. Figure 1, which presents gross debt-to-GDP ratios, documents this pattern. The Swedish debt follows a trend similar to that of the rest of Europe, but with a marked decline halfway in the 1980s, sharply reversed in the wake of the economic and banking crisis of 1990-1.

The general upward trend of the 1970s and early 1980s was clearly unsustainable, and concern was rising both on financial markets and within the population. Starting in the mid 1980s, most governments have started to shift gears. Bringing public indebtedness to the top of the economic policy agenda has resulted in a sharp trend reversal, less marked in the European Union than in the US.

Figure 1

Why did governments so generally fall in the debt trap in the first place? Figure 2 shows that that, in the US and Europe, spending has risen ahead of revenues. The rectangles identify the periods between the cyclical peaks and troughs. In the US, each cyclical downswing is marked by a sharp increase in spending, which is corrected over the ensuing upswing, until the massive Reagan boost to spending definitely tipped the odds of keeping the debt under control. In Europe, spending and revenue are less affected by the business cycle – with the notable exception of the mid 1970s. Spending is simply increased every year without corresponding adjustment in tax intakes. Most of that increase consisted of hard-to-reverse welfare payments. The Swedish situation resembles that of Europe as far as the continuous rise in spending is concerned, but revenue is actually increased more than sufficiently, except during the two cyclical downturns of the early 1980s and 1990s which open a financing gap.

The correction of the 1990s generally takes the form of severe spending cuts which eventually allow for a more modest reflux of revenues once budget balance is restored and the debt GDP starts declining. It remains to be seen whether the emerging pattern of the early 2000s represents a new era, one where discipline is established but where the will to cut spending is eroded and replaced with a new emphasis on rolling back revenues. This new trend would be one where spending reductions barely follow tax cuts, under the constraint that budgets be kept in balance, just about. This would leave growth as the engine of reductions in debt-to-GDP ratios.

2.2. Countercyclicalities of Fiscal Policies?

The challenge of fiscal policy is to achieve debt sustainability while running counter-cyclical policies. Assuming that fiscal policy is effective – more below – counter-cyclical actions is the reason often advanced to temporarily err away from discipline. Has it been the case, in fact? Do budget deficits systematically rise during periods of slowdown and, if so, are they corrected during the cyclical upswings? And if counter-cyclicalities are achieved, is it through tax or spending adjustments, and does it go beyond the automatic stabilizers?

The European Commission (2001) – see also Buti et al. (1997) – claims that fiscal policies in Europe have been characterized by “pro-cyclical activism”. This conclusion is based on a graphical analysis where the 1990s play an important role. Melitz (2000) finds instead that they are counter-cyclical, but to a much smaller extent than asserted in the previous literature.³ Visual inspection of Figures 1 and 2 offers few clues. This section examines the statistical linkage between fiscal policy and the cycles in four countries: the US, France, Germany and Sweden.

In order to detect whether fiscal policies have systematically been counter-cyclical, three budgetary indicators – public spending, public revenue and the budget balance (revenue less spending) – are regressed against their own lags as well as the output gap (actual less potential GDP as estimated by the OECD).⁴ If fiscal policy is counter-cyclical we expect that, the output gap increases, spending declines when, revenue increases, and therefore the balance increases too. In order to test for the debt-stabilization motive, the lagged debt-to-GDP ratio is also used on the right hand-side. If fiscal policy is systematically adjusted to reduce the public debt when it has risen,

³ A well-known “0.5 rule of thumb”, mostly derived from OECD estimates, asserts that for any 1 percentage point decline in GDP, the deficit increases by 0.5% of GDP (see Eichengreen and Wyplosz, 1993 and the review of the literature in Melitz, 2000). Melitz (2000), in line with Wyplosz (1999), finds instead a coefficient of 0.1-0.2. This may be an effect of the extension of the sample period to include the 1990s, an atypical period of low growth and closing down of the deficit to meet the Maastricht convergence criteria. It may also reflect the combination of the counter-cyclical automatic stabilizers, with an elasticity of 0.5, with discretionary pro-cyclical actions. Causality may be an important issue here as highly autocorrelated restrictive fiscal policies may have led to low growth during the 1990s. Most of the evidence is obtained through panel data estimation.

⁴ To account for lags, and to avoid the endogeneity problem, the lagged output gap could be used. The results thus obtained are not different from those presented here.

we expect to see a negative coefficient in the spending regression, a positive sign in the revenue regression, and a positive sign in the balance regression.

The results shown in Table 1 also test two frequently suggested hypotheses. First, it is asserted that fiscal policy is asymmetric over the cycle, being more relaxed in downswings than it is tightened in upswings. This can be tested by allowing the output gap to enter separately in years when it is declining (the gap is interacted with a dummy variable which takes the value of 1 when the gap declines, 0 when it increases). A stronger counter-cyclical reaction in downswings would correspond to the interacted gap variable appearing with a coefficient of the same sign as the gap itself.

Second, it has been claimed that, over the 1990s, to meet the Maastricht convergence criteria until 1998 and then the Stability Pact requirement, debt stabilization has led to a lesser counter-cyclical use of fiscal policy, possibly even to fiscal policy becoming pro-cyclical. To test for this possibility, the output gap is also interacted with a dummy variable that takes the value 1 over the period 1992-2001, 0 otherwise. Pro-cyclicality would require the corresponding coefficients to be of the opposite signs and larger than those for the output gap alone. If the coefficients are smaller but of the same sign, we would conclude that fiscal policy remains counter-cyclical, but weaker. It could also be expected that during 1999-2001 fiscal policy has been less smooth. This is tested by checking whether the coefficient of the lagged dependent variable is negative when interacted with the same dummy.⁵

Finally, at the purely technical level, it can be objected that the variables used are not statistically stationary. In order to meet this objection, for each of the three policy indicators, Table 1 displays two regressions: in the first one all variables are used in level, in the second one they are all – including the gap – first-differenced. The results provide for a varied set of conclusions.

⁵ Following the political economic literature, e.g. Alesina and Perotti (1997), it would be desirable to add a number of political variables. The existing database, however, ends in 1995, which would preclude a meaningful study of the 1990s.

First, the evidence that the budget balance systematically moves counter-cyclically is weak, except for the US where a 1 percentage point decrease in GDP is met in the short run with a decline in the deficit of 0.4% of GDP. The effect is weaker (about 0.2) and very imprecisely estimated for France and Sweden. It is negligible for Germany where, however, the response is found to be asymmetric, with a relatively strong counter-cyclical reaction in downswings, but at best a weak correction in upswings.

Second, except for Sweden, spending is counter-cyclical, and revenues are either acyclical (US, Sweden) or pro-cyclical (France, Germany). This may come as surprise, since taxes are thought to be the main channel for the automatic stabilizers. As Melitz (2000) observes, some taxes may indeed be sensitive to cyclical conditions, but when all public revenues are put together, the automatic stabilizers may have been systematically thwarted by discrete policy actions on other taxes. The combination of counter-cyclical spending and pro-cyclical revenues explains why the overall stance of fiscal policy is, at most, weakly counter-cyclical.

Third, in France and Sweden, the public debt exerts a significant disciplinary effect on the size of the deficit. Except for the US (where the evidence is conflicting), spending declines when the debt rises. In Sweden it is taxes that seem to respond most and rise when the debt is high, while they decline in Germany.

Fourth, there is little evidence of an asymmetry over the cycle. For the budget balance indicator, the estimated coefficients of the gap interacted with the downswing dummy suggest more counter-cyclicality during downswings, but they are never statistically significant. The exception is Germany where procyclicality during the downswing cannot be ruled out, and can be traced back to public revenues.

Finally, do we detect a different pattern in the 1990s? In the US, the deficit seems to have become considerably more counter-cyclical, although the evidence is not clear cut. This could be the coincidental result of the two “Clinton miracles”: unusually fast growth and the end of the era of large federal deficits. In France and Sweden, it seems that spending, and the overall budget, have become asymmetric, reacting counter-

cyclically to downswings and pro-cyclically to upswings. There is no clear change in Germany.⁶

Table 1

2.3. Policy Effectiveness and the Ricardian Equivalence

An important contribution to current thinking about fiscal policy is the increasingly popular view that it has not delivered on its promises, that its effects are small, slow and irregular or even that it fails to affect the macroeconomy. The background for much this change of heart is the growing realization that most macroeconomic economic decisions are intertemporal, i.e. that private decisions – to spend or save, to invest in productive equipment or acquire assets, to work or leave the labor market, etc. – are subject to forward-looking considerations.

The extreme implication of the intertemporal approach is the principle of Ricardian equivalence according to which every euro spent by the government is offset by an equivalent decline in private spending. Whether the extra public spending is financed through higher taxes or through a deficit is irrelevant since today's borrowing represents future taxes. Budget deficits simply don't matter and fiscal policy does not affect aggregate spending.

The verdict on Ricardian equivalence remains largely undecided after a massive research effort spread over more than two decades.⁷ On the theory side, the assumptions required for fiscal policy to be ineffective are too demanding to be met in practice.⁸ Ricardian equivalence fails in the presence of such realistic features as uncertain lifetime, non-altruistic bequest motives, credit rationing, distortionary

⁶ This stands in contrast to the view of the European Commission (Buti, 2001; Buti, Franco and Ongera, 1997) which claims that fiscal policy has turned procyclical in the 1990s and concludes that the Stability and Growth Pact will improve things by making fiscal policy at least neutral and possibly countercyclical when the automatic stabilizers are allowed to operate.

⁷ Surveys can be found in Bernheim (1987), Seater (1993), Becker (1997) and Gruen (1991).

⁸ For evidence that people ignore the size of the public debt, and that the cost of this ignorance is likely to be trivial enough to be near-rational, see Gruen (1991).

taxation. On the other side, the picture that emerges from a host of empirical studies is muddy: Ricardian equivalence is not easily rejected although complete equivalence is rarely found.

Without attempting to directly test the Ricardian equivalence, Blanchard and Perotti (1999) estimate the output effects of fiscal policy in the US. They find that the aggregate effects are qualitatively standard – spending increases and tax cuts raise output – but quantitatively small and with lags that vary quite significantly according to circumstances. In addition, the current account seems to offset a significant part of fiscal policy, suggesting even smaller effects in small open economies.

2.4. Synthesis

The reflux of public deficits and debts observed in the OECD area during the 1990s in both Europe and the US is often interpreted in two ways. According to the first interpretation, fiscal policy has been found to be too weak and unreliable to be of significant use. According to the second one, high debt levels have forced governments to change their behavior and put a premium on debt reduction.

The empirical evidence presented above does not quite back either interpretation. There is little doubt that fiscal policy is less effective than previously thought, yet it is far from powerless. The automatic stabilizers have a role to play, they are an important element of fiscal policy even if they do not require explicit action. Their role has been thwarted in recent years by pro-cyclical discretionary actions that reflected the wish to re-establish budgetary discipline. Counter-cyclical discretionary actions may be helpful too. The existence of lags (in recognition, decision and implementation) argues against frequent manipulation, but it does not apply to the automatic stabilizers, nor does it rule out the usefulness of occasional actions. In fact, if the main problem lies with lags – so that the problem is not the instrument itself by the timing of its use - it ought to be directly confronted, as suggested below.

Two conclusions follow. First, fiscal policy has been muted not because it is useless but because debts had risen too far. Second, discipline finally set in, but too late and,

possibly, too much. A good illustration is the parallel evolution of public debts in fast-growth USA and slow-growth Europe (Figure 1).

The question is whether the new wisdom reflects an optimal combination of long-run discipline and short-run flexibility. The answer is negative. Discipline had been overlooked over the 1960s and 1970s, but it may have been overemphasized over the 1990s. For example, the pro-cyclical pattern observed in Germany did not translate into budgetary discipline.⁹ The challenge is to find a new and better balance.

It is fairly straightforward to see how fiscal policy can be used as a macroeconomic instrument without necessarily bringing about deficits and growing debts: deficits ought to be balanced over the cycle while being as strongly counter-cyclical as needed. The search for a better balance is already under way. Many countries, and the Eurozone, have established rules that precisely aim at a better balance. The problem with rules is that they tend to be rigid and artificial (arbitrary debt or deficit limits, golden rules based on thin air and falsifiable accounts), which makes them ultimately impossible to defend in the face of public opinions. Blaming politicians for transgressing the rules that they previously established is always pleasurable, but it fails to recognize the role of incentives. The appropriate response is to build institutions which create the proper incentives. This is the path that the rest of the paper explores.

3. The Challenges of a New Fiscal Policy

3.1. Short and Long Term Objectives

Budgetary discipline means that the public debt must not be allowed to rise continuously, as was the case during the 1960s and 1970s. For countries still saddled with high debts, discipline additionally means bringing the debt down to more comfortable levels (for which there can be no accurate definition). This is clearly not

⁹ The procyclical pattern of German fiscal policy may be only apparent. Von Hagen et al. (2001) note that the Kohl government has increasingly made use of off-budget items.

an objective to be met in any particular year, but a constraint to be satisfied in the long run. At the same time, in the short run fiscal policy can play a useful output and inflation stabilization role.

The challenge, therefore is to credibly combine long term commitments with short term flexibility. This is not a new challenge, but one that has not often been met in the past. Experience has shown how easily the long term can be overlooked when debt levels are low. Europe in the 1990s has largely overlooked the short term when the convergence program has put debt stabilization at the top of the political agenda.

This challenge is not specific to fiscal policy. Monetary policy faces exactly the same dual concern: it aims at delivering price stability in the long run, but it can help stabilize output in the short run. On the basis of demonstrated relative effectiveness, Taylor (2000) concludes that monetary policy can usually achieve both goals, so that fiscal policy could be left to operate through the automatic stabilizers. This conclusion may be valid for the US – even though the very recent US experience suggests that discretionary fiscal policy¹⁰ may be needed in severe circumstances – but not for Europe for two main reasons. First, the evidence reviewed in the previous section suggests that the stabilizers are not efficient in Europe, in contrast with the US. Second monetary union members have given up national monetary policies, which leaves fiscal policy as the sole national macroeconomic instrument.

In recent years, central banks have found a way of combining their short and long term objectives. Section 4 draws the lessons for fiscal policy-making suggested by the progress achieved with monetary policy, but some important differences between the two instruments are first outlined in the remainder of the present section.

3.2. The Economic Complexity of Fiscal Policy

In comparison with monetary policy, fiscal policy is relatively ineffective. Not only is its impact rather slow and (too) long lasting (Blanchard and Perotti, 2000), it is also

¹⁰ Note, however, that under the Stability and Growth Pact the US would likely not be allowed to claim “special circumstances”, i.e. a drop of GDP of 2%, an illustration of how severe are the constraints imposed by the Pact.

uncertain. The debate on Ricardian equivalence underlines that much depends on how economic agents perceive fiscal policy actions. Temporary tax measures are understood to be largely ineffective, for agents adjust their saving behavior. “Permanent” tax measures are of limited credibility. Spending actions raise the question of how they are to be financed, which may elicit partially offsetting private reactions. In the extreme case where the debt path is seen as unsustainable, restrictive fiscal policies have been observed to exert an expansionary effect if they are seen as stabilizing an otherwise explosive public debt (Giavazzi, Jappelli and Pagano, 2000).

Monetary policy is more efficient primarily because it acts not on quantities (spending, private income) but on an important price, the real interest rate. This crucial difference should not be exaggerated, though. As the Japanese experience suggests, monetary policy may be ineffective when banking sector balance sheets call into doubt its stability. Both monetary and fiscal policies require that some crucial budget constraints be satisfied.

In the case of fiscal policy, the state’s balance sheet must be compatible with its budget constraint but assessing this condition is not easy. Governments are held accountable to deliver both explicit and implicit entitlements such as welfare payments and the retirement of future generations. Faced with an ageing population, many governments have moved to establish funded pension plans which are meant to deal with the future payment of retirement deficits. While this represents a step forward towards making these future payments explicit and funded, it stills leaves open the possibility that the financial performance of the funds will turn out not to provide enough resources for what society will consider a decent retirement income twenty fifty years down the road. In addition, governments often operate with an explicit on-budget side and an implicit off-budget side. This complexity cannot be fully eliminated – nor can banking sector balance sheets be considered as fully transparent – but the effectiveness of fiscal policy can be enhanced by improving the visibility of implicit commitments and by eliminating off-budget items.

3.3. The Political Complexity of Fiscal Policy

Traditionally, fiscal policy is subject to democratic oversight. Every action has to be approved by the parliament. The result is a high degree of politicization which naturally involves differences of opinion but also open the door to lobbying by a myriad of interest groups that care little for the common public good.¹¹ There follows a number of important differences between fiscal and monetary policy.

First, monetary policy actions can be decided virtually instantaneously. Fiscal policy actions, on the other side, must go through a lengthy decision process. Precious time can be lost. In addition, the parliament-sanctioned result may be quite different from the government's initial intentions, possibly with no action at all. Indeed, one of the strongest arguments against the discretionary use of fiscal policy is that it often is implemented too late, thus destabilizing the economy.

Second, policy is conducted in an uncertain world. Economic forecasts are far from precise and largely unreliable when it comes to identifying the all-important turning points which typically trigger the need for a change of course of policy. Not only this requires rapid action when the situation is becoming less cloudy, but it may also result in the need to reverse gear when previous forecasts turn out to be wrong.¹² Central banks are known to be loath to reverse themselves for fear of sending confusing signals – possibly for fear of being seen as confused. Governments simply cannot turn around. At best they can abort an action if it is still under consideration by the parliament.

3.4. Lessons From Monetary Policy

Lesson No.1: less activism

Fiscal policy is a less good instrument than monetary policy. Whenever monetary policy alone can deal with the situation, fiscal policy should remain inactive, relying only on the automatic stabilizers, certainly avoiding to become pro-cyclical.

¹¹ See von Hagen and Harden (1994).

¹² The deterioration of economic conditions during the course of 2001 is a case in point.

Lesson No.2: long term debt sustainability ought to be a binding constraint

Most modern central banks are given a clear, explicit mandate to aim at price stability. The equivalent long-term concern for fiscal policy is debt sustainability, and it ought to be made explicit.

Debt sustainability is an imprecise concept. We do not have acceptable theories of the optimum debt level, nor clear guidelines on how soon should a target debt level be achieved. But the same applies to the concept of price stability. Like central banks with their own long-run objective, the fiscal policy authorities have to struggle to define debt stability. This definition may be time-varying: demographic considerations, major upheavals like political disruptions, natural disasters or wars, may warrant some re-basing. Yet, the very fact that an objective is announced that serves two purposes. First, it anchors expectations and provide a clearly understandable policy goal. Second, the debate on the objective itself forces into the open a concern that already exists but that is left for internal debate within the administration. An open democratic debate will not only responsabilize the political players but also alert the broad public to the need for understanding, and hopefully supporting the ultimate constraint faced by fiscal policy.

Lesson No.3: qualified freedom over the business cycle

Like monetary policy, once its long-term constraint is set and serves as an anchor, fiscal policy can be used as a counter-cyclical tool whenever it can make a contribution to economic (price and output) stability.

The difficulty is that a short-term relaxation can trigger a debt buildup. Debt accumulation is an inherently explosive process, which implies that the antidote must be administered at the same time as the medicine. Ideally this would take the form of a multi-year commitment to expand first and then eliminate the resulting debt increase. Given the uncertainty inherent to policy-making, such a commitment cannot be specified in calendar time. But it can be formulated in terms of the business cycle,

calling for debt reductions during the next upswing if debt has been allowed to rise in a downswing.¹³

Lesson No.4: an ability to respond in real time

Part of the advantage of monetary over fiscal policy is its speed of reaction. Monetary policy can be decided and implemented in a short time. The counter-cyclical use of fiscal policy requires that the automatic stabilizers be powerful enough and, for discretionary actions, that the decision and implementation lags be sharply reduced.

Automatic stabilizers are mostly the by-product of the tax system, with some limited contributions from the expenditure side. One possibility would be reconsider the tax system with an eye to increasing the size of the stabilizers. This is likely to be a daunting undertaking for the tax system is primarily designed to gather resources in the least distortionary way possible and to redistribute income. Both requirements are extraordinarily difficult and politically controversial to put into practice. Adding a third criterion will considerably complicate an already difficult task. For that reason, it is better to accept the stabilizers as they happen to be and focus instead on the essential role of sound discretionary policy.

Current constitutional arrangements typically preclude any fast track possibility of adjusting the budget to cyclical conditions (Germany being a counter-example). In this respect, the contrast between monetary and fiscal policy is striking: monetary policy is subject to *ex post* democratic control while fiscal policy is subject to *ex ante* control. One reason for this asymmetry seems to be that the power of taxing is universally seen as a prerogative of the sovereign, hence the need for democratic control. Yet, monetary policy also involves the inflation tax. Another reason is that the allocation of public spending is a deeply political act, but monetary policy too produces allocative effects. The judgment, borne by the history of democratic societies, must be that, in comparison with fiscal policy, the inflation tax and the allocative effects of monetary policy are of a second order of magnitude, at least at low rates of inflation. But that cannot be an absolute judgment as it involves a trade-off between democratic control and policy effectiveness.

¹³ Such a principle has been accepted by popular vote in December 2001 in Switzerland.

The deeper reason for the asymmetry is that the political independence of monetary policy has been realized, after considerable experimentation and much academic research, both of which have documented how counter-productive the political control over monetary policy can be. Much as the legacy of high inflation has tilted the balance towards central bank independence, the legacy of high debts is now leading to the adoption of constraints on fiscal policy in the form of rules or institutional changes. When designing such a new approach, however, it is important to distinguish between the macroeconomic side of fiscal policy, which resembles monetary policy, and its allocative and structural aspects, which require indeed political oversight.

Lesson No.5: long term commitments must be backed up by specific legal and operational arrangements.

Monetary policy is now typically subject to a clear long-term mandate via legal arrangements. The debt sustainability imperative of fiscal sustainability is rarely backed by a similar legal mandate. Balanced budget requirements have systematically been rejected in most countries. In the US, the Gramm-Rudman Act has largely failed to seriously affect the budgetary process. Europe's Stability and Growth Pact (SGP) is quite unique in this respect, as discussed in more detail below.

One problem with such attempts, possibly including the SGP, is that they may impose too much rigidity on fiscal policy. Combining a long-run debt constraint with short-run fiscal policy flexibility is difficult, at least more so than the comparable monetary policy requirement. It may be that we have not yet fully drawn all the lessons from monetary policy institutions. Monetary policy is not subject to rigid quantitative rules, it is rather entrusted to policy-makers that are independent from political influence and given a clear mandate. What remains to be imagined is an arrangement for fiscal policy that has similar properties and yet fits its specific characteristics. Some steps in this direction are taken in the following section.

4. Principles for a New Approach to Fiscal Policy

A new fiscal policy framework must combine a credible commitment to long-run debt sustainability with sufficient short run flexibility for policy to operate as a counter-cyclical instrument. To that effect, two steps need to be taken: (1) defining long-run debt sustainability and short-run flexibility: (2) establishing institutions which support this aim.

4.1. Defining the Objectives

At the minimum, long-term debt sustainability requires that the debt level not increase as a percent of GDP. A more demanding definition is that the debt level not rise in real or nominal terms, ensuring that it eventually becomes trivial as a proportion of GDP. In a way, the precise formulation matters little for there is no clear definition of what is a reasonable public debt level.¹⁴ The 60% Maastricht convergence criterion, for example, is an accident of history, the average debt level in Europe on the day the Maastricht Treaty was finalized. A high debt level is clearly undesirable since it plays havoc with the budget when interest rate fluctuations affect part of the debt service.¹⁵

Is zero debt desirable? In principle, because taxes are distortionary, the lowest possible debt level allows to reduce the tax burden, provided of course that the government does not replace debt service with public spending. In practice, there is no indication that the tax burden is lower where debt is smaller. Figure 3 shows that, in the OECD area there is no such link: the partial correlation coefficient is negative (-0.03) and insignificant (t-statistics = 0.42).¹⁶ In addition, under the view that the

¹⁴ See Perotti et al. (1998) for a discussion of sustainability as well as for useful references. They consider fiscal policy to be sustainable when there is no need for sharp adjustments. These authors conclude that, because sustainability cannot be appropriately defined and measured, attention should shift to controllability. In a sense, this is the view adopted here too, as the focus shifts to institutions which are likely to deliver a debt that remains under control, independently of its size.

¹⁵ In high-debt countries, it can be a source of self-fulfilling crisis since concern with debt service may lead markets to ask for higher interest rates, which leads to a deterioration of the budget and an increase in debt, further fueling market concerns.

¹⁶ It can be objected that the three Scandinavian countries and Japan are outliers. Without these four countries, the partial correlation coefficient is positive (0.13) and significant (t-statistics = 2.27), but it is not clear why these countries should be excluded. The Scandinavian countries illustrate the main

government borrows on behalf of credit-constrained citizens, some positive debt level is welfare-enhancing. Similarly, with standards of living likely to continue to rise over the foreseeable future, intergenerational equity calls for some negative transfers to richer future generations.

All in all, therefore, the only possible conclusion is that a moderate debt level is desirable, but “moderate” cannot be precisely pinned down. We simply have to rely on good judgment. “Judgment” is the crucial word here. It means that human thinking, guided by clear principles, is a superior alternative to binding rules.

Figure 3

Short-term flexibility means that fiscal policy has a role to play in dealing with cyclical movements. Pro-cyclical policies, frequently observed, are clearly undesirable. Beyond that, there is no generally accepted prescription, except that fiscal policy is a blunter instrument than monetary policy, suggesting that its discretionary use should be limited to situations that cannot be handled by monetary policy along with the automatic stabilizers. It is important to keep in mind that the full use of the automatic stabilizers cannot be a source of debt unsustainability. Almost by definition, over the cycle the automatic stabilizers give back what they take.

4.2. Institutions

Long-run constraints are notoriously hard to enforce because of the time inconsistency problem: there will always exist circumstances where giving up a commitment is actually welfare improving, although as seen from the current perspective it is highly undesirable.

One response to the time inconsistency problem is to rely on credibility. When policymakers’ credibility is important to their task and is linked to their ability to stick to commitments, especially when the temptation to renege is high, they are more

point that a low debt level may be intentionally accompanied by a large tax burden, while Japan shows that small governments can run unsustainable fiscal policies.

likely to stick to their initial course of action. This is indeed the case of central bankers whose ability to influence market expectations is directly tied to their credibility. Markets can provide a reinforcement when they price some variables which are associated with the policymakers' performance. Interest and exchange rates, for instance, are often seen as a gauge of a central bank's commitment to price stability. Yet, the record of markets as guardian of the temple is mixed at best. The near-consensus view is that they tend to react too much too late (see e.g. Bayoumi, Goldstein and Woglom, 1995).

Another response is to link policymakers' rewards to their adherence to commitments. Elected policymakers may earn their reputation by resisting calls to change track, and reputation may help for reelection. Populism, however, is far too common to give much credence to this approach. Linking central bankers' salaries to a performance measure has been proposed by Walsh (1995) but has never been applied. A weakness of the arrangement is that the performance rating itself can be changed.

A more promising response is to enshrine commitments in constitutions and institutions. Once more, monetary policy provides a good example. By giving central bankers a clear constitutional mandate and making them independent has reduced the probability that they renege on their commitments. Such arrangements are not iron-clad either, since laws can always be changed (Persson and Tabellini, 2000). The (imperfect) solution is to include the law in high-level legislation such as the Constitution, which makes it much harder to be changed.¹⁷

4.3. Defining debt sustainability

Debt sustainability can be defined in two alternative ways:

¹⁷ For example, the statutes of the ECB are part of the Maastricht Treaty, so it would take another treaty to reduce its independence or change its mission, a very unlikely prospect. In contrast, the independence of the Federal Reserve is set by an Act of the US Congress, and what the Congress makes the Congress can undo. This explains the importance that Fed Chairmen attach to their appearances in front of the Congress, in contrast to the considerably more casual "monetary dialogue" between the ECB President and the European Parliament.

- It can be an obligation to achieve budget balance on average over a number of years. The number of years should be of the same order as the length of ordinary business cycles (4 to 6 years). It should not be fixed *ex ante* since cycles are never alike, rather peaks and the troughs should be identified by an independent institution, as the NBER does for the US.

- Countries which start with a high debt, or which face large future commitments (due to an ageing population, for example) can aim at a given reduction of the debt-to-GDP ratio over a given horizon. As before, the horizon ought to be tailored to the length of the business cycles.

Multiyear commitments are essential to allow for short-run counter-cyclical policies. Such an arrangement sets the incentives right. The authorities know *ex ante* that any budget relaxation will have to be clawed back in the not-too-distant future. As a result, they are likely to adopt a debt-increasing stance only if they think that it will be efficient, not only in the short run but intertemporally, i.e. if today's gains outweigh tomorrow's costs. Similarly, they will take advantage from favorable conditions to garner room for maneuver in anticipation of future adverse shocks. The main danger is that governments use this formulation to act strategically, i.e. to play political tricks: if they expect to lose the next election, they may engage in reckless behavior to create problems for their political opponents in the hope of regaining power at the following election.¹⁸ Finding a solution to limit this risk is an important issue in the following suggestions.

An important aspect of these principles is that they eschew any numerical target for the debt level. As noted above, there is no optimal target level for public debts. Setting quantified targets inevitably elicits criticism, to which the response is to create an artificial "holly cow" which may be difficult to change later on. In addition, as

¹⁸ Persson, Persson, and Svensson (1987) have proposed structuring the debt in a way that could alleviate the risk.

made abundantly clear by the Maastricht convergence process, artificial targets can be easily flouted precisely because they lack a solid enough basis to be adhered to.¹⁹

Finally, a good institution is one that can accommodate extraordinary circumstances. This calls for an escape clause. Escape clauses are dangerous, as has been shown by Obstfeld (1997) in a different context. The mere existence of an escape clause may feed expectations that it will be activated, which in turns may make activation too tempting to be resisted. Yet, there may be cases when clinging to a policy may be so costly, economically and politically, that attempting to do so will irremediably discredit the policy and the principle that it serves.²⁰ The definition of debt or deficit targets must be left in safe hands, relying on human judgment rather on purely mechanical rules.

5. Four Possible Approaches

Drawing on the previous analysis, this section envisions a number of possible ways in which fiscal policy can be reframed. In all cases, the crucial question is which agent of restraint can be used to both guarantee that debt always remains on a sustainable path, and allow for counter-cyclical fiscal policy when needed. The first solution, a constitutional limit on debts or deficits, has long been in place in the US states. This approach may be too rigid for sovereign states. The other solutions rely on outside institutions. One possibility is to establish external control, as with IMF programs or the European Stability and Growth Pact (SGP). Another possibility is to confer the power to exercise judgment by to a non-elected body outside of the direct sphere of influence of government, as is the case for monetary policy and central banks. An intermediate solution relies on “wise men” to discipline governments.

¹⁹ A common problem with quantified constraints, which also applies to balanced-budget laws, is that they can be escaped through creative accounting, including off-budget spending or the creation of separate government agencies exempt from the constraints, see von Hagen (1992).

²⁰ The example of the Argentinean currency board is hard to resist. No matter how useful it has been in the past and could be in the future, it has proven to be far too rigid to be a lasting institution. Its very robustness has required extraordinary – and tragic – pressure to bring about its end.

5.1. The US States Approach: Quantitative Limits

All US states governments – with the exception of Vermont, which has one of the smallest debts – are subject to one form or another of constitutional limit, as described in Bayoumi, Morris and Woglom (1995). Some states operate a ceiling on the debt, typical set very low, less than 10% of Gross State Product, and mostly below 5%. Other states rule out any budget deficit. Others still require that the deficit be balanced over a number of years.

Of these three forms, only the last one fulfills the criteria developed earlier. Why, then, have drastic limits been accepted and have successfully passed the test of time? Partly because the US federal government budget is much larger than the state budgets and provide for a significant degree of counter-cyclical transfers, see Sala-i-Martin and Sachs (1992), Italianer and Pisani-Ferry (1994), Bayoumi and Masson (1995), and the review in Kletzer and von Hagen (2001).²¹ Also, given the high degree of economic integration among states, and the extent of labor mobility across states, the costs of a rigid approach are reasonably small in comparison to the costs of fiscal indiscipline. As clearly shown by Eichengreen and Bayoumi (1994), this approach is unlikely to work for independent states. The repeated rejection of balanced budget acts is a case in point.

5.2. The IMF and Maastricht Approaches: External Restraint and Peer Pressure

If governments cannot be fully trusted for exercising discipline, a natural solution is to use an external source of restraint. The IMF and the Excessive Deficit Procedure (EDP) mandated by the Maastricht Treaty are two prominent examples of this approach.

The EDP binds national governments with an international agreement that is nearly impossible to change since it is part of an international treaty. As such, it is

²¹ Federal transfers alone do not provide sufficient incentive for debt sustainability as seen from the example of Switzerland where several cantons have built up high debts.

guaranteed to survive a change of heart of domestic policymakers and legislators. This is both its strength and its weakness. Any external restraint runs the risk that citizens may come to balk at the loss of sovereignty, making the arrangement politically unsustainable. Europe's response is peer pressure, designed to dispel the notion of foreign interference.

The IMF agreements provide for two distinct mechanisms: Article IV consultations and loan programs. The annual Article IV consultations – surveillance in IMF parlance – are explicitly designed as peer review. They are conducted by the Fund's staff and approved by the Executive Board which is meant to represent the community of nations. Application to IMF programs is voluntary, meaning that there is no formal loss of sovereignty. In addition, the constraints set by the programs are not set in advance but tailored to each country, and formally agreed upon jointly by the recipient country and the IMF which insists on program's "ownership" by the country. Even so, the external nature of the constraint often leads to criticism that the IMF interferes with national sovereignty.

The crucial question is what gives "teeth" to the external restraint. IMF consultations only work through peer pressure, i.e. shaming countries that misbehave. Until recently the consultation reports were confidential. If the country agrees, they are now posted on the Fund's website. IMF programs rely on a carrot, external funding, and a stick, no funding or the denial of further loans. In Europe, the Stability and Growth Pact (SGP), which gives operational content to the EDP, similarly rests on peer review in the form of the Broad Economic Policy Guidelines (BEPG) process, and on a stick in the form of fines in case of violation of the constraint.²²

At the end of the day, the acid test of external restraints is whether the combination of peer pressure and sanctions delivers good behavior, i.e. long-run discipline and short-run flexibility. The IMF record is mixed, displaying many successes and a few

²² The IMF reviews a broader array of policies than the SGP, since it includes both monetary and fiscal policies. Over the years, the IMF has extended its attention to structural policies, including banking sector regulation and supervision, corruption, and poverty alleviation. A similar creep is now occurring within the BEPG which extend to employment, competition, financial markets, education and the environment policies.

spectacular failures.²³ Most successes are characterized by temporary short-run restraints – sometimes characterized as excessive – and a return to sustainable policies. Once an IMF program is concluded, short-run flexibility is recovered but remains subject to Article IV surveillance, and relapses are not uncommon. Most failures occur when a government does not abide by the constraints previously agreed to. In such cases, the sticks and the carrots are found not to be powerful enough. Thus the IMF success can be characterized as the result of expert judgment – i.e. no uniformly quantified targets – combined with an appropriate dose of incentives and punishment.

All European countries are subject to IMF surveillance but have decided to adopt the more demanding SGP framework. The SGP differs from the IMF in many respects. As noted, it relies on quantified targets, it offers no carrots and a stick (fines) that is often seen as extremely harsh. This harshness may reflect the view that, in contrast to IMF programs, there can not be any major failure if the monetary union is to remain credible. It is far too early to pass judgment on the SGP, but some weaknesses are already apparent.

One weakness is the battery of quantified criteria (the deficit limit, the triggers for exemption) which lack any solid justification and are therefore difficult to rigorously impose from the outside. Official comments emphasize that the true purpose is to encourage member countries to operate on average a balanced or slightly positive budget, a better understandable and justified aim. It is hoped that common sense will prevail and prevent the testing of the limits. This is not a safe assumption.

Another weakness is that imposing a fine is seen as a step to be taken only in the gravest of circumstances. This is why the mechanism that leads to fines is both lengthy and eventually subject to a political decision. Length increases the odds that the deficit problem will be softly eliminated before sanctions are required. Since fines are decided by the Finance Ministers, there is no automatism, which mitigates the risk of misguided actions, but it gives an uncomfortable political flavor to the procedure.

²³ This is not the place to review the IMF's track record. For a recent appraisal, see Jeanne and Zettelmeyer (2001).

The SGP sanctions can be seen as a deterrent never to be used for fear of triggering dangerous opposition within the country ordered to pay a fine.²⁴ If this view is correct, then the SGP lacks teeth and may turn out to be mostly gentle peer pressure.

It seems fair to conclude that the SGP represents an imperfect attempt at using an external foreign agent of restraint. It suffers from quantified restraints that do not adequately achieve the difficult balance between long-run sustainability and short-run flexibility. Its fine scheme is formally rigid, a feature mitigated by an implementation mechanism that suffers from too much politics, and may therefore may turn out to be too soft. The rigid application of the BEPG may easily prevent the appropriate dose of short-run flexibility, as seems to be the case by late 2001.

5.3. The Central bank Approach: Fiscal Policy Committees

In increasing number of countries have adopted institutional arrangements which deliver a high degree of monetary policy discipline. The common feature of these arrangements is the delegation of power to independent committees mainly subject to a long run constraint, that of delivering price stability. Given the fundamental similarity between the long and short-run aims of monetary and fiscal policies outlined in Section 3.1, it is surprising that similar steps have not been taken regarding fiscal policy. Where changes have been introduced, they rely on rules that aim at preventing governments from engaging again in debt buildup. Delegation of power is nowhere to be seen, except maybe where the relevant treasury or Finance Minister is given more power.²⁵ Why such an asymmetry?

As noted earlier, this is largely because fiscal policy powerfully re-allocates income, which creates the need for direct democratic control. One important distinction is insufficiently appreciated, though. It concerns two aspects of fiscal policy-making: the setting of the budget balance on one hand, and choices regarding the size of government, the public spending programs and the structure of taxation on the other hand. The bulk of income and wealth redistribution occurs through the latter aspect.

²⁴ For an analysis of the SGP, see Eichengreen and Wyplosz (1993) and Brunila et al. (2001).

²⁵ This process is analyzed in von Hagen, Hughes-Hallett and Strauch (2001).

In contrast, budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play not part in democratic control.²⁶ Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, not the size of the budget deficit.

This distinction carries a crucial implication. Taking the deficit and the debt out of the standard democratic process (design by the government and approval by the parliament) does not imply any serious loss of democratic control where it is fully justified. Once this point is accepted, the similarity between monetary policy and setting the budget deficit becomes even more striking. How then can the key aspects of monetary policy discipline – independence and a clear mandate – be applied to fiscal policy?²⁷

The key step would be to create a new institution, the Fiscal Policy Committee (FPC). Like the central banks' Monetary Policy Committees (MPC), the FPC would include a small number of qualified persons appointed for long, non-renewable terms of office. FPC members could not be removed from office unless they violate their mandates and they would not be allowed to seek or receive instructions from governments, members of parliaments or any outside person or group. The FPC would be supported by a staff that would produce its own forecasts of economic conditions and budgetary figures.

The FPC would operate under a precise and explicit constraint, that of ensuring debt sustainability over the appropriate horizon. The definition of debt sustainability, and the horizon, would be made precise along the lines of the principles laid out in Section 4.3 above. As explained in that section, over the short run this would leave the FPC

²⁶ It could even be argued that the current generation is ill-suited to provide a fair treatment of future generations.

²⁷ As I was formulating the present proposal I came upon a nearly identical one by Eichengreen, Hausmann and von Hagen (1999). They go in considerably more details regarding the design and functioning of their proposed National Fiscal Councils.

free to opt for deficits and surpluses, as justified by their analysis of current and future conditions. They would, however, have to deliver debt sustainability.

The power of the FPC would be limited to set annual deficit figures (say, in percent of planned GDP) ahead of the government budgetary cycle. Their decision would have the force of law, and impose themselves on both the government and the parliament.²⁸ The FPC would have no authority regarding the size of the budget, the tax structure and the allocation of public spending, all matters left to the currently existing political process. The FPC would have to approve the budget bill, checking its spending and revenue projections, before it becomes law.

The constraint on the government and/or parliament could take either of two forms. Any budget that does not comply with the FPC's decision could be void, and would have to be redrawn. Alternatively, a procedure could be automatically activated to bring the budget in line. This could be either a pro-rata reduction in spending, or a pro-rata increase in (some) tax revenues, or a combination of both, with a view to avoid redistribution. The procedure is to be decided as part of the creation of the new institution.

The FPC would be accountable to parliament. At an agreed-upon frequency, its Chair would have to report on its decisions. The parliament could formally state its approval or disapproval of FPC's decisions, but it could not censure it unless the FPC fails to deliver budget sustainability as defined in its mandate. In case the FPC fails in this respect, the parliament would be allowed to censure the FPC, possibly including collective dismissal. The rules under which the FPC operate (voting, reporting of its deliberations, collective or individual responsibility) also need to be spelled out.²⁹

²⁸ A step in this direction has been adopted in Italy in the early 1990s. The deficit is decided by the government in the summer, and it takes the form a law. When the rest of the budget (size, spending, taxation) is set by the government and discussed by the parliament in the fall, the budget law cannot be modified anymore. von Hagen and Harden (1994) convincingly argue that this step has been crucial in Italy's successful efforts at stabilizing and reducing its public debt. Another related development is the increased power of the Belgian High Council for Finances which can issue recommendations regarding the size of deficits at the federal and sub-federal levels, see von Hagen (2001).

²⁹ For a detailed discussion of MPC rules, see Blinder et al. (2001).

It is important to stress that setting up a FPC would not reduce the power of parliament in any meaningful way. The mandate of the FPC, debt sustainability, is not a political objective, rather it is a constraint, but not a new one. It is only the embodiment of the state's budget constraint, one which imposes itself on all policymakers, in one way or another, sooner or later. Presumably, parliaments do not plan to approve budgets that *ex ante* violate the state's budget constraint.

If economic conditions were to change abruptly, the FPC should be able to mandate a change in the budget law. This could take the form of a new deficit figure, leaving again the government and the parliament with the task on adjusting spending and/or revenues. Eichengreen, Haussmann and von Hagen (1999) provide an excellent discussion of the relative merits of fixed review dates vs. discretionary interventions.

Finally, exceptional circumstances – unforecastable, by definition – may warrant a suspension of the debt sustainability obligation. This is what lies behind the over-ride provision discussed in the case of monetary policy (see, e.g., Roll et al., 1993). As any escape clause, there is a risk that the over-ride be abused. It is besides the point to attempt to draw a list of such exceptional circumstances. On the other side, in the absence of an over-ride, the whole FPC procedure stands to lose credibility and to be abandoned in the midst of unusual and unforeseen events. What is needed is a exceptional procedure that is truly difficult trigger. For instance, it could require a parliamentary vote with a super-majority.

5.4. The Wise Persons Approach

A solution similar in spirit to the FPC but less politically demanding, is to appoint a Court of Wise Persons (CWP). The Court would share most of the characteristics of the FPC (mandate, tenure, independence, support staff) but its decisions would not have the power of law. The CWP would issue guidelines on the size of the following year's budget balance and report on the previous year's budget execution. Its findings and recommendations would be made public, possibly solemnly presented to the government and parliament. The government and parliament could be required to publicly respond to the CWP.

This mellow version of the FPC is essentially internal peer pressure, similar to the BEPG but without the threat of fines. Its weakness is that politicians could find expedient to gang up and diminish its preeminence, treating public disagreements with the CWP as a minor embarrassment.³⁰ In order to avoid such an outcome, it would be desirable to provide the CWP with at least some of the powers envisioned for the FPC.

For instance, during a legislature the budget law might not be allowed to deviate more than twice from the norms set by the CWP. But the risk is that violations could systematically happen in the final years, resulting in disruptive political business cycles. It could even encourage early dismissal of parliament where it is constitutionally possible. Alternatively, any deviation on the deficit side might have to be corrected within a set period (three to five years), with the risk that incumbents would intentionally leave a bad inheritance to their successors in government.

These examples show that the space between strong and weak fiscal institutions is narrow. Wise persons essentially work by shaming the authorities for bad behavior, which is unlikely to be enough, except maybe in very open societies with high moral standards in politics. Elsewhere, FPCs are more appropriate.

6. Conclusions

Initiatives like balanced-budget proposals or the SGP show that there is now a recognized need for combining long-run discipline and short-term flexibility in the realm of fiscal policy as well. This is always a difficult exercise. The natural tendency is to establish fences, in the form of quantitative ceilings and rules. The problem with fences is that, to be effective, they have to be rigid. In normal times, fences can be set so as to leave a reasonable degree of flexibility but circumstances stubbornly tend to

³⁰ Germany is one country which has established a wisemen committee. The German Council of Economic Experts, however, only evaluates the government's economic policies *ex post*. Its mission is formally set as advising and educating the public. A superficial observation is that the institution has progressively lost its lackluster.

be unusual and to test the best-crafted devices. The risk that the counter-cyclical use of fiscal policy, already limited, be lost to the quest for sturdiness.

The SGP's solution to the quandary is to allow for escape clauses. But escape clauses are potentially destabilizing, hence the tendency to design triggers that are excessively severe. On the other side, softer escape clause undermine the constraints. The SGP's triggers (a GDP decline of 2%, possibly only 0.75%) are very unlikely to be met under most circumstances where a relaxation of the deficit ceiling would be desirable.

Competent and dedicated policymakers are better able than quantitative ceilings and rules to exercise good judgment and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from the temptation and pressures that are part of political life. This is the approach that has been adopted for monetary policy by an increasing number of countries, so far successfully.

Fiscal policy has not yet benefited from a similar treatment because of both traditions and the perception that fiscal policy belongs exclusively to the political sphere. Traditions too were once invoked to keep central banks under the thumb of politicians, but the recent changes show that traditions can be relatively easily shaken. The challenge for a new type of fiscal policy to emerge is to recognize that some of its aspects indeed ought to remain in the political sphere, but that the deficit and the debt level do not. Monetary policy was freed from political interference when it was recognized that it is neutral in the long run.

The natural implication is that the institutions adopted for monetary policy can and should be applied to fiscal policy as well. Independent Fiscal Policy Committees can play the same role as Monetary Policy Committees, deciding on deficits and the evolution of the debt. To deliver good results, they need to be given a clear mandate, debt sustainability, and to be freed from the temptation and pressures of political life. There is no reason why FPCs would be less successful than the MPCs.

Because independent FPCs run against established traditions, it may be politically difficult to go there in one step. Quantitative rules are already shaking the established view that fiscal policy is an inalienable attribute of national sovereignty. The danger is

that they are far too rigid and may give a bad name to attempts to depoliticize the fiscal policy process. Wise Men have much of the required flavor but they are unlikely to provide the required influence unless they have some decision power. Strengthening their power is a short step from a fully-fledged FPC.

References

- Alesina, Alberto and Roberto Perotti (1997) "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", *International Monetary Fund Staff Papers* 44(2): 210-48.
- Bayoumi, Tamim and Paul R. Masson (1995) "Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe", *European Economic Review* 39(2): 253-74.
- Bayoumi, Tamim, Morris Goldstein and Geoffrey Woglom (1995) "Do Credit Markets Discipline Sovereign Borrowers? Evidence from the U.S. States", *Journal of Money, Credit, and Banking* 27(4): 1046-59.
- Becker, Torbjorn (1997) "An Investigation of Ricardian Equivalence in a Common Trends Model", *Journal of Monetary Economics* 39(3): 405-31.
- Bernheim, B. Douglas (1987) "Ricardian Equivalence: An Evaluation of Theory and Evidence", in: S. Fischer, ed. *NBER Macroeconomics Annual 1987*: 263-304.
- Blinder, Alan, Charles Goodhart, Philipp Hildebrand, David Lipton and Charles Wyplosz (2001) "How Do Central Banks Talk?" *Geneva Report on the World Economy* 3, CEPR, London.
- Blanchard, Olivier and Roberto Perotti (1999) "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output", NBER Working Paper 7269.
- Brunila, Anne, Marco Buti and Daniele Franco (2001) "Introduction" in: A. Brunila, M. Buti and D. Franco (eds.) *The Stability and Growth Pact*, Basingstoke: Palgrave.
- Buchanan, James M. and Gordon Tullock (1962) *The Calculus of Consent: Logical Foundation of Constitutional Democracy*, University of Michigan Press, Ann Arbor, Mich.
- Buti, Marco (2001) "The Stability and Growth Pact Three Years on. An Assessment", paper presented at the seminar on Fiscal Policy in EMU, Stockholm, 3 May 2001.
- Buti, Marco, D. Franco and H. Ongena (1997) "Budgetary Policies during Recessions - Retrospective Application of the "Stability and Growth Pact" to the Post - War Period", Economic Papers No. 121, European Commission. Brussels.
- Drazen, Allan (2000) *Political Economy in Macroeconomics*, Princeton University Press, Princeton, N.J.
- Eichengreen, Barry and Charles Wyplosz (1993) "The Stability Pact: More than a Minor Nuisance?", *Economic Policy* 26: 65-104.

- Eichengreen, Barry and Tamim Bayoumi (1994) "The Political Economy of Fiscal Restrictions: Implications for Europe from the United States", *European Economic Review* 38(3-4): 783-91.
- Eichengreen, Barry, Ricardo Hausmann and Jürgen von Hagen (1999) "Reforming Budgetary Institutions in Latin America: The Case for a National Fiscal Council", *Open Economies Review*: 10(4): 415-42.
- European Commission (2001) "Fiscal Policy and Cyclical Stabilization in EMU", *European Economy* 3: 57-80.
- Giavazzi, Francesco, Tullio Jappelli and Marco Pagano (2000) "Searching for Non-linear Effects of Fiscal Policy: Evidence from Industrial and Developing Countries", *European Economic Review* 44(7): 1259-89.
- Gruen, David W. R. (1991) "What People Know and What Economists Think They Know: Surveys on Ricardian Equivalence", *Australian Economic Papers* 30(56): 1-9.
- Italianer, Alexander and Jean Pisani-Ferry (1994) "The Regional Stabilization Properties of Fiscal Arrangements" in: J. Mortensen, ed. *Improving Economic and Social Cohesion in the European Community*, London: Macmillan Press: 155-94.
- Jeanne, Olivier and Jeromin Zettelmeyer (2001) "International Bailouts, Moral Hazard and Conditionality", *Economic Policy* 33: 407-32.
- Kletzer, Kenneth and Jürgen von Hagen (2001) "Monetary Unions and Fiscal Federalism" in: C. Wyplosz (ed.) *The Impact of EMU on Europe and the Developing Countries*, Oxford University Press, Oxford.
- Melitz, Jacques (2000) "Some Cross-Country Evidence About Fiscal Policy Behaviour and Consequences for EMU", *European Economy* 2: 3-21.
- Obstfeld, Maurice (1997) "Destabilizing Effects of Exchange Rate Escape Clauses", *Journal of International Economics* 43(1-2): 61-77.
- Perotti, Roberto, Rolf Strauch and Jürgen von Hagen (1998) *Sustainability of Public Finances*, CEPR, London.
- Persson, Mats, Torsten Persson and Lars E. O. Svensson (1987) "Time Consistency of Fiscal and Monetary Policy", *Econometrica* 55(6): 1419-31.
- Persson, Torsten and Guido Tabellini (2000) *Political Economics*, MIT Press, Cambridge, Mass.
- Roll, Eric et al. (1993) "Independent and Accountable: A New Mandate for the Bank of England", A Report of An Independent Panel Chaired by Eric Roll, CEPR, London, 1993.
- Sala-i-Martin, Xavier and Jeffrey Sachs (1992) "Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States", in: M. Canzoneri, V.

Grilli, P. Masson, eds. *Establishing a central bank: Issues in Europe and lessons from the U.S.*, Cambridge: Cambridge University Press: 195-219.

Seater, John J. (1993) "Ricardian Equivalence", *Journal of Economic Literature* 31(1): 142-190

Taylor, John (2000) "Reassessing Discretionary Fiscal Policy", *Journal of Economic Perspectives* 14(3): 21-36.

von Hagen, Jürgen (1992) "Fiscal Arrangements in a Monetary Union: Evidence from the U.S." in Donald E. Fair and Christian de Boissieu, eds., *Fiscal Policy, Taxation and the Financial System in an Increasingly Integrated Europe*, Kluwer, Dordrecht.

von Hagen, Jürgen and Ian J. Harden (1994) "National Budget Processes and Fiscal Performance" *European Economy Reports and Studies* 3: 311-408

von Hagen, Jürgen, Andrew Hughes-Hallett and Rolf Strauch (2001) "Budgetary Consolidation in EMU", *Economic Papers* 148, European Commission.

Walsh, Carl E. (1995) "Optimal Contracts for Central Bankers", *American Economic Review* 85(1): 150-67.

Wyplosz, Charles (1999) "Economic Policy Coordination in EMU: Strategies and Institutions", paper presented at the German-French Economic Forum in Bonn, January 12, 1999.

Table 1. Cyclical Behavior of Fiscal Policy

USA						
Dependent	Public spending		Public revenue		Budget balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.48 3.24		0.69 3.69		0.42 3.15
D92-01*Dependent (-1)		-0.04 -2.51		0.01 0.55		-0.51 -2.92
Output Gap	-0.38 -3.04	-0.37 -3.17	0.02 0.15	0.05 0.86	0.40 1.86	0.44 3.73
Downswing*Output Gap	-0.01 -0.03	-0.06 -0.45	0.09 0.47	0.03 0.37	0.10 0.29	0.03 0.18
D92-01*Output Gap	-0.01 -0.02	-0.30 -1.55	-0.10 -0.29	0.18 0.95	-0.09 -0.16	1.52 3.71
D92-01*	0.53	0.46	0.37	-0.09	-0.17	0.23
Downswing*Output Gap	0.63	1.05	0.43	-0.26	-0.12	0.43
Debt Lagged	-0.02 -1.74	0.09 2.60	0.00 0.21	0.01 0.82	0.02 1.14	-0.06 -2.45
Adjusted R2	0.71	0.89	-0.06	0.82	0.52	0.88
Standard Deviation	0.52	0.63	0.52	0.47	0.90	0.75
D.W.	2.20	1.59	2.49	2.21	2.42	2.33
N. observations	1971-2001		1971-2001		1971-2001	
Sample	31		31		31	

France						
Dependent	Public spending		Public revenue		Budget balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.88 8.72		0.68 5.27		0.24 0.91
D92-01*Dependent (-1)		0.04 3.33		0.00 -0.38		0.77 3.18
Output Gap	-0.51 -1.95	-0.02 -0.12	-0.48 -1.59	-0.12 -0.80	0.03 0.07	0.20 1.25
Downswing*Output Gap	0.10 0.22	-0.20 -1.19	0.20 0.38	-0.11 -0.66	0.10 0.15	-0.01 -0.07
D92-01*Output Gap	0.73 1.48	-0.06 -0.22	0.05 0.10	-0.11 -0.41	-0.68 -0.95	-0.45 -1.18
D92-01*	-1.30	0.17	0.09	0.10	1.40	0.06
Downswing*Output Gap	-1.91	0.58	0.12	0.38	1.41	0.19
Debt Lagged	-0.05 -3.35	-0.10 -3.45	-0.01 -0.48	0.03 0.94	0.04 1.93	0.06 3.20
Adjusted R2	0.67	0.94	0.18	0.90	0.18	0.70
Standard Deviation	0.60	0.69	0.69	0.65	0.86	0.79
D.W.	2.01	1.74	2.24	2.17	2.20	1.52
N. observations	24		24		24	
Sample	1978-2001		1978-2001		1978-2001	

Germany						
Dependent	Public spending		Public revenue		Budget balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		0.80 9.50		0.77 6.32		0.39 2.20
D92-01*Dependent (-1)		0.03 2.16		0.02 1.15		0.30 1.03
Output Gap	-0.25 -1.18	-0.13 -1.09	-0.35 -1.62	-0.15 -1.51	-0.10 -0.33	0.05 0.35
Downswing*Output Gap	-0.30 -0.90	-0.08 -0.51	0.56 1.65	0.10 0.77	0.86 1.78	0.20 1.02
D92-01*Output Gap	0.31 0.48	0.17 0.33	-0.12 -0.17	-0.03 -0.08	-0.43 -0.45	-0.17 -0.26
D92-01*	-0.33	-0.27	-0.26	-0.18	0.07	0.01
Downswing*Output Gap	-0.43	-0.58	-0.33	-0.46	0.06	0.02
Debt Lagged	-0.03 -2.12	-0.06 -2.97	-0.03 -2.18	-0.03 -1.50	0.00 -0.08	0.02 1.01
Adjusted R2	0.56	0.85	0.13	0.77	0.22	0.21
Standard Deviation	0.77	0.87	0.79	0.72	1.13	1.14
D.W.	1.48	1.79	2.31	2.49	2.18	1.77
N. observations	31		31		31	
Sample	1971-2001		1971-2001		1971-2001	

Sweden						
Dependent	Public spending		Public revenue		Budget balance	
	Change	Level	Change	Level	Change	Level
Dependent (-1)		1.07 9.90		0.76 8.16		0.80 4.07
D92-01*Dependent (-1)		0.01 0.52		-0.02 -0.98		-0.14 -0.51
Output Gap	-0.47 -1.26	0.07 0.35	-0.31 -0.73	0.19 1.24	0.16 0.33	0.33 1.16
Downswing*Output Gap	0.00 0.00	-0.40 -1.02	0.50 0.77	-0.36 -1.12	0.50 0.65	0.10 0.21
D92-01*Output Gap	0.21 0.39	0.12 0.25	-0.69 -1.12	0.12 0.31	-0.90 -1.23	0.63 0.70
D92-01*	-1.28	-0.70	0.92	0.04	2.20	0.38
Downswing*Output Gap	-1.71	-1.10	1.09	0.08	2.19	0.44
Debt Lagged	-0.08 -4.25	-0.12 -2.69	0.01 0.39	0.05 1.74	0.09 3.50	0.06 1.69
Adjusted R2	0.67	0.92	-0.06	0.83	0.54	0.79
Standard Deviation	1.36	1.74	1.53	1.44	1.82	2.19
D.W.	2.46	2.19	1.76	1.80	1.85	1.30
N. observations	30		30		30	
Sample	1972-2001		1972-2001		1972-2001	

Source: OECD *Economic Outlook*, June 2001
Note: constant not shown

Figure 1. Gross Public Debt (% of GDP)

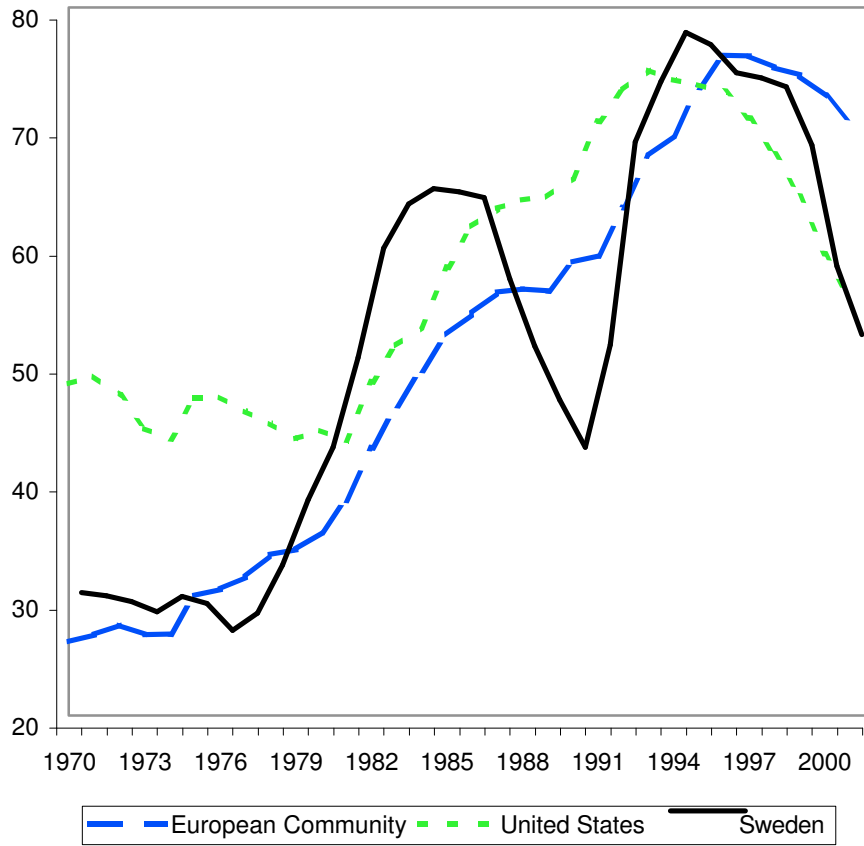
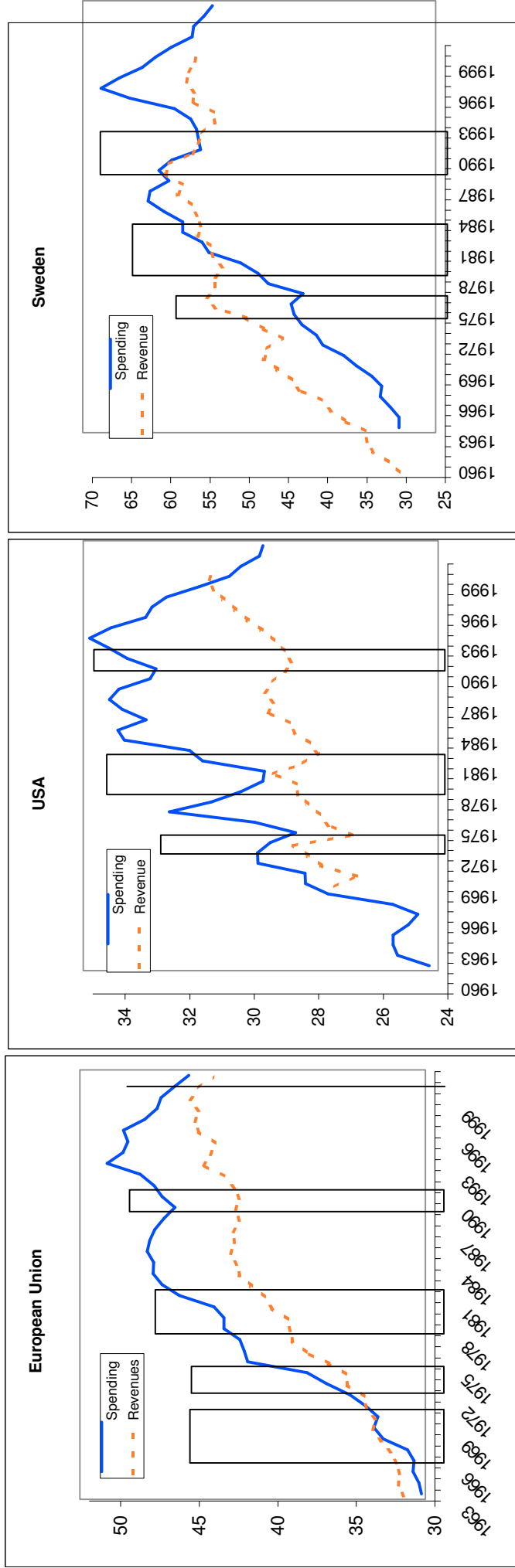
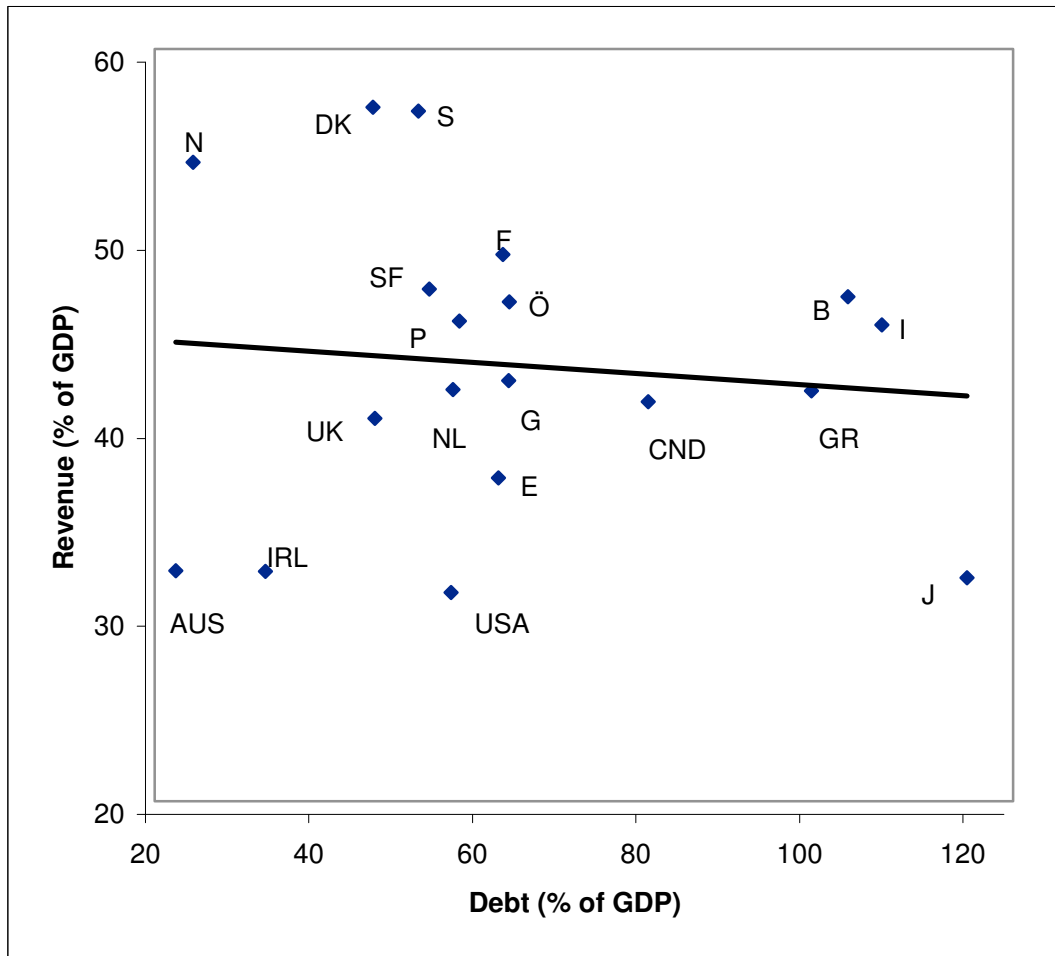


Figure 2. Government Spending and Revenue (% of GDP)



Source: OECD Economic Outlook

Figure 3. General Government Public Debt and Revenue in the OECD



Source: OECD *Economic Outlook*, June 2001