



BANCA D'ITALIA
EUROSISTEMA

**STRUCTURAL ECONOMIC ANALYSIS DEPARTMENT
PUBLIC FINANCE WORKSHOP**

Fiscal Policy: Current Issues and Challenges

Papers presented at the Banca d'Italia workshop held in
Perugia, 29-31 March, 2007

COMMENTS ON SESSION 3 FISCAL POLICY AND BUDGETARY INSTITUTIONS

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I have been asked to speak about two papers – one on Germany and the other on China. I know a limited amount about these countries: rather more about Germany so I will start with the paper by Baumann and Kastrop.

There is an obvious question as to whether fiscal rules are enunciated at the European level or at the national level, or at both. In my view, it is likely that different countries will make different decisions about whether they need their own national rules as well as European Union rules. One of the issues about fiscal rules is whether, and under what circumstances, governments will game those rules. Quite a lot of discussion at this conference has appeared to work on the assumptions that rules would be respected and that the measurement issues are clear-cut. In contrast, I believe the measurement issues are not clear-cut. For example, governments may position activities, assets and liabilities just outside the general government boundary and devise mechanisms such as Public-Private Partnerships which – whatever their claimed efficiency benefits – allow borrowing to be classified as private and therefore outside the fiscal rules. So the general question is whether fiscal rules lead to connivance about gaming behaviour. In my view, discussion of fiscal rules is often accompanied by an underestimation of the potential for creative accounting.

There is also the question of the substitutability of regulation for direct public expenditure. Economists tend to have a preference for government not to do things by regulation but by explicitly paying for things through market transactions. However, the more one emphasises explicit rules on expenditure, tax and/or borrowing, the more one encourages the search for substitute instruments. This is particularly the case if political commitment to those rules does not exist; the situation is worse if the rules are seen to be externally imposed and are perceived to lack legitimacy.

A key contextual factor about Germany is the federal system, which means that the federal government must work through negotiation and not imposition. I have some notion of how the Germany federal system works, but I would not want to take a firm position on the institutional alternatives proposed in the paper by Baumann and Kastrop. On the basis of the presentation, my instinct is to favour the option of the Council of Economic Advisers, but I would want more information and time for reflection before arriving at a considered judgement.

Reference was made in the presentation to government accounting reform. I strongly agree that Germany should pay close attention to how it does its

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government accounting. Germany had an enormous shock through the impact of unification. In this context, and with its tradition of cameral accounting, it is no surprise that Germany was not one of the leaders in the move to accruals accounting in government. Leadership in that project was given by Australia and New Zealand, with the United Kingdom following somewhat behind. However, the kinds of question that arise in the context of fiscal rules – such as how one measures net investment and how one measures depreciation – are much easier to address when government accounts have already moved to an accruals basis.

The window of opportunity for constitutional change in Germany clearly exists, and I would not suggest delaying it until government accounting can be changed. However, I do think that reforms to government accounting should be on Germany's planning horizons, a project on which the Federal Ministry of Finance will need to give clear leadership. In the United Kingdom, the original move to accruals accounting was seen primarily in terms of financial reporting and financial management. However, since the change of government from Conservative to Labour in 1997 and the subsequent adoption of UK fiscal rules, the accruals accounting system – known as Resource Accounting and Budgeting – has been seen as connected to the fiscal rules, particularly in terms of the plan to produce Whole-of-Government Accounts.

When designing fiscal rules, their implications need to be thought through. If a country has a golden rule that applies over the economic cycle, practical difficulties can be encountered towards the end of economic cycles, particularly if these are long. Towards the end of the cycle there are temptations to redetermine the cycle in a way that is advantageous to policy: for example, to avoid being forced by the fiscal rules to engage in pro-cyclical policy in trying to meet the numbers. Creative accounting is not done just for reasons of political presentation or manipulation: it might be seen by decision-makers as beneficial to the economy, in the sense of avoiding damage caused by inappropriate policy dictated by rules. But, once unleashed, creative accounting is difficult to rein in.

Turning to the paper by Lida on China, I find it difficult to say much because I do not know enough about China. Before the paper is published in the Conference Proceedings, it would be very helpful to have basic data about the Chinese public sector – about the structure of the public sector in terms of the central government and the local governments, and in terms of the composition of tax revenues and of expenditures.

It is conventional wisdom in OECD countries to regard discretionary fiscal policy as not particularly effective. However, this paper emphasises discretionary fiscal policy. It may be that the institutional context of China is so different because of its incomplete transition to being a market economy. I found it difficult to see exactly what was the role of monetary policy, the role of fiscal policy, and the role of administrative controls. One has to be careful about describing an economy like China in the language that one applies to an OECD economy, because the impression conveyed by such terminology may oversimplify and misrepresent reality.

One issue that is common to the German paper and the Chinese paper is that of relationships within the state, between the federal/central government and sub-national governments. Important legitimacy questions arise. External fiscal roles can lead to further centralisation of fiscal power within a particular country. Coming from the United Kingdom, which has persistently been over-centralised in a fiscal and governmental sense, I am particularly sensitive to that consideration.

In its published form, the Lida paper on China requires a more extensive description and justification of the periodisation. The periodisation that I understand is: 1993-97: contractual fiscal policy; 1998-2004: pro-active fiscal policy; and from 2005: prudent fiscal policy. More data are required to support both the distinctiveness of each fiscal policy "style" and the actual periodisation.

There are issues about the extent to which fiscal policy in China is pro-cyclical or counter-cyclical, and whether/how the automatic stabilisers work. China does not have the kind of tax and benefit structure that is closely associated with automatic stabilisers in a typical OECD economy. A supplementary question, arising from my own research interests in comparative budgetary systems, is the extent to which the budget in China is comprehensive in the sense that it covers the full range of general government activities.