BANCA D'ITALIA
EUROSISTEMA

Fiscal Policy: Lessons from the Crisis

Seminari e convegni
Workshops and Conferences

PUBLIC FINANCE WORKSHOP
Papers presented at the Banca d'Italia workshop
held in Perugia, 25-27 March, 2010

COMMENTS ON SESSION 3
FISCAL POLICY AND FISCAL RULES

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I have three quite diverse papers to discuss:

1) "The Great Crisis and Fiscal Institutions in Eastern and Central Europe and Central Asia" by Luca Barbone and Luis Álvaro Sanchez Baracaldo of The World Bank,
2) "Fiscal Multipliers in the Euro Area" by Esther Gordo and colleagues at the Bank of Spain and the European Central Bank,
3) "Fiscal Policy in Colombia and a Prospective Analysis After the 2008 Financial Crisis" by Ignacio Lozano of the Central Bank of Colombia.

These comments relate to the versions presented at the Perugia workshop, not to subsequent revisions.

Although their coverage and methodologies are different, there is a common theme – whether fiscal policy works. That sub-divides into two questions: (a) whether fiscal policy only works in extreme circumstances; and (b) whether there has been a rethinking of the consensus that the main weight should be on monetary policy, with fiscal policy set for the long or at least the medium term. That is not just a technical question for policymakers and economists, as governments have issues about this with their electorates. If not just in extreme circumstances, why has what seemed an established consensus suddenly collapsed with the global financial crisis?

Turning to Barbone and Baracaldo, my comments relate to the Powerpoint slides in the absence of a formal paper. It is striking that there are many things happening in overlapping time periods. First, there is the collapse of Communism and the transition to market economies, very variable experiences across the countries that are considered. Second, for some countries, there is preparation for membership of the European Union (EU), and for other countries it is actual membership of the EU. Thirdly there were big shocks in 1998 and again in 2008. The latter seems to have led to a rethink about the role of fiscal policy in a way that I do not believe happened equivalently after 1998.

Therefore, I want to pose a set of questions and then make a number of suggestions. These questions resonate across the workshop as a whole. The first question is the extent to which the evolution of events has changed views on the role of fiscal policy, and, if so, does that apply to "normal times" or solely to "abnormal times"? Moreover, one of the Powerpoint slides shows that GDP growth rates, and the changes in them from year to year, are exceptionally large in these countries.

The second question is to what extent a country can or indeed should prepare for unlikely but extreme events. Obviously if every country tries to run balance of payments surpluses and fiscal surpluses, that in aggregate has significant implications for world trade and the global economy.

The third question is how to distinguish false dawns from genuine transformations whereby one suddenly manages to run the economy at a macro level and a micro level much more efficiently and hence government finances are in a much better state. How does one distinguish between false dawns and real structural changes in economies?

Fourth is the question of how to respond to the big increases in government debt associated with the global financial crisis. These countries face quite different absolute levels of debt and, if

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they have access to capital markets, some countries would seem to have the ability to accept an increase in debt whereas other countries would not.

The fifth question relates to conservative oil price assumptions. I am not sure quite when "prudent" becomes "conservative", meaning that the government is deliberately understating potential oil revenues. If the government is doing that, over time that will become obvious with a resulting loss of trust in government forecasts. This runs completely contrary to more general arguments in favour of transparency.

I will now move on to specific comments on the Powerpoint slides, which might be useful when Luca and Luis proceed from the slides to writing a formal paper. First, a difficulty with the slides is that there is a lot of moving backwards and forwards between different groups of countries and individual countries, particularly Russia; I found that difficult to follow at times.

Second, the formal paper needs to go back to the three questions[1] asked at the beginning of the presentation and either say they can answer those questions or they cannot.

My third suggestion is in the context of access to finance for infrastructure, where Public-Private Partnerships (PPP) are mentioned. That is one of the themes of my own research (Heald and Georgiou, 2010). I would very strongly urge countries to concentrate on the possible value-for-money benefits of PPPs and to resist using them as a way around fiscal rules.

Fourth is the question about putting fiscal institutions in place. It came up in Richard Hughes' discussion of G20 (Hughes and Ljungman, 2010) but applies here probably even more. One has to be very careful about the distinction between what formal institutions are in place and how those institutions work in practice. One needs a large amount of country knowledge to be confident about the latter.

Moving on to the Gordo *et al.* paper, I would like to congratulate Esther and her colleagues at the Bank of Spain for an exceptionally informative paper which is helpful in allowing the reader to follow complex arguments. It is fairly standard in the way that it adopts a Structural Vector Autoregression (VAR) approach. One of the positive features of the paper is that it clearly relates what it does to other research, thereby positioning itself within the emerging literature of the 2000s, within which it emphasises Blanchard and Perotti (2002). Where necessary, the paper holds the reader by the hand and takes them through the comparisons and contrasts very clearly. This is a background research paper, not explicitly about policy at the moment and not about policy in terms of the response to the global financial crisis.

I have some issues that the authors should consider. Firstly, I was struck by the period covered which runs from the first quarter of 1981 to the fourth quarter of 2007, hence my comment that it does not cover the global financial crisis. I would need to be convinced that the United States, which has been a single country over that period, is actually comparable to the Eurozone where fiscal policy was run entirely independently in those countries for the first twenty years and has been run within the context of the EU Stability and Growth Pact and membership of the single currency for the subsequent period. One of the reasons why I think that is important is that the paper gets very plausible econometric results which tie up very neatly to the US findings. At one level this is very attractive but I think the paper needs to offer greater justification of why that comparison is believed to hold, given the entirely different constitutional and fiscal circumstances that exist in the US and the Eurozone.

1 Those three questions are: (1) How the fiscal institutional reforms introduced over the last decade help manage the crisis and mitigate its impact; (2) How did fiscal policy prior to the crisis affect the readiness of the countries to deal with the crisis; and (3) What are the lessons and what fiscal priorities are emerging after the crisis?

My second point relates to the issue of data measurement. This might be covered in Paredes *et al.* (2009), Paredes being one of the joint authors of the Gordo paper. The issue is about generating quarterly fiscal data. I am an accountant by academic background and the reference to "mostly on a cash basis" is a reminder that one has to think carefully about the cash-accruals distinction. I did not understand the very brief reference to methodology where it talked about a mixed-frequencies state space model; this is outside my expertise.[2] I have been very heavily involved in the UK's move from cash accounting to accruals accounting in government. When the UK moved in 2001-02 from cash to accruals one thing that emerged was that there were problems with the previous cash figures.

My third point is about periodisation. The Gordo *et al.* paper discusses the fact that the results for the US differ from those of Perotti (2004) when the sample length is taken as a whole, but for 1981 to 2000 the results are actually very similar. They make the point that the output multipliers are higher for both the US and EMU from 2000 onwards and I think it needs more discussion about why that might be so during that period. There was a suggestion that it might possibly be due to the global savings glut or to a decrease in global risk. Given what we now know about what happened in 2008 I find it difficult to believe that there was actually a decrease in global risk in the period 2000 to 2007. They also include dummy variables but the dummy variables for the period are not significant. This is an issue that I think needs further discussion.

Fourth, there is a reference in the paper to the decision whether or not a country entered EMU being taken on the basis of the fiscal deficit recorded in 1997. There is evidence of data manipulation, on which I would cite James Savage of the University of Virginia on the discussions between Eurostat and Greece in the run up to membership of the Eurozone (Savage, 2006). There is an issue about the data and what incentives there might have been to manipulate. In addition, this is another place where PPPs are mentioned and this raises the whole question of off-balance sheet transactions. The way in which these might affect the data used in the study is something that could usefully be discussed.

Ignacio Lozano's paper is quite different from the first two because it is a case study of Colombia. The key results are that fiscal policy by central government in Colombia has been pro-cyclical in the period 1960 to 2008. I would have been interested to know what would have happened if the measure was for general government but I do not know how important sub-national government is in the context of Colombia. Another interesting finding is that fiscal volatility was highest in the 1990s during the period of highest growth. Colombia generally seems to be coping well with the global financial crisis. If the increase in public debt is only 10 per cent as a result of the crisis and that is for the consolidated public sector, then many other countries would be pleased with that outcome.

When the paper is revised for publication there needs to be more discussion about how much confidence one can have in output gap calculations. Again, I do not know about Colombia but output gap calculations for the UK suggest that one should be somewhat careful; obviously, the cyclically adjusted figures depend on what you think the output gap is.

Secondly, Lozano (p. 488) notes that "The adoption of fiscal rules has become an institutional strategy for most OECD countries and for several [Latin American countries]". I can see why Colombia is attracted to fiscal rules. The circumstances whereby it lost its investment grade rating in the 1990s are not explained but, given that other countries around it have investment grade rating, I can see the attractions of trying to re-acquire it. I can see that fiscal rules have some potential significance but when you can get hit by fiscal shocks, whose severity nobody could have

2 In the words of Gordo: "In the case of the euro area …, fiscal data have been taken from a newly available quarterly fiscal data set compiled by Paredes *et al.* (2009). They employ intra-annual fiscal data, mostly on a cash basis, in a mixed-frequencies state space model to obtain quarterly fiscal data for the aforementioned period [1981 Q1 to 2007-08 Q4]" (p. 521).

anticipated, I would take the view that fiscal rules need to be supplemented by very clear escape clauses and also by a requirement on governments to be transparent and give explanations.

Finally, returning to the data manipulation problem, we know that if governments are tied in by what they perceive as arbitrary rules unconnected with present circumstances, they will find ways to circumvent them. While understanding why Colombia would be attracted to fiscal rules in terms of its international profile, I would reinforce the general point that transparency about what is happening is just as important as fiscal rules.

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