Fiscal Rules:
Some Lessons from International Experience

Barry Anderson

Statement before the

National Commission on Fiscal Responsibility and Reform

Washington, DC

July 28, 2010

Outline

- A Note About Me
- Characteristics of Budget Systems
- A Better Fiscal Rule
- Two Examples of Rules That Limit Spending
  - The Swiss “Debt Brake”
  - The Swedish Medium Term Budget Framework
- Final Observations

A Note About Me

- Nearly 40 years in Budgeting
- US Experience: 1972-2003
  - **GAO**: Program Evaluator, 1972-80
  - **OMB**: Senior Career Civil Servant: 1980-98
  - **CBO**: Acting & Deputy Director: 1999-2003
- International Experience: 2003-2010
  - **IMF**: Budget Advisor, 2003-5
  - **OECD**: Head of Budgeting Division: 2005-10
- Private Consultant on Budget Issues: 2010

Characteristics of Budget Systems

- Characteristics Predetermined by the Country's Overall Political Framework
  - Presidential or Parliamentary
  - Federal or Unitary
- Characteristics Determined by Political Choice
  - Cash or Modified Cash or Accrual (including Budgeting for Capital and for Credit)
  - Gross or Net Expenditures
  - Years the Budget Covers
  - Top Down or Bottom Up Budget Formulation
  - Budgeting for Emergencies
  - Mechanisms to Utilize Performance Information
  - Fiscal Rules

A Better Fiscal Rule: Rules Reviewed

- Deficit-Based Rules (Summarized in “Design Choices for Fiscal Policy Rules”, Barry Anderson & Joe Minarek, *OECD Journal on Budgeting*, Volume 5, Number 4.)
  - European Monetary Union, 1999-current
  - Netherlands, 1989-1994
  - US (Gramm-Rudman-Hollings), 1985-90
- Spending Rules (Summarized in the paper above)
  - Finland, late 1980s - current
  - Netherlands, 1995 - current
  - Sweden, 1997 - current
  - US (Budget Enforcement Act), 1991-2002
- Other Rules (Reviewed but not summarized in the paper)
  - Switzerland
  - Chile, Norway, UK & several Latin American countries

Why A Spending Rule Is Better

- Deficit-based rules are inherently pro-cyclical; spending rules (including tax expenditures) are inherently counter-cyclical.
- The ability to successfully adjust a deficit-based rule for the cycle is unproven and, at best, can only mitigate the pro-cyclical bias of the rule.
- Spending rules work best in good times; deficit-based rules don’t bind in good times & are nearly impossible to support when times are bad.
- Violations of a spending rule are transparent & incontrovertible; non-compliance with a deficit-based rule can be hidden. In sum, spending rules are more credible & understandable.

Major Elements of a Spending Rule

- **Targets**: the goal of a spending rule is to better achieve a deficit (or debt) target but the specific choice of a target is more a political decision than an economic one.
- **Economic Assumptions**: must be independent.
- **Coverage**: must include tax expenditures.
- **Time Frame**: the longer, the better.
- **Enforcement**: sequesters should be designed to penalize all forms of government aid (discretionary and mandatory spending, and all taxes) not as a substitute for policies but to encourage compliance.
- **Flexibility**: carefully-defined safety valves for recessions, wars, & natural disasters can help. “Cushions” or “buffers” can also be used if they are centrally controlled.

The Swiss “Debt Brake”

- **Target**: budget balance over the business cycle
- **Mechanism**:
  - **Spending** one year ahead is **capped** at predicted **revenues** for that year **adjusted** for predicted stage in the **cycle**; that is, if “trend” GDP > predicted GDP (i.e., a downturn), spending can be increased.
  - **Historical data** is used to estimate “trend” GDP.
  - **Errors** from bad estimates or breaking the limits are to be eliminated, but no time limit or enforcement process is specified.
- **Parliament** can change the level or composition only with a “qualified” majority.
- Limits can be exceeded under “**exceptional circumstances**” but these are not defined.

Some Comments on the Swiss "Debt Brake"

- The focus is short term balance, not long-term debt sustainability.
- The are very few, and no strong, enforcement provisions.
- The method to eliminate additional debt accumulated because of forecast errors or deliberate overspending is not specified and may end up being pro-cyclical.
- Unlike the constraints of the BEA, unforeseen upswings can permit additional spending.
- But most of all, the ability to accurately predict the stage of the business cycle is limited, at best.

The Swedish Medium Term Budget Framework (MTBF)

- Target: A surplus of 1% of GDP (originally 2%) over the business cycle that contributes to:
  - Long-term sustainability
  - Smoothing the cycle & providing for new initiatives through a buffer
  - Intergenerational equity
  - Economic efficiency
- Mechanism:
  - Rolling 3-year expenditure ceilings set by Parliament that include buffers of 1.5, 2, & 3% in years 1, 2, & 3
  - Strong top-down budget control
  - Transparency (ex., comprehensive & all items are reported gross)
  - External monitoring of compliance by the Fiscal Policy Council & others
  - Local government balance
  - Most of all, strong political support for the process

The Swedish MTBF: Some Comments

- The focus is mostly **long-term**.
- The Swedish process has been **successful** in contributing to the **conditions for economic growth** (including relative good predictability of fiscal policies & low interest rates) & **limiting spending** over the last 13 years--**in both good times & bad**.
- **Tax expenditures** are not explicitly covered.
- **Enforcement** of the process rests entirely on the strong political commitment to it.
- The importance of **predictions of the cycle** is relatively small.

Final Observations

- <u>Political commitment</u> is paramount (see, for example, what happened at the end of the BEA).
- A spending rule & a deficit-based rule can coexist, but only one can be <u>controlling</u>.
- A spending rule should be based on <u>realistic deficit or debt targets</u>.
- A spending rule can (& should) cover <u>*all* spending</u>--discretionary, mandatory, & tax expenditures.
- No rule is forever, but a <u>longer rule</u> & especially a <u>longer commitment</u> are better.
- Transparency & <u>simplicity</u> matter.