UDC: 336.02
Keywords: fiscal policy – fiscal rules – public budgets

Fiscal Policy: Too Political?

Petr HEDBÁVNÝ* – Ondřej SCHNEIDER**

1. Introduction

Perhaps surprisingly, fiscal policy has emerged as the most pressing economic policy issue in both developed and emerging countries in the early 21st century. The 1990's saw a considerable consolidation of fiscal positions in most countries. The European Union, prodded by the desire of its members to qualify for eurozone membership, experienced very robust consolidation whereby the year 2000 was the first (and last) in which the eurozone ran a balanced budget. The United States propelled by its burgeoning economy had even managed to switch its budget into surplus by 2001. Even emerging economies seemed to be on their way to a more responsible fiscal policy, as they cut their public debt from an average of 68 % of GDP in 1993 to less than 60 % in 1997 (IMF, 2003).

However, in the late 1990's and early years of the new millennium the picture changed dramatically. The EU countries' penchant for fiscal restraint vanished as they had attained the prized euro membership and the eurozone is now back to the bad old days as its average public deficit stood at -2.2 % of GDP in 2002 and is expected to remain at 2.5 % of GDP in 2003 and 2004 (EC, 2003). The US suffered an economic slowdown coupled with heightened security expenditures and its public budgets experienced one of the most rapid deteriorations in history as its deficit in 2003 will reach 5–6 % of GDP. Following Argentina's collapse, emerging countries have begun to accumulate deficits again and by 2002 the average debt of 32 emerging markets represented in an IMF study stood at 71 % of GDP (IMF, 2003).[1]

Transition countries have always been a little different. They started the 1990's with high public spending, highly distortive and arbitrary tax systems and with a radical re-adjustment of their economies. The fiscal pressures that resulted from this mix were enormous and most transition countries, sooner or later, experienced severe fiscal problems. As a group, however, the Central and Eastern European countries managed to cut the public debt from more than 100 % of GDP in 1992 to less than 60 % in

* Institute of Economic Studies, Faculty of Social Sciences, Charles University, Prague (hedbavny@mbox.fsv.cuni.cz)

** Institute of Economic Studies, Faculty of Social Sciences, CharlesUniversity, Prague, and the Institute of Economic and Social Analysies, Prague (schneider@mbox.fsv.cuni.cz)

[1] The sample of 32 countries consisted of the 27 countries from the J. P. Morgan Emerging Markets Bond Index (dominated by the Latin America, but including countries from Eastern Europe, Asia, Africa and Middle East), plus India, Israel, Jordan, Costa Rica and Indonesia.

2002. This positive development was facilitated by some generous debt underwriting in the case of Poland and fiscal consolidation in Russia powered by high oil prices.

More recent trends among transition countries are more worrisome, however. The eight Central and Eastern European countries that are about to join the European Union – Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – have recorded public deficits at about 4 % of GDP. Some of the most advanced countries in this group have seen deficits as high as 10.4 % of GDP (Slovakia in 2000) or 9.2 % of GDP (Hungary in 2002). The average (unweighted) deficit in 2002 of these eight countries stood at 4.1 % of GDP, i.e. on an accelerating debt/GDP ratio path.[2]

The Czech Republic has experienced one of the most dramatic fiscal developments. Long cherished for its prudent fiscal stance, the country became a pariah in 1997 and 1998 when hidden imbalances emerged.[3] It expects to reach the highest deficit among EU members-to-be in 2003 (7.6 % of GDP) and according to its government's official fiscal strategy Czech public budget deficits should remain the highest among this group until 2006. The Czech government does not expect to satisfy the EU's fiscal criteria of 3 % GDP deficit as the maximum even by 2007.

The editors of the journal *Finance a úvěr – Czech Journal of Economics and Finance* have thus had many reasons to devote this volume of the journal to the issues of fiscal policy with particular attention to the Czech Republic. This brief paper opens the volume with an analysis of the role of fiscal rules and their advantages and pitfalls. The paper illustrates that the Czech fiscal framework is insufficient and requires a rigorous overhaul.

The following paper by *Bezděk, Dybczak and Krejdl* analyzes Czech structural budget deficits. The authors use two alternative methods for estimating the structural budget deficits, as applied by the European Central Bank and by the OECD. They show that both methods yield very similar results for the Czech Republic. The Czech cyclically adjusted budget position has been worsening, and the Czech fiscal policy has been highly pro-cyclical, exaggerating business cycle swings.

The structural balance of public budgets always reflects the expenditure and revenue sides of a budget. The two following papers analyze these in turn. *Michal Ježek* shows that the Czech pension system, the largest expenditure program, is highly inefficient and its overhaul, namely by introducing private savings, would significantly improve both the fiscal position of the state and the well-being of pension system participants. Any future adjustment in public budgets will have to deal with the public pension scheme and Ježek's paper indicates a possible route for reform.

Salí, Schneider and Zápal[4] analyze the Czech tax system, namely taxation of personal and corporate income. The authors show that the low labor flexibility allows relatively high taxation of labor. They also estimate

---

[2] Data from the individual countries' Pre-accession Economic Programmes – see the EU web page.

[3] For details see (Drabek – Schneider, 2000) or (Schneider – Štěpánek, 2001).

[4] This paper is published in Czech, as the issue is very relevant for Czech policy makers and as the underlying research was done in Czech.

the tax burden that falls on capital and labor and show that capital probably bears more than a proportional tax burden in the Czech Republic. The authors argue that this leads to under-investment and a lower long-term growth rate.

The last paper, authored again by *Bezděk, Dybczak and Krejdl*, shows very lucidly that the Czech public budgets face immense challenges rooted in the country's fast aging society. As the authors demonstrate, age-related expenditures (pensions, health care) will explode unless a radical reform is embraced and tax revenues may well decline as the labor force stagnates and then shrinks.

We believe that the five papers in this volume fill, at least partially, the long felt gap in the Czech economic literature. Fiscal policy does have a crucial impact on the Czech Republic's economic developments and it indeed has become the single biggest threat to long-term prosperity of the country. We would like to believe that the papers in this volume will mark a turning point in the fiscal policy discussion in the Czech Republic and will stimulate further research.

The rest of this introductory paper is organized as follows. First, we provide a rationale for introducing fiscal rules that would bind government's hands. Second, we give a basic classification of quantitative (numerical) fiscal rules, describe the most discussed rules and provide a brief assessment of them. In the third part, we discuss institutional reforms that may prevent excessive deficits. We conclude with a brief discussion of the current and proposed fiscal rules in the Czech Republic.

2. Rationale for Fiscal Rules

If the 1990's might have led some economists to believe that governments' bias toward deficits[5] was overcome, the current situation proves them wrong. Governments are as conducive to deficit as ever. The economic theory, and practice as well, shows that permanent and high deficits lead to excessive public debt, crowd out private investments, increase interest rates and make the government macroeconomic policy highly inflexible. Thus it is highly relevant to look at policy alternatives that may prevent excessive budget deficits.

As discretionary fiscal policy tends toward pervasive deficits, an apparent candidate is a rule-based system whereby fiscal policy would be subject to an external limit. While this limit might vary (annual deficit, total debt, cyclically adjusted deficit...) it inevitably restricts the freedom of policy-makers and limits the politicians' reign. This makes fiscal rules very controversial and susceptible. What government would like to be subject to an external rule? As the current row about France's breach of the Stability and Growth Pact illustrates all too vividly, politicians despise any external authority that may impose its preferences over the politicians' tendency to set budget deficits according to their (rather short-term) goals.

[5] For a detailed discussion of the governments' tendency for deficits see (Kydland – Prescott, 1977) or (Buchanan – Wagener, 1977).

And still, were not the governments similarly beleaguered 20 or so years ago when monetary policy was taken from them and vested in independent central banks? As politicians, especially in Europe, were not trusted to run prudent monetary policy, the power to set interest rates and intervene in currency markets was transferred to non-elected technocratic institution, with some oversight from parliaments. This transfer has proved to be successful, as independent central banks have been able to run monetary policy in a less myopic and more predictable way than politicians.

Why should fiscal policy be any different? Certainly, fiscal decisions lie at the heart of any government policies. Politicians win or lose elections on their promises to increase spending on particular programs or to introduce tax preferences. Inefficient as it often is, this political process should not be eliminated. Government will always have the ultimate authority to set taxes and spend revenues. However, they do not need to do so without any limits. As we show below, it may be perfectly compatible with democracy for governments to accept *overall* limits on spending and set their structure according to its political preferences. Or governments may be told only what a deficit (or surplus) must be and then decide on the amounts to raise through taxes and spend on various expenditure programs. Such a mechanism would let governments redistribute from the rich to the poor as much as they deem fair and would let them finance defense and all other expenditures programs. It would only expose governments to hard budget constraints.

It is evident that in the long-term everybody benefits from a prudent fiscal policy, as it spares the economy from high interest costs, crowding-out effects and other negative consequences of high deficits. However, in the short-term, every government may be tempted to use a fiscal stimulus to gain politically. This is a parallel of the argument of time-inconsistency of government monetary policy that eventually led to a separation of monetary policy from the government. If the government is not the best policy-maker in the monetary policy area, why should it be unconstrained in the other main macroeconomic policy tool, fiscal policy?

Indeed, even now many countries pursue different fiscal rules.[6] The United States uses nominal caps on discretionary spending while Britain uses the "golden rule". Perhaps most famously, the European Union has adopted the Stability and Growth Pact that limits national budget deficits and can even punish countries that exceed the limit of 3 % of GDP.

The main objective of such rules is to reinforce the credibility and predictability of macroeconomic policies. In other words, fiscal rules are usually aimed at mitigating the democratic government's tendency to abandon previous policy commitments. Thus fiscal rules are particularly helpful if the government is not able to persuade economic actors that it will conduct a prudent fiscal policy although the government is committed to do so.

[6] In this paper a fiscal policy rule means a permanent constraint on fiscal policy, expressed in terms of an indicator of overall fiscal performance, such as the government budget deficit, borrowing, or debt (i.e. we follow the definition of Kopits and Symansky (1998)). A rule is often expressed as a numerical target for a public budget deficit or debt as a share in GDP.

Fiscal rules are sometimes criticized for being redundant, for representing an unnecessary bureaucratic obstacle and also for being conducive to misuse via “creative accounting”. However, even as an imperfect tool, fiscal rules can play a positive role. They introduce a long-term horizon to the government’s often shortsighted decision making. Fiscal rules also “guide” financial markets, the ultimate source of fiscal discipline for governments, as strict transparency requirements are identified as a common denominator of efficient rules[7]. Without such a guide, financial markets react to a change in fundamentals with a considerable time lag and they impose high costs (sudden capital outflow, high risk premium) on the government that departs from a prudent fiscal policy.

In order to guide fiscal policy successfully, fiscal rules should be forward oriented and should incorporate increasing pension entitlements stemming from aging populations.[8] Fiscal rules should also encompass various quasi-fiscal transfers and programs that are used to mask the true size and effects of fiscal policy. Some authors also argue that fiscal policy rules should take into account the risk of fiscal revenues and expenditures and use more sophisticated financial methods to estimate the “value at risk” of a fiscal policy (Barnhill – Kopits, 2003).

Taking account of the preceding criticism, an ideal fiscal policy rule should have – according to Kopits and Symansky (1998) – the following properties: it must be (i) well-defined in terms of the indicator to be constrained, institutional coverage and escape clauses, (ii) transparent regarding accounting conventions, forecasts and reporting practices and (iii) simple. Furthermore, it should be (iv) adequate with respect to the ultimate goal and (v) flexible so that in the case of an unexpected macroeconomic shock it does not hinder the achievement of the goal. Finally, the fiscal rule like any rule has to be (vi) enforceable, (vii) internally consistent and in accordance with other policies and, finally, should be (viii) reinforced by structural reforms so that the whole fiscal framework is not seriously endangered by increasing budget liabilities (e.g. implicit pension debt).

There are two main types of fiscal rules: (a) numerical rules, such as permanent constraints on the budget balance, borrowing or debt of central and local governments and (b) “institutional” proposals aimed at curing the causes of excessive deficits by promoting responsible fiscal behavior. We deal with these two groups in turn.

3. Quantitative Fiscal Rules

Numerical (quantitative) fiscal rules can be divided into four main categories: budget balance rules, expenditure rules, borrowing rules and debt rules. We will concentrate on the first two categories.

A budget balance rule can be defined as the requirement to meet overall balance, current balance (i.e. the golden rule) or operating balance each

[7] See (Craig – Kopits, 1998) on transparency in fiscal policy.

[8] More on the issue of implicit pension debt in (Schneider, 1999) and also (Bezděk – Dybczak – Krejdl, 2003b).

year. The requirement can be set for a number of years, and then the rule deals with a structural (i.e. cyclically-adjusted) balance. A further modification is the permanent balance rule, which requires that the inflation-and--real-growth adjusted permanent government budget be in balance. We will turn our attention to two proposals recently discussed in the literature: the golden rule and the permanent balance rule.

3.1 The Golden Rule

Under the golden rule[9] borrowing is allowed to finance public investment, that is:

$$b_t{}^* + k_t = 0 \tag{1}$$

in each period t, where b^* denotes overall budget balance and k stands for (capital) public investment. The budget is therefore split into current spending and investment spending.

The benefits of the golden rule are the biggest in the periods in which current generations have to shoulder the costs of new investment and pay interest on past debt at the same time. The dual approach to current and investment expenditures facilitates the financing of expensive projects (e.g. infrastructure investment) while the costs are spread across generations. The golden rule also mitigates the efficiency loss stemming from distortionary taxation which accompanies the tax rate fluctuations over time.

Major criticism of the golden rule can be summarized into the following three points. First, the rule should take into account depreciation (δ):

$$b_t{}^* + k_t - \delta = 0 \tag{2}$$

since to achieve tax smoothing over time, net public investment needs to be spread across generations. However, this would pose additional difficulty since commonly agreed estimates of amortization are unavailable.[10]

Second, a dual approach to expenditures may result in excessive expenditure on physical assets, as these would be exempted from the official budget deficit. Other expenses (e.g. education) would be discriminated against and the golden rule could lead to a worsening of public good provision. Finally, the existence of two budgets with unequal treatment in terms of deficits might stimulate creative accounting on the part of government. Such practices would probably negatively affect the country's growth prospects – see (Craig – Kopits, 1998).

3.2 Permanent Balance Rule

The permanent balance rule proposed by Buiter and Grafe (2002)[11] requires that the inflation-and-real-growth adjusted permanent government budget be in balance.

[9] The following discussion is based on (Buti et al., 2003).

[10] New Zealand fiscal rules represent a unique effort to include depreciation estimates into government budget reports. No other country has followed the New Zealand example so far.

[11] This subchapter draws substantially on (Buiter, 2003).

The permanent balance rule can be expressed in the general government's intertemporal budget constraint:

$$\overset{g}{b}_{t-1} \leq \sum_{j=t}^{\infty}\prod_{s=t}^{j}\left(\frac{1+n_s}{1+r_s}\right)(\overset{g}{\tau_j} + \theta_j - g_j) = \sum_{j=t}^{\infty}\prod_{s=t}^{j}\left(\frac{1+n_s}{1+r_s}\right)\sigma_t \tag{3}$$

where $\overset{g}{b}_{t-1}$ is the share of total government interest-bearing debt B^g in GDP,

n_s is the growth rate of real GDP,

r_s is the domestic real interest rate,

$\tau_g \equiv \dfrac{T^g}{Y}$ is the share of the real government tax receipts T^g in GDP,

$\theta \equiv \dfrac{\Theta}{Y}$ is the share of total gross financial returns earned by the government on its capital stock Θ in GDP,

$g \equiv \dfrac{G}{Y}$ is the share of government spending G in GDP.

Budget surplus as a fraction of GDP, σ, can be expressed as $\sigma \equiv \tau_g + \theta - g$. Thus the general government is solvent if its gross financial debt is not greater than the present discounted value of current and future primary surpluses. The rule is a tax smoothing one. Its authors accentuate that it allows for any departures of current public spending from permanent public spending. Therefore automatic fiscal stabilizers can operate freely and symmetrically.

However, the permanent balance rule requires unbiased estimates of future tax receipts and spending levels, which are difficult (if not impossible) to estimate without reliable estimates of future social and political preferences. Furthermore, the rule requires anticipation of future real growth rates of the economy. The rule is thus exposed to political risks, as it is tempting for a government to raise its official "forecasts" to justify high current spending.

For transition countries another worry is relevant, i.e. that a high volatility of GDP growth may make a permanent balance rule very unoperational, as the volatile growth rates render any estimates of business cycle position and long-term trends very difficult.[12]

3.3 Expenditure Rules

Expenditure rules refer to budgetary items the government can control and be made responsible for since expenditure is less responsive to busi-

[12] Indeed, Coricelli and Ercolani (2002) argue that the high output volatility of transition countries' GDP makes it more likely that they will find it more difficult to comply with the current Stability and Growth Pact rules. On the other hand, Bezděk et al. (2003a) show, that the Czech Republic budget has a lower sensitivity vis-à-vis GDP fluctuations.

ness cycles than revenues. Expenditures should grow in line with a consistent and sustainable trend and the business cycle will demonstrate itself in the revenue side. Also, expenditure rules allow automatic stabilizers to work and thanks to their simplicity they are easily defined and monitored. Expenditure rules can either apply to nominal or real targets. In terms of coverage they can set a limit on primary expenditure, wage (and pension) expenditure, and also debt service.

Recently, Coricelli and Ercolani (2002) have proposed the introduction of an expenditure rule intended for the enlarged European Union. The rule targets structural deficit close to balance and focuses on nominal expenditure.

The ex ante balanced budget rule is defined as follows:

$$sR(1+\pi^{*}_{t+1}) + cR^{s}\left\{1+\varepsilon_{cR;Y}\left[(1+\dot{Y}^{r*}_{t+1})(1+\pi^{*}_{t+1})-1\right]\right\} = R^{f}_{t+1} = E^{f}_{t+1} \tag{4}$$

where: cR^{s} is the component of revenues linked to the cycle at time t,

sR are revenues not linked to the cycle at time t,

$\dot{Y}^{r*}_{t+1}$ is the percentage change of potential output,

π^{*}_{t+1} is the inflation target,

R^{f}_{t+1} is the nominal value of total revenues for the time t+1, decided at time t,

E^{f}_{t+1} is the nominal value of expenditures, excluding unemployment benefits, for the year t+1, decided at time t and

$\varepsilon_{cR;Y}$ stands for the elasticity of the cyclical component of revenues with respect to GDP.

The targeted level of expenditures excludes unemployment benefits, which further lowers sensitivity of the targeted variable to cyclical movements. The rule accounts for cross-country differences in the growth of potential output. Therefore a country with a higher growth of potential output can run higher deficits during an economic downturn.

Buti et al. (2003) note that expenditure rules cannot prevent deficit and debt increases resulting from tax cuts. That is why they suggest complementing the expenditure rule with a deficit or debt rule. In the case of a country heavily in deficit, the expenditure rule should entail a consolidation factor whereby expenditures would grow at a lower rate than (the long-term) rate of revenues, thus eventually eliminating a deficit.

4. Institutional Fiscal Reforms

Institutional fiscal reforms try to modify the framework in which fiscal policy is carried out and thus limit the causes of excessive deficits. Most typically, institutional reforms may substantially redefine policymakers' powers or take into account the progress of structural reforms. In an extreme version, this may entail shifting a part of the fiscal policy setting from the government to an independent authority. More timidly, institutional (procedural) reforms may strengthen the position of the finance ministry to spending ministries.[13] Lastly, institutional reforms may enhance the resistance of domestic financial markets to shocks and thus decrease the possibilities to burden domestic financial markets with excessive debt.[14]

There are several proposals for deep institutional reforms – for example (Wyplosz, 2001), (Eichengreen, 2003) and (Gleich, 2003). They are often inspired by an institutional setup of monetary policy whereby the policy-making is insulated from politicians' short-term preferences.

4.1 Fiscal Policy Committee – Wyplosz (2001)

Wyplosz defends the notion that counter-cyclicality of fiscal policy may be suppressed by artificial and excessively rigid numerical rules. He suggests concentrating on building institutions that create the proper incentives for and set the right constraints on politicians. In order to credibly combine long-term commitments with short run flexibility in the realm of fiscal policy, he calls for the creation of an independent body with a clear mandate and insulated from the "temptation and pressures of political life", a body similar to the monetary policy committee.

Wyplosz underlines the distinction between the macroeconomic side of fiscal policy and the allocative and structural aspects of fiscal policy. He maintains that only the latter aspects need to be decided in the political arena. A newly created institution, the Fiscal Policy Committee (FPC) would be responsible for the macroeconomic side of fiscal policy. The FPC would set the level of budget deficit (surplus) ahead of the government budgetary cycle and the constraint on budget balance would be a binding one. It would decide on the basis of a debt sustainability constraint defined over a number of years. The FPC would be accountable to parliament.

Wyplosz also discusses an institutional arrangement similar in spirit to the FPC. The Court of Wise Persons would differ from the FPC in one crucial thing: its decisions would not have the power of law. Wyplosz concludes that such internal peer pressure may only work in very open societies with high moral standards in politics.

Buti et al. (2003, p. 15) question the feasibility of Wyplosz's proposal. They maintain that "[...] it is hard to conceive that a minister of finance would delegate part of fiscal policy authority to an independent agency".

4.2 Two-tier Stability Pact – Eichengreen (2003)

Eichengreen (2003), like Wyplosz (2001), focuses on fundamental fiscal institutions rather than transitory fiscal outcomes. He identifies the follow-

[13] Procedural rules concern the presentation, adoption and execution of government budgets. Hierarchical procedures where the finance ministry dominates are conducive to greater fiscal discipline than vertical ones. Limiting the parliament's power to amend the government's budget proposal has the same effect, but is rather inconsistent with democratic principles.

[14] A fast-rising government debt is potentially dangerous for the domestic banking sector if there is a low degree of diversification of government debt on the side of domestic banks. Buti et al. (2003) recommend assigning the government's debt a risk greater than zero and placing them in the corresponding risk category. Secondly, they call for making the so-called large exposure directive (no more than 25 % of the bank's capital can be lent to a single borrower) applicable to the government, as well. Not surprisingly, both these proposals meet strong resistance from banks as they would increase their costs.

ing problematic institutions, which can potentially endanger the health of fiscal policy: public enterprises, unfunded pension systems, labor market and social welfare programs and budget-making institutions that create common pool and free rider problems.

Eichengreen looks for an alternative arrangement to current numerical thresholds in the Stability and Growth Pact, which lack clear economic rationale and are excessively uniform for European Union member countries. As a potentially feasible solution, he proposes to supplement current numerical rules with an index of institutional reform. The respective binary indices would mirror the development of future pension system liabilities, the (non-) existence of appropriate fiscal institutions and the state of labor market reforms. A country would then be exempt from the 3 per cent limit on current budget deficit if the country's pension system, fiscal institutions and labor market arrangements were "sustainable enough". Should it not be the case, the country would be subject to the 3 per cent ceiling.

The indices constructed by Eichengreen are partly based on indicators developed by Hallerberg, Strauch and von Hagen (2001). Eichengreen concedes that such an institutional index is context specific. Thus he proposes that an independent committee of fiscal policy experts would define the index (indices). The committee would also have the right to adjust the index, should the index lose some rationale over time.

Gleich (2003) contributes to this approach by creating an institutional index of budgetary processes and applies it to transition countries. He shows that countries with institutions conducive to coordination in budgetary policy, a strong position of the finance ministry and limited autonomy of spending ministries (as Estonia) tend to have lower budget deficits than countries with many competing spending ministries and a strong parliamentary role in budget-making (as Romania).

5. European Fiscal Rules and the Czech Fiscal Quagmire

The fiscal rules discussed above could be used either in a national or international context. The latter requires, on top of the individual countries' adherence to the chosen fiscal rule, coordination among the countries that make the international entity. The most obvious example of an international fiscal rule mechanism is the European Union's Stability and Growth Pact (SGP). The Pact, established as a supporting mechanism for the new European currency, the euro, was meant to introduce and maintain fiscal discipline to European governments that wanted to use the euro.

However, the Pact has been criticized for its rigidity[15] and it remains to be seen whether the European Commission that is formally vested with the right to reprimand countries for running too high a deficit will have the power to take on the two largest eurozone countries, i.e. Germany and

[15] See, for example, (Buiter, 2003).

France. France is the first country that is set to exceed the 3 % of GDP limit for budget deficits in three consecutive years. This should, in theory, trigger a harsh reaction from the Commission that may culminate in imposing France huge fines. However, in this respect the SGP probably fails on one of the key requirements for an ideal fiscal rule: it is not enforceable. France seems determined to ignore the Pact rules and there is no independent power that would make France adhere to the rules.

The main weakness of the SGP lies in its asymmetric nature: it prevents governments from running a deficit above the 3 % of GDP threshold in bad times but it does not penalize countries that run lower deficits during economic expansion.[16] There has been no shortage of proposals on how the SGP could be changed. We have discussed some of them above. The European Commission itself modified the SGP as it stresses that "structural deficits" are to be considered, as opposed to nominal values.

Many economists outside the Commission have suggested various reforms to the European budgetary process. The proposals vary from fundamental, institutional changes in line with the Fiscal Policy Committee's proposal discussed above[17] to parametric changes in the existing framework (Buti et al., 2003). European countries are instead turning to "creative accounting" techniques. Germany and France briefly advocated exempting defense spending from the Pact considerations. Italy favors "ring-fencing" of European investment programs that are supposed to kick-start the lethargic European economy. The European Investment Bank would become responsible for financing projects that are now included in national budgets.

Czech economists and politicians have a very particular comparative advantage in this respect. The Czech Republic has been most innovative in creating off-budget institutions and programs similar to the proposals of Italian Finance Minister Gulio Tremonti. We have seen hospital banks, stabilization funds, development funds, health-care spin-offs and many other tools that helped to maintain a mirage of fiscal prudence until the late 1990's when the whole structure collapsed. The costs to the taxpayer have been indeed dire, as a plethora of off-budget institutions and programs, often hidden from official financial reports and always prone to inefficient operation, have accumulated debt approaching 20 % of GDP.[18] These costs slowly dissipate into official deficits and hamper the Czech fiscal position even now as Bezděk et al. show in the paper in this issue (2003a).

The Czech experience thus warns against too creative fiscal arrangements. Using the country's complex fiscal set-up, the Czech government could have avoided a fiscal consolidation well until 1997 as the government often used off-budget institutions to finance expenditure programs that should have been included in the official budgets.

[16] Formally, the SGP calls for close to balance or slightly surplus budgets over the medium-term but there has been no tangible effort to reach balanced or surplus fiscal positions in the late 1990's when the European Union member-countries enjoyed strong economic growth.

[17] See also a modified golden rule for the European Union proposed by Blanchard and Giavazzi (2003).

[18] For details see (Drabek – Schneider, 2000) or (Schneider – Štěpánek, 2001).

At the same time, the Czech experience highlights the importance of transparency in fiscal policy and general government activities. Any government may be tempted to manipulate its fiscal books, either by a straightforward "cooking-up" of numbers or by using more sophisticated "estimation" methods. There are two possible ways to remedy this government tendency. A comprehensive set of fiscal rules that would compel the government to fully account for its net wealth and to account for full future costs of its current policies would be the "first-best" solution.

However, given the complexity of such a set of rules, a "second-best" solution of a highly transparent, but unsophisticated rule, as, for example, a nominal limit for budget deficits, could be considered. Such a rule shares all the features with the dreaded Stability and Growth Pact, but it does help to expose the government to a virtual hard budget constraint. Moreover, if adhered to for several years, such a nominal rule may become entrenched and thus become supportive for a prudent, anti-cyclical fiscal policy.

In this respect, the current proposals[19] to introduce medium-term fiscal plans and incorporate them into the traditionally one-year budgets in the Czech Republic represent a step in the right direction, but remain "procedural" rather than "institutional". The Czech Republic's abysmal standards of fiscal policy execution, whereby Parliament often dominates government, off-budget institutions spring out without any thought given to their self-financing abilities, and long-term issues of health care and pension provision are all but ignored, requires a more substantial reform.

The Czech Republic is one of the few countries that have no permanent fiscal rule whatsoever. There is no limit on budget deficit, no limit on public debt, no limit on tax revenues, and so on. The Czech Republic should, we argue, adopt a permanent fiscal rule limiting its deficit by a share of GDP (3 % of GDP is an obvious candidate). Such a rule should be accompanied by a requirement to run a balance budget over a business cycle.

This broad rule, inspired by the EU's Stability and Growth Pact must be, however, supported by two other institutional changes. First, budgetary procedures must be changed and made binding. As it stands now, the Czech government ignores the budget at the moment it is approved in the Parliament. There are no procedures that would force the government to adjust its budgetary policy if the actual budget differs significantly from the approved budget. The government does not report to the Parliament until the budgetary year is well over and forgotten.[20] This lack of procedures must be remedied if the government is to run a predictable and sustainable fiscal policy.

Second, the Czech Republic, and other transition countries as well, must find a flexible rule that will allow them to eliminate their huge budget deficits in an orderly manner. A modification of the expenditure rule as proposed by Coricelli and Ercolani (2002), with a regular elimination of a part

[19] See the Czech government fiscal reform reported at the Finance Ministry web: www.mfcr.cz.

[20] The budget is approved typically in November of the preceding year; its results are "discussed" only 18 months later when nobody cares about the "old" budget anymore.

of the deficit (say a $^1/_2$ percentage point annually) would be most appropriate. Although such a modification would conflict with one of the requirements of fiscal policy rules, i.e. its permanent character, it would facilitate the shift toward a sustainable fiscal policy.

6. Conclusions

In this paper we have demonstrated that fiscal policy has not yet lost its deficit bias. We argued that time inconsistency, present in all government actions, demonstrates itself in fiscal policy as strongly as it used to in monetary policy. We thus argued that the fiscal policy framework should, and could, be changed in a way emulating the separation of monetary policy from regular government intrusion.

The EU's Stability and Growth Pact is an attempt to incorporate fiscal rules into the European Union's economic policy setting. Some may argue that the SGP complicates the current economic recovery in Europe, as it limits (or rather is supposed to limit) governments' arbitrary fiscal policy stimuli. But that is a price worth paying for longer-term stability and prudence of European fiscal policy. The first storm should not wreck the SGP Project. Governments would be better advised to put their fiscal house in order, slash high expenditures and run surplus budgets. This would allow them to tolerate swings in fiscal position generated by business cycles. And it would also allow them to prepare for a fast increase in expenditures as baby-boomers head for their retirement and will draw public pensions and use public health care programs enthusiastically.

The argument for transition countries is more nuanced. These countries need fiscal discipline even more than "old" European Union members, as their fiscal systems are more susceptible to quick accumulation of debt. This vulnerability stems from higher volatility of budget revenues[21] and from the transition countries' still immature political system that tolerates non-transparent fiscal shenanigans.

Concentrating on the Czech Republic, we argued that it requires a substantial reform of fiscal rules. The country should adopt a permanent fiscal rule accompanied by a change of budgetary procedures and a rule that will guide it as the Czech Republic eliminates its high budget deficit.

Fiscal policy has become, as we argued above, a threat to long-term macroeconomic stability in most developed countries. The current regimes, where fiscal policy is mostly vested with elected officials, are flawed, as they lead to a deficit-biased fiscal policy. It is time to reconsider the proper role for arbitrary annual election-influenced political decision-making and to reevaluate which aspects of fiscal policy should be institutionalized outside the politicians' reign.

[21] See (Coricelli, 2003) for a detailed exposition.

LITERATURE

AUERBACH, A. J. (2003): Fiscal Policy, Past and Present. *NBER Working Paper,* no. 10023, October 2003.

Banca d'Italia (2001): *Fiscal Rules*. Rome, 2001.

BARNHILL, T. M. Jr. – KOPITS, G. F. (2003): Assessing Fiscal Sustainability Under Uncertainty. *IMF Working Paper*, no. 03/79, April 2003.

BEZDĚK, V. – DYBCZAK, K. – KREJDL, A. (2003a): Cyclically Adjusted Fiscal Balance — OECD and ESCB Methods. *Finance a úvěr – Czech Journal of Economics and Finance*, vol. 53, 2003, no. 11-12.

BEZDĚK, V. – DYBCZAK, K. – KREJDL, A. (2003b): Fiscal Implications of Population Ageing. *Finance a úvěr – Czech Journal of Economics and Finance*, vol. 53, 2003, no. 11-12.

BLANCHARD, O. J. – GIAVAZZI, F. (2003): Improving the SGP through a Proper Accounting of Public Investment. CEPR, *European Economic Perspectives Newsletter,* February 2003, no. 1.

BLINDER, A. S. (1997): Is Government Too Political? *Foreign Affairs* (New York), Nov/Dec 1997.

BUCHANAN, J. M. – WAGENER, R. F. (1977): *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York, Academic Press, 1977.

BUITER, W. H. – GRAFE, C. (2002): Patching up the Pact: Some Suggestions for Enhancing Fiscal Sustainability and Macroeconomic Stability in an Enlarged European Union. *CEPR Discussion Paper*, no. 3496. (available at: www.cepr.org/pubs/dps/DP3496.asp.)

BUITER, W. H. (2003): Two Naked Emperors? Concerns about the Stability and Growth Pact and Second Thoughts about Central Bank Independence. *CEPR Discussion Paper*, no. 4001. (available at: www.cepr.org/pubs/dps/DP4001.asp.)

BUTI, M. – EIJFFINGER, S. C. W. – FRANCO, D. (2003a): Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment? *CEPR Discussion Paper*, no. 3692. (available at: www.cepr.org/pubs/dps/DP3692.asp (January))

BUTI, M. – EIJFFINGER, S. C. W. – FRANCO, D. (2003b): Revisiting EMU's Stability Pact: A Pragmatic Way Forward. *Oxford Review of Economic Policy*, vol. 19, 2003, no. 1.

CORICELLI, F. – ERCOLANI, V. (2002): Cyclical and Structural Deficits on the Road to Accession: Fiscal Rules for an Enlarged European Union. *CEPR Discussion Paper*, no. 3672. (available at: www.cepr.org/pubs/dps/DP3672.asp (December))

CRAIG, J. – KOPITS, G. (1998): Transparency in Government Operations. *IMF Occasional Paper*, no. 158 (January 1998).

CREEL, J. (2003): Ranking Fiscal Policy Rules: The Golden Rule of Public Finance vs. the Stability and Growth Pact. *OFCE Working Paper,* no. 2003-4, July 2003.

DRABEK, Z. – SCHNEIDER, O. (2000): Size of the Public Sector, Contingent Liabilities, and Structural and Cyclical Deficits in the Czech Republic, 1993–1999. *Post-Soviet Geography and Economics*, vol. 41, 2000, no. 5.

EICHENGREEN, B. (2003): The Future of the European Growth and Stability Pact. *CESifo Forum*, 2003, no. 2, pp. 68–72.

European Commission (EC) (2003): *Public Finances in EMU 2003*. Directorate – General for Economic and Financial Affairs, Brussels, 2003.

GLEICH, H. (2003): Budget Institutions and Fiscal Performance in Central and Eastern European Countries. *European Central Bank, Working Paper*, no. 215 (February 2003).

HAGEN, J. von (1998): Budgeting Institutions for Aggregate Fiscal Discipline. (Bonn, Center for European Integration Studies) *ZEI Policy Paper*, no. B98-01.

HALLERBERG, M. – STRAUCH, R. – HAGEN, J. von (2001): *The Use and Effectiveness of Budgetary Rules and Norms in EU Member States.* (Report prepared for the Dutch Ministry of Finance.) University of Bonn, Justitute of European Integration Studies, June 2001 – mimeo.

IMF (2003): *World Economic Outlook 2003*. IMF, 2003.

INMAN, R. P. (1996): Do Balanced Budget Rules Work? U. S. Experience and Possible Lessons for the EMU. *NBER Working Paper Series*, no. 5838.

JEŽEK, M. (2003): A Microanalysis of Pension Reform: To Switch or Not to Switch in the Czech Republic. *Finance a úvěr – Czech Journal of Economics and Finance*, vol. 53, 2003, no. 11-12.

KOPITS, G. – SYMANSKY, S. (1998): Fiscal Policy Rules. *IMF Occasional Paper*, no. 162.

KOPITS, G. (2001): Fiscal Rules: Useful Policy Framework or Unnecessary Ornament? *IMF Working Paper*, no. 145.

KYDLAND, F. E. – PRESCOTT, E. C. (1977): Rules Rather Than Discretion: The Inconsistency of Optimal Plans. *Journal of Political Economy*, vol. 85, 1977, no. 3, pp. 473–492.

OECD (2002): *OECD Economic Outlook 72*. Paris, 2002.

SALÍ, M. – SCHNEIDER, O. – ZÁPAL, J. (2003): Zdanění práce a kapitálu – teorie a aplikace na českou ekonomiku. *Finance a úvěr – Czech Journal of Economics and Finance*, vol. 53, 2003, no. 11-12.

SCHNEIDER, O. – ŠTĚPÁNEK, P. (2001): A Looming Financial Crisis in the Czech Republic. In: Dabrowski, M. – Rostowski, J. (eds.): *The Eastern Enlargement of the EU*. Kluwer Academic Publishers, 2001.

SCHNEIDER, O. (1999): Implicit Public Debt of the Czech Social Security System. Center for Social and Economic Research *CASE* (Warsaw), *Working Paper*, no. 167, 1999.

WYPLOSZ, Ch. (2001): *Fiscal Policy: Institutions vs. Rules*. Report prepared for the Swedish Government's Committee on Stabilization Policy in the EMU (December 2001).

SUMMARY

JEL Classification: E6, H6
Keywords: fiscal policy – fiscal rules – public budgets

Fiscal Policy: Too Political?

Petr HEDBÁVNÝ – Institute of Economic Studies, Faculty of Social Sciences, Charles University, Prague (hedbavny@mbox.fsv.cuni.cz)
Ondřej SCHNEIDER – Institute of Economic Studies, Faculty of Social Sciences, Charles University, Prague, and the Institute of Economic and Social Analysis, Prague (schneider@mbox.fsv.cuni.cz)

The paper provides an analysis of the role of fiscal rules. The authors first provide a rationale for the existence of fiscal rules, namely to avoid a governmental bias toward budget deficits. The paper then surveys existing fiscal rules and analyzes their applicability in the context of the Czech Republic. The authors argue that the institutional arrangement of fiscal policy should mirror the arrangement that has emerged as regards monetary policy, namely a certain separation of powers in which an independent body would be responsible for setting the overall budget deficit level. In the case of the Czech Republic, the authors argue that the country needs a simple and transparent fiscal rule rather than a more sophisticated and seemingly more appropriate rule.