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Fiscal rules and institutions: Introduction

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Fiscal rules and the role of fiscal policy have been discussed and debated actively in recent years. This interest in fiscal policy follows after successful reforms of the monetary framework, with the implementation of inflation targeting and independent central banks. While monetary frameworks have moved from rules toward institutions that allow more flexibility, reforms of fiscal frameworks have typically focused on long-run sustainability and restricted short-run fiscal flexibility.

Recent research and policy discussions ask what role fiscal policy has in this new framework, what the effects of fiscal rules have been, and if fiscal institutions can be reformed along the lines of the monetary reforms. In the fall of 2007, the Economic Council of Sweden organized a conference on "Fiscal rules and institutions" to let some of the leading macroeconomic researchers address such questions. This issue of the *Swedish Economic Policy Review* contains the five papers presented at the conference.

In the first paper, *Peter Claeys* analyzes the behavior of Swedish fiscal policy since 1970. Claeys examines how the public budget surplus has reacted to the level of public debt, business cycle conditions etc. Henning Bohn (1998) demonstrated that fiscal policy is sustainable in the long run only if the budget surplus increases in response to increases in public debt. Claeys finds that Swedish fiscal policy did not satisfy the stability condition in the period 1970-2006, but that the typical reaction to debt accumulation was smaller surpluses or larger deficits in the public budget. A closer examination of the components behind the budget surplus shows that the problem is on the spending side; in addition to interest payments also public consumption and transfers have tended to increase in response to debt accumulation. Although Sweden reformed the fiscal framework and introduced

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strict budget rules in the 1990s, Claeys finds little evidence that the fiscal-policy reactions to debt accumulation has improved in recent years.

One may question if budget rules are at all effective since they are typically not specified in constitutions but designed and decided by the same governments that can choose to repeal the rules if they turn out to put severe restrictions on current policy. In the second paper, *Alan Auerbach* considers the experience with and without budget rules in the United States since the early 1960s. Auerbach finds some evidence that the budget rules have impacted on fiscal policy as long as they have remained in force, but he also notes a tendency for the budget rules to be repealed or reformed when becoming too incompatible with short-run policy objectives. As expected, he finds that in the periods prior to 1975 and after 1998, with no or limited budget rules, discretionary spending increases in economic downturns and with the general health of the public budget. Between 1975 and 1998, however, the reactions of discretionary spending to economic conditions varied with the details of the various budget rules that were then in force.

Auerbach also notes some distortions implied by inefficient design of budget rules. For example, fiscal policy became pro-cyclical under the inflexible annual restrictions in force in the late 1980s. Budget rules that focused on current spending and tax revenues may also have resulted in policies that raised the implicit long-term liabilities of the public sector.

Stefann Niemann and *Jürgen von Hagen* consider how fiscal policy interacts with monetary policy. They demonstrate that distortions may arise if fiscal and monetary policies are decided independently by a fiscal authority and a central bank, respectively. These distortions arise if two conditions are satisfied. First, the fiscal authority is impatient or has a short planning horizon. This impatience can be a result of politicians' risk of not being re-elected. Second, the central bank puts a high weight on inflation stabilization. This may be an intentional result of the government's attempts to overcome the inflation bias that arises if the central bank tries to exploit the short-run Phillips curve to push down the unemployment rate (Kydland and Prescott, 1977; Rogoff, 1985). Under these conditions, the fiscal authority accumulates inefficiently high levels of debt which results in the central bank letting inflation rise.

Based on their analysis, Niemann and von Hagen argue that an integrated view on fiscal and monetary policy is needed. Rules and institutions set up to limit distortions in monetary policy may result in new fiscal distortions etc. Clearly, however, any reform that reduces or eliminates the core problems—the fiscal impatience and the inability to commit to not exploiting the short-run Phillips curve—would be beneficial and reduce both the fiscal and monetary distortions.

In the fourth paper, *Allan Brunner* quantifies the fiscal effects of population aging in Sweden. It is well known that the populations in Sweden and most other countries are growing older and that, given current labor-market patterns, a smaller fraction of workers will have to support a larger fraction of old dependents. Calibrating a macroeconomic model with Swedish policies and demographic forecasts, Brunner finds dramatic fiscal implications. To balance the public budget year-by-year and maintain the current generosity in the welfare systems, public revenues must rise from 55 percent of GDP in 2004 to 70 percent in 2050 in Brunner's baseline scenario. Alternatively, to maintain a budget balance with constant tax rates, public expenditure must be substantially reduced.

In the final paper, *Charles Wyplosz* discusses more fundamental reforms of the fiscal framework. Budget rules surrounding fiscal policy in different countries typically do not address the underlying inefficiencies with impatience and similar political frictions. Instead of correcting the fiscal incentives—what fiscal authorities *want* to do—the rules restrict what fiscal authorities *can* do, and the rules imply an inflexibility that sometimes prevents efficient policy reactions.

Several economists (including Wyplosz, 2005) have argued that to achieve more flexibility, decision over some isolated parts of fiscal policy should be delegated to an independent Fiscal Policy Council, in parallel to how monetary policy has been delegated to independent central banks. Such suggestions have, however, been met with skepticism by politicians. Wyplosz summarizes the arguments for Fiscal Policy Councils and suggests some reasons for the politicians' resistance.

These five papers provide valuable insights into how to design good fiscal institutions. Hopefully the readers will find the contributions in this issue of the *Swedish Economic Policy Review* both informative and thought-provoking.

References

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