Public Expenditure Management Reform and Fiscal Consolidation in OECD Countries[1]

by

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Abstract

The past two decades have witnessed a remarkable fiscal consolidation among OECD countries. A defining characteristic of this recent fiscal adjustment is that it has been based primarily on expenditure restraint and fundamental changes in public expenditure management, with increasing adoption of fiscal rules, coinciding with major tax and tax administration reforms. Fiscal discipline has been directly pursued in number of ways, ranging from hard rules to consolidation plans both at individual country and regional level. Public expenditure reforms have been instrumental in underpinning new fiscal frameworks focused on debt ceilings and deficit targets, on expenditure rules, and on the overall transparency of fiscal management. After presenting some stylized facts on fiscal developments in OECD countries, the scope of this paper is to discuss the role public expenditure management reforms and their impact on fiscal consolidation and on the increasing adoption of fiscal rules.

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Contents

I. INTRODUCTION

Countries around the world have significantly improved their fiscal positions since the early 1990s. This development has been particularly striking in the advanced economies, where a number of countries have attained sizable surpluses for the first time in nearly half a century. Several factors may have underpinned this general strengthening of fiscal positions and fiscal institutions. The government's role in the economy expanded during much of the twentieth century, both in producing goods and services and, especially, in providing transfer payments. In the 1980s and particularly the 1990s, however, many countries appeared to change their view, preferring a more limited role of government. In addition, there may have been increased recognition of potential distortions arising from high rates of taxation and from the public sector's call on economic resources, including the financing needed to support ongoing deficits. Competitive pressures from the growing international integration of goods and capital markets, together with generally lower rates of inflation, may have further constrained government's ability to raise taxes, monetize deficits, and build up public debt.

A key issue looking ahead is whether this recent fiscal adjustment will endure or whether—as in the 1980s—it will be reversed during a future economic slowdown. There is some reason for optimism in this regard, but also a need for caution. On the positive side, empirical assessments of earlier fiscal consolidations have identified a number of factors that tend to be associated with durable adjustment. These include a focus on expenditure reductions rather than tax increases; cuts in transfer spending and in the public sector wage bill; and an urgent need to address high levels of public debt. Lower interest payments and capital outlays have also made an important contribution to the recent decline in expenditure, most significantly in Europe where, for example, a number of countries have seen sizable reductions in interest rate risk premiums associated with the introduction of the euro. Although revenue rose as a share of GDP in the 1990s, compared with the role of spending, its contribution to fiscal adjustment was much less than during similar efforts of the 1980s. Instead, the emphasis in many countries, particularly in Europe, has been on changing the tax structure, shifting from direct taxes on labor and capital income toward indirect taxes.

Public sector management reforms have helped improve the prioritization and control of public spending, contributed to greater fiscal discipline, and underpinned the strengthening of fiscal frameworks, including the increasing adoption of fiscal rules. Although these reforms should help sustain the recent wave of fiscal consolidation, these fiscal and institutional measures have yet to face the test of a cyclical downturn. As a further note of caution, substantial additional fiscal improvements from lower interest rates cannot be expected, and further reductions in capital outlays are not necessarily desirable. Recent experience with the new fiscal frameworks is too limited to identify which approach might best help to withstand prospective pressures for an expansion of spending over the short to medium term. Some further refinement of rules may also be needed—for example, to ensure ongoing emphasis on restraining discretionary expenditures.

After presenting some stylized facts on the recent wave of fiscal consolidation, this paper discusses the role of public expenditure management reforms in OECD countries and the impact they are likely to have in locking-in fiscal consolidation. In so doing, the paper also tries to assess their role in the increasing adoption of fiscal rules and frameworks. In particular, the paper review the factors that originated such reforms and led an increasing number of countries to shift toward output-oriented budgeting. This shift has had, and continues to have, important implications for budget accounting and reporting systems. As it will become clear in the paper, the emphasis on fiscal transparency has been at the core of most of these reforms. The paper concludes that public expenditure reforms have indeed played a role in making the recent wave of expenditure-led fiscal consolidation more credible by allowing the adoption of a second generation of fiscal rules and frameworks based on fiscal transparency and accountability. As a result, recent fiscal consolidation are unlikely to be reversed as quickly as the previous ones. Nonetheless, only a future cyclical downturn will provide the answer.

II. Fiscal Adjustment in OECD Countries: Stylized Facts

The fiscal positions of almost all industrial countries have improved markedly since the early 1990s (Figure 1). Only Japan has not contributed to this area-wide adjustment, reflecting the use of expansionary fiscal policy during much of the 1990s to promote and sustain economic recovery. Taken together, other industrial countries have seen an improvement in the overall structural balance of the general government of about 4½ percent of GDP (Figure 2).[3]

As primary surpluses began emerging toward the end of the 1990s, the overall government debt ratio has declined from its peak of about 75 percent of GDP. However, fiscal adjustment has not been as large in the euro area, where the overall surpluses that are now commonplace among other OECD countries have yet to be seen in the three largest member countries: France, Germany, and Italy (Figure 3).[4]

Since 1980, there have been two periods of fiscal adjustment (1983–89 and 1993–2000), separated by a period of fiscal expansion triggered by the economic slowdown of the early 1990s (Figure 4). Precise comparisons between the two periods of adjustment are complicated by the decline in inflation over this period and its differential impact on the various fiscal indicators.[5] Nonetheless, the two episodes differ in key respects:

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[3]The figures are based on OECD data sources and cover the original OECD member countries plus those that joined in the 1960s (Finland) and in the early 1970s (Australia and New Zealand). In addition to Japan and the new non-industrial country members of the OECD, Luxembourg, Switzerland, and Turkey have been excluded because comparable data are not available. All aggregate measures are weighted averages based on 1995 GDP and purchasing power parities as reported in OECD *Economic Outlook 68* (Paris: Organization for Economic Cooperation and Development, 2000).

[4]The groups are as follows: mainly Anglophone countries (Australia, Canada, New Zealand, the United Kingdom, and the United States); euro area countries; and northern European countries that do not participate in the euro area (Denmark, Iceland, Norway, and Sweden).

[5]A decline in inflation can affect the fiscal position through various channels, most notably through lower nominal interest rates. The primary fiscal deficit is less subject to such an effect and is therefore a more useful indicator for fiscal comparisons across periods with different inflation levels.

- The more recent fiscal adjustment has been the result of a sharp reduction in primary expenditure, especially wages and transfers, and a marked reduction in interest payments, especially in the euro area countries with relatively high levels of government debt;[6] in contrast, the fiscal adjustment in the 1980s was driven mainly by revenue increases.

- Debt dynamics in the 1990s have been favorably influenced by the emergence of primary surpluses, lower interest rates, and buoyant growth. In the earlier fiscal adjustment, government debt ratios generally increased, as primary deficits more than offset the effect of negative real interest rates. Recent trends have raised questions in the United States and elsewhere about the implications of a diminishing supply of government securities.

- Discretionary fiscal policies have played more of a role during the recent fiscal adjustment (Figure 4).[7] This may reflect the smaller size of automatic fiscal stabilizers in the 1990s, partly due to reforms that have reduced the overall progressivity of the tax system, lowered social benefits, and improved the targeting of benefits.[8]

- Changes in estimates of potential output growth in the second half of the 1990s should also be noted. In the United States, a portion of the improvement in the structural balance can be attributed to upward revisions to estimated potential output growth, as part of the increase in revenues and of the fall in spending that resulted from underlying improvements in the economy. Hence, the increase in the structural fiscal balance may overstate the extent of discretionary policy actions. Conversely, in the euro area, a decline in estimated potential output growth implies that the fiscal effort has been larger than shown by the change in structural balances.[9]

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[6]In the euro area, the move toward European Economic and Monetary Union contributed to reducing the real interest rate by enhancing the credibility of the exchange rate peg.

[7]According to the OECD methodology, the difference between the actual and cyclically adjusted (structural) balances, corrected for net interest payments, provides a measure of automatic stabilizers. The change in the structural primary balance measures the change in the stance of fiscal policy; see *OECD Economic Outlook* Sources and Methods at http//www.oecd.org/eco/sources-and-methods/index.htm. A discussion of the differences between the OECD, the European Union, and the IMF methodologies used in assessing the fiscal stance can be found in Bank of Italy, *Indicators of Structural Budget Balances* (Rome: Bank of Italy, 1999).

[8]This point is discussed in Paul van den Noord, “The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond,” OECD Economics Department Working Paper No. 3 (Paris: Organization for Economic Cooperation and Development, January 2000). The cyclical adjustment may not take full account of other factors, such as the stock market boom in the United States and related revenues from realized capital gains, together with the increase in effective tax rates as incomes increase.

[9]See “Growth Divergences in the United States, Europe, and Japan: Trend or Cyclical?” Chapter III of the October 1999 *World Economic Outlook*. Between 1994 and 2000, estimates of potential output in 1999 have increased by 1.7 percent in the United States and decreased between 1½ and 2 percent in the euro area. Assuming a revenue elasticity slightly higher than one and an elasticity of current spending in the range of 0 and ¼, and bearing in mind all the uncertainty surrounding potential output and elasticity measures, about ½ of a percent of GDP of the fiscal adjustment in the United States would be accounted for by higher potential

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A. Revenue contribution to fiscal adjustment

Unlike in the 1980s, revenue growth has made a relatively small contribution to the fiscal adjustment that has taken place since 1993. Revenue to GDP ratios rose only modestly in the 1990s in the euro area and mainly Anglophone countries, and generally stabilized in northern Europe (Figure 5). While revenue ratios from the business sector increased slightly across all countries, European countries have shifted toward taxing consumption, whereas in Anglophone countries direct taxation of households has risen.

The limited recent contribution of revenue increases reflected a wave of tax reforms that started in the United States, Canada, and the United Kingdom in the first half of the 1980s and then moved to other industrial countries. These reforms were directed at strengthening tax administration and improving the efficiency of the overall tax structure.[10] These reforms were motivated by the realization that during the previous decades the personal and corporate income marginal tax rates had become excessively high, penalizing incentives to work and invest while favoring tax evasion. Moreover, because of a host of tax incentives and concessions tax bases had been increasingly eroded and tax systems has become increasingly complicated to administer and to comply with.

By and large, tax reforms shared the following common features: lowering of marginal rates, and broadening of tax bases, with significant simplification of tax systems; addressing basic distortion in the taxation of capital; shifting away from sales to value added taxes; and strengthening of tax administration.

- Following the U.K. 1984 Finance Act and the U.S. 1986 Tax Reform Act, most OECD countries enacted structural changes in the personal and corporate income taxation. During the period 1985–1998 top personal income tax rates were reduced, on average, from 55 percent to 40.6.[11] In the same period the corporate tax basic rate (including surcharges) was reduced from 43.5 percent to 36.3 (Figure vv). In 1990 the countries with the highest and the lowest corporate tax rate were respectively Germany and Finland with 50 and 23 percent, while in personal income taxation the highest top rate was in The Netherlands with 60 percent, and the lowest top rate rate was in Switzerland with 13 percent.

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output, whereas euro area countries would have adjusted their structural balances by about two third of a percent of GDP more than would have been justified by changes in estimated potential output.

[10]A more detailed account of tax and tax administration reforms over the last two decades can be found in Ken Messere, "Half a Century of Changes in Taxation," *Bulletin for International Fiscal Documentation*, Vol. 53 (August/September 1999); Jeffrey Owens, "Emerging Issues in Tax Reform: the Perspective of an International Bureaucrat," *Tax Notes International,* Vol. 15 (December 1997); and Vito Tanzi, "Globalization, Tax Competition, and the Future of Tax Systems," IMF Working Paper 96/141 (Washington: International Monetary Fund, December 1998).

[11] The first substantial reduction of the personal income tax rates was in the UK in 1979 from 83 to 60 percent.

- To counter revenue losses, tax exemptions, relief, concessions, and credits were drastically reduced, including full tax deductibility of interest on mortgage and on consumer credit; capital gains and fringe benefits were brought under the tax base; and depreciation allowances were set closer to economic depreciation. The average number of income brackets under the personal income tax schedule was also halved, from 10 in 1986 to 5 in 1998, so reducing *bracket creep* phenomena.

- As a reaction to international tax competition triggered by the increasing mobility of capital, many OECD countries, starting with Denmark in 1987 and soon after Sweden, Norway and Finland during the early 1990s, have reduced the tax burden on capital income with a view to enhance tax neutrality on capital income accruing from different financial assets. In this connection, there has been a general shift toward a more favorable tax treatment for dividends, within nearly all OECD countries, the US being the notable exception, providing total or partial tax credit at shareholder level. Some EU countries have been moving away from a comprehensive income tax module towards a separate taxation of labor and capital under the personal income tax whereby capital income is subject to a lower flat rate than the basic corporate tax rate.[12]

- As to the taxation of consumption, the value added tax (VAT) was successfully introduced and became the main general consumption tax and revenue source during the last two decades.[13] As a partial offsetting measure to the downward trend in income tax marginal rates, VAT standard rates have been gradually increased from 13 percent at the moment of introduction to about 17 ½ percent in 1999. Other indirect taxes have increasingly reflected growing environmental concerns by differentiating excises on petrol based on its carbon content; by imposing new green taxes, such as the carbon tax introduced in most EU countries; and by increasing the tax burden on the use of motor vehicles.

Most of the measures described above simplified the tax systems, thus contributing to lower collection and compliance costs. At the same time, collection strategies moved to rely increasingly on voluntary compliance and self-assessment, on withholding taxes on employees' wages and salaries, and certain capital incomes. These trends were accompanied by new emphasis on tax audit, the setting up of large taxpayers units, and by enhancing communication and information technology. The broadening of the tax bases has also helped combating tax evasion and elusion (whether through transfer pricing, thin capitalization, or tax shelters), along with a move towards harmonizing income and social security tax bases.

B. Expenditure contribution to fiscal adjustment

The most striking feature of the recent fiscal consolidation has been the smaller amount of economic output accounted for by government expenditure. On average, general government

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[12] Denmark, Finland, Norway, and Sweden have introduced a dual income tax (DIT) regime between 1987 and 1993; Italy has introduced it in 1997.

[13] With the introduction of a VAT in Australia in 2000, the US remains the only OECD country without a VAT.

expenditure in the advanced economies (excluding Japan) declined by close to 6 percent of GDP during 1993-2000, with the sharpest reduction in the northern European countries (10½ percent of GDP). The bulk of adjustment has fallen on expenditure categories that contributed to the earlier long upward trend in the expenditure ratio: wages and salaries, current transfers, and interest payments (Figure 5).

- Expenditure on *wages and salaries* contributed substantially to the latest fiscal adjustments, largely due to a slowdown in government employment growth; these expenditures were almost constant as a share of GDP throughout the 1980s.

- In the Anglophone and northern European countries, the increase in the share of GDP absorbed by *current transfers* in the 1980s and early 1990s was largely reversed during 1993-2000. This change reflects declining unemployment rates, privatization, increased targeting of social spending, and, in some cases, major pension reforms (e.g., Sweden).

- The decline in the share of *interest payments* as a percent of GDP coincided with the reduction of primary deficits and the subsequent emergence of primary surpluses. This reduction was more accentuated among euro area and northern European countries, due to their higher level of public indebtedness and, for some euro area economies, to sharp declines in interest rates in the run-up to monetary union.

- *Public investment* declined in the euro area and, to a lesser extent, in northern European countries, both in percent of GDP and as a ratio to primary outlays.[14]

- There was also a reduction in *defense spending,* largely driven by the United States and the United Kingdom, where the peace dividend amounted to some 2 percent of GDP.[15]

Reforms in public expenditure management, including mechanisms to strengthen budgetary procedures and to enhance budget flexibility while strengthening expenditure control, have contributed significantly to expenditure restraint.[16] Furthermore, reconsideration of the role

[14]On the other hand, in some countries of the euro area, the reduction in public investment may have reflected the privatization process or changes in the classification of public utilities and other units from the general government to the private sector, as pointed out in Daniele Franco and Fabrizio Balassone, "Public Investment, the Stability Pact, and the 'Golden Rule'," *Fiscal Studies*, Vol. 21 (June 2000), pp. 207--29. The same authors also point to the increasing use of project financing, which, in the case of the United Kingdom, appears to explain about a third of the decline in public investment. That being said, the United Kingdom has recently adopted a golden rule (government should borrow only to finance investment) as part of its fiscal framework to facilitate public investment, which had fallen to historically low levels.

[15]For most countries, data on the functional breakdown of expenditure are available only through 1995, largely reflecting problems associated with shifting national accounting standards from SNA93 to ESA95.

[16]These aspects will be further discussed in the next section. Measures have included *ex ante* and *ex post* program evaluation (Australia), creating responsibility centers (France), and performance agreements (New Zealand and the United Kingdom). For a discussion of these measures, see Jim Brumby, "Budgetary Devices That Deliver," Oxford Policy Institute Policy Brief No. 3 (June 2000); and OECD, "Modern Financial

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of government has led to an expanded role for markets in the provision of public goods and services, including contracting out of government services, liberalizing public procurement, introducing user charges, and using vouchers in the distribution of merit goods and services. These factors will be discussed in some detail later in the paper.

C. The role of one-off factors

Several forces, such as privatization and tax amnesties, that may not be repeated in the future have helped to drive the recent fiscal adjustment. These factors have included privatization receipts, the use of tax amnesties, and more recently a number of measures loosely defined as creative accounting. While such moves may have been significant in particular countries, the overall influence of these one-off sources of revenue has been limited.

Privatization proceeds during the 1990s were modest for the countries covered in this paper (0.3 percent of aggregate GDP a year on average), with about two-thirds generated within the European Union.[17] Although the scope for further revenue from privatization is limited, new income sources (such as spectrum license fees) have recently emerged, particularly in the European Union.[18] Privatization proceeds have helped improve the fiscal positions of a number of countries. The process began in the late 1980s, with the United Kingdom in the lead, followed by New Zealand and Portugal among the European countries. During the 1990s, privatization has been more widespread and total proceeds stood at $455 billion for the group of countries covered in this paper.[19] About 2/3 of these proceeds have been generated within the European Union and more than one third between 1997 and 1999, with an impact in terms of GDP of about 1 percent. Southern European countries within the Euro area are those that have benefited the most.

A number of countries used various forms of **tax amnesties** in the last two decades. All groups were affected: in the Euro area the list includes Belgium, France, Ireland and Italy; Australia and New Zealand among small industrial countries; and 35 states plus the District of Columbia in the US.[20] Tax amnesties took various forms, from general or sweeping amnesties to specific ones; their objectives were also different, from sheer revenue

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Management Practices," PUMA/SBO (98)8 (Paris: Organization for Economic Cooperation and Development, 1998), available at http://www.oecd.org/puma.

[17]In EU countries, privatization receipts do not count toward reducing the general government deficit in the Maastricht definition. Furthermore, these are gross proceeds that do not necessarily correspond to net proceeds to government. For further detail, see Ladan Mahboobi, "Recent Privatization Trends," OECD *Financial Market Trends*, No. 76, (Paris: Organization for Economic Cooperation and Development, June 2000).

[18]IMF staff estimates indicate that revenue in 2000 from the allocation of third-generation licenses amounted to 1½ percent of GDP in the euro area.

[19] In 1999 Australia, Italy, and France accounted for half of all privatization proceeds. It should be noted that these are gross proceeds that do not necessarily correspond to net proceeds to government. For further detail, see Mahboobi, Ladan, 2000,"Recent Privatization Trends," OECD *Financial Market Trends*, No. 76, June.

[20] See Hasseldine, John, 1998, "Tax Amnesties: An International Review," Bulletin for International Fiscal Documentation, Vol. 52, No. 7, and the references therein contained.

generating purpose to remove backlog of tax appeals.[21] It is now well documented that while generating immediate revenue voluntary tax compliance rarely increases because of expectation of future amnesties unless tax amnesties are accompanied by substantial tax and tax administration reforms. Other disadvantages are also well known: they are intrinsically unfair towards honest taxpayers or taxpayers subject to withholding taxes, typically employees; generate expectation for future tax amnesties, so reducing the credibility of tax authorities; and, finally, amnesty returns have often been disappointing and not economically-viable.

There has been much debate about various "**creative accounting**" measures used by EU countries in the run up to meet the deficits and debt targets under the Maastricht criteria.[22] These included measures taken in anticipation in previous years which led to a structural change in the deficit. To verify countries' compliance with the targets, Eurostat identified "new or exceptional measures affecting the 1997 data" and "the principal changes [in statistics] which occurred during the period." [23] Some of these measures were seen by commentators as unusual to the point fiscal adjustment has been considered illusory to the extent that adjustment does not lead to an increase in the government's net worth.[24] Overall, the impact on the Euro area group was modest (½ percentage point of GDP), although for some individual member countries the affect was sizeable (Austria, Italy, and Spain).

D. The success of fiscal consolidation

Recent economic analysis suggests that, in advanced economies, a fiscal improvement is more likely to be successful when based on cuts in expenditure, especially reductions in the wage bill (via lower public employment) and in transfers (such as pensions), and when undertaken by countries with high levels of debt.[25] This analysis has identified successful fiscal consolidations mostly in the 1980s and 1990s, possibly reflecting growing opposition

[21] For instance, in France a tax amnesty was announced in 1988 9?) to encourage repatriation assets from abroad that had been largely untaxed; in Ireland two general and three specific amnesties were carried out in the period 1988-1993. Interestingly enough, the last one brought much lower revenue than the first one.

[22] This section draws from a recent IMF Board Paper "Issues in Fiscal Accounting," prepared by the Fiscal Affairs Department in consultation with the Statistics Department, SM/00/241, October 2000.

[23] Eurostat, 1998, "Statistics on Convergence Criteria-Assessment by Eurostat," March. A discussion

[24] See, for instance, Easterly, William, 1999, "When is Fiscal Adjustment an Illusion?", 1999, European policy: An European Forum, No. 28, April.

[25]See Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *IMF Staff Papers*, International Monetary Fund, Vol. 44 (June 1997), pp. 210--248; IMF, *World Economic Outlook* (May 1996), Ch. III "Fiscal Challenges in Industrial Countries," pp. 44--62; Alberto Alesina and Silvia Ardagna, "Tales of Fiscal Adjustment," *Economic Policy* (1998) pp. 488--545; Roberto Perotti, Rolf Strauch, and Juergen Von Hagen, *Sustainability of Public Finances* (London: Centre for Economic Policy Research, 1998); and Juergen Von Hagen, Andrew Hughes Hallett, and Rolf Strauch, "Budgetary Consolidations in EMU," Economic Papers No. 148 (Brussels: European Commission, March 2001).

to the progressive enlargement of public sector participation in the economy and, for some countries, growing concerns about the sustainability of public debt.[26]

These considerations suggest that the fiscal consolidations of the 1990s are more likely to be successful than those of the 1980s. However, caution is needed. Successful consolidations are defined over a relatively short period and can be reversed over time. Many of the consolidations of the 1980s unraveled during the early 1990s—for example, in the United Kingdom. This highlights the importance of factors other than just the composition of fiscal adjustment. In particular, sound fiscal frameworks supported by institutional reforms—considered in the following section—may help reinforce political commitment to fiscal restraint in the face of pressures for expansion.

III. The Role of Institutional Reforms[27]

The reductions in fiscal deficits since 1993, and associated macroeconomic benefits, have occurred in the context of widespread reforms to fiscal frameworks.[28] These reforms, which have built on earlier fundamental changes in public expenditure management, have been aimed primarily at achieving and maintaining fiscal consolidation, while continuing to leave room for fiscal policy to dampen the business cycle through automatic stabilizers and (if necessary) discretionary policy actions.

Over the last two decades, there has been increased acceptance that budgetary process and institutions influence budgetary results. As tax reforms had an effect on revenue composition, changes intervened in public expenditure management had an impact not only on expenditure composition but also, and more fundamentally, on fiscal management. These changes have implied a lengthening of the horizon of fiscal policy along with the introduction of better accounting systems similar to those prevailing in the private sector. As a result, there has been a shift to output-based budgeting and ex-post accountability as opposed to input-based budgeting and more formal compliance audit. Along with improvement in reporting systems, budgetary processes have become more transparent to the public. The outcome of these reforms has been the establishment of medium-term budgetary frameworks and explicit commitments to accountability for performance based on formal requirements for transparent and timely financial reporting.

Another key feature of these reforms was an expanded role of market mechanisms within the public sphere of intervention. These mechanisms included contracting-out in the provision

[26]Examples of successful fiscal consolidations include the fiscal adjustments experienced by the United Kingdom in 1979-90, Ireland in 1987-89, and Denmark in 1983-86. For examples of unsuccessful fiscal consolidations, the literature points to Ireland in 1982-84 and Sweden in 1983-90.

[27]This section draws on Richard Hemming and Michael Kell, "Promoting Fiscal Responsibility: Transparency, Rules, and Independent Fiscal Authorities," paper prepared for a Bank of Italy workshop on fiscal rules held in Perugia, Italy (February 1–3, 2001); and Jim Brumby, "Budgetary Devices That Deliver," Oxford Policy Institute Policy Brief No. 3 (June 2000).

[28]A major exception, in terms of both consolidation and institutional reform, is Japan.

of local consumer goods and services; liberalization of public procurement markets; user charging to extract market signal so as to reduce excess demand in the provision of public goods and services; and use of vouchers in the distribution of merit goods and services. At the same time, mechanisms have been introduced to enhance budget flexibility while strengthening expenditure control, ranging from ex-ante and ex-post program evaluation (Australia), creating responsibility centers (France), financial audit (Sweden), performance agreements (New Zealand and UK).[29]

At various speeds, from different starting points, most OECD countries have introduced large scale reforms to deal to these two problems. Changes have dealt with the three tiers of efficiency associated with budgeting:

- the general call on resources made by the public sector (aggregate efficiency);
- the ability to direct resources to where they will be most beneficial (allocative efficiency); and
- the technical problems associated with producing specific goods and services (technical efficiency).

This section discusses the nature of these reforms and the role they have played in the recent fiscal consolidations. In particular, reforms in public expenditure management emerged as a way to address the expenditure or deficit bias intrinsic in government decision making as emphasized in the political economy literature.[30] However, the economic literature has mainly focused on problems of aggregate fiscal management without indulging into some systemic features of traditional public management which also add to the likelihood for upward bias. These include:

- poorly developed product markets for public services, which make the public sector often a captive purchaser;
- non-existent control markets, which make public sector supply immune to market-based monitoring and pressure;

[29] See OECD, 1998, "Modern Financial Management Practices," PUMA/SBO (98)8.

[30] Several variants are found in the literature: early explanations from the "public choice" school, such as Buchanan, James M., and Richard E. Wagner, 1977, *Democracy in Deficit: The Political Legacy of Lord Keynes*, New York: Academic Press, explained a bias towards fiscal deficits in democracies in terms of myopia on the part of the electorate. More recent explanations of suboptimal fiscal outcomes have moved away from this unsatisfactory assumption and focused instead on the degree political cohesion, including Roubini, Nouriel, and Jeffrey D. Sachs, 1989, "Political and Economic Determinants of Budget Deficits in the Industrial Democracies," *European Economic Review*, Vol. 33 (May), pp. 903–38, and Alesina, Alberto, and Allan Drazen, 1991, "Why are Stabilizations Delayed?" *American Economic Review*, Vol. 81 (December), pp. 1170–88; on the use of deficit spending and debt accumulation as a strategic tool to tie the hands of future governments with different policy objectives (Alesina, Alberto, and Guido Tabellini, 1990, "Positive Theory of Fiscal Deficits and Government Debt," *Review of Economic Studies*, Vol. 57 (July), pp. 403–14); and the use of preelection deficits as a signaling device (Rogoff, Kenneth, and Anne Sibert, 1988, "Elections and Macroeconomic Policy Cycles" *Review of Economic Studies*, Vol. 55 (January), pp. 1–16.

- complex, incoherent, or unstated goals, making allocation decision difficult and often compounded by unclear accountability after the fact;
- limited authority being passed down the line to where information is more complete and where decision congestion is less; and
- unequal access to information, placing higher decision making at a severe disadvantage relative to lower decision making.

Reasons behind public expenditure management reforms are analysed below, followed by a discussion of their main implications in terms of budgeting, performance measurement, and accounting.

A. Problems of aggregate fiscal management

An excess level of government spending is often related to problems of decision making regarding a common resource and to the way individual politicians' utility may be influenced by gains and losses. The idea that a common pool problem is intrinsically rooted in the typical public budget process can be traced back to the paper by Weingast, Shepsle, and Johnsen.[31] Focusing on the parliamentary stage of the budget process, they consider a legislature made up by representatives with a geographically based constituency and explain why a cooperative legislature would stand for policies that are Pareto dominated. The legislature will oversupply those programs that concentrate the benefits in geographically specific constituency, while spreading their costs across all constituencies through generalized taxation.[32] In other words, each representative will fail to internalize the full cost, in terms of deployment of the common pool of national tax revenues, of financing expenditure programs that benefit mainly his constituency. The divergence between real and perceived costs will be wider, and hence the commons problem more serious, the more fragmented is the legislation (that is, the higher is the number of districts for a given total population or the number of ministries).

Decision makers' preferences appear to reflect "loss aversion," whereby utility is affected by changes in resources rather than by their absolute level.[33] Thought of in terms of collective decision making processes, this suggests that there will tend to be upward accretion for total aggregate spending. Under loss aversion, the marginal utility from a gain is strictly less than the marginal utility from an equivalent loss—standard concave utility function applied for gains but a convex utility function applies to losses. Policy decision makers will find it

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[31] Weingast, B. R., K. A. Shepsle, and C. Johnsen (1981), "The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics," *Journal of Political Economy*, vol. 89, no. 4, 642-664.

[32] The possibility that legislatures may be captured by local interests, owing to different concentration of benefits and costs, is reminiscent of Olson's logic of collective action, on which it is also based the early theory of regulatory capture developed by the Chicago school, starting with Stigler.

[33] Kahneman, Daniel and Amos Tversky, "Prospect Theory: An Analysis of Decision Under Risk" Econometrica, 1979, pp.263-291.

difficult to agree to a reduction, but will always pursue an increase—whatever the starting point.

B. Splitting sectoral allocation

An important development has been to split up various components of budget decision making based on the view that separate consideration of overall budget and sectoral/program allocations can increase the hardness of the budget constraint. It means that the systematic bias for creating demands for additional spending can be constrained through cascading commitments to hard budget constraints. The split level consideration assists in dealing with both the common pool and the loss aversion problems discussed above by introducing a transparent means to assess ministers collectively in meeting their responsibilities to manage the common pool. It also allows ministers to accept a reduction in spending based on the common interest while pursuing any individualized increase though a policy initiative's round. The fact that the visible costs for renegotiating any higher level commitment are very high means that they have credibility. As a result, actors at lower levels will see this and accept the hardness of their constraints.

Such top-down spending controls are being applied by a significant number of countries to varying degrees. Many countries have shown a preference for applying targeted cuts rather than across-the-board cuts, and rewarding ministries who have successfully downsized. This approach should allow resources to flow from less valued to more valued areas and act to encourage ministries and agencies to establish their own spending priorities and seek out productivity gains. Evaluations have played a role at this level and at within sectoral allocations. But generally the higher level allocations are about preference revelation and involve political signalling.

Canada, Sweden, Norway, Iceland, the Netherlands, Finland and the UK have continued their top-down budgeting systems. The *frame budgeting* in Iceland, consisting of an initial policy decision by the Cabinet to lay down an expenditure frame for each ministry for the coming year, has done much to restrain demands for new expenditures and has helped to reduce the stock of existing expenditure programmes to make way for new ones. France has also followed this new budgetary procedure, using a preparatory ministerial meeting for overall mandates to ministries to establish itemised budgets.

The reinvention of the budget determination process into split level games has also involved the legislature. A number of countries involve the legislature in agreeing the aggregates and accepting that consideration of the detailed estimates will be done on the basis of these aggregates. This makes the commitment even more credible at the Executive level, and removes another potential avenue from Ministries seeking increased resources.

There is a trend also for the legislature to split consideration of the budget—with the aggregates being considered by the economics/finance/budgeting committee, and the programme allocation being considered by the sectoral committees. This appears to work well with the specific interests and specialities of the sectoral committees being able to challenge allocative decisions, but within the context of the hard constraint. The introduction of cascading limits has coincided with increased flexibility over the choice of inputs being devolved down the line.

C. From inputs to outputs

The central budget office typically does not have the information necessary to make lower level allocative decisions. Accordingly, a failure to provide managers with discretion over the use of their budget constrained resources may induce higher costs than necessary. In exchange for giving agencies greater freedoms in operational decisions, those charged with these decisions rights are being held more directly accountable for results. This increased flexibility generally includes an ability to shift funds among certain items of expenditures (generally those items relating to running costs) and often, between fiscal years.

Shifts between fiscal years have been liberalised by permitting ministries and agencies to carry over unused funds to the following year and, in some cases, to pre-spend a portion of the next year's budget. These changes have been made to reduce incentives for end-of-year spending splurges and to limit poor resource use as a result of arbitrary time-lines. An important aspect of the incentives regime is that future indicative funding levels are not reduced by under-expenditure in a previous year. Typically, the amount that may be carried forward or pre-spent is limited to a certain percentage of appropriated funds, or running costs funds. Not surprisingly, the tests to carry-over to the future or draw down from the future are not symmetrical—with tougher tests being employed to control pre-spending.. Reflecting this, most recent data from the OECD's meeting of Senior Budget Officials showed that 21 countries had power to carry-over operating cost budgets from one year to the next, while only 8 countries had power to draw down from the next year to the present year.

Consolidation of appropriation line items into less detailed appropriations and the devolution of resource allocation decisions to ministries and agencies have become increasingly common. Many countries including Australia, New Zealand, the Nordic countries, and the Netherlands allow discretion in spending within aggregate limits on operating or running costs, or even between operating and program costs. The devolution of central control on running costs is generally accompanied by strict restrictions to keep their rate of increase through time below the rate of inflation. The main restrictions, still in use in some countries, is on the number and remuneration of senior officials, generally reflecting the fact that line ministries do not always meet the full cost of being an employer. France still maintains separate controls on personnel, but these may be eased as reform progresses. There are often restrictions on transfers between programmes and running costs so as to ensure that focus is kept on managing the efficiency of running costs. Until two years ago, 16 OECD countries had head count ceilings in place, now it appears that only nine do.

Another arrangement providing greater flexibility is the introduction of net appropriations which allow ministries or agencies to retain all or some revenue raised from user charges, even in tight budgetary situations. This is designed to reward successful organisational effort at revenue collection. Concerns are often raised about a weakening of spending control of the parliament and the central budget office and full accounting for such revenue retention is important in meeting these concerns. In some countries, net appropriations also provide the means to give an incentive for the identification and sale of surplus assets. Agencies may be credited with all or a portion of the proceeds from asset sales, rather than these going entirely to the central budget.[34] In such cases, it is important to be clear over which assets can be controlled fully by agencies and those over which the agency has only limited rights.

D. Performance measurement

In many countries devolution and flexibility in budgeting and financial management have been associated with accountability mechanisms and performance measurement. Those countries have introduced performance reporting including benchmarking, performance contracting arrangements and performance budgeting. These devices have gained increasing prominence as a means of holding ministries and agencies accountable for their performance.

Most countries have put considerable emphasis on developing performance indicators and many of their annual reports and budget documents contain an extensive range of performance information. More than half the OECD countries now routinely include non-financial performance information in the budget documentation provided to the legislature.

The theory on providing flexibility to line managers backed by requirements for more performance information seems sound; the evidence regarding improved economic performance is harder to find. One study in New Zealand examined the costs of production through time for some typical government outputs.[35] The outputs examined included property titling, social security claim handling and immigration application handling. In general there was some evidence that cost moved downward and quality moved upward in the years immediately following the introduction of the new system. But the causality could not be proved. Systematic examination of this issue requires measuring government output through time. This is very difficult for a number of reasons, not least of which being the failure of governments to measure output routinely and the tendency for governments to make changes in organisational and accounting treatments making comparable data hard to access.

If increased managerial flexibility is provided as a way of delivering on a harder and more credible budget constraint, then it would be reasonable to expect such flexibility to be positively related to improved fiscal outturns. The argument is that the more responsive movement of resources at the line management level the less pressure is placed on spending caps, and the more likely fiscal consolidation exercises that rely on reductions in spending are to be successful. An investigation of fiscal consolidation cases in a subset of nine OECD countries from 1986 to 1997 shows that consolidation efforts in countries with high managerial flexibility are less likely to fail than in countries with low flexibility. All

[34] There are generally different rules for assets which serve directly the operating interest of the line ministries versus those assets that are more heritage or custodial in nature.

[35] Brumby, Jim, Peter Edmonds, Kim Honeyfield, *Effects of Financial Managerial Reform in New Zealand*, Australasian Evaluation Society, 1996.

stabilisation efforts in countries with high managerial flexibility were persistent, seven of the 17 episodes in countries with low flexibility were short lived. [36]

Benchmarking is also being increasingly recognised as a useful tool for improved value for money by establishing performance targets in reference to the best practices identified in comparable public or private organisations. The UK is seeking benchmarking of agencies against the private sector and public services in other countries. The initial findings of this exercise indicate that this approach may be highly effective in assessing the overall performance of organisations. Australia has even benchmarked its own budget formulation process. New Zealand has made benchmarking a central part of its output pricing review process.

Contractual arrangements have been developed as a tool to specify expected results and to assign accountability as a way of increasing performance in the public sector. The traditional idea of purchaser-provider contract is being broadened significantly to budgetary agreements between the central budget office and spending ministries, and even within ministries between ministers and chief executives. The UK and New Zealand have made widespread use of contractual arrangements on performance between ministries and agencies. Australia has developed resource agreements between the Department of Finance and individual departments or agencies. Box 1 below provides an example of purchasing contract from New Zealand.

Box 1. Purchase Contracting

Purpose and scope

"The objective of the purchase agreement process is to provide the Vote Minister with information to assess the strategic importance and value of departmental outputs and to make comparisons with similar outputs across both the public and private sectors. By allowing meaningful comparisons of value and cost, the output descriptions in this agreement should assist the Vote Minister to select those outputs that conform to the Government's strategy and which, in the Minister's opinion, represent value for money.

This purchase agreement sets out the outputs the Minister of (name of Vote) has agreed to purchase, their performance attributes and costs and the terms and conditions surrounding the agreement.

The purchase agreement should allow the Minister to:

- determine which outputs to purchase
- agree to appropriate cost, quantity and quality standards for desired outputs
- make comparisons with other providers where possible;
- assess the risks and obligations associated with delivery
- record and change decisions;
- subsequently verify that the output has been delivered;
- hold the provider accountable for delivery of the specified output.

[36] Strauch, Rolf, *Managerial Flexibility and Fiscal Performance*, Mimeo. According to a standard definition of success (broadly two successive years of deficit improvement or a debt reduction in the second year after the consolidation exercise), there were 22 successful cases and seven unsuccessful cases.

Source: “Guidelines”, NZ Treasury, 1996, p.6.

There are two main issues to be confronted in developing performance indicators or performance orientation. These are the technical problems associated with developing indicators which are meaningful, and, secondly, the manner in which the performance orientation integrates with the resource allocation process.

The mere name—indicators—suggests that such performance information is not seen as complete, but that it generally represents aspects of performance. There are many illustrations of how a narrow range of measures can distort organisational behaviour—a tax office that has costs per unit of tax collected may shy away from complex, costly tax evasion cases, thereby setting up a dynamic for evaders to need only to signal credibly that they have deep pockets for this purpose to scare away the tax collectors. Of course these distortions can be expected to flow only if incentives are altered to reflect them and this requires some degree of integration in either the resource allocation system or the personal performance management system or both. In any event, just because such distortions may be visible does not mean that are greater than in a world with no indicators—it may be just that the previous distortions were less visible.[37]

The trend in assessing wider organisational performance is to move of a balanced scorecard approach, picking up on dimensions of performance which are not captured in one period output contracts, such as the ethical fabric of the workforce and the institutional capability of continuing to do the things government wishes, and managing the assets used in producing government outputs.

E. Implications for accounting

The increased focus on results and outputs has led authorities to question the basis of the financial information provided about these outputs and results. More countries are seeking full cost information so that they can represent to citizens the full cost of service provision. By its very nature, cash information is not complete. By changing disbursement profiles, large scale changes in apparent ‘costs’ can emerge. If this does not represent a change in underlying costs then it is misleading and can induce poor decision making. It is reasonable to expect that financial markets and politicians will become ever more demanding of the reliability of information about public sector finances. This trend has already created a migration to accrual accounting.

The difference between cash and accrual accounting is that accrual accounting recognises the financial implications of transactions (or decisions giving rise to transactions) or events when they occur irrespective of when cash is paid or received. It seeks to match the costs

[37] Wilson has characterized the contracting problems and the creation of performance information as relating to two dimensions: the degree to which outputs and outcomes are observable. The most easily contracted are cases where both are easily observable; the hardest is where neither is observable (so-called ‘coping’ organizations, such as education). See James Q. Wilson, 1989, *Bureaucracy*, Basic Books.

incurred during a particular accounting period with the benefits earned, and revenues with goods or services provided. The relationship of revenues and expenses enables the determination of profit or permits assessment of the net cost of providing goods and services. The relationship between assets and liabilities also enables assessment of an organisation's financial position.

There is another large benefit to public management from shifting to standard accrual practices. It removes a barrier which may be preventing access of private sector trained financial managers to many public sector financial management jobs. Adoption of accruals means that the public sector can attract properly trained accountants who can put their skills to use. This is important for creating sources of innovation and also for removing the monopoly on the knowledge of public agencies' financial conditions from those with limited general financial skills but who happen to have deep particularistic knowledge.

These are broadly three groupings of country practice in relation to accounting.

- Only three OECD countries that have adopted full accrual accounting and budgeting practices for their budgets. They are New Zealand, Australia and the UK. Another five countries plan to move to full accrual based budgeting.

- Six countries have adopted—or are in the process of adopting—accrual accounting principles for their whole-of-government financial reporting, but not budgeting.

- Four other OECD countries that have adopted accrual accounting standards at the level of individual agencies.

The general transition to accrual accounting appears unstoppable. The shift will be accelerated as financial markets reward countries for making the commitment to accruals. There is evidence in the USA that States using accrual information borrow more favourably than those states using solely cash accounting. But it is important to remember that the shift to accruals does confront institutions and individual interests with change. It can dispossess information monopolists and unleash dynamic processes. Once countries commit to agency or departmental accrual reporting, they set themselves on a journey which logically can only stop at accrual budgeting and whole of government accrual reporting. This is irrespective of whether this is the goal when they set out. Evidence to date suggests that markets quite happily accept the cessation of 'old' cash based financial reports and the shift to new accrual based reports. New Zealand is a case in point - financial markets did not react adversely to the dumping of the traditional format cash aggregates (the so-called Table 2 reports). Discussions with financial market operators showed that they never had much confidence in the old cash data.

An important development in this regard is the migration to the IMF's Government Finance Statistics (*GFS*) from a cash basis to accrual. In the revised GFS system, flows are recorded on an accrual basis, which means that flows are recorded at the time economic value is created, transformed, exchanged, transferred, or extinguished. In the *1986 GFS Manual*, transactions are recorded when cash is received or paid. Using the accrual basis also means that transactions in kind are fully integrated in the revised GFS system. In the *1986 GFS Manual* only selected in-kind transactions were recorded as memorandum items.

F. Implications for the budget office

All these changes have profound implications for the orientation and skills of the central budget office. This should not be underestimated. The job is different, and it requires a different central budget office to do the new job.

The new results-oriented managerial climate has meant that the budgeting and financial management function of the central budget office should concentrate on strategic and performance issues to make the best use of available resources. The new role of the central budget office is reflected in such activities as:

- devising a more effective budget system to control the budget totals and establish priorities among programmes;
- integrating budgeting with other management processes;
- requiring spending agencies to measure performance and evaluate results;
- developing new guidelines and methods for holding managers accountable; and
- promoting new information and reporting systems.

The central budget office still has the lead role in maintaining budget discipline. But increasingly its role is now about developing and managing a set of institutional arrangements most likely to achieve efficiency at the three levels referred to at the outset.

The creation of the "efficiency culture" is probably the most important strategic task left at the centre. This means that the central budget office has to accept that its job is not to take over the policy and programme aspirations of the line agencies. It is through its ability to co-ordinate decision-making and the rules that support it, that the central budget office can create the information and incentives to get government agencies seeking efficient solutions to public intervention problems. This is likely to mean a much lower investment in operations and a greater investment in analytical skills to provide strategic advice, institutional design advice, and second opinion sectoral advice.

IV. FISCAL RULES AND FRAMEWORKS

The progressive adoption of the aboive discussed changes has allowed a number of countries to overhaul their fiscal management framework starting from the second half of the 1990s. these frameworks, whether legally based or relating to a political commitment to a rule of thumb, have been designed to increase the credibility of government's commitment to a course of action. The basic idea is to create rules and mechanisms which impose a cost on government for deviating from a course of fiscal rectitude or responsibility. In spite of the many differences, two have been the common features of these frameworks:

- the establishment of medium term budget targets; and

- requirements that commit to accountability for performance, to transparency and timeliness requirements for financial reporting.

Recent institutional reforms can be classified into three broad, but not mutually exclusive, groups:

- *Formal deficit and debt rules.* The main examples of this approach are the countries of the euro area, which are bound by the Maastricht Treaty and subsequent Stability and Growth Pact limit of 3 percent of GDP on the deficit; and the United Kingdom, which since 1997 has operated a golden rule (borrowing only to finance capital spending) and a sustainable investment rule, which limits net debt to 40 percent of GDP over the cycle. Several countries have deficit and debt rules at the subnational level.[38]

- *Expenditure limits.* Other countries, such as Sweden and the United States, as well as Finland and the Netherlands in the euro area, have put more emphasis on expenditure limits, supported by procedural requirements, whereby proposals resulting in overruns in certain expenditure areas must be accompanied by offsetting expenditure cuts elsewhere or by revenue increases. Canada has also focused on instituting a rigorous expenditure review process.

- *Transparency.* New Zealand pioneered an approach to fiscal management that places primary and explicit emphasis on transparency (generally defined as being open to the public about the structure and functions of government, public sector accounts, and fiscal policy intentions and projections), with the Fiscal Responsibility Act of 1994.[39] Australia and the United Kingdom have since adopted similar approaches. The key elements that these frameworks share are an explicit legal basis, an elaboration of guiding principles for fiscal policy, a requirement that objectives are clearly stated, an emphasis on the need for a longer-term focus to fiscal policy, and demanding requirements for fiscal reporting to the public.

These approaches have often been combined and have, in some instances, evolved over time in the light of experience. For example, the United Kingdom, Australia, and New Zealand combine legally mandated transparency with rules or objectives for deficits and debt, and the Netherlands uses expenditure and revenue rules to meet its requirements under the Stability and Growth Pact. The United States now places relatively more emphasis on expenditure rather than deficit rules, while the deficit and debt criteria of the Maastricht Treaty have been complemented by the provisions of the Stability and Growth Pact. The evolution of fiscal frameworks has been driven in some cases by a change in focus from improving an

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[38]All but two U.S. states have laws requiring the submission, passing, or signing of balanced budgets and limiting the ability of states to issue debt. Nine provinces and territories in Canada have fiscal rules, with balanced budgets being required in all but one case. Italian local governments are allowed to take on debt only for the purpose of financing investment projects. In the euro area, Austria, Belgium, Italy, and Spain have internal stability pacts to ensure that the finances of subnational governments are consistent with commitments under the Stability and Growth Pact.

[39] See Cangiano, Marco, "Accountability and Transparency in the Public Sector: The New Zealand Experience," IMF Working Paper/96/122 (Washington: International Monetary Fund); and George Kopits and Jon Craig, *Transparency in Government Operations*, IMF Occasional Paper No. 158 (Washington: International Monetary Fund, 1998).

initially weak fiscal position toward maintaining a sound position over the medium term. In the former case, fairly inflexible ceilings on deficits or expenditure have typically been applied; in the latter, more sophisticated considerations generally come into play, including imposing debt ceilings, specifying rules in cyclically adjusted terms, and emphasizing fiscal transparency.

There are two main justifications for these institutional reforms. First, fiscal rules and transparency strengthen fiscal discipline, thus helping governments maintain commitments to improve public finances: while rules limit the influence of contingent events on fiscal outcomes, transparency increases accountability for the design and implementation of fiscal policy. The United Kingdom, for example, introduced deficit and debt rules after having experienced in the early 1990s the unwinding of a sizable fiscal adjustment achieved during the 1980s. Second, problems caused by lax fiscal policy can spill from one jurisdiction to the next within a currency area or a federation. This would provide justification for the deficit and debt limits in a European framework under the Maastricht Treaty.

V. Assessing Institutional Reforms

The existing theoretical and empirical literature on fiscal rules is of limited value in addressing this question. The theoretical case for fiscal rules is in general ambiguous; moreover, existing analyses tend to focus on simple (and rigid) balanced budget rules.[40] The theoretical literature does however highlight the trade-offs between simplicity and enforceability on the one hand, and flexibility in responding to shocks on the other hand. The empirical literature on fiscal rules is also not conclusive. That said, two lessons emphasized in Kopits and Symansky are worth recalling: first, some fiscal rules have resulted in decreased transparency; and second, experience with fiscal rules around the world suggests that it is preferable to prepare well in advance for the adoption of fiscal rules by committing to a discretionary fiscal adjustment path to establish or restore fiscal discipline rather than introducing fiscal rules immediately following a financial crisis.[41]

Kopits and Symansky specify eight criteria by which to judge fiscal rules. Fiscal rules should be well-defined; highly transparent; adequate with respect to the specified goal(s); consistent with other macroeconomic policies; simple in the eyes of the public; flexible enough to accommodate cyclical fluctuations and exogenous shocks; enforceable in the given environment; and supported by efficient policies, including structural reforms, rather than one-off measures. Following Kell, in what follows some of the above discussed fiscal frameworks and rules are assessed against those criteria.[42]

[40] In particular, the simplifying assumptions that would be involved in a theoretical analysis of U.K. fiscal rules would be easily criticized; Buiter (2001) highlights the “inherent difficulty of putting together an interesting economic system and a recognizable political governance structure.” For an overview of the different approaches to, and difficulties in, modeling the behavior of political decision makers, see van Velthoven, Verbon, and van Winden (1993).

[41] Kopits, George, and Steven Symansky, 1998, *Fiscal Policy Rules*, IMF Occasional Paper No. 162 (Washington: International Monetary Fund).

[42] Kell, Michael, 2001, “An Assessment of Fiscal Rules in the United Kingdom,” *International Monetary Fund Working Paper*, forthcoming.

The advantage of deficit rules is that, compared with other approaches, they are clear and focus on a generally well-understood macroeconomic aggregate. The main criticism of deficit rules in general, and balanced budget rules in particular, is that they are inflexible and therefore tend to be procyclical.[43] This is an important issue for national governments, although less so for subnational governments owing to the openness of regions within a country.[44] Deficit rules for national governments have increasingly been refined to address this problem and now generally apply either to a cyclically adjusted deficit measure or an average over the economic cycle. Thus, these rules allow the operation of automatic stabilizers and possibly provide some room for discretionary policy within the cycle.[45] This increased flexibility comes at a cost, however, since the benchmark against which fiscal performance is to be judged is made more complicated (especially if estimates of potential output are revised, as discussed earlier). This increases the scope to bypass the rules, making them potentially harder to enforce, which in turn undermines credibility.

Debt ceilings can be a useful adjunct to deficit rules, although the definition of an appropriate ceiling is difficult.[46] In practice, debt ceilings have been driven not by calculations based on theory but rather by concerns about reducing high debt levels, and have thus generally been chosen on the basis of circumstances of individual countries.[47] However, if debt is well below the ceiling, there may be significant room for maneuver in the short term and little restraint on policy.[48]

[43]Alberto Alesina and Roberto Perotti, "Budget Deficits and Budget Institutions," in *Fiscal Institutions and Fiscal Performance*, ed. by James Poterba and Jurgen Von Hagen (Chicago: University of Chicago Press, 1999).

[44]Tamim Bayoumi and Barry Eichengreen, "Restraining Yourself: The Implications of Fiscal Rules for Economic Stabilization," *IMF Staff Papers*, International Monetary Fund, Vol. 42 (March 1995).

[45]According to the 1997 Resolution of the European Council on the Stability and Growth Pact (European Council Resolution 97/C), the "close to balance requirement" under the Pact also leaves room for automatic stabilizers to operate (and in some cases for discretionary measures) without breaking the 3 percent of GDP deficit limit under the Maastricht Treaty. See Michael Artis and Marco Buti, " 'Close to Balance or in Surplus': A Policy-Maker's Guide to the Implementation of the Stability and Growth Pact," *Journal of Common Market Studies,* Vol 38, No. 4 (November 2000).

[46]Theory provides little guidance. Three distinct approaches are contained in Robert J. Barro, "On the Determination of Public Debt," *Journal of Political Economy*, Vol. 87 (October 1979) pp. 940--71; Gian Maria Milesi-Ferretti and Nouriel Roubini, "On the Taxation of Human and Physical Capital in Models of Endogenous Growth," *Journal of Public Economics,* Vol. 70 (November 1998); and S. Rao Aiyagari and Ellen R. McGrattan, "The Optimum Quantity of Debt," *Journal of Monetary Economics,* Vol. 42 (October 1998) pp. 447--69.

[47]See, in this regard, the debate on eliminating the U.S. federal government debt summarized in recent papers prepared for the September 2000 Brookings Panel on Economic Activity: for example, Vincent Reinhart and Brian Sack, "The Economic Consequences of Disappearing Government Debt," *Brookings Papers on Economic Activity*: 2, Brookings Institution (2000) and, in the same issue, Michael J. Fleming, "Financial Market Implications of the Federal Debt Paydown."

[48]The choice of debt measure is also an issue: gross debt can be easily measured and compared across countries, but net debt is the best indicator to assess fiscal sustainability, although it presents substantial measurement difficulties (in terms of which assets to consider and how to value them).

Expenditure rules typically impose ceilings on specific areas of expenditure—for example, discretionary as opposed to nondiscretionary and, in some cases, for particular programs.[49] The principal advantages of capping expenditure are that this process is well understood by players in budget negotiations and the wider public, and it tackles deficit bias by addressing the principal source of rising deficits, namely political and institutional pressures to increase expenditure. Governments are also made accountable for what they can control most directly, which is not the case with deficits, given that they are highly dependent on economic developments. Ceilings on specific expenditure items can impose fiscal discipline while allowing the operation of automatic stabilizers on both the revenue and on the expenditure side, and can therefore operate in effect like a cyclically adjusted deficit rule. In contrast, caps on overall spending could force unwarranted cuts in discretionary spending items during a cyclical downturn in order to support higher transfer spending.

Fiscal transparency helps to relax the trade-off between the need for flexibility and discipline in fiscal policy. A commitment to transparency should improve credibility generally and increase the chances that a government can retain credibility in the event that it needs to temporarily deviate from, or substantively change, its fiscal rules or targets. In this context, it is noteworthy that Japan introduced a rules-based approach in 1997 without a commitment to transparency, but was forced to abandon this approach in the wake of the Asian crisis. As noted above, New Zealand, Australia, and the United Kingdom have recently introduced legislation specifically directed at enhancing transparency. Among other things, these frameworks address the standard criticism of rules—namely, that rules encourage creative accounting—by adopting uniform accounting and classification standards and setting demanding reporting requirements as a means of encouraging independent scrutiny.[50] Hence, transparency legislation can complement other elements of a fiscal framework, such as deficit rules. Legislation, however, is not the only means to achieve fiscal transparency; in other advanced economies, such as Canada, Sweden, and the United States, transparency is associated with a long tradition of open government.

VI. The Impact of Institutional Reforms

As fiscal developments in OECD countries in the 1990s have shared a common pattern, it is difficult to see substantial differences in behavior between countries such as Australia, New Zealand, and the United Kingdom, which have most emphasized fiscal frameworks based on transparency; the overall group of EU countries, with the strongest rules-based approach to fiscal policy; and North America, where the United States in particular places more emphasis on procedural rules. Against this background, the specific role of fiscal rules and transparency in contributing to fiscal adjustment is not immediately obvious. However, some other evidence points in this direction, especially for the euro area and North America.

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[49]This interpretation excludes the medium-term expenditure frameworks that some countries (e.g., the United Kingdom) have put in place.

[50]See Gian Maria Milesi-Ferretti, "Good, Bad, or Ugly? On the Effects of Fiscal Rules with Creative Accounting," IMF Working Paper 00/172 (Washington: International Monetary Fund, October 2000). The elaborate peer review process in the European Union, combined with common principles of fiscal accounting, is intended in part to limit the scope for creative accounting.

For the euro area, one recent study notes that fiscal rules have been associated with stronger fiscal performance and have been less reactive to cyclical fluctuations and monetary policy changes in the 1990s than in earlier periods.[51] This difference has been ascribed to a "Maastricht effect." The effect appears to have been more pronounced in high-debt countries—Greece, Italy, and Belgium—as well as in countries that experienced large increases in debt ratios in the period preceding Maastricht, such as Finland, the Netherlands, and Portugal. This may be viewed as evidence of the effectiveness of strict quantitative targets, but one could also argue that the underlying political commitment to qualify for EMU and concerns about high debt levels were the real forces behind the large fiscal adjustment during the 1990s.[52] Evidence from U.S. state governments also indicates that balanced budget rules have lowered fiscal deficits and public debt, but at the cost of more limited automatic stabilizers.[53]

For the U.S. federal government, several studies have concluded that the specific expenditure ceilings embodied in the Budget Enforcement Act have played a significant role in reducing expenditure. This approach was better suited to the U.S. budget process than the earlier deficit reduction targets contained in the Gramm-Rudman-Hollings Act, which were so sensitive to economic and technical factors that they threatened large sequestrations that could not be implemented, thereby undermining credibility.[54] In Canada, expenditure reviews across government to identify specific areas where permanent cuts would be feasible and reforms to the expenditure management system were deemed largely successful in contributing to fiscal improvements.[55]

Transparency also seems to have played a central role in locking in fiscal adjustment and preventing the unwinding of previous reforms, as in New Zealand, for example. However,

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[51]Von Hagen, Hallett, and Strauch, "Budgetary Consolidation in EMU." The empirical evidence presented in this and in similar studies should be regarded cautiously because the effectiveness of both transparency and fiscal rules, and especially rules supposed to apply over the cycle, can only be assessed over an extended period.

[52]However, note that while adjustment in the Netherlands may have been primarily driven by EMU considerations, the switch to a fiscal framework emphasizing expenditure ceilings in 1994 has been judged to have resulted in a smoother and more predictable budget process, as discussed in *OECD Economic Surveys: The Netherlands* (Paris: Organization for Economic Cooperation and Development, 1998).

[53]See James M. Poterba, "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics," *Journal of Political Economy*, Vol. 102 (1994); James E. Alt, "Credibility, Transparency, Accountability, Institutions," paper prepared for the Annual Meeting of the American Political Science Association, Washington, DC (September 2000); and Bayoumi and Eichengreen "Restraining Yourself."

[54]James M. Poterba, "Do Budget Rules Work?" in *Fiscal Policy: Lessons from Empirical Research*, ed. by Alan Auerbach (Cambridge, Mass.: MIT Press, 1997), pp. 53--86; *OECD Economic Surveys: The United States 1999* (Paris: Organization for Economic Cooperation and Development, 1999); and Allan Schick, "A Surplus, If We Can Keep It," *The Brookings Review*, Brookings Institution, Vol. 18, No. 1 (2000).

[55]See *OECD Economic Surveys: Canada 1998--1999* (Paris: Organization for Economic Cooperation and Development, 1999); and OECD, "Managing Structural Deficit Reduction," Public Management Occasional Paper No. 11 (Paris: Organization for Economic Cooperation and Development, 1996).

the New Zealand legislation did not prevent recent slippage relative to long-term fiscal goals, and this has cast some doubt on whether transparency by itself is sufficient to promote fiscal responsibility.[56] In the United Kingdom, the combination of transparency and fiscal rules has supported the adjustment process. The use of deliberately prudent forecasting assumptions, together with unexpected structural improvements to the level of receipts, has now created substantial room for maneuver within current fiscal rules; hence, the role of transparency in sustaining fiscal policy credibility will continue to be very important.[57]

VII. Concluding Remarks

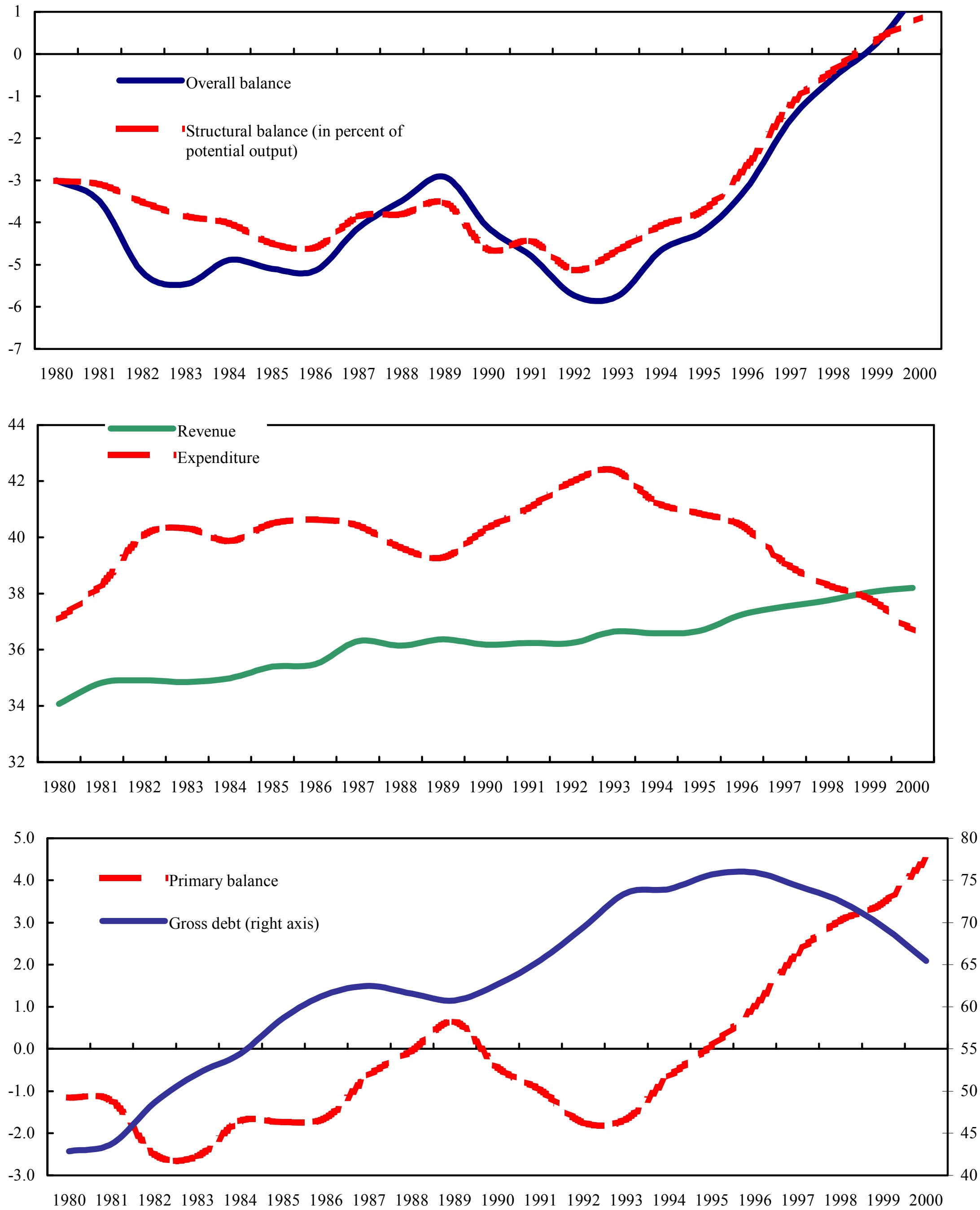
This paper has tried to argue that the recent wave of fiscal consolidation is likely to be more resilient than previous ones. Besides the conclusion reached by empirical literature that composition matters, this paper has argued that fundamental changes in public expenditure management has first allowed the adjustment to take place on the expenditure side, so directly addressing the expenditure or deficit bias. Secondly, by shifting budget focus from accounting for input to output, by devising performance measures and moving toward more appropriate accounting standards, these changes have been instrumental in underpinning a second generation of fiscal rules and frameworks in which transparency and accountability are essential elements.

Nonetheless, these second generation of fiscal rules and frameworks are a recent innovation, so definitive statements are difficult to make. The real test appears likely to come during an economic slowdown when pressures emerge to unwind recent fiscal adjustment by more than can be justified under the established rules. In particular, the expenditure reductions that have spearheaded recent adjustment may be significantly reversed. Such a circumstance is tailor made for fiscal rules, and especially expenditure ceilings, which can help to directly contain reversals on the spending side while providing scope for countercyclical fiscal policy, and a debt ceiling, which addresses longer-term sustainability. One conclusion is clear. The credibility of fiscal rules and objectives is strengthened if such measures are accompanied by enhanced fiscal transparency, as this openness complements a rules-based approach in three ways: by removing any tendency to be nontransparent to meet rules; by facilitating judgments of actual fiscal performance against rules, which makes transparency an essential requirement for rules to be effective; and by allowing justifiable flexibility in the application of rules.

[56]*OECD Economic Surveys: New Zealand 1999* (Paris: Organization for Economic Cooperation and Development, 1999.)

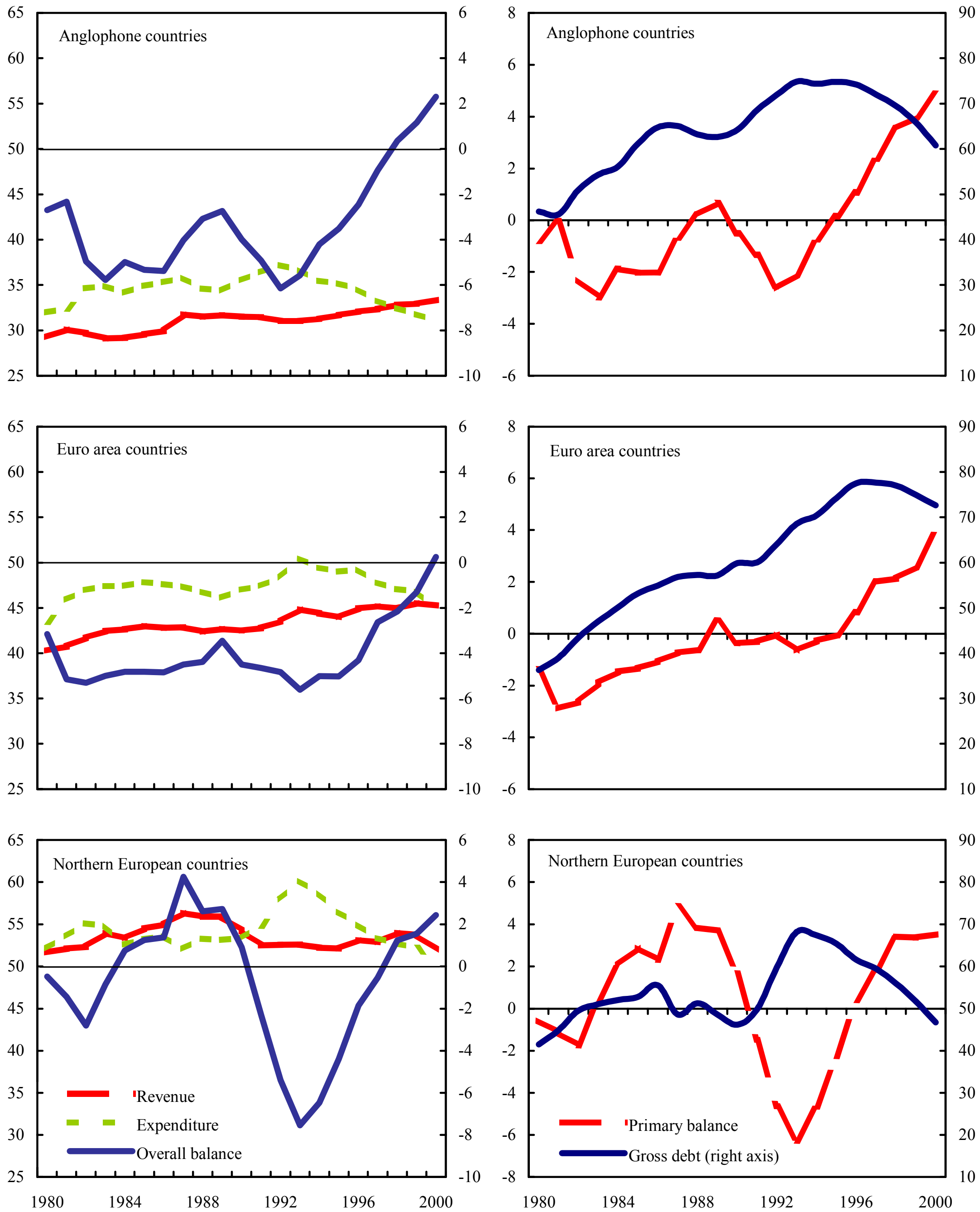
[57]IMF, "United Kingdom: Staff Report for the 1999 Article IV Consultation" (Washington: International Monetary Fund, 2000), available at http://www.imf.org/external/pubind.htm. Finland and the Netherlands also incorporate cautious growth assumptions in their fiscal projections.

Figure 1. Fiscal Developments in the OECD Area, 1980-2000
(In percent of GDP)



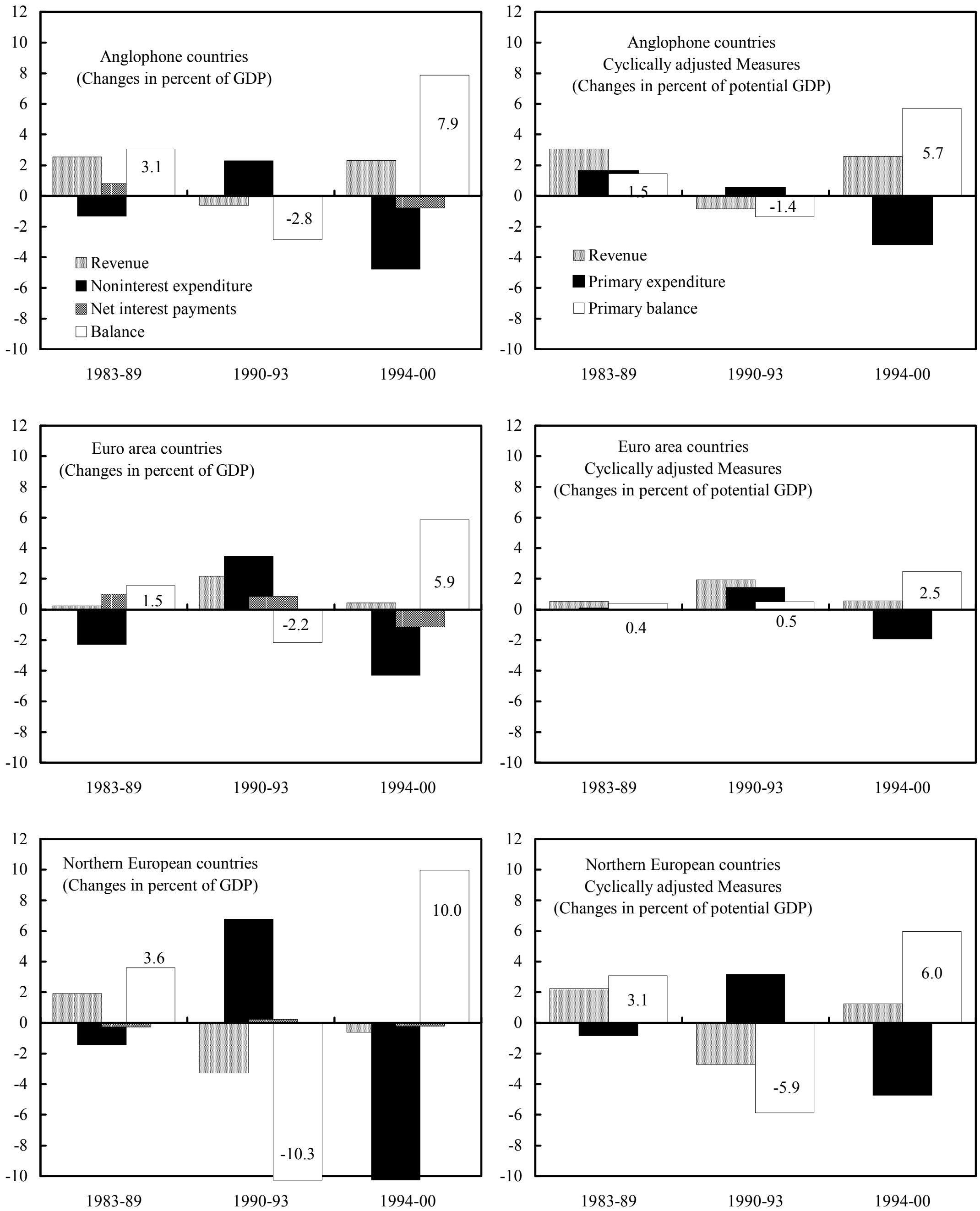
Source: OECD Analytical and Economic Databases.

Figure 2. Fiscal Developments in Groups of OECD Countries, 1980-2000
(In percent of GDP)



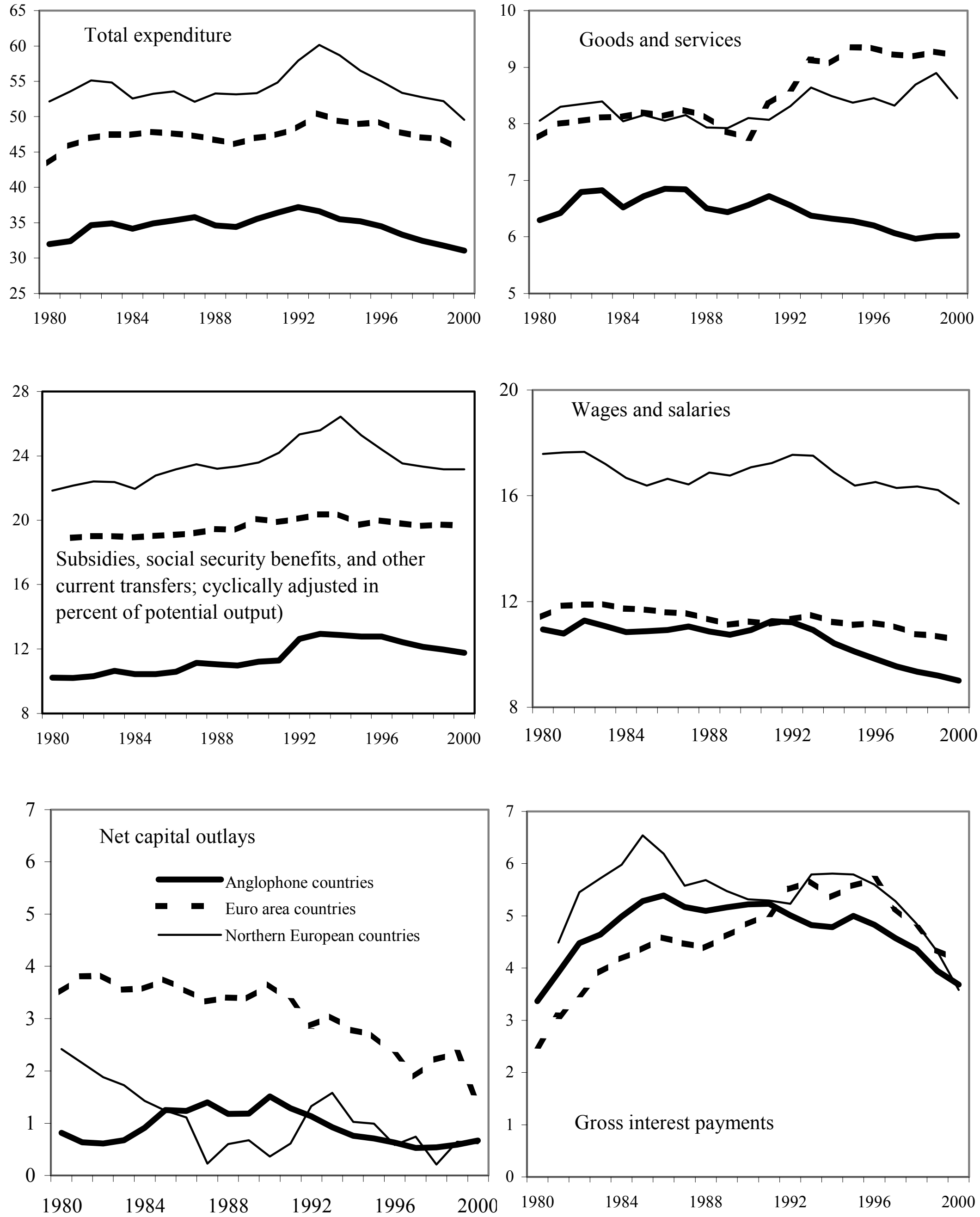
Source: OECD Analytical and Economic Databases.

Figure 3. Fiscal Developments in Groups of OECD Countries, 1983-89, 1990-93, and 1994-2000



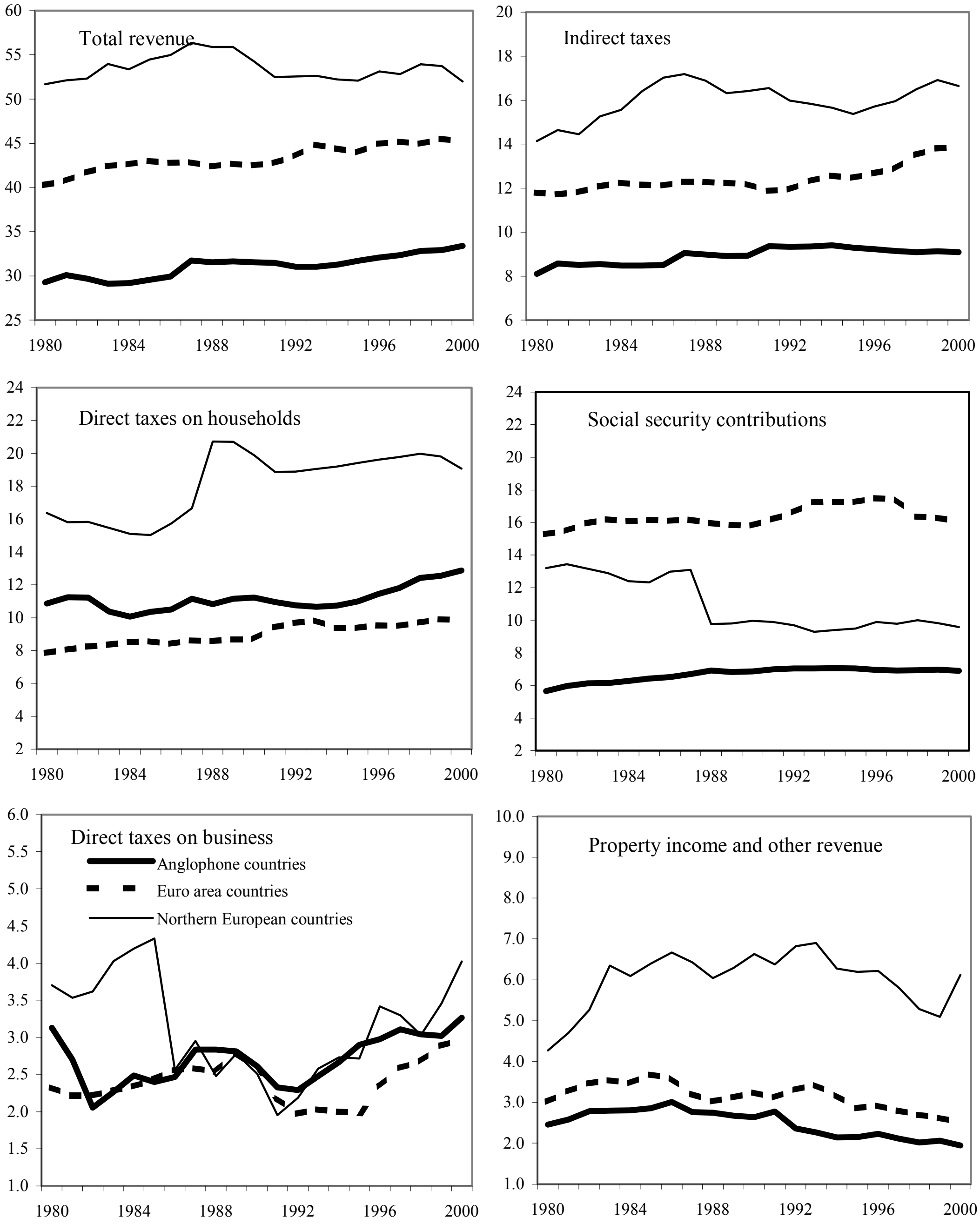
Source: OECD Analytical and Economic Databases.

Figure 4. Expenditure Developments in Groups of OECD Countries, 1980-2000
(In percent of GDP)



Source: OECD Analytical and Economic Databases.

Figure 5. Revenue Developments in Groups of OECD Countries, 1980-2000
(In percent of GDP)



Source: OECD Analytical and Economic Databases.

Figure 6. Selected OECD Countries: Top Marginal Individual Income Tax Rate, Corporate Income Tax Rate, Income Tax Brackets, and Standard VAT Rate