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Fiscal Rules and Targets and Public Expenditure Management: Enthusiasm in the 1990s and its Aftermath

Hideaki Tanaka

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ASIA PACIFIC SCHOOL OF ECONOMICS & GOVERNMENT

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Fiscal Rules and Targets and Public Expenditure Management: Enthusiasm in the 1990s and its Aftermath

The 1990s saw an era of fiscal consolidation in industrialised countries, which struggled with fiscal deficits throughout the 1970s and 1980s. Reforms in public expenditure management, typically the introduction of fiscal rules and targets, together with favourable economic growth contributed to a significant improvement in fiscal positions. However, fiscal deficits have been increasing again since the turn of the 21st century in many OECD countries. Interestingly, some countries have been able to maintain fiscal discipline since the achievement of fiscal balance in the latter half of the 1990s. What has caused this difference? This paper derives important lessons for reform in public expenditure management from the experiences of major OECD countries', including Australia, France, Germany, Japan, the Netherlands, New Zealand, Sweden, the UK and the USA. Essentially, success in maintaining fiscal discipline lies in maintaining a firm political commitment, and strengthening expenditure management that underpins any such commitment, specifically a medium-term fiscal plan in line with fiscal rules and targets in a centralised and transparent manner. Public expenditure management reform is a cornerstone of the restructuring of public sector services, especially in welfare programs aimed at overcoming problems arising from an aging population.

Introduction

Major OECD countries improved their fiscal positions and achieved significant fiscal consolidation by the end of the 1990s. Strikingly, on average the general government fiscal balance of OECD countries turned into a surplus in 2000. Several factors were involved in this strengthening. Economic growth was, of course, important but it did not explain the whole picture. A distinctive character of fiscal adjustment in 1990s was that a large number of countries made efforts to reform their budgeting systems and institutions, typically by the introduction of fiscal rules and targets. The Maastricht Treaty criterion of restricting budget deficits to 3 per cent or less of GDP highlighted this. Furthermore, several countries such as Sweden overhauled their budgeting and public expenditure management, challenging not only the introduction of fiscal rules but also the political decision-making process involved in budgeting.

However, budget deficits appear again in most OECD countries at the turn of the twenty-first century. Fiscal rules and institutions introduced in the 1990s are now under the stringent stress testing fiscal performance. Why didn't fiscal rules and institutions stop fiscal deterioration in 2000 and beyond?

Table 1–1 Major economic and social indicators in selected countries (2003)

Indicators	Australia	France	Germany	Japan	Netherlands	New Zealand	Sweden	UK	USA
Population (thousands)	19,881	59,767	82,502	127,619	16,224	4,009	8,958	60,483	291,049
Total area (thousands sq.km2)	7,687	549	357	378	41	269	450	245	9,372
Nominal GDP (PPPs, billion US$)	569.1	1708.9	2171.1	3571.4	472.8	92.1	251.3	1720.3	10933.5
GDP per capita (PPPs, US$)	28,500	27,800	26,300	28,000	29,100	22,800	28,100	29,000	37,600
General government finance									
Total outlay (% of GDP)	36.0	54.5	48.8	37.6	49.0	38.3	58.2	43.7	36.1
Total revenue (% of GDP)	36.8	50.4	45.0	29.9	45.8	41.4	58.3	40.2	31.5
Balance(% of GDP)	0.8	–4.1	–3.8	–7.7	–3.2	3.1	0.1	–3.5	–4.6
Gross financial liabilities (% of GDP)	19.6	71.2	65.1	157.5	63.2	37.4	60.9	42.0	62.5
Net financial liabilities (% of GDP)	2.4	44.1	51.9	79.1	36.8	13.9	4.5	34.9	42.8
Gross national saving	(2002)	(2002)		(2002)	(2002)	(2001)			(2002)
(% of GDP)	19.0	20.9	20.4	25.7	22.6	18.2	21.6	14.7	14.6
Current account balance (% of GDP)	–5.9	0.4	2.3	3.1	2.9	–4.2	6.4	–1.9	–4.8
Long-term interest rate	5.4	4.1	4.1	1.1	4.1	5.9	4.6	4.5	4.0
Consumer price index increase	2.8	2.2	1.0	–0.3	2.2	1.8	1.9	1.4	2.3
Unemployment rate(%)	6.0	9.7	9.1	5.3	4.1	4.6	4.9	5.0	6.0

Source: OECD (2004), *OECD in Figures*, 2004 Edition and OECD (2004), *Economic Outlook, No. 76.*

Interestingly, some countries including Australia, Finland, New Zealand and Sweden, have been able to maintain a fiscal surplus since the end of 1990s, while others, notably France, Germany, and the United States have not. What has caused this difference? What is the major difference in fiscal rules and institutions between the former and the latter? This paper argues that the design of fiscal rules and the integrity of public expenditure management are significant in accounting for this phenomenon.

This paper mainly analyses budgeting reforms and public expenditure management reforms in major OECD countries in 1990s and tries to make a comparison among them, obtaining some lessons from this analysis.[1] Country-specific case studies are conducted for Australia, France, Germany, Japan, the Netherlands, New Zealand, Sweden, the United Kingdom, and the United States.[2] The aim in this paper is to identify the critical elements in expenditure management that are responsible for preserving fiscal discipline. This may be useful for those countries that are supposed to resume fiscal consolidation in the latter half of the 2000s, namely Japan and Germany. The paper is structured as follows: Chapter 2 reviews overall fiscal developments in major OECD countries; Chapter 3 surveys literature on how fiscal institutions and budgeting systems affect fiscal performance of OECD countries and shows the basic idea of analytical framework in this paper; the next three chapters describe and analyse reasons, contents, and aftermath of reforms; Chapter 4 examines why major countries started fiscal consolidation and reformed their fiscal institutions in the late 1990s; Chapter 5 analyses details of reforms in fiscal institutions; Chapter 6 explores some problems that countries have faced from 2000 and beyond and evaluates the efficacy of fiscal rules and institutions; Chapter 7 discusses how to ensure fiscal discipline and strengthen public expenditure management and summarises major lessons that can be drawn from OECD countries' experiences; finally we conclude in Chapter 8.

Overall fiscal developments in OECD countries

The general government fiscal balances of almost all OECD countries improved dramatically in the 1990s, as shown by the fact that they moved from a deficit of 5 per cent of GDP in 1993 to almost balanced budgets in 2000 in terms of the OECD average (Table 21 and Table 2–2).[3] There were a few countries that did not achieve fiscal consolidation in 1990s, notably Japan.[4] If we look at the cyclically adjusted fiscal balance, the OECD average improved by 3 percentage points during 1994–2000, which accounted for nearly two thirds of the nominal improvement in fiscal balance (Table 2–3). Surprisingly, cyclically adjusted figures Greece, Italy and Sweden's improved by more than 10 percentage points. The willingness of governments to restore fiscal positions, coupled with favourable economic circumstances, brought major countries into fiscal surplus at the end of 1990s. New Zealand achieved fiscal balance in 1994, Australia, Sweden, the United Kingdom, and the United States in 1998, the Netherlands in 1999, and Germany in 2000. In terms of general government gross debt, some countries such as Australia, the Netherlands and the US experienced a significant reduction, although the OECD average was almost stable in 1990s (Table 2–4 and Table 2–5). Australia and Sweden eliminated almost all their public debt in the first half of 2000 in terms of net debt.

Did OECD countries achieve fiscal consolidation with expenditure cuts or tax increases in the 1990s? Generally speaking, fiscal consolidation during the 1990s was brought about mainly through reductions on the expenditure side, notably in wages, transfers and interest payments, although the balance between expenditure and revenue varies from country to country.[5] General government total expenditure in terms of GDP, as an OECD average, was reduced from 43.3 per cent in 1993 to 39.3

Table 2–1 General government/fiscal balances (% of GDP)

Countries	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Australia	–1.7	–4.3	–6.4	–5.8	–4.8	–3.9	–2.2	–0.4	0.7	2.0	–0.8	–0.8	0.3	0.8	0.7	0.4
France	–2.1	–2.4	–4.2	–6.0	–5.5	–5.5	–4.1	–3.0	–2.7	–1.8	–1.4	–1.5	–3.3	–4.1	–3.7	–3.1
Germany	–2.0	–2.9	–2.6	–3.1	–2.4	–3.3	–3.4	–2.7	–2.2	–1.5	1.3	–2.8	–3.7	–3.8	–3.9	–3.5
Japan	2.1	1.8	0.8	–2.4	–3.8	–4.7	–5.1	–3.8	–5.5	–7.2	–7.5	–6.1	–7.9	–7.7	–6.5	–6.4
Japan(ex. social security)	–1.4	–0.9	–1.7	–4.6	–5.7	–6.6	–6.8	–5.6	–6.9	–8.3	–8.0	–6.2	–7.7	–7.4	–6.2	–6.1
Netherlands	–5.3	–2.7	–4.2	–2.8	–3.5	–4.2	–1.8	–1.1	–0.8	0.7	2.2	–0.1	–1.9	–3.2	–2.9	–2.7
New Zealand	–4.3	–3.9	–3.3	–1.3	2.5	3.0	2.9	1.9	0.3	0.6	1.5	2.0	2.5	3.1	2.9	2.1
Sweden	3.8	–1.9	–7.6	–11.4	–9.3	–6.9	–2.8	–1.0	1.9	2.3	5.1	2.9	–0.3	0.1	0.5	0.7
UK	–1.6	–3.1	–6.5	–7.9	–6.8	–5.8	–4.2	–2.2	0.1	1.0	3.8	0.7	–1.7	–3.5	–3.2	–3.2
USA	–4.2	–4.9	–5.8	–4.9	–3.6	–3.1	–2.2	–0.8	0.4	0.9	1.6	–0.4	–3.8	–4.6	–4.4	–4.1
Euro Area	–4.6	–5.0	–5.1	–5.8	–5.1	–5.1	–4.3	–2.6	–2.3	–1.3	0.1	–1.7	–2.4	–2.8	–2.9	–2.6
Total OECD	–2.9	–3.7	–4.6	–5.0	–4.2	–4.0	–3.1	–1.7	–1.2	–0.8	0.3	–1.2	–3.2	–3.7	–3.5	–3.2

Source: OECD (2004) *Economic Outlook*, No. 76.

Table 2–2 General government/cyclically-adjusted fiscal balances (% of potential GDP)

Countries	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Australia	–1.1	–2.6	–4.7	–4.6	–4.2	–3.4	–1.9	–0.2	0.5	1.6	0.3	–1.1	0.1	0.6	0.5	0.2
France	–2.9	–2.9	–4.5	–5.2	–4.9	–4.9	–3.0	–1.9	–2.1	–1.5	–1.9	–2.0	–3.2	–3.4	–3.1	–2.5
Germany	–4.0	–3.5	–3.2	–2.1	–1.6	–2.8	–2.6	–1.9	–1.7	–1.4	–2.0	–3.4	–3.4	–2.7	–2.6	–2.3
Japan	1.2	1.2	0.3	–2.4	–3.7	–4.6	–5.4	–4.2	–5.3	–6.7	–7.2	–5.5	–6.8	–6.8	–6.5	–6.4
Netherlands	–7.5	–4.7	–5.2	–2.1	–3.0	–4.0	–2.1	–2.1	–2.7	–1.8	–1.4	–1.9	–2.2	–1.4	–0.6	0.0
New Zealand	–2.8	–0.6	0.1	0.3	2.3	2.3	1.9	1.4	1.1	0.5	1.0	1.6	1.7	2.5	1.8	1.7
Sweden	3.9	–5.7	–3.6	–5.2	–5.0	–4.4	–0.1	0.9	2.6	1.8	3.6	2.7	–0.1	0.6	0.6	0.3
UK	–2.5	–2.1	–4.4	–5.9	–5.9	–5.2	–3.6	–2.0	0.2	1.2	1.0	0.3	–1.7	–3.4	–3.4	–3.4
USA	–4.4	–4.2	–5.2	–4.4	–3.3	–2.6	–1.8	–0.6	0.5	0.6	1.3	–0.1	–3.2	–4.1	–4.0	–4.2
Euro Area	–5.9	–5.8	–5.2	–4.4	–4.0	–4.3	–3.3	–1.9	–2.0	–1.4	–1.8	–2.3	–2.4	–2.0	–2.1	–1.8
Total OECD	–3.8	–3.8	–4.4	–4.3	–3.8	–3.6	–2.8	–1.5	–1.1	–0.9	–0.8	–1.4	–3.1	–3.4	–3.4	–3.3

Source: OECD (2004) *Economic Outlook*, No. 76.

Table 2–3 Fiscal consolidations in 1990

Changes in general government (% of GDP)

	Periods	Net lending	Cyclically-adjusted net lending	Cyclically-adjusted revenues	Cyclically-adjusted expenditures	Net interest payments	Gross debt
Australia	1993–1999	7.1	5.4	4.5	0.6	–1.4	–0.5
France	1994–2000	4.6	3.3	2.1	–0.6	–0.1	13.8
Germany	1997–2000	4.5	1.0	0.5	–0.3	–0.3	0.2
Netherlands	1995–2000	6.4	4.7	0.3	–4.3	–1.1	–19.9
New Zealand	1991–1994	7.7	5.8	–1.2	–2.3	–2.9	
Sweden	1994–1998	14.0	10.6	2.2	–4.5	1.8	2.6
UK	1994–2000	11.9		3.1	–2.0	–0.2	–6.6
USA	1993–2000	7.3	6.2	3.0	–1.9	–1.0	–14.6
Euro Area	1994–2000	5.9	3.2	0.5	–0.6	–1.6	4.1
Total OECD	1994–2000	5.1	3.3	1.1		–1.0	1.9

Notes: 1 Fiscal consolidations are defined between 1990 and 2000 as periods of protracted (more than three years) improvements in the annual general government's net lending in percent of GDP, as compared to the previous years, where such periods are allowed to be interrupted if the worsening of that balance does not exceed 0.5 percent of GDP and does not last fore more than one year.
2 Values in that last year of the consolidation minus the value in the year before the consolidation.
3 Excluding interest payments.

Source: Pedro de Lima et al (2003), Macroeconomic Policy and Economic Perspective, OECD *Economic Department Working Paper* No. 353.

percent in 2000, while total tax and non-tax receipts increased from 38.3 per cent to 39.3 per cent in the same period. An examination of the cyclically adjusted figures shows that, on the one hand, countries that reduced expenditure were Sweden, the Netherlands, Canada, while on the other hand countries that increased expenditure were the US, France and Australia (Table 2–3).

It is less easy to keep public finance sound than to achieve fiscal consolidation. Since 2000, fiscal positions have deteriorated in most OECD countries and the OECD-wide general government fiscal deficit reached 3.8 per cent of GDP in 2003. It should be noted that these deteriorations cannot be explained simply by economic downturns. A discretionary relaxation of fiscal policy has been observed particularly in the United States, and to lesser extent in France, Germany and the United Kingdom. While these big countries failed to keep fiscal discipline, some OECD countries have still maintained a fiscal surplus continuously from the end of 1990s. They include Australia, Canada, Denmark, Finland, Korea, New Zealand, Norway, and Sweden. Importantly, these countries have not made their cyclically adjusted fiscal balances significantly worse.

Table 2–4 General government/gross financial liabilities (% of GDP)

Countries	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Australia	23.1	28.7	32.2	42.6	44.6	41.4	39.6	34.1	28.4	25.2	22.1	20.7	19.6	20.6	18.2	
France	39.5	40.3	44.7	51.6	55.3	63.9	67.5	69.4	71.1	67.3	66.2	64.9	68.7	71.2	74.0	76.2
Germany	41.5	38.8	41.8	47.4	47.9	57.1	60.3	61.8	63.2	61.6	60.9	60.5	62.9	65.1	67.0	68.6
Japan	68.6	64.8	68.7	74.9	79.7	87.1	93.9	100.3	112.2	125.7	134.1	142.3	149.3	157.5	163.5	170.0
Netherlands	87.8	88.9	92.8	97.7	87.7	90.8	89.8	84.5	82.9	74.2	66.7	62.1	63.2	66.1	68.1	68.7
New Zealand				70.8	62.7	56.9	50.8	50.1	49.7	47.1	44.7	42.2	40.2	37.4	34.6	33.2
Sweden	46.8	55.5	74.0	79.0	83.5	82.2	84.7	82.8	81.2	71.6	64.2	63.2	62.1	61.9	61.2	60.3
UK	33.0	33.6	39.8	49.6	47.8	52.7	52.6	53.2	53.8	48.8	45.9	41.2	41.5	42.0	43.4	44.9
USA	66.6	71.3	73.7	75.4	74.6	74.2	73.4	70.9	67.7	64.1	58.2	57.9	60.2	62.5	63.5	64.9
Euro Area	62.7	63.3	66.8	72.2	73.3	78.7	82.7	82.6	82.7	79.2	77.0	75.5	76.6	77.4	78.3	79.0
Total OECD	60.8	62.7	66.3	70.4	71.2	73.9	75.5	74.3	74.6	73.4	70.9	71.1	73.2	75.4	76.8	78.4

Source: OECD (2004) *Economic Outlook*, No. 76.

Table 2–5 General government/net financial liabilities (% of GDP)

Countries	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Australia	10.9	11.7	16.5	22.6	27.5	28.2	22.3	22.5	17.0	15.9	9.9	5.8	4.1	2.4	1.9	1.4
France	17.5	18.8	20.4	27.1	28.3	38.9	42.6	43.3	41.7	33.6	34.9	36.7	42.3	44.1	46.1	47.6
Germany	21.0	20.2	24.5	28.1	29.3	39.6	42.5	43.4	46.1	45.3	42.4	44.1	48.6	51.9	54.7	57.1
Japan	24.6	12.6	14.3	17.7	20.3	24.5	29.7	35.2	45.8	53.6	59.1	65.2	71.4	79.1	84.4	90.1
Netherlands	33.4	34.6	40.6	45.3	44.2	54.1	52.9	50.7	48.0	36.6	35.1	33.3	35.3	36.8	39.0	41.1
New Zealand				47.9	40.8	34.7	30.7	28.4	25.8	23.8	20.7	20.3	18.0	13.9	9.9	7.4
Sweden	–7.8	–5.0	4.5	10.3	20.4	25.3	25.7	23.1	20.0	9.4	1.4	–2.9	4.8	4.5	3.8	2.9
UK	14.9	15.5	22.5	32.3	33.0	38.9	40.5	42.6	43.7	39.8	36.9	33.5	34.3	34.9	36.3	37.8
USA	48.9	52.5	55.9	58.4	57.9	57.2	56.3	53.1	49.3	44.3	39.0	38.0	40.7	42.8	44.3	45.7
Euro Area	36.1	37.5	40.6	45.4	46.6	53.1	56.4	55.8	50.8	49.0	49.1	51.5	52.5	53.4	54.0	
Total OECD	35.4	36.1	39.6	43.4	44.3	46.9	48.0	46.7	43.5	40.8	40.6	43.1	45.2	46.6	48.0	

Source: OECD (2004) *Economic Outlook*, No. 76.

What explains this difference? In 2000, when all countries involved in the case studies enjoyed 3 to 4 per cent real GDP growth (Table 2–6), cyclically adjusted fiscal balances in France, Germany and the Netherlands deteriorated by more than 1 per cent of GDP. This was mainly due to tax cuts. Problems emerge during periods of economic growth, rather than times of recession. This is a typical case of asymmetry of fiscal policy. The UK was able to keep a cyclically adjusted surplus until 2001, but thereafter it deteriorated to 2.3 per cent of GDP deficit in 2003 with a nominal deficit of 2.9 per cent of GDP. Countries experiencing cyclically adjusted fiscal deficits in 2003 also included the USA at 4.5 per cent of GDP, France at 2.9 per cent and Germany at 2.3 per cent. It is evident that all these big countries have loosened fiscal discipline.

Fiscal institutions

Theories and arguments

There has been increased awareness of the need for effective fiscal institutions in dealing with the issue of fiscal reforms and budgeting. A number of theoretical and empirical studies have been done to analyse the relationship between the nature of fiscal institutions and a country's performance particularly in the 1990s. Their general conclusion suggests that the size of budget deficits and debt depends on the

Table 2–6 Real G D P growth rates

(%)

Countries	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Australia	1.4	–0.7	2.3	3.9	4.7	3.9	4.1	3.7	5.4	4.3	3.3	2.7	3.6	3.3	3.6	3.8
France	2.6	1.0	1.3	–0.9	1.9	1.8	1.0	1.9	3.6	3.2	4.2	2.1	1.1	0.5	2.1	2.0
Germany	5.7	5.1	1.8	–1.1	2.4	1.8	0.8	1.5	1.7	1.9	3.1	1.0	0.1	1.4	2.3	
Japan	5.2	3.4	1.0	0.2	1.1	1.9	3.4	1.9	–1.1	0.1	2.8	0.4	–0.3	2.5	4.0	2.1
Netherlands	4.1	2.4	1.5	0.7	2.9	3.0	3.0	3.8	4.3	4.0	3.5	1.2	0.6	–0.9	1.2	2.4
New Zealand	0.5	–1.9	0.8	4.7	6.2	3.9	3.5	2.9	0.2	4.9	3.6	2.7	4.5	3.2	4.8	2.1
Sweden	1.1	–1.1	–1.3	–2.0	4.0	4.2	1.3	2.6	3.7	4.3	4.4	1.2	2.0	1.7	3.3	3.3
UK	0.8	–1.4	0.2	2.3	4.4	2.9	2.8	3.3	3.1	2.9	3.9	2.3	1.8	2.2	3.2	2.6
USA	1.8	–0.2	3.3	2.7	4.0	2.5	3.7	4.5	4.2	4.4	3.7	0.8	1.9	3.0	4.4	3.3
Euro Area	3.6	2.5	1.2	–0.9	2.4	2.3	1.4	2.4	2.8	2.8	3.7	1.7	0.9	0.6	1.8	1.9
Total OECD	3.1	1.3	2.1	1.4	3.3	2.5	3.1	3.6	2.7	3.3	1.1	1.6	2.2	3.6	2.9	3.1

Source: OECD (2004) *Economic Outlook*, No. 76.

characteristics of fiscal institutions of an individual country rather than economic performance.[6] Fiscal institutions can be defined as anything that may influence how budgets are prepared, approved and carried out, and fiscal rules and targets are typical examples of them. It is not only the design of budgeting which matters, but also the nature of political systems. Several papers emphasise the role of the electoral system, party structure and cabinet structure.[7] Why do fiscal institutions matter?[8] Fiscal institutions are the rules of the game the players obey and can influence decision-making in the politics of budgeting. This should be no surprise because budgeting is essentially a political process, which allocates scarce resources.

In addition, we should remember the nature of public goods and services when it comes to the rules of budgeting imposed through fiscal institutions. Unlike private goods and services, those who consume public goods and services do not usually pay the full cost of the value received. Broad-based government taxes are collected across the country and pooled as a 'common property resource'.[9] Then public goods and services are financed from this fund. This induces a 'common-pool problem' in which interest groups, including politicians and spending ministries, try to obtain money from this fund with little attention to the burden of expenditure. Therefore it results in an excessive level of public expenditure and higher deficits. If the government tries to reduce spending on a particular program, those who benefit from it are naturally strongly against the reduction. In addition, the government, unlike families and companies, can redistribute resources inter-temporally with budget deficits (issuing bonds) and easily transfer costs of deficits to the next generation. They cannot prevent prodigality because the next generation is not eligible to vote. This institutional mechanism inherent in the public sector may eventually destabilise the economy due to the problem of sustainability of public finance.

Any fiscal reforms that do not pay attention to the common-pool problem cannot mitigate deficit bias. In other words, experiences of other countries particularly in the 1990s suggest the bias could be controlled and managed by strategically reforming budget processes and expenditure management. If we take the view that budgeting is a matter of political decision making that allocates scarce resources, then this decision-making process should be the highest priority for reformers. Porterba and von Hagen (1999) argue that the less individual actors take into account the externality created by the general tax fund, the larger the bias is toward higher spending and larger deficits. Thus we need mechanisms designed to make participants in the budgeting process internalise the costs of budget deficits. They also argue that we have to keep in mind two key issues; one is 'centralisation' of decision-making in the budget process; the other is 'transparency' of the budget system. One of these mechanisms is the application of fiscal rules and targets. While fiscal reforms of OECD countries differ from country to country in their specifics, there has been a general tendency of these governments to try and tighten expenditure control in the medium-term in line with fiscal rules and targets introduced in advance.

Fiscal rules and targets are not new issues. They have been discussed variously over how to conduct a fiscal policy. Traditionally, the fiscal rule of the government was similar to the balancing of a family budget. However, this changed with Keynes' revolutionary policies of using budget imbalances as a countermeasure against the business cycle. Active fiscal policy was dominant in many countries in the 1960s and 1970s, however there has been increased skepticism about counter-cyclical discretionary fiscal policy in economic literature ranging from the neoclassical synthesis of Milton Friedman to public choice theory of James Buchanan. Today, there is a reasonably widespread view that monetary and fiscal policy should be implemented based on a set of rules. The rationale behind rule-based policy making is grounded in skepticism about the ability of governments to implement economic policy in a rational manner.[10] If the government is omniscient and omnipotent in assessing economic downturns and upturns and in implementing discretionary policy in a timely and adequate manner necessary to stabilise the economy, discretionary policy would be the most desired, in theory. In such a world, rules and targets might undermine the flexibility of the government to adopt the best policy for dealing with specific economic circumstances. However, government omniscience does not always come to pass in the real world; nor can one assume authorities have complete competency and practice the best policy.

Skepticism about the effectiveness of discretionary fiscal policy has been dominant in industrialised countries. Hemming et al (2002a,b) survey various empirical literature on the effectiveness of fiscal policy and draw the conclusion that estimates of fiscal multipliers are overwhelmingly positive, but small and short-term multipliers average around a half for taxes and one for spending with only modest variations across countries and models. Some empirical analyses suggest that the macro-economic impact of fiscal consolidation on output can be positive under special circumstances.[11] This suggests a negative fiscal multiplier, although the standard Keynesian theory suggests fiscal consolidation will result in lower output over the short-term. The latest empirical analysis on what we might call the non-Keynesian effect, done by Giudice et al. (2003), suggests roughly half the episodes of fiscal consolidation that have been undertaken in the EU in the last thirty years have been followed by an acceleration in growth. It should be remembered that fiscal consolidation does not always result in a deflationary effect on the economy, as it depends on various factors such as how people react to the government's fiscal policy in terms of consumption and investment.

Fatás and Mihov (2002) argue that even though discretionary fiscal policy has some kind of positive multiplier, it induces volatility of output and hence lower economic growth. The OECD

(2003a) assesses the extent to which the fiscal policy stance has been pro- or counter-cyclical in the OECD countries, and shows that the fiscal stance has been counter-cyclical in about half of the countries examined and pro-cyclical in others. In particular, discretionary fiscal policy is likely to be easing in economic upturns. Lane (2003) analyses whether pro-cyclical or counter-cyclical public expenditures would be by country and by item, and concludes that the higher the volatility of GDP and the more fragmented political decision-making process is, the more pro-cyclical fiscal policy is likely to be.

Thanks to these empirical and theoretical studies, the role of discretionary fiscal policy in stabilising the economy has been decreasing since the 1980s in industrialised countries. It is suggested that monetary policy should be more responsive to the economy while fiscal policy should rely more on automatic stabiliser.[12] Furthermore, active fiscal policy should be avoided because it makes conduct of monetary policy more difficult. In the end, a general consensus has emerged in academia and amongst authorities that some kind of restrictions should be imposed on developing both monetary and fiscal policy. When it comes to restrictions on monetary policy, the so-called inflation target has become more popular than ever. It is not so simple in the case of fiscal policy. While monetary policy has the relatively simple objective of stabilising price fluctuation, usually measured by price indexes, and is implemented by a central bank given strong legal independence from political control, fiscal policy has several objectives such as stabilising the economy and redistributing wealth and cannot be implemented without a democratic process. In general, although the necessity of restrictions on fiscal policy has been recognised, the nature of such restrictions is still a point of contention. The effectiveness of restrictions depends on various circumstances. Even if one rule is successfully implemented in one case, the same rule would possibly be ineffective in another.

Definitions and analysis of framework

It is possible to develop the potential nature of institutional restrictions on fiscal policy through an examination of the reasons for the existence of budget deficits. This paper focuses mainly on the budgeting process, fiscal institutions, and expenditure management, because they influence fiscal outcome directly. It takes into account political decision making in the budget process, but other factors such as party and electoral systems, which may influence fiscal outcomes, are not discussed specifically in this paper.

It is not easy to sort out institutions and management tools necessary for reforming budgeting and public finance in a structured way. First of all, it is helpful to begin by examining how fiscal rules and targets can be defined, as they are considered to be the most popular and important institution.

Alesina and Perotti (1996b) define budgetary institutions as all rules and regulations according to which budgets are drafted, approved, and implemented. They classify rules and regulations into the following three types; numerical targets of the budget, procedural rules which regulate the preparation and legislative approval of the budget; and rules regarding the transparency of the budget.

Kopits and Symansky (1998) define fiscal policy rules as a permanent constraint on fiscal policy in terms of an indicator of overall fiscal performance. An example is would be a numerical ceiling or target in terms of gross domestic product (GDP) to budget deficit, borrowing and debt. They do not define guidelines or targets that are not intended for application on a permanent basis by successive governments as a fiscal rule. Regulation and rule of the budget formulation does not qualified as a fiscal rule by their definition. Their definition of fiscal rules and targets is narrow.

Hemming and Kell (2001) suggest four possible approaches to addressing deficit bias; improving fiscal transparency; adopting fiscal rules or binding fiscal targets: implementing traditional institutional reform such as strengthening the powers of the finance minister over spending ministers; or undertaking radical institutional reform by creating an independent fiscal authority. They then categorise fiscal rules into the following three types; deficit rules; debt rules; and expenditure rules. They distinguish rules with institutions and transparency.

This paper does not follow the narrow definitions employed by Kopits and Symansky (1998) and includes guidelines or regulations relating to the budget process. That is, any restrictions that may affect how the budget is adopted, approved and implemented will be discussed here. The paper analyses fiscal reforms of major OECD countries using a framework that covers the following three types of institutions.[13]

(1) Macro rules

Macro rules can be defined as any rules and targets that impose on fiscal policy in terms of overall fiscal performance, such as rules on fiscal deficit, borrowing, and outstanding debt. They include laws and guidelines, but in principle they are implemented permanently. Numerical targets of general government expenditure or revenue as a proportion of GDP are also classified into this category. The classification of macro rules is shown in Table 3–1.

(2) Expenditure rules

Expenditure rules can be defined as any rules and targets that bind and control expenditures in annual budgeting, such as expenditure ceilings and caps, and pay-as-you-go principles. Expenditure rules are

Table 3–1 Classification of macro rules and targets

F / S	Indicators	Examples
Flow/ balance	Nominal balance	US (Gramm–Rudman–Hollings, Budget Enforcement Act) Japan (Public Finance Act)
	Nominal balance in current account (incl. golden rule)	Germany (Constitution) Japan (Public Finance Act) UK (based on the Code for Fiscal Stability)
	Primary balance	Japan (Reforms and Perspectives)
	Cyclically-adjusted balance (structural balance)	Netherlands (structural balance) Norway (structural deficit, ex. oil revenues is less than 4% of GDP) Switzerland (expenditure limits set by cyclically-adjusted revenues)
	Balance over economic cycle	Australia (based on Charter of Budget Honesty Act) New Zealand (based on Fiscal Responsibility Act) UK (based on the Code for Fiscal Stability)
	Limit on deficit (or surplus)	EU (Maastricht Treaty: 3% deficit of GDP) Japan (Fiscal Structural Reform Act: 3% deficit of GDP, ex. social security) Sweden (2% surplus over economic cycle)
Flow/ expenditure revenue	Upper limit on expenditure	Japan (Reforms and Perspectives: keeping the current level) New Zealand (based on Fiscal Responsibility Act: 35%)
	Upper limit on revenue	Australia (based on Charter of Budget Honesty Act: not increase from current level)
Stock debt outstanding	Upper limit on debt nominal value)	USA (Liberty Bond Act)
	Upper limit on gross debt (% of GDP)	EU (Maastricht Treaty: 60%)
	Upper limit on net debt (% of GDP)	Australia (based on Charter of Budget Honesty Act: 10%) UK (based on the Code for Fiscal Stability: 40% over economic cycle)
	Net worth (% of GDP)	New Zealand (based on Fiscal Responsibility Act: more than 30%)

Notes: 1 Contents derived from Table 5–1, as well as OECD (2002a), Appendix Table IV. A1. Rules not effective now are included (eg. Gramm–Rudman–Hollings).
2 The coverage of balance and debt may be different (eg. central government, general government.
3 'Based on Fiscal Responsibility Act' means target levels are not stipulated in relevant law but decided based on law.

normally presented in relation to medium-term fiscal plans, so this paper analyses both together in the case study of each country.

(3) Budgeting process

Budgeting process refers to any fiscal institutions other than macro and expenditure rules, particularly focusing on the decision-making process of budget proposals in the cabinet, transparency of budget and fiscal information, and organisation involved in budgeting.

Finally, the paper uses the term 'public expenditure management' when it focuses on controlling and managing public expenditure through fiscal institutions as listed above, since the term 'fiscal institutions' inadequately expresses aspects of implementation and management.

Reasons for fiscal reforms

The 1990s can be accurately be described as the era of fiscal consolidation among OECD members. Reforms of public expenditure management including fiscal rules and targets (Table 3–2), together with favourable economic circumstances contributed to improvements of fiscal position. Most countries however have experienced a deterioration of their position since 2000. This may be as a result of the resurgence of old bad habits. The following questions constitute an examination of this phenomenon.

Question No.1: Why was fiscal consolidation achieved in most OECD countries in 1990s? Why did many countries initiate fiscal reforms and in particular introduce fiscal rules and targets?

Question No.2: What kind of reforms in public expenditure management contributed to fiscal consolidation?

Question No.3: Why were most countries unable to keep fiscal discipline throughout the 2000s? What has made a differences in fiscal performance between countries that have lost fiscal discipline and those that have not?

This chapter deals with question 1, Chapter 5 with question 2 and Chapter 6 with question 3. Answers can be derived from detailed analysis of fiscal developments and experiences among Australia, Germany, France, Japan, the Netherlands, New Zealand, Sweden, the UK and the USA. Generalisation from the experiences of only nine countries' should of course be taken cautiously, but among the many OECD members these countries can be considered particularly good examples in answering the above questions.

We now may proceed to the question of why most OECD countries reformed fiscal institutions and expenditure management. What was the basic momentum of reforms? Momentum can be seen to

Table 3–2 Major reforms in public expenditure management

Country	Year	Contents of reforms
Australia	1984	Financial Management Improvement Program (FMIP)
	1985	Program budgeting
	1996	National Audit Commission Report
	1997	Financial Management Accountability Act
	1998	Charter of Budget Honesty Act
	1999	Accrual budgeting for FY1999–2000 Budget
France	1993	Economic and Social Reconstruction Program
	1994	5 Years Basic Act on Public Finance Control
	2001	Budget Ordinance Act
Germany	1994	Action Program on Growth and Employment
	1996	Action Program on Investment and Employment; Fiscal Policy 2000
	1999	Future Program 2000
	2000	Basic Principle on Fiscal Policy
	2002	Domestic Stability Act
Japan	1997	Fiscal Structural Reform Act
	1998	Fiscal Structural Reform Act suspended
	2001	Administrative Reform of the Central Government (The Council on Economic and Fiscal Policy established)
Netherlands	1992	Public Accounting Act amended (performance information included in budget) Agency created
	1994	Trend-based Approach for budgeting
New Zealand	1988	State Sector Act
	1989	Public Finance Act; Performance Agreements
	1991	Accrual budgeting1
	1993	Purchase Agreements
	1994	Fiscal Responsibility Act
	1995	Strategic Result Areas
Sweden	1992	Report by Parliament on Budget Reform
	1993	Accrual accounting and frame budget for agencies
	1996	Public Finance Act; Frame Budget and Expenditure Ceilings (for 1997 Budget)
	2000	Plan on accrual budget
UK	1982	Financial Management Initiative
	1988	Next Steps Agencies
	1992	Public Finance Initiative (PFI)
	1993	Control Total for budgeting
	1997	Comprehensive Spending Review; Public Service Act
	1998	The Code for Fiscal Stability
	1999	Financial Statements by accrual account
	2001	Accrual budgeting for 2001 Budget
USA	1985	Gramm-Rudman-Hollings (amended in 1988)
	1990	Budget Enforcement Act (amended in 1993 and 1997); Chief Financial Officer Act
	1994	Government Performance and Results Act
EU	1992	Maastricht Treaty singed
	1993	Treaty enacted
	1997	Stability and Growth Pact
	1998	EMU participating countries decided; European Central Bank; First Convergence Program
	1999	Currency EURO

have come from the following three broadly categorised events; economic crisis; government change; and external pressure such as the Maastricht Treaty.

The most commonly referred to incentive to reform is an economic crisis. Economic crisis, which is typically caused by a plunge in currency value in foreign exchange markets, is likely to downgrade credibility of economic and fiscal policy to which the government adheres, and forces the government to redefine its policy. Two notable examples are Sweden and New Zealand.

First, let us examine the case of Sweden. No industrialised country seems to have been more affected by economic and fiscal fluctuation in the 1990s than Sweden. In the early 1990s, the Swedish economy deteriorated after an initial economic boom and experienced its worst recession since the 1930s. The crisis culminated in 1992–93 with extreme turbulence in the foreign exchange market. The Swedish government tried to maintain a fixed exchange rate, while a loss in confidence by investors led to strong pressure on the value of the currency. In November 1992, the attempt to defend the currency resulted in the central bank raising interest rates to close to 500 per cent until the government finally adopted a floating exchange rate. Real GDP growth subsequently became negative for three consecutive years after 1991. The recession, together with collapse of major financial institutions, brought general government borrowing in 1993 to the unprecedented level of 11.9 per cent of GDP.

This economic and fiscal environment forced the new government, elected in September 1994, into starting structural reforms immediately. There seemed no other alternative than drastic reforms. At first the government took several deficit reduction packages, including both expenditure cuts and revenue increase. The total amount of the packages until 1998 exceeded over 8 per cent of GDP, which was the most drastic deficit reduction among OECD members (Blöndal (2001)). These painful efforts were furthered by the first Convergence Programme in 1995, which was required by the EU. The upshot of it was that the Swedish government committed to achieving a general government fiscal balance by 1998. The remarkable attempt by the government in structural reforms included not only deficit reduction but also the overhaul of its budgeting process.[14] The centrepiece of the new system was the implementation of an overall expenditure ceiling for the next three years, which was to be decided by the political top-down process in advance of presenting the subsequent year's ordinary budget.

New Zealand's case is another good example of an economic crisis preceding reforms. New Zealand enjoyed relatively high economic growth, low unemployment and low inflation until the middle of 1970s. The world recession and the UK's membership of the European Community in 1973 led to a deterioration of the New Zealand economy from 1975 to 1983. The aggressive intervention policy adopted by the National Party government of Prime Minister Muldoon, which included regulation, protection and subsidies, had little effect on the overall economy. New Zealand experienced high inflation (CPI, 1982: 16.2 per cent increase), deterioration of the current account (1983: minus 8.6 per cent of GDP) and an increased budget deficit (1984: minus 9.2 per cent of GDP). In 1984, New Zealand faced a currency crisis due to the loss of market credibility. The general election in 1984 saw a new Labor government led by Mr.Lange, who then began an overall economic and fiscal structural reform.

When it comes to public sector reform, New Zealand is often cited as a leader of New Public Management because of its overall and drastic reforms, including the introduction of market mechanisms.[15] Reform in fiscal policy formulation, however, was not immediate, but came to fruition with the promulgation of the Fiscal Responsibility Act 1994 (FRA). The FRA is the most important law governing fiscal management in New Zealand, and its basic idea has also been incorporated in the Australian and British fiscal policy frameworks. The paper now turns to an explanation of the origins of the FRA.

Janssen (2001) described how the NZ Treasury realised that problems existed in fiscal policy, by analysing NZ Treasury papers published since 1990. The problems identified, which were considered a base for law making, are as follows.

(1) The impact of fiscal policy on economic activity in the short-term in New Zealand had not been positive, and in normal circumstances it was considered not desirable to make fiscal policy with a view to managing real aggregate demand.
(2) The presence of some overarching target or ceiling was seen as a way of improving the control of public expenditure.
(3) Better fiscal outcomes require mechanisms to ensure for more regular information regarding the medium-term fiscal outlook to be accessible to the public.

In principle, the FRA requires the incumbent government to set fiscal rules and targets and publish several fiscal reports that attest to how the government's fiscal policy complies with its own rules and targets. Imposing accountability for the conduct of fiscal policy on the government and improving fiscal transparency was meant to prevent fiscal policy from being distorted by short-sighted political decisions. It should be noted that the reform of the electoral system was also an impetus for the introduction of the FRA (Scott 1996). In the 1993 national referendum, it was decided to change the electoral system from a single-representative constituency to a new system, known as Mixed Member Proportional (MMP) system. Under the MMP, it is more difficult to form single-party majority government, making a coalition government more likely.[16] The experiences of other countries suggest it is difficult to maintain fiscal discipline under a coalition government.[17]

The second catalyst for budgeting reform was a change of government. An incoming government is likely to reconsider policies of a previous government and to develop their own policies in order to achieve new policy agendas. Australia, the United Kingdom, and the United States are classified in this group.

The experience of budgeting reform in the UK is an interesting example. The incoming Blair Labour government began significant expenditure management reform in 1997, although a long history of public sector reform including financial management existed prior to this in the UK The current fiscal framework in the UK is guided by the Code for Fiscal Stability.[18] The Code does not contain fiscal rules as such but requires the incumbent government to set rules in accordance with its policy objectives. Two fiscal rules and targets were decided by the current government: (1) the 'golden rule,' under which borrowing will not be used to finance current spending; and (2) the 'sustainability rule', which promises to keep net public debt as a share of GDP at a 'stable and prudent' level. Both rules are to be applied over the economic cycle. After the 1997 election, the British business community, known as the 'City', was uncertain if the incoming government would return to its traditional Labour economic policy such as pursuing a policy of 'big government' at the same time as an increasing structural deficit. The new government urgently needed to present a clear vision to the public in order to enhance the credibility of its economic and fiscal policies. In the language of the Chancellor of the Exchequer, who thought that a radical reform of the institutions of policy making was essential if growth and employment were to be delivered (HM Treasury (2002)), a 'new paradigm' was required. The first initiative was the establishment of a new monetary policy framework with operational responsibility for meeting its monetary policy objectives transferred to the newly created Monetary Policy Committee of the Bank of England. The second initiative was the introduction of the Code for Fiscal Stability as already mentioned.

It should be remembered that the UK had experienced mismanagement in fiscal policy in the first half of 1990s, when a combination of tax cuts and spending during a boom period led to a subsequent post-boom deterioration in the fiscal position.[19] The general government deficit reached as high as 7.9 per cent of GDP in 1993. These experiences led to the new government characterising the problems of past fiscal policies in the following terms (HM Treasury (2000)):

(1) A lack of clear principles and targets
(2) A lack of transparency and accountability
(3) Ill-defined roles and responsibilities
(4) Inadequate mutual support between monetary and fiscal policy in promoting stability

(5) Overly-optimistic and insufficiently forward-looking assessments
(6) Decisions not always made in the best long-term interests of the economy.

These points were taken into consideration in the framework of the Code. As Balls (1997) notes, the essence of the Code is in the ex-ante commitment and transparency, which improves the credibility of fiscal management.

The next example to be examined is Australia. After the economic downturn in the first half of the 1980s, the Labor government elected in 1983 started a wide range of structural reforms, including public sector reform. Although they established the foundation for the current economic growth, that has given Australia one of the best economic records among OECD countries, there seemed to be some barriers that the Labor government was not able to break through. The Howard liberal coalition government, elected in 1996, introduced further reform of fiscal management together with a greater reliance on using market mechanisms to regulate government service provisions. The flagship reform was the introduction of the Charter of Budget Honesty Act 1998, described below.

The Howard government urgently needed a policy agenda and vision revising the former government's policies from the beginning of its term. The National Commission of Audit (NCA) was set up in order to accomplish this, finalising its report to the government in June 1996. The NCA covered a range of reforms in the public sector, and emphasised the following problems in fiscal management in Australia:[20]

(1) Australian governments faced no legislative obligation to articulate their fiscal strategy or set fiscal targets, or to report on their progress in meeting their fiscal objectives.
(2) A comprehensive report on the fiscal and economic outlook was normally published only once a year at budget time and no requirement existed for the release of such a report either before elections or mid year.
(3) No requirement existed for discretionary policies that were intended to smooth the economic cycle to be identified as such or to be accompanied by a statement explaining the process for their reversal.
(4) Responsibility for reports on the fiscal and economic situation lay with the relevant government Minister (usually the Treasurer or the Minister for Finance, but sometimes the Prime Minister), not the heads of the agencies that prepared them. This had the potential to impede transparency and accountability.

The NCA finally proposed legislation that introduced a requirement of the government of the day to set and to report on a clear fiscal strategy that would include setting targets and benchmarks.

One of the important factors that pushed structural reforms in Australia should not be forgotten. Australia had not faced as severe a crisis as that of Sweden and New Zealand, and general government gross debt was not as high as that of other OECD countries.[21] Nevertheless, a serious current account deficit led to a firm government resolve to reduce fiscal deficits and to manage government debt.[22] The current account deficit was the most significant factor influencing the formation of fiscal policy in Australia (Robinson, 2002). It was realised that the current account deficit was a problem that would undermine Australia's credibility in the financial market and put a risk premium on the domestic interest rate, thus reduction of budget deficit was seen as urgent.[23]

The United States has had a long history of fiscal consolidation since the 1980s that has witnessed a transition of fiscal rules and targets. The problem originated in huge budget deficits, which were caused mainly by so called 'Reaganomics', or Reagan's supply-side economics. The US Congress, which has the constitutional power to make a national budget, legislated the Balanced Budget and Emergency Deficit Control Act of 1985 (more commonly known as Gramm-Rudman-Hollings (GRH)) in order to consolidate public finance. GRH was in a sense epoch-making in terms of the mandatory deficit cutting process 'sequestration'. If the deficit reduction targets, which were stipulated in the law, were not met due to the inability of the Congress to keep to its budget keeping deficit target, the president's special order could be enacted to cut expenditures across-the-board. However, GRH was far from achieving deficit reduction; actual deficits increased substantially after the inception of GHR.

The turning point in efforts to achieve fiscal consolidation came in 1990, as a result of an impending budget crisis. GRH required \$64 billion as the deficit limit for fiscal year 1991, while the Office of Management and Budget (OMB) projected a tremendous deficit of more than \$230 billion in July 1990. That meant the rate of across-the-board cuts applied to defense and non-defense expenditures would range from 30 to 40 per cent if the Congress did not decide to cut expenditures or increase tax at the budget time, in order to offset the enormous difference between the target and projected deficit. Simply put, such a drastic expenditure cuts were not feasible, so the issue became a priority for members both in the executive and the Congress. All parties were forced to sit down at the same table to negotiate a breakthrough. Although the negotiation ran into troubled waters, the Bush administration was forced to back down on its promise at the election, and accepted tax increases. The negotiation finally came to fruition as the Omnibus Budget Reconciliation Act of 1990 (OBRA90). OBRA90 included new budget enforcement rules, namely the Budget Enforcement Act of 1990 (BEA) as well as an omnibus package of spending cuts and tax increases. BEA made a significant contribution to fiscal consolidation in the USA in the 1990s. The basic principle of BEA was maintained even after the Clinton Administration took office in 1993, as shown by its successive laws such as OBRA93 and the Budget Balanced Budget Act of 1997.

BEA reflected some lessons from the failure of GRH and incorporated much more effective mechanisms for deficit reduction than GRH. Under the GHR, an economic downturn that increases the size of deficit may trigger a sequestration as a penalty, even though legislators are not directly responsible for a change of economy. You cannot hold anyone accountable for what they cannot manage responsibly. BEA is a law that holds legislators accountable for only those outcomes that they can control such as discretionary tax cuts. It should be noted that the BEA rules and high economic growth cannot explain all aspects of fiscal consolidation in 1990s. There were several differences in the political and economic environment between the 1980s and 1990s, for example:

(1) Political environment

One of the most critical factors for fiscal consolidation in the USA was that both the president and legislators realised the necessity of fiscal consolidation and committed to it firmly. President Clinton declared his intention to halve the budget deficit in four years during the 1992 presidential election campaign. Interestingly, the budget deficit problem was a focus of that election, due to the efforts of Congressman Pello – who didn't belong to any major political party – in raising the issue. The Republicans significantly increased their seats in the House during the mid-term election of 1994 by adopting the manifesto 'the Contract with the USA', which included the target of balancing budget. The inability of the Congress to pass appropriation acts before the fiscal year began forced various government services to be suspended, and this impacted on people's ordinary livelihood. American people were increasingly led to believe that a tax increase was inevitable. Overall, American people became aware of a problem on fiscal deficit, and this affected politicians' attitude.

(2) Economic environment

Since the latter half of 1980s, the twin deficit problem of both budget deficit and current account deficit came up increasingly and it was seen as a time bomb for the world economy. Thus the credibility of US dollar mattered significantly. The Clinton Administration released its political agenda after the election, which explicitly argued deficit reduction was a key to the US economic recovery as it would reduce long-term interest rates and increase private investment.

The third catalyst for reforms was external pressure, such as the Maastricht Treaty. EU Countries like Germany, France, Italy and the Netherlands were subject to such pressure.

The case of the Netherlands is as follows. The Netherlands faced severe economic stagnation in the first half of 1980s, with statistics showing negative economic growth, high unemployment (1980:4.0 per cent to 1983:11.0 per cent) and large budget deficit (1980:4.2 per cent of GDP to 1982:6.6 per cent). The newly elected government began structural reform in various areas including the labour market, the financial market, social welfare and public finance in 1982, and achieved a remarkable economic recovery, which was often called 'the miracle of the Netherlands'. When it comes to fiscal policy during this period, the government introduced a multi-year deficit reduction plan for the central government budget. Slashing 1.5 percentage points of GDP from deficits every year from 1983 to 1986 was set out in the plan. However, these fiscal rules were not successful because the government was required to cut spending further in supplementary budgets during economic downturns in order to maintain them and fiscal policy developed a tendency to be pro-cyclical (Watson et al., 1999). Berndsen (2001) criticised this arguing that the tight margins imposed with respect to the annual targets often caused budget revision and the budget horizon to be reduced to one year, causing short-term considerations to gain the upper hand at the expense of an integral approach to spending. In short, towards the end of the 1980s, Dutch fiscal rules became ineffective in maintaining budgetary discipline.

A turnaround eventually occurred in 1993 with a report by the Study Group on the Budget Margin, which proposed budgeting reforms to the Finance Minister.[24] The main proposal of the report was what might be called the 'Trend-based Approach', which the new government adopted after the 1994 election. The government started fiscal consolidation based on the trend-based approach, which regulates the overall framework of fiscal policy in the Netherlands. Needless to say, the budgeting reforms in the Netherlands were facilitated by the decision of the Netherlands to join the Economic and Monetary Union (EMU). It was urgent to restore fiscal discipline so that the Netherlands could comply with Maastricht criteria.

The trend-based approach is an expenditure control system, which sets ceilings on overall as well as sectoral expenditures for the government's entire term of four years, in real terms and with cautious economic assumptions. This is not based on law or regulations but on coalition agreements. In the Netherlands, no political party enjoys a majority in the parliament because of the nature of the electoral system. A coalition government tends to be fragmented in decision-making in the budget process, thus making it difficult to maintain fiscal discipline in general. The Netherlands position necessitates some sort of control system to keep its fiscal position in line with the requirements of the Maastricht Treaty. An agreement to form a coalition is critical so that several parties can form a majority government and reconcile their policy agenda. Coalition agreements existed before, but since 1994 they have incorporated the fiscal policy framework based on the trend-based approach. This requires the incoming government to present a budget policy that stipulates its fiscal rules and targets, as well as four-year economic and fiscal projection and priorities for budgeting. Dutch fiscal rules can be changed every four years because they are based on the agreement to form a coalition. The trend-based approach, introduced in 1994, has survived with minor changes through 1998 and 2002 general elections, however, and has now become the foundation of Dutch fiscal policy making.

Budgeting reforms in France and Germany have been less remarkable than others already examined here. This paper summarises recent developments in both countries quickly.

The fiscal position of France deteriorated in the early 1990s and reached to the worst of 6 per cent deficit and 50 per cent gross debt in terms of GDP when the Maastricht Treaty came into force in 1993, although France enjoyed a relatively healthy fiscal position in the 1970s and 1980s. France needed to start fiscal consolidation to adhere to the Maastricht fiscal criteria.

The Paradule Cabinet, elected in March 1993, released a consolidation plan called 'the Reconstruction Program for the Economy and Society' and legislated a special act in 1994, which codified the fiscal consolidation program for five years. The act itself had only four articles, but explicitly declared, as a fiscal target, that the central government deficit in terms of GDP should be reduced to 2.5 per cent by 1997 with an annual average rate cut of 0.5 percentage points, from the initial deficit of 4.5 per cent in 1993. In addition, the act emphasised spending cuts for achieving the target and required that the government adopt a five-year fiscal outlook. This was the first medium-term fiscal plan introduced in France.[25] The fiscal target could not be met in 1995, because the difference in deficit between the original projection and the actual figure diverged, mainly due to a tax reduction aimed at stimulating the economy. The act expired after the ruling party was defeated in the 1997 election.[26]

France, like Germany has been considered reluctant in embracing institutional reform in budgeting and public sector management so far. However, a gradual change can be seen since the latter half of the 1990s in France. For example, in 1996 pre-budget discussion ('un debat d'orientation budgetaire') was introduced, in which the government is required to explain its overall economic and fiscal policy to the parliament in spring, several months before tabling the following year's budget proposal. In addition, the Budget Organisation Act of 2001 is aimed at trying to introduce significant reforms to the French budgeting process. Firstly, since 2002 the medium-term fiscal plan for four years including the budget year is now attached to the government budget proposal, which is duly tabled in the parliament, while the medium-term fiscal plan is introduced after the parliamentary session and submitted to the European Commission as a stability program. This means that the French parliament now gets involved in the process of fiscal planning much more than before and the French stability plan is now under parliamentary scrutiny. Secondly, France has decided to change its budget structure fundamentally away from the so called 'line-item' budget to a program budget, in which resources are appropriated according to programs' objectives, although this reform is not scheduled to come into force until 2006.

In Germany, *ad-hoc* economic and fiscal programs proposed by successive governments are characteristic of fiscal consolidation. They consisted of a series of policy packages that included spending cuts, tax reforms, social welfare reforms and investment incentives, for example, 'Action Plan on Growth and Employment' (February 1994), 'Fiscal Policy 2000' (March 1996) and 'Future Program for Employment, Growth and Stability' (June 1999). Various fiscal targets were embodied in each package or medium-term fiscal plan that was based on figures in the package. For instance, 'Fiscal Policy 2000' suggested that the general government expenditure in terms of GDP should be reduced to the same level as before the integration of West and East Germany.

In addition, several fiscal rules have been introduced, most important of which are the Moratorium Principle and the domestic stability program. The Moratorium Principle was introduced in 1994, and required spending ministries to offset additional spending or tax cuts in the budgeting process. The Domestic Stability Pact was introduced in 2002 so that the Federal government and state governments could share the fiscal responsibility to keep to the Maastricht criteria.

It was pointed out earlier that fiscal reforms, including the introduction of fiscal rules and, targets have been given momentum by shocks such as economic crisis, change of government, and external pressure in major OECD countries. This categorisation may be too simple for detailed analysis. Actual reform in each country was affected by various political and economic factors other than these three already mentioned, and to what extent each factor promoted reforms varied from country to country. New governments in New Zealand and Sweden undertook reforms during economic crisis and a sense of impending crisis proceeded reforms in Australia, the UK and the USA. Japan may be an exceptional case, since none of the three causal factors can be clearly identified. In Japan, reform culminated in the Fiscal Structural Reform Act of 1997, which was enacted under the political leadership of Prime Minister Hashimoto when the huge indebtedness that resulted from the aggressive fiscal policy in the first half of 1990s aimed at sustaining the stagnant economy after the burst of 'bubble economy' was acknowledged. After a series of financial misfortunes the Act was suspended in 1998, after just one year. In a sense, there has been insufficient momentum to initiate real fiscal reform in Japan. In 1990s the Japanese economy suffered from stagnation, but it was not caused mainly by fiscal crisis. Japan can finance enormous amount of government debts domestically with almost no increase of interest rate. In other words, excessive domestic savings can prevent public finance from going into deterioration.

Almost nobody can realise the necessity to consolidate public finance as long as the coupon rate of 10-years government bond is around 1 per cent.

What needs to be emphasised is that these three causal factors are just a catalyst for commencing reforms. Other factors are needed, such as ideas and innovations of reforms and political leadership, to allow them to be successfully implemented. For example, Sweden could not perform so well in public finance without detailed analysis of her underlying budgeting system, recognition of the weakness of expenditure management, and innovation in the budgeting system. There the consensus among politicians, bureaucrats and the public, induced by economic crisis and strengthened by incoming political leadership, translated ideas and innovations into reality.

Details of fiscal reforms

This chapter analyses main features of fiscal reforms among nine OECD countries, including Australia, France, Germany, Japan, the Netherlands, New Zealand, Sweden, the UK, and the USA, based on a framework that classifies them into the following three categories; macro rules; expenditure rules; and budgeting process.

Macro rules

Table 5–1 summarises macro rules of each country. Discussion now turns to the major issues in implementing macro rules, in particular, the trade-off between credibility and flexibility, the choice of indicators in either flow or stock, and compliance of rules.

One of the biggest difficulties in designing macro rules is how to reconcile the trade-off between credibility and flexibility, since on the one hand a strictly defined numerical rule cannot coexist with general economic fluctuation, on the other hand a flexible rule can make difficult for a government to maintain the fiscal prudence. While the nature and strength of macro rules varies across countries, broadly speaking the approaches to this issue are divided into two groups. The first group includes those who introduce legally binding rules, often with some sort of sanctions in case of noncompliance. The rules embedded in the US Budget Enforcement Act, the Maastricht Treaty, the Stability and Growth Pact and the Japanese Fiscal Structural Reform Act fall into this category. The second group includes those who introduce rules and targets that are not necessarily legislated. Governments have the freedom to choose what kind of rules and targets should be introduced, and may also use discretionary fiscal policy more flexibly under the overall framework of fiscal policy. New Zealand innovated this approach in 1994 by means of the Fiscal Responsibility Act, followed by Australia and the UK in 1998.

The former rules are basically characterised by setting numerical targets on deficit, typically achieving balance in nominal terms or preserving balance under some threshold in terms of GDP. These kinds of rules and targets seem clear and understandable for politicians and for the public, and so have traditionally been adopted in many countries, although the definition of deficit and balance has long been a point of contention. Balancing rules and numerical upper limits on deficit are, however, difficult to implement in accordance with rules in a real economy, because the deficit fluctuates frequently in response to the business cycle. These kinds of rules are often breached by revenue shortfalls during a recession. Evidence for this is clearly shown in Gramm-Rudman-Hollings in the 1980s in the USA, the Fiscal Structural Reform Act in 1990s in Japan and the Maastricht Treaty, breached by Germany and France, in 2000 and beyond. Problems not only include the difficulty of maintaining compliance over the entire economic cycle, but also the likely incentive of creative accounting including deliberate transactions between accounts and the transferral of cost to the future.[27] Eventually, such rules lose credibility. The Budget Enforcement Act in 1990, which replaced Gramm-Rudman-Hollings, made deficit targets for several years adjustable to the change of economic and other factors, although it stipulated a target to achieve fiscal balance in law. The BEA was improved by learning from previous failure and by granting some flexibility in setting targets.

In order to accommodate the economic cycle, macro rules designed to keep fiscal balance or some level of debt over the economic cycle have become more popular in 1990s.[28] For instance, the UK introduced two macro rules in 1998 based on the Code of Fiscal Stability, namely the 'golden rule' and the sustainability rule. The former seeks to ensure that the government will borrow only to invest over the economic cycle and the latter says public debt as a proportion of GDP will be held at a stable and prudent level over the economic cycle. The Maastricht criteria of a 3 per cent deficit in terms of GDP should be taken as a hard budget constraint as it cannot be breached at any time, but the Stability and Growth Pact (SGP) has been implemented with a greater focus on the economic cycle than previous pacts. Brussels now regularly monitors the cyclically adjusted fiscal balance of member countries in order to assess their fiscal stance in relation to the economic cycle. Only the USA and Japan appear to have not conducted fiscal policy in a manner that explicitly considers the economic cycle. Of course, it should be kept in mind that cyclically adjusted data is a product of various estimations and assumptions and thus has inherited many technical problems.[29] In addition, cyclically adjusted data is not easily understood by politicians and the public, leading to the risk of undermining fiscal transparency.

Of course, the legislated rules do not necessarily the ignore the need for flexibility to accommodate the business cycle. They often have some kind of exceptional clause. For example, the Maastricht Treaty specifies that the excessive deficit procedure, under which a noncompliance penalty is imposed upon the relevant country, can be avoided if the real GDP growth rate is less than minus 2 per cent.

Table 5–1 Macro rules and targets in selected countries

Country	Start	Legal status	Rules and targets	Coverage	Penalty	Compliance and other distinctive features
Australia	1998	Cabinet decision based on the Charter of Budget Honesty Act	(Main rules) –Maintain budget balance on average over the economic cycle (in terms of cash and accrual) (Supplementary rules) –Maintain surplus over forward estimates period –No increase in tax burden from 1996–97 levels –Improve net worth position over the medium to longer term	Central gov. in general government	Nil	–The Charter of Budget Honesty Act governs the overall fiscal framework. –Government sets her own rules and targets based on 5 principles of sound financial management stipulated in the Act. –Exceptional procedure by the Act –Assessment of compliance by related reports
France	1993	Maastricht Treaty	–Maximum deficit 3% of GDP –Maximum gross debt 60% of GDP	General gov.	Non-interest deposit	–Budget balances and expenditure growth rates targeted and assessed in Stability Program
	1997	SGP	–Close-to-balance or surplus in medium-term			
Germany	1967	Constitution	–Debt finance only for investment (golden rule)	Central gov.	Nil	–Budget balances and expenditure growth rates targeted and assessed in Stability Program and Medium-term Fiscal Plan (based on Economic Promotion Act) –Domestic Pact mandates Fiscal Council (consists of central and states' finance ministers) to monitor and recommend necessary actions
	1993	Maastricht Treaty	–Maximum deficit 3% of GDP –Maximum gross debt 60% of GDP	General gov	Non interest deposit	
	1997	SGP	–Close-to-balance or surplus in medium-term			
	2002	Domestic Pact	–Federal and states achieve fiscal balance in medium-term	Central + states		
Japan	1947	Public Finance Act	–Balance budget with exceptional golden rule	Central gov.	Nil	
	1997	Structural Reform Act	–Reduce fiscal deficit to 3% of GDP by FY2003 –Terminate deficit-financing bonds by FY2003	Central+ local gov	Nil	–Act suspended in 1998
	2002	Reforms and Perspectives (cabinet decision)	–Achieve primary balance surplus in the early 2010s –Maintain current level of expenditure per GDP until FY2006	Central+ local gov		–Perspectives is made for reference, thus its targets not explicitly committed by gov.
Netherlands	1993	Maastricht Treaty	–Maximum deficit 3% of GDP –Maximum gross debt 60% of GDP	General gov	Non-interest-deposit	–Coalition Agreement after election specifies expenditure ceilings for 4 years in real terms (1994 introduced)

	1997	SGP	–Close-to-balance or surplus in medium-term			–Budget papers assess compliance with ceilings in Agreement
New Zealand	1994	Cabinet decision based on the Fiscal Responsibility Act	(Long-term) –Maintain operating surplus on average (accrual) –Maintain gross debt 30% of GDP on average –Increase net worth (Short-term) –Targeted levels in operating balance, expenses, gross debt and others for 5 years	Public sector (consolidated based on accounting framework)	Nil	–The Fiscal Responsibility Act governs the overall fiscal framework. –Government sets her own rules and targets based on 5 principles of sound financial management stipulated in Act. –Exceptional procedure by Act –Assessment of compliance by related reports
Sweden	1994	Cabinet decision	–Maintain surplus 2% of GDP on average over economic cycle (fiscal balances for 3 years also targeted) –Local gov: balance budget except borrowing for investment (since 2000)	General gov	Nil	–Assessment of compliance by Spring and Autumn Budget Report
UK	1998	Cabinet decision based on the Code for Fiscal Stability	–Borrow only to invest and not to fund current spending over the economic cycle (Golden Rule) –Maintain a prudent level in net debt % of GD over the economic cycle (Sustainability Rule)	Public sector (general gov +public corporations).	Nil	–Code governs overall fiscal framework –Government sets her own rules and targets based on 5 principles of sound financial management stipulated in Act. –Exceptional procedure by Act –Assessment of compliance by relevant reports
USA	1917	Liberty Bond Act	–Upper limit of nominal debt outstanding (approved by the Congress in necessary)	Central gov	Nil	
	1990	Budget Enforcement	–Deficit targets for 5 years (flexibly adjustable)	Central gov.	Sequest -ration	–If estimated deficit exceeds over the target, President's order to cut expenditures across-the-board
Euro	1993	Maastricht Treaty	–Maximum deficit 3% of GDP –Maximum gross debt 60% of GDP	General gov.	Non-interest-deposit	–International treaty with penalty and peer pressure for compliance –Monitor structural and cyclical balance recommend to keep safety margin not to (exceed 3% in recession)
	1997	Stability and Growth Pact (SGP)	–Close-to-balance or surplus in medium-term Measures for compliances in SGP Surveillance: member countries submit Stability & Convergence Program every year, assessed by Council Excessive Deficit Procedure: in case of non-respect of deficit rule, non-remunerated deposits applied through complex process (with exceptional case if GDP falls by over 2%)	General gov.		

Which are better, legislated rules or unlegislated, more flexible ones? There is no simple answer here, but it is thought that there is no numerical and legally defined rule that is implemented actually with reasonable effectiveness other than the Maastricht criteria. It can be called exceptional, in a sense, because the legally stipulated rules are the only way to monitor a fiscal position of various countries uniformly and make them comply. There is also a problem of how to define the target level of deficit or debt economically and rationally when the government has stipulated it in a law. A legally bound balanced budget rule seems effective only in a special circumstances when immediate action in reducing deficit is needed because government credibility in the financial market is rapidly deteriorating.[30]

Macro rules are generally defined in terms of either flow measures (balance) or stock measures (debt), or both. There has been a tendency to emphasise flow measures. For example, as debt levels in Belgium and Italy have been over 100 per cent of GDP, they have beyond any dispute breached the debt criteria of 60 per cent of GDP. However, Belgium and Italy have not been penalised so far on the grounds of breaching debt limit. A flow measure is easy to understand and useful for measuring the extent to which the fiscal position has improved. However, much more attention should be focused on stock measures because they can assess the sustainability of fiscal policy and an ageing population, with which almost all OECD countries have to contend. This will increase the risk of derailing public finance from a sustainable long-term track.

A couple of approaches have been used to measure level of debt in public finance. First of all, public debt can be quoted as either gross or net. Gross figures capture the total amount of the government's financial liabilities without taking account of offsetting financial assets. The most frequently quoted example using gross figures is the Maastricht debt criteria of 60 percent of GDP. Net figures subtract liquid financial assets from gross figures. Net figures can provide a more accurate measure of sustainability in theory, however they may induce manipulation of accounting. The UK is a good example of a country that adopts a measure of net debt, which is currently 40 per cent of GDP. Another example is a measure of net worth, which extends the coverage to all outstanding liabilities, including the net actuarial value of government employee pension schemes and other quantifiable liabilities. Australia and New Zealand, which produce an overall government balance sheet based on full accrual accounting, consider a measure of net worth in making fiscal policy, in tandem with other fiscal targets.

The notorious problem with stock rules is that it is much more difficult to define the target level rationally than when using flow measures. There seems no other way than setting a level based on the current level and past history of debt as well as the potential growth rate and rate of interest.[31] The targeted level actually varies across countries, as already described. Strictly speaking, the sustainability of fiscal policy can be taken as the inter-temporal budget constraint the government meets, tested by the calculation if the present value of future expected primary balances is equal or greater than the outstanding stock of debt. The concept of sustainability is usually estimated by the primary balance as the proportion of GDP required to stabilise net debt ratio at a given target level.[32] What we have to do is how to define this notion in a meaningful way and translate it into macro rules.[33]

The example of New Zealand suggests some interesting ideas for defining the target level of debt. The Fiscal Responsibility Act of 1994 stipulates five principles for fiscal management based on which the government should publish its specific fiscal rules and targets. One principle is to reduce the overall government debt to a prudent level, and a second is to maintain that level once achieved, although the Act does not specifically speak of what a 'prudent level' means. What should be emphasised is the Act distinguishes a debt level for a period of fiscal consolidation from one to be applied in a steady fiscal state. In short, a debt level can be changed quite flexibly. Although there is sometimes criticism of inconsistency in defining the debt level, the New Zealand government provides some kind of adjustment to its target level of debt in order to cope with the impact of an ageing population on long-term fiscal projections.[34]

Ensuring that the government continuously complies with its rules and targets is much more difficult than simply introducing a system. Fiscal rules are always at risk of being broken, and no rules survive once they have been breached. In other word, rules and targets should be reviewed and amended in response to changes in political and economic circumstances. As fiscal policy cannot be enacted without a democratic process in the parliament, any rules and targets need to be acknowledged by politicians and cannot function without strong political will. There has been abundant evidence in the USA to support this hypothesis. The Budget Enforcement Act was remarkably well implemented in the middle of 1990s, but was not adhered to immediately after legislators lost their political will. Although detailed analysis from a political economy point of view is beyond this paper's scope, incentives to comply with rules should be embedded in the overall framework.

A direct and immediate answer for ensuring compliance from the government may be some sort of sanctions. An example of a sanction is the Excessive Deficit Procedure (EDP) stipulated in the Maastricht Treaty. The sequestration procedure by GRH and BEA in the USA, in which a failure to achieve the annual targets for deficits reduction triggers an automatic, across-the-board cut, is also a form of sanction. However, the successful enforcement of either approach in order to prevent a breach of rules has been most difficult. The EDP is detailed in the rule book of the Treaty, and there are many hurdles and steps before the triggering of a decisive sanction, which requires a country to make a non-interest bearing deposit with the Community, such as the European Commission paper, requiring the opinion of the Economic and Financial Committee and decision of the ECOFIN Council (Finance Ministers board).[35] Finance Ministers in the ECOFIN Council carry out the final adjudication of the penalty, even if the criteria appear to have been breached by a member country. The complex procedures and political bargaining as a matter of practice hamper the implementation of penalty.[36] The EDP merely serves as a trigger for a more precise assessment of the situation. The European public has never regarded the EDP as a credible protection of the euro against profligate fiscal behaviour (Fatás et al. (2003)). In the end the penalty regulated by the Treaty would be concerned with the sovereignty of the state.

Sequestration based on the Budget Enforcement Act, which in itself considerably contributed to fiscal consolidation in the US in the 1990s, was executed only once and the amount of money cut by the President's order was tiny. Several exceptional items were immune to the sequestration, so it was regarded just as the heirloom sword. At any rate, the ultimate penalty would be a rejection of the responsible government by the public in an election.

Another approach used to make governments comply with rules and targets is to improve fiscal transparency. It was previously mentioned that Australia, New Zealand and the UK have established an overall fiscal framework which necessitates the incumbent government to present its own fiscal objectives in line with the general principle stipulated in the relevant laws. What distinguishes these systems is that the government is required to make several fiscal reports open to public. For instance, the Pre-Budget Report in the UK assesses whether or not the fiscal policy executed by the government is on the course suggested by the rules, presenting various fiscal measures and economic analysis. The Maastricht Treaty has arguably helped to raise the issue of fiscal deficits in public debates, which had been confined to each country's domestic affairs. International comparisons of fiscal position among member countries have caused a sort of 'peer pressure' that focuses people's attention on the issue of fiscal discipline of their own country. The effectiveness of transparency in keeping fiscal discipline is not so straightforward, and it depends on various factors in an individual country. There seems no other ultimate solution other than making an effort to increase transparency under any democratic system.

Expenditure rules

Table 5–2 summarises expenditure rules and other distinctive features regarding budgeting processes among relevant countries. In particular, the paper discusses the effectiveness of expenditure rules in maintaining aggregate fiscal discipline and the *ex-ante* and *ex-post* assessment of medium-term fiscal planning.

Target levels regulated by macro rules are often defined in term of proportion to GDP. Although they may be easily comprehended by the public as well as politicians, they are likely to be just a pronouncement or wish by themselves. Target levels such as a general government deficit in terms of proportion to GDP are not likely to be a direct guideline in the process of making an annual budget that

Table 5–2 Expenditure rules and medium-term fiscal plans in selected countries

Country	Start	Legal status	Expenditure rules	Medium-term fiscal plan	Distinctive features in budget process
Australia	1980s	Forward Estimates (cabinet decision)	–4 years' expenditures by ministry fixed as baseline, and binding future budgets but revised every year –If ministry change Forward Estimates Pay-as-you-go applies in principle	Forward Estimates (4 years)	–Strategic decision-making by small inner cabinet (Expenditure Review Committee) –Within the Estimates, discretion to allocate resources –Accrual budget introduced in 1999
France	1997	Stability and Growth Pact (SGP)	–Fiscal balances and expenditure growth rates targeted in Stability Program (but no clear binding rules)	Stability Program (4 years) >submit to Parliament with budget, then after to EC	–Medium plan and expenditure rules weak in binding budgeting –Budget process reforms starts since 2001
Germany	1967	Economic Stability and Growth Act	Fiscal balances and expenditure growth rates targeted in both Stability Program and Medium-term Plan (but no clear binding rules)	Medium-term Plan based on the Act (4 years)	
	1997	SGP		Stability Program (4 years) >After approval of budget by parliament, submit to EC	–Federal and states government equally independent by Constitution, difficult to maintain fiscal discipline in terms of general government –Several ad-hock economic packages to consolidate finance to date –Weak expenditure management based on rules and medium-term plan
Japan	1980s	Cabinet decision	Ceiling for spending ministry to request next year's budget: limit set by expenditure categories	Medium-term Fiscal Projection by Ministry of Finance (4 years, since mid–1970s)	–Objective of terminating deficit-financing bonds was usually set in the past, for example, to terminate them by FY 1990 was set in 1983
	1997	Structural Reform Act	Expenditure cut targets for 3 years by categories		
	2002	Reforms and Perspectives (cabinet decision)	Outlook for fiscal balances (central and local gov) is released every year	Reference Estimates attached to Perspectives by Cabinet Office (5 years, since FY 2002)	–Both of two medium-term plans are just for information, not binding future spending at all.

Table 5–2 contd.

Country	Start	Legal status	Expenditure rules	Medium-term fiscal plan	Distinctive features in budget process
Netherlands	1994	Coalition agreement	–Ceiling Coalition agreement fixes 4 years' total spending and upper limits for major spending areas in real term –Budget balance adjustment rule At the budget time, updated fiscal balance estimate is referred to figure in reduction equally. coalition agreement, how to cope with revenue windfall and shortfall is predetermined. For example, if deficit is estimated less than 0.75 % of GDP and revenue is expected more than predicted in agreement, windfall can be used for deficit reduction and tax reduction equally	Trend-based Approach (4 years) Intentionally cautious economic growth is assumed	–Principle on fiscal policy is politically committed in coalition agreement –Idea of Trend-based Approach has been almost maintained although some minor changes since 1994 –Expenditure is fixed in real term, while automatic stabilisers are expected to work as revenue side –Bureau of Economic policy Analysis projects economic and fiscal outlook, strongly independently from politics
	1997	SGP		Stability Program (4 years)	
New Zealand	1994	Baselines (cabinet decision)	–4 years' expenditures by ministry fixed as baseline, and binding future budgets but revised every year –Spending caps for 3 years' discretionary spending (since 1996)	Baselines (4 years)	–Strategic decision-making by small inner cabinet –3 years' spending caps together with baseline system try to control expenditure –Accrual budgeting
Sweden	1994	Cabinet decision	–Ceiling Based on deficit targets, 3 years' total expenditure ceilings are fixed (not adjustable in principle). Expenditure limits for 27 major areas are also set but revised every year within the predetermined ceiling –Expenditure margin Margin is included in expenditure to cope with economic fluctuations	3 years expenditure frame Basic expenditure framework for 3 years is decided and approved by parliament in spring, and the next year budget is formulated based on this framework in autumn (two-stages budgeting)	–Overhaul budgeting system in 1990s and introduce top-down budgeting system –Introduce expenditure rule in which resource allocation among 27 expenditure areas is done in politically centralised manner within predetermined expenditure total

UK	1998	Spending Review (SR) (cabinet decision)	–Ceiling 3 years' discretionary spending limits by departments	Spending Review (3 years) Revised every 2 years, thus 3rd years figures are rolled over to next review (can be called biennial budget)	–Committed by strong finance minister –Strategic decision-making by small inner cabinet-medium-term fiscal planning has been developed since 1970s –Growth and other assumptions are examined by National Audit Office
USA	1974 1990	Congressional Budget and Impoundment Act Budget Enforcement Act	–Establish congressional budget process, especially budget resolution system to control fiscal aggregate expenditure ceilings for discretionary spending Pay-As-You-Go principle for mandatory spending and revenue	Baseline (10 years)	–Fragmentation among President, upper and lower houses induces conflicts in budgeting –Learned from failure of Gramm-Rudman-Hollings Acts, more flexible rules are introduced while constricting congressional procedure –Baselines are taken a base for next year budget negotiation, but binding is not so strong

becomes fiscal policy. This is because the coverage of a central government's budget does not usually correspond to that of general government.

We need a more practical mechanism to translate macro rules into practical language in budgeting. This could be an expenditure rule that regulates annual budgeting processes in which political conflicts should be solved as resource allocation occurs. Common examples are expenditure ceilings or caps for the aggregate total and major areas, limits to the growth rate of expenditure, and pay-as-you-go principles in which new additional spending or tax cuts would be offset by corresponding expenditure cuts or tax increases somewhere else. A kind of top-down process is necessary for maintaining aggregate fiscal discipline because simply adding up all the spending ministries requests is not feasible when tax revenue is generally not expected to increase rapidly. Aggregate norms are not likely to be effective if they apply only to the totals; there must also be a means of controlling the main subtotals (Schick 1997). One of the benefits in adopting expenditure rules is the capacity to let the revenue side work automatic stabilisers sufficiently (Mills and Quinet 2001).

While almost all countries have introduced some sort of expenditure rules, their details vary widely. A common example is a ceiling or cap on expenditures. The features of such ceilings can be classified into groups based on the extent to which a ceiling can bind expenditures for future fiscal years. Less binding ceilings are adopted by France, Germany and Japan. The weakness in expenditure control in annual budgeting has resulted in both EU member countries breaching the three per cent deficit criterion. Growth rates of expenditure for either total or major areas are stipulated in the German and French stability programs for controlling expenditure annually or in the medium term. However, they are not used to bind expenditure strictly at the time of the annual budget process. As a matter of fact, actual expenditures often grow beyond targets in the stability programs. In Japan, an expenditure ceiling is set by the cabinet for each budget category as the maximum amount of money that a spending ministry can request from the Ministry of Finance. Recently, a so-called 'minus ceiling' has been common in annual budgeting in Japan with some exceptions for prioritised expenditures. For example, when it comes to the category of current expenditure, a spending ministry can only ask the Finance Ministry for an amount of money that is 10 per cent less than the previous-year's amount. Although this ceiling often determines total sizes of almost all expenditure in the General Account, the ceiling rate is set in an *ad hoc* manner every year, depending on the availability of revenue. In other words, the ceiling has no medium-term perspective nor is it based on a medium-term fiscal plan.[37] The major difference between the ceiling used in Japan and other countries, such as Sweden, is that the former is the upper limit a spending ministry can request to the Finance Ministry at the early stage of budget process, while the latter is the upper limit that nearly equals the final amount of resources a spending ministry can receive.

The types of ceilings in countries examined here except Germany and France can be divided into two categories as follows:

Group 1: The ceiling is fixed in principle in Sweden, the UK and the Netherlands;
Group 2: The ceiling is usually revised annually in Australia, New Zealand and the USA.

Sweden has established one of the most robust expenditure management systems among OECD countries (OECD 2003b), and the critical point in the Swedish system is that the overall ceilings for three-year expenditures, including the budget year, are predetermined before details of the next year's budget are discussed within the government.[38] The ceiling covers almost all central government expenditure including entitlement programs such as pensions with debt servicing the only exception. Interestingly, what is initially decided is the ceiling for third-year expenditure. For instance, the overall ceiling for the fiscal-year-2007 expenditure is decided in 2004 when the details of the fiscal-year-2005 budget is discussed, while the overall ceilings for 2006 and 2005 were already decided in 2003 and 2002 respectively. These ceilings are not only decided by the cabinet but also approved by parliament. Even if the government proposes a supplementary budget in the middle of a fiscal year, the expenditure total for the current year should be kept within the overall ceiling already fixed.[39] In addition to the overall ceiling, the sectoral ceilings for 27 major expenditure areas are decided as targets. Targets are much more flexible because at the annual budget process, the government can reallocate funds amongst targets as long as they can maintain the overall ceiling already fixed. In other words, when the government intends to increase expenditure for one area, this increase should be offset by cutting expenditure in other areas.

The UK introduced the Comprehensive Spending Review (CSR) mechanism in 1998, which estimated the subsequent three years' expenditures and revenues. In the CSR, all items of expenditures are classified into either the Departmental Expenditure Limits (DELs) or the Annually Managed Expenditure (AMEs). The distinction between DELs and AMEs is not always apparent. AMEs generally include programs such as social security benefits and debt interest payments that are subject to volatilities making them difficult to sensibly budget for over a three-year time frame. AMEs represent half of the total expenditure. On the other hand, DELs includes discretionary spending for both the current and capital accounts. Complying with the overall spending totals set to meet the fiscal rules, the British government sets out limitations so that DELs are guaranteed their level of funding for three years rather than just one. This may give public services the stability to plan their operations on a sensible timetable. The third-year spending of DELs is revised and rolled over to the next Spending Review, as the Spending Review is revised every two years.[40] In other words, the British system can be taken practically as the biennial budget, which fixes the two-year spending of DELs.

The Netherlands fixes four-year-limits for expenditure totals and the major subtotals in real terms. They are incorporated into a coalition agreement, which concludes after the general election every four years. In the annual budget process, the Ministry of Finance translates ceilings from real terms into ceilings in nominal terms that actually determine expenditure, taking price increases into account. In addition, another rule was introduced which represents the adjustments necessary if the updated estimate of fiscal balance in the annual budget process has deviated from the original version in a coalition agreement. For example, if revenue surplus is expected in the case where the budget deficit is less than 0.75 per cent of GDP, the amount of surplus has to be utilised for deficit reduction and alleviation of tax burden on a fifty-fifty basis.

By contrast, the Australian and New Zealand ceilings fix subsequent expenditures to a large extent, but they are usually revised and rolled over in the annual budget process. Both systems are almost the same in principle.[41] Budgeting in Australia is regulated by the forward estimates, which reflect the minimum cost of maintaining on-going government policy. They do not include any provision for new programs or expansion of existing programs that has not been agreed upon by the government, or for programs that are not expected to continue.[42] The forward estimates record the cost of on-going government policy after allowances have been made for estimated movements in parameters. If there is no change in the budget process, not only in existing policy and programs but also in economic parameters such as GDP growth and interest rates, the appropriation bill for the next year would be formulated by copying budget figures for the same year already decided in the previous year's forward estimates. In practice, the forward estimates are usually revised in the budget process, since new programs are proposed, existing programs are amended and the economic outlook is updated. In the early stage of budgeting, spending ministries need to update their forward estimates based on the latest economic outlook and subsequent to cabinet's agreement to new policy. If spending ministries propose new initiatives or amendment of programs that may affect the existing forward estimates, they are in principle required to offset increases of spending, maintaining the existing forward estimates. In other words, if spending ministries propose additional spending in one area, they have to decrease spending in other areas or increase revenue. In this sense, the forward estimates function as ceilings for spending. It should be noted that the extent the offsetting rule would be strictly applied in reality depends on several circumstances such as the prevailing fiscal balance and political priority.

Since the assumptions used for budgeting are variable, reflecting economic circumstances, the baseline system adopted in Australia and New Zealand is sufficiently rational that it can accommodate changes in various factors flexibly.[43] However, the baseline system inherits some weakness in maintaining fiscal discipline, as the level of spending stipulated in the previous baseline is likely to be revised upward in the actual budgeting process. The risk of upward revision in the Swedish ceiling is very low, because the government needs to obtain an approval in the parliament to amend the predetermined ceiling. In reality, New Zealand has been struggling with this problem. Discretionary spending within the three-year baseline assumes no increase against the previous year, while spending for entitlements assumes an increase in parallel with the price index or population ageing. Politicians are likely to increase the baseline in the actual budgeting process, simply because they want more money. This assumption is not realistic.

In the United States, the Budget Enforcement Act of 1990 introduced caps on discretionary spending that are, in principle, fixed in advance, but can be flexibly adjusted because of inflation, war costs, and emergency expenditure for natural disaster. The flexibility of the caps appears from the failure of the Grumm-Radman-Hollings. While the caps that were originally set were maintained reasonably well until the fiscal surplus emerged, caps were often revised upward by large amounts after that. The flexibility in setting caps was abused by legislators within the congressional budget process.

Expenditure rules could not work as expected without an effective medium-term fiscal planning (MTFP). The three-year expenditure ceilings in Sweden and the forward estimates in Australia are a good example of MTFP. The paper now discusses the importance of MTFP. In most countries, a government budget is formulated annually, because a democracy needs a process in which its parliament authorises any government spending periodically, usually every year. The short time-limit inherited in the democratic process of budgeting has been widely criticised, typically as follows; fiscal policy is likely to be stop-and-go; economic stability is undermined in the medium-term; resources are allocated in an ad hoc manner. Medium-term fiscal planning can be seen as a system that makes up for shortcomings given the short time-limit of budget processes without breaking the convention that a budget should be appropriated annually. The history of MTFP goes back to the 1960s in the UK and West Germany.

Following the UK and German initiatives, some form of MTFP was introduced into many countries. However, most programs have not been successfully implemented and governments have been unable to control overall expenditure and curb fiscal deficits. There are several reasons for the failure of MTFP, and the OECD (1997) analysis is as follows.

(1) There was a tendency to overestimate the future growth of the economy. This made excessive resources available in the forecast period and created an upward pressure on public expenditure.

(2) Ministries viewed their forecast expenditures as an entitlement. This made subsequent downward revisions in expenditures difficult, even when it became clear that the economic assumptions on which the allocations were made were not correct.

(3) The multi-year budget framework was in real terms rather than in nominal terms. In the 1970s, when economic growth fell and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically for increases in prices. This created further pressure on public finances.

The MTFP measures implemented in the 1990s drew from these past experiences. The main purpose of the MTFP programs can be states as follows (OECD (1997).

(1) Setting overall fiscal policy targets and stating explicitly how the government would meet them over a number of years, and translating these targets into operational terms, thus establishing a ceiling for expenditures.
(2) Showing the cost of continuing existing policies. This frequently revealed that very limited, if any, additional resources would be available if the government's fiscal policy targets were met. This served to impose self-discipline on ministers in proposing new expenditures and to alert the government to decisions that might need to be made immediately to achieve future targets.
(3) Illuminating the budget implications of current decisions on future years budgets where the expenditure may not be fully reflected in the current budget. This may refer to: (i) the operating costs of new capital projects; (ii) programs that come into effect late in the budget years thus not exposing their full costs in the initial year; or (iii) new or on-going programs whose future spending implications may not be fully reflected in the current budget year but will grow in future years.

Medium-term fiscal planning is in a sense the double-edged sword. If the government mismanages MTFP, it will undermine fiscal discipline, rather than serving to maintain fiscal rules and targets. MTFP is much more difficult to implement in the political game of budgeting than the theory expects, and we need additional measures to manage MTFP properly. Expenditure rules are not enough to manage MTFP. Final figures for expenditure and revenue usually result in deviations from original estimates and projections in MTFP, since they are based on several assumptions for economic growth and inflation. This is often the case when less-than-expected economic growth decreases revenue and makes it difficult to adhere to fiscal rules and targets. The government has to identify the differences in fiscal figures between original estimates and results, analyse the reasons for them and take actions, as necessary, to uphold fiscal rules and targets. OECD countries have introduced the following mechanisms to address this problem.

(1) Ex-ante assessment

- In the Netherlands, the budgeting assumes lower economic growth than in an official economic outlook. This is an evidence of a more prudent approach.
- In the UK, the National Audit Office is invited to audit any changes to key assumptions and conventions underlying the fiscal projections. The Comptroller and Auditor General ensure that any advice is communicated to the Treasury and laid before parliament.
- New Zealand produces the most comprehensive analysis including a scenario analysis based on different economic paths, presenting different fiscal outlooks based on scenarios and sensitivity analysis, which estimates fiscal balance in case of lower economic growth by a one percentage point than the assumption incorporated in the budget.
- In the 1990s, several countries adopted fiscal rules and targets to maintain fiscal balance over the business cycle. These rules can be assessed in a narrow sense only after the business cycle is completed. But it may be useless, if you cannot assess the outcome of fiscal policy in the forward-looking manner. In the UK and Sweden, budget papers estimate the GDP gap to capture the current fiscal position over the business cycle and assess the possibility and risk of compliance within the medium-term framework (Table 5–3 and Figure 5–1).

(2) Ex-post assessment

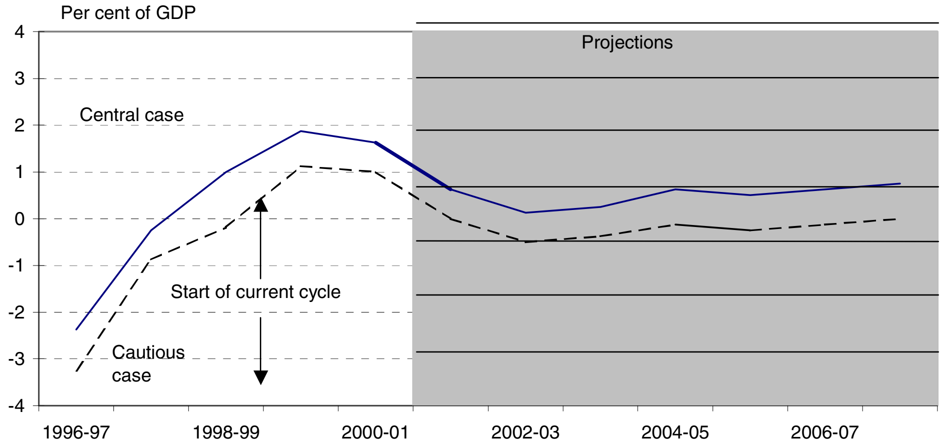
- In Australia, New Zealand and the UK, budget papers analyse the differences in fiscal figures between original estimates and results and present reasons for any differences by categorising the information into change of policy and change of parameter (Table 5–4). This is also the case

Table 5–3 Compliance with macro rules in the UK (% of GDP)

	Outturn 2001–02	2002–03	2003–04	Projections 2004–05	2005–06	2006–07	2007–08
Golden rule							
Surplus on current budget	0.8	–0.5	–0.4	0.2	0.4	0.6	0.7
Average surplus since 99–00	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically–adjusted surplus on current budget	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Sustainability rule							
Public sector net worth	30.4	31.0	32.1	32.4	32.6	32.7	33.0

Source: HM Treasury (2002), *Pre–Budget Report 2002.*

Figure 5–1 Cyclically-adjusted surplus on current budget in the UK



Note: Cautious case assumes trend output/percentage point lower in relation to actual output than in the central case.
Source: HM Treasury (2002), *Pre-Budget Report 2002.*

in the Netherlands and Sweden. This analysis is often called 'reconciliation' and can be regarded as an evaluation of fiscal policy. It is essential to establish a system, which forces the government to commit to fiscal rules, to assess periodically its compliance, and to reveal the assessment results to the public.

Budgeting process as political decision-making

Finally, political decision-making in budgeting is discussed below. As the distinguished American academic Wildavsky) says, the essence of budgeting lies in the political negotiating process to allocate scarce resources. Thus, fiscal reforms, which do not inter-act with the decision-making process, seem pointless. Broadly speaking, there have been two approaches to reform decision-making process in OECD countries, as follows.

(1) Centralisation of power to small group (Australia, New Zealand and the UK)

Budgeting in Commonwealth countries is characterised by the practice whereby the Finance Minister is usually superior to other spending ministers in the cabinet, and an inner cabinet committee on

Table 5–4 Reconciliation table in the budget (Australia, Commonwealth government)

	2002–03	2003–04	2004–05	AU$ million 2005–06
2002–03 Budget fiscal balance	**180**	**2,611**	**5,037**	**7,676**
(% of GDP)	0.0	0.3	0.5	0.9
Changes between 2002–03 Budget and MYEFO				
Effects of policy decisions				
Revenue	93	181	192	245
Expenses	464	393	449	498
Net capital investment	26	11	0	–7
Total policy decisions	–397	–224	–256	–246
Effects of parameter and other variations				
Revenue	–116	350	–791	–1,485
Expenses	11	–794	–177	149
Net capital investment	206	154	–8	0
Total parameter and other variations	–333	990	–605	–1634
2002–03 Mid–year update fiscal balance	**–548**	**3,377**	**4,176**	**5,797**
(MYEFO) % of GDP	–0.1	0.4	0.5	0.7
Changes between MYEFO and 2003–04 Budget				
Effects of policy decisions				
Revenues	–58	–2,491	–2,828	–2,765
Expenses	732	1,729	1,238	1,298
Net capital investment	192	65	111	72
Total policy decisions	–982	–4,285	–4,177	–4,135
Effects of parameter and other variations				
Revenue	2,235	731	–972	–1,092
Expenses	–863	–875	122	197
Net capital investment	67	–14	54	50
Total parameter and other variations	3,032	1,619	–1,148	–1,338
2003–04 Budget fiscal balance	**1,501**	**711**	**–1,148**	**324**
(% of GDP)	0.2	0.1	–0.1	0.0

Notes: 1 A positive number for revenue indicates an increase in the fiscal balance, while a positive number for expenses and net capital investment indicates a decrease in the fiscal balance.
2 Excluding the public debt net interests effect of policy measures

Source: Budget Paper No.1, Fiscal *and Economic Outlook, (Budget* 2003–04, May 2003), Table 2 budgeting strengthens this arrangement. While the membership of this committee varies from country to country and from time to time, in general it consists of about five senior cabinet members and is chaired by either the Finance Minister (Treasurer) or the Prime Minister. The budget policy including the overall fiscal balance and priorities for additional spending is discussed and decided exclusively by the committee. The idea of the inner cabinet committee may be derived from the fact that the more players that are involved in the budgeting process the more difficult it is to maintain fiscal discipline.

The case in Australia is explained here. In November or December, nearly eight months before the new fiscal year starts in July, the Senior Minister's Review (SMR) takes place, led by the Prime Minister, the Deputy Prime Minister, the Treasurer and the Finance Minister. The SMR process determines the strategy and policy priorities for the coming budget, considering information provided with the spending minister's proposals. In December, the Prime Minister advises spending ministries of the priorities and targets for the budget. In January, each spending ministry prepares its budget proposal in line with the cabinet guidance and it is scrutinised initially by the Department of Finance and Administration. Then after the budget proposal is lodged with the Expenditure Review Committee (ERC) in March. The ERC is a committee of the Cabinet that considers various new policy and savings proposals and recommends to the Budget Cabinet proposals to be included in the budget. All major and sensitive proposals are considered by ERC, whilst minor proposals are handled bilaterally between spending ministers and the Finance Minister in the first instance. After all proposals are considered, the Budget Cabinet approves the final package and the budget measures in April.

The ERC system was developed by the Labor Government since the middle of the 1980s and become the centrepiece in controlling public expenditure in Australia.[44] O'Fraircheallaigh et al. (1999) says the cabinet was traditionally marginal to the budget process, but increasingly came to play a crucial priority-setting role and to be responsible for approving fiscal targets, setting aggregate expenditure levels, determining savings targets and approving portfolio limits, through the ERC. In short, the ERC is a critical institution to impose fiscal discipline on the government. It should be remembered that without the prime minister's support the finance minister would not be able to stick to his/her positions.

(2) Strict rules in decision-making (New Zealand, the Netherlands, Sweden and the US)

The approach of centralising the authority to the Finance Minister and small cabinet committee may function well in a single-majority government that is formed through the single-member electoral system, as von Hagen and Haden (1994) suggests. On the other hand, this approach does not always function in a coalition government, because the Finance Minister is often out-ranked by the head of the party. It is well known that a coalition government that is formed through a proportional presentation electoral system is likely to result in fragmentation in decision-making. Some sort of strict rules are necessary in decision-making in order to overcome fragmentation.

The typical example of this approach is the Netherlands. As already mentioned, a series of political negotiations take place to form a new government after a general election, eventuating in a coalition agreement that includes not only core policy of the new government but also a four-year fiscal framework. In 1996 New Zealand introduced a similar approach for the fiscal year 1997 budget, after which coalition governments became common. The coalition agreement included a fiscal provision that fixed the total additional spending for the coming three years (that is, the parliamentary cycle).[45] It focused only on discretionary spending, while spending for entitlement programs, such as unemployment benefits, could be adjusted according to parameter changes such as price increases. The expenditure limit meant a pool of funds became available for the incoming government, and it was hoped it could thereby avoid a spending build-up caused by disputes among different parties in a coalition government.

Another example is Sweden. The first step in budgeting in Sweden is to decide on a three-year overall expenditure ceiling, and is followed by deciding spending limits of 27 major areas for three years within the overall ceiling. The three-year budget framework, including both ceilings and targets, is drafted by the Ministry of Finance based on budget requests from spending ministries, but importantly it is done only by consultation with the prime minister. The recommendation of the Ministry of Finance is presented to members of the cabinet several days prior to the Cabinet Budget Meeting at the end of March. This meeting facilitates the political process of negotiating and finalising the three-year budget framework, which takes place at the Prime Minister's Retreat located outside Stockholm for two days. The Finance Ministry's recommendation for the three-year fiscal framework can be amended in this meeting, but amendments are possible only when spending ministers who seek additional resources can finance their initiatives by reallocating within their respective expenditure areas or by obtaining money from other ministers. This is why the overall expenditure total is decided before going to discuss the allocation. Sweden has established rules and regulations in the budget negotiation that impose fiscal discipline on cabinet members.

In the United States, the Budget Enforcement Act of 1990 (BEA) introduced multi-year spending caps for discretionary spending and a pay-as-you-go principle for mandatory spending and tax.

The BEA was an innovation based on learning from the failures of Gramm-Rudman-Hollings (GRH) in the 1980s, which was mainly caused by inflexibility in reducing fiscal deficits. One of the shortcomings in GRH was that a change in the economy that increased the costs of entitlements resulted in more deficits and triggered a sequestering of across-the-board cuts, even if nobody was responsible for a recession. On the other hand, the BEA was successfully implemented by regulating legislators' activities in the budgeting process. The BEA not only strengthened the norms of fiscal balance, but also held legislators accountable for only those outcomes that they controlled (Rubin (2002)).

Aftermath of fiscal reforms

As argued above, budgeting is essentially a process of political decision-making. This means that no fiscal rules and targets or consolidation programs can be effective without political will and commitment even, if they are economically and theoretically well designed. Furthermore, their efficacy depends on public attitudes towards binding fiscal management and in particular towards fiscal consolidation. Consensus in public opinion and commitment by politicians are much more easily achieved at times of economic crisis than at normal times. This is clearly demonstrated in the case of the US losing its fiscal discipline just after the federal fiscal balance turned into surplus, and by the example of some EU countries like Germany, France and Italy, which lost their commitment to comply continually with the Maastricht criteria, even after they decided to participate in the EMU. This chapter focuses mainly on two case studies; the US and EU to address how industrialised countries have faced the difficulties in maintaining fiscal discipline in the first half of the 2000s.

The long journey of fiscal consolidation in the US ended in fiscal year 1998 with a budget surplus achieved in term of a consolidated budget. However, the expenditure rules based in the Budget Enforcement Act (BEA) became increasingly ineffective and finally expired at the end of 2002, when legislators were not able to extend the BEA. The surpluses too have disappeared. As a matter of fact, the deficit has now reached the worst historical level ever; the Congressional Budget Office (CBO) baseline in August 2003 showed the deficit for 2003 estimated at nearly $480 billion.[46] The OECD (2004c) projects the general US government fiscal deficit increasing in terms of GDP from around 4 per cent in 2003 to 4.6 per cent in 2006. There are several reasons for the deficit widening so much; the recession of 2001; tax cuts; and spending increases, especially for defence and homeland security.

Why has the enormous swing from surplus to deficit occurred in the US? It is not simply a matter of a sluggish economy. We have to look into the details of how the BEA has been circumvented since the end of 1990s. There were two distinctive expenditure rules in the BEA that regulated federal budgeting: one was spending caps for discretionary expenditure and the other the pay-as-you-go principle for mandatory expenditure and taxation. To what extent have they actually been achieved since their inception?

Spending caps can be revised flexibly in order to adjust and accommodate additional budgetary needs such as an emergency expenditure, because legislators in the House and the Senate learned much from previous experiences in implementing Gramm-Rudman-Hollings (Balanced Budget and Emergency Deficit Control Act). We can see to what extent the final spending caps deviated from their original caps as stipulated in the relevant laws (Table 6–1). The deviation ratio, calculated by dividing the difference between the final and original caps by the original figure, remains at just one to two per cent until fiscal year 1998, although it jumped to four to seven per cent from 1991 to 1993 due to the extra spending necessary for the Gulf War. We could say the original spending caps were almost unchanged.[47] However, once the fiscal surplus was achieved, the deviation ratio increased year by year to be more than thirty per cent in fiscal year 2002. What accounted for such a deviation? The legislators increased the caps on the grounds of emergency spending and revised the relevant legislation, overriding the BEA, to accommodate additional military spending.

It should be noted that the term 'emergency spending' is ambiguous in its definition. It can be abused as a process even though the definition is legally consistent. For instance, the expenditure for the national census in 2000 was recorded as emergency spending, despite the fact that it was already known that it is scheduled to be carried out every ten years.

The pay-as-you-go principle cannot be as easily assessed as spending caps, since there seems to be no specific timing to assess the extent to which any additional spending or revenue shortfall that has been introduced by a new measure has been offset. Offsetting is allowed over the course of the fiscal year. The Final Sequestration Report, which has to be released by the Office of Management and Budget (OMB) within fifteen days after the end of the congressional session, may be of some help. Table 6–2 indicates the net cost of pay-as-you-go legislation, namely the additional spending cuts or revenue increases necessary for offsetting at the time of the Report. If the President and the Congress do not fully offset it by other legislative saving, the BEA requires that a sequester of non-exempt direct spending programs offset the net cost. The net cost was almost zero or negative until fiscal year 2000, but subsequently increased rapidly to reach US$100 billion in FY2002. This suggests that legislators enacted measures while paying little attention to financing them.

Expenditure rules, which functioned well in circumstances where the objective of fiscal consolidation was shared among politicians, could not bind politicians once the value of compliance disappeared together with the fiscal surplus in 1998. Alesina (2000) says that in a situation of fiscal surplus, resources are available to compensate the temporary losers of reforms and it may be difficult for politicians to overcome this temptation to spend, while in a period of deficits, compensating the losers may be more difficult if an additional increase in deficit is economically or politically costly. The BEA

Table 6–1 Changes to discretional spending limits (Caps) in the US

(US$ billion,%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Statutory caps original set	514.4	524.9	534.0	534.8	540.8	547.3	547.3	547.9	559.3	564.3	564.4	560.8
Adjustments to caps												
Changes in definitions		1.0	2.4	2.3	3.0	–0.5	–2.6	–2.8	–0.3	0.1	–0.1	–3.3
Changes in inflation		–0.3	–2.5	–5.8	–8.8	1.8	2.3	0.9		35.8	20.5	31.7
Emergency requirements	1.1	1.8	5.4	9.0	10.1	6.4	8.1	7.0	22.9			
Expenses for Gulf War	33.3	14.9	7.6	2.8	1.1	0.0						
Special adjustment 2001											58.6	
Special adjustment 2002												133.1
Caps after adjustments	551.6	545.7	550.4	547.6	548.7	552.7	553.6	560.2	584.2	604.2	652.2	731.3
Deviations from original %	7.2	4.0	3.1	2.4	1.5	1.0	1.2	2.2	4.5	7.1	15.6	30.4
Actual spending	533.3	533.8	539.4	541.4	544.9	532.7	547.2	552.1	572.0	614.8	657.4	740.5
Deviation from original %	3.7	1.7	1.0	1.2	0.8	–2.7	0.0	0.8	2.3	8.9	16.5	32.0
Deviation from adjusted %	–3.3	–2.2	–2.0	–1.1	–0.7	–3.6	–1.2	–1.4	–2.1	1.8	0.8	1.3

Notes:
1. Deviation ratios are calculated by using data from OMB (2002), OMB *Sequestration Update Report to the President and Congress for Fiscal Year 2003*
2. These caps are in terms of outlay.
3. The original statutory caps were amended by relevant acts in 1993 and 1997, these figures are indicated in the top column.

Table 6–2 Necessary spending cuts required by pay-as-you-go principle in the US

(US$ million)

	95	96	97	98	99	00	01	02	03	04	05	06
FY1995 (Dec94)	–2,009	–148	–357	–9								
FY1996 (Jan96)		717	778	1,515								
FY1997 (Nov96)			–6,234	–3,466								
FY1998 (Nov97)				0	6	6	3	1	0			
FY1999 (Dec98)					0	–2,927	–833	–164	–1,092			
FY2000 (Jan00)						0	0	0	0	0		
FY2001 (Jan01)							0	16,053	18,465	19,336	20,673	
FY2002 (Feb02)								0	110,684	129,857	130,571	134,698

Notes: 1 Figures are taken from Final Sequestration Reports, which OMB is required to publish no less than 15 day after the Congress ends the session.
2 Dates in parenthesis indicate when the Report was published.

included great scope for flexibility, incorporated after experiencing the failures in Gramm-Rudman-Hollings. But ironically this very flexibility induced misuses and gimmicks. In this way, the fiscal surplus, which had been achieved through blood and tears, disappeared just four years after fiscal year 1998, and the deficit has now reached a historically high level in the US Compliance with rules burdens politicians with a cost, because discretionary powers to spend and tax are restricted. Adherence to fiscal rules was not worth the cost at the turning point of fiscal surplus, but the situation was further exacerbated by the loss of public interest due to the simultaneous events of economic recession, a series of terrorist attacks and the Iraq War giving a justification for budget deficits. In short, the political will and public support that definitely existed when the BEA was enacted, disappeared. Without them, rules and institutions could not survive in the real political world.

The fiscal position in EU member countries deteriorated after the EMU commenced. In particular, Portugal breached the deficit criteria of three per cent of GDP in 2001, both France and Germany followed suit in 2002, the Netherlands in 2003, and Italy was forecasted to breach the criteria in 2004.[48] According to the OECD's forecast (OECD 2004c), France and Germany were expected to clear the deficit criteria after 2006, at earliest. On the other hand, Denmark, Finland, and Sweden have been able to maintain fiscal surplus continuously, and in Austria, Belgium, Ireland, and Spain, the general government deficit is less than 1 per cent in the 2000s. One of the critical reasons for French and German noncompliance was that both countries conducted expansionary fiscal policies, particularly tax cuts, in the economic boom of 1999 and 2000. This suggests that the fiscal rules in the Treaty and SGP is more effective in small countries than in large countries.[49] Discretionary loosening of fiscal policy around the year 2000 in the EU seems to have been accelerated by elections. Governments that would like to improve their chances for re-election, need fiscal expansions in the year preceding the election (von Hagen 2002). Buti and van den Noord (2003) also show statistically that the electoral cycle increases the temptation to run expansionary policies in the early years of EMU. In short, old bad habit die hard.

What has caused the difference in fiscal performance between France, Germany and Sweden? The European Commission (2002) listed the following problems in implementing the Stability and Growth Pact (SGP) as follows:

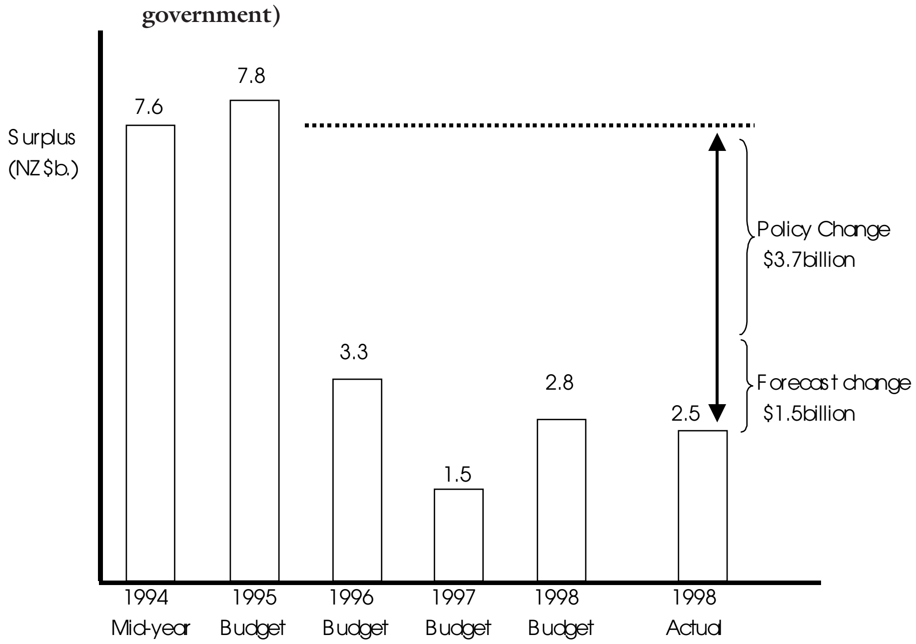
(1) Political ownership of the SGP by member states has diminished;
(2) It has been difficult to establish clear and verifiable budget objectives that take account of underlying economic conditions

(3) The framework for the collection and assessment of budgetary statistics has experienced a number of difficulties;
(4) Some member states did not run sound budgetary policies in periods of economic boom;
(5) The enforcement procedures of the SGP have been found wanting at critical junctures;
(6) The SGP has struggled to develop an effective co-ordination framework for dealing with country-specific circumstances in a consistent manner;
(7) It has been difficult to communicate effectively to the press, the market and the public the benefits of achieving and sustaining sound public finance positions and how the SGP works.

First of all, we should examine whether or not strong political commitment exists in the making of fiscal policy. Political commitments as well as peer pressure are indispensable in implementing rule-based approaches like the Maastricht Treaty and the SGP. At the time of entry to the EMU, political will was a decisive factor in leaping the hurdle of the Maastricht criteria and enabling participation in the EMU to proceed. In other words, not being able to enter into the EMU meant political failure, while being able to meant political success. This effectively worked as a strong 'enforcement' mechanism. On the other hand, once countries have entered into the EMU, even if they have clearly breached the criteria such as France and Germany, they are not always serious either about taking necessary budgetary action to reduce budget deficits, or even about proceeding with further tax cuts. Buti and Giudice (2002) found that the SGP works asymmetrically; while an excess of over three per cent of GDP deficit ceiling is penalised, there is no apparent reward for correct budgetary behaviour in good times. Taking into account the complex and ambiguous procedure for penalties in the Excessive Deficit Procedure, the political temptation to spend more and tax less is not easily contained in the real world.

This paper has examined the difficulty experienced in maintaining fiscal discipline in France, Germany and the USA. What about the cases of Australia, New Zealand and Sweden, where fiscal surpluses have been maintained even after 2000? A similarity seems to exist among these countries. It is much more difficult to ensure politicians tighten their belt in conditions of fiscal surplus than it is in times of fiscal deficit. Sweden has succeeded in controlling public expenditures through its three-year expenditure framework, which was introduced in 1997 and includes some kind of contingency reserves to cope with unexpected spending in the future.[50] The majority of Sweden's contingency reserves have been used for discretionary spending since their inception in 1997 (OECD 2004a), although the actual total spending has never exceeded the total ceiling. New Zealand has also faced the same problem. The New Zealand fiscal surplus originally estimated as the base line usually ended up much smaller, even if revenue did not decrease significantly (Figure 6–1). This is because some discretionary spending was added in the annual budgeting process. This problem is inherent in the mechanism of the base line projection that captures only increases in entitlement programs due to inflation or other economic parameters (Janssen (2001)). The base line is, by definition, based on existing programs excluding any new decisions that might be taken in the future. In Australia, difficulty in controlling spending ceiling has not emerged. However, compliance with the fiscal rule of keeping fiscal balance over the business cycle is not as self-evident as nominal fiscal surplus suggests. The current surplus of nearly 1 per cent of GDP is likely to be insufficient for dealing with various fiscal risks such as the East Asian Financial Crisis, if we take into account the historical experience that the budget deficit deteriorated to 5 to 6 per cent of GDP in the first half of 1990s. In other words, in order to uphold the fiscal rule of balancing over the cycle, a budget surplus should be somewhere between 3 to 5 per cent of GDP. Strictly speaking, the actual fiscal rule in Australia is just not to incur a budget balance deficit.

Figure 6–1 Changes in projected 1997–98 operating balance (New Zealand, the central government)



Source: OECD (1999) *Economic Surveys of New Zealand*.

To summarise, maintaining fiscal discipline is much more difficult than achieving fiscal surplus and much more difficult in good times than in bad times. There seems no rule that is effective to preserve fiscal discipline in perpetuity. Its effectiveness depends on various conditions. In other words, a government should modify or revise its rules and adjust to a new environment. Effective measures to tackle this problem will be discussed in the next chapter.

Need for further reforms

The first half of the 2000s revealed wide variation in the implementation of fiscal rules and expenditure management. On the one hand, the US and some big countries in the EU experienced increased deficits; on the other hand, Nordic countries and some Commonwealth countries have managed to maintain balanced budgets. Does this mean the fiscal rules and targets introduced in 1990s are ineffective in preserving fiscal discipline? Should we scrap them? Is there any room to improve them? Generally speaking, discussion about this among OECD countries has not been enthusiastic, but this is changing, particularly in the EU where the reform of the SGP has become firmly placed on the agenda, although consensus is not easy to find. This chapter discusses some important issues in strengthening public expenditure management, based on experiences in the 1990s. It focuses on three important issues here: political commitment; monitoring and surveillance; and quality of expenditure.

Firstly, political willingness and commitment are the critical element in adhering to fiscal rules and targets. A continuous commitment undoubtedly requires that politicians, as well as the public, understand the rationale and necessity of compliance. Experiences in the USA and the EU clearly suggest that political commitment and public awareness have disappeared since the turn of a century. They can be achieved without much trouble in an economic crisis or with a change of government; however, it may be extremely difficult in normal times and in particular, times of surplus.

Although there seems to be no definite answer to this problem, one down-to-earth solution is to establish a legal framework of fiscal policy, which is best exampled by the Fiscal Responsibility Act 1994 (New Zealand), the Charter of Budget Honesty Act 1998 (Australia) and the Code of Fiscal Stability 1998 (the UK). These frameworks are often cited as mechanisms to promote fiscal transparency (IMF (1998)). But their critical point is to make the incumbent government commit itself to observing fiscal rules and targets based on their own economic and fiscal policies and to conducting self-assessment of their compliance with rules in the form of several fiscal reports open to public scrutiny. To take an extreme view, rules themselves perhaps do not matter significantly. No fiscal rules and targets can survive forever, because the type of rules required may depend on various political, economic and social circumstances of a particular time and arbitrary factors in deciding a numerical target such as debt outstanding per GDP cannot be avoided. In a sense the Fiscal Responsibility Act has artificially established an institution in which the government is always required to commit to fiscal rules by itself even if the government changes. As already mentioned, New Zealand has been struggling to maintain aggregate fiscal discipline, and this situation was expected to be further undermined by the introduction of a mixed-member proportion (MMP) electoral system in 1996.[51] The MMP has significantly transformed the governance structure in New Zealand's politics away from a single majority government to a coalition government. The Fiscal Responsibility Act was introduced at least partly because it would be generally difficult for a coalition government to maintain fiscal discipline (Scott (1996)). Boston and Church (2002) analyse how the budget process in New Zealand was changed by several governments from the beginning of the 1990s to the early 2000s and conclude that the MMP has not hampered the capacity of governments to impose significant fiscal discipline in general.

Commitment by governments is a prerequisite to guarantee compliance with rules and targets, but what makes each government maintain any commitment is the rationale and the public support for it. As long as the government recognises the necessity to maintain fiscal rules and targets, it must endeavour to explain the rationale behind them to the public. What is the rationale in normal times? It might be the ageing population that most OECD countries now face. There seems no clear and understandable rationale other than addressing the issues of fiscal sustainability and intergenerational equity and reforming the social welfare system including public pensions and health care. Currently, in the US, there are no effective fiscal rules and targets because the Budget Enforcement Act expired at the end of 2002. But many experts and international organisations argue that the budgeting system should be reformed further in order to tackle ageing problems faced by the US Auerback (2003), Rivlin and Sawhill (2003), Mühleeisen and Towe (2004). The OECD (2004b) suggests that the fiscal policy rule prescribed in the SGP, i.e. balanced budgets or small surpluses of about half percent of GDP, is the minimum needed during the transition period to the new demographic steady state until around 2020. That means this rule may be far too lenient for countries like Finland, Germany, the Netherlands and Portugal.

Secondly, the government should revise and redesign fiscal rules and targets uninterruptedly. They are being discussed in the US and the EU, although a decisive course of action has yet to be resolved.

In the USA, refining the BEA rules is most commonly discussed as a solution, since the BEA worked well in the 1990s. There seems no alternative other than modification of BEA if the Congress is not to challenge the basic structure of US budgeting system. For example, Kell (2004) sorts out the following five options for reform: limit discretionary caps to the budget authority; clarify and codify into law the criteria for emergency spending;, redesign the pay-as-you-go principle to trigger examination of the base; make the pay-as-you-go requirement contingent on a level or forecast of the debt-to-GDP ratio; and clarify and refine the scorekeeping guidelines. Rivlin and Sawhill (2003) also suggest a similar approach to reform. Basically speaking, these proposals seek to close several loopholes in the BEA so that politicians act in a fiscally responsible manner and do not abuse their legislative power. The question is, however, whether or not politicians have the will to legislate these amendments.

In the EU's case, the reform of SGP has been very widely discussed. Buti et al. (2003) identify and assess several proposals. They conclude that problems in the SGP can be solved by internal adjustment rather than by attempting to redesign the rules from scratch. Specifically, redefining the medium-term budgetary target, improving transparency, tackling the pro-cyclical fiscal bias in boom times, moving towards non-partisan application of the rules, and improving transparency in the data can achieve both stronger discipline and higher flexibility (Table7–1). The European Commission has put forward a proposal to strengthen the current policy framework enshrined in the SGP (European Commission (2002)). Major points of this are as follows:

(1) Establishing budgetary objectives that take account of the economic cycle;
(2) Transitional arrangements for countries with underlying deficits exceeding the 'close to balance or in the surplus' requirement;
(3) Avoiding pro-cyclical budget policies in times of high economic growth;
(4) Ensuring that public finances contribute to growth and employment;
(5) The sustainability of public finances should become a core policy objective;
(6) Member states should reaffirm their political commitment to the SGP;
(7) Upgrading the analysis of economic and budgetary policies;
(8) More effective enforcement procedures;
(9) Better communication through openness and transparency.

The critical theme behind these proposals is to deal with the business cycle while keeping rules and targets.[52] Macro rules cannot escape the trade-off between credibility and flexibility. A typical example is the Budget Enforcement Act in the US The BEA learned the failure of Gramm-Rudman-Hollings and incorporated adjustable spending caps that undoubtedly contributed to fiscal improvement, but this flexibility, together with the absence of explicit macro targets, was not enough to maintain fiscal discipline in the first half of the 2000s. The SGP is well designed to balance credibility and flexibility,

Table 7–1 Strengthening the stability and growth pact proposed by Buti et al (2003)

Proposal	Goal	Operational steps
Diversify close-to balance	Overcome excessive uniformity of the rules	–Common estimates of contingent liabilities –Common estimates of net investment
Structural balance targets **Monitor cash figures**	Improve transparency	–Define one-off measures –Countries to explain divergence Between cash and national accounts
Early warning in good times **Rainy-day funds**	Correct pro-cyclical bias	–Define maximum allowed worsening of cyclically adjusted balance
Commission implements the rules, Council decides on policy measures	Move to non-partisan enforcement	–Define relative tasks between Commission and Council

Source: Buti et al (2003), Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?, *CEPR Discussion Paper*, No. 3692, Table 4.

but the ambiguity in the process for assessment of deficit spending has not produced results as expected, given that France breached the rules intentionally.

Overall, the only way to abate this trade-off is to improve fiscal transparency. Among all the European Commission's answer to this problem is to strengthen monitoring and surveillance of fiscal policies in member countries. The European Commission (2002) emphasises that the key challenge is to distinguish budgetary components that have more permanent influences from purely short-term transitory elements. With this in mind, it developed a new method to cyclically-adjust budget balances based on a production-function approach to estimating output-gaps.[53]

There are several approaches to improve transparency as already discussed. Perhaps one of the most extreme arguments is that setting simple numerical limits on deficits or debt is not sufficient to maintain fiscal discipline or to limit irresponsible fiscal behaviour in a democratic society. Wyplosz (2001) proposes the establishment of an independent fiscal policy committee, which would be comprised of a small number of economists and specialists, and whose major role would be to assess independently whether or not the government's fiscal policy follows their pre-determined fiscal objectives and to recommend necessary actions. The basic idea seems to come from the growing use of an independent board to determine monetary policy. Fatás et al. (2003) also take a similar approach, and propose to establish a Stability Council with detailed picture of it, and they argue that a rule-based approach like the SGP is not suitable for safeguarding the sustainability of public finance. This requires a much more specialised analysis, independent from political pressure; an independent institution with a clear mandate to assess public finances and make recommendations as necessary. I wonder if the creation of an independent institution is incompatible with democratic governance, but there have been some examples so far. The High Council of Finance in Belgium is one such example. In 1992, the Belgian parliament gave the Council the role of monitoring the compliance of all parts of government with the convergence program.[54] In short, we need a kind of institution to monitor and analyse closely how the fiscal policy goes on and performs, either inside the government or outside.

The third issue is the quality of public finance. One dilemma, in which the BEA and the Maastricht Treaty have been trapped, is that reducing fiscal deficits has become the ultimate objective, although it was both necessary and urgent. Slashing deficits is an important step in ensuring long-term fiscal sustainability; however, it is not a final outcome. Rubin (2002) says the BEA's success created a raft of unintended consequences, which can be labelled a 'short-term focus', a 'lack of prioritisation', and a 'lack of strategic resource allocation' and everything else. His major criticisms are as follows:

(1) Legislators and policymakers were enthused over calculating figures to try to meet reconciliation targets;
(2) In many cases, what would be cut was that which was easy to cut, rather than that which needed to be cut;
(3) They tried to avoid claiming credit now for putting off difficult decisions and painful cuts until later;
(4) Hollow government occurred, because the cutting back mission and adjusting responsibilities proportional to the budget cut was very difficult, and agencies' ability to perform their tasks was threatened.[55]

The most difficult task, which most OECD countries have been facing, is to restructure social welfare programs in order to overcome problems associated with an ageing population. Generally speaking, revenue cannot be raised significantly for this purpose, as an increase in tax may result in undermining private investment and a loss of international competitiveness. Thus the approach remaining is to use public money more efficiently and effectively. We also need budgeting reforms at the micro level in order to allocate resources strategically and to provide public services efficiently. For example, many governments have been trying to develop what we might call performance budgeting, in which resources allocated based on performance information. What needs to be underlined here is that painful reforms in social welfare and other area rarely happen unless the government faces severe financial constraints. They are the very fiscal rules and targets, which in a sense can be called the prerequisite for structural reforms.

Conclusion

We have learned a lot of things through the experiences of OECD countries' in the 1990s and the early 2000s. First of all, it should be emphasised that the introduction of fiscal rules and targets does not lead to maintaining fiscal discipline automatically. Their performance is subject to political and economic circumstances and public understanding, as well as their institutional design. Even if they function effectively in some periods, they cannot always adjust to changes in circumstances. In short, fiscal rules and targets are doomed to be breached from the start. Unlike monetary policy, we have not had a single solution to management of fiscal policy. OECD counties try and learn and evolve along the way to find better fiscal rules and targets. Analysing these experiences might be worthwhile for other countries, particularly those required to consolidate public finance from now on, while we should bear in mind that the experiences of other countries were set in their own political and economic backgrounds and are not easily transplanted to different countries and contexts. The final chapter summarises the main lessons learned from the experiences of OECD countries in implementing fiscal rules and targets in the following three points.

(1) Rationale of compliance and political commitment

No rules can be reinforced without strong political commitment. The critical question is how the rationale behind keeping fiscal rules can be addressed clearly and understood among both the public and politicians. It may be relatively easily received when some sort of catalyst such as an economic crisis or change of government exists, but it is extremely difficult in normal times, as clearly shown by the early 2000s experience in the US. Although there is no simple solution to this issue, one possible approach is to introduce a fiscal management framework like the Fiscal Responsibility Act in New Zealand. The Act requires the incumbent government to set its fiscal rules and targets based on her economic and fiscal policy and to assess its compliance through a fiscal reporting system. In other words, the Act has established a system of mandatory commitment and institutionalised a revision of rules and targets to adjust to changes of circumstance.

(2) Institutional design of fiscal rules

Political commitment is an indispensable condition, but the government should install several institutional and technical mechanisms that strengthen such a commitment. We need a careful consideration in designing rules, institutions and public expenditure management. Among others, three important elements for it should be emphasised: centralisation of decision-making system at the cabinet; linkage of macro rules to expenditure rules; and ex-ante and ex-post assessment of fiscal policy. These can be summarised as follows.

Budgeting is in essence a political decision-making process to allocate scarce resources, thus the more players that are involved in the process, the more difficult it is to keep fiscal discipline due to fragmentation. There have been several approaches to centralisation, such as giving stronger political power to the Finance Minister or Prime Minister as in the UK; creating a small inner cabinet committee as in Australia; introducing a strict decision-making rule in the budget cabinet meeting as in Sweden, or making a coalition agreement including an overall fiscal framework for the coming several years as in the Netherlands. In an event, as long as we have a parliamentary democratic system, the cabinet ought to be the institution that makes final decisions and takes responsibility for this. In the ultimate sense, the issue may be related to reform of the electoral system. Fiscal policy, which every party intends to carry out upon winning an election, should be clearly stated in the party manifesto so that people consider this in their decision-making.

Macro rules are simple and clear to most politicians and publics. But simply declaring their implementation does not guarantee compliance. A target such as a general government fiscal deficit of 60 per cent of GDP is unlikely to be a guideline that can directly regulate annual budgeting. Some kind of mechanism is needed to control budgeting in which political bargaining takes place, and the process in which macro rules can be broken down into more operational means. In this regard, most countries have already introduced expenditure rules. What is critical in keeping fiscal discipline is to link macro rules to expenditure rules effectively.

There seems no effective way of enforcing compliance with fiscal rules or maintaining fiscal discipline other than raising the political cost of breaching rules through improving fiscal transparency. There are many things that any government should bear in mind in order to improve transparency.[56] In particular, an ex-ante and ex-post assessment of fiscal policy is critical for transparency and a medium-term fiscal planning (MTFP) is a useful tool for such assessments.

MTFP has an important role in enforcing expenditure rules in reality. In most countries, a budget is prepared and approved annually because of the need for democratic financial controls. This traditional annual process quite often results in fiscal policy being formulated in a short-sighted manner without much attention being given to the business cycle or the impact of fiscal policy on the overall economy. Managing MTFP is, however, not an easy task. If anything, it contains some inherent risks of undermining fiscal discipline as already mentioned. Revenue and expenditure estimates in MTFP are just figures calculated using several assumptions, meaning they usually deviate from actual results. This is often the case when an economic recession produces less tax revenue than estimated and makes it difficult for governments to adhere to fiscal rules and targets. Even in that case, if we stick to the rules in the medium-term, we have to analyse the deviation between original estimates and results and take necessary action. In short, the ex-post assessment of fiscal policy, which is often called 'reconciliation', is vital for managing MTFP. The simplest way to assess whether or not MTFP in one country is the real thing is to ask whether it produces reconciliation tables. In addition, we need a risk analysis of the various factors that would impact on revenue and expenditure in the medium term to be presented at the time of budgeting. In particular, the experience of other countries' suggests that fiscal discipline is likely to loosen much more in an economic boom than in an economic recession. The need for the adoption of careful monitoring and risk analysis in boom times should be emphasised.

(3) Micro budgeting reforms

Although maintaining fiscal discipline through fiscal rules and targets is undoubtedly required to maintain fiscal sustainability when a population is rapidly ageing, there is a tendency on the part of governments to adopt the achievement of fiscal balance or the reduction of public debt itself as a final goal. This should not be misunderstood. The most difficult task facing OECD countries is overcoming the ageing population issue, and all the reforms that must be undertaken, such as reform of the welfare system, particularly the pension and health care, and reform of the tax system to accomplish this. In this sense, we have to proceed with micro budgeting reforms in order to achieve strategic resource allocation and efficient provision of public services simultaneously with macro budgeting reforms. It should be stressed that structural reforms in public services cannot be accomplished without some sort of strong fiscal pressure, typically imposed by fiscal rules and targets. No government is willing to undertake such painful reform.

Schick (2003) argues that fiscal rules operate at the crossroads of politics and economics and that every rule has the potential to redistribute political power, alter budget outcomes and other policies, and influence political power, while political and economic conditions influence the effectiveness of budget rules. Undoubtedly, budgeting reforms mean political reforms; something that alters the political decision-making process and the rules of relevant players involved in budgeting. Thus budgeting reforms are always difficult to proceed everywhere. We need to realign the incentive structure for the players involved, to do so the reform of legal system in budgeting is not sufficient, and the point of management view should be focused. What I have emphasised in this paper is that the government has to learn and adopt management skills in conducting fiscal policy, which are summarised as lessons from major OECD countries' experiences. Of course, they cannot be easily transplanted to other countries, because political and economic circumstances are different. However, difficulties in maintaining fiscal discipline are shared in almost all countries, the ways to tackle them are not so varied; and alternatives are limited. The last question remaining is how to carry out budgeting reforms and public expenditure management in the future. We should keep in mind that restructuring public services, especially welfare program, to overcome population ageing needs some kind of infrastructure to strengthen governance in the public sector. This is in the form of budgeting reforms.

Notes

* The views expressed are those of the author and not necessarily those of any institutions.

1 My research on fiscal rules and targets consists of the following three parts; (1) case-studies on individual countries for Australia, France, Germany, the Netherlands, New Zealand, Sweden, UK, and USA; (2) this paper; (3) a paper on Japan. The last paper is expected to be released in the near future.

2 See Table 1–1, which shows major economic and social indicators of these countries.

3 Economic and fiscal data in this paper are taken from the OECD Economic Outlook unless other sources are specifically indicated.

4 Countries in which fiscal balance deteriorated significantly through 1990s were only Japan and Slovak Republic.

5 IMF (2001) compares the fiscal consolidation from 1993–2000 with that from 1983–89, the former was driven mainly by expenditure reduction, while the latter was driven mainly by revenue increase.

6 See von Hagen (1992), von Hagen and Harden (1994), and Alesina and Perotti (1996 a,b). For example, von Hagen (1999) developed a measure of indices that captured the strength of the Finance Minister, the possibility of amendment of the budget in parliament, the transparency of the budget and so on, and used regression analysis of these indices and budget deficits. He then showed that the stronger the Finance minister is and the more transparent the budget process is, the less the budget deficit will be.

7 There have been several approaches in analysing the relationship between the political and electoral system and budget deficits. However debate has been continuing with different conclusions derived from using different data. Roubini and Sachs (1989) suggest that there is a tendency for larger deficits in countries characterised by a short average tenure of government and by the presence of many political parties in a ruling coalition. But Haan and Sturm (1997) say their conclusion does not display robust empirical analysis. Balassone and Giordano (2001)

argue that the deficit bias increases with the degree of polarisation of the ideological motivation and generally decreases with the degree of concentration of power within the government.

8 The institutional approach is not the only one to explain budget deficits. Alesina and Perotti (1995) classifies political economy models into six categories; (1) models based on opportunistic policy makers with fiscal illusion; (2) models of intergenerational redistributions; (3) models of debt as a strategic variable; (4) models of coalition governments; (5) models of geographically dispersed interests and (6) models emphasising the effects of budgetary institutions. They argue (5) and (6) are particularly significant.

9 Details are explained by Weingast et al. (1981).

10 This is often called the 'time inconsistency' problem, originally analysed by Kydland and Prescott (1977).

11 The expansionary fiscal contractions are said to be seen in Denmark (1983–86), Ireland (1987–89), Sweden (1989–94) and Italia (1989–92). See Giavazzi and Pagano (1990,1995) and Alesina and Perotti (1996a).

12 But this does not mean fiscal policy would not totally ineffective. Taylor (2000) argues there would exist the role of fiscal policy in an extraordinary situation in which an interest rate is almost zero.

13 The following classification should be considered for convenience. Some rules and targets may fall into both categories, thus it may be difficult to simply classify measures into one of three categories.

14 The idea of reform originated in the parliamentary research committee, which argued that the budget process in Sweden was based on a bottom-up approach and the ability to control budget was insufficient (SOU (1993)). Molander (1992) showed that the Swedish fiscal institutions were very weak from the perspective of an international comparison based on the analytical method developed by von Hagen (1992). This kind of analysis was often cited in the discussion for reforms in Sweden.

15 See the overall structural reform in New Zealand in Scott (1996).

16 Mulgan (1997) says that MMP eliminates the bias against smaller parties, and thus opens the way for a more representative multi-party parliament, greatly reducing the likelihood that any one party will have a parliamentary majority with which to force through its government's program. He adds that the change to MMP represents a much more radical departure from the Westminster model. Thus, MMP may be the counter-action of radical reforms that NZ has implemented since the middle of the 1980s.

17 A coalition government is also common in Australia, but it is not the same as that in most European countries such as the Netherlands.

18 The Finance Act 1999 is identified as the highest regulation concerning fiscal policy. The Act stipulates the following three articles : the Code of Fiscal Stability; reporting of economic and fiscal issues; and the power of the Auditor-General. It should be remembered that the Finance Act does not cover public finances in general. The Code was formulated by the mandate of the Finance Act, and was approved by the House of Commons in December 1998. The Code itself is not a law but is required to presented to the parliament by the Finance Act.

19 See details in detail HM Treasury (1997) and HM Treasury (1998).

20 The NCA report was not so innovative, because many of its recommendations were already in existence. However, it did help frame the development of the agenda and did provide a formal justification for work on some of the reforms.

21 The gross debt in Australia peaked at 43.2 per cent in 1995. This level was relatively low, but the fact that gross debt in terms of GDP nearly doubled in five years (1990:22.6 per cent) was distinctly troubling.

22 The Fitzgerald Report (1993) identified the current account deficit as a major problem and recommended to the government that savings in the public sector should be increased to increase domestic savings as a whole. The government then announced a plan to reduce the budget deficit to 1 percent of GDP by fiscal year 1996–97 in the 1993–94 budget.

23 Robinson (2002) says that the current account deficit is no longer seen as a key fiscal policy concern that is distinct from the fiscal sustainability issue since the latter half of 1990s, citing the official budget paper. This is because the increase of the current account deficit is not directly related to government savings but the difference between private savings and investment.

24 The study group is usually set up once every four years by the Finance Minister and is asked to write a report on specific themes. It normally consists of senior officials from the Finance Ministry and Economic Ministry, a board member of the Central Bank and others. The report in 1993 was Studiegroup Begrotingsruimte (1993).

25 The French government regularly produced a five-year economic plan, which included some kind of fiscal outlook until the 1980s. At the beginning of 1993, the 11th Economic Plan for 1993–97 was scheduled to be released, but it was not enacted after the election.

26 The French Finance Ministry analysed in 'Le Budget del'Etat' that one of the reasons why the act resulted in failure was there was little clear linkage between the multi-year fiscal plan and the annual budget process.

27 See Milesi-Ferretti (2000).

28 Rules considering the economic cycle is not so new, it can be said the revival of what Keynes argued.

29 See Giorno et al. (1995).

30 Inman (1996) raises effective deficit constrains must be ex-post deficit accounting, constitutionally grounded, enforce by an open and politically independent review panel or court with significant sanctions for violations, and costly to amend, based on recent US experiences.

31 For instance, the Maastricht debt criteria of 60 per cent of GDP was said to be the weighted average of gross debt among EU countries in 1991. In the context of economics, the 3 per cent deficit limit and the 60 per cent debt limit were originally chosen to be consistent with a stable debt ratio and a trend annual growth rate of nominal GDP of 5 per cent. With 5 per cent growth, the increase in debt implied by 3 per cent exactly offsets the reduction in a debt ratio of 60 per cent (Fatás et al (2003)).

32 The following formula is usually used. PB/GDP=(rate–growth) X (Debt target/GDP) where PB is the primary balance, rate is the real interest rate, and growth is real growth rate of GDP.

33 Balassone and Monacelli (2000a) and Uctum and Wickens (2000) compare several approaches to assess the sustainability of fiscal policy.

34 The New Zealand Superannuation Fund was created in 2001, upon which the measure of balance and debt in fiscal rules and targets was revised. See detail in McCulloch and Frances (2003).

35 The detail process is explained by Schuknecht (2002).

36 For instance, in January 2003 the German 2002 deficit turned out to be above 3 percent of GDP, the ECOFIN Council launched the Excessive Deficit Procedure, and recommended to cut the excessive deficit by 2004. However, according to the Commission's 2003 autumn forecast the deficit was expected to reach 3.6 percent of GDP in 2003, then the Commission recommended the ECOFIN Council to establish that no effective action had been taken. Finally, in November 2003 the ECOFIN Council rejected the Commission's recommendation and decided to hold in abeyance the EDP. France was also treated in the same way.

37 See the detail of medium-term fiscal plan in Japan in Tanaka (2003)

38 There is a formula for estimating ceilings. Sweden has adopted a macro rule of keeping cyclically-adjusted fiscal surplus of 2 per cent of GDP, thus an annual actual surplus expected is calculated as follows (Brusewits (2002). Surplus (in terms of GDP) = 2% + 0.7% GDP gap, where 0.7 means an average elasticity of fiscal balance to GDP gap. An expenditure ceiling can be derived from this projected fiscal balance and revenue estimates.

39 The overall ceiling can be amended only through the parliament's approval for revision, however, it has never happened since its inception in 1997.

40 The review was called the 'Comprehensive Spending Review' in 1998 when firstly introduced, but called just the 'Spending Review' since the second one in 2000.

41 New Zealand followed the Australian system in the 1990s.

42 This definition is derived from 1996–97 Budget Paper No. 1. The forward estimates is called 'baseline' in general terms, which is actually used in New Zealand and the US.

43 The baseline is updated not only in the budgeting but also in the middle of fiscal year.

44 The detail of ERC is explained by Wanna et al. (2000).

45 Barnes and Leith (2001) describes the detail of fiscal provision.

46 CBO (2003) shows the budget deficit increasing in fiscal year 2003 and 2004, but declining thereafter and reaching a surplus by the end of ten years. But Rivlin and Sawhill (2003) argue the CBO's projections are distorted by congressional rules, as they estimate 10-years budget balances with adjusted baseline which is based on much more likely assumptions. Their estimation shows the budget deficit will be further deteriorating to more than $600 billion in 2013, rather than improving as CBO suggests.

47 OECD (1999) says that discretionary spending did not increase so much in terms of SNA statistics although spending caps was soft limits.

48 These figures are cited from European Commission (2004).

49 There seem a lot of reasons to explain this phenomenon. First of all, France and Germany are much more powerful and influential in decision-making in EU than small countries. If small countries violate the Treaty and large countries don't, the former is likely to be blamed and penalised, but if the opposite case, the latter is able to stand against the penalty.

50 This reserve is called a 'budget margin', and it is not only used for additional spending like natural disasters but is also expected to work as a safety net, which shows the difference between the overall spending ceiling and the sum of spending limits of 27 areas. We may call it an 'unallocated fund'.

51 Prior to the 1996 election, New Zealand had a single constituency electoral system, in which the political party that won the most votes in an electoral region won the electoral seat. Parties that gained a majority of the electoral seats formed the government, thus a two parties was common. However, in this system smaller parties could not obtain representation. In 1993, New Zealand decided to change to a 'mixed member proportional' (MMP) system of representation, in which around half of the 120 members of the Parliament are elected directly as representatives of their region, while the remaining members are chosen by the parties in proportion to the percentage of the overall party vote received in the election. The outcome of the new electoral system is a shift from a single majority government to a coalition government, because smaller parties are able to gain more seats. In 1996, the first year under the new MMP system, the National Party won 44 out of 120 seats and formed the coalition government together with the New Zealand Fist Party (17 seats). See details of political and electoral system of New Zealand in Miller (2003).

52 One of the criticisms in the Maastricht Treaty and the SGP is that EU fiscal rules are too strict and may undermine the stabilisation role of fiscal policy. But some empirical studies suggest that there is no clear evidence that rules undermine the stabilisation function. Pro-cyclicality decreases or disappears after rules were implemented even if some kind of pro-cyclicality existed before that (Gardi and Perotti (2003), Fatás et al (2003), OECD (2003a)).

53 Larch and Salto (2003) found that the cyclically adjusted budget balance is not always a sufficiently accurate indicator to measure a fiscal policy's stance. Optimism in forecasting growth, coupled with pervasive lags and inertia in the implementation phase of the budget, will result in a fiscal expansion, even in the absence of discretionary measures.

54 See details in Steinlet (1999).

55 In the Clinton administration, some efforts to increase efficiency and effectiveness in providing public services, such as the National Performance Review and Government Performance and Results Act, were undertaken, but their actual results were not clear in terms of net savings in dollars.[60] Recently the IMF and the OECD have released a standard approach to assess the fiscal transparency of an individual country, and this may be helpful for measuring to what extent that country's fiscal system is transparent. See IMF (1998) and OECD (2000).

56 Recently the IMF and the OECD have released a standard approach to assess the fiscal transparency of an individual country, and this may be helpful for measuring to what extent that country's fiscal system is transparent. See IMF(1998) and OECD(2000).

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