Fiscal Rules From A Political Economy Perspective

Allan Drazen

Tel Aviv University, University of Maryland, NBER, and CEPR

January 25, 2002
This version June 9, 2002

Prepared for the IMF-World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies, Oaxaca, Mexico, February 14-16, 2002. I wish to thank George Kopits, Andres Conesa, and conference participants for useful comments. Financial support from the Yael Chair in Comparative Economics, Tel Aviv University is gratefully acknowledged.

1. Introduction

Persistent deficits, implying secular growth of debt, have led many to argue that fiscal rules may play an important role in helping reduce or eliminate deficits and help control the growth of government debt. There are two general classes of fiscal rules. First, there are legislated quantitative constraints on fiscal policy. These limits take a variety of forms: restrictions on deficit financing, including balanced budget laws; expenditure ceilings; numerical targets for fiscal variables; borrowing rules; and, restrictions on issuance of debt. Much of the discussion of fiscal rules concerns such restrictions.[1] Second, there are restrictions or rules on the procedure by which fiscal decisions are made. Procedural rules may concern both the general procedures by which fiscal policy is formulated, as well as procedures to help ensure that policy rules are actually executed. Examples of the former include: the extent to which the process of formulating the budget is "hierarchical"; effective requirements for "transparency" in the budget document; rules of amendment in both the formulation and approval of the budget; and, the nature of voting in the approval process. Examples of the latter include: restrictions on supplementary budgets and open-ended appropriations in the budget implementation stage; automatic contingency rules, such as across-the-board spending cuts; and sequestering of funds.

A key question (perhaps the key question) about fiscal rules is whether they have the effect of slowing the growth of deficits. Many observers argue that fiscal rules are ineffective, with governments having easy ways of getting around them. A related question is whether such rules are necessary if a government is committed to fiscal restraint, with the reputation of a government as a fiscal conservative taking the place of such rules. Do rules matter at all, in the

[1] Kopits and Symansky (1998) provide an excellent in-depth discussion of fiscal policy rules. (These are sometimes termed "numerical rules," but as Kopits and Symansky point out, restrictions on fiscal procedure may have a distinct numerical character as well.)

sense that governments truly committed to fiscal discipline build a reputation for sound budget policy and hence make credible their announcements to that effect, while governments that are not committed to fiscal discipline and that have no intention of following fiscal rules find ways to get around them. (See, for example, the discussion in Kopits [2001].) In the latter case, it is argued that a fiscal rule is in fact worse than useless, as it invites "creative fiscal accounting," which introduces fiscal distortions that would not be present in the absence of rules.

The answer to the question of whether fiscal such rules can play an important role in reducing or eliminating deficits involves far more than the technical design of rules to make them more effective, which has been a focus of much research. It concerns the more basic question of what problems a fiscal rule is meant to address and how a rule can address these problems. This in turn raises more general questions of how formal rules or laws can be more effective than announced non-legal commitments to the same objectives. A political economy perspective on fiscal rules in particular and rules in general will help answer these questions. It will also help us better understand the relation between fiscal rules and the notion that governments find that can build a reputation for fiscal discipline do not need to rely on rules. As we shall see, rules, rather than substituting for reputation, may help a government build its reputation.

The plan of this paper is as follows. In the next section I summarize the rationale for fiscal rules, which is primarily to address the bias toward positive budget deficits that characterizes the political process of budgeting in many countries. In section 3, I discuss the general question of how legislated restrictions can have an effect and make policy more credible relative to simply announcing a commitment to the same goal? Section 4 uses the insights of these two sections to make some more specific observations on the choice between fiscal policy

rules and fiscal procedure rules. In section 5 I discuss the "alternative" of reputation for fiscal discipline and argue that adoption of a rule may itself be a device to help build reputation. In section 6 I consider the issue of how it can be made credible that a fiscal rule won't be changed whenever a government finds it inconvenient not to follow the rule, and I consider why in fact governments often have not been able to make a commitment to the given rule credible. Section 7 concludes. An Appendix contains a very brief overview of budget procedural rules.

2. The Rationale for Fiscal Rules – Deficit Bias

Let's begin from a general perspective on why rules, fiscal or otherwise, may be optimal. Basic economic theory suggests that welfare will be higher when a policymaker who wants to maximize social welfare is free to choose policy without arbitrary constraints, that is, to use his discretion. If we consider a specific policy guideline, an unconstrained policymaker can always follow that guideline if he so chooses, so that allowing him to deviate from a pre-set guideline should only increase welfare.

A standard argument for rules over discretion for a social-welfare-maximizing policymaker concerns cases where, first, individual behavior depends on expectations of future policy and, second, where the policymaker is limited in his choice of policy instruments. If he can choose policies over time, he will often have the incentive to announce one policy for the future and then implement a different policy when the time comes to carry out his policy announcement. This is the well-known case of *time-inconsistency* in the choice of policy. (See Drazen [2000a, chapter 4] for a full discussion.) Moreover, the policymaker has the incentive to be time inconsistent in the choice of policies *because his objective is to maximize social welfare*.

When individuals know the incentives of policymakers to be time inconsistent, time inconsistent policy is not an economic equilibrium. People will form their expectations of future policy on the basis of the known incentive of the government to deviate from announcements. The cost of discretion is that the equilibrium that results may imply low welfare, lower than the case in which the government could credibly commit itself *ex ante* to a specific policy. If rules can be made credible in the sense that the government is expected to follow them, "rules" give higher welfare than discretion.

The literature on time inconsistency provides many examples. The best-known macroeconomic example is probably the "inflation bias" result of Barro and Gordon (1983). (Readers familiar with the Barro-Gordon model may costlessly skip this paragraph.) In their example, the government is maximizing the welfare of the representative individual, whose utility depends on fluctuations of unemployment and inflation around their target values. Surprise inflation will lower actual unemployment relative to the natural rate of unemployment, where the representative individual's (and hence the government's) target unemployment rate is below the natural rate. Suppose that the target inflation rate is zero. If people expected a zero inflation rate (let's say due to a government announcement), the government would have the incentive to choose an inflation rate above zero in order to lower unemployment below the natural rate and move it closer to the socially optimal target. This incentive to inflate will be anticipated so that a zero inflation announcement would not be believed. The equilibrium is one where a positive rate of inflation is correctly anticipated, so that unemployment is at the natural rate, but inflation is sub-optimally high. The problem is that if the government can, it will use its discretionary policymaking power to try to lower unemployment. This attempt will be unsuccessful in equilibrium, but will have adverse inflation implications. If the government had

a mechanism to credibly commit itself to choice of zero inflation, welfare would be higher. Hence, we have an illustration of the argument for a (credible) rule over discretion.

Two points should be stressed about the basic time inconsistency result on inflation. First, there is a case for constraining the policymaker even if he is a social welfare maximizer. Second, the argument for rules revolves not around the unpredictability of inflation policy, but around its known positive bias. Credible rules may also improve welfare by lowering the unpredictability of policy, but that is not the main lesson.

In the case of fiscal policy, we begin from a similar perspective. Credible rules may make fiscal policy more predictable, but the main argument for fiscal rules is the bias towards positive government budget deficits we observe in many countries. That is, as indicated in the introduction, the attraction of rules is that by constraining policymakers, they will reduce or eliminate the tendency towards budget deficits.

There is another major argument, in addition to any time inconsistency reasons, why it is argued that there is an inherent bias towards fiscal deficits in many countries. Put simply, budgets are not chosen by a social-welfare-maximizing social planner, but are the result of a political process of budgeting that appears to have a deficit bias. The term "political process" refers not simply to the legislative budgetary process, that is, meaning the rules and institutions by which the budget is made. It refers to the process of making and implementing the budget *combined* with the political forces that determine the nature of the budget that emerges from that political process. Hence, one must ask two questions. First, what is the nature of the legislative budget process that allows political forces to bias the budget outcome relative to what is considered socially optimal? Second, what are these political forces such that this bias tends to be towards excessive deficits? Here, I consider the second question, briefly summarizing the

arguments on the political forces that suggest a positive bias. There is a significant literature on the first question, that is, on how the details of the budget process may lead to a deficit bias in general. (See Drazen (2000a), chapter 14, or Alesina and Perotti (1996) for a summary of the literature on the budget process from a political economy perspective.)

The political forces leading to deficit bias has several aspects, the unifying point being that politicians may use the budget process to increase expenditures in excess of taxes for their own political aims. There are several arguments. First, there is the electoral motive towards high spending in election years. To put it simply, in many countries incumbents appear to increase government spending before elections in order to improve their re-election prospects. (See Drazen (2000a), chapter 7, for a discussion of opportunistic political business cycles, in which incumbents manipulate economic variables before elections in order to influence election outcomes.) Fiscal manipulation before elections is especially strong in developing countries (see Drazen [2000b] for a summary of the evidence and references).[2]

More generally, it has been argued that voters suffer from "fiscal illusion" both in considering the size of government and in analyzing budget deficits. The first argument is that voters can be led to underestimate the size of government expenditures, thereby accepting a government larger than they would if their perceptions were correct. Hence, fiscal illusion is not simply an empirical statement about misperceptions about government size, but a hypothesis about how policymakers may succeed in deceiving voters about the true size of government. It

[2] On the other hand, there is also the argument that voters penalize fiscal excess at the polls. Niskanen (1975) analyzes U.S. Presidential elections from 1896 to 1972 and finds that, holding macroeconomic performance constant, increases in federal spending imply lower vote totals for the incumbent party. Similarly, Peltzman (1992) argues that there is strong econometric evidence for this effect on several levels of government.

is argued that voters measure the size of government by their tax bill and policymakers can disguise taxes so that voters underestimate the true tax bill.

Parallel to the discussion of "fiscal illusion" about government expenditures, there is the argument about fiscal illusion with respect to government deficits. One explanation of persistent deficits is in terms of misperceptions about deficits. A classic argument is that individuals favor expenditures, but do not want to pay for them. Wagner (1976) and Buchanan and Wagner (1977) have formalized this point in the notion of a "deficit illusion," whereby voters do not understand the government's intertemporal budget constraint. Faced with deficit-financed expenditure, voters overestimate the value of the expenditure side and underestimate the future tax burden. Opportunistic incumbents take advantage of this misperception, running deficits to win the favor of voters.

A third political process argument concerns bureaucratic behavior. Niskanen (1971) argues that the behavior of bureaucrats may be explained by *budget maximization*. They try to maximize their budgets since a higher budget translates into both higher salaries and more power. He views bureaucratic behavior as a principal-agent problem under asymmetric information. In brief, his theory is that the bureau receives a budget (say, from the legislature) as an increasing, concave function of the output g it is perceived as producing. The bureau's budget, but not its true output, is observed by the principal (here, the legislature), which takes the budget itself as a measure of the benefits from the bureau's activities. The bureau's costs are an increasing, convex function of g, where the cost function is known only to the bureau. Given the asymmetric information problems, the principal cannot monitor whether the bureau is efficient in providing services. Nonobservability allows the bureau to maximize its budget, subject only to the constraint of covering costs. The resultant maximization implies a higher level of g and a

higher budget than would be implies by maximizing net benefits, that is, by setting marginal benefit equal to marginal cost.

A fourth political argument is that conflict of interest over who should pay for reducing the deficit (either higher taxes or expenditure cuts falling on specific groups) means that deficit reduction may be a long-delayed process. The basic idea is that deficit reduction is a public good, so that the classic free-rider problem is present. The basic argument in a dynamic context was presented by Alesina and Drazen (1991). Grilli, Masciandaro and Tabellini (1991), among others, present evidence that this problem may be especially severe for coalition governments.

A fifth argument stressing political factors is that deficits are used to constrain successor governments who may have different spending preferences, as in the work of Persson and Svensson (1989) and Tabellini and Alesina (1990). To summarize the argument, policymakers, though partisan, care about social welfare. Only distortionary taxes are available to finance public spending and to service the debt, with the level of distortion rising with the tax burden. Hence, the spending a government would find optimal would depend on the level of debt (via debt service) existing when it began office: the higher is level of debt, the lower will be desired spending for given preferences. If a government knew it would be retained in office, utility smoothing would imply no issuance of debt in their non-stochastic models. In contrast, under certain reasonable parameter configurations, the probability of being replaced leads to debt issuance in order to reduce the spending of a successor government, with the debt issuance higher, the higher is the probability of being replaced.

The existence of a deficit bias is especially problematic when considering the use of countercyclical fiscal policy. There is evidence in many OECD countries that countercyclical fiscal policy has a positive bias, meaning that expenditures are raised in a recession but not

sufficiently lowered in an expansion to balance the budget over the cycle. (See, for example, Hercowitz and Strawczynski [2001]). The arguments presented above on the political pressures for high government spending combined with the problems of cutting spending when the government coffers are full may help explain the countercyclical bias to government spending. The existence of such a bias implies that deficits in recessions meant to counteract the cycle risk calling into question the government's long-term commitment to fiscal discipline. We return in section 5 to the issue of the implications of spending when the government's commitment to fiscal discipline is unobserved.

To summarize, there are various arguments why the political system may yield a bias towards deficits. Fiscal rules are thus meant to try to contain the political pressures that yield such a bias. Before considering any particulars of the design of rules to contain political pressures, I address the general question of how rules may constrain behavior.

3. Why Do Rules Have an Effect? – A General Perspective

Much of the research on fiscal rules treats the technical question of how fiscal rules should be best designed to constrain policymakers and reduce deficit bias, given the political nature of policymaking and the loss of flexibility that rules imply. This is an important question and one that will be discussed at length at this conference. Instead of considering the details of how fiscal rules may "best constrain" policymakers, I want to consider a more general question. How in general can legislated rules, especially on outcomes, have an effect and make policy more credible relative to simply an announced commitment to the same goal? That is, what exactly do rules do?

In considering how to achieve a specific outcome, in the face of political pressures, legal restraints that attempt to "bind" the policymaker, that is, which legally enjoin him to follow a specific course of action, may seem especially attractive. If a society wants policy to achieve a specific goal, why not legally require the policymaker to achieve that goal? Such legal restrictions could take several general forms. They could be embodied in the country's basic set of laws, that is, in its constitution. For example, fiscal rules in many states in the United States are embodied in their constitutions, such as strictures on issuance of debt to cover regular operating expenses. On the federal level, the last decade has seen continued debate on a Balanced-Budget Amendment to the U.S. constitution.[3] On a less "permanent" level, governmental units on all levels pass laws attempting to regulate their own economic behavior. To take but a few examples, there are restrictions on the financial or commercial agreements the government is allowed to enter, limits on tax authorities with the effect of disallowing types of tax collection, or, on a more macroeconomic level, mandates concerning the level of economic aggregates, meant to reflect current policy concerns. The fiscal authority may be enjoined to achieve full employment, the monetary authority to hit an inflation target. These injunctions could take the form of specific laws (such as a Full-Employment Act) or of directives that have the force of law. Restrictions could also take the form of unwritten laws, such as norms or "social contracts" which also have much of the force of law. Standards of ethical behavior for public servants may be unwritten, but have a powerful effect on their actions if such standards are widely accepted.

Investing a policy with credibility by means of a law directing a policymaker to carry out the policy raises a basic question. Why do such laws have any force? Put another way, what

[3] I ignore the problem of how one interprets the constraining power of laws that give only qualitative targets, or whose escape clauses imply that law has few if any effective constraints.

forces a policymaker to obey the law, especially in cases where breaking the law *ex-post* improves welfare? In the absence of any explicit or implicit restrictions to the contrary, a politician will renege on a promise if it benefits his constituents. If a law is passed directing him to fulfill his promise, the benevolent (that is, welfare-maximizing) policymaker should similarly be tempted to break the law if so doing will increase social welfare. By considering laws that direct the policymaker to adopt a policy, are we just moving the problem of time inconsistency one level higher? What makes an inflation target written into law any more credible than an announcement of the same inflation rate as a policy goal? Is there a real, as opposed to semantic difference?

There *are* important differences between promises that have no legal backing *per se* and laws. One primary difference is that laws have *penalties* attached to them, so that there are explicit costs to breaking them.[4] Similarly, social norms have recognized costs associated with not following them. (See, for example, Elster [1989], chapter 3.) In short, one key to understanding how laws can make policy credible is in understanding the specific mechanisms that give laws their force, namely the penalties or costs of breaking the law.[5] (There is the

[4] To the extent that there is significant leeway in the application of the penalty, as is often the case, the law clearly loses much or all of its force. Hence, in discussing the role of penalties in enforcing good behavior, I assume that penalties are unambiguous, and unambiguously applied.

[5] It is trivial, but beside the point, to argue that with a harsh enough penalty for disobedience, the law will certainly be obeyed. If the penalty for disobedience is so harsh that it implies that the law will be obeyed no matter what, then it is not credible that the penalty will be applied in all circumstances. Hence, harsh penalties simply shift the credibility problem from whether the law, as written, will be obeyed to whether it will actually be enforced. That is, since individuals know that such a harsh reaction is not optimal *ex post*, the punishment itself is not credible. If laws make policies credible only to the extent that the penalties that enforce the laws are themselves credible, then enhancing credibility depends on choosing the optimum structure of penalties to do this. McCallum (1995) makes a similar point in criticizing some of the work on institutional solutions to the time-inconsistency problem in monetary policy. He argues that some of the proposed solutions do not solve the problem, they merely “relocate” it, in that it is not clear why the institutions are themselves credible.

obvious follow-up question of what prohibits the government from changing a law when it perceives that it is optimal to do so, so that the old law is "broken" in a way that is fully legal? We consider this in detail in section 6.) The key conclusion is that laws (and institutions more generally) enhance credibility to the extent that they *raise the cost* and *lower the benefit* from deviating from a given policy.

This argument may be obvious when laws regulate individual behavior and the government is the body that punishes the lawbreaker, but it holds equally well for laws that regulate the government itself, such as fiscal rules. What exactly are the costs that can be imposed on the government for breaking its own laws? Rather than addressing this question in the abstract, we consider the specific case of fiscal rules. First of all, many fiscal rules have both explicit monitoring of the fiscal authority by some other agency, as well as explicit penalties. In the case of the Maastricht fiscal criteria, "significant divergences" of budgetary positions from the medium term budgetary objectives trigger "early warnings," and the Stability and Growth Pact spells out the type and scale of sanctions in the event of persistent excessive deficit, the Excessive Deficit Procedure (see Buti and Giudice [2002] for a discussion). Australia, Canada, New Zealand, and the U.K. have very similar monitoring and reporting requirements with external auditing and ministerial responsibility for the results (see Craig and Manoel [2002]).

Another typical type of cost is that failure to meet a fiscal policy target triggers an automatic expenditure cut of some sort. For example, the Gramm-Rudman-Hollings Deficit Reduction Act of 1985 in the United States, which gave explicit deficit targets over the ensuing five years, legislated an equal cut in defense and non-defense expenditures to meet the target in any year in which it was not met. Many other fiscal rules are similar. (Though in the case of "Gramm-Rudman," as it was commonly referred to, or other laws, one may ask what happens if

legislators simply change the law. We return to this below.) Hausmann (2002) argues that fiscal rules must be enforced by an open and politically independent review panel or court with significant sanctions for violations. Rules without independent enforcement, he suggests, are simply not credible.

There are other costs as well. Formalizing a directive as a law may also increase the probability that it is carried out by making deviations more obvious. That is, fiscal rules cannot force legislators to be fiscally responsible. But, they may significantly increase the public's awareness of deviations from fiscal responsibility and the negative publicity that such deviations incur. Consider "Gramm-Rudman," which contained deficit targets implying a deficit falling to zero over five years. The act did not have its desired effect of eliminating the deficit, in part because when the targets became binding, the Congress passed new legislation to modify the targets. Nonetheless, it is argued that Gramm-Rudman did have an effect by putting more of a negative spotlight on lawmakers who introduced "budget-busting" bills. I think this "negative spotlight" effect is an important possible effect of formal fiscal rules.

A skeptic may point to the problem of the "creative fiscal accounting" that fiscal rules often engender. That is, in many countries, fiscal policy rules dictating specific numerical targets induce policymakers to engage in fiscal accounting tricks that make it appear as if the targets are being met, when in practice they are not being met at all. Such accounting tricks may induce significant distortions, so that rules that are not well designed are likely to backfire, perhaps even causing a greater distortion than they were meant to address. Such an effect is an important consideration in considering the use of fiscal rules and their design. (See the discussion in section 4 below.) But the use of creative accounting is not an argument against the *existence* of a "negative spotlight" effect. Just the opposite is true. The use of creative

accounting is due to the costs that legislators or governments perceive are attached to the failure to meet the fiscal targets. The greater is the cost, the more a government may engage in such creative accounting. That is, the problem of creative accounting is a problem of the difficulty of making it transparent that a target has not been met, not a problem that not meeting targets has no cost.

The greater visibility that a fiscal rule gives to perceived deviations may also reduce the costs of monitoring compliance. That is, the formalization of a fiscal rule may induce the creation of mechanisms to monitor compliance that did not previously exist. These may exist within the political system, but may also be created outside of the narrowly defined political system, for example, in the press.

4. Policy Rules Versus Procedural Rules – Some Observations

As indicated in the introduction, the aim of this paper is not to consider the optimal design of fiscal rules from a technical point of view. Nonetheless, one may ask whether it is possible to draw any broad conclusions about optimal fiscal rules even on the basis of the conceptual discussion in the previous two sections. In brief, there may be a number of reasons to prefer procedural rules. (A brief overview of the budget process is presented in the Appendix.) This is in line with a number of papers that argue that the focus on fiscal rules should shift away from numerical policy rules towards more focus on institutions and the budget process (see, for example, von Hagen [1992], von Hagen and Harden [1995], Alesina and Perotti [1996], and Milesi-Ferretti [1997]).

The first broad conclusion is, quite obviously, that a fiscal rule is more likely to be effective the more it is designed to address the specific cause of the problem. This is a key

argument in favor of procedural instead of numerical policy rules and is in line with the discussion in section 2 on political causes of deficit bias. To the extent that one can pinpoint what aspect of the budget procedure may be responsible for the bias towards deficits, procedural rules should be tightened with respect to this aspect. Of course, being able to pinpoint the exact cause of the problem is far easier said than done.

In this respect, numerical policy rules seem like a "blunt instrument" used in the absence of more precise ones. There is a difficult trade-off in the design of a numerical policy rule. Too simple or rigid a rule (that is one with no state contingencies or escape clauses) lacks the flexibility that may be necessary in the face of economic developments. Hence, over the long term, it will be impossible to satisfy and hence is not credible. (Unless of course, "creative accounting" is used to satisfy it, also reducing its credibility.) It will not be obeyed or will be changed. However, allowing too much flexibility also reduces the credibility of the commitment to fiscal discipline itself. Though state-contingent quantitative rules are generally preferable from a theoretical point of view, they are not always workable. First of all, it is impossible to specify all possible contingencies *ex ante*. Second, given private information, it is often difficult to verify if the government has reneged on a state-contingent rule or not. The difficulty of verifying whether the government has abided by a numerical fiscal restriction in itself suggests that to be credible, numerical fiscal policy rules must be simple, though we come back to the problems listed earlier.

The requirement that compliance with a fiscal rule be easily verifiable is usually labeled *transparency* of fiscal rules. The problems of too simple a rule notwithstanding, transparency is generally thought to be central for quantitative fiscal restrictions to be effective in controlling the growth of deficits. Among the methods used to thwart the effectiveness of balanced budget rules

are: overoptimistic predictions of key macroeconomic variables; strategic use of what is kept on- or off-budget; measuring fiscal adjustment relative to an inflated baseline; and multiyear budgeting, in which difficult changes are postponed, with the budget being revised before the "day of reckoning". Quantitative restrictions may increase the incentives for "creative accounting" and hence could actually lead to worse outcomes in terms of welfare. Another aspect of transparency is the difficulty of measuring fiscal variables, much more so than for inflation. Not only is there disagreement about which measure of the deficit is the "correct" one, but also even when there is agreement about which measure to use, the ease with which deficit measures may be manipulated makes verification especially difficult.

Milesi-Ferretti (1997) suggests that numerical policy rules can play a positive role if they are adopted in a framework for reform of the budget process that addresses procedural problems, especially in the budget formulation stage. Otherwise, he argues, such rules are not only likely to be ineffective, but also, as was argued above, create incentives for creative accounting and reduce the transparency of the budget process. This suggests that rather than rely on numerical targets, one may want to concentrate on procedural rules that modify the structure of the budget process so that it is more difficult to for actors in the process to adopt fiscally irresponsible behavior." Milesi-Ferretti suggests that specific reforms would include strengthening the position of the finance minister, limiting the scope for amendments to the budget at the parliamentary level, and enforcement of hard budget constraints at the implementation stage. One may add that the adoption of numerical fiscal rules may be counterproductive in that they divert attention from the need to change the fiscal policymaking process itself.

Why then is there an apparent preference of many for simple numerical policy rules? A key reason may be that both policymakers and the public may not be convinced that procedural

reforms will yield as unambiguous a discipline as simple numerical targets. Unless one can draw a clear link between an aspect of the budgeting process and a high deficit outcome (and one sometimes can), the argument that process reform will yield a reduction of the deficit even of an approximate size may not be persuasive. The case of the Maastricht criteria in Europe may be informative. Corsetti and Roubini (1996) argue that this is the case in Europe, with Germany, for example, concerned about "excessive deficits" of other countries in Europe, having expressed a clear preference for clear numerical targets. (See their article for a comparison of European and American perspectives on fiscal rules.)[6]

5. Reputation and Fiscal Rules

Let us now return to our general discussion of the effects of rules in enforcing good behavior. There is another way in which a fiscal rule can make the commitment to fiscal discipline more credible than simply an announced commitment to deficit reduction. This has to do with the *adoption* of a rule as a signal in itself. To understand this, we need to backtrack a bit and consider the notion of the information content of government actions when its commitment to fiscal discipline is unobserved. This will also help us understand the relation between reputation for fiscal discipline and fiscal rules.

We begin with a brief review of reputation under incomplete information. Generally speaking, the argument that observing an increase in government spending reduces our belief in the government's commitment to fiscal discipline is a story about unobserved characteristics. That is, it assumed that there is incomplete information about each player's "type," with different

---

[6] Corsetti and Roubini also suggest that in the case of Europe the need to balance the economic integration which was crucial for monetary unification one the one hand, and the principle of political sovereignty of member countries on the other made numerical targets more politically acceptable than directives for similar procedural rules across countries.

types expected to play in different ways. We then make an inference about what is unobserved (the type) on the basis of observed past actions, so that the expectation of future behavior is based on what has been observed in the past. "Reputation" is summarized by the public's belief about the government's type, where reputation depends on observed past actions.

We could thus think of two types of policymakers – committed and less committed to fiscal discipline. If commitment is unobserved, the public uses observations of government spending and deficits to form inferences on type, with lower deficits leading the public to update the probability it assigns to the government being committed to fiscal discipline. It is in this sense that it is often argued (as summarized in the introduction) that actions showing a commitment to fiscal discipline may substitute for fiscal rules in making credible the commitment to deficit reduction.

There are, however, a number of ways in which this basic argument must be amended. First, in applying the notion of reputation under asymmetric information to fiscal policymaking, the key observation is that there is not a "policymaker," but a political process that generates outcomes. Hence, observing fiscal outcome gives information on the nature of the political budgetary process as described above. "Type" thus refers to the characteristics of the fiscal process, including the strength of the political forces in pushing for higher spending and higher deficits.

Second, once we realize that what is being signaled is the characteristics of the budgetary process, which reflects the interactions of a large number of political actors, a signal of commitment to fiscal discipline may be important not so much to an outside observer, but to participants in the fiscal process itself. To take a homespun analogy, when I buy or refrain from buying something at a store, the important signal may not be in terms of my own commitment to

fiscal discipline. It may be a signal to my two-and-a-half year old daughter about the likelihood she can succeed in inducing me to buy something for her. Anything that signals fiscal discipline in the process may thus be self-reinforcing.

What then is the role of fiscal rules in a reputational story? A fiscal rule may serve not as an alternative to actions that build reputation, but as one of those actions in itself. When a single policymaker chooses policy, the willingness to adopt a rule can convey information about preferences of the policymaker himself, as outlined above. Hence, adoption of a rule can make the commitment to fiscal discipline more credible not because it imposes constraints on a policymaker with a known incentive to fiscal profligacy, but because it signals his commitment.[7]

When fiscal outcomes reflect a political process with many actors, a fiscal rule that signals the willingness of those involved in the policy process to limit their own flexibility may similarly convey information about their preferences. However, unlike the case of a single policymaker, it may also convey information about the budgetary process itself. That is, politicians themselves must legislate the fiscal restriction, their ability to do so may provide information about how the process works that is consistent with the expectation that future budgetary outcomes will be more reflective of fiscal discipline.

This gets us back once again to the issue that has been lurking in the background. The fact that the legislators who are the forces pushing for increased spending are the ones who must credibly commit themselves, there may be a weak expectation that the law will actually be carried out. Even if a fiscal discipline law is passed, what prohibits the government from changing a law when it perceives that it is optimal to do so? We now turn to this issue.

---

[7] This distinction mirrors that of reputation under incomplete information versus "reputation" under complete information. See Drazen (2000a, chapter 6).

6. Credible Commitment to Unchanging Fiscal Rules

As indicated above, the Gramm-Rudman-Hollings Deficit Reduction Act failed to eliminate the U.S. budget deficit because when the targets became binding, the Congress passed new legislation to modify the targets. The Israeli Deficit Reduction Law of 1991 has similarly seen the target modified numerous times since its adoption. Every new government that has been elected since the law's adoption has in fact changed the targets even in the very first budget it submitted. Such experiences should perhaps not be surprising, since one way to break a law in a way that is fully legal is simply to change it when the government perceives it is not optimal to follow it. If a fiscal rule is continually being changed, it cannot really be considered a rule.

On the basis of experiences such as these, Kopits and Symansky (1998, p. 2) argue that to be considered a fiscal rule, a restriction, by definition, must be "intended for application on a permanent basis by successive governments." If a rule is followed by successive governments, then it certainly may be seen as a credible commitment to fiscal discipline[8], while one that is regularly revised is not really a rule. However, I think it is only a part of the story, for one may ask what makes credible an announcement that successor governments will be bound by the rule? More generally, how can it be made credible that existing laws will not be changed whenever current circumstances make it convenient to do so. To answer this, we detour into what are known as "constitutional laws" and, more generally, the issue of *constitutionalism*. Such a discussion is useful not only for understanding what gives laws their force, but also illustrates a number of issues specific to fiscal rules.

[8] I would also argue that even a restriction that is meant to bind only a single government can be thought of as a fiscal rule if it is credibly believed that it will really bind the government and will not be changed over the period of time it is meant to be effective. For example, governments and organizations facing large budget shortfalls put in place severe expenditure restrictions meant to remain in force until the budget situation improves. These are often rigidly enforced and credible. They are fiscal rules, their relatively short horizon notwithstanding.

Constitutional laws refer to at least one of four kinds of laws – those that concern restrictions on the government's use of authority; those that concern the process of policymaking; those that have more stringent amendment procedures than other laws; and, those that often treat issues that are seen as "fundamental" in a deeper conceptual sense, that is, basic rights or liberties. Fiscal rules may be certainly be seen as constitutional in all of the first three senses. As we shall see, the use of constitutional fiscal rules to achieve fiscal discipline may satisfy the fourth characteristic as well.

The third and fourth characteristics of constitutional laws are key to making it credible that the law will not be changed whenever circumstances make it tempting. The third characteristic, more stringent amendment procedures, may be thought of as a concrete, rather than conceptual, approach to engendering such an expectation. Procedures that make it difficult to amend a constitution include: super-majorities; waiting periods; confirmation; referendums; and (in federal systems) ratification by states. Such restrictions are seen as "protecting the electorate against itself", in that a majority may act under the influence of a "momentary passion". In short, a promise to follow through on a certain action may be made credible by enacting it into a law which itself is difficult to undo, that is, by "constitutionalizing" it. This is the main result and should be stressed. *Effective commitment follows from the extreme difficulty in changing a law once it is given constitutional status*. This is analogous to the key result in section 3 on what gives a legal restriction its force. In both cases, raising the cost of deviating from a law (or changing a law) makes it more credible that the law will be followed (or not changed.)

The fourth characteristic, namely the fundamental nature of the issue the law addresses is a more conceptual approach to engendering the expectation that the law will not be changed

whenever it is deemed convenient. A fundamental right, by definition, is one that is seen by its very nature as having more permanence than an ordinary piece of legislation. Hence, giving a provision constitutional status is meant to give it a permanence it would not otherwise have. In fact, the use of constitutional fiscal rules to achieve fiscal discipline may be seen as meant to send the signal that fiscal discipline is seen as an important or basic goal of society, hence relating to the fourth constitutional characteristic. That is, independent of any implied legal restrictions on changing the law, "constitutionalizing" a law sends the signal that a society sees the law as one not "to be tampered with." Zero deficits is not a "fundamental right" on par with freedom of speech; a balanced budget restriction in the constitution sends the signal that a society attaches fundamental importance to it.[9] However, since constitutional laws are meant as an extreme form of commitment (and hence loss of flexibility), this solution should be used for fiscal restraint when other solutions have been tried, but have repeatedly failed.

This discussion may also indicate why in practice numerical policy rules are often changed. To the extent that lawmakers see little cost to changing a numerical fiscal target, it will be changed. Perhaps somewhat paradoxically, in both the case of the Gramm-Rudman-Hollings Deficit Reduction Act in the U.S. and the Deficit Reduction Law of 1991 in Israel, lawmakers apparently placed a lower cost on changing the law than on breaking the law. In part, this may be due to the fact that the cost of breaking the law was the negative publicity it engendered (what I termed the "negative spotlight" effect above). It may be that not meeting the target at a well-specified time may in fact be more conspicuous than changing the target as part of the budget proposal, but this is simply a conjecture. In the U.S., commentators have pointed out that

[9] The third and fourth characteristics are connected. If a law is seen as fundamental, it is natural that it cannot be changed through the ordinary legislative process, but requires a more stringent procedure. Many argue (see, for example, Elster [1995]) that this connection is the heart of constitutionalism.

Gramm-Rudman may have been unconstitutional, in that read literally, the law allowed one Congress to restrict the lawmaking power of a successive Congress, which violates the U.S. Constitution. In that sense, each Congress choosing what the deficit target was may have been viewed as acceptable procedure. It seems fairly clear the a Balanced-Budget Amendment to the Constitution, for all its drawbacks (and there are many) would not suffer from the problem of being easily changed.

It may also be that the ease with which laws with numerical targets were changed in these cases reflects less than full acceptance of the concept of a numerical target law to begin with. The lack of flexibility inherent in a zero-deficit law in the face of changing economic circumstances may mean that the public fully expects the law to be changed as circumstances change, and accepts this procedure. One may argue that including state-contingencies in the rule makes it less likely to be changed, but as argued near the end of section 4, this introduces problems of credibility and effectiveness of the rule.

To take an alternative case, the Maastricht fiscal guidelines have not been changed even though many European countries have not found them easy to comply with. (However, compliance has often been achieved by creative accounting.) One reason is the state contingencies they include. Perhaps more importantly, the rules are part of the European Unification process. This has two key implications. First, they are seen as a crucial part of the process of integration and as a condition for successful monetary union. Hence, the importance attached to the larger goals that fiscal rules are meant to advance help ensure that they will not be easily changed. Second, the multi-country nature of the policy authority provides an enforcement mechanism across governments not present in the case of fiscal rules constraining a single government.

7. Conclusions

This paper was meant to highlight a number of conceptual issues in the political economy of fiscal rules. It was not meant as a prescription for what kind of rules are optimal (though some conclusions could nonetheless be drawn), nor as a user's guide to fiscal rules. It was meant to help us think more clearly about some basic issues involved in the use of fiscal rules. I think the paper can give significant insight into why rules often don't work – they don't address the cause of fiscal bias; they attach no real costs to deviating from the rules; they attach no real cost to changing the rules. It also suggested some different kinds of costs that may help enforce rules. Both perspectives should be helpful in thinking how rules should be designed.

REFERENCES

Alesina, A. and A. Drazen (1991), "Why are Stabilizations Delayed?," *American Economic Review* 81, 1170-88.

Alesina, A. and R. Perotti (1996), "Fiscal Discipline and the Budget Process," *American Economic Review Papers and Proceedings* 86, 401-7.

Baron, D. (1991), "Majoritarian Incentives, Pork Barrel Programs, and Procedural Control," *American Journal of Political Science* 35, 57-90.

Barro, R. and D. Gordon (1983), "A Positive Theory of Monetary Policy in a Natural Rate Model," *Journal of Political Economy* 91, 589-610.

Buchanan, J. and R. Wagner (1977), *Democracy in Deficit: The Political Legacy of Lord Keynes*, New York: Academic Press.

Buti, M. and G. Giudice (2002), "EMU's Fiscal Rules: What Can and Cannot Be Exported," paper presented at IMF-World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies, Oaxaca, Mexico, February 2002.

Corsetti, G. and N. Roubini (1996), "European versus American Perspectives on Balanced-Budget Rules," *American Economic Review Papers and Proceedings* 86, 408-13.

Craig, J. and A. Manoel (2002), "Budget Management Systems in Anglo-Saxon and Latin American Countries: A Comparastive Assessment," paper presented at IMF-World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies, Oaxaca, Mexico, February 2002.

Drazen, A. (2000a), *Political Economy in Macroeconomics*, Princeton, NJ: Princeton University Press.

_______ (2000b), "The Political Business Cycle After 25 Years," *NBER Macroeconomics Annual 2000*, Cambridge MA: MIT Press

Elster, J. (1989) *The Cement of Society, A Study in Social Order*, Cambridge: Cambridge University Press.

_______ (1995), "The Impact of Constitutions on Economic Performance," *Proceedings of the 1994 World Bank Annual Conference on Development Economics*, 209-39.

Ferejohn, J. and K. Krehbiel (1987), "The Budget Process and the Size of the Budget," *American Journal of Political Science* 31, 296-320.

Grilli, V., D. Masciandaro and G. Tabellini (1991), "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy* 13, 341-92.

Hausmann, R. (2002), “Unrewarded Good Fiscal Behavior: the Role of Debt Structure,” paper presented at IMF-World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies, Oaxaca, Mexico, February 2002.

Hercowitz, Z. and M. Strawczynski (2001), “Cyclical Ratcheting in Government Spending: Evidence from the OECD,” working paper, Bank of Israel.

Kopits, G. (2001), “Fiscal Rules: Useful Policy Framework or Unnecessary Ornament, IMF Working Paper WP/ 01/145, Fiscal Affairs Department.

_______ and S. Symansky (1998), “Fiscal Policy Rules,” Occasional Paper 162, International Monetary Fund.

McCallum, B. (1995), "Two Fallacies Concerning Central-Bank Independence,” *American Economic Review Papers and Proceedings* 85, 207-10.

Milesi-Ferretti, G.M. (1997) “Fiscal Rules and the Budget Process,” *Giornale degli Economisti e Annali di Economia.*

Niskanen, W. (1971), *Bureaucracy and Representative Government*, Chicago: Aldine-Atherton.

_______ (1975), “Bureaucrats and Politicians,” *Journal of Law and Economics* 18, 617-43.

Peltzman, S. (1992), “Voters as Fiscal Conservatives,” *Quarterly Journal of Economics* 107, 327-61.

Persson, T. and L.E.O. Svensson (1989), “Why a Stubborn Conservative Would Run a Deficit: Policy with Time-Inconsistent Preferences,” *Quarterly Journal of Economics* 104, 325-345.

Tabellini, G. and A. Alesina (1990), “Voting on the Budget Deficit,” *American Economic Review* 80, 37-49.

von Hagen, J., (1992), “Budgeting Procedures and Fiscal Performance in the European Community,” Commission of the European Communities Economic Paper no. 96, Brussels.

von Hagen, J. and I. Harden (1995), “Budget Processes and the Commitment to Fiscal Discipline,” *European Economic Review* 39, 771-79.

Wagner, R.E. (1976), “Revenue Structure, Fiscal Illusion, and Budgetary Choice,” *Public Choice* 25, 45-61.

APPENDIX – A BRIEF OVERVIEW OF BUDGET PROCEDURAL RULES

The budgetary process can be characterized as a system of rules and regulations, formal and informal, which determine the fiscal decisions made. One needs to consider the effect of procedural rules at all three stages of the budget process, namely, formulation, approval, and implementation of the budget. The first budget stage, that of budget formulation in which the budget is prepared via negotiation within the executive, itself consists of sub-stages. An important institutional detail is the extent to which the drafting of the budget is centralized. A key issue is the relative influence of agents representing specific constituencies, such as cabinet ministers with specific constituencies, versus agents whose function it is to represent the populace as a whole in the process of budget negotiations, such as the finance minister or the chief executive, such as the prime minister. A "*hierarchical*" process is one where the latter have relatively more power in the preparation of the budget, there being a defined hierarchy in the process; a "*collegial*" process is one where individual ministers have significant power, decisions being made democratically. The drawback of hierarchical rules is that they may produce budget proposals that do not protect minority interests.

The second stage is the legislative approval stage. Procedural rules in the legislature concern several dimensions of the nature of voting on the budget, such as rules of agenda (including whether the size of the budget is set first or emerges as a residual) and rules of amendment. Much of the work in the political science literature on this stage of budgeting shows not only how the effect of procedural rules may be analyzed formally using game-theoretic bargaining models, but also, on the basis of such analysis, how (and why) intuitive conclusions may be incorrect.

To take one example, Ferejohn and Krehbiel (1987) consider the effect on the overall size of the budget of whether it is determined as a residual in the process, after individual appropriations are chosen (a "piecemeal appropriations" or "bottom-up" process) or chosen first, after which appropriations are chosen subject to the overall constraint (an "overall budget" or "top-down" process). The former resembles the process used by the U.S. Congress prior to 1974, the latter the Congressional process instituted by the 1974 Budget Implementation and Control Act. One might naturally think (as did the framers of the 1974 act) that the latter process would impose more budget discipline and hence lead to lower budgets. Ferejohn and Krehbiel show this isn't necessarily the case. Depending on the preferences of individual legislators, a piecemeal appropriations process may yield a *lower* overall budget.

When one considers the amendment process, similar results emerge, whereby conclusions that seem intuitive do not necessarily stand up to careful scrutiny. Voting on the budget in the legislature may be subject to a *closed* rule on amendments, whereby once a proposal is made, it must be either passed or voted down (in which case another proposal is made and voted on), but may not be amended. Under an *open* rule, amendments may be offered to proposals. For example, under a simple open rule an unlimited number of amendments may be proposed, but they must be put up one at a time against the proposal on the floor. A legislator may propose an amendment or may make a motion that the amendment process be closed, subject to majority vote. If that motion is passed, the proposal on the floor is voted on; if an amendment is

proposed, it is voted on against the proposal on the floor, the winner becoming the new proposal on the floor.

Intuitively, one might think that an open rule would lead to higher or more wasteful spending than one where a proposal must be simply voted up or down, as the latter limits the possibility of adding extra provisions favorable to special interests. In fact, the theoretical effect of amendment rules on the size of the budget is not so clear. Baron (1991), for example, shows in a carefully worked out bargaining model that more wasteful programs may be adopted under a closed rule than under an open rule. The reason is that a more generous budget will be proposed under a closed rule because of the need to gain majority support when no amendments are allowed. Simple intuition fails if it ignores the fact that legislators are forward-looking and sophisticated in making and voting on budget proposals. In deciding to vote for or against a proposal, a legislator considers the consequences of the proposal being adopted versus it being rejected and other proposals being made. A legislator supports a program not simply if it provides benefits in excess of the tax burden to his constituents, but if the net benefits are at least as great as what could be expected if the current proposal is defeated and the budget process continues. To put the point more prosaically, if the proposed budget must be passed as is without amendment or voted down with the need to formulate a new budget, the budget may be formulated to contain "something for everyone" to ensure passage.

At the implementation stage, there are also a number of conceptual issues concerning procedural rules. One concerns the issue of flexibility versus commitment already discussed above. If there are unforeseen events, there is a trade-off between the how much the budget should bind the government's actions during the fiscal year and how much flexibility the government has to respond to unforeseen events. The binding force of the budget law depends on the government's ability to enact supplementary budgets during the fiscal year, on the use of open-ended appropriations in the budget, and on the power of the executive to enforce the original budget.

The effect of procedural rules at different stages is not independent. Lax rules at one stage will undo the effect of tight rules at another stage. Two further general conceptual issues are important in assessing the effectiveness of institutions in enforcing budget discipline. The first is that institutions themselves are endogenous. Countries that want fiscal discipline develop institutions to support these preferences. Second, political factors may determine budget outcomes independent of fiscal institutions and legal restraints.