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May 2009

The Need for Constraints on Fiscal Policy

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With the plummeting of the U.S. budget from a surplus to one of largest post-World War II deficits, the question of how to ensure the sustainability of public finances has grown urgent. The debate is not new. Indeed, across the globe, economists have long considered various institutional and political arrangements that would impose restrictions on fiscal policy. Such restrictions have been adopted in certain U.S. states, the European Monetary Union, and other countries around the world.

Yet constraining fiscal policy can lead to inaction that imposes significant costs. Do restrictions to fiscal policy have an overall negative or positive effect on a nation's economy? In recent research, my colleague Ilian Mihov of INSEAD and I studied this notoriously difficult question using a large sample of countries that have experimented with fiscal policy over the years. We found that governments facing *fewer* restrictions in the political process of setting budgets add *more* volatility to their business cycle, resulting in a *negative* effect on their growth rates. Ultimately, the practice of limiting changes in fiscal policy appears to have more pros than cons.

Fiscal policy reexamined

Monetary policy has been the tool of choice for guiding economies through rough spots in the past, including the current crisis. Yet when interest rates get close to or reach the zero level (the situation currently faced by many advanced economies), its benefits are typically exhausted. For this reason, fiscal policy is now receiving renewed interest.

Fiscal policy takes many forms, which we can broadly group into three categories:

1. **Automatic stabilizers.** These changes, including increases or reductions in income and business taxes, are built into a government's tax and spending code. In most cases, automatic stabilizers, such as progressive taxation, result from political goals rather than economic ones. Our cross-country examination shows that governments with more powerful automatic stabilizers do better than those with less powerful stabilizers.

2. **Stimulus packages.** Governments undertake this kind of countercyclical spending policy at their discretion, as the Obama Administration recently did with the backing of Congress. Evidence of the effectiveness of stimulus packages has been mixed. There is consensus that they have a positive impact, but disagreement exists about the size of the effects.

3. **Politically motivated changes.** These changes to fiscal policy—such as those caused by an armed conflict or a change in the party in power—are unrelated to the business cycle, but affect it nonetheless. From an economic point of view, such changes should ideally be as small and infrequent as possible.

The perverse role of politics

How effective is fiscal policy as a stabilizing tool within a business cycle? Studies have shown that tax cuts and government spending can have a positive impact on an economy by boosting GDP. Yet these powerful tools can cause as much harm as good, if undertaken improperly or at the wrong time.

Beyond the technical difficulties of measuring the true state of the economy and responding with appropriate policies, the biggest risk arises from the fact that governments are motivated by political or electoral considerations. Using the example of monetary policy, even if interest rates should increase to keep pace with an improving economy, a government facing reelection might postpone the rate hike to enjoy the electoral benefits of a roaring economy.

Such well-document pathologies have inspired almost all countries to undertake serious reforms to reduce the flexibility of monetary policy, in one of two ways. Some have adopted an institutional approach. That is, they keep a particular policy tool in place, but put it in the hands of an institution that has the right incentives: an independent central bank. Countries unable to create such high-quality, independent institutions have opted for much more serious restrictions on monetary policy, such as currency boards, or even replacing their currencies with the U.S. dollar.

Which limits work best?

The proponents of restrictions on fiscal policy argue that such restrictions will bring two positive effects: (1) a guarantee that governments will not run excessive deficits and pile up unsustainable levels of debt; and (2) elimination, or at least reduction, in the possibility that fiscal policy itself, for political reasons, is a source of macroeconomic volatility.

How can we ensure that fiscal policy will not be subject to political interference while it remains a powerful tool for controlling business cycles? How can fiscal policy maintain the balance between the need for short-term action and long-term sustainability? Three measures have been proposed:

1. **Budget restrictions.** Some economists have argued in favor of strict numerical limits on budgets, such as the "balanced budget amendments" under which many U.S. states operate. While budget restrictions guarantee long-term sustainability by preventing the government from borrowing, they might overly constrain fiscal policy. This concern frequently appears in the pubic debate, as summarized in this 1997 petition, signed by 1,100 U.S. economists: "These so-called built-in stabilizers limit declines of after-tax income and purchasing power. To keep the budget balanced every year would aggravate recessions."

2. **Deficit limits.** An alternative to a "balanced budget amendment" is to restrict deficits to a certain amount. This amount can be fixed (such as 3% of GDP in the case of EMU countries), or it can be related to the government's investments. The United Kingdom follows this so-called "Golden Rule"; the government can only borrow to finance public investment. This type of restriction provides more flexibility than the extreme proposal of ruling out government borrowing, but the empirical evidence suggests that deficit limits are not flexible enough to cope with the business cycle; in addition, they are subject to political and accounting manipulation.

3. **Implicit constraints.** A third alternative, the use of implicit constraints, includes the creation of political and electoral institutions that establish checks and balances in the budget process. We believe this is likely the best choice. Rather than following "dead rules," it is better to rely on "living institutions" that can provide the necessary judgment to balance short-term needs and long-term stability. Armed with short-term flexibility, we can enjoy the benefits of restricting bad behavior while enjoying the power of fiscal policy when it is needed, just as central banks do with monetary policy.

The value of checks and balances

The difficulty of imposing implicit constraints is political feasibility. Taken to the extreme, this proposal transforms into the notion of creating independent councils that make fiscal policy decisions.

Should we take fiscal policy away from governments? This proposal may sound radical, just as the concept of independent central banks did was when it was first discussed. Yet its aim is not to prohibit governments from making politically based tax and spending decisions. Rather, the goal is to establish an institution that can provide the necessary checks and balances for decisions that affect the overall balance of the government budget. Some countries, such as Sweden, have moved in this direction with the creation of fiscal policy councils, although their powers are still quite limited.

We expect this debate will continue over the coming years. As many countries struggle to keep their public finances under control, they will face a need to explore more radical and innovative solutions, including those that today might appear politically infeasible.

Bio

Antonio Fatás is the Portuguese Council Chaired Professor of Economics at INSEAD, an international business school with campuses in Fontainebleau, France, and Singapore. During the 2008-09 academic year, he is on sabbatical from INSEAD as an International Fellow in Residence at the Georgetown Center for Business and Public Policy at the McDonough School of Business at Georgetown University.

Fatás received his Master's and Ph.D. in Economics from Harvard University. He has worked as an external consultant at the International Monetary Fund, the World Bank, the OECD, and the European Commission. He was the Dean of INSEAD's MBA program from 2004 to 2008.

His research covers areas such as the macroeconomic effects of fiscal policy, the connections between business cycles and growth, and the effects of institutions on macroeconomic policy. His work has been published in academic journals such as *Quarterly Journal of Economics, Journal of Monetary Economics, Journal of Economic Growth, Journal of Money, Banking and Credit,* and *Economic Policy*.

References and further reading

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