1 Introduction and Overview

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Serious discussion of fiscal policy has almost disappeared. A reading of the literature on macroeconomic theory and policy would lead you to believe that there is only one policy goal – the control of inflation – and that task is assigned to monetary policy. Fiscal policy is either impossible or undesirable or both.

Robert M. Solow (2002), p. 1

The financial crisis and its global repercussions came as a wake-up call for macroeconomists and policymakers all over the developed world. According to the pre-crisis consensus, it could not happen. After all, we knew how to conduct macroeconomic policy, and the Great Moderation was proof that we had mastered our job relatively well. We were wrong. Eight years after the fall of Lehman Brothers, the developed world is still struggling with lacklustre growth and rising public indebtedness poses serious questions over fiscal sustainability in many countries. Moreover, ageing societies represent a substantial headwind for both growth performance and debt reduction policies. In this environment, we should think hard about how to adjust our understanding of the economy and upgrade the frameworks we use to analyse macroeconomic policies.

The main goal of this book is to contribute to this debate by rethinking several aspects of fiscal policy. In particular, it is argued that significant improvements in the institutional set-up and analytical toolkit of fiscal policy are indispensable to avoid policy mistakes in the future.

1 Fiscal Policy in the Backseat

The two decades prior to the crisis were all about monetary policy. There was a widespread belief that so long as inflation was stable, actual output could not be too far away from its potential (‘divine coincidence'). In other words, one primary target (low inflation) and one instrument (short-term interest rate) were sufficient for stabilization purposes. And the profession believed that 'the quiet revolution' (Blinder, 2004a) in central banking made it possible to pursue close-to-optimal policies. The world achieved consensus on monetary policy (Goodfriend, 2007). Advances in macroeconomic modelling and the Volcker disinflation enabled convergence between monetary theory and actual policymaking. Flexible inflation targeting pursued by independent central banks has become the state-of-the-art monetary policy framework. Transparency gradually replaced secrecy and simple rules as guideposts defeated complete discretion.

Fiscal policy played a secondary role in the literature on macroeconomic stabilization. As Blanchard et al. (2010) describe, if monetary policy could maintain a stable output gap, there was little reason to use another instrument. Moreover, as the quote by Solow at the beginning of this chapter illustrates, there was widespread scepticism about the use of fiscal policy for macroeconomic stabilization. First, forward-looking models with rational expectations had Ricardian equivalence as their built-in feature and thus questioned the effectiveness of fiscal policy for stabilization purposes. Second, the political economy literature (Drazen, 2000) pointed out that politicians have many motives other than welfare maximization for the median voter. Third, the recognition of long implementation lags made fiscal policy impractical as a stabilization tool in normal business cycles. In the light of these developments, the major policy recommendation was to stay away from discretionary fiscal policy and let automatic stabilizers do their job (together with monetary policy). Blinder (2004b) made an attempt to issue at least a warning by stating that 'there are circumstances under which the lessons of Lord Keynes are best not forgotten'; however, he himself was cautious in arguing against the consensus (Blinder presented the 'case against the case against' and not 'the case for' discretionary fiscal policy).

The almost unlimited belief in the power of monetary policy to stabilize output had an unfortunate consequence, namely that fiscal policy was left under less scrutiny by the financial markets and the profession in general. Although secular upward trends in debt levels hinted in the direction of a serious deficit bias, attempts to pursue counter-cyclical policies failed, especially in good times.

1.1 Wake-Up Call

The crisis has brought fiscal policy back to the front pages of newspapers for several reasons. First and most importantly, the financial crisis and the subsequent deep recession pushed standard monetary policy to its limits on both sides of the Atlantic. Central banks, after hitting the zero lower bound on interest rates, had to come up with an alphabet soup of unconventional policy measures to avoid the collapse of economic activity. Many had doubts as to whether this would be sufficient, so policymakers had little choice but to turn to fiscal policy.

Second, many advanced countries had no adequate fiscal space to absorb the consequences of the Great Recession without serious financing problems. The euro-area countries in particular found themselves suddenly in the middle of a sovereign debt crisis. The need to bail out the financial sector and massive losses of revenues (no longer supported by financial boom) rapidly escalated debt levels, forcing several countries to seek international financial assistance. Moreover, the euro area also lacked some important institutional aspects to deal with the crisis, most notably resolution schemes and the lender-of-last-resort functions.

Third, neither the actual fiscal positions nor academic policy advice were prepared for the crisis. Limited understanding of the effects of fiscal policy, neglect of monetary-fiscal-financial interactions or ignorance of market expectations often led to policy advice by international organizations and prominent economists that was based more on conventional wisdom than on sound analysis.

1.2 Can We Do Better?

Despite the recent difficulties with monetary policy, there remains a striking gap between the ways in which monetary and fiscal policies are conducted. As Ľudovít Ódor and Gábor P. Kiss (Chapter 7) document, independent central banks, inflation targets, transparent communication of objectives and policy and monetary research all contributed to a much better understanding and execution of monetary policy. On the other hand, fiscal policy still relies on old-fashioned models, lacks clear objectives and is conducted in a very opaque environment. The huge gap between monetary and fiscal policy is understandable to some extent. Fiscal policy cannot be delegated to technocrats in its entirety ('no taxation without representation') because of the large distributional impacts which lie at the core of the political process.

On the other hand, a substantial part of the difference in the treatment of monetary and fiscal policy is not justified (here, we focus only on macroeconomic aspects of fiscal policy). One line of criticism relates to the institutional set-up. In order to achieve fiscal discipline, Wyplosz (2005) explicitly argues in favour of adopting a similar approach to inflation targeting, used by central banks to reach monetary discipline. Another strand of criticism targets the analytical approaches used in fiscal policy advice. Leeper (2010) talks about monetary science and fiscal alchemy, although in Chapter 2 of this volume he admits that fiscal analysis is intrinsically hard – 'darned hard'.

To sum up, we can and should do much better in institutional and analytical aspects of fiscal policy. This book brings fresh ideas to both areas. Part I sets the stage by describing the frontiers of fiscal policy. Part II focuses on institutional aspects of fiscal policy both in general terms and in the euro area in particular, where fiscal issues seem to be the most serious ones. Part III offers the reader interesting thoughts on new analytical perspectives in fiscal policy. Part IV is about the comeback of discretionary fiscal policy.

2 Frontiers of Fiscal Policy

Much of the existing fiscal analysis is less helpful than it could be. At least, this is a conclusion presented by Eric M. Leeper in Chapter 2. Although he displays a lot of sympathy with fiscal analysts in recognizing that fiscal research is harder than monetary research, he nevertheless sees huge room for improvement in the former. After colourfully illustrating fiscal 'alchemy' through examples from economic headlines, he constructively sets up a fiscal research agenda to improve upon current practices. Several ingredients seem to be essential for fiscal analysis to lose the 'alchemy' label and join monetary policy in the 'science' camp. The most important items on Leeper's to-do list are the following. First, we need a modelling framework which combines all important aspects of fiscal policy into one coherent analytical framework. Joint analysis of fiscal policy, monetary policy and financial stability, explicit treatment of the stabilization-versus-sustainability trade-off and political economy considerations are all elements without which a decent understanding of fiscal trends is simply not possible. Second, contrary to the current practice, fiscal policy needs to incorporate much more heterogeneity. Fiscal policy requires modelling many different tax and expenditure instruments and their impacts on a wide variety of economic agents. It also highlights the importance of including demographic structure and trends in policy analysis. Third, in most macroeconomic models, government debt serves merely as a vehicle for private saving and tax smoothing. In reality, debt might perform many additional roles: liquidity, collateral or maturity transformation. Ignoring these other purposes might substantially decrease the policy relevance of fiscal analysis.

The delegation of monetary policy to independent technocrats was possible mainly because of the limited distributional impacts of monetary policy over normal business cycles. This is, however, no longer true for the large-scale asset purchases which central banks are conducting under the banner of unconventional monetary policy. As Athanasios Orphanides argues in Chapter 3, at the zero lower bound on interest rates, some central bank balance-sheet policies may be effectively equivalent to fiscal operations. During the crisis, central banks provided preferential treatment to some entities, but not to others. Orphanides points out that the Federal Reserve used its 'fiscal' discretionary power to support some sectors of the economy (construction) and bailed out some firms, but not others. The European Central Bank proved to be an effective central bank during the crisis, but only for some members of the euro area. Orphanides' chapter shows how thin the line between monetary and fiscal policy is in crisis times. He understands the criticism both central banks received from politicians during the crisis, and advocates the setting of clear ex ante rules and boundaries for crisis management in order to maintain the independence which central banks need for their effective action. Otherwise, as Goodhart (2010) notes, 'the idea of the Central Bank as an independent institution will be put aside'.

3 Better Institutions for Better Policies

The three decades of a secular upward trend in government debt in OECD countries prior to the crisis discredited pure discretion in fiscal policy and introduced the term 'deficit bias' to the fiscal literature. One of the most important questions in practice was how to design effective constraints for fiscal policy action. The first line of attack came in the form of fiscal rules, usually embedded in fiscal responsibility laws or treaties. As Wyplosz (2005, p. 64) highlights, the record is not satisfactory: 'rules are either too lax or too tight and then ignored.' To address the weaknesses of rule-based frameworks, many countries started to complement fiscal rules with independent fiscal institutions to allow for discretion in the short run, while preserving sustainability in the long run.

3.1 Fiscal Frameworks in General

Chapter 4 looks at fiscal rules adopted around the world. Klaus Schmidt-Hebbel and Raimundo Soto identify conditions under which some countries decided to adopt constraints on their fiscal policies in the form of numerical fiscal rules. They define six categories of potential determinants: political and institutional variables, monetary regimes, degree of financial development, level of economic activity, costs of fiscal rules and fiscal performance indicators. The results are the following. Institutional and political conditions contribute significantly to the likelihood of having a fiscal rule in place. From monetary policy regimes, inflation targeting helps explain the presence of rules. This is understandable, since fiscal dominance might seriously undermine the effectiveness of reaching inflation targets. Both financial and overall economic development increase the likelihood of having a rule. On the other hand, costs associated with fiscal rules – as measured by the volatility of government revenues – have the opposite effect. Finally, better fiscal conditions contribute significantly to having a national fiscal rule in place. This raises the delicate question of reverse causality. It may well be that only countries with good fiscal performance adopt fiscal rules.

In Chapter 5, Roel W. M. J. Beetsma and Xavier Debrun introduce an important channel through which fiscal councils might operate (in addition to easing trade-offs associated with fiscal rules). Asymmetric information between voters and elected policymakers is at the heart of their model. Because of a lack of information, voters find it difficult to distinguish between bad luck and bad policy and between good luck and good policy. If this is the case, society might benefit from the presence of an independent fiscal institution tasked with minimizing the noise surrounding signals of competence of the incumbent government. Importantly, the fiscal council's positive value added in taming the deficit bias applies regardless of the type of government (competent or not). The second part of the chapter looks at the important preconditions which the existing fiscal councils should have in place in order to effectively reduce the noise in signals of competence. The conclusion is encouraging. Using the comprehensive IMF dataset on fiscal councils, Beetsma and Debrun show that strong majority of fiscal councils exhibit features – political independence and functions – that allow them to clarify existing signals about fiscal policy.

3.2 *Fiscal Discipline in the Euro Area*

No current monetary union arrangement illustrates the importance of ensuring fiscal discipline better than the euro area. Its management of the crisis, one could argue, also leaves much to be desired. The natural question is: what should be done to increase the European single currency's resilience to future crises? Economists might have somewhat different views on the nature of the optimal medicine.

Some would agree that a fully fledged fiscal union (something like the United States of Europe) would, at least in theory, go a long way towards solving most of the problems. In the current political environment, however, only a small minority of member states would be willing to transfer more sovereignty to Brussels. If the first-best solution is unattainable, is the euro project doomed to failure, or are there other options to ensure fiscal discipline? In Chapter 6, Charles Wyplosz argues that the fiscal policy problem in the euro area can be solved without further integration. In his view, compulsory adoption of effective fiscal discipline frameworks by member countries should replace the several-times-discredited Stability and Growth Pact. At the national level, these frameworks should combine intelligent fiscal rules and independent fiscal councils apt at combining rule and discretion. At the collective level, the implementation of national frameworks should be monitored by an independent European fiscal council vested with the power to bring cases to the European Court of Justice. The no bail-out clause should also be restored to eliminate moral hazard. In addition, Wyplosz argues that legacy debts should be significantly reduced in order to allow countries to pursue counter-cyclical fiscal policies.

In Chapter 7, Ľudovít Ódor and Gábor P. Kiss also advocate a decentralized and depoliticized fiscal framework in the euro area. The current European framework is plagued by extreme complexity, inconsistency between the various elements and non-existent enforcement. Paradoxically, there are so many rules that the final verdict is often a discretionary decision of the Council. Ódor and P. Kiss call for a clear separation of accountability between the Union and the national level. The first line of defence against irresponsible fiscal policy behaviour should be at the local level, using better indicators, home-grown fiscal rules and fiscal councils. Their design should, however, meet commonly agreed minimum standards. Under this model, if a member state operates with no significant fiscal risks, no yearly intervention from the Union level is necessary. At the European level, the European Commission and an independent euro-area fiscal watchdog should ensure compliance with minimum standards, focus on countries breaching European limits (represented by a single fiscal rule) and avoid pro-cyclicality at the Union level. A decentralized framework is thus theoretically sounder and practically more enforceable than the current web of complicated rules and procedures. Ódor and P. Kiss also note that completing the banking union and creating ex ante sovereign resolution schemes are necessary pre-conditions for any successful reform of the European fiscal architecture.

In Chapter 8, Michael Bordo and Harold James also agree that the euro area is still far away from a new political equilibrium that shifts towards greater fiscal federalism. In contrast to the minimalistic approach advocated by Wyplosz, Bordo and James propose a series of measures which amount to ‘partial fiscalization’. Their rationale is quite simple, and based on the historical analogy between the US and EU: in order to achieve further integration, voters should first see the value added of a common action. Europe should focus on win–win situations which would increase cross-border ties and thus represent a ‘strong cement to the union’. These partial fiscalizations might come in the form of reaping efficiency gains from a collective action or as insurance mechanisms at the Union level. Bordo and James provide a number of examples, among which the most prominent are banking union, capital markets union, common social security, energy union or, for example, common defence policy. Using the trade negotiations analogy they advocate for a ‘big bang’ strategy, where individual measures are not implemented sequentially, but rather as a comprehensive reform package.

There is a widespread consensus that the severity of the euro-area debt crisis was amplified by the rather hesitant crisis management of the authorities. Their ‘too little, too late’ behaviour was criticized extensively in the media. With the benefit of hindsight, George Kopits, in Chapter 9, looks at the effectiveness of the steps euro-area officials took before and during the crisis and presents the most important lessons for future crisis prevention and management. Kopits identifies the two main mistakes prior to the crisis in the failure of the peer pressure mechanism to guarantee the enforcement of fiscal rules and in the ECB's uniform treatment of government bonds as (riskless) collateral. After the crisis hit, several member states suffered from a sudden stop in financial markets. In these cases, crisis management has to focus on three issues: access to liquidity or financing renewal, macro-fiscal adjustment and structural measures. The authorities delivered satisfactory action in none of these areas. One can question the initial strong resistance to debt restructuring, the optimistic design of adjustment packages and the insufficient implementation of structural reforms. According to Kopits, some of the lessons have already been internalized. Stronger macroeconomic governance and more centralized financial sectors are prime examples. On the other hand, modifications to the fiscal framework have been rather modest.

4 New Analytical Perspectives

Even the most carefully designed fiscal frameworks and best-intended policy advice have little value added if we use the wrong metrics to measure fiscal performance. We need to know the diagnosis before recommending a cure. In Chapter 2, Eric M. Leeper sketches out a future research agenda for fiscal policy in general terms. According to Leeper, fiscal analysis might substantially benefit from calculating 'fiscal limit' distributions by integrating economic and political economy considerations. In Part III of this book we look at other promising analytical tools and concepts. We have at least three strong candidates for inclusion in the emerging post-crisis consensus on the essential ingredients of a fiscal toolbox: the balance sheet perspective, the relevance of financial cycles to fiscal cycles and the importance of sovereign default models.

4.1 Balance Sheet Analysis

It is easy to find in the literature highly critical articles, dating back as far as thirty years, on the deficiencies of the commonly used fiscal measures. Buiter (1983) advocated assembling comprehensive public sector balance sheets (including the central bank and the present value of future taxes and entitlements) in order to get a better understanding of fiscal trends. Kotlikoff (1986) pointed out that judging fiscal policy by government deficit figures only is a linguistic exercise and has nothing to do with economics.

'Statistics are like bikinis. What they reveal is suggestive, but what they conceal is vital.'[1] This quote attributed to Aaron Levenstein seems to be true also for public accounts. Fiscal gimmickry and creative accounting are the norm rather than the exception in many countries. Therefore, it is essential to look behind the official accounting numbers. In Chapter 7, Ódor and P. Kiss argue that only a comprehensive (inter-temporal) analysis of stock, flow and cash-flow data enables analysts to achieve more complete understanding of fiscal developments and to escape Goodhart's famous law.[2]

In Chapter 10, Jerry R. Green and Laurence J. Kotlikoff demonstrate that standard fiscal measures, including the deficit, taxes and transfer payments, are economically ill defined. Similarly, just as, a century ago, measures of time and distance were found to depend on one's reference point, many accounting exercises in fiscal policy have no absolute meaning and can be understood only in relation to other variables. In other words, they lack fundamental economic content and should be treated as mere labels. According to Green and Kotlikoff, economic theory provides a clear guide as to which measures are not invariant to the choice of the fiscal language. The infinite-horizon fiscal gap and generational accounting are the only options consistent with the fundamental inter-temporal budget constraint of the government. They present estimates of fiscal gaps for a number of advanced countries and show the difference in the ranking of countries based on this measure compared to traditional measures of deficit and debt. It is important to note that the infinite-horizon fiscal gap and the inter-temporal net worth of the government are different expressions of the same underlying principle, namely, taking into account all future flows in the public sector.

[1] www.oxfordreference.com/view/10.1093/acref/9780191804144.001.0001/q-oro-ed3-00016754?result=82&rskey=42Jyhf

[2] Goodhart's law is named after the economist Charles Goodhart. Its most popular formulation is: 'When a measure becomes a target, it ceases to be a good measure.'