Enhancing fiscal policy design

That the conduct of fiscal policy has been a source of dispute and dissatisfaction over recent years is beyond doubt. Indeed, fiscal policy has often contributed to exacerbate the economic cycle while failing to prevent the appearance of extremely large public deficits that may stay with us for many years. These difficulties have a lot to do with domestic institutional weaknesses that hamper expenditure control and sap the effectiveness of fiscal policy as an instrument of economic stabilisation.

With ageing-related financial pressures looming larger than ever, restoring the sustainability of public finances and the capacity of fiscal policy to smooth economic fluctuations will be crucial. To succeed in this difficult endeavour, it will be necessary to re-establish or revitalise medium-term oriented fiscal frameworks and to improve fiscal institutions so as to enhance the cost-effectiveness of public expenditures in a context where competing claims are on the rise. Moving forward it will be useful to take inspiration from the successes achieved by various OECD countries in revamping their budgetary institutions.

This Newsletter provides an overview of recent empirical work by the OECD Economics Department on the design of fiscal institutions. In particular, it summarises work on the factors shaping the behaviour of fiscal policy over the business cycle; the principles and practical issues attached to decentralising public spending responsibilities to sub-national governments; and the contribution of budget processes and public management practices to making government spending more cost effective.

I would like to thank the many readers who responded to the first Newsletter. We received useful comments and suggestions on both the content and style. This issue takes on board some of your suggestions.

Jean-Philippe Cotis,
OECD Chief Economist
Fiscal Policy and Institutions

What factors influence fiscal policy over the business cycle?

One of the objectives of fiscal policy is to exert a stabilising influence on economic activity. But this is not always achieved. Recent OECD research has tried to identify and measure the key factors that shape the behaviour of fiscal policy over the business cycle. It found that pro-cyclical budget policies tended to be more prevalent in countries with unsustainably high government indebtedness, high tax ratios and expenditure rigidities. The institutional and political frameworks in which policies are designed and managed may also induce a pro-cyclical pattern. The rules of the Stability and Growth Pact, however, have not created a discernible pro-cyclical bias in the euro area as a whole.

The fiscal stance has been pro-cyclical in some countries

The fiscal stance is pro-cyclical when it contributes to exacerbate business cycle fluctuations and counter-cyclical when it mitigates them. Pro-cyclicality occurs for instance when, in an upturn, measures are taken to increase spending or cut taxes adding further unnecessary stimulus to economic activity while deteriorating the underlying budget balances.

While easy to describe in broad terms, pro-cyclicality is not easy to track down in practice. Allowing fiscal balances to worsen in good times obviously leads to pro-cyclicality, but balances that remain stable or improve only modestly while the economy is strong may also prove pro-cyclical. Strong economic activity gives a boost to tax receipts and tends to reduce spending, thus improving fiscal balances. This cyclical “bonus” may be large enough at times to mask the impact of expansionary fiscal measures such as discretionary increases in spending or tax cuts. To better capture the true stance of fiscal policy it is therefore necessary to adjust fiscal balances for cyclical influences.

In practice, fiscal policy is pro-cyclical if these adjusted balances worsen during upswings or improve in downswings. Over the past two decades – a period spanning about two full business cycles – the stance of fiscal policy has been characterised by episodes of both counter- and pro-cyclicality (see figure). In about half the OECD countries examined, including most of the EMU economies, the fiscal stance has tended to be pro-cyclical over the past two decades. However, the frequency of pro-cyclical fiscal policy was higher during the 1980s and early part of the 1990s, compared with the past 10 years or so.

It is no simple exercise to examine empirically the sources of pro-cyclicality. The fiscal stance may happen to be pro-cyclical even when it is not intended to be so. This may occur when fiscal authorities follow binding deficit objectives in the short-run despite the fact that budgetary forecasts are rarely completely reliable. During downswings, for instance, revenue shortfalls and expenditure overruns are not uncommon, calling for remedial measures that may turn out to worsen the slowdown.

Fiscal policy has not always smoothed cyclical fluctuations

1. The shaded areas identify cyclical downturns, defined as the years in which changes in the output gap relative to the previous year are negative.
2. France, Germany and Italy.

Debt sustainability may condition the fiscal stance

The OECD has investigated the extent to which counter- or pro-cyclicality, and asymmetries in the fiscal stance between booms and downswings, have been affected by institutional and political economy factors. In particular, there is evidence that lack of debt sustainability influences the fiscal stance. With debt accumulation increasingly unsustainable, fiscal adjustment may become necessary, regardless of the economy’s position in the business cycle. However, cutting deficits in a downturn may not be contractionary, if this contributes to restore confidence in the future among households and businesses.

Tax cuts are often at the heart of pro-cyclicality...

Another key finding is the propensity for discretionary shifts in fiscal stance to be counter-cyclical in downturns and pro-cyclical in upturns. Hence there is a tendency towards fiscal easing in both upswings and downturns, though over longer time periods the excessive accumulation of public debt will lead to fiscal correction.

Such a bias towards fiscal easing may be linked to a number of factors. But on average among the OECD countries the main source of difficulty may be the existence of a high tax burden. Governments come under intense political pressure to cut taxes when the economy is peaking and budgetary constraints seem to be loosening under the influence of large but temporary revenue windfalls. The OECD experience suggests that tax cuts implemented during the upturn tend to reduce the scope for counter-cyclical easing in subsequent downswings. This was a feature in many euro area economies over the most recent business cycle. In contrast, instances of pro-cyclical expenditure retrenchment during downturns are rarer. The benefits for short-term stability that arise from government primary expenditure being inflexible in a downward direction have to, however, be set against the fact that there is no evidence of corresponding expenditure stability in upturns, with the risk of resultant longer term “ratcheting-up” effects on aggregate public spending.

...and some fiscal rules may induce a pro-cyclical bias

Not surprisingly, fiscal rules have an important bearing on the profile of government budgets. For instance, rules requiring actual, rather than cyclically adjusted budgets to be in balance automatically dampen cyclical fluctuations in the budget balance. In principle, they restrict the ability of the government to let automatic stabilisers work freely and symmetrically in tandem with fluctuations in economic activity, leading to pro-cyclical budgeting. But the empirical evidence is less conclusive, possibly because governments provide for some budgetary flexibility by accumulating “rainy day” funds in good times. The fiscal framework codified in the Maastricht Treaty and, later, the Stability and Growth Pact has also come under close scrutiny, regarding its impact on the fiscal stance. Again, however, the OECD finds no conclusive evidence to suggest the EU’s fiscal framework has created a discernibly pro-cyclical bias during downturns in the EMU area as a whole.

Political institutions also matter

While political processes are complex and country experiences differ significantly and are not easy to generalise, overall OECD evidence suggests that pro-cyclical retrenchment is less prevalent in countries with more politically fragmented governments and electoral systems based on proportional representation, rather than plurality (e.g. “first-past-the-post”) regimes. This may be because the decision-making process tends to make consolidation measures more difficult and time-consuming, requiring more political give-and-take, when the government and its base in the legislature are politically fragmented. Electoral cycles also appear to play a role, with pro-cyclical action generally more prevalent after election years.

For further reading on recent OECD empirical work on fiscal policy design, see:


OECD (2003), Economic Outlook No. 74, Chapter V, “Fiscal relations across levels of government”, Paris.

Assigning public spending responsibilities to sub-national governments

Public spending responsibilities are increasingly assigned to sub-national governments in OECD countries, albeit with a considerable diversity in institutional arrangements. There are advantages to the provision of public services at the local level. Proximity makes governments more directly accountable, allowing a better matching of public services to local preferences and needs. Decentralisation also introduces a degree of competition between localities, thus boosting efficiency in the public sector. This comes, however, with a number of potential difficulties, including co-ordination problems, reduced economies of scale and spillover effects, and poses a risk to macroeconomic stability. OECD countries have dealt with these problems in various manners.

Public services are increasingly delivered by sub-national governments

Expenditures by sub-national governments have increased over time as a share of total public spending, reflecting the re-assignment of certain functions to lower administrative layers (see table). For instance, outlays on education, health care and social security increasingly tend to be assigned to sub-national governments in the context of public administration reforms. This reflects the principle that the provision of public services should be assigned to the level where they can be most efficiently delivered.

Assigning spending responsibilities to sub-national levels can however create inefficiencies in the absence of adequate institutions. In particular, incentives are required to make sure that services are delivered in a cost-effective manner. Such incentives can take the form of contractual arrangements, where central governments impose norms, in terms of quality standards, prices and coverage of services, and eligibility criteria. In addition, in countries where sub-national governments have small jurisdictions, decentralisation can reduce economies of scale and increase delivery costs. Spillovers across boundaries can also result in problems of spending control. The budgets of metropolitan areas are for instance often stretched because they have to provide infrastructure and health care services to inhabitants of adjacent localities. A possible strategy to deal with this problem is to encourage smaller territories to amalgamate into larger ones, although this can meet considerable political resistance.

The financing of sub-national governments varies across countries

Sub-national governments can be financed by sizable grants and financial transfers from the centre, with limited taxing powers. In other cases, regional and local levels are allowed to set their own tax rates on personal and even corporate incomes. Greater tax policy autonomy can lead to some degree of tax competition between jurisdictions, which may be beneficial to counteract trends towards excessive public spending and taxation. Sub-national governments may lower income tax rates to attract highly mobile tax bases and therefore put some constraint on spending. This competition has, however, led in some cases to an erosion of tax bases, as sub-national governments granted tax privileges to encourage enterprise relocation. Financial transfers from the central government have therefore a role to play, especially when there are wider community benefits, but provided they come with explicit conditions on the quality and cost-effectiveness of public services.

Decentralisation may affect macroeconomic management

Assigning greater spending responsibilities to sub-national governments also poses challenges for macroeconomic management. Sub-national governments may run into financial difficulties and have to be bailed out by the central government. In addition, fiscal imbalances at the sub-national level may be large enough to have a sizeable impact and counteract efforts at the national level to consolidate public finances. Financial markets can in principle contribute to fiscal rectitude, in particular when credit ratings reflect budgetary trends. However, the expectation of a bailout often weakens the reaction of financial markets to fiscal slippages. Governments therefore rely on a variety of strategies to encourage sub-national fiscal discipline. These include administrative controls on sub-national borrowings and ceilings on budget balances. Co-operative arrangements to ensure consistency between national and sub-national government borrowing are also possible. Overall, the assignment of spending responsibilities to lower layers of government can help improve the efficiency of public services, but this needs to be accompanied by arrangements ensuring policy coherence at the national level.

More spending is assigned to local governments

(Percentage of public spending by sub-national governments)

<table>
<thead>
<tr>
<th>Country</th>
<th>1985</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>54.5</td>
<td>56.5</td>
</tr>
<tr>
<td>France</td>
<td>16.1</td>
<td>18.6</td>
</tr>
<tr>
<td>Germany</td>
<td>37.6</td>
<td>36.1</td>
</tr>
<tr>
<td>Italy</td>
<td>25.6</td>
<td>29.7</td>
</tr>
<tr>
<td>Japan</td>
<td>46.0</td>
<td>40.7</td>
</tr>
<tr>
<td>United States</td>
<td>32.6</td>
<td>40.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>22.2</td>
<td>25.9</td>
</tr>
</tbody>
</table>

1. Excludes transfers to other levels of government.
2. Or earliest year available; 1987 for the United Kingdom; 1990 for Japan; and 1991 for Germany.
How to make public spending more cost effective?

The apparently inexorable rise in public spending as a share of GDP came to a halt during the mid-1990s. After growing for three decades, government outlays declined mildly, to stand at around 40 per cent of GDP in the OECD area, with most countries sharing this profile. However, this stabilisation resulted from factors that appear to be more transient than permanent, such as lower debt service payments, reduced military expenditures and ad hoc spending freezes. Meanwhile, in a context of population ageing, spending on pensions and health care has continued its upward trend. Faced with persistent pressure, governments have taken steps to enhance the cost effectiveness of public spending. In particular, they have improved budget processes, public management practices and used market signals to limit and help allocate public spending.

Adapting the budget process to new challenges

Since the early-1990s, OECD countries have reformed their budget processes to regain control over public spending. An important innovation has been the adoption of fiscal rules that constrain public spending directly. Expenditure caps, for example, have been useful to curb the rise in public spending, but they have not always been fool-proof. Rules have often been flouted or ignored, in particular during cyclical downturns. In some European countries, for instance, expenditure limits that were set in the context of Stability and Growth Pact Programmes have not always been adhered to. In the United States, the Budget Enforcement Act, which was an effective means to control spending growth, expired in 2002. In addition, expenditure rules have occasionally been circumscribed by creative accounting practices. This experience does not preclude the use of fiscal rules in the future, but calls for greater flexibility in the design of budgetary frameworks.

Trends in general government outlays: Total OECD

As a percentage of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Social security</th>
<th>Consumption</th>
<th>Interest payments</th>
<th>Subsidies</th>
<th>Capital outlays and other current transfers</th>
<th>Cyclically-adjusted primary outlays (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>1975</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>1980</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>1985</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
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<tr>
<td>1990</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
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<tr>
<td>1995</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>2000</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>2005</td>
<td>10</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>10</td>
<td>90</td>
</tr>
</tbody>
</table>

1. Expressed as a percentage of potential GDP.

Strategies to strengthen fiscal sustainability require looking beyond the short-term horizon. In this context, an important innovation has been the framing of budgets over longer time periods. A number of OECD countries now include long-term budget projections and/or generational accounts in the information submitted to their parliaments. Efforts should also be made to present budget documents in a less fragmented manner. Information on tax expenditures, off-budget funds, public-private partnerships or loan guarantees should be published so as to improve transparency and enhance public scrutiny.

New public management practices focus on outcomes

Many countries have reassessed public sector management practices and focused on the services delivered or outcomes achieved, rather than just the resources used. This helps to clarify priorities and improves accountability. The implementation of performance-oriented approaches poses, however, a number of problems. Effective evaluations depend on the existence of well-defined performance targets, which are often difficult to identify. Independent auditors may, therefore, have an important role to play when comparing actual performance with targets.

Result-oriented approaches have made human resource management reforms all the more urgent. Governments have for instance introduced a degree of flexibility in working contracts and strengthened performance appraisal systems. In addition, in some countries, mobility between the public and private sectors is encouraged and public sector wages are adjusted to better reflect market conditions.

Using market signals to make public spending more effective

Some OECD countries have also allowed a degree of competition between public service providers to promote cost-efficiency and improve responsiveness. Users have for instance been allowed to choose between alternative providers in the health care, job placement, training and education sectors. In most cases, governments have introduced systems whereby money follows the user. This carries some risks, however, notably of “cream skimming” – servicing only the most profitable patients – leaving some hospitals to assume the role of agent of last resort and take care of the more costly patients. Market signals have also been promoted by the introduction of user charges, for instance in health care services and tertiary education. Countries that impose tuition fees can reduce excessively long study duration. Reliance on user fees, however, can conflict with equity objectives. The experience of some OECD countries suggests that this risk can be reduced, for example by adequate ‘stop-loss’ provisions in public health insurance.
Recent Working Papers

**The trade-off between output and inflation in Japan**

This paper examines the relationship between the output gap and inflation in Japan by estimating Phillips curves. The work provides empirical support for the hypothesis of a change in the relationship between output and inflation in an environment of low inflation for Japan. In particular, there is evidence that the slope of the Phillips curve becomes flatter when the inflation rate is below ½ per cent and that there has been a break in the relationship between demand pressures and inflation since the beginning of the 1990s. Evidence is also found that the relationship changes when the inflation rate is either rising rapidly or falling sharply. At such times, changes in demand pressure have stronger effects on inflation. These results are robust to a wide range of specifications and the basic pattern of results still holds when forward-looking expectations are explicitly introduced in the model and other measures of inflation are used.


**Female labour force participation: past trends and main determinants**

This paper examines the determinants of female labour force participation in OECD countries, including a number of policy instruments such as the tax treatment of second earners (relative to single individuals), childcare subsidies, child benefits, paid maternity and parental leaves, and tax incentives to sharing market work between spouses. The econometric analysis uses a panel data set covering 17 OECD countries over the period 1985-1999. It shows a positive impact on female participation of a more neutral tax treatment of second earners (relative to single individuals), stronger tax incentives to share market work between spouses, childcare subsidies, and paid maternity and parental leaves. Unlike childcare subsidies, child benefits reduce female participation due to an income effect and their lump-sum character. Female education, the general labour market conditions, and cultural attitudes remain major determinants of female participation.


**Health-care systems: lessons from the reform experience**

This study reviews health-system reforms in OECD countries over the past several decades and their impact on the following policy goals: ensuring access to services; improving the quality of care and its outcomes; allocating an “appropriate” level of resources to health care (macroeconomic efficiency); and ensuring microeconomic efficiency in service provision. While nearly all OECD countries have achieved universal insurance coverage, initiatives to address persistent disparities in access are now being undertaken in a number of countries. Instruments aimed at cost control have succeeded in slowing the growth of health-care spending over the 1980s and 1990s but health-care spending continues to rise as a share of GDP in most countries. There is some evidence that supply of health services has become more efficient, particularly in the hospital sector, but scope for further gains exists.

Coping with ageing

This paper examines whether the potential impact of several policy reforms is able to attenuate or to offset the adverse trend in aggregate participation rates that would otherwise occur because of ageing populations. It uses a simple dynamic modelling framework that generates longer-term projections of participation rates and labour supplies in OECD countries and alternative scenarios of policy reforms. The main outcome of this analysis is that the combined effect of possible reforms targeting prime-age women, older workers and youth might suffice to stabilize the average participation rate in OECD countries over the next 25 years but will be insufficient to offset the additional reduction of participation likely to be caused by demographic changes beyond 2025.


The retirement effects of old-age pension and other social transfers

This paper examines the impact of old-age pension systems and other social transfer programmes on the retirement decision of older males in OECD countries. For each of the 55-59, 60-64 and 65+ age groups, a new panel dataset of retirement incentives embedded in those schemes is constructed for an illustrative worker. Simple cross-country correlations and panel data econometric estimates both show that implicit taxes on continued work have sizeable effects on the departure of older male workers from the labour force. For the 55-59 age group, there is clear evidence that these effects result from a number of social transfer programmes, which have been used de facto as early retirement schemes, rather than from old age pension systems themselves. For the 60-64 and 65+ age groups, eligibility ages also appear to have a specific impact on the retirement decision, probably reflecting liquidity and/or customary effects.


Drivers of real long term interest rates

This paper documents some features of recent trends in bond yields and discusses the drivers of these trends. The analysis shows that cyclical and portfolio-allocation factors seem to have been the main driving force behind the decline in long-term real interest rates over 2000-2003. However, in some European countries, declining risk premia suggest that the equilibrium real interest rate may now be lower. The weight of recent evidence also suggests a causal relationship from fiscal positions to long-term interest rates, at least for the United States. Thus, the actual and projected deterioration in US fiscal positions might have contributed to the recent rise in bond yields, although part of the fiscal-policy-related increase may still be yet to come. There is also evidence that US-denominated shocks have a greater influence on bond yields in Europe and Japan than vice versa, raising the risk that bond markets might push interest rates in Europe above the levels that would be justified by domestic determinants. However, there are some reasons why interest rate transmission from the United States to Europe may be milder than in 1994. Finally, the paper discusses the implications of substantial fixed-income portfolio losses for exposed financial institutions, as well as corporate balance sheets.

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