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LESSONS FROM THE CRISIS: WILL THE CRISIS CHANGE BUDGETING?

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LESSONS FROM THE CRISIS: WILL THE CRISIS CHANGE BUDGETING?

By Allen Schick

The Great Recession has been an unplanned but important stress test of contemporary fiscal policy and financial management. Its destabilizing impact on public finance and devastating aftershocks have challenged OECD countries to reexamine settled doctrines and established practices. Regardless of their views on the causes of the crisis or of the remedies that should be applied, it behooves Member countries to objectively review recent financial history, both to avoid future policy missteps and to build sturdy fiscal and governmental institutions that can better withstand financial crises.

National budgets have been at the epicenter of the crisis and on the front lines of the recovery that is now underway. In the most heavily-impacted countries, budget surpluses or small, seemingly manageable, deficits rapidly mushroomed into large, destabilizing imbalances. Budget processes which not long ago focused on financing expenditure increments and program enhancements have been transformed into politically-difficult decisions on austerity and cutbacks. Debt burdens which once were mere after-effects of revenue and spending actions now narrow the budget's opportunities.

In OECD countries, contemporary budgets are not just bearers of bad fiscal news; they also are essential means for national governments to stabilize the economy and put public finance on a sustainable course. A country's post-crisis budget should be a process for translating lessons about what went wrong into policies and actions that restore confidence to capital and political markets, promote economic recovery, and finance public programs and social benefits.

This paper seeks to draw lessons from a crisis whose final chapters have not yet been written. It is presented with due regard for ongoing debates over the sturdiness of the EMU, austere budgets versus growth strategies for stabilizing distressed countries, and the effects of credit derivatives and other modern financial instruments on public finance. It may be premature for journalists to write the first draft of current budget history, let alone for scholars to tease conclusive findings out of the babble of clashing views about what went wrong and how to make things right. Nevertheless, political leaders and public managers cannot wait for history's verdict. They must act in the next budget that awaits them and in the budgets that follow.

The lessons discussed in this paper fall into two broad, overlapping categories: fiscal policy and budget management. Section 1 looks back at the crisis to identify markers that distinguish between fiscally strong and weak countries. Section 2 looks forward to consider how governments may avert future fiscal meltdowns by incorporating risk assessment and other early warning mechanisms into routine budget work, and by enforcing rules that constrain fiscal mischief. Section 3 reviews recent budget innovations to assess their effectiveness in averting or ameliorating fiscal collapse.

1. WHAT HAPPENED: CYCLICAL WEAKNESS OR FISCAL MISMANAGEMENT?

A useful starting point for deriving lessons from the Great Recession is to investigate how OECD countries fared before, during and after the crisis. If all experienced similar economic and fiscal stress, we would have justifiable basis to conclude that no country, regardless of its fiscal policies or economic position, was able to withstand global pressures that transcend national boundaries. The persuasive explanation would be that interlocked capital markets overwhelm national policies and destabilize the budgets of all countries, those with manageable pre-crisis deficits and debt burdens along with those with unsustainable imbalances. Arguably, the most economically developed countries in the world are tightly linked to international financial flows, and are now hostage to a global financial market that is beyond the effective control of national governments. Vast amounts of money migrate into and out of countries and to or away from financial institutions in response to the latest news or rumor, triggering wild fluctuations in sovereign bond yields and in the cost of financing public debt. Among advanced countries, the argument runs, euro zone countries are the most vulnerable to supra-national pressures because they share a common currency and cannot act independently when crisis strikes.

To make matters worse, a huge, weakly regulated market in swaps and derivatives has grown up, ostensibly to enable creditors to hedge against possible losses by purchasing insurance against default. In practice however, this market is dominated by speculators who neither hold nor issue debt but nevertheless are free to bet on the prospect of default. The effect has been to greatly magnify both the amount of money at risk and the contagion of default. A one billion euro bond might be exposed to ten or more times that amount if counterparts were compelled to indemnify losses arising out of default.

Cycles versus Crises. The term "Great Recession" denotes that the turmoil in public finance has not been due principally to cyclical weakness that robbed governments of tax revenue and unbalanced national budgets. Rather, a deeper, more pervasive malaise has spread fiscal havoc among a broad swath of countries, including those with sturdy fiscal constraints and prudent budget policies. Lesson 1 draws from OECD data to conclude that although most countries have experienced an ordinary recession, albeit one that has been more severe than most recent downturns, a few have suffered extraordinary shocks that differ from cyclical swings.

1. All Member countries have suffered significant deterioration in fiscal balances, but there has been enormous variation in the extent to which government budgets have been destabilized, ranging from mild, brief downturns in the least impacted countries to profound shocks in the most impacted.

Table 1, drawn from OECD's November 2011 *Economic Outlook* suggests that the "all in the boat together" argument has some validity, but does not explain wide disparities in the fiscal fortunes of member countries. On the one hand, no country escaped deterioration in its fiscal position during the 2008-2011 period, every OECD country experienced either a larger deficit or smaller surplus than it had in 2007, the last pre-crisis year. But there is a fundamental difference between Switzerland's slight 1.1 percentage points (relative to GDP) drop in its fiscal balance compared to declines in excess of 8 percentage points in the most distressed countries. (These amounts are relative to a single pre-crisis year, and measure the deterioration in the most distressed year; they are not averages of the 2008-2011 years). In almost half of the OECD countries the deterioration was less than 6 percentage points during this period, a decline that was due mostly to economic weakness and fiscal stimulus. The few outliers that have had oversized declines they have triggered anxiety of a financial tsunami that might damage the economies of fiscally-sturdy countries. Because of their special situation, the outliers are discussed separately later in this section.

Countries that entered the crisis with positive fiscal balances were not inoculated against crisis-induced deterioration. According to Table 1, half of the OECD countries had positive balances in 2007; yet they averaged almost a 10 percentage points drop in fiscal balance between that year and the trough year during crisis. However, excluding outliers (such as Iceland, Ireland and Spain) the average decline was a more modest 5 percentage points. Countries that entered the crisis in sound fiscal condition navigated the crisis more smoothly if they were not buffeted by shocks than those that entered with significant imbalances. The shocked countries underwent severe turbulence regardless of their pre-crisis condition.

2. The nominal pre-crisis fiscal position is an insufficient indicator of a country's vulnerability to crisis. To understand why the recession was so damaging, it is essential to examine pre-crisis conditions in terms of fiscal behavior during an extended period of economic vigor.

The fact that some countries (including the outliers) that appeared to be fiscally sound on the eve of the crisis were among the worst performers during the Great Recession suggests that the nominal fiscal position is not a sufficiently reliable measure. During boom times, fiscal outcomes may be distorted by asset bubbles that produce unsustainable increases in tax revenue, induce government to boost public spending, and generate pressure to increase pensions and other social benefit whose costs will be paid in future budgets. We will say more about asset bubbles later in this paper; for the present, it suffices to emphasize that countries and the international community need deeper insight into fiscal strength and vulnerability than is provided by a snapshot of a single year's nominal outturn.

The nominal balance is not only a measure of cash flows, but also is a proxy measure of underlying conditions. These conditions may be a legacy of debt that burdens future budgets, bubble-inflated revenue that produces ephemeral surpluses, rigid labor markets or regulatory policies that discourage investment, and much more. When a fiscal downturn mutates into a full-blown crisis that endangers the country's financial security, it is essential to probe the true import of financial balances.

A necessary step in assessing what went awry is to look at cyclically-adjusted data, that is, to assess fiscal outcomes through the performance of the economy, not just through the performance of the budget. Table 2 shows that the OECD community (as well as the euro area) enjoyed real GDP growth every year from 2000 through 2007. In five of those years, every Member country had positive growth; in the other years, 3 or fewer had negative growth.

The seeds of fiscal trouble were sown during those good times. Despite favorable conditions, in every one of these years at least half of the countries had cyclically-adjusted deficits. (Almost half of the countries regularly incurred nominal deficits during 2000-2007.). Moreover, both the OECD community as a whole and the euro area had total fiscal deficits every year during the 2000-2007 period. Evidently, many national governments distributed the dividends of economic growth through tax relief or program enhancements. They encountered only weak constraints on deficits because fiscal rules did not distinguish between the growth and contraction phases of economic cycles. This defect provided an open invitation for governments to incur deficits when the economy was strong.

Pre-crisis harbingers. In 2007, the year that signs of dire crisis emerged in the United States before spreading to other countries, every OECD Member had positive GDP growth, which averaged 3 percent across the community the median growth rate was 4 percent, and soared above 5 percent in a dozen countries. This favorable performance followed a decade of uninterrupted growth in almost all OECD countries, and gave rise to the notion that national governments now had the tools and know how to sustain economic expansion, and therefore no longer need to be concerned about cyclical downturns. Economic euphoria was the order of the day, and was reinforced by a global capital glut that enabled low-cost financing of public debt. By 2007, the last OECD-wide recession had been more than a decade earlier, a long-enough stretch to forget or ignore the damaging impact of even mild economic contraction on public

budgets. Due to the lack of effective political, legal or market constraints, vote-seeking politicians had a clear path to approve budget deficits that might have been appropriate when the economy was weak but had little justification for an economy that had gone through a protracted growth spell.

Table 3 details this story in terms of cyclically-adjusted fiscal imbalances among OECD countries. These totaled -2.6 percent of GDP in 2007, only slightly below the 3 percent limit permitted by the Stability and Growth Pact for euro zone countries. The sudden end to the long growth spurt spawned cyclically-adjusted deficits that exceeded 4 percent of GDP in 2008 and 7 percent the next year. As evidenced by these data, it is almost always the case that a country which runs up deficits during boom years will have significant larger deficits when growth stalls.

3. Fiscal discipline must be maintained during growth periods in order for governments to avoid crisis when the economy weakens.

This is not a new lesson, but it is one that is hard to learn and even harder to apply, especially when interest rates are low and capital markets eagerly finance the rising stock of public debt. During the pre-crisis decade, the once generally-accepted notion that government debt drives up interest rates and crowds out private investment when aggregate demand is strong was discredited by the easy money available to finance public ambitions. It took a crisis to remind political leaders and economic advisors of the necessity for fiscal prudence during buoyant periods. In the absence of effective constraints on fiscal behavior during favorable times, this lesson will probably again be forgotten when economic prospects brighten.

It should not be, for the fiscal missteps of the good times contributed to turning what might otherwise have been a conventional downturn into the Great Recession. Why has the fall been deeper than in other recent recessions, and what has been so remarkably different about it that despite economic stagnation, so many governments have announced plans for fiscal consolidation rather than fiscal stimulus? True, during the early stages of the crisis, most OECD governments responded to recession by allowing automatic stabilizers to pump up demand. Many also took discretionary actions that increased public consumption and investment, or gave temporary tax relief to employers or workers. These policy interventions generally had salutary effect, as evidenced by the resumption of growth in all but a few member countries in 2010. However, growth has been rather tepid, averaging barely 3 percent of GDP that year and less than 2 percent the next. Apparently, this has been a recovery that ran out of steam not long after it got underway. Moreover, unemployment rates, which are a politically-sensitive barometer of economic wellbeing, have continued to trend upward. Although there is reason to expect recovery to resume this year (2012) and to be more sustained than was the case a few years ago, this recession and its aftermath have been different.

These differences have several interlocked characteristics that include elevated debt burdens, the fragile condition of major private financial institutions, the risk of contagion from "shocked" countries, and the growing pains of the European Monetary Union. Even though a final rendering has not yet been made of these causes, each holds lessons for avoiding or mitigating future crises.

4. Elevated public debt ratios should alert governments to the possibility of future fiscal distress.

During the pre-crisis years, many OECD governments exhibited concern about public debt burdens, principally in terms of the long-term demands (30 or more ahead) of ageing populations and rising health and pension costs on national budgets. Although the focus was on future sustainability, current debt levels also drew attention. The Stability and Growth Pact set a 60 percent of GDP ceiling on EU country debt burdens, but enforcement was weak. On the eve of crisis in 2007, general government gross public debt in

the euro area amounted to 66 percent of GDP, with 2 countries above the 100 percent mark and 5 in breach of the SGP limit. What is remarkable about these levels is that they were so high after a decade of sustained economic growth. During the growth years, there was only a slight dip in aggregate debt levels in the euro zone – from 69 percent of GDP at the start of the millennium to 66 percent seven years later.

Table 4 reveals that gross financial liabilities of the entire OECD community rose from 70 percent of GDP in 2000 to 73 percent in 2007. There was, however, wide variation among member countries; ten had 2007 debt levels below 40 percent and 8 were above 70 percent of GDP. It is likely that pre-crisis debt levels influenced subsequent fiscal outcomes. The least indebted countries averaged financial imbalances of 4 percent of GDP during 2008-2011; the most indebted averaged imbalances of 5.4 percent. Excluding Ireland, whose gross public debt ballooned from less than 30 percent of GDP in 2007 to more than 110 percent four years later, the least indebted countries averaged imbalances only 27 percent during the crisis years, exactly half the amounts of the most indebted countries.

Recent research by Reinhard and Rogoff on centuries of financial crisis suggests that a country's economic potential is significantly diminished when its public debt exceeds 90 percent of GDP. Judging from the recent economic performance of the member countries that have reached or are close to this tipping point, it appears that other factors such as the structure of the economy and political arrangements, influence a country's capacity to service its debt. Although an elevated debt load might not do immediate damage, it can signal trouble ahead. Gross financial liabilities of OECD Members have jumped 30 percentage points since 2007, and now total 100 percent of GDP. The obvious lesson is that a country which does not reduce its debt during favorable periods risks having dangerously high burdens when the economy weakens.

It will require sustained political will and fiscal discipline for heavily burdened countries to pare public debt down to manageable size. Some governments will have to resist the tendency to relax discipline when economic and budget conditions improve, and may have to maintain an austere fiscal policy even when the economy stagnates. Beyond these medium-term concerns, financing future pension and health obligations will challenge most countries, and may be an impossible mission for those which already have excessive debt levels. The crisis and its legacy of debt will almost certainly motivate many member countries to review long-term commitments and take decisions that were virtually unthinkable a few decades ago.

During the good years, many countries rolled over a large volume of sovereign debt each year, and floated additional debt to cover fiscal shortfalls. This was a low-cost, low-risk strategy for governments as long as lenders were willing to go along with it. Despite low sovereign bond yields, lenders were eager to acquire sovereign debt because they could ensure repayment by purchasing credit default swaps, and were sedated by the decade-long expansion to believe that defaults do not occur. They also were calmed by the strong expectation that countries using a common currency would whole-heartedly come to the rescue if any euro zone country was in distress.

In retrospect, we know that things have not worked out this way. The borrowing window was narrowed for a few countries, and cost of financing their debt soared. Greece, Iceland, Ireland, Portugal, and Spain have been the most impacted countries; all have been compelled by financial realpolitik to take strong action to curtail fiscal deficits. Their 2007 fiscal position was an unreliable harbinger of the crisis-induced troubles they would soon face. Three (Iceland, Ireland and Spain) had positive fiscal balances, one (Portugal) had a modest imbalance (3.2 percent), and only Greece had a large (6.8%) financing gap.

5. Governments and supranational institutions require additional measures of a country's economic condition, and of its capacity to adjust to fiscal and other shocks.

Evidently, governments must supplement the standard fiscal metrics with other official and unofficial measures that portray a country's economic strengths and vulnerabilities, and its capacity to respond to

profound shocks. Governments and other entities have vast amounts of data at their disposal pertaining to each country's economic competitiveness on various quantitative scales.

The current account is a useful starting point for assessing each country's economic standing relative to other countries. Prior to the crisis, the current account revealed large deficits in four of the countries: Greece, Iceland, Portugal and Spain had double digit current account deficits. Estonia was the only other OECD country to have a current account deficit at this level, but it acted with alacrity and turned a 16 percent deficit in 2007 into a 3.7 percent surplus only two years later. In some instances, the current account can be a misleading indicator, even in tandem with standard fiscal measures. The United States has incurred large fiscal and current account imbalances over an extended period, but interest rates have been low and the federal government has easily financed its vast stock of debt. Of course, the dollar's status as the reserve currency has shielded the country against short-run costs of economic mismanagement. Australia is another country with persistent current account deficits, but, it has benefited from a protracted boom in commodity prices, as well as from its strong fiscal condition.

The point is that the current account, like the fiscal aggregates, cannot be assessed independently of other indicators of a country's economic health, particularly those pertaining to its labor market, regulatory policies, and competitiveness.

Some of these characteristics have been distilled into comparative rankings such as the World Bank's "Ease of Doing Business" index, the Global Entrepreneurship Monitor, and the Global Competitiveness Index. Viewed together, the various indices and standard economic indicators provide insights into each country's economic resiliency.

At the end of the day, what matters most in determining a country's capacity to carry debt is the willingness of financial institutions to provide money. For them, the current account and other indicators are pieces of an interlocking puzzle that includes the fiscal situation, debt levels, political risks, and the cost of purchasing credit insurance. When other vital signs are favorable, a fiscal or current account deficit probably will not deter financial institutions from purchasing sovereign debt. But a country that has multiple risks may have difficulty attracting lenders when it is in dire need of financial support.

Financial instability. The Great Recession started as a financial crisis that halted a long expansion and ended as a severe recession with declining output, rising unemployment, and fiscal shortfalls. This is the usual trajectory of financial crises, but it greatly complicates policy responses by governments and other authoritative entities. The textbook formula for recovery from recession is to stimulate demand by allowing automatic stabilizers to enlarge the fiscal deficit, and often , to also adopt temporary tax cuts and spending increases. Early governmental responses hewed to this approach, but as the crisis deepened and concern shifted from high unemployment to the risk of sovereign default, international and regional institutions demanded austere budget policies in the most impacted countries as a condition of aid. In effect, the financial crisis took priority over economic crisis, with the fiscal deficit the link between the two.

6. A financial crisis takes more time and resources to resolve than a conventional recession and may entail different policies and remedies.

Viewed from the perspective of recession, giving primacy to fiscal stability may have been untimely; from the vantage point of financial crisis, it may have been necessary. When recession drains a country of demand and households of income, the standard solution is stimulus, often through a combination of tax reduction and expenditure increase. The deficit rises, but if the remedy works, the economy bounces back. When a financial crisis drains a country and its key financial institution of confidence and willingness to take risk, adding to the deficit may exacerbate and prolong financial instability. Furthermore, it takes much longer to restore confidence than demand, especially when deleveraging becomes the order of the day,

lenders become risk-averse, and credit becomes scarce. Reinhart and Rogoff have found that it usually takes years to wash away the after-effects of a financial crisis. Arguably, therefore, treating a financial crisis as a recession may delay recovery and put financial institutions at greater risk.

How government responds to crisis may depend on the mobility of capital, that is, on whether money flows to or flees from an economically-distressed country. During the crisis, the United States and Greece have been near the opposite ends of this spectrum. The US has benefited from a large inflow of money, with external investors purchasing treasuries and driving down interest rates; Greece, by contrast, has witnessed a large outflow of cash and credit, very high interest rates and extreme difficulty in financing its sovereign debt. This difference in cash flows and credit availability has frequently disadvantaged lower-income countries during recession. With cash and credit scarce, when faced with fiscal imbalances these countries must tighten their belts, often at the cost of deepening social misery, while more affluent countries can adopt stimulative policies that add to the fiscal deficit but accelerate recovery. In recent decades, the harsh effects of this double standard have been experienced by countries in other continents; now they have spread to Europe. Although the different fiscal fates of countries lie principally in the actions of capital markets, international institutions should not be blind to the perception that the richer countries are disadvantaging less fortunate countries.

Regional and international authorities can draw some lessons from the recent crisis to facilitate recovery and reduce misery. Perhaps the least contestable is that when the onset of a crisis is more financial than fiscal, bold measures that are rapidly applied may reduce the risk of collapse and contagion. In different ways, the United States and Ireland acted boldly to put the financial crisis behind them. Almost immediately after the collapse of Lehman Brothers, the US speedily established a \$700 billion relief program that provided more money than financial institutions (and certain enterprises) may have needed, but certainly much less than would have been required if political leaders had not acted decisively. When its large banks became illiquid, Ireland opted to cover all bank losses before it knew the magnitude of the obligations it was taking. The actual cost proved to be significantly higher than expected when political leaders acted, but Ireland may soon regain access to capital markets. Both countries are now on the way to recovery, although both have suffered residual effects that still overhang the economy and capital markets.

The response to crisis in some other countries has been to do as little as possible, in the hope that conditions would improve without having affected governments taking forceful action. When recovery did not ensue, regional and international institutions had to significantly boost assistance. Of course, there are significant differences between a country that acts unilaterally to aright its finances and one that must reach out for external aid. But the lesson that delay and minimalism do not promote recovery applies to a broad swath of situations.

7. Shocks differ from recessions in severity and impact, and have characteristics that are distinctive to each affected country.

The Great Recession brought not only a rapid deterioration in economic wellbeing, but collapse of financial institutions and a rise in deficits and unemployment that greatly exceeded the decline in output. Admittedly, the line between ordinary recessions and shocks is arbitrary, but there should be no difficulty distinguishing between countries that have had mild downturns and those whose financial institutions have been at grave risk of collapse. For example, there are vast differences in the dislocations experienced by countries such as Luxembourg, Norway and Sweden, and those suffered by Greece, Iceland and Spain. The two sets of countries have had quite different declines in output and increases in unemployment and fiscal imbalances. In addition to differences in economic troughs, shocks tend to have lasting effects, such as retarded recovery, persistently wide gaps between potential and actual GDP, and chronic unemployment.

The countries identified here as having experienced shocks differ significantly in both the conditions that triggered dislocation and in the actions taken by government. The shocks to Ireland and Iceland were generated by collapse of national financial institutions. Ireland covered bank losses, Iceland did not. Banks have withstood the crisis in Spain and Portugal, though both countries have had sharp spikes in interest rates on sovereign debt. Greece has been a special case in terms of its incapacity to act decisively early in the crisis and its dependence on massive external aid.

Stabilizing public finance. Our aim in calling attention to distinctive characteristics of shocks is to emphasize that retrenchment and recovery need to be combined in order for the country to put the crisis behind it. In different ways, Iceland and Ireland appear to have done that by resolving bank crises and adopting austere budgets. But the resumption of economic growth is essential, in order to sustain political will and legitimacy, and to stabilize the country's finances. It is exceedingly difficult for any country to comply with preset deficit and debt limits when output and tax receipts are falling while unemployment and social unrest are rising.

8. *Austerity does not suffice to stabilize public finance when output is falling and budget deficits are rising. Ideally, growth-generating initiatives should be coupled with fiscal consolidation.*

A difficult issue for policymakers is when and how to shift from austerity to growth. Arguably, the more forcefully government acts early in the crisis, the faster it will be able to consider growth-oriented budget policies. For good reason, it may be easier to switch to a growth strategy when a country has sturdy budget institutions, reliable financial management practices, and political support for fiscal prudence. When these basic conditions are lacking, austerity programs may fail to reduce deficits and debt to manageable levels, and growth will likely be delayed.

The textbook remedy for stimulating growth in a country that has depressed output and fiscal deficits is to combine temporary stimulus with longer term structural reform. Because it is temporary, the stimulus does not add to structural imbalances, but would quickly boost economic activity; and because structural reforms would take effect only when cyclical improvement is already underway, they would not dampen short-term economic performance. In fact, this remedy was applied by Member countries during the early stages of the crisis, but as economic growth resumed in most countries and financial risks escalated in a few others, it was displaced by calls for fiscal consolidation. Twenty nine countries experienced GDP decline in 2009, 30 countries grew the next year and approximately the same number in 2011. However, recovery brought only modest improvement in fiscal posture. Twenty two countries had financial imbalances in excess of 3 percent of GDP in 2010 and an estimated 22 countries in 2011. With the prospect of increased budget pressure as their population ages, many OECD countries now regard fiscal consolidation as necessary to avert future trouble.

At the same time that many countries were recovering, the small number that did not required massive amounts of aid to stabilize their fragile financial systems. It is not hard to understand why countries that were disciplining their own finances expected highly-troubled countries to embrace fiscal austerity. The fiscally stronger countries that have been called upon to bolster fragile economies generally have adopted the view that austerity is an essential remedy for countries with oversized deficits that will persist at elevated levels long after recovery has commenced. Although those providing assistance have not been indifferent to the plight of those who lost jobs, homes and hope, they sometimes give the appearance that they are. In their view, the best – possibly the only – way to help those whose economic wellbeing and social status has been severely damaged by the Great Recession is to take tough measures needed to restore confidence in the country's financial system.

To be sure, policies with respect to aiding distressed countries have been influenced by political and other considerations, as well as the conviction that in some countries the problems have been due to fiscal mismanagement, bloated public expenditure, and inadequate tax mobilization, along with rigid labor markets and regulatory policies that put them at a competitive disadvantage. Pressuring beleaguered national governments to face fiscal and economic realities have been deemed a basic precondition to get them to take necessary decisions.

Ideally, fiscal consolidation would be coupled with measures to protect vulnerable populations and ease adjustment for those severely affected by adverse economic conditions and tough fiscal actions. Although the money required to finance such measures would diminish the potency of consolidation, neither governments nor the international community can be blind to the social costs of fiscal rehabilitation. The health of a country rests not only on its financial books, but also on the wellbeing of its citizens and the legitimacy of its political and policy institutions.

Europe as a special case. The great success of the euro in establishing a common currency has brought enormous economic and social benefits to EMU countries. This accomplishment has occurred despite the weak coordination of fiscal policy. Prior to the crisis, fiscal integration was sought through the Stability and Growth Pact (SGP) which set limits on annual budget deficits and aggregate debt. However, inadequate enforcement and frequent breaches impaired SGP's effectiveness, and EU is now in the process of replacing it with a sturdier fiscal compact. (Fiscal rules are examined in the next section.) This is not the place for assessing EU's fiscal arrangements, but it is the place for inquiring how the common currency may have affected the crisis.

9. The incompleteness of Europe's fiscal arrangements has increased the risk of contagion and impeded response to crisis.

When crisis strikes, effective policy response can come either from the impacted countries or from supranational authorities. Both had their hands tied in the euro zone, countries because they could not take independent action, supranational authorities because they lacked fluid policy processes and sufficient monitoring and enforcement capacity.

A country that exercises full sovereignty over monetary policy can seek to stabilize the economy by devaluing its currency or by restructuring its debt. There are, to be sure, significant costs and risks to both approaches, including higher inflation and impaired access to capital markets. Moreover, there is no assurance that once it has taken these measures, the country will act decisively to address economic shortcomings and right its fiscal position. A country that is inefficient and uncompetitive, and is weighted down by a bloated public sector and unaffordable social commitments may lack the political capacity to reform labor market policy and to rein in public sector profligacy after it has devalued and restructured. However, as demonstrated by recent events, there are countries that have the political will to act on their own, but their initiatives may be blunted or delayed by dependence on EMU institutions.

Supranational action through EU institutions is the necessary alternative to each country acting alone. Before the crisis, these institutions were not sufficiently developed to monitor compliance, or once the crisis took hold, to rapidly take corrective action. The EU has recognized these shortcomings and is moving forward through a new fiscal compact and financial facility to strengthen fiscal integration and its response to crisis. It is likely that additional measures will be forthcoming in the years ahead.

Has the crisis vitiated social protections financed by the state? Some politicians and observers have argued that the crisis proves that national governments must roll back expensive social benefits, especially for pensions and health care. They believe that an ordinary recession was transformed into a deep crisis partly because over-extended national governments could no longer afford the entitlements they had

established. Many countries have already curtailed benefits, in some cases to ease short-term budget strains, in most to correct structural imbalances that will not vanish when the crisis abates.

10. The size of government (expenditure as a share of GDP) and the scale of social benefits do not account for the severity of the crisis. What matters is the willingness and capacity of government to finance entitlements with current revenue.

The key issue is not how much a country spends on welfare benefits, but whether citizens who receive benefits are willing to pay the taxes required to finance them. Northern European countries generally came through the crisis in good fiscal condition, while some countries with relatively small expenditure footprints fared much worse. The key difference has not been the government's largess but whether governments have the political strength to tax citizens for the generous social benefits they receive, and to adjust entitlement formulas when necessary to keep them on a sustainable path. In fact, some countries with very large public expenditures exceeding or nearing 50 percent of GDP took decisive action before the crisis to assure the sustainability of inter-generational financial obligations. They acted not to shrink the welfare state, but to safeguard its future.

The crisis was not triggered by concern that governments cannot afford long-run financial commitments for pensions and health care that will come due 30-50 years from now. It was caused by the prospective inability of some countries to finance current obligations by floating or rolling over debt. However, the crisis has aggravated long-term fiscal gaps by lowering growth and revenue trends, and it has spurred governments to take actions that ease current budget stress and projected future payouts.

The welfare state model that has been called into question does depend on robust growth that is sustained over an extended period, as well as a tax system that mobilizes sufficient revenue to maintain solvency. Both are essential: growth cannot by itself correct structural imbalances in costly entitlement programs; and levying additional taxes cannot fully compensate for sluggish growth.

2. CAN THE NEXT GREAT RECESSION BE AVERTED?

The foregoing retrospective provides a fundamental lesson for averting or cushioning future fiscal shocks. Their behavior in good times is the main variable in determining how governments weather the bad times. Sound fiscal management goes well beyond maintaining budget balance and stable or declining debt levels when the economy is strong. It also means stress testing fiscal projections to gauge how they would be affected by economic downturns, full accounting of the risks held by government and prudence in taking on new risks, guarding against bubbles that distort revenues and fiscal outcomes, exercising due diligence before locking the country into long-lasting expenditure commitments, and establishing and enforcing rule-based barriers to fiscal misbehavior.

Designing and implementing sturdy fiscal rules. The only way for government to maintain a positive financial balance over the course of an economic cycle is to accumulate surpluses when the economy is strong by foregoing popular spending increases or tax cuts. When surplus funds are available, the natural instinct of politicians is to reward voters by expanding programs and lowering taxes. Doing so will likely deplete the surplus, and add to the deficit when the cycle turns and conditions become less favorable. Fiscal rules aim to alter this pattern by making it easier for politicians to pursue prudent policies and constraining them when they don't.

11. Fiscal rules must constrain revenue and spending decisions when the economy is buoyant; if they don't, the rules will not be enforceable when growth slows or disappears.

During the past two decades, fiscal rules generally have been both popular and ineffective. Before the crisis, many countries adopted formal limits on deficits, debt, aggregate expenditures, or some other fiscal variable, but few were genuinely constrained. Lax rules tied to nominal outcomes permitted deficits in good times, and lax enforcement permitted breaches in bad times. Governments spent the dividends of economic growth when resources were plentiful, and they spent to stimulate the economy when resources were scarce.

In line with the argument made earlier that the seeds of fiscal distress were planted when the economy was vigorous, rules can be effective only to the extent they counter the inclination to dissipate surpluses. Maintaining a surplus in good times can be abetted through several devices: a structural formula that determines the appropriate surplus; an expenditure rule that limits spending increases to trend GDP or another measure of economic vitality; a formula for reducing public debt; a reserve fund that holds surplus fund and acts as a countercyclical stabilizer. Combining these devices into a strong fiscal regime is likely to be more effective than a standalone rule that merely sets an upper limit on deficits or debt.

A robust fiscal rule should have several features that were generally absent in the pre-crisis periods. They should target structural outcomes as well as spending aggregates and fiscal balances, have strong enforcement arrangements, and have a medium-term horizon.

It is not necessary to repeat the argument made earlier that rules which constrain nominal balances are doomed to fail. They provide too much slack when the economy is strong and not enough when the economy is weak, and they inevitably yield to political and economic reality when growth stalls and built-in stabilizers push the deficit above permitted levels. EU's new fiscal compact is well-intentioned, but the maneuvers by economically-distressed countries to stretch their allowable deficits speak to the futility of fixed constraints that are blind to cyclical disturbances. While structural rules appear to be more permissive when the economy stagnates, they definitely have more bite when the economy booms. Rather than settle for nominal balance, a rule that is sensitive to changes in economic conditions can demand that

government accumulate surpluses and pare debt level during boom times. Such a rule can be strengthened by attaching an expenditure rule that limits real or relative (to GDP) expenditure increases.

Standard rules have a one-year time span that corresponds to the fiscal calendar, and can thereby be closely coordinated with the budget cycle. However, in maintaining fiscal discipline, the economic cycle is as important as the budget cycle because it spans risks due to both expansion and contraction. The expansionary risk is that government will launch initiatives whose costs will fall principally on future budgets. The contractionary risk is that governments will run current deficits without planning to eliminate the imbalances when the economy recovers. Thus, the short time frame encourages tactics that shift expenditure and deficit increases to future years, and discourages a longer-term view of fiscal trends and budget pressures.

Ideally, a fiscal rule should be embedded in a medium-term expenditure (or fiscal) framework that establishes budget policy for the next 3-5 years. It must be noted, however, that medium-term policies are only provisional and often are revised when political or economic conditions change.

Whatever its time frame, a fiscal rule is effective only to the extent it is enforced. Inadequate enforcement was one of the weakest features of fiscal rules before the crisis. Enforcement is not just a matter of sanctioning countries that breach the rules, but entails will and capacity to review the assumptions and estimates on which the budget is based, to guard against bookkeeping tactics that distort the budget's true position, to monitor outcomes throughout the fiscal year, and to intervene with corrective action when appropriate. In the first instance, these responsibilities should be entrusted to political leaders in the affected country who are committed to keep within preset fiscal parameters. Without commitment, fiscal rules are hollow gestures; with them, even permissive rules, such as those established through fiscal responsibility processes, can cushion countries against destabilizing crises.

Accounting for and controlling fiscal risks. All national governments hold fiscal risks that are not accounted for in official budget (or financial) statements, but have a significant bearing on how countries are affected by economic downturns and financial crises. Some of the countries most heavily impacted by the Great Recession had large off budget and off balance sheet contingent or implicit liabilities, such as guarantees for bank deposits and home mortgages that came due when financial institutions collapsed or were near insolvency. Managing risks before crisis strikes can reduce the government's exposure, but doing so requires changes in regulatory policies as well as new accounting and budget instruments.

It is useful to distinguish three types of risks to the government's fiscal position. One arises out of the inherent uncertainty about future revenues and (to a lesser degree) expenditures that are dependent on the performance of the economy and on other unknowns such as natural disasters; another derives from contingent liabilities that may require future payouts if certain events (such as default) occur; and the third is rooted in financial support provided by governments through open-ended entitlement schemes. The first type inheres in the fact that government has imperfect knowledge when it prepares a budget for the next year; the second and third result from policies taken by government. The first type of risk can be mitigated by basing the budget on prudent economic and related assumptions;; the second and third can be reduced by caution in taking on obligations that have low short-term but potentially high long-term costs.

12. The onset of fiscal crisis is characterized by wide variances between budgeted and actual fiscal outcomes. It would be useful to strengthen early-warning systems that alert government to variances between planned and actual revenues and expenditures.

Every country experiences variances between budgeted and actual revenues and expenditures. In advanced countries, these variances generally are small during stable times, but can be very large when the economy veers off its projected course, especially when destabilizing events make it difficult to foresee how the

economy will perform. Although there have been instances when governments have intentionally based the budget on unduly buoyant assumptions, the much more prevalent problem occurs when well-grounded revenue and expenditure projections are rendered erroneous by economic realities.

This type of fiscal risk occurs both when the economy over-performs and underperforms, when revenues come in above budget and below. An unbudgeted surge in revenues is typical during bubbles, and can spur governments to euphorically expand programs that will require large future expenditures, and to take on new contingent liabilities in the expectation that it will never be called upon to make good on its commitments. A shortfall in revenue can undermine confidence in the government, boost borrowing costs, and compel it to remake the budget during the fiscal year.

There is no sure antidote to every budget's uncertain fiscal results. A few countries have established independent fiscal offices to produce economic assumptions or to review those issued by the government. It is good practice for governments to be transparent about the key assumptions on which the budget is based, and to explain the risks to projected revenues and expenditures. It also is good practice to closely monitor revenue and spending outturns during the year, though it does not necessarily follow that the government should revise the budget when revenues or expenditure deviate from projections. It may be better to allow automatic stabilizers to take effect than to amend budget allocations and take away money previously promised to spending units.

Supranational institutions have become active in monitoring government budgets and urging corrective action. Regional and international organizations openly examine risks to country budgets – EU in its ongoing reviews of member country finances, OECD in country economic surveys, IMF in Article 4 consultations and other interactions with countries, and the World Bank in public expenditure reviews. However, these useful activities do not substitute for prudent, responsible budgets.

The second type of risk are contingent liabilities that expose the government to potential future payments. These liabilities usually are incurred outside the budget process through legislative or administrative actions that protect risk-takers against possible future losses, or other adverse events. Although budget considerations may be neglected when the government tenders guarantees, the budget has to account for outlays deriving from guarantees. It also has to account for payments made for implicit obligations, when the government indemnifies losses even though it is not legally required to do so.

13. Fiscal crises intensify when the government is exposed to large risks taken when the economy is strong but compel payouts when the economy weakens. Future crises may be mitigated by exercising due diligence before assuming risks, being transparent about potential costs, and avoiding actions that increase moral hazard.

Contemporary governments have become the risk holders for society, protecting citizens against a vast portfolio of cradle-to-grave risks, including illness, unemployment, old-age, home loans and other forms of credit, manmade and natural disasters, environmental degradation, declining commodity prices and deteriorating terms of trade, and much more. The shift of risk to the state has brought enormous benefits, including greater willingness of enterprises to take risks and of financial institutions to devise new credit instruments. Economic stability and widespread affluence have ensued from the pooling of risk in public hands, and from the willingness of government to be the shock absorber for households and enterprises.

The financial crisis has taught an obvious lesson that is often ignored: risks taken in good times come due in bad times. When things are going well, governments become blinded to the simple fact that all risks have costs. If they didn't, there would be no incentive to shift costs from households and other actors to government.

In other words, risk shifting really is a form of cost shifting and should be treated as such when government takes financial responsibility for contingencies. Ideally, it should expense projected costs in the budget, accounting for them as current expenditures that are included in fiscal totals, and are subject to fiscal rules and other constraints. The United States expenses the discounted costs guaranteed loans in the budget, but it does not expense insurance programs and other contingent liabilities.

Recognizing contingent liabilities as costs would likely spur increased caution *before* assuming these obligations. However, prudence in issuing explicit contingent liabilities would have done little to mitigate the Great Recession. Far greater fiscal damage was done by obligations assumed by governments *after* economic conditions had deteriorated. That is, by financial commitments made after banks and other financial institutions had collapsed or were at risk of insolvency. These generally were implicit liabilities for which governments had no legal obligation, but were motivated to act by fear that failure to do so would trigger economic ruin.

Taking responsibility for implicit liabilities can have a mammoth impact on the government's fiscal position when the risks are highly concentrated in a few financial institutions. This was Ireland's fate when it opted to underwrite bank losses, and to a lesser degree that of the United Kingdom and the United States. In the aftermath of crisis, at-risk governments have realized that rather than being "too big to fail", very large financial institutions may be "too big to save". If this is so, it behooves governments to de-concentrate risk by breaking the largest banks into smaller institutions, and by deterring them from taking actions that greatly increase the risk to government. Risk mitigation may include separating banking from investment, boosting minimum capital requirements, changing pay incentives for risk-takers, and stricter regulation of bank activities.

The third category of risk is embedded in open-ended obligations for social security, unemployment benefits, medical care, and various income support programs. These obligations typically are prescribed in permanent legislation, and the budget accommodates their estimated cost each year. Unless it modifies underlying legislation, the government must bear these costs each year regardless of its fiscal condition or other demands on the budget. Before the Great Recession, the projected ageing of populations stirred concern that OECD countries cannot afford their long-term commitments. The crisis and lower growth trends shortened the time frame for remedial action because they put government at risk of having to make higher payments at the time that financial resources were stagnant or shrinking.

14. *Governments should exercise due diligence before taking on income-support risks by testing whether they can be sustained under adverse long-term scenarios, and they should act to adjust existing commitments before crisis strikes.*

The Great Recession and ageing populations have induced some countries to return a portion of the income-support risks they hold back to households. This is a truly historic shift that has yet to run its full course. For more than a century, governments in OECD countries expanded their portfolio of risks, assuming that they would finance escalating costs with the dividends of economic growth. Slower growth in most OECD countries (decline in a few), lengthened life expectancies, and rising medical costs have induced national governments to modestly shrink the footprint of the welfare state. However, the bulk of income-support risks still are held by the state, if only because efforts to roll them back usually generate strong political protest.

Asset bubbles. Like other financial crises that have occurred over the centuries, the Great Recession was preceded by a bubble economy, which drove up the prices of certain assets, gave risk takers a false sense of security and wellbeing, greatly augmented government revenue and (in some countries) expenditures, spurred households, enterprises and governments to take on more debt, and jeopardized financial institutions when asset prices declined. The pre-crisis bubble spawned careless risk taking, overleveraging,

and short-term misbehavior that provoked the crisis in some countries and aggravated it in others. In the United States and some EU countries, bubble-induced risk was centered in home financing; easy money and the misguided conviction that home prices will continue to rise spurred purchasers and lenders to disregard telltale signs of trouble ahead.

One problem with bubbles is that it can be difficult to detect them while they are underway. Not every run-up in asset prices is the result of irrational exuberance, and not every steep rise is followed by collapse. Another is that it is exceedingly difficult for democratically-elected leaders to try to burst them through cautionary policies that slow economic growth and depress asset prices. Bubble-suppressing policies turn winners into losers, reduce output, add to unemployment and give rise to protests that the government has mismanaged the economy. Central bankers who are supposed to be insulated from political pressures may hesitate to take decisive anti-bubble actions, especially when the economy is operating below potential.

15. Governments and international organizations should develop early warning indicators of excessive asset price appreciation, along with policies that shelter the budget from bubble-generated distortions in revenues and expenditures.

Bubbles usually emit mixed signals and stir controversy over the causes and sustainability of asset appreciation, and the appropriateness of corrective action. (Almost four centuries after *tulip mania* wracked the Dutch economy, some insist that the very high tulip prices were rational, not a speculative binge). To cut through the babble of conflicting arguments, governments would benefit from indicators that alert them to whether inflated prices may be due to unfettered speculation. To be indicators must identify the assets that have experienced greatest appreciation, and must be alert to shifts in the assets or sectors subject to speculation.

Because home prices have been at the center of financial turmoil in various OECD countries, it is sensible to use them as a test case of the feasibility of devising indicators that warn governments of undue speculation. OECD routinely publishes relevant data on changes in house prices, and price-to-rent and price-to-income ratios. Data distilled in Table 5 do show price distortions in some heavily impacted countries, but the pattern is not sufficiently unambiguous to permit firm conclusions. The rise in home prices and decline in relative rental costs have occurred in countries (such as Australia) that have not gone through boom-to-bust bubbles. Ideally, housing indicators should be supplemented with other measures, such as the percentage of homes purchased by investors rather than by residents, the percentage of capital flowing into the housing sector, the volume of housing debt, the quality of this debt, the percentage of housing purchases financed by debt, and the percent of bank financial assets in the housing sector. These indicators illustrate my main point: it is feasible to construct indicators, focused around the volume and quality of debt, that sensitize government to danger signs.

Home financing was the past decade's bubbled asset; some other sector might be the next decade's fancy. For this and other reasons, the concentration of assets held by financial institutions may be a better indicator of risk than sector-specific data. Of course, financial stability may be as much at risk when institutions hold a diverse portfolio of risky assets as when their assets are over-weighted in a single sector or class of assets.

National governments usually experience surge in revenues when bubble-behavior inflates asset prices. Whether due to rising incomes or rising consumption, the revenue surge is likely to alter both short and long-term budget policy. For the current or forthcoming fiscal year, government will be inclined to pursue procyclical policies that cut taxes and boost spending, and may put upward pressure on asset prices. Government may also be inclined to enhance transfer programs that add little expenditure in the period immediately ahead, but have large long-term budget impacts.

It is difficult, but not impossible, to wall off the budget from adverse effects of price surges. Chile has had considerable success diverting excess copper revenue into a reserve fund; this model can be adapted to revenues that deviate from trend or derive from a particular class of assets. However, it is hard to lock away revenue when the economy is undergoing a bubble but the government is nevertheless running a budget deficit.

The greater impact of bubbles occurs when they burst, financial institutions are at risk, the economy suffers a hard landing, revenues decline, and the budget deficit soars. As discussed earlier, this situation calls for stimulus, but the shaky financial predicament may demand austerity. Recent experience reminds us that the best – perhaps the only effective – way to dampen bubbles is to enforce prudential regulation of banks and other financial institutions that block overleveraging and reckless risk-taking. The bubble that does not occur does least damage to the budget.

3. BUDGETING IN THE SHADOW OF THE GREAT RECESSION

During the decades preceding the Great Recession, many OECD countries modernized their budget processes by adopting rules that constrain key fiscal aggregates, along with medium-term frameworks that extend the budget's horizon 3-5 years ahead and performance budgets that purport to base spending decisions on actual or expected program results. Through program and impact evaluations, accrual-based accounts, output and outcome indicators, medium-term and long range fiscal projections government greatly enriched the quality and quantity of information available to policy makers and program managers.

Evidently, recent innovations have not averted fiscal crisis and breakdown of orderly budget procedures in heavily- impacted countries. In the face of economic contraction and financial trouble, many countries have disregarded medium-term plans, discarded previously-approved annual budgets, and sought to stabilize public finance by rushing crisis packages to adoption. Fiscal rules have been breached in many countries by actual or projected deficits and debt levels significantly above preset targets. It is hard to argue that budget results would have been less favorable if governments had lacked modern budget machinery.

16. Contemporary budget innovations rely on three sets of tools or levers – information, incentives and constraints – to influence decisions and outcomes. These proved too weak to blunt the crisis, though they may be effective in other circumstances.

Arguably, there is (or should be) a logical sequence in reforming budget institutions, beginning with changes in information content and structure, then manipulating incentives to spur voluntary changes in behavior, and culminating in constrictive rules that proscribe or prescribe particular actions or results. Information is the essential first step, for government cannot alter or constrain behavior if it lacks relevant data. In fact, national governments now know much more about the fiscal outlook, medium and long term implications of current policies, program effectiveness, and administrative operations than they did a generation ago. If it is measured in terms of the volume of information produced, budget reform has been remarkably successful. But the assessment is less favorable when attention shifts from how much data are produced to how and whether the additional data make much of a difference in budget outcomes. Oversize deficits that ignore fiscal targets call information-centered reforms into question, as do rigid budgets that impede reallocation from less to more effective programs and disconnect decisions on resources from information on results. The coexistence of well informed budget makers and subpar budget outcomes should spur open-minded reformers to re-examine the premises on which their innovations rest.

Adding information to improve budget decisions encounters formidable challenges, not the least of which is the congested, deadline- driven calendar. Political leaders and budget experts routinely simplify the task of completing their work by disregarding information that gets in the way of timely decisions. For example, when evaluations find that popular programs have been ineffective, skillful politicians and bureaucrats routinely avoid conflict by disregarding adverse evidence and continuing established spending practices.

The Great Recession did stir demand for improved fiscal and budget information, but in the most distressed countries much of the interest came, at least in the first instance, from outsiders such as international and regional organizations and financial institutions that were skeptical about data supplied by official government sources. As the crisis deepened and countries became dependent on external support, they, too, had need for timelier budget projections and assessments in order to prepare budget plans that would meet the conditions of outside authorities. In many cases, however, critical data were externally generated by international monitors who regarded country-produced data as unreliable.

The crisis transformed objective fiscal information from "desirable" to "essential", from data that intelligent decision makers should want to have into information that they needed to carry out required tasks. This transformation, I have argued elsewhere, is critical in determining the fate of the additional information made available through modernized budget procedures. When this transformation does not occur, there is little cost to ignore data that get in the way of routine budget work.

At the same time that the crisis made reliable fiscal and budget information more urgent, it also made critical information less credible and less useful. Medium-term projections were a principal casualty of economic turmoil, as 3-5 years forecasts of deficits and other key variables were overtaken by rapidly-changing conditions. Yesterday's projections were superannated by today's economic news, and one day's policy pronouncements were made obsolete by the next day's reports. In the rush to stabilize public finance, performance data and program evaluation were shunted aside by the drive to find easy, expedient cuts.

The inherent limitations of information-driven innovation have impelled budget reformers to emphasize the second set of levers – the critical role of incentives in reshaping behavior and changing revenue and spending decisions. To improve budgeting and related financial management practices, reformers consider it essential to give policymakers and spenders incentive to behave rationally and efficiently. Political leaders will adopt disciplined budgets, their optimistic argument runs, when they are rewarded by voters for adhering to fiscal limits, and penalized when they don't. Moreover, ministers and managers will be motivated to shift money from less to more productive uses through medium-term frameworks that protect their budgets when they propose spending cuts in existing programs. The expectation is that budgets will thereby become less rigid and more responsive to changing priorities. In addition, service providers will actively seek opportunities to improve performance when they are given flexibility in managing operations and are held accountable for results.

One wishes that government could generate good budget outcomes simply by tugging on a few purse strings. But, in this writer's observation, altering procedural features of budgeting rarely suffices. Desired behavioral change occurs when the country's political-administrative culture rewards good governance and spurs political leaders and managers to continuously strive to improve performance. If politicians are prone to implement fiscally-irresponsible budgets, it is because voters want to pay less in taxes and to get more in benefits. They often act in ways that damage the country's fiscal future not because their vision is stunted by the short timeframe of annual budgets but because the voices of today's voters are much more influential than those of tomorrow's voters. When they do act to safeguard the country's finances, as has happened in the wake of the Great Recession, it is often because capital markets have spoken or because powerful outside authorities have demanded fiscal discipline.

Budget makers bring a complex of motives to their work, including in almost all venues the aim to produce a budget that is technically sound and makes the right choices. But they also want to mitigate conflict and to complete the budget on schedule. These unarticulated but fundamental aims impel them to shorten their time horizon, to be sensitive to the demands of spending units and program beneficiaries, and to make suboptimal decisions that disregard evidence on results and perpetuate status quo policies.

Of course, there are countries where politicians do consistently produce budgets at or near balance, pay attention to the connection between resources and results, and shift resources from lower to higher priorities. These countries generally have been motivated by internalized norm that are reinforced by voter sentiment, not by manipulation of budget procedures. When enabling conditions are lacking or weak, leaders who favor political expedience over fiscal stewardship have no difficulty justifying their actions in the public interest.

The inadequacies of information and incentive-centered reforms explain the popularity of the final set of lever-rules that formally constrain politicians and managers. The rapid spread of fiscal rules that formally limit deficits, debt or aggregate spending suggests that voluntary action is not sufficient and needs to be supplemented or replaced by proscriptions against policies that would breach preset targets. It is feasible--though hardly ever done--to construct allocative rules that would fund programs rated more effective (or of higher priority) before spending money on less effective or lower priority programs. It would be foolhardy, however, to ignore other relevant considerations and to allocate resources solely (or principally) by rule or formula. For example, it requires judgment to decide whether government should spend less on schools that are failing, or perhaps more because they are failing. Political judgment, historical perspective and common sense are essential qualities of sound budgeting, even when they override the priorities dictated by allocative rules.

In fact, allocative rules have displaced annual decisions in the large portions of governments' budgets that entitle households to ongoing payments from government. Of course, because they can be altered or terminated by new legislation, entitlements differ from constrictive rules that tie the government's hands.

At the end of the day, rules are only as effective as their means of enforcement. The troubled state of public finance in many rule-constrained countries provides powerful evidence that when weakly-enforced rules collide with incentives to overspend or under-tax, the outcome will likely be large deficits and elevated levels of public debt. In effect, rules are needed because incentives are inadequate, but without the right incentives, rules will not be adequately enforced. Most of the countries on the short list of good budget practices and outcomes make and enforce their own rules. They pay attention to what the rules prescribe, but also to trends in socioeconomic and other relevant conditions. They sometimes tweak the rules, but never to the extent of disabling them or compromising their credibility.

Whether their good behavior is due to political culture or favorable economic conditions, the rule-abiding countries are distinguishable from the much larger number of countries that rely on external enforcement. When they are combined with robust information and sound incentives, self-enforced rules have a good chance of working.

The lesson from disciplined countries is that each country must summon the will to make and live by rules, to be fiscally prudent, to strive for results, and to pay attention to program effectiveness in spending public money. Outsiders can guide and prod, but the most important quality is that government leaders, program managers, and citizens yearn to do the right thing.

Will the crisis change budgeting? The crisis has challenged the notion that the nation-state should have full sovereignty to determine budget and fiscal policy. The spread of fiscal disarray across and within continents has driven home the message that no country is a fiscal island. Bad news travels fast, and sometimes puts seemingly-sound countries at risk of economic or fiscal crisis. Even before globalization and Europeanization, there were spillovers from one country's economic fortunes and fiscal policies to others. Global integration has increased the risk of contagion, especially in Europe, and has spurred effort to give supranational policymakers and monitors a greater voice in national economic and budget policies.

To stabilize public finance and mitigate the risk of sovereign debt default, the European community has strengthened its enforcement of fiscal standards and has introduced sanctions for failure to adopt the rules or for breaching them. If they were actually applied, sanctions would be a big step toward shifting final authority for key budget decisions in fiscally-stressed countries from the national government to supranational institutions. However, because they have not been tested yet, one cannot know whether sanctions are a hollow threat or will compel beleaguered politicians to take hard decisions they might otherwise avoid.

For rules to matter, it is not sufficient that enforcers can pressure or penalize violators; it is critical that the rules change the way governments make and implement budgets. This concluding section discusses how reforms spurred by the crisis might affect budget practices. It begins with the impact of rules, moves to consideration of the time frames of budgeting, the role of central budget agencies and the openness of the process, and concludes with reflections on the prospect of non-incremental budget outcomes.

To be effective, fiscal rules must be should fully integrated into the budget process at several key points: when the margin available for spending initiatives or required for spending cutbacks is decided; when policy changes are considered and their budget impact is assessed; during in-year monitoring of budget outturns; and in projecting the medium-term impacts of current budget policies. At each of these stages, which cover the full budget cycle, preset rules establish the boundaries of revenue and spending decisions, prescribe some actions and proscribe others, and enable policymakers and budget monitors to determine policy changes needed to keep fiscal conditions on course.

The next generation fiscal rules will likely prod governments that still have bottom-up processes, which permit spending units to submit unconstrained bids, to adopt top-down processes that set fiscal aggregates and sub-aggregates before bids are prepared. This shift has already occurred in many Member countries, but it will certainly be given greater impetus by rule-constrained budgets that require governments to decide the size of the fiscal envelope before spending units submit detailed estimates.

Top-down constraints are part of the process of transforming central budget offices from control agencies that oversee the details of expenditure to managers of fiscal policy that guard the country's fiscal position and analyze the budget impact of policy options. Although the retreat from detailed spending control is well-advanced in many countries, embrace of the new role as guardian of the country's fiscal position has lagged somewhat.

In rule-based budgeting, the central budget office's key fiscal management responsibilities include integrating macroeconomic projections into budget work, constructing and maintaining baseline estimates of the future fiscal implications of established budget policy, and estimating the effects of adopted or proposed policy changes on the baseline. In countries where this role transformation has been completed or is underway, baseline projections (or forward estimates) replace the base--conventionally defined as the current level of spending – as the starting point for preparing the budget. The baseline gains prominence because the critical question in enforcing fiscal rules becomes what is the government mandated or expected to spend in the next year or beyond, not what is it spending now.

In some countries, measuring (or scoring) the changes to the baseline due to policy initiatives has become the overriding task of the central institutions responsible for keeping the budget within rule-based limits. When this occurs, policy debate tends to become fiscalized, substantive issues are subordinated, and -the key question becomes whether and how policy changes fit within the fiscal constraint. The fixation on budget impacts can distort budget policies, and may spur ploys that hide the true cost of policy initiatives and thereby damage long-term fiscal prospects. When budgeting becomes a matter of scoring, as has happened in the United States and a few other countries, it is difficult to fund new priorities, and the budget risks becoming more rigid and hostage to old policies. Transforming the budget into a scoring exercise does not assure compliance with fiscal limits; the United States has a robust scoring system operated by its quasi-independent Congressional Budget Office. Yet it also has extremely high budget deficits and public debt.

During the past 60 years, budgeting in almost all Member countries has been an incremental process for allocating additional resources to public programs and agencies. There have been a few periods when constrained budgets forced countries to trim programs, but the overall trend has been to increase public spending apace with or in excess of the expansion of economic output .However, the severity and duration

of the Great Recession appear to have reversed this trend. The most stressed countries have been compelled to adopt decremental budgets with deep cuts in current and future spending, while mildly-impacted countries have slowed spending increases or adopted status quo budgets.

A brief hiatus in the upward march of public spending would not itself spell an end to the incremental era in budgeting. After all, budgets may bounce up when national economies bounce back, as has occurred in the past, most notably during SBO's early years, in the 1980s and 1990s. There are however, several reasons to expect this time to be different, and for decremental or status quo budgeting to become standard procedure for many countries. One reason is the severity of the crisis and the structural damage done to the economies of the most heavily impacted countries. These countries have already enacted large spending cuts, including permanent reductions in major benefit programs. Another impediment to the return of incremental spending patterns is the elevated level of debt that will continue to burden many national budgets long after economic growth has resumed. Third, future budgets will be beholden to rising pension and health care costs for ageing populations, leaving little or no increments for program enhancements.

A fourth factor, which may be the most important but also the most difficult to foresee, is the future pace of economic expansion. Economic increments are the wellspring of budget increments; if the former are ample, the latter will likely become available. Anemic economic growth will not suffice to finance both built-in spending increases for existing programs and incremental spending on program enhancements. The minimum growth needed to produce unencumbered funds for policy initiatives will vary among countries, but certainly will be above the levels that many Member countries have experienced over the past decade.

Even without robust increments, budgeting's future will probably be remarkably similar to its "normal" pre-crisis past. Normal means stable budgets that base the next year's allocations more or less on the previous year's and on pre-existing commitments, not budgets that are torn up and replaced long before the year to which they pertain has ended, and not budgets that bring down governments, abridge long-term social commitments, and provoke mass protests. Normal budgeting is the great routinizer of government spending decisions. It drains budgets of conflict by relying on procedures that are repeated, sometimes with variation, year after year. Budgeting cannot thrive as an incendiary process that destabilizes the political system and sows uncertainty about the role of government and the services citizens will receive.

The logical basis of Incrementalism is the notion that in order to complete its budget work, governments act to reduce conflict and the volume of decisions they make. This logic pertains both when government allocates increments and when it allocates decrements. Though they are obviously different situations, in both government focuses on marginal changes from its previous budget. In fact, the impulse to calm budgeting by simplifying the process and narrowing the scope of issues that have to be decided is likely to be greater when cuts are made than when expansion is the order of the day. Once economic and political conditions stabilize, decremental budgets will probably be constructed in much the same way as incremental budgets have for decades – by looking back to past spending to decide future spending.

National governments have strong incentives to stabilize future budget conditions by restructuring pension and health commitments in response to looming demographic pressures. Rather than face the need to trim programs every year, many governments will opt for big bang cuts that significantly reduce future budget liabilities and enable them to produce status quo or incremental budgets.

Decremental budgets do not only deliver cutbacks; they often contain selective spending increases that do not add much to spending, but ease the budget's path to enactment. Even when they must propose cutbacks, governments are motivated to search for opportunities to spend more on priorities, and to thereby demonstrate that they are responsive to demands for program improvement.

Faced with pressure for large corrections in fiscal policy, deeply stressed countries have bypassed conventional budget practices and have relied on ad hoc procedures to produce crisis packages that are presented to parliament, along with demands that it immediately approve the proposed policies without change. Information and decisions have been tightly controlled by a small corps of policymakers at the center of government or the finance ministry. Bilateral negotiations between central and sectoral ministers and between the central government and regional or municipal authorities have been replaced by unilateral decisions shrouded in secrecy, with little or no opportunity for sub national governments or civil society to influence outcomes. The concentration of information and power has reversed decades of progressive opening of the budget process through formal or informal consultations between government and stakeholders.

The current period of profound fiscal stress, intense conflict, concentrated power, and political instability is not the template for budgeting's future. If it were, budgeting as it has been practiced for more than a century would become an improvised process, with rules and procedures fabricated to suit each year's circumstances. Breakdowns would be common, and governments would be unable to complete mandated budget work on schedule.

Coping with less buoyant fiscal conditions will provoke democratic governments to alter prominent features of budgeting. Some countries may get serious about linking results and results through performance-based budgets that promise to deliver value for money. Some will organize budget policy around medium-term frameworks that firmly constrain current decisions on the basis of future impacts. Some will shift a portion of the risks accumulated by government back to households and enterprises. Some will seek to rationalize major entitlement programs by reducing their draw on public funds. Some will yield a portion of fiscal sovereignty to supranational institutions. These would be big changes, but having made them the routines of budgeting will still be easily recognizable to those who toiled in budgeting before crisis struck.

Table 1
GENERAL GOVERNMENT FINANCIAL BALANCES
(% GDP)

	2007	2008-2011 Average	Peak-Trough Decline
Australia	2.1	-2.7	-6.8
Austria	-1.0	-3.2	-3.4
Belgium	-0.3	-3.7	-5.6
Canada	1.4	-4.0	-7.0
Czech Republic	-0.7	-4.1	-6.5
Denmark	4.8	-1.5	-7.6
Estonia	2.4	-1.1	-5.3
Finland	5.3	-0.8	-8.1
France	-2.7	-5.9	-4.9
Germany	-0.2	-2.2	-4.5
Greece	-6.8	-11.4	-9.0
Hungary	-5.1	0.4	-4.1
Iceland	5.4	-9.8	-18.9
Ireland	0.1	-15.8	-31.4
Israel	-1.5	-4.8	-4.9
Italy	-1.6	-4.1	-3.8
Japan	-2.4	-6.9	-6.5
Korea	4.7	0.7	-5.8
Luxembourg	3.7	-0.1	-4.9
Netherlands	0.2	-3.6	-5.7
New Zealand	4.5	-3.6	-12.5
Norway	17.5	13.2	-6.8
Poland	-1.9	-6.1	-6.0
Portugal	-3.2	-5.9	-7.0
Slovak Republic	-1.8	-5.9	-9.8
Slovenia	0.0	-4.8	-6.1
Spain	1.9	-7.8	-13.1
Sweden	3.6	0.4	-4.5
Switzerland	1.7	1.2	-1.1
Turkey	-1.2	-4.0	-5.5
United Kingdom	-2.8	-9.0	-8.2
United States	-2.9	-9.7	-8.7

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Table 2
REAL GDP: PERCENTAGE CHANGE FROM PREVIOUS YEAR

(2-year averages)	2006-07	2008-09	2010-11
Australia	3.6	2.0	2.2
Austria	3.7	-1.3	2.8
Belgium	2.8	-0.9	2.2
Canada	2.5	-1.1	2.7
Czech Republic	6.4	-0.8	2.4
Denmark	2.5	-3.1	1.4
Estonia	8.9	-9.0	5.2
Finland	4.9	-3.6	3.3
France	2.5	-1.4	1.5
Germany	3.7	-2.4	3.3
Greece	4.3	-1.7	14.8
Hungary	2.0	-3.0	1.4
Iceland	5.9	-2.7	-0.6
Ireland	5.3	-5.0	0.4
Israel	5.6	2.4	3.8
Italy	2.0	-3.2	0.1
Japan	2.2	-3.8	0.8
Korea	5.2	1.3	3.8
Luxembourg	5.8	-2.3	1.2
Mexico	4.2	-2.5	3.7
Netherlands	3.7	-0.9	0.9
New Zealand	2.7	-0.3	2.0
Norway	2.5	-0.5	1.8
Poland	6.5	3.3	3.4
Portugal	1.9	-1.3	-2.4
Slovak Republic	9.4	0.5	2.7
Slovenia	6.4	-2.2	0.4
Spain	3.8	-1.4	0.5
Sweden	4.0	-3.0	2.7
Switzerland	3.6	0.1	1.3
Turkey	5.8	-2.8	5.2
United Kingdom	3.1	-2.8	0.7
United States	2.3	-1.9	1.9
OECD	3.0	-2.0	1.8

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Table 3
GENERAL GOVERNMENT CYCLICALLY-ADJUSTED FINANCIAL BALANCES

	2007	2008-2011 Average	2007-to-trough decline
Australia	1.6	-2.6	-5.9
Austria	-1.8	-2.6	-1.1
Belgium	-1.0	-2.9	-3.1
Canada	0.8	-3.1	-5.1
Czech Republic	-2.1	-3.9	-2.7
Denmark	2.9	-0.1	-4.2
Estonia	-1.5	0.2	-3.9
Finland	3.9	0.8	-4.2
France	-3.4	-4.7	-2.6
Germany	-0.5	-1.7	-2.8
Greece	-8.1	-8.0	-5.4
Hungary	-6.8	-1.4	1.8
Iceland	3.3	-8.5	-18.8
Ireland	-2.4	-12.6	-23.1
Israel	-2.6	-4.9	-3.2
Italy	-3.3	-3.3	-0.6
Japan	-3.3	-5.9	-4.0
Korea	4.2	-0.9	-4.7
Luxembourg	1.5	0.4	-1.6
Netherlands	-0.8	-3.7	-4.9
New Zealand	4.2	-2.4	-11.1
Norway	3.3	-4.3	0.2
Poland	-2.1	-6.3	-10.1
Portugal	-3.8	-6.7	-5.3
Slovenia	-2.8	-4.7	-2.6
Spain	0.2	-6.5	-10.0
Sweden	1.6	1.8	-0.5
Switzerland	1.1	1.4	0
United Kingdom	-4.1	-7.7	-5.1
United States	-3.9	-8.5	-5.9
OECD Average	-2.6	-5.9	-4.5

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Table 4
GENERAL GOVERNMENT GROSS FINANCIAL LIABILITIES
(% of GDP)

	2000	2007	2011
Australia	25	14	27
Austria	71	63	80
Belgium	114	88	100
Canada	82	67	88
Denmark	60	34	56
Estonia	9	7	12
Finland	52	41	61
France	66	73	99
Germany	61	66	87
Greece	116	115	165
Hungary	62	73	90
Iceland	73	53	127
Ireland	40	29	113
Israel	84	78	75
Italy	121	112	128
Japan	135	167	212
Luxembourg	13	11	28
Netherlands	64	52	73
New Zealand	37	26	44
Norway	33	57	57
Poland	45	52	65
Portugal	60	75	112
Slovak Republic	58	33	50
Spain	67	42	74
Sweden	64	49	46
Switzerland	52	47	42
United Kingdom	45	47	90
United States	55	62	98
OECD Average	70	73	102

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Table 5
HOUSE PRICES 2000-2007

	Average Annual Percentage Change	Price to Rent Change in Ratio	Price to Income Change in Ratio
Australia	10.5	61.7	38.3
Belgium	8.3	53.8	46.3
Canada	8.6	51.6	37.9
Denmark	8.3	56.9	48.8
Finland	5.4	24.4	8.0
France	10.8	51.6	61.6
Germany	-0.3	-9.1	-14.9
Greece	9.8	31.6	13.7
Ireland	12.1	3.7	44.3
Italy	8.2	18.0	33.8
Japan	-4.1	-24.3	-22.3
Korea	6.1	25.5	4.6
Netherlands	7.3	24.5	23.8
New Zealand	10.5	77.4	53.6
Norway	9.2	47.2	31.4
Spain	12.8	73.5	63.8
Sweden	9.1	48.4	33.2
Switzerland	2.3	5.3	4.3
United Kingdom	11.2	62.6	53.5
United States	7.0	28.2	19.1

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