Can fiscal discipline be imposed?

Not without cross-party agreement and certainly not by fiat

President Obama this week called on Congress to agree to postpone the next round of planned sequestration (ie, mandatory spending cuts), due to take effect on 1st March. In Europe, Prime Minister Rajoy has said that the Spanish government's budget deficit for 2012 ended below 7% of GDP, down from 9.4% in 2011, but still above the European Commission's 6.3% target. The Australian government has postponed its return to a budget surplus (as forecast in my Comment *Look beyond the RBA rate cut*, 2nd October 2012) and in the UK, the government is repeatedly urged to abandon or at least temper is austerity. (Actually, so far British austerity has been mainly higher taxes; spending cuts have not yet begun to bite.) Fiscal issues will remain important, not just in 2013 but in coming years as well, with countries attempting to tackle their fiscal imbalances and again dabbling with using fiscal policy to promote growth.

At the same time, governments are also experimenting with ways of enforcing fiscal discipline, from constitutionally mandated balanced budgets to international agreement. But, is that at all possible? This Comment will look at a number of attempts (by no means exhaustive) from recent history and try to draw conclusions as to what can and cannot be done.

At this stage, a fair warning is necessary. At eight pages, this is a much longer Comment than usual. For readers not interested in the examples but only in the conclusion, the subheading above says it all.

The US is perhaps the country that is in theory most committed to the idea of a balanced budget, although in practice it is perhaps further than anyone (at least anyone not in a crisis) from achieving that target. As early as in 1798 Thomas Jefferson dreamed of a balanced budget amendment. There have been numerous attempts since, including an on-going process to call a constitutional convention to adopt such an amendment.[1] A less ambitious attempt was the Gramm-Rudman law (actually two laws, the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985 and the Budget and Emergency Deficit Control Reaffirmation Act of 1987). This imposed federal spending caps and automatic sequesters(!) if the deficit exceeded specified targets. As a result, federal government net borrowing dropped from 217 billion dollars in calendar 1985 to 164.2 billion in calendar 1989. (All comparisons in this Comment will be by calendar year. That may be unfair to countries whose fiscal year differs from the calendar year but broad trends will be unaffected.) However, the federal government continued to run a deficit on a calendar year basis, ranging from 5.2% of GDP in 1986 to 3% in 1989.

[1] Beware of what you wish for, though. Once a constitutional convention is called, there is no limit to what it can decide to do.

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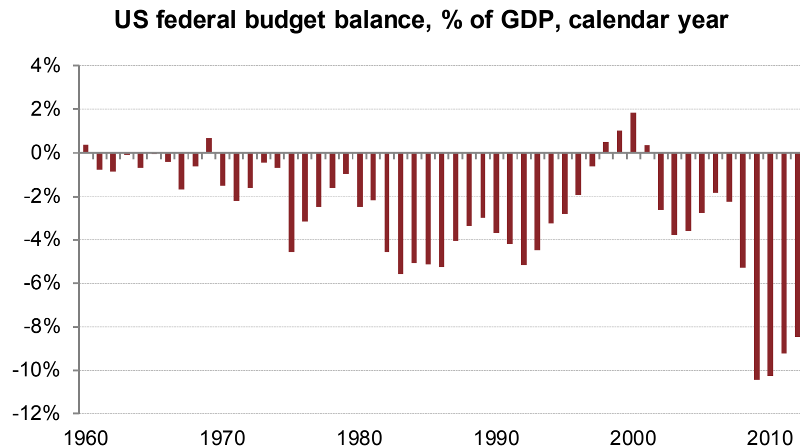
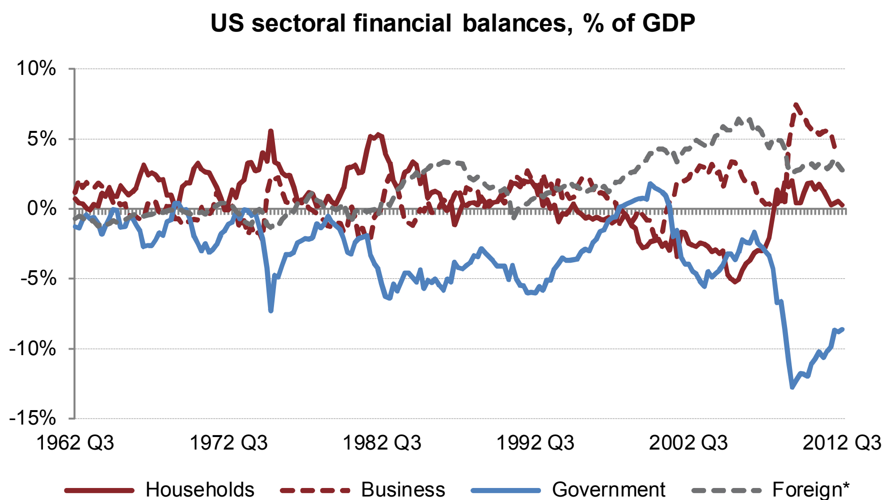


Gramm-Rudman was succeeded by the Budget Enforcement Act of 1990, which retained the spending caps but did away with the automatic penalties. Of course, as it happened, this was a period (the late 1990s) when the US government briefly did go into surplus, prompting talk of repaying the government debt. However, as we now know to our cost, this brief era of budget surpluses was only made possible, and off-set, by large private sector deficits – which since then have rotated back into the public sector again.



Meanwhile, US politicians are frantically trying come to grips with their fiscal imbalances, but are unable to do so, partly because of a political system set up to ensure either bipartisan agreement or deadlock – and currently, deadlock rules. Hence the 2011 attempts to enforce fiscal discipline by mandating tax

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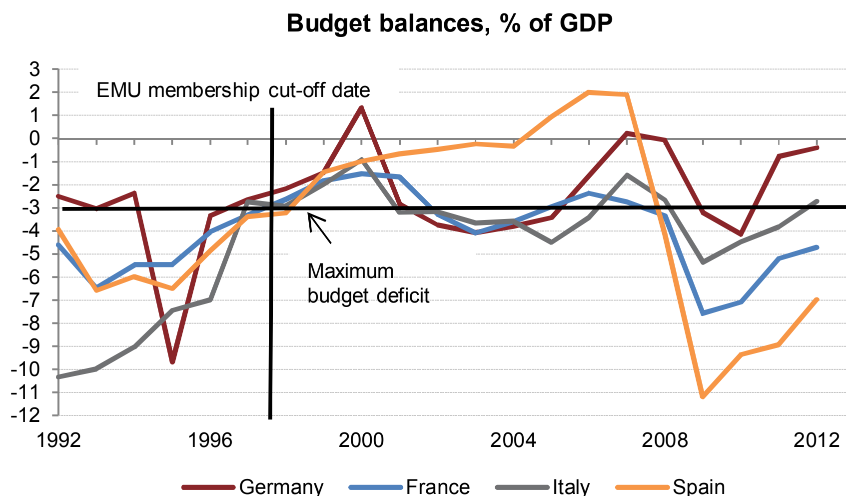
increases and spending cuts unless agreement was reached. Of course, agreement wasn't reached – and Congress and the White House are now equally frantically trying to get out of the fiscal discipline they have tried to impose on themselves. Incidentally, it should be pointed out that where the debate in some European countries is about the desirability of fiscal discipline, this is less the case in the United States. Broadly speaking, both parties agree that this is desirable. Where they disagree – substantially – is how to achieve it.

A more spectacular attempt to impose fiscal discipline is related to the formation and continuation of EMU. The Maastricht convergence criteria were originally formulated with the aim of excluding Italy from EMU. There is no particular reason why a 60% debt-GDP ratio or a 3% of GDP budget deficit are intrinsically 'better' than – say – 70% and 4%; but, at the time of formulation, Germany and France broadly fulfilled the criteria and Italy (and Spain) did not.



The Maastricht criteria were helped by two factors. First, there was a reasonably credible carrot and stick: if you fulfil the criteria, you join EMU, if not, you won't. Second, they were only relevant for one point in time, namely when the decision as to who was joining, would be made. (Strictly speaking, there were two such decision points, but that is not really relevant for this exercise.) They were therefore susceptible to cheating. That was of course what happened, since on a strict interpretation, none of the EMU candidates except Luxembourg would have passed all the criteria.

This was also a concern for the German originators of the Maastricht criteria. As a result, they pushed for the introduction of a further agreement that would perpetuate the fiscal discipline engineered by the Maastricht criteria, the Stability and Growth Pact (SGP).

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However, the SGP suffered from a number of flaws. First, there was no credible stick (nor much of a carrot either, apart from the warm glow of doing the right thing – assuming you agree that this was the right thing to do). Second, the Pact was riddled with exemptions: if output was too weak, you could ignore its strictures. And third, and fatally, some countries unsurprisingly turned out to be more equal than others. When Germany and France breached the rules of the SGP from 2002 to 2005, they insisted that the Pact did not apply to them and there would be no penalties. (In fact, I believe that the only reprimand ever handed out under the rules of the SGP was to Ireland – for running too large a budget surplus!)

Since then we have had various balanced budget amendments passed in euro area countries, beginning with Germany, where from 2016 the federal government will be forbidden to run a structural deficit in excess of 0.35% of GDP; and from 2020 the *Länder* will be forbidden to run structural deficits at all. Under the EU 2012 Fiscal Compact, Germany successfully pushed for similar constitutional changes in other countries, eg, Spain. The Fiscal Compact itself also tightens the rules, allowing a general budget deficit of 3%, and a structural deficit of 1%, but only if the debt /GDP ratio is below 60%; otherwise the deficit limit is 0.5% of GDP.

Again, however, there are problems. Leaving aside the difficulty of measuring ahead of time something as variable as government revenues, government expenditure and nominal GDP to within two decimals (perhaps the 0.35% was chosen precisely because it would be impossible to pinpoint a zero deficit), who defines structural budget balances and how? In addition, there are of course let-out clauses for natural disasters – and for economic slumps. Most likely, the Fiscal Compact will ultimately turn out to be just as efficient as the SGP.

Definitions were also one of the problems in Britain, where the Blair and Brown governments claimed to be following a Golden Rule, meaning that over the course of the economic cycle the government would only borrow to invest and not to fund current spending. Here, Gordon Brown elegantly avoided breaking his own rules by simply redefining the cycle to suit the numbers, rather than attempting to force the numbers to conform to the rule.

What all these examples have in common, is that whatever politicians say they wish to do, they are not prepared to impose on themselves a functioning straitjacket, particularly one that is likely to be politically unpopular. In the populist democratic welfare state, the pressure is always for public expenditure to rise. Politicians may pay lip-service to the idea of balancing budgets and enforcing austerity; but they are rarely willing to tie their hands and actually implement either of those. (It is debatable whether they could or should be able to tie their hands and those of future successors in a democracy.)

This being said, there are countries that have succeeded in imposing fiscal discipline. How has this been possible?

One such country is Australia. The Australian government ran a budget surplus from 1996 to 2007, went into deficit during the Great Recession and is repeatedly promising to return to surplus in the near future. Here too, incidentally there was talk in the mid-2000s of repaying the entire outstanding government debt,

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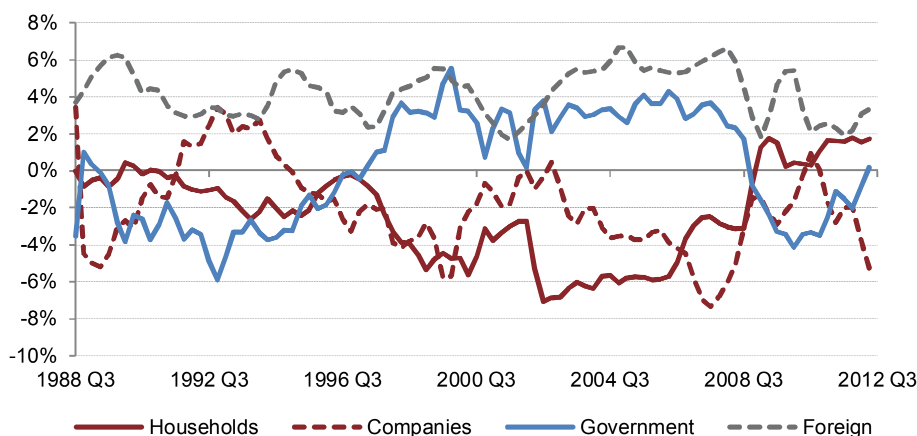
to the horror of bond markets.[2] However, as a glance at the Australian sectoral financial balances shows, a since Australia almost always runs a current account deficit (ie, a foreign sector surplus), a public sector surplus is only achievable if the private sector is prepared to run a deficit.

Australian sectoral financial balances, two-quarter moving averages, % of GDP



The Australian private sector duly obliged, companies by massive investment, notably in the resources sector, and households by going into debt to buy housing. However, households shifted back into a financial surplus in late 2008 and have remained there, the longest surplus period since 1988. The corporate sector is still running a deficit; but there are already warnings that resource sector investments are tapering off. If so, it is difficult to see how Australian public sector finances can realistically be expected to return to the black unless Australia somehow begins to run a persistent current account surplus. This has certainly not been the case since 1959 and probably not before that time either.

The main reason for the long-term Australian budget surplus, therefore seems to be not so much political will, as the long commodities boom due to strong output growth in China and the rest of East Asia. That makes this example somewhat less relevant for other countries.

However, one country that seems to have discovered the art of healthy public finance without relying on, eg, commodities, is Sweden. This was not always the case. From 1970 to 1997 Sweden ran budget deficits averaging 5.5% of GDP, including six years (1981-1983 and 1992-1994) when the deficit was in double digits. Since 1998, however, the Swedish government budget balance has averaged a surplus of 0.6% (assuming a 2.2% deficit in 2012). What happened? Simply put, following years of deficits, there was cross-party agreement that budget policy would aim for a surplus of 2% over the business cycle

[2] There seems to be an economic law which ensures that whenever governments talk about repaying their outstanding debt, large deficits are around the corner.

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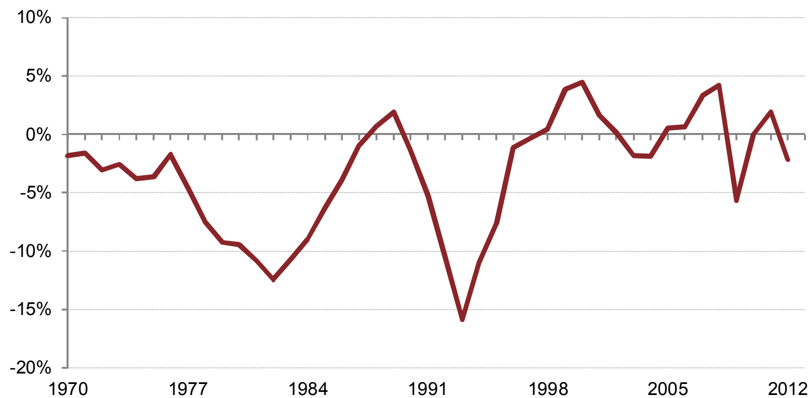
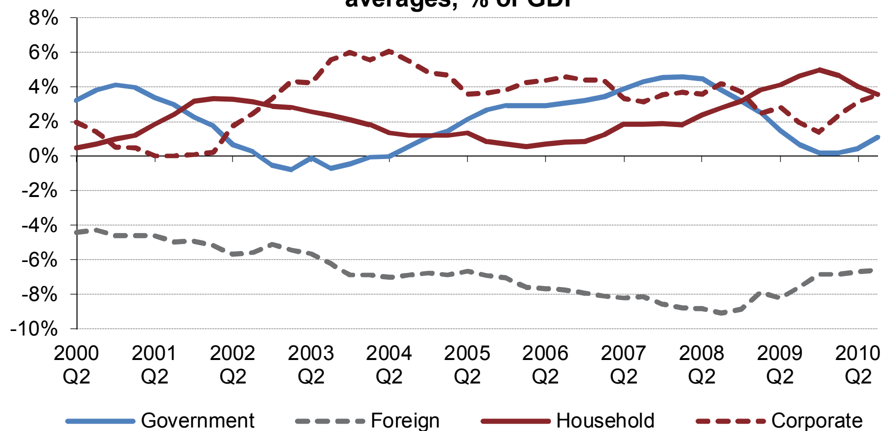
(since changed to 1%) – and no Brownian redefinition of the cycle to suit the data. Other fiscal reforms included changing the budget process so that the government budget is presented to the Riksdag on a take-it-or-leave-it basis, with no room for amendment.



Of course, running a budget surplus means that Sweden – like Australia and like the US in the late 1990s – is confronted by the fact that some other sector must run a deficit, since sectoral financial balances by definition must add up to zero.



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As noted in previous Comments, the Riksbank is highly concerned about rising household indebtedness. But, in contrast to Australia and the US, Sweden runs a sizeable current account surplus, and it is this which is the counterpart to the healthy public finances, enabling all domestic sectors to run financial surpluses.

The case of Sweden is perhaps more interesting than that of Australia, because it does give some pointers to how you can, if so desired, impose fiscal discipline. A sense of crisis helps: In 1993, Sweden's budget deficit was just short of 16% of GDP. Moreover, Sweden had clearly reached the end of the line of its previous growth model: a huge devaluation at the beginning of each decade and then waste the gains thereof over the coming years, partly by running public spending at between 50% and 60% of GDP at a deficit, necessitating ever rising tax revenues which eroded household purchasing power and led to higher wage claims in a vicious circle.

What these – and other – examples show, is that a crucial component in achieving and then sticking to fiscal discipline is a bipartisan or widely shared conviction that it is necessary and the right thing to do. Attempting to force through discipline by fiat, be it balanced budget laws or constitutional amendments, runs into two problems. First, all such rules must contain let-out clauses for unforeseen circumstances. In turn, this means that the restrictions (almost) always can be avoided. Second, the recourse to such laws usually implies that the need for fiscal discipline is not generally agreed. This may be unfair to some countries, eg, Germany. But it is almost certainly true for countries like Spain, France or the UK. Ultimately, what this boils down to, is that any fiscal rules will only be valid and workable for as long as they are acceptable to decision-makers. If that is not the case, they will be circumvented. Whether the rules are hewn in stone, enshrined in law or a matter of an unspoken agreement doesn't really matter; what matters is the willingness to stick to them.

That means that there probably is no way of ensuring permanent fiscal discipline. For that, other measures are needed, eg, letting revenue determine spending, rather than, as has been the case for decades in most developed economies, letting spending determine revenues and deficits. Other possible measures might include setting public spending to a particular percentage of GDP one or two years previously, but this is likely to be counter-cyclical in turning points and otherwise pro-cyclical and would probably suffer from the same weakness as the rules mentioned above, ie, the need for let-out clauses to accommodate crises.

Occasionally, the argument is raised that removing government's ability to print money – eg, by returning to the Gold Standard – would enforce fiscal discipline. That is not necessarily likely. The 50 American states almost all operate under some form of balanced budget law or constitutional amendment; and they all lack the ability to create money. But this has not stopped them from running deficits and doing their best to circumvent the rules – California is probably just the best known example of fiscal shambles. It might have worked under the classical Gold Standard in a 'small government' world – but is unlikely to work today.

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Of course, all this begs the question of whether fiscal discipline is desirable or not. This is partly a subjective issue. For what it's worth, my view is that governments should, as a matter of course, run balanced budgets over the business cycle. But it is also a question of how effective fiscal policy is. If fiscal policy has little or no impact on economic developments – and over anything but the very shortest term, it arguably does not – then there is no reason why governments should run persistent deficits. In addition, given that the sum of sectoral financial balances as a matter of accounting definition must add up to zero, balanced budget policies would broadly remove the government fiscal balance as an agent, leaving the private sector and the foreign sector in each country to adjust to each other.

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