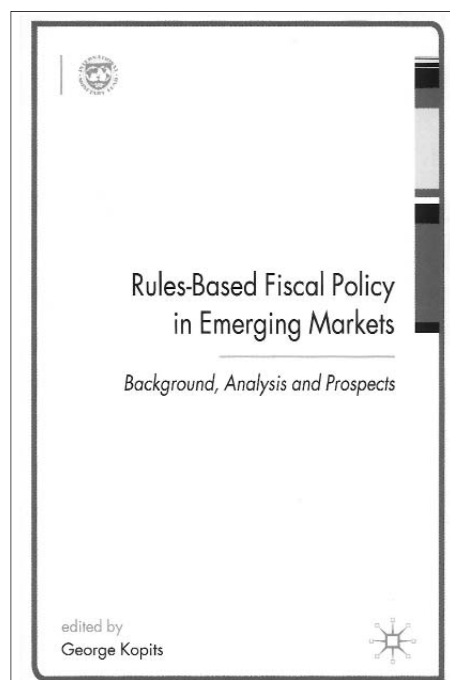
George Kopits (ed.)

Rules-Based Fiscal Policy in Emerging Markets

Background, Analysis and Prospects



Palgrave Macmillan, 2004

The necessity of short-term economic stabilisation and a structural reform affecting longer-term expectations has clearly set the topic for common talk in the past few months in Hungary. While an animated discussion has been continued on the order of magnitude of an adjustment and the desirable course of a reform, professional debates are still short of a line that would link the formation of fiscal policy to rules, and thus would attempt to accomplish policy credibility. This book edited by *George Kopits* (National Bank of Hungary) may contribute to this approach gaining ground in Hungary, too, in view of the fact, if not for a different reason, that compliance with fiscal rules (and principally using the derived benefits) for Hungary as a member of the European Union is (would be) not only an option but also an obligation.

The reviewed book is an edited and completed collection of materials prepared for a conference held and organised by the Mexican government, the IMF and the World Bank in cooperation. Systematic research into the application of fiscal policy rules is certainly not a recent development. The editor of this book, George Kopits himself has, for instance, popularised this vehicle of depoliticising fiscal policy in a number of publications (see in particular Kopits and Symansky, 1998, and Kopits, 2001). However, earlier articles on this issue concentrated on economically developed and stable democratic countries almost without an exception, and particularly on the Euro-zone. A decisive feature of this recent book in the literature of political economy may precisely be the fact that it construes the use of the fiscal policy rules specifically in the context of emerging economies. Certainly, in this globalised world, distinctions between developed and emerging countries stop making sense in many aspects, even if some believe this is exactly when differences begin to show clearly. The editor himself, similarly to the author of the foreword, *Agustín Carstens* (IMF), makes a number of references

to the fact that emerging countries are incessantly exposed to the value judgement of international markets due to the liberalisation of capital mobility. An inappropriate economic policy considerably intensifies the vulnerability of these countries. Not infrequently, an overspending government policy leads to a crisis, which then adversely affects broad social strata. Another serious problem for emerging markets is a high degree of macroeconomic volatility (measured in output or the employment rate), a phenomenon that bears hardly or at least to a lower extent on so-called developed countries. All these in combination require (and at the same time justify) a radical change in the course of fiscal policy accustomed to before the eighties and the nineties: accomplishing a balanced budget, which holds – as the message of this book goes – a powerful but still not almighty instrument in the form of fiscal policy rules.

While the topic is specific, it is worth stating in advance that the volume is highly readable and – without exaggerations – constitutes an exciting piece of literature on the new political economy. The book is organised in three major parts.

■ *In the first part,* authors collected theoretical explanations of and general experience with the use of fiscal policy rules. Readers less familiar with the field of fiscal policy rules can also easily orient themselves to the topic, given that the first part serves as a kind of general review and an introduction. Specifically: following Chapter 1 that both trails and summarises the topic, Chapter 2 describes different interpretations of dissaving tendencies from a political economy perspective, pointing out the options and limitations of rules-based fiscal policy. Chapters 3 to 6 analyse the features non-specific to countries, which draw on emerging countries in general, such as public debt structure and debt rating (Chapter 3), macroeconomic volatility (Chapter 4), the impacts and strengthening of capital mobility (Chapter 5), as well as the issue of political will and credibility (Chapter 6).

The first part that provides a thorough orientation to the reader even for studying the second and third parts, which present the fiscal policy practices of a number of mostly emerging countries in the form of case studies. The second unit of this book focuses on regulation at a national level, discussing countries such as Brazil (Chapter 8), Mexico (Chapter 9), or Central and East Europe (Chapter 10), as well as Venezuela and Norway (Chapters 11). The third part enhances literature with a level of analysis for application of fiscal policy rules, i.e. the regional or provincial levels, which is scarcely investigated but is all the more relevant to emerging market economies. The difficulties of harmonising interests within a country are summarised in a simple game theoretic model in Chapter 12, then longer presentations are given on India (Chapter 13), Argentina, Colombia and Mexico (Chapter 15). Two chapters (Chapters 7 and 14) address the analysis of the EU's fiscal rules with a clear intention to be used as a moral to emerging countries.

Although Kopits mentions in the starting chapter of this book that it would be too early to give a comprehensive evaluation of the application of fiscal policy rules in emerging countries, as emerging (transitory) economies have recently replaced earlier discretion-based policy with rules-based fiscal policy commencing in the late nineties (page 1), the reader may draw a number of useful conclusions recommended for consideration in Hungary. A principal message of this book is that the existence of fiscal rules in itself does not guarantee a reduced vulnerability of emerging countries, even if the application of these rules in Latin America has become widespread as a result of bitter experience from the past and with apparently permanent crises. "…There is nearly unanimous agreement that fiscal policy rules are not a magic wand that somehow will immunize the economy against macroeconomic volatility or financial crises and will sustain high economy growth. Clearly, the timing, design, circumstances and overall insti-

tutional basis are critical for the success of rule-based approach" – Kopits writes (page 8). It is certainly not insignificant for success whether the use of rules is widely supported by a social consensus, whether they are formulated amidst debates facilitating public understanding, and whether they represent broad empowerment and an imperative force. Anyway, experience shows that it is mostly not the countries laying down their fiscal rules in their constitutions that are successful indeed in macroeconomic stabilisation, but it is the ones using them as some kind of guidelines or recommendations, such as Chile or Estonia (page 9).

A remarkable statement is that rules alone, without an appropriate arrangement of institutions/procedures of fiscal policy rarely yield any results. On successful application of rules high values are attached to the procedural requirements that focus on the transparency of planning of, decision making on and implementation of fiscal policy, and reinforce the role of audit – be it any level of public finance. In emerging economies, institutional development and the capacity and expertise of the state are attributed particular significance (page 9).

In his review, *Allen Drazen* (Tel-Aviv University) considers it worth emphasising, among others, that fiscal policy rules are no other than a useful commitment technique, and, as such, are essentially an instrument to achieve credibility of government policy – especially in countries where the problem of time-inconsistency is crucial. Another important conclusion: it is more correct to construe rules as a potential means of imposing burdens on policy-makers – instead of hoping for actual benefits derived from them –, in the sense that deviation is given publicity. (This, at the same time, also represents the strongest and most authentic punishment, as opposed to the sanctions that lose credibility precisely by being too harsh on the government or its employees. It is hard to imagine, for instance, that any of the EU countries would actually pay into the common budget an amount up to as much as half a percent of its GDP.)

Another statement by the author also gives food for thought: paradoxically, the practice of creative accounting gaining ground in the countries applying fiscal policy rules is evidence of the efficiency of rules, as politicians rely on creative accounting techniques precisely because they are afraid of the consequences (costs) of incompliance with the rules.

In his exciting study, *Ricardo Hausmann* (Harvard) calls attention to the fact that the poor credit rating of emerging economies is not simply attributable to high public debts and, accordingly, an improper, irresponsible and wasteful economic policy, but much more to a relatively unfavourable debt structure. The majority of debt securities of emerging market economies are not issued in the domestic currency, and neither for long term or at a fixed yield. As a consequence, the high volatility of exchange rate risk and interest movements causes low credit rating of countries with relatively small amounts of public debts. As he points out, "from a policy perspective, managing the debt structure may reduce risk premia and allow rapid fiscal consolidation through a self-reinforcing reduction in interest rates. This implies that governments should be concerned not only with the debt stock but also with its riskiness." (page 34). Accordingly, the author proposes use of a fiscal rule that would set up a limit for the debt stock weighted by risk (page 50).

The principal aim of using fiscal rules in emerging economies is the long-term sustainability of public finance, which often desensitizes the users of rules to economic cycles – *Guillermo Perry* (World Bank) states. Now the price of procyclical policy may be unreasonably high, especially in an emerging economy. If countries fail to produce more at times of prosperity, governments will be forced by money markets to trim down deficit by reducing expenses at the times of recession, slowing

down the growth rate of the economy (page 53 and pages 55 to 56). In addition, the growth restraining effect of procyclical policy affects mostly the poor, among others by forcing the government to reduce social expenses – precisely at a time when the poor lack revenues anyway (page 62). Examples of Latin American countries show that none of the countries in the region, except for Chile, have succeeded in achieving a closing surplus at times of prosperity. Crises in Colombia and Argentina are partly explained by dissavings in periods of recession, deemed unsustainable by lenders (page 57).

With reference to crises seen in emerging economies, Kopits adds that a permanent concealment of implicit commitments of the public sector has considerably contributed to the crises in Argentina, Mexico, Indonesia, Korea, Russia and Thailand. As he writes: "in an open economy, a weak and opaque fiscal policy can undermine credibility and thus contribute to a speculative attack. Conversely, public finances underpinned by transparency and strong institutional infrastructure can foster credibility. Accrual-based accounting, economic and functional classification of expenditures, wide institutional coverage and an explicit medium-term macroeconomic framework enhance the clarity of public finances." (page 75). At the same time, Kopits also challenges Perry by stating that countries gain more by the rules reinstating the credibility of the government than the cost of losing the flexibility of fiscal policy (such a cost is for instance the implementation of procyclical policy – page 76). Perry from the World Bank does not renounce rules himself, what is more, similarly to the authors of Norwegian and Venezuelan country studies, *Olav Bjerkholt* and *Irene Niculescu* (see later), he also recommends stabilisation and savings funds in combination with the rule fixing the structural deficit to avoid crises (page 59).

Allen Schick (Brookings Institute) discusses in detail an opinion stating that rules can only ensure substantial lessening of the vulnerability of emerging economies in combination with political commitment, which recurs throughout the book. In his analysis, he points out an obvious contradiction whereby supporting institutions that play an indispensable role in the success of rules – for example comprehensive and transparent budget planning – "are most likely to be present in countries that need targets the least, and least likely to be present in countries that need them the most." (page 92). Drazen in Chapter 2 argued similarly when he construed the rule as an indication (expressing commitment), and, as such, considered it a vehicle of achieving reputation and not an alternative to it. It is important to emphasise Drazen's idea separately because the issue is mostly raised in the literature stating that either the rule or reputation constitute a vehicle that ensures credibility in the everyday practice of fiscal policy (page 25).

■ *In the second part of this book, Ilan Goldfajn* (Central Bank of Brazil) and *Eduardo Refinetti Guardia* (Sao Paolo state) have made the presentation of Brazilian fiscal policy particularly interesting to Hungarian readers by linking the issue of using fiscal rules to the problem of sustainability of the Brazilian public debts stock. The task assigned to Brazilian governments in the late nineties was complex: stabilise the public debt stock, efficiently control spending at the level of member states and local governments, eliminate bailout policy at all levels of the state, rationalise the budget process, introduce a medium-term macroeconomic budgetary framework and create transparency (page 121). Surveying the reforms implemented in terms of public funds in the nineties, the authors arrived at the conclusion that numerical rules alone would have proved insufficient to eliminate the bailout policy and a resulting further indebtedness also condemned by Kopits. However, fiscal rules have been successfully amalgamated by Brazil with various procedural requirements circumvallating the budget process, and rules rein-

forcing transparency, which in combination have been able to eliminate structural imbalances, and significantly improve the quality of controlling macroeconomy (pages 127 to 128). Let us remember that previously Hausmann (in Chapter 3 of this book) also argued in general for the idea that the problem of emerging economies is in fact that they are only able to fund their public spending from the market at a considerably higher risk premium even in case of equal debt stocks. For this reason, a debt reducing policy credible also to them is a question of life and death. For him also, quality improvement in public finance represented a solution.

Unfortunately, the Central and Eastern European region has not been assigned too much space in this book. A refreshing exception is a writing by *Fabrizio Coricelli* and *Valerio Ercolani* (University of Siena), in which the authors, having examined Hungary, Poland, Slovenia and Romania, state that the budgetary deficits of newly acceded countries are basically of structural origin, procyclical in nature, and the proportion of their public investment projects is high above those of old EU members. These three factors are described as particular features of countries where a change of regimes has taken place. Consequently, the authors advocate changes to the fiscal rules set up by the Stability Pact considered by them to be strict and rigid. They suggest that the European Commission and the Council of Ministers should focus on the structural balances of countries in the continuation, and that adoption of the British fiscal rules could present a solution, namely, by applying the golden rule (current expenses are not permitted to be funded from a deficit) and by aiming at a sustainable debt stock. It is interesting, by the way, that on reviewing the European regulation, two excellent analysts of the European Commission, *Marco Buti* and *Gabriele Giudice* – besides being front-line fighters for the preservation of the Stability and Growth Pact in the European Union – in Chapter 7 clearly take sides stating that the rules for debts and deficit laid down in the Pact would not be suitable in Latin America, and they would require emerging economies to generate a surplus in the primary structural balance instead of keeping up a deficit (page 107). Hungarian readers may draw two considerably different conclusions from this:

- countries of Central and Eastern Europe cannot be considered emerging market economies, what is more, by finding themselves in the club of the most developed countries as EU members, the states in our region do not need such flexible interpretation of rules any more, or
- the authors consider maintenance of the status quo more important in the EU at any price (and this is why they also mention Central and Eastern Europe in addition to Latin America) than engaging in a debate that may easily prove to be Pandora's box.[1]

An interesting study is presented by Olav Bjerkholt (University of Oslo) and Irene Niculescu (Central University of Venezuela) on rules applied in countries rich in non-renewable resources (particularly oil). In their comparative study, they showed that rigid rules that merely provide for deficits cannot be applied in these countries, because the price of raw material depends on external factors, and the income side of the budget is exposed to considerable volatility. Instead, a more flexible form of fiscal rules is recommended to them (such as an indicator of structural deficit considering cyclical effects), which is reasonable to be combined with funds used as instruments of stabilisation on the one hand, and also generates savings that can be applied for education, health care and infrastructure on the other hand (pages 169 and 178). This dual system complemented by transparency requirements may be capable of depoliticising the application of assets generated from exploiting resources once and for all (see, for instance, the case of Ecuador).

It is not a recent recognition in Mexico, either that rich oil resources may be a nuisance, when combined with weak fiscal discipline and the procrastination of structural reforms. *Andrés Conesa* and co-authors (from the Mexican Ministry of Finance) say about the application of fiscal rules adopted in the country in the second half of the nineties that they are far from being perfect as yet, but a combination of improving control on expenses and efficiency of tax collection reduced the public sector's credit requirement from 6.3% (of the GDP) of 1998 to 2.7% by 2002 (page 135). The authors provide an exhaustive documentation of other requirements adopted in the country to support the numerical rules, especially in terms of planning, approving and implementing the budget, in order to achieve predictability and credibility of fiscal policy. In this way, if income is behind the budgeted amount, for example, the government must cover the discrepancy from a stabilisation fund, and if the sufficient funds are not available (because it was not topped up in time), then public expenses must be reduced. The surplus income generated in good periods can only make up for a part of a current budgetary deficit. A quarter of income surplus is used to top up the reserve fund, while one half is statutorily applied to public investment projects (pages 133 to 134).

▪ *The third part of the* book presents the options of applying fiscal rules at the level of member states and provinces. *Miguel Braun* and *Mariano Tommasi* (University of San Andrés) in their game theoretical model warn that no permanent fiscal discipline is conceivable without coordination between the various levels. Responsible spending by the central government is all in vain if it is not combined with self-restraint on the part of provinces and states – typically with high levels of autonomy. This proposition is backed by *Kalpana Kochhar* and *Catriona Purfield* (IMF) using the example of India. (Purfield's name may be familiar to Hungarian readers: her study published by IMF in 2003 under the title 'Fiscal adjustment in transition countries: evidence from the 1990s' gives an exhaustive and duly objective presentation of the challenges and faults in fiscal policy in the nineties.) The authors provide a thorough and comprehensive overview of the status of Indian public funds, emphasising that despite a robust growth and a recent opening, the country has still a lot to do in terms of macroeconomic management. Since the end of the nineties, India has generated a 10 percent annual deficit, or more, which resulted in its debt stock reaching 80 percent by 2002 (page 200). The fact that the country has had nothing to fear from a crisis is a result of a domestic money market system still relatively closed (state-owned banks), high amounts of (forced) savings, denomination of the debt in domestic currency, and relatively long maturity ranges (pages 201 to 205). Nevertheless, fiscal laxing has involved considerable costs of growth, which – similarly to other emerging economies – mostly affected the poorer layers of the population (page 198). Although the authors welcome the efforts of the central government primarily hallmarked by the Act on fiscal responsibility and budget planning in effect since 2003, still, parallel to that, they also voice their doubts stating that a down-to-top approach in the fiscal policy is still dominant in India, ensuring a great deal of autonomy to each state, which duly use (or misuse) it – accumulating considerable deficits from year to year. The authors propose a solution whereby stronger central fiscal budgeting controlled from above is implemented in India in the not too distant future, similarly to Brazil.

Although not rare, self-restraining requirements implemented in the member states are still an exception. On the other hand, as presented in a study by *Fabrizio Balassone, Daniele Franco* and *Stefania Zotteri* (National Bank of Italy) addressing the Euro-zone, a number of member countries adopted internal stability pacts embedded in their national laws that obvi-

ously aim at forcing their governments (and even heads of provinces) to implement discipline in fiscal policy. This endeavour is particularly successful in Spain, Austria and Belgium, and attempts at regional regulation have also been made in Italy and Germany, although these latter two have not had any convincing results.

The last chapter in the book, authored by *Christian Y. Gonzalez* (University of Georgetown), *David Rosenblatt* and *Steven B. Webb* (World Bank), can also be construed as practical implementation of the game theoretical model detailed initially in the third part. Examining three Latin American countries, the authors have shown that inappropriate delegation of responsibility between levels of government necessarily generates conflicts. Analysing the transfers between the government and the member states/provinces in Argentina (for a long time), as well as in Colombia and Mexico (for a short time), they found that a full central guarantee for provincial transfer payments significantly increases the emergence and embedding of moral risk at lower levels. Guaranteed payments not only lull the politicians of member countries but also prompt them to coordinate their activity with the central government as little as possible. The three authors reasonably see the issues of reinforcing coordination and distribution of responsibility as the solution, a specific form of which would be manifest in a fiscal policy rule endorsing the distribution of risks among the different levels of government, matching the particularities of each country.

In summary, it can be stated that this book can be a useful and enjoyable reading for anyone who views the delay in the adoption of Euro in Hungary with concern, and would finally like to find some aid to achieve depoliticising fiscal policy, ensuring public finance sustainable in the long run in Hungary. The book offers a number of general and practical guidelines richly illustrated by country studies on this topic. Especially appealing is the authors' approach that they do not promote fiscal rules disregarding the circumstances. Instead, they agree to point out where and on what conditions fiscal policy rules can or could become a token of success. One thing is surely seen: this solution is gaining ground to achieve credibility not only in the developed part of the world but also among emerging market economies. As for myself, I am waiting for a sequel – which perhaps will also have a chapter on Hungarian success.

Benczes István

Notes

[1] For more details of this dilemma, see Buti et al. (2003)

Literature

BUTI, M.–EIJFFINGER, S.–FRANCO, D. (2003): Revisiting the Stability and Growth Pact: grand design or internal adjustment? *European Economy, Economic Paper, Issue No. 180*

KOPITS, GY. (2001): Fiscal Rules: useful policy framework or unnecessary ornament, *International Monetary Fund, Working Paper, Issue No. 145, September*

KOPITS, GY.–SYMANSKY, S. (1998): Fiscal policy rules, *International Monetary Fund, Occasional Paper, Issue No. 162*

PURFIELD, C. (2003): Fiscal adjustment in transition countries: evidence from the 1990s, *International Monetary Fund, Working Paper, Issue No. 36, February*