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Fiscal Discipline in Emerging Market Countries: How to Go About It?

Charles Wyplosz

The collapse of Argentina's currency board has been largely blamed on fiscal indiscipline at the federal and mostly provincial levels. For example, while the crisis was gathering strength in the Spring of 2001, the IMF Managing Director stated unambiguously that the problem's origin was to be found in the fiscal deficit, not the currency overvaluation:

> "Argentina's programme aims at strengthening confidence through fiscal consolidation to achieve the programme's targets for 2001 and fiscal balance by 2005, while promoting the recovery of investment and output through fiscal incentives and regulatory changes. Firm implementation of the programme is needed to initiate a virtuous circle of stronger public finances, lower interest rates, and a recovery of economic activity. In this regard, it is essential that tax compliance be improved and that expenditures be contained, in accordance with the commitments under the federal pact of December 2000.
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> "Argentina's convertibility regime, the independence of the central bank, and the high capital and liquidity defenses of the banking system are important pillars of the country's economic strategy and have been vital in helping withstand turbulent international financial conditions in recent years. The IMF therefore welcomes the authorities' reaffirmation of their commitment to these policies."
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> Horst Köhler, *IMF News Brief*, No. 01/44, May 21, 2001.

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At the same time, Dornbusch articulated a similar view:

"A devaluation strategy must be considered perilous; a government that goes that way is likely to take Argentina back to 1990 but with this extra; the country will also be totally bankrupt. Not a good policy idea! [The] central issue of Argentina is the bankruptcy of the government."
Rudi Dornbusch, *World Economic Trends*, No. 2, April, 2001.

However, his interpretation is not fully shared. Stiglitz (2002), for instance, writes:

"Did those large deficits, corruption and public mismanagement cause the Argentine crisis? Many American economists suggest that the crisis would have been averted had Argentina followed the advice of the International Monetary Fund (IMF) religiously, especially by cutting back on expenditures (including at the provincial level) more ruthlessly. Many Latin Americans, however, think that the full IMF plan would have led to an even worse crisis – sooner. I think it is the Latins who are right."
Joseph Stiglitz, "Argentina, Shortchanged: Why the Nation That Followed the Rules Fell to Pieces," In: *The Washington Post*, May 12, 2002.

Why do these distinguished observers, like much of the profession, disagree so sharply on such a basic question? The general public would be shocked to find out that the famously-dissenting profession of economists cannot decide whether the peso was overvalued or not, and whether Argentina's public finances were lethally off-balance. More shocking even is the apparent inconsistency of as clear-headed a macroeconomist as Stanley Fischer, who states two views in the same text, first:

"The growth performance was based too much on large fiscal deficits, especially as the decade progressed. The deficit of the federal government averaged 1 percent of GDP in the first half of the 1990s and 3 percent in the second half."

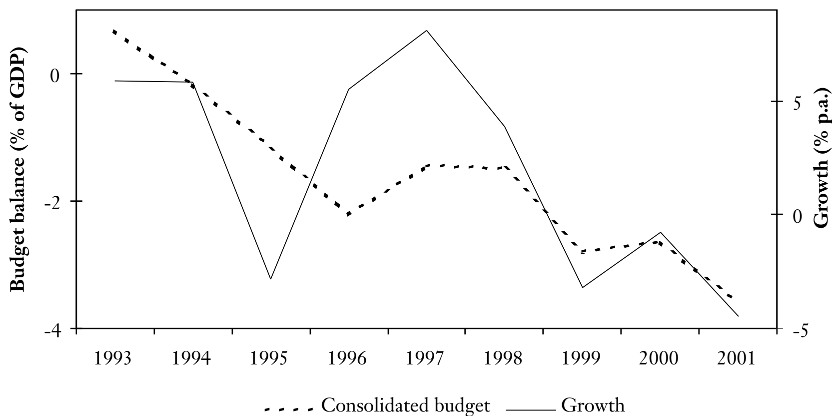
and then:

"The question that has to be asked at this time of recession is whether Argentina really needs fiscal adjustment. The obvious concern is that such an adjustment would only impede the recovery of the economy. After all, neither public debt (at around 50 percent of GDP) nor the fiscal deficit (at around 2.5 percent of GDP) are particularly high by international standards – indeed both would satisfy the Maastricht criteria, as would its inflation performance. The problem is that with the current level of spreads on Argentine bonds, the debt dynamics are on an escalating path."

Remarks by Stanley Fischer at the Argentine Bankers Association Meeting, Buenos Aires, June 25, 2001.

Fischer would not use technical jargon, but he is describing a self-fulfilling crisis. The fiscal position was perfectly sound and would have remained perfectly safe if markets had not started to expect a crisis. The peso overvaluation prompted fears of a devaluation, which led to high interest rates. The combination of currency overvaluation and high interest rates, the classic hallmark of an excessively tight monetary policy, provoked a deepening recession. The recession resulted in declining tax revenues and a budget deficit, especially in the provinces, as Figure 1 illustrates. The rational perception that the fiscal situation was unsustainable led to increasing concerns about the currency board survival, hence higher interest rates and a worsening vicious circle that could only break out in a full-blown crisis.

Figure 1 Budget Balance and GDP Growth: Argentina 1993-2001



Source: Ministry of Economy, Argentina.

This description seems to vindicate both opposite views, but with the subtle nuance inherent to self-fulfilling processes. Had Argentina been growing, the budget would not have been in deficit, or the deficit would have been small enough to be accompanied by a declining debt-to-GDP ratio. The slowdown was partly due to worsening international conditions, partly to an overvalued peso. The refusal of the Argentine authorities to prepare an exit from the straitjacket of the currency board – while the economic situation was good – is the fundamental source of the crisis. It left the Argentine economy vulnerable to adverse national or international conditions. While a crisis was therefore unavoidable, its timing remained to be determined by some event dramatic enough to unleash a pressure commensurate with the hardness of the exchange rate regime. It turned out that the (mild) deterioration of public finances played this role.

Thus the real puzzle is why the budget deficit, well below levels which are considered lenient elsewhere, unleashed one of the worst crises of the past several decades. Three reasons come to mind.

First, without any monetary policy left, fiscal policy had to take up all of the burden of dealing with shocks. Worse, with monetary policy structurally excessively tight – due to peso overvaluation – fiscal policy became structurally lax. The deficit, which has been widening, would have had to widen further, with uncertain results.

Second, the fiscal record of the Argentine authorities is chequered with spectacular failures. A lack of discipline had long characterised monetary policy too. This is the reason why adopting the straitjacket of a currency board had been hailed as a positive step. Over the 1990s, the deficit has been trending downward, confirming fears that fiscal policy had become Argentina's Achilles heal.

Third, while the federal government had displayed some willingness and ability to avoid fiscal indiscipline, its ability to rein in provincial governments was increasingly in doubt. As the recession continued, the federal structure encouraged a classic free-rider problem: each provincial government had an interest in collective discipline but a strong incentive to depart from rigour. Coupled with political gaming, there was no reason to expect that the federal government would be successful in negotiating fiscal discipline with the provinces.

This interpretation of the Argentine crisis leads to a number of conclusions. The first one concerns the appropriateness of the

currency board arrangement; it will not be pursued further in this chapter. The second one concerns the dual challenge faced by fiscal policy: in the short run, fiscal policy must be available as an instrument to deal with large macroeconomic shocks while being subject in the long run to an overriding discipline constraint. This is another instance of the debate between rules and discretion. The third conclusion is that discretion in fiscal policy is more desirable the tighter is monetary policy. Countries which adopt extreme exchange rate fixity regimes (currency boards, dollarisation, monetary union membership) face a steeper trade-off between fiscal policy rules and discretion. Finally, in "federal" arrangements, such as federal states or monetary unions, the overall budget deficit becomes a matter of common concern for all "sub-federal" entities, which requires adequate safeguards, possibly in the form of legally binding arrangements or institutions.

These are the issues explored in this chapter. The debate on rules and discretions has been mainly applied to monetary policy. The result has been significant progress all over the world. From New Zealand to Sweden, and from Mexico to Poland, an increasing number of countries have made their central banks independent and entrusted the conduct of monetary policy to Monetary Policy Committees. The same principles can be applied to fiscal policy as well. I suggest that the budget deficit – not the size and structure of public spending and taxes – should be delegated to independent Fiscal Policy Committees for precisely the same reasons. I further argue that this solution is likely to enhance attempts at regional cooperation in the realm of exchange rate policy.

The next section examines the common logic of monetary and fiscal policies.[1] Section 2 draws some important lessons from the experience with monetary policy, recognising a number of differences between monetary and fiscal instruments. A workable definition of debt sustainability is proposed in Section 3. How to achieve debt sustainability while allowing the counter-cyclical use of fiscal policy? Section 4 presents a proposal inspired by monetary policy institutions. The link between debt sustainability and exchange rate cooperation, including the institutional aspects, is analysed in Section 5. Section 6 concludes.

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[1] The case for regional exchange rate cooperation is developed in Wyplosz (2002).

1 The Common Logic of Monetary and Fiscal Policies

Faith in the ability of macroeconomic policies to effectively erase business cycles and foster growth has long been oscillating, and it is now at a low point. During the last decade, policy activism has been rejected, increasingly replaced by rules of various kinds.[2] Most central banks now accept responsibility only for price stability and most governments put budget balance at the forefront of their concerns.

The sharp change from the trigger-happy 1970s can be traced back to both facts and academic research. Double-digit inflation and record levels of public debts in peace time have exposed the excesses of unconstrained policymaking. Academic research has analysed the limits of discretion.

In the field of monetary policy, the first shot has been fired by Friedman's celebrated defense of a monetary rule. Subsequent work by Lucas (1972) and Sargent and Wallace (1975) have developed the view that monetary policy is only effective if it is unanticipated. The obvious implication was that there should not be any systematic attempt at using monetary policy to support growth. Combined with Friedman's and others analyses on the cost of inflation, the conclusion has been that central banks ought to restrict themselves to delivering low inflation. More recent work, e.g. Blinder (1998), expresses doubts about the "only unanticipated money matters" view, but recognises the view that monetary policy must concentrate on inflation in the long run. Current conventional wisdom follows the view set forth *inter alia* by Svensson (1999) that central banks ought to be mainly driven by a medium-run inflation target, while carrying out counter-cyclical actions in the short run, in the spirit of Taylor (1993).

In the field of fiscal policy, a similar evolution is under way. The principle of Ricardian equivalence, put forward by Barro (1974), carries implications for fiscal policy similar to the results obtained by Lucas (1972) and Sargent and Wallace (1975) for monetary policy: Ricardian equivalence implies that fiscal policy is not an effective counter-cyclical instrument. The next step is the view that governments tend to misuse fiscal policy for short-term political

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[2] See "Symposium on Keynesian Economics Today", In: *Journal of Economic Perspectives*, Winter 1993 issue.

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advantage (Drazen, 2000; Persson and Tabellini, 2000). The natural conclusion is that fiscal policy should not be used as a macroeconomic policy tool and should focus instead on aiming at a low and sustainable public debt. This view is now enshrined in the Stability and Growth Pact adopted by the European Monetary Union and in fiscal codes in place in various countries, in the form of multi-annual limits on spending (the Netherlands, New Zealand, Sweden, the UK and the US) or on public debts (New Zealand, Poland and Switzerland).

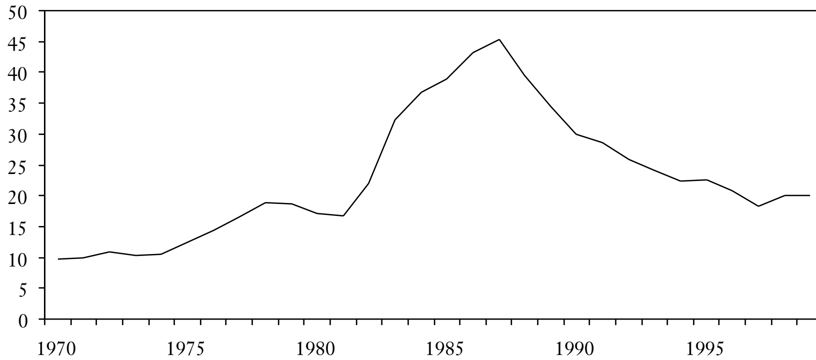
Much as strict monetary rules have been abandoned for being too rigid and arbitrary, fiscal rules are unlikely to be the final word. The next stage is to recognise the deep similarity between monetary and fiscal policies. Both have a short-run counter-cyclical role to play (the Ricardian equivalence is not found to be a robust description of how fiscal policy operates, see e.g. Bernheim, 1987, Gruen, 1991). When left in the hands of undisciplined political authorities, both produce adverse long-run effects: inflation for monetary policy, public debts for fiscal policy.

The Latin American experience is a case in point. Figure 2 shows the evolution of the overall public debt in the region. Over the 1970s, and even more spectacularly over the early 1980s, fiscal indiscipline has been the rule and public debts have exploded. Public debts have fragilised these economies, often resulting in crises and defaults. Consequently, over the subsequent decade, most countries have concentrated on bringing their debt levels down, with many successes.

Thus both macroeconomic policy instruments can be useful in the short run and dangerous in the long run. The challenge, therefore, is to combine short-run flexibility with long-run discipline. This may look like squaring the circle but considerable progress has been achieved in the realm of monetary policy. The recipe is now well-known and reasonably uncontroversial. Central banks have been made independent and given a very precise long-run mandate: price stability. Decisions are typically made by formally independent Monetary Policy Committees (MPC) who can exercise judgment but not for political expediency.

Can fiscal policy also be used as a macroeconomic instrument without necessarily bringing about deficits and a growing debt? In theory, the answer is obviously positive: deficits can be balanced over the cycle while being as strongly counter-cyclical as appropriate. The

Figure 2 Public and Publicly Guaranteed Debt of Latin America, 1970-1999
(percentage of GDP)



Note:
The countries are: Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Salvador, Ecuador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Vincent and the Grenadines, Trinidad and Tobago, Uruguay, Venezuela.
Source: World Development Indicators, World Bank

challenge for fiscal policy, therefore, is to credibly combine long-term commitments with short-term flexibility.

2 Lessons From Monetary Policy

In comparison with monetary policy, fiscal policy is relatively ineffective. Its impact is rather slow, (too) long lasting, and uncertain (Blanchard and Perotti, 2000). The debate on Ricardian equivalence underlines that much depends on how economic agents perceive fiscal policy actions. Temporary tax measures are understood to be largely ineffective, for agents adjust their saving behaviour. "Permanent" tax measures are of limited credibility. Spending actions raise the question of how they are to be financed, which may elicit partially off-setting private reactions. In the extreme case where the debt path is seen as unsustainable, restrictive fiscal policies have been observed to exert an expansionary effect if they are seen as stabilising an otherwise explosive public debt (Giavazzi, Jappelli and Pagano, 2000).

A complicating factor for fiscal policy is that assessing the budget constraint is not easy. Governments are held accountable to deliver both explicit and implicit entitlements such as welfare payments and the retirement of future generations. This complexity cannot be fully eliminated, but the effectiveness of fiscal policy can be enhanced by improving the visibility of implicit commitments and by eliminating off-budget items.

A further complicating factor is that fiscal policy is subject to democratic oversight. Every action has to be approved by the parliament. The result is a high degree of politicisation which naturally involves differences of opinion but also open the door to lobbying by a myriad of interest groups that care little for the common public good.[3]

Having recognised these differences, five main lessons can be drawn:

Lesson 1: Less activism.

Fiscal policy is a less good instrument than monetary policy. Whenever monetary policy alone can deal with the situation, fiscal policy should remain inactive, relying only on the automatic stabilisers, certainly avoiding to become pro-cyclical.

Lesson 2: Long-term debt sustainability ought to be a binding constraint.

Most modern central banks are given a clear, explicit mandate to aim at price stability. The equivalent long-term concern for fiscal policy is debt sustainability, and it ought to be made explicit.

Lesson 3: Qualified freedom over the business cycle.

Like monetary policy, once its long-term constraint is set and serves as an anchor, fiscal policy can be used as a counter-cyclical tool whenever it can make a contribution to economic (price and output) stability.

Lesson 4: An ability to respond in real time.

Part of the advantage of monetary over fiscal policy is its speed of reaction. The counter-cyclical use of fiscal policy requires that the automatic stabilisers be powerful enough and, for discretionary actions, that the decision and implementation lags be sharply reduced.

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[3] See von Hagen and Harden (1994).

Lesson 5: Long-term commitments must be backed up by specific legal and/or operational arrangements.
Monetary policy is now typically subject to a clear long-term mandate via legal arrangements. The debt sustainability imperative of fiscal sustainability is rarely backed by a similar legal mandate. Europe's Stability and Growth Pact is quite unique in this respect.

3 Defining Debt Sustainability

Long-term debt sustainability requires that the debt level does not increase as a percent of GDP. Where it is high, the objective ought to be more demanding, calling for a decline in the debt-to-GDP ratio.

Alternative definitions have been proposed. The Maastricht Treaty, and the Stability and Growth Pact adopted by the European Monetary Union, have made popular a budget deficit target set at 3 percent of GDP. The target is highly arbitrary, the result of heavy bargaining when the Treaty was being negotiated.[4] The arbitrariness by itself would be of little concern if it did not make the threshold difficult to grasp by public opinions. Two recent incidents (Germany and France, the largest economies in the euro zone) well illustrate the political sensitivities at stake. More importantly, a small deficit is neither necessary nor sufficient for debt stability. The debt, as a ratio to GDP, can grow even if the budget is balanced, as it can decline even if the budget is in deficit.[5] Countries can default on their debts even if they have small deficits, as was the case in Mexico in 1995 and in Argentina in 2002.

Another definition of debt sustainability is that the debt should be "low". This is the definition adopted by New Zealand, for instance. But, of course, what does "low" mean? Truth is that there is no clear

[4] As is well-known, the idea comes from Germany which operates a "golden rule" stating that the deficit should not exceed public investment, which presumably pays for itself. Germany has estimated that public investment averages 3% of GDP, an estimate hard to check given the imprecision of what constitutes public investment.

[5] If b is the debt-to-GDP ratio, d the deficit-to-GDP ratio, the evolution of the debt is given by the following formula: $b = d + (i - n)\ b$, where i is the nominal interest rate and n is the growth rate of nominal GDP.

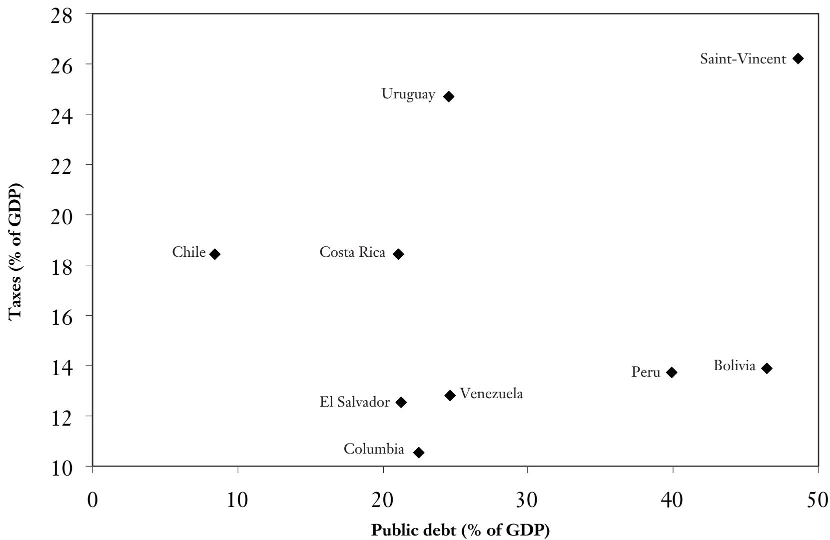
definition of what is a reasonable public debt level.[6] The 60 percent Maastricht convergence criterion, for example, is an accident of history, the average debt level in Europe on the day the Maastricht Treaty was finalised. Is zero debt desirable? In principle, because taxes are distortionary, the lowest possible debt level would be desirable under the assumption that the tax burden is lower where the debt is smaller. However, there is no indication that this assumption holds in practice. In the OECD area, for instance, the partial correlation coefficient is negative (-0.03) and non-significant (*t*-statistics = 0.42).[7] Figure 3 shows nine Latin American countries for which data is available. The partial correlation coefficient is 0.08 and non-significant (*t*-statistics = 0.50). Another view is that the government borrows on behalf of credit-constrained citizens, which implies that some positive debt level is welfare-enhancing. Similarly, with standards of living likely to continue to rise over the foreseeable future, intergenerational equity calls for some negative transfers to richer future generations.

The only reasonable conclusion is that a moderate debt level is desirable, but "moderate" cannot, and should not be precisely pinned down. We simply have to rely on good judgment as to what is a desirable debt level for a country at a moment of its history. "Judgment" is the crucial word here. It means that human thinking, guided by clear principles, is a superior alternative to binding rules built around unavoidably arbitrary numbers. It requires that such judgment be made by reasonable people, free from political or other pressure.

[6] See Perotti *et al.* (1998) for a discussion of sustainability as well as for useful references. They consider fiscal policy to be sustainable when there is no need for sharp adjustments. These authors conclude that, because sustainability cannot be appropriately defined and measured, attention should shift to controllability. In a sense, this is the view adopted here too, as the focus shifts to institutions which are likely to deliver a debt that remains under control, independently of its size.

[7] It can be objected that the three Scandinavian countries and Japan are outliers. Without these four countries, the partial correlation coefficient is positive (0.13) and significant (*t*-statistics = 2.27), but it is not clear why these countries should be excluded. The Scandinavian countries illustrate the main point that a low debt level may be intentionally accompanied by a large tax burden, while Japan shows that small governments can run unsustainable fiscal policies.

Figure 3 Public Debts and the Tax Burden in 1999
(percentage of GDP)



Source: World Development Indicators, The World Bank.

4 Institutions for Debt Sustainability

Summarising so far, two central arguments have been developed. First, fiscal policy ought to combine short-run flexibility with long-run discipline. The aim is to allow for the counter-cyclical use of fiscal policy when monetary policy alone is not enough, while ensuring that the public debt remains sustainable at all times. Second, debt sustainability cannot be defined in a precise way. In general terms, it means that the debt-to-GDP ratio is not allowed to drift upward endlessly and, where the debt is high, that it is on a declining trend. This section develops a proposal which matches these requirements.

The proposal starts from two premises. First, fiscal discipline cannot be entrusted to rigid, arbitrary rules. It requires qualified human judgment. Second, the same challenge, combining short-run flexibility with long-run discipline, has been met in the area of monetary policy by setting up adequate institutions. Accordingly, the section describes similar institutions for fiscal policy.

Rationale

Long-run constraints are notoriously hard to enforce because of the time inconsistency problem: there will always exist circumstances where giving up a commitment is actually welfare improving, although as seen from the current perspective it is highly undesirable. The challenge, therefore, is to provide incentives for the authorities to abide by past commitments. The proposed solution is to rely on the delegation mechanism: a principal entrusts an agent to deliver a particular task. The question is which agent, which task, and which control.

The experience of central banks points to the answers. For both monetary and fiscal policies, the principal is the same – the people. But monetary policy is vastly simpler than fiscal policy. Monetary policy deals mainly with macroeconomic issues, inflation, growth, employment, the exchange rate. Fiscal policy includes deeply redistributive functions that cannot be delegated to a single agent: all democratic countries delegate such choices to their parliamentary institutions which, by construction, embody the diverging interests.

It is essential to realise that fiscal policy fulfils two very different tasks. The first task is structural and redistributive: the size and aims of various spending items and the structure of the tax system. Redistributive decisions cannot be delegated to an agent. The second task is macroeconomic and is largely subsumed by the budget balance.[8] That task does not fundamentally differ from monetary policy and, to a first order of approximation, it can be designed independently from the first one. As such it can be delegated to an agent.

The key aspect of monetary policy is that the agent, the central bank, is given a clear constitutional mandate, and is made independent. These combined attributes sharply reduce the probability that the central bank will renege on its commitments. At the same time, the agent can exercise judgment (this is one reason why monetary rules have been discarded) and today's independent central bankers deliver both long-run price stability and short-run stabilisation. This feature lies at the roots of other cases of

[8] The macroeconomic effects of spending items and taxes differ, but these differences can be safely taken as second order of magnitude.

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delegation, such as anti-trust or financial regulation. There is no reason why it would not work for the macroeconomic aspect of fiscal policy making as well.

Fiscal Policy Committees

In each country, responsibility for setting the budget balance would be delegated to a new institution, the Fiscal Policy Committee (FPC). Like the central banks' Monetary Policy Committees (MPC), the FPC would include a small number of qualified persons appointed for long, non-renewable terms of office. FPC members could not be removed from office unless they violate their mandates and they would not be allowed to seek or receive instructions from governments, members of parliaments or any outside person or group. The FPC would be supported by a staff that would produce its own forecasts of economic conditions and budgetary figures.

The FPC would be given the explicit mandate of ensuring *debt sustainability* over the appropriate horizon. Over the short run this would leave the FPC free to choose deficits and surpluses, as justified by its analysis of current and future conditions.

The power of the FPC would be limited to set annual deficit figures (say, in percent of planned GDP) ahead of the government budgetary cycle. Its decision would have the force of law, and impose itself on both the government and the parliament.[9] The FPC would have no authority regarding the size of the budget, the tax structure and the allocation of public spending. All these matters would remain as in the currently existing political process.

The budget bill, including spending and revenue projections, would require FPC approval before it becoming law. Any budget that does not comply with the FPC's balance decision would either be

[9] A step in this direction has been adopted in Italy in the early 1990s. The deficit is decided by the government in the summer, and it takes the form of a law. When the rest of the budget (size, spending, taxation) is set by the government and discussed by the parliament in the fall, the budget law cannot be modified anymore. Von Hagen and Harden (1994) convincingly argue that this step has been crucial in Italy's successful efforts at stabilising and reducing its public debt. Another related development is the increased power of the Belgian High Council for Finances which can issue recommendations regarding the size of deficits at the federal and sub-federal levels, see Von Hagen *et al.* (2001).

void – and would have to be redrawn – or, alternatively, would activate an automatic procedure to bring the budget in line. As an example of the latter, spending and/or tax revenues would be adjusted pro-rata.

In the event of abrupt change in economic conditions during the period of budget execution, the FPC would mandate a change in the budget law. This could take the form of a new deficit figure, leaving again the government and the parliament with the task on adjusting spending and/or revenues. Eichengreen, Hausmann and von Hagen (1999) provide an excellent discussion of the relative merits of fixed review dates *vs.* discretionary interventions.

Finally, exceptional circumstances – unforecastable, by definition – may warrant a suspension of the debt sustainability obligation. This is what lies behind the override provision discussed in the case of monetary policy (see e.g. Roll *et al.*, 1993). Such a procedure must be exceptional: for instance, it could require a parliamentary vote with a super-majority.

The Debt Sustainability Mandate

The debt sustainability mandate can be formulated as the obligation to stabilise the debt-to-GDP ratio over the long run, i.e. cycle after cycle. Countries which start with a high debt, or which face large future commitments (due to an ageing population, for example) could aim at a given reduction of the debt-to-GDP ratio over a given horizon tailored to the length of the business cycles.

Such an arrangement sets the incentives right. The authorities know *ex ante* that any budget relaxation will have to be clawed back in the not-too-distant future. As a result, they are likely to adopt a debt-increasing stance only if they think that it will be efficient, not only in the short run but inter-temporally, i.e. if today's gains outweigh tomorrow's costs. Similarly, they will take advantage from favourable conditions to garner room for manoeuvre in anticipation of future adverse shocks.

An important aspect of these principles is that they eschew any numerical target for the debt level. As noted above, there is no optimal target level for public debts. Setting quantified targets inevitably elicits criticism, to which the response is to create an artificial "holly cow" which may be difficult to change later on. In addition, as made abundantly clear by the Maastricht convergence

process, artificial targets can be easily flouted precisely because they lack a solid enough basis to be adhered to.[10]

Democratic Accountability

The present proposal may be seen as a technocratic encroachment on a fundamental aspect of democracy. This is not the case, for the following reasons.

Macro vs. Microeconomics

The reason why fiscal policy is everywhere under direct parliamentary control is that it powerfully redistributes income. This aspect almost entirely originates in choices regarding the size of government, public spending programmes and the structure of taxation. In contrast, budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play no part in democratic control.[11] Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit. Taking the deficit and the debt out of the standard democratic process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is not different from that of monetary policy. In fact, the similarity between monetary policy and setting the budget deficit can serve as a guide to the procedure of democratic accountability to be applied to a FPC.[12]

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[10] A common problem with quantified constraints, which also applies to balanced-budget laws, is that they can be escaped through creative accounting, including off-budget spending or the creation of separate government agencies exempt from the constraints, see von Hagen (1992).

[11] It could even be argued that the current generation is ill-suited to provide a fair treatment of future generations.

[12] As I was formulating the present proposal I came upon a nearly identical one by Eichengreen, Hausmann and von Hagen (1999). They go in considerably more details regarding the design and functioning of their proposed National Fiscal Councils.

Parliamentary Oversight

The FPC would be accountable to a national elected body. The FPC will not be goal independent, it will be instrument-independent, since the goal will be set either in its mandate (balanced budget over completed cycles) or by the government (debt target for the length of the legislature). Accountability requires both *ex ante* and *ex post* oversight.

Ex ante oversight takes the form of regular testimony by the FPC president and the timely publications of the minutes of the FPC's policy setting meetings, including the votes of individual committee members, who could also be called to testify to the parliament. The FPC would be bound to publish its analysis, backed by all the technical material and data that may be used.

Ex post, the FPC would be held accountable of its record. In the event that the goal is not achieved, the parliament could take a number of actions: a reprimand to the committee, or to some of its members on the basis of published minutes and votes; the disappointment of the FPC, or some of its members, in case of serious failure.

5 Fiscal Discipline and Exchange Rate Coordination

Principles

When a number of countries decide to coordinate their exchange rate policies, they accept to go a long way towards sharing their monetary policies. The European Monetary System has become increasingly tight in this respect, to the point where full currency unification barely represented an institutional shift, not an economic one any more.[13] No matter how deep is the commitment – from agreeing to bilateral margins of fluctuations to joint pegging to a third currency or basket and to a monetary union – it carries important implications for fiscal policy as well.

First, with monetary policy partly or fully dedicated to the exchange rate commitment, the fiscal policy instrument assumes an increasing role in macroeconomic stabilisation.

[13] This point is elaborated in Wyplosz (1997)

Second, fiscal policy indiscipline represents a direct threat for monetary policy and undermines the exchange rate commitment. Run-away debt must be ultimately monetised, which means that the exchange rate must be devalued. The expectation of such an outcome never fails to trigger speculative attacks, Argentine being a recent example, as noted above.

Third, the exchange rate is partly determined by the policy mix. While we currently do not know precisely how the mix operates, this link is not disputed. When a number of countries undertake to jointly manage their exchange rates, one country's fiscal stance becomes a common concern because it creates an externality that goes beyond the income flow spill-overs.

For these reasons, any exchange rate agreement cannot operate satisfactorily unless it is underpinned by some agreement on national fiscal policies. In Europe, this has taken the form of peer pressure, eventually formalised by the Broad Economic Policy Guidelines as a tool to enforce the Growth and Stability Pact. In federal states – a form of monetary union – local governments typically face restrictions on their budget deficits. When they don't, as is the case in Argentina, the result can be catastrophic.

At the same time, the increased reliance on fiscal policy as a counter-cyclical instrument sharpens the trade-off between short-run flexibility and long-run discipline. Each country needs to use fiscal policy reasonably actively in the short run while committing itself to deliver strict discipline in the long run.

FPCs provide the right answer. Countries that contemplate to coordinate their exchange rates need to be reassured that all members will not rock the boat by running up their debts. At the same time, each country will want to retain national control on both aspects, microeconomic and macroeconomic, of their budgets. The natural solution is to agree to set identical national-level FPCs. By providing the same incentives to deliver fiscal discipline, such an agreement would go a long way towards assuaging fears that one country's indiscipline would wreck the exchange rate agreement. At the same time, national FPCs would guarantee that fiscal policy will be available as a stabilisation instrument.

The Case of Latin America

Latin America exhibits a number of unfavourable economic features.

It has been rocketed by a large number of financial crises. Several countries of the continent have achieved some of the worst inflation performances. Default on public debts have been rather frequent and widespread. Lack of macroeconomic discipline is therefore widespread. A number of countries have taken steps to remedy the situation. One of them, Chile, recently adopted a wisemen arrangement that shares many characteristics with the proposed FPC.

Equally disappointing is the low level of trade integration. Table 1 presents the openness index for those Latin American countries for which comparable data is available. By international standards, given how small their economies are, these countries are not very open. Comparing how trade splits internally (among the 11 countries reported) and externally, trade among Latin American countries is remarkably lower than among EU countries.

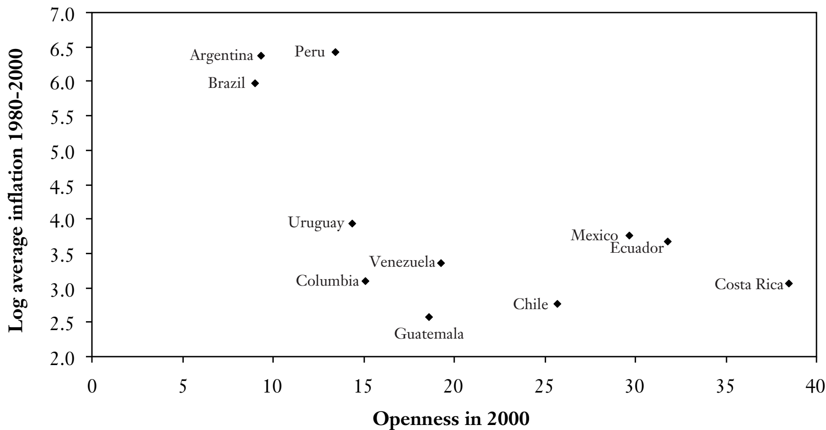
Table 1 Trade Openness Index[a] in 2000
(percentage of GDP)

	Total	Internal
Argentina	9.0	
Brazil	9.3	
Chile	25.7	
Mexico	29.7	
Venezuela	19.3	
Colombia	15.1	
Peru	13.4	
Uruguay	14.4	
Ecuador	31.8	
Costa Rica	38.5	
Guatemala	18.6	
Latin America[b]	17.8	2.2
European Union	*27.9*	*16.4*
US	*10.3*	
Japan	*9.0*	

Notes:
[a] The index is the average of exports and imports as a percentage of GDP.
[b] Latin America as consisting of the 11 countries reported above.

Source: IMF.

Figure 4 Trade Openness and Inflation in Latin America



Source: IMF.

The limited extent of intra-Latin America trade is a well-known feature. One of the many reasons is economic instability. For example, Figure 4 displays for the countries shown in Table 1 the apparent association between trade openness in 2000 and inflation over the previous decade. This negative link is well-documented in empirical trade studies. One key channel is exchange rate volatility, as shown in Rose (1999).

An immediate implication is that Latin America would greatly benefit from the gains provided by deeper regional trade. To achieve progress in this direction, it would need to sharply cut exchange rate volatility, which requires enhanced macroeconomic discipline.

So far, Latin American countries have sought greater discipline through purely domestic means. Success has occurred, but occasionally and, sometimes sporadically. The recent tendency has been to seek deeper ties with the US dollar, either through a currency board or through outright dollarisation. The fiscal component of macroeconomic instability seems to remain largely neglected, though. Unless this component is firmly secured, it is to be feared that the successes achieved so far will be short-lived.

Dollar links may have serious advantages, but they fail to bring home the point that fiscal discipline is as essential to macroeconomic stability as tying the exchange rate. Chile, the first country to adopt a sound, largely depoliticised fiscal institution, has done so a decade

after stabilising its exchange rate, in fact after it had abandoned a reasonably fixed parity. The failure to ensure simultaneously monetary and fiscal discipline is characteristic of the Latin American experience and lies at the roots of repeated mishaps.

A different route is possible. Jointly undertaking to stabilise their bilateral exchange rates will not only promote regional trade and overall economic efficiency, it will also encourage the Latin American countries to focus on fiscal discipline. Concern over each other's fiscal actions – and their deep politicisation – may have played an important role in discouraging regional exchange rate cooperation. Such concern is understandable and in fact desirable. But it can be turned around from a hindrance to an incentive.

The novelty of FPCs is obviously a barrier. It shakes much conventional wisdom, especially politically. The joint adoption of identical FPC institutions would help break through such barriers. It could make the arrangement more legitimate and it would go a long way towards assuaging suspicions of poor commitment to fiscal discipline. It would open the way to exchange rate cooperation, itself a step towards monetary discipline. Peer pressure could operate in the two spheres of macroeconomic policy: through joint management of bilateral exchange rates and through formal exchanges among the national FPCs.

6 Conclusion

The institutions of fiscal policy discipline have been lagging behind those of monetary discipline. Yet, the challenges are almost identical. While monetary policy has moved away from rules – often adopted two decades ago – the trend now is to introduce fiscal rules. Adopting FPCs would save time and disappointments.

FPCs are the fiscal policy equivalent of MPCs. They superficially clash with the notion that fiscal policy is a purely political function, which must remain fully subject to the usual process of parliamentary oversight. This view misses the crucial distinction between the deficit, which is essentially a macroeconomic choice, and the budget structure (size, allocation of expenditures and taxes) which falls indeed in the domain where democratic oversight is essential. Budget deficits, like interest rates, are best left to non-political bodies which operate in full light and are subject to democratic accountability.

Latin America stands to be a prime beneficiary of such an approach. The politicisation of fiscal policy has been excessive and has resulted in deep and repeated economic instability. That would be a good enough reason to adopt FPCs. There is an additional reason to do it jointly: it would break the barrier of mutual suspicions and open the way, at great last, to more regional exchange rate stability, a key pre-requirement for deeper trade integration.

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