FISCAL POLICY: WHEN THEORY COLLIDES WITH REALITY*

By

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Introduction

The term fiscal comes from the Latin word *fiscalis* which in turn comes from fiscus, i.e. a basket used for collecting money. In Italian “il fisco”refers to the agency that collects taxes. Thus “fiscal policy” means policy related to taxes. The same is the case in Spanish, French, and Portuguese. In English the expression “fiscal policy” was apparently first used by Edwin R.A. Seligman, a prominent professor of public finance at Columbia University in the early part of the 20th century. He used the expression to criticize Adolf Wagner, a German economist, who had suggested that governments should engage in some redistribution of income through their budgetary activities. This seems to be the genesis of the “redistribution branch” of the trilogy made popular by Richard Musgrave (1959). The Keynesian revolution changed the meaning of fiscal policy moving it away from the tax or revenue side of the budget to include both revenue and spending. For the Keynesians, fiscal policy refers to the manipulation of taxes <u>and</u> public spending to influence aggregate demand. Thus we had the genesis of the “stabilization branch” in Musgrave’s trilogy.

I. The Theory of Fiscal Policy

The theory of fiscal policy owes much to North European economists such as Jan Tinbergen, Bent Hansen, Leif Johansen, and others who five decades ago developed it. In spirit, if not in geography, Richard Musgrave could be placed among this group. There were obviously also contributors from North America such as: Alvin Hansen, Lawrence Klein, Abba Lerner, Robert Solow, Paul Samuelson, and others, but, in their writing, they focused mostly on the stabilization role of fiscal policy. The Keynesian stabilization policy is only a part, though an important part, of the modern theory of fiscal policy. In the conception of this theory, especially well developed in Musgrave's (1959) and in Johansen's (1965) treatises, the goals of fiscal policy extend beyond stabilization because fiscal tools can be used also for redistributing income and for reallocating resources

I will sketch the "Theory of Fiscal Policy" in its most essential elements and will outline the assumptions implicit in it. I will then argue that the reality can be far removed from this theory, at least in some countries. In contrasting the theory with the reality, I will use Italian examples. The reason is that, having been part of the Italian government, I know the Italian situation best and not necessarily because that situation is farthest from the theory. In fact my knowledge of other countries and discussions with foreign colleagues with inside knowledge of particular countries have convinced me the conclusions of this paper are also valid, to varying degrees,

for many other countries. However, this discussion may be less representative of the countries in the North of Europe for which the theory was originally developed.

Let me start with the main elements of this theory. Policymakers are assumed to have no other objectives but the promotion of the social welfare or the public interest of the citizens. The social welfare does not depend on any single variable or indicator, but on several indicators, some of an economic nature and some of a social nature. The way in which the policymakers rank these indicators change with time or with the government in power. In representative democracies this ranking is assumed to reflect the preferences of the citizens and changes in those preferences.

Examples of economic indicators are: economic growth, growth of employment, growth of productivity, the rate of inflation, income distribution, unemployment among particular groups, and so on. Examples of social indicators are: life expectancy, incidence of crime, literacy rates, the quality of the physical environment, the incidence of illnesses, and so on.

The policymakers responsible for economic policy will naturally focus on economic indicators. They have some perception of the weight that each of these indicators, y_i, has on the welfare function, W1. Thus we can write the equation,

(1) $W = f\,(y_1, y_2 \ldots\ldots y_n)$

The policymakers are aware that the indicators, y_i can be influenced by changes in particular policy instruments, x_j. These instruments are the "handles" available to the policymakers to modify the social welfare and to steer it toward an

optimum.[1] Therefore, each indicator is a function of the policy instruments. Thus, we can write the equation,

(2) $y_i = f(x_1, x_2, x_3 \ldots x_j)$

Often a particular instrument x_i is especially efficient in influencing a specific indicator y_i. Efficiency in this context means the change in an instrument, Δx, necessary to change an indicator by a given amount, Δy. If a small or realistic change in an instrument can produce a significant change in an indicator, then the instrument is considered efficient with respect to that indicator.[1] When efficient instruments are available to promote desirable objectives economic, policy becomes easier.[2] Examples of policy instruments are: various taxes; particular features of taxes such as deductions and rates; various categories of expenditures; particular features of expenditures; and so on. Fiscal deficits can also be seen as indirect instruments to pursue stabilization policies. They are influenced by changing taxes and spending. Non-fiscal economic instruments are the exchange rate, the interest rate, regulations and so on. They also influence the socio-economic indicators but they will be ignored in this discussion, which is focused on fiscal policy.

If some technical conditions are satisfied then the implicit system of equation formed by the relationships mentioned above can be solved for the values of the instruments that would maximize the social welfare, W.[3] This mathematical solution may require too large changes in the instruments. However, if the instruments are

efficient, the solution of the equation will require changes in their value that are technically or politically feasible.[4]

Stripped to the bare bones, this is the Theory of Fiscal Policy. It provided the essential theoretical framework or guidance for much of the fiscal work in the past half century. Jan Tinbergen got the first Nobel Prize in Economics largely for his contribution to the development of this theory.

II. Assumptions of the Theory

Most theories contain assumptions. Sometimes the assumptions are explicit; often they are not. Sometimes they are realistic; often they are not. What are the important assumptions implicit in the Theory of Fiscal Policy? And how realistic are they? I will discuss the main ones.

First Assumption: The existence of a Nerve Center, that is of an office or a place where that rather abstract concept that we call the "government" decides which policy instruments to use to influence the economic objectives that it considers important to promote and to maximize the social welfare. The existence of a Nerve Center implies to a large extent: (a) a unitary form of government; (b) a unified budget; and (c) a prime minister, president or finance minister with the political power to set the desired objectives and to change the policy instruments in the desired direction and by the needed magnitude.

This first assumption implies the existence of an all-inclusive budgetary process. No public finance decision is made outside the budget; or, at least, all decisions, whether in or out of the formal budget are directly or indirectly controlled by the Nerve Center. There cannot be any fragmentation of decision making either because of different levels of government , each with independent power, or because of policy differences among ministries or between agencies. This also implies that the budget for sub-national governments, or for extra-budgetary institutions, must not be a soft one.

When differences in objectives or in the use of instruments exist among policymakers, they must be ironed out within the Nerve Center. This assumption deals essentially with political power and administrative controls and with how fragmented the political power is and how it can be used. Obviously, the political power is partly the result of the support that the government receives from the electorate and partly the result of institutional arrangements determined by a country's constitution.[5] It is also partly the result of the real control that the government has over the bureaucracy and the legislature.

Second Assumption: Those who represent the government have only the public interest of the citizens in mind when they make the policy decisions. They are not influenced by their personal interests, or by the special interests of particular groups or geographical areas. There are no effective lobbies operating outside the electoral process and there is no scope for corruption, rent seeking or "state capture."

Policymakers avoid "populist" policies, that go against the public interest, even when these policies have short run appeal that could help those in power win the next election. Thus the electoral cycle plays no role in budgetary decisions.

Third Assumption: When it makes the budgetary decisions, the government has available to it the best economic analyses that money can buy. These analyses must be based on reliable data, on unbiased forecasts, and on accepted economic principles that establish links between changes in policy instruments and changes in policy objectives. From these analyses, the policymakers must be able to determine, with a reasonable degree of accuracy, that a given change in policy instrument is expected to cause a given change in a particular objective. These analyses rule out policy decisions based on "gut feelings," impressions, ideology, wrong data, biased forecasts, electoral promises, or simply antagonism toward previous governments.

Fourth Assumption: Because the policy instruments are generally imbedded in legislation, they can only be changed by enacting specific new laws or by changing current laws.[6] The bills submitted to parliament and the approved laws are assumed to be clear, specific and to contain as little "noise" as possible. They must not create asymmetric information, or problems of different interpretation, between the government, on one side, and the citizens, on the other; or even between the policymakers and the public servants who write the laws, on one side, and those who must enforce or administer them, on the other. A law must be identifiable, as much as possible, with a specific policy instrument. It must be possible and easy to

determine which instrument a specific law wants to change and which policy objective it wants to influence. In other words, the x_s in equation (2) above must be identifiable in the laws. To the extent possible, the laws should avoid dealing with, or be directed towards, multiple objectives. It is generally inefficient to try to influence more than one objective with one instrument.

Fifth Assumption: The executive branch must have as much control over the policy instruments (i.e. over the proposed laws) as it is feasible in a democratic society. This assumption has several corollaries some already implicit in the above discussion.

First, parliaments must, of course, have the prerogative to approve or turn down the proposals submitted to them by the executive. They should also have the prerogative to improve the proposals or amend them in some relevant ways. However, they should not have the prerogative to change them in fundamental ways; or to delay unduly action on proposals submitted by the executive. It is the executive branch of government that, within clear constitutional limits, must control the instruments of economic policy, not the parliament.[7]

Second, and related to the first assumption, the various ministries must operate in a harmonious or coordinated way and must not push for conflicting legislation. What we have called the Nerve Center must solve any internal conflicts.

Third, most spending or taxing decisions must be exercised during the budget period, which is normally one year but can be longer. The authorization to spend

money authorized in a budget must not stretch out over several budget periods, except for spending connected with large capital projects that by necessity take several years to complete. Unspent resources or unpaid liabilities should not characterize the end of the budget period. When this happens, the impact of fiscal policy on the economy and the budgetary outcome become more difficult to determine.

Fourth, decisions made upstream, by the executive, and approved by parliament, must not be distorted downstream by the existence of principal-agents problems. Principal-agents problems can occur at the level of ministries, institutions, departments, or even at the level of local offices. When principal-agents problems are significant, the signals sent from the top can change in various ways in their application. See Tanzi (2000). When these problems are common, the impact of the change in the policy instruments, can be much different from the expected one.

III. The Reality of Fiscal Policy

What I described above is the framework that many economists have in mind (even though they might not be aware of it) when they write theoretical papers dealing with fiscal policy. For sure that framework is still reflected in textbooks. As I described it, that theory of fiscal policy originated in the writings of mostly North

European economists in the 1950s and 1960s.[8] It was a “normative” theory, that is, a theory that tells us how the world should behave, not how it does. Or, perhaps it was a “naïve positive theory” based on a view of the world as seen by the citizens of particular countries. Unfortunately, it was far from the reality that exists in other countries, both industrial and especially developing countries. Thus, while the theory is still useful in telling us what the world should be like, it is less useful in telling us how much of the world actually behaves.

There have been two main challenges over the years to this theory. An earlier one coming from the “Public choice School” and a more recent one coming from “The Positive Theory of Fiscal Policy.” Both have been influenced by present or past works of Italian economists.

The “School of Public choice”, largely developed by James Buchanan, Gordon Tullock and others, and inspired by the “Scienze delle Finanze,” the literature that prevailed in Italy about a century ago, would not accept the “Theory of Fiscal Policy” because of its deep suspicion of governments and its skepticism that policymakers and bureaucrats can be separated from their personal interests and incentives in the pursuit of the “public interest”. The “positive theory of fiscal policy” developed by economists such Alberto Alesina, Guido Tabellini, Alan Drazen, Torsten Persson, J. Von Hagen and others seems less suspicious about the notices of policymakers and bureaucrats and more attentive to the institutions and institutional set up that determine policy outcomes. This school seems to conclude

that with better institutions and better institutional arrangements good policies could be pursued and better objectives could be achieved. In other words, the "Positive Theory of Fiscal Policy" does not necessarily invalidate the "Theory of Fiscal Policy" but it argues that the latter can be valid only if given institutions are in place.

In the rest of this paper I shall take the assumptions outlined above and assess them for their degree of realism. The conclusion will be one of skepticism that, in realistic circumstances, the premises of the Theory of Fiscal Policy can be realized.

First Assumption: The existence of a Nerve Center where all the economic decisions are made and intragovernmental differences are ironed out. What impressed me most in my two years as an Undersecretary in the Ministry of Economy and Finance was the absence of such a center. The prime minister's office did not play such a role. The ministry of economy and finance, in spite of, or perhaps because of, its enormous power,[9] was in frequent conflict with other ministries, which pushed for a different allocation of budgetary resources. These conflicts originated from different objectives which, in turn, reflected different party affiliations or even geographical areas represented. This made it difficult for the ministry of economy and finance to guide economic policy. The various parties in the government coalition were often in sharp disagreements with one another on specific policies and these disagreements were not ironed out within the government. Rather they often went public, giving the impression that the government did not have a clear sense of direction. Each group saw the public interest in a different

way. Some parties were continually threatening to leave the coalition and some ministers were threatening to resign unless policies of interest to their supporters were enacted.[10]

Out of this situation it would have been difficult to come out with a coordinated set of policies that would put in motion changes in policy instruments that would in turn lead to changes in objectives consistent with the "public interest." Putting it bluntly, there was no clear compass to guide the government in a specific direction. Therefore, in spite of the absolute parliamentary majority of the government, which made it possible for it to pass any law on which the parties that formed the governing coalition could agree, the political power necessary to make coherent economic policy was either missing or could not be exercised. The result was inaction on several fronts so that essential reforms were not made or when made were watered down.

Second Assumption: The government has the public interest in mind and only promotes the social welfare of the citizens. I must confess that I always had difficulty with the concept of public interest and social welfare. In a real sense I could never see precisely what it meant.[11] The public interest or the social welfare, should be the outcome of many objectives. Different citizens, or regions, or ethnic groups, or demographic cohorts, or different political parties inevitably give different weights to each of these objective. Thus, to determine what the public interest is and to promote it, it must be possible to give values to and to weigh, the various

objectives that contribute it. But how is this possible? Who decides on the trade offs among the objectives? When can one say that the government is not following the public interest? There is often no place within the political structure of most countries where the basic question of interest to economists is asked: what is the public interest and what can we do to promote it?[12]

It can be argued that the more even is the income distribution of a country, and the more homogeneous is the population, the easier it should be to determine "the public interest." In these circumstances, as a first approximation, it could be assumed that the citizens would rank and value the objectives in similar ways.[13] The countries where the theory of fiscal policy originated, the Northern European countries, especially in the 1950s and 1960s had in fact, fairly homogeneous populations and low Gini coefficients. However, today many countries are characterized by great heterogeneity of the populations, uneven income distributions, cultural, ethnic, and income differences among regions of the same country and other characteristics that would make it difficult, even in theory, to determine the public interest. The increase in income inequality, the growing cross-country movement of people, and the aging of the population may have increased the heterogeneity of the populations making economic policy more difficult.

Third Assumption: The government bases its policy decisions on the best economic analysis possible. The naked truth is that often there is no economic analysis behind a policy decision. The decisions often appear out of nowhere, or,

sometimes, are justified because they reflect some electoral promise. Ideology becomes a substitute for analysis. Or the analysis may be the one provided mainly by lobbies interested in promoting a specific policy.[14] Often there has not been a serious assessment of what effects a policy decisions will produce, or how much it will cost, or will generate in revenue. This is especially the case with proposals promulgated in the last few days before the budget is sent to parliament for discussion and approval.

In Italy the submission of bills to the two commissions in each "camera" in Parliament that deal with budget or finance issues must be accompanied by some numbers on their costs, or their revenue generations and their probable effects. The Italian Constitution specifically requires the provision of these estimates. These estimates are prepared by the Ragioneria Generale dello Stato, if they involve spending, or by the Dipartimento per le Politiche Fiscali, if they involve revenue. The staff of these offices is made up for the most part by lawyers whose expertise is in drafting laws or in checking whether existing laws are being observed. They have little specific training in analyzing the economic or fiscal consequences of policy proposals.[15] Perhaps more importantly, they are given little time to prepare these estimates. In spite of their best efforts, it is no surprise that their estimates are often widely off.

Take as an example a law that, by providing specific incentives, was intended to make individuals working in so-called underground economic activities emerge

and become officially registered workers.[16] The estimate that was prepared and was sent to parliament predicted that a total of 900,000 workers would emerge. The actual number that emerged was about 450 (sic) workers. Errors in estimates are normal, but errors of this magnitude point to deeper problems. On the other hand a law that encouraged the "repatriation" of capital illegally held abroad (a kind of amnesty) had been estimated to encourage the "repatriation" of about 50 billion euro. By sheer coincidence the actual figure came close to it. But it was just a coincidence. The 50 billion euro had been largely picked out of thin air.

Major tax reforms are at times made after a lot of preparatory work. This was, for example, the case with the Carter Commission in Canada, the Meade Commission in the United Kingdom, and the 1986 Reagan reform in the United States. At times, however, little work goes into them.

The Legge Delega (Loi Cadre) which set the stage for the 2002-2003 Italian tax reform, was prepared with <u>no quantitative analysis</u> even though it aimed at drastically changing the Italian tax system.[17] In a country with a very high public debt and fragile public accounts one would have expected that, before sending a proposal for a major tax reform to Parliament, its potential revenue implications, as well as the redistributional impact of the reform and its impact on economic variables, should have been assessed carefully and in detail. It was not the case. The reform was sent to Parliament <u>before</u> any serious empirical evaluation of it was made.[18] The impression that one got was that such an evaluation was not necessary

because the tax reform responded to an electoral promise and electoral promises do not require empirical analyses or evaluations. If the reform did not fit the macroeconomic situation, so be it. In any case, it was promised that “fiscal space” would be created in future budgets to accommodate it. There was no explanation of where this space would come from in a situation of deteriorating fiscal accounts.

I could provide other examples but the above should convey the essence of the problem.[19]

Fourth Assumption: Matching of proposed laws with specific policy instruments and economic objectives. And clarity of the laws.

The theoretical view of fiscal policy in a democratic setting must assume that a country’s laws are the (fiscal) instruments through which policymakers aim at changing the policy objectives in the desired direction.[20] It also requires, for efficiency reasons, that an instrument should not aim at promoting more than one objective. Each law should, thus, preferably aim at promoting a single objective.[21] Unfortunately the real world is more complicated than that. Parliaments tend to be law factories. They produce too many laws. Furthermore, most laws are very complex, deal with multiple objectives, and are written in a language too arcane for the common citizen to understand.

According to different estimates, there are now somewhere between 30 thousand and 150 thousand laws in existence in Italy.[22] Many of these laws do not deal with economic objectives. But many do. Some of these laws may be a hundred

years old but are still valid. One curious feature is that laws are almost never abrogated. They are just amended. These laws are the instruments through which the government aims, or better was aiming at the time the laws were enacted, at influencing particular social or economic objectives. Thus, they are, in effect, the x_s in equation (2) above. Since the desired objectives cannot be that many, there is obviously an over abundance of instruments. It would be difficult to claim that many of these laws are efficient policy instruments. Many laws contain hidden tax incentives or tax expenditures even when they do not deal explicitly with taxation or spending. Many of them attempt to promote indirectly some redistributional objectives. In Italy there is almost an obsession to use most instruments for some broadly defined and vague equity objective. This makes many laws inefficient vis-à-vis their original, intended purposes.

When a bill is presented to Parliament for approval into law and begins to make the round through the various parliamentary commissions, amendments begin to be attached to what may already be a complex bill. Many of these amendments are proposed by the government itself. More will be proposed in the discussion in the full Parliament, often encouraged, behind the scene, by some interested minister. At times these amendments are in the thousands. This Christmas tree approach, in which every member of Parliament can, in theory, hang something on the initial proposal, often produces a final product (the law that is approved) that is quite different from the initial or the intended one. This

also means that it becomes progressively more difficult to estimate the impact of the law on the fiscal accounts or on the intended objective, even though the relevant offices try hard to produce estimates of that impact. These offices must, at times, prepare these estimates for major revisions literally within hours of the time the revisions are proposed. This is especially the case when the proposals for changing the budget document are discussed in Parliament just before Christmas.[23]

In Italy there is a legal requirement to limit the content of bills, presented to Parliament for approval into laws, to single issues. This requirement is consistently violated. In 2002, this problem became so acute that the President of Italy,[24] for this reason, took the extraordinary step of refusing to sign into law some bills already approved by Parliament, that had been sent to his office for his final official imprimatur, before they became laws. This is not an exclusively Italian problem. It exists, for example, in the United States where, occasionally, totally unrelated spending requests are attached to a bill that deals with some other issue.

The <u>clarity of the laws</u> also deserves a comment. Laws are directed at citizens and thus the citizens should be able to read and understand them so that they can follow their directives. This was the case with the laws were written on stones in old times. Often in the modern world this is not the case. More than once I found myself in situations in which a particular bill presented to Parliament

dealt with topics in which I was considered, and considered myself, an expert. In spite of this, I had great difficulty in understanding what the bill said. This was in part a consequence of the "legalese" or archaic language used by those who draft these laws. In part it was due to the fact that most bills make reference to, and are linked on, existing laws that may have been on the books for decades and that themselves may have been amended several times before. Without consulting these past laws, and without spending a lot of time doing it, it would be impossible for a normal person, even one with some relevant training, to understand the content of specific bills. When there are tens of thousands of laws, it is easy to see the difficulty for the normal citizens. The Romans used to say that ignorance of the law is no excuse. I often wondered whether non-understanding can become an excuse.[25]

The result is the creation of de facto asymmetric information between the bureaucrats who write the laws, and the citizens, who must observe them, or even the parliamentarians who approve the laws. This asymmetry gives a lot of power to a few, well-placed bureaucrats and leads to the creation of an extensive industry of advisors, consultants, and facilitators on whom the citizens must depend for interpreting the laws and for abiding by some of their requirements. There are important consequences that follow from this situation.

First, the industry of advisors, consultants, and facilitators is a largely unproductive activity; it is a dead weight. However, it is an industry that attracts

a lot of very able people because of the high incomes that it makes possible. By absorbing much valuable human capital, which could have been put to more directly productive uses, it must slow down the rate of growth of the country. Second, estimates of costs and revenues (for the public accounts) made for these bills are often wrong leading to potential fiscal difficulties.[26] Third, the specific role of the state that the government tries to promote through these laws is difficult to identify. As a consequence, it is difficult to identify the public interest that is being pursued and the causal relation between a law (as a policy statement) and a particular objective. Fourth, as it almost surely happens with the many tax incentives buried in hundreds of laws that are strictly not tax laws, some of the objectives pursued by the laws are likely to neutralize one another. Fifth, many citizens often live with the uncertainty as to whether they have complied with the requirements of the tax laws. Uncertainty is not good for economic development, as Kydland and Prescott, the 2004 winners of the Nobel Prize in Economics have shown. This is certainly the case with tax laws.

Finally, I often asked myself whether what was not clear to me, as a public finance expert with a lot of training and experience, could possibly be clear to the members of the Italian Parliament most of whom had far less training and experience than I had. The only reasonable answer to this question is that most of them probably pay attention only to those features of bills that interest them personally, or interest directly their supporters or their region. For the rest of the

budget, they largely follow party instructions, which in turn follow the advice of the civil servants politically close to their party. But again, it should be stressed that this problem is far from being confined to Italy.

Fifth Assumption: Government control over the policy instruments. This assumption has various components. However, the key question is whether the group of policymakers that make up "the government" truly controls the policy instruments, coordinates their use, determines the objectives to be pursued, and has full and timely information on what is going on.

On the issue of control of policy instruments and determination of the objectives to be pursued, I argued earlier that (a) the absence of a powerful Nerve Center; (b) frequent disagreements on the use of instruments and on the goals to be pursued among ministries and coalition parties; (c) the power of each member of parliament to propose amendments to legislative proposals; and (d) the existence of asymmetric information between policymakers, on one side, and, on the other side, the civil servants who draft the legislative proposals and, as importantly, the regulations that give specific content to these proposals (the "regolamenti attuativi"), imply that the government's control over the instruments is often tenuous.[27]

Some of these issues would require a lot of time and space to discuss in detail. Rather than discuss them, I will address briefly a topic of particular interest to macroeconomists, namely the pursuit of fiscal policy for stabilization,

the issue of concern for the Stability and Growth Pact and for the use of fiscal rules in general. This topic is closely related to the question of control over policy instruments. Thus, it provides a good example of some of the issues discussed above. How much real control do the policy makers have on the fiscal instruments necessary for countercyclical policy?.

IV. Fiscal Deficits and the Stability and Growth Pact

As, perhaps, the best known fiscal rule, the Stability and Growth Pact (SGP) sets limits to the fiscal deficit, as a share of GDP, that a country that is a member of the European Monetary Union, can have in a particular year. Economists and policymakers have debated at length whether this is a good or bad rule.[28] However, most agree that it is a clear rule and most would assume that the authorities of the member countries know at any one time whether or not they are complying with it.[29] If they are not, or are in danger of breaking the rule, it is generally believed that the policymakers could take quick and precise actions to make the needed correction. Whether various lags make this possible is an issue that will be ignored here. See Tanzi, 2005. If they do not want to challenge the fiscal rule, they can decide on what measures to take to bring the deficit back toward the required level. Unfortunately, the reality is often not so simple. First,

because the policymakers often do not know where they are. Second, even if they knew, they might not be able to get the deficit where they wanted it to be.

The concept of deficit used to assess compliance with the Maastricht rule is, in theory, an "accrual" concept that follows rules established by Eurostat, the European statistical office.[30] This "accrual" concept, though theoretically superior to the cash measure still used by many countries, has some complex and controversial rules; it is not simple to calculate and can only be calculated ex post, that is, after the fiscal year has ended. In Italy, it is calculated (by the Statistical Office) a few months after the end of the fiscal year. Furthermore, at the time it is calculated some important data used in the calculations are estimated and not final ones.[31] Therefore, during the fiscal year, when corrective measures could be taken, the policymakers do not know precisely what the deficit is and can be quite wrong about its true level.[32] The European Commission's, Excessive Deficit Procedure notification, that informs a country that it has exceeded the deficit limit, can be a complex document that can run into a hundred pages.

During the relevant fiscal year, the policymakers receive information on a "cash" measure of the deficit --in Italian, "fabbisogno". The cash measure reports the difference, in cash, between payments and receipts. This measure can be calculated on a monthly or even, if accounting permits, on a daily base. Thus, it has the virtue of being timely. However: (a) it is not the concept used by Eurostat; (b) it can diverge significantly from the accrual concept; (c) it can

change for totally spurious reasons;[33] (d) it can be easily manipulated by the authorities;[34] and (e) it can relate to different parts of the public sector so that two different institutions such as the Central Bank and the Ministry of Economy can produce different results for this concept because they are measuring different parts of the public sector.[35] If it is added that both the accrual and the cash concepts of the fiscal deficit can be changed by once-for-all (una tantum) policy measures, such as tax amnesties, sale of public assets, or maneuvers of financial engineering, it is easy to see the predicament: The government does not know where it is in a true or precise sense. And it does not know how far it is from the desired destination. It can be misguided by the impact of transitory measures and by the inevitable optimism that often characterizes public discussions.[36]

Naturally to the above difficulties must be added the problem discussed earlier: namely whether the government, even if it knew where it was, would have enough control over the instruments of policy, and enough knowledge of the relationships between changes in the laws and changes in the fiscal outcomes to be able to take prompt and precise actions. In the absence of this control and knowledge, governments may rely on primitive and inefficient measures, such as the building up of arrears, the rationing of cash, and so on. These measures have often been taken by developing countries to meet the fiscal ceilings agreed in programs with the IMF.

VI. Concluding Remarks

Papers on fiscal policy are largely silent on which measure of the fiscal deficit (the cash or the accrual) is the more relevant one for stabilization purposes.[37] When economists or even fiscal economists, write papers about fiscal policy and discuss the fiscal deficit of a country, they rarely bother to specify which concept they are using. They assume that this issue is trivial.

But when a "cash" measure of the deficit is, say, 2-3 percentage points of GDP higher than the accrual measure, and both measures can be wrong, how expansionary is fiscal policy?[37] Which measure gives the best assessment of the Keynesian stimulus? And, what corrections should be made when once-for-all measures are used? Which fiscal deficit provides the best instrument for conducting counter-cyclical fiscal policy? In fact, should governments use counter cyclical policy at all or simply aim at improving the fiscal account in the medium run trying to avoid running pro-cyclical fiscal policy as argued in Tanzi (2005)?

Economists have not addressed these important questions and have let the statisticians choose the relevant concept. The concept that the statisticians have chosen, though superior to the cash concept in some ways, suffers from the shortcoming that it does not provide to the policymakers a gauge of the fiscal situation at the time when it is needed – during and not after, or much after, the

fiscal year. Economists should pay attention to these questions and to the issues raised in this paper. Through their assumptions and their rigorous analysis economists have attempted to be scientific and precise. This has resulted often in too much rigor and too little relevance. But, as Keynes once remarked: "it is better to be broadly right than precisely wrong."

Endnotes

1. It must recognized that changes in instruments can be constrained by laws, politics, or administrative difficulties. Small changes in instruments are more likely to be made than large changes.

2 However, as Graaff put it as far back as 1957 in his classic work on welfare economies, "…it does not seem to be realized how detailed the agreement on ends must be if a consistent theory of welfare economics is to be erected…"

3 The conditions to be satisfied are specified in Johansen's book.

4. Passing from the mathematical to the economic solution, it must be realized that the mathematical solution may imply unrealistic changes in the instruments. Thus a mathematical solution does not imply a feasible policy. This aspect has attracted very little attention.

5. This is an area where the work of Persson and Tabellini (2004), von Hagen (1992), Alesina et al (1999) and IDB (2005) is relevant.

6. This is an area where fiscal policy is fundamentally different from monetary policy. The changes in the instruments of monetary policy do not require legislation while those of fiscal policy always do. This makes the conduct of fiscal policy much more difficult and it has led to proposals to create "fiscal councils' that would have power within certain limits to change policies without parliamentary approval. See Eichengreen, Hausmann and Von Hagen (1997).

7. This, for example, is a requirement well satisfied by the legislation of Chile where the Constitution limits the initiative of parliament in promoting policies that have fiscal implications. See IDB (2005).

8. Probably the clearest expression of it is in Johansen's book (1965).

9. For example in 2004-2005, while in the United Kingdom the budget directly controlled by the Chancellor's Departments was only about one percent of the total Departmental Expenditure Limits, in Italy the budget (net of interest payments) directly controlled by the Ministry of Economy and Finance was 52 percent of the total. Reported in Giarda et al (2005) p. 10.

10. Of course, this situation was largely the result of the fact that the government was one of coalition. Thus, it was the consequence of electoral rules. See IDB (2005) for a discussion of the importance of electoral rules.

11. This concept was much discussed in the economic literature around 1960. See Down (1957) and Arrow (1963). For skepticism about this concept see also Graaff (1957).

12. This question tends to become highly relevant when equity and growth objectives must be traded one against the other. But the question is much broader than that choice.

13. However even in these countries, the age distribution of the population may create different objectives for retirees and those in working age.

14. This seems to have become a major problem in the United States in recent years.

15. The same comment can be directed to the Corte dei Conti whose staff is made up mostly by lawyers who are experts in the legal rather than the economic aspects of budgeting.

16. ISTAT, the Italian statistical office, had estimated that four million workers worked in these unregistered activities in Italy and that they produced about 15 percent of the Italian GDP.

17. The whole discussion about a fundamental tax reform was limited to a single day's meeting by a group of experts.

18. Later various groups produced (often contrasting) estimates.

19. Newspapers reports indicate that the experience in the United States has been similar to that reported for Italy.

20. There are no independent National Fiscal Councils anywhere so that in democracies changes in fiscal policy require legislative approval.

21. Although there might be occasions where it would be possible to promote more than one objective with the use of one instrument.

22. The estimate of 30,000 is probably more reliable.

23. The desire to go home for Christmas is the major incentive to conclude the budgetary process. Typically the budget is approved 2–3 days before Christmas.

24. The President of Italy must be distinguished from the President of the Council of Ministers. He is the president of the country and not the head of government.

25. There have been attempts on the part of some countries (Australia, New Zealand and France) to simplify the language of the laws. But so far success has been limited. These attempts require more time than any government is likely to last in power. So there are no strong incentives to push them to completion. Also one suspects that the bureaucracy may not have much interest in this simplification because it would reduce its power.

26. Inevitably underestimation of costs or overestimation of revenue are frequent. There is no systematic study of this problem in Italy. The conclusion of the sentence is based on the experience of several individual laws.

27. Often the "regolamenti attuativi" are the ones that give real, operational content to the laws. The policymakers play a limited role, if any, in these regulations.

28. Inter alias, see Tanzi (2004 and 2005).

29. Of course, this is not the same thing as to whether in previous years they were or were not in compliance. The discovery that in past years the fiscal deficit of particular countries were higher than previously reported is a problem not limited to the European Union. It has been a frequent problem in IMF programs.

30. In practice the concept is a combination of accrual and cash data.

31. This is especially the case for data on health expenditure. This implies that there may be large revisions years after the end of the fiscal year.

32. For 2001, the difference between what the government thought (as late as September 2001) that the deficit was and the actual revised deficit was about two percent of GDP.

33. For example, it is influenced by the decisions of the tax authorities to accelerate or slow down the reimbursement of overpaid taxes, especially by exporters in relation to value added taxes.

34. Through pressures on enterprises, over which the government has a controlling share, to anticipate a dividend distribution; or by decisions to postpone some payments including salaries and even interest payments.

35. In Italy it has not been possible so far to reconcile these differences.

36. On this point see also Balassone, et a. (mimeo: no date).

37. However, they agree that the concept should include as large a part of the public sector as possible, although a controversial issue is the inclusion or not of public enterprises.

38. These are differences that have existed in Italy in recent years.

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