Returning to the Golden Rule of Balanced Budgets: The Institutional and Political Economy of Restricting Public Deficits and Debt

Bernard Dafflon
IMFG Visiting Scholar
November 15, 2017

@imfgtoronto | #IMFGtalks

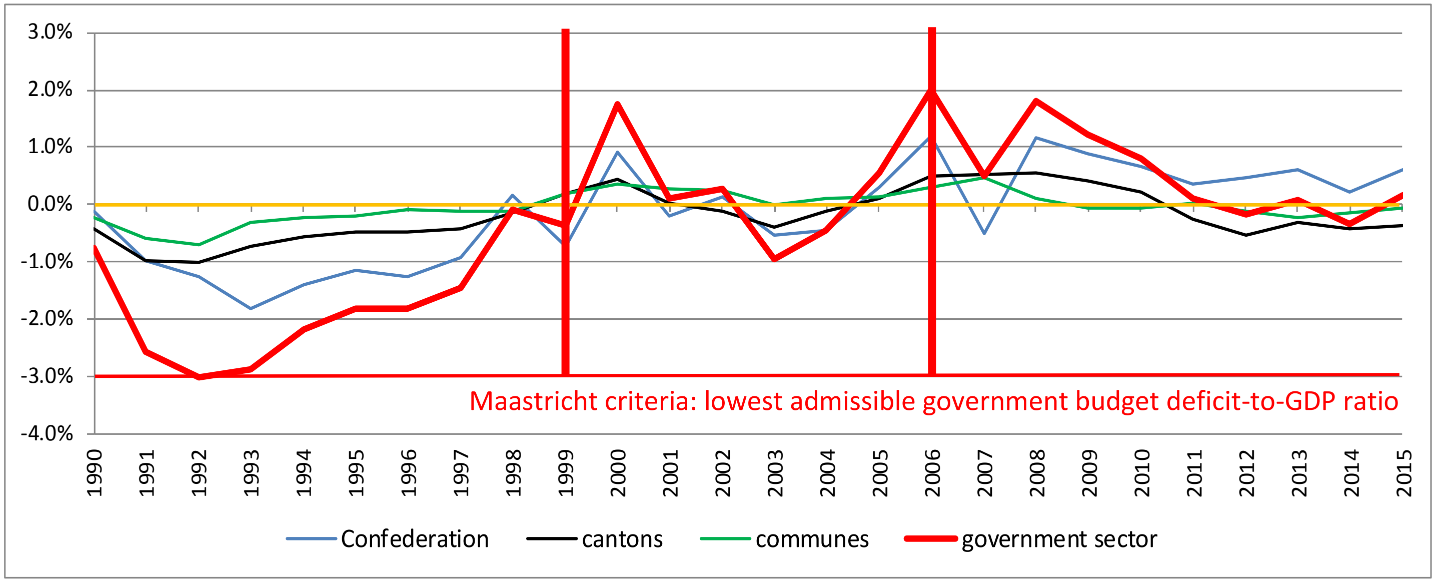
IMFG Institute on Municipal Finance & Governance at the Munk School of Global Affairs, University of Toronto

The Institutional and Political Economy of Fiscal Rules: Restricting public Deficits and Debt – the Swiss experience

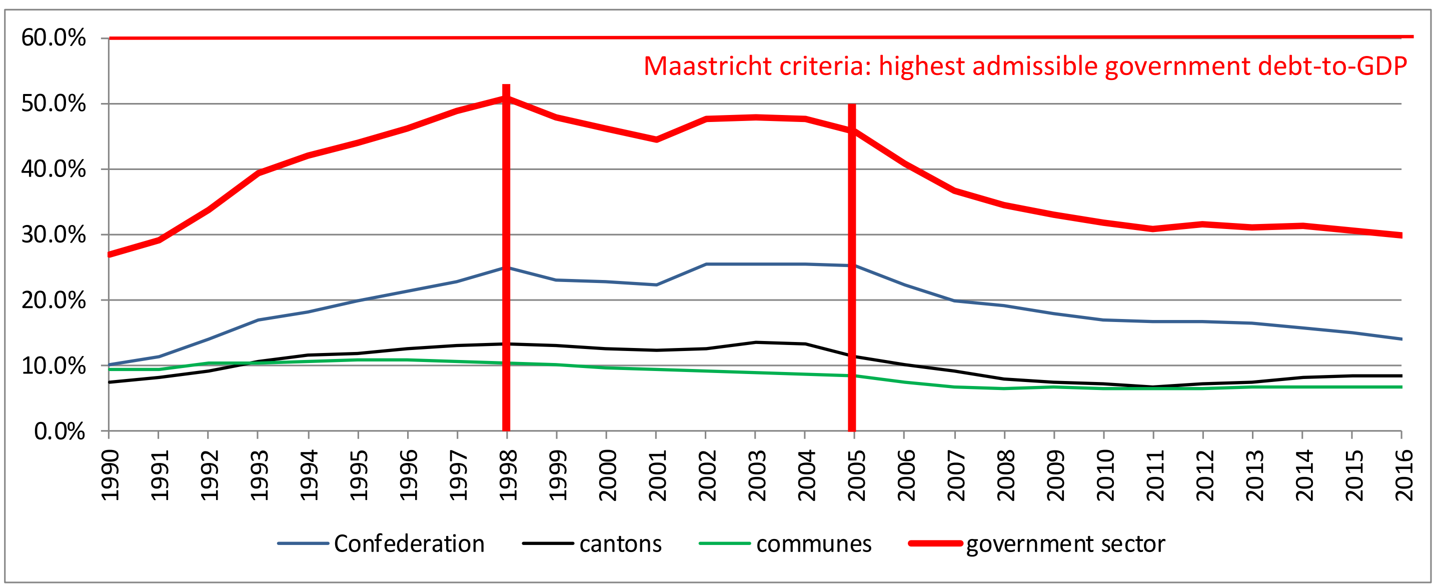
Bernard DAFFLON

1. Introduction: where do we start from? **2. The fiscal position of government layers through time: facts and figures** **3. The golden rule and more** **4. From concepts to practice : six questions for the design of fiscal rules** **5. Implementation**	How does one design the legal framework on government deficit and debt brakes? What are the legal and technical requirements in the budgeting process to implement the rules? How is organized the accounting system so that the operationalization is effective, traceable and accountable? How can one evaluate the outcome or performance? Are governments really doing in terms of budget responsibility / discipline what they said they would do?

Government deficit / surplus-to-GDP ratio 1990 - 2015



Government debt-to-GDP ratio 1990 - 2016



What reasons are behind the inflexion points?

In the Swiss case, municipal performances are better than cantonal ones and cantonal performances are better that federal ones.

Fiscal rules in the form of deficit and debt brakes give better results than macroeconomic-based rules such as the Maastricht criteria.

The "small story" behind the analysis

1977 **1) Association of bankers' letter to the Ministry in charge of Municipal Affaires: municipalities <u>do no pay</u> debt instalments <u>in due time</u>! Some are in a situation of over-indebtedness.**

2) First control in the municipalities' balance sheets over ten years:

- **amortizations in the book <u>are not coupled</u> with effective debt instalments:** 79 communes (out of 265) had excessive indebtedness
- **rates of amortization are <u>too low</u>: 1 or 2% in the cantonal authorizations to borrow given to the municipalities for their investments:** all communes with few exceptions

3) What were the references at the time?

Buchanan **1958** Public Principle of Public Debt **Buchanan and Wagner** **1977** Democracy in Deficit The Public Choice and the Virginian School	**Musgrave** **1959** The Theory of Pubic Finance "pay-as-you-use" principle **1963** "Should we have a capital budget?"	**canton St. Gallen** **1926** (revised 1990) Finance law **canton Fribourg** **1960** Finance law	**Dafflon** **1973 Macroeconomics of Public Debt** **1977 Federal Finance in Theory and Practice**
▪ Normative, centered on the behavior of government ▪ general academic debate	▪ description (pp. 562-565) ▪ some indication about operationalisation: economic lives of investment, separation current / capital budgets	▪ self-decided fiscal rules: balances budget, deficit limit 3% of expenditures in the closure account	▪ 1973 of no use ▪ 1977 some indication about operationalisation

4) The answer was to introduce in the **1981** Law on the organization of municipalities, canton Fribourg, a first concept of **the "revisited" golden rule.**

1995 Ten years later: measuring the results? Where do we start from?

Budget constraints theoretically discussed were grouped in four categories:

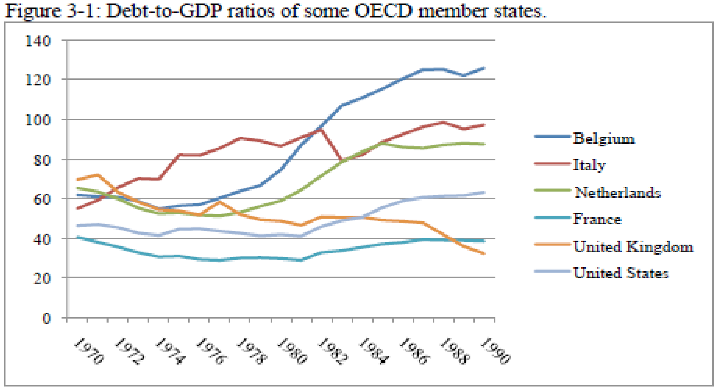
1	2	3		4
financial market discipline	negotiation process	fiscal rules		direct control
		macro	budget constraint	

1 – financial market discipline

did not function

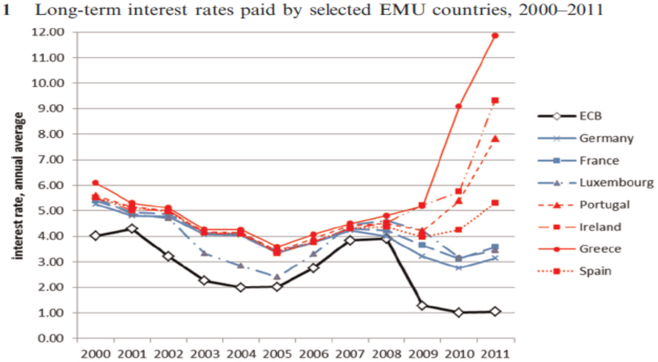
Berset, 2014: 49

Figure 3-1: Debt-to-GDP ratios of some OECD member states.



Rossi Dafflon 2012: 114

Figure 1 Long-term interest rates paid by selected EMU countries, 2000–2011



2 – negotiation process

unpredictable case studies?

3 – fiscal rules: macro

Maastricht criteria
(1992)
will not function
Laughland 1996
Dafflon Rossi 1999

did not function
“numerous successive amendments”
“legal bases amended 1997, 2001, 2007,
sixteen regulation decrees from 1993 t0 2013”

1992 Maastricht criteria
1997 Stability Growth Pact
2005 SGP II
2011 the “Six Pack”
2012 The Treaty on Stability, coordination and Governance
2013 the “Two Pack”

Berset 2014: 81-82

3 – fiscal rules: budget constraint / 4 – direct control

1985 Council of Europe

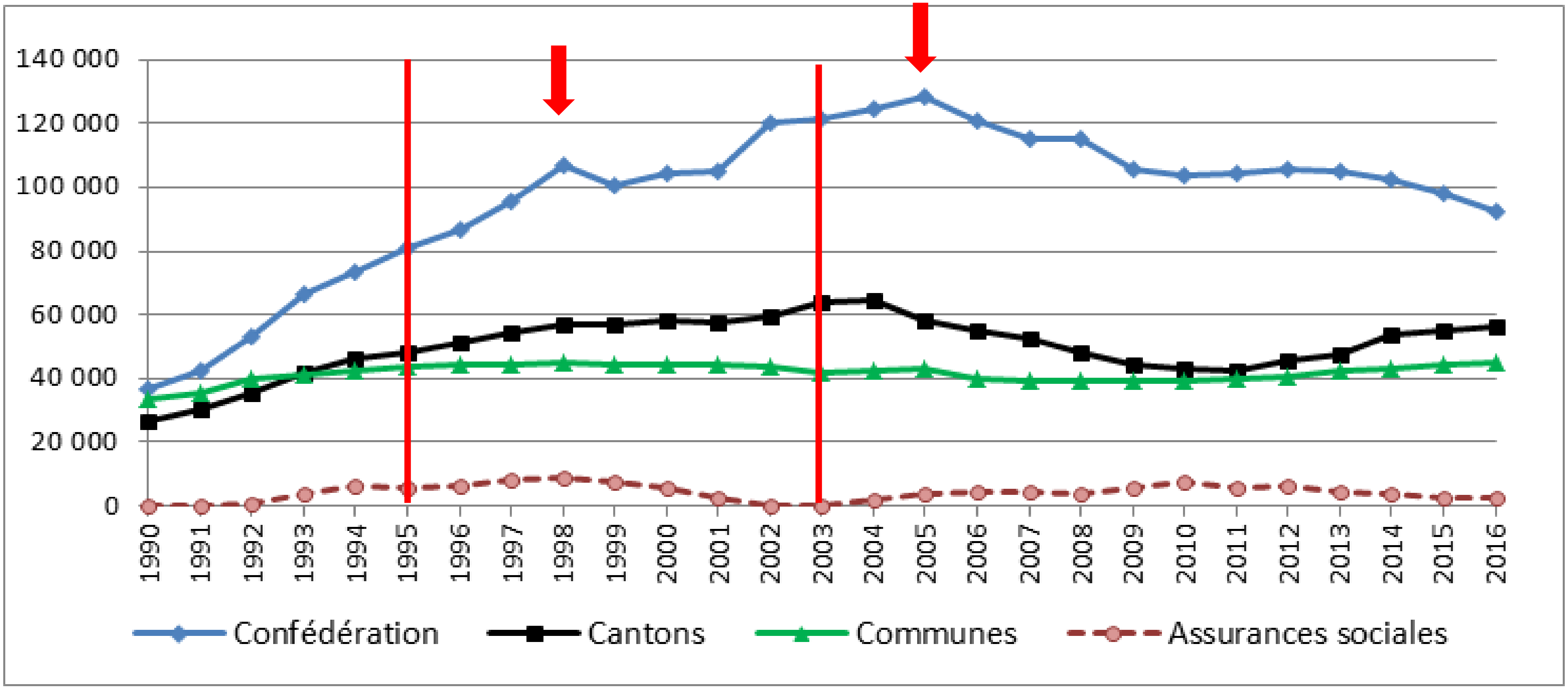
1987 A.C.I.R.

“**Balanced budget requirements**”
von Hagen (1991),
Poterba (1994),
Eichengreen and Bayoumi (1994),
Bohn and Inman (1996)

“**Fiscal stringency indices**”:
Dafflon (1996)
Novaresi (2001)
Debrun et al. (2008)
Yerly (2103)

“**Budget process**”:
von Hagen and Harden (1996)
Feld and Kirchgässner (1999)
Hallerberg, et al. (2007)

Government indebtedness, 1990 – 2016, million CHF



Government indebtedness once more:
In 1990, 15 cantons out of 26 already had fiscal rules constraining deficits and debt. 4 cantons did the same in the 90s.
At the federal level, the vertical bars correspond to changes in the legislation; the arrows correspond to the resulting incidence on federal budget and account, with a time-lag of 2 to 4 years.

Can we explain these results?

Deficit and debt brakes legal rules, Federal government, 1951 – 2017

year	federal vote*	object
1951-54	December 20, 1950 69% voters 17 cantons 6 semi-cantons	Cst amendment (art. 88 al. 2 and 3): qualified majority to decide a new public expenditure unique > 5 million CHF recurrent > 250 mille CHF
1975-79	December 8, 1974 76% voters all cantons	new expenditures year t > year t-1 qualified majority on demand of the finance commission or 1/4th of MPs in one of the two Chambers
1992		fiscal consolidation
1993		fiscal consolidation
1994		fiscal consolidation
1995		additional urgent measures
1993-95	March 25, 1995 85% voters all cantons	Cst amendment (art. 88 al. 2 and 3): qualified majority to decide a new public expenditure unique > 20 million CHF recurrent > 2 million CHF
1997-98	June 7, 1998 71% voters all cantons	Cst amendment (art. 24): "Objectif budgétaire 2001" deficit less than 2% revenues corrective measures if the target is not reached
2000-03	December 2001 85% voters all cantons	debt brake introduced 2003
2008-10		debt brake "extraordinary budget", introduced 2010

Can we explain these results? **But first the distinction:**

Budget responsibility versus budget discipline

Budget *responsibility* ⇒ self-assessment	
• Self-control	of sublevel government finances; proactive attitude;
• Best practices	in planning and managing investment programmes;
• Capacity and cost measurements	measuring the real financial capacity, and the future (operating and maintenance) costs related to the investment;
• Morphology of government budgeting	the budget is not an exercise of liability management and accountability, but is first and foremost a mirror of the public policies (expenditures and revenues) pursued by the government.

Budget *discipline* ⇒ rules and sanctions	
• Institutional restrictions on borrowing	deficit ceiling, regulatory framework of borrowing, accounting and reporting requirements, instruments of administrative control, collaterals;
• Sanctions	against excessive debt, forced administrative procedures aiming at the correction of local government budgets in which deficit and debt is accumulated.
• Bailout	sanctions are effective only in the absence of bailout

Construction of the Golden Rule "revisited"

Theoretical concepts		+	Application principles	
[1]	[2]		[3]	[4]
Balance of the total budget ***Classical golden rule of public finance*** 1958 Buchanan 1977 Buchanan and Wagner 1987 Tollison and Wagner 1987 Rowley 2006 Council of Europe	"Pay-as-you-use" finance ***current and capital accounts*** 1959, 1963 Musgrave 2006 Council of Europe		interest ("i") + ***amortization policy*** ("d") 1995, 1996 Dafflon	Future annual running and maintaining costs ("M") + operating costs of the services that the new investment permits ("E") ***Golden rule "revisited"*** CoE (2006) Dafflon and Beer-Tóth (2009) Dafflon (2010)

(1) $T - G = S$

(2) $\Delta I = \Delta B + F$

(3) $\Delta B = \dfrac{S - [(M+E)-(R+O)]}{i+d}$

(4) $\Delta I = \dfrac{S - [(M+E)-(R+O)]}{i+d} + F$

A "classical" example: new cultural centre (ΔI).

The net surplus of the current account (S) should be sufficient to cover

- the annual interest payments ($i \times \Delta B$),
- the annual amortisation = instalment of the debt ($d \times \Delta B$),
- the annual maintenance costs related to the building (wage and social charge of the maintenance team, heating, electricity, insurance etc.) (M),
- the annual current costs related to the cultural events offered in the building (E),
- minus entrance fees, revenues from sponsors (R), annual theatre grants (O), and external finance (F).

From concepts to practice: six question for the design of fiscal rules

The implementation of the rule must accommodate several situations:

Possible institutional / legal design

	golden rule	rules-based
self-decided / budget responsibility	1	2
top-down / fiscal discipline	3	4

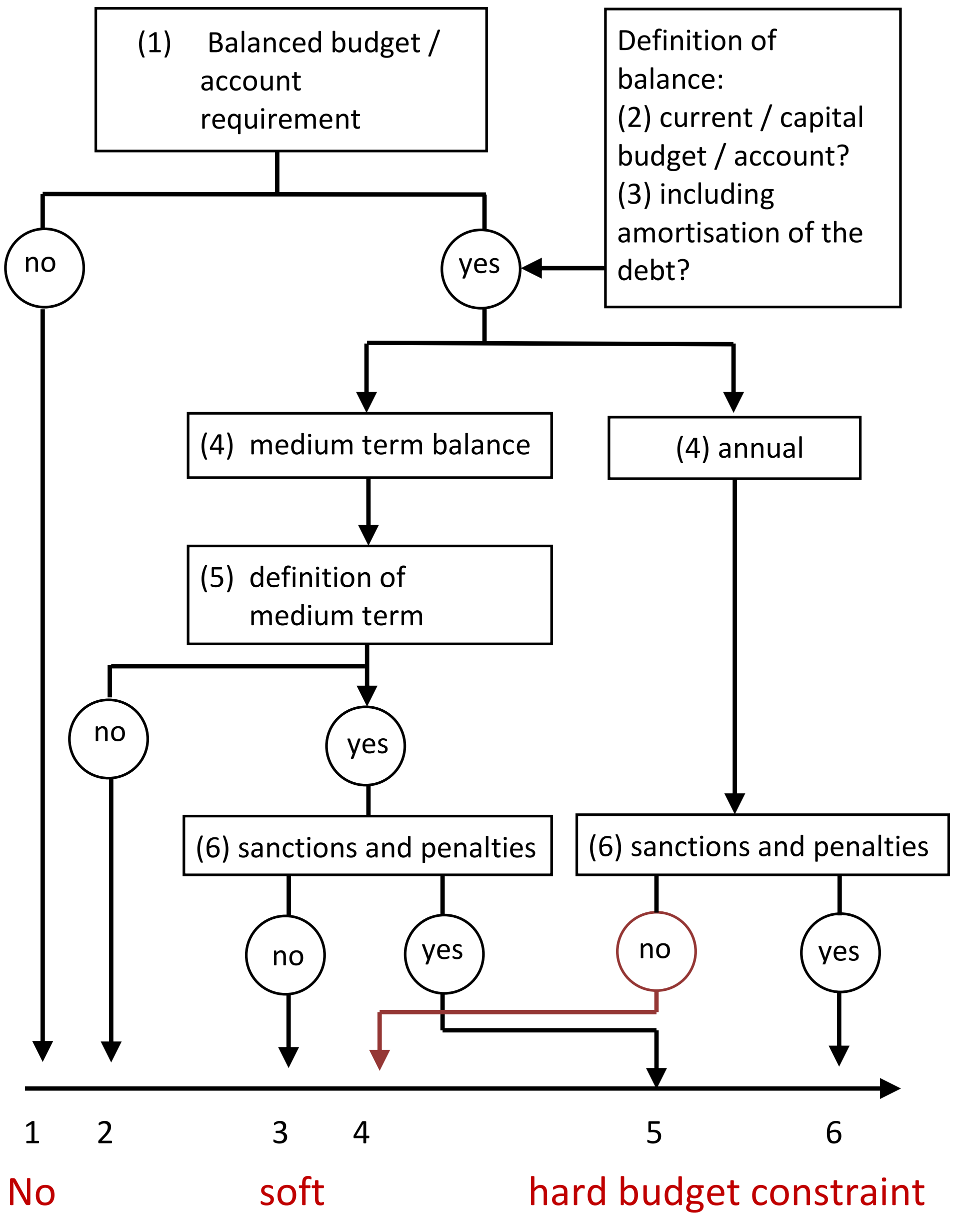
Possible outcome in the current budget / account

		account		
		surplus	**balanced**	**deficit**
budget	**surplus**	1	2	3
	balanced	4	5	6
	deficit	7	8	**9**

Three steps are necessary:

1. Write the constitutional and /or legal rule
2. Design the budgeting process
3. Organize the accounting model so that the budget and account trace the legal requirement and mirror the budgeting process

The path from soft to hard budget constraint: a catalogue of six key questions



(1) Is a balanced budget required? Is the requirement extended to the account?

(2) If the affirmative holds, the rules must define the extent to which the balance is required: total (current + capital) budget or current budget only.

(3) Is amortisation of the assets included in the current budget (which must be balanced)?

and corresponds to debt instalment?

(4) If the rule of a balanced budget is constitutionally or legally fixed, is this an immediate or a medium-term requirement?

(5) In the case of a medium-term balance requirement, is the medium term properly delimited?

(6) what would the sanctions and penalties?

← **Scale measuring the stringency of the budget constraint**

The [possible] **answers** (example: canton Fribourg)

(1)	The annual budget, presented by the executive Council to the cantonal parliament (legislative) must be **balanced** [5, 40a].
(2)	The requirement extends to the **current and capital** budgets and accounts [39, 40a].
(3)	**Amortization** of assets are included in the current budget [27];
(4)	The balanced budget requirement is **immediate** in normal circumstances; deficits are admissible only in ***economic downturn*** or for ***exceptional unpredictable reasons*** [40a];
(5)	**If the account (of year t) presents a deficit** (account closure in early year t+1), the deficit must be reported in the following budget(s) (year t+2) that have to be decided in balance. The deficit must be amortized in no more than **five years in normal circumstances** [40a]: 1/5th annually Deficits due to **economic downturns** must also be compensated within **five years** [40d]: 1/5th annually With **exceptional circumstances**, the time limit may be prolonged by two years (total: **seven years**), but the decision belongs to parliament at the majority of its members [40a, 40b, 40c]: 1/7th annually
(6)	If, with reported deficits (1/5th annually or 1/7th, the following budget(s) cannot be balanced, then the Parliament must decide an **increase of the direct tax coefficient** in order to recover the balance [40a]. The maximum increase is 20 percent [41]. If the deficit of the account is higher than 2% of total revenues (off extraordinary revenues and pure bookkeeping entries), the **increase of the direct tax coefficient is compulsory** in the following budgets, and as long as needed, in order to recover balanced budgets.
+(7)	If, in surplus, the **yield of direct taxation** (personal income and wealth, business profit and capital, withholding tax on wages) is **6% higher** than the budgeted amount and (cumulative) at least **equal to 4% of total expenditures**, then the government must propose to parliament in the first session after the closure account (normally May) a **direct tax reduction** with particular attention paid to the tax position of families with children.

Fiscal Rule applied to the budgetary process, canton Fribourg, Switzerland

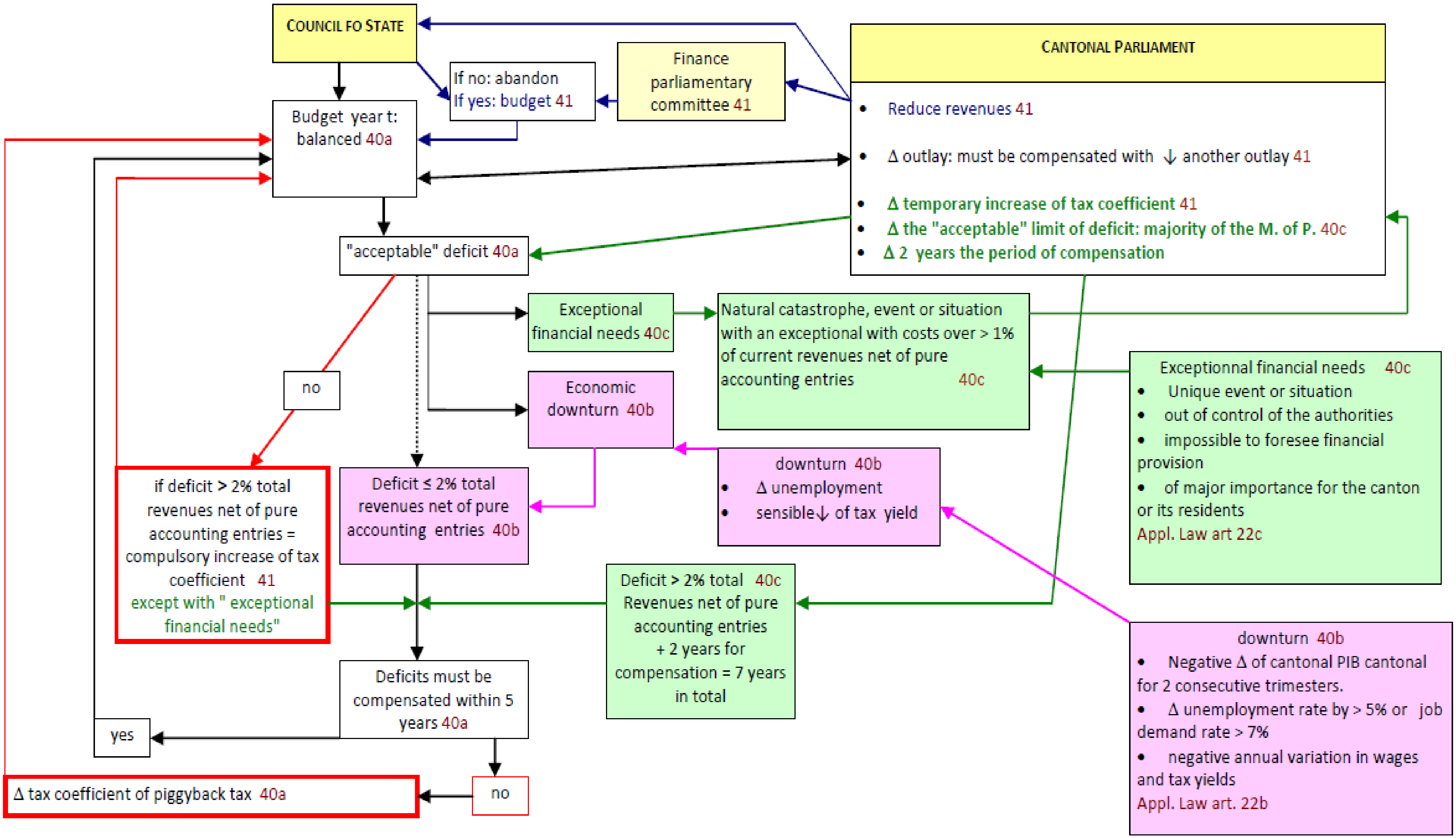
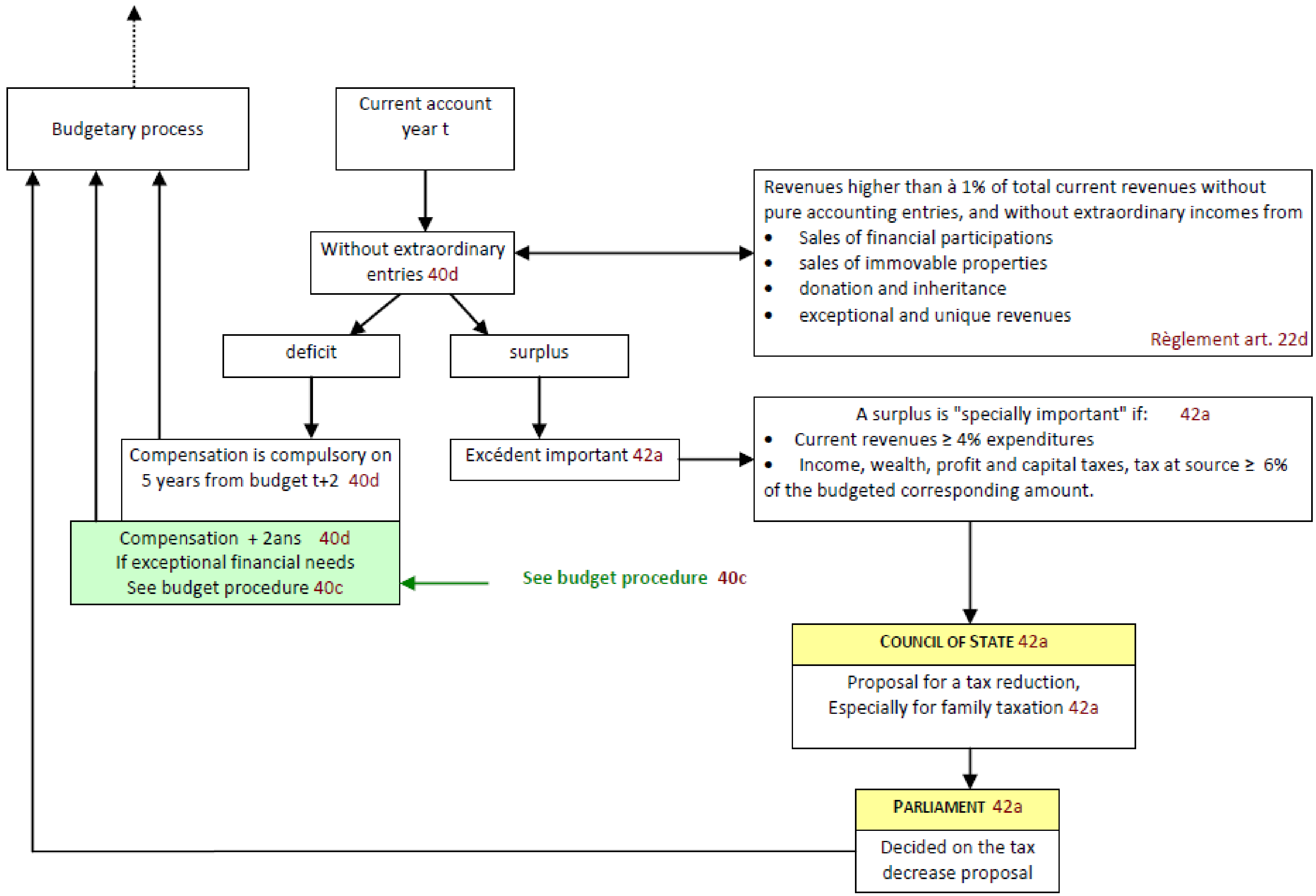


Chart 14 Fiscal Rule applied on the account, canton Fribourg (Switzerland)



Fiscal rules, investment projects, referendum and top-down direct control at the local level

Fiscal Rules

(1)	The annual budget must be balanced [87].
(2)	Current budget [87] and the account [145].
(3)	Amortization included in the current budget [93]; the rates of amortization fixed in the application decree [AD 52, 53]
(4)	The balanced budget requirement is immediate [87].
(5)	If budget deficit higher that 5% (off pure accounting entries), the direct taxation coefficient must be increased [87].
(6)	No sanction is mentioned in the law.

Each Investment project [AD 48, 86]

(a)	object and objectives
(b)	financing
(c)	interest and amortization
(d)	future maintenance and operating costs

Information and referendum

- the investment project must be announced in the written convocation of the assembly or parliament [12] the full dossier and report must be accessible to citizens at least ten days before the session
- each investment-project must be voted separately in the capital budget [10]
- If the decision is taken by a local parliament in place of the citizens' assembly, the yes-vote is subject to the facultative referendum [52]

Cantonal direct control

(i)	respect of the rule, balanced current budget and balanced account [145]
(ii)	the accuracy of the investment report described above, and the commune's capacity to support the future recurrent costs in the medium-term insofar that the commune needs borrowing above its **credit line** to finance the new investment [148].

Definition of the credit line *["debt control"]*

	year of decision	total cost	earmarked investment revenues	federal, cantonal, investment grants, if any	annual amortization	number of years	residual value December 31, 2016
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**
investment 1							3 – (4+5) – (6x7)
investment 2							3 – (4+5) – (6x7)
…..							3 – (4+5) – (6x7)
investment 9							3 – (4+5) – (6x7)
the **credit line** is the residual value of the realized investments if investment revenues (4, 5, 6x7) have served to reduce the total initial cost of investment and the amortization have been regularly booked and the equivalent debt instalment paid						**credit line**	sum A
The net debt is the total external debt of the commune minus it monetary capital and savings						**net debt**	sum B
credit available						A-B	

(A>B) new investment possible See equation (4) ΔI in the golden rule "revisited"
(A=B) ok but no new investment

(B>A) 1st year: a warning the first year; 2nd present a consolidation program; 3rd increase direct tax coefficient in order to recover a balanced budget and account. The measure holds as long as the balance is not achieved.

The "credit line" method also offers new opportunities in debt management. Within it credit line, the commune can organize its debt with the most favorable mix of short term, long term, fixed or variable loans.

Conclusions

1/ YES fiscal rules are efficient in braking down deficits and constraining indebtedness. They guarantee sustainable government finances.

2/ BUT fiscal rules in the law must be detailed so as to give the design of the budgeting process in parliament

3/AND both fiscal rules and the designed budgetary process must be supported with a coherent accounting framework so that results can be traceable and verified and performance assessed.

More information:

Refer to the paper and the references it contains

www.unifr.ch/finpub /collaborateurs /professeur emerite/
demand to : bernard.dafflon@unifr.ch

THANK YOU

Returning to the Golden Rule of Balanced Budgets: The Institutional and Political Economy of Restricting Public Deficits and Debt

Bernard Dafflon
IMFG Visiting Scholar
November 15, 2017

@imfgtoronto | #IMFGtalks

IMFG Institute on Municipal Finance & Governance at the MUNK SCHOOL OF GLOBAL AFFAIRS UNIVERSITY OF TORONTO