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Thinking ahead for Europe

Fiscal Policy:

When Theory Collides with Reality

Vito Tanzi

Abstract

During the 1950s Jan Tinbergen and other prominent economists developed an attractive theoretical way of using fiscal instruments (taxes and public spending) to promote socially-desirable economic objectives, such as stabilisation, income redistribution and more efficient allocation of resources. The theory may well have reflected the institutional arrangements that prevailed at the time in the countries of origin of these economists. For these countries, it could be seen as a perhaps naive but still 'positive theory'. Of course, the arrangements or institutions prevailing in these countries could be significantly different from those in other countries. This would make the theory less realistic for other countries and less useful in predicting policy outcomes.

This paper outlines the basic assumptions implicit in the theory and assesses how applicable they are to what is happening in practice. The paper takes the example of Italy in particular. It finds major differences between the theory and the observed reality. In Italy there was no specific policy centre within the government where relevant questions of policy were analysed in detail. There was also much less effective control by the executive over the fiscal instruments than assumed by the theory. Deficiencies in essential information, such as the precise fiscal situation at a specific time, also made the pursuit of fiscal goals more difficult. Two core questions are asked. First, whether the European Commission should expand its role to include the promotion of institutions that economists have argued would improve the pursuit of fiscal policy in member countries. Second, whether the deficit concept now used in the evaluation of the outcome of fiscal policy should not be assessed to make it easier to calculate and less controversial.

The author is a former Director of the Fiscal Affairs Department of the IMF (International Monetary Fund) and a former Undersecretary in the Economic and Finance Department of the Italian Government. He is, at present, a consultant to the Inter-American Development Bank. The views expressed in this paper are strictly personal.

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FISCAL POLICY:
WHEN THEORY COLLIDES WITH REALITY

VITO TANZI

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 this expression to criticise 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 the revenue side of the budget to include both revenue and spending. For the Keynesians and now for economists generally, fiscal policy refers to the manipulation of taxes *and* public spending to influence aggregate demand. With Keynes we had the genesis of the 'stabilisation branch' in Musgrave's trilogy. In this paper the term fiscal policy is understood in this broader sense.

This paper was inspired by the two years (May 2001-July 2003) that I spent in the Italian government as an Undersecretary of Economy and Finance. I had gone into that position with an unusually strong background in public finance and with some clear expectations about the formulation and implementation of fiscal policy. I was thus somewhat surprised to discover the wide gap that I found between the way economists generally think about fiscal policy and the way I saw it in practice. I realised that things can look very different from inside a government, even for someone who had been dealing with governments and with fiscal policy for many years from outside. When I joined the Italian government, I had just completed almost 20 years as Director of the Fiscal Affairs Department of the IMF (International Monetary Fund), which has one of the largest concentrations of highly trained fiscal economists in the world. That position had required me to advise policy-makers of many countries on how they should conduct their policies.

In relating the practice of fiscal policy (at least as I saw it in Italy during that period) to the theory, it was necessary to have a reference point for the theory. To bring out the issues in the starkest terms, the 'practice' of fiscal policy will be compared with the purest version of fiscal theory. This is the version developed mostly by northern European economists, including Tinbergen, who was the recipient of the first Nobel Prize in economics for his work in this area. Of course over the past four to five decades since Tinbergen's seminal work, the pure theory of fiscal policy has been amended in various ways to bring it closer to reality. Economists associated with the 'school of public choice' and with the 'positive theory of fiscal policy' have played a major role in this process. Thus, the contrast between the practice, as reported in this article, and the theory may appear wider than many economists interested in this area see it. Still I felt that the use of the 'pure theory' as a kind of 'straw man' is a useful device.

1. The theory of fiscal policy

The theory of fiscal policy owes much to northern 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 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 stabilisation role of fiscal policy because this role was considered the most important in the 1950s and 1960s. However, Keynesian stabilisation policy is only a part, though an obviously important part, of the modern theory of fiscal policy. In the conception of this theory, especially well developed in Musgrave's (1959) and Johansen's (1965) treatises, the goals of fiscal policy extend beyond stabilisation because fiscal tools can be used also for redistributing income and for reallocating resources in desired ways.

I will sketch out the most essential elements of the theory of fiscal policy and outline the assumptions implicit in it. At this stage I will ignore the modifications made to it in more recent decades. I will then argue that the reality can be far removed from this theory, and in some countries more than in others. In contrasting the theory with the reality, I will use Italian examples. The reason is that I could observe the Italian situation closely and not necessarily because that situation is the farthest from the theory. My knowledge of other countries, including other European Union countries, and discussions with foreign colleagues with inside knowledge of particular countries have convinced me that the conclusions of this paper are valid, to varying degrees, for many other countries. However, this discussion may be less appropriate for the countries in the north of Europe for which the theory was originally developed.

Let me start with the main elements of this theory. Policy-makers are assumed to have no other objectives but the promotion of the 'social welfare', or the 'public interest', of the citizens. Social welfare cannot be observed directly – it does not depend on any single variable or indicator. Rather it depends on several indicators, some of an economic nature and some of a social nature. The way in which policy-makers rank these indicators inevitably changes with time or with the government in power. In representative democracies this ranking by the government in power is assumed to reflect the preferences of the citizens and the changes in those preferences.

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

The policy-makers responsible for *economic* policy focus on *economic* indicators. They have some perception of the weight that each of these indicators, y_i, has on the welfare function, W. Thus we can write the equation:

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

The policy-makers are aware that the indicators, y_i can be influenced by changes in particular policy instruments, x_j. These instruments are the 'tools' available to the policy-makers to modify the social welfare and to steer it toward an optimum. Therefore, each indicator is a function of the policy instruments. Thus, we can write the equation:

(2) $$yi = f(x1, x2, x3 \ldots xj)$$

Often a particular instrument x_i is especially efficient in influencing a specific indicator y_i. Efficiency in this context refers to the change in an instrument, Δx, necessary to change an

indicator y 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 and better results can be achieved in terms of social welfare.[2] Examples of policy instruments are: various taxes, particular features of taxes such as exemptions, deductions and rates, various categories of expenditures and particular features of expenditures. Fiscal deficits can also be seen as *indirect* instruments to pursue stabilisation policies. They are determined by changing taxes and spending which are the *direct* instruments that governments can control. Non-fiscal economic instruments include the exchange rate, the interest rate, specific regulations, etc. The non-fiscal economic instruments also influence 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 equations, formed by the relationships mentioned above, can be solved for the values of the instruments that would maximise the social welfare, W.[3] This mathematical solution might require excessive changes in the instruments. However, if the instruments are efficient, the solution of the equation will require changes in their values that would be technically or politically feasible.[4]

Stripped to the bare bones, this is the theory of fiscal policy. It has provided the essential theoretical framework or guidance for much of the fiscal work in the past half century. As mentioned earlier, over the years there have been many qualifications to this theory in order to identify the conditions and the institutions that would make it more realistic.

2. 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. Of course the assumptions may be more realistic for particular situations and less for others. What are the important assumptions implicit in the theory of fiscal policy? And how realistic are they within the context of particular countries? I will discuss the main ones.

First Assumption: The existence of a ‘nerve centre’, 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 maximise social welfare. The existence of a nerve centre 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. Obviously this assumption relates to a large extent to the specific institutional arrangements that may exist in some countries and not in others.

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

[2] However, as Graaff put it as far back as 1957 in his classic work on welfare economics, “…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…”, p. 169.

[3] The conditions to be satisfied are specified in Johansen (1965).

[4] Passing from the mathematical to the economic solution, it must be realised 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 no attention.

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 centre. 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 constraint for sub-national governments, or for extra-budgetary institutions, must not be a 'soft' one.

When there are differences in objectives or in the use of instruments among policy-makers, they must be ironed out *within* the nerve centre. This assumption deals essentially with political power and administrative controls and with how fragmented political power is and how effectively it can be used. Obviously, 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 laws and constitution.[5] It is also partly the result of the real as distinguished from formal 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'. Policy-makers avoid 'populist' policies that go against the public interest even when these policies have short run appeal that could help them win the next election. Thus, the electoral cycle plays no role in budgetary decisions.

Third Assumption: When it makes budgetary decisions, the government has available to it the best economic analyses that it is possible to get given the available resources. These analyses must be based on reliable data, on unbiased forecasts and on accepted economic principles that have established links between changes in policy instruments and changes in policy objectives. From these analyses, the policy-makers must be able to determine, with a reasonable degree of accuracy, that a given change in a 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, pressures from lobbies or simply antagonism toward previous governments.

Fourth Assumption: Because fiscal policy instruments are generally embedded 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 and specific and to contain as few extraneous and irrelevant provisions as possible. They must not create asymmetric information, or problems of different interpretations, between the government, on one side, and the citizens, on the other; or even between the policy-makers and those 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 variables in equation (2) above must

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[5] This is an area where the work of Persson & 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 more political and it has led some economists to propose the creation of 'fiscal councils' that would have power within certain limits to change policies without parliamentary approval. See Eichengreen et al. (1999).

be identifiable in specific laws. To the extent possible, 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 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 or 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 at least in a coordinated way and must not push for conflicting legislation. What we have called the nerve centre must solve any internal conflicts.

Third, most spending or tax decisions must be executed during the budget period, which is normally one year but can be longer. The authorisation to spend money authorised 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. Of course budgetary plans can cover several years but these are different from spending authorisations. Unspent resources or unpaid liabilities should not characterise 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-agent'[8] problems. Principal-agent problems can occur at the level of ministries, institutions, departments or even at the level of local offices. When principal-agent 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 significantly different from the expected one.

3. 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, this theory of fiscal policy originated in the writings of mostly northern European economists in the 1950s and 1960s.[9] It could be considered a 'normative' theory, that is, a theory that tells us how the world should behave given the existence of particular institutions. Or it could be considered a 'naïve positive theory' based on a view of the world as seen by the citizens of particular countries, a view that

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[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] The principal-agent problem arises when a principal compensates an agency for performing certain acts which are useful to the principal and costly to the agent, and where there are elements of the performance which are costly to observe. Agents may distort the instructions that they receive from the principals to their advantage.

[9] Probably the clearest expression of it is in Johansen (1965).

may have been partly shaped by the traditions and institutions that existed in those countries. Unfortunately, it was remote from the reality that exists in other countries, both industrial and especially developing countries. Thus, while the theory is useful in telling us what the world should be like and what institutions countries should create, it is less useful in telling us how much of the world actually behaves. Predictions based on this theory would probably not prove accurate in many countries.

There have been two main challenges or qualifications to this theory over the years. An earlier one coming from the public choice school and a more recent one coming from what is sometimes called the positive theory of fiscal policy. Interestingly, both have been influenced by present or past works of Italian economists.

The school of public choice was largely developed by James Buchanan, Gordon Tullock and a few others. It was inspired by the 'Scienza delle Finanze', the public finance literature that prevailed in Italy about a century ago. This school would not accept the theory of fiscal policy because of its deep suspicion of government actions and its scepticism that policy-makers and bureaucrats could be separated from their personal interests and incentives in their pursuit of the 'public interest'. This school would probably argue that those who make decisions have an interest in preventing the creation of effective institutions that could tie their hands in the pursuit of their personal interests.

The 'positive theory of fiscal policy', to which economists such as Alberto Alesina, Guido Tabellini, Alan Drazen, Torsten Persson, Jurgen Von Hagen and others have contributed, seems less suspicious about the motives of policy-makers and bureaucrats and more concerned with 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. Furthermore, it seems to believe that better institutions can be created. In other words, the positive theory of fiscal policy does not reject the theory of fiscal policy described earlier but it argues that the latter can be valid only if given institutions are in place. Thus much of its attention has been directed at the identification of institutional improvements that would make fiscal policy more effective.

In the rest of this paper I shall take the assumptions of the theory of fiscal policy outlined above and assess them for their degree of realism within the Italian context.

First Assumption: The existence of a nerve centre where all the economic decisions are made and intra-governmental differences are ironed out. What struck me most in my two years as an Undersecretary in the Ministry of Economy and Finance was the absence of such a centre. 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,[10] was in frequent conflict with other ministries, which pushed for a different allocation of budgetary resources. These conflicts originated from different objectives on the part of policy-makers which, in turn, reflected different party affiliations or even geographical areas that they represented. The fact that this was a coalition government played a large role. This made it difficult for the Ministry of Economy and Finance to determine and guide economic policy. The various parties in the government coalition were often in sharp disagreement 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 party saw the public interest in a

[10] 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. 234.

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.[11]

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 have always had difficulty with the concept of public interest and social welfare. I could never see precisely what the concept meant.[12] 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 objectives. Thus, to determine what the public interest is and to promote it, it must be possible to assign values to it and to weigh up the various objectives that contribute to 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?[13]

It can be argued that the more even the income distribution of a country is, and the more homogeneous the population is, the easier it should be to determine 'the public interest'. In these circumstances, as a first approximation, it could be assumed that the citizens of a country would rank and value their objectives in broadly similar ways.[14] 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[15]. However, today many countries are characterised by great heterogeneity in their 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 ageing of the population may have increased the heterogeneity of the population making the determination of public interest and 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 policy decision. The

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[11] Of course, this situation was partly 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.

[12] This concept was much discussed in the economic literature around 1960. See Downs (1957) and Arrow (1963). For scepticism about this concept see also Graaff (1957).

[13] 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 and goes beyond that trade-off.

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

[15] The Gini coefficient is often used to measure income inequality.

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.[16] Often there has not been a serious assessment of what effects a policy decision 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 committees in each 'chamber' in Parliament that deal with budget or finance issues must be accompanied by some figures 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 predominantly of lawyers whose expertise is in drafting laws or in checking whether existing laws are being observed. They have, for the most part, little specific training in analysing the economic or fiscal consequences of policy proposals.[17] 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 wide of the mark.

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.[18] 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 workers. Errors in estimates are normal, but errors of this magnitude point to deeper problems. In another case, 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 historical reform proposals such as those made by the Carter Commission in Canada, the Meade Commission in the United Kingdom and for the 1986 Reagan tax reform in the United States. At times, however, little work goes into them.

The Legge Delega[19] (Loi Cadre), which set the stage for the 2002-03 Italian tax reform, was prepared with *no quantitative analysis* even though it aimed at drastically changing the Italian tax system.[20] Prior to sending a proposal for a major tax reform to Parliament, one would have expected in a country with a very high public debt and fragile public accounts, that its potential revenue implications, as well as the redistributional impact of the reform and its impact on economic variables, would have been assessed carefully and in detail. This was not the case. The reform was sent to Parliament *before* any serious empirical evaluation of it was made.[21] The impression that one got was that such an evaluation was not necessary because the tax reform

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[16] This seems to have become a major problem in the United States in recent years. The power of these lobbies has increased dramatically.

[17] The same comment can be directed to the Corte dei Conti whose staff is made up mostly of lawyers.

[18] 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 Italy's GDP.

[19] A law approved by Parliament authorising the government to issue a legislative decree in a given area within a specific time limit.

[20] The whole discussion about a fundamental tax reform was limited to a single day's meeting at the University of Pavia by a group of experts.

[21] Later various groups produced (often contrasting) estimates.

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.[22]

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 policy-makers aim at changing the policy objectives in the desired direction.[23] It also requires, for efficiency reasons, that an instrument should not aim at promoting more than one objective, although this principle is often relaxed. Each law should thus, preferably, aim at promoting a single objective.[24] Unfortunately the real world is more complicated than that. Parliaments tend to be 'law factories' and compliment themselves for the number of laws that they produce. 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 30,000 and 150,000 laws in existence in Italy.[25] 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 was aiming (at the time the laws were enacted) at influencing particular social or economic objectives. Thus, they are, in effect, the x variables in equation (2) above. Since there cannot be that many desired objectives, there are obviously too many instruments. It would be difficult to claim that many of these laws are *efficient* policy instruments. Many laws contain hidden tax incentives or tax expenditure 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 committees, amendments are 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 minister with a specific interest. 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

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[22] Newspaper reports indicate that the experience in the United States has been similar to that reported for Italy even though in this country institutions such as the Congressional Budget Office and the many think tanks provide empirical analysis of decisions already made or, when possible, of announced decisions.

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

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

[25] The estimate of 30,000 is probably more reliable.

offices must, at times, prepare 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.[26]

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,[27] for this reason, took the extraordinary step of refusing to sign into law some bills already approved by Parliament, which 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 worthwhile issue.

The *clarity of the laws* 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 when the laws were written on stones and publicly displayed in old times. In the modern world this is often 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 and are linked to 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 relevant training, to understand the content of specific bills. When there are tens of thousands of laws, it is easy to see the difficulty faced by normal citizens. The Romans used to say that ignorance of the law is no excuse. I often wondered whether non-understanding of the law can become an excuse.[28]

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 also 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 socially 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 they can command. By absorbing much valuable human capital, which could have been put to more directly productive uses, it slows 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.[29] Third, the specific role of the state

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[26] 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.

[27] 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.

[28] 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.

[29] Underestimating costs or overestimating revenue happens frequently. There is no systematic study of this problem in Italy. The conclusion of the sentence is based on the experience of several individual laws.

that the government is trying to promote through these laws is difficult to identify. As a consequence, it is difficult to identify the public interest that presumably is being pursued and the causal relationship between a law (as a policy statement) and a particular objective. Fourth, as almost certainly happens with the many tax incentives buried in hundreds of laws that are not strictly *tax* laws, some of the objectives pursued by the laws are likely to cancel one another out. 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, and who had to vote for these laws. The only reasonable answer to this question that I could give 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 unlikely to be confined to Italy. For example, the US tax laws are now spread out over some 65,000 pages of regulations.

Fifth Assumption: The effective control that governments have over policy instruments. This assumption has various components. However, the key question is whether the policy-makers that make up 'the government' truly control the policy instruments, coordinate their use, determine the objectives to be pursued and have 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 centre; (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 policy-makers, on one side and, on the other side, the civil servants who draft the legislative proposals and, as importantly, those who draft the rules that give *specific content* to these proposals (the *regolamenti attuativi*), imply that the government's control over the instruments is often tenuous.[30]

Some of these issues would require more time and space to discuss in detail than can be given to them in a paper. Rather than discuss them, I will briefly address a related topic of particular interest to macroeconomists, namely the pursuit of fiscal policy for stabilisation, the issue of concern for the Stability and Growth Pact and for the use of fiscal rules for stabilisation in general. This topic is obviously 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 and timely control do policy-makers have on the fiscal instruments necessary for countercyclical policy? This is surely a topic of particular interest to the European Union.

[30] Often the *regolamenti attuativi* are the ones that give real, operational content to the laws. The policy-makers play a limited role, if any, in these regulations.

4. Fiscal deficits and the Stability and Growth Pact

As, perhaps, the best known fiscal arrangement among independent countries, the Stability and Growth Pact (SGP) sets quantitative 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 policy-makers have debated at length whether this is a good or bad rule.[31] However, most agree that it is a relatively *clear* rule and most would assume that the policy-makers of the member countries know at any one time during a year whether or not they are complying with it.[32] If they are not, or are in danger of breaking the rule, it is generally believed that the policy-makers could take timely and precise actions to make the needed correction. Whether various time lags or political impediments to the actions would make this impossible is an issue that will be ignored here. If they do not want to challenge the fiscal rule, they can decide on what measures to take to bring the deficit back towards the required level. Unfortunately, the reality is at times not so simple. First, because the policy-makers often do not know with any precision what the deficit is. Second, even if they knew, they might not be able to get it where they wanted it to be. Of course if they are far removed from where they ought to be, they could take actions to move in the right direction even if they could not be sure of reaching the desired destination.

The concept of deficit used to assess compliance with the Maastricht rule is, presumably, an 'accrual' concept that follows rules established by Eurostat, the European statistical office.[33] This 'accrual' concept – though superior in some ways to the cash measure that is still used by most 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. For this reason economists have shown less enthusiasm for it than statisticians. In Italy, it is calculated (by ISTAT, 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 are not final ones.[34] Therefore, *during the fiscal year*, when corrective measures could be taken, the policy-makers *do not know precisely what the deficit is and can be quite wrong about its true level*.[35] The European Commission's 'excessive deficit procedure' (EDP) notifications, which inform a country that it has exceeded the deficit limit, is a complex document that can easily run into a hundred pages, can be controversial, and can be understood by only a few specialists.

During the relevant fiscal year, policy-makers receive information on a 'cash' measure of the deficit (in Italian *fabbisogno*). The cash measure reports the difference, *in cash flows*, between payments and receipts. This cash measure can be calculated on a monthly or, if accounting permits, even on a daily basis. Thus, it has the virtue of being timely, which is an important virtue. This is one reason why most countries still use this cash concept. However: (a) it is not the concept adopted by Eurostat; (b) it can diverge significantly from the accrual concept; (c) it

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[31] On whether countercyclical policy is or is not effective, there is now an extensive literature. See Andersen (2005), Gali (2005), Woods (2005) and Tanzi (2004 and 2005).

[32] 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 deficits 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 programmes.

[33] In practice the concept is a combination of accrual and cash concepts.

[34] 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.

[35] For 2001, in Italy the difference between what the government thought (as late as September 2001) that the deficit was and the actual revised deficit for that year was more than two percent of GDP.

can change for spurious reasons;[36] (d) it can be more easily manipulated in the short run by the authorities;[37] 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.[38] This latter point, however, applies also to the accrual concept. If we add to this that *both the accrual and the cash concepts* of the fiscal deficit *can be changed by one-off (una tantum) policy measures* such as tax amnesties, sale of public assets or other types of financial engineering, it is easy to see the predicament. The government does not know with any precision where it is at a given time and, consequently, it does not know how far it is from the desired destination. Furthermore, it can be misguided by the impact of transitory measures and by the inevitable optimism that often characterises public discussions.[39]

To the above difficulties must be added the problem discussed earlier – namely whether the government, even if it knew what the deficit 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 that would result in the desired improvements over the relevant period. In the absence of this control and knowledge, governments tend to rely on primitive and inefficient measures, such as the building up of arrears, the rationing of cash, and so on. These measures have also often been taken by developing countries to meet the fiscal ceilings agreed in financial programmes with the IMF. Thus this problem is not limited to the European Union. Interestingly the question of the quality of public finance policies is an issue that has recently attracted the attention of the European Commission while it had attracted the attention of the IMF two decades ago (see Tanzi, 1991, Chapter 9). This paper was first published in 1987.

5. Implications for the European Union and concluding remarks

This paper has dealt with the process of formulating fiscal policy in conditions where the basic assumptions of the pure theory of fiscal policy (as formulated several decades ago by Jan Tinbergen and other economists) do not hold true. It has been shown that this was clearly the case, at least in the period between 2001 and 2003, in Italy, where the author of this paper could observe closely the formulation of fiscal policy. It is likely that the issues identified in the Italian context arise also to varying degrees in other countries of the European Union.

When there is a wide gap between a theory and the practice that the theory is supposed to explain, the expectation is that the theory must be revised or abandoned. Several economists have in recent years been revising the ‘pure theory’ and replacing it with a ‘positive theory’. The latter largely aims at showing that, *if certain institutions are created*, fiscal policy would perform closer to the expectations of the theory. The pure theory of fiscal policy could be seen as both a ‘naïve positive theory’ for northern European countries and a ‘normative theory’ for other countries. Being a normative theory, it suggests institutional changes that would bring the practice of fiscal policy closer to the theory.

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[36] 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.

[37] 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.

[38] In Italy it has been difficult to reconcile these differences.

[39] On this point see also Balassone et al. (2004).

Particular institutional changes tend to be easier in some countries than in others. Furthermore, cultural factors may imply that formally similar institutions may give different results in different countries. The work of several economists, who, over the past couple of decades, have made important contributions to the positive theory of fiscal policy, has identified specific institutional changes that could improve the performance of fiscal policy in most countries. Should the European Commission draw from this work to establish institutional guidelines that could encourage member countries to modify and improve their fiscal institutions? Of course the Commission could not force countries to make these institutional changes. However, through good research and the diffusion of the results of this research, it could encourage policy-makers to make institutional changes that could lead to better fiscal policy. The Stability and Growth Pact provides guidance on policy *results* and not on the *working of institutions*. Some guidance by the Commission on the latter would be useful.

The paper has also dealt, in Section IV, with the numeric outcome of fiscal policy, that is, with the measurement of the fiscal deficit. Papers on fiscal policy have been largely silent on the method of measuring the fiscal deficit (the cash or the accrual method) that is the more relevant for stabilisation purposes.[40] When economists write papers about fiscal policy and assess the significance of the fiscal deficit of a given country, they rarely bother to specify which deficit concept they have in mind. They probably consider that this issue is trivial. But when a 'cash' measure of the deficit is, say, 2-3 percentage points of GDP different from the accrual measure, how can we judge how expansionary fiscal policy is?[41] Which measure gives the best assessment of the Keynesian stimulus? And, should corrections be taken when one-off measures have influenced the outcome. Which fiscal deficit provides the best gauge for conducting countercyclical fiscal policy?

Economists have largely ignored these important questions and have let the statisticians choose the officially relevant fiscal deficit concept. The concept that the statisticians have chosen (the accrual concept), though superior to the cash concept in some ways, suffers from the shortcoming that it is not easy to calculate and does not provide policy-makers with a gauge of the fiscal situation at the time when it is most needed – during and not after, or much after, the fiscal year. These are major shortcomings. The European Commission should pay more attention to these concerns. As John Plender wrote in a Financial Times comment: "The further the budget discussion moves from cash, the greater the risk of becoming lost in the fiscal fog of war. (FT, 4 April 2003).

In conclusion there is a need for research that would establish convincingly whether the accrual concept of the fiscal deficit is the more relevant one for fiscal policy. There is also a need for Eurostat to clarify and simplify the rules that go into the measurement of the relevant fiscal deficit. The rules are still too complex, too controversial and not always obvious to fiscal experts.

[40] 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.

[41] These are differences that have existed in Italy in recent years.

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