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CONSTITUTIONAL ECONOMICS, FISCAL POLICY RULES, AND THE CASE OF TURKEY

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Abstract

Discretionary fiscal policies have arisen because of dominant Keynesian economic policies from 1930's to 1970's. Public expenditures intensively and excessively increased in order to ensure macroeconomic stability during this period. Many countries faced the emergence of macroeconomic problems such as affectively using public resources, budget deficit and inflation. As a result, Keynesian economic policies and the stagnation experienced in following high inflation years have faced economies with stagflation process in the 1970's.

However, Keynesian approach did not solve the problem. Therefore, new economic approaches developed for solving the problem. One of the new economic approaches was Constitutional Economic Theory. The theory includes economic policy rules including fiscal rules as well as monetary rules.

Fiscal rules have been one of the main stabilization tools in obtaining budget and public finance balance. Many countries have implemented specific fiscal policy rules to struggle with economic instabilities, budget deficits and public financial imbalances.

A specific form of fiscal policy rule has been started to implement in Turkey since 1999. Several fiscal policy rules have been adopted in Turkey's public financial management system as part of the economic program which was conducted with the collaboration of IMF since 1999. These rules are called as implicit fiscal policy rules. These fiscal rules have become a draft legal text in 2010 as "Fiscal Rule Draft Law". Although the fiscal rule was planned to start the application *period as of 2011, it is delayed to fiscal year 2012 because of some economic reasons.*

Key Words: *Constitutional Economics, Fiscal Policy Rules, Turkish Economy.*
JEL Classification: E60, E61, E 62, E63

1. INTRODUCTION

State intervention in economic life and the weight of its economic activity through fiscal policy mainly public expenditure increased in order to ensure macroeconomic stability according to Keynesian economic policies economics that is an economic approach was developed as a solution to the Great Depression. Discretionary fiscal policies have arisen because of the Great Economic Depression experienced during 1930's and dominant Keynesian policies. This process has even increased its effectiveness in 1960s. During this process, political powers have begun to implement voluntary policy to maximize their own interest due to the increasing role of the state in the economy. Discretionary fiscal policies applied in many countries especially towards the end of 1970s had some negative macroeconomic implications. As a result, intensively and excessively increasing public expenditures because of Keynesian policies and the stagnation experienced in following high inflation years have faced economies with a new macroeconomic problem: economies entered a stagflation process in the 1970s.

However, Keynesian policies did not solve the problem of stagflation in the 1970s. Therefore, new economic approaches developed for solving the problem of stagflation. The new macroeconomic problem has forced economists to think about the economy policies depending on some preset rules. Consequently, the thought of "rules versus discretion" have prevailed in the macroeconomic policies. One of the new economic approaches developed for solving the problem according to this thought is Constitutional Economic Theory. Constitutional Economics (CE) is a field of economics which focuses on the conditions that exist in and choices constrained by the legal framework of a political constitution.

CE includes fiscal and monetary rules. In this study, we will focus on fiscal rules. Fiscal policy rules have been used to achieve macroeconomic stability in both domestic and foreign markets, and to increase the credibility of the government's fiscal policy and aid in deficit elimination and to make sure long-term sustainability of fiscal policy. Legal arrangements, international contracts, budget plans, medium-term budget plans and policy rules are forms the legal framework of fiscal rules.

Many developed countries have implemented specific fiscal rules. In Turkey, a fiscal policy rule have been started to use since the beginning of 2000's. Public fiscal management system was reconstructed after the 2001 crisis in the country.

2. THE THEORY OF CONSTITUTIONAL ECONOMICS

Constitutional Economic Theory, as an economic discipline, was born and started to gain weight at the end of the 1970s. CE directs analytical attention to the choice among constraints (Buchanan, 1990:3). The theory describes and analyses the specific inter-relationships between constitutional issues and the structure and functioning of the economy. CE studies the compatibility of effective economic decisions with the existing constitutional framework and the limitations or the favorable conditions created by the constitutional framework (Barenboim, 2001:160). Another words, CE deals with the legal and institutional constraints for intervention in the economy by the political powers. According to CE, these limitations and scope of these limitations should be determined as constitutional management activities. The principles of CE are used to estimate how a country or political system will grow economically, since a constitution limits what activities individuals and businesses can legally participate in. Consequently, CE is a practical approach to apply of the tools of economics to constitutional matters. CE allows for a combined economic and constitutional analysis, helping to avoid a one-dimensional understanding. The approach emphasizes the importance of a constitution for economic stability and economic development. According to this approach, there is an interrelationship between a constitution and the economic growth; an effective protection of basic economic rights promotes economic growth.

The most important pioneering work in this field includes such developments as "Public Choice Theory". The theory is developed by James M. Buchanan and Gordon Tullock (Buchanan and Tullock, 1962). Besides Buchanan, the main protagonists of constitutional economics are the political economists Walter Eucken, Friedrich A. von Hayek, and Douglass C. North (Leschke, 2000:266).

CE is distinct from explaining the choices of economic and political agents within those rules, a subject of orthodox economics (Van den Hauwe, 2005:223-224). CE includes fiscal and monetary rules. The next sub-section focuses on the fiscal rule taking into consideration the scope of this study.

3. FISCAL POLICY RULES

Macro economic policies prepared in line with the rules have started to be generally accepted in the world during years beginning from nineties. For example in the monetary area, many countries started to apply an inflation targeting. Similarly, a monetary targeting and exchange rates targeting have put in place. In parallel to monetary policies, significant importance is paid to restrictions on budget deficits and lowering the public debts in many countries (Susam, 2011:2).

Fiscal policy rules have been one of the main stabilization tools in obtaining budget and public finance balance. Restrictive fiscal instrument especially fiscal policy rules have been used to achieve fiscal balance and economic stability by some countries. Many developed and developing countries have implemented specific fiscal policy rules to struggle with economic instabilities, budget deficits and public financial imbalances. The matter of fiscal policy rule has attracted remarkable attention over a decade, as several countries have adopted fiscal rules in an attempt to eliminate large budget deficits.

Fiscal rule is defined, as the regulations and statutory or constitutional restrictions on fiscal policy that sets a specific limit on a fiscal indicator such as budget balance, public debts, public expenditures, tax rates and structures. At the same time, a fiscal policy rule is defined, in a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. In other words, the focus is restricted to rules that impose a specific, binding constraint on the government's range of policy options (Kennedy-Robbins, 2003:3; Susam, 2011:3).

The statutory basis of existing and proposed fiscal rules can be found in a variety of instruments: constitution, law, regulation, policy guideline, or international treaty. The instrument selected by a given country is largely a function of custom, legal precedent, or convention. Although a constitutional provision or amendment would be expected to carry much greater weight than a law or a policy guideline, the latter may in fact be equally or even more binding (Kopits-Symansky, 1998:8). The fiscal rules have been implemented in various countries have been arranged in different legal ways. In practice the legal arrangements that the fiscal policy rules have been based on gain importance especially in developing countries (Şimşek-Bekar, 2008:104).

Fiscal rules provide the sustainable framework for annual budgeting by binding politicians to actions in the long-term national interest but not always in their own short-term interests. They address the time-inconsistency problem, i.e., priorities and preferred policies of governments change over time. Together, if applied credibly and harmoniously, fiscal rules and inflation targeting are expected to result in overall economic stability. Many countries and supranational entities such as the Eurozone have tried to design and apply different numerical fiscal rules over several decades with mixed success. The consensus is that fiscal rules by themselves do not guarantee budgetary discipline. The most striking example is the dismal failure of the Eurozone fiscal rules in Greece. They require institutional reforms to support them in a positive political environment based on the consensus that fiscal stability is a long-term national objective (Erdilek, 2010a).

3.1. Rationale for Fiscal Rules

Fiscal rules have been adopted for a wide variety of fundamental reasons, for example: (a) to ensure macroeconomic stability, as in post-war Japan; (b) to enhance the credibility of the government's fiscal policy and aid in deficit elimination, as in some Canadian provinces; (c) to ensure long-term sustainability of fiscal policy, especially in light of population ageing, as in New Zealand; or (d) to minimize negative externalities within a federation or international arrangement, as in the European Economic and Monetary Union (Kennedy – Robbins, 2003:3; Kopits-Symansky, 1998:6-8).

3.2. Futures for Fiscal Rules

The enactment of fiscal rules raises a number of issues. These issues are defined as basic properties regarding functional features. These properties should be achieved for a fiscal rule to be labelled "ideal"; the rule should be well-defined, enforceable, efficient, adequate, flexible, simple, consistent and transparent (See more information: Kopits-Symansky, 1998:18-19; Drazen, 2002:15; Biraschi, 2008:11; Kennedy–Robbins, 2003:3; Susam, 2011:5-6):

3.3. Types of Fiscal Rules

Fiscal rules show different characteristics according to economic conditions and governance culture of the countries, and the targets aimed to be reached after the practice of rule-based fiscal policies (Kaya, 2009:1). Fiscal rules can be set as numerical ceiling or target for the public finance figures or they can be set as a ratio of gross domestic product. Alternatively, a fiscal rule can be set as a procedure. For these reasons, fiscal rules may be grouped in two types as numerical and procedural.

3.3.1. Numerical Fiscal Rules

Numerical fiscal rules consist of quantitative constraints on fiscal policy. These limits brought by these legislations take a variety of forms: restrictions on deficit financing, including balanced budget laws; expenditure ceilings; numerical targets for fiscal variables; borrowing rules; and, restrictions on issuance of debt (Drazen, 2002;1).

Tablo-1. Major Types of Fiscal Policy Rules

Balanced-budget or deficit rules
• Balance between overall revenue and expenditure (that is, prohibition on government borrowing); or limit on government deficit as a proportion of GDP.
• Balance between structural (or cyclically adjusted) revenue and expenditure; or limit on structural (or cyclically adjusted) deficit as a proportion of GDP.
• Balance between current revenue and current expenditure (that is, borrowing permitted only to finance capital expenditure).
Borrowing rules
• Prohibition on government borrowing from domestic sources.
• Prohibition on government borrowing from central bank; or limit on such borrowing as a proportion of past government revenue or expenditure.
Debt or reserve rules
• Limit on stock of gross (or net) government liabilities as a proportion of GDP.
• Target stock of reserves of extrabudgetary contingency funds (such as social security funds) as a proportion of annual benefit payments.

(Kopits-Symansky, 1998:2)

Different types of classification are used in literature about numerical fiscal rules are categorized as budget balance, debt, expenditure and revenue rule (Cottarelli, 2009:5; European Commission, 2008:101; Şimşek-Bekar, 2008:108-109):

3.3.2. Procedural Fiscal Rules

Second types of fiscal rules are procedural rules. There are restrictions or rules on the procedure by which fiscal decisions are made. Procedural fiscal rules are restrictions in the decision making process for fiscal policy issues or proper definitions of the processes. An example to the general procedure definitions is; established transparency requirements for hierarchical levels in the budget process. Amendment of the budget is prescribed in certain procedures with regard to formulation and approval including the voting requirements for approval phases (Susam, 2011:5; Drazen, 2002:1).

4. FISCAL RULES AND TURKEY

Turkey is classified as an emerging or developing country in the world from the economic point of view. Turkey has started to experience extraordinary high inflation, big budget and current account deficits starting from seventies. During 1980's and 1990's, public fiscal discipline and transparency in public financial management have experienced a period of being ignored. At the and of the period, budget deficits out of the high levels of the government borrowing requirements as well as an high level inflation. High budget deficit, high level inflation, and high domestic and foreign debt burden caused economic instability especially in public finance. Public sector financial deficit has been boosted and public sector borrowing requirement has increased while the budget deficit to GDP ratio has increased since 1990 in Turkey.

Shortly, public sector deficit rapidly increased, tax revenue was not enough even just for domestic debt service, public sector cash deficit financed even through domestic borrowing after 1990. Additionally, the resources of the Central Bank rapidly consumed, because the deficit was compensated with external debt and foreign exchange reserves of the Bank. On the other hand, balance of payments' activities concerning the current account and capital flows were significantly liberalized with the financial liberalization of Turkey's economy after 1989.

In such an economic situation monetary, interest rate and exchange rate policies separated from the current account targets, because of the public sector deficits, and rapidly rising inflation, liberalization of the foreign exchange regime and the capital movements. Under this structure, erosion of exchange rates in domestic markets and interest rates are connected to each other. This became out of control of Central Bank and domestic financial markets have been opened to international speculation through short-term portfolio investments. Therefore, to avoid undesired capital outflows, high real interest rates and the real overvaluation of the TL has become inevitable. Consequently, the public finance measures were the fundamentals of the stability program of 5 April 1994 at this point of economy. During this period, efforts were put forth both for the reduction of public expenditures and for the increase of public revenues. The main focus was to quickly suppress the public sector deficits and end the debt-interest vicious cycle. However, the budget deficit continued while there was a primary budget surplus after 1994. The largest share has come from the interest payments as a part of transfer expenditures (Susam, 2011:24).

Fiscal discipline concept in public financial management, ignored through 1990s, started to be taken into account just after the 2001 crisis. Medium term budgeting system was adopted, public debt management was set out, and debt stock was brought under control in 2001. At the same time, by stand-by arrangements were made with the IMF to exit from the economic crises in 1999 and 2001, it has been aimed to get out of public debt problem in the economy and to ensure fiscal discipline by maintaining a sustainable debt structure. A specific form of fiscal policy rule has been started to implement in 2000; non-interest budget surplus of 6.5 percent was used by governments as a specific fiscal rule to reduce economic instability.

As a result of reforms made for the conduct of fiscal discipline, on hand Turkey's economy recovered between to 2002-2007 on the other hand public sector borrowing requirement yielded a surplus in 2005 and 2006. In addition, the primary surplus decreased while central government budget deficits were increasing.

Nevertheless, the budget deficit and debt stock has increased because of the negative impact of the 2008 global crisis on the economy and the measures taken against the global crisis in the country.

4.1. Implicit Fiscal Policy Rules in Turkey

The main goal of fiscal policy implemented since 1994 in Turkey is; to have the budget surplus, increase privatization revenues and take control of the domestic debt stock through financing it with foreign debt. Governments have put their policies in force firstly towards primary budget surplus from 1994 crisis for Turkey.

Several fiscal rules have been adopted in Turkey's public financial management system as part of the economic program which was conducted with the collaboration of IMF since 1999. The primary budget surplus target which has tightly put into practice after the 2001 crisis, has presented as the most basic element among the Turkey's macroeconomic programs and it has become the rule in IMF supported programs (Kaya, 1999:75-105; BSB, 2006:36; Karabulut-Akdemir, 2010:332).

Another implicit fiscal policy rule can be associated with the Maastricht Criteria. By taking Maastricht Criteria into account, bringing public debt to GDP ratio below 60 percent and reducing the budget balance to GDP ratio to 3 percent has been treated as a performance indicator for fiscal policy and has become a fiscal rule (Susam, 2011:26).

Public finance deficit and high level inflation by using strict fiscal policies were tried to reduce with 2000 Stabilization Program, 2001 Transition to Strong Economy Program (TTSEP) and 2003 Stabilization Program. One of the main targets of the stabilization programs is a specific fiscal rule-the budget rule-. In all programs the fiscal rules have been implemented in the form of non-interest budget surplus of 6.5 percent (Şimşek-Bekar, 2008:101 and See Table-2).

Tablo-2. Budget Rule in Stabilization Programs

Budget Rule in 2000 Stabilization Program and Public Finance Balance - Achieving Fiscal Discipline - Using a Budget Rule – non-interest budget surplus of 6,5 percent - Reducing Public Expenditure – especially interest payments- - Increasing Public Revenues – especially taxes-
Budget Rule in 2001 TTSEP and Public Finance Balance - Achieving Fiscal Discipline - Continuing to Use the Budget Rule – non-interest budget surplus of 6,5 percent - Implementing Restrictive Public Policies - Achieving Sustainable Economic Development
Budget Rule in 2003 Stabilization Program and Public Finance Balance - Reducing Public Expenditure – especially interest payments- - Increasing Tax Revenues - Making Tax Reforms - Reducing Budget Deficit - Continuing to Use the Budget Rule – non-interest budget surplus of 6,5 percent

Furthermore, there are some laws and regulations in our country's domestic law which constitutes some quasi fiscal rules. After the 2001 crisis, in economic and financial studies that can be regarded as reform in Turkey, it is possible to find many elements of fiscal policy rules. The most important ones of these are the legislations. (See more information: Susam, 2011:26-27; Kaya, 1999:106-111; Dedeoğlu, 2010:3-4).

In addition to the regulations, fiscal policy rule was officially on the agenda in Turkey with the Medium Term Program for the period of 2010-2011 adopted in September 2009. Finally, in this direction, the "Fiscal Rule Draft Law" has been prepared in 2010 in the country.

Apart from these regulations and programs, inclusive reforms targeting at transparency in public financial system were launched in different sectors including energy, agriculture, heath, and social security. All these reforms were designed and implemented in a short period of time. These are attempts that shall not be overlooked and that can set an example at global level. At this point, it is possible to say that the public financial management reform was implemented successfully considering the budget processes in particular (Dedeoğlu, 2010:4).

4.2. From Implicit Fiscal Policy Rules to Open Fiscal Policy Rules in Turkey

The fiscal rules have become a draft legal text in 2010 as "Fiscal Rule Draft Law". The draft law was prepared to be presented to the parliament subsequently.

In the draft law, it was aimed to maintain the achievements following the 2001 crisis in public financial management, the draft law focused on; the production of long-term policies in public finance, strengthening macro-economic stability by improving fiscal sustainability and predictability. Finally, it was concentrated on introducing fiscal rules to make fiscal discipline permanent (Susam, 2011:27; Şen, 2010; 46-47).

Projected fiscal policy rule, which has been seen as the most important step taken in the context of Turkey's structural reform, consisted of two main components: One of them is the deficit for the medium and long-term budget balance was foreseen as 1 percent of gross domestic product (GDP). It means that fiscal rule would force the government to target a budget deficit of 1 percent of economic output. The second main component is annual growth was foreseen as 5 percent. At the same time the rule, according to the legislation, aims to reduce the ratio of debt to GDP, to 15 percent in the long term. It appears that the basic principle for the fiscal policy rule is again fiscal discipline (Erdilek, 2010b).

Although the fiscal rule was planned to start the application period as of 2011, it is delayed to fiscal year 2012. Because, according to the government, the fiscal rule was not considered for 2011 and the budget for 2011 was not formed in accordance with the fiscal rule.

The declaration of political will for implementing fiscal rule and the emphasis put on fiscal discipline are good developments being the sign of the realization at political level that budget deficit which reached 6.5% of GDP during the crisis period shall be controlled. However, it is sensed that the will to implement a fiscal rule was a snap decision based on the conjuncture, as the anti-transparent budget practices, the failure to implement the medium term expenditure program completely; and the budget constraints in both revenue and expenditure sides are considered. What is more, the infrastructural deficiencies in the independent monitoring-auditing and sanctioning raise question marks about the process. The implementation of a fiscal rule will be a favorable development considering fiscal discipline in the long term. The government's will to control itself is a favorable development (Dedeoğlu, 2010:9).

5. CONCLUSION

Constitutional Economic Theory was born and started to gain weight at the end of the 1970's. The theory, as an economic approach, developed for solving the problem of stagflation in 1970's.

Constitutional Economy describes and analyses the specific inter-relationships between constitutional issues and the structure and functioning of the economy. Constitutional Economic Theory studies the compatibility of effective economic decisions with the existing constitutional framework and the limitations or the favorable conditions created by the constitutional framework. The theory consists of fiscal and monetary policy rules.

Restrictive fiscal instrument especially fiscal policy rules have been used to achieve fiscal balance and economic stability by some countries. Many developed and developing countries have implemented specific fiscal policy rules to struggle with economic instabilities, budget deficits and public financial imbalances.

A specific form of fiscal policy rule has been started to implement in Turkey's public financial management system as part of the economic program which was conducted with the collaboration of IMF since 1999. These rules are called as implicit fiscal policy rules. Finally, these fiscal policy rules have become a draft legal text in 2010 as "Fiscal Rule Draft Law". It was concentrated on introducing fiscal rules to make fiscal discipline permanent. Although the fiscal rule was planned to start the application period as of 2011, it is postponed to fiscal year 2012 by the government. Because, according to the government, the fiscal rule was not considered for 2011 and the budget for 2011 was not formed in accordance with the fiscal rule.

In shortly, Economic reforms made since 2000, particularly fiscal discipline as well as introduction of inflation targeting, and overhaul of financial sector oversight, together with political stability, significantly improved confidence in the management of the economy in Turkey. These factors contributed to a high fiscal primary surplus, rapidly falling public debt, and moderate inflation in the country. On the other hand, The Medium Term Program (MTP) for 2010-12 foresees a gradual improvement in the fiscal balance, supported by a deficit-based fiscal rule from the 2011 budget cycle.

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