POST-CRISIS FISCAL RULES

Allen Schick
Annual OECD Meeting
Senior Budget Officials
Athens, Greece 3-4 June, 2010
Fiscal Rules Are Applied In Many Countries

- Fiscal Rules are numerical targets that constrain key budget aggregates
- Approximately 80 countries now have fiscal rules compared to fewer than 10 countries in 1990
- The rules have not been standardized across countries
- Many countries target budget deficit or public debt
- Targets typically are stated as a percentage of GDP
- Targets also can be applied to total revenues or expenditures
- Some have been adopted by the country to constrain its budget decisions
- Others have been imposed by supranational authorities such as the EU or the IMF
Many Countries Ignored Their Fiscal Rules During the Crisis

- Most rules are expressed in nominal terms and do not distinguish between periods of economic growth and decline.
- When output declines and unemployment rises, automatic stabilizers generate budget deficits in excess of the levels allowed by the targets.
- Despite the rules, some governments have taken discretionary action that cut revenues, boosted expenditures and raised the deficit.
- Countries have not repealed pre-crisis rules, but some have adjusted the targets.
- IMF and others have urged countries to continue stimulative policies.
- The after effects of crisis will linger for years, with elevated unemployment, depressed demand and high deficits.
Rules Play an Important Role in Post-Crisis Fiscal Consolidation

- High deficits and the risk of sovereign debt default has motivated countries to act before their economies have stabilized.
- Some of the most heavily impacted countries have begun to stabilize public finance by tabling austere budgets.
- Adopting new rules or resetting targets are means of restoring confidence and making credible commitments to correct fiscal imbalances.
- Timing new rules is a difficult decision: deficit levels signal government to act now; unemployment rates signal delay until economic conditions improve.
- A sensible path may be to announce new targets or rules now but to delay full implementation until recovery is well underway.
- This approach can be effective only if the new targets are realistic and credible.
Next Generation Rules Will Differ from Many of the Earlier Rules

- They will adjust to changes in economic conditions
- They will be embedded in fiscal frameworks linked to the budget
- They will have a medium-term or longer time frame
- They will cover all levels of government
- They will be sensitive to impacts on different types of expenditure
- They will take account of fiscal risks
- They will have stronger enforcement mechanisms
Rules Should be Sensitive to Economic Conditions

- Most first-generation rules have fixed targets that do not adjust to changes in economic conditions.
- They are procyclical and allow government to spend more and borrow when the economy is strong but demand austerity when the economy is weak.
- In practice, government spends more in good times because money is plentiful and in bad times because the economy needs stimulus.
- Governments need structural rules that aim to achieve balance and stabilize the debt/GDP ratio over the course of a cycle.
- Some countries target a structural surplus that would reduce debt burdens over time.
- Measuring structural balance can be difficult; the usual approach is to compute it in terms of potential GDP.
- Some countries have rules targeting the primary balance, some exclude automatic stabilizers from fiscal targets.
- The critical test of fiscal rules occurs when the economy is robust, and the political inclination is to increase spending rather than save some of the dividends of economic growth.
Fiscal Frameworks May be More Effective than Stand-Alone Rules

- Some countries have rules established in law or by external authority; others have processes for government to define its framework on a regular basis, typically every year if the country has an annual budget.
- The framework is connected to the budget in a two-stage process: first the government adopts the framework, then it prepares the budget which must be consistent with it.
- The government may adjust the framework to suit economic conditions and policy preferences, often on the basis of principles set out in law.
- Frameworks tend to be more realistic and have stronger political commitment than free-standing targets.
- Frameworks work best when the country has attentive media, mobilized elites, and the government pays a political price for weakening or breaching its declared objectives.
- Without these conditions, the ease of altering the framework diminishes its usefulness as a constraint on government action.
Newer Rules have a Medium-Term (3-5 Years) Time Frame

- Many early rules cover only a single fiscal year.
- This limited time frame enables governments to shift finances between fiscal years to show better results.
- It also reinforces the procyclical bias of fiscal rules.
- Recent rules have been embedded in Medium-Term Frameworks that extend 3-5 years into the future.
- These frameworks are rolled forward each year, enabling the government to reset its target.
- Some advanced countries have devised long-term sustainability analyses extending 30-50 years ahead.
- These may prepare the way for future rules that link current budget decisions to long-term impacts.
Next Generation Rules May Cover All Levels of Government

- Most early rules covered only the national government, not regional or local governments.
- Federal systems and countries that have undergone significant decentralization assign significant revenue, spending, (and in many cases) borrowing authority to subnational governments.
- The National Government can circumvent fiscal rules by shifting expenditures or debt to lower levels.
- Extending rules to all levels may entail fundamental redistribution of government power to the national government.
- Comprehensive rules require accounting and monitoring systems covering all levels, but operated by the central government.
Fiscal Rules have Different Impacts on Various Types of Expenditure

- Fiscal Rules generally affect discretionary spending more than mandatory programs.
- When confronted with pressure to curtail expenditure, government may find it expedient to freeze spending, adopt across the board cuts, or reduce public sector pay, but not to change pensions and other benefits.
- Fiscal pressures often have adverse effects on public investment, which serves as the balance wheel of public finance.
- The result may be inadequate investment, Shop-Stop funding of projects, and higher costs.
- Some governments have a “Golden Rule” that requires a balanced budget but excludes investment expenditure.
New Rules Should Take Account of Fiscal Risks

- Contemporary governments are holders of enormous amounts of risks for society
- They indemnify citizens against illness, loss of income, unemployment, disability, old age, natural disasters, etc.
- They protect businesses against environmental hazards, changes in exchange rates, defaults, and other risks
- These contingent liabilities do not appear in conventional expenditure accounts, but when they come due, government must make payment
- In hardest-hit countries, the fiscal crisis was partly triggered by government expenditures arising out of explicit or implicit contingent liabilities
- Innovative governments have begun to devise means of regulating fiscal risks
- An initial step is to recognize these risks in supplementary statements to the balance sheet or budget
- A few governments impose limits on the volume of guarantees issued each year or the total outstanding
- A few have devised means to expense in the budget their projected exposure to certain continent liabilities
New Rules Will Require Stronger Enforcement Mechanisms

- Fiscal rules are not self-enforcing; they require procedures and (in some cases) sanctions to ensure compliance.
- But they also depend on political commitment, without which enforcement would be difficult.
- Enforcement begins with realistic targets that can be achieved: escapist targets that serve as political statements weaken enforcement.
- Key enforcement procedures include: assuring that the budget is consistent with constraints, monitoring budget results during the year and taking corrective action when appropriate, and safeguards against ploys that hide transactions or their fiscal effects.
- Some countries have established independent fiscal councils to manage the rules process or to measure budget impacts of policies.
Budget Institutions Can Be Engineered to Expand or Constrain Public Expenditure

- Budget Institutions accommodate to political and economic conditions. The same procedures can curtail spending one year and boost it the next.
- However, flawed budget institutions – those that lack all necessary information – tend to bias outcomes.
- Budget institutions that limit information to the year immediately ahead will bias government to take actions that commit it to future spending increases. Institutions that do not limit the amounts the spending units can request, but generate upward pressure on expenditures.
- Top-down budgeting can be used (at it was in the postwar era) to stimulate program expansions: or to limit the amount that spenders may demand.
- Medium-Term Frameworks can compel expert upward pressure on future budgets, or constrain the future impact of current decisions.
- Performance budgeting may facilitate shift of resources from less to more effective uses or complicate the task of curtailing public expenditure.