Fiscal Affairs Department
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Second Generation Fiscal Rules:

Balancing Credibility, Flexibility, and Simplicity

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MAY 7, 2018

Main motivations for the SDN

- **Revisiting the case for fiscal rules in light of experience.** Rules have been under fire in recent years: too complicated, too rigid, noncredible, unable to curb rising public debts…
- **Post-GFC developments.** Rapid evolution, a new generation of rules has emerged
- **Contribute to the debate**. The last Board Paper on fiscal rules dates back to 2009

Main takeaways

- **Fiscal rules have evolved over time:** attempts to combine simplicity, flexibility, and enforceability → simplicity was sacrificed
- **New evidence (econometric and case studies) shows:**
  - Fiscal rules can tame excessive deficits, despite weak legal compliance
  - Enabling factors include a proper design of the rule, supportive institutions, and political buy-in
- **Policy lessons**
  - Adopt a holistic approach to fiscal rule design
  - Tradeoff between flexibility and simplicity can be improved
  - Leveraging reputation costs of breaching a rule more promising than piling up formal sanctions

Outline

I. From First to Second Generation Rules

II. New Empirical Evidence on Rules' Effectiveness

III. Remaining Challenges

IV. Three Guiding Principles for Future Reforms

I. From First to Second Generation Rules

Main purpose of fiscal rules is to contain excessive deficits

Fiscal rules

Commitment device

Signaling effect

Political function

Promote discipline and contain deficit

A Balancing Act

Cyclically-adjusted balance rules, escape clauses

Flexibility

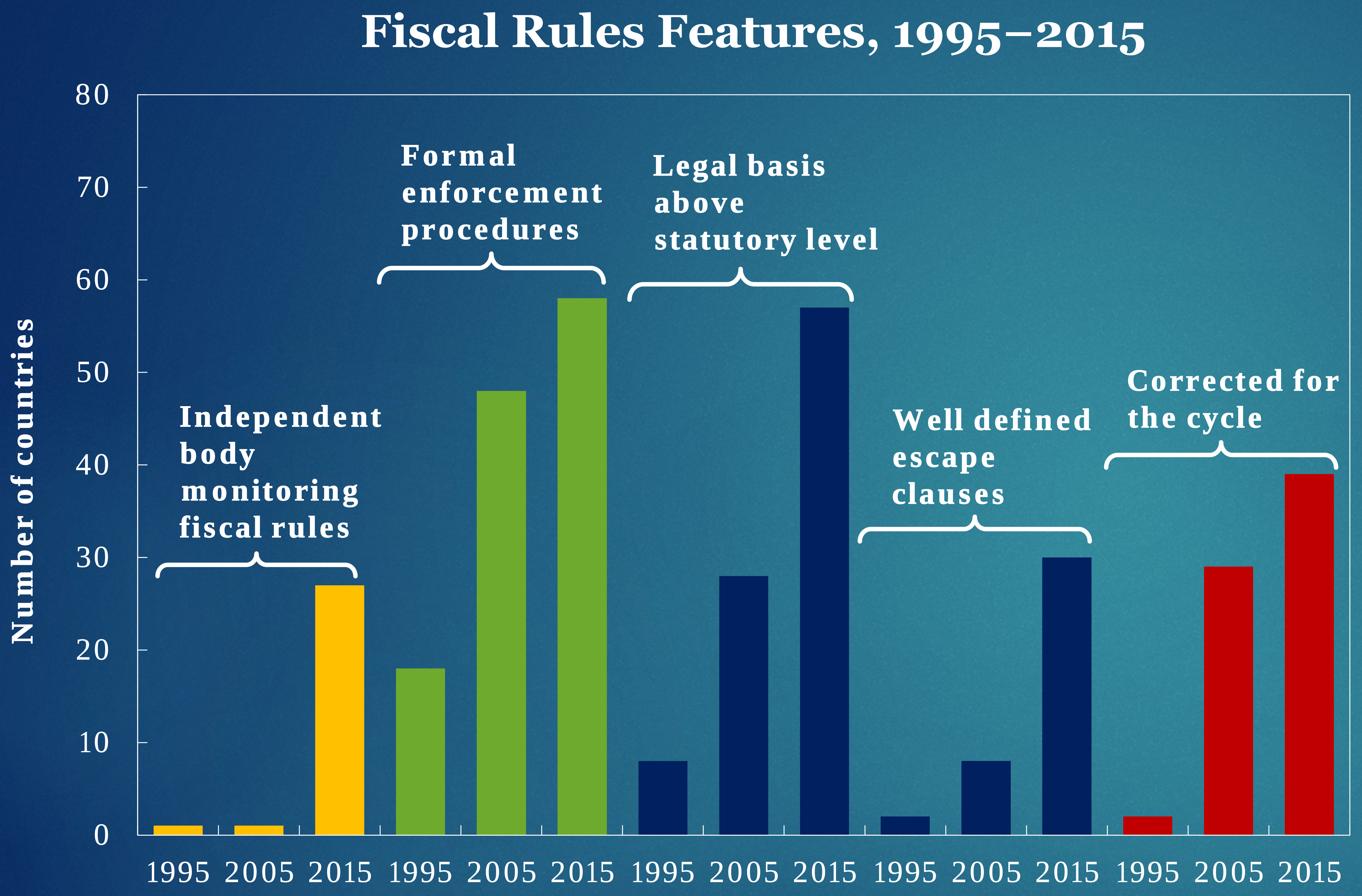
Simplicity

Nominal balance rules

Enforceability

Sanctions, correction mechanisms, fiscal councils

The emergence of a second generation of rules



Source: IMF fiscal rule dataset.
Note: All countries considered in this chart have, at least, one fiscal rule. Rules "corrected for the cycle" include cyclically-adjusted balance rules, structural balance rules, over-the-cycle balance rules, and expenditure rules excluding cyclical items. Total number of countries with at least one fiscal rule are 23, 72, and 92 in 1995, 2005, and 2015 respectively.

Post-GFC rules

- **More flexible:** e.g., escape clauses and flexibility for growth-enhancing reforms
- **More enforceable:** e.g., correction mechanisms and fiscal councils
- **More operational:** e.g., expenditure rules
- **...but also more complicated**

Not just a European innovation

- **Features introduced in selected countries since 2008:**
  - ***Escape clauses***: Colombia, Georgia, Jamaica, Tanzania
  - ***Correction mechanisms***: Grenada, Mongolia, Panama, Peru
  - ***Expenditure rules***: Australia, Brazil, Mexico, Paraguay
  - ***Independent body monitoring rules***: Chile, Peru, Kenya, Uganda

II. New Empirical Evidence on Rules' Effectiveness

Taking stock of past experiences with rules

- SDN discusses evidence from the literature and new empirical results in background papers using a global sample

- Effectiveness of rules assessed based on ability to reduce deficits

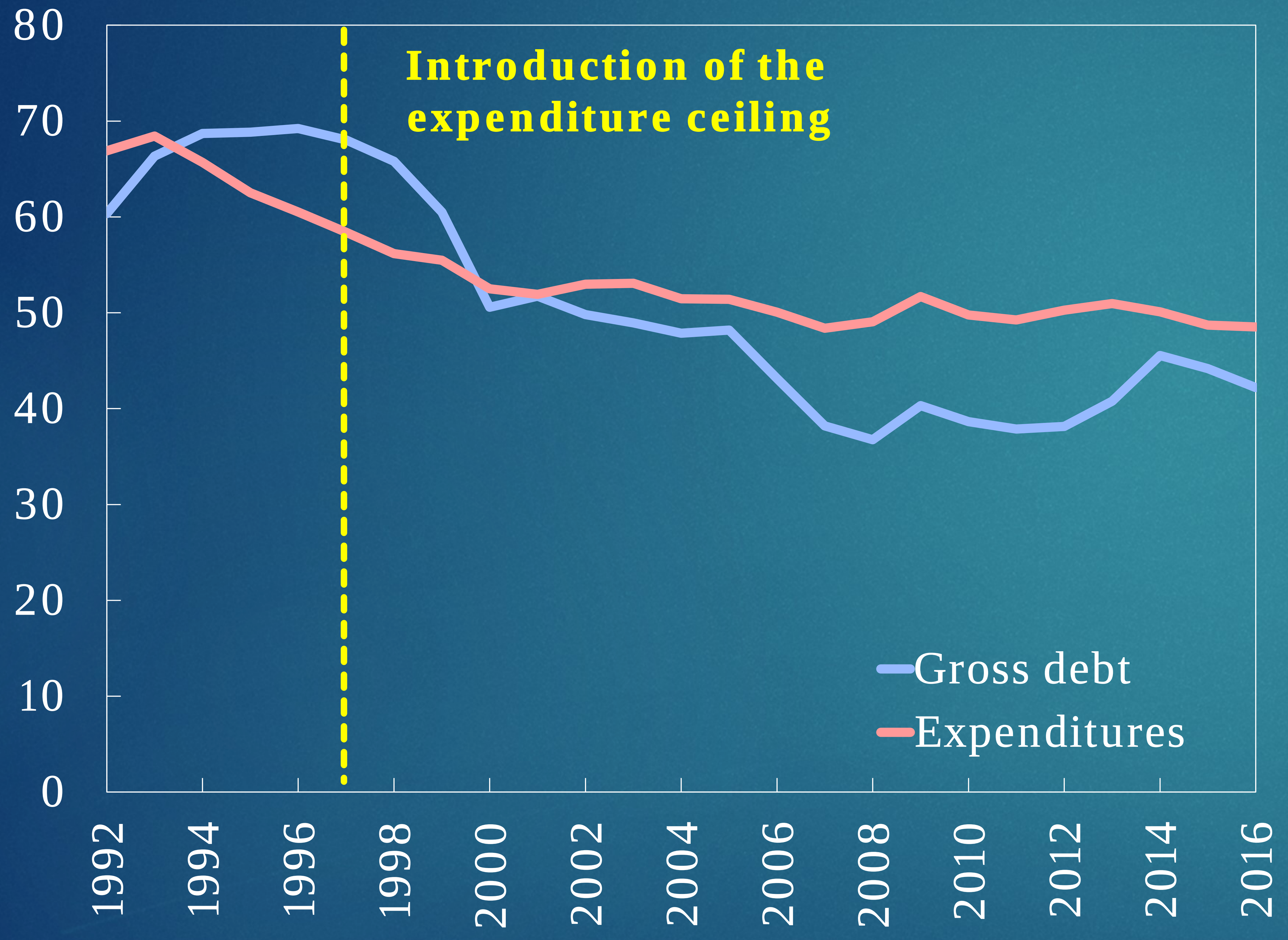
- Main message: no universal effect of rules on deficits

  - Elusive average effects: “average” rule implemented in “average” country seems ineffective (after correcting for endogeneity)

  - Effectiveness depends on (i) the design of rules and (ii) the context in which they are implemented → effectiveness varies across rules and countries (heterogeneity)

Different impacts across rules

Sweden: General Government Finances Following Rule Adoption, 1992-2016
(Percent of GDP)

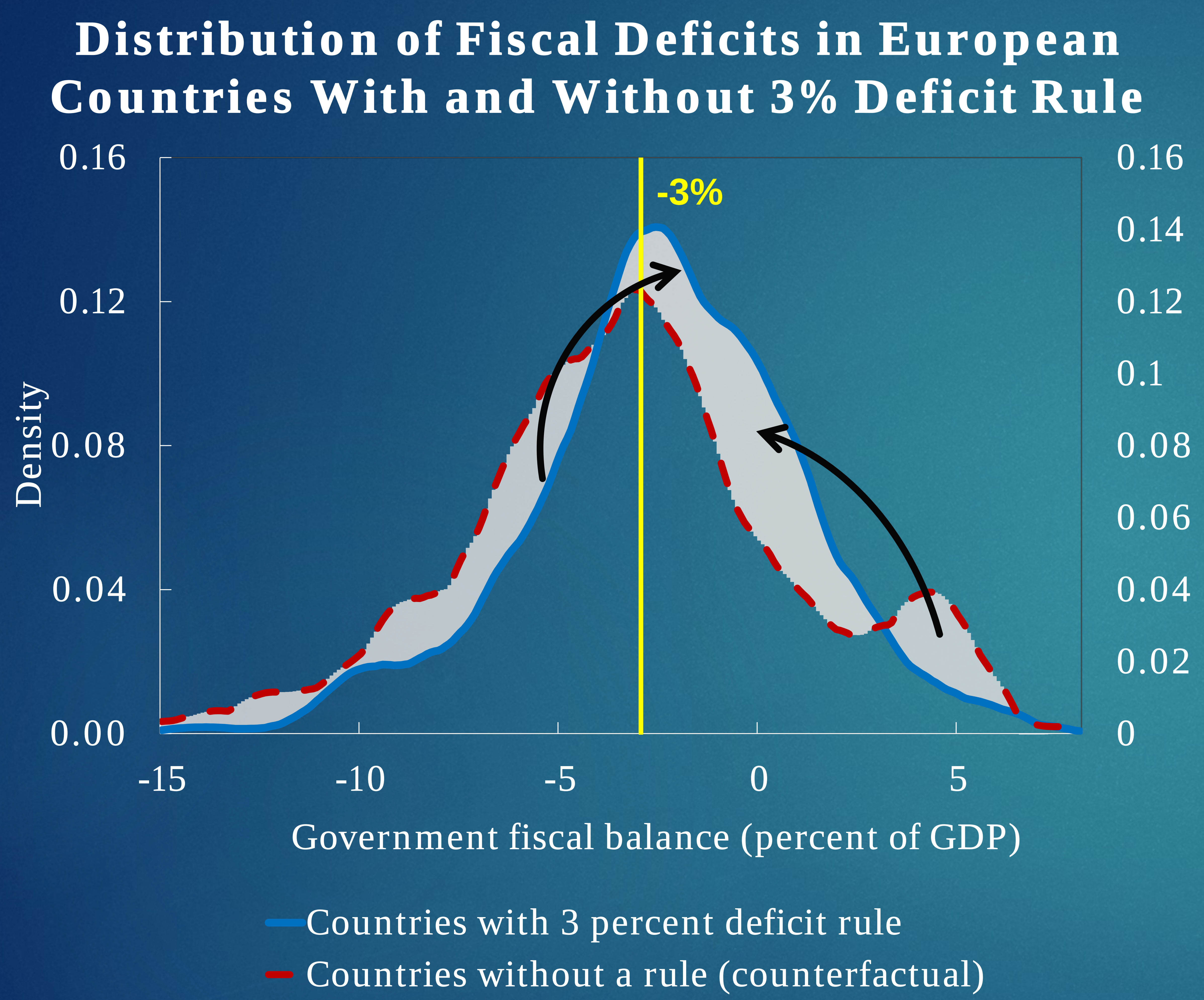


Source: Sixth Background Paper by Mbaye and Ture.

Successful rule design

- Broad economic and institutional coverage
- Builds buffers in good times
- Good calibration
- Well-designed escape clauses
- Supporting institutions (correction mechanisms and fiscal councils)
- Sound PFM and political buy-in

Different impacts across countries

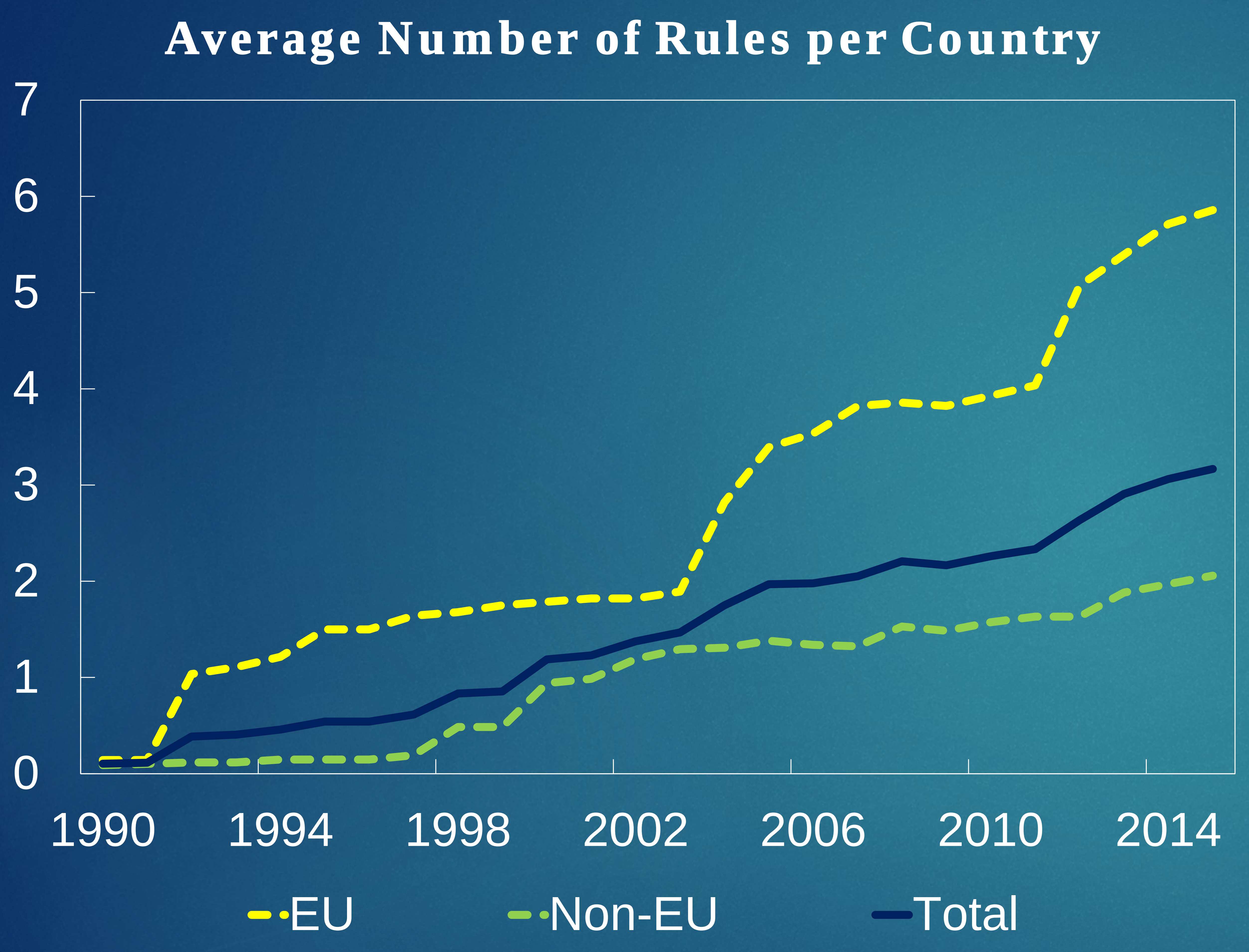


Source: Third Background Paper by Caselli and Wingender.

- Rules affect countries with low and high fiscal balances in opposite directions
- The rule's threshold acts as a magnet
- Over time, fiscal aggregates move closer to the threshold

III. Remaining Challenges

1. Combining rules causes headaches



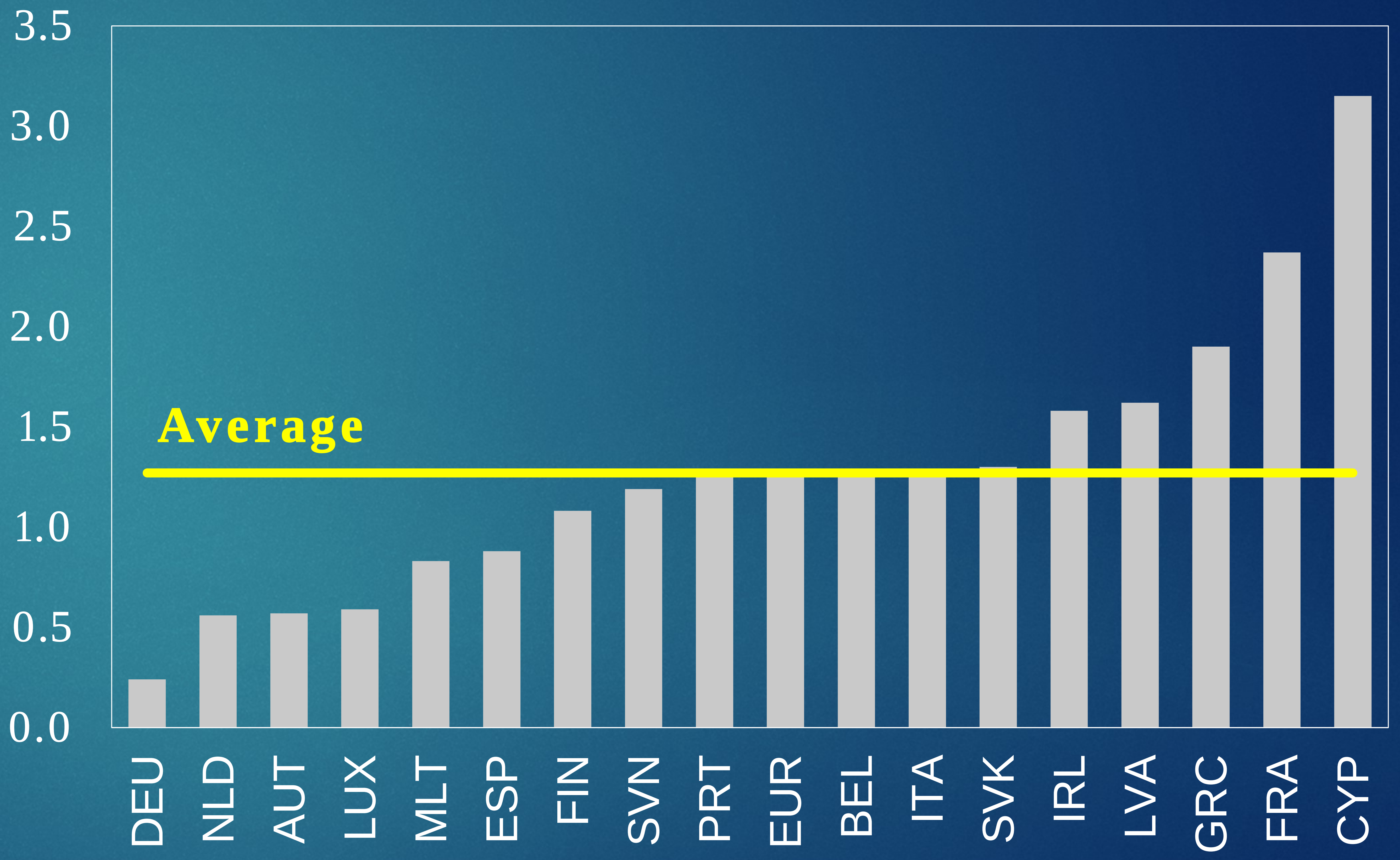
Source: IMF fiscal rule dataset.
Note: Based on a constant country sample (including countries with no rule at some point during the period).

Pitfalls of multiple rules

- **Overlap** between rules (creates operational and political economy problems)
- **Inconsistency** between rules' ceilings
- **Overdetermined** systems (leads to suboptimal policies)
- **Lack of credibility**

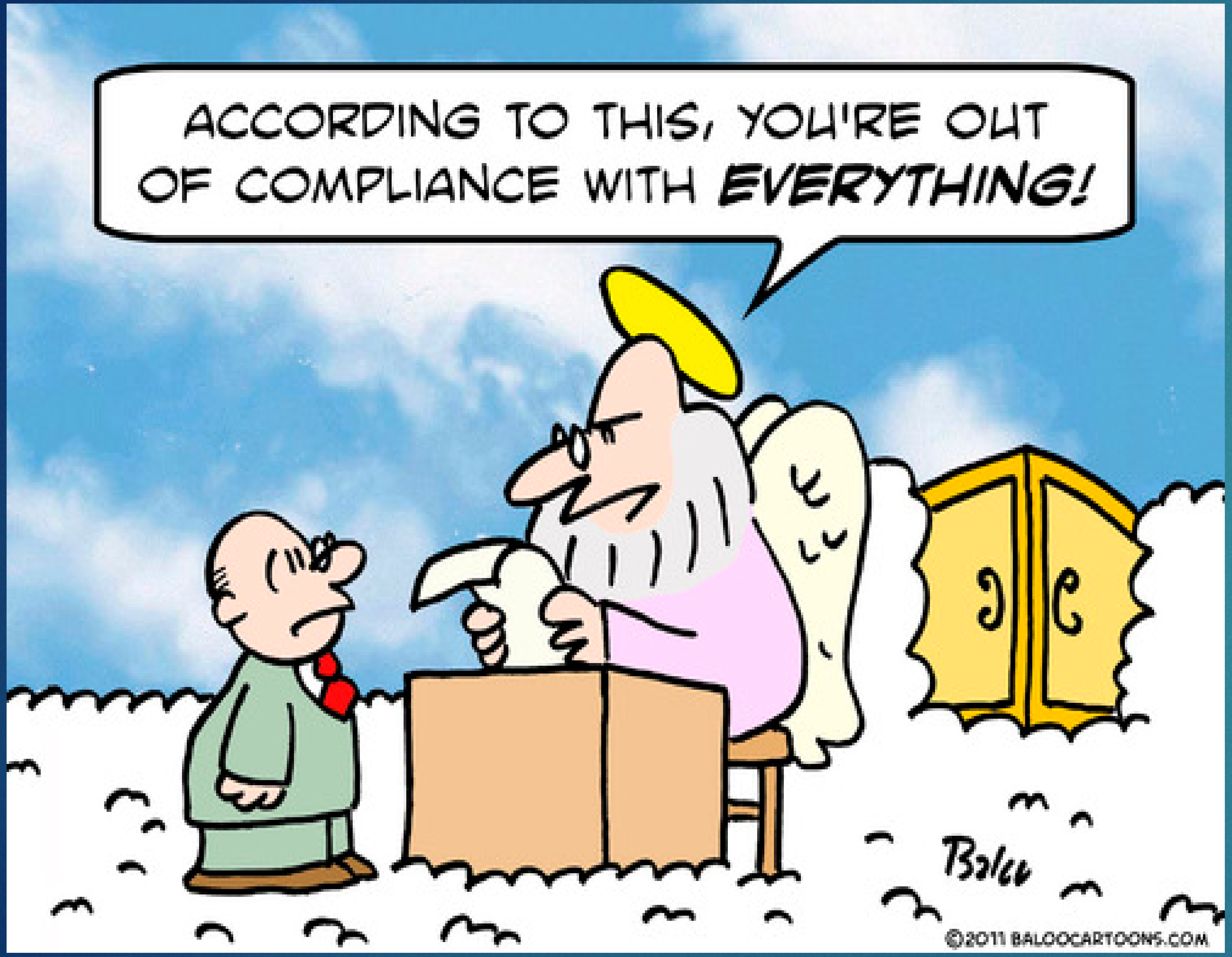
2. Flexibility creates complexity

Real-Time Underestimation of the Output Gap in Europe
(In ppts; 2003-16)

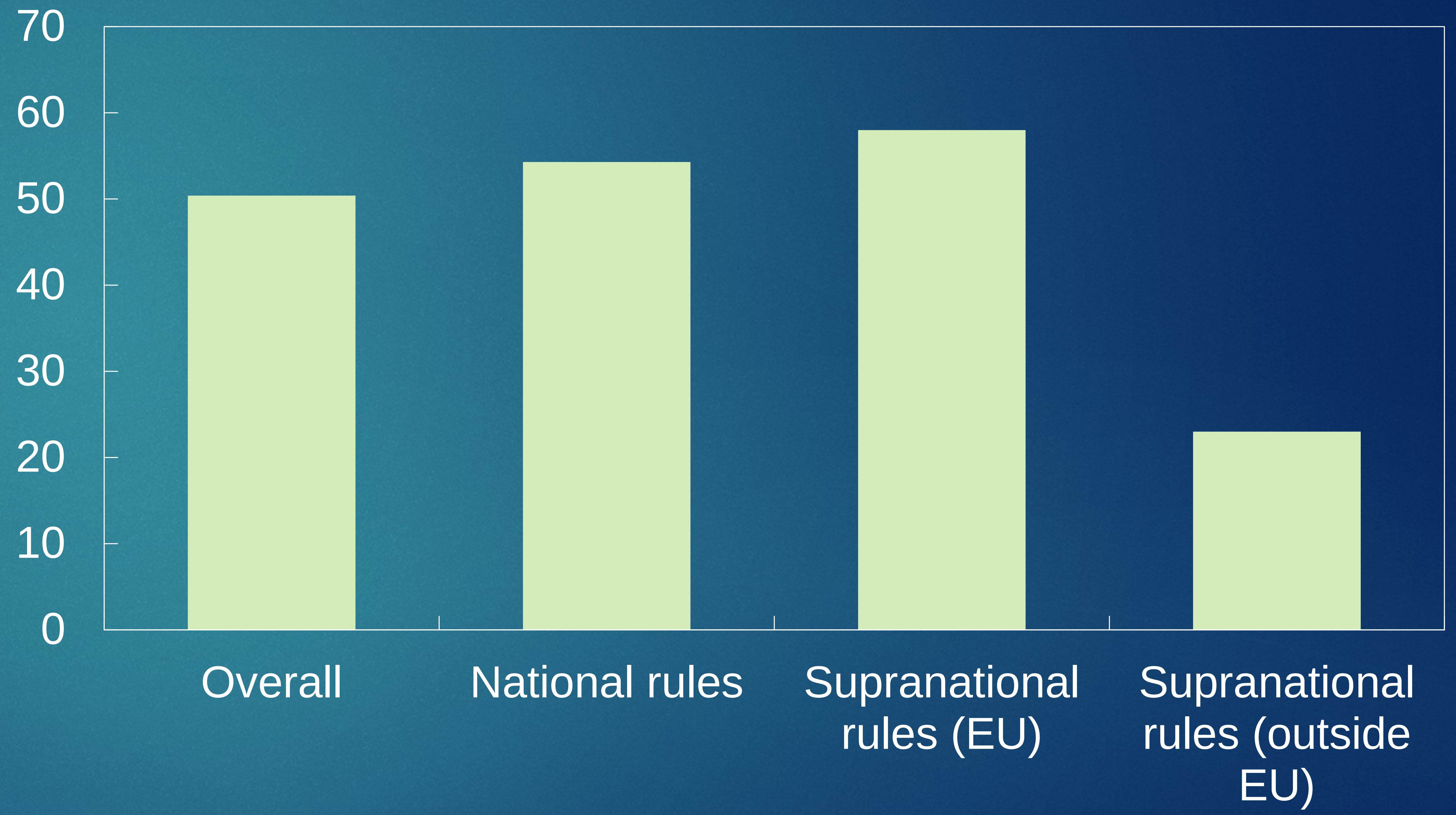


Source: AMECO database (ex post data), and stability programs (real time estimates).

3. Compliance remains low



Average Compliance Frequency with Budget Balance Rules 1/
(In percent)



Source: Fourth Background Paper by Lledo and Reuter (2018).
1/ Average frequency for all types of budget balance rules in force between 1985-2016 (all years, all countries).

IV. Three Guiding Principles for Future Reforms

1. A holistic approach to rule-based frameworks

- Fiscal frameworks should be designed and reformed as a whole

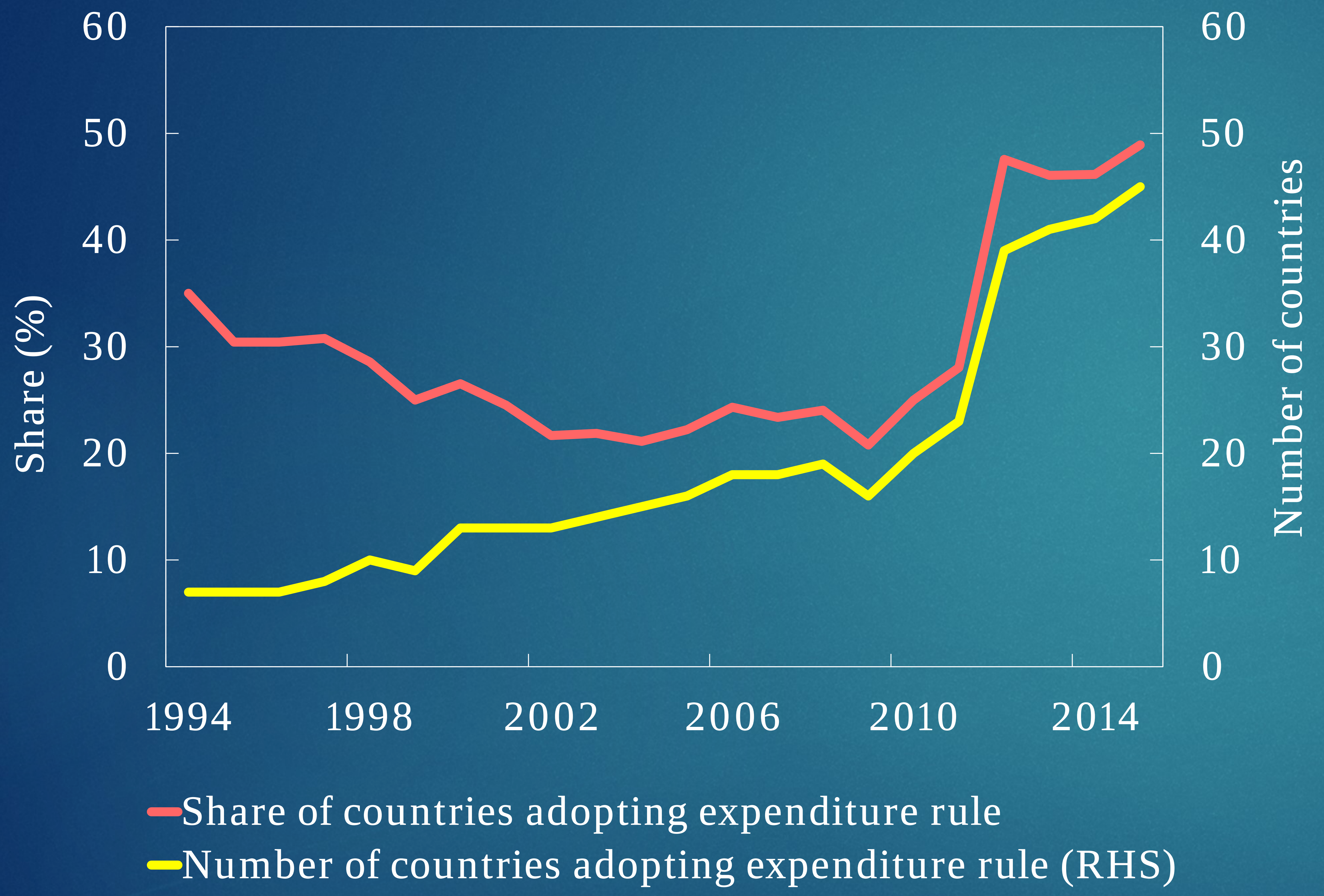
- Frameworks should be reviewed periodically

Criteria for "good" systems of rules

- **Anchoring**
- **Parsimony**
- **Consistency**

2. Flexibility made simpler

Countries Adopting Expenditure Rule, 1994-2015



Source: IMF Fiscal Rule Dataset.

Alternative approaches to flexibility

- ❑ Expenditure growth rules often strike a better balance between simplicity and flexibility
- ❑ Flexibility provisions should be more prevalent. Design matters to avoid abuse!

3. Better compliance through stronger incentives

Higher costs for noncompliers

- Limited effectiveness of sanctions
- Better to magnify reputational costs

More tangible benefits for compliers

- Lower financing costs?
- Create new carrots in supranational settings

Tailoring the three principles to country circumstances

	Advanced Economies	Emerging Markets	Low Income
Holistic approach	Reduce the number of rules	Achieve greater consistency across rules and calibrate debt rule properly	Adopt two-pillar framework with debt anchor and operational rule(s)
Flexibility	Review costs/benefits of cyclically-adjusted balance rules	Place more emphasis on expenditure rules	Use well-designed escape clauses and promote self-insurance
Enforcement	Rely on fiscal councils to facilitate enforcement	Fiscal transparency (comprehensive, clear, timely reporting)	Sound budgeting practices and data quality

Conclusion

Getting the design right

- Empirical evidence suggests that rules can be effective at containing excessive deficits under specific conditions

- Design matters: existing rules have become too complicated and some are counterproductive

- The next frontier is to achieve flexibility and enforceability without sacrificing simplicity. Greater reliance on expenditure rules suggests that it is possible

- Key role of supporting institutions (e.g., fiscal councils and PFM systems)

- Fiscal frameworks should be reformed in a holistic manner