

Fiscal Rules

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Outline



1. Why Fiscal Rules?
2. Effectiveness
3. Challenge
4. Lessons Learned and Conclusions

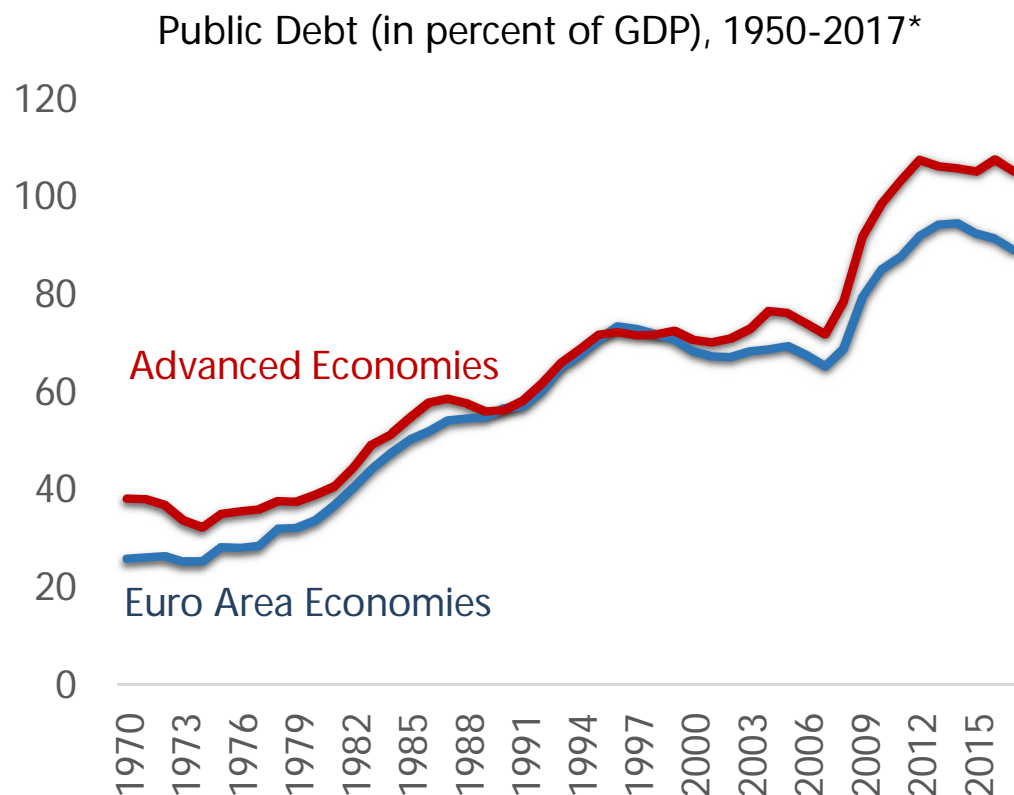


1. Why Fiscal Rules?



Public Debt Developments

- Public Debt has Risen by More than tripled in Advanced Economies During the last 40 years.
- The Next 35 Years Population Aging will Increase Public Spending in Advanced Economies by 5 percentage points of GDP, further adding to Deficits and Debt.



Source: IMF Global Debt Database (2018).

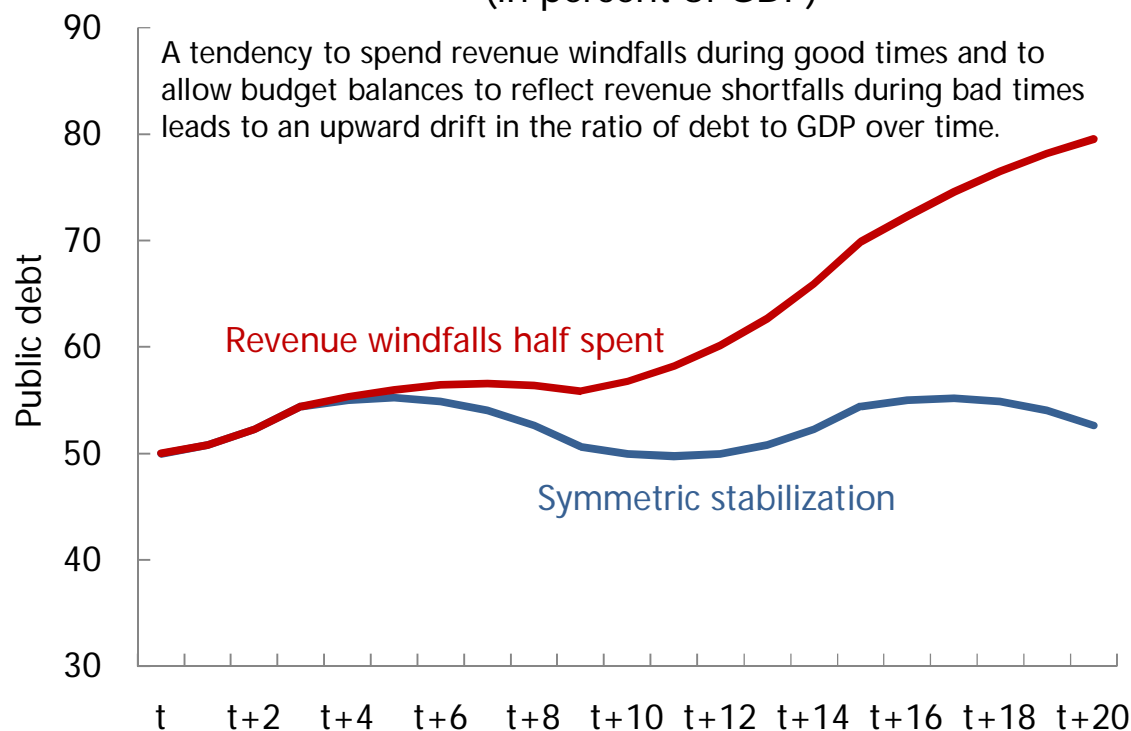
* Weighted Average; Preliminary estimates.



The Role of Discretionary Fiscal Policies

- Countries tend to pursue more fiscal stabilization during downturns than upturns.

Impact of Asymmetric Stabilization on Public Debt
(in percent of GDP)

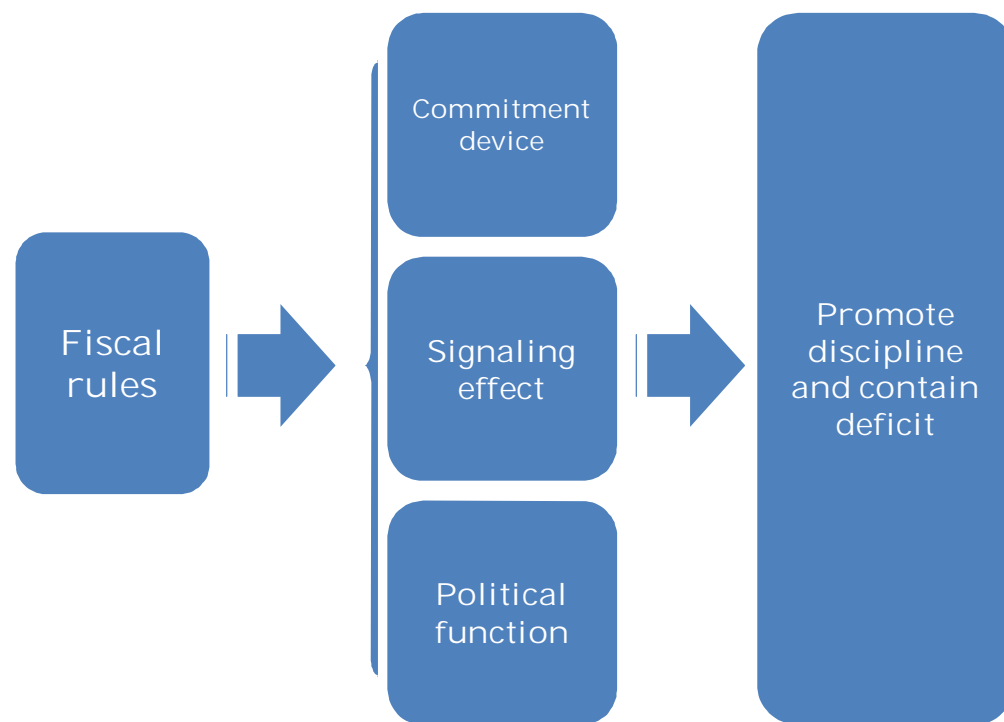


Source: IMF Fiscal Monitor (April 2015).



Fiscal Rules for Fiscal Discipline – a Country Perspective

- *Fiscal rules* are numerical constraints on key indicators of fiscal policy.
- *Fiscal Rules Help Address:*
 1. Short-sightedness of Political Process.
 2. Debt Bias.
 3. Pro-cyclicality Bias.



Fiscal Rules for Fiscal Discipline – Euro Area Perspective



In Euro Area, Stronger Need for Fiscal Rules,

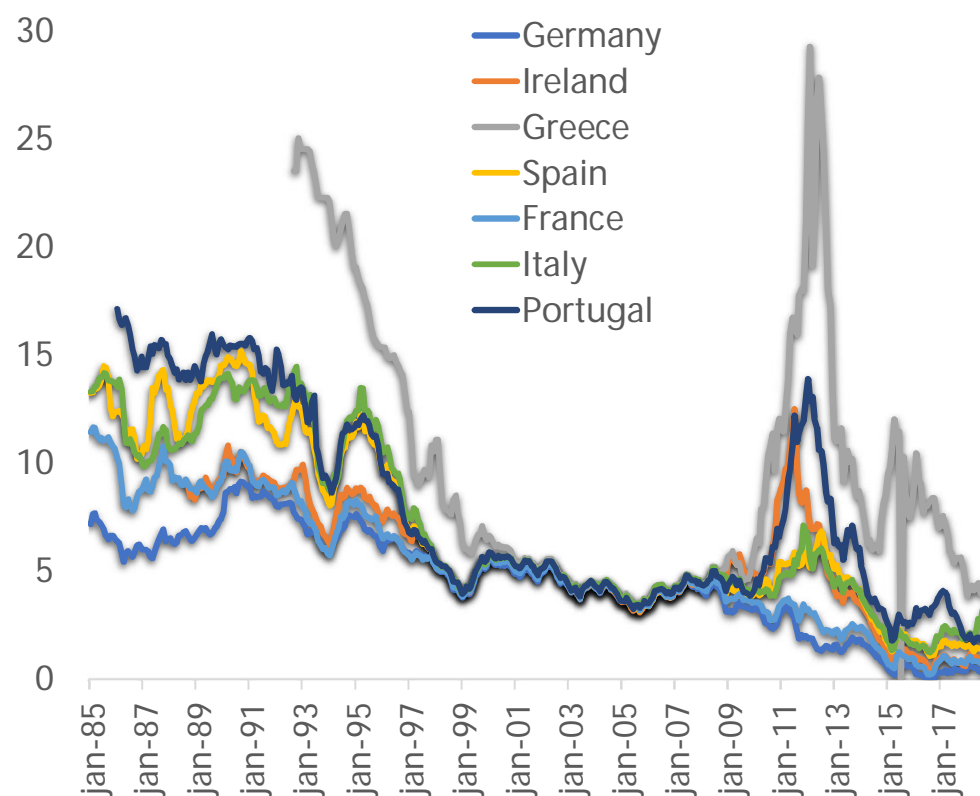
Because ...

Monetary union requires coordination to avoid unsustainable fiscal policies in member countries...

Therefore ...

Fiscal Rules are a cornerstone of the Euro Area Architecture.

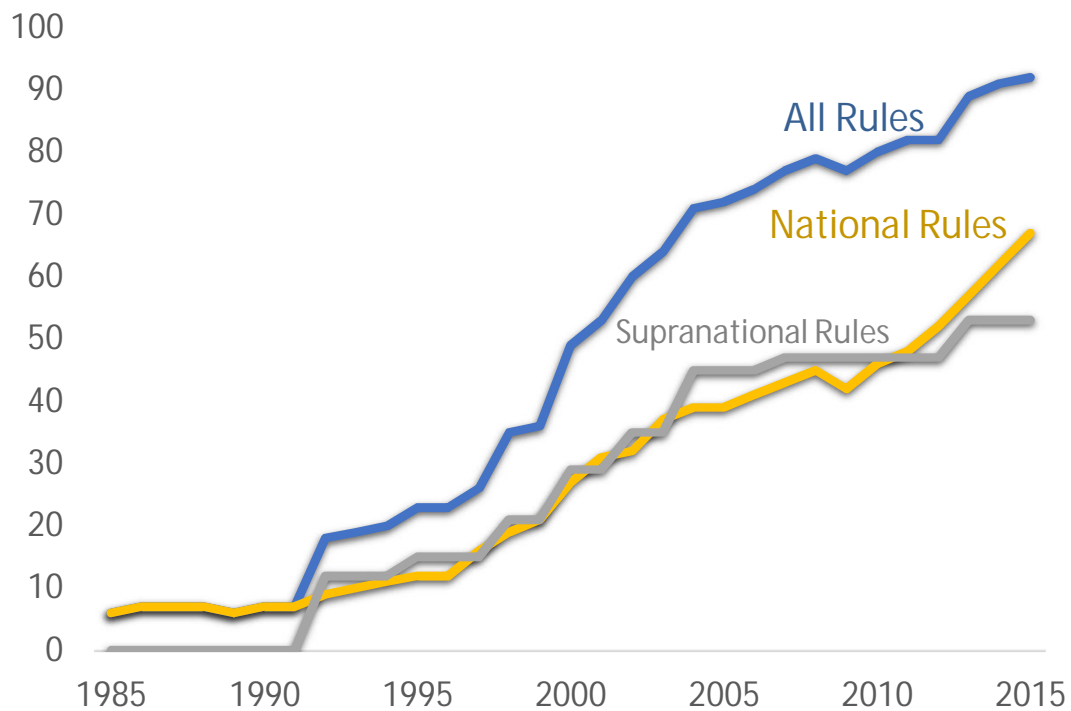
10-year Bond Yields, 1985-2018 (percent)



Source: Eurostat.

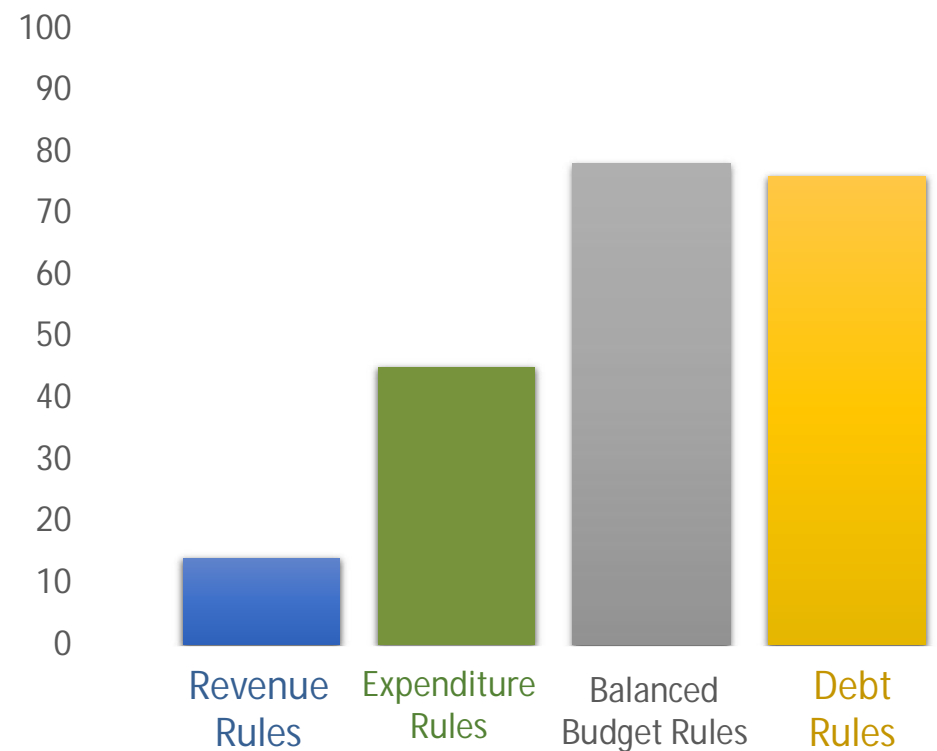
Growing Popularity of Fiscal Rules

Number of Countries with Fiscal Rules



Source: IMF Fiscal Rules Database.

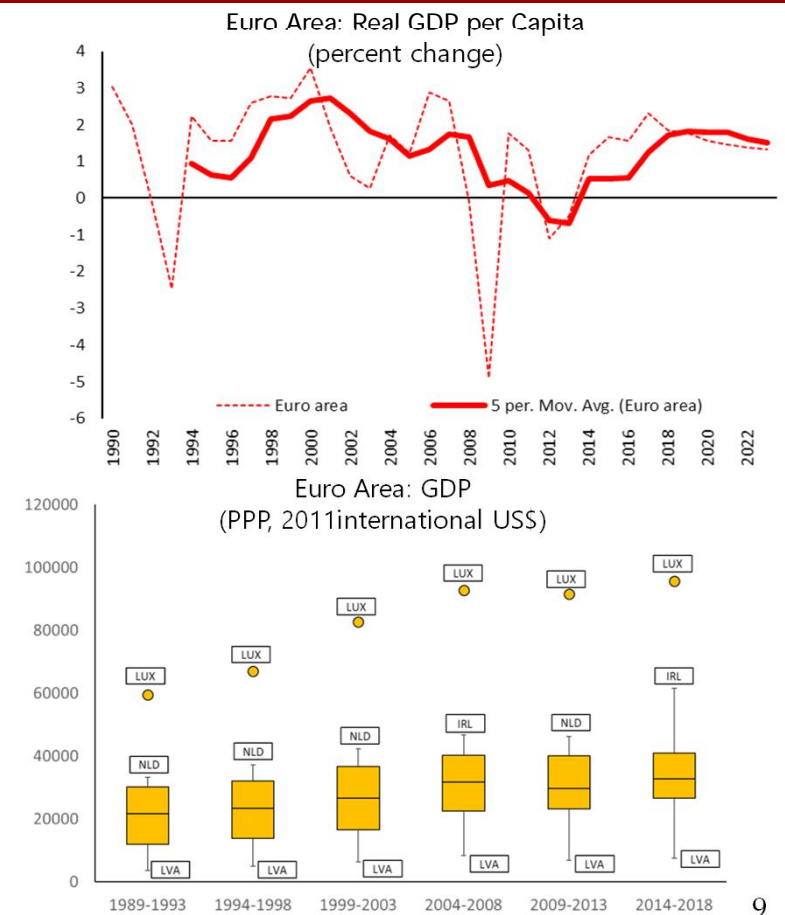
Types of Fiscal Rules in Use, 2015



Euro Area Fiscal Rules

Key Elements of the Euro Area Fiscal Rule

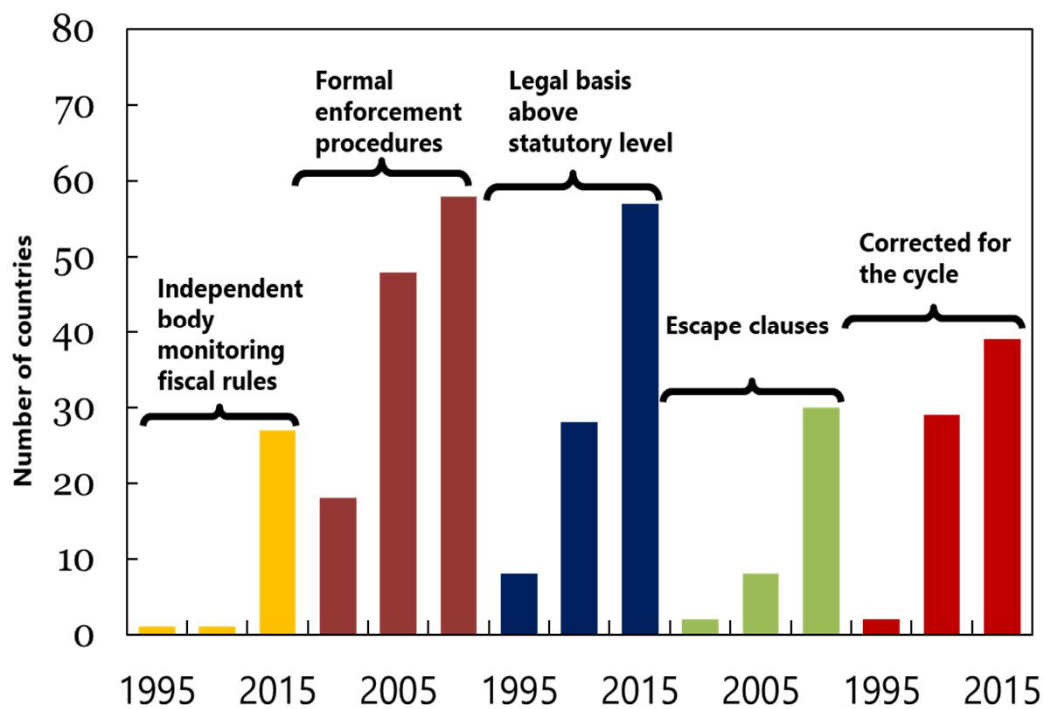
- Deficit Ceiling of 3% of GDP.
- Public Debt Anchor at 60% of GDP.
- Country-specific medium-term targets in cyclically adjusted terms (MTOs)
- Annual adjustments toward MTOs
- Debt reduction benchmark stipulating that the distance to the 60% threshold be reduced by 5% on average per year.
- Expenditure benchmark.



Source: IMF WEO. Euro area includes 19 countries throughout the entire period.

Recent Trends in Rules

Fiscal Rules Features, 1995–2015



Source: IMF fiscal rule database.

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

Criticism	Response	Example
Too Rigid for Stabilization	Increased Flexibility	Escape clauses and flexibility for growth-enhancing reforms
Low compliance	More enforceable	Correction mechanisms and fiscal councils
Too Complicated for guiding fiscal policy *	More operational	Expenditure rules

* For example, the Vade Mecum on the SGP alone provides 220-page long guidance.



2. Effectiveness



Average Effectiveness

- § *Positive correlations between fiscal rules and budget balances...*
- § *... but causality difficult to establish*
 - ü After correcting for endogeneity, no difference between rule adopters and nonadopters.
 - ü “Average rule” does not impact fiscal balance of an “average country”.
- Significant heterogenous effects across rules and countries.

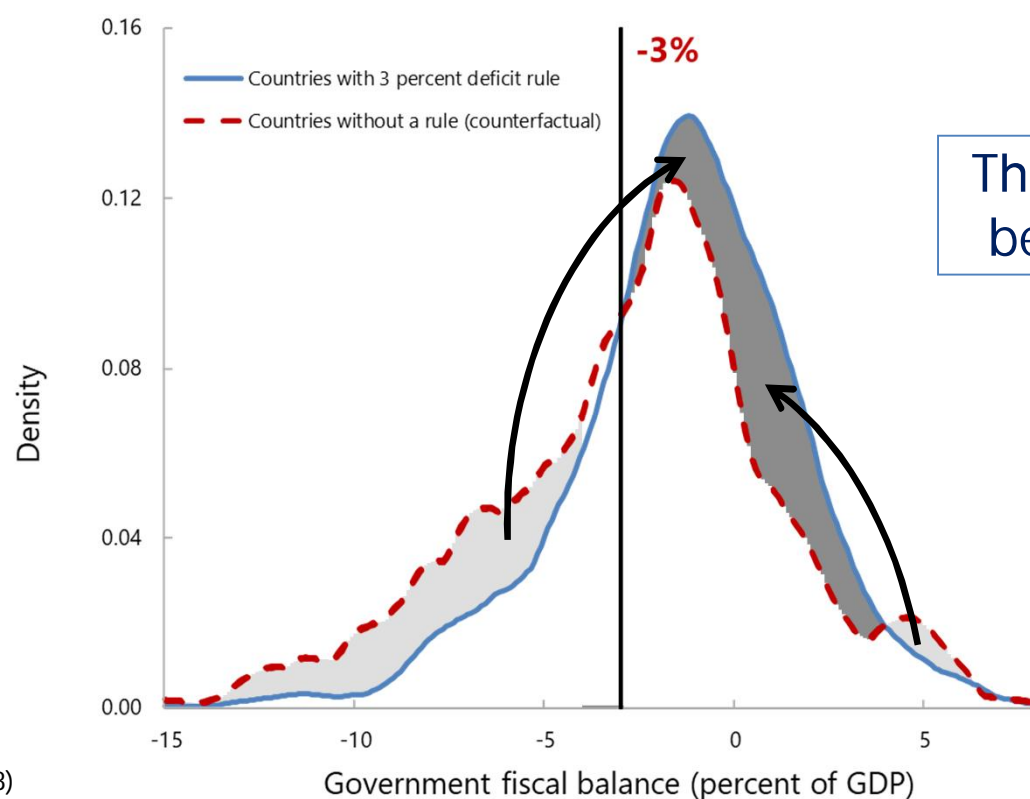
Relationship between Fiscal Balance and Fiscal Rules (OLS and New IV Approach) and Fiscal Strength Index

	(1)	(2)
Fiscal Rule Dummy	0.8*** (0.22)	
Fiscal Rule Dummy		1.38 (0.87)
Fiscal Rule Strength Index		
Observations	2,823	2,797
R-squared	0.71	0.3
Method	OLS	New IV

Source: Caselli and Reynaud (2018).
 *** p<0.01, ** p<0.05, * p<0.1.

... But Effective as a Pulling Force, Even in Case of Noncompliance

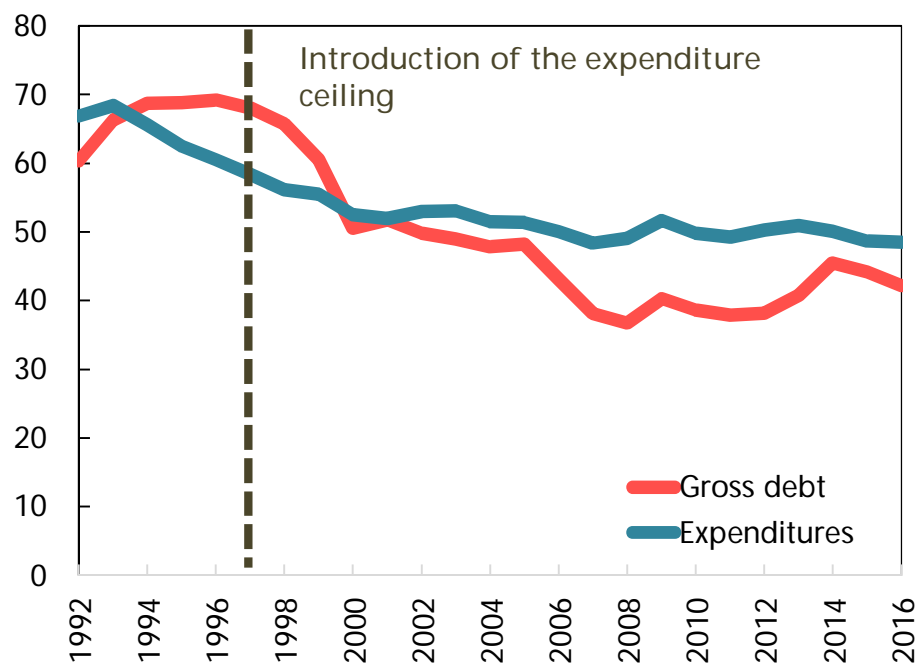
Probability Distribution of Deficits



Source: Caselli and Wingender (2018)

Different Impacts Across Rules

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



Source: Mbaye and Ture (2018).

Successful rule design - Sweden

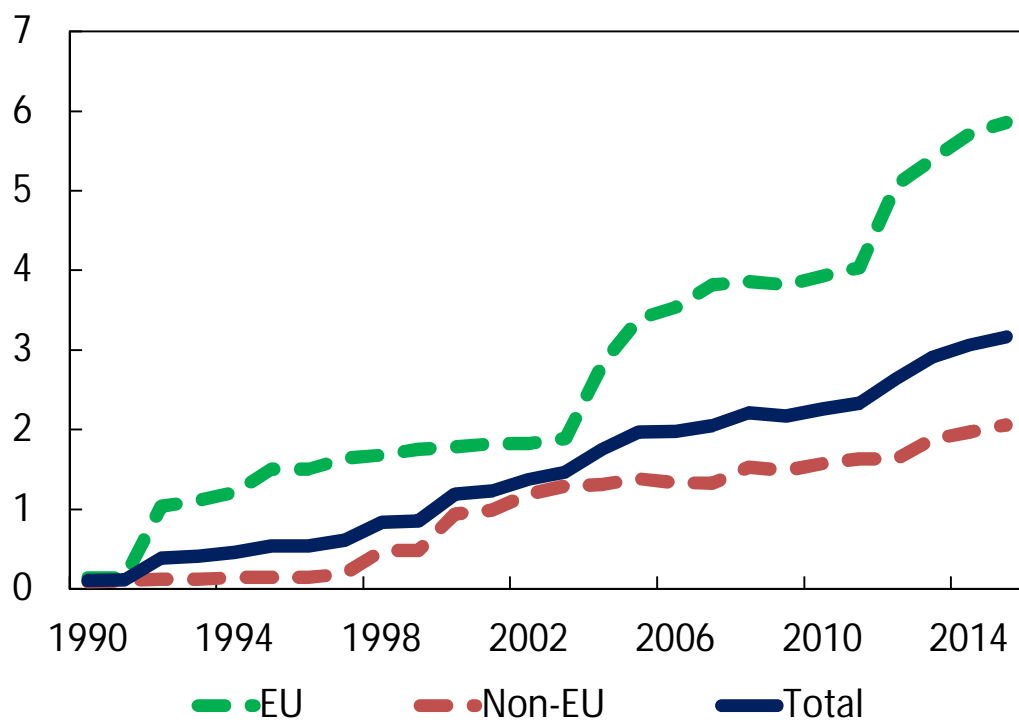
- Broad institutional coverage
- Consistent/good calibration.
- Builds buffers in good times
- Supporting institutions (Fiscal Council, sound PFM)
- Political buy-in



3. Challenge

A. Multiplicity of Fiscal Rules

Average Number of Rules per Country



Source: IMF fiscal rules dataset.

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

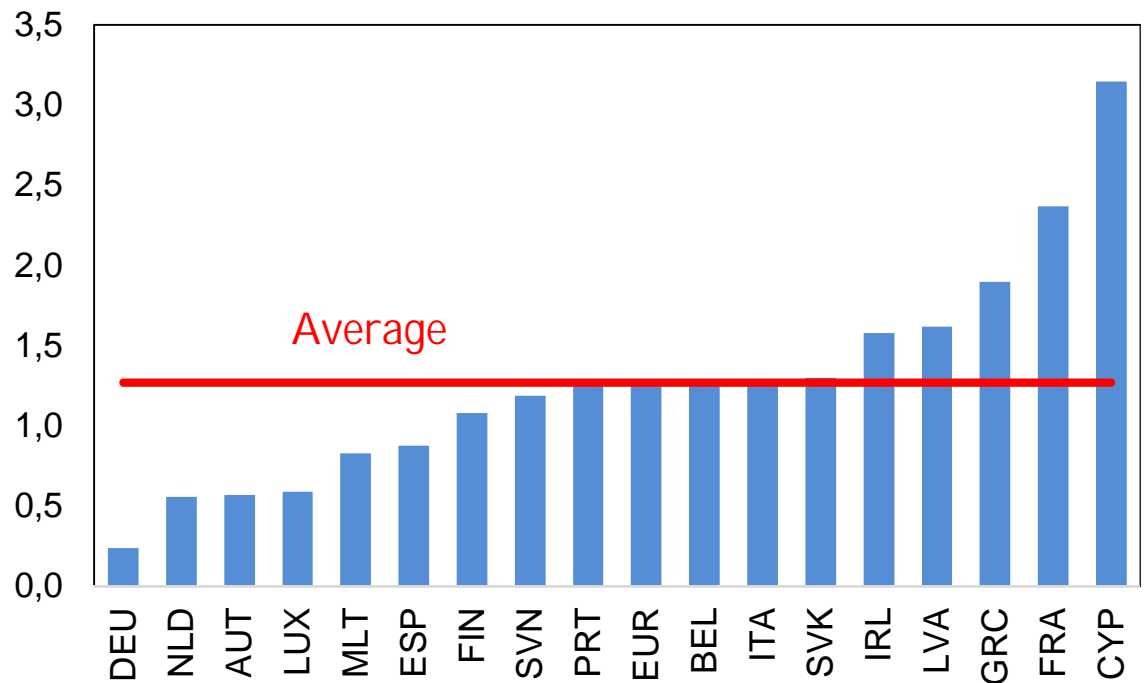
Pitfalls of multiple rules

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

B. More Flexibility at the Expense of Complexity



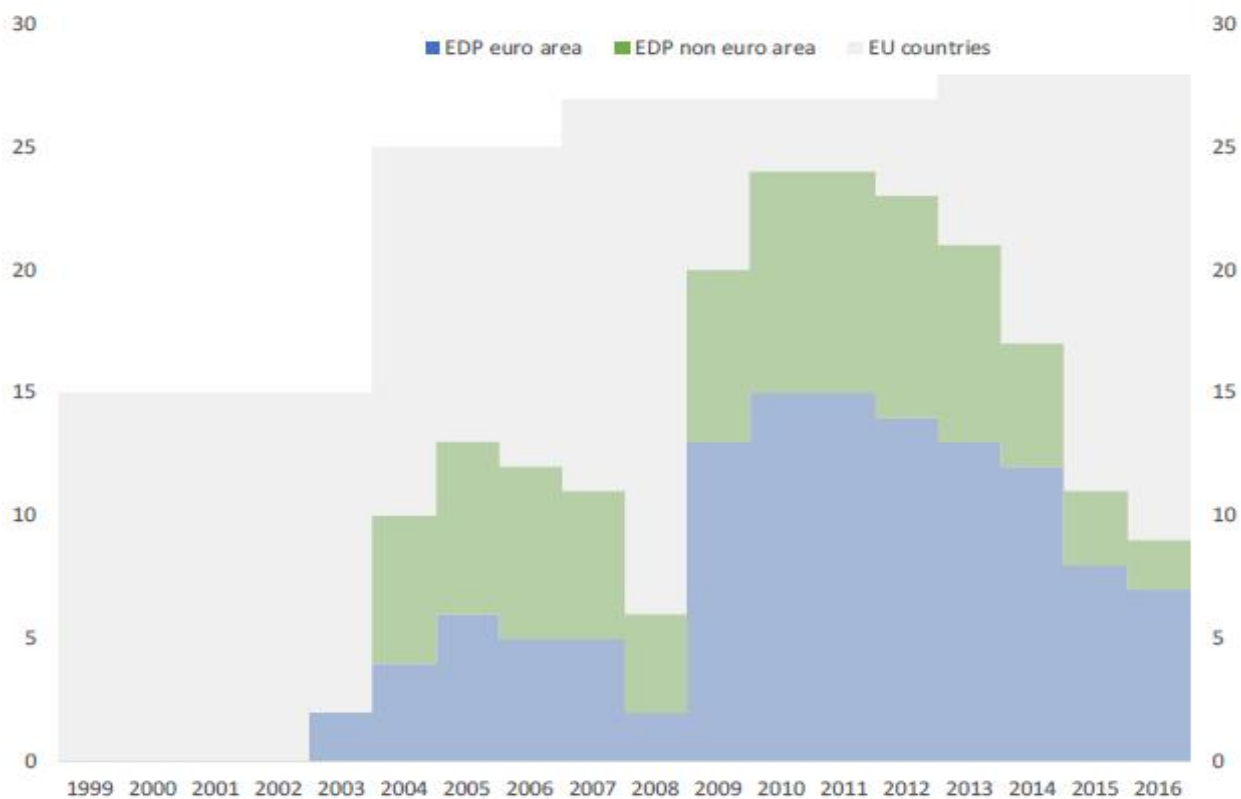
Real-Time Underestimation of the Output Gap in Europe
(In ppts; 2003-16)



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

C. Poor Compliance Track Record

Evolution of Number of EU Countries under the EDP

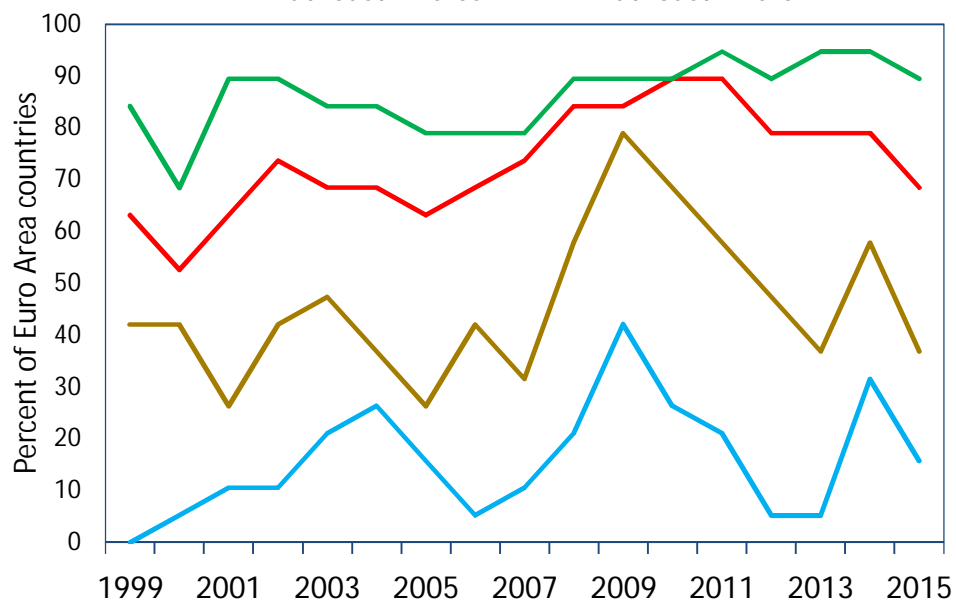


Source: Diaz Kalan, Popescu and Reynaud (2018)

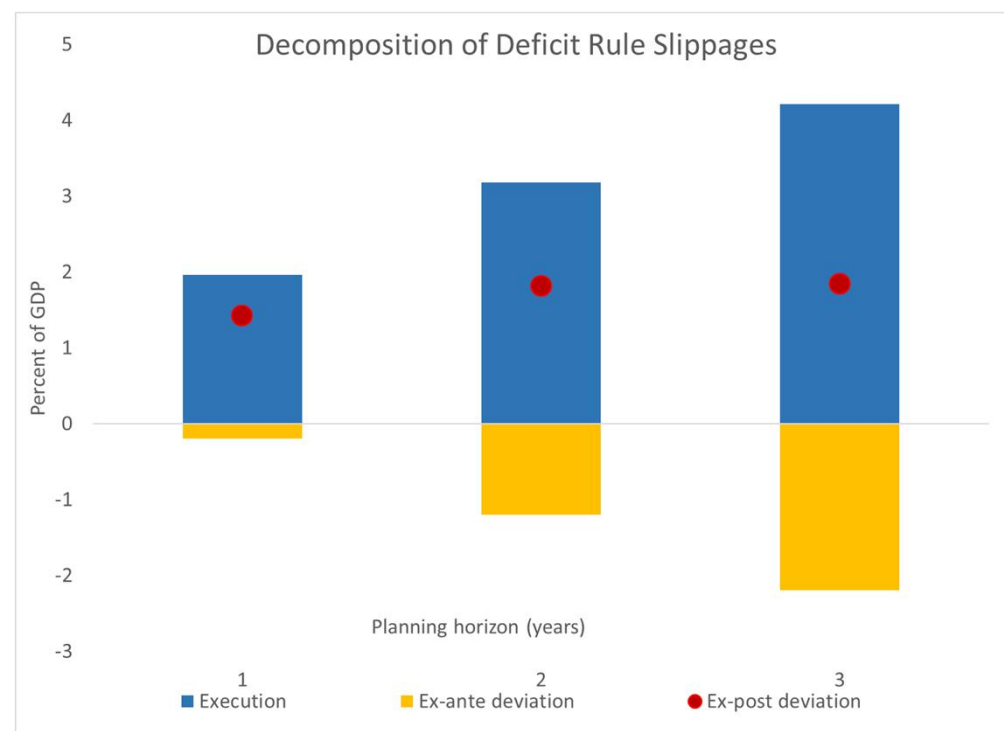
C. Poor Compliance Track Record (continued)

Euro Area countries that did not comply with:

- 4 rules
- at least 3 rules
- at least 2 rules
- at least 1 rule



Note: Reported is the share of euro area countries that did not comply with the following fiscal rules: (1) Deficit rule = overall deficit-to-GDP ratio should not exceed 3%, (2) Debt rule = public debt-to-GDP ratio should not exceed 60%, (3) Medium-Term Objective (MTO) rule = structural deficit ratio should not exceed the MTO, and (4) Fiscal effort rule = decline in the structural deficit ratio should be at least 0.5% in a given year when the structural deficit exceeds the MTO in the previous year. The assessment is illustrative and subject to a number of caveats.
Source: Eyraud, Gaspar, and Poghosyan (2017).



Note: Decomposition formula: $\underbrace{DEF_{t|2016} - 3}_{Ex\text{-}post\text{ slippage}} = \underbrace{(DEF_{t|2016} - DEF_{t|i})}_{Execution} + \underbrace{(DEF_{t|i} - 3)}_{Ex\text{-}ante\text{ compliance}}$

Medians reported.

Source: Eyraud, Gaspar, and Poghosyan (2017).



4. Lessons Learned and Conclusions



Lessons from Country Experiences

What makes rules effective?

- Strong and enduring political consensus and buy-in.
- Broad institutional and economic coverage.
- Simple design conducive to countercyclical fiscal policy.
- A good calibration.
- Well-defined escape clauses against tail events.
- Effective enforcement mechanism (e.g. fiscal councils).



Conclusions

- Politics is Key.
- An Expenditure Growth Rule With a Debt Anchor Strikes a Good Balance between Flexibility and Simplicity.
- Central Fiscal Capacity Could Safeguard Against Idiosyncratic Shocks and Help Avoid Overreliance on Monetary Policy.
- Complete Remaining Elements of the Euro Area Architecture (Capital Markets Union, Banking Union, Further Fiscal Integration).



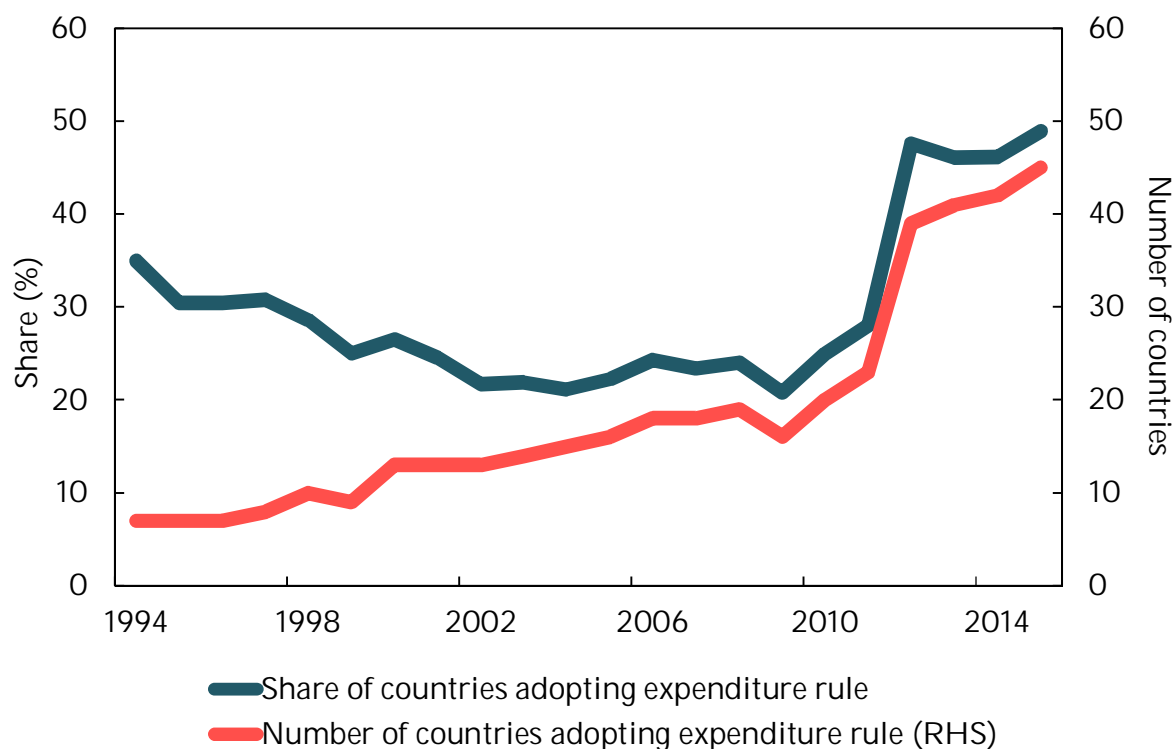
Thank You!



Background Slides

Flexibility Made Simpler

Countries Adopting Expenditure Rule, 1994-2015



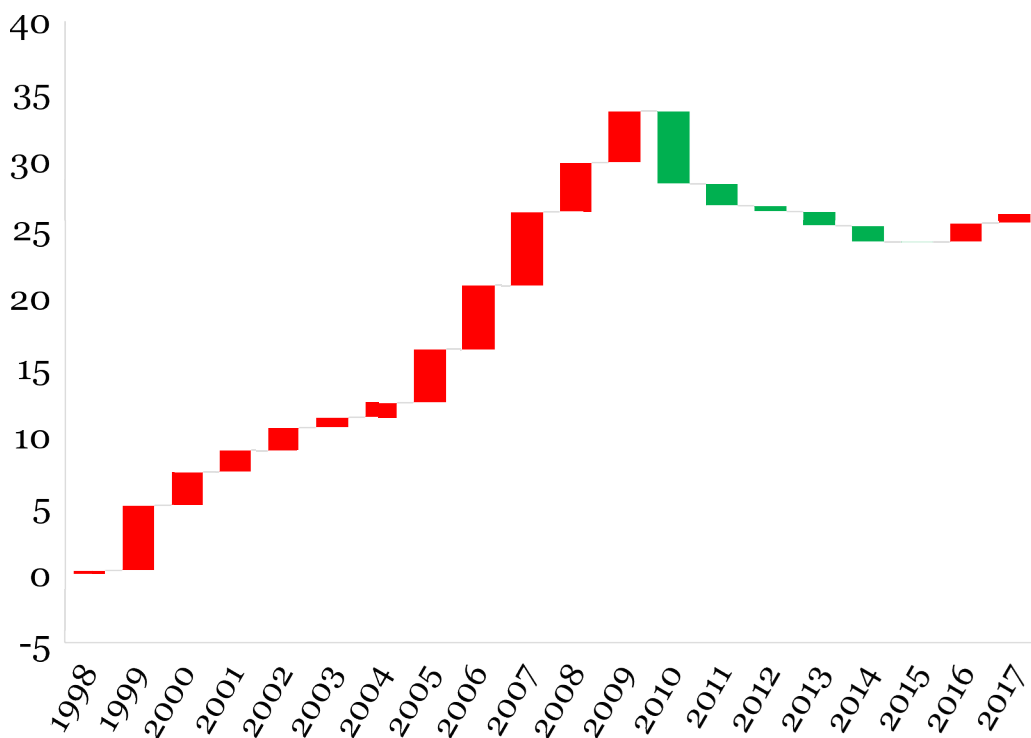
Source: IMF Fiscal Rule Dataset.

Alternative approaches to flexibility

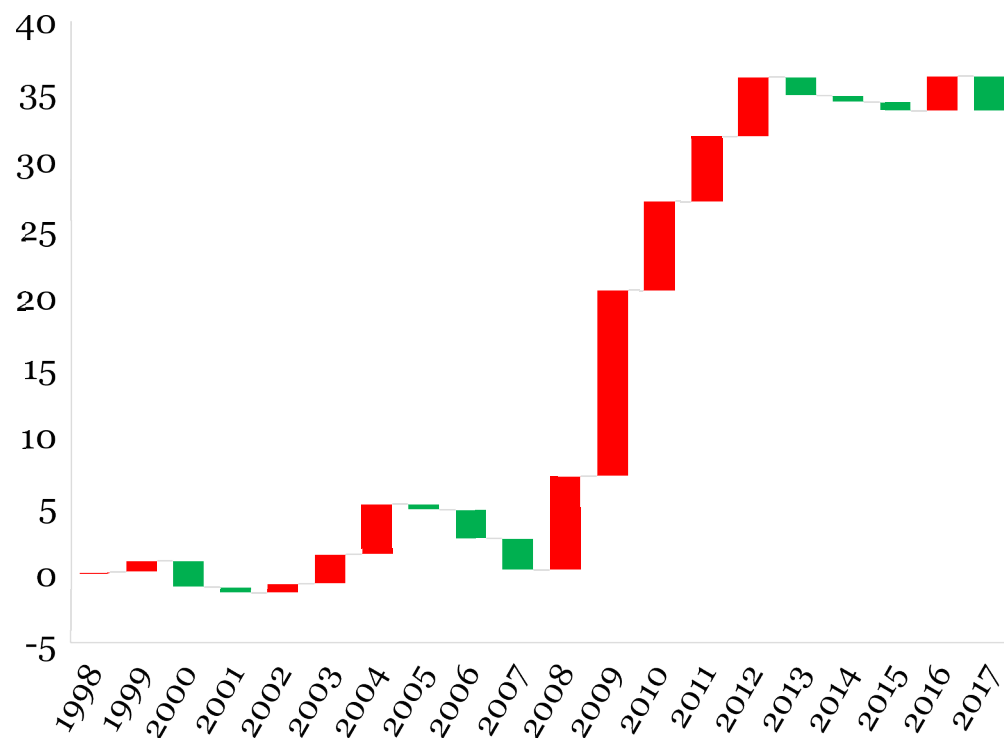
- q Expenditure growth rules often strike a better balance between simplicity and flexibility
- q Flexibility provisions should be more prevalent. Design matters to avoid abuse!

Debt Trends in Advanced Economies

Changes in Private Debt, 1998–2017



Changes in Public Debt, 1998–2017



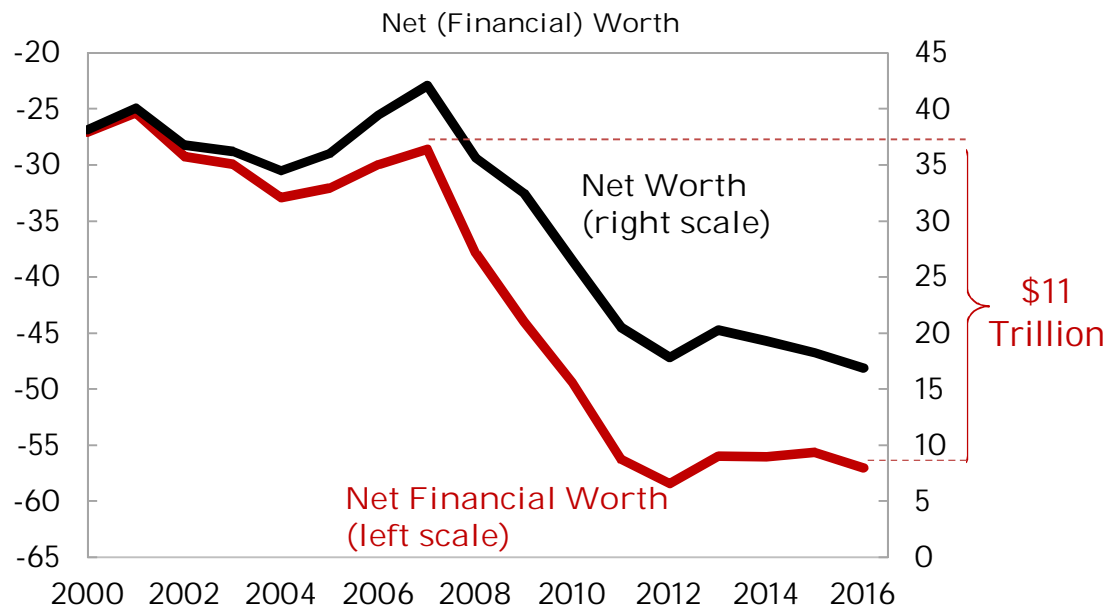
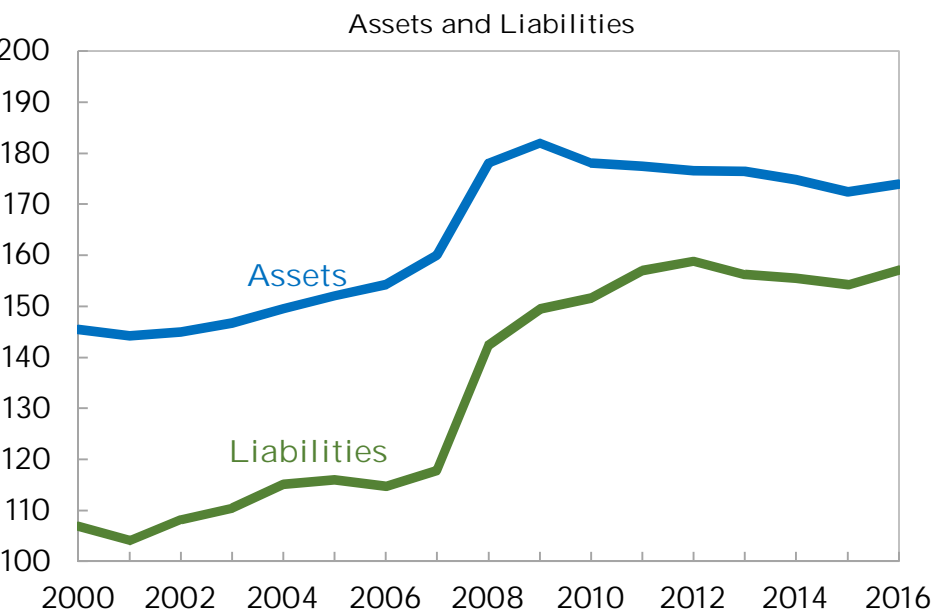
Source: IMF Fiscal Monitor, October 2018.

Note: The data excludes natural resource assets and pension liabilities.



The Public Sector Balance Sheet

Public Sector Balance Sheet
(Weighted average of 17 countries, percent of GDP)



Source: IMF Fiscal Monitor, October 2018.
Note: The data excludes natural resource assets and pension liabilities.