Second Generation Fiscal Rules:
Balancing Simplicity, Flexibility, and Enforceability

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Presentation based on new IMF paper on fiscal rules

- Revisit the case for fiscal rules in light of experience. Rules have been criticized in recent years: too complicated, too rigid, noncredible, unable to curb rising public debts...

- Post-Global Financial Crisis developments. Rapid evolution. A new generation of rules has emerged

- Contribute to the debate. Take stock of new thinking and discuss options for future reforms
I. Definition and Purpose of Fiscal Rules

II. From First to Second Generation Rules

III. Lessons from Country Experiences with Rules

IV. Guiding Principles for Future Reforms
I. Definition and Purpose of Fiscal Rules
How does the IMF define a fiscal rule?

Fiscal rules impose long-lasting constraints on fiscal policy through numerical limits on large budgetary aggregates.

- **Long-lasting:** Rules can impose temporary constraints, but they have to be binding for a minimum of three years. Multiyear expenditure ceilings that can be changed annually are not considered fiscal rules.

- **Numerical:** Fiscal rules differ from procedural rules that improve budget management but do not establish numerical limits (e.g., reporting).

- **Large:** Fiscal rules set targets on aggregates that capture a large share of public finances (e.g., fiscal deficit, debt, expenditure).
Main purpose of fiscal rules is to contain excessive deficits

- Fiscal rules
  - Commitment device
  - Signaling effect
  - Political function
  - Promote discipline and contain fiscal deficit
Difficult to achieve three properties of rules simultaneously

- Escape clauses, cyclically-adjusted balance rules
- Simplicity: Nominal budget balance rules
- Flexibility
- Enforceability: Sanctions, correction mechanisms, fiscal councils
II. From First to Second Generation Rules
Fiscal rules have spread worldwide

Number of Countries with Fiscal Rules, 1990-2015

National and Supranational Rules

By Country Groupings

Source: IMF Fiscal Rule Database.
Note: The charts describe the number of countries with, at least, one rule.
First-generation rules have tried to combine simplicity and flexibility

- Rules introduced before the global financial crisis...
  - ...were initially **simple**, such as budget balance rules
  - To ensure that simple rules were not too rigid, provisions were progressively added to create **flexibility**, meaning the ability to modify the application of the rule in case of shocks
  - Enforcement procedures were underdeveloped before the crisis
An example of flexible rule: the cyclically-adjusted balance rule

- Less common in Asia but widespread elsewhere
- Introduced in Chile in 2001 and in European countries in 2005
- This rule targets the “structural” fiscal deficit, meaning the deficit excluding the effect of the cycle
- Can correct for the economic cycle (e.g., Switzerland) and/or the commodity price cycle (e.g., Mongolia)
- Allows higher headline deficits in bad times (when cyclical revenues are low) but requires lower deficits in good times (when cyclical revenues are high)
The emergence of a second generation of rules

Post-GFC rules

• **More flexible**: e.g., escape clauses and flexibility for growth-enhancing reforms

• **More enforceable**: e.g., correction mechanisms and fiscal councils

• **...but also less simple**

**Fiscal Rules Features, 1995–2015**

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.
Not just a European innovation

- **Features introduced in selected countries since 2008**
  - *Escape clauses*: Georgia, India, Jamaica, Tanzania
  - *Correction mechanisms*: Grenada, Mongolia, Panama, Peru
  - *Independent body monitoring rules*: Chile, Peru, Kenya, Uganda
III. Lessons from Country Experiences with Rules
1. Certain features make rules more effective

**Successful rule design**

- Broad economic and institutional coverage
- Build buffers in good times
- Good calibration
- Well-designed escape clauses
- Sound public financial management and political buy-in

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

Source: IMF Staff Discussion Note SDN/18/04.
2. Adjusting rules for the cycle has created problems

- Cyclically-adjusted balance rules are difficult to compute and communicate to the public.
- These rules are based on potential output estimates, which tend to be overestimated in real time.
- Therefore, cyclically-adjusted rules may allow excessive expenditure.

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. Combining multiple rules has been challenging

**Pitfalls of multiple rules**

- **Inconsistency** between rules’ ceilings (in particular, debt and balance rules)
- **Overlap** between rules (creates operational and political economy problems)
- **Overdetermined** systems (leads to suboptimal policies)
- **Lack of credibility**

### Average Number of Rules per Country

![Graph showing the average number of rules per country from 1990 to 2014 for EU, Non-EU, and Total.](image)

Source: IMF fiscal rule dataset.

Note: Based on a constant country sample (including countries with no rule at some point during the period).
4. Despite many reforms, compliance with fiscal rules has remained low

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

<table>
<thead>
<tr>
<th>Rule Type</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>50%</td>
</tr>
<tr>
<td>National rules</td>
<td>60%</td>
</tr>
<tr>
<td>Supranational rules (EU)</td>
<td>70%</td>
</tr>
<tr>
<td>Supranational rules (outside EU)</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: IMF Staff Discussion Note SDN/18/04.

1/ Average frequency for all types of budget balance rules in force between 1985-2016 (all years, all countries).
IV. Guiding Principles for Future Reforms
1. Fiscal rules frameworks should have 3 characteristics

- **Anchoring**: Two-pillar structure: the framework should include a fiscal anchor (a debt ceiling or target), and one or several operational rules under the control of policymakers (e.g., budget balance rule or expenditure rule).

- **Parsimony**: The fiscal framework should not have too many operational rules (one as default option).

- **Consistency**: Relationships between the thresholds of the debt anchor and the operational rule(s) should be transparent and grounded in economic analysis.
2. Some operational rules achieve a better balance between simplicity and flexibility

- Expenditure rules have become more popular
- Expenditure ceilings can be expressed as a ratio of GDP or in growth rate
- They are simple to measure and understand
- They give flexibility to governments: allow higher fiscal deficits in bad times and require to save in good times

Source: IMF Fiscal Rule Dataset.
3. Stronger incentives are key to improve compliance

**Higher costs for noncompliers**
- Limited effectiveness of sanctions
- Better to magnify reputational costs

**More tangible benefits for compliers**
- Lower financing costs?
- Create new carrots
Conclusion
Getting the rules’ design right

- History suggests that rules can be effective at containing excessive deficits under specific conditions.

- Design matters: some rules are too complicated and can even be counterproductive.

- Fiscal rule frameworks should include a fiscal anchor (debt) and a small number of operational rules.

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

- Supporting institutions play a key role (e.g., public financial management systems).