

Rules-Based Fiscal Framework: Rationale, Design and Experience

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Outline

- **Rationale**
- **Key elements**
- **Policy rules, procedural rules**
- **Transparency**
- **Enforcement, surveillance**
- **Experience**
- **Developing good practices**

Rationale

Discretionary policy: problems

- Time inconsistency
- Free rider, common pool problem
- Deficit bias
- Procyclical bias
- Expenditure composition bias
- Risk of unsustainable public debt
- Difficulty in anchoring expectations

Key elements of RFF

- ***Policy (numerical) rule:*** permanent constraint on a summary fiscal indicator
- ***Procedural rule:*** regulation of budget process
- ***Transparency in:*** functions, coverage, time horizon, accounting and forecasting
- ***Enforcement, surveillance:*** monitoring, sanctions for non-observance

Types of policy rules

Budget balance rules

- overall balance (incl. deficit limit, min. surplus)
- current balance (“golden rule”)
- primary balance
- operating balance
- medium-term, structural, or cyclically-adjusted balance

Types of policy rules

Expenditure rules

- **primary expenditure limit (*)(**)**
- **discretionary expenditure limit (**)**
- **wage expenditure limit (**)**

(*) possibly inclusive of tax expenditures

(**) defined in nominal terms, real terms, or as a ratio to actual or potential GDP

Types of policy rules

Debt rules

- debt ratio limit
- target debt ratio → primary surplus ratio
- real debt limit → nominal primary surplus

Types of policy rules

Debt rules

Convergence to target debt ratio (Brazil):

Given target debt ratio

$$d_{t+n}^* < d_t$$

derive target primary surplus ratio

$$s_t^* \geq \left(\frac{i - g}{1 + g} \right) d_{t-1} + x$$

Types of policy rules

Debt rules

Real debt limit (Hungary):

Given debt target

$$D_t^* \leq (1 + \pi_t)^3 D_{t-3}$$

derive primary surplus target

$$S_t^* = (i_t^f - \pi_t^f) D_{t-1}^* \geq 0$$

and discretionary balance target

$$SR_t^* \geq S_t^* - SM_t^f$$

Policy rules: selected countries

	Basic Rule	Statute	Authority	Sanction
New Zealand	operating balance (MT)	law		reputational
EU (SGPact)	overall balance (MT); debt limit	treaty	peer review	reputational
Sweden	structural surplus; primary exp. limit	law	fiscal council	judicial
Bulgaria	overall balance; primary exp. limit	guideline		reputational
Poland	debt limit	constitution		judicial
Chile	structural surplus; stabilization fund	law	expert group	judicial
Peru	overall balance; stab. fund; exp. limit	law	central bank	judicial
Brazil	current balance; debt limit; wage limit	law		judicial
India	current balance; deficit limit	law		judicial
Switzerland, Germany	structural balance	constitution		judicial
Hungary	debt limit; primary expenditure limit	law	fiscal council	reputational

Types of procedural rules

Major examples

- **medium-term budget planning**
- **pay-go principle for budget (incl. tax) proposals**
- **limit on end-year carryover of appropriations**
- **rules on supplementary appropriations**

Transparency

Widespread access to timely information

- **functional clarity (e.g., policy functions, intergovernmental relations)**
- **institutional coverage of public sector (incl. extra-budgetary operations, SOEs)**
- **accounting conventions (accrual, cash)**
- **realistic macro-fiscal forecasts**
- **contingent liabilities, risk assessment**

Enforcement, surveillance

Enforcement

- **statutory basis: constitution, law, guidelines**
- **implementation:**
 - *ex ante* targets, *ex post* realization
 - escape clauses, contingency funds
- **sanctions: reputational, legal, financial**

Surveillance

- **self, independent fiscal institution, other**

Surveillance: independent fiscal institution

Structure

- **Individual or collective**
- **technical staff**

Remit, main functions

- **assessment of fiscal stance, debt sustainability**
- **assessment of compliance with fiscal rules**
- **macro-fiscal forecasts; costing of proposals**
- **limited advisory or normative role**

Independent institutions: selected countries

	Structure			Remit / Functions			
	Head	Staff	Compliance	Macro-fiscal	Sustainability	Costing	Advisory
United States (CBO)	individual	X		X	X	X	
Netherlands (CPB)	individual	X	rules	X	X	X	
Belgium (HCF)	collective	other	targets	X	X		X
Korea (NABO)	individual	X		X		X	
Sweden (FPC)	collective	other	rules	X	X		X
Canada (PBO)	individual	X	targets	X		X	
Hungary (former FC)	collective	X	rules	X	X	X	
United Kingdom (OBR)	collective	X	target	X	X	X	

Experience: compliance with rules

Good compliance: New Zealand, Brazil*, Bulgaria, Chile, Estonia, Norway, Peru,* Sweden, Canadian provinces, Switzerland, some euro members (Belgium, Finland, Ireland, Luxembourg, Spain)

Mixed compliance: Colombia,* Poland, most euro area (incl. national rules), UK, US states

Teething problems: India,* Mexico, Nigeria,* Hungary*

Poor compliance: Argentina,* Ecuador,* Venezuela*

Experience: performance with rules

In complying countries

- **enhanced policy credibility, decline in risk premium**
- **lower vulnerability to crises (with exceptions)**
- **improved fiscal sustainability**
- **latitude for expansionary countercyclical stance**
- **above-average growth and stability**

Complying countries: output performance

	Growth		Volatility	
	Own	Comparator	Own	Comparator
New Zealand	3.4	2.7	0.3	0.3
Sweden	3.3	2.3	0.3	0.4
Euro: Belgium	2.3	2.3	0.4	0.4
Euro: Finland	3.7	2.3	0.3	0.4
Euro: Luxembourg	5.3	2.3	0.4	0.4
Bulgaria	5.1	4.3	0.3	0.5
Estonia	7.5	4.3	0.2	0.5
Poland	4.2	4.3	0.4	0.5
Chile	4.4	3.6	0.3	0.6
Peru	5.1	3.6	0.5	0.6
Brazil	3.4	3.6	0.5	0.7

Experience: performance with rules

In complying countries

- **Creative accounting ?**
 - Rarely, not significant
- **Pro-cyclical effects ?**
 - In some cases where low policy credibility, brief track record
- **Stop-gap measures or reforms ?**
 - In some cases compliance through distortionary measures (composition bias), where structural reforms are postponed
- **Impact of recent crisis?**
 - In some countries rules have been temporarily suspended, but mostly no impact
 - Ireland and Spain are exceptions, due to weak banking sector

Experience: challenges facing independent fiscal institutions

- **Conception and birth**
- **Establishing reputation**
- **Threats to funding**
- **Difficulties with timely access to data**
- **Survival threatened in a few countries**

Experience: Summing Up

- **Experience is recent, in some cases jury is still out**
- **Not fully comparable in design, implementation**
- **Basic tests:**
 - at least one full economic cycle and one electoral cycle
 - performance compared to counterfactual
- **Identification problem (when applied in tandem with inflation targeting, etc.)**
- **On balance, experience has been favorable**

Developing good practices

Fiscal policy rules

- **Definition of performance indicator**
- **Transparency in accounts and forecasts**
- **Adequacy for achieving objective**
- **Policy consistency**
- **Simplicity**
- **Flexibility in the face of shocks, cycles**
- **Enforceability**
- **Efficiency in application**

Developing good practices

Transparency standards

- **Institutional transparency**
 - coverage, functional clarity
 - budget process, financing, regulation
 - tax treatment
- **Transparency in public accounts**
 - statistical coverage
 - recording basis
 - valuation and recognition
 - classification
- **Transparency in indicators and forecasts**
 - Direct and analytical indicators
 - Short- to medium-term forecasts
 - Long-term scenarios

Developing good practices

Independent fiscal institutions

- Institution must be home-grown and home-owned
- Independent, nonpartisan, competent, and accountable
- Technical infrastructure (staff, access to data)
- Remit
 - surveillance of compliance with fiscal rules, targets, transparency
 - assessment of fiscal stance and debt sustainability
 - macro-fiscal forecasting (baseline and policy), costing
 - exclusion of normative or decision-making functions
- Identifying itself and operating as soon as possible
- Early development of effective communication channels

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