

Fiscal Discipline: From Theory to Practice

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Logic and structure

- A large number of experiments
 - With mixed results (IMF, 2018)
 - Lessons learned
 - Quality of rules and frameworks
 - Role of specific national institutions
- Presentation
 - Need to go back to principles
 - Link implementation to principles
 - Draw simple conclusions for simple rules
 - Even if no single rule is good for all countries

Fiscal discipline principles: why?

- Policy failures: deficit bias
 - Many reasons, large literature (Von Hagen-Harden, Alesina-Tabellini, etc.)
- Market failures: multiple equilibria
 - Market-based discipline not enough and too disruptive
- Implication: constraint is required (Kopits-Symansky, 1998, Ter-Minassian, 2010)

Fiscal discipline principles: what?

- Cleanest and closest definition: solvency
 - Translation: debt must be repaid at infinite horizon
 - Implementation: problems
 - Infinity is approximated by long horizon
 - But then debt does not have to be repaid
 - Anyway, cannot be forecasted accurately
 - Inflation may make any debt sustainable ($r - g$)
 - Debt can be defaulted upon quasi-legally
- Solvency is a weak guide

Fiscal discipline principles: what?

- Cleanest and closest definition: solvency
- Solvency is a weak guide
- Illiquidity (market-based discipline)
 - Different from solvency: just too risky for lenders
 - Rare disasters (Barro, 2006; Veldekamp and Venkateswaran, 2014, 2018; Reinhart, Reinhart and Rogoff, 2015)
 - Self-fulfilling
 - Market reaction often too strong, too late (Eijffinger, 2012)
 - Concept is inadequate
 - Large Type I and Type II errors

Fiscal discipline principles: how?

- Approximate solvency: sustainability (DSA)
 - Requires long horizons
 - Therefore brave assumptions
 - Transparency, justification
 - Probability assessment (fan charts)
 - Requires deciding on sustainability
- Long run debt targets
 - No theory of adequate debt level, explicit choice
 - Associated budget balance paths

Debatable rules

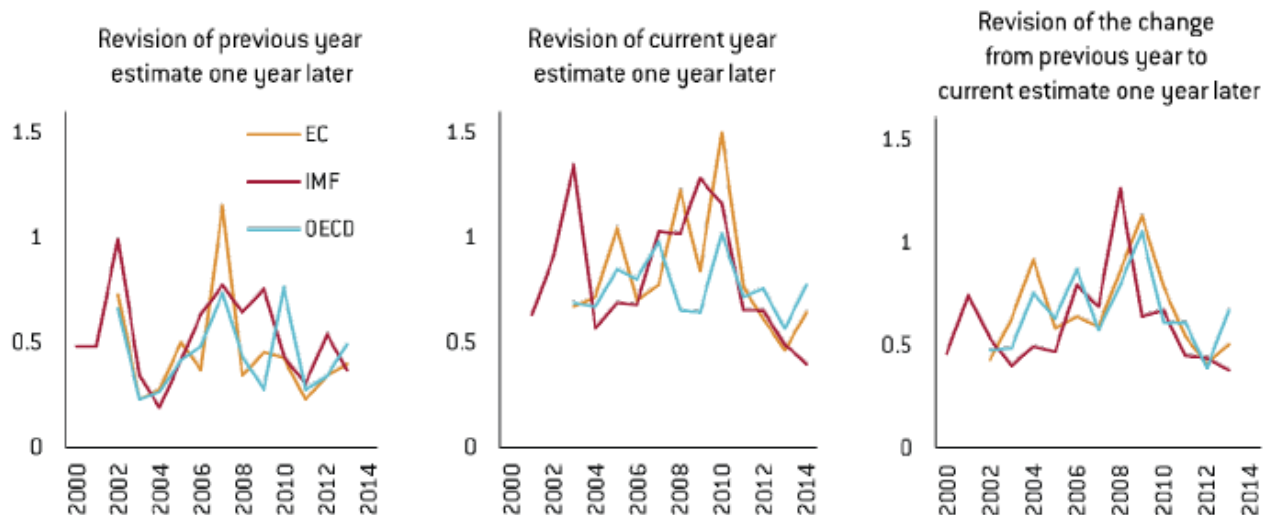
- Budget balance target
 - Zero deficit neither sufficient nor necessary
 - Other fixed targets are arbitrary
 - Prevents counter-cyclical policy
- Cyclically-adjusted balance target

Cyclically-adjusted balance target

- The theoretically-correct measure of fiscal policy
- Imprecisely measured by significant margin
 - Case of the Eurozone

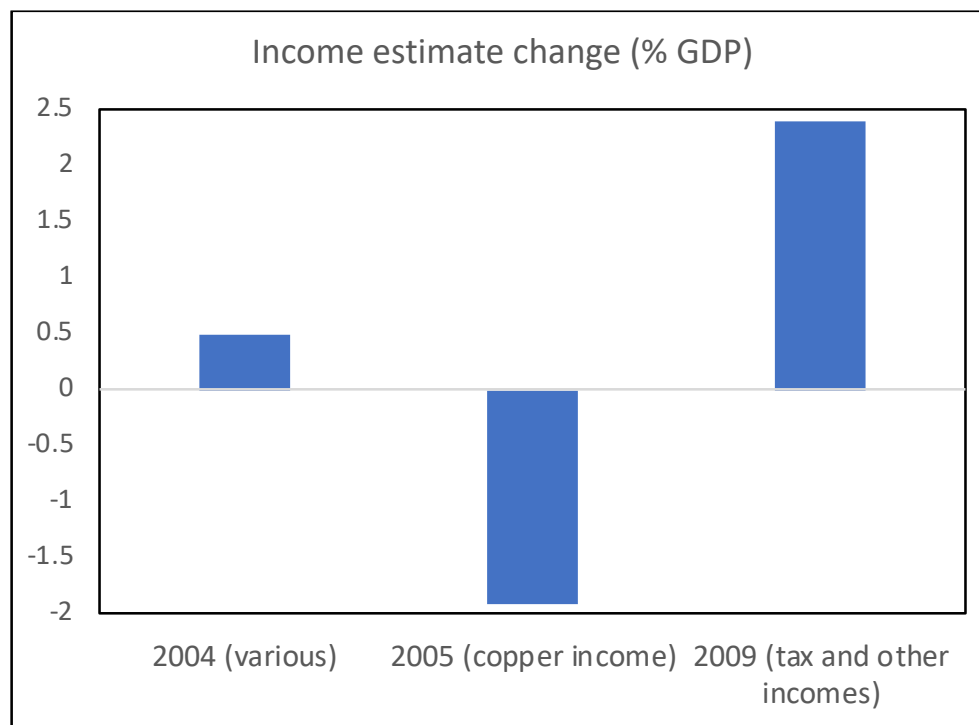
Three measures of structural balance estimate revisions (% of potential GDP,

[A] Average of Austria, Belgium, Denmark, Germany, Finland, France, Luxemburg, Netherlands, Sweden and the United Kingdom



Cyclically-adjusted balance target

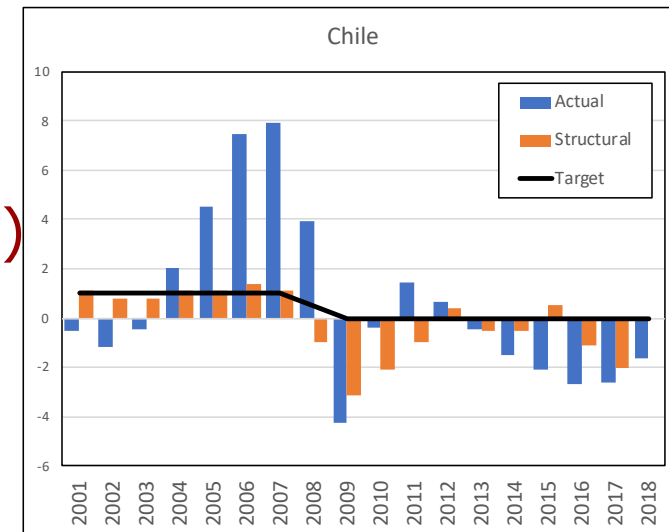
- The theoretically-correct measure of fiscal policy
- Imprecisely measured by significant margin
 - Case of the Eurozone
 - Case of Chile



Source: Marcel (2013)

Cyclically-adjusted balance target

- The theoretically-correct measure of fiscal policy
- Imprecisely measured by significant margin
 - Case of the Eurozone
 - Case of Chile
- Not countercyclical enough
 - Case of Chile (Schmidt-Hebbel, 2012)
- Hard to understand/explain



Debatable rules

- Budget balance target
 - Zero deficit sufficient but not necessary
 - Prevents counter-cyclical policy
- Cyclically-adjusted balance target
 - Imprecisely measured by significant margin
 - Not countercyclical enough
 - Hard to explain/understand
- Spending ceiling
 - Orthogonal to balance and debt accumulation
 - Case of commodity producers

The case of commodity producers

- Large income: remote budget constraint
 - Case of Norway
 - Rule is about sharing with future generations
 - Windfall to Wealth Fund and spending rule
- Moderate Income: still a budget constraint
 - Price volatility ➔ Income volatility
 - Risk of procyclical policy
 - Case of Chile:
 - Adjust rule (structural budget measure)
 - Set money aside for implicit liabilities

Multiple rules

- The Gulliver syndrome
 - Tie with a thousand knots looks good



Multiple rules

- The Gulliver syndrome
 - Tie with a thousand knots looks good
 - Rules are not knots
 - Unlikely to be consistent with each other
 - Allows government to pick and choose
 - Complexity undermines legitimacy
- The Eurozone example

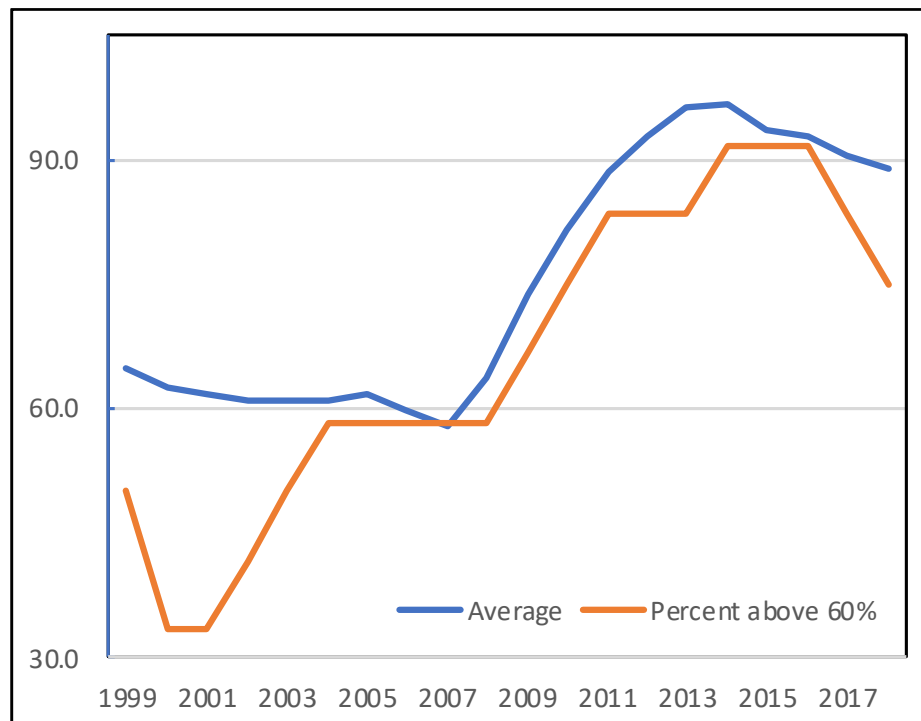
The Eurozone: more and more rules

- Initially:
 - Debt rule (60% GDP)
 - Budget rule (3% GDP)
- Successive reforms (additions to previous rules)
 - Structural budget
 - Correct excessive deficit by 0.5% per year
 - Correct excessive deficit by 5% per year on average
 - Various escape clauses
 - Cyclical conditions and unforeseen "severe" contractions
 - Structural reforms
- More sanctions

Frequent non-compliance

Eurozone: Frequent non-compliance

Debt rule



Debt reduction by 5% observed in 15% of relevant cases since 2012

Deficit rule observed 42% of the time since beginning

Multiple rules

- The Gulliver syndrome
 - Tie with a thousand knots looks good
 - Rules are not knots
 - Unlikely to be consistent with each other
 - Allows government to pick and choose
 - Complexity undermines legitimacy
- A strong case for a unique and simple rule
- Theory says: long term debt target
 - With DSA-style deficit path as instrument

Fiscal council

- Every step subject to controversy
 - Forecasts of debt and associated deficits
 - Judgement about target appropriateness
 - Evaluation over budget cycle
 - “Exceptional” situations
- Fiscal bias implies that the government is unlikely to do it right
- Requires independent and competent councils
 - Ideally Council sets each step
 - Second best: advisory
 - But then must be influential

Enforcement

- Budget rule enshrined in Constitution
 - Debt target set by government for duration of mandate
- Parliament must comply when voting on budget
- Fiscal council embedded in Parliament
- No escape clause but deviation accounts
 - To be purged by end of mandate
 - Encourage “rainy fund” accumulation

Thank you