

Fiscal Rules for Long-Term Objectives

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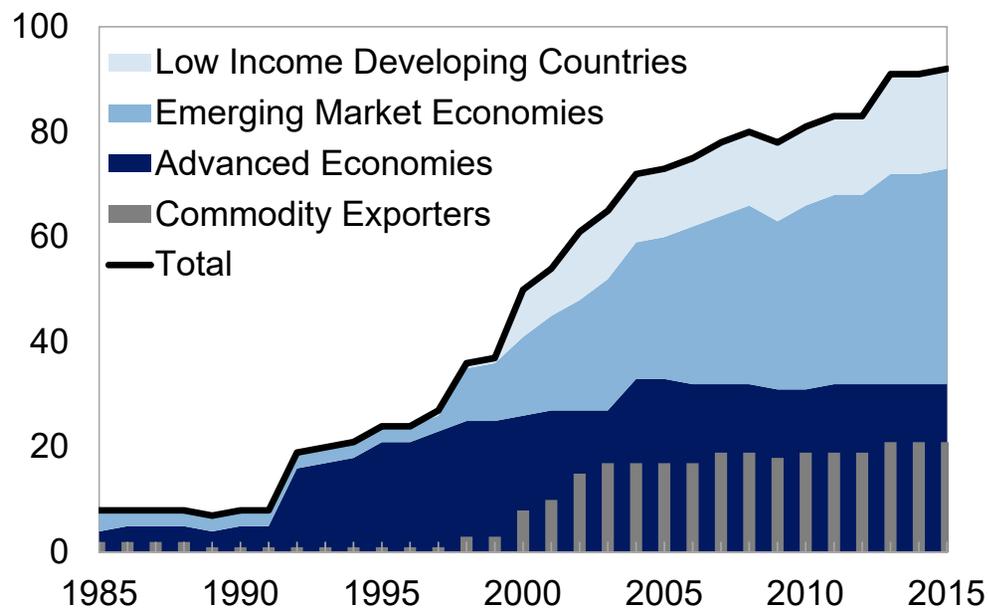
**Workshop on “Enhancing Chile’s Fiscal Framework: Lessons
from the Domestic and International Experience”**

Santiago, Chile, January 18, 2019



Introduction and main questions

Number of Countries with Fiscal Rules



Source: IMF, Fiscal Rules Database.

Outline



General framework and country experience with rules

Principle 1: A holistic approach to rule design: anchoring, consistency, and parsimony

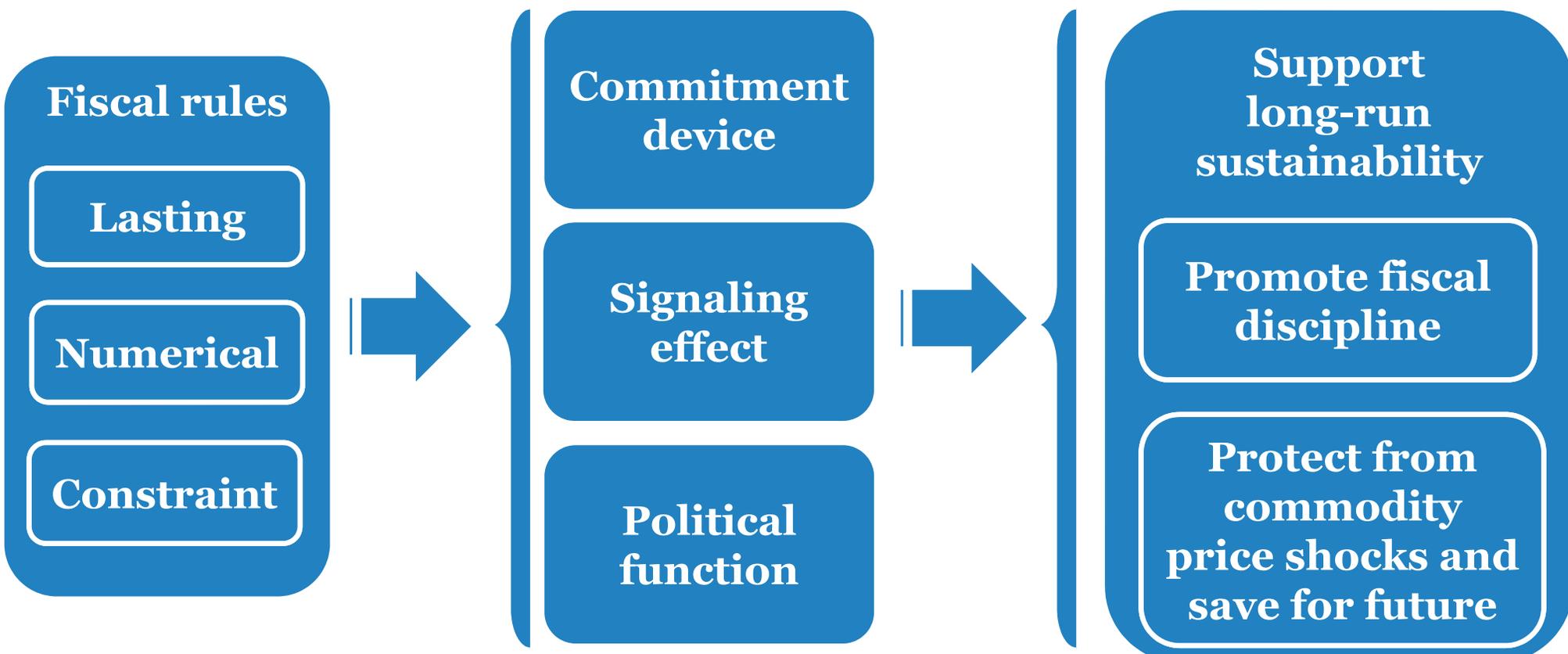
Principles 2 and 3: Flexibility made simple, and stronger compliance through incentives

Concluding remarks



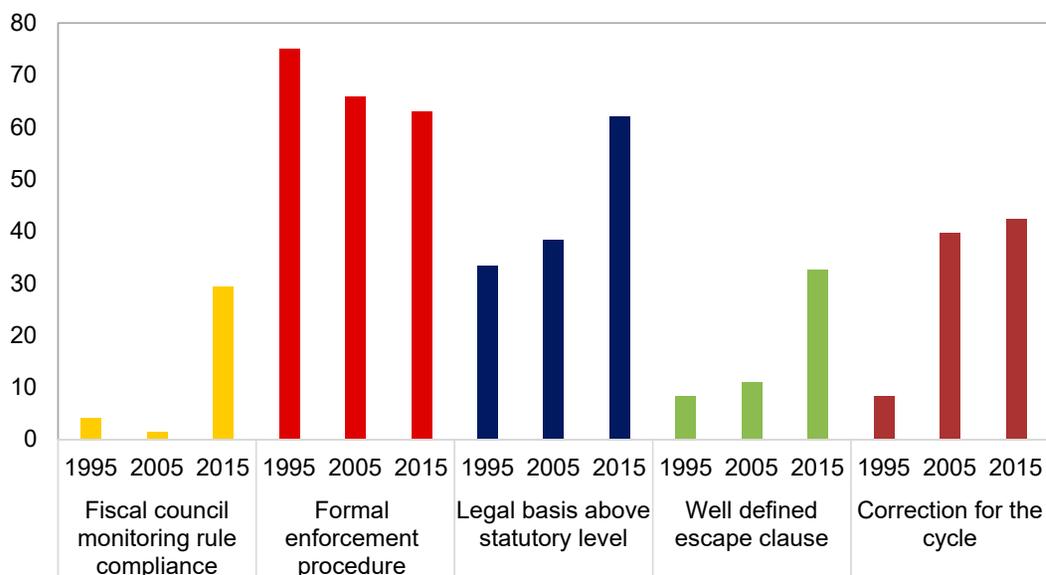
1. General framework and country experience with rules

The essence and objective of fiscal rules



The emergence of second generation rules

Fiscal Rules Features, 1995-2015
(in percent of total number of countries with at least one rule)



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

Source: IMF fiscal rule database.



Lessons learnt on the effectiveness of rules

1. Fiscal rules per se do not improve fiscal balance, but good design does

2. Rule threshold may act as a magnet

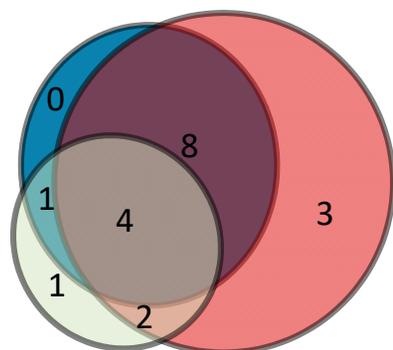
3. Financial markets punish non-compliers

4. Ample coverage, inducing savings, proper calibration, precise escape clauses, and good institutions enhance effectiveness

Source: "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability". Staff Discussion Note 18/04 (April 2018). International Monetary Fund.

Resource-rich countries' experience with rules

Combination of Rules in 2015 in Resource Rich Countries



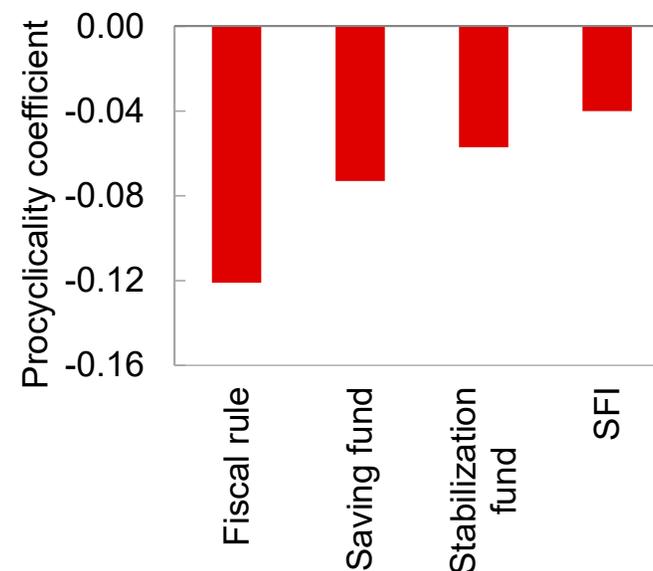
- Debt Rule
- Budget Rule
- Expenditure Rule

Source: IMF, Fiscal Rules Database.

Examples of Indicators Considered by Rules In Resource Rich Countries

Indicator	Countries
Overall balance (w/o reference price)	IDN, MEX, MNG, NGA
Current balance	VEN
Structural balance	CHL, COL, PER
Non-resource balance	ECU, RUS, TLS
Struct. non-resource primary balance	NOR
Expenditure rule	BWA, TCD, ECU, MEX, MNG, PER, RUS, VEN
Debt-to-GDP	ECU, IDN, MNG, VEN

Funds and Rules and Procyclicality of Expenditure to Prices



Source: IMF "The Commodity Roller Coaster: A Fiscal Framework For Uncertain Times" Chapter 2 of Fiscal Monitor (October 2015).

The 3 guiding principles to design fiscal rules

Take a Holistic Approach

Anchoring

Consistency

Parsimony

Make Flexibility Simple

Expenditure rules

Well-defined flexibility provision

Design Incentives for Compliance

Higher reputational costs

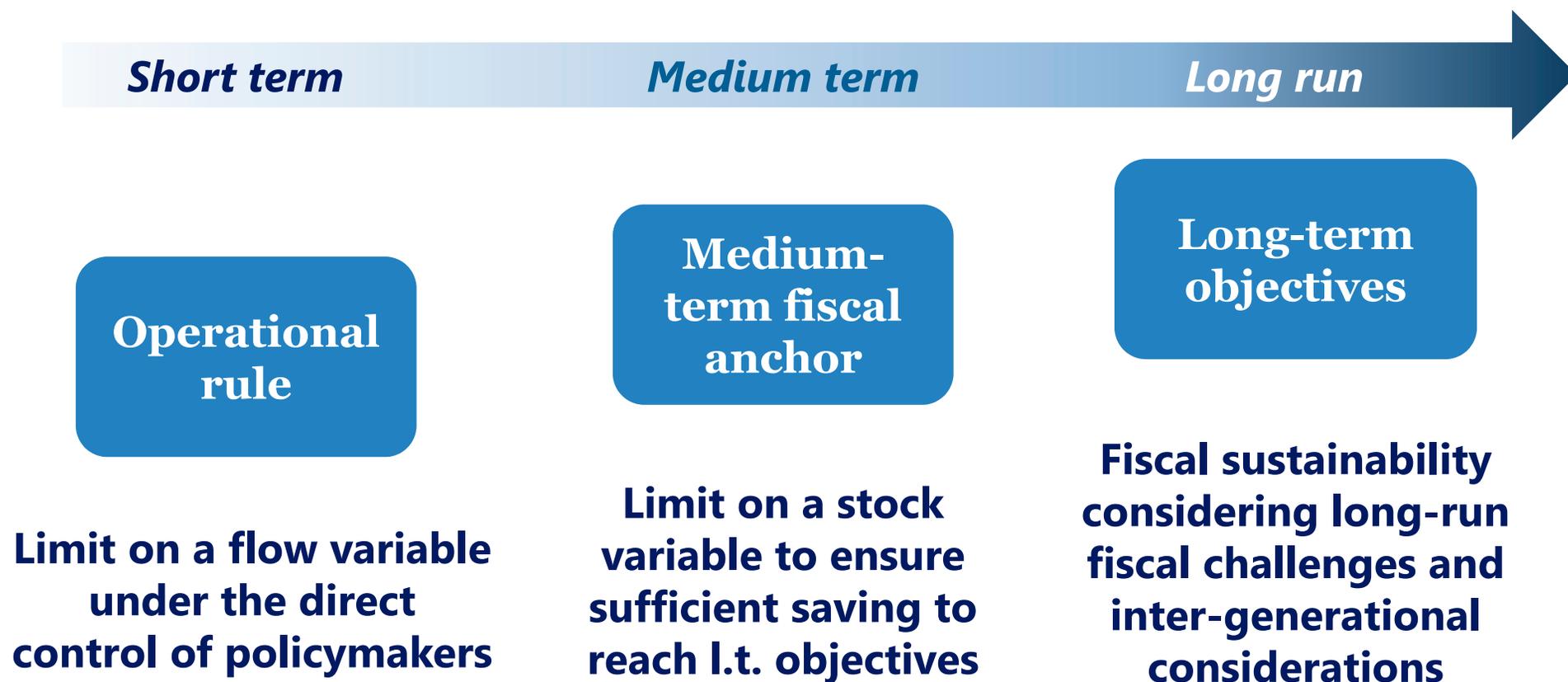
Incentives in supranational settings



2. Principle 1: A holistic approach to rule design: anchoring, consistency, and parsimony

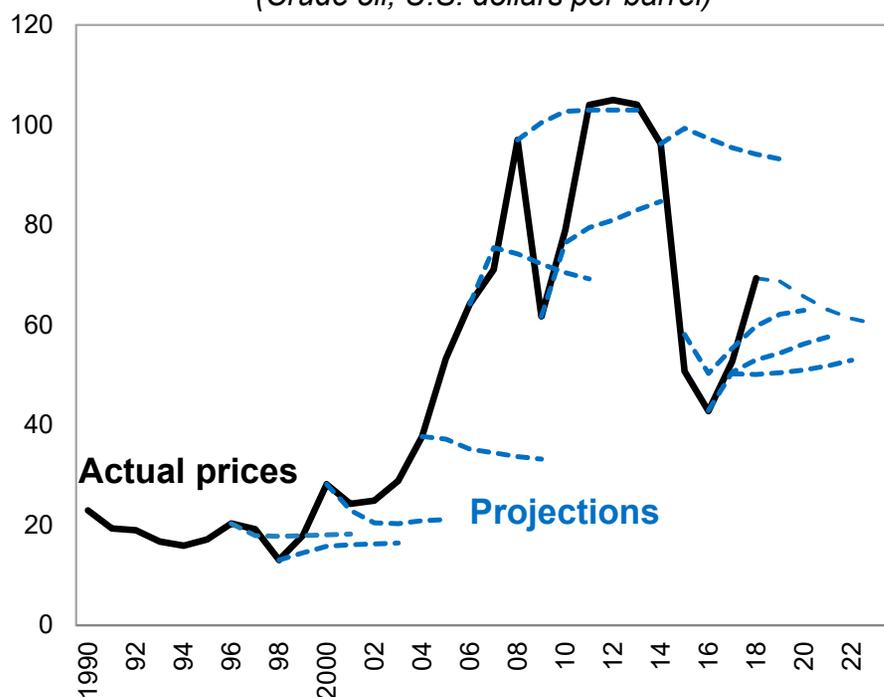


Anchoring: long-term objectives, medium-term anchors, and short-run operational rules



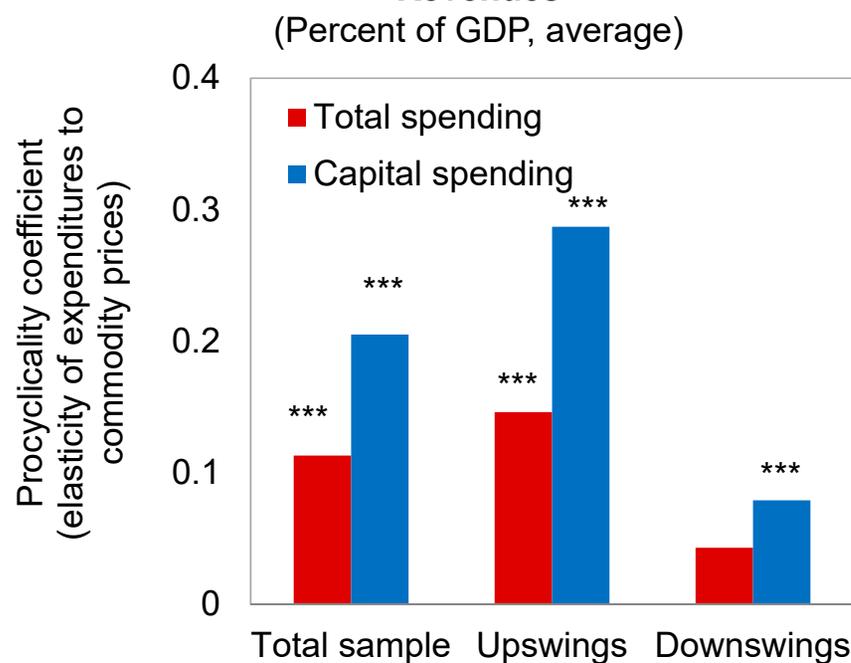
The challenge of tackling price unpredictability and volatility over the long and medium-term

A Poor Record of Forecasting Oil Prices
(Crude oil, U.S. dollars per barrel)



Source: IMF staff estimates and market projections.
Note: The solid line represents actual crude oil average prices for the year. The dashed lines are based on future contract prices.

Impact of Commodity Price Swings on Fiscal Revenues
(Percent of GDP, average)



Source: "The Commodity Roller Coaster: A Fiscal Framework For Uncertain Times" Chapter 2 of Fiscal Monitor (October 2015). International Monetary Fund.



Frameworks to assess long-term objectives and set anchors for resource-rich countries

PIH-based Models

- Focus on total net wealth
- Focus on aggregate primary spending
- Imply volatility

Price-smoothing

- Focus only on tackling volatility
- Does not directly address optimal level of savings

Bird-in-hand

- Focus on saving (possibly too much?)
- Reduce volatility as a byproduct

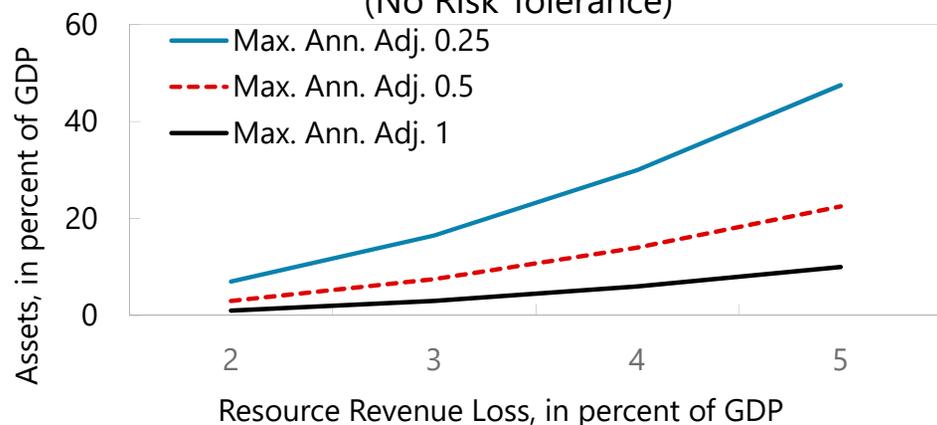
With long reserve horizon saving is still need

- As a buffer to tackle volatility
- For long-term challenges/objectives

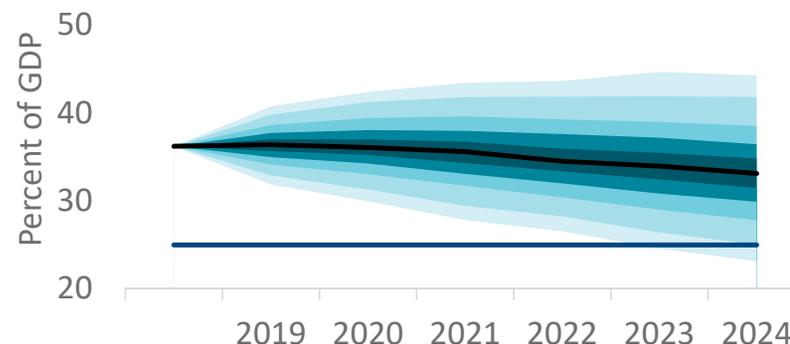
Setting medium-term anchors with a risk-based and prudent approach

Buffers Required to Smooth Adjustment to a Permanent Loss in Resource Revenue

(No Risk Tolerance)



Risk-based Buffer Model for Assets

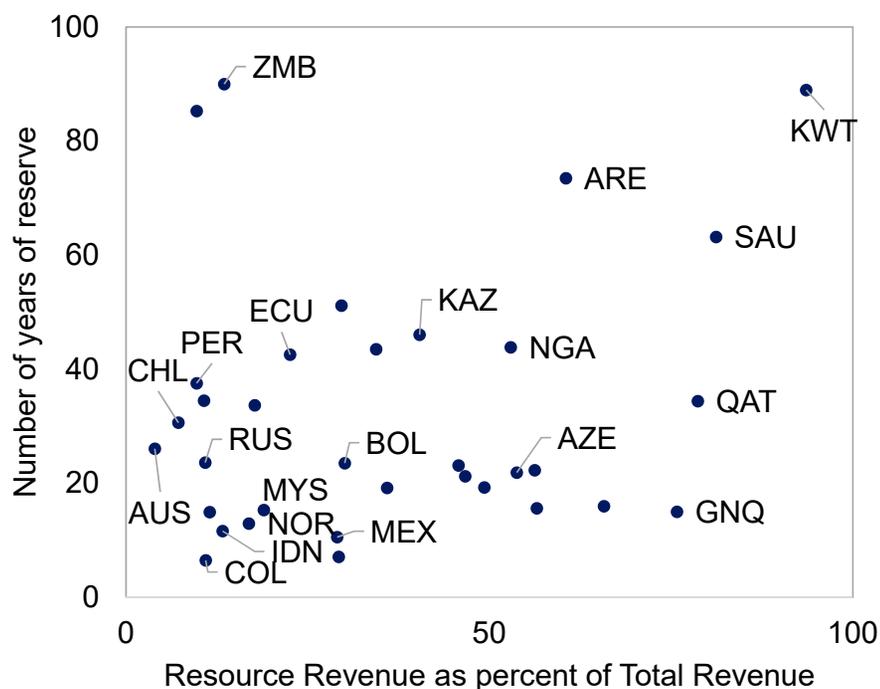


An asset-based or a low-debt-based buffer?

- Financial conditions in downturn
- Cost of holding assets

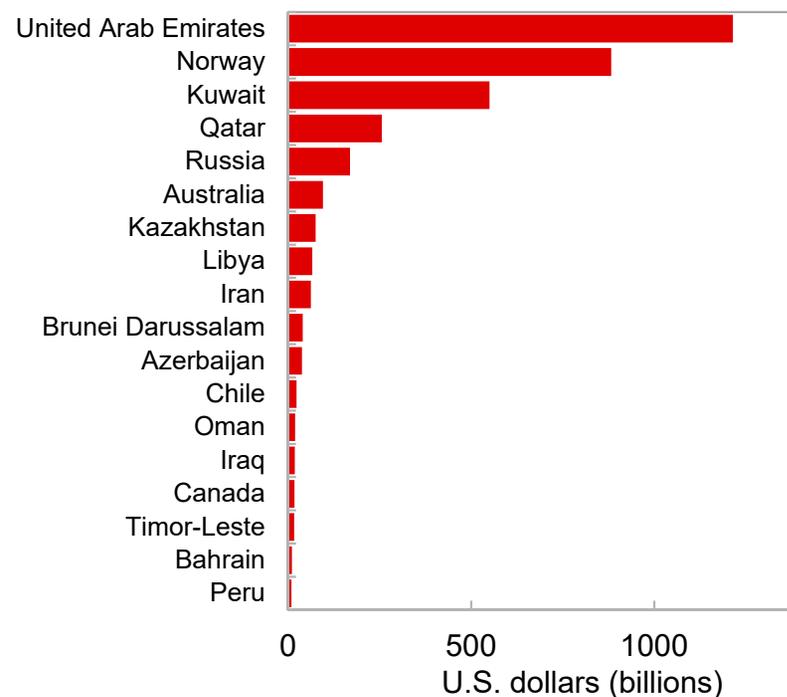
Heterogeneity makes it difficult to compare frameworks, rules, and saving decisions

Relevance and Potential Duration of Resource Revenues Across Countries



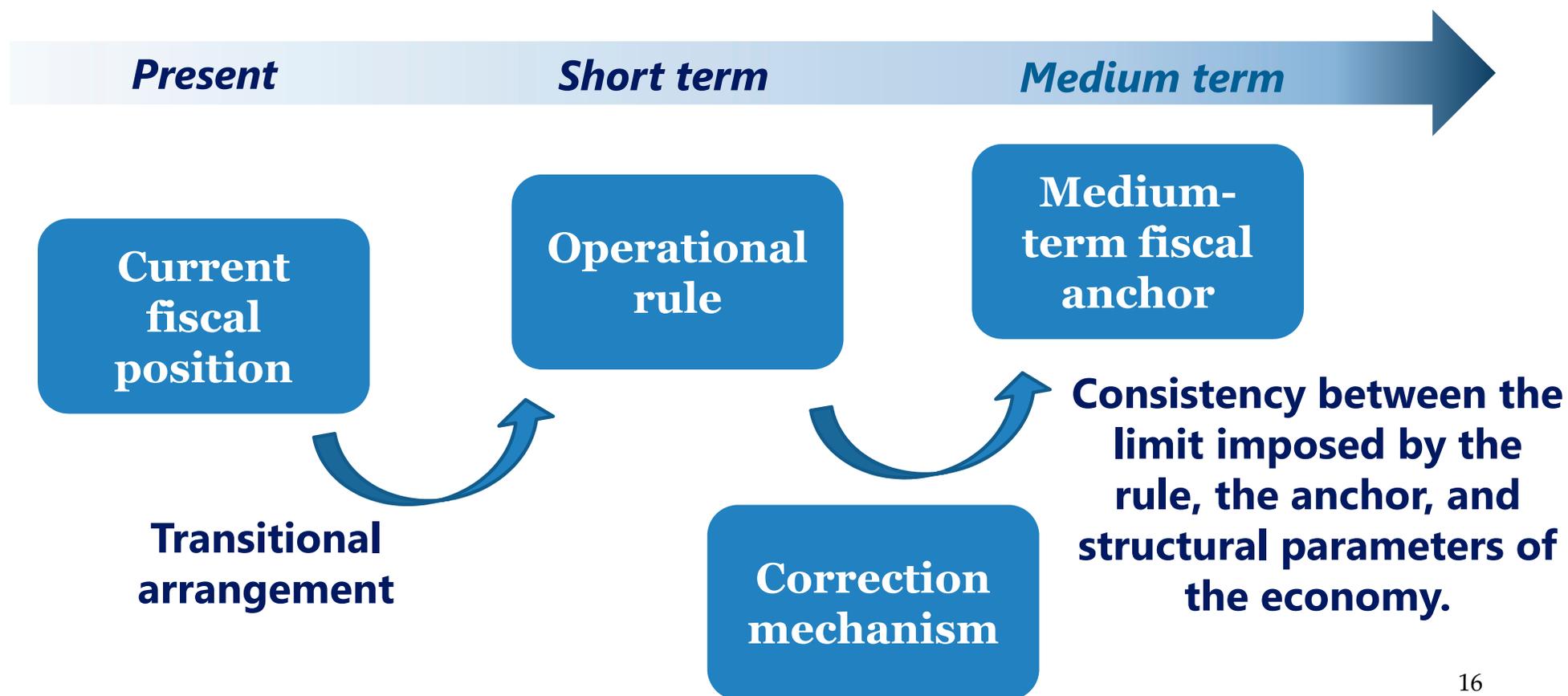
Source: U.S. Geological Survey "Mineral Commodities Summary 2018", British Petroleum "Statistical Review of World Energy 2018"

Sovereign Wealth Funds, 2014



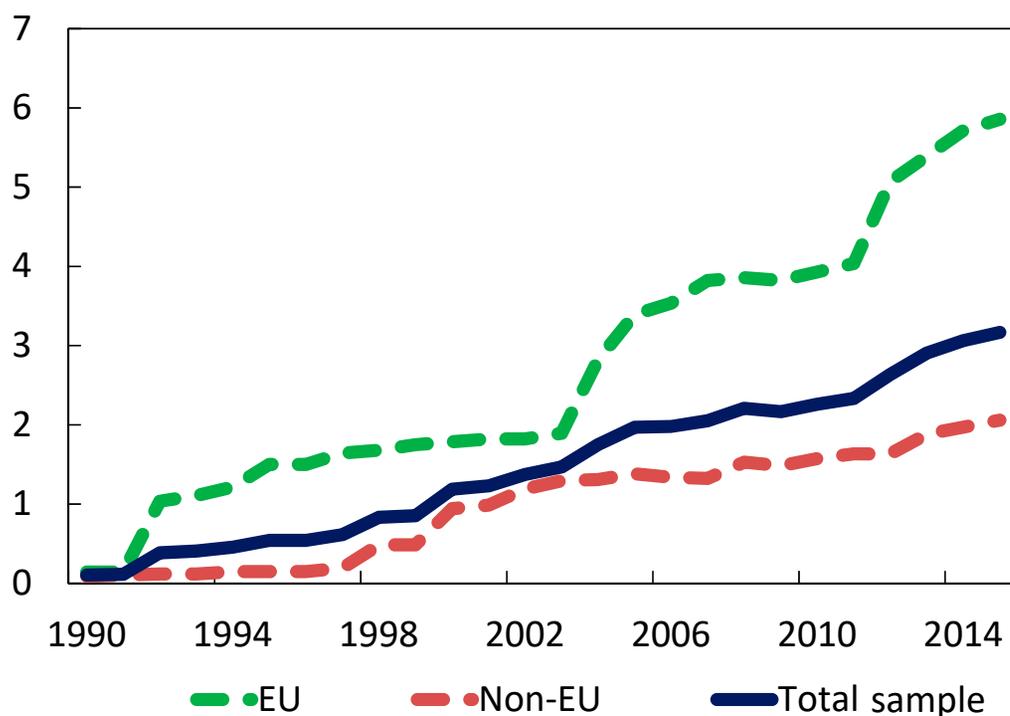
Source: Institutional Investor, national authorities, Sovereign Wealth Center, Sovereign Wealth Fund Institute, and IMF staff reports.

Consistency: Calibrating the fiscal rules



Parsimony: How many rules? The dangers of multiple rules and the virtue of parsimony

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)
- **Lack of credibility**
- **Inconsistency** between rules' ceilings
- **Overdetermined** systems (leads to suboptimal policies)

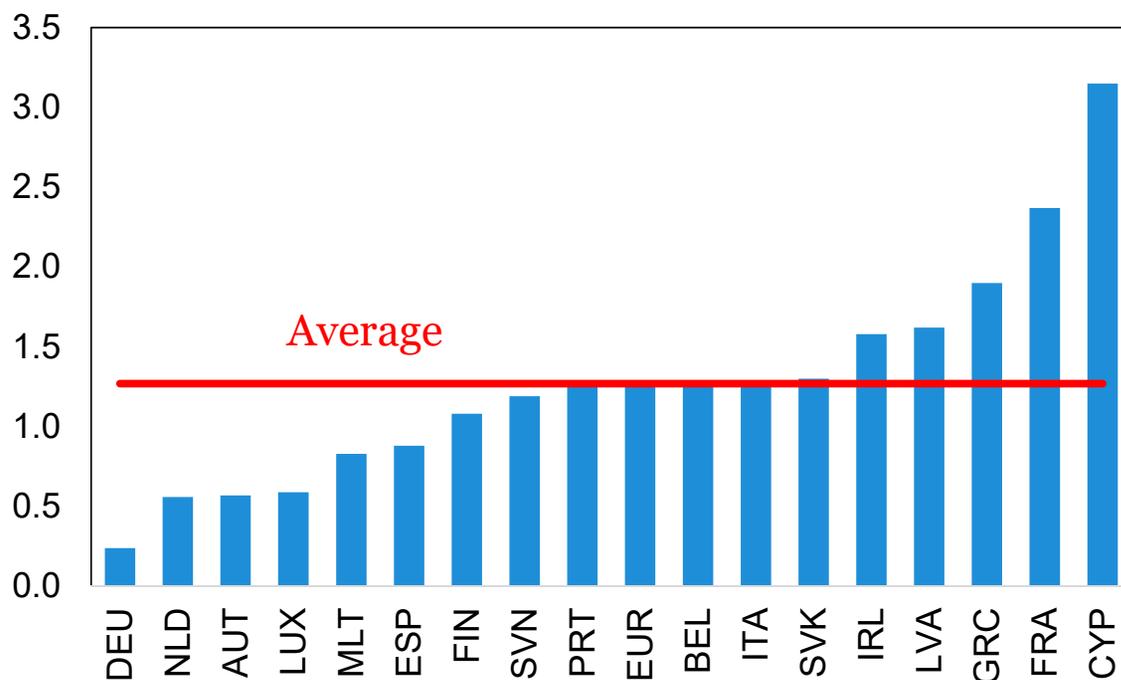


3. Principles 2 and 3: Flexibility made simple, and stronger compliance through incentives

The risk that flexibility leads to complexity and the pitfalls of cyclical adjustments



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



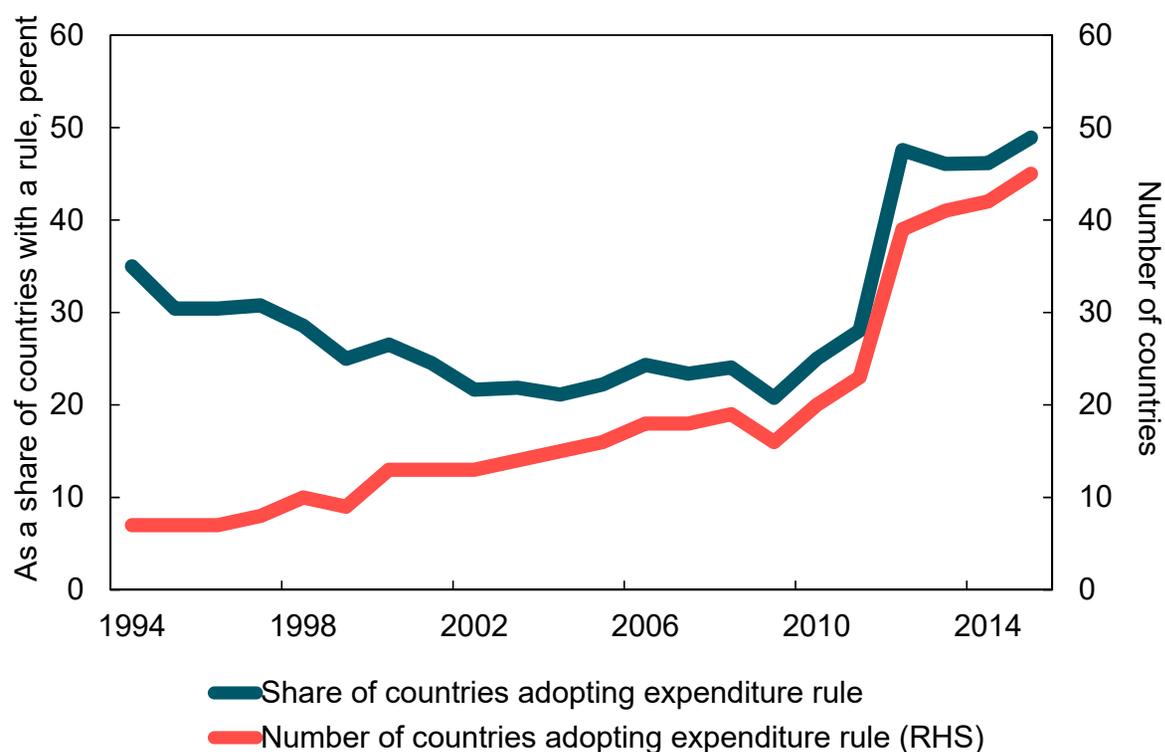
Source: AMECO database (ex post data), and stability programs (real time estimates).

Flexibility made simpler

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!

Countries Adopting Expenditure Rule, 1994-2015



Source: IMF Fiscal Rule Dataset.

Stabilization properties and caveats of expenditure rules

Stabilization properties

Levels or growth rates

Nominal terms



Macroeconomic stabilization

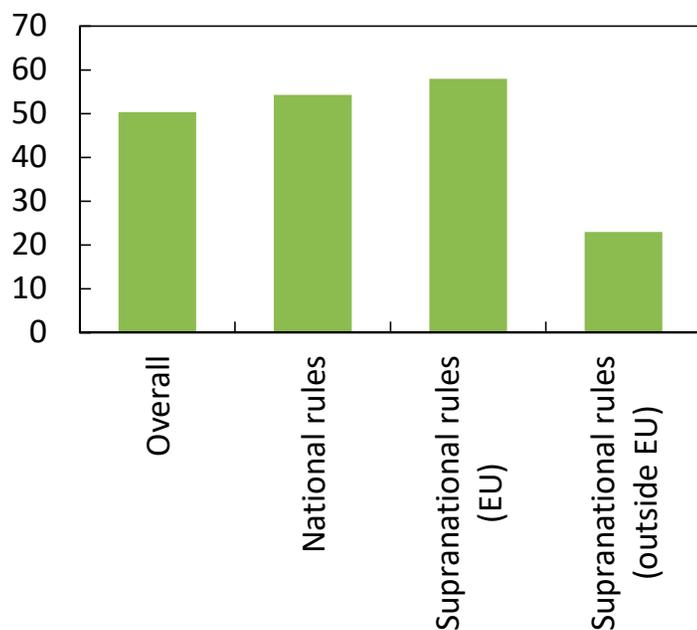
Caveats

Periodic revisions

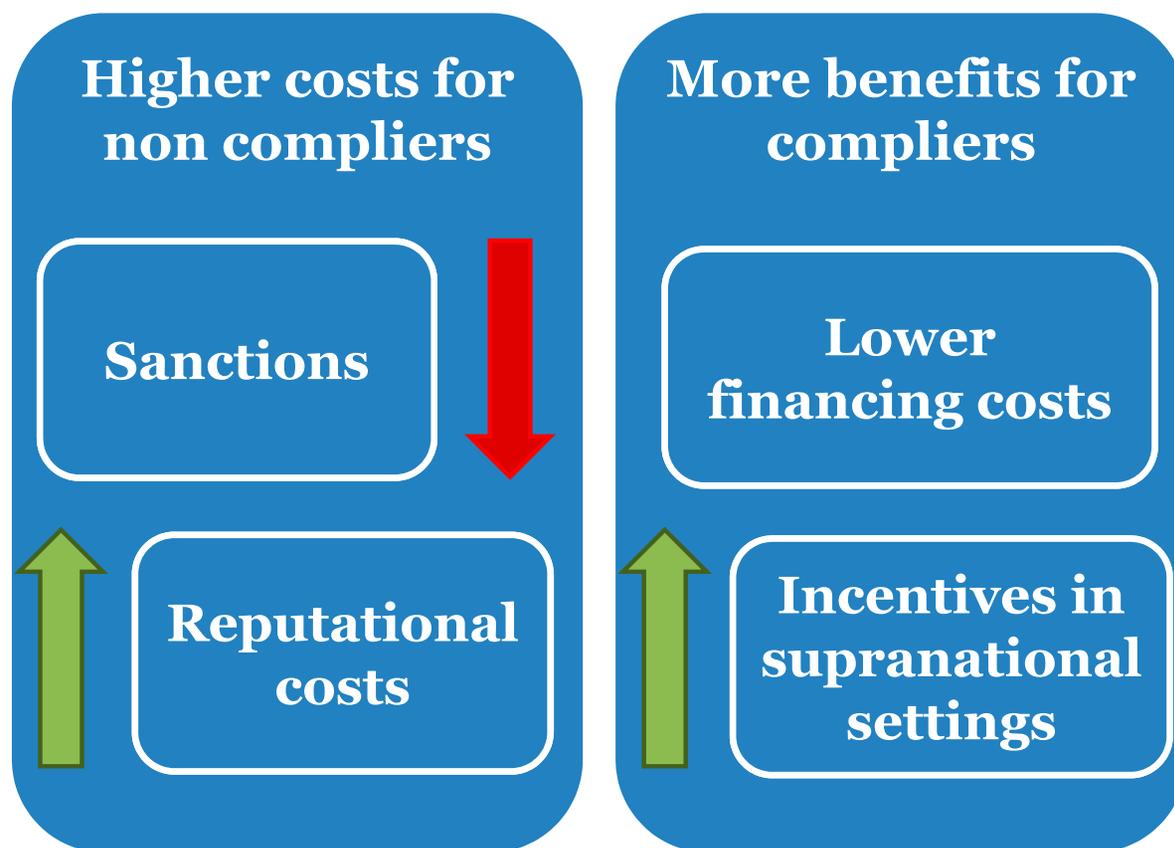
Composition of spending

Improving compliance

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



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

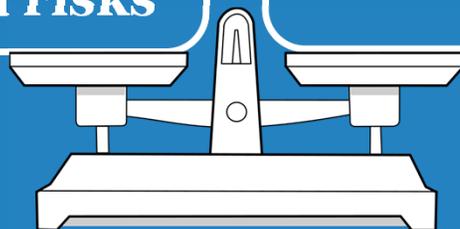


Lessons learnt on institutions for effective rules

Institutional coverage

Capture all sources of fiscal risks

Applicability



Institutional framework

Fiscal rule

Public
Financial
Management

Medium-
term fiscal
framework

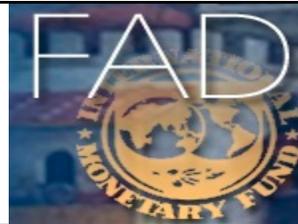


Conclusions



Getting the design right

- 1) Fiscal rules are one component of the fiscal framework and their design should be based on a holistic view of such framework.
- 2) Anchoring is important. Fiscal rules should provide operational guidance in the short term to guarantee fiscal policy is consistent with medium-term fiscal anchors. Anchors should be set with a view on long-term objectives.
- 3) The fiscal rule framework should be designed in a consistent and parsimonious way, and provide well-defined flexibility as well as incentives for compliance.
- 4) For resource rich countries, buffers protect against un-predictability of long-term price trends. The appropriate size of the buffer can be determined using a risk-based approach.
- 5) Because rules are part of a framework, the rest of the framework (PFM and MTF) are equally important for their effectiveness.



Thank you!

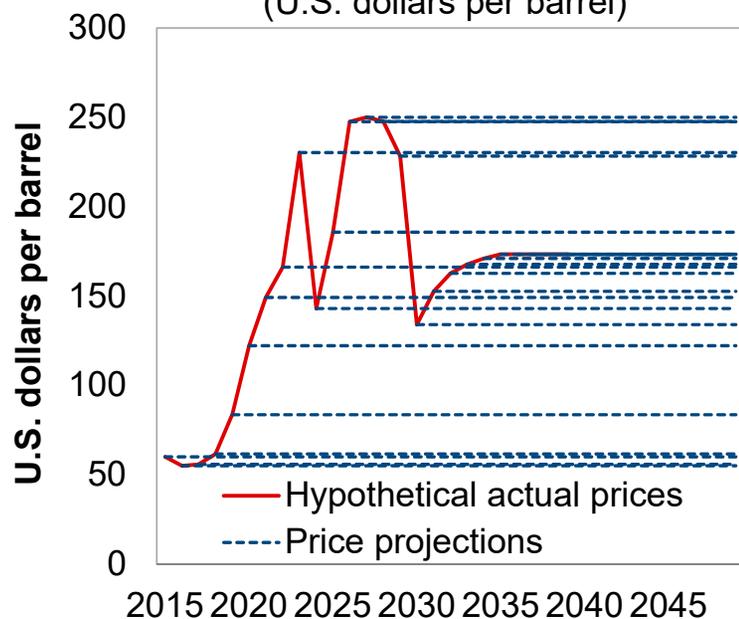


Background slides

Features of benchmark frameworks for resource-rich countries

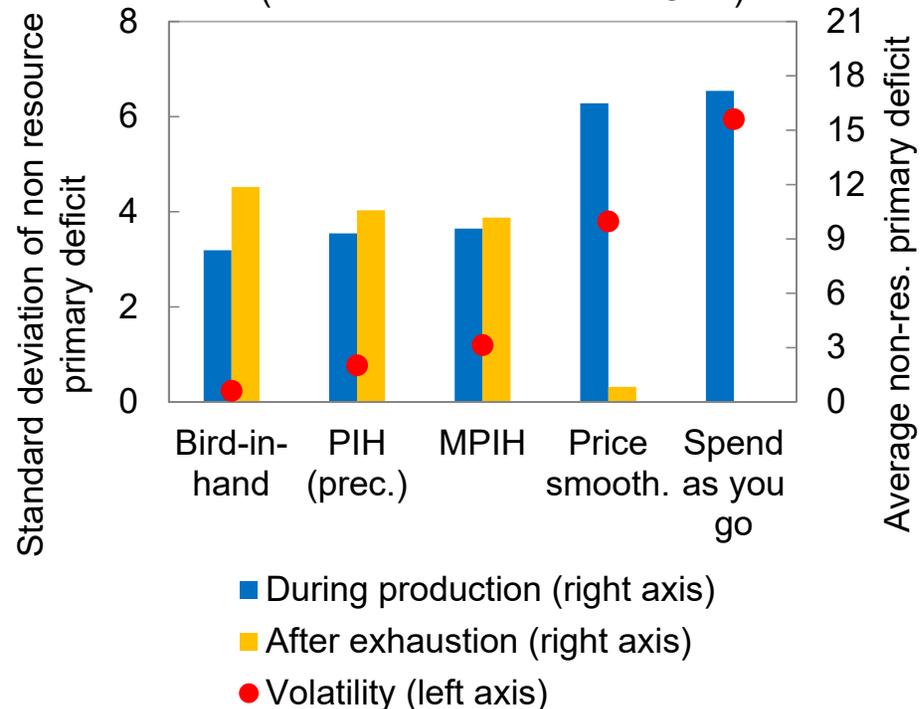
Hypothetical Price Scenario: Actual and Projections

(U.S. dollars per barrel)

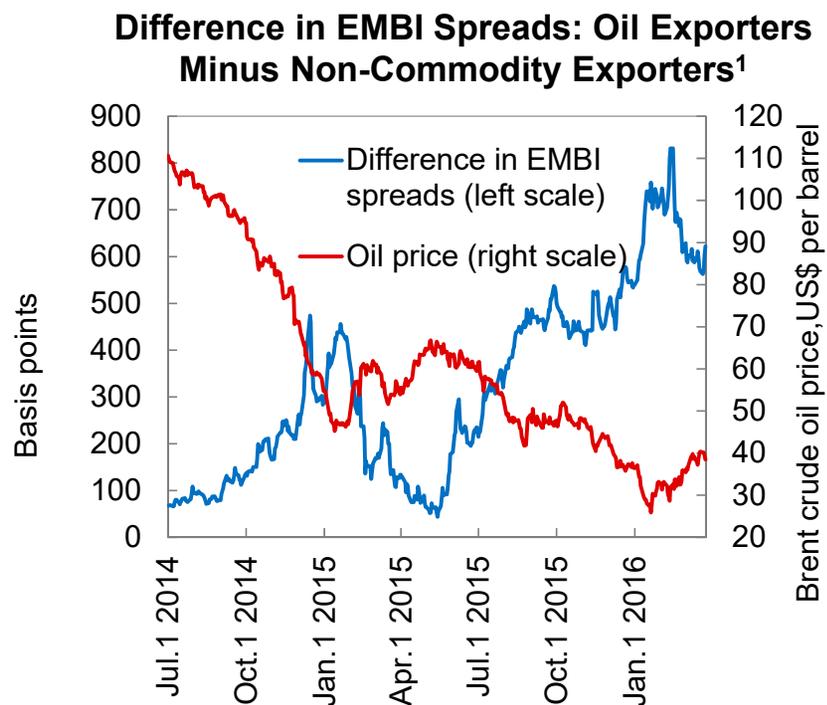


Primary Deficit and its Volatility Under Different Frameworks

(Percent of non-resource GDP)



Oil prices and spreads



Source: Thomson Reuters DataStream, and IMF staff estimates.

Note: EMBI = Emerging Markets Bond Index.

¹ Data are through March 24, 2016.