

# Fiscal Rules for Long-Term Objectives

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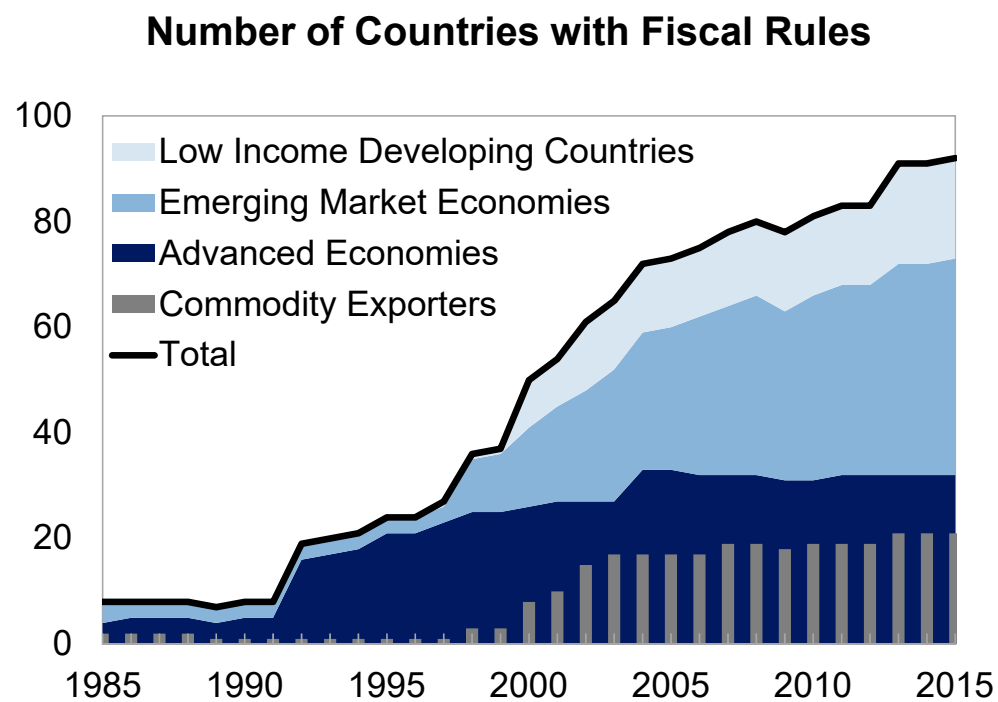
Fiscal Affairs Department, Fiscal Policy and Surveillance Division  
International Monetary Fund

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

Santiago, Chile, January 18, 2019



# Introduction and main questions



Source: IMF, Fiscal Rules Database.

# Outline



**General framework and country experience with rules**

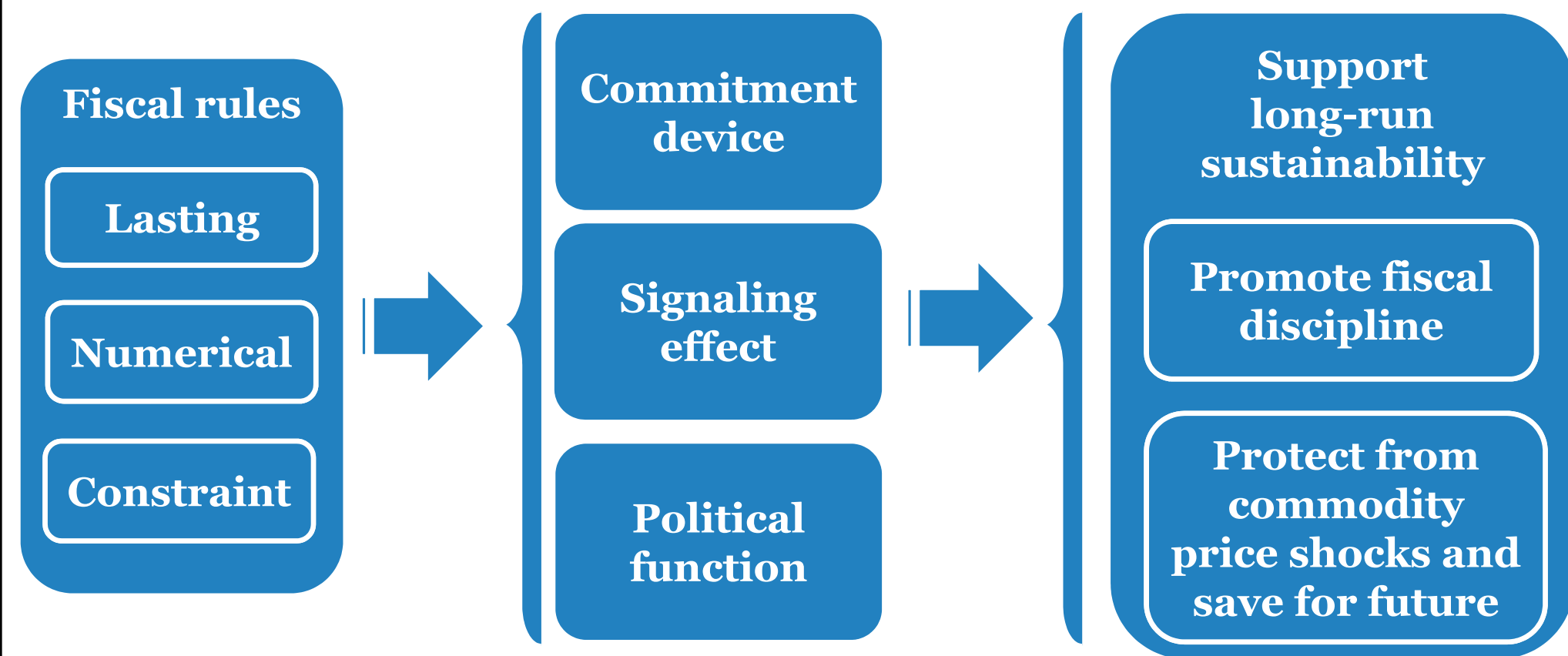
**Principle 1: A holistic approach to rule design: anchoring, consistency, and parsimony**

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

**Concluding remarks**

# **1. General framework and country experience with rules**

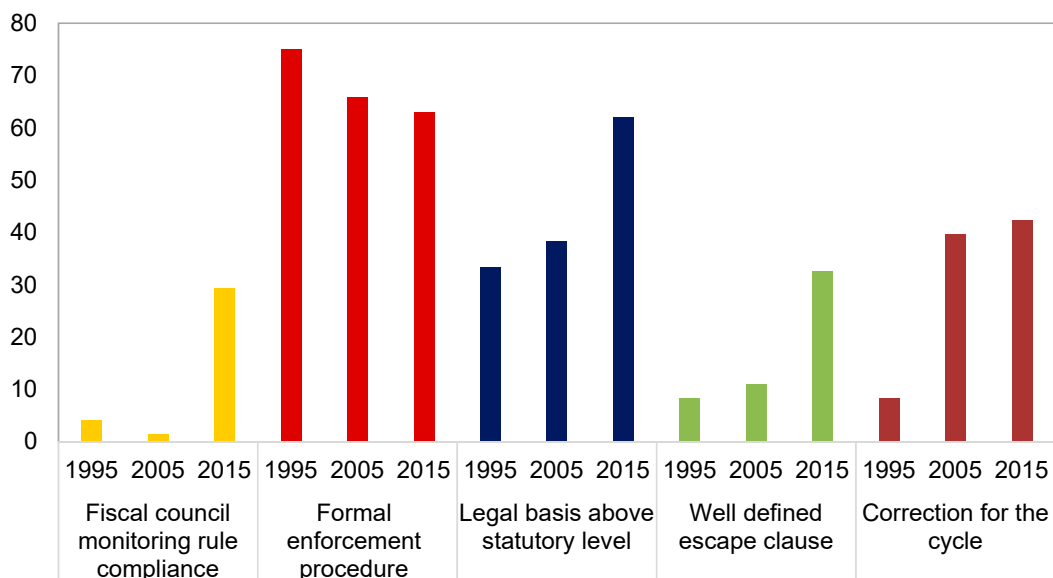
# The essence and objective of fiscal rules



# 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**

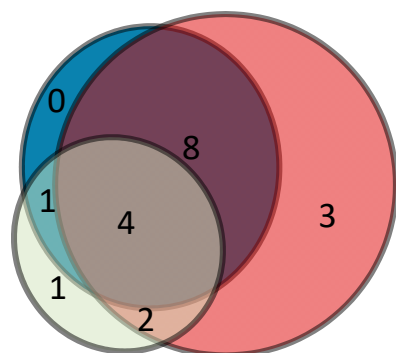
**3. Financial markets punish non-compliers**

**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



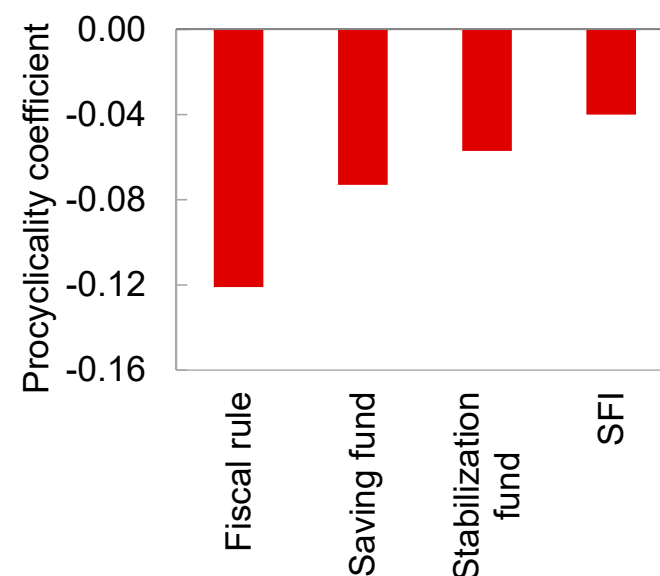
- Debt Rule
- Budget Rule
- Expenditure Rule

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**

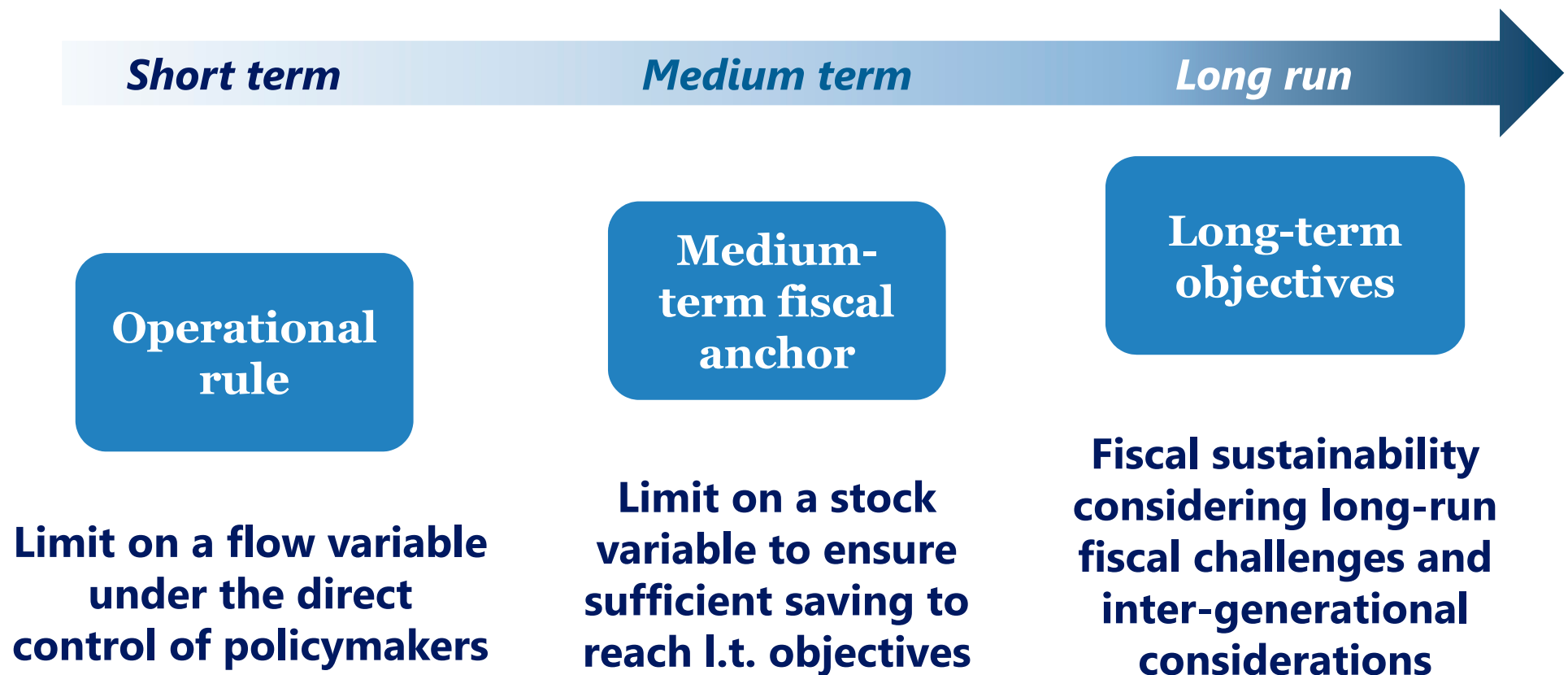
## Design Incentives for Compliance

**Higher reputational costs**

**Incentives in supranational settings**

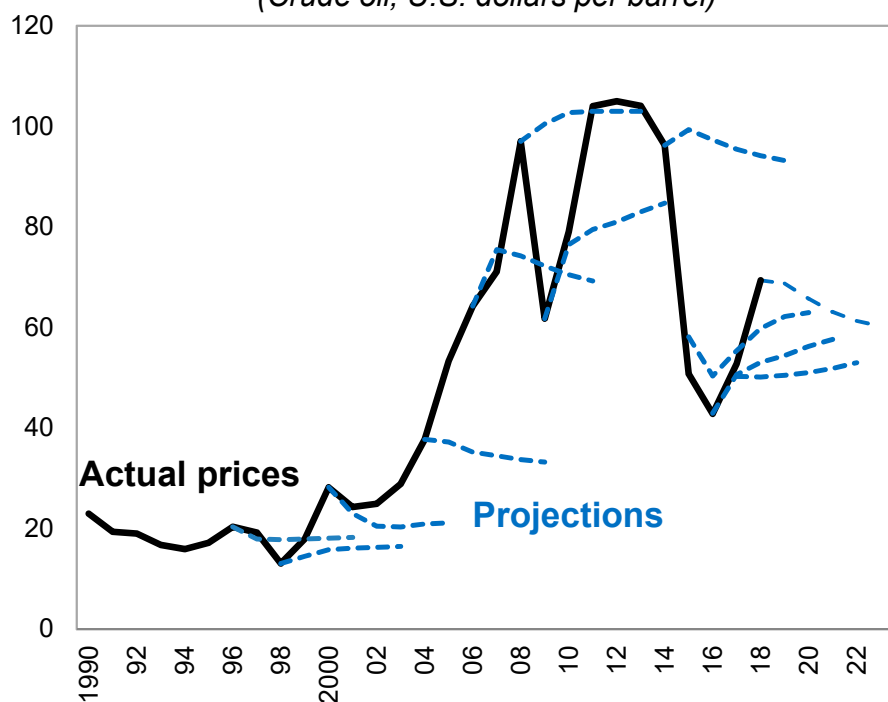
## **2. Principle 1: A holistic approach to rule design: anchoring, consistency, and parsimony**

# 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

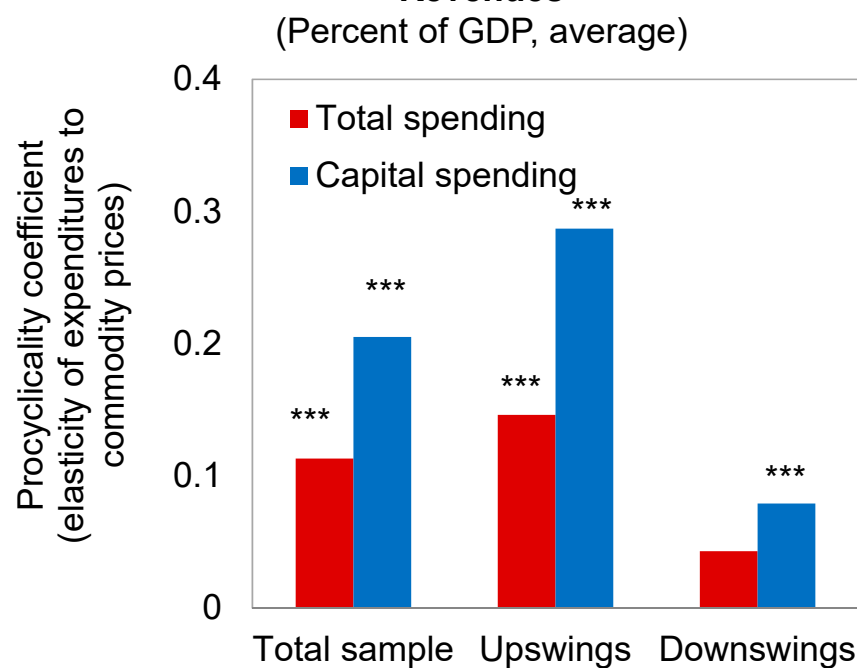
**A Poor Record of Forecasting Oil Prices**  
(Crude oil, U.S. dollars per barrel)



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

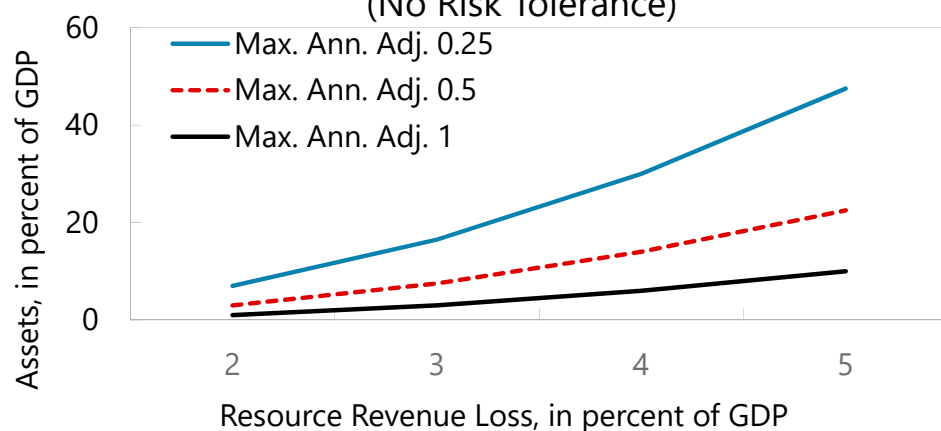
## With long reserve horizon saving is still need

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

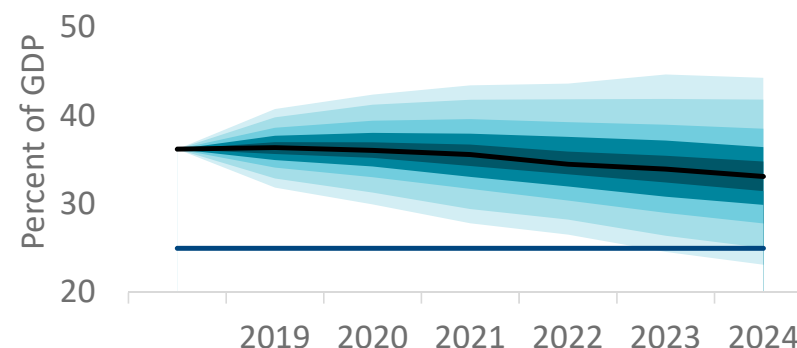
# Setting medium-term anchors with a risk-based and prudent approach

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

(No Risk Tolerance)



## Risk-based Buffer Model for Assets

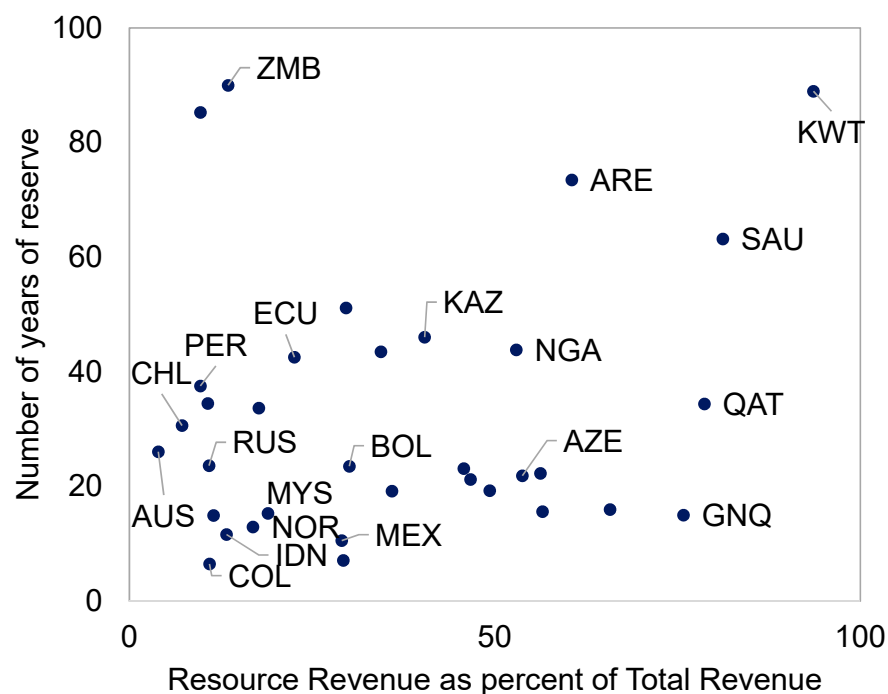


## An asset-based or a low-debt-based buffer?

- Financial conditions in downturn
- Cost of holding assets

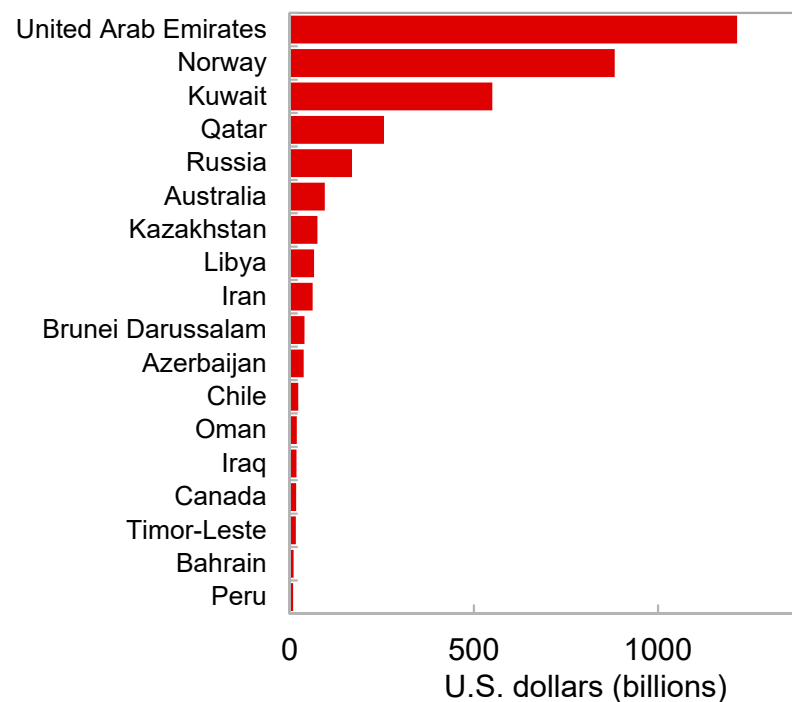
# Heterogeneity makes it difficult to compare frameworks, rules, and saving decisions

**Relevance and Potential Duration of Resource Revenues Across Countries**



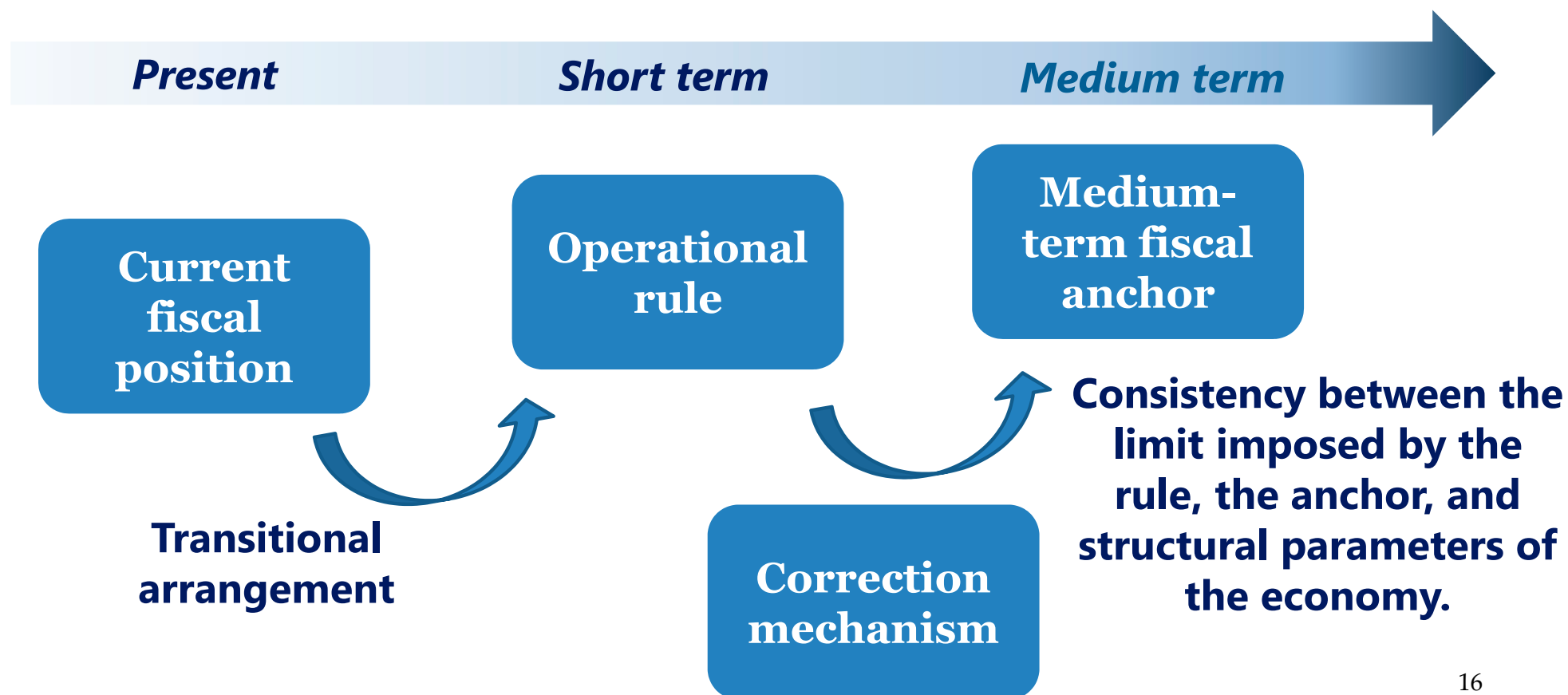
Source: U.S. Geological Survey "Mineral Commodities Summary 2018", British Petroleum "Statistical Review of World Energy 2018"

**Sovereign Wealth Funds, 2014**



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

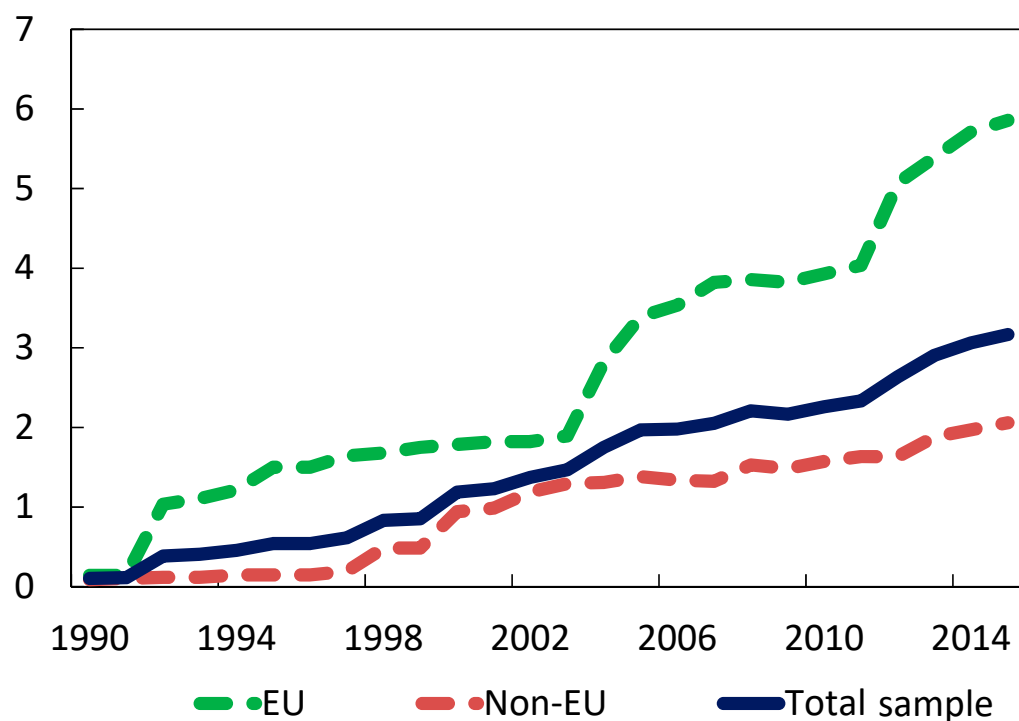
# Consistency: Calibrating the fiscal rules





# 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

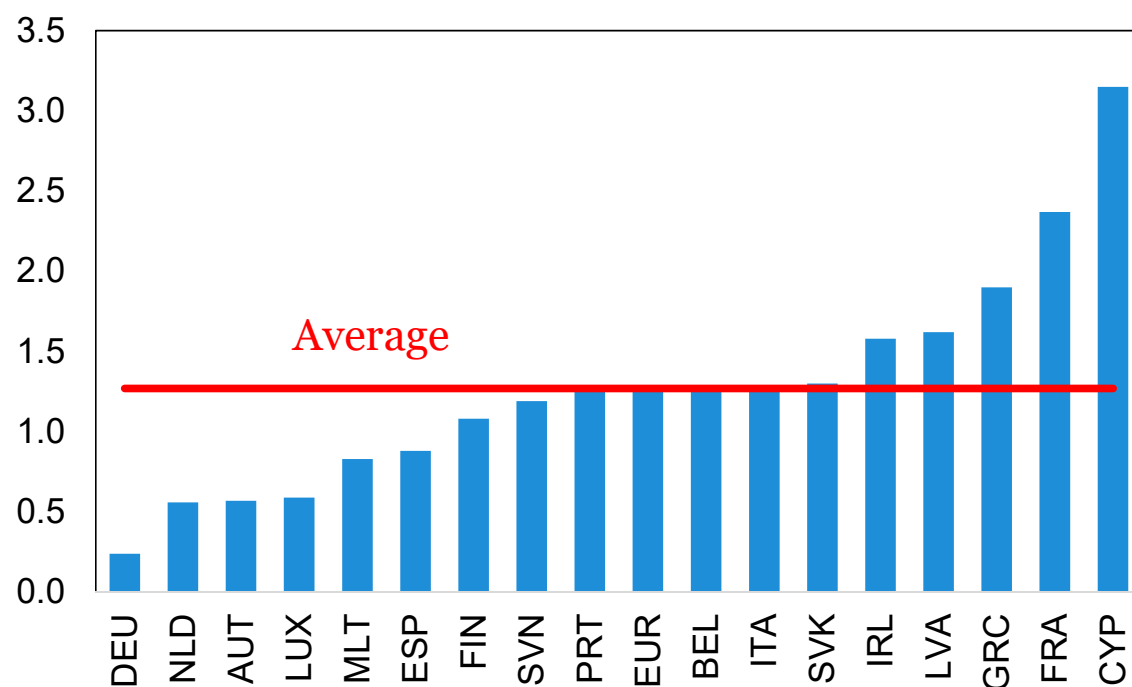
- **Overlap** between rules (creates operational and political economy problems)
- **Lack of credibility**
- **Inconsistency** between rules' ceilings
- **Overdetermined** systems (leads to suboptimal policies)

### **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)



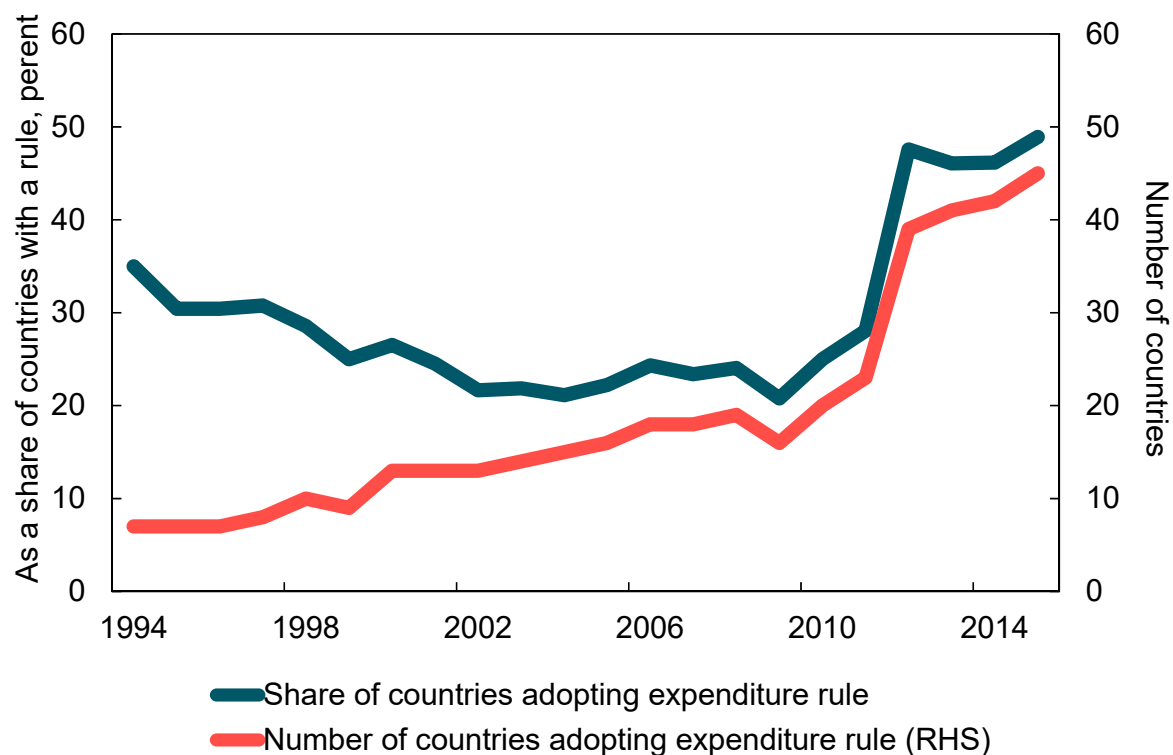
Source: AMECO database (ex post data), and stability programs (real time estimates).

# 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**

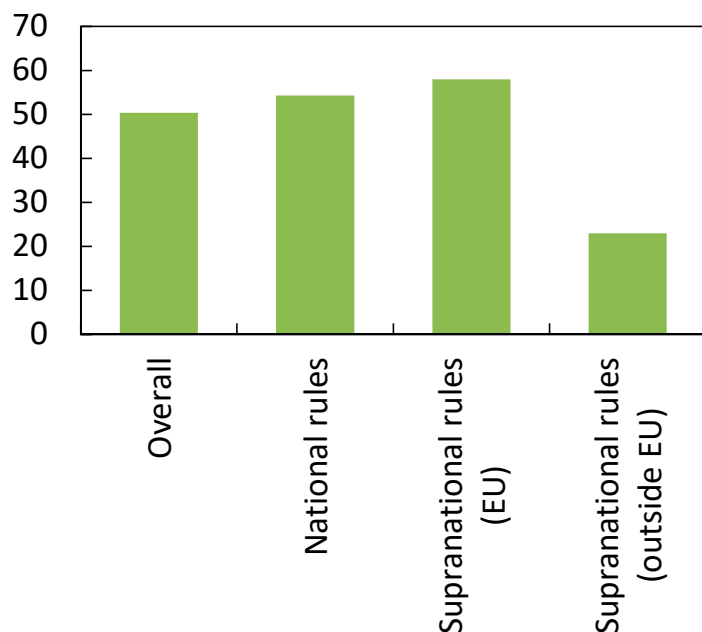
## Caveats

**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).

**Higher costs for non compliers**

**Sanctions**

**Reputational costs**

**More benefits for compliers**

**Lower financing costs**

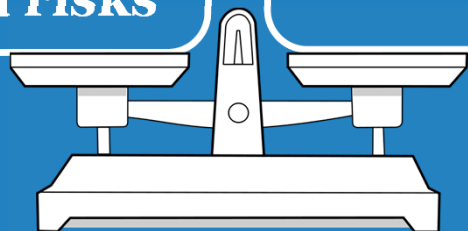
**Incentives in supranational settings**

# 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.



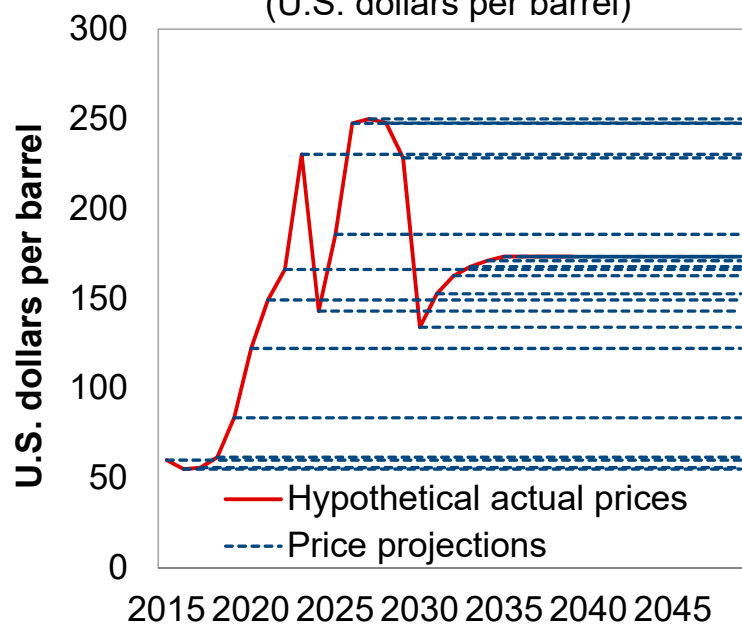
**Thank you!**

## **Background slides**

# Features of benchmark frameworks for resource-rich countries

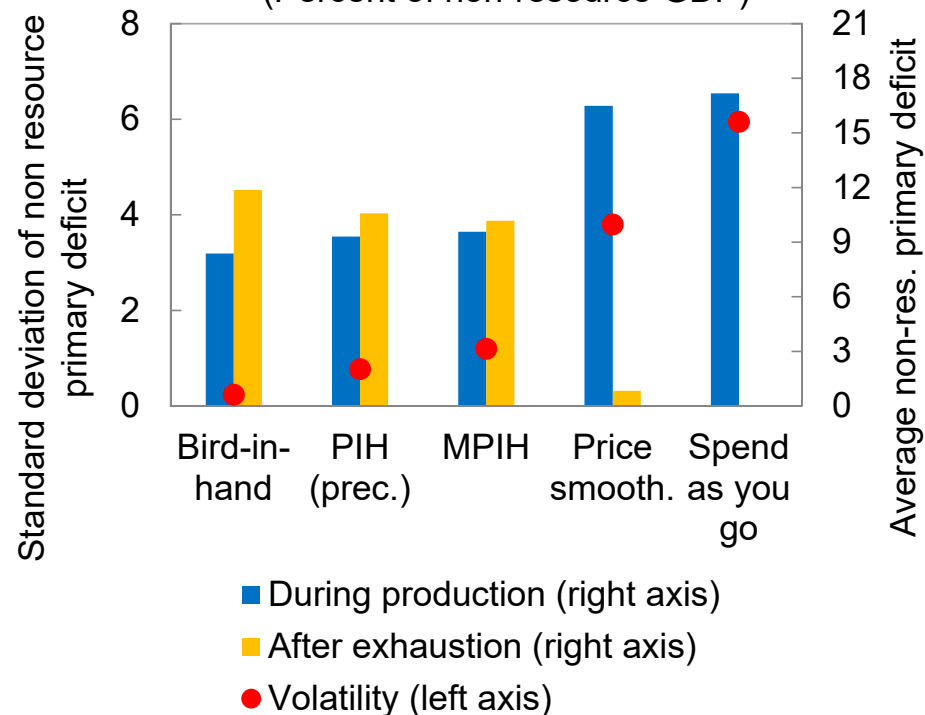
**Hypothetical Price Scenario: Actual and Projections**

(U.S. dollars per barrel)

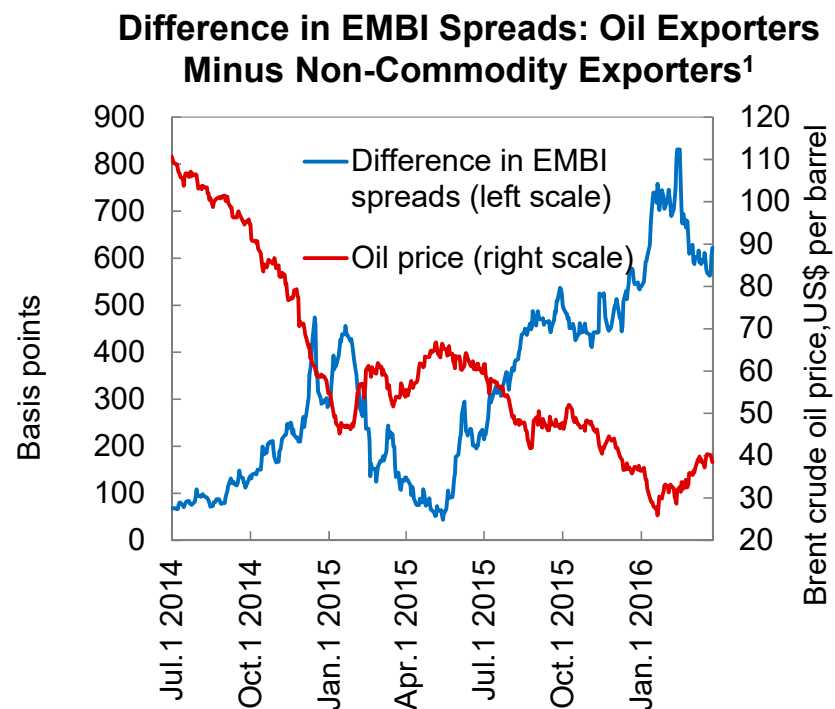


**Primary Deficit and its Volatility Under Different Frameworks**

(Percent of non-resource GDP)



# Oil prices and spreads



Source: Thomson Reuters DataStream, and IMF staff estimates.

Note: EMBI = Emerging Markets Bond Index.

<sup>1</sup> Data are through March 24, 2016.