Enhancing Fiscal Discipline Over the Cycle

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Fiscal Discipline

• Components of fiscal discipline
  • Avoidance of borrowing that exceeds debt servicing capacity;
  • Avoidance of procyclical policies;
  • Maintenance of budgetary cushions to respond to economic or financial shocks.

• Prerequisite for macroeconomic stability, and long-term growth. Its benefits are heightened by globalization.

• Effects of lack of fiscal discipline:
  • Aggregate demand pressures, leading to inflationary and/or balance of payments pressures;
  • Crowding out;
  • Adverse debt dynamics.

• Focus of presentation:
  • Factors affecting fiscal discipline, especially over the cycle;
  • Policies and institutions to promote it.

• Presentation draws on recent work undertaken in the Fiscal Affairs Department.
Role of Policy Discretion

• A degree of policy discretion is desirable in principle, since it provides the flexibility to respond promptly to economic shocks.

• But discretion can be misused and can lead to deficit bias because of:
  • Political economy factors
  • Weak fiscal management
  • Off-budget fiscal activity

• Avoiding misuse of policy discretion is crucial to promote fiscal discipline.
Cyclicality of Policy: Evidence

- Inappropriate use of discretion is often reflected in policy procyclicality.

- Procyclicality can reflect the impact of both automatic stabilizers, and discretionary policy measures.

- Empirical evidence suggests that discretionary policy tends to be procyclical:
  
  - In industrial countries, a percentage point decline in the output gap results on average in an improvement of around 0.3 percent in the ratio of fiscal balance to GDP. But since automatic stabilizers average around 0.5 percent of GDP, this suggests that discretionary policy is procyclical.

  - In developing countries, the sensitivity of the fiscal balance to output gap is close to zero. Although the size of automatic stabilizers is smaller in developing countries, it is still positive, again indicating procyclicality of discretionary policy.
Asymmetry in the Cyclicality Pattern

The cyclicality of fiscal policy is generally asymmetric in the up and down phases of the economic cycle. Specifically:

- In *industrial countries*, in good times, automatic stabilizers are on average offset by procyclical discretionary measures;
- However, in bad times, discretionary fiscal policy is neutral, and automatic stabilizers are allowed to operate fully.
- In *developing countries*, in good times, procyclical discretionary measures on average outweigh automatic stabilizers, and fiscal policy as a whole is procyclical.
- In bad times, automatic stabilizers are generally bolstered by countercyclical discretionary measures, except in countries that are financing-constrained.
Cyclicality of Policy: Causes

- **Lags in the formulation and implementation of policy**
  - Difficulties in assessing the stage of the cycle, or the size of the output gap, and its impact on the budget. This is especially the case in developing economies, given the frequency of shocks, and data weaknesses.

- **Political economy factors**
  - Common pool problems
  - Time inconsistency of governments
  - Spending exuberance in good times

- **Financing constraints during downturns**
  - These have been especially evident in Latin America
Consequences of procyclicality

- Procyclical fiscal policy exacerbates economic fluctuations.

- Output volatility in turn affects adversely welfare, especially for the lower income groups.

- Most empirical studies also find an inverse relationship between volatility and long-term growth.

- The asymmetric reaction of fiscal balances to positive and negative cyclical conditions affects adversely the public debt dynamics.
Automatic Stabilizers

- Given the evidence on procyclicality, there are merits in implementing countercyclical fiscal policy through automatic stabilizers.

- Automatic stabilizers do not require political decisions, do not suffer from identification and implementation lags, and are self-reversing.

- However, they also have limitations:
  
  - They reflect past decisions about the levels and structure of taxation and government expenditure that were not motivated primarily by stabilization objectives.

  - Their size in most developing countries is relatively small.
Discretionary Measures

- Discretionary tax and spending measures can play a useful role in bolstering weak automatic stabilizers;

- They may also be needed to respond to noncyclical shocks;

- However, above noted empirical evidence points to their frequent procyclicality, with attendant deficit bias;

- Moreover, the scope for discretionary fiscal expansion may be constrained by current fiscal position: financing constraints and/or unsustainable debt dynamics.
Cyclically Adjusted Fiscal Balances

- To correct procyclicality bias, need reliable indicators of the impact of the cycle on the budget.

- **Cyclically adjusted fiscal balances** (CABs) eliminate the cyclical components of taxation and spending from nominal fiscal balances.

- Difficulties in calculating CABs include accurate measurement of the output gap, and the output elasticities of revenues and expenditures.

- Steps to improve the accuracy of CABs include:
  - Focusing on changes in output and budget balances, rather than their levels;
  - Taking into account changes in the composition of output; and
  - Using estimates of elasticities derived from tax and expenditure laws

- In most cases, however, using CABs to inform the choice of nominal targets over the cycle may be a more realistic initial objective.

- Chile is the only country that successfully targets CABs.
Expenditure Targets

- Alternative approach: target expenditure, rather than CABs.
- Expenditure targeting tackles deficit bias at one of its main sources, and makes governments accountable for the fiscal aggregate most directly under their control.
- However, it may lead to across-the-board, or other low-quality, spending cuts.
- May also create incentives for creative accounting or off-budget activities.
- May also lead to indiscipline being shifted to the revenue side of the budget (tax cuts may also be inappropriate from a stabilization or debt sustainability standpoint).
- To make an effective contribution to macroeconomic stability and debt sustainability, expenditure targets are best used to help implement deficit or debt rules, or to meet other fiscal targets.
Fiscal Rules

• An increasingly popular means of tackling deficit bias.

• Focus more on long-term sustainability concerns than on cyclicality issues.

• Can help reduce the inappropriate use of discretion, but are not a substitute for political commitment to fiscal discipline.

• Are intended to shape policy design and be long-lasting, and therefore are usually enshrined in constitutional or legal provisions.

• Can help reduce uncertainty about the direction of policy, and anchor expectations.
Types of Fiscal Rules

- **Deficit rules** include balanced budget rules and overall deficit limits.
  - These rules focus on indicators most relevant for short-term macroeconomic management.
    - But they tend to be procyclical.

- **Debt rules** place an upper limit on gross or net public debt.
  - Attempt to respond to, or prevent, a debt sustainability problem.
  - But, level of debt is not all that matters in assessing debt sustainability; cost or structure of the debt are also important.
  - Also, debt rules tend to ignore contingent liabilities.

- **Expenditure rules**, as noted above, are conceptually simple, and most effective in containing the size of government. They need, however, to be anchored in an aggregate deficit or debt target.
Design and Implementation Issues

- Fiscal rules can be potentially useful, but are not a panacea.
- Their effectiveness depends on political commitment to fiscal discipline.
- Their design and implementation are also critical to their effectiveness.
- Their rules must be clearly specified, easy to monitor, and costly to circumvent.
- They must fit in with the broader institutional environment of a country.
- Their effectiveness can be enhanced through appropriate institutional reforms, such as the enactment of fiscal responsibility legislation or the creation of independent fiscal councils.
Fiscal Responsibility Laws

- Aim to consolidate a government’s commitment to fiscal discipline by attaching legal force to its fiscal policy objectives.

- Are intended to provide a clear signal about a government’s commitment to monitorable fiscal policy outcomes and/or strategies.

- Their design features differ significantly from country to country, e.g. in the type of rules they contain:
  - Procedural rules define the attributes and interaction of participants in the budget process, aiming to enhance transparency, accountability, and fiscal management.
  - In contrast, numerical rules are a formal constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance.

- FRLs also differ according to other characteristics, including their jurisdiction, the importance of escape clauses and sanctions, and the role of cyclical considerations.
Efficacy of FRLs

- No rigorous cross-country empirical analysis so far of the effectiveness of FRLs in improving fiscal outcomes.
- Informal evidence points to significant variance in their effectiveness across countries.
- Political commitment is key.
- So are underlying fiscal management institutions, in particular comprehensiveness of budget, timeliness and accuracy of fiscal reporting.
- FRLs supported by financial or other sanctions tend to be more effective than those relying mainly on reputational costs.
Fiscal Agencies

• Proposals to create **nonpartisan fiscal agencies** are in part a reflection of the success with granting independence to central banks.

• Two main types of fiscal agencies have been proposed:
  
  • **Independent Fiscal Authorities** (IFAs): These are given a mandate to make fiscal policy decisions. There are to-date no IFAs in operation, reflecting issues of democratic accountability.
  
  • **Fiscal councils** (FCs): These are in place in a number of countries, with a wide range of specific mandates, including the provision of normative fiscal policy assessments and advice, independent macroeconomic and fiscal projections, and objective policy analysis.

• FCs can help to curb the misuse of discretion and reduce deficit bias without raising issues of democratic accountability.

• They increase the transparency of fiscal policy, and thereby raise the reputational cost of misuse of discretion.
Successful FCs

- In addition to political commitment and strong fiscal management institutions, a variety of country-specific factors can influence the mandate of an FC and its effectiveness:

  - **Deficit bias and credibility**: the greater past deficit biases of a government, the more authority should be bestowed on a FC in providing fiscal policy assessments and advice
    - The existence of fiscal rules: the creation of a FC charged with monitoring the implementation of a fiscal rule can bolster the credibility of the rule.
    - Institutional accountability: where checks and balances are strong between different branches of government, an FC is likely to be more influential, even if it has a limited mandate.
Summary

• Fiscal discipline is a prerequisite for sound macroeconomic performance.

• Safeguarding fiscal discipline requires avoiding the misuse of policy discretion and curbing deficit bias.

• Discretionary fiscal policies tend to be procyclical in good times, and countercyclical in bad times. Procyclicality reflects largely political economy factors, and has significant adverse consequences. The key challenge is to promote fiscal discipline in good times.

• The use of CABs can be useful in this regard, but it is difficult to target CABs. Expenditure ceilings can also assist in reducing pro-cyclicality. Fiscal rules can make a useful contribution to sustaining fiscal discipline. FRLs and FCs can also play an important role in this regard.

• A strategy that combines different approaches can exploit their complementarity. It can, in turn, bolster political commitment by highlighting self-imposed restraints on government and raising the costs of evading them.