

# Fiscal Rule for Albania

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Challenges in the Move Towards  
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# Outline

- What are fiscal policy rules (FPR)? Brief history.
- Major types of FPR.
- Why to introduce FPR? Pros and cons.
- Institutional arrangement for FPR.
- Experience with FPR.
- Desirable characteristics of FPR.
- What FPR for Albania?

# What is fiscal policy rule?

- Permanent constraint on fiscal policy
- Usually defined in terms of macro fiscal indicator
- Supplementary fiscal rules may include some subset of macro fiscal indicators
- Fiscal rule has to be applied permanently, for successive governments → fiscal targets in Fund programs are not fiscal rules

# History of fiscal rules

- Until early 1970s, B-W system of fixed exchange rates constrained discretionary fiscal policy
- During 1980s and early 1990s, rapid growth of government spending and budget deficits (deficit bias) which threatened macroeconomic stability
- Limited success of discretionary fiscal adjustment plans, but rules-based adjustment plans more successful (e.g., EMU) → thus increased interest in fiscal rules
- However, some fiscal rules did not work – in the US Gramm Rudman Hollings (spending cuts if the deficit exceeded a set of fixed deficit targets) was a failure

# Why Fiscal Rules?

- Fiscal rules seek to address a number of fiscal policy failures to improve fiscal results:
  - fiscal illusion by voters (see immediate benefits of higher expenditure, discount future higher tax costs)
  - common pool problem where agencies compete for public resources disregarding macro implications
  - time–inconsistency of fiscal policy (deviation from announced policies at the time of implementation)
  - pro-cyclical character of fiscal policy and debt bias producing excessive debt and macro instability
- If credible, rules increase fiscal policy credibility and reduce interest rate premium

# Potential Costs and Limits of Fiscal Rules

- Not effective when not backed by political commitment and strong budgetary institutions
- Limit FP discretion and ability to respond to shocks (see recent problems with fiscal stimulus in some countries), limit smoothing expenditure over cycle → particular problem when monetary policy also restricted
- Could promote procyclical fiscal policy (e.g., debt ceiling may require procyclical fiscal tightening)
- May lead to effort to circumvent them – creative accounting or low quality adjustment measures
- Repeated circumvention damages policy credibility

# Types of fiscal rules

- Defined by: fiscal variable, time dimension (annual, multi-year, over cycle) or cyclical adjustment
- Expenditure rules
  - Limits on overall expenditure (either as % of GDP, or nominal or real growth)
  - Limits on current expenditure
- Revenue rules
  - tax rates
  - tax burden as % of GDP
  - allocation of extra revenue

# Types of fiscal rules – cont.

- Rules based on budget balance
  - Limit on government deficit, possibly including balance between overall revenue and expenditure (zero government borrowing)
  - Limit on structurally or cyclically adjusted government deficit
  - Limit on current balance (borrowing only for investment purposes)
- Borrowing rule
  - Prohibition of domestic government borrowing
  - Prohibition of or limits on government borrowing from central bank
- Debt or reserve rules
  - Limits on the stock of government debt (gross or net), as % of GDP (e.g., Maastricht limit)
  - For resource rich countries, rules on saving part of the resource-related revenue



# Institutional arrangements

- Could apply to national or sub national governments
- Efficacy depends on the quality of budgetary process and budgetary institutions
- To carry weight, fiscal rules need to be institutionally ‘anchored’
- Different institutional arrangements in practice:
  - highest level – international treaty or constitutional law
  - laws or regulations
  - policy guidelines
- Sanctions for violating fiscal rules
- Most important: strong political commitment to fiscal discipline (UK takes its rule seriously although not in law; Germany's golden rule is in the constitution but not adhered to)

# Desirable features of fiscal rules

- Well-defined, comprehensive coverage and simple for the public and legislature to understand/monitor
- Transparent government operations (accounting, forecasting)
- Sufficient flexibility to accommodate shocks and cyclical fluctuations (including escape clauses) and allow for aid supported and good investment projects to take place
- Adequate to support the specific goals (debt sustainability, macro stability)
- Monitorable, enforceable and supported by efficient policies

# Experience with fiscal rules

- Fiscal rules became widespread during the 1990s – particularly Europe, but also a number of emerging market countries
- EC – Public Finance in EMU 2006 – comprehensive assessment of numerical fiscal rules in EMU
- Results indicate a positive impact of rules on fiscal outcomes:
  - primary cyclically adjusted balance improved after introduction of numerical FR
  - expenditure rules lead to lower primary expenditure as % of GDP
- However countries without rules also did quite well during this period

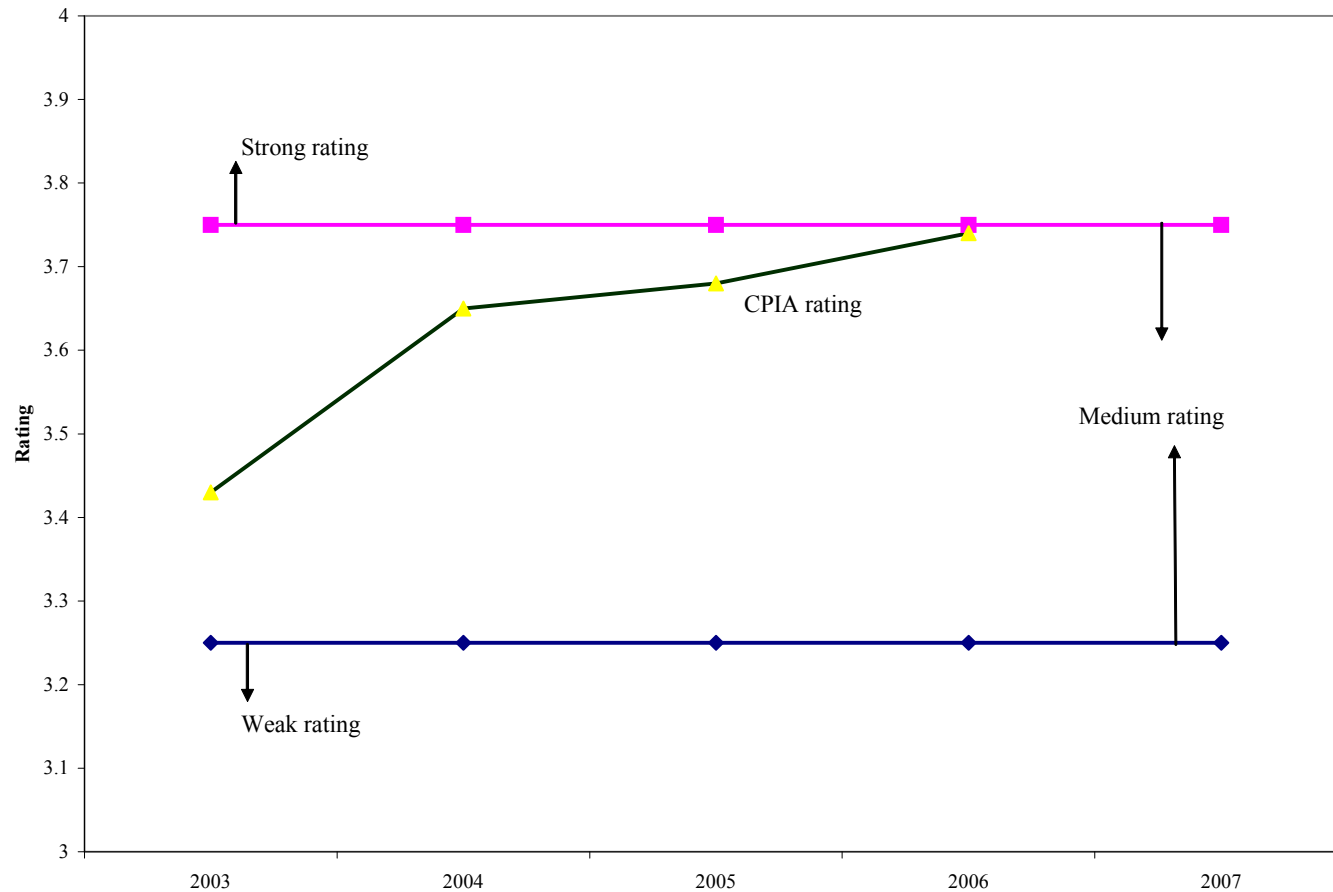
# Fiscal rule for Albania?

- So far, fiscal policy “anchored” by fiscal conditionality under IMF programs
- Large investment needs & opening of access to capital markets → potential for rapid debt build up → useful to “anchor” fiscal policy
- Clear and credible fiscal policy target reduces risk of adverse market reaction and increases room for maneuver – fiscal rule as signaling and commitment rule

# What should fiscal rule achieve?

- General objective: macro stability/debt sustainability
- Specifically: reduce public debt/GDP to a sustainable level
- Sustainable debt level country-specific, depends on a number of factors (quality of policies, institutions)
- WEO (2003) → in EMCs with market access, could be as low as 25 percent
- CPIA rating – Albania approaches strong performer status → would imply higher debt tolerance

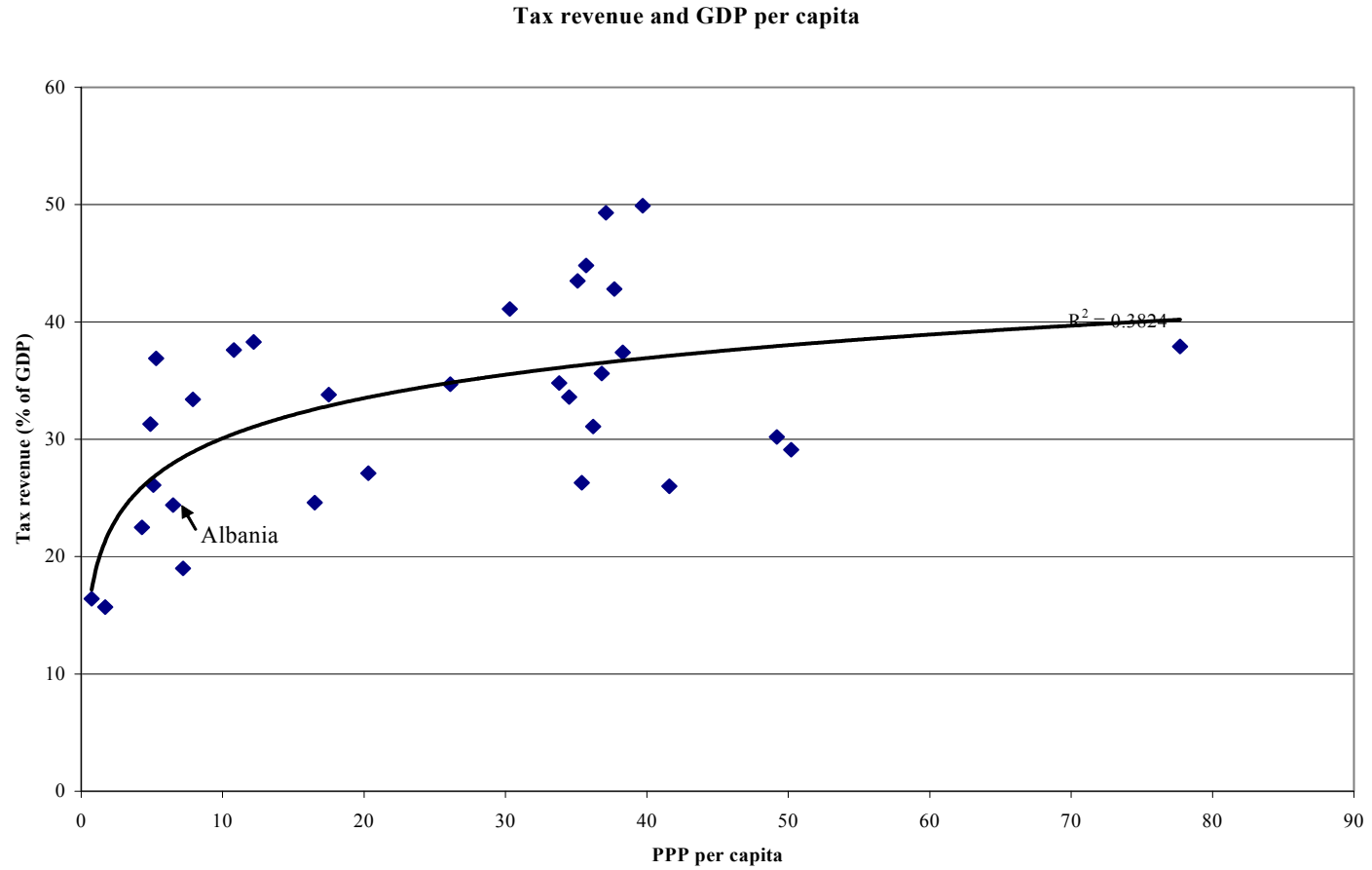
# Albania – CPIA rating



# Debt sustainability analysis

- Baseline scenario shows a declining path of debt/GDP
- Over the 20-year horizon, public debt declines to around 20 percent of GDP
- Baseline assumptions:
  - expenditure to stabilize at 30 percent of GDP
  - revenue to gradually increase from 26 percent to 31 percent of GDP
  - as a result, primary fiscal balance will move from a deficit 2 percent of GDP in 2008 to a similar surplus by 2027.

# Tax revenue and GDP per capita

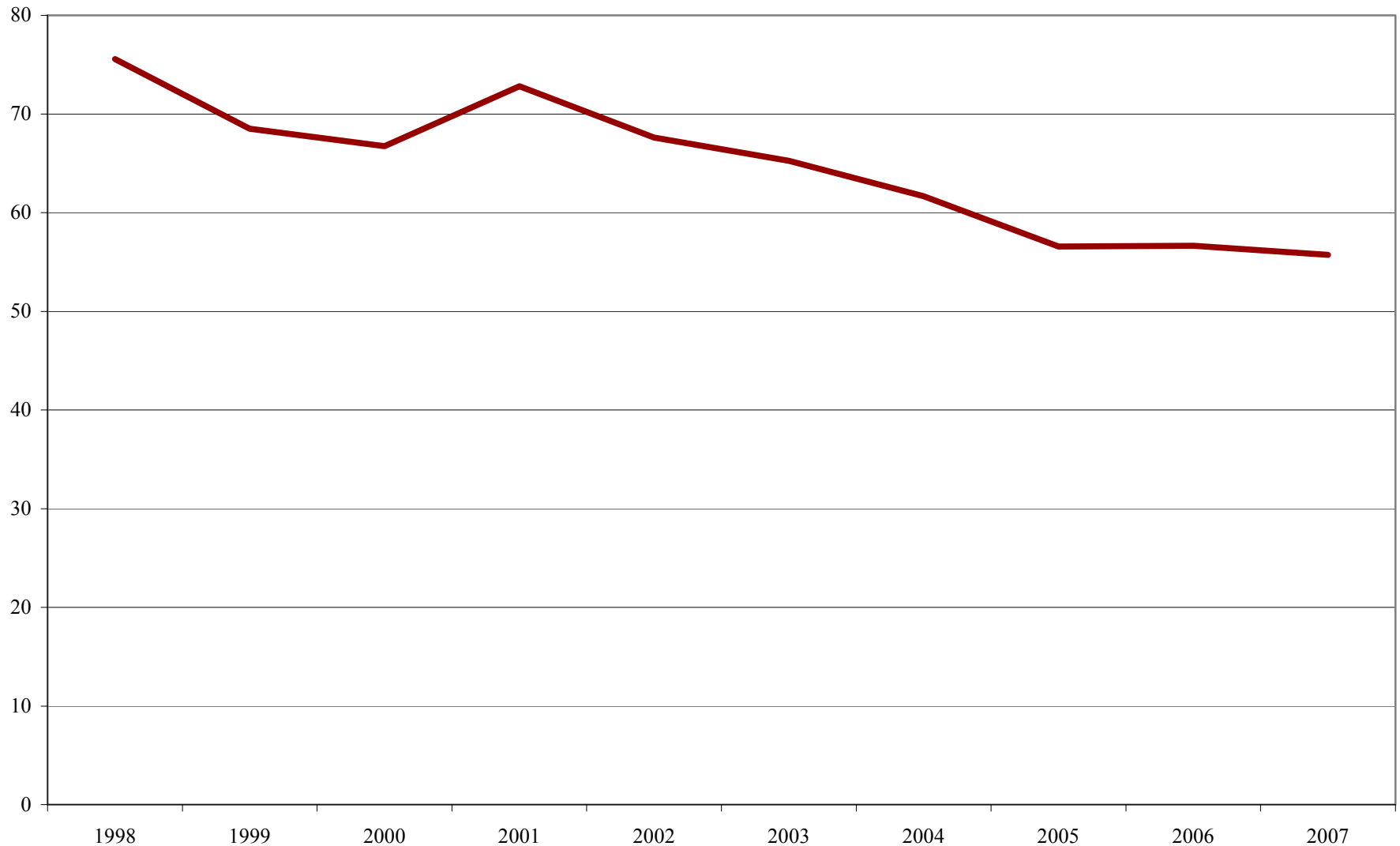




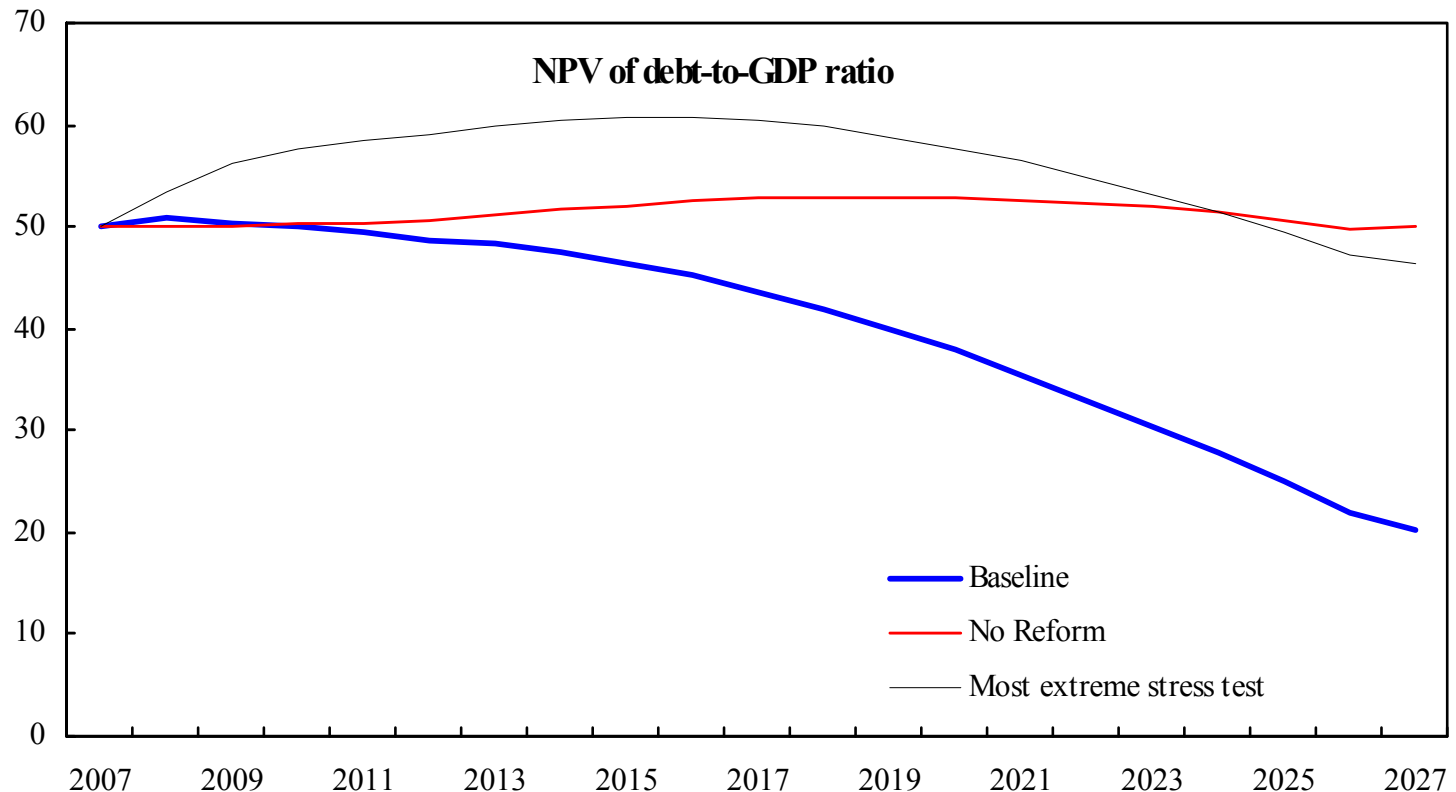
# Debt sustainability – alternative scenarios

- Alternative debt sustainability scenarios produce less benign results
- No reform scenario (variables at historical level) → debt/GDP remains stable at broadly present level over 50% of GDP
- Shock to GDP (2008-9 growth = baseline minus one standard deviation of 1998-2007 growth) → debt increase to about 60 percent of GDP, before declining slowly
- If the standard deviation includes 10 percent GDP decline in 1997, debt increases to about 80 percent of GDP

# Public Debt/GDP has been declining since 1997...



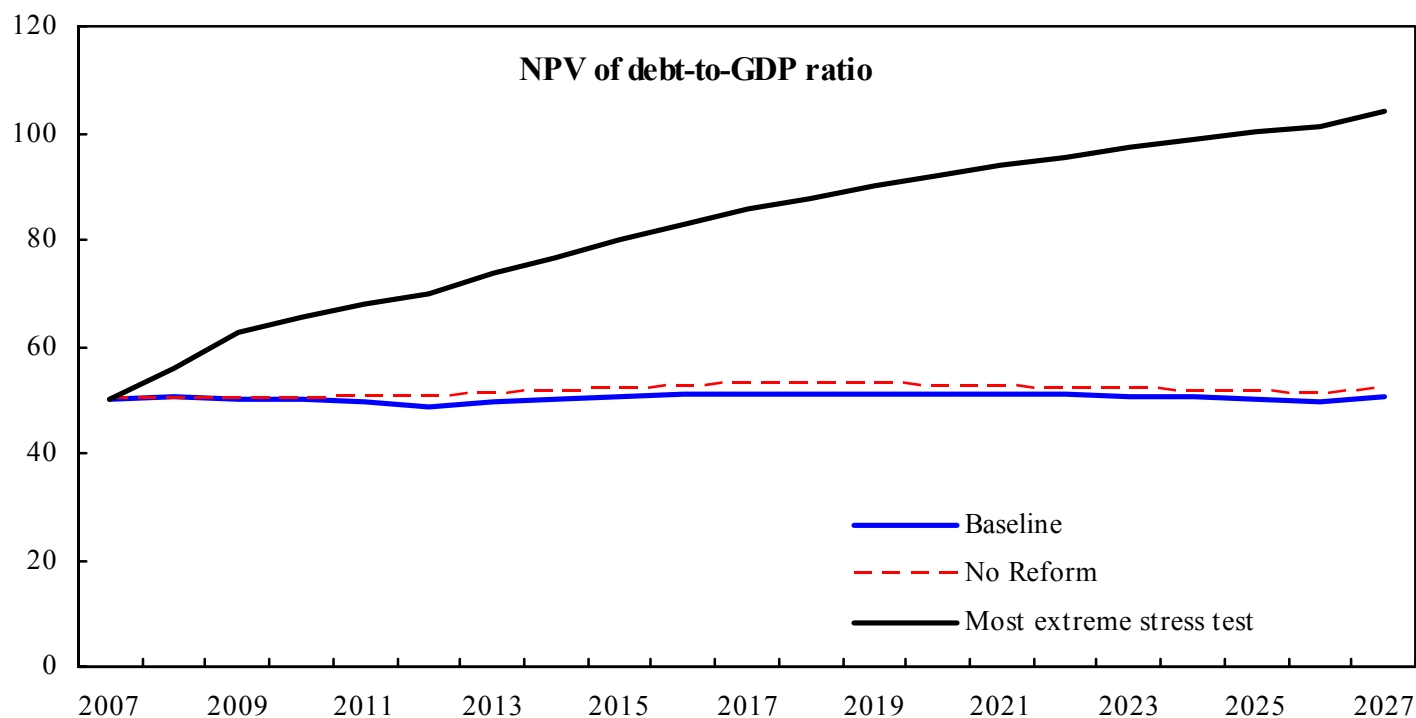
...and is projected to decline further under certain assumptions



# Long-term implications of keeping deficit at 4 percent of GDP

- Use DSA to illustrate debt impact of the present limit on deficit of 4 percent of GDP
- Baseline and historical scenarios almost identical – debt/GDP remains about the same somewhat above 50 percent
- Vulnerability to shock too high → standard growth shock, though temporary, puts debt on explosive path
- Clearly, a more ambitious fiscal target needed

# Debt path with 4 percent deficit



# Debt-stabilizing fiscal balance

- What primary balance needed to stabilize debt/GDP ratio ( $pb^*$ )?
- $pb^* = [(r-g)/(1+g)]*(debt/GDP)$
- For 2008, assuming:  $r = 0.05$ ;  $g = 0.06$ ;  
 $debt/GDP = 0.543 \rightarrow pb^* = -0.5\%GDP$
- Actual primary balance =  $-2.1\% GDP \rightarrow$  fiscal gap  $1.6\%$  of GDP = adjustment size needed to stabilize debt/GDP ratio at 2008 level
- 2008 gap reflects temporary increase in capital expenditure, in 2009, fiscal gap close to zero

# What debt/GDP ratio to target?

- Need to continue below the present level, and below 50 percent of GDP
- Eventually political decision, need to consider different tradeoffs: higher debt allows more spending but also raises the risks of adverse financial market reaction, keeps interest payment higher and crowds out private investment
- In moving to that target, debt-GDP need not be declining every year (increased investment could temporary halt the decline)

# Fiscal rule to achieve debt target

- Overall or primary balance one option, direct link to debt, but has some problems:
  - if not cyclically adjusted, could be procyclical, but cyclical adjustment complicated and more difficult to monitor
  - less under policy makers control
- Expenditure target appear more attractive
  - more directly under policy makers control
  - less sensitive to cyclical developments, particularly in Albania where unemployment insurance is small
  - expenditure discipline removes an important source of fiscal problems



# Fiscal rule to achieve debt target

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# Expenditure rule

- Expenditure rule would be based on expenditure/GDP policy target, in line with policy objective to keep small government
- Assuming constant expenditure/GDP ratio, reduction of debt/GDP ratio would be driven by improvements in tax revenue collection
- Speed of tax revenue increase would be the main determinant of the speed of debt reduction

# Expenditure target – cont.

- A number of issues to be addressed:
  - how to specify numerically expenditure rule - nominal or real growth ceiling?
  - how fast to increase tax revenue? (Depends on target for debt/GDP and when to achieve it)
  - would other political parties and governments be committed to a certain expenditure/GDP target? Would it be revised?
  - what if revenue over performs? Increase spending or reduce debt faster? Keep current 50-50 rule?
  - What if debt/GDP target becomes off track? Adjust fiscal policy or target?

# Conclusion

- Fiscal rules become increasingly popular as a tool of supporting fiscal discipline
- Fiscal rule could play a useful role in Albania as well to help reduce public debt and ensure fiscal sustainability
- However, strong political consensus and political commitment to sound fiscal management required
- Improvements in budgetary process (comprehensiveness, transparency, reliability) could also help improve fiscal outcomes
- Also, independent fiscal agencies could play a role (independent analysis, projections, assessment)
- IMF ready to assist with the design and implementation of institutional framework for successful fiscal policy