



Expenditure Rules: A Free Lunch?

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Institutions for Fiscal Credibility—Fiscal Policy Rules and Fiscal Councils: Experience and Prospects in the Asia-Pacific Region

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First of all...



Background work done for the Spring 2014 Fiscal Monitor by a staff team comprising Tidiane Kinda, Priscilla Muthoora and Anke Weber

Outline

- Why?
- Mapping expenditure rules
- Are they effective?
- Are there side effects?

Why?

- **Definition**
 - durable constraint on expenditure through numerical ceilings that are binding for a minimum of three years.
- **Expenditure rules have a number of desirable features:**
 - aimed at addressing the expenditure pressures often at the origin of excessive deficits → direct operational appeal to implement other rules,
 - most directly related to the formulation of the annual budget,
 - can be transparent and generally easy to monitor,
 - **Countercyclical:** accommodate revenue shortfalls resulting from adverse economic shocks (automatic stabilizers), help creating buffers in good times, when revenue windfalls (regardless of its cause) can make spending pressures difficult to resist.

Why?

- **These features contrast with growing frustration about the implementation of “new-generation” rules:**
 - Tendency to combine inconsistent constraints on different aggregates.
 - Focus on structural balance rule: complex, opaque, uncontrollable, and even misleading.
- **Caveats:**
 - Stand-alone → No clear mapping to a debt path (revenue side is unconstrained) → need to be somehow anchored in debt.
 - Can be complex too:
 - Issue of exclusions: interest payments, “cyclical” spending items.
 - Need some built in flexibility (to avoid undesired trends in government size).
 - Potential side effects in terms of expenditure composition:
 - Low quality cuts when the rule binds: across the board freezes, targeted cuts on high-quality discretionary items (investment,...)



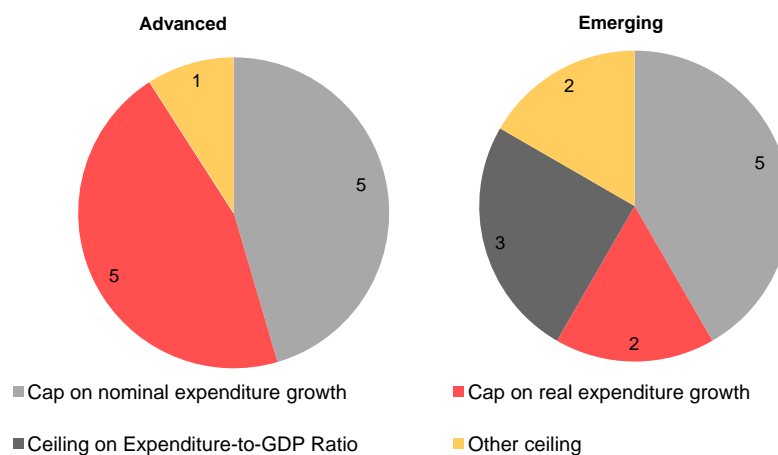
Mapping Expenditure Rules

Who uses them?

Who currently uses them?		Who used them in the past?	
Advanced	Emerging and Low Income	Advanced	Emerging and Low Income
Australia (2009)	Botswana (2003)	Belgium (1993-98)	Argentina (2000-2008)
Denmark (1994)	Brazil (2000)	Canada (1998-2005)	Hungary (2010-2011)
Finland (2003)	Bulgaria (2006)	Iceland (2004-2008)	Kosovo (2006-2008)
France (1998)	Croatia (2012)		
Israel (2005)	Ecuador (2010)		
Japan (2006)	Lithuania (2008)		
Luxembourg (1990)	Mongolia (2013)		
Netherlands (1994)	Namibia (2010)		
Spain (2011)	Peru (2000)		
Sweden (1997)	Poland (2011)		
United States (1990)	Romania (2010)		
	Russia (2013)		

What type of expenditure rules exist?

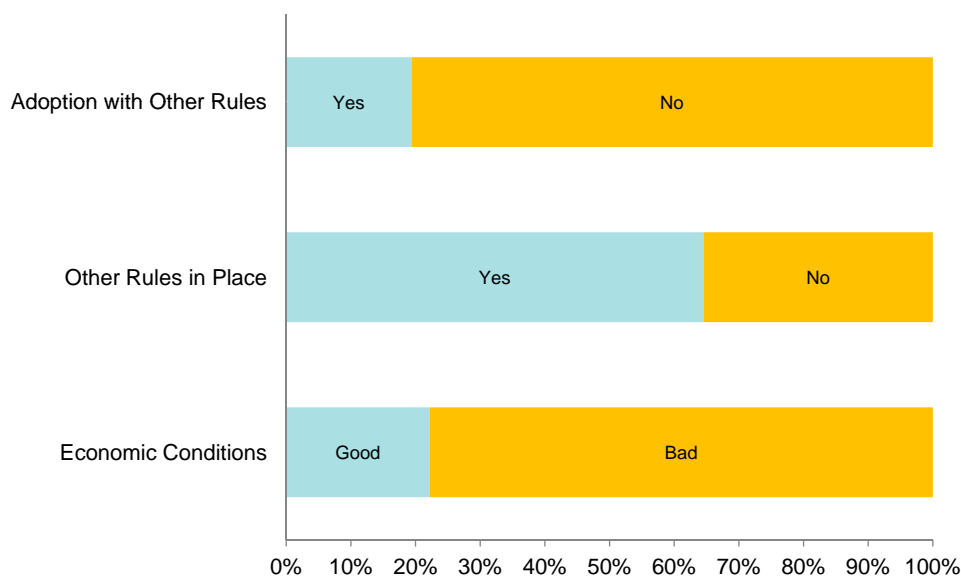
**Types of Expenditure Rules in 2013
(Number of Countries)**



Source: FAD Fiscal Rules Database; and IMF staff calculations

When are expenditure rules adopted?

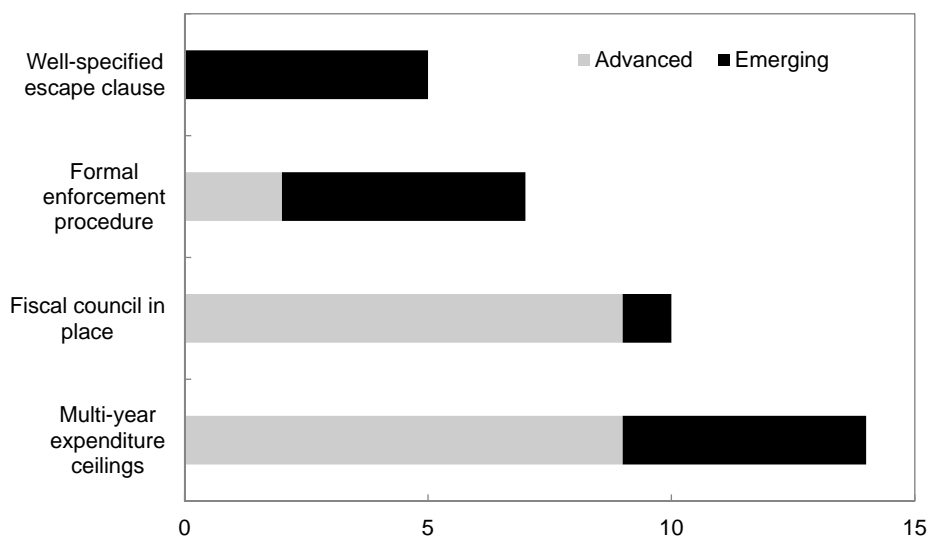
Conditions around the adoption of expenditure rules



Source: FAD Fiscal Rules Database; and IMF staff calculations.

What are their design features?

Design Features of Expenditure Rules in 2013 (Number of Countries)



Source: FAD Fiscal Rules Database; and IMF staff calculations



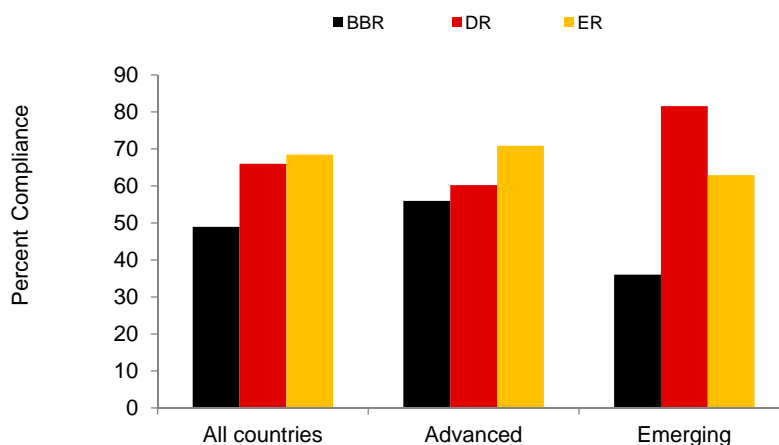
Are they effective?
Compliance and Impact on Policies

Compliance

- **Why look at compliance?**
 - Provides information on the capacity of the rule to bind.
 - Of course, strong compliance could also reflect a poorly defined rule (one that is never binding).
- **How is compliance measured?**
 - Focus on Expenditure Rules, Budget Balance Rules and Debt Rules during 1985-2012.
 - Compliance measured as a 0-1 variable.
 - Use both quantitative and qualitative information from WEO, staff reports, assessments by fiscal councils, assessments in annual budgets, journal articles.
 - Coverage uneven; some missing observations.

What is the record of compliance?

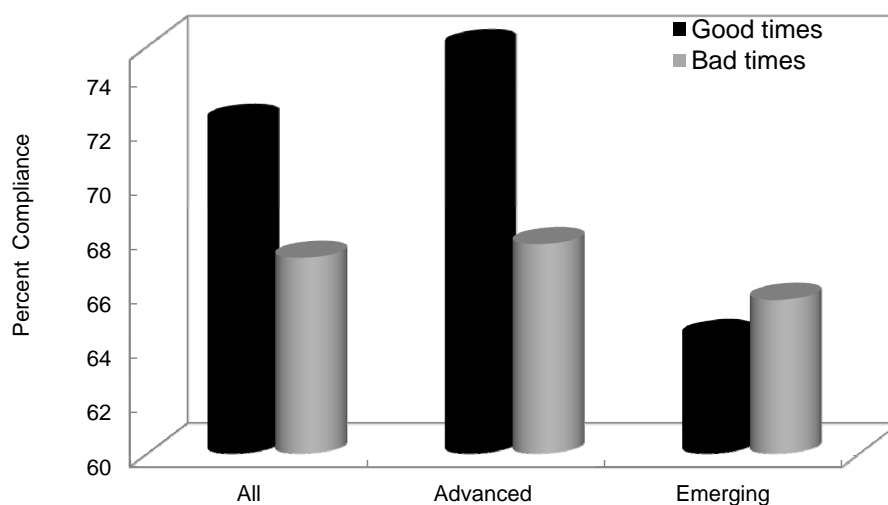
Compliance with Fiscal Rules: 1985-2012



Source: FAD Fiscal Rules Dataset and IMF staff estimates.

Compliance in good times and bad

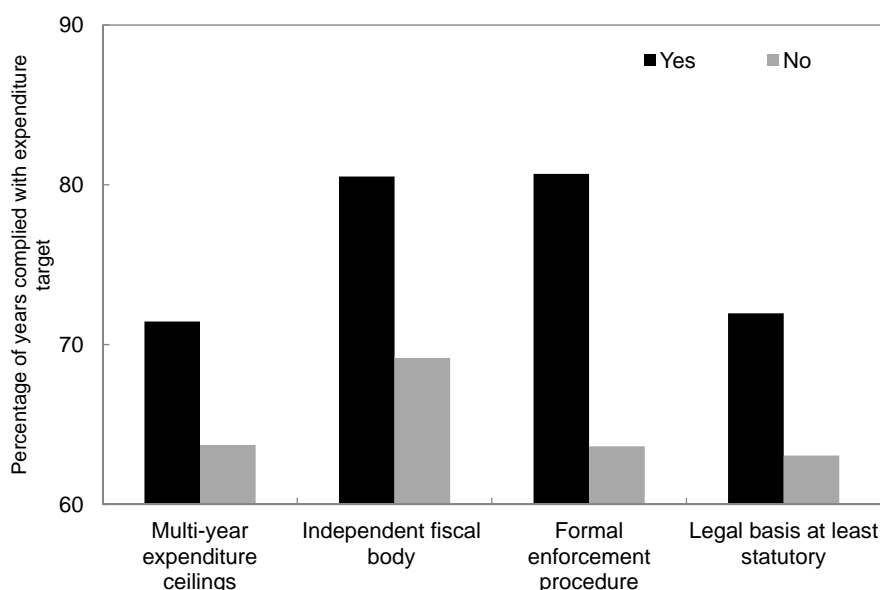
Compliance during good and bad times



Source: FAD Fiscal Rules Dataset and IMF staff estimates.

Design features and compliance

Expenditure Rules: Design Features and Compliance



Source: FAD Fiscal Rules Dataset and IMF staff estimates.

Impact on policy

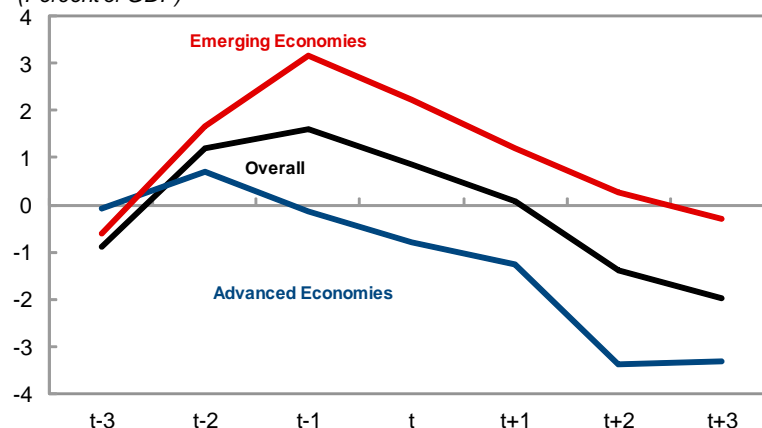
- **Have expenditure rules promoted long-term sustainability and macro stability?**
 - Higher primary balance
 - Lower primary spending
 - Countercyclical fiscal policy
- **Existing studies focus on EU countries or all rules**
 - Expenditure rules could help mitigate spending and procyclical bias (Debrun and others, 2008; Wierdsma 2008; Holm-Hadulla and others, 2010)
 - Well-designed rules are associated with higher fiscal balance (Debrun and Kinda, 2014)
- **New empirical evidence for ER covering a representative sample.**
 - It includes all advanced, emerging, and developing economies with expenditure rules

ER's and average fiscal behavior

- **Expenditure rules and fiscal performance**

- Primary deficit tends to decline more rapidly following the introduction of expenditures rules

Average Primary Deficit Before and After Expenditure Rule Implementation
(Percent of GDP)



Note: t indicates the first year of implementation of rule.
Figure shows an average across countries with expenditure rules in place.

Source: FAD Fiscal Rules Database; and IMF staff calculations

ER's and average fiscal behavior

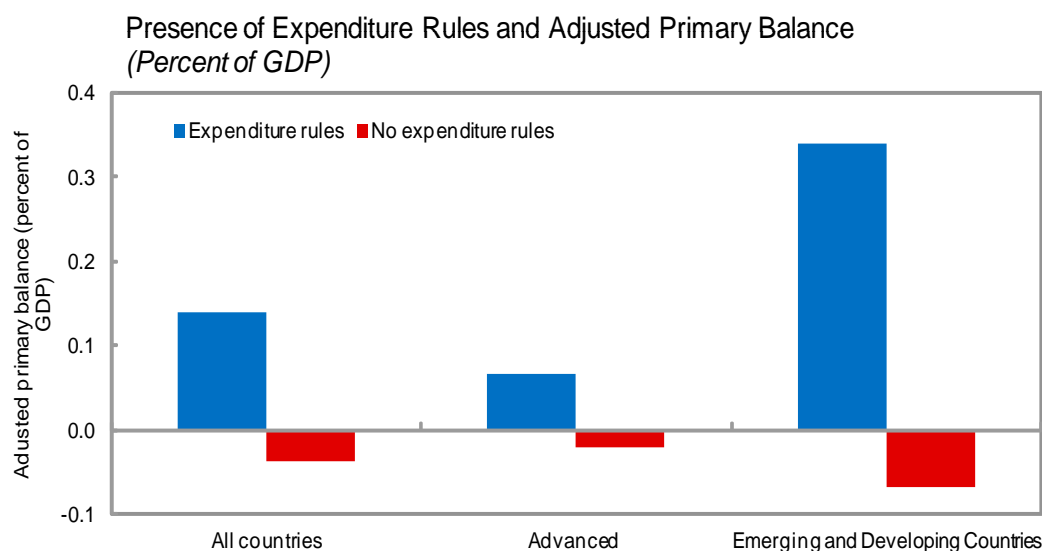
- **Expenditure rules and fiscal performance**

$$FP_{i,t} = \gamma FP_{i,t-1} + \theta DEBT_{i,t-1} + \vartheta OG_{i,t} + \varphi ER_{i,t} + \partial OR_{i,t} + \mu_i + \delta_t + \varepsilon_{i,t}$$

- Primary balance or primary spending (FP)
- Lagged dependent variable (to allow for persistence)
- Lagged gross debt (to capture long-term solvency constraint)
- Output gap (OG : to control for the cyclicity of fiscal policy)
- Expenditure rule (ER)
- Presence of other rules (OR : budget balance and debt rules)
- Time and country fixed-effects

ER's and average fiscal behavior

- **Main result: Expenditures rules (in addition to other rules) associated with higher primary balances.**



Source: FAD Fiscal Rules Database; and IMF staff calculations

ER's and average fiscal behavior

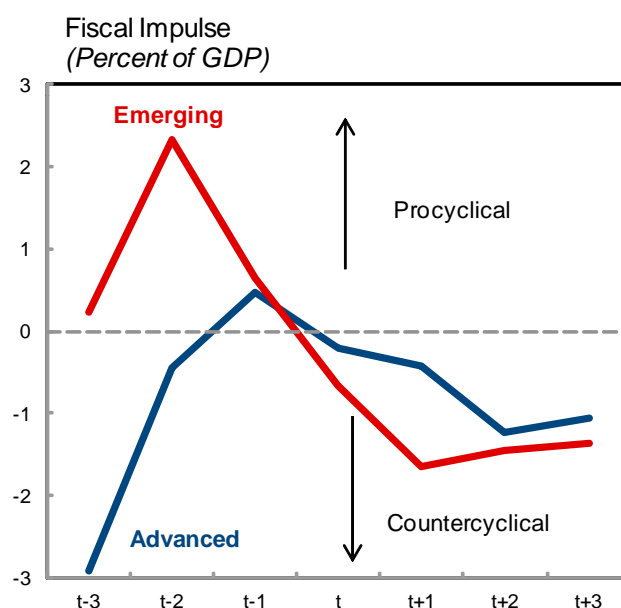
- **Expenditure rules and fiscal performance**

	Dependent Variable			
	Primary balance in percent of GDP		Primary expenditure in percent of GDP	
Lag dependent	0.79 (28.47)***	0.791 (28.30)***	0.901 (44.16)***	0.902 (44.66)***
Lag debt	0.013 (3.48)***	0.013 (3.60)***	-0.012 (3.04)***	-0.012 (3.15)***
Output gap	0.064 (2.42)**	0.065 (2.46)**	-0.021 -0.74	-0.022 -0.77
ER dummy	0.81 (2.62)***		-0.656 (2.01)**	
ER index		0.315 (2.83)***		-0.246 (2.11)**
Other rules	0.777 (3.25)***	0.708 (3.23)***	-0.552 (2.15)**	-0.491 (2.10)**
Observations	1,085	1,085	1,085	1,085

ER's and average fiscal behavior

- Expenditure rules and countercyclical fiscal policy

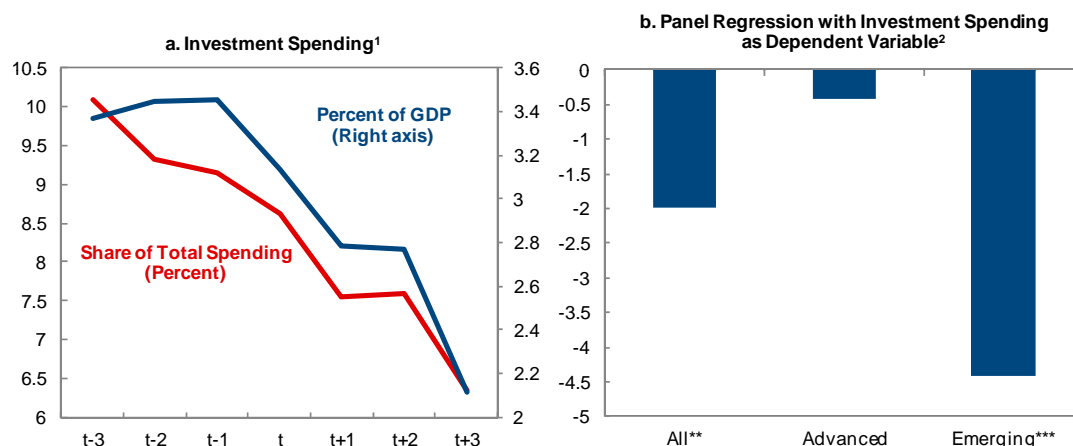
- **Procyclical impulses:** improvements in the primary balance during bad times (when growth is below potential)
- **Countercyclical impulses:** deteriorations in the primary balance during good times (when growth is above potential)



Are there Side Effects?

ER's and investment spending

Expenditure Rules and Spending Composition



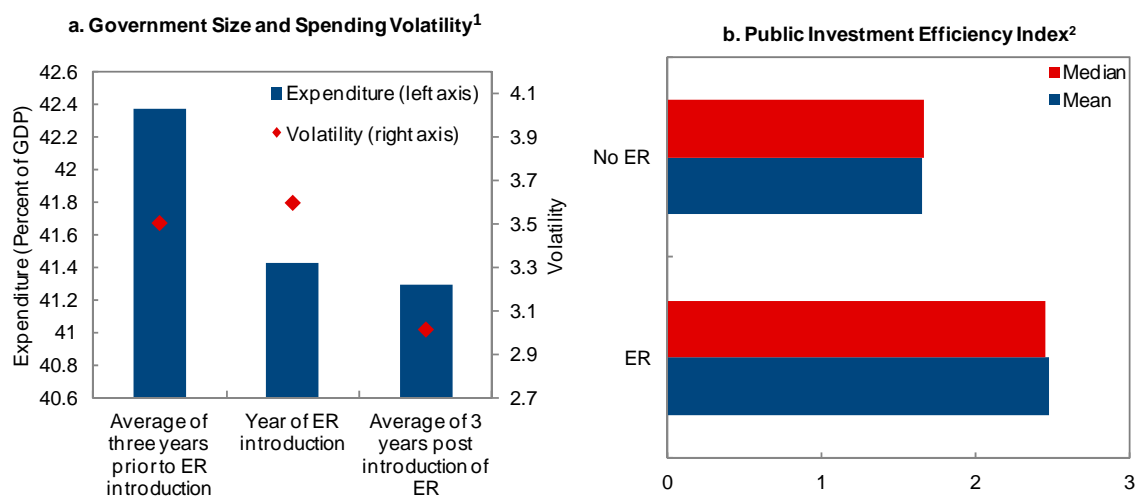
Sources: FAD Fiscal Rules Database; and IMF staff calculations.

¹ t is for the first year of implementation of rule. Figure shows an average across countries with expenditure rules in place.

² ** and *** denote significance at 5 and 1 percent level respectively. The chart shows coefficients from panel regressions of the investment share of spending on an expenditure rule dummy and other control variables, which include political variables from the World Bank database.

ER's, government size and efficiency?

Expenditure Rules, Efficiency and Government Size



Sources: FAD Fiscal Rules Database; Dabla-Norris and others (2012); and IMF staff calculations.

¹Volatility is calculated as the absolute value of the percentage change in the deviation of expenditure from its trend as calculated by the HP filter.

² The public investment efficiency index covers 71 emerging and low-income countries and captures the institutional environment underpinning public investment management across four different stages: project appraisal, selection, implementation, and evaluation. ER=expenditure rule.

Conclusions

- **Expenditure rules, if well designed, can be a useful tool for sound fiscal policy**
- **Evidence gives some empirical backing to desirable properties:**
 - Likelihood of compliance greater than for budget balance rules
 - Presence of expenditure rules associated with stronger fiscal performance
- **Risk of undesirable side properties needs to be considered.**