

Making Fiscal Rules Enforceable

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Experience & Prospects in the Asia-Pacific Region

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Questions to be Addressed

1. What determines **compliance** with fiscal policy rules?
2. What are **prominent cases of success and failure** of fiscal policy rules in Asia and elsewhere?
3. What specific **enforcement mechanisms** can be envisaged?
4. What can be the **role of a fiscal council**?

My Responses to these Questions

Questions 1.-3. Compliance, Success & Enforcement?

❖ **Spending rules work;
deficit/debt rules don't.**

Question 4. Fiscal Councils/Parliamentary Budget Offices?

❖ **An all-but-necessary condition
for success.**

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Detail Behind My Responses

- What I'm *Not* Talking About
- Fiscal Rules Reviewed
- A Spending Rule is Better
- Outline for a Spending Rule
- Potential Value of Fiscal Councils (FCs) & Parliamentary Budget Offices (PBOs)
- Final Observations
- References:
 - ✓ “ “Design Choices for Fiscal Policy Rules”, by Barry Anderson & Joe Minarik, **OECD Journal on Budgeting** (2006).
 - ✓ The Changing Role of Parliament in the Budget Process”, Barry Anderson, **OECD Journal on Budgeting** (2009).

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What I'm *Not* Talking About

- Not to argue for a fiscal rule, but...
- Not to say that principles aren't better than rules—they are—but...
- Not to state that a bad rule is better than none, but...
- Not to say what the limits on spending should be, but...
- **If a fiscal rule is needed, a spending rule is better.**

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Fiscal Rules Reviewed in the 2006 OECD Paper

- Deficit-Based Rules (summarized in the paper)
 - **EMU**, 1999-current
 - **Netherlands**, 1989-1994
 - **US** (Gramm-Rudman-Hollings), 1985-1990
- Spending Rules (summarized in the paper)
 - **Finland**, late 1980's-current
 - **Netherlands**, 1995-current
 - **Sweden**, 1997-current
 - **US** (Budget Enforcement Act), 1991-2002
- Other Rules (reviewed but not summarized in the paper)
 - **Chile, Norway, Switzerland, Latin American countries**

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A Spending Rule Is Better—Summary

- **Deficit-based rules are inherently pro-cyclical; spending rules are inherently counter-cyclical.**
- The ability to successfully adjust a deficit-based rule for the cycle is unproven and at best only mitigates the pro-cyclical bias of the rule. Again, spending rules are inherently counter-cyclical.
- Spending rules work best in the good times, thus promoting compliance; deficit-based rules don't bind in the good times and are very difficult to support in the bad times.
- Violations of a spending rule are transparent and incontrovertible; non-compliance with a deficit-based rule can be hidden.

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<u>A SPENDING RULE IS BETTER—DETAIL</u>			
Fiscal Responsibility:	<u>Deficit Rules</u>	<u>Cyclically Adjusted Deficit Rules</u>	<u>Spending Rules</u>
Expansion	Encourages larger deficit	Encourages larger deficit	Requires that surplus be saved
Recession	May require a smaller deficit	May require a smaller deficit	Allows deficit to grow
Macroeconomic Stabilization:			
Expansion	Pro-cyclical	Pro-cyclical, but less so than unadjusted deficit rule	Counter-cyclical, through automatic stabilizers
Recession	Pro-cyclical	Pro-cyclical, but less so than unadjusted deficit rule	Counter-cyclical, through automatic stabilizers
Administrability	Verification more difficult	Verification more difficult	Verification easier
Credibility	Status more contentious	Status more contentious	Status more transparent
Public Investment	Can be protected	Can be protected	Can be protected, possibly better than under deficit rules
Core Government Functions	Volatile funding	Volatile funding	Predictable funding
Monetary Policy	Cooperation difficult	Cooperation difficult	Cooperation easier

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Outline for a Spending Rule

- **Coverage:** annual spending limits + some kind of limits (such as PAYGO) on entitlements *and* tax expenditures
- **Time Frame:** at least 3 years
- **Country Specific** [for multi-country monetary union rules]: start with deficit target & adjust current spending patterns by country to meet target
- **Enforcement:**
 - Warnings don't work: laws do
 - Statistics matter
 - No pain: no gain



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Potential Value of FCs & PBOs

- Eliminate Executive's information monopoly
- Simplifies complexity
- Promotes transparency
- Enhances credibility
- Promotes accountability
- Improves budget process
- Serves both majority & minority
- Provides rapid responses

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FC & PBO Core Functions

- I. Economic Forecasts
- II. Baseline Estimates
- III. Analysis of Executive's Budget Proposals
- IV. Medium Term Analysis
- V. Supports Enforcement



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I: Economic Forecasts

- **Objective**
 - Not a function of policy proposals: not “dynamic”
 - Not based on wishful thinking: no rosy scenario
 - Not a means to an end: for example, interest rates, & oil & crop prices should be estimates, not targets
- **Conservative**: allows for better-than-forecasted performance to reduce deficits/debt
- **“Centrist”**, based on:
 - Panel of experts
 - Private forecasters
 - Central Bank



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II: Baseline Estimates

- **Projections, not Predictions**
 - “Centrist” Economic Forecast
 - Current Law Basis, including
 - “Spend Out” of Enacted Legislation
 - Termination of Expiring Legislation
- Medium Term Focus
- Replaces Previous Year & Executive Baselines

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III: Analysis Of Executive’s Budget Proposals

- An objective budgetary assessment
 - ❑ A technical review—**not** a programmatic evaluation
- Enhances credibility—both of government as a whole and of executive forecasts

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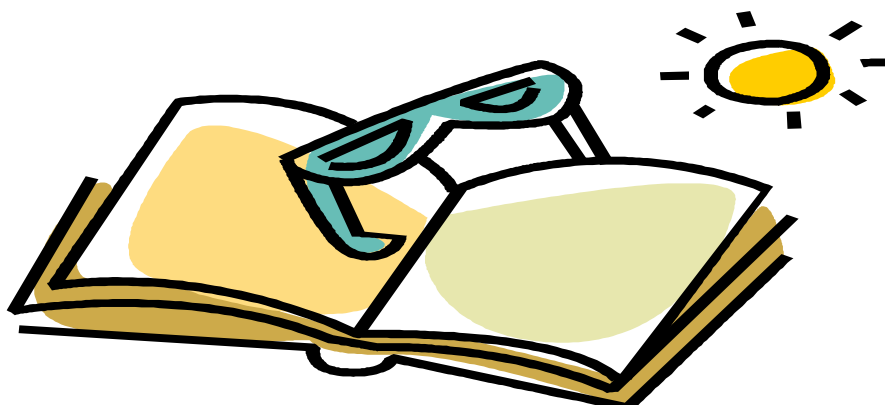
IV: Medium Term Analysis

- Forces Executive to look beyond one year
- Estimates medium term economic and fiscal impacts of policy proposals
- Takes into account Fiscal Risks:
 - Guarantees
 - Pension liabilities
 - Contingent liabilities
 - PPPs
- Provides basis for Long Term Analysis

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V. Supports Enforcement

- Simplifies complexity
- Promotes transparency
- Enhances credibility
- Promotes accountability
- Serves both majority & minority
- “Sunshine is the best disinfectant.”



Other Functions

- Analysis of proposals
- Options for spending cuts
- Analysis of mandates (regulatory analysis)
- Economic analyses
- Tax analyses
- Long term analysis
- Policy briefs



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Final Observations

- Political commitment is paramount.
- Independent economic assumptions should be the starting point.
- A spending rule & a deficit-based rule can't coexist, but a spending rule should be based on realistic deficit targets.
- No rule is forever, but a longer rule & especially a longer commitment are better.
- Transparency & simplicity matter & a Fiscal Council/PBO helps.

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