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Do Fiscal Rules Make a Difference?

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Outline

- Some Success Stories
- Practical Criticism of Fiscal Rules
- Compliance and Effectiveness
- Lessons Learned and the Road Ahead

Some Success Stories

Sweden (1997): expenditure rule and over-the-cycle 1 percent of GDP surplus target

Switzerland (2003): structural balance rule (Swiss debt brake)

Practical Criticism of Fiscal Rules

- Poor track record in delivering medium term budget balance and containing the debt-to-GDP ratio;
- Too complicated to guide fiscal policy;
- Low compliance;
- Too rigid for economic stabilization;
- Undesirable side effects (e.g. *creative accounting, cuts in capital and social spending).*

Performance of Debt and Deficits

Sources: IMF WEO; and IMF staff calculations.

Compliance Track Record is Poor

Note: Reported is the share of euro area countries that did not comply with the following fiscal rules: (1) Deficit rule = overall deficit-to-GDP ratio should not exceed 3%, (2) Debt rule = public debt-to-GDP ratio should not exceed 60%, (3) Medium-Term Objective (MTO) rule = structural deficit ratio should not exceed the MTO, and (4) Fiscal effort rule = decline in the structural deficit ratio should be at least 0.5% in a given year when the structural deficit exceeds the MTO in the previous year. The assessment is illustrative and subject to a number of caveats.

Sources: AMECO; and IMF staff calculations.

Poor Compliance Driven by Ex-Post Deviations

Note: Decomposition formula: $\underbrace{DEF_{t|2016} - 3}_{Ex-post\ slippage} = \underbrace{(DEF_{t|2016} - DEF_{t|t-i})}_{Execution} + \underbrace{(DEF_{t|t-i} - 3)}_{Ex-ante\ compliance}$ Medians reported.

Sources: Stability and Convergence Programs, AMECO, and IMF staff's calculations.

Little Effectiveness on Average …

- *Positive correlations* between fiscal rules and budget balances…
- … but *causality difficult to establish*
  - ✓ After correcting for endogeneity, no difference between rule adopters and nonadopters.
  - ✓ "**Average rule"** does not impact fiscal balance of an "average country".
  - ✓ Strong rules matter.

- Significant heterogenous effects across rules and countries.

Relationship between Fiscal Balance and Fiscal Rules (OLS and New IV Approach) and Fiscal Strength Index

VARIABLES	(1) Balance	(2) Balance	(3) Balance
Fiscal Rule Dummy	0.80***		
	(0.22)		
Fiscal Rule Dummy		1.38	
		(0.87)	
Fiscal Rule Strength Index			3.91**
			(1.70)
Observations	2,823	2,797	2,797
R-squared	0.71	0.30	0.30
Method	OLS	New IV	New IV

Source: Caselli and Reynaud (forthcoming)

… But Effective as a Pulling Force, Even in Case of Noncompliance

The 3 % deficit ceiling became an attractor

Source: Caselli and Wingender (forthcoming)

Excessive Deficits are Penalized by Markets

Cost for Countries under EDP ≈ 50-150 basis points

Source: Diaz Kalan, Popescu and Reynaud (forthcoming)

Disciplining role of the market

"The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive."

Alexandre Lamfalussy (Delors' Report 1989)

10-year Sovereign Bonds

Sources: Bloomberg; and EC.

Lessons from Country Experiences

What makes rules effective?

- Strong and enduring political consensus and buy-in.
- Broad institutional and economic coverage.
- Simple design conducive to countercyclical fiscal policy.
- A good calibration.
- Well-defined escape clauses against tail events.
- Effective enforcement mechanism (e.g. fiscal councils).

Future of Fiscal Rules: Roadmap

- **More Holistic Approach**
  - ✓ A fiscal anchor and operational rule(s).
  - ✓ Parsimony of rules.
  - ✓ Internal consistency across various rules.

- **Rule Flexibility**
  - ✓ Right balance between flexibility and complexity.

- **Fiscal Councils**
  - ✓ Fiscal councils in monitoring rules is widely seen as compliance-enhancing.

THANK YOU!

References

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Background Slides

Fiscal Rules Have Spread Worldwide

Number of Countries with Fiscal Rules, 1990–2015

Note: The charts describe the number of countries with at least one rue

Source: IMF fiscal rule database

Growing Number of Rules by Country

The Multiplication of Fiscal Rules, 1990-2015

Source: IMF fiscal rule dataset.

Note: Figure 2a is based on a constant country sample (including countries with no rule at some point during the period). In Figure 2b, categories are mutually exclusive; for instance, “Debt and expenditure rule” denote countries having both types of rules but no other rule.

Excessive Debts Are Largely Driven by Weak Enforcement

Note: Decomposition formula: $\underbrace{DEBT_{t|2016} - 60}_{Ex-post\ slippage} = \underbrace{(DEBT_{t|2016} - DEBT_{t|t-i})}_{Execution} + \underbrace{(DEBT_{t|t-i} - 60)}_{Ex-ante\ compliance}$ Medians reported.

Source: Stability and Convergence Programs, AMECO, authors' calculations.