* Column title, "Equilibrium"
* Suggested story title: Fiscal Rules!?
* Author: Dennis Botman, IMF Resident Representative to the Philippines

# Fiscal Rules!?

The policy prescription for addressing the sovereign debt woes in Europe, and high debt levels in many economies more generally, is clear: countries that are facing market pressures have no choice but to go ahead with forceful fiscal adjustment, even if this means slower growth. Countries, advanced and emerging alike, that so far have not faced market stress, but have high debt levels, need to announce credible medium-term consolidation plans. For the latter, although not a panacea, adopting a Fiscal Responsibility Law (FRL) can be helpful, to enhance fiscal transparency and accountability. Fiscal rules are sometimes enshrined in FRLs and can provide an important anchor and commitment.

Many larger emerging market and developing economies, including Brazil, India, Argentina, Nigeria, have introduced some form of fiscal responsibility legislation in the past years. FRLs are presently being developed or considered in countries as diverse as Mongolia, Jamaica, Romania, Ghana, and The Maldives.

During past consultations, the IMF has advocated the introduction of a more formalized medium-term budgeting framework anchored on enhanced revenue efforts for the Philippines as well. This could help to resolve the last remaining hurdle for a credit upgrade and support budget preparation and execution. Key elements of such a framework would include a statement of fiscal risks, a medium-term expenditure framework, public disclosure of the annual costs of tax incentives and exemptions, and a medium-term debt management strategy.

Currently, the Philippines does not have an explicit fiscal rule, although there is an intention to reduce the deficit over the medium term.  A more explicit fiscal rule should aim to strike a balance between flexibility to accommodate shocks while anchoring fiscal policy to a medium-term target and avoiding deficit bias.

The rationale for implementing a fiscal rule varies from country to country. Objectives typically include: (i) achieving medium-term macroeconomic stability, without sacrificing short-run stabilization objectives and tax smoothing; (ii) assisting other policies (monetary policy); (iii) achieving or maintaining long-run fiscal sustainability; (iv) preventing subnational government deficits; or (v) enhancing credibility by avoiding deficit bias.

There is also a wide menu of fiscal rules to choice from, usually distinguished by balanced-budget or surplus/deficit rules, borrowing rules, or debt or reserve rules. Balanced-budget or surplus/deficit rules include for example: (i) balance between overall revenue and expenditure, or a limit on the surplus/deficit to GDP; (ii) balance between structural (or cyclically adjusted) revenue and expenditure, or a limit on structural surplus/deficit as a percent of GDP; (iii) balance between current revenue and expenditure (that is, borrowing is

permitted only to finance capital expenditure, which is also known as the "golden rule"); or a mix between these different arrangements.

Although potentially an important commitment tool, the empirical evidence shows mixed economic effects of fiscal rules. On the one hand, fiscal rules can lower inflation and interest rates, and lower country-risk premia and indebtedness. However, fiscal rules can also create distortions. On the expenditure side, they can lead to compression of public investment, accumulation of payment arrears, creative accounting practices, and recourse to one-off measures (privatization). On the revenue side, they can result in distortions in the tax structure and administration (advance tax payments), and cause frequent adjustments in tax rates. More generally, rigid fiscal rules may limit budget flexibility and lead to higher variation in economic growth. Specifically, while binding balanced-budget rules can limit deficits and reduce fiscal vulnerabilities, a poor design can lead to inefficient expenditure frameworks and procyclicality of fiscal policy.

To maximize success, the empirical and theoretical literature has identified the following eight key characteristics of a model fiscal rule. First, it should be well-defined, meaning that the overall balance is preferred over current balances as investment expenditure suffers from both conceptual and measurement weaknesses. It is also better to apply the rule to the public sector as a whole rather than the central government (to include off-budget operations and the cost of quasi-fiscal activities of public enterprises).

Second, the rule should be transparent in terms of accounting, forecasting, and institutional arrangements. Thirdly, it should be adequate to meet it key objectives. If the goal is to contain inflation, the rule should include limits on borrowing from the central bank. If the goal is to reduce remaining external vulnerabilities, then limits on the budget deficit should be targeted. On the other hand, if the sustainability of public debt is the key issue, the rule should place a limit on government debt or aim for a minimum primary surplus.

Fourth, the rule should be consistent, both internally and with other macroeconomic or policy rules (such as inflation targeting). Fifth, it should be a simple as possible, appealing to both the legislature and the public at large. Sixth, it should be flexible, to accommodate external shocks by allowing room for automatic stabilizers and discretionary policies to work (i.e., use of structural primary surplus rule or balanced-budget rules over a medium-term horizon).

Seventh, it should be enforceable, possibly through constitutional or legal statutes, in combination with penalties and monitoring by independent fiscal councils. Finally, the rule should be efficient, in that it should prevent one-off measures (frequent adjustment in tax rates).

If the above lessons from international experience are followed, fiscal rules and fiscal responsibility acts more generally can be important catalysts for fiscal reforms that ensure greater sustainability, transparency, and economic efficiency.

The Author is the IMF Resident Representative for the Philippines