



Fiscal Rules and Public Investment Management

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- ◆ Summary: Fiscal Rules and Public Investment Management

The main objective of a fiscal rule is to build the credibility for the long-term sustainability of fiscal policy

- ◆ The **primary objective** of a fiscal rule for most developing countries is not to achieve counter-cyclical policy...
 - ❖ Business cycles are less economically important in emerging economies compared to advanced economies
 - ❖ Due to the large size of emerging markets' informal economies, macroeconomic data is also 'noisier', making counter-cyclical fiscal policy especially challenging
- ◆ ...but rather to build and maintain **credibility** of macroeconomic policy, thus providing a solid foundation for growth
 - ❖ Credibility requires managing moral hazard and time consistency challenges, and avoiding the 'tragedy of the commons' bias towards overspending in subnational governments because some of the burden can be shifted to the central government
- ◆ Yet fiscal rules are meant to compel fiscal consolidation, which tend to **first affect public investment** needed for growth



Institutional Framework: Comprehensiveness and Transparency

Fiscal rules operate between policy and politics

- ◆ Fiscal rules are tools to help ‘depoliticize’ fiscal policy and solve time consistency and moral hazard problems:
 - ❖ It is difficult for politicians to commit to fiscal restraint since the political costs of spending less today are immediate, while the political costs of spending more today will only be borne out in the future, and only if the politician is still in office when the adjustments are required
 - ❖ For states, the costs of spending more today is further dampened by the implicit guarantee from the center
 - ❖ FRLs and MTEFs attempt to introduce an intertemporal dimension to fiscal policy by creating an explicit commitment to a path for fiscal variables and actions to achieve this path and by providing greater transparency on fiscal policy

- ◆ If political incentives are misaligned, fiscal rules will be subject to ‘gaming’, changes of goal posts and other budgetary implementation risks:
 - ❖ Governments may ignore the fiscal rules openly;
 - ❖ Non-transparent conduct: lack of budget credibility (e.g., over-optimistic growth and revenue projections), and “creative” accounting;
 - ❖ Politicization of data-generating institutions (especially statistical institutes in charge of nominal GDP compilation);
 - ❖ Recourse to arrears financing; and
 - ❖ Rearrangement of budgetary structure to the detriment of (growth-stimulating) public investments

Fiscal rules are most effective when they help **reinforce political commitment** to fiscal responsibility

- ◆ Making public commitments to a fiscal path and increasing transparency through more comprehensive coverage of fiscal targets can help make good politics out of good policy by
 - ❖ creating an easily-observed benchmark that the Government can be held (politically) accountable for, and
 - ❖ reducing the scope for creative accounting
- ◆ ...but building strong institutions that will not always serve the short-term interests of the government of the day requires strong and visionary political leadership
- ◆ Well-designed FRLs and MTEFs need to be **incentive compatible** and **politically sustainable** across the political cycle and across mandates of governments led by different political parties or coalitions, taking into account local political circumstances

Examples of commitment challenges posed by fiscal rules



In 1986, courts struck down as “unconstitutional” the *Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act* of 1985 (the first binding spending constraint on the US budget).



In 2003, Germany and France were the first euro area countries breaking the 3-per cent-of-GDP fiscal deficit criterion, the principal anchor of the Maastricht criteria underpinning the common currency.



New Zealand sought to anchor fiscal policy on the “operating balance excluding revaluations and accounting changes” (OBERAC)—ignoring the fact that it is not an accurate definition of “cash surplus” as the indicator of what Government has to spend.

A comprehensive, transparent and simple rule builds credibility

- ◆ **Comprehensiveness** of the target is more important than the specific number
 - ❖ A commitment to target and monitor liabilities from the **consolidated public sector** ensures that there are no ‘skeletons in the closet’; it builds credibility and strengthens institutions by reducing scope of creative accounting
 - ❖ The consolidated public sector includes PPPs, SOEs, etc.
- ◆ **Fiscal transparency** requires accurate and timely fiscal reporting
 - ❖ Timely reporting of fiscal data reduces scope for deviations from fiscal responsibility and permit rapid course correction
 - ❖ Reducing gaps in subnational fiscal reporting
 - ❖ Enhancing disclosure of contingent liabilities, implicit and explicit, at all government levels
- ◆ **Simple** numerical targets are still useful for accountability and transparency
 - ❖ Targets will realistically be derived from considerations of what is politically feasible in terms of debt reduction or stabilization in the medium-term
 - ❖ Targets can include the consolidated liabilities of the public sector, borrowing requirements of the consolidated public sector, or the overall level of expenditures

Comprehensive coverage and transparency are key features of effective fiscal rules

- ◆ Effective implementation of fiscal rules requires a **comprehensive, accurate** and **timely** picture of consolidated public finances
 - ❖ All levels of Government (center, provinces, districts)
 - ❖ State-owned enterprises (SOEs)
 - ❖ Other entities with an implicit public guarantee (BLUs, PPPs)
- ◆ Consistency in applying acceptable accounting standards is required to ensure **accuracy and comparability** of fiscal data across government entities and over time
- ◆ Comprehensiveness means that **fiscal targets** should cover the consolidated public sector, including state-owned enterprises, especially if they run chronic deficits

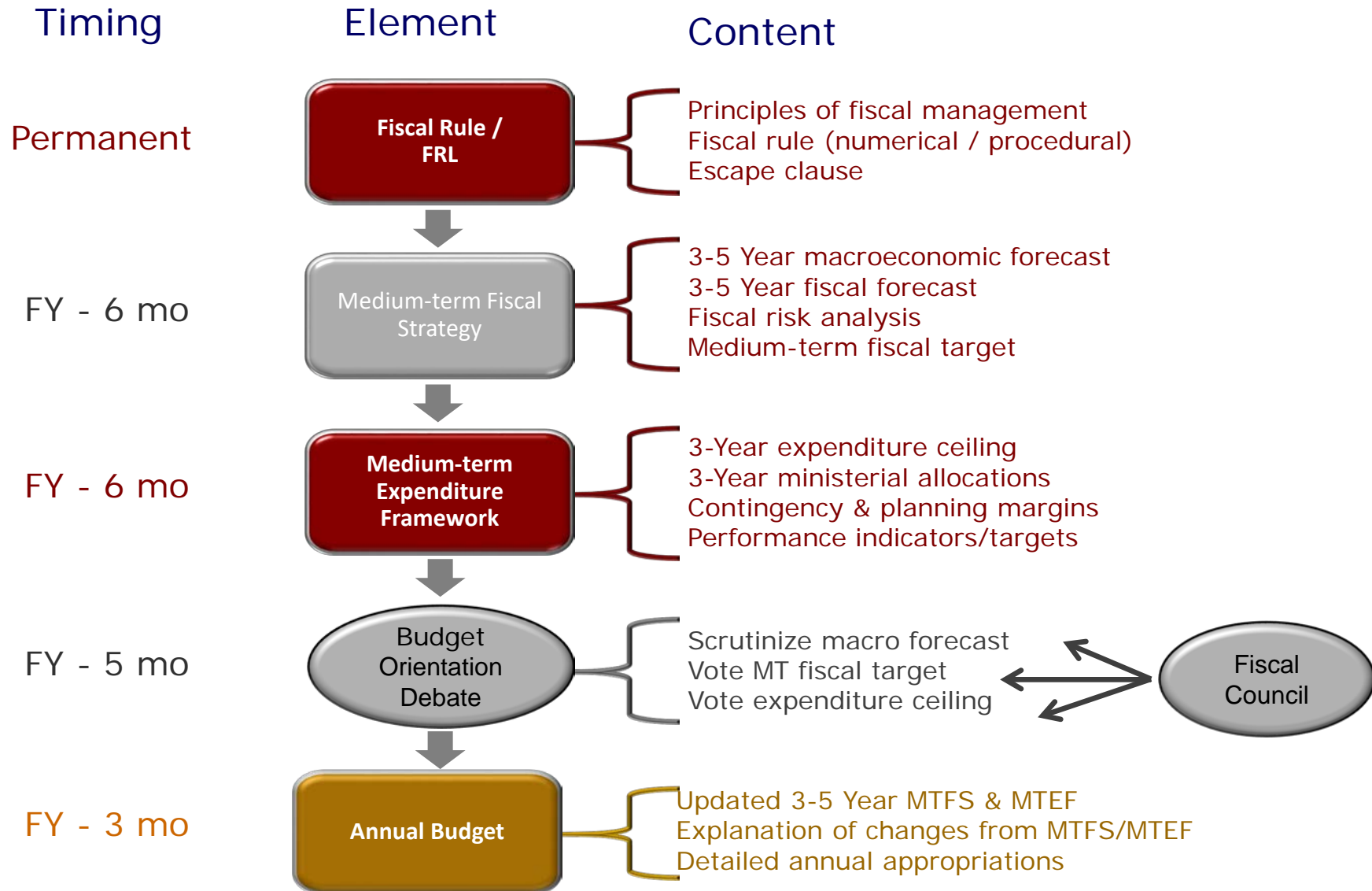
Comprehensive coverage and transparency are key features of effective fiscal rules (cont.)

- ◆ Comprehensive also requires that all **fiscal risks and contingent liabilities** need to be accounted and disclosed
 - ❖ Normally, only guarantees (explicit liabilities) systematically disclosed
 - ❖ But fiscal risks and contingent liabilities extend beyond explicit guarantees
 - ❖ The International Public Sector Accounting Standard (IPSAS) requires inclusion of the expected fiscal cost of a CL in government's financial statement, if it can be measured and its probability of realization exceeds 50%; disclosure in notes to the statement, if its probability is less than 50%, but "not remote"
- ◆ A lesson from the Chinese experience is that a high-level coordinating agency may be necessary to manage a target on the consolidated public sector
 - ❖ Alternatively, separate targets can be specified for the government (and states) and the PSUs

Fiscal rules can be strengthened when used in the context of a **medium-term expenditure framework**

- ◆ A medium-term *expenditure* framework (MTEF) is a tool to enforce fiscal discipline, ensure inter-temporal consistency of fiscal policies, and prioritize spending across sectors
- ◆ A MTEF typically includes:
 - ❖ A medium-term *fiscal* framework (MTFF), which are macroeconomic and fiscal estimates, informed by debt sustainability analysis for a (minimum) three year period (t+1, t+2, t+3)
 - ❖ Sectoral (agency-level) aggregate *budget ceilings* for years t+1, t+2, t+3, including allocations for recurrent and capital spending, issued in a budget circular early in the fiscal year
- ◆ Medium-term **expenditure ceilings** are a key disciplining mechanism in MTEFs
 - ❖ The ceilings draw from macro-fiscal projections and fiscal policies, where year t+1 is a hard budget constraint for agencies and years t+2 and t+3 (these are the outer-years) are indicative
 - ❖ The ceiling for year t+2 acts as the starting point for budget discussions that year. While adjustments are expected to be made to reflect the actual out-turns of year t+1 and new economic and fiscal forecasts, the earlier ceiling provides a benchmark
 - ❖ Ceilings can also be set conservatively and interpreted as a commitment (e.g. as in Australia) to spending agencies, although in most jurisdictions it is not legally binding
- ◆ MTEFs and fiscal rules are mutually-reinforcing tools of fiscal sustainability
 - ❖ Fiscal sustainability is ultimately about building the credibility of the Government's fiscal policy, in the sense that its trajectory is not *expected* (by market participants) to require disruptive adjustments; lack of credibility tends to precipitate disruptive adjustments as financing costs spike
 - ❖ Credibility is driven by (i) a track record of prudent policies, (ii) fiscal plans consistent with macro stability ...as well as (iii) communicating these plans to the markets
 - ❖ Both MTEFs and fiscal rules are tools that can contribute to these drivers and they reinforce each other by providing legal backing (via FRLs) to the expenditure ceilings (whether driven by a deficit or expenditure rule)

FRLs and MTEF: putting it together





A Framework for Fiscal Responsibility

Different flavors of fiscal targets

◆ Primary or overall fiscal balance

- ❖ does not respond to high debt levels, which may require temporary fiscal surplus to bring down debt levels fast enough
- ❖ may lead to pro-cyclical fiscal policy even when country has low debt and fiscal space to use fiscal policy to smooth out the cycle
- ❖ Can be manipulated by moving spending off-budget

◆ Cyclical balance

- ❖ Difficult to calculate (potential output, relation to expenditures and revenues, one-off factors to exclude)
- ❖ Often ends up being cyclical as well (potential output estimation can itself be cyclical)
- ❖ If calculation method is not tightly constrained by formula, this can be prone to manipulation (opinions on potential output differ)
 - EU uses full formulaic approach to define the minimum Medium Term Objectives (MTOs) for Member States, but the equations are very cumbersome.

◆ Expenditure

- ❖ Doesn't cover revenues, or by extension, debt
- ❖ Gives relatively less flexibility on how to meet target

◆ Debt

- ❖ If not comprehensive, can be manipulated by running up arrears or increasing guarantees
- ❖ Banking sector bail-out could lead to debt jump, which would require drastic fiscal consolidation to meet debt target
 - In practice, such shocks could lead the debt target to be ignored for a prolonged period of time, undermining its credibility and relevance

◆ Many combinations possible – and often desirable

- ❖ Fiscal balance plus debt
- ❖ Expenditure plus debt
- ❖ Debt is used as the medium-term anchor, which is to be achieved through short-term targets on fiscal balances or expenditures

Which target and institutional framework to achieve the proper balance of ‘flexible rigidity’?

- ◆ Ideal rule: short-term fiscal flexibility and medium-term fiscal discipline

Goals of fiscal policy rules		Medium-term fiscal discipline	
		Yes	No
Short-term fiscal flexibility	Yes	Ideal fiscal framework	Counter-cyclical but anchorless fiscal framework
	No	Overly rigid, pro-cyclical fiscal framework	Poor fiscal framework, policy drift

Source: Annet and Jaeger (2004).

Navigating the Rigidity vs. Flexibility Trade-offs

- ◆ Some level of rigidity is required to achieve medium-term fiscal discipline, which:
 - ❖ reduces uncertainties about the Government's future borrowing and fiscal adjustment path, thus reducing risk perceptions and financing costs throughout the economy
 - ❖ forces greater prioritization (and thus effectiveness) of expenditures
- ◆ Excessive rigidity will have different negative implications according to country characteristics:
 - ❖ In countries subject to regular business cycles, rigid rules prevent Governments from engaging in counter-cyclical fiscal policies to stabilize aggregate demand and bring the economy back to potential
 - ❖ In countries where a significant share of revenues (and overall economic activity) is linked to the performance of certain commodities, rules that do not adapt to changes in commodity prices will amplify the volatility of commodity prices in the economy, in detriment of macroeconomic stability
 - ❖ To the extent rules are observed and cuts are needed, public investment tends to be the first to be cut, which may slow down growth and contribute negatively to inter-temporal solvency
- ◆ Excessive rigidity also increases the temptation to circumvent rules, thus undermining the medium-term fiscal discipline objective

Paths to flexibility: Exclusions from Coverage

- ◆ **Capital expenditures:** this is the most common exclusion from fiscal rules; for example, India has an effective revenue balance rule that excludes capital grants from its revenue balance rule. Croatia, Ecuador, Peru and Japan are other examples of countries that exclude capital expenditures from their fiscal rules.
 - ❖ The concern with this type of exclusion is the disconnect between the capital expenditure and the associated recurrent expenditures: it can be as costly to run a hospital for a year than to build it
 - ❖ In addition, marginal capital expenditures will only be growth-enhancing if there is matching capacity for implementation of infrastructure investments
- ◆ **Interest payments:** Finland, France, Japan and Brazil exclude interest payments by focusing on the primary balance. The focus on primary balance is less about providing flexibility (since if anything it declines during recessions when monetary policy is relaxed) but more about having a target that links more directly with debt sustainability
- ◆ **Cyclically-sensitive expenditures:** Finland, Poland and the US exclude ‘automatic stabilizers’ such as unemployment insurance from the fiscal targets. The rationale is sensible since these are by design expenditures that increase during economic downturns. However, the risks are that many types of expenditures get reclassified as ‘cyclically-sensitive.’
- ◆ **Security-related expenditures:** Peru and Israel are examples of countries that exclude security expenditures
- ◆ While exclusions from coverage can serve legitimate objectives, they carry a substantial risk of reducing transparency and create incentives for ‘creative accounting’

Other Paths to flexibility

- ◆ **Cyclically-adjusted balances:** Many countries, especially those with high dependence on natural resource revenues, have fiscal rules around a cyclically-adjusted (or structural) fiscal balance, which would be counter-cyclical by nature
 - ❖ Structural/cyclically-adjusted balance rules are dependent on the reliable estimation of economic cycles, a challenging task even in the absence of manipulation and in countries with high capacity
- ◆ **Escape clauses:** Many countries allow exemptions from compliance with the fiscal rules in cases of economic downturns and natural disasters
 - ❖ Escape clauses need to be well-specified in order to avoid undermining commitment to medium-term fiscal sustainability

	Natural disaster	Recession	Banking system bailout, guarantee	Change in Government	Change in budget coverage	Other events outside control
Brazil	x	x				
Colombia		x				x
Jamaica	x	x				x
Mauritius	x	x				x
Mexico		x				
Panama	x	x				x
Peru	x	x				x
Romania		x		x	x	x
Slovakia	x	x	x			x

- ◆ **Role of fiscal councils:** Fiscal councils are independent bodies that help increase the credibility of flexible fiscal rules by vetting projections and agreeing on the occurrence of events that lead to escape clauses



Fiscal Rules in a Federal Structure

Application of fiscal rules to subnationals

- ◆ In a federal country, fiscal rules are required to address the ‘common pool’ or ‘soft budget constraint’ problem whereby states expect the center will prevent them from becoming insolvent
- ◆ Many subnational fiscal rules include numerical ceilings on a variety of fiscal indicators of the subnational entity
 - ❖ Peru restricts the debt stock at 100 percent and debt service at 25 percent of current revenues for each subnational government
 - ❖ In Brazil, there are 7 fiscal targets rolling over for 3 years, including: primary surplus, debt, personnel expenditures and own revenue collection
 - ❖ In Colombia and India, current expenditures cannot exceed current revenues (zero revenue balance)
- ◆ Numerical rules are primarily enforceable through restrictions on the state’s ability to acquire liabilities (borrowing regimes)

A range of borrowing regimes

Borrowing regime	Definition
Prohibited	No subnational borrowing is allowed.
Administrative	Central government direct control over sub-national borrowing decisions.
Centrally imposed rules	Use indicators and rules as constraints on choices by sub-national governments in order to guarantee desirable fiscal outcomes.
Cooperative	Borrowing controls are designed through negotiation/consensus between central and lower levels of government.
Self-imposed rules	Rules and constraints based on local jurisdictional laws and regulations.
Market Discipline	Financial markets regulate the behavior of borrowers and lenders through interest rates.

Key tradeoffs of different borrowing regimes

- ◆ More restrictive borrowing regimes place the burden of raising financing on the central government, curtail local government fiscal autonomy, and may also lead to the higher incentives for the proliferation of non-debt liabilities
- ◆ More liberal borrowing regimes require a credible commitment by the center to avoiding bailouts, which is usually not politically sustainable
- ◆ A second pre-requisite for a borrowing regime that relies on market enforcement is the presence of a well-established insolvency regime for subnationals
 - ❖ Best known example is Chapter 9 in the US, which deals with the bankruptcy of local governments; few other well-functioning examples globally

A balanced approach to fiscal discipline

- ◆ The ‘ideal’ rule provides a degree of fiscal autonomy (thus allowing subnationals to borrow) and strikes a balance between market and central controls on the amount or conditions for borrowing
- ◆ Central controls are prevalent, especially in developing countries
 - ❖ Indonesia, where local governments were essentially prevented from borrowing, is developing a subnational borrowing regime to allow provinces to borrow
 - ❖ Brazil implemented tighter restrictions on borrowing by states, which previously were able to borrow from the center and from banks they controlled
 - ❖ In India, states must obtain central permission for market borrowings
- ◆ But mechanisms for credit differentiation of subnational entities can provide an important supplement to administrative controls
 - ❖ Colombia and Mexico are moving to systems with a creditworthiness rating system that influences the costs of subnational borrowing directly, as well as the price of sovereign guarantees, thus creating a role for market enforcement
 - ❖ Credit differentiation in the markets requires a move towards developing an insolvency framework for subnationals
 - ❖ Fiscal transparency and independent (private) credit ratings are also critical

Non-debt liabilities

Fiscal discipline, including at the sub-national level, requires monitoring the creation of **non-debt liabilities**, often described as contingent liabilities or off-balance sheet transactions

I. Explicit contingent liabilities: guarantees

II. Infrastructure financing mechanisms

- ◆ Loss-making public enterprises
- ◆ **Land and other asset sales**
- ◆ **BLUs/PPPs**

III. Other liabilities

- ◆ Pension liabilities
- ◆ Litigation
- ◆ Deficit financing through arrears

Land transactions for infrastructure financing

- ◆ Land transactions in the past few years in cities such as Cairo, Cape Town, Istanbul, and Mumbai have generated revenues much greater than the prior annual capital spending of the city.
 - ❖ In Malaysia, states generate most revenues through land transactions
- ◆ However, land transactions also pose significant fiscal risks
 - ❖ Unlike the regulations on direct borrowing, there is a general lack of regulatory frameworks for managing fiscal risks from land financing in many developing countries.
 - ❖ Revenues from the sale of land assets exert a much more volatile trend and could create an incentive to appropriate auction proceeds for financing operating budgets, particularly at a time of budget shortfalls during economic downturns.
 - ❖ Land sales often involve less transparency than borrowing. When sales are conducted off-budget, it is easier to divert proceeds into operating (noncapital) budgets.
 - ❖ Transactions by different development agencies and public entities may be ad hoc without a coherent city- and region-wide medium-term capital investment framework.
 - ❖ Bank loans for financing infrastructure are often backed by land collateral and expected future land-value appreciation. This can lead to excessive borrowing, and the volatility of land and real estate markets can create risk of nonperforming loans, which, in turn, can create contingent liabilities and macroeconomic risks for national governments.

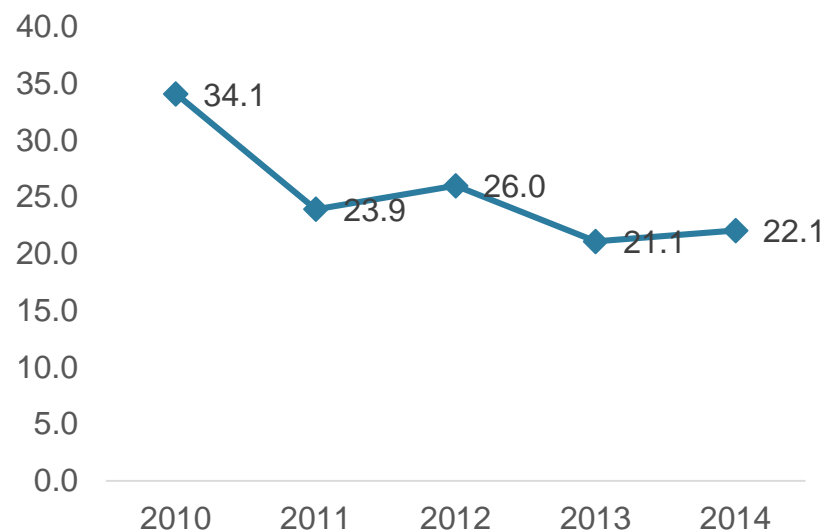
Land transactions for infrastructure financing (cont.)

- ◆ It is critical to develop ex ante prudential rules, comparable to those governing borrowing, to reduce fiscal risks and contingent liabilities associated with land financing of infrastructure.
- ◆ Key guiding principles would include
 - ❖ asset sale proceeds must be used to finance investment, with exceptions given only for key, one-time institutional reforms;
 - ❖ collateral-to-loan ratios linked to prudential banking regulations;
 - ❖ linking of land financing with medium-term fiscal framework and capital budgeting;
 - ❖ All information on public land inventories, public land valuations, land sales, and land contributions to public-private joint ventures or subsidiaries to be conducted through standardized instruments, be reflected in the budget or its annexes and financial statements

China's Subnational Fiscal Framework: Before the Budget Reform

- ◆ China's subnational governments could generally not borrow on budget
- ◆ Strong incentives on local officials to achieve GDP growth targets
- ◆ Local Governments set up off-budget Urban Development Investment Corporations (UDICs) to secure debt-financing for large-scale public investment

Growth of total UDIC liabilities (%)



Source: Wind Database & WB calculations

China's Subnational Fiscal Framework: The Budget Reform

- ◆ Budget reform of 2014:
 - ❖ On-budget borrowing allocations for subnational governments (but with strict quotas)
 - ❖ UDIC financing for new public investment projects prohibited
 - ❖ Existing UDIC liabilities linked to public investment swapped for government bonds at lower interest rates
 - ❖ National audit to stock-take contingent liabilities
- ◆ Given concerns that the budget reform forces too abrupt fiscal tightening, clarifications were subsequently issued:
 - ❖ UDICs can continue financing on-going public investment projects
 - ❖ Public-Private Partnerships (PPPs) with explicit limited government liability encouraged
- ◆ Ongoing efforts to develop debt management framework in subnational governments, including sustainable medium-term fiscal strategy



Summary – Fiscal Rules and Public Investment Management

Summary thoughts on fiscal rules and public investment management

- ◆ The point of fiscal rules is to create commitment to fiscal adjustment...
- ◆ ...but fiscal adjustment episodes tend to be accompanied by large public investment cuts, contributing to the well-documented pro-cyclical bias in public capital expenditures
- ◆ Excluding investment (in all its forms) from fiscal rules may lead to creative accounting, underspending on maintenance, and the build-up of non-transparent liabilities
- ◆ Embedding the fiscal rule into a MTEF can help
 - ❖ MTEF can help prioritize expenditures across the cycle, protecting priority capital and asset maintenance expenditures
- ◆ Some flexibility may be warranted – but needs to be well-designed:
 - ❖ In countries with either no fiscal rule, or with a rigid fiscal rule, a fiscal consolidation of at least 2 percent of GDP is associated with a 9 percent cut in public investment, on average
 - ❖ In countries with flexible fiscal rules, the decline in public investment is less than 2 percent

Bottom-line: A fiscal rule needs to be part of the country's overarching development strategy

- ❖ The development strategy entails a medium-term vision of the role of central and local governments, based on
 - ❖ what priority infrastructure needs it has to meet;
 - ❖ what capacity the Government has to spend effectively in these areas; and
 - ❖ how much the Government can raise in revenues
- ❖ Increasingly, infrastructure gaps are with local governments, which have insufficient financial and operational capacity
- ❖ The quality and capacity for implementation of public investment program become key to the credibility of a more relaxed fiscal stance
- ❖ A **medium-term expenditure framework** can be useful in operationalizing the vision by helping prioritize expenditures and ensure fiscal policy remains on a sustainable path
- ❖ 'Ex-ante' flexibility in the sense that fiscal targets should take into account the needs and circumstances of a growing economy

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