Fiscal Discipline: From Theory to Practice

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Peruvian Fiscal Framework: 20 Years From the First Fiscal Rules

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CF Consejo Fiscal

Main theme

- We have learned a lot
  - Experience since the 1990s
  - Theory
- Disconnect practice/theory
  - Explains successes and failures
- Looking at both theory and experiments
  - Large literature, excellent IMF studies
  - What works, and why
  - What doesn't work, and why

Issue No.1 : What target?

- Many targets in use, including:
  - Budget deficit, annual or over 1 to 4 years
  - Cyclically adjusted deficit
  - Public spending
  - Public debt
- Two criteria:
  - Practice says: target must be:
    - Observable
    - Easily understandable
  - Theory says:
    - Discipline means debt is low enough in the long run
    - There must be just one target and one instrument

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  - Cyclically adjusted deficit — No
  - Public spending — No
  - Public debt — Yes
- Two criteria:
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- Many targets in use, including:
  - Budget deficit, ~~annual~~ or over ~~1 to 4 years~~ long run — No — Instrument
  - Cyclically adjusted deficit — No
  - Public spending — No
  - Public debt in the long run — Yes — Target
- Two criteria:
  - Practice says: target must be:
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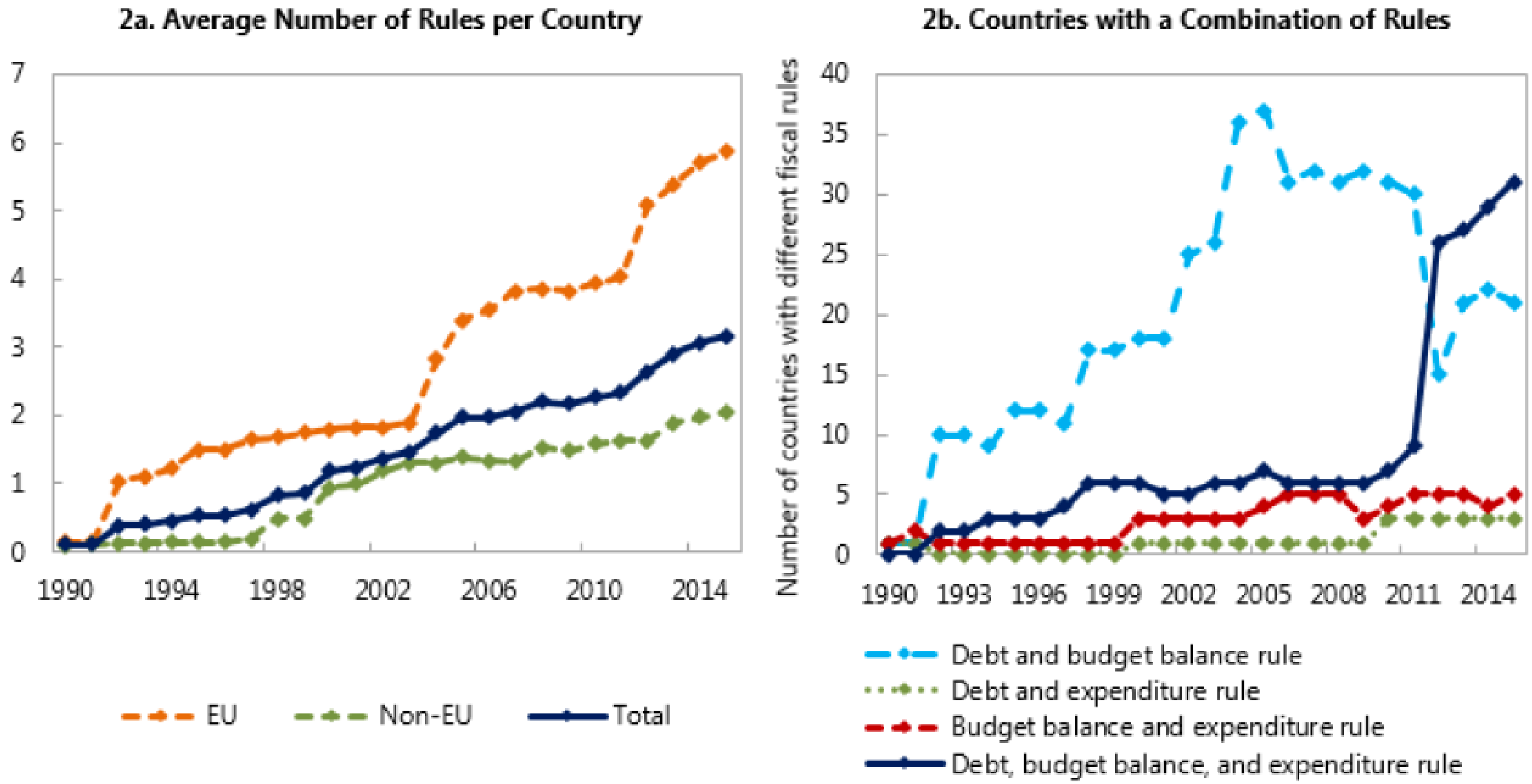
Tendency: more rules

Figure 2. The Multiplication of Fiscal Rules, 1990-2015



Source: IMF "Second Generation Fiscal Rules", 2018

Issue No.2: numerical rules and escape clauses

- Most rules include numerical target(s)
  - Based on assumptions and forecasts
  - But forecasts are rarely met, especially over many years
- What when surprises emerge?
  - Escape clauses
  - Change of rules
- Numerical rules hurt credibility
- Non-numerical rules work better
  - Provided they are well specified

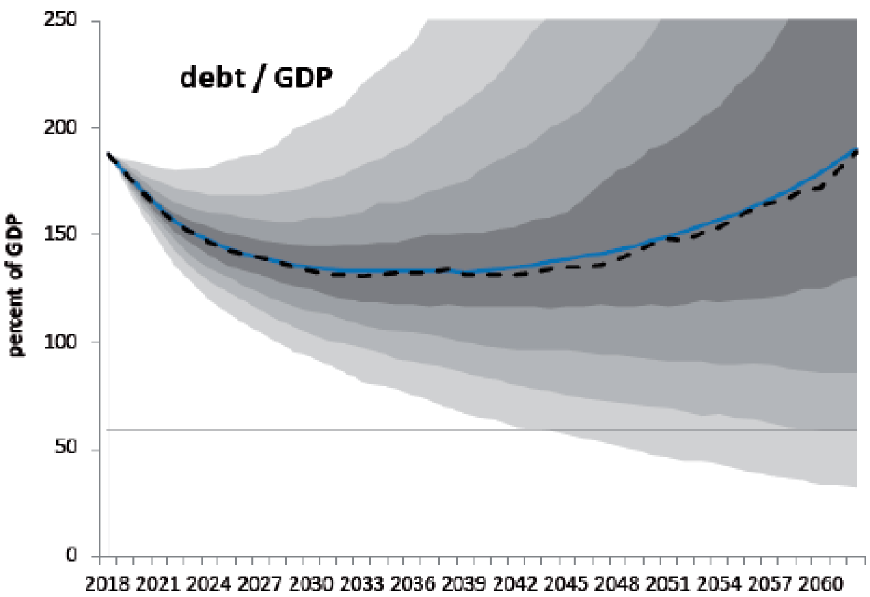
Issue No.2: numerical rules and escape clauses

- How to specify a non-numerical long-run debt rule?
- Target and instrument over long horizon
  - Explicit assumptions on interest rate and growth
  - Explicit assumptions on actual budget balance
  - Derivation of debt path**s**: the eyeball test
- Example 1: Greece
- Example 2. New Zealand and the concept of prudence

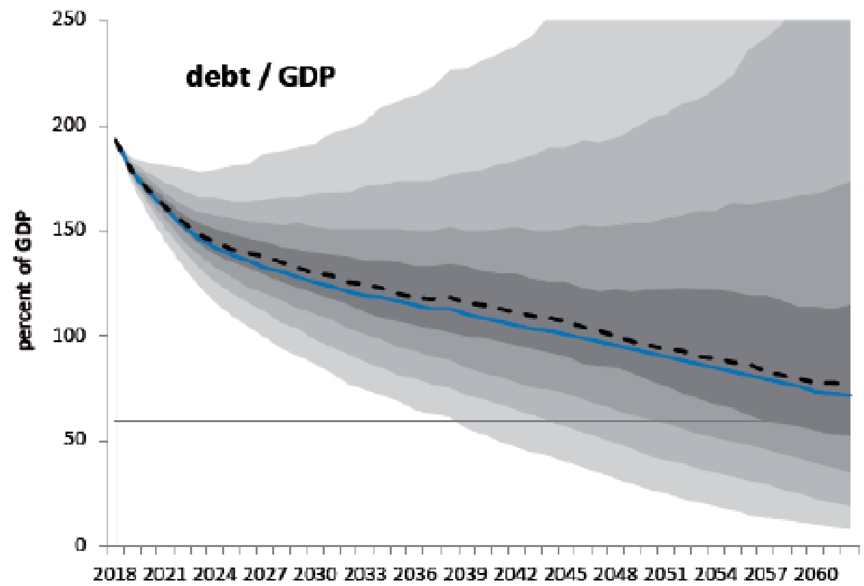
Eyeball test
Example 1: Greece

- Two scenarios

Scenario 1



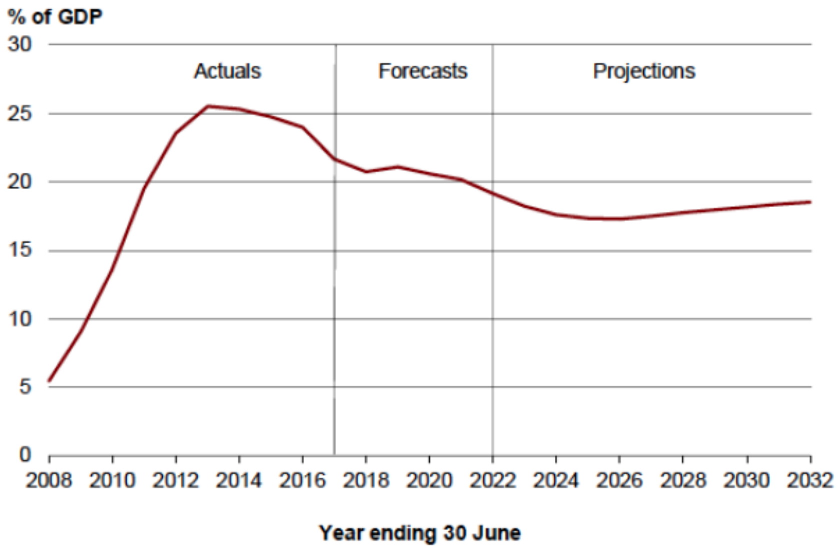
Scenario 2



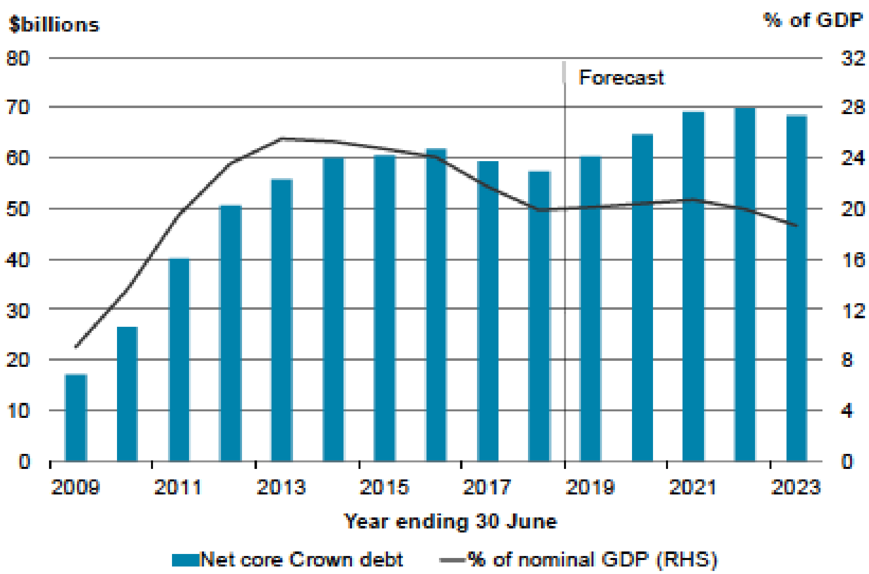
Source. Eichengreen et al., 2018

Note the fan, based on explicit assumptions

Eyeball test
Example 2: New Zealand



Source: *Fiscal Strategy Report* 2018, The Treasury



Source: *Update 2019*, The Treasury

No fan, but sensitivity analysis

Issue No.2: numerical rules and escape clauses

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- Target and instrument over long horizon
  - Explicit assumptions of interest rate and growth
  - Explicit assumptions on actual budget balance
  - Derivation of debt path**s**: the eyeball test
- Example 1: Greece
- Example 2. New Zealand and the concept of prudence
- Calls for professional judgment and independence
- Allows for flexibility (e.g. counter-cyclical policy)
  - A few years of deficit have small effects

Issue No.3: Primary resources

- Special case of flexibility
- Explicit assumptions for the long run
  - Prices and quantities
- Explicit assumptions about duration
- Rainy day funds can help, not strictly necessary
  - Saving for bad days or borrowing on bad days

Issue No.4: Fiscal Council

- Professional judgment is key
  - Assumptions and calculation
  - Evaluation of risks (forecast, shocks)
  - Judgment on “prudence”
  - Sufficient staff and data access
- Independence is also essential: institutional setup
  - The US model: CBO imbedded in parliament but independent
  - The NZ model: statutory independent Treasury
  - Many other possibilities

Conclusions

- Target and instrument
  - Discipline is a (very) long-run concept
  - Instrument is weak part
    - Budget outcomes not under direct control
    - No known solution, but small risk (bygones are not bygones)
- Independent councils
  - Resources
  - Institutional insertion