Fiscal Rules and Small States: A Brief Overview

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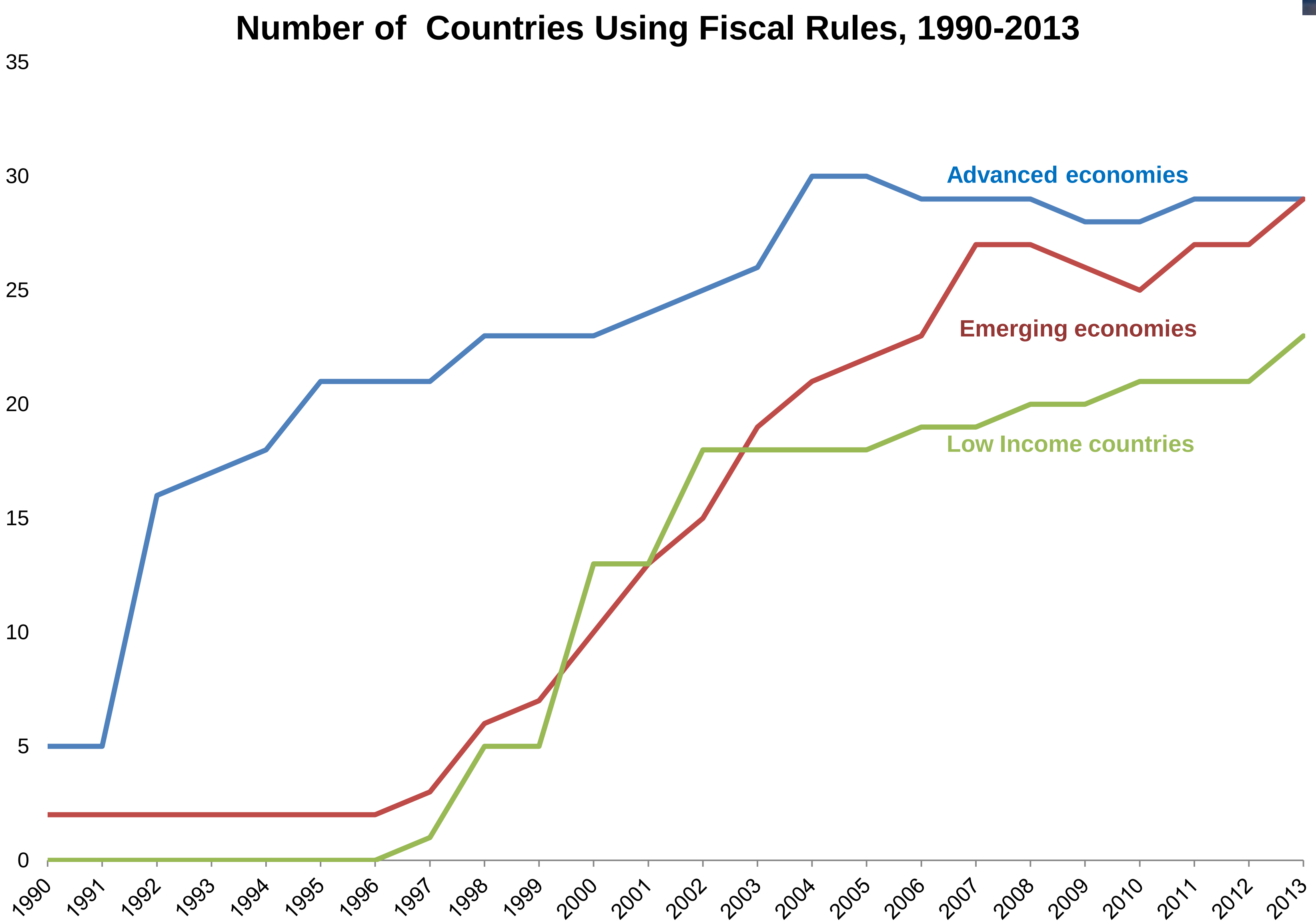
The growing use of fiscal rules



Source: FAD Fiscal Rules database.

What are fiscal rules and why use them?

- Definition:

A fiscal rule imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates.

- Purpose:

To contain pressures to overspend, so as to ensure fiscal responsibility and debt sustainability

Types of fiscal rules

DEBT RULES
Set an explicit limit on the stock of public debt

Examples:
Liberia, Poland: debt ceiling of 60 percent of GDP
Kosovo: debt ceiling of 40 percent of GDP

BUDGET BALANCE RULES
Constrain the size of the deficit and thereby control the evolution of the debt ratio

May account for the business cycle: structural budget balance rule

Examples:
Indonesia, Israel: overall deficit ceiling of 3 percent of GDP
Sweden: surplus of 1 percent of GDP over the cycle

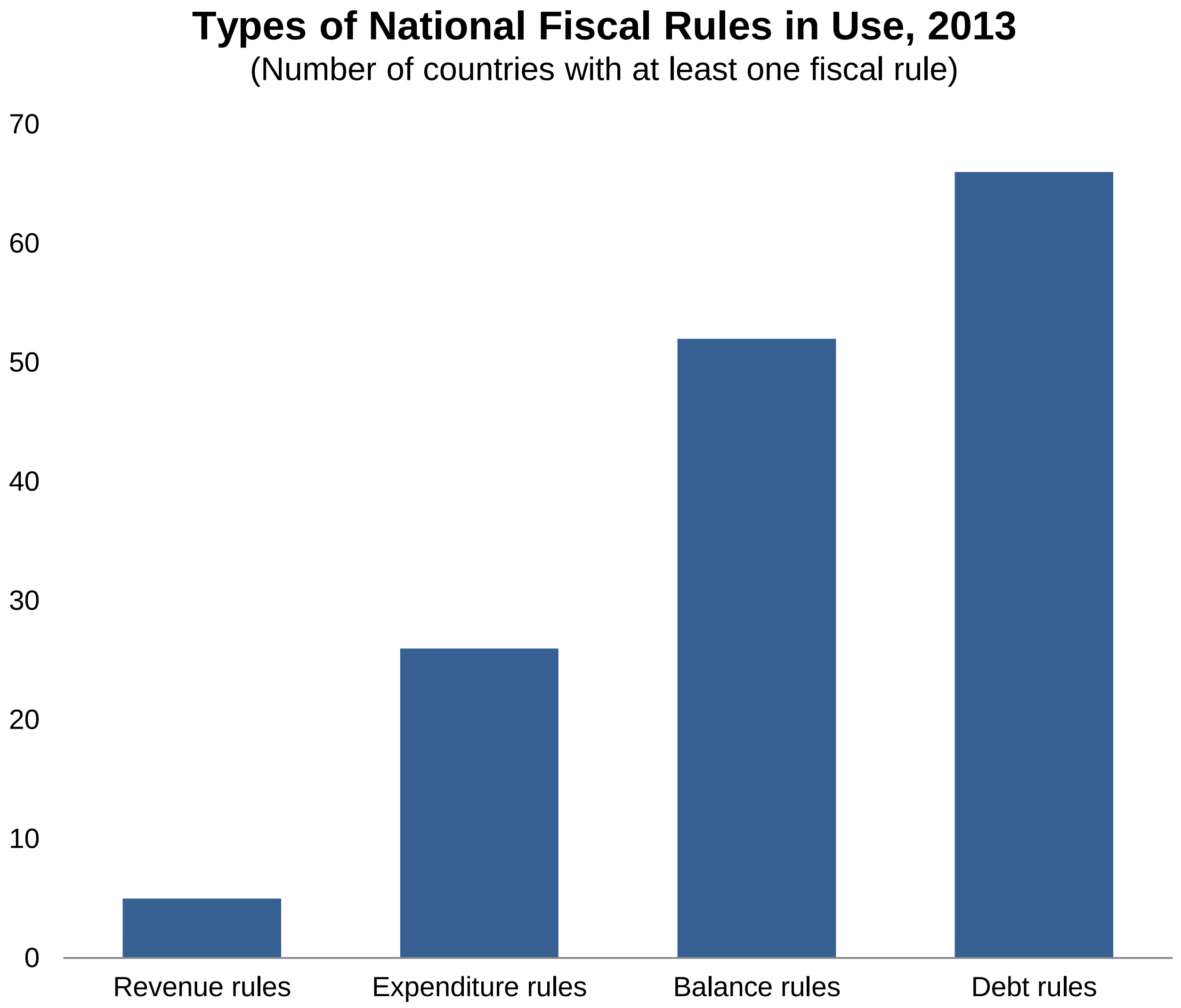
EXPENDITURE RULES
Limit total / primary / current spending, either by putting a ceiling on its growth, or on the relevant ratio to GDP.

Examples:
Namibia: public expenditure levels below 30 percent of GDP
Peru: real growth of current expenditure ceiling of 4 percent

REVENUE RULES
Set ceilings or floors on revenues, or determine use of windfall revenues

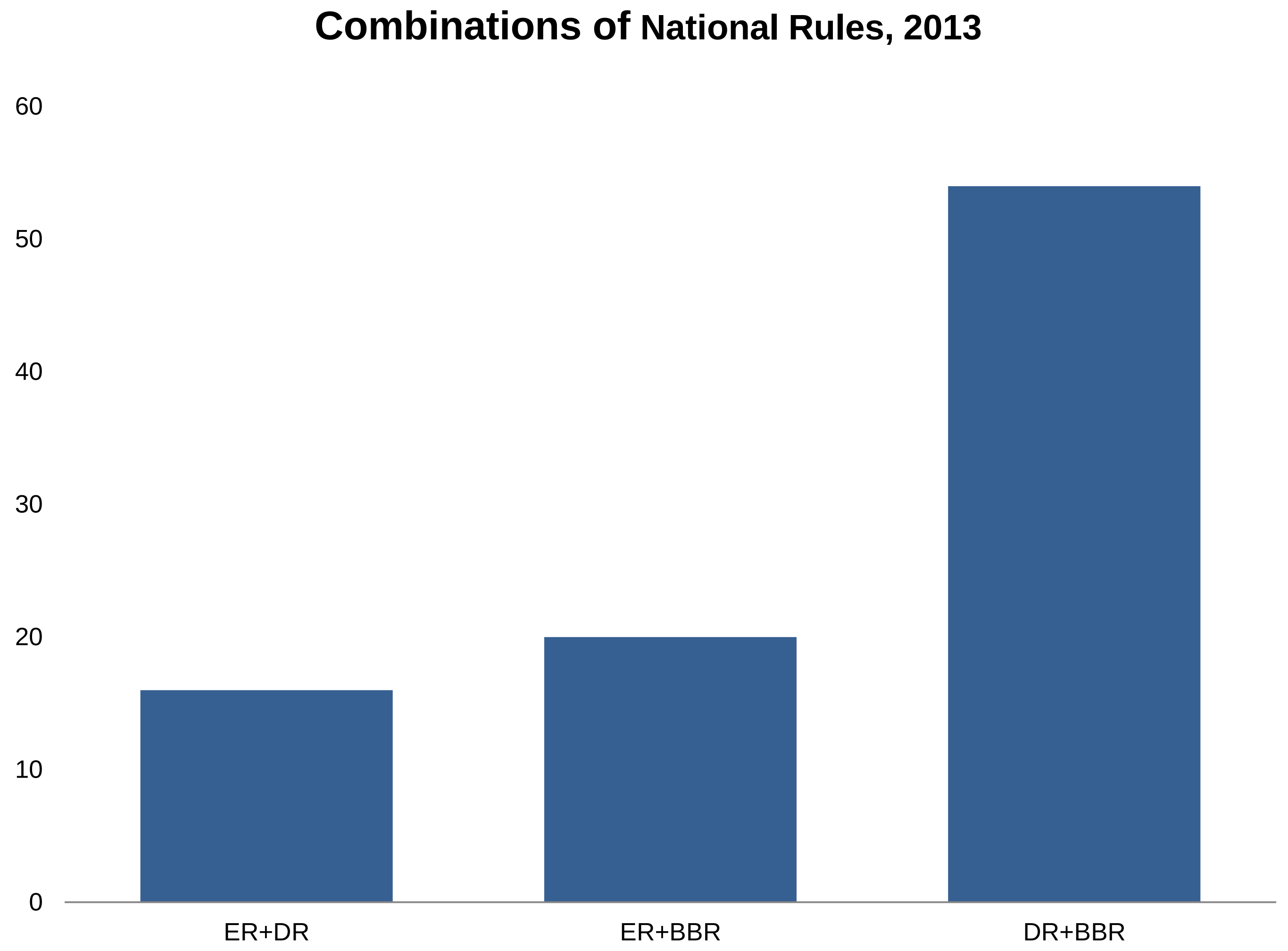
Examples:
Kenya: maintain revenues at 21-22 percent of GDP.
France: determine ex ante the allocation of higher than expected tax revenues.

Budget balance rules and debt rules are most frequently used…



Source: FAD Fiscal Rules database.

And often in combination



Source: FAD Fiscal Rules database.
Notes: Chart reflects fiscal rules in use in 2013 and number of countries with at least one fiscal rule.

Potential drawbacks

- Some rules may entail a pro-cyclical stance in bad economic times.
- With focus on aggregates rather than composition, quality of fiscal policy may suffer.
- Rules may distract from other priorities.
- Rules could encourage creative accounting and reduce transparency.

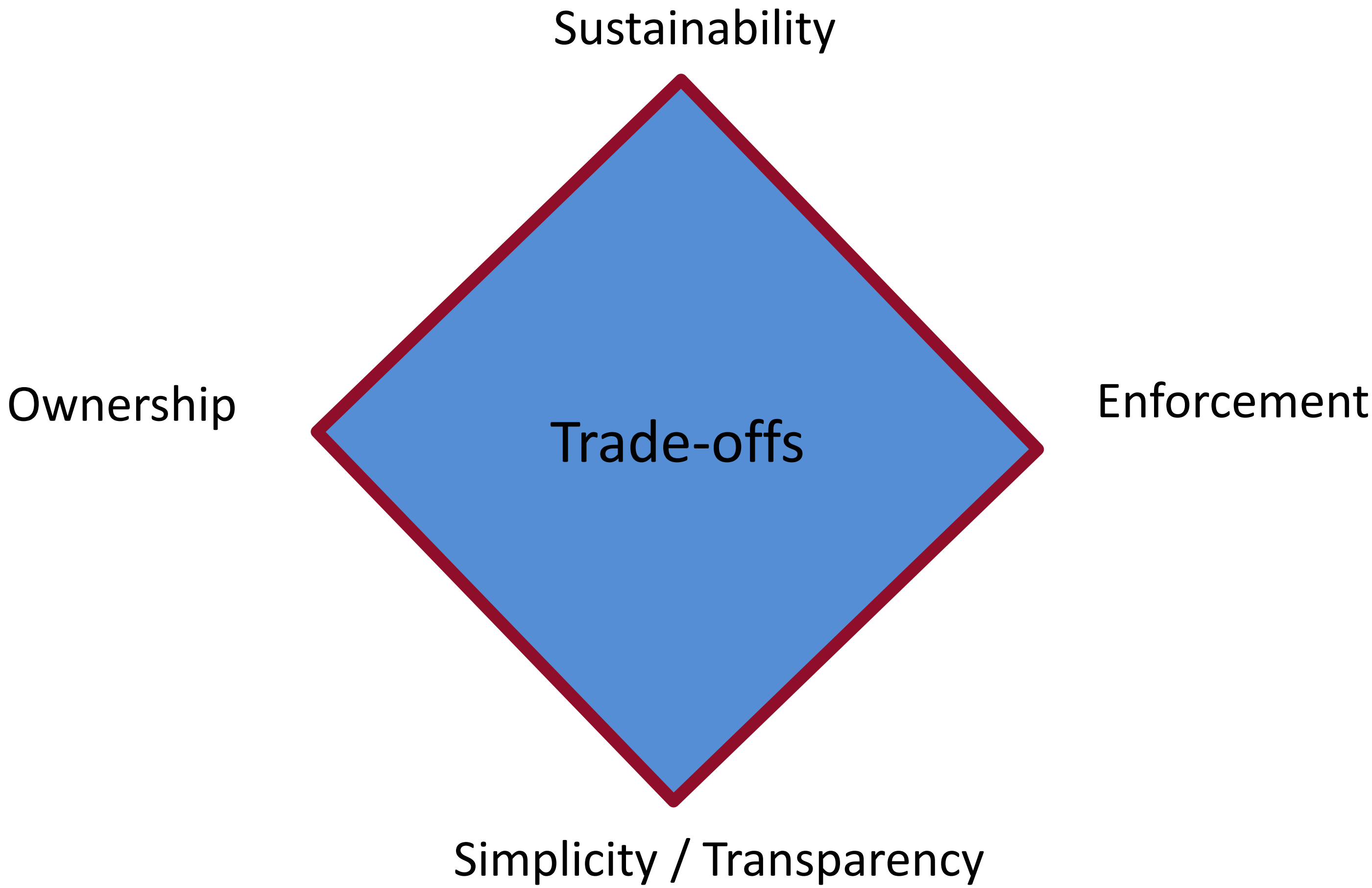
Mitigating the drawbacks: recent trends

- More countries are operating with more than one numerical fiscal rule. This helps to mitigate the cons of individual rules.

- More countries are adopting rules that provide flexibility to deal with the ups and downs of the business cycle.

- More countries are strengthening enforcement mechanisms, including through the use of automatic correction mechanisms (debt brakes).

The trade offs of fiscal rules



Preconditions

- Political commitment: lack of commitment may undermine credibility.
- Adequate public financial management systems (data reliability, budget reporting systems, internal and external audit systems, public release of data).

References

- Budina and others, *Fiscal Rules at a Glance: Country Details from a New Dataset*, IMF Working Paper 12/273.
- Schaechter and others, *Fiscal Rules in Response to the Crisis. Toward the "Next Generation" Rules*, IMF Working Paper 12/187, July 2012.
- International Monetary Fund, *Fiscal Rules: Anchoring Expectations for Sustainable Public Finances*, 2009.