RESEARCH INSIGHTS

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Can the Design of Fiscal Rules Help to Protect Productive Public Investment from Budget Cuts?

Flexible fiscal rules include mechanisms to accommodate unexpected / exogenous shocks.

In countries without fiscal rules, or with rigid rules (i.e., rules without flexible features), public investment falls sharply during fiscal consolidation episodes—by as much as 10 percent on average.

The negative impact of fiscal consolidations on public investment disappears in countries using flexible fiscal rules

CONTEXT

When countries must slash budget deficits, they tend to cut capital expenditure (public investment) relatively more than current expenditure (government consumption), as reducing the former is more politically palatable. As a result, public investment in Latin America and the Caribbean has lost more than 10 percent in primary budget share since 1980.

This bias is problematic from an economic welfare standpoint, as public investment can enhance growth: its fiscal multipliers are usually higher than those of current expenditures. Moreover, low public investment can have negative and regressive distributional effects, as lower-income households are made to pay for more expensive services.

Key Concept

FISCAL RULE

Imposes a constraint on fiscal policy through numerical limits on budgetary aggregates, such as limits on the fiscal deficit.

THE PROJECT

While fiscal rules have been shown to improve fiscal sustainability, they have also been criticized for unintendedly encouraging fiscal procyclicality and public investment compression, because pressure to comply with aggregate targets provides incentives to cut spending items that may have long-term payoffs. In response to these concerns, countries have been incorporating flexible features into their fiscal frameworks. Specifically, those features consist of cyclically-adjusted fiscal targets, well-defined escape clauses to address unanticipated shocks, and rules that exclude capital expenditures from numerical targets. This paper documents that flexibility mechanisms effectively safeguard public investment from budget cuts during fiscal consolidations, thus reducing the procyclicality of public investment.

RESULTS

The empirical exercises are undertaken using a sample of 75 advanced and developing countries during 1990-2018. Results show that in countries without flexible fiscal rules (both countries without fiscal rules and those with rigid fiscal rules), a fiscal consolidation episode equivalent to at least 2 percent of GDP is associated with an average 10 percent reduction in public investment. On the other hand, in countries where the fiscal rule includes flexibility features, the ensuing decline in investment is less than 2 percent, and not statistically significant. The results are robust to a battery of sensitivity analyses and hold after controlling for potential endogeneity in the estimations.

How do these flexible features help in protecting public investment from budget cuts? Investment-friendly provisions do so directly, because investment is largely exempted from the rule, thus promoting public investment growth during booms and protecting capital spending from excessive cuts during busts or fiscal adjustment episodes. Cyclically-adjusted balance rules and the inclusion of escape clauses contribute indirectly to the protection of public investment through different channels. Fiscal rules in which targets are defined in cyclically-adjusted terms allow policymakers to delink public spending (and thus, investment) from cyclical shocks, avoiding boom-bust cycles in fiscal policy in general, thus reducing the need to over-compress investment during bad times in particular. The inclusion of well-defined escape clauses in fiscal rules contributes to enhancing the reaction of fiscal policy to unexpected shocks by allowing temporary deviations from the rules' targets. Those clauses give policymakers room to implement discretionary fiscal stimulus in response to shocks. Public investment is the quintessential example of such a countercyclical response. Thus, while achieving compliance with a rigid rule may require the compression of public investment during downturns, the activation of an escape clause could actually stimulate it.

Key Concept

FISCAL CONSOLIDATION

Is a policy move to reduce the fiscal deficit by increasing revenues, cutting government spending (public investment and / or current expenditures), or both.

POLICY IMPLICATIONS

Even before the coronavirus pandemic, there was growing concern about the decline in public investment, which, on average, had fallen below 1 per cent of GDP across emerging economies in 2019. After the pandemic recedes, many countries will likely need to undertake major fiscal consolidations as debt sustainability concerns increase. While fiscal adjustments may be inevitable, countries can implement mechanisms to dampen their negative welfare impacts. Several countries have already introduced fiscal rules, and others are considering them. The results in this paper suggest that including elements related to the protection of public investment in the design of these rules can add a growth-enhancing dimension to the fiscal sustainability concerns that have typically been the focus of fiscal rules in the past—provided capital spending is productive.

From an economic welfare perspective, this does not necessarily imply that governments should choose to preserve public investment under all circumstances. In fact, cutting public investment may be preferred to reducing other types of expenditures in some cases, such as the following:

1. when investment is inefficient or the productivity of public capital is low;
2. when maintaining or increasing current expenditures (such as targeted transfers) may be needed in response to an exogenous shock in which consumers are credit constrained;
3. in the aftermath of a period of over-investment in the economy; or
4. as a result of a policy decision to shift the provision of certain infrastructure services toward the private sector.

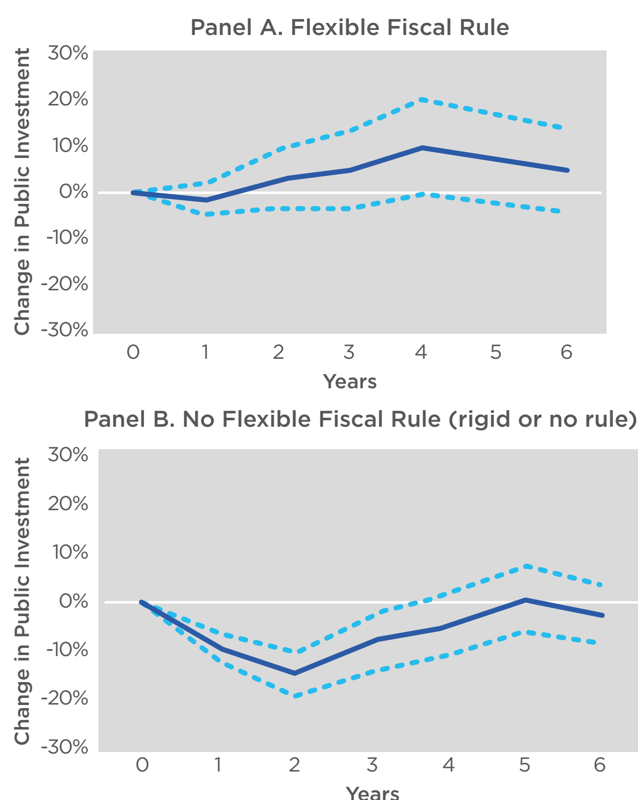
Flexible fiscal rules can nonetheless reduce incentives for policymakers to pursue disproportional cuts in public investment during fiscal adjustments that tend to reinforce the bias in spending composition, thus undermining long-term growth prospects. In other words, flexible mechanisms provide a safeguard to protect productive public investment in circumstances when it may not be necessary—or optimal—to reduce it.

Key Concept

FLEXIBLE FISCAL RULES

Include mechanisms that allow fiscal authorities to accommodate unexpected external shocks to the economy and protect public investment, a key component of growth.

Dynamic Effect of Having a Flexible Fiscal Rule



Source: Authors' compilation based on IMF-WEO and IMF Fiscal Rule Dataset.
Note: Marginal Effects with 90 percent confidence interval

IDB RESEARCH ON FISCAL RULES

This was a joint research project involving the Research Department (RES) and the Fiscal and Municipal Management (FMM) Departments of the IDB, in collaboration with researchers from the Economics Departments of Universidad Nacional de la Plata (UNLP) in Argentina.

FULL STUDY

Ardanaz, M., E. A. Cavallo, A. Izquierdo, and J. Puig. 2020. "Growth-friendly Fiscal Rules? Safeguarding Public Investment from Budget Cuts through Fiscal Rule Design."

Also forthcoming in the *Journal of International Money and Finance.*

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

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