RESEARCH INSIGHTS

How Can Policymakers Make Fiscal Rules More Effective?

- Despite the relative popularity of fiscal rules, they are *per se*, no panacea for improving fiscal performance.
- Fiscal rule effectiveness is enhanced when policymakers consider i) the quality of rule design; ii) supporting mechanisms to boost compliance and provide a forward-looking orientation to fiscal policy; iii) the impact of rules on different dimensions of public finances, such as the composition of public spending; and iv) clear, ex-ante guidance for the return to fiscal rule compliance after invoking an escape clause.
- There is ample space to improve rule-based fiscal frameworks in emerging markets.

CONTEXT

Fiscal rules, designed with the purpose of constraining policy discretion and, therefore, of strengthening debt sustainability, have become a widespread policy tool. While they began to gain traction in emerging markets in the 2000s, the surge in debt after the global financial crisis has accelerated fiscal rule adoption and prompted changes in their design. Not many of those rules, however, have succeeded in stabilizing public debt levels. Although the global recession associated with the COVID-19 pandemic triggered the suspension of rules, governments are seeing the postpandemic recovery as an opportunity to rethink and reform their rules-based fiscal frameworks.

Key Concept

FISCAL RULES

Set numerical limits on budgetary aggregates such as debt, deficits, revenues, and public expenditures.

PROJECT

This project draws on the empirical literature on fiscal rule effectiveness and on lessons from international experience to explore the functioning of fiscal rules in emerging markets. It offers stylized facts on the adoption and key design features of numerical fiscal rules, compares fiscal performance between rule adopters and non-adopters in terms of public debt accumulation, assesses the role of fiscal rule quality on debt outcomes (yearly average growth, accumulation in pp of GDP, and volatility), and finally discusses key challenges and reform opportunities to rules-based fiscal frameworks.

Key Concept

FISCAL COUNCILS

Are technical bodies with a mandate to evaluate a government's fiscal plans, policies, and performance. They assess government macroeconomic and budgetary forecasts and monitor compliance with fiscal rules.

RESULTS

Fiscal rule effectiveness is often hindered by several factors. The first of these is low-quality fiscal rules. Rules that do not meet high quality standards—such as broad institutional coverage, a sound legal basis, supporting monitoring arrangements, enforcement procedures, and flexibility mechanisms to respond to shocks—have not been successful in stabilizing debt-to-GDP ratios. Indeed, raising the quality of fiscal rules can be instrumental to achieve better debt outcomes. As shown in Figure 1, average debt-to-GDP yearly growth falls by more than 3 percentage points with high-quality fiscal rules, compared to low-quality fiscal rules. Similarly, the change in average debt falls by almost 1.4 points of GDP per year with high-quality rules. Moreover, volatility in debt-to-GDP growth rates falls under high-quality rules to one third of the volatility under low-quality rules.

Other more specific aspects of rule design can also undermine fiscal rule effectiveness. For example, fiscal rule targets are commonly defined in isolation from debt dynamics or sustainability concerns, instead of responding in pre-established ways to increasing risk of fiscal unsustainability. Moreover, when escape clauses are invoked in the face of negative shocks, the path towards compliance sometimes remains unclear, with no guidance on re-entry. This introduces additional uncertainty into debt markets.

A third problem involves low compliance and lack of forward guidance. Even well-designed rules will fail to improve fiscal outcomes if they are systematically violated. Overall, the evidence shows that deviations from fiscal targets are common across emerging markets. Moreover, tools aimed at providing a forward-looking orientation of fiscal policy usually present drawbacks. Overoptimism in macro-fiscal projections, for example, can undermine policy credibility.

Finally, policymakers frequently pay insufficient attention to the impact of rules on spending allocation. Fiscal rule compliance can have unintended consequences on public spending composition, since pressure to comply with aggregate numerical targets provides incentives to cut expenditures that typically don't have strong political support, despite their proven economic benefits, such as productive public investment.

POLICY IMPLICATIONS

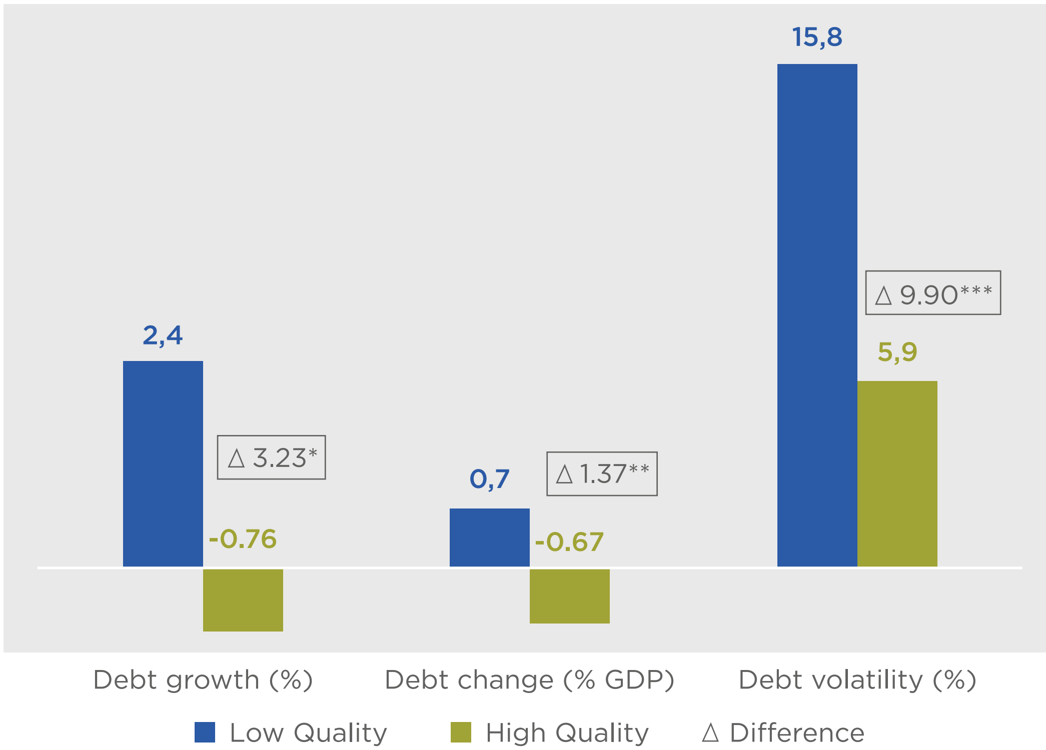
Fiscal rules on their own are not enough to stabilize debt-to-GDP ratios and ensure fiscal sustainability. Several additional features are necessary to improve fiscal rule effectiveness in emerging markets.

First, fiscal rule design should introduce debt anchors or set debt limits that allow the gradual build-up of fiscal buffers, as well as feedback mechanisms in operational rule targets that are consistent with those limits. Rule flexibility and/or limits to current spending, moreover, should be designed to protect public investment, adding a growth-enhancing dimension to existing sustainability concerns. Escape clauses should set clear paths of return to rule targets. The quality of fiscal rules should additionally be reinforced with adequate institutional coverage and sound monitoring and enforcement arrangements.

Compliance and forward guidance provide additional opportunities for improvement in fiscal rules. These include establishing fiscal councils with power to increase incentives for fiscal rule enforcement, both by impinging reputational costs on governments that deviate from the rule, and by having a say following periods of non-compliance on how the rule will be enforced. Fiscal rules can be further improved by strengthening the credibility of medium-term fiscal frameworks that provide "forward guidance" on how fiscal targets will be achieved in the future, thus contributing to anchoring expectations and providing a path for government reforms to promote compliance with the rule.

Fiscal rules are one component of a comprehensive fiscal framework, and hence their design cannot be improved in isolation from the quality of the overall policy framework. A well-designed fiscal policy framework should have a clear long-term objective, that is, an explicit anchor that guides fiscal policy, and a rule that orients policy towards that objective. Credible medium-term fiscal frameworks and independent fiscal councils are complementary fiscal institutions that, together with numerical rules, can support the goal of safeguarding fiscal sustainability.

Figure 1. Fiscal Rule Quality and Debt Performance (difference in means tests)



Note: The fiscal rule quality index varies between 0 and 1, with higher values indicating higher quality rules. Rules with index value lower than 0.33 (greater than 0.66) are considered low (high) quality rules. Asterisks denote statistically significant differences (* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$).

IDB RESEARCH ON FISCAL RULES

This is a joint research project involving the Research Department (RES) and the Fiscal Management (FMM) Division of the IDB. It is part of a broader research agenda at the Inter-American Development Bank on fiscal rules. Previous work has examined the effects of fiscal rules on debt performance, compliance behavior, and the role of rule design in protecting public investment during fiscal adjustments.

FULL STUDY

Ardanaz, Martín, Eduardo A. Cavallo, and Alejandro Izquierdo. 2023. "Fiscal Rules: Challenges and Reform Opportunities for Emerging Markets."

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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