Design Choices for Fiscal Policy Rules

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Outline

- What I’m *Not* Talking About
- A Better Fiscal Rule
- Outline for a Spending Rule
What I’m *Not* Talking About

- Not to argue for a fiscal rule, but…
- Not to say that principles aren’t better than rules—they are—but…
- Not to state that a bad rule is better than none, but…
- Not to say what the limits on spending should be, but…
- If a country needs a fiscal rule, spending rules are better.
Spending Rules Are Better—Summary

- Deficit-based rules are inherently pro-cyclical; spending rules are inherently counter-cyclical.
- The ability to successfully adjust a deficit-based rule for the cycle is unproven and at best only mitigates the pro-cyclical bias of the rule. Spending rules are inherently counter-cyclical.
- Spending rules work best in the good times, thus promoting compliance; deficit-based rules don’t bind in the good times and are very difficult to support in the bad times.
- Violations of a spending rules are transparent and incontrovertible; non-compliance with a deficit-based rule can be hidden.
<table>
<thead>
<tr>
<th>Fiscal Responsibility:</th>
<th>Deficit Rule</th>
<th>Cyclically Adjusted Deficit Rule</th>
<th>Spending Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expansion</td>
<td>Encourages larger deficit</td>
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<td>Requires that surplus be saved</td>
</tr>
<tr>
<td>Recession</td>
<td>May require a smaller deficit</td>
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<td>Allows deficit to grow</td>
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<tr>
<td><strong>Macroeconomic Stabilization:</strong></td>
<td></td>
<td></td>
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<td><strong>Administrability</strong></td>
<td>Verification more difficult</td>
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<td>Verification easier</td>
</tr>
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<td><strong>Credibility</strong></td>
<td>Status more contentious</td>
<td>Status more contentious</td>
<td>Status more transparent</td>
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<tr>
<td><strong>Public Investment</strong></td>
<td>Can be protected</td>
<td>Can be protected</td>
<td>Can be protected, possibly better than under deficit rules</td>
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<td><strong>Core Government Functions</strong></td>
<td>Volatile funding</td>
<td>Volatile funding</td>
<td>Predictable funding</td>
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<tr>
<td><strong>Monetary Policy</strong></td>
<td>Cooperation difficult</td>
<td>Cooperation difficult</td>
<td>Cooperation easier</td>
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Outline for a Spending Rule

- **Coverage**: annual spending limits + PAYGO for entitlements and taxes
- **Time Frame**: at least 3 years
- **Country Specific** [for multi-country monetary union rules]: start with deficit target and adjust current spending patterns by country to meet target
- **Enforcement**:
  - Warnings don’t work: laws do.
  - Statistics matter.
Final Observations

- Political commitment is paramount.
- Independent economic assumptions should be the starting point.
- Spending rules and deficit rules can’t coexist, but spending rules should be based on realistic deficit targets.
- No rule is forever, but longer term commitment is important.
- Transparency and simplicity matter.