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RETHINKING FISCAL RULES IN TIMES OF ECONOMIC UNCERTAINTIES

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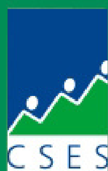

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Pinaki Chakraborty

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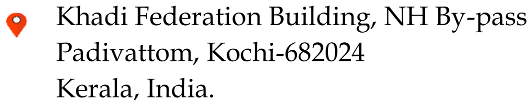

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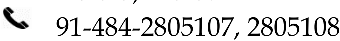

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Abstract

Increasing fiscal risks in the context of rising macroeconomic uncertainties have generated new discussions on the nature of fiscal rules to be adopted by countries. I argue in this paper that for post-COVID fiscal management, in the medium term, instead of a ceiling on fiscal deficit, a combination of expenditure and debt rule-with a threshold value of debt to GDP ratio could provide necessary fiscal space to the government without violating debt sustainability. However, operationalising such a rule would require a comprehensive and transparent measurement of public debt.

Keywords: public debt, fiscal rules, post-COVID, economic growth

About the author:

Professor Pinaki Chakraborty is currently the Vice-Chairman of the Institute of Development Studies, Jaipur. He is the former Director of the National Institute of Public Finance and Policy, New Delhi. Prior positions held by him include Chief-Social Policy, UNICEF - Kerala and Tamil Nadu; Member, Advisory Council to the Fifteenth Finance Commission of India; and Economic Adviser to the Fourteenth Finance Commission of India.

Rethinking Fiscal Rules in Times of Economic Uncertainties

Pinaki Chakraborty[*]

I. Introduction

Honourable Finance Minster of Kerala, Sri K. N. Balagopal, Honourable Vice Chancellor-Cochin University of Science and Technology, Professor K. N. Madhusoodanan, Professor, M. K. Sukumaran Nair, Honorary Director, Centre for Budget Studies-Cochin University of Science and Technology, Professor K. J. Joseph, Director, Gulati Institute of Finance and Taxation, Respected Mrs. George, and other members of the family of Dr. K. K. George, distinguished participants, friends and dear students, I am greatly honoured by the kind invitation to deliver the K. K. George Memorial lecture. I am grateful to Professor K. J. Joseph, Director, Gulati Institute of Finance and Taxation, Professor Nair, Honorary Director, Centre for Budget Studies, and Dr N. Ajith Kumar, Director, Centre for Socio-economic and Environmental Studies, Kochi, for giving me this opportunity to pay respect to Professor K. K. George. Today, we assembled here also to celebrate his life and his

[*] This is a revised version of Professor K. K. George Memorial Oration delivered at the Cochin University of Science and Technology in October 2022. Author may be reached at pinakicha@gmail.com.

legacy. He was a distinguished scholar and renowned economist with a deep understanding of Kerala's public finances and development policies. Professor George did a considerable amount of work on public finance and related policies at the sub-national level in India and on regional and inter-state disparities.

My introduction to applied public finance, particularly on sub-national finances, started with two very important contributions in the area of public finance by Professor George. The first is the book "Essays in Federal Financial Relations" written jointly by Professor I. S Gulati and Dr. K.K. George, and the second is the widely acclaimed book by Dr. George titled "*Limits to Kerala Model of Development*".

I met Professor George for the first time in CDS (Centre for Development Studies, Trivandrum) in 1994. During those days Professor George used to visit CDS regularly. I often met him in Dr. I. S. Gulati's office, sometimes in the CDS library or the CDS canteen. Those informal meetings were very rewarding for me. He gave me considerable time to discuss issues related to Union-State relations, State finances and decentralisation. Apart from the core public finance issues, as a practising banker, he had a nuanced view of the role of banking and finance in addressing regional disparities within the federal fiscal framework of India. He also had a great understanding of Kerala's public finances.

After I moved to Delhi in the year 2000, our association continued. We continued meeting in Delhi, at CDS and in various other places as and when opportunities came by. Over the last 25 years or so, whenever we met, we discussed wide-ranging issues, sometimes nothing very important but always very enriching. Whenever I met him, I always felt happy. He was affable and caring. He was unassuming, kind and extremely helpful.

All of us present here know that Professor George was the Chairman of the Centre for Socio-economic and Environmental Studies, Kochi. This Centre is doing very important work on social and environmental issues in the context of Kerala. I wish the Centre all success in its endeavour.

I have decided to speak today on the subject titled *Rethinking Fiscal Rules in Times of Economic Uncertainties*. Let me start with a quote from the book titled "Financial and Fiscal Policies: Crises and New Realities" by Y V Reddy, N. Valluri and Partha Roy (2014). In this book, while narrating the likely impact of the Global Financial Crises of 2008 on the word economy, authors mentioned, and I quote "Lord Keynes once said that it is worthwhile to be vaguely right than precisely wrong. This is particularly relevant when addressing evolving public policy issues in a rapidly changing global economic environment in the context of the global financial and economic crisis."

In this paper, I do not intend to do a rigorous quantification of economic uncertainties. I attempt to present before you what, in my view, is important for the management of fiscal risks in the context of rising macroeconomic uncertainties in comparison to economic trends we observed before COVID. The available options for macro policy in general and the role of fiscal policy and fiscal rules in particular are discussed in this paper. At the outset, let me also clarify that today's discussion is about the global economy and the reworking of fiscal rules to contain rising global public debt without limiting governments' ability to spend. In this paper, we will draw examples from India and other emerging market economies wherever necessary.

The paper has the following sections: Section II discusses the macroeconomic uncertainties, global growth slowdown and levels of debt and deficit across regions. In Section III, macro policy measures during economic shocks and uncertainties are discussed. Disruption and global rethinking on fiscal rules are discussed in Section IV. Section V highlights the emerging issues and concludes.

II. Macroeconomic Uncertainties

Let me start with the macroeconomic uncertainties. The global economy is facing four unprecedented challenges: (a) Growth slowdown in 2022 and 2023, (b) elevated levels of debt and deficit,

(c) rising cost of fuel and other intermediate commodities resulting in sharp rise in prices, and (d) serious disruption in supply chain due to the ongoing war between Russia and Ukraine resulting in a shortage of essentials like food and energy in some parts of the world. The fear of a prolonged global recession is looming large. Let me explain the magnitude of the problem using some data recently published by the IMF.

a. Growth Slowdown 2022 and 2023

According to the IMF's *World Economic Outlook, April 2022,* titled *War Sets Back The Global Recovery*[1], economic damage from the conflict will contribute to a significant slowdown in global growth in 2022 and add to inflation. According to the same IMF Report, "global growth is projected to slow from an estimated 6.1 percent in 2021 to 3.6 percent in 2022 and 2023. This is 0.8 and 0.2 percentage points lower for 2022 and 2023 than projected in January. Beyond 2023, global growth is forecast to decline to about 3.3 percent over the medium term."[2]

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[1] International Monetary Fund (2022): Global Economic Outlook,https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

[2] International Monetary Fund (2022): Global Economic Outlook,https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

"The baseline forecast is for growth to fall from 3.4 percent in 2022 to 2.8 percent in 2023 before settling at 3.0 percent in 2024. Advanced economies are expected to see an especially pronounced growth slowdown, from 2.7 percent in 2022 to 1.3 percent in 2023. In a plausible alternative scenario with further financial sector stress, global growth declines to about 2.5 percent in 2023, with advanced economy growth falling below 1 percent. Global headline inflation in the baseline is set to fall from 8.7 percent in 2022 to 7.0 percent in 2023 on the back of lower commodity prices, but underlying (core) inflation is likely to decline more slowly. Inflation's return to target is unlikely before 2025 in most cases."[3] As evident, compared to 2022, there has been a further downward revision of the growth outlook of the global economy for the year 2023.

Another important dimension of global growth is highly uneven post-COVID recovery across regions (See Table 1). A comparative understanding of post-COVID global growth recovery is presented in Table 1. As evident, during COVID, the global economy contracted by 3.27%, advanced economies contracted by 4.3% and emerging market economies contracted by 1.5%. Among the emerging market economies, China, grew at the rate of 2.2% in 2020 and at the rate of

[3] World Economic Outlook, April 2023: A Rocky Recovery (imf.org)

8.1% in 2021. Among major emerging market economies, the contraction in Mexico was highest-at the rate of 8%. The contraction in South Africa was 6.3%. The Indian economy contracted by -6.6% in 2020, followed by a recovery in 2021 at 8.7 per cent. According to the World Bank (2023), the Indian economy is expected to grow at around 6.5 % during 2022 to 2024. This rate is significantly higher than the world average. For the next two years, the expected growth differential between India and the rest of the World is 3.4 percentage points.

Table 1: The Real GDP Growth Rate: Cross Country View (% per annum)

Regions/Countries	2020	2021	2022e	2023f	2024f
World	-3.27	5.9	2.9	1.7	2.7
Advanced Economies	-4.3	5.3	2.5	0.5	1.6
Emerging Market and Developing Economies	-1.5	6.7	3.4	3.4	4.1
Brazil	-3.3	5.0	3.0	0.8	2.0
China	2.2	8.1	2.7	4.3	5.0
India	-6.6	8.7	6.9	6.6	6.1
Mexico	-8.0	4.7	2.6	0.9	2.3
South Africa	-6.3	4.9	1.9	1.4	1.8

Source: World Bank (2023): Global Economic Prospects. https://openknowledge.worldbank.org/bitstream/handle/10986/38030/GEP-January-2023.pdf
Note: 'e' and 'f' denote forecast and estimates respectively.

b. Levels of Debt and Deficit

Uneven growth recovery has implications for fiscal policy, revenue mobilisation and debt sustainability. The General Government debt to GDP ratio for the Advanced Economies for the year

2020 was hovering around 120 per cent of GDP. For the Emerging and Middle-Income Economies, the ratio was around 60 per cent. Though the global debt to GDP ratio stabilised during the fiscal year 2021, IMF Fiscal Monitor (2021) observed that "The pandemic will leave a lasting mark on government finances, inequality, poverty, and the level of GDP in many countries." It further noted that "(F)ollowing this one-time jump, debt in the coming years is expected to remain persistently higher than the levels projected before the pandemic—in advanced economies it is projected to be almost 20 percentage points higher through 2026…." These elevated levels of debt in both developed and developing economies need to be financed. How we finance this increasing debt servicing cost without reducing other essential expenditures, particularly on health, education and livelihood securities remains uncertain.

c. Rising Cost of Fuel and High Inflation

According to the same IMF report, "war-induced commodity price increases and broadening price pressures have led to 2022 inflation projections of 5.7 percent in advanced economies and 8.7 percent in emerging market and developing economies." Rising inflation is hitting the poorest regions of the world the most. Staple food prices in sub-Saharan Africa surged by an average 23.9 percent in 2020-22—the most since the 2008 global

financial crisis.[4] "A new paper by IMF staff estimates that the rising cost of food and fertilizer imports in countries highly exposed to food insecurity will add $9 billion to their balance of payments pressures in 2022-23. This will erode their international reserves and ability to pay for food imports.

III. Macro-Policy Measures During Economic Shocks and Uncertainties

In many countries, policymakers have introduced fiscal measures to protect people from the food crisis. Countries highly exposed to food insecurity, "will need as much as $7 billion this year alone to help the poorest households, according to staff estimates." Given that these economic vulnerabilities have arisen due to unusual events like COVID and war, conventional policy tools that are used to arrest downturn/ or cyclical movement of the economy may not be adequate. Policy tools itself has its own limitations in a situation like this. However, if we look at the sequence of events, we observe some common policy elements across countries. What are the commonalities featured in the global macro policy during COVID and is still continuing?

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[4] https://www.imf.org/en/Blogs/Articles/2022/09/26/africa-food-prices-are-soaring-amid-high-import-reliance

Commonality 1:

Countries across the world provided fiscal stimulus to deal with the crisis. Globally, the total support was estimated to be USD 17,000 billion, of which government guarantees accounted for more than USD 4000 billion- roughly one-fourth of the total. The downside fiscal risk of this cannot be ignored. If there is a large default, it can weaken the fiscal balance sheet in the medium term for items that are below the line at the moment and not reflected in the Budget.

Commonality 2:

Post-COVID, Central Banks are increasing interest rates to deal with rising inflation. This reflects that the monetary stance is fast moving to inflation management. An IMF blog by Adrian, T (2023) noted that "(T)he world's central banks have unleashed the steepest series of interest-rate increases in decades during their two-year drive to tame inflation—and they may not be done yet. Policymakers have raised rates by about 400 basis points on average in advanced economies since late 2021, and around 650 basis points in emerging market economies."

Commonality 3:

The increase in money supply has been significant and thus the current inflation is to a large extent policy induced especially in advanced

economies. What was the increase in money supply during the last two years to support the government to deal with COVID? The growth of the Central Bank's "Claims on Central Government" provides some idea of the additional increase in money supply due to the Government operation during COVID. Even if not a precise estimate, the data on "Claims on Central Government" reflects an increase in money supply due to the Central Bank support to the Government. It showed a sharp increase among major advanced economies during the year 2020. In the US, immediately after the Global Financial Crisis, in 2010, the growth of Central Bank support to the Government was 0.4 per cent. In the year 2020, this support increased to 9 per cent. It was above 9 per cent in the United Kingdom, 10.5 per cent in Brazil and 6 per cent in China.

Commonality 4:

Both domestic and external debt stock increased sharply during the pandemic. The International Debt Statistics published by the IMF for the year 2022 show that the external debt stock to the export ratio for 123 low- and middle-income countries increased from 101 per cent in 2018 to 123 per cent in 2020. The export to debt service ratio for these countries increased from 14 to 17 per cent during the same period. The share of public sector external debt in total external debt increased from 37 per cent to 39 per cent during this period.

IV. Disruption and Global Rethinking on Fiscal Rules

As discussed above, these are highly disruptive challenges for macroeconomic management. This increase in the debt to GDP ratio across countries resulted in a reassessment of the conventional wisdom on fiscal rule and the accumulation of public debt. In a recent paper, Ardanaz et. al. (2021) observed that in 75 advanced and emerging economies "with either no fiscal rule or with a rigid fiscal rule, a fiscal consolidation of at least 2 percent of GDP is associated with an average 10 percent reduction in public investment. Instead, in countries with flexible fiscal rules, the negative effect of fiscal adjustments on public investment vanishes, which implies that flexible rules protect public investment during consolidation episodes."

In the context of the European Union, Blanchard., O., et. al. (2021) made following observations:

"The European Union's fiscal rules have been suspended until at least the end of 2021. When they are reinstated, they will need to be modified, if only because of the high levels of debt. Proposals have been made—and more are to come— suggesting various changes and simplifications." The paper discusses "how one should think about debt sustainability in the current and likely future EU

economic environment." According to *Blanchard, O. et. al. (2021)*, "it is an illusion to think that EU fiscal rules can be simple. But it is also an illusion to think that they can ever be complex enough to accommodate most relevant contingencies. This leads us to propose the abandonment of fiscal rules in favor of fiscal standards, i.e., qualitative prescriptions that leave room for judgment together with a process to decide whether the standards are met. Central to this process would be country-specific assessments using stochastic debt sustainability analysis, led by national independent fiscal councils and/or the European Commission."

William G., Paulo M., (2021), argued that "The COVID-19 pandemic and the global economic contraction will put rule-based fiscal frameworks to the test. The severity of the shock will likely result in a temporary large deterioration in the fiscal deficit and public debt. Many countries are already activating escape clauses to deviate or suspend the fiscal rules. It will be important to ensure that the use of this flexibility is temporary and done transparently, including explaining the size of the deviation and process to return to the rule, to preserve the credibility of the fiscal framework."

Government of India's Economic Survey 2020-21 (2021) observed that "Amidst the COVID-19 crisis, fiscal policy has assumed enormous significance across the world. Naturally, the debate

around higher Government debt to support a fiscal expansion is accompanied by concerns about its implications for future growth, debt sustainability, sovereign ratings, and possible vulnerabilities on the external sector." The Survey further noted that "For India and other emerging market economies, which have consistently grown their GDP at high rates over the last few decades, the relationship between debt and growth exhibits a clear direction of causality: Higher growth lowers debt-to-GDP ratios but lower debt does not necessarily lead to higher growth."

A recent IMF Working Paper by Davoodi et. al, (2022) also observed that "The rules-based fiscal framework came under pressure during the COVID-19 pandemic, with countries using different ways to adapt their fiscal rules in response to the crisis, including activating the escape clauses, suspending the fiscal rules temporarily, and modifying the fiscal rule limits. In particular, the widespread activation of escape clauses showed how fiscal rules can have large flexibility during large shocks within a well-defined rules-based framework." Davoodi et. al, (2022) further noted that "(F)iscal councils have played an important role during the pandemic, including analyzing the COVID-19 impact, monitoring the use of escape clauses, and costing pandemic-related fiscal measures. Many fiscal councils stressed the need for transparency for

COVID-19 fiscal responses. In general, fiscal councils have risen to their mandates during the pandemic to provide fiscal oversight."[5]

Given this, rethinking about fiscal rules and the effectiveness of institutional structures like Fiscal Council in times of crisis has become an important issue. The IMF provides a comprehensive dataset on fiscal rules across countries. This data-set provides information on types of fiscal rule, year of implementation, number of rules, legal basis, coverage of rule by level of government, monitoring and enforcement procedure. This dataset also contains information related to institutional supporting features[6] and activation of escape clause and suspension of fiscal rules. We briefly discuss the operation of the Fiscal Councils across countries and the issues related to fiscal rules and their effectiveness during the crisis in subsequent sections.

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[5] Davoodi, R. H. (2022): Elger, P., Fotiou, A., Garcia-Macia, D., Han, X., Lagerborg, A. Raphael, W. L., and Medas, P., Fiscal Rules and Fiscal Councils Recent Trends and Performance during the COVID-19 Pandemic, International Monetary Fund, Working Paper No. WP/22/11 https://www.imf.org/en/Publications/WP/Issues/2022/01/21/Fiscal-Rules-and-Fiscal-Councils-512128

[6] Institutional features include information related to multi-year expenditure ceilings; fiscal responsibility laws; independent body providing budget assumptions; and independent body monitoring implementation.

a. Fiscal Councils

At the outset, it needs to be mentioned that globally there is no unanimous view on the usefulness of a Fiscal Council (Reddy and Chakraborty: 2023). In a recent book titled "Independent Fiscal Councils: Watchdogs or lapdogs?" Tessa Ogden (2018) observed that "(I)n modern democracies, decisions on government spending are typically influenced by citizens, through their role as the electorate. The recent emergence, therefore, of independent fiscal councils (IFCs), where unelected bodies of experts are given the power to oversee fiscal policy, is of considerable interest." Tessa Ogden (2018) further mentioned that "whether fiscal policy can take the same path that monetary policy did, two decades earlier, when it was devolved to independent central banks. Spending from the public purse is inherently a political decision, so the question surrounding IFCs is whether their role will be that of watchdog, directly exerting restraint on fiscal policy and freeing it from overly political control, or whether they inevitably become lapdogs to that same political control." In European Union, Fiscal Councils differ significantly from one Member State to another in terms of the breadth of their mandates, the size of their personnel and financial resources and their level of visibility in the public debate on fiscal issues (Jankovics, L and M. Sherwood: 2017)

As per the Fiscal Council data set published by the International Monetary Fund, there are 51 fiscal institutions identified as operational fiscal councils as of end 2021. Out of these 51 Councils, 41 have been constituted between 2007 and 2021 and 37 of them after the 2008 Global Financial Crisis (Reddy and Chakraborty: 2023).

b. Flexible Fiscal Rules and creation of fiscal space:

On the Fiscal Rules, there are several reasons for having flexibility. To me following three are critical:

a. Flexibility to create fiscal space
b. effectiveness
c. long run debt sustainability.

The flexibility in fiscal rule, among others, can have two very specific dimensions. One is increasing the borrowing limit itself. This would provide more resources to the government for making interventions necessary to deal with the macroeconomic challenges. This option is difficult to exercise given that already deficit and debt levels are high. In a macroeconomic scenario, when interest rates are increasing, an increase in deficit would mean more high-cost borrowing. Another option is flexibility in terms of time to adjust the level of deficit. Here the option is to bring down the debt and deficit level to sustainable levels over a specified

time period. This can vary depending on the country-specific levels of fiscal imbalance. Thus, the initial condition of debt and deficit would be important parameters in operationalising such rule.

The deficit rule is generally implemented with a fixed numerical target. When national budgets are based on cash flow accounting in most countries, fixed numerical limits on deficits can make adherence to such rules challenging during macroeconomic uncertainties. In the medium-term, to deal with the crisis and uncertainty, debt rule is probably a better option. It is more flexible than the deficit rule and may help in operationalising countercyclical fiscal measures without violating debt sustainability.

However, operationalising debt rule is not free of challenges. The most important challenge is that there is no comprehensive measure of public debt in most countries. This is primarily due to various off-budget risks emanating from guarantees and various other contingent liabilities of the government. These liabilities routinely add to the debt stock and this process is generally not transparent.

Secondly, the debt rule alone cannot put a cap on the deficit arising due to the increase in current expenditure of the government. Current expenditure can increase due to the increase in

committed expenditures like interest payments, pension, wages and salaries, subsidies and transfers. There is a need to have a control on deficit arising due to such expenditures of the government.

Third, the debt sustainability condition requires real GDP growth rate to be higher than the real interest rates on government borrowing and a declining or stable primary deficit. However, targeting primary deficit is not an effective measure to ensure the quality of expenditure. Thus, having an expenditure rule may be more effective in improving the quality of expenditure.

Thus, to overcome these challenges and to ensure fiscal sustainability, a combination of expenditure rule and reduction of debt to GDP ratio or the debt rule in the medium-term would be helpful as economies recover from the macroeconomic shock of the COVID-19 pandemic. Appropriate fiscal transparency and the most accurate measure of debt can help in taking the expenditure-debt rule as a prudent measure of fiscal consolidation in the medium-term. As the debt rule is more flexible, it should be considered over the cyclical to create fiscal space for more capital expenditure.

c. Effectiveness of Rules in Times of Crisis

The effectiveness argument emanates from the fact that a flexible fiscal rule targeting debt and

a part of the government expenditure, may help bring down the debt level without reducing the fiscal space for development spending. In this context, we also need to take a broader view of the current and capital expenditure. To give an example, physical asset creation and creation of human capital need not be based on the principles of substitution but based on the complementarity. We need a more nuanced view when we try to make a distinction between current and capital expenditure. The distinction between revenue and capital expenditure often appears artificial because of large complementarity between the two. In conclusion, when the global economy is recovering from the shock of the pandemic, a careful approach to fiscal expansion cannot be emphasised more. Rebalancing fiscal expenditure between redistribution and growth in a time like this is extremely challenging. The focus on public capital investment is an instrument of choice with an underlying assumption that it will create a virtuous circle of higher growth and larger development spending and revenue-led fiscal consolidation. If that does not happen, and pressure to increase current expenditure goes up, we may end up with a higher deficit, larger debt and reduced space for primary spending due to enhanced debt servicing costs.

V. Conclusions: Towards long-term debt sustainability

The long run debt sustainability should always be focused on growth recovery, interest rate, and the level of debt. The fiscal vulnerabilities need separate analysis when we talk about debt sustainability. To normalise, we need a clear assessment of the quantum of fiscal shock and the time required for readjustment.

The preceding discussion also shows that post-COVID fiscal consolidation is emerging as a major issue as countries deal with large deficits and debt, high inflation and uneven economic recovery. Though in the short run, necessary flexibility for the creation of fiscal space needs to be provided through higher borrowing, there is a need to return to a sustainable fiscal management for macro stability and growth when we take a medium-term view (Chakraborty: 2021). Though the economic shock in terms of GDP contraction due to the COVID-19 pandemic was reversed in the fiscal year 2021-22 for major advanced and emerging market economies, including India, a stable and sustained recovery is needed.

Finally, reduction of debt takes time; management of inflation cannot wait. Options are complex. Going forward, the global economy needs a coordinated policy for monetary tightening and

fiscal sustainability. There is a need to start fiscal normalisation without creating adverse distributional consequences. For this, countries need to chart out a fiscal normalisation plan to ensure that it is not abrupt and responses are sequenced in a manner that helps bring the economy back on track, enhance fiscal resources for the government for public investment in the social and economic sector and create a framework for sector-specific differentiated responses for a full recovery.

Finally, the money spent by low-income developing countries to deal with COVID-19 was far less than that of the advanced and emerging market economies, and most of this spending was on health and emergency response. Rising debt and inflation are only going to compound macro challenges for these countries. There is a need for a quick and efficient resolution of the challenges arising due to the elevated debt levels of low-income countries. One can hope for an equitable, fair and sustained recovery post-COVID only when there is greater international cooperation to ensure more resource flow to the poorer regions of the world and a credible fiscal recovery plan.

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