2013 SMALL STATES FORUM

FISCAL SUSTAINABILITY: BUILDING RESILIENCE AND ADDRESSING VULNERABILITY

ISSUES NOTE

SESSION I: FISCAL SUSTAINABILITY AND FISCAL RULES IN SMALL STATES

The global economic crisis has had wide-ranging impacts across small states, reflecting not only the diverse economic structures and transmission channels, but also the availability of policy tools and resources.

Small states that had greater fiscal space were able to undertake more significant countercyclical stimulus, influencing aggregate demand and reducing any negative impacts on human development outcomes and social and economic infrastructure. Similarly, fiscal space helped small states manage vulnerabilities to natural disasters and cope with significant reconstruction costs.

To achieve its goals, fiscal policy in small states needs to remain sustainable if it is not itself to become a source of instability. In this context, fiscal rules may help guide fiscal policy and promote fiscal responsibility and debt sustainability, boosting inclusive growth and reducing poverty in a sustainable manner.

FISCAL RULES[1]

Fiscal Rules are increasingly used as a tool to guide fiscal policy and promote debt sustainability. Their usage started in advanced economies, but has now spread to developing

[1] Four types of fiscal rules are commonly used: Debt rules, which set an explicit limit on the stock of public debt; Budget balance rules, which constrain the size of the overall budget deficit; Expenditure rules, which constrain the level of public spending; and revenue rules, which control the level of revenues. Budget balance rules and debt rules are most commonly used, and often in combination.

economies. According to the IMF, 83 countries now have at least one fiscal rule in place. However, only few of them are small states.

Country	Type of fiscal rule in place				National, SupraNational			
	Expenditure rule	Revenue rule	Budget balance rule	Debt rule	Expenditure rule	Revenue rule	Budget balance rule	Debt rule
Antigua and Barbuda; Dominica; Grenada; St. Kitts and Nevis; St Lucia; St. Vincent and the Grenadines			1998-2005	1998-			SupraN	SupraN
Botswana	2003-				Nat			
Cape Verde			1998-	1998-			Nat	Nat
Cyprus; Malta			2004-	2004-			SupraN	SupraN
Equatorial Guinea			2002-	2002-			SupraN	SupraN
Estonia			1993-	2004-			Nat/SupraN	SupraN
Gabon			2002-	2002-			SupraN	SupraN
Guinea Bissau			2000-	2000-			SupraN	SupraN
Iceland	2004-2008				Nat			
Mauritius			2008-					Nat
Namibia	2010			2001-	Nat			Nat

Source: IMF, Fiscal Rules Dataset, 1985-2012

Although it is difficult to measure the impact of fiscal rules on fiscal outcomes, a growing body of empirical analyses concludes that they are associated with lower deficit and debt levels. Fiscal rules can help increase the predictability and credibility of fiscal policy, two outcomes that could be of particular appeal to small states.

Fiscal rules can also raise challenges for fiscal policy design, some of which are particularly relevant for small states:

- Fiscal rules may lead to a pro-cyclical fiscal stance. A strict budget target, for example, may require sharp spending cuts or tax increases in a downturn, thereby aggravating the slowdown in demand. This is a particular concern for small states as the options to support demand through other means are often limited.

- With a focus on fiscal aggregates rather than on their composition, the quality of fiscal policy may suffer. More specifically, efforts to contain the fiscal deficit may respond to expediency rather than efficiency reasons. For example, the authorities may choose to raise the taxes that yield quick results (e.g., excise taxes) even if these are not the most efficient for the economy. This may lead to long lasting distortions in the tax system since tax increases, even if presented as temporary, often prove difficult to reverse.

- Rules may distract from other policy priorities. Fiscal policy choices may be overly determined by the rule criteria, obscuring important longer term objectives (e.g., a large growth enhancing investment program).

- Rules could encourage creative accounting and reduce transparency. Strict debt or budget rules may create incentives to put spending off budget or use special financing vehicles, undermining the reliability of the fiscal accounts.

The recent crisis revealed such shortcomings, and in its aftermath many countries have been revising their fiscal rule framework so as to mitigate these drawbacks.

- More and more countries are using different fiscal rules in combination. This helps mitigate the cons of individual rules, while maintaining the enhanced credibility of a rule-based framework.

- A growing number of rules are designed so as to provide flexibility to deal with business cycles. Cyclically-adjusted and structural rules are increasingly popular.

- More countries are strengthening enforcement mechanisms, including through the use of automatic correction mechanisms, helping to preserve credibility if the rule leaves significant scope for discretion in designing short term fiscal targets.

These changes generally aim at making rules more flexible, increasing the capacity to deal with unexpected shocks, but also more steadfast by ensuring that deviations from the rules are corrected in a timely manner. At the same time, such adjustments also increase the institutional and technical apparatus associated with the rules. Cyclically-adjusted targets, for example, are complex to understand and implement, raising significant technical and communication challenges. Implementation of these “second generation” rules may thus be more challenging for countries with capacity constraints, although these can be partly alleviated through the use of internationally-vetted mechanisms (e.g., the use of international reporting and accounting systems, regional monitoring).

In small states where “shocks” rather than “cycles” are the norm, the rules will likely need to be adapted rather than borrowed from larger countries. Capacity building in these areas, including for an articulation of context-relevant rules, would enhance not only the effectiveness of a rule-based fiscal framework, but more broadly the quality macroeconomic policy design and implementation.

In the end, the effectiveness of a rule-based fiscal framework depends on a key pre-requisite: political commitment. Fiscal rules can provide a framework to set alternative policy options and increase the legitimacy of certain policy choices, but they cannot be a substitute for the willingness of the authorities, and the public at large, to maintain fiscal discipline.

SOVEREIGN WEALTH FUNDS

Sovereign wealth funds (SWFs) have long been advocated as an important rules-based fiscal policy instrument to manage the use of government revenues and help overcome political economy problems that favor excessive consumption and address the issue of inter-generational equity.

Eight island countries in the Pacific have, or have had, sovereign wealth funds (SWF) and trust funds (TF), financed through the exploitation of natural resources (Kiribati, Nauru, and Timor-Leste), by donor grants (Federated States of Micronesia, Marshall Islands, Palau, and Tuvalu), or by fee revenue (Tonga). In other regions, all SWFs have their origins from natural resources (Bahrain, Botswana, Brunei, Equatorial Guinea, Gabon, Qatar, and Trinidad and Tobago).

The traditional objectives of SWFs in small states are macroeconomic stabilization to insulate the economy from large fluctuations in prices and revenues, and stable budget financing to smooth out the government budget fluctuations. SWFs in small states are also viewed as a way of providing a permanent income flow to preserve wealth for future generations, achieve budgetary self-reliance, and address inter-generational equity.

However, in practice, only few Funds in small states have been able to achieve all their stated objectives. Nauru’s fund, which was designed for providing permanent income, is now closed. The fund established in Kiribati, which grew to roughly eight times its GDP, has experienced substantial draw downs in recent years as well as value losses, and can now give little permanent income support.

The funds in Marshall Islands, Federated States of Micronesia, and Palau, which were established as part of the Compact of Free Association with the United States to replace fully compact grants, are also unlikely to maintain fiscal sustainability once grants under their Compact with the US are discontinued in 2024. Tuvalu fares somewhat better in terms of fiscal sustainability but the outlook is heavily dependent on the continuation of large donor grants, and is vulnerable to external shocks.

Some of the remaining small states funds, which have their origins from oil receipts, have achieved a sizable volume such that it would provide not only room for macroeconomic stabilization but also some permanent income flow for future generations. A key challenge for such countries, like Timor-Leste, is to build on recent efforts to further strengthen the quality of public expenditure.

QUESTIONS FOR DISCUSSION:

- *Many fiscal problems faced by small economies stem from their vulnerability to natural disasters and exogenous shocks. Can fiscal rules provide compelling policy options for small states? What rules are the most useful and effective in a small states context?*

- *Despite significant aid flows, some small states continue to run large fiscal deficits to undertake critical investment. What lessons can be learned from the experience of SWFs? Are SWFs a viable option for small states given the experience to date?*

- *Where do Ministers see the need for capacity building to enhance the effectiveness of a rule-based fiscal framework?*

Fiscal Rules in Small States (1985-2012)

	Type of fiscal rule in place				National/SupraNational				Description of the rules
Country name	ER: Expenditure rule	RR: Revenue rule	BBR: Budget balance rule	DR: Debt rule	ER: Expenditure rule	RR: Revenue rule	BBR: Budget balance rule	DR: Debt rule	Key elements of fiscal rules
Antigua and Barbuda; Dominica; Grenada; St. Kitts and Nevis; St Lucia; St. Vincent and the Grenadines	-	-	1998-2005	1998-	-	-	SupraN	SupraN	Supranational rules: Eastern Caribbean Currency Union (ECCU). The member countries aim at reducing public debt to 60 percent of GDP by 2020. Before the revision in 2006, fiscal benchmarks included an overall deficit target of 3 percent of GDP.
Botswana	2003-				Nat				ER (since 2003): Ceiling on the expenditure-to-GDP ratio of 40 percent. 30 percent of total expenditure should be directed toward development spending, which includes all capital spending and the recurrent spending for health and education.
Cape Verde			1998-	1998-			Nat	Nat	BBR (since 1998): Ceiling on domestic borrowing of 3 percent of GDP. DR (since 1998): Debt ceiling of 60 percent of GDP. Regarding domestic borrowing, the annual budget authorizes the amount for net domestic financing for the year. The government needs to return to parliament and seek another authorization if it wants net domestic financing to exceed the budget authorization amount. However, there is an absolute ceiling of 3 percent of GDP. That amount cannot be exceeded unless the parliament votes to change the underlying budget legislation which would be a more complicated process. This functions as a binding limit which the government watches carefully. The 60 percent debt limit is not binding (public debt is currently above it with no action being taken). There is enough transparency in the public accounts of Cape Verde so that breaches of the domestic borrowing limit would eventually be detected and become an accountability issue. In addition, the government can increase spending above what has been approved in the budget as long as the spending is financed by external concessional resources. This is a prerogative that parliament delegates to the government as part of the budget law.
Cyprus; Malta			2004-	2004-			SupraN	SupraN	Under the "fiscal compact" signed March 1, 2012, the government commits to adopt a structural budget balance rule in its constitution or in durable legislation, as well as an automatic correction mechanism by 2014. Supranational rules: EU since 2004 and euro area since 2008. The Maastricht criteria include limits of 3 percent of GDP for the fiscal deficit and 60 percent of GDP for general government debt. Moreover, country-specific medium-term objectives (MTO) are set for the structural budget balance (not less than 1 percent of GDP deficit). With the November 2011 governance reform, a required annual pace of debt reduction was introduced (no less than 1/20th of the distance between the actual debt ratio and the 60 percent threshold), starting three years after a country has left the current excessive deficit procedure (EDP).
Equatorial Guinea			2002-	2002-			SupraN	SupraN	Supranational rules: Central African Economic and Monetary Community (CEMAC). BBR (since 2002): The basic fiscal balance, defined as total revenue net of grants minus total expenditure net of foreign-financed capital spending, should be in balance or surplus.
Estonia			1993-	2004-			Nat/SupraN	SupraN	National rules: BBR (from 1993): Balanced budget for GG. A debt rule applies only for local governments (since 1997). The rule recently evolved to take into account the cyclical component: in 2007 and 2008 the authorities switched to targeting nominal surpluses because it became increasingly clear that the requirement for a nominal budget balance was not sufficient to rein in the overheating tendencies in the economy. Currently, given the still negative output gap, the government targets small deficits. Under the "fiscal compact" signed March 1, 2012, the government commits to adopt a structural budget balance rule in its constitution or in durable legislation, as well as an automatic correction mechanism by 2014. Supranational rules: EU since 2004. See other EU countries
Gabon			2002-	2002-			SupraN	SupraN	Supranational rules: Central African Economic and Monetary Community (CEMAC). BBR (since 2002): The basic fiscal balance, defined as total revenue net of grants minus total expenditure net of foreign-financed capital spending, should be in balance or surplus. BBR (since 2008): In 2008 the CEMAC Commission introduced two supplementary criteria: (i) the basic structural fiscal balance in percent of nominal GDP should be in balance or surplus—this concept is derived from the main criterion by replacing actual oil revenue with its three-year moving average; and (ii) the non-oil basic fiscal balance in percent of non-oil GDP should be in balance or in surplus. DR: The stock of external plus domestic public debt should be kept below 70 percent of GDP.
Guinea Bissau			2000-	2000-			SupraN	SupraN	Supranational rules (from 2000): West African Economic and Monetary Union (WAEMU). It has fiscal convergence criteria. First-order convergence criteria include a balanced budget (excluding foreign-financed capital expenditures) or better and public debt no higher than 70 percent of GDP.
Iceland	2004-2008				Nat				ER (2004-08): De facto expenditure rule. Real expenditure growth limit of the central government (2 percent for public consumption and 2.5 percent for transfers). In practice, the fiscal rule served as guidepost during the period although in some years these limits were exceeded and were discontinued (after the bank crisis) from 2009 onwards. Under the IMF-supported Stand-By Arrangement, the authorities committed to achieving specific primary balance targets in 2009-11.
Mauritius			2008-					Nat	DR (since 2008): Fiscal rule defined in the 2008 Public Debt Management Act (PDMA). The PDMA puts a legally mandated ceiling of 60 percent on the debt-to-GDP ratio. The ceiling was expected to be 50 percent of GDP starting in 2013, but the authorities recently changed the date to 2018.
Namibia	2010			2001-	Nat			Nat	ER (since 2010): Public expenditure levels below 30 percent of GDP. DR (since 2001): Public debt-to-GDP ratio of 25–30 percent annually.

Source: IMF, Fiscal Rules Dataset