Definition and Scope of Fiscal Rule

Recently, there has been much talk about, and much hope for the Fiscal Rule (FR) legislation to be implemented under the economic reform programme, as agreed with the IMF. The FR can be defined as "A rule that imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates."

These rules provide a credible operational frame in which the government crafts fiscal policy that is in line with established parameters. By virtue of the limits, these rules are aimed at correcting distorted incentives and containing the usual overspending action of the government, which has been a significant contributor to our high debt to GDP ratio and low productivity levels. This will ensure that governments practice fiscal responsibility and that the country's debt to GDP ratio is sustainable, which currently stands at over 130 percent, when a sustainable Debt to GDP ratio is 60 percent. The sustainable target of 60 percent is expected to be achieved in 2026, under the current IMF programme.

So in effect, the FR legislation will provide some limit to government spending, ensuring that we do not continue to spend our children's' future income by asking them to pay back for our in discretionary spending, as the generations before us has done.

In addition, these rules may promote economic stability, as an important feature of FR is that it promotes greater economic stability since by construct they discourage actions to overspend and thus negates the need to borrow to correct the debt problem. FR also promotes the stable growth in output because they allow for fiscal actions that adjust to shocks in economic activity.

FRs are adopted for various reasons; for the most part they are intended to promote budgetary discipline. They seek to confer credibility on the conduct of macroeconomic policy by acting as a visible constraint on potentially damaging short-term spending, with no long-term benefit, as well as an effective commitment device to fiscal discipline. FRs is thus a solution to the problem in which governments commits to a prescribed fiscal policy but deviate from it when the need arise without giving sufficient thought to the long-term impact on the economy. These rules can be somewhat rigid and permanent and hence flexibility is created by developing flexibility clauses that allows the policy maker to deviate under predetermined harsh economic conditions.

The implementation of this FR legislation, as a condition of the IMF programme, promises to see restrictions being placed on loose spending by government and the public sector. In other words, with this restriction in place it is expected that policy makers will be much more responsible about their expenditure decisions, thereby ensuring that our fiscal accounts, and debt servicing costs, remain in a manageable state.

Developing an Effective Fiscal Rule

The International Monetary Fund has developed a framework that establishes the components of an effective FR, these include the fact that there must be clear link between the numerical target and the ultimate objective; this may for example be public debt sustainability. In addition, the rule must have sufficient flexibility to respond to shocks so that the rule should at least not make the initial situations in the economy worse. In the same vein, the IMF posits that there must be a clear institutional framework or mechanism that enables the government to observe the factors contributing to the movement away from the numerical targets and therefore find solutions to the problems. Additionally, FRs should be simple and transparent so that players in the financial sector can understand them and monitor government's actions.

Types of Fiscal Rules

There are four types of FRs outlined by the International Monetary Fund. The Budget Balanced Rules, these are the most widely adopted rules, these are then followed by Expenditure Rules ,Debt Rules, and Revenue Rules, which are the less applied set of rules. In practice the rules are often combined and applied simultaneously. The following outlines the scope and application of the rules;

Expenditure Rules- These rules set a limit on the total, primary or current spending. The principal objective of this rule is to ensure that there is fiscal discipline through improved expenditure management. The policy maker may set a limit on the rate of growth of expenditure or as a percentage of Gross Domestic Product.

Revenue Rules- These rules generally take a floor or ceiling on government revenue collection. Their main objective is to influence the overall fiscal stance by controlling the rate at which revenue can grow. Their more practical application is where they counteract a developing excessive tax burden.

Balanced Budget Rules - These rules establish a target to balance the country's budget in a year or over some predetermined time frame. They constrain a government's capacity to over spend, over-commit or fail to meet its revenue needs. The budget to which it sets a limit can vary; it deals specifically with the total budget, the current budget, the primary budget or the structural budget. In the case of the current budget capital investment is excluded and in the case of the primary budget interest payment is excluded.

The structural balance is the recommended balance that government should focus on since it is the best measure of government discretionary budget position and it is not impacted by short-term fluctuations. These rules are generally flexible and are effective stabilizers for the economy. The major problem with this rule is that the structural component of the budget may be hard to determine and may be subjected to many revisions.

Debt Rules- These rules set a limit on the debt stock of the public sector to a predetermined level which is generally expressed as a percentage of GDP. Given the relationship between historical debt levels and historical GDP levels then debt rules provide an analysis on the ability of the country to meet its debt obligations. These rules are generally easy to communicate, transparent and easy to determine whether they are being followed.

Major Issues and Challenges in Designing Fiscal Rules

A major challenge that policy makers face in the design of FRs is whether the rule should be backward looking, forward looking or for the near-term. Backward looking rules are engineered to balance the budget over the economic cycle, while forward looking rules are designed to forecast budget positions for a number of years in the future, on the other hand near-term rules are designed to deal with borrowing in the current year. While each of the three types have their advantages and disadvantage, the forward looking rule is said to be flexible and protective of the daily management of the country's finances from shock to the country's spending. Forward looking rules also prevent the government from implementing policies too quickly that is designed for the sake of meeting targets.

Fiscal rules are designed to promote greater fiscal restraint and fiscal responsibility, there are always mitigating economic conditions or shocks that may cause a country to set aside or to abandon these rules temporarily. This means that flexibility must be taken into consideration when these rules are be written to ensure that the economy can make the necessary adjustments back to normality.

However, there is no doubt that having a FR in place adds to the confidence needed for creating the confidence in an economy, where the historical experience has been one of fiscal mismanagement. This is the case in Jamaica, where mismanagement of the fiscal accounts resulted in large fiscal deficits and a debt to GDP ratio approaching 150 percent.