

# **New Fiscal Rules: Green and Flexible?**

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**1. Green Fiscal Rules?  
Challenges and Policy Alternatives**  
(Francesca Caselli, Andresa Lagerborg, Paulo Medas)

**2. Fiscal Rules and Countercyclicality:  
New Evidence**  
(Francesca Caselli, Andresa Lagerborg)

# **Green Fiscal Rules? Challenges and Policy Alternatives**

# Should green spending be excluded from fiscal rules?

## Traditional fiscal rules

- Definition:
  - ✓ Numerical ceilings on fiscal aggregates
- Objectives:
  - ✓ Preserve debt sustainability
  - ✓ Build buffers and prevent pro-cyclical policies
- *Desirable design characteristics*:
  - ✓ A medium-term fiscal anchor with an operational rule
  - ✓ Escape clauses to ensure flexibility

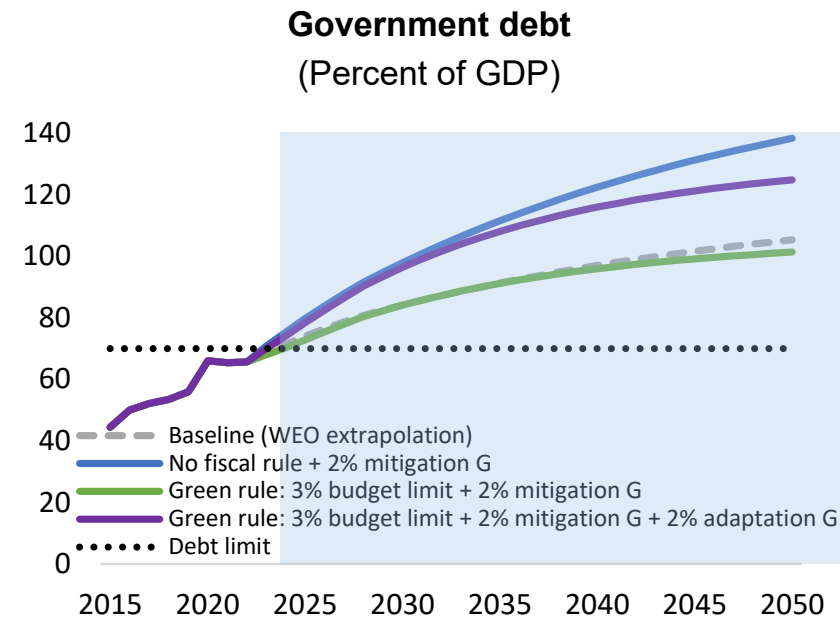
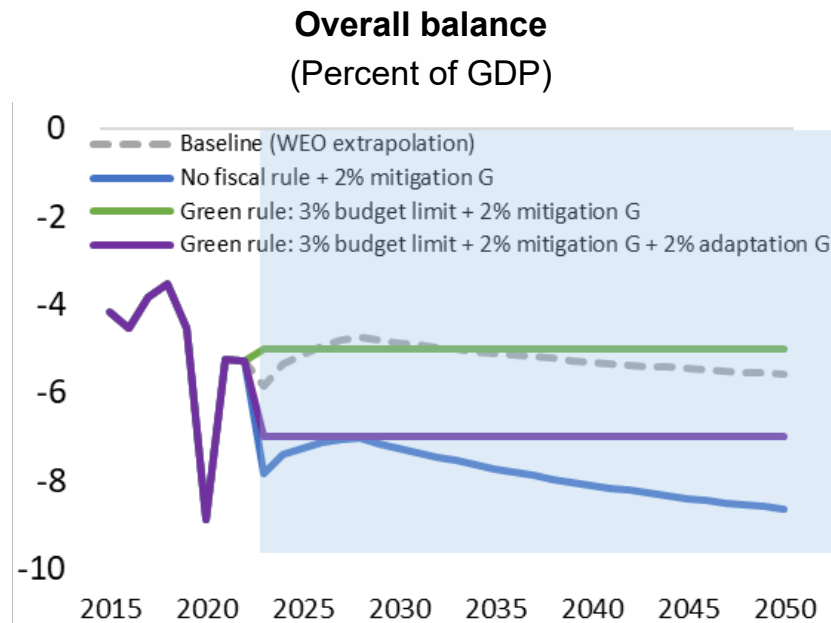
## Green fiscal rules?

- Objectives:
  - ✓ Increase green spending to address the climate agenda
  - ✓ Preserve green spending during fiscal adjustment
- *Proposed design characteristics*:
  - ✓ Similar to traditional '*golden rules*'
  - ✓ Exclude green public spending from the rule

# Green rules could lead to unsustainable debt levels ...

## Fiscal rule simulations for a typical EM:

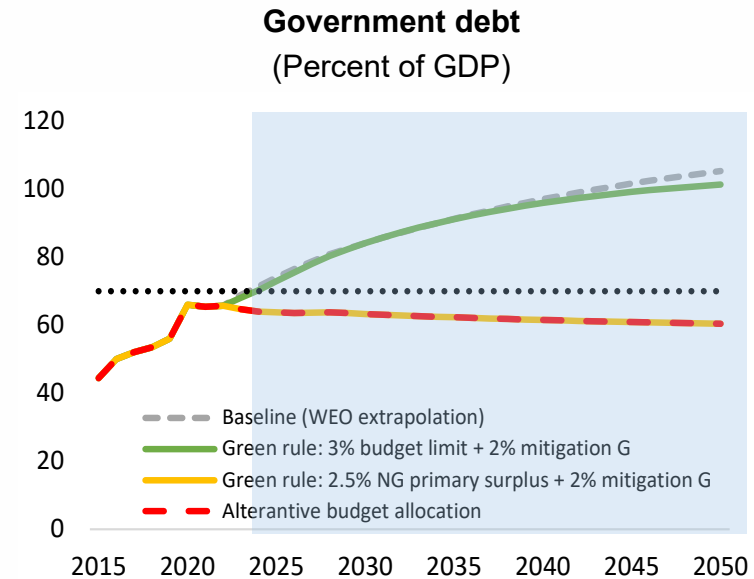
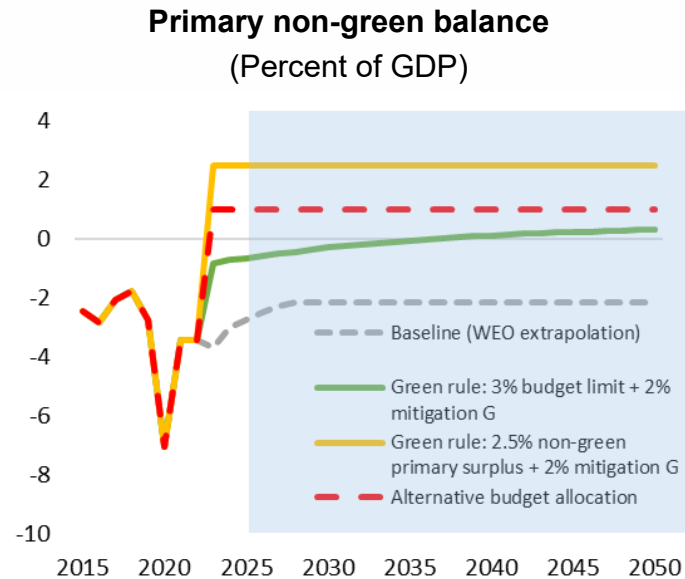
- Fiscal anchor: debt limit at 70-95 percent of GDP with safety buffers of ~20pp (Caselli et al., 2022).
- To achieve net zero, 2 percent of GDP per year on mitigation spending needed (October 2023 FM).
  - Green fiscal rules could lead to unsustainable debt (green)
  - Even more so if the rule exempts both mitigation and adaptation spending (extra 2 percent) (purple)



# ... or require overly large (non-green) surpluses to ensure sustainability.

## Fiscal rule simulations for a typical EM:

- Calibrating a fiscal rule consistent with the budget constraint that preserves debt sustainability:
  - Would require overly tight balances
  - With a large non-green primary surplus  $\sim 2.5$  percent of GDP (yellow).
- A more appropriate mix of climate policies, including actively using carbon pricing and regulations, should be considered in countries MTFs (red).



# Further operational design challenges on green rules

- **Defining green:** How to properly define what constitutes green spending and should hence be excluded from the deficit limit?
- **Complexity:** add complexity to rules' design, providing incentive for 'greenwashing' (similar to golden rules), while limiting the scope of interventions to public investments.
- **Consideration to green revenue:** The potential introduction of other measures on the revenue side, such as carbon taxes, should be considered in the design of green rules.
- **Skewed budget priorities:** Green rules can skew budget priorities – from other priority spending (e.g., SDGs) and might not prioritize green spending according to its impact.

# A green medium-term fiscal framework

- Our proposal is to amend MTFFs by incorporating climate change effects, the related policy choices and their impacts.

Macroeconomic projections	Climate-related policies	Risks and Debt sustainability	Fiscal Rules	Other green PFM practices
✓ Economic costs of climate change (e.g., on potential growth)	✓ Choice of measures	✓ Risks related to climate change.	✓ Mitigate risks (reduce needed buffers)	✓ Green PFM through other phases of the budget
✓ Related fiscal costs	✓ Impact on taxes (e.g., carbon taxes)	✓ Effects of climate-related policies (e.g., adaptation)	✓ Target broad aggregates	✓ Climate-smart public investment
✓ Scenarios	✓ Impact on expenditures (investment; energy subsidies, safety nets)	✓ Longer-term perspective		



# **Fiscal Rules and Countercyclicality: New Evidence**

# Fiscal rules key objectives

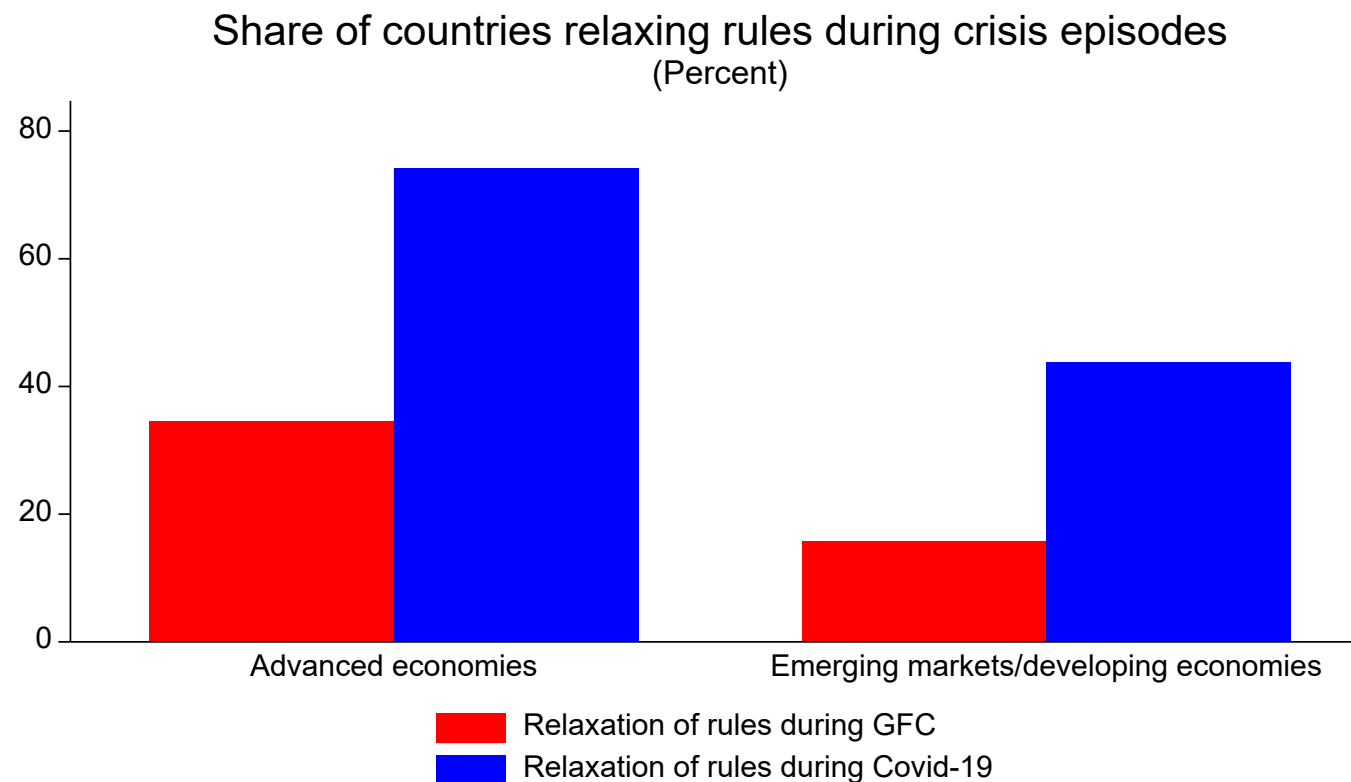
## 1) Promote fiscal sustainability

- Despite weak compliance, rules can have a positive impact on containing deficits, promoting fiscal sustainability, and reducing sovereign spreads (Kalan et al. 2018; Afonso and Jalles, 2019; Caselli and Reynaud 2020; Caselli and Wingender, 2021; Caselli et al., 2022).

## 2) Promote countercyclical fiscal policy by building buffers in good times

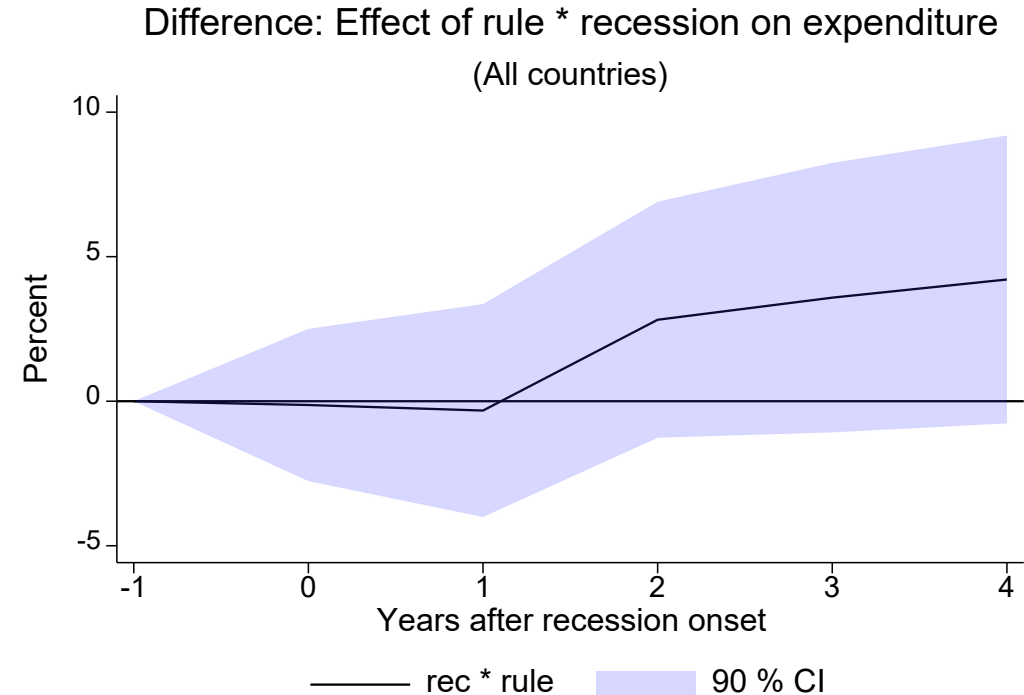
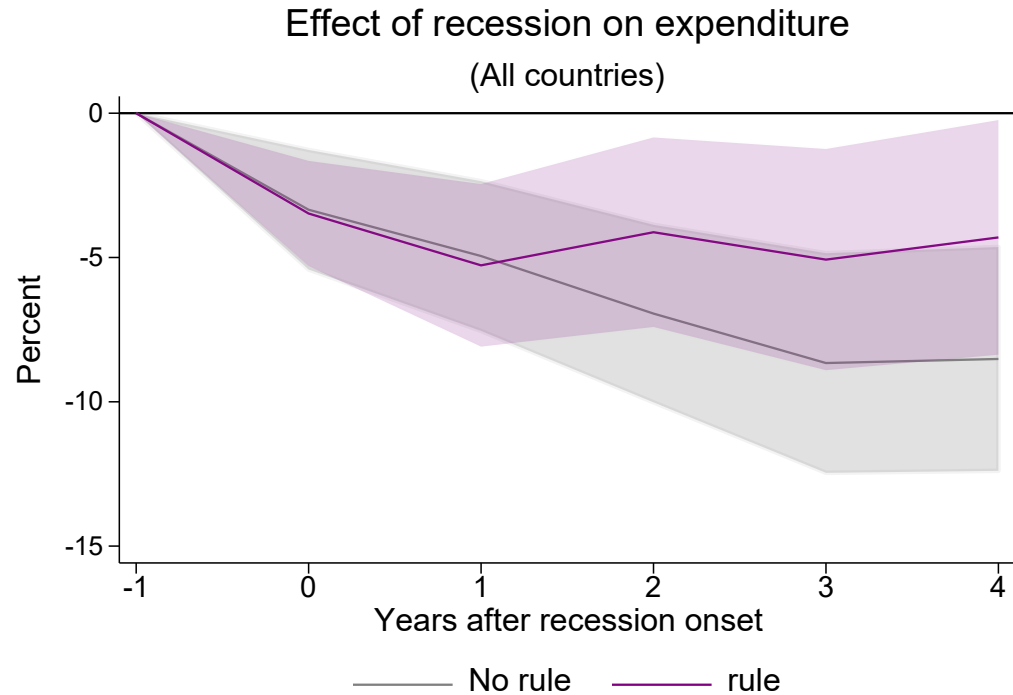
- Failure:
  - Political pressures to spend windfall revenues during booms. (Talvi and Végh, 2005)
  - Fiscal rules constrain fiscal space during downturns, leading countries to especially over-compress public investment. (Alesina and Bayoumi, 1996; Blanchard and Giavazzi, 2004; Clemens and Miran, 2012; Arezki and Ismail, 2013)
- Success:
  - ✓ Fiscal rules reduced procyclicality in EU. (Gali and Perotti, 2003; Manasse, 2006; Gootjes and de Haan 2022)
  - ✓ Structural factors matter in determining the cyclical impact of rules: level of debt and development, legal enforcement/monitoring of rules and government efficiency. (Guerguil et al., 2017; Bergman and Hutchison, 2015)
  - ✓ Rules designed to allow for flexibility improve fiscal policy countercyclicality. (Ayuso-i-Casals et al., 2007; Bova et al., 2014; Combes et al., 2014; Ardanaz et al., 2021)

# More than 70 percent of countries suspended fiscal rules during the pandemic



- Do standard rules-based frameworks provide the necessary flexibility to respond to shocks?

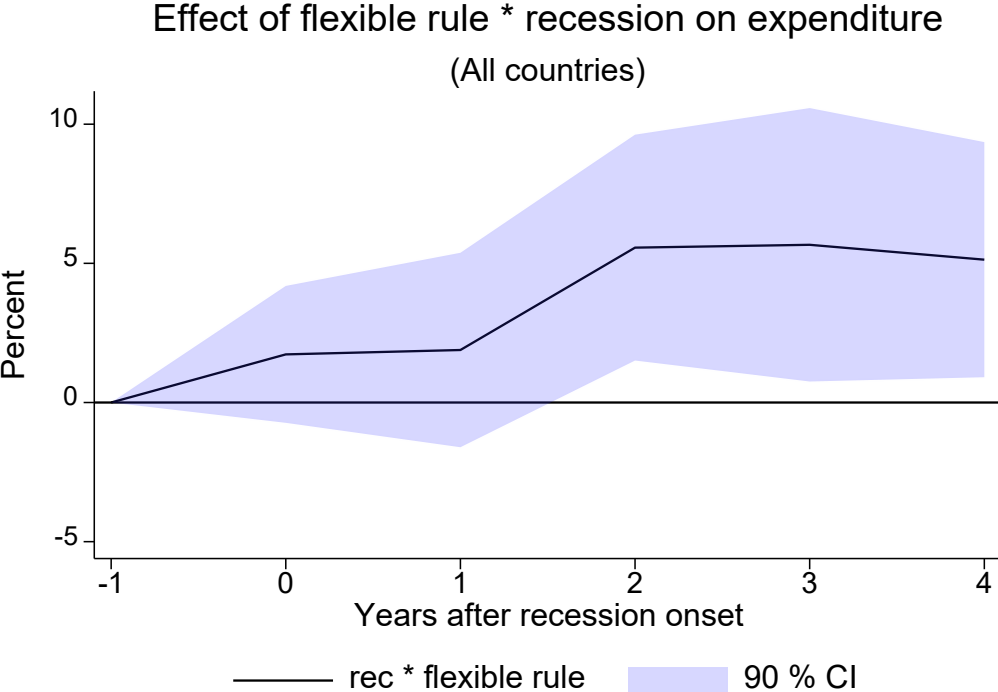
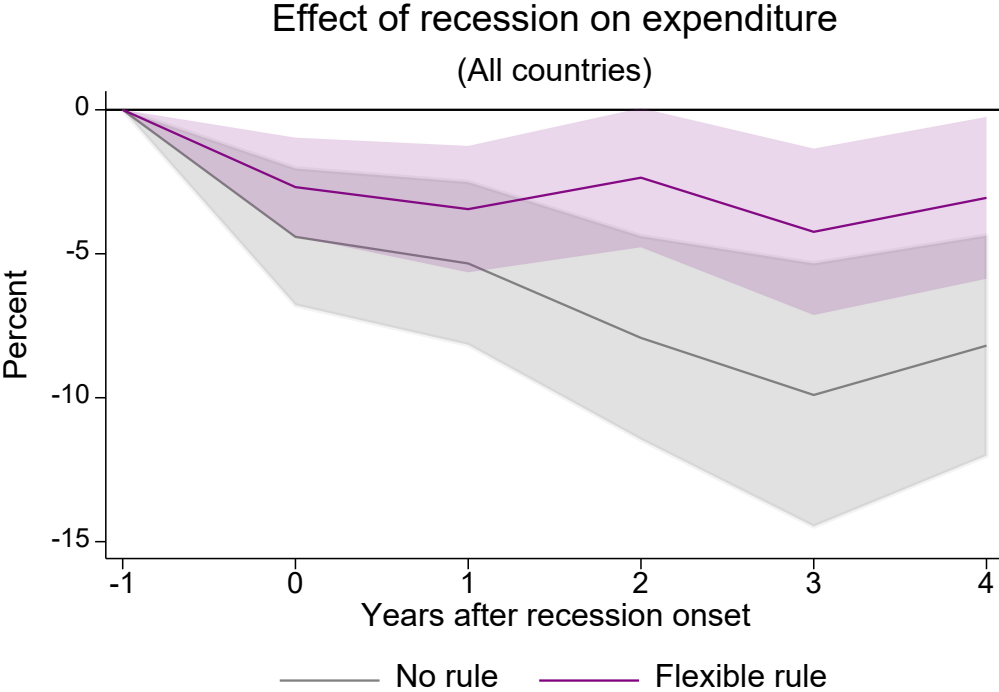
# Fiscal policy is procyclical, independent of rule presence.



... similar insignificant result for subcomponents: current and capital spending (and C & I).  
Across country groups, fiscal policy is more procyclical in EMs.

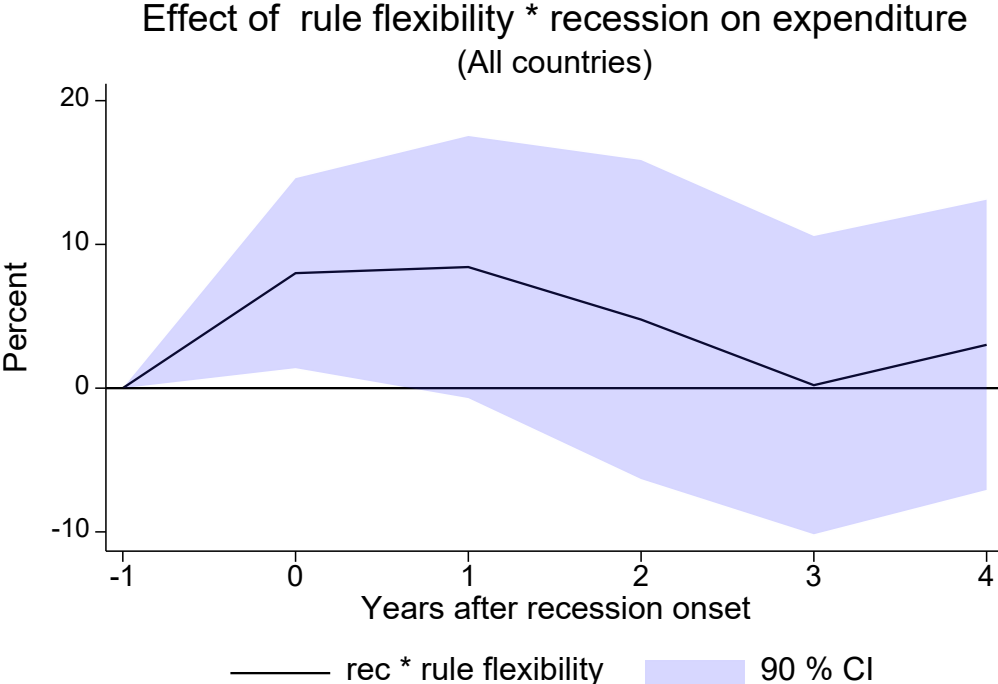
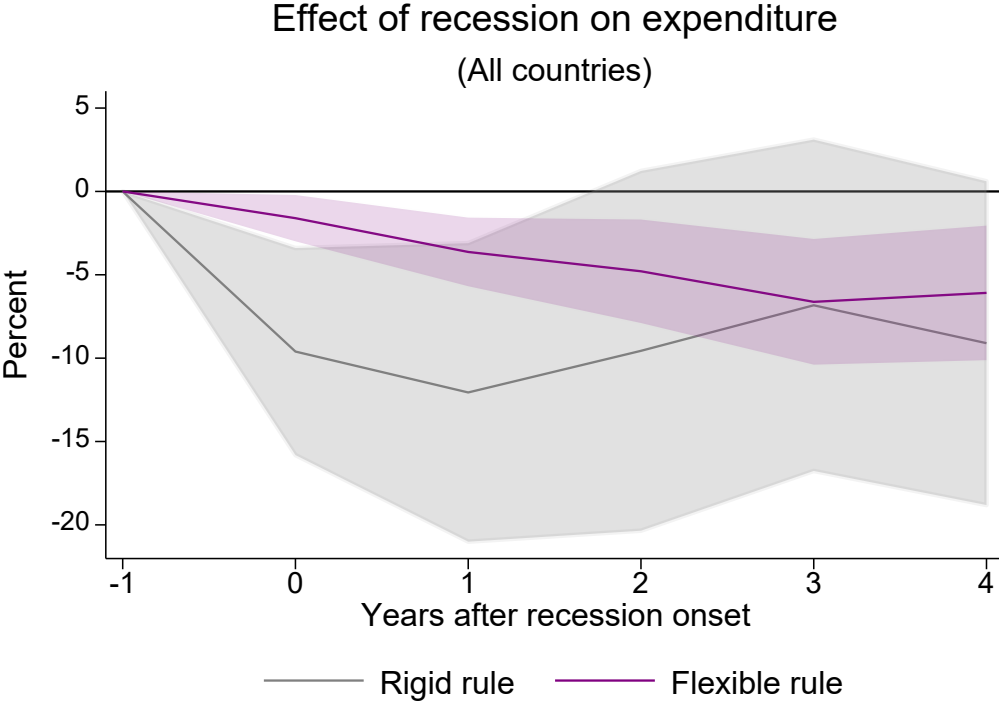
# Overall, *flexible* rules reduce procyclicality (vs. No rules)

*Flexible rule: defined as having an escape clause, cyclically-adjusted balance, and/or multi-year expenditure ceiling*



# Overall, *flexible* rules reduce procyclicality (vs. Rigid rules)

*Flexible rule: defined as having an escape clause, cyclically-adjusted balance, and/or multi-year expenditure ceiling.*



# Conclusion

## **Fiscal rule exemptions for green spending are not advisable.**

- Green fiscal rules could either:
  - Lead to unsustainable debt levels, or
  - Require overly large non-green surpluses
- Further design challenges include: defining green, added complexity, consideration to green revenues, and the impact on skewing budget priorities
- Addressing climate change decisively will imply difficult policy choices that go well beyond fiscal rules
- The priority should be to enhance medium-term fiscal frameworks to incorporate green considerations

## **Flexibility of rules mitigates procyclicality of fiscal policy.**

- Fiscal policy is on average procyclical, independent of rule existence
- Countries with more flexible rules tend to have a more countercyclical policy response
- This points to the importance of well-designed rules with flexible features (e.g., escape clauses and cyclically-adjusted balance targets)

**Thank You!**