



Fiscal Institutions and the Pandemic

Chile's experience shows the value of building the right framework for fiscal policy

Felipe Larraín Bascuñan

Fiscal institutions are crucial for every country, but especially for those that are resource-intensive. And they become particularly important in pandemic times. Let us see why.

In individual countries' responses to the COVID-19 pandemic, diversity in fiscal policy frameworks was a differentiating element. Richer countries or those that pursued responsible fiscal conduct in the years before the arrival of the virus were better able to strengthen health systems and deliver fiscal transfers, subsidies, and guarantees. This allowed faster recovery from the shock.

Aggressive fiscal responses to the pandemic had positive effects on stock markets, currencies,

industrial production, employment, confidence, and sovereign risk premiums in the countries that implemented them (Deb and others 2021). There is also evidence that the effects were greater in advanced economies and in those with lower public debt. Most countries that had fiscal space or sovereign wealth funds were able to use these to deal with the economic and social effects of the pandemic.

In contrast, the poorest countries in Africa, the Americas, and Asia had limited leeway to respond, bolstering spending or forgoing revenue by less than 2.5 percent of GDP. Thus it will take years for them to recover from the economic and social effects of the pandemic, with significant negative impacts on output and income distribution.

The difference in many cases reflects the presence or absence of an institutional framework for fiscal policy. Chile, with the world's 43rd largest economy and with a sound fiscal policy framework, was able to respond to the pandemic on roughly the same scale as some of the world's richest nations—Germany, Japan, the United Kingdom, and the United States—increasing outlays or forgoing revenue by more than 10 percent of GDP.

How could this be? Quite simply, without an institutional framework for fiscal policy, government spending is bound by the amount of public resources available in a given year—reflecting mainly tax revenue—and a limited capacity to borrow. The problem with this mechanism is that fiscal revenues tend to be procyclical, and a spending policy financed with current revenues and constrained credit only exacerbates—rather than mitigating—the economic cycle. This generates pernicious macroeconomic effects on the volatility of key variables such as the exchange rate, inflation, and interest rates, with repercussions on investment, economic growth, and employment. It also puts at risk the long-term sustainability of financing required for more permanent policies such as public health, education, housing, and pensions.

This problem is even more pronounced for countries like Chile that are natural-resource-intensive, where commodity exports typically account for over 60 percent—and in some cases more than 90 percent—of total exports. In these cases, fiscal revenues depend not only on GDP but also on the prices of the goods the country produces and exports. In such economies it is even more important to establish an institutional framework to guide fiscal policy decisions.

Such a framework should be composed of at least three elements: a fiscal rule with a medium- to long-term perspective, sovereign wealth funds, and an independent fiscal institution such as an advisory fiscal council.

Beyond the sustainable financing of social policies, an institutional framework allows for a longer-term orientation for fiscal policy, which otherwise would be implemented with a time horizon in line with government terms. Thus, an appropriate fiscal framework highlights the existence of an intertemporal budget constraint that contemplates very long time horizons. This is crucial for responding to a shock such as the COVID-19 pandemic, both when resources need to be used and when it is necessary to carry out a

fiscal consolidation to ensure the long-term sustainability of public finances.

It is essential that countries—especially emerging market and resource-intensive nations—have a fiscal framework with the three pillars.

Fiscal rule: A long-term vision that isolates public spending from the cyclical fluctuations of the economy must be set out. This can be achieved, for example, through annual fiscal balance targets based on the country's capacity to generate long-term or structural revenues rather than on current revenues. When actual income is higher than long-term levels because the country is experiencing a boom, part or all of the extra funds should be saved for the next down cycle, when tax revenues will inevitably fall.

Fiscal rules must be flexible so that governments can deal with unexpected shocks.

Sovereign wealth fund: This is where the country saves the extra revenues from, say, a boom in the prices of the natural resources it produces and exports. These funds should be invested in a diversified, highly liquid portfolio of assets, normally in international markets, and should be available for use based on objective criteria when the nation faces an economic crisis.

Independent fiscal institutions: Building a framework for fiscal policy usually takes more than a single government term, so it is increasingly important to establish and strengthen autonomous fiscal councils. Such institutions advise governments and legislatures on fiscal issues. They must make technical recommendations, macro-fiscal projections, and assessments of fiscal sustainability. Most important, they should contribute to the public debate on fiscal policy, sounding the alarm about the fiscal risks of economic and political decisions that put the sustainability of public finances at risk.

Some countries prefer fiscal rules that establish limits for spending, public debt, or the fiscal deficit. However, these do not set a long-term vision, which makes them less appropriate for commodity-exporting emerging market economies. Such mechanisms can be used as a complement to a cyclically adjusted revenue rule if an additional constraint is needed, especially for countries whose debt is high or those that are rapidly accumulating liabilities.

Together with Chile's Ministry of Finance, the IMF (Larraín, Ricci, and Schmidt-Hebbel 2019) analyzed

the Chilean fiscal framework and international experience and found increased adoption of fiscal rules by emerging market and developed economies. The findings stressed that fiscal discipline is necessary because governments are subject to an intertemporal budget constraint, and fiscal rules reinforce that discipline. The paper notes that fiscal rules are potentially efficient tools that can contribute to fiscal sustainability, solvency, and economic performance. It shows that there is growing empirical evidence that fiscal rules tend to improve fiscal performance. However, the efficacy of fiscal rules can be affected by their complexity or by noncompliance—something observed in several Latin American countries—so the authors recommend flexibility, simplicity, transparency, and achievement of a fiscal objective.

Fiscal rules must be flexible so that governments can deal with unexpected shocks, but there should be clear boundaries set by an escape clause. Such a clause ideally contains not only a quantitative definition of failure to meet fiscal targets but also describes the mechanisms and deadlines for a return to a sustainable fiscal path.

Once this pandemic is over, governments will carry more debt; sovereign funds will be smaller, and in many cases fiscal adjustments will be necessary to ensure the sustainability of fiscal accounts. In this context, the strengthening of fiscal institutions should be an economic policy priority to help ensure that the process is carried out in an organized and transparent way, according to technical standards, and with the least possible social impact. **FD**

FELIPE LARRAÍN BASCUÑAN is professor of economics at Universidad Católica de Chile, researcher at the Latin American Center for Economic and Social Policies (CLAPES UC), and a former Chilean minister of finance.

References:

Deb, Pragyan, Davide Furceri, Jonathan D. Ostry, Nour Tawk, and Naihuan Yang. 2021. "The Effects of Fiscal Measures during COVID-19." IMF Working Paper 2021/262, International Monetary Fund, Washington, DC.

Larraín, Felipe, Luca Antonio Ricci, and Klaus Schmidt-Hebbel. 2019. *Enhancing Chile's Fiscal Framework: Lessons from Domestic and International Experience*. Washington, DC: International Monetary Fund.

