FISCAL AFFAIRS

Special Series on Fiscal Policies to Respond to COVID-19

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Fiscal Rules, Escape Clauses, and Large Shocks[1]

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 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.

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I. FISCAL RULES, FISCAL DISCIPLINE, AND SHOCKS

Fiscal rules are long-lasting constraints on fiscal policy aimed at providing a credible commitment to fiscal discipline. They set numerical limits on a budgetary aggregate (e.g. level of public debt, deficit, growth of public expenditures). These constraints are useful to address deficit biases (that can lead to excessive debt levels) and procyclical policies (exacerbating economic cycles), ultimately helping promote more prudent and stabilizing fiscal policies.[2] At the same time, fiscal rules must be sufficiently flexible to manage unexpected economic or other large shocks (Eyraud et al., 2018). This is particularly relevant for rare events that can have very large fiscal and economic impacts, such as the current pandemic, and will likely require escape clauses to allow temporary deviations from the rules.

The use of escape clauses, however, should involve a well specified and transparent process to preserve the credibility of the framework. While the high degree of uncertainty around this crisis calls for greater flexibility, this should not be at a cost of excessive discretion that could be abused and undermine the

[1] Prepared by William Gbohoui and Paulo Medas.

[2] See Wyplosz 2013; Persson and Tabellini 2000; Alesina and Tabellini 1990.

return to the fiscal rules over the medium term. In addition, some countries either do not have escape clauses and may need to consider suspending their rules without a well-defined process or even abandoning or revising the rules. This note discusses how flexibility in the framework can be best used in the event of a large shock with an uncertain outlook as we are experiencing now, and alternatives when escape clauses are inexistent or inadequate.

II. DESIGN AND USE OF ESCAPE CLAUSES

Several countries have introduced escape clauses in their fiscal rule frameworks over the past years, especially after the global financial crisis (GFC). For example, new escape clauses were created in 2011 in the European Union (EU) fiscal framework. Other examples include Colombia (2011), Jamaica (2014), and Grenada (2015). Cross-country experiences suggest that a well-defined escape clause should specify (i) a limited and clearly defined set of events triggering the operation of the clause, (ii) the authority to activate it, (iii) the timeline and procedures to revert to the rule, (iv) an effective control mechanism, and (v) a good communication strategy (see IMF Fiscal Rules Dataset for country examples).

When to activate the escape clause? The events triggering the activation of an escape clause should be outside government's control and preferably defined in quantitative terms if possible. They typically include severe economic downturns, large natural disasters, and states of emergency.[3] It is also important for the credibility of the rules that escape clauses are only activated when necessary to respond to the events—that is, the size of the deviation should be linked to the policies directed at the crisis. In the present crisis there are several factors that justify activating the escape clause in many countries:

- The temporary health crisis could demand significant additional fiscal resources that could lead to a breach of the fiscal rule (e.g. breach of fiscal deficit or debt limit).
- The fall in economic activity is expected to be severe due to the containment measures in the country or due to spillovers from actions in other countries that affect external demand. The budgetary impact is likely to be large due to the so-called automatic stabilizers—as tax revenues fall and cyclical expenditures like unemployment benefits rise due to lower economic activity—but also because of the discretionary measures needed to respond to the crisis. For example, 2020 fiscal deficits at present are projected to increase on average by 7.7 percent of GDP in advanced economies and 4.3 percent in emerging markets compared to 2019. Public debt is projected to rise by more than 17 percent of GDP for advanced economies, by 10 percent in China and 15 percent in South Africa (April 2020 Fiscal Monitor).
- Commodity exporters are facing sudden and sizable negative terms of trade shocks. This includes the large fall in oil prices leading to considerable shortfall in budget revenues in oil exporters. The response to such a large shock will depend on the size of fiscal buffers of the country and the degree of budget dependence on commodity revenues. However, if the rules prevent an

[3] When these events are measurable, the rules of some countries specify a minimum size (for example in terms of expected impact on growth or fiscal balances) that is required to trigger the clause. Limiting the size of the allowed deviation is also helpful in finding the right balance between precision and discretion.

appropriate response to the shock, countries may also need to activate escape clauses.[4] For instance, April 2020 Fiscal Monitor projected oil exporters' deficit to increase by almost 7 percent of GDP in 2020 from around 1 percent in 2019.

- The strategy when activating the escape clause—including the size of the deviation from the rule—will depend on the impact of the shock (e.g. health spending needs, lifelines to households and firms) and will be constrained by the existence of fiscal space and availability of foreign aid.

How to activate the escape clause? The proposal to invoke the escape clause should preferably explain (i) the reasons for activating the clause; (ii) why these are in line with the triggers predefined in the legislation; (iii) the period over which the rule will be suspended; and (iv) the adjustment to be applied to revert to the rules. Parliamentary approval is important given the budgetary impact and help ensure the escape clause is being used appropriately.

Many countries are already using the flexibility in the rule-based fiscal frameworks, including escape clauses to deviate or suspend the rules. They used different approaches, including supranational mechanisms, supplementary budgets, or taking advantage of the legal flexibility in structural rules or when declaring national emergency. For example:

- In Brazil, the government asked Congress to declare state of "public calamity", which allows to breach the primary balance target and other restrictions under the fiscal responsibility law. The request included an end date (end-2020), explained the reasons, and included an estimate of the economic impact. Costa Rica enacted a National Emergency Decree and is expected to activate the emergency escape clause to allow a growth in current expenditure higher than threshold in 2020. In Colombia, the Fiscal Rule Consultative Committee noted that the framework allows additional (countercyclical) spending of up to 20 percent of the projected output gap.
- The European Union activated the general escape clause, as proposed by the European Commission, to suspend the adjustment member states have to do to meet their fiscal targets. Moreover, more than half of European countries have also activated their national escape clauses.[5] In some cases, this activation is automatic as countries national rules are linked to the EU rules. These are the case of Portugal, France, Italy. Others have their own rules and escape clauses. For example, in Germany the parliament approved with a supermajority a supplementary budget—with a large fiscal package—and suspended the debt brake rule.
- Other countries are also considering activating escape clauses. WAEMU countries are likely to suspend the 3 percent deficit regional convergence criteria soon.[6] In most cases, the rules are

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[4] See note on Fiscal Policy Responses to the Sharp Decline in Oil Prices.

5 According to the European Fiscal Monitor (March 2020), by the EU independent fiscal institutions, Austria, Bulgaria, Croatia, Czech Republic, Germany, Estonia, France, Greece, Italy, Lithuania, Latvia, Portugal, Romania, Slovenia have already activated their national escape clauses.

[6] All member countries, except Guinea Bissau, have or are in the process of revising their fiscal deficit target up for 2020 beyond 3 percent regional convergence criteria. The suspension of the regional rule would be formalized pending an understanding within the WAEMU authorities.

expected to be re-instated from 2022. Ghana is expected to suspend the rule limiting the fiscal deficit to no more than 5 percent of GDP in accordance with the Fiscal Responsibility Act which allows for suspension for a public health epidemic or an unanticipated severe economic shock. Honduran President has submitted to the National Congress a set of fiscal measures and the government is planning to trigger the escape clause with a transitional path to return to the 1 percent of GDP deficit target within 2 years. Grenada is also planning to invoke the "public health epidemic" escape clause to accommodate the fiscal effects of the crisis.

Procedures for returning to rule compliance. Some escape clauses impose limits on how long fiscal policy can deviate from the targets in the rule, and a requirement for fiscal policy to return to the targets afterwards. Specific requirements can make the framework more robust, but they need to strike the right balance between ensuring a timely return to the rule and avoiding abrupt corrections. Countries have adopted approaches with different degrees of flexibility. For example, in Panama, the escape clause requires returning to rule compliance within 3 years without the need to compensate for accumulated deviations. Honduras' escape clauses mandate a transitional path to return to the 1 percent of GDP deficit target within 2 years. In some countries, some restrictions may apply even when escape clauses are activated. The German constitution requires that the use of escape clause in the events of natural disasters or national emergency should be accompanied by the adoption of "reimbursement plan" for the extra borrowing "within a reasonable time frame". In Switzerland, when escape clauses are activated, deficits arising from extraordinary expenditures accumulate in an amortization account, which needs to be zeroed over the next six years by running structural surpluses. Escape clauses may also apply to only some fiscal rules and levels of government.

The economic impact of a rare event, as the present pandemic, involves a high degree of uncertainty and may require larger deviations or a longer transition back to the rule. For instance, fiscal and economic projections in most countries rely on a normalization in the second half of 2020. Currently, countries are expected to follow the adjustment path prescribed by the escape clauses, in many cases envisaging the return to the rule in one or two years—in some cases there is no explicit date, like in the EU activation, but depends on conditions. Giving the high degree of uncertainty, countries should prepare plans based on their baseline scenario when activating the escape clause. If necessary, governments should be ready to reassess and use all the flexibility allowed under the framework, including renewal or extension of escape clauses. This makes it even more critical ensuring full transparency in the process (see also below). Extending the use of the escape clause should follow the same principles that underpin the activation of escape clauses in the first place, including a revised plan to return to the rules. A crucial element is subjecting the process to external scrutiny and parliamentary approval, which will allow to balance flexibility with credibility.[7]

Effective monitoring and control. The monitoring of activation and implementation of escape clauses can be challenging. One way to overcome this is to grant this mandate to independent fiscal councils staffed by

[7] The extension of the use of escape clauses may in some cases require legislative amendments, particularly to clarify the powers to approve and resort to such an extension or to legislatively prescribe or limit the period of such extension. It will also allow to clarify cases where the limits under the escape clause are not clear.

experts, with the supreme audit institutions also playing a role.[8] Such agencies could assess the macroeconomic and fiscal projections of the government to determine if an escape clause is being appropriately triggered and are more likely to be viewed as credible because of their independence. For example, in Peru, the fiscal council supported the decision to suspend the rule in 2020-21, but recommended the publication of reports assessing the exceptional measures being adopted and explain the target for the deficit in 2021 to ensure transparency and accountability.

III. GOOD COMMUNICATION IS ESSENTIAL

A well-crafted communication strategy is instrumental when activating the escape clauses to foster the credibility of the fiscal framework and avoiding adverse market reaction. A successful communication strategy should rely on simple and clear messages aimed at informing the public and the markets about the recent economic developments and the assumptions behind the fiscal projections as well as the uncertainty surrounding them. It should spell out the implications of the activation of the escape clauses, the expected size and duration of the deviation, and the adjustment path to revert to the rule. Frequent communication will be required to explain how the outlook and policies will adapt as more information becomes available given the heightened uncertainty at present. Some of the elements that the communication strategy should include are:

- *Publish a credible medium-term fiscal strategy* to anchor expectations. This should include estimates of the economic and fiscal impact of the crisis. While there will be a high degree of uncertainty around the baseline projections (e.g. size and length of the shock), this will be an important document to ensure there is a commitment and strategy to return to the rules over the medium term. The policy document could stress the risks and include alternative scenarios allowing flexibility to governments, but also ensuring transparency as policies change.
- *Regular reports by the government* on all the measures and programs. This would include a description of the objectives of all the programs and measures, their fiscal costs, and potential risks to the budget (e.g. contingent liabilities). Regular reports would include updated estimates of costs and risks as more information is available. Several countries have already developed working groups or websites to monitor and provide transparency to the measures taken (see note on Keeping the Receipts: Transparency, Accountability, and Legitimacy in Emergency Responses).
- *Reports by independent agencies*. A fiscal council or a supreme audit agency (or a technical group) could provide regular independent reports. For example, the Netherlands Bureau for Economic Policy Analysis (fiscal council) prepared several scenarios to assess the impact of the Covid-19 pandemic in the economy and public debt.

[8] The division of roles on oversight will depend on each country's institutional framework. Fiscal councils are typically tasked with macro-fiscal policy analysis and assessment, and often ex-ante or ex-post verification of fiscal rule compliance. They could also have a role in verifying ex-ante if the escape clause should be activated. Audit agencies typically focus on checking abidance by public finances laws and have an ex-post perspective. However, in some cases the audit agency may be asked to do a preliminary ex-ante verification as well.

IV. SUSPENDING AND REVISING FISCAL RULES

What should governments do if the rule framework does not envisage escape clauses or they are too rigid? A large shock may put significant pressure on the rule-based fiscal framework that is too inflexible.

- In the absence of escape clauses, fiscal rules could be suspended if they impede the government from responding to the pandemic or other large shocks. For example, during the GFC, since few rules had escape clauses in place, several countries put their fiscal rules into abeyance to provide the countercyclical stimulus measures needed to mitigate the economic impacts of the crisis while also defining an adjustment path to revert to the rules (Schaechter et al. 2012). Such suspension should follow legal procedures (e.g. likely will require changes to laws) and it is recommended that Parliament establishes the conditions under which this temporary deviation will be done and monitored. It should also be supported by a communication strategy and, if possible, assessed by independent bodies, as when escape clauses are activated. For example, the Indonesian government has announced a temporary suspension of the fiscal deficit cap for 3 years.
- If escape clauses exist, but are too strict, governments could consider changes to allow more flexibility. The changes to the escape clause should still envisage being as explicit as possible regarding when and for how long rules could be suspended and require transparency. Having an independent agency that verifies if the escape clause is appropriately used would allow for flexibility in the design of the escape clause while maintain the robustness and credibility of the framework. For example, in Panama, the law contains escape clauses with caps that would allow the government to relax the fiscal deficit by 2 percent of GDP in 2020. But the National Assembly adopted a new legislation to modify the SFRL limit for 2020, allowing for larger deviations. In Peru, the government suspended the fiscal rule for two years (2020-21) by legislative decree instead of using the escape clause which would include conditions on the path back to the rule.

Should countries consider revising the rules as the shock may make unviable to abide by them for a long period? A large shock may expose weaknesses in the design of the fiscal rules or make the assumptions behind the calibration of the quantitative limits no longer realistic. This is more so if the effects of the shock are persistent (e.g. oil prices remain low for long). The collapse in commodity prices in 2014 and 2015 prompted many commodity exporters to revise or recalibrate their fiscal rules. The current crisis and the expansionary fiscal policies needed to contain its impacts may also put pressure on existing frameworks. For example, in some countries, it could result in a large debt increase that is significantly above the debt limit. The large fall in oil prices will also, once again, test the robustness of the fiscal rules in countries with high dependence on oil exports.

It may be opportune to review and upgrade the fiscal rules to guide the period after the pandemic is under control and to make the rules more resilient. Periods after large shocks are usually a time to review and, if necessary, revise rules. The GFC has put many fiscal rules to tests, prompting a raft of reforms to rules including the introduction of new rules, revamping of escape clauses, and enhancement of monitoring and enforcement mechanisms.

However, caution is needed when changing fiscal rules as there are costs. For example, frequent revisions may signal weak government commitment to fiscal discipline and have adverse market reactions (higher borrowing costs). In general, rules should not be revised unless there are large and persistent deviations from "first-best" policies (Eyraud et al. 2018). If done, a revision should follow a transparent procedure (e.g., via legislation envisaging the procedures for rule revision) and should typically require parliamentary approval. An independent fiscal council, if it exists, could be asked for recommendations. The revision could address several aspects of the framework (e.g. calibration, escape clauses) and should ensure the new rules are consistent with forward-looking policy goals (e.g. debt sustainability, stability) and not to accommodate past violations of the rule. Finally, a suspension or upgrade of fiscal rule should be supported by a communication strategy to explain the reasons to the markets and the public.

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