

**COMMENTS ON SESSION 4**  
**NATIONAL FISCAL FRAMEWORKS: THE WAY FORWARD**

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**Comments on “Russian Fiscal Framework: Past, Present and Future. Do We Need a Change?” presented by Sergey Vlasov, “The Story of Israel’s New Fiscal Rule: Theoretical Design Meets Politics” presented by Adi Brender and “Reforming Iceland’s Fiscal Framework” presented by Gunnar Gunnarsson**

These three case studies are dealing with very different topics. All three of them are very pleasant to read and manage to provide very clear and deep insights on local situations that are complex. I took great pleasure in reading all of them. In this comment I will focus on the main points that I find questionable in order to start the general discussion.

The study on the fiscal rule in Russia presents the design of a rule dedicated to find the best use of volatile and non-renewable resources in order to stabilize public accounts: revenues from oil and gas. The second outlines very clearly how the Israelis have chosen to create a fiscal rule in the context of sound budgetary positions. The perspective adopted is that of political economy. The various arrangements that led to the adoption of the rule are presented very clearly. The last paper deals with the case of Iceland and how Iceland has implemented changes to recover from the financial crisis following the recommendations of the IMF.

Although each of the presented papers are very different in terms of countries studied, the economic and budgetary contexts and of the selected analytical perspectives, these three countries share one same pattern: fiscal variables were following a favorable trajectory of debt burden reduction when the 2008 crisis has hit the world economy and has called into question the sustainability of each pattern (see table 1). This led to the postponement of the fiscal reforms underway in the Russian case, to the creation of a new fiscal rule to overcome the crisis in the Icelandic case and to create a new fiscal rule to improve the credibility of the fiscal rules in the Israeli case.

In each case, the 2008 crisis revealed structural breaks hidden by the favorable pre-crisis context: pro-cyclicality of fiscal policy in the case of Russia, consumption boom driven by rising asset prices and privatization in the case of Iceland, unexpected revenue enabling the Israeli government to run unsound expenditure in Israel.

The economic contraction following the financial crisis has put these structural fiscal failures up to front in each of these countries.

Russia recorded high public deficits as shown in the following figure taken from the Russian paper.

Iceland budget balance recorded huge deficits in 2008 and 2009: respectively 13.5 and 9.1 per cent of GDP. In Israel budget balance recorded smaller deficits: respectively 2.8 and 5.6 per cent of GDP.

In the rest of this comment, I will come back to what each of these countries considers being good fiscal rule with respect to these developments.

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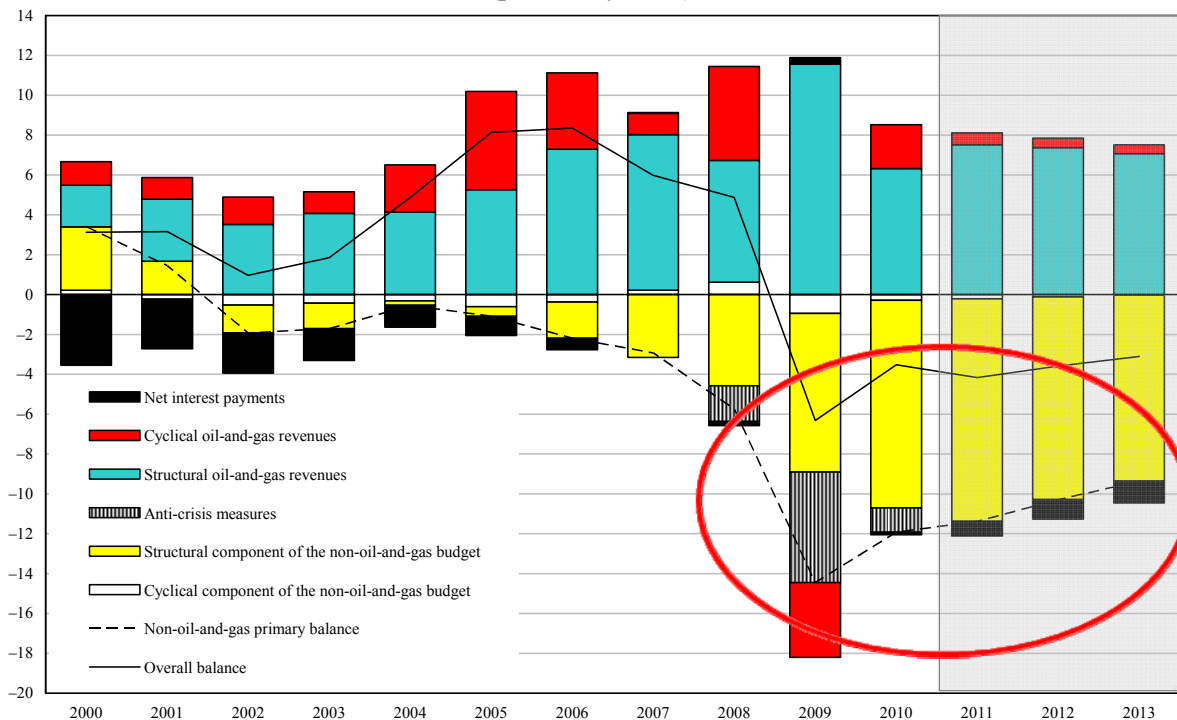
Table 1

## Fiscal Developments in Russia, Iceland and Israel Before the Financial Crisis

Country	2006	2007
<b>Budget balance</b> <i>(percent of GDP)</i>		
Russia	+8.0	+6.0
Iceland	+6.3	+5.4
Israel	-1.1	-0.6
<b>Debt Ratio</b> <i>(percent of GDP)</i>		
Russia	9.1	7.4
Iceland	27.9	29.1
Israel	84.5	78.2

Source: OECD.

Figure 1

General Budget Balance Decomposition for 2000-13  
*(percent of GDP)*

Source: Sergey Vlasov: "Russian Fiscal Framework: Past, Present and Future. Do We Need a Change?", in this volume.

## The Icelandic case

In the case of Iceland the crisis has revealed two main weaknesses of the fiscal framework: a deficit bias of the fiscal policy, a banking regulation problem related to the rise in asset prices.

To cope with the first issue the following renewed fiscal framework has been proposed under the influence of IMF stand-by arrangements. I will not enter into the details of this framework which has been extremely well-presented in the paper of my colleague. I will just summarize the main features:

- At the national level the reform proposes the adoption of a medium term budget framework, three fiscal rules (a budget balance rule, a debt level ceiling rule, and a fixed two year nominal ceiling rule). The introduction of a top down formulation and approval of the budget has been partly adopted as well as a more stringent supervision process.
- At the subnational level, municipalities are prohibited from running operating deficits over a rolling three-year-period. A debt-to-revenue ceiling of 150 per cent is to be introduced as well as sanction for non compliance with the rules. A coordination body between central and local governments has been created.
- A modification of the legal framework is in progress with a reform of the Parliament budget power.

The new architecture follows the recommendations of the IMF to correct the deficit bias observed previously. It does not introduce measures destined to tackle the excessive use of credit in connection with the asset prices bubble. This leaves open the question of the policy mix. Can an optimal fiscal rule be built without connections with the implementation of broader prudential supervision of credit? Indeed, in a crisis, the boundaries between the public and private sphere may be blurred in the sense that private debts tend to finally become public ones (through bank rescue mechanisms for instance). How to do it remains an open issue. Have these aspects been mentioned in the case of Iceland?

Another comment came to my mind when reading the following sentence justifying the introduction of the nominal ceiling rule: “Nominal rules are beneficial if economic stabilisation is a goal because higher inflation leads directly to lower real expenditure in a counter-cyclical fashion”.

Indeed, almost all of us have been introduced with common economics textbooks mentioning that a rise in growth leads to a rise in inflation. Thus, if the ceiling is defined in nominal terms then, real expenditure should decrease to respect the target. But what happens if growth and inflation are negatively correlated? There had been examples of such correlation in the history for instance in France. In this case, on the contrary, following a nominal ceiling may be procyclical. I think one should keep this possibility in mind and not abandon completely real targets when designing a fiscal rule.

## The Israeli case

The paper presents the different discussions that have occurred in Israel on the creation of an expenditure ceiling with a mechanism destined to enable to increase the ceiling at the long term growth rate of the economy. The mechanism was destined to reduce the rate of increase according to the distance of the debt ratio from the intermediate target of 60 per cent with preset parameters for the speed of convergence.

In practice, taxes are excluded from the rule. Nevertheless, a plan has been adopted to cut taxes on a long term horizon. Rules were mainly destined to commit the government not to moderate the pace of tax reduction, at the same time, enabling political sustainability.

A first rule has been proposed by a team of economist from the Bank of Israel. The rule was the following:

$$PE_{gr} = GDP_{POT_{gr}} - a \left( \frac{D}{Y_{t-2}} * 100 - 60 \right) + 2 \quad (1)$$

With  $PE_{gr}$  the growth rate of primary expenditure,  $GDP_{POT_{gr}}$  the growth rate of potential GDP,  $a$  the parameter for the speed of convergence to the target of 60 per cent,  $\frac{D}{Y}$  denotes the debt-to-GDP ratio.

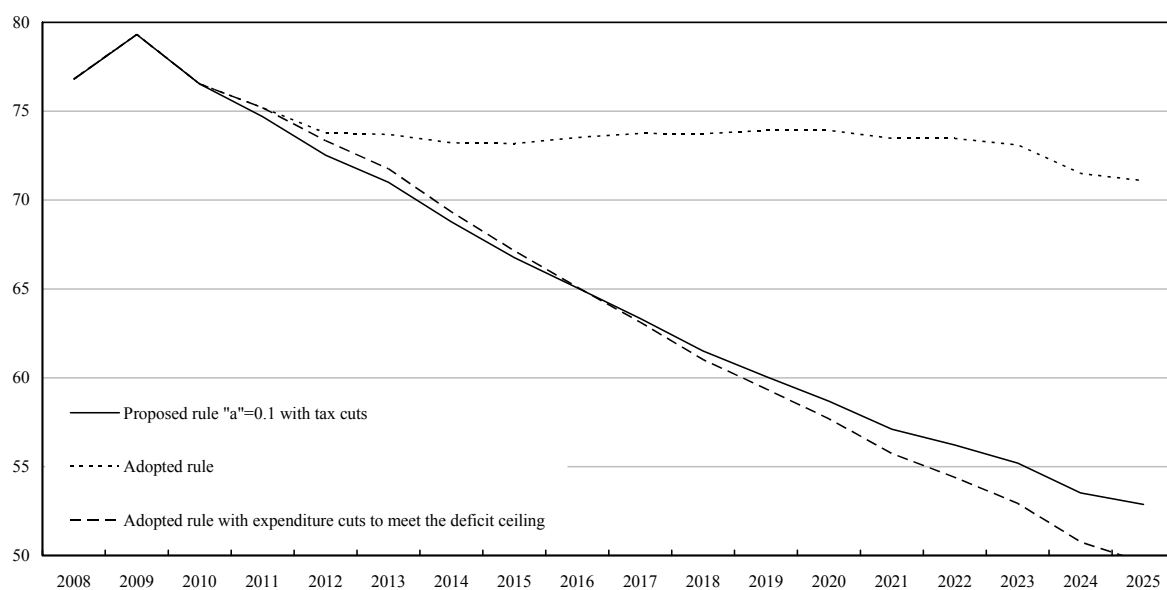
The rule was formalized that way in order to let the representatives of Israel the possibility to choose the different parameters of the rule. Nevertheless, they prefer to adopt another rule without a “free” speed of convergence parameter to define which was considered as less politically demanding. The new rule was the following:

$$PE_{gr} = GDP_{POT_{gr}} * \left( \frac{60}{\frac{D}{Y_{t-2}}} * 100 \right) + 2 \quad (2)$$

This rule set the convergence speed. Nevertheless, Adi Brender shows that this formulation is less stringent than the previous one, thanks to the following simulation exercises:

Figure 2

**Fiscal Aggregates based on the Adopted Rule, 2008-25**  
**Public Debt/GDP Ratio, Various Policy Scenarios, 2008-25**  
 (percent of GDP)



Source: Adi Brender, “The Story of Israel’s New Fiscal Rule: Theoretical Design Meets Politics”.

Nevertheless, one can go even further. Indeed, the new formula contains an implicit convergence speed parameter  $a$ . By equalizing the two equations, one gets:

$$GDP_{POT\ gr} - a \left( \frac{D}{Y_{t-2}} * 100 - 60 \right) = GDP_{POT\ gr} * \left( \frac{60}{\frac{D}{Y_{t-2}}} * 100 \right) \quad (3)$$

This implies that:

$$a \left( \frac{D}{Y_{t-2}} * 100 - 60 \right) = GDP_{POT\ gr} - GDP_{POT\ gr} * \left( \frac{60}{\frac{D}{Y_{t-2}}} * 100 \right) \quad (4)$$

and, finally, that:

$$a = \frac{GDP_{POT\ gr}}{\frac{D}{Y_{t-2}} * 100} \quad (5)$$

The following expression means three things:

- First, implicitly the new rule set definitely the convergence parameter. The different governments commit to respect it. One justification of the abandon of the first rule was the will of not having to choose a specific  $a$ . In this respect, the result is the opposite.
- Second, if we compare the magnitude order of the different components of the ratio, it means that the chosen  $a$  is rather small which confirms the simulation exercise run by the Central Bank team. Indeed, the potential GDP growth rate stands likely somewhere below 10 per cent compared to a debt ratio that may be largely higher than this proportion.
- Third, the rule set the following relation: the higher the debt ratio the lower the convergence speed. Hence, in the new rule  $a$  evolves mainly with the value of the debt-to-GDP ratio, the lower this ratio the faster the convergence speed. The chosen convergence pattern postpones the fiscal adjustment.

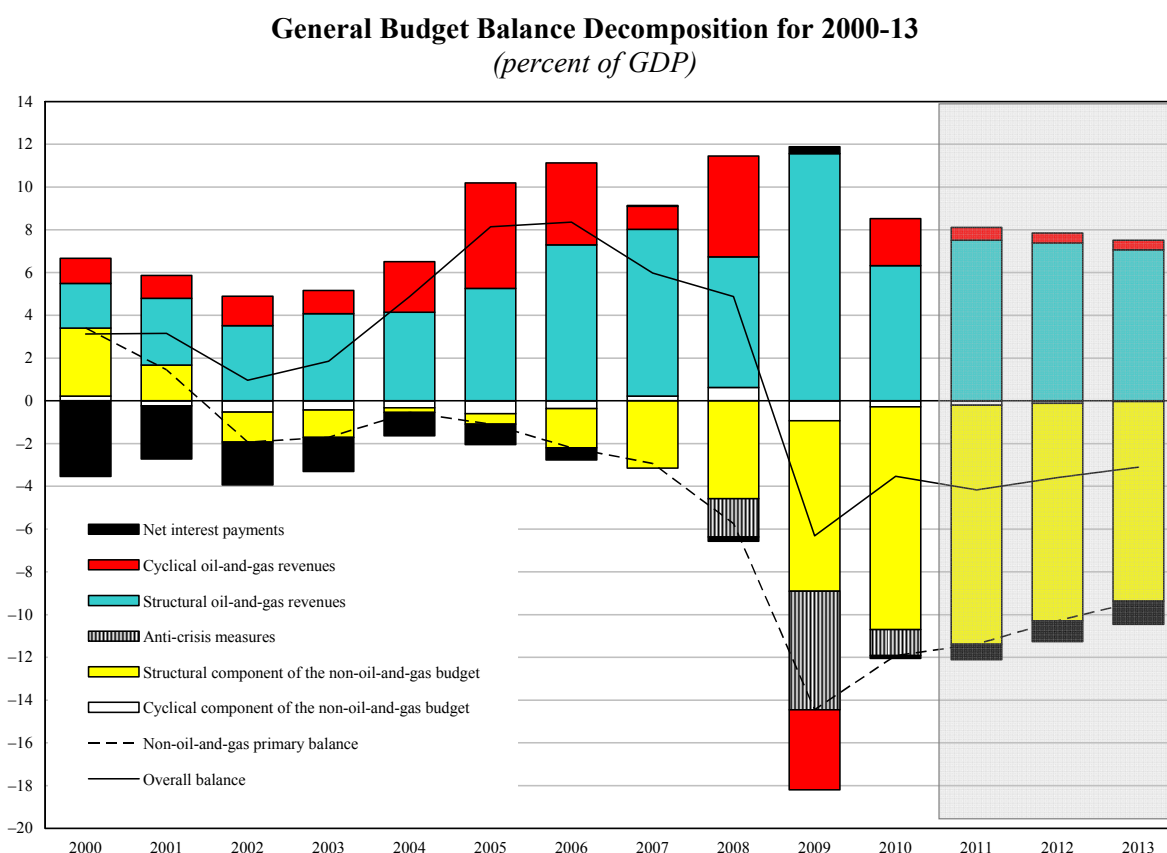
## The Russian case

This paper deals with a very different issue. It investigates the question of how using properly non renewable resources or revenue in a fiscal stability purpose. Since the fall of the Soviet Union political and economic changes have been huge in Russia. Concerning the fiscal framework and the question of the last main two changes are:

The creation of a stabilization fund in 2004 which is financed by the difference between the revenue under the base oil price which are used on spending and the revenue above which are saved. Since 2008 non-oil-and-gas revenue must record a balanced budget.

To summarize, these two rules initiate a separate treatment of oil-and-gas and non-oil-and-gas revenues, create a ceiling for non-oil-and-gas deficits, and put into place a fixed transfer of oil-and-gas revenues to finance the budget the difference being covered by borrowing.

Figure 3



Source: Sergey Vlasov, "Russian Fiscal Framework: Past, Present and Future. Do We Need a Change?", in this volume.

The rules parameters were the following, oil and gas transfers were set at 3.7 per cent of GDP and the authorized deficit for non oil and gas budget at 4.7 per cent of GDP. The 2008-10 period was supposed to be a transition period. But, the crisis hit and the implementation of the rule has been postponed. For the moment we do not know until when. This raises the question of the absence of guidelines to deal with exceptional circumstances like in the European case. The absence of such mechanisms which submits the rule to the use of discretionary power may hamper the credibility of these rules.

The paper presents some simulation exercises on the way the rule has been calibrated. Different scenarios have been studied. In each case the rule fails to ensure sustainable fiscal developments. To succeed one has to modify the parameters by authorizing less transfers and more borrowing. But in the end, the oil and gas resources vanish and the budget situation is not sustainable any more.

The last studied simulation envisages a situation close to the Norway model: the bird-in-the-hand scenario. In the Norway model almost all non oil and gas deficit are financed by the real return on the asset of the oil fund. But, in Norway the fund value is exceeding the GDP value and the returns are equal to almost 5 per cent of GDP, whereas in Russia the respective figures are 7.8 and 0.3 per cent of GDP. Hence, the conclusion of a necessary decrease in budget expenditure to put fiscal variables into a sustainable path.

We fully agree with this conclusion especially when looking more carefully at the simulation exercises based on governmental figures. Indeed, the volatility of oil-and-gas revenue has been reduced (see the blue component of the shady area of Figure 3, taken from the Russian paper).

As the structural component of oil-and-gas revenues is deduced from it, it may change the results. In our opinion the unsustainable aspect of the fiscal pattern may be reinforced if one takes a higher volatility into account.

All in all, these three papers are very informative and very pleasant to read and I recommend the readers to read them.

