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Fiscal Monitor, April 2021
From Deficit Delusion to the Fiscal Balance Rule

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ALESSANDRA CAMERON

On the Measurement and Impact of Fiscal Decentralization
International Monetary Fund
The IMF Working Papers series is designed to make IMF staff research available to a wide audience. Almost 300 Working Papers are released each year, covering a wide range of theoretical and analytical topics, including balance of payments, monetary and fiscal issues, global liquidity, and national and international economic developments.

Decentralization Or Fiscal Autonomy?
International Monetary Fund
We examine how the cost of corporate credit varies around fiscal consolidations aimed at reducing government debt. Using a new dataset on fiscal consolidations and syndicated corporate loan data, we find that loan spreads increase with

fiscal consolidations, especially for small firms, domestic firms, and for firms with limited alternative financing sources. These adverse effects are mitigated substantially if consolidations are large, and can be avoided if consolidations are also accompanied with more adaptable macroeconomic policies and implemented by a stable government. These findings suggest that lenders price the short-term recessionary effects in loans but large consolidations can reduce or undo the increase in spreads, especially under favorable country conditions, by signaling credibility and creating expansionary expectations.

From Deficit Delusion to the Fiscal Balance Rule

How to Measure the Fiscal Deficit

We estimate the effects on growth of nine fiscal reform episodes in seven high-income countries using the Synthetic Control Method. These episodes are selected using an indicator-based approach applied to the evaluation of growth-friendly fiscal reforms during 1975-2010. We find that in reform countries the annual growth rate of real GDP was on average about 1 percentage point above their synthetic units 10 years after each respective reform. Moreover, countries which were initially less developed seemed to experience

a larger growth impact after their reforms. Results are broadly robust to controlling for structural reforms on business regulation, financial market, labor market, and legal and product markets, which may also affect growth. Our findings also suggest that inequality is not affected by the growth-friendly fiscal reforms analyzed in this paper.

How to Measure the Fiscal Deficit

Washington, s.n.

Fiscal stress is an important and recurring problem that states face. Research to date on state fiscal stress involves, predominantly, cross-sectional and case study analyses and does not address the effectiveness of state responses. Many of these studies use different definitions and measures of fiscal stress compounding the difficulty of comparing fiscal stress findings. The present research effort adds to the fiscal stress literature by (1) clarifying the meaning of fiscal stress in the state context, (2) developing a measure of fiscal stress that operationalizes this meaning and is comparable across units, and 3) using this measure analyzes patterns in and the effectiveness of state responses. Fiscal stress is measured using four indexes: budget, cash, long-run, service-level. Eleven financial indicators, calculated using data from state Comprehensive Annual Financial Reports (CAFRs), are used to create these indexes

for all fifty states for the years 2002-2009. Descriptive analysis compares state fiscal stress levels (grouped into low, moderate, and high fiscal stress by cluster analysis) to state economic growth rates, state responses, and institutional factors yielding several findings. First, states do not use an incremental or punctuated equilibrium strategy in responding to fiscal stress; nor do their responses follow the pattern predicted by Cutback Management theory. Second, institutional factors affect both the levels of fiscal stress and state responses to fiscal stress. Regression analysis supports and extends these findings. First, short-term responses of expenditure cuts, tax increases, and rainy day fund use do not affect state fiscal stress levels. Second, these responses have long-term effects on fiscal stress levels. A major implication of this research is that there is very little states can do in the short-term to reduce fiscal stress. However, by balancing expenditures and revenues states can set themselves up to weather the next economic downturn with lower levels of fiscal stress.

The Neglected Role of School District Revenue Instability

International Monetary Fund

Much of the school finance literature has focused on the distribution or equality of resources across school districts. Such

literature compares levels of spending between school districts or states. But it has ignored the variability and unpredictability of those revenues within school districts over time. Meanwhile, public finance literature has focused on states or counties, and disregarded school districts as a unit of analysis for responses to fiscal stress. This dissertation addresses these gaps. First, drawing from techniques both within and outside of public finance, I contribute a new measure of fiscal stress based on unpredictability of state revenues. Second, I explicitly assess policy and tax mechanisms that may aggravate revenue instability for school districts and to what extent instability changes over time. Finally, I examine school districts response to chronic unpredictability in state revenues. Despite states' increasing reliance on more volatile sales and income taxes to fund public education, I find that unpredictability in state revenues to districts has declined by one-fourth of a standard deviation over time. In states that shifted to the more volatile sales and income tax base while also centralizing school finance as part of efforts to equalize school funding, unpredictability in state revenues to districts declined by a full standard deviation. In effect, centralization and more equal

distribution of funding appears to trump the effects of a volatile tax base, as states have a greater ability to buffer against shocks than local education agencies do. Yet districts still face uncertain and unstable revenues from the states, aggravated by economic downturns. With primary and secondary data, I study the case of California where districts face uncertain cuts to their allocations during the year and between years. I use three key fiscal health measures: average revenue instability over time, whether revenues declined in the prior period, and the experience of the budget officer. I find that highly unstable districts are more likely to raise local revenues, but that cost-cutting is more prevalent that revenue-raising. Experienced budget officers use a greater variety of policy instruments to cope with instability, pointing to the under-explored role of management in the fiscal health of a district. These findings as a whole suggest that revenue instability merits further attention in the school finance literature in particular and public management in general. Unpredictability in states revenues is a phenomenon that concerns school districts, one that changes over time, but one to which they may adapt.

Measures of State and Local Fiscal Capacity and Tax

Effort International Monetary Fund
How to Measure the Fiscal DeficitInternational Monetary Fund
Fiscal Reforms, Long-term Growth and Income Inequality
Stanford University
Fiscal impulse measures are used in the WEO and elsewhere to indicate the changing impact of the budget on the economy. Such measures are intended to provide more accurate indications of whether the budget is becoming more or less expansionary than would just observing moments in the actual budget balance. However, they have been criticized for lacking an analytical rationale. This paper uses a simple framework to show that the fiscal impulse measure can be analytically derived. While this removes one source of criticism, the measure, nevertheless, should be used carefully when making inferences of fiscal impact.

The Use of Income as a Measure of School District Fiscal Capacity International Monetary Fund
Fiscal policy seeks to equilibrate the public sector's financing needs with the private sector's demand for investment and a sustainable balance of payments. Correct measurement of the public sector's net use of resources is therefore an important prerequisite for managing the macroeconomy. This volume, edited by Mario I. Blejer and

Adrienne Cheasty, is organized around four issues: the adequacy of summary measures of the fiscal deficit, conventional and adjusted deficits, coverage (size) of the public sector, and the public sector's intertemporal budget constraint.

Fiscal Stress in the U.S. States Palala Press

This paper examines the macroeconomic effects of tax changes during fiscal consolidations. We build a new narrative dataset of tax changes during fiscal consolidation years, containing detailed information on the expected revenue impact, motivation, and announcement and implementation dates of nearly 2,500 tax measures across 10 OECD countries. We analyze the macroeconomic impact of tax changes, distinguishing between tax rate and tax base changes, and further separating between changes in personal income, corporate income, and value added tax. Our results suggest that base broadening during fiscal consolidations leads to smaller output and employment declines compared to rate hikes, even when distinguishing between tax types.

Fiscal Stabilization and Growth International Monetary Fund

Notwithstanding its widespread use as a measure of fiscal policy, the government deficit is not a well-defined concept from the perspective of neoclassical macro

economics. From the neoclassical perspective the deficit is an arbitrary accounting construct whose value depends on how the government chooses to label its receipts and payments. This paper demonstrates the arbitrary nature of government deficits. The argument that the deficit is not well-defined is first framed in a simple certainty model with nondistortionary policies, and then in settings with uncertain policy, distortionary policy, and liquidity constraints. As an alternative to economically arbitrary deficits, the paper indicates that the "Fiscal Balance Rule" is one norm for measuring whether current policy will place a larger or smaller burden on future generations than it does on current generations. The Fiscal Balance Rule is based on the economy's intertemporal budget constraint and appears to underlie actual attempts to run tight fiscal policy. It says take in net present value from each new young generation an amount equal to the flow of government consumption less interest on the difference between a) the value of the economy's capital stock and b) the present value difference between the future consumption and future labor earnings of existing older generations. While the rule is a mouth-full, one can use existing data to check

whether it is being obeyed and, therefore, whether future generations are likely to be treated better or worse than current generations

The Use of Income As a Measure of School District Fiscal Capacity

International Monetary Fund

We use discounted cash flow analysis to measure a country's fiscal capacity. Crucially, the discount rate applied to projected cash flows includes a GDP risk premium. We apply our valuation method to the CBO's projections for the U.S. federal government's deficit between 2022 and 2051 and debt in 2051. In spite of low rates, our current measure of U.S. fiscal capacity is lower than the debt/GDP ratio. Because of the backloading of projected surpluses, the duration of the surplus claim far exceeds the duration of the outstanding Treasury portfolio. This duration mismatch exposes the government to the risk of rising rates, which would trigger the need for higher tax revenue or lower spending. Reducing this risk by front-loading the surpluses also requires major fiscal adjustment.

Equity in Taxation

International Monetary Fund

Although the deficit is a useful construct for Keynesian analyses of fiscal policy, the deficit appears to be a less useful measure of fiscal policy within all but a restricted class of intertemporal

neoclassical models. This paper suggests that the nature of deficits in a simple certainty model with nondistortionary policies, and the in settings with uncertain policy, distortionary policy, and liquidity constraints is, to a large extent, arbitrary. It then posits a more appropriate description of fiscal policy for the class of models in question, and proposes the economically meaningful “fiscal balance rule” as an alternative to the economically arbitrary “balanced budget rule” as a means of assessing whether fiscal policy is intergenerationally tight or loose.

Toward Defining and Measuring the Fiscal Impact of Public Enterprises World Bank Publications

In many countries, the activities of public enterprises have an important fiscal impact. While the precise nature of this impact is often obscured, it is important that it be reflected in measures of overall fiscal activity. The paper is intended to raise and clarify some of the issues involved in this task.

Fiscal Impulses and Their Fiscal Impact

International Monetary Fund

The concept of fiscal impulse is defined, discussed, and differentiated from measures that attempt to summarize the macroeconomic effects of fiscal policy. Two methodologies are briefly discussed and their corresponding

measures presented for the G-7 countries over the ten-year period ending in 1989. Controversies about the measure are highlighted and potential improvements are also discussed.

Macroeconomic Effects of Tax Rate and Base Changes: Evidence from Fiscal Consolidations
International Monetary Fund
Fiscal impulse measures are used in the WEO and elsewhere to indicate the changing impact of the budget on the economy. Such measures are intended to provide more accurate indications of whether the budget is becoming more or less expansionary than would just observing moments in the actual budget balance. However, they have been criticized for lacking an analytical rationale. This paper uses a simple framework to show that the fiscal impulse measure can be analytically derived. While this removes one source of criticism, the measure, nevertheless, should be used carefully when making inferences of fiscal impact.

Fiscal Impulse
International Monetary Fund
The problem active in this study was the use of income as a measure of fiscal capacity of local school districts. More specifically, the research concerned the legal ramifications of incorporating such a measure into a public school finance system.

The research included a review of the principles of taxation and legal precedents concerning uniformity and equality of taxation, a discussion of the quantitative evaluation of the use of income as a measure of fiscal capacity, and an analysis of the legal precedents that could influence the future use of an income measure in a public school finance system. The use of an income measure has been viewed by some authorities as a positive step towards taxpayer equity due to its close relation to the ability-to-pay principle of taxation and the progressive effect it has on the taxpayers. However, other authors have criticized the use of the measure on the basis that most school districts do not have-- page missing -- taxing authority to local school districts which would allow local access to tax income. The problems seem to arise in states that prohibit a state income tax or a graduated income tax. The possibility of utilizing an income plus property measure of fiscal capacity in these states would probably be limited. Just as the laws concerning taxation differ among the states, the legal precedents will also differ dependent upon the laws. There is no pervasive rule that will determine the legality of a tax system that includes an income factor. The major determinant will come from the precedents that come from the legal challenges that

will occur in the states, and these precedents will influence the design and implementation of the tax structure within each state.

Measuring the Fiscal "blood Pressure" of the States, 1964-1975
OECD Publishing
This book deals with two issues. The first concerns the various measurement of fiscal decentralization in general and their usefulness for policy analysis. The second and more specific issue concerns the taxonomy of intergovernmental grants and the limits of the current classifications.

Measuring Fiscal Vulnerability and Fiscal Stress International Monetary Fund
The April 2021 edition of the Fiscal Monitor focuses on tailoring fiscal responses to the COVID-19 pandemic and adopting policies to reduce inequality and gaps

Fiscal Sustainability with Non-Renewable Resources
International Monetary Fund
We combine state-level fiscal data with household survey data to assess the links between sub-national fiscal policy and income inequality in Brazil over the period 1995-2011. The results indicate that a tighter fiscal stance at the sub-national level is not associated with a deterioration in inequality measures. This finding contrasts with the conclusions of several papers in the burgeoning literature on the effects of fiscal consolidation on inequality using

national data for OECD economies. In addition, we find that a tighter stance is typically positively associated with a measure of “shared prosperity”. Hence, our results caution against extrapolating policy implications of the literature focusing on advanced economies to other settings.

Fiscal Consolidation and the Cost of Credit
International Monetary Fund
This paper proposes a set of fiscal indicators to assess rollover risks using the conceptual framework developed by Cottarelli (2011). These indicators provide early warning signals about the manifestation of these risks, giving policymakers the opportunity to adjust policies before extreme fiscal stress events. Two aggregate indices are calculated: an index of fiscal vulnerability and an index of fiscal stress. Results show that both indices are elevated for advanced economies, reflecting unfavorable medium-term debt dynamics and aging-related spending pressures. In emerging economies, solvency risks are lower, but the composition of public debt remains a source of risk and the fiscal position is weaker than before the crisis.

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