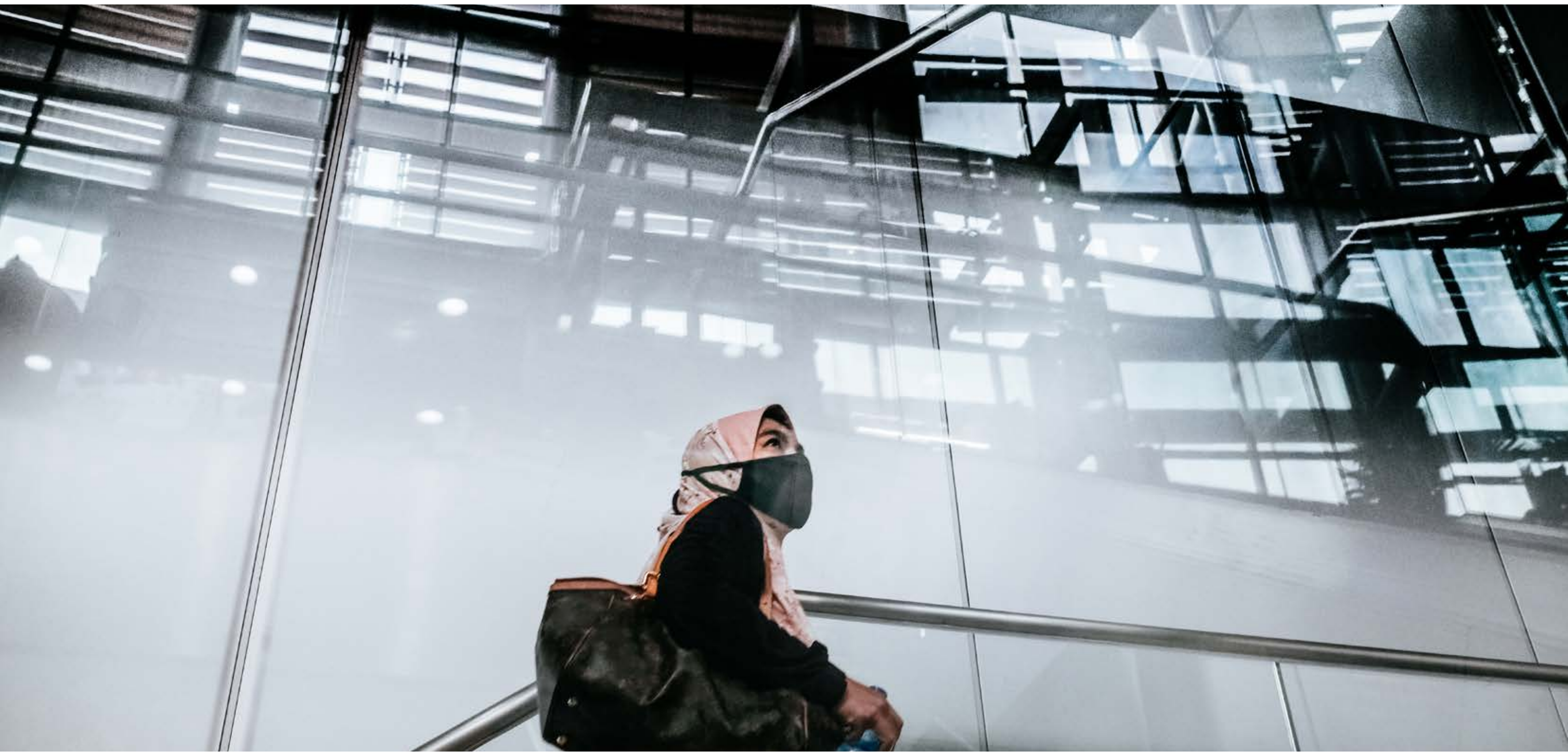
A JOINT POLICY BRIEF FROM NIESR AND ACCA:

Resetting Fiscal Frameworks through Covid-19

The Covid-19 crisis resulted in the most severe global recession in decades, although many advanced economies are expected to regain their pre-pandemic level of output later this year (see ACCA's *Global Economic Conditions Survey Report Q2 2021*). The recovery in many economies has been swift owing, in part, to the substantial policy response to Covid-19.



While monetary policy played a role, the primary policy response was fiscal: governments supported the incomes of households and companies affected by lockdowns with direct transfers, wage subsidies, increased benefits, and loan guarantees. The International Monetary Fund (IMF) estimates that the total fiscal support in response to Covid-19 is around US$16 trillion. This support created the conditions for strong economic recovery once lockdowns were lifted, but it has left a legacy of public sector liabilities and broken fiscal rules that require a reset in governments' fiscal frameworks.

A surge in government spending to support private sector incomes and a sharp drop in tax revenues as output collapsed led to ballooning budget deficits across the globe. In advanced economies the overall government balance jumped from an average deficit of 3% of GDP in 2019 to over 11.5% of GDP in 2020; in emerging markets the jump was from 4.7% to 9.8% of GDP over the same two years. As with so many aspects of the Covid-19 crisis, there is a divergence between advanced economies and emerging markets. The IMF notes that the increase in fiscal deficits in advanced economies is explained roughly equally by increased spending and a fall in revenues, while in the case of emerging markets falling revenues were the primary cause of wider fiscal deficits.

Large increases in public sector deficits also pushed debt levels higher. Global public debt climbed to 97.3 % of GDP in 2020, a surge of 13 percentage points from the level projected before the pandemic. In advanced economies, public sector debt jumped by 16 percentage points to 120% of GDP, while the rise in emerging markets was 10 percentage points to 64% of GDP. Greatly increased levels of public sector debt will be a long-lasting legacy of the Covid-19 crisis: budget deficits will shrink as fiscal support is withdrawn and tax revenues pick up, but elevated debt-to-GDP ratios will persist for many years. Global public debt is projected by the IMF to stabilise at about 99% of GDP through the medium term.

As Covid-19 hit, it quickly became apparent that any fiscal rules would be broken by a significant margin. Some countries' frameworks had 'escape clauses' that lifted the rules in the event that certain trigger points were reached, such as a large fall in GDP. In other cases, the fiscal rules were simply suspended altogether. In any case, governments must now find a route

back to long-term fiscal sustainability and credibility. Given the scale of the impact on fiscal metrics, credible medium-term fiscal frameworks will need to be expressed over several years—thereby extending the horizon for fiscal policymaking beyond an annual budget.

As fiscal policy has regained prominence as a macro policy tool so the case for reform has increased The thrust of this has been towards a much greater role for independent experts, increased transparency and better communication – similar to the evolution that has taken place in monetary policy. Certainly, the Covid-19 crisis has highlighted the importance of transparency and communication in the development and implementation of fiscal policy. But there are limits to the monetary policy model for fiscal policy. Monetary policy has two primary objectives – price stability and financial stability. Meanwhile, fiscal policy has multiple objectives beyond traditional macroeconomic stabilisation in order to support more robust and inclusive growth. These include, but are not limited to, income redistribution, providing incentives to encourage certain activities (such as capital accumulation and productive use of financial resources) and to discourage others (such as smoking, pollution), reducing regional inequalities, preparing for future shocks to public health or reducing the risk of catastrophic climate change. Hence, the design of an appropriate fiscal policy framework is more complex than its monetary policy counterpart and cannot be removed from the political process. Drawing on the above and on the NIESR report *Designing a New Fiscal Framework*, we suggest the following principles for a post-pandemic fiscal framework.

A post-pandemic fiscal framework

Fiscal events should be timetabled at least 12 months ahead and not subject to change according to political developments. This is analogous to the monetary policy meeting schedules of many central banks. There are likely to be fewer fiscal events than monetary policy ones in a given year, but they should be used to set out the goals of fiscal policy which that are then scrutinised by Parliament.

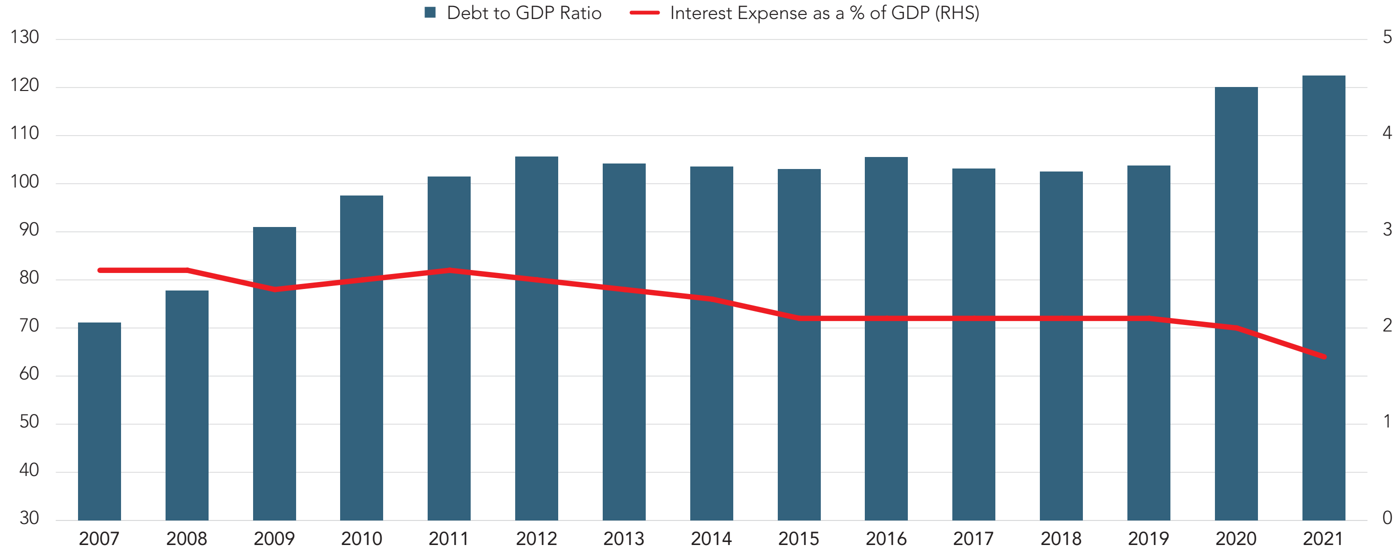
Establish an independent economic body to make economic forecasts that are relied upon by governments in setting fiscal policy. The credibility of fiscal policy is greatly enhanced when the government must base its fiscal plans on independent economic forecasts. This avoids the risk that governments will justify announcements of fiscal largesse by making excessively optimistic economic growth forecasts. The economic body should also present scenarios that include not only the effect of automatic stabilisers on debt and deficit and debt servicing costs from different macroeconomic outcomes, but also the effect of any fiscal policies likely to be deployed in the event that certain risks materialise.

Develop a refreshed set of credible fiscal rules. Fiscal rules (also known as fiscal targets) are parameters set by the government to limit its own tax and spend excesses. They are designed to help it avoid the temptation to borrow more, leaving future generations to deal with the consequences. The Covid-19 crisis has demonstrated a few essential characteristics of fiscal rules. First, given the rise in public sector debt and persistence of high deficits, credible fiscal rules need to be framed over a multi-year period. As well as concern about the debt itself, there is likely to be an intensified focus on debt-servicing costs in future. Despite high levels of debt, the cost of servicing that debt is close to record lows, reflecting low long-term bond yields (see charts). But there is now heightened sensitivity of debt servicing costs to interest rates such that a modest rise in interest rates could undermine the health of the public finances unless the rises are accompanied by stronger growth prospects. More importantly, fiscal rules should adopt a balance sheet approach rather than focusing entirely on public debt stocks and deficits. Nearly 40% of the global fiscal support during the Covid-19 crisis came in the form of loans or guarantees, equity injections, and other quasi-fiscal measures. Any surge in bankruptcies or calls on guarantees could undermine public sector balance sheets, such that taking a balance sheet approach to the public finances will be more important than ever in the post-pandemic environment. (See ACCA's *Sustainable Public Finances* report.)

A Fiscal Council to be made up of public finance professionals to assess ex ante and ex post the effectiveness of proposed and implemented fiscal policies. By giving impartial and expert advice, a Fiscal Council will help informed decision making. This body may also prepare independent pre-fiscal event reports outlining the areas of focus for the Budget. The Council would have a crucial role in boosting the transparency of all aspects of fiscal policy, and the involvement of professional accountants in this process would be vital.

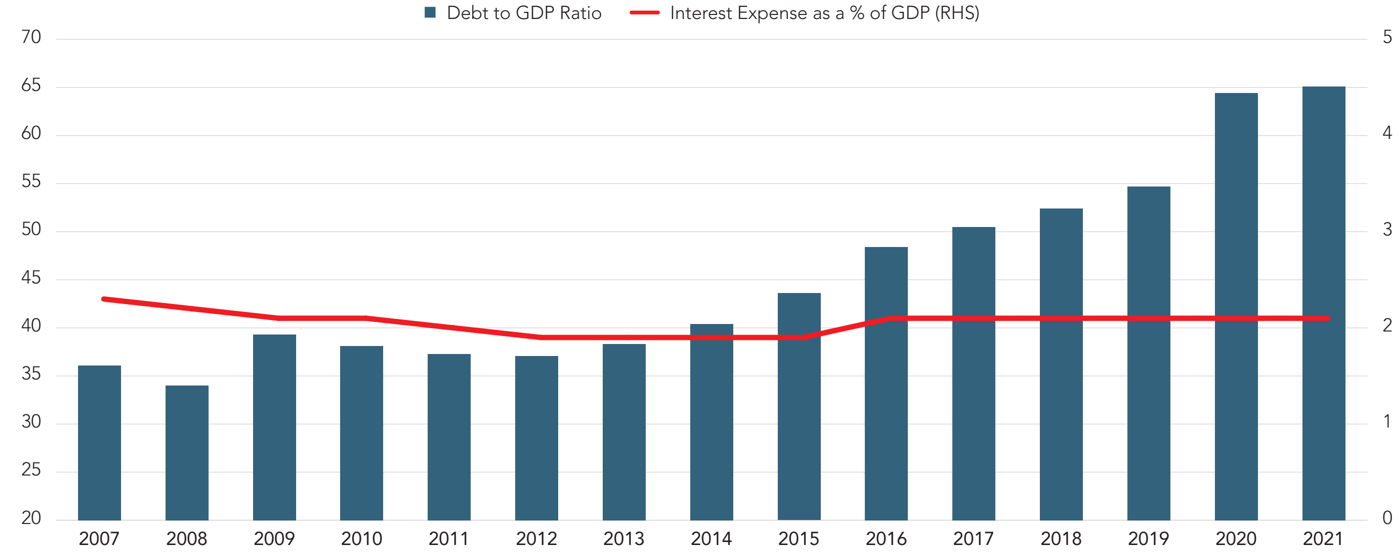
Debt and debt-servicing costs 2007 to 2021

FIGURE 1: Debt and debt-servicing costs – Advanced economies



Source: IMF

FIGURE 2: Debt and debt-servicing costs – Emerging Markets



Source: IMF

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