DOI: 10.20472/EFC.2022.017.019

SULKHAN TABAGHUA

Ivane Javakhishvili Tbilisi State University, Georgia

FISCAL RULES AND POST-PANDEMIC (COVID19) ECONOMIC RECOVERY

Abstract:

Empirical experience in many countries shows that governments spend more than they can afford. In order to ensure long-term economic stability and support economic growth, most countries have established legal restrictions on fiscal parameters, which significantly reduce the possibility of exceeding the quantitative or qualitative limits set by the government. In economic literature, this type of limitation is known as "fiscal rules".

Different topics of fiscal policy have been the subject of scientific research for many years, but research around fiscal rules have become more common in recent times. The actuality of this topic has increased in the conditions of covid19 crisis, which led to the reduction in economic growth in many countries, including Georgia, and a deterioration in a number of macroeconomic parameters (notably, a rapid increase in debt and budget deficit). Pandemic has been a massive test of the fiscal rules.
Scientific literatures underline fiscal rules importance for long-term economic growth and macroeconomic sustainability. Thus, the pandemic challenges raise the issue of updating and assessing the effectiveness and flexibility of rules during the economic crisis.

During the past two decades, a growing number of countries across the world have adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule, 11 countries more than the last update in 2015 and 96 countries more than 1985.

The present article highlights the impact of covid19 shocks on fiscal rules and economic growth, with particular attention to post-pandemic (Covid19) recovery. The given analysis creates a precondition for the further development of this topic in the future, to expand the relevant econometric model for calibration of fiscal rules, assessment effectiveness of fiscal limits in the context of post-pandemic economic recovery.

Keywords:

Fiscal Rules, Covid19 Shocks, Economic Growth, Economic Recovery, Debt, Deficit.

JEL Classification: O40, E62, H61

I. INTRODUCTION*

According to the most widespread definition, fiscal rules set permanent constraints on fiscal policy, typically defined in terms of a summary indicator of fiscal performance, often expressed as a numerical ceiling or target in proportion to GDP. According to Kopits and Symansky (1998), the following two types of rules are in place:

- Numerical fiscal rules - are lasting constraints on fiscal policy through predetermined limits on aggregate fiscal indicators. Rules are generally defined as fixed numerical limits (floors or ceilings) on fiscal variables set in legislation and binding for at least three years;
- Procedural rules - that set standards on how the annual budget should be prepared and executed - for instance, by setting and enforcing expenditure ceilings at the ministry level. Procedural rules that can be found in many countries to ensure the execution of either discretionary or rules-based policies. Procedural rules include automatic contingency measures, such as across-the-board cuts in noninterest spending (usually, but not always, excluding transfers under mandatory programs), cash limits, sequestration of funds, or imposition of a surtax.

Different topic of fiscal policy is a subject of scientific research for many years (Alesina, Bayoumi, 1996; Bayoumi, Eichengree, 1995; Eichengreeq, 1992 and etc.), but research around fiscal rules have become more common in recent time. The actuality of this topic has increased in the conditions of covid19 pandemic (Hamid, Davoodi, Elger, Garcia-Macia, Xuehui, Lagerborg, Raphael, Medas, 2022; World Bank 2021 and etc.).

Fiscal rules are a long-term constraint on fiscal policy through numerical limits on the budgetary aggregates. Without overall limits, incremental budgeting can become an open-ended process in which governments accommodate date demands by spending more than they have. Thus, fiscal rule has two fundamental characteristics. First, it presents a constraint that binds political decisions made by the legislature and by the executive. And second, it serves as a concrete indicator of the executive's fiscal management. While fiscal rules can help governments to achieve fiscal objectives and discipline, there is no one-size-fits-all rule for every country (OECD 2013).

Well defined fiscal rules should be assessed based on its implication on macroeconomic environment with the following three main features characterizes:

- permanent character - meaning that the constraint must be perceived to be binding for a sufficiently long period of time;
- specification in terms of an overall fiscal performance indicator (such as the government budget deficit, debt, expenditure, revenue, etc.);
- the provision of a numerical ceiling or target. While the first primary objective of fiscal rules is to enhance budgetary discipline, they can also foster policy coordination between different levels of government depending on their institutional coverage. Additionally, fiscal rules may further contribute to the reduction of uncertainty about future fiscal policy

*This work was supported by Shota Rustaveli National Science Foundation of Georgia (SRNSFG) [grant number YS-21-2451].

developments. However, fiscal rules can only yield these benefits if appropriate institutions for monitoring and enforcement mechanisms are in place, or if they are supported by strong political commitment.

During the past two decades, a growing number of countries across the world have adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule, 11 countries more than the last update in 2015 and 96 countries more than 1985. 2 advanced countries were frontrunners on the adoption of fiscal rules, but it is increasingly common in emerging market and developing economies especially since the late 2000s. As of end 2021, there are more than twice Emerging Markets and Developing Economies (EMDEs) than advanced economies with fiscal rules (Davoodi, Elger, Fotiou, Garcia-Macia, Han, Lagerborg, Lam, Medas, 2022, Rakesh, Prabheeshb, 2021).

Georgia introduced fiscal rules in 2011[2], which at this time are defined as follows: Numerical rules - limits for the state debt (60 percent of GDP), the budget balance (3 percent of GDP); procedural - Revenue Rule, the introduction of a new type of national tax, except for excise tax, or the introduction of an increase in the upper margin of the rate according to the type of national tax, except for excise tax, shall be permissible only through a referendum. Only the Government of Georgia will have the right to initiate the calling of a referendum[3].

II.FISCAL RULES AND ECONOMIC FREEDOM

Fiscal rules impact on economic freedom has become one of the most actively discussed issues in developed and developing countries governments and scientific literatures (Gwartneya, Lawsonb, 2002; Heckelman, Stroup, 2002) where for analysis of economic freedom following components evaluated:

- Government Size: Government Expenditures, Taxes, and Government-Owned Enterprises;
- Property rights and legal structure;
- hard currency: Monetary and Inflation Policy;
- International Trade and Trade Policy;
- Regulation of business, labor force, credit market.

However, international organizations that study the country's economic freedom index determine it in the following way “personal choice, voluntary exchange coordinated by markets, freedom to enter and compete in markets, and protection of persons and their property from aggression by others. Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others. Individuals are free to choose, trade, and cooperate with others, and compete as they see fit[4]” the Fraser Institute; Heritage Foundation „Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please. In economically free societies, governments allow labor, capital, and goods to move freely, and refrain from coercion or

[2] The expenditure rule was phased out in 2018.
[3] Organic Law of Georgia “On Economic Freedom“.
[4] See: www.fraserinstitute.org

constraint of liberty beyond the extent necessary to protect and maintain liberty itself[5]".

These organizations assess the index of economic freedom within the country based on the following criteria:

- Fraser Institute - Size of Government (Government consumption, Transfers and subsidies, Government enterprises and investment, Top marginal tax rate, State ownership of assets), Legal System and Property Rights (Judicial independence, Impartial courts, Protection of property rights, Military interference in rule of law and politics, Integrity of the legal system, Legal enforcement of contracts, Regulatory costs of the sale of real property, Reliability of police,Business costs of crime, Gender Disparity Adjustment; Sound Money (Money growth, Standard deviation of inflation, Inflation: most recent year, Freedom to own foreign currency bank accounts), Freedom to Trade Internationally (Tariffs, Regulatory trade barriers, Black-market exchange rates, Controls of the movement of capital and people), Regulation (Credit market regulations, Labor market regulations, Business regulations);
- Heritage Foundation - Rule of Law (property rights, government integrity, judicial effectiveness); Government Size (government spending, tax burden, fiscal health); Regulatory Efficiency (business freedom, labor freedom, monetary freedom); Open Markets (trade freedom, investment freedom, financial freedom).

It should be noted that top countries rankings with haighet economic freedom index in the world have at least one fiscal rule in place (table 1).

Table 1. Top Countries According to Economic Freedom Rankings

Countries	Fiscal Rules			
	BBR	DR	ER	RR
Singapore	X		X	
Switzerland	X			
Ireland	X	X	X	
Luxembourg	X	X	X	
New Zealand	X			
Estonia	X			
Netherlands	X	X	X	
Finland	X	X	X	
Denmark	X	X	X	

Source: www.heritage.org, www.imf.org

Note: BBR = Budget balance rule; DR = Debt rule; ER = Expenditure rule; RR = Revenue rule.
Source: Fiscal Rules Dataset, 1985-2021, IMF.

Economic freedom has a positive effect on the control of the Covid19 pandemic only among highly egalitarian nations. New interventions are needed to help countries heighten economic freedom and equality as they continue to battle Covid19 and other collective threats (Huang, Long, et al, 2022).

III. COVID19 SHOCKS ON ECONOMIC GROWTH

Since the onset of the new coronavirus (Covid19) pandemic in the world, countries have been

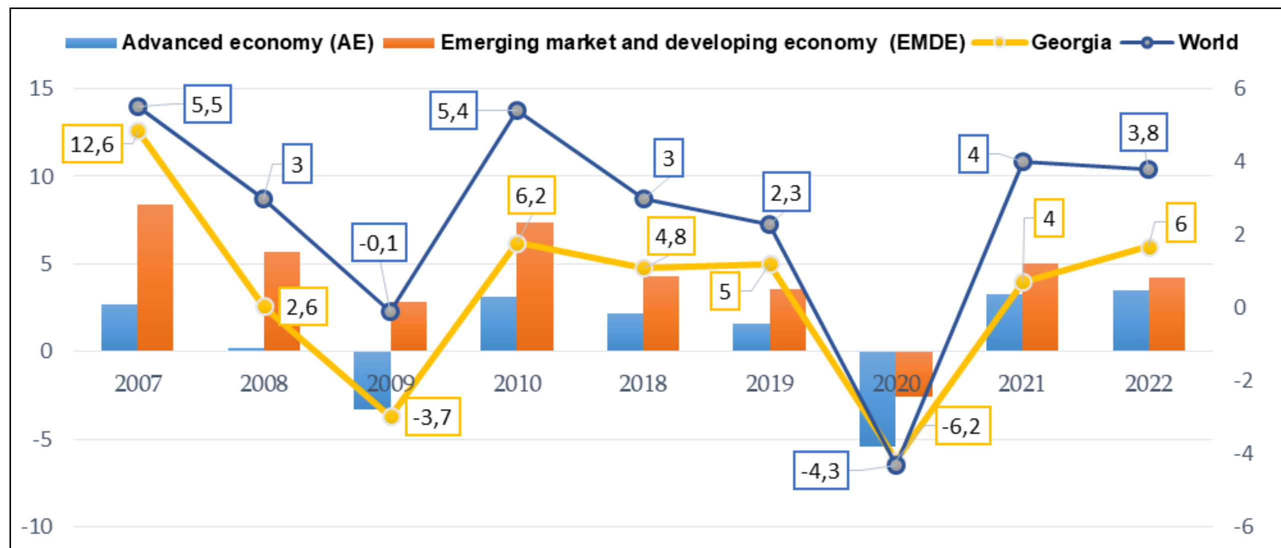
[5] See: www.heritage.org

actively taking various measures to slow down the spread of the virus, and find ways to fully implement the expansionary fiscal policy (reducing taxes and/or increasing government expenditures). As a result of that, the volume of fiscal stimulus worldwide in 2020 to reduce the impact of Covid19 shock on the economy amounted to $11 trillion[6].

Although there has been considerable research on pandemic[7] and/or pandemic-induced economic crises around the world (McKibbin 2004, Cuddington 1993, Figura 1998, Haacker 2002), the new coronavirus (Covid19) pandemic has exposed society to different realities /challenges[8].

In the short-run, the Covid19 shock caused a significant decrease in GDP of 2020 in developed and developing countries. As a result of these circumstances, there is a rapid decline in world GDP, which exceeds the rate of decline (-1.67) caused to the 2008-2009 financial crisis[9]. The level of reduction of Georgian GDP (-6.2)[10] of the recent year exceeded the similar rate of 2009 (-3.7%) (Figure 1). Based on the current situation, the goal of macroeconomic policy is to try to replicate this short-lived V-shaped recession by mitigating the demand externalities and financing constraints, utilizing monetary and fiscal instruments to dampen the impact of adverse shocks. What makes Covid19 a different shock? Firstly, it is a massive and highly contagious global shock, secondly, it is simultaneously a negative supply shock and a negative demand shock, and thirdly, it may hurt low- and middle-income countries disproportionately.

Figure 1. Real GDP Growth Rate (%)



Source: *www.worldbank.org*

Against the background of the total implementation fiscal stimulus by many countries, based on separate organization forecast world economy, including Georgia (IMF, 2021) will move to a post-

[6] See: https://blogs.imf.org/2020/07/10/fiscal-policies-for-a-transformed-world/
[7] Two pandemics in the XX century after the Spanish flu (Asian flu, 1957, Hong Kong flu, 1968), four pandemics in the 21st century (N1H1,2009; SARS, 2002; MERS, 2012; Ebola, 2013-2014).
[8]COVID19 The first cases were reported in late 2019. On March 11, 2020, World Health Organization declared a pandemic.
[9] See World Bank.
[10] The Georgian economy has not experienced such a decline since 1994.

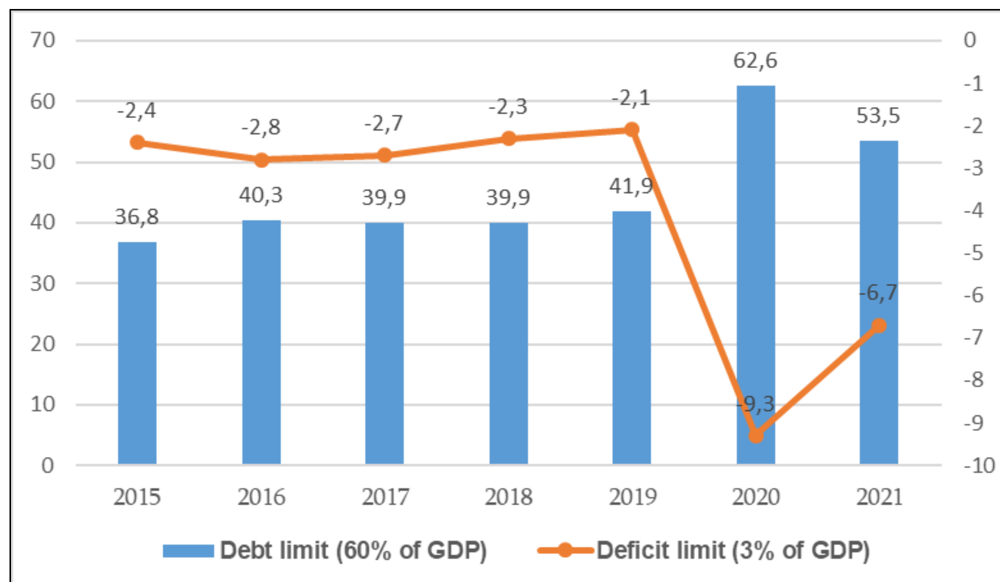
pandemic (Covid19) stage[11] in 2021 if all other things being equal[12], there will be an improvement in macroeconomic parameters.

IV. DEFICIT AND DEBT RULES

Deficits and debt in many countries surged during the pandemic, leading to large deviations from fiscal rule limits. Both of them are very commonly used by governments in different countries. But debt rules are particularly mutual in developing economies, with over 80 percent of EMDEs having adopted them. The majority of national debt rules is set as a debt limit or ceiling, while a minority (about 10 percent) uses a (medium-term) anchor concept (Finland, United Kingdom). Most countries have the debt rule expressed in percent of GDP, and sometimes the debt rule is set in net present value terms for low-income countries, as they receive a significant share of concessionary financing. Budget balance rules accounting for business cycles are more predominant in advanced economies (Czech Republic, Estonia) than emerging markets (Chile, Colombia). Even for the former group, assessing the output gap in real time is challenging. For those EMDEs that have deficit limits accounting for economic cycles, they often rely on thresholds on actual activity rather than a measure of output gap (Burger, Marinkov, 2012).

Most countries with debt and deficit rules, such as Georgia, will begin post-pandemic economic recovery based on deteriorating fiscal parameters (Figure 2). External debt increased by 20.7% in 2020, compared to 2019. The same year's deficit, similar in comparison, increased by 7.2%. In 2021, the amount of debt is in line with the defined rule, although the amount of deficit is over the ceiling. External debt's negative shock can be a deterrent to economic recovery and long-term economic growth.

Figure. 2. Deviation from Fiscal Rules



Source: www.mof.ge

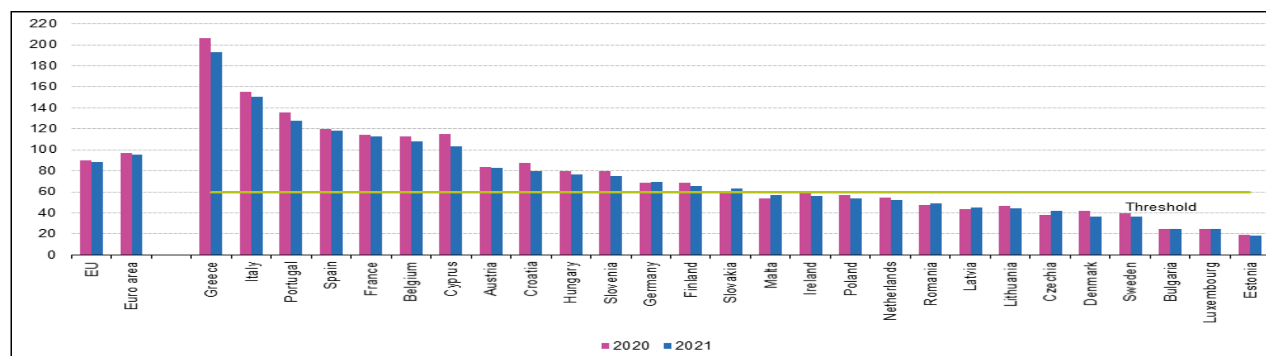
The situation is similar to Georgian with the example of the EU member states, Covid19 negative

[11] Period when the virus is seasonal in nature, the majority of the population gaining immunity.

[12] Assumptions are based on stopping the spread of Covid19, the scale of the vaccination process, the proper analysis of the post-pandemic period, and the development of appropriate policies (Burger, Marinkov, 2012).

impact on the economy and a sharp increase in the amount of debt over the defined rule in 2020 (figure 3). Namely, Slovakia, Finland, Germany, Slovenia, Hungary, Croatia, Austria, Cyprus, Belgium, France, Spain, Portugal, Italy, Greece. Thus, those countries' debt rate decreased in 2021, but the debt ceiling indicator still remains excessive.

Figure.3. EU member States General Government consolidated Gross Debt (2020 and 2021, % of GDP)



Source: https://ec.europa.eu/eurostat/data/database

V. ESCAPE CLAUSE

The pandemic has been a massive test for fiscal rules. It led to the activation of escape clauses to temporarily suspend the rules within the fiscal framework, allowing for flexibility to adopt extraordinary fiscal support to households and firms.

Fiscal rules are long-lasting constraints on fiscal policy aimed at providing a credible commitment to fiscal discipline. 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. At the same time, fiscal rules must be sufficiently flexible to manage unexpected economic or other large shocks. 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. While the high degree of uncertainty around this crisis calls for greater flexibility, this should not be at the cost of excessive discretion that could be abused and undermine the return to the fiscal rules over the medium term. In addition, some countries either do not have escape clauses or may need to consider suspending their rules without a well-defined process or even abandoning or revising the rules.

Before the pandemic hit, two thirds of countries with fiscal rules had included escape clauses, a notable rise relative to previous decades across all income groups and among supranational and national fiscal rules (Table II).

Table II. Escape Clauses and Activation Date in Selected Countries

	Type of fiscal rules				Activation of escape clause		
	ER	RR	BBR	DR	2019	2020	2021
Andorra	X			X		X	X
Armenia	X		X	X		X	
Azerbaijan	X		X				
Bulgaria	X		X			X	X

Costa Rica	X		0			X	
Croatia	X		X		X	X	X
Denmark	X		X		X	X	X
Ecuador	X		X	X			X
Georgia	X		X	X			
Grenada	X		X	X		X	X
Latvia	X		X	X	X	X	X
Mongolia	X		X	X	X	X	X
Peru	X		X				
Poland	X				X	X	X
Romania	X						
Tanzania	X		X				
Uruguay	X		X				
Vietnam	X	X	X	X			

Note: BBR = Budget balance rule; DR = Debt rule; ER = Expenditure rule; RR = Revenue rule.
Source: Fiscal Rules Dataset, 1985-2021, IMF.

Activation of the escape clause in the case of Georgia must fulfil the following regulatory criteria:

- In case of the need to finance, liquidation or damage measures as a result of the state emergency or war declared in accordance with the rules established by the legislation;
- In case of slowdown/recession - if according to the data published by the National Statistics Office of Georgia, the real economic growth rate of the last two consecutive quarters is 2 percentage points lower than than the average real economic growth rate of the last 10 years[13].

At the same time in case of Escape clause activation Georgian Government shall submit to the Parliament:

- A plan to return to the parameters defined by law. The duration of this plan should not exceed 3 years;
- After the end of the fiscal year reporting, in case of violation of fiscal rules (except cases prescribed by law) reporting about that with draft annual budget performance report;
- Information about on the causes of the violations;
- Information on the current budget execution and, consequently, its impact on the parameters of the consolidate state budget in the direction of compliance with defined marginal dates.

VI. CONCLUSION

Legal limitations on significant macroeconomic parameters It is important for many countries to maintain a socio-economically stable environment and reduce the risk of governmental accumulation of significant economic power, which is also significant for maintaining a sufficient level of economic freedom and stimulating economic growth.

In 2020 Covid19 shocks led to a sharp decrease in the world economy. In the wake of declining economic growth and rising social spending, there have been breaches of fiscal rules. The size of the fiscal deficit, as well as the external debt rate, will continue to be the primary focus of

[13] Article 2, Organic Law of Georgia “On Economic Freedom“.

macroeconomic policy in the post-Covid19 economic recovery period.

Covid19 introduced new challenges to fiscal rules that had previously been broadly tested by economic cycles. However, in the case of many countries, it exceeds deficits and debt defined ceilings. As economic practicy shows, reducing debt and deficits and approaching the seted limits will require significant efforts by the government, which is a rather difficult task in the short term. At the same time, there is quite a bit of economic literature where the effectiveness of the maximum limits set by quantitative fiscal rules, in particular, has not been in deep assessed. Based on given facts and the existing reality, it is clear that in the post-pandemic (Covid19) period, the issue of updating the existing numerical rules and its effectiveness/flexibility again in the economic crisis should be the main topics of scientific discussions.

Addintionaly, post-pandemic (Covid19) economic recovery, the shocks of aggregate supply and demand will move the economy to a new general macroeconomic equilibrium, which will increase the urgency of in-depth analysis of the current economic crisis, reassessment, innovative analysis of traditional economic approaches, macroeconomic policies, and of conducting scientific research on these issues.

REFERENCES

Kopits, G., Symansky, S. (1998). Fiscal Policy Rules, IMF.

Alesina, A., Bayoumi, T. (1996). The Costs and Benefits of Fiscal Rules: Evidence from U.S. States. Working Paper 5614. NBER.

Bayoumi, T., Eichengree, B. (1995). Restraining Yourself the Implications of Fiscal Rules for Economic Stabilization”. StiflPapers, March 32-48.

Eichengreeq, B. (1992). Should the Maastricht Treaty be Saved? Princeton Studies in International Finance, No. 74, December.

OECD (2013). Fiscal rules, in Government at a Glance. Publishing, Paris.

Hamid, R. Davoodi, P. Elger, A. Garcia-Macia, D. Xuehui, H. Lagerborg,, A, Raphael, L. and Medas, P (2022). Fiscal Rules and Fiscal Councils Recent Trends and Performance during the COVID-19 Pandemic” IMF, WP/22/11.

Rakesh, P, Prabheesh, K.P. (2021). The economics of COVID-19 pandemic: A survey. Econ Anal Policy. Published online 2021 Feb 25. doi: 10.1016/j.eap.2021.02.012.

World Bank (2021). A Review of Fiscal Policy Responses to COVID-19”. MTI Insight. World Bank, Washington, DC. License: Creative Commons Attribution CC BY 3.0 IGO

Davoodi H. R., Elger, A., Fotiou, D., Garcia-Macia, X., Han, A. Lagerborg., W.R. Lam., P. Medas (2022). Fiscal Rules and Fiscal Councils: Recent Trends and Performance during the Pandemic”, IMF Working Paper No.22/11, IMF, Washington, D.C.

Gwartneya. J, Lawsonb, R. (2002). The concept and measurement of economic freedom. European Journal of Political Economy Vol. 19 (2003) 405–430.

Jac C. Heckelman., Michael, D. Stroup (2002). “Which Economic Freedoms Contribute to Growth?”. KYKLOS.

Huang, G., Yu, X., Long, Q. et al. (2022). The impact of economic freedom on COVID-19 pandemic control: the moderating role of equality. Global Health 18, 15 https://doi.org/10.1186/s12992-022-00800-0)

IMF (2021). World Economic Outlook Update.

World Bank (2021). Global Economic Prospects.

McKibbin, W (2004). Globalization and Disease: The Case of SARS. Asian Economic Papers Vol. 3 no1. MIT Press Cambridge USA. pp. 113-131 (ISSN 1535-3516).

Cuddington, J. T (1993). Modeling the macroeconomic effects of AIDS, with an application to Tanzania. World Bank Economic Review 7(2), 173-89.

Figura, S. Z. (1998). The forgotten pandemic. The Spanish Flu of 1918 was gravest crisis American hospitals had ever faced. The Volunteer Leader 39(2): 5.

Haacker, M (2002). Modeling the macroeconomic impact of HIV/AIDS. IMF Working Paper W/02/195, 41-95.

IMF (2021). Georgia: Eighth Review Under the Extended Fund Facility Arrangement-Press Release; and Staff Report.

Burger, P. and Marinkov, M. (2012). Fiscal rules and regime-dependent fiscal reaction functions: The South African case. OECD.