# Fiscal Risks, Fiscal Sustainability and Rethinking Fiscal Rules

**Central, Eastern, and South-Eastern European Annual Meeting of OECD Senior Budget Officials**

3 December 2024

Brian Finn
OECD, Paris

# Overview

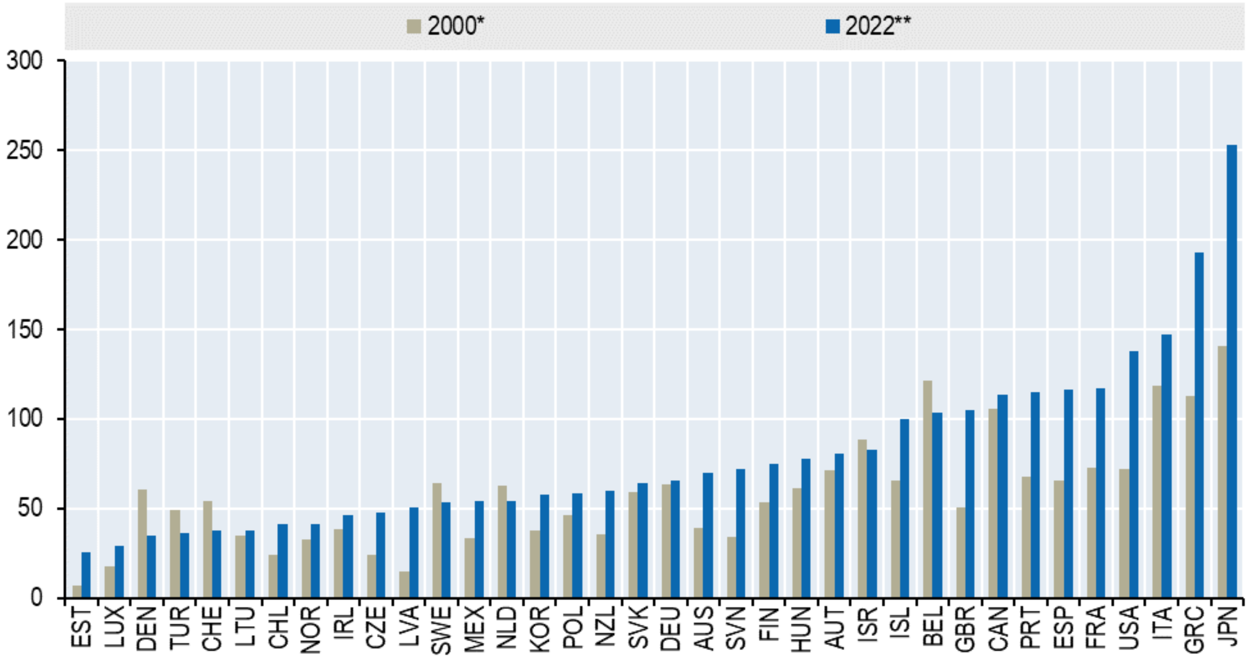
- **I.** Introduction
- **II.** Fiscal risks
- **III.** Sustainability
- **IV.** Rethinking fiscal rules

*"I'd like you to meet Marty Thorndecker. He's an economist, but he's really very nice."*

# Introduction

- In many (but not all) countries, rapid transformation from comparative macro stability and prosperity in the late 20th century to shocks and cyclicality in the 21st.
- With fiscal deterioration to debt levels beyond what until now had been considered sustainable.
- Problems generally arose from unforeseen or unexpected risks.
  - To date, economies have withstood these challenges; however, the unprecedented fiscal conditions raise serious concerns.
  - Current elevated debt levels seem to be taken for granted.
- Will the economic and fiscal risks of the last two decades recur in the future? If so, what will be the consequences, given debt levels that are already elevated beyond what was considered prudent just two decades ago?

General government gross debt as a percentage of GDP, OECD countries, 2000 vs. 2022



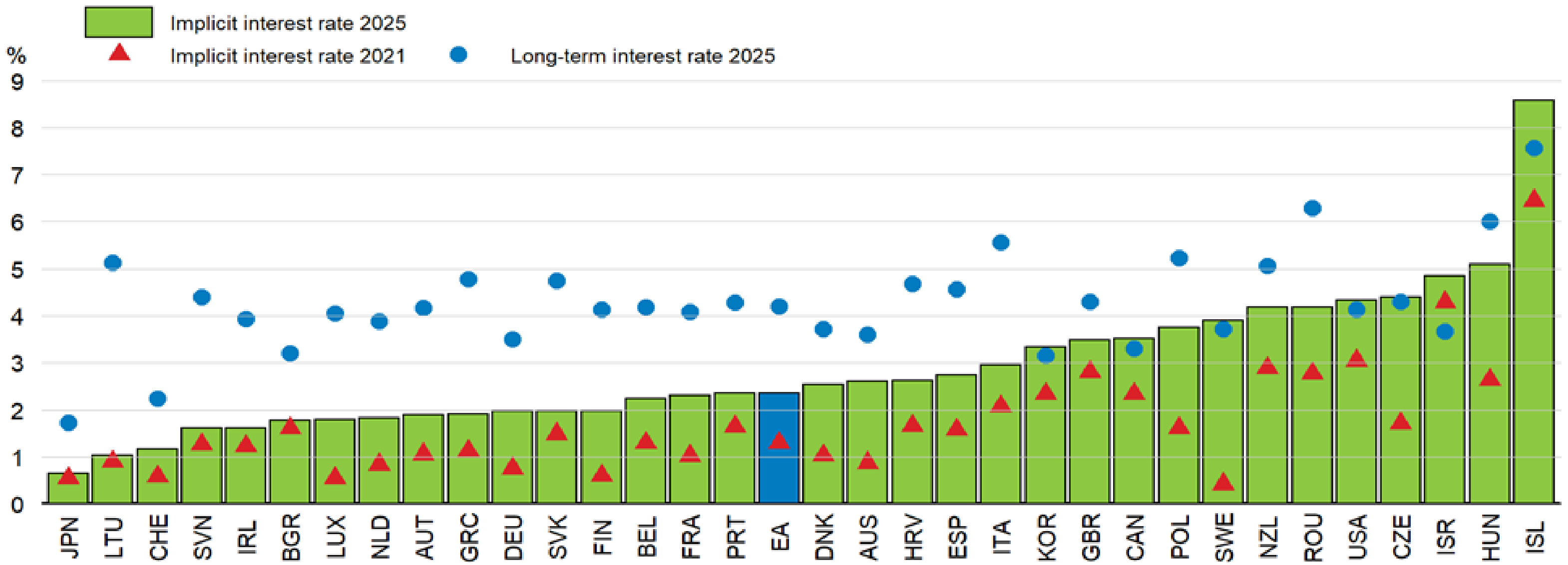

* = 2000 or first available year, ** = 2022 or most recent
Note: data for Türkiye is for 2010 and 2022. Data for Chile, Mexico, and Iceland is for 2003 and 2022. Data for Korea is for 2008 and 2022. Data for New Zealand is for 2009 and 2022. Data for Israel is for 2001 and 2021. No data is available for Colombia and Costa Rica.
Source: OECD National Accounts Statistics (2024)

# Introduction

With elevated levels of debt comes greater interest expense, notwithstanding increases to interest rates.

- How should countries respond to elevated debt and expenditure?
- What should be done to prepare for both known and unknown threats?
- Do we need to rethink the meaning of sustainability in this new context?
- How can sound fiscal rules help us to move back to sustainability and stability?

Interest rates on government debt are set to rise further




Note: The implicit interest rate is defined as general government gross interest payments in a given year divided by general government gross financial liabilities at the end of the preceding year.

Source: OECD Economic Outlook 114 database; and OECD calculations.

# Fiscal risks

Defining risks – **Sources of large potential deviations in the fiscal forecast**

## 1. Baselines versus risks

- Distinction from fiscal pressures, which are known adverse influences on the fiscal forecast, e.g., population ageing.
- Known pressures are included in the baseline; however, even baseline items can cause large deviations in the forecast, and so cannot be ignored.
- Quintessential risks today would include:
  - Climate change
  - Health care costs
  - War
- Other risks might not be known or anticipated at this time (much as war or the pandemic were not anticipated).

## 2. Analysing risks

Improving the effectiveness of existing practices:

- Make a part of the regular budget process.
- Involve line ministries around a coordinating hub in a budget or finance ministry.
- Require senior-level involvement.

## 3. Managing risks

- An organised, regularised process, with high-level involvement and buy-in.
- Requires prevention and mitigation.
- Costs of risk management may be one-time or permanent.
- Stress tests are an important tool but must be used with care. Worst-case costs must not be used to divert funds from essential day-to-day operation of government.
- Risk management requires sustainability.

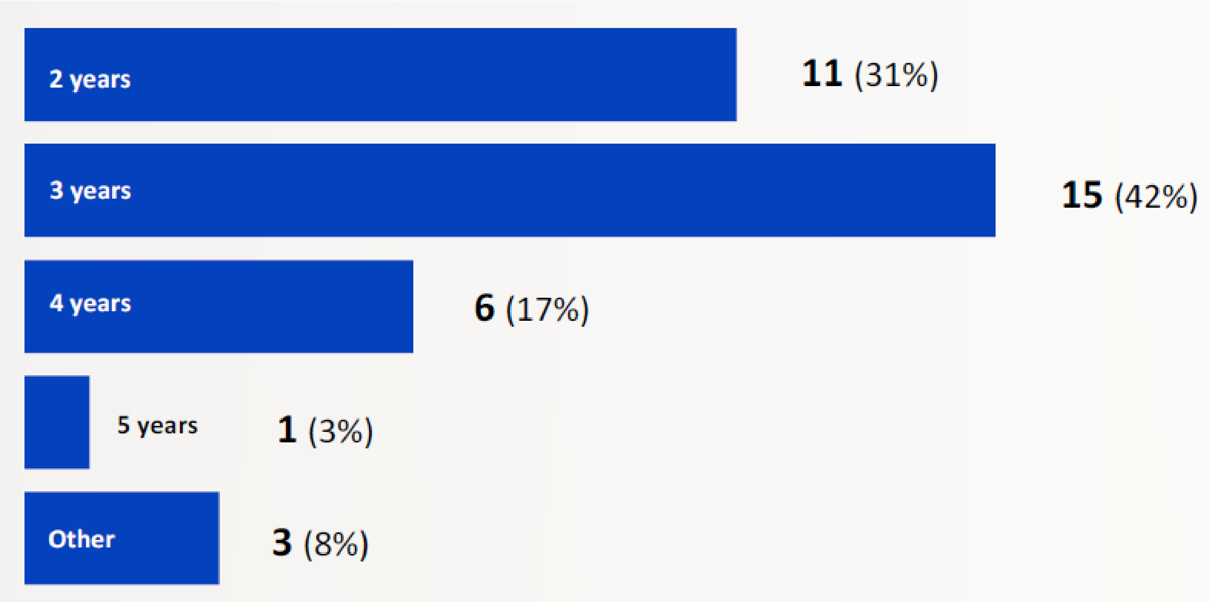
# Sustainability

## Defining sustainability – **Favourable and consistent access to credit markets**

The definition of sustainability will differ across countries according to size, history, governance, and other factors: Initial conditions will be important.

- Will some countries take too much comfort from the lack of market reactions to the recent run-up of debt?
- If sustainability is defined as merely a target ratio of debt to GDP – will that target be taken as a ceiling, or a floor?
- Will a target become a knife-edge condition, such that any favorable budget outcome is spent, and any unfavorable outcome will increase debt?
- And what would such complacency imply if the economic and fiscal environment were to continue to be characterised by risk?

Viewing sustainability well beyond the coming budget: Multi-year expenditure baselines in OECD countries




Note: The indicated period does not include the upcoming budget year.
Source: OECD (2023) OECD SBO Survey on Budget Frameworks, results for 36 countries, Q11.

- Sustainability in times of risk might require:
  - Prudent, cautious economic forecasts
  - Rainy-day funds.
- Any such device must be honoured in good times, lest it become a slush-fund to be squandered whenever it in fact yields favorable budget outcomes.
- Best would be a mindset that the target for the ratio of debt to GDP is not some specific number, but rather a perpetually falling ratio, to avoid the knife-edge condition that has served us poorly.

Type of fiscal risks identified and quantified in budget documentation or fiscal risk reports in OECD countries

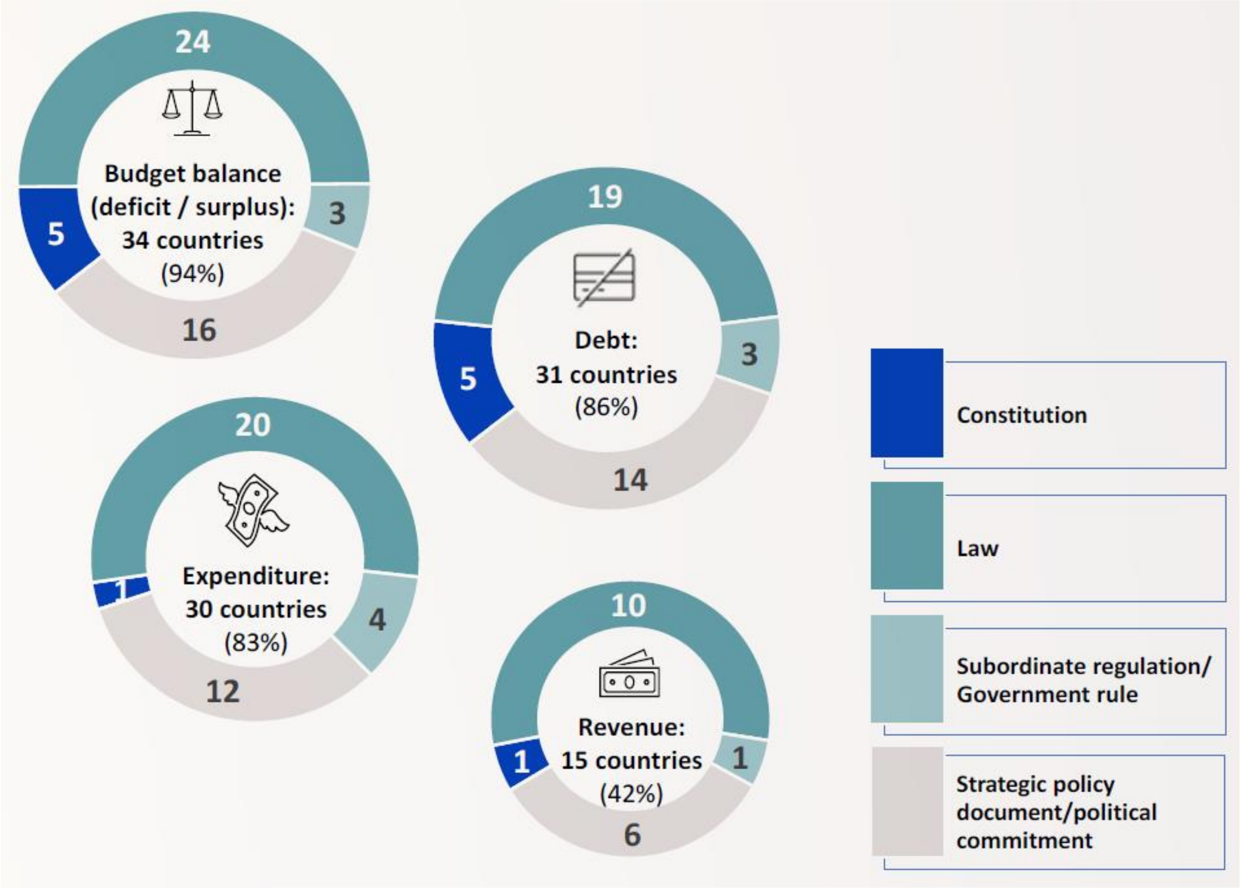
| | Identification | Quantification |
|---|---|---|
| Government guarantees risks | 26 | 20 |
| Debt risks | 24 | 17 |
| Pension net liability risks | 21 | 15 |
| Financial sector risks | 19 | 8 |
| Geopolitical risks | 18 | 4 |
| Climate risks | 18 | 7 |
| Pandemic risks | 17 | 10 |
| Government policy or programme risks | 16 | 8 |
| Litigation risks | 16 | 10 |
| State-owned enterprise (SOE) risks | 12 | 6 |
| Natural disaster risks | 11 | 4 |
| Balance sheet risks | 10 | 6 |
| Public Private Partnership (PPP) risks | 10 | 6 |
| Subnational government risks | 10 | 6 |

Source: OECD (2023) OECD SBO Survey on Budget Frameworks, results for 36 countries, Q34.

# Rethinking fiscal rules

- Fiscal rules today seem roundly dismissed or disdained as too complex and seldom honoured.
- With debt levels elevated by economic shocks, fiscal rules must be re-thought to bring down debt burdens, and then to keep them in a more-sustainable range.
- Fiscal rules must allow automatic stabilizers to work in bad times, but not be permissive of spending better-than-forecast in good times.
- Tax-and-spending rules can expose steps that worsen a budget, whereas deficit rules can cover over tax cuts or spending increases with optimistic economic forecasts.

Legal basis for national fiscal rules and fiscal objectives in OECD countries




Source: OECD (2023) OECD SBO Survey on Budget Frameworks, results for 36 countries, Q3.

# Rethinking fiscal rules

- Credibility requires that budget rules be realistic. Assuming impossible future budget restraint merely postpones difficult decisions, with interest.
- The last two decades of adverse risks and elevated debt require that medium-term budgeting requirements be honoured and, if anything, extended into the future.
- The perceived complexity of fiscal rules has eroded confidence in the instrument; but the wider adoption of best practices could increase both understanding and confidence.
- Where confidence is eroded, improvements to budget rules may be the best first step that countries can take to break the vicious cycle of failure and cynicism.
- In addition to a renewed resolve to drive debt-to-GDP ratios downward, budgets need to recognise the likely costs of prevention and mitigation of budget risks.
- Space must be created for both temporary and permanent costs in a transparent way that allows verification of restraint elsewhere in the budget.

Thank you