WHAT ARE FISCAL RULES, AND WHY DOES T&T NEED THEM NOW?

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ELUSIVE ECONOMIC DIVERSIFICATION

The quest for economic diversification has been with us for decades, but as our current economic circumstances suggest, one sector of the economy (directly and indirectly, in real and perceived ways) is still the single largest contributor to our foreign exchange earnings, fiscal revenue, and by extension, our broader socio-economic performance. A 2007 IADB paper found that there is an 80% correlation between historical real GDP growth in T&T, and international crude oil prices. Therefore, it could be argued that any economic diversification that has been achieved thus far has been inadequate. But why is diversification so important anyway?

Diversification is at its core, a risk management technique. Just like concentration limits on investment portfolios, economic diversification seeks to minimize macroeconomic volatility by ensuring that no single sector of the economy is dominant, and as such, no single sector's (mis)fortunes have the power to drive the overall economy into recession or boom.

A 2005 study by Booz & Company found that the world's five most diversified economies then were Canada, Japan, U.K., U.S.A. and France. We know that since 2005, all of these economies experienced some form of economic downturn precipitated by the Global Financial Crisis, indicating that economic diversification is by no means a panacea to economic decline. In fact, Canada experienced a technical recession as recently as the first half of 2015, based on the effects of low commodity prices and other challenges. Diversification does however, reduce the overall impact of any one sector, and the duration and severity of economic gyrations, as all sectors are less likely to suffer the same fate simultaneously. The business cycle is therefore likely to be 'smoother' in a more diversified economy, but not entirely devoid of volatility or downturns.

The fact that we have been unable to meaningfully diversify away from our overdependence on the energy sector over the years, implies that there are some powerful factors at work – but this is well beyond the scope of this article. Based on our apparent inability to diversify however, are we forever doomed to endure this level of volatility in macroeconomic performance, or is there another mechanism via which we could realize greater stability?

This article seeks to explore how fiscal policy plays a critical role in determining the energy sector's socio-economic impact, economic diversification notwithstanding.

FISCAL POLICY IN T&T

The Keynesian approach to economic management assumes that higher fiscal spending stimulates growth. And governments like growth because in theory it creates jobs, higher incomes, better standards of living, and most important, by so doing, it convinces the electorate of the government's ability to manage the economy.

The Keynesian approach suggests that when the economy is in decline, fiscal spending should increase, acting as a form of economic life-support, creating jobs and supporting private spending and overall economic activity. When consistent growth returns, this fiscal stimulus should be gradually withdrawn, and the economy will continue to grow organically.

But in T&T, what should happen when we are experiencing growth (usually driven by the energy sector), rarely does. Instead of running fiscal surpluses and saving energy windfalls, we continue to spend more, at times even incurring fiscal deficits and borrowing to spend when energy revenues are high. When energy prices decline, we are left with insufficient fiscal space or capacity to borrow and compensate for the attendant shortfall in energy-derived fiscal revenues. This fiscal overspending during booms and (involuntary) austerity during downturns (as currently obtains), is called pro-cyclical fiscal policy, and is in effect what T&T has experienced, post-independence.

Cotton, Finch, and Sookraj (2013) found the fiscal policy stance in T&T to be predominantly pro-cyclical, potentially magnifying the effects of the business cycle - causing sharper increases during upswings and more prolonged recessions during downturns. Further, they found that historically in T&T, fiscal policy is pro-cyclical on two levels – it is accommodative in times of growth and austere during slowdowns, but also, it is more accommodative in the 12-18 months prior to a general election.

WHY IS FISCAL POLICY PRO-CYCLICAL IN T&T?

It may be fair to say that over the years, we have grown to expect more buoyant fiscal spending when energy prices are high, supporting the not-to-be-underestimated, empirically proven election motive for pro-cyclical fiscal policy just mentioned. However unlikely, it is also possible that policymakers may be responding to a genuine desire to achieve growth and higher standards of living for the sake of progress, regardless of the likely electoral rewards of so doing. But apart from these, a powerful motivator driving high levels of / rapid increases in fiscal spending during 'boom' years, is simple human nature.

Aren't we all more inclined to spend more in general, when we are earning more versus less, especially on non-essentials? And given that decision-making, whether at the household or at the national / policy level, is conducted by human beings, is it not reasonable to expect similar behaviours, and therefore similar outcomes? In other words, they may not want to engage in pro-cyclical fiscal spending, but policymakers probably can't help themselves.

BUT, WHAT'S THE PROBLEM WITH PRO-CYCLICAL FISCAL POLICY ANYWAY?

As mentioned earlier, pro-cyclical fiscal policy during booms could mean that there are insufficient fiscal resources to compensate for lower energy-derived fiscal revenues during an energy-driven downturn. But, does pro-cyclical fiscal policy have any other harmful effects?

In fact it does. An IMF paper on this topic stated:

1. pro-cyclical fiscal policy has been found in oil producing countries to amplify the effect of oil price volatility on the overall economy - it causes higher wages and inflation, and a real appreciation of the exchange rate, which undermines competitiveness in the non-oil sector, which then <u>makes overall economic activity and exports even weaker when oil prices are low</u>.
2. The pro-cyclicality of fiscal policy in oil-producing countries amplifies the effect of oil price volatility and <u>reduces long-term growth</u> (see Sturm et al. 2009).
3. The pro-cyclicality of fiscal policy to changes in oil prices tends to intensify the effects of fluctuations in macroeconomic performance in oil-producing countries, which is also found to be <u>negatively</u>

related to income levels (see Sturm, Gurtner, and Alegre 2009).

4. Pro-cyclical fiscal policy crowds out private spending and investment, and usually results in a decline in private sector output and employment (Cologni and Manera 2011).

Further, a recent IADB study found that almost 50% of the increase in fiscal spending between 2003-2008 was devoted to Transfers and Subsidies alone, and such spending has been found to reduce growth in the short run, as evidenced by a post-crisis real GDP growth average of close to zero. The same study also found that a positive oil income shock (growth in energy revenues) increases economic output almost immediately, but only in the short-term – i.e. it does not lead to sustained growth. The main reasons for this, is that the T&T economy is characterized by low fiscal multipliers (where a 1% increase in fiscal spending leads to a 0.32% increase in growth) and high fiscal leakage (where roughly 80% of fiscal spending 'leaks' out in the form of imports).

Put simply therefore, it would be a mistake to continue believing that high energy prices and pro-cyclical fiscal policy have the potential to drive sustainable growth in the T&T economy. An energy driven boom which provides the fiscal space to increase spending will at best only boost growth in the short-term, and in the longer term, only promotes higher imports and eventually reduces growth.

Are we therefore doomed to forever endure the harmful volatility of the boom / bust cycle brought on by energy price movements, and amplified by pro-cyclical fiscal policy?

WHAT TO DO?

We know that our overdependence on the energy sector is unhealthy, and economic diversification is necessary. We have always known this. For now, let's assume that a robust economic diversification strategy is being formulated, but that this will take time to fully implement, as it would involve deep macroeconomic structural reforms.

We know that our fiscal policy stance is pro-cyclical, and this only amplifies the inherent high volatility associated with our energy overdependence. We also know that human nature and other powerful motivators underpin the pro-cyclicality of fiscal policy. But is there something we can do relatively quickly, to dampen the pro-cyclicality of fiscal policy and make it more counter-cyclical?

The answer is yes :

1. Legislated limits can be placed on government spending, the size of the fiscal deficit and the debt level.
2. National savings can be mandated when fiscal revenues are high / rising, for example, in the Heritage and Stabilization Fund (HSF).

THE HERITAGE AND STABILIZATION FUND

The HSF was launched in 2007 with the dual objective of smoothing the level of fiscal spending (the stabilization motive) and promoting inter-generational equity (the heritage motive). The HSF rules state that savings (withdrawal) is triggered when actual energy revenue exceeds (falls below) budgeted energy revenue by at least 10%. The HSF was estimated at USD5.6 billion at the end of 2015, and as announced by the Prime Minister in December 2015, roughly USD3.5 would be earmarked for the Heritage component, and are inaccessible for stabilization purposes. The Prime Minister announced that over the course of 2016-2017, roughly USD1.5 billion of the total HSF will be accessed for stabilization purposes, representing a veritable depletion of the Stabilization component of the fund over a two year period.

As this development clearly demonstrates, the existence of an HSF alone is necessary but insufficient in smoothing fiscal spending and promoting a counter-cyclical fiscal stance. According to the literature, stabilization funds cannot replace sound fiscal management. The effectiveness of Chile's and Norway's stabilization funds for example, is attributed to a sound fiscal policy framework, management rules, and savings and investment decisions that helped to lessen expenditure volatility (Crain and Devlin 2003).

For improved effectiveness therefore, the HSF should be supported by an appropriate fiscal framework and fiscal rules, to ensure that fiscal discipline is maintained.

WHAT ARE FISCAL RULES? HOW DO THEY WORK?

The conditions under which a government would voluntarily impose limits on its ability to spend are difficult to conceive and probably relatively uncommon. Unless the electorate is swayed more by evidence of sound fiscal management than by the private benefits of fiscal (over)spending, it is unlikely to reward the ruling administration for the former via reelection, rendering fiscal responsibility a less likely policy outcome for any administration seeking another term in office. It is arguable that currently in T&T, the electorate mostly displays a preference for policies which yield tangible (even if short-term) personal benefits, rather than policies which are more likely to yield longer-term sustainable benefits for all.

Empirical research shows that countries with fiscal rules, benchmarks or fiscal responsibility frameworks have less debt than those who do not. The adoption of fiscal rules, particularly, but not exclusively by developing countries, has increased in recent years. According to Schaechter et al. (2012), the number of countries using one or more fiscal rules increased from five in 1990 to 76 in 2012. In the Caribbean, Jamaica is the only country with legislated fiscal rules, which were adopted in 2014 as part of the current IMF programme.

According to the IMF, a fiscal rule is a legislated numerical limit on budgetary aggregates of expenditure, revenues, or deficits and debt. The four main types of fiscal rules are:

1. Debt Rules – a numerical limit on the level of public debt as a percentage of GDP
2. Budget Balance Rules – target for the overall budget surplus / deficit
3. Expenditure Rules – limits on total, primary and / or current expenditure, and / or on the variables that have repeatedly contributed to debt
4. Revenue Rules - aimed at boosting revenues or decreasing tax burdens by setting revenue ceilings or floors

The most frequently used rules are the Budget Balance Rules and Debt Rules, and drawbacks with individual rules have led most countries to adopt a combination of rules.

The objectives of fiscal rules include:

1. The ultimate objective of fiscal rules is to promote sustainable growth, while at the same time controlling deficits and limiting debt accumulation. However, as Anderson and Minarik (2006) point out, the ultimate objective is supported by at least two proximate ones: (i) long-term fiscal responsibility and sustainability; and (ii) short-term macroeconomic stabilization.
2. Governments also implement fiscal rules to foster policy coordination between different levels of government, contribute to the reduction of uncertainty about future fiscal policy developments, control size of government, and promote cyclical stability.

WHAT RULES MIGHT A FISCAL FRAMEWORK IN T&T INCLUDE?

Ideally, and to be deemed fully diversified from a fiscal and export revenue standpoint, we should not incur ongoing non-energy fiscal or balance of payments deficits. This means that the economy would not be reliant on the energy sector to compensate for shortfalls in the non-energy sector.

Failing this 'utopian' goal, some guidelines that may be worth considering :

1. We should never run a primary fiscal deficit. Recurrent expenditure (excluding interest payments) should not exceed recurrent revenues, and the gross public sector debt level should be maintained accordingly – otherwise we would be borrowing to service interest payments on existing debt.
2. The size of the overall fiscal deficit relative to GDP should be numerically smaller than the real GDP growth rate. In this way, the debt to GDP ratio will not increase. Further, the debt-stabilizing size of the fiscal deficit should not be exceeded.
3. Deposits to the HSF should not take place when there is an overall fiscal deficit, unless the cost of the debt we are raising to finance the deficit is lower than the return being earned by the HSF portfolio, otherwise we are borrowing to save and incurring a negative carry.

4. Tighter control should be exercised over contingent liabilities, as these sometimes end up becoming central government obligations. A profitable, creditworthy state-owned enterprise shouldn't need a government guarantee to raise debt within reasonable levels, and should be divested where possible. Lossmaking state-owned entities should only benefit from government guarantees alongside a robust reorganization programme to bring the entity to self-sufficiency.
5. A thorough assessment of the social welfare system is desperately needed as there is rampant waste and duplication. While some collect undeserved benefits, many deserving citizens, such as the mentally ill, elderly and disabled, go without. Once the system has been rationalized, we could consider imposing a minimum or floor on social welfare spending as a proportion of total fiscal revenue, to make sure that those truly in need are appropriately supported.

CONCLUSION

The tradeoff our policymakers weigh now on the scale of political will, puts an appropriate front-loaded adjustment and reform programme (with benefits potentially kicking in at just the right time in the electoral cycle), against a less potentially politically risky, gradual and tentative adjustment process.

Overdependence on the energy sector and pro-cyclical fiscal policy are two elements of a vicious cycle that we have been stuck in for over five decades. In the same way that we have grown to expect buoyant fiscal spending when energy prices are high, we are also used to enduring some pain when energy prices are low. There is no better time than the present therefore, to implement the necessary but painful (in the short term) reforms mentioned earlier to break the vicious pro-cyclical, energy-dependent cycle.

We all have our part to play by supporting the necessary reforms, and shifting our mindset to acknowledge the need for private sector led growth going forward, as we already know that higher fiscal spending does not create sustained growth in T&T.

GOVERNMENT SPENDING DŒS NOT IMPROVE LIVES SUSTAINABLY IN TRINIDAD & TOBAGO

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