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Ten Lessons from Country Experiences with Fiscal Policy Rules[1]

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Abstract

This paper reviews country experiences with the implementation of fiscal policy rules focusing on eight advanced and emerging economies with the objective of drawing policy relevant lessons for the implementation of fiscal rules in developing countries. It explores a range of design features, statutory provisions, penalties for non-compliance and operational arrangements. The analysis provides a number of useful lessons for the design and implementation of fiscal rules centering on elements of good design, appropriate coverage of fiscal rules, timing of its introduction, mechanisms to encourage compliance, key implementation issues, and supporting institutional arrangements. Country experience shows that fiscal rules established in legislation are likely to be more successful and are important in countries where political change could undermine the credibility of fiscal policy. In addition, the legitimacy of the rules is necessary for its success implying the need for the rule to enjoy a broad spectrum of political support. To be effective, fiscal rules need supporting institutions and structural reforms in a number of areas. Key reform areas include the introduction of a fiscal responsibility law and the establishment of an independent fiscal policy council that would enhance the quality of budget discussions and foster greater transparency. The paper concludes that a comprehensive fiscal strategy needs to combine fiscal policy rules with longer term development strategies. Policies and initiatives aimed at enhancing revenue collection and improving the efficiency of the public sector are essential components of a broad strategy to improve fiscal capacity and performance.

Keywords:

Fiscal policy rules, fiscal performance, fiscal policy councils

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In normal economic times, the UK government should run an overall budget surplus, so our country is better prepared for whatever storms lie ahead. In short, we should always fix the roof while the sun is shining.

George Osborne, Chancellor of Exchequer, Budget Speech, July 8, 2015

1. INTRODUCTION

Over the past few years, the global economy has been characterized by rising fiscal deficits and high public debt. The European sovereign debt crisis reminds countries of the importance of fiscal discipline and clarifies many issues on the nature of fiscal discipline and on the ways to achieve it. The crisis illustrates how slowly fiscal indiscipline can assert itself. The crisis highlights that governments can run budget deficits for several years, even decades before facing the wrath of financial markets.

To reduce the worrisome trends in discretionary fiscal policy (deficit bias, procyclicality, and structural distortions), an increasing number of countries have introduced rules based fiscal responsibility frameworks, characterized by fiscal policy rules, transparency standards, and surveillance and enforcement mechanisms. More recently, fiscal rules have been advocated to support fiscal consolidation efforts and to ensure long term sustainability of government finances.

In theory, well designed and effectively implemented fiscal rules, although second best policies, can help reduce time inconsistency in budgetary policies, strengthen the credibility of a government's commitment to fiscal sustainability, and facilitate countercyclical fiscal management. This paper reviews country experiences with the implementation of fiscal policy rules focusing on eight advanced and emerging economies with the objective of drawing policy relevant lessons for the implementation of fiscal rules in developing countries. It explores a range of design features, statutory provisions, the penalties for non-compliance and operational arrangements.

The main lessons from our review of country experiences with fiscal policy rules include:

- In the absence of a strong reputation of prudent macroeconomic management, fiscal policy rules are indispensable;
- A well designed fiscal rule consists of establishing a depoliticized framework for fiscal policy combined with increased transparency standards;
- The legitimacy of the rules is necessary for its success implying the need for the rule to enjoy a broad spectrum of political support;
- The usefulness of fiscal rules depends on detailed reporting, periodic reviews of numerical targets, and a multiyear macroeconomic framework. These need to be combined with well designed surveillance and enforcement mechanisms;
- Fiscal rules are more effective when implemented on a broader definition of government;
- An appropriate sanctions regime helps to strengthen the credibility of the fiscal rule;

- Countries have implemented automatic mechanisms to correct ex post deviations from the rule to improve compliance;
- The trigger of escape clauses that allow deviations from the fiscal target have been limited to extraordinary circumstances;
- Rules entrenched within a stronger legal framework including fiscal responsibility laws have been more successful; and
- An independent fiscal policy council has been used in a number of countries to enhance the quality of budget discussions and foster greater transparency.

The remainder of the paper is organized as follows. After this introduction, section 2 discusses the literature on fiscal policy rules analyzing the different forms of fiscal rules from a theoretical point of view as well as the theoretical and empirical justification for the establishment of fiscal policy rules. Section 3 describes individual country experiences with fiscal rules. Section 4 presents ten lessons from our review of country experiences with the implementation of fiscal rules. Section 5 provides a summary and conclusions of the paper.

2. FISCAL POLICY RULES: THEORY AND EMPIRICAL EVIDENCE

This section examines the theoretical foundation of fiscal rules and their empirical relevance. The section discusses what fiscal policy rules are, the types of fiscal rules, and the theoretical and empirical evidence supporting their implementation.

2.1. WHAT ARE FISCAL POLICY RULES?

According to Kopits and Symansky (1998), a fiscal rule is a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates. This definition implies that targets that are difficult to change frequently are set for fiscal policy, and some operational guidance is provided by specifying a numerical target that limits a particular budgetary target.

Fiscal rules are normally aimed at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability. In many countries, the existence of many competing interest groups usually results in the "voracity effect" (Tornell and Lane, 1999) where different groups compete and push for overspending especially in good times leaving little or no room for countercyclical policies in bad times. To solve these problems, a number of fiscal institutions including fiscal rules and medium term budget frameworks have been established around the world over the past three decades with a view to supporting more prudent and balanced fiscal policies.

Fiscal rules are also introduced to regulate the size of the government and support intergenerational equity. Containing the size of government is a key function of expenditure rules as well as setting ceilings on revenues. In addition, budget balance rules can aim to support intergenerational equity by, for instance, requiring the buildup of public assets from the proceeds of exhaustible natural resources. Revenue rules have also been introduced to help protect priority spending by earmarking funds for specific sectors such as health and education in the case of Brazil.

2.2. FISCAL RULES: THEORETICAL BASIS

It is generally believed that the source of fiscal indiscipline is the common pool problem**.** The presumption is that recipients of public spending do not fully internalize the costs that tax payers must assume. Consequently, governments in democracies are led to postpone tax collections or expenditures cuts. The solution to the fiscal discipline problem therefore requires internalizing this externality with fiscal rules and adequate institutions (Kopits, 1995).

Fiscal rules are mainly mechanisms of correcting coordination failures inherent in the budget decision-making process**.** The argument is that governments usually consist of multiple decision makers who cater to diverse constituencies and compete for overall fiscal resources available to the general population leading to a common pool problem. As a result, fiscal policy is usually biased towards inefficiently high levels of government spending and this might be mitigated by restricting

governments' discretion through the adoption of fiscal rules (Holm-Hadulla, Hauptmeier and Rother, 2010).

The literature also suggests that the common pool problem may in addition to fiscal excesses induce a pro-cyclical bias in fiscal policy. Tornell and Lane (1999) developed a dynamic framework in which multiple political groups with diverse preferences compete for a common tax base via the budgetary process. Under favorable macroeconomic circumstances (that is when the tax base increases) the incentive for each group to raise its share of the common pool becomes stronger, whereas in bad times the opposite happens. This theoretical argument provides the basis for empirical findings suggesting a positive relationship between public spending and the cyclical position of the economy (Gali and Perotti, 2003).

Another justification for the implementation of numerical fiscal rules is to prevent policy makers from worsening macroeconomic volatility through procyclical fiscal policies. More specifically, there is a widespread consensus on the impact of fiscal rules that restrict government expenditure. According to the European Commission, enforced national expenditure rules help to counteract forces leading to pro-cyclical fiscal policy in good times and thus prevent the need for fiscal austerity measures in difficult times (Box 1).

The main criticisms of fiscal rules center on their usefulness or effectiveness. Skeptics argue that rules-based fiscal policy lack theoretical foundation (Kopits, 2001), and at the same time reduce fiscal policy flexibility. A common objection is that by reducing fiscal policy flexibility, fiscal rules create incentives to artificially achieve targets by adopting dubious accounting practices, and thereby reducing the transparency of government budgets (Milesi-Ferretti, 2000; Basdevant, 2012).

Box 1. General Objectives of Fiscal Rules

- Strengthening governments' commitment to sound macroeconomic and fiscally sustainable policies by raising the costs of policies inconsistent with the rules.
- Signaling such commitment to sound policies in a transparent and credible manner.
- Promoting sustained budgetary savings to address predictable long-term needs, for example, from aging populations, the exhaustion of natural resource endowments, or infrastructure investment requirements.
- Extending the planning horizon for public policies by providing increased certainty about their medium-term financing.
- Avoiding pro-cyclicality in budgetary policies.
- Limiting the size of government, or capping the tax burden.
- Safeguarding certain types of expenditures.

Source: Ter-Minassian (2010)

Another argument is that governments can credibly commit to fiscal discipline without necessarily tying their hands with permanent fiscal rules. Citing the cases of the US and Germany, Kopits (2001) notes that fiscal rules may be redundant when the government acquires a reputation of prudent macroeconomic management. At the same time, it is argued that the absence of reputation is a good reason to adopt fiscal rules. Moreover, fiscal rules are also seen as imposing unnecessary bureaucratic requirements and that market forces should instead enforce discipline on fiscal behavior.[2]

2.3. FISCAL POLICY RULES: EMPIRICAL EVIDENCE

Several studies have adopted statistical and econometric techniques to investigate the role of fiscal policy rules in determining fiscal performance or budgetary outcomes. The most comprehensive analyses have been carried out for the EU countries based on detailed data on national fiscal rules collected by the European Commission and summarized in fiscal rule indexes. Marneffe et al (2011) examined the impact of fiscal rules on public finances in the Euro Area. They found that fiscal rules have in most cases a significant positive effect on the fiscal balance. Their results suggests that fiscal rules have had a deficit reducing effect and are in that sense important for the workings of fiscal policy in the euro area. Their results show that stronger fiscal rules in a country and over time contribute to a lower deficit. For the EU countries, tighter and more encompassing fiscal rules are associated with stronger cyclically adjusted primary balances. The relation weakens, however, when measuring fiscal performance in terms of changes in public debt to GDP ratios. This may be an indication that creative accounting could have played a role in conforming to the rules' requirements.

Amo-Yartey (2014) examined the impact of fiscal rules on the probability of a large debt reduction in a sample of 160 advanced and emerging economies. The result shows that fiscal rules tend to increase the probability of a large debt reduction because they help strengthen the fiscal framework and improve fiscal transparency.

He also finds that debt and budget balance rules are important in explaining the probability of a large debt reduction. Revenue and expenditure based fiscal rules do not appear to have any significant impact on the probability of a large debt reduction.

A well designed medium term expenditure rule could overcome procyclical bias on the expenditure side. Deroose, Moulin, and Weirts (2006) argue that expenditure rules are important in complying with national medium term expenditure plans. Expenditure rules were very common in cases of large fiscal adjustment and were usually combined with budget balance rules (IMF, 2009). The findings on the impact of expenditure rules differ across expenditure items, with the impact being muted for nondiscretionary items.

2 Findings by Bayoumi, Goldstein and Woglom (1995) support the market discipline hypothesis. Generally, evidence from the literature, however, suggests that markets tend to react too slowly. They tend to punish fiscal profligacy in a discontinuous fashion, and often in an extreme situation (Debrun, Hauner and Kumar, 2009).

The empirical literature also shows that the type of fiscal rules and the level of government at which it is applied matters. Concerning the type of fiscal rules, budget balance and debt rules have contributed to better budgetary outcome. For expenditure rules, an impact is found only in terms of restraining primary spending. The level of government at which the rules apply matters. Rules for higher levels of government have been associated with more fiscal discipline than those applying to local governments. In addition, some design features of fiscal rules seem to have a particularly beneficial impact on fiscal performance, including a strong legal basis of rules and strict enforcement.

Fiscal rules have also been identified as an important factor accounting for the success of fiscal consolidation**.** In the Organization for Economic Cooperation and Development (OECD), the size of fiscal consolidation was significantly larger when national or supranational fiscal rules were present (Guichard et al., 2007). For the EU, empirical studies show that stronger and wider fiscal rules as measured by a fiscal rules index were associated with a greater likelihood of successful fiscal consolidation (European Commission, 2006). Econometric evidence on whether national fiscal rules have contributed to triggering fiscal consolidation in EU countries is not clear cut. When estimating the probability of a fiscal retrenchment occurring, the fiscal rules index is found to be only weakly significant (Larch and Turrini, 2008).

However, the probability of fiscal rules triggering a sharp consolidation rather than a gradual one is somewhat higher.

Findings are mixed regarding the impact of fiscal rules on government's ability to engage in countercyclical fiscal policy. While the main motivation in the literature was to analyze the impact of fiscal rules, a related issue is whether the reduced discretion could affect the responsiveness of fiscal policy to output volatility. Fatas and Mihov (2005) find that strict budgetary restrictions lower the responsiveness of fiscal policy to output shocks. In contrast, Brzowski and Siwinska-Gorzelak (2010) find limited cost in terms of increased output volatility. It is argued that the impact of fiscal rules on the extent of fiscal policy volatility may depend on the type of rule and fiscal measure being constrained.

3. TYPES OF FISCAL RULES

Four types of rules can be identified namely budget balance rules, debt rules, expenditure rules, and revenue rules (see Table 1).

BUDGET BALANCE RULE

Budget balance rules can be specified as overall balance, structural or cyclically adjusted balance, and balance over the cycle. These rules can help ensure that the debt-GDP ratio converges to a finite level. Primary balance rules are less linked to debt sustainability as increases in interest payments would not require an adjustment even if they affect the budget balance and public debt.

DEBT RULE

Debt rules normally set explicit limits or targets for public debt as a percentage of GDP. When converging to a debt target is the most important objective, this type of rule is the most effective. Debt rules, however, do not provide enough guidance for fiscal policy especially when the debt is well below the desired target.

EXPENDITURE RULE

Expenditure rules usually set permanent limits on total, primary, or current spending in absolute terms, growth rates, or as a percentage of GDP. These rules are not linked directly to debt sustainability objectives since they do not constrain the revenue side of the budget. Expenditure rules, however, can provide an operational tool to trigger the required fiscal consolidation consistent with sustainability when they are accompanied by debt or budget balance rules.

REVENUE RULE

Revenue rules set ceilings or floors on revenues and are aimed at boosting revenue collection and or preventing an excessive tax burden**.** These rules are also not directly linked to control of public debt, as they do not constrain spending. In addition, setting ceilings or floors on revenues can be challenging as revenues could have a large cyclical component, fluctuating widely with the business cycle.

TABLE 1. PROPERTIES OF DIFFERENT TYPES OF FISCAL RULES

Type of Rule	Advantages	Limitations
Debt Rule	Direct link to debt sustainability Easy to communicate and monitor	No clear operational guidance in the short run as policy impact on debt is not immediate No economic stabilization feature Rule could be met via temporary measures (For instance below the line transaction)
Budget Balance Rule	Clear operational guidance Close link to debt sustainability Easy to communicate and monitor	No economic stabilization feature Headline balance could be affected by developments outside the control of government.
Structural Balance Budget Rule	Relatively clear operational guidance Close link to debt sustainability Economic stabilization function Takes into account other one off and temporary factors	Correction for cycle is complicated especially for countries undergoing structural changes. Need to predefine one off and temporal factors to avoid their discretionary use. Complexity makes it more difficult to communicate and monitor.
Expenditure Rule	Clear operational guidance Allows for economic stabilization Steers the size of government Relatively easy to communicate and monitor	Not directly linked to debt sustainability since no constraint on the revenue side Could lead to unwanted changes in the distribution of spending if to meet the ceiling, shift to spending categories occurs that are not covered by the rule
Revenue Rule	Steers the size of government Can improve revenue policy and administration Can prevent procyclical spending	Not directly linked to debt sustainability since no constraint on the expenditure side. No economic stabilization feature.

Source: Schaechter et al 2012

Schaechter et al (2012) noted that revenue rules alone could result in procyclical fiscal policy, as floors do not generally account for the operation of automatic stabilizers on the revenue side in a downturn or ceilings in an upturn for revenue ceilings. However, like expenditure rules, revenue rules can directly target the size of the government.

Fiscal rules have different implications for the way fiscal policy responds to shocks. Overall balance or debt rules have the least degree of cyclical flexibility in terms of responding to output shocks. A cyclically adjusted or structural balance rule allows the full operation of automatic stabilizers but does not provide room for discretionary fiscal stimulus. Expenditure rules are consistent with cyclical and discretionary reductions in tax revenues, but they do not normally permit discretionary expenditure stimulus. Revenue rules do not generally account for the operation of automatic stabilizers on the revenue side in a downturn. As automatic stabilizers are stronger on the revenue side, these rules per se tend to result in procyclical fiscal policy.

Even when its design features are fine-tuned, not all types of fiscal rules are equally able to support the objectives of sustainability, economic stabilization, and the size of government. Many countries attempt to close these gaps by adopting a combination of rules.

3.1 COUNTRY EXPERIENCES WITH FISCAL RULES

This section presents a few examples of fiscal arrangements from advanced and emerging economies. While most fiscal rules and institutional arrangements are recent, other countries have a long history of rules and institutions to enhance fiscal discipline. The focus of the review is on the types of rules implemented, important design features, enforcement mechanisms, and fiscal performance with the implementation of the rules.

BRAZIL

Brazil adopted a fiscal responsibility law in 2000 to improve public finances at both federal and subnational levels. The law requires a qualified majority (two-thirds) for approval and modification, and it is binding for all entities of the public sector at all levels of government. The law introduced the use of primary surplus but does not specify quantitative targets or limits for all items. However, the law requires that quantitative targets are specified in separate legislations and regulations:

- The target is defined in terms of primary balance expressed in levels in the annual budget law and is binding for the first year. It must also include projections for the fiscal balance, expenditure and debt for the subsequent two years and the detailing of fiscal risk with an assessment of contingent fiscal liabilities.
- The ratio of net public debt to net revenues cannot exceed 3.5 for the federal government, 2.0 for state governments, and 1.2 for municipalities.
- There are maximum limits on personnel expenditure as proportion of net current revenue (50 percent for the federal government and 60 percent for the municipal and state government).
- There are also specific limits on new spending and borrowing in the last year of a government.

Fiscal rule in Brazil places a number of restrictions on the relations between public sector agencies and the levels of government to prevent excessive spending and misuse of public financial institutions. More specifically, it prohibits any credit arrangement between entities of the public sector as well as direct deficit financing of any form by the central bank. Public enterprises are also prohibited from lending any funds to their controlling agency. Despite provisions in the law, no institution is mandated in Brazil to provide an independent view on the government's proposed fiscal frameworks, policies, and macroeconomic assumptions.

Fiscal performance in Brazil started to improve with the implementation of the fiscal rule. Fiscal targets were met but expenditure growth in real terms increased significantly since 2003. Strong revenue performance resulting from good economic performance contributed to achieving the fiscal target. In addition, net public sector debt declined steadily from a peak of 60 percent of GDP in 2002 to around 40 percent of GDP in 2010 but gross debt remains relatively high. The composition of debt also changed with a reduction in the share of foreign currency debt, a lengthening in average maturity and a rise in the share of fixed rate instruments.

Brazil has introduced significant changes to the law in recent times. The country established a sovereign wealth fund in 2008 to be used as a countercyclical instrument. The fund also aims at smoothing exchange rate volatility and promoting investment. So far it has been used only in 2008 to accumulate part of the fiscal over performance (about 0.5 percent of GDP was injected in 2009). The fiscal framework was also modified as the government was allowed to exclude part of the investment spending from the calculation of the fiscal target and the exclusion of Petrobras from the fiscal target commencing in 2009.

Brazil's fiscal framework was put to test during the global financial crisis and the country was able to adopt countercyclical fiscal policy to support the full operation of automatic stabilizers. The government implemented temporary and targeted tax cuts and a reduction of the primary fiscal balance target. While the response to the crisis was effective, there was a weakening of fiscal transparency and the credibility of the fiscal framework may have been weakened.

CHILE

Chile has been mentioned as the paradigmatic example of prudent fiscal management using a balanced structural budget as a target for fiscal policy. Chile's adoption of a fiscal rule came at the end of a long period during which the public debt was reduced from 165 percent of GDP in 1985 to 20 percent in 2000. The objective behind the adoption of the rule was to consolidate the gains made and institutionalize the emerging fiscal discipline tradition. Initially introduced without legal backing, the rule has been written into the fiscal responsibility law.

Chile's fiscal rule requires that the cyclically adjusted primary balance be in surplus. The original target was one percent of GDP between 2001 and 2008 and the surplus target was reduced further to 0.5 in 2008 and zero in 2009 to allow for countercyclical response to the global financial crisis.

Practically, the rule involves the estimation of the cyclical adjusted government revenues and a

derivation of the maximum government expenditure. From a methodological point of view, the structural balance removes the cyclical or transitory components of revenues and expenditures included in the traditional balance. In the case of Chile, besides controlling for variations in revenues that result from the business cycle, the procedure isolates variations in the price of copper from its long run projection. Proceeds from privatizations are also excluded from the structure measure. In other words, the structural budget reflects what the budget would have been had the economy been on its medium term trend.

Using a (balanced) structural budget also implies that fiscal policy operates as an automatic stabilizer in the sense that whenever the economy is below its medium term trajectory there will be an observed fiscal deficit while the structural measure remains stable. For example, let us assume fiscal revenues increase from their medium term trend. If there is no cyclical adjustment to fiscal expenditures as is the case in Chile, this implies that fiscal expenditures will remain stable in order to keep a balanced structural budget. This consequently generates a balanced structural budget but a surplus according to the traditional cash flow budget. The government accumulates assets that are then used when fiscal revenues are below their trend value. Government expenditures are maintained in bad times (equal to the structural level of revenues) and the result is then balanced structural budget and a fiscal deficit. It is important to mention that the mechanism does not require preexisting assets as long as these are credible and sustainable policies, investors should believe that the government is capable of paying them back.

The calculation of the structural revenues is therefore the main component of the rule. The calculation has to take into account cyclical effects and Chile's revenue is highly sensitive to copper price fluctuations because tax revenues from copper production represent about 25 percent of total revenue. Given the volatility of copper prices, it is important to correct for these fluctuations ex ante. The country has set up a committee of independent experts in charge of providing the government with assumptions regarding GDP and the long run price of copper. The implication is that forecast errors concerning GDP cannot be the result of government manipulation. The surplus rule implies that eventually the government must be a net creditor. It was recognized that copper resources are finite and that the country needed to build buffers for a welfare system. As a result, Chile operates two Sovereign Wealth Funds.

Chile does not have an escape clause but the target can be changed to allow for government response to adverse shocks. While the budget must be in conformity with the fiscal rule, there is no sanction when the budget outturn differs presumably because underlying assumptions proved to be too optimistic.

The main reason for the success of the Chilean rule is the existence of an independent expert group, which is involved in the budgetary process as it produces cyclically adjusted figures. A second reason is the transparency of the process. The calculation of the cyclically adjusted budget, which have been refined over time are presented and explained in great detail to the broad public. Another reason is the relationship between government and parliament. The power to set the budget is entirely in the hands of the executive. Parliament is not allowed to reduce taxes or increase spending.

UNITED KINGDOM

Between 1997 and 2008, the UK implemented a golden rule over the cycle from 1997 to 2008. According to the rule, the central government is only allowed to borrow for investment, not to fund current spending. Performance against the rule is measured by the average surplus on the current budget in percent of GDP over the economic cycle. A sustainable investment rule was in place that required public sector net debt in percent of GDP be held at a stable and prudent level over the cycle. Other things being equal, net debt will be maintained below 40 percent of GDP over the cycle. The rule was to be monitored by the Chancellor (Minister of Finance) based on forecasts by HM Treasury, which was also requested to produce long run forecasts to gauge debt sustainability.

The rule struggled to gain traction as it had no enforcement mechanism. As a result, between November 2008 and December 2009, the UK government departed temporarily from the fiscal rules and adopted a temporary operating rule to set policies to improve and achieve a balanced cyclically adjusted current budget in each year and reduce debt GDP ratio, once the economy emerges from the downturn.

This led the new government to pass in 2011 the Budget Responsibility and National Audit Act. The new Act combines a set of rules and an independent fiscal policy committee. Similar to the previous rule, the country adopted a budget balance rule to achieve a cyclically adjusted current balance by the end of the rolling five year forecast period (currently by FY2016/17). The rule requires a year on year reduction in public sector net borrowing to FY2015/16 so that public sector net borrowing as a percentage of GDP is more than halved over the four years. The main difference is the replacement of the golden rule—a difficult concept since making a decision regarding the nature of public investment, is open to manipulation and abuse.

The real innovation is the creation of the Office for Budget Responsibility (OBR). This independent body takes over the forecasting tasks so far carried out by the Treasury. This arrangement was in response to the fact that many of the slippages over the years were due to optimistic forecasts regarding macroeconomic variables and budget figures. The office for Budget Responsibility provides economic and fiscal forecasts for the budget and examines and reports on the sustainability of public finances. A Budgetary Responsibility Committee that includes five members runs the OBR. The first committees include widely respected economists. It has 15 members of staff with the assumption that the OBR has full access to the resources of the Treasury.

In July 2015, the Chancellor announced a revised fiscal rule that resumes the spirit of prudence by targeting a surplus in overall public sector borrowing by 2020. Thereafter, it requires [omission] in each year of the medium term forecast unless GDP growth is assessed by the UK fiscal council to be less than 1 percent. The rule also requires public sector debt to be falling as a share of GDP in each year until 2020. To achieve these targets, the government also announced the second stage of its fiscal consolidation program, with plans to reduce public sector expenditure to 36 percent of GDP by 2019, compared to 41 percent this year and 46 percent at the height of the financial crisis in 2009. The UK fiscal rules combine a reasonable set of fiscal targets with an institution that is

intended to act as a Whistleblower. According to Jonung and Larch (2006), delegating forecasting to an independent agency is a key ingredient to achieve fiscal discipline.

GERMANY

Germany has a long history of fiscal rules implementing a golden rule at the national level between 1969 and 2010. The golden rule stipulates that net borrowing must be equal to the level of investment unless in exceptional circumstances. An expenditure rule has also been in place since 1982 and applies to central and regional governments. Expenditure was not permitted to grow faster, on average, than revenue until 2008 when an annual expenditure growth ceiling of 1 percent took effect. In addition, Germany revised its constitution in June 2009 and introduced a debt break with a view to ensuring the sustainability of public finances. A new structural balance rule was introduced in 2011 with a transition period until 2016 for the federal government and until 2020 for the states. At the regional level, the country observes the fiscal rules applicable to the EU since 1992.

Germany's new rule adopted in 2011 limits the structural federal budget deficit to 0.35 percent of GDP, while the states need to balance their structural budgets. The cyclical component of the budget allows roles for automatic stabilizers, and is calculated in accordance with the European Commission's methodology. If the fiscal structural balance outturn deviates from the 0.35 percent of GDP deficit limit, the positive or negative gap is saved in a notional account corrected for those errors deriving from real GDP growth projections. Thus, the control account acts as a memory and buffer if non compliance of the rule is established ex post. An adjustment is required whenever the control account debit exceeds 1½ percent of GDP.

The implication of Germany's fiscal rule is that debt must grow at a substantially lower pace than GDP. The rule also allows for exceptions, if adopted by a majority of the Members of Parliament, in case of a natural disaster or exceptional emergencies. The adoption of exceptionally higher budget deficits, however, needs to be accompanied by an amortization plan. In effect, the design of the rule guarantees its effectiveness, and at the same time eliminates policy makers' incentives to use temporal deviations within the budget process to their advantage. While there are no binding sanctions for violating the new budget rule, a new Stability Council established in 2010 with the mandate to avert severe budget problems, is expected to monitor compliance and issue early warnings to the authorities.

The new fiscal rule is consistent with EU's supranational fiscal framework and is an important element in Germany's exit strategy from the 2008 global financial crisis. Even though the process for reforming the fiscal rule started well before the crisis, the adoption of a transition regime from 2011 to 2016, when the rule is expected to take effect for the federal government is consistent with the country's envisaged timing for exiting from the crisis supported policies. Additionally, the 0.35 percent structural budget balance target is in line with Germany's obligations under the EU's Stability and Growth Pact, which include a medium term budgetary objective of a deficit of 0.50 percent of GDP.

PERU

As a permanent institutional device to promote fiscal discipline in a credible, predictable and transparent manner, Peru established a fiscal rule in 2000. Before the establishment of the rule, fiscal performance in the country had deteriorated with the overall fiscal balance turning from a surplus in 1997 to a deficit of 3 percent of GDP in 1999. The law contained both procedural and numerical rules. The numerical rule includes caps on the public balance and on the real current expenditure for the non-financial public sector and general government, respectively. It allowed for an overall non financial public sector deficit of up to 1 percent of GDP from 2002. The rule also capped the increase in real non-financial expenditures of the general government to 2 percent, using the GDP deflator to calculate the nominal increase.

The rule has features to control spending behavior during elections. During the first seven months of an election year, non-financial expenditure of the general government cannot be more than 60 percent of budgeted amount and the fiscal deficit of the nonfinancial public sector in the first half of an election year, cannot exceed 50 percent of the budgeted annual deficit to prevent outgoing governments from engineering an opportunistic fiscal expansion.

The fiscal rule does not have individual specific sanctions and sanctions are only institutional. However, public officials must comply with the fiscal rule according to the rules and principles of the law on ethics of public service. The rule also included an escape clause that allowed for a temporary (one year) relaxation of the target in case of national emergency or international crisis. The suspension of the rule has to be approved by Congress at the request of the Executive. In addition, in cases where there is sufficient evidence backed by a report from the Minister of Economy and Finance that the economy is declining or could decline in the following fiscal year, the deficit target could be missed (never exceeding two percent of GDP).

The fiscal rule in Peru was partially modified in 2003 with a clear aim of debt consolidation due to the fact that regional governments were created in 2002-03 and obtained substantial autonomy including the right to borrow. The central government transferred important roles and fiscal resources to regional governments and reinforced the existing municipal governments. Both levels of subnational government doubled their budget revenues in only five years but they are mainly financed through a transfer from the central government. The rule also stipulates that the relationship between the annual total debt stock and the current revenue of regional and local governments should not exceed 100 percent; and the moving average of the primary balance of three years must show a positive value for each regional and local government.

To ensure compliance, the fiscal rules restrict access to intergovernmental funds for the regional and local governments in case of failure of fiscal rules. The government was empowered to through emergency decree adopt fiscal measures aimed at stabilizing public finances of these entities. The subnational governments need the central government's guarantees to contract external debt, which must be allocated to finance infrastructure. There has been high non-compliance with the rules at the subnational level and no subnational government has ever been sanctioned. This is probably

because subnational public finances in Peru have not deteriorated to the level which has adversely affected the country's overall debt sustainability.

Compliance with the debt limits during 2000-02 was difficult and following repeated breaches, the target was loosened in 2003, when a new sliding scale for the deficit was put in place, from 2 percent of GDP in 2003 to 1 percent of GDP in 2005 and beyond. Compliance with the fiscal rules improved significantly since 2003 with the commodity price boom and the limits were met with growing margins until the global financial crisis of 2008. On the contrary, the expenditure rules, despite undergoing several modifications did not provide a binding constraint during the upswing as the fiscal rule and did not help anchor fiscal policy formulation process and moderate procyclicality. Nevertheless, due to the commodity price boom, the government reduced its debt on the upside from 44 percent of GDP in 2004 to 24 percent of GDP in 2010.

The fiscal rule in Peru also created a fiscal stabilization fund *(Fondo de Estabilizacion Fiscal (FEF))* to mitigate cyclical variations. The fund accumulates income from:

- the fiscal surplus at the end of the year (if current income from ordinary resources exceeded its three previous year's average of 0.3 percent of GDP);
- 10 percent of net income from each sale of assets for privatization;
- 10 percent of down payments by state concessions and 30 percent of funds raised by new royalties for the exploitation of nonrenewable natural resources owned by the state; and
- Interest from the FEF.

The stabilization fund may not exceed 4 percent of GDP with the resources exceeding the limit used for debt reduction. The resources from the Fund are used when revenues are at least 0.3 percent of GDP lower than the average of the last 3 years and GDP declines in two consecutive quarters. However, no more than 40 percent of total funds can be used in a given year, except when the escape clause applies.

INDIA

India adopted a rules based fiscal framework, the Fiscal Responsibility and Budget Management Act (FRBMA) in August 2003 against the background of deteriorating governance finances. The stated objective of the framework is to ensure intergenerational equity in fiscal management and the fiscal sustainability necessary for long term macroeconomic stability. In July 2004, a set of implementing rules came into effect and the FRBMA established the general framework for the conduct of fiscal policy by setting out both procedural and numerical rules.[3]

The FRBMA and the associated rules established fiscal targets in a multi-year context. The rules set out the following numerical limits:

3 Procedural rules are those that define attributes and interaction of participants in the budget process with the objective of increasing transparency, accountability and fiscal management. Numerical rules, on the other hand, are defined on the basis of overall indicators of fiscal policy including fiscal balances, debt, revenue, and expenditure.

- Reduction of current deficit by at least 0.5 percent of GDP in each financial year starting with 2004/05.
- Reduction of the fiscal deficit by at least 0.3 percent of GDP in each financial year so that the fiscal deficit is reduced to no more than 3 percent of GDP at the end of March 2008.
- Limit of 0.5 percent of GDP on the incremental amount of guarantees given by the central government;
- Initial annual limit on debt accumulation of 9 percent of GDP, to be progressively reduced by at least one point of GDP each year.

The original deadline to meet the specified targets was postponed to March 2009 in 2005/06 and again to March 2010 in 2008-09. The Act permits breaches of the fiscal target only on grounds of national security or national disaster or such other exceptional grounds as the central government may specify.

India adopted a bottom up approach in its institutional mechanism towards overall fiscal discipline. With about half of the general government's fiscal deficit coming from the states, the success of fiscal consolidation depended on the fiscal performances of the subnational governments. At the state level, Indian states were given incentives by the Twelfth Finance Commission to implement their own fiscal responsibility laws (FRLs) in the form of conditional debt restructuring and interest rate relief. As of mid 2008, about 26 of India's 28 states have established FRLs.

A number of features of the FRBMA have been adopted in the states' FRLs even though there are some variations in the design of the FRLs across states. The design of FRLs at the state level followed the recommendations of the Twelfth Finance Commission (TFC) created by the Group of State Finance Secretaries in 2005. It includes the following measures:

- The reduction of the overall deficit to 3 percent of gross state domestic product;
- Annual reduction targets of current and fiscal deficits;
- Measures to enhance transparency in budgetary operations; and
- A medium term fiscal policy framework.

The introduction of fiscal rules at the central government level coincided with significant improvements in fiscal indicators. Between 2003-04 and 2007-08, the central government fiscal deficit declined from 5.1 percent to 2.8 percent of GDP, achieving one year ahead of the stipulated medium term target of 3 percent of GDP. The reduction in the central government current deficit was equally impressive, down by a third of its 2003-04 levels. Most of the fiscal consolidation over the period was due to revenue gains, with strong tax performance underpinned by robust economic growth, strong corporate profits, and improvement in tax administration.

The enactment of the FRLs coincided with a process of fiscal consolidation at the sub national level with deficit indicators demonstrating marked improvement. The states' consolidated deficit was more than halved from 4.5 percent of GDP in 2003-04 to 2.5 percent in 2008-08. The aggregate

current balance also shifted from a deficit of 2.2 percent to a surplus of 0.5 percent of GDP, a correction of 2.7 percent of GDP. The level of debt at the state level also declined along with state guarantees. Most states were well ahead of the scheduled time to achieve their current and overall balance targets as of 2007-08.

India's experience with fiscal rules has been mixed. The FRBMA helped to strengthen India's fiscal policy framework. The implementation of the rules initiated in the FY2004-05 budget period coincided with a decline in India's central government fiscal deficit by about 1.8 percent of GDP between its introduction and 2007-08. Meanwhile, the date for achieving the FRBMA current deficit targets had been postponed repeatedly, off budget activities were increasing, and significant policy slippages with respect to the 2008-9 budget target were evident before the onset of the global financial crisis. The crisis led to calls for fiscal expansion raising questions about the effectiveness of the FRBMA. Most Indian states also adopted their own FRLs and have experienced significant improvements in their overall balances in the last few years.

NEW ZEALAND

New Zealand introduced the Fiscal Responsibility Act in 1994 to safeguard improvements in government finances and increase policy credibility. Although fiscal targets are not prescribed in the legislation, governments are required to set short term fiscal intentions and long term objectives for key fiscal aggregates related to the principles. Short term fiscal intentions for key aggregates still create issues when interpreting results given cyclical changes and valuation changes. These issues explain further evolution of the framework, including the role of the fiscal provisions as a key anchor in the short term.

The aim of the FRA is to improve fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirements. The five principles of responsible fiscal management are:

- Reducing total government debt to prudent levels in order to provide a buffer against adverse shocks by ensuring that the total operating expenses of the government in each financial year is less than its total operating revenues in the same year.
- Maintaining a prudent level of debt by ensuring, on average, over a reasonable period of time, the total operating expenses of the government do not exceed its operating revenues.
- Achieving and maintaining government net worth that provides a buffer against factors that may adversely impact future government net worth.
- Managing prudently the fiscal risks facing the government
- Pursuing policies consistent with predictability in the level and stability of the tax system over the medium to long term.

Governments may deviate temporarily from the principles but must do so publicly, explain why they have deviated, and indicate how and when they intend to conform to the principles.

The FRA also specified a number of reporting requirements. Governments must publish a Budget Policy Statement before the annual budget and a Fiscal Strategy Paper at the time of the budget. These publications need to demonstrate the consistency of the government's short term fiscal intentions and long term fiscal objectives with the principles of responsible fiscal management. The Act requires the FSR to include fiscal projections for a minimum of 10 years for the variables specified as long term fiscal objectives. The principles of fiscal responsibility and enhanced reporting requirements were incorporated into the Public Finance Act in 2004.

Fiscal outcomes in New Zealand improved significantly during the first half of the 1990s. With revenues remaining broadly stable as share of GDP, the change in the fiscal balance was achieved largely through the expenditure side. The reduction in expenditure was mainly due to lower interest payments as fiscal surpluses and privatizations helped reduce the level of debt. Although significant progress was made in reducing operating expenses as a share of GDP from their early 1990s levels, progress against the stated long term objectives for net debt stalled during the mid to late 1990s. Forecasting errors resulted in optimistic projections of progress towards the long term fiscal objective raising credibility issues about likely progress towards long term fiscal goals.

The 2013 amendment of the Public Finance Act 1989 expanded the fiscal framework to incorporate additional principles of responsible fiscal management relating to the interaction of fiscal policy with monetary policy; intergenerational equity, the efficiency and fairness of the tax system, and the effectiveness and efficiency in the management of the government's resources. The government's long term fiscal objective is to reduce net debt to GDP to 20 percent by 2020. Beyond 2020, the government intends to maintain net debt within a range of around 10 percent to 20 percent of GDP acknowledging that debt will fluctuate over the business cycle.

Fiscal policy in New Zealand has seen a consistent emphasis on maintaining relatively low levels of public debt. While the fiscal framework has no legislated numerical rules, there has been strong political commitment to self imposed fiscal targets. In addition, the flexibility of the framework allows the government to set broadly similar debt targets with somewhat different preferences for the size of the government. Some researchers have seen this flexibility as a weakness and have argued for a legislated expenditure rule (Wilkinson,2004). In practice, fiscal consolidation has relied mainly on changes to structural expenditure, with the caveat that assessing the overall structural fiscal position is challenging given the effect of fluctuations in the terms of trade and labor supply via net migration.

JAPAN

The basic rule for Japan's public finance is the "Public Finance Law" enacted in 1947. The law stipulates that the government can issue bonds only for financing public works, investments and loans. Until 1964, the government kept a balanced budget without issuing any bonds and after 1965, it started to issue construction bonds.

In 1975, the government requested for a waiver of this rule by enacting a special law which enables the government to issue special deficit financing bonds during the specific single fiscal year in order to deal with the worldwide recession after the commodity price shock.

After 1975, the government enacted the same special law every year, and introduced rules for fiscal management which stipulated the target year of coming back to no special deficit financing bonds budget formulations as cabinet decisions. To achieve this target the government introduced annual ceilings to expenditure and sold the equities of public corporations such as Nippon Telegraph and Telephone (NTT) and the national railway to increase revenues. Due to the growth in tax revenue resulting from the sharp increase in asset prices in the second half of the 1980s, the government was able to stop issuing special deficit financing bonds in 1990.

The government formulated budgets without issuing special deficit financing bonds between 1990 and 1993, but it was supported by temporary increases in tax revenues. The collapse of the bubble economy and the aging population made fiscal management difficult and unstable in the mid 1990s. The Fiscal Structure Reform Act was enacted in 1997 to guide fiscal policy and provide a legislative framework for fiscal consolidation.

The Act specified the following fiscal consolidation targets:

- A reduction of the fiscal deficit to less than 3 percent of GDP by 2003;
- Yearly reduction in the issuance of deficit financing bonds and the termination of bond issuance by 2003; and
- A reduction of the ratio of bond issuance to the total budget in 2003 relative to 1997.

To achieve these targets, a numerical framework for multiyear expenditures was set legislatively for 12 major expenditure categories including social security and public investment. The Asian financial crisis led the government to change its fiscal stance towards expansionary and the act was finally suspended in 1998.

In 2006, the cabinet decision, "Basic Policy 2006", stipulated the fiscal consolidation target of primary surplus in 2011 and a numerical multiyear expenditure framework. The framework included the restraining plan for social security related expenditures along with reforms of the system, nominal reduction rate in public investments, and expenditure ceiling for the other categories. The controls over expenditures along the lines of the framework were applied until the 2008 budget. The government abandoned the framework and developed an expansionary budget in 2009 to deal with the global financial crisis.

In June 2010, Cabinet adopted the Fiscal Management Strategy. The strategy established targets for primary balance of central and local governments and government debt. The rule requires the government to achieve a primary deficit target of 3.2 percent of GDP in 2015 and a surplus in 2020. The strategy also required a steady reduction in the public debt to GDP ratio after 2021. To achieve these targets, the strategy contained the medium term fiscal framework for three years and the "Basic Rules on Fiscal Management" as cabinet decisions. After the change in government in

December 2012, the new government expressed commitment with the fiscal consolidation targets and formulated medium term fiscal consolidation plan to achieve these targets.

Japan experienced several economic and political turbulences that compounded the difficulties in fiscal discipline and management. The government introduced a number of legislations to guide fiscal policy such as the Fiscal Structure Reform Act. Fiscal rules established in legislation are likely to be more difficult to reverse or abandon. Legislated rules are more important in countries where political change could undermine the credibility of fiscal policy (Kumar et al., 1997).

The experience of the FSRA provides a number of lessons. First, it is unwise to legislate expenditure ceilings during an economic downturn. Second, any cap on categories of expenditure needs to target not only the initial budget but also the final budget. The FSRA capped only the initial budget and expenditure increased significantly through the adoption of supplementary budgets.

THE EUROPEAN UNION

Twenty of the 33 advanced countries are European Union member countries. The euro zone countries are subject to the three fiscal rules of the Stability and Growth Pact (SGP):

- The general government fiscal deficit is less than 3 percent of GDP;
- Government gross debt is less than 60 percent of GDP; and
- Over the economic cycle, the general government fiscal deficit needs to be close to balance or in surplus.

To comply with these rules, the euro zone countries have developed the Stability and Convergence Program resembling provisions of a fiscal responsibility law.

In principle, the Stability and Growth Pact can be seen as a federal rule in as much as it commits member countries. In practice, however, the pact has not been effective. Over the first 13 years of existence of the euro, the 12 initial member countries together have satisfied the 3 percent budget deficit limit only 60 percent of the time. The frequency of violation has reduced the credibility of the rule.

The EU framework does not require EU member countries to adopt a FRL for many aspects of fiscal stability. It however provides an obligation on member countries to provide a quantified medium term fiscal framework and also declare its policy actions designed to get back on track in the event of a slippage relative to the numerical targets. More specifically, under the excessive deficit procedure, a country needs to indicate how an excessive fiscal deficit could be corrected. The authorities agree with the EU on annual targets for achieving the threshold stipulated in the SCP within a specified period of time.

Some EU countries have adopted fiscal stability laws in order to apply the comprehensive EU fiscal framework, which focuses on general government. In Spain and Portugal, fiscal stability laws were adopted in 2001 to apply the SGP's framework in the context of decentralized fiscal management. Due to constitutional factors relating to the autonomous regions, two laws were adopted in each

country. In 2006, Spain amended its law to include rules for a balanced budget over the cycle to align its own framework and budget procedures closely with the SGP's fiscal stability requirements and numerical rules. The absence of fiscal discipline at the national level with few exceptions and the inherent ability of the center to promote debt sustainability has been well known for some time. The recent sovereign debt crisis in the EU demonstrates the dangers of this situation. The loss of the no-bailout rule has considerably weakened an already lax arrangement. Currently, efforts have focused on strengthening and widening the Stability and Growth Pact.

The EU experience shows that numerical rules namely the deficit and the debt limits of the Stability and Growth Pact that are neither supported by hard legislation nor endorsed by the political system, are not sufficient to deliver fiscal discipline. The European Commission could be seen as an advisory council dedicated to establishing fiscal discipline. In a politically heterogeneous situation, the council must be politically independent, which the Commission is not as its members are known to receive informal instructions from their governments and as the Commission has its own elaborate and complete program. Alternatively, the council must be ad hoc, with a narrow fiscal discipline agenda, and must include policymakers and non policy makers with the explicit objective of seeking agreements along the contract principle of Hallerberg et al. (2009).

4. LESSONS FROM COUNTRY EXPERIENCES WITH FISCAL RULES

The review of the empirical literature as well as international experiences provides a number of useful lessons for the design and implementation of fiscal rules in other developing countries. The lessons center on elements of good design (Box 2), appropriate coverage of fiscal rules, timing of its introduction, mechanisms to encourage compliance, key implementation issues, and supporting institutional arrangements.

Lesson 1. In the absence of a strong reputation of prudent macroeconomic management, fiscal policy rules are indispensable

Country experiences indicate that many countries have adopted fiscal rules to restore public finances and reduce debt levels. A government with a strong reputation of prudent macroeconomic management may not need fiscal rules. However, where such reputation is lacking, fiscal rules could provide a useful policy framework, and over time contribute to macroeconomic stability and growth. A recent type of rule introduced is known as "*the debt brake*". The rule, which targets a structural budget balance, was motivated by the need to curtail a significant build up of debt (Switzerland and Germany). Another motivation for the adoption of fiscal rules is to consolidate fiscal consolidation gains and institutionalize the emerging fiscal discipline tradition (Chile).

Box 2. Desirable Properties of a Fiscal Rule

- A fiscal rule should be well defined to avoid ambiguity and ineffective implementation. This requires clarity about the indicator being constrained, the institutional coverage, and specific escape clauses, if any.
- It should be transparent in relation to government fiscal operations, including accounting, forecasting and institutional arrangement. It should avoid a misrepresentation of the true timing and magnitude of future fiscal obligations, especially contingent liabilities.
- It should be adequate with respect to the specified proximate objectives. For instance, debt sustainability would require a rule expressing debt as a non-decreasing percentage of GDP, or a minimum primary balance in percent of GDP.
- A fiscal rule should be internally consistent with other fiscal rules in place, as well as with other macroeconomic policies. For example, a fixed nominal exchange rate anchor should be accompanied by an explicit restriction on the monetization of budget deficits.
- It should be simple to apply. This enhances the understanding of the general public and Parliament, and therefore draws large popular support.
- A fiscal rule should be flexible to accommodate exogenous shocks. An example is when the central bank's advances to the government are subject to specified limits and full repayment during the year. In recent years, escape clauses provide some form of flexibility and enable governments to respond to uncertainties relating to a recession, adverse economic development, banking system bailout, and natural disaster.
- It should be enforceable by incorporating penalties for non-compliance and authorities for enforcement. The consequences for noncompliance—judicial, financial, and reputational—should be agreed upon. Implementation should be within the control of government. A case has been made for an independent fiscal council to monitor compliance.
- A rule should be supported by efficient policy actions, including by engaging in more fundamental fiscal reforms to restore public finances to sustainable levels.

Source: Kopits and Symansky (1998)

When should a fiscal rule be introduced? On this, evidence from the literature suggests that fiscal rules are commonly adopted to cement tangled results of earlier fiscal adjustment. This is because prior consolidation seems to make the adjustment more credible. For example, countries that achieve debt reduction in the order of 2 percentage points of GDP in the three years before the introduction

of fiscal rules, had twice the probability of adopting a fiscal rule compared to other countries (IMF, 2009). It is advisable not to introduce fiscal rules during periods of excessive economic uncertainty.

Lesson 2. A well designed fiscal rule consists of establishing a depoliticized framework for fiscal policy combined with increased transparency standards

What design characteristics make a fiscal rule a useful policy framework? The literature and country experiences identify two design aspects: technical and institutional. Technically, fiscal rules must be designed to reflect, among other things, the interaction between the public sector and the economy, incorporating estimates of fiscal responses to exogenous shocks. On the institutional side, rules must be based on a set of infrastructure, such as transparency standards, an arbitration authority to monitor compliance and sanctions for non-compliance.

A well designed fiscal rule consists of establishing a depoliticized framework for fiscal policy. Under such a framework, information should be widely available about macroeconomic developments and prospects. Budget balance, or aggregate spending are determined by fiscal rules, and only relative spending priorities and tax structure are subject to legislative, political and public decisions. Periodic reviews of the numerical targets and rational economic assumptions could play a useful function to ensure that the framework remains realistic over time (Kopits**,** 2001).Fiscal rules should strike a balance between short-term macroeconomic stabilization and long-term fiscal sustainability. Even when its design features are fine tuned, not all types of fiscal rules are equally able to support the objectives of sustainability, economic stabilization and the size of the government (Ljungman, 2008).

A budget balance rule only works when the standard solvency and credibility conditions are present. If credibility is lacking, countries may need additional restrictions to limit expenditures whenever they can jeopardize the structural balance objective. However, an appropriate balance will be needed to achieve the desired objectives. If the rules end up being too tight, they do not give space to use the resources during slowdowns, undermining its effectiveness as a countercyclical device.

Countries have generally supported rules-based frameworks with targets on the wage bill and the stock of guarantees. The debt ceiling and overall balance floor are most directly related to fiscal sustainability. Constraining the wage bill has been an important supporting tool to help resist short-term expenditure pressures in a number of countries. In addition, some countries have established targets on government debt guarantees to help them have a complete picture of their debt situation.

The design of a fiscal rule has included features to cause public expenditures on social protection programs to increase during downturns. For instance, the adoption of a structural balanced budget rule in some countries have accommodated a social spending program that is activated when certain conditions are met. This includes subsidies for on- the- job training programs and or conditional cash transfers to prequalified households. These programs have typically been designed in advance and are triggered by some previously determined criteria (for instance, a certain level of unemployment or rate of economic growth).

Lesson 3. Fiscal rules are more effective when implemented on a broader definition of government

Country experiences show that fiscal rules have been implemented on a broader definition of government. Appropriate coverage of the fiscal rule is needed to ensure transparency and to capture activities associated with government. Typically, a rules-based fiscal framework applies to entities that primarily fulfill the functions of government. Consistent with the *GFSM 2001* convention, "the general government sector consists of all government units and all nonmarket nonprofit institutions that are controlled and mainly financed by government units." In Europe, where the classification is crucial for assessing compliance with the debt and deficit rules, public bodies that cover less than 50 percent of their costs from market-based sales are usually classified as part of government. A broadly defined government sector including commercial entities could enhance fiscal transparency by capturing implicit contingent liabilities. In this way, broader coverage could also help to mitigate an incentive to shift fiscal activities "off-budget". The main drawback is that the required fiscal consolidation may constrain the scope to undertake profitable investments in commercial entities.

Lesson 4. The usefulness of fiscal rules depends on detailed reporting, periodic reviews of numerical targets, and a multiyear macroeconomic framework. These need to be combined with a well designed surveillance and enforcement mechanism

The usefulness of fiscal rules hinges on transparency in institutional structure and functions. Transparency, as used here, refers to the relations within the public sector on the one hand, and the relation between public sector entities and the private sector on the other. Transparency would contain quasi-fiscal activities, which arise through hidden subsidies at below-cost pricing, or government guarantees. Detailed fiscal reporting and transparency would also mandate comprehensive, timely, frequent, and detailed government reporting based on best–practice accounting standards.

A rolling multi-year macro-framework is an important requirement of effective fiscal rules. This prepares the government ahead of time for the policy adjustment or reforms that may be needed to comply with the rule. It disciplines policymakers and fosters accountability in observance of budget targets. The preparation of medium–term forecasts should be an integral part of fiscal rules, which is the case in a host of countries, such as Brazil, New Zealand, and Peru, and demonstrates ex ante whether government policy is consistent with fiscal rules. The time horizon over which a fiscal target should be met is crucial, especially in providing flexibility (Basdevant, 2012).

A key institutional aspect is the authority responsible for surveillance and enforcement. This could be done by the independent audit office, which reports to Parliament. However, ultimately, arbitration and judgment should rest with the courts. Because of the technical competencies that may be required, an independent fiscal authority, also known as fiscal councils have been suggested.

Some countries have implemented periodic reviews of the numerical targets and economic assumptions underlying their fiscal frameworks to ensure that the framework remains realistic over time**.** Efficient functioning of fiscal rules hinges on a realistic assumption of the nominal GDP growth rate. The required annual budget balance target could be updated in periodic reviews by

refreshing the average nominal GDP growth rate based on historical outcomes. This mechanistic update has helped a number of countries to strengthen the credibility of the process.

Lesson 5. An appropriate sanctions regime helps to strengthen the credibility of the fiscal rule

The extent and nature of sanctions for non-compliance should be made clear. Any punishment for non-compliance must be credible. Typically, sanctions consist of loss in reputation of the government, or adverse judicial decision, including imposing penalties on elected or appointed public officers responsible for compliance. In a federal setting, it may take the form of an outright fine, financial levies, or suspension of transfers to offending jurisdictions. It may be extended to personal sanctions, including salary cuts, or criminal charges for elected officials. Compliance costs of fiscal rules are necessary investments to establish credibility, which would ultimately pay off (Wyploz, 2005).

Lesson 6. The legitimacy of the rules is necessary for its success implying the need for the rule to enjoy a broad spectrum of political support

Successful implementation of fiscal rules rests on an active public dialogue, and broad legislative support. A public dialogue is necessary to create sufficient understanding of the need for fiscal rules and to eventually support their implementation. A public campaign, which should take a few years, should immediately be followed by political debate to generate a broad legislative consensus, especially when legislative approval is needed before introduction. The EU experience shows that numerical rules namely the deficit and the debt limits of the Stability and Growth Pact that are neither supported by hard legislation nor endorsed by the political system are not sufficient to deliver fiscal discipline. In a politically heterogeneous situation, the council must be politically independent, which the Commission is not as its members are known to receive informal instructions from their governments and as the Commission has its own elaborate and complete program. Fiscal rules require accountability and periodic reviews of the budget and the overall fiscal policy stance.

Lesson 7. Countries have implemented automatic mechanisms to correct ex post deviations from the rule to improve compliance

To encourage compliance with the rules, a number of countries have implemented automatic correction mechanisms. An automatic correction mechanism such as the Swiss and German "debt brake" rules requires that ex post deviations from the overall balance target are debited in a notional account. Once the cumulative deviations exceed a pre-specified threshold, additional fiscal adjustments would be required in subsequent fiscal years to correct for these deviations and bring fiscal performance back in line with the fiscal rule. This mechanism provides a strong incentive to formulate realistic budgets since deviations from the budget target would require an offsetting fiscal adjustment in subsequent years. In designing an automatic correction mechanism, a number of considerations should be taken into account. A threshold must be clearly specified for the cumulative deviation in overall balance target. Exceeding this threshold would immediately trigger

an adjustment. A higher threshold provides flexibility to respond to short-run macroeconomic fluctuations and would limit the need for within year supplementary budgets. A lower threshold, however, provides a stronger link to debt sustainability.

Lesson 8. The trigger of escape clauses that allow deviations from the fiscal target have been limited to extraordinary circumstances

The rules-based fiscal policy framework should allow deviations from the fiscal targets in exceptional situations**.** Current triggers of the escape clause include factors in the interest of national security; to reduce or eliminate the effects of a period of public disaster, a period of public emergency, and international crisis. Objectively, escape clauses can be specified as a medium-term target balance, or surplus, without explicit margins around it (the case of New Zealand), or with explicit margins around a target balanced-budget or surplus requirement, calibrated on cyclical deviations in output growth (European Monetary Union). In some countries, escape clauses are accommodated in the form of contingency funds, and/ or multiyear definition of the rule in order to account for economic volatility. A decision to activate the escape clause is required to include a new time schedule and measures to meet the targets. These broad activation criteria may weaken the credibility of the framework since the rules can be easily suspended. Best practices suggest that criteria for triggering the escape clause have generally been restricted to extraordinary factors (Table 2).

The triggers are usually quantified by the measured threshold level of economic damage. Activating an escape clause in most countries usually requires broad political and public support, and independent validation. To enhance credibility, a sufficiently large parliamentary majority is needed to trigger escape clauses. The provision in most countries also specifies the path back to the rule and the regime in the interim.

TABLE 2. FISCAL RULES WITH ESCAPE CLAUSE

Country and Date	Natural Disaster	Economic Recession	Banking System bailout, guarantee schemes	Change in government	Change in budget coverage	Other events outside government control	Voting mechanism defined	Transition path defined
Brazil (2000)	x	x	-	-	-	-	x	-
Colombia (2011)	-	x	-	-	-	x	-	-
Germany (2010)	x	x	-	-	-	x	x	x
Mauritius (2008)	x	x	-	-	-	x	-	-
Mexico (2006)	-	x	-	-	-	-	-	-
Panama (2008)	x	x	-	-	-	x	-	x
Peru (2000)	x	x	-	-	-	x	-	x
Romania (2010)	-	x	-	x	x	x	-	x
Slovak Republic (2012)	x	x	x	-	-	x	-	-
Spain (2002)	x	x	-	-	-	x	x	x
Switzerland (2003)	x	x	-	-	-	x	x	x
European Union (2005)	-	x	-	-	-	-	-	x
WAEMU (2000)	-	x	-	-	-	-	-	-

Note: x represents the presence of escape clause

Source: Shaechter and others (2012)

Lesson 9. Rules entrenched within a stronger legal framework including fiscal responsibility laws have been more successful.

Fiscal rules can also be classified according to whether they are part of a broader institutional or policy framework. Rules entrenched within a stronger legal framework, including fiscal responsibility laws are more difficult to reverse. Legislated rules are more important in countries where political change could undermine the credibility of fiscal policy (Kumar et al., 1997). However, it can take longer to establish them, particularly in times of economic and political uncertainty. Other important features include mechanisms for accountability, monitoring, and enforcement that are important in determining rules' effectiveness. Lessons from the EU suggest that rules embedded in the law or in a constitution, appear to have a larger impact on fiscal outcomes (Larch and Turrini, 2008). A well designed oversight mechanism is indispensable and a non partisan committee of experts has been used by a number of countries in cases where the annual discussion of the budget law does not provide enough comfort.

Lesson 10. An independent fiscal policy council has been used in a number of countries to enhance the quality of budget discussions and foster greater transparency

Country experiences suggest that a number of countries have implemented supporting institutions and reforms to improve the functioning of fiscal rules including the

establishment of independent fiscal policy councils (Boxes 3 to 5)**.** An independent fiscal policy council has been used in a number of countries to enhance the quality of budget discussions and foster greater transparency[4]**.** Fiscal policy councils can exercise important supporting functions for fiscal policy. In a number of countries, independent fiscal councils have key roles in assessing the reliability of the macroeconomic and revenue assumptions underpinning the budget, and estimating the fiscal impact of proposed measures.

Box 3. Fiscal Policy Councils

Fiscal councils (FCs) are publicly-funded, non-partisan institutions mandated by governments to evaluate fiscal policy, monitor fiscal performance, and/or advise policymakers on policy options. As fiscal challenges have increased in recent times, fiscal councils have become increasingly popular, often in line with the implementation of rules-based fiscal frameworks. Globally, about 20 fiscal councils are now in place, mostly in advanced economies. Fiscal councils are very diverse in their features and responsibilities, but a number of salient stylized facts emerge from international experience.

- In contrast to audit institutions, fiscal councils analyze public finances *ex ante*. They generally provide detailed analyses of budget plans and their expected outcomes, together with an unbiased assessment of the quality of the underlying assumptions and of the main sources of fiscal risks. Many fiscal councils can raise awareness of policy biases and budget constraints, by assessing long-term fiscal trends.
- Thus fiscal councils' influence on fiscal policy operates mainly through a better informed public debate, fostering transparency and accountability. They publish regular reports in time to contribute to the debate, and in many cases, they benefit from formal communication channels with Parliaments.
- To alleviate partisanship and foster reputation, fiscal council members commonly include academics as well as recognized public-finance experts. In some countries, one of the members is expected to be a non-national.

4 Fiscal policy councils are similar to monetary policy committees in the literature on monetary policy. The rationale is to isolate the fiscal policy making process from the preferences of politicians and thereby make fiscal policy more independent and credible (See Box 3).

- Many fiscal councils have been set up in countries where fiscal rules are in place, and have been tasked with monitoring compliance with the rules. Fiscal councils act as a watchdog and alert the public of deviations from the rules, particularly when the underlying calculations—e.g. cyclical adjustment—are complex. Some fiscal councils can issue normative assessments of fiscal performance under a rule, for instance, signaling when unusual circumstances make it sensible to depart from the rule, or advising the government on how to improve the rules.
- A few fiscal councils have a remit that allows them to directly influence the budget process through technical inputs, such as macroeconomic and budgetary forecasts the government must use, and the costing of policy initiatives. Some also assess the appropriateness of given policies and recommend a particular fiscal stance.

Box 4. Fiscal Policy Council: The Experience of Hungary

Hungary was faced with a deteriorating debt situation, sharply declining investor confidence, and a large deficit peaking at 10 percent of GDP in 2006. In November 2008, the then government enacted a Fiscal Responsibility Law, which included a fiscal policy council as part of a wider reform package establishing a rule based fiscal policy.

The law established the fiscal council as a collective body with its own technical staff (Office of the Fiscal Council). The model adopted by Hungary is closer to the Congressional Budget Office (CBO) model of the US in terms of its remit and functions. Although the new law contained several compromises, it could not gain the support of the main opposition party. Consequently, when the opposition came in to office the framework and the working conditions of the fiscal council was significantly abolished.

Originally, the council was established as a body consisting of three non-partisan members independent from the government and political parties. The three members were nominated by the President of the Republic, the Governor of the National Bank of Hungary, and the President of the State Audit Office. Following public hearings in the Budget and Finance Committee, the members had to be elected by a simple majority in Parliament for a 9 year period on a nonrenewable basis. The council had an office of the fiscal council with more 30 economists, mainly public servants, headed by the Chair of the Council. The mandate of the fiscal council was to restore the sustainability of fiscal policy and to promote fiscal transparency. The council was charged with a broad range of tasks including macro-fiscal baseline scenarios, independent fiscal impact assessment of bills, the provision of methodological guidelines and formulating proposals to enhance sustainability and transparency.

Within two years of the council's operation, the newly elected government made significant revisions to its legal framework. The council was replaced by a new significantly reduced and much more compliant model (Hemming and Joyce, 2013). It is composed of three members: a chairperson of the council appointed by the President, the Governor of the Central Bank, and the head of the state audit office, both of them ex officio. The council's staff was reduced from 30 to three. The mandate of the council was restricted to assessing the state budget and its execution, developments in public debt, and supporting parliamentary legislative activities.

The experience of Hungary is a prime example of a fiscal council that could not take off as its independence and effectiveness was significantly curtailed before it had an opportunity to impact policies. This experience suggests that new councils need to tread carefully and be able to perform their watchdog function, which often entails criticizing the government, and protecting itself from the challenges this criticism can generate to its independence.

In a highly charged political environment, maintaining independence is very difficult since the council's messages can easily be labeled as partisan by one side. In this direction, it is imperative for the council to build institutional credibility and trust. This is a long term process and it cannot be taken for granted that the role and features of the new institution will be readily understood, its non-partisanship trusted, or its beneficial effects recognized without any validation (Kopits, 2011).

Box 5. The National Assembly Budget Office (NABO) in South Korea

Korea established the National Assembly Budget Office in 2003 as an independent office to provide fiscal policy advice to Parliament. The NABO was created to provide the legislature with independent information and expertise on fiscal and budgetary issues to match that of the executive, and to provide the capacity to scrutinize the President's draft budgets. Korea already had sound public finances before the establishment of the NABO with general government debt of around 18.6 percent of GDP in 2002.

The responsibilities and organizational structure of NABO are described in the National Assembly Budget Office ACT. The NABO is exclusively an organ for the National Assembly with the Director appointed by the Speaker of the National Assembly based on recommendations of a committee established to vet candidates for the post. A panel of outside advisors made up of a chairperson and fourteen members advise the Director of NABO. These members are experts in public finance and economics from universities, research institutions, government offices or the media.

The council is well-equipped with resources and in 2011 had a total staff of 125. The budget of NABO is part of the overall budget of the National Assembly with a separate line item in that budget.

The Council is committed to four principles namely independence, non-partisanship, expertise, and credibility. Its stated goal is to become the global standard in budget analysis and policy evaluation.

The NABO was built on the model of the US Congressional Budget Office (CBO) and has the responsibility of providing support to the national assembly. It performs all the main functions of a fiscal council including monitoring and reviewing the government's fiscal policy, developing alternative forecasts, and costing of proposals and programs. A unique mandate of the NABO is policy evaluation. The council evaluates and reviews a diverse range of projects, programs, and policy initiatives.

The NABO has matured over the past decade. Public finances in Korea were sound when the fiscal council was established and continued to be so during its initial years of operation. The organization provides valuable reports and analyses and thus helps to increase the transparency of the government's budgetary data, which was one of the motives for its establishment. The council is now actively involved in public discussions on fiscal policy, and is largely being perceived as a conservative and sensitive voice. It appears to be raising public concerns at times when there are significant fiscal policy actions occurring, and raising alarms when the government's policy is deviating from sound policy setting even going as far as recommending an alternative course of action

The independence of the NABO is entrenched in the National Assembly Budget Office Act with a separate budget in the parliamentary budget. In practice, its independence has not been challenged during the past decade. However, one weakness in the NABO's framework is the lack of a fixed term limit for the Director. The NABO Director can be dismissed by the Speaker of the National Assembly. These rules have led to the practice of NABO Directors voluntarily resigning when House Speakers change. This mechanism raises the risk that the leadership of NABO is exposed to political pressure from the Speaker and so is not fully able to work independently (OECD, 2012).

In some countries, fiscal councils also play a "watchdog" role by monitoring compliance with fiscal rules. In addition, forecasts produced by fiscal councils can serve as a neutral baseline to assess the fiscal cost and macroeconomic impact of policy proposals. The mandate of fiscal councils in a few countries (for example, Chile) even allows for direct influence over the budget by specifying technical inputs, such as the macroeconomic and budgetary forecasts. Box 3 summarizes the salient facts from international experience with various fiscal policy councils.

Government interference with the activities of a fiscal council, as observed in a few cases (Sweden, Hungary), can seriously undermine its effectiveness. A recent tendency has been to establish strong formal guarantees on their independence, not unlike those prevailing for central banks. These may include long and non-renewable terms of office for fiscal council members, unrelated to the political cycle, and outright prohibitions on government interference with fiscal council work. In

addition, independent fiscal councils should have their own technical staff, be properly funded (preferably through secured multiyear financing) and have the autonomy to determine their own work program within their clearly-defined mandate. They should have full and timely access to all relevant information, including the methodology and assumptions underlying the budget and other fiscal proposals.

5. SUMMARY AND CONCLUSION

This paper has reviewed country experiences with the implementation of fiscal policy rules with the objective of deriving policy relevant lessons for developing countries. To that end, it began by discussing what fiscal rules are, and why governments may choose to adopt them. It next explored country experiences centering on a range of design and implementation features, along with various supporting requirements that would ensure the success of fiscal rules.

Fiscal rules could be useful devices for tackling fiscal indiscipline, regulating the size of the government, supporting intergenerational equity, cementing policy credibility, and lessening vulnerability to crisis. In particular, they are potentially useful when introduced as part of an adjustment program, or as part of a broader effort to strengthen key national institutions and adopt best practices in the management of public finances. Fiscal rules can function as a meaningful commitment device only if well designed, properly implemented, and backed by robust institutional infrastructure.

Fiscal rules require discipline and governments need to resist the temptation to spend, while safely investing the savings. Political considerations make these decisions difficult to implement but they are also the reasons why the rules are needed. Incumbents typically do not want to leave resources for someone else to benefit politically, while special interest groups put pressure on the government to spend those resources. To solve these problems, countries like Chile have institutionalized some rules.

Empirical evidence suggests that fiscal policy rules are statistically associated with better fiscal performance. Fiscal rules have also been identified as an important factor accounting for the success of fiscal consolidation. Empirical studies on advanced countries show that stronger and wider fiscal rules as measured by a fiscal rules index were associated with a greater likelihood for successful fiscal consolidation. They reveal that coverage, design and strength of fiscal rules, as well the quality of budgetary procedures promote fiscal consolidation.

The empirical literature also shows that the type of fiscal rules and the level of government at which it is applied matters**.** Budget balance and debt rules have contributed to better budgetary outcome. Rules for higher levels of government have been associated with more fiscal discipline than those applying to local governments. In addition, some design features of fiscal rules seem to have a particularly beneficial impact on fiscal performance, including a strong legal basis of rules and strict enforcement.

A government with a strong reputation for prudent macroeconomic management may not need fiscal rules. However, where such reputation is lacking, fiscal rules could provide a useful policy framework, and over time contribute to macroeconomic stability and growth. Rules entrenched within a strong fiscal framework, including fiscal responsibility laws are more difficult to undo.

However, it can take longer to establish them, particularly in times of economic and political uncertainty.

To enhance their usefulness, fiscal rules should be well-designed combining both the technical and institutional aspects. The fiscal framework should reflect the interaction between the public sector and the economy, incorporating estimates of fiscal responses to exogenous shocks. Fiscal rules must be based on a set of infrastructure, such as transparency standards, an arbitration authority to monitor compliance and sanctions for non-compliance.

A well designed fiscal rule consists of establishing a depoliticized framework for fiscal policy. Periodic reviews of the numerical targets and rational economic assumptions could ensure that the framework remains realistic over time. Reliable data availability and technical capacity is required to ensure accurate forecasting of budgetary aggregate to avoid the risk that large deviations from the announced fiscal policy stance undermine the credibility of fiscal rules.

Appropriate coverage of the fiscal rules is needed to ensure transparency and to capture activities associated with the government. A key coverage issue is the definition of the government sector that should be covered. In this context, a rules-based fiscal framework should apply to entities that primarily fulfill the functions of government. General government sector should be the target coverage, and consists of all government units and all nonmarket nonprofit institutions that are controlled and mainly financed by government units. Transparency requires comprehensive, timely, frequent, and detailed government reporting based on best–practice accounting standards.

Mechanisms are needed to encourage compliance with the annual fiscal targets. Such mechanisms could be modeled along the lines of the Swiss and German "debt brake" rules, which mandates additional fiscal adjustment in subsequent years to correct for ex post deviations and bring fiscal performance back in line with the fiscal rule. In designing an automatic correction mechanism, the threshold for deviation from targets that would trigger an adjustment needs to be clearly specified.

A rolling multi-year macro-framework is an important requirement of effective fiscal rules. It disciplines policymakers and fosters accountability in observance of budget targets. The preparation of medium–term forecasts should be an integral part of fiscal rules, which is the case in a host of countries, such as Brazil, New Zealand, and Peru, and demonstrates ex ante whether government policy is consistent with the fiscal rule.

The extent and nature of sanctions for non-compliance needs to be clarified to enhance the effectiveness of the rule. Any punishment for non-compliance must be credible. Sanctions include loss of reputation of the government, or adverse judicial decision, including imposing penalties on elected or appointed public officers responsible for compliance. Compliance costs of fiscal rules are necessary investments to establish credibility.

Successful implementation of fiscal rules rests on an active public dialogue, and broad legislative support. A public dialogue is necessary to create sufficient understanding of the need for fiscal rules and to eventually support their implementation. As country experiences show, fiscal rules have been adopted based on popular and broad political consensus in Germany, Peru and Switzerland.

Fiscal rules require supporting institutions and structural reforms to be successful. Key reform areas include the introduction of a fiscal responsibility law and the establishment of an independent fiscal policy council that would enhance the quality of budget discussions and foster greater transparency. Indeed, the existence of an independent expert group, and the transparency of the budget process are some reasons for the success of fiscal rules, as in the Chilean example. Adequate public financial management systems are equally important and strong internal and external audit systems are needed to ensure accountability.

Fiscal rules that generate countercyclical fiscal policy do not guarantee macroeconomic stability. While they provide a framework that can help governments have more space to use fiscal policy when needed, business cycles have multiple causes and effects and fiscal policy alone cannot entirely offset them. A comprehensive fiscal strategy needs to combine fiscal policy rules with longer term development strategies. Policies and initiatives aimed at strengthening tax collection and improving the efficiency of the public sector are essential components of a broad strategy to improve fiscal capacity and performance.

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Notes

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