CHAPTER 2

Developing Legal Frameworks to Promote Fiscal Responsibility: Design Matters

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One of the most pervasive problems in public finance is the upward drift of government expenditure, deficits, and debt over time (Rodrik, 1998; Mosley, 2005; Erauskin-Iurrita, 2008). The economic literature espouses various theories to explain the upward drift of expenditures as a percentage of GDP in the course of economic development. The cause of debt and deficit levels becoming unsustainable is, however, more often attributed to political economy factors. Among the most commonly discussed theories is the deficit bias hypothesis, which contends that politicians increase public expenditures in excess of taxes for their own political gain, including by providing benefits to favored interest groups and increasing spending during election years.

Another factor, increasingly important in advanced economies, is that discretionary fiscal policy is often applied asymmetrically during the business cycle: government expenditures are raised in a recession but not sufficiently lowered in good economic times to balance the budget over the course of the business cycle. Although fiscal stimulus is strongly supported during recession, consolidation is pursued with great hesitancy. The fear of suppressing an emerging economic recovery, or the attempt to stimulate the economy out of structural problems, often leads to the postponement of fiscal consolidation efforts. Fiscal policy that is not applied symmetrically over the business cycle often leads to unsustainable growth in government expenditure and debt. A key lesson of the 2008–09 global economic and financial crisis may be that discretionary fiscal stimulus should be applied only if assurances are made that fiscal stimulus will be adequately compensated for down the road by fiscal retrenchment. In sum, cyclical fiscal policy measures should not impose permanent structural consequences on public finances.

1 These include Wagner’s Law, which argues that the demand for public goods and services in many countries seems to rise more than proportionately with income. Another theory is Baumol’s disease, which contends that lower productivity growth of the public sector compared with the private sector leads to an increasing share of government in the overall economy to keep relative activity levels in both sectors equal.
Various public financial management (PFM) institutional innovations have appeared during the past 20 years in an effort to support more prudent and balanced fiscal policies. This chapter discusses the scope of legal frameworks, specifically fiscal responsibility legislation, to induce less biased and more sustainable and transparent fiscal policy. It looks at how the design of fiscal responsibility laws (FRLs) can improve fiscal outcomes, how the development of these laws over time affects their functioning, and what role the relative strengths and weaknesses of a country’s PFM system should play in making choices about designing FRLs. It argues that, to some extent, FRLs can help solidify support for fiscal sustainability but cautions that they should not get too far ahead of societal acceptance of fiscal prudence. As the literature suggests, in many cases FRLs are more a consequence of changing societal views than a cause. FRLs can become more effective as they build positive reputational capital over time.

In general, and especially for developing countries, when designing FRLs it is better to start simple and develop complexity gradually, that is, to begin with more modest and flexible frameworks and slowly firm up the legislative prescription of fiscal policy. Under most circumstances, PFM capacity is an additional reason to develop FRLs gradually. Aligning PFM capacity with the complexity of the FRLs is important—the more complex the FRL the greater the PFM capacity required. An exception to this gradual approach might arise in times of fiscal crisis, when the opportunity for a more sustainable fiscal policy regime should be grasped.

The first section of this chapter defines FRLs and discusses three types of FRLs most commonly used by countries. The second section seeks to explain the sudden popularity of this innovation, including examining evidence of FRL effectiveness and the various rationales for introducing it. The third section explores the main design choices to consider when developing an FRL and then discusses how countries’ choices have affected their relative success. This section also describes the progressive development of FRLs as countries enhanced their institutional frameworks. The fourth section reviews PFM capacities needed for implementing FRLs. The final section draws conclusions about how and under what conditions FRLs can play a positive role in strengthening fiscal outcomes.

### 2.1. Fiscal Responsibility Laws as an Institutional Response

#### 2.1.1. What Are FRLs and What Makes Them Unique?

This chapter defines FRLs broadly as legal frameworks that embed in law an agreed-on set of policies, processes, or arrangements intended to improve fiscal outcomes, discipline, transparency, and accountability by requiring governments to commit to fiscal policy objectives and strategies that can be monitored. These legal frameworks can be part of budget system laws, but such laws frequently have a much wider scope encompassing the whole PFM process. In the past, however,
budget laws have often neglected the fiscal policy process and have thus generated the need for many countries to develop separate FRLs.

As a policy tool, FRLs are unique for several reasons. First, they sacrifice discretion in making fiscal policy for the sake of rules. The issue of discretion versus rules makes the careful design of fiscal legal frameworks important. Rules can be blunt instruments and, if not designed properly, can limit the ability of governments to make crucial adjustments to fiscal policy when needed to adapt to changes in economic circumstances.

Second, FRLs evoke the issue of reputational investment and costs. The literature provides some evidence validating the hypothesis that FRLs’ effectiveness in supporting fiscal discipline strengthens as the lifespan of their successful implementation lengthens, and conversely, the reputational costs of their disbandment increases in proportion to the length of their establishment. Credible FRLs can help politicians be tougher on fiscal policy than they would otherwise be. A law, if it has a strong enough reputation, “forces the politician’s hand.” Thus, how to successfully build the reputational capital of such frameworks becomes critical.

Third, to work effectively, a legal framework for fiscal responsibility requires adequate PFM systems aligned with the framework’s level of sophistication. These three issues combined lead to a number of specific recommendations for the design and development of fiscal responsibility legislation. It should, however, be stressed that these recommended design and development characteristics are often not followed in practice, which may be one of the reasons for the positive but still limited impact of FRLs on fiscal outcomes.

2.1.2. Three Types of FRLs

In the mid-1990s, only a few countries had FRLs; since 2000, these laws have become increasingly widespread, particularly in emerging market economies. These laws take various forms. This section focuses on three types of FRL commonly used. “Type I” FRLs focus on fiscal responsibility principles (transparency, accountability, and sustainability), but do not identify in detail how these principles are to be met. Frequently the law requires the government to state its fiscal policy objectives for the medium term, but not necessarily in numerical terms, and to report on whether these objectives have been achieved. These FRLs do not have much legal force because they do not require concrete fiscal policy actions.

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2 See, for example, Box 3 in IMF (2009). Countries that have maintained their FRLs for longer periods seem to have had greater success with fiscal consolidation. The direction of causality is, however, not completely clear.

3 For a discussion of establishing credible policy commitments through institutional arrangements (including legislation), see North (1999). The issue of credibility of FRLs has parallels with that of establishing credibility for independent monetary policy.

4 The impact of FRLs is broader and somewhat more positive than that of numerical fiscal rules for which the impact is mixed at best (Corbacho and Schwartz, 2007; Caceres, Corbacho, and Medina, 2010).
Type I FRLs were adopted in the 1990s in New Zealand and Australia. New Zealand began developing an informal fiscal framework in the 1980s and enacted a Fiscal Responsibility Act in 1994. The Australian Charter of Budget Honesty Act was passed in 1998. In advanced economies with a critical press and independent academia, such laws can still have a considerable impact, but in many less advanced economies such unspecific laws only present good intentions with little or no impetus for follow-through by the executive (Caceres, Corbacho, and Medina, 2010).

Type II FRLs focus much more concretely on procedural rules, both for fiscal transparency and for the fiscal process. These laws can, for example, prescribe requirements for reporting on fiscal outcomes both within and at the end of the budget year, or require that concrete fiscal policy targets be presented ahead of the budget submission. This type of legislation can also prescribe development of a fiscal policy statement and, at a more advanced stage, a fully defined medium-term fiscal framework (MTFF) as a way to enforce appropriate decision making on fiscal aggregates. Type II FRLs can also prescribe how to achieve the fiscal targets, for example, by setting line ministry expenditure ceilings in line with those decisions at the start of the budget preparation process. This process helps to ensure that the detailed preparation and negotiation of the budget is not “solved” by expanding the budget deficit. With regard to parliament, such types of FRL can legislate the discussion, review, and even approval of the fiscal strategy document ahead of the budget review process. Brazil, India, and Pakistan are emerging market economies with such process-focused FRLs.

Finally, a third type of FRL includes rules for the stance of fiscal policy or places limitations on key fiscal policy aggregates. Type III fiscal responsibility legislation is much more demanding with regard to the fiscal policy process than the previous two types of FRL. In 2012, some 76 countries worldwide had fiscal rules and of these approximately 70 had a legal basis either in national law or supranational treaty or agreement and the remainder were based on coalition agreement or political commitment (see Chapter 3). In such laws, fiscal policy action is determined, at least in part, by numerical fiscal rules, or key fiscal aggregates are subject to quantitative limits, that is, fiscal policy has to be set within certain predetermined boundaries (which may or may not be effectively binding fiscal policy).

5 Lienert (2010) reports that of 11 selected countries with FRLs, 8 required statement of multi-annual fiscal objectives and 5 had enhanced reporting requirements. These were not always the same countries.

6 Sweden’s Fiscal Budget Act of 1996, for example, requires parliament to set nominal expenditure limits for 27 central government expenditure areas.

7 See Chapter 3. About two-thirds of the 76 countries with fiscal rules operate under national rules or a combination of national and supranational fiscal rules; one-third are governed only by supranational rules. In 2012, 34 countries had national fiscal rules and 47 had supranational fiscal rules (either in combination with national rules or separately).
As discussed in Chapter 3, more and more countries with fiscal rules have two or more such rules, indicating a willingness to give up a substantial amount of policy discretion.\(^8\) Most common are debt and deficit rules, often in combination.\(^9\)

Deficit rules usually have a more immediate impact on fiscal policy than do debt rules. Debt limits can be substantially higher than the actual debt level. In those cases, fiscal policy is still largely discretionary, and the debt ceiling mostly signals to markets the concrete translation of the government’s sustainability objective. Deficit ceilings take away from the discretionary powers of government based on the assumption that temporarily high deficits may quickly turn to overshooting of the debt target. The level of discretion can be lowered even further by constraints on other fiscal aggregates such as government expenditure, current expenditure, or external (rather than total) debt financing.

The rules in type III laws have tended to become more complex over time, for example, imposing limits on the level of the structural deficit rather than the nominal deficit. The structural deficit is usually defined as a deficit from which the influence of the business cycle is removed on the basis of an econometric model of the economy’s output gap.\(^10\) Box 2.1 provides more background on the use of fiscal rules in anchoring fiscal policy. Type III legislation can either be focused only on the fiscal rules or be part of more comprehensive FRLs incorporating both type I and type II legislation, including fiscal policy principles and process and transparency procedures as described above.

The section on FRL design will address the issue of cumulative progression from type I to type II, and finally to type III legislation.\(^11\) Type I and type II FRLs can, in principle, be integrated into the regular budget system law or public financial management act, or be part of a separate FRL. This chapter argues, however, that most countries will find significant benefit to keeping the FRL separate from the budget system law.\(^12\)

Fiscal rules can also be integrated into other parts of the legal framework. For example, they can be part of fiscal decentralization legislation, specifying fiscal

\(^8\) This willingness is often limited by escape clauses.


\(^10\) Structural deficits can be defined in various ways. Other factors can be removed from the fiscal balance as well, such as the impact of fluctuations in asset prices, commodities, terms of trade, and so on. Because the output-gap method is fraught with uncertainties, especially in developing countries (in which the structural growth rate of the economy is uncertain), in some resource-rich economies structural balances are defined much more simply by structural resource revenues minus expenditures, with structural resource revenues defined by the “structural” (long-term or moving average) price of the main resource. Mongolia and, in the past, Chile are examples of countries with these simpler definitions of the structural balance. Chile presently uses a structural balance definition that combines an output-gap approach with a structural minerals-revenue approach.

\(^11\) As noted by Lienert (2010), some advanced economies have chosen to adopt type III FRLs without elements of type I and II laws. The reasoning is often that the basic requirements for fiscal policy are supposedly adequately dealt with in those countries’ regular budget system laws.

\(^12\) New Zealand, however, which had a type I FRL beginning in 1994, integrated its FRL into its Public Finance Amendment Act of 2004.
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A significant weakness of fiscal principles and procedural rules is their lack of specificity about the actual fiscal policy stance a country should adopt. Numerical fiscal rules, however, provide a clear anchor for fiscal policy. Ideally, they determine, given the present economic and fiscal situation of the country, the levels at which fiscal aggregates should be set. Fiscal rules—in the ideal situation—provide automatic and objective answers that would otherwise require a great deal of economic analysis, judgment, and political compromise. They thus decrease policy transaction costs and provide better fiscal outcomes.

Since the late 1990s, many countries have adopted fiscal rules to guide their fiscal policy processes. Although these rules have been successful in certain circumstances, such as under relatively stable growth conditions, in controlling local government expenditure and, in some cases, during exit from fiscal crisis, they have been much less successful in dealing with large economic shocks or fundamental transformations of economies. In practice, designing fiscal rules that apply well to all economic circumstances has been difficult. Nominal deficit rules are procyclical, but structural deficit rules may not address long-term fiscal sustainability concerns (if the structural growth rate of an economy is decreasing). Debt rules may be too lax when overall public debt is low, but too restrictive when debt is high. Expenditure rules may be overly restrictive when extraordinary fiscal stimulus is called for, whereas fiscal consolidation processes are more likely to be guided by a consolidation timeline than a fixed numerical rule.

For the above reasons, the jury is still out on whether fiscal rules should be included in fiscal responsibility laws (FRLs) in all circumstances. Given the need to address multiple fiscal policy objectives (sustainability, stability, intergenerational equity) in a variety of economic circumstances, two discernible trends have emerged. The first, as discussed above, is to make fiscal rules more complex (e.g., in mineral-exporting economies structural fiscal balance rules are designed to incorporate both the domestic economic cycle and fluctuations of major mineral prices). This additional complexity enables them to be relevant under differing economic circumstances. Second, more countries are adopting two or more fiscal rules to define the anchor for fiscal policy, the idea being that different rules will address different policy objectives, and that at any one time only one rule will be the primary constraint under particular economic circumstances.

A more practical solution to these issues is perhaps the development of well-designed escape clauses in FRLs, allowing the fiscal rule framework to be inoperative during exceptional economic circumstances. A second solution, combining rules and discretion, would be for the FRL to define the fiscal rules that must be adhered to but leave the numerical values to be determined by government on a recurring basis.

limits for each of the layers of government. In their most “heavy” form, fiscal rules can be part of the constitution, providing a much stronger legal status than ordinary legislation, or they can even be part of international treaties. The 1992 European Union (EU) Maastricht Treaty is the most prominent example of the

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13 Seven countries had constitutional FRL requirements in 2011: Comoros, France, Finland, Germany, Poland, Singapore, and Switzerland.

Forty-seven countries are subject to fiscal rules under currency unions and the EU. These are set forth, at least in part, by international treaties. The Eastern Caribbean Currency Union aims at reducing debt. The Central African Economic and Monetary Community limits deficits and debt. The West African Economic and Monetary Union requires both balanced budgets and a reduction in debt to 70 percent of GDP.
latter. It specifies for member governments a maximum deficit of 3 percent of GDP and limits debt to 60 percent of GDP. These ceilings were also included in the 1997 Stability and Growth Pact. The 2012 EU Fiscal Compact requires member countries to adopt, in either their constitutions or other durable legislation, a structural budget balance rule by 2014 (see Chapter 3 for details).

This chapter argues that choosing the most forceful legal instruments in formalizing FRLs is not always wise, especially if there is a risk that the fiscal requirements will not be met and the strong legal mechanism does not have enough support from the political establishment or society at large.

2.2. EVIDENCE AND RATIONALE FOR FRLs

2.2.1. Evidence of Impact of FRLs

Evidence that FRLs of the types discussed in the previous section have been successful in promoting better fiscal outcomes is mixed (Corbacho and Schwartz, 2007; EC, 2006; IMF, 2009; Lienert, 2010; OECD, 2002). Cross-country studies provide evidence of both success and failure, although results suggesting effectiveness seem to have been on the rise during the recent global crisis. A number of studies seem to indicate that countries with FRLs in place before the financial crisis were better placed going into it (IMF, 2009; Schick, 2010). Of course, many countries put their FRLs on hold during the crisis: in some cases this procedure was fully in line with their FRLs’ escape clauses; in others, FRLs were breached and their reputation and future effectiveness suffered badly. The recent global crisis has made clear that many countries found it challenging to maintain fiscal rule requirements during a severe, once-in-a-generation economic downturn, or to return rapidly to fiscal sustainability after such a crisis.

FRLs, in the view of this chapter, should not be judged by how they manage such extreme circumstances. Arguably, they could play a role in returning fiscal circumstances to the precrisis situation, for example, by signaling postconsolidation fiscal targets. This chapter argues, however, that FRLs in general should deal with the “normal” structural and cyclical issues that countries face. The real disappointment of some FRLs was their failure to restrain fiscal parameters before the global financial crisis, and their inability to play a more decisive role in getting countries back on track toward fiscal sustainability after the crisis. This chapter argues that the reason for the varying degrees of success of fiscal responsibility legislation has had much to do with design choices. The choice of legislation has to fit the country’s economic circumstances, the political will available to support fiscal discipline, and the level of PFM development.

2.2.2. Rationale for Adopting FRLs

Despite the relatively weak empirical basis, countries have “voted with their feet” to introduce FRLs. During the past 20 years, the number of countries with FRLs
has increased significantly, especially since 2000 (see Chapter 3). The inherent logic and appeal of the FRL to policymakers have proved to be strong. The appeal rests on three propositions that have gradually received more acceptance in the literature and among policymakers. First, rules trump discretion in fiscal policymaking (see also Chapter 1). Second, the legal system can exert a powerful controlling influence on the actions of politicians, especially if higher-ranking legislation, such as “organic laws” and the constitution, is used. Third, the reputational capital of FRLs can build over time if they are appropriately designed and developed gradually.

**Rules versus Discretion**

The more fundamental discussion about whether a legal, rules-based framework for fiscal policy is really preferable to discretionary fiscal policy has slowly shifted. Twenty years ago, the prevailing view in policy circles was that if political will was present, no legislation was needed. Also, discretion, it was argued, if used appropriately, always provides the first-best response to economic circumstances while legal frameworks provide less flexibility. The FRL skeptics argued that political will cannot be legislated and that institutions by themselves cannot effect society’s fiscal choices. Moreover, attempts by the executive, and especially the legislature, to bind themselves were misplaced, because any law could easily be superseded by a new law or a new budget (the budget is itself passed as a law). The prevailing argument was that an FRL could be revoked at any time. Moreover, FRLs may seem to function well in economic good times, but they invariably crumble during economic adversity—when they are most needed.

These arguments against FRLs have, in this chapter’s view, proved to be overly pessimistic. This does not mean that political will cannot by itself suffice to steer fiscal policy. It clearly can. A number of emerging market and advanced economies have done so successfully for many years. These countries are, however, in the minority, and history has shown that the favorable political circumstances for discretionary policy can change and become less supportive. Westminster-system countries have until recently followed a tradition of not enshrining policy in law, but as pressures on government spending increased, countries such as Australia, New Zealand, and the United Kingdom have all promulgated FRLs of one type or another.

Recent developments in the rules-versus-discretion debate focus on the point that discretionary policy may be optimal if it is unaffected by political pressures and is implemented in a purely technocratic, “enlightened” way. However, even though enlightened discretion might lead to first-best solutions and rules-based policy only to second best, the biases and pressures on fiscal policy in reality often lead to third- or fourth-best outcomes for discretion. In those circumstances, a legal basis for fiscal policy might be preferable, even one that provides second-best solutions (Rodrik, 2008).
The Effectiveness of Legal Frameworks

The second rationale, the effectiveness-of-law argument, notes that FRLs in practice often have a higher status than normal legislation. In some countries—francophone countries are an example—FRLs are defined as organic laws, which have a higher formal status and cannot be overruled by new, “normal” legislation. In other countries, the most crucial elements of fiscal responsibility legislation are included in the constitution or in international treaties, also placing FRLs above other legislation and making reversal by the executive or legislature much more difficult.

More notably, FRLs can acquire their primacy over normal legislation through a process of reputation building somewhat akin to the development of independence by central banks. A central bank always remains, in principle, subject to reversal of its statutory legislation, but as its independent role in society earns approval, it becomes virtually impossible for politicians to attack the central bank’s position. In a similar vein, there has been growing acceptance that fiscal legislation can attain reputational “capital” if designed and developed appropriately.

The Power of Reputation

A third objection to FRLs is that without adequate political will to reverse fiscal imbalances, FRLs are powerless, whereas with political will they are seen as irrelevant, more an expression of that political will than an effective factor in improving fiscal outcomes. This chapter proposes a more nuanced view. Although fiscal responsibility legislation needs a certain amount of political will to be enacted, it can strengthen political resolve by building up reputational capital. Also, by adjusting the amount of discretion allowed by the law, or by providing the opportunity for temporary suspension in exceptional circumstances, the law can be calibrated to the force of political will in society to sustain it. The government or the ministry of finance can gradually tighten the legislative framework as the law builds up reputational capital.

Such a dynamic view of the development of FRLs decreases the risk that effectiveness will be undermined by lack of political will. As noted, this view increases the importance of properly designing these laws so that they reflect the strength of political will in the society. In the authors’ experience in advising countries, ministries of finance often err by proposing fiscal responsibility laws that are too strict and demanding, and that fail to reflect the actual political will in their countries. Such legislation often breaks down in the first few years (or weeks) of application. Modest FRL-type legislation often provides a better start to the process. Middle ground has to be sought though. A law that is continuously suspended during business cycle downturns will also fail to garner societal support and will fail to build up political capital. Some of the FRLs in South America and South Asia have suffered this fate. A perhaps unsurprising conclusion is that FRLs thus need to be neither too strict, nor too loose.
A Separate Law or Not?

The choice between enacting a new FRL or amending existing budget legislation to accommodate fiscal responsibility requirements is relevant in building up support and reputational capital for better fiscal outcomes. Many of the fiscal transparency and process requirements of an FRL could fit, from a legal and technical point of view, in existing organic budget laws or financial management acts.

The drawback to including such requirements in existing legislation is that a few amendments to such laws will have relatively little impact at the political or societal level. In many countries, proactive fiscal policy does not really exist, let alone a medium-term orientation to fiscal policy. Fiscal policy in such countries is an outcome, rather than a determinant, of the budget process. The concept of government proposing and deciding on fiscal policy for the medium term, ahead of the budget process, and determining the overall budget envelope thus represents a substantial change in the political economic process.

In many cases, the procedural rules introduced in FRLs explicitly limit the amendment rights of parliament, for example, by requiring adherence to fiscal limits decided on early in the budget process or just ahead of the budget review. This stricture usually implies that compensatory tax or expenditure measures have to be suggested when budgetary amendments are introduced. Introduction of fiscal rules will have an even larger impact on the budget process, further limiting the discretion of the executive and legislature. Such substantive changes to the fiscal-budgetary process need to be promoted and decided on in full recognition of what they mean. A new, separate law can promote such a new vision of the fiscal and budgetary process and thus be instrumental to building up reputational capital for disciplined fiscal policy.

2.3. DESIGN CHOICES

This section discusses a number of design issues important to the effectiveness of FRLs. Appendix 2.1 provides further details of the main features of fiscal responsibility legislation in selected countries.

Definitions

All laws need to be clear about the concepts they use. The macroeconomic and fiscal variables in FRLs should be defined according to, or aligned with, international standards on national accounts, and with government statistical reporting and accounting standards. Without use of such standards, FRLs can easily accommodate creative accounting, and fiscal limits can seemingly be met through definitional tricks.

Coverage

In principle, FRLs should encompass as much of general government activity as possible. The fiscal policy stance is determined by the impact of all government expenditures and revenues on macroeconomic activity. Ideally, the whole of
general government should be covered, or even the wider public sector. The problem—from a fiscal management point of view—is that the central government often lacks the authority to regulate expenditure and revenue totals of the whole of general government, let alone the public sector. Local government and extrabudgetary funds frequently have their own budgetary autonomy.

A narrowly focused FRL can lead to shifting activities to those parts of the government, or even of the public sector, that are not captured by its rules or procedures. Including lower levels of government in the FRL can help ensure that fiscal policy is coordinated between levels of government. Extrabudgetary funds should be covered by the FRL if they are allowed to run a deficit or surplus. Tax expenditures and government guarantees are also common escape valves for FRLs—just as they are for medium-term fiscal and budgetary frameworks. Again, in principle, an FRL should cover these expenditures and quasi-expenditures.

Nevertheless, exceptions to the full-coverage rule can be acceptable. First, an exception can be acceptable when the fiscal impact of the part of government or public sector not included in the FRL is fiscally neutral—for instance, if that subsector is not allowed to borrow, or its borrowing is limited by regulation and not subject to political manipulation. Second, for many countries, including local government in the FRL as a means of achieving progress on fiscal sustainability might become too challenging politically. In practice, the full-coverage rule is often broken. FRLs cover local government only in roughly 54 percent of cases. Other examples are exempting social security spending or interest payments from the deficit rule and excluding government guarantees from public debt rules.

In such cases, the optimal should not be the enemy of the good. Central government can mitigate the impact of less than full coverage of the FRL by estimating the fiscal impact of the parts of government not under its control. It can then set its fiscal stance taking into account the position of parts of government, or even the public sector, not covered by the FRL. Another approach separately regulates, or eliminates, the borrowing powers of parts of government not covered by the FRL.

The full-coverage principle should be seen as a developmental objective. Most developing countries initially find it difficult to include local government in the FRL given that doing so requires a substantial amount of political and fiscal coordination between levels of government, especially if the country has a federal structure (see Chapter 12). Tracking tax expenditures can also be overly demanding for the PFM system and therefore is also often initially ignored in the coverage principle.

Statement of Fiscal Objectives and Targets
As countries develop more ambitious FRLs, fiscal objectives tend to become more detailed and specific. In a type I law, the fiscal objective could be framed as “maintaining debt levels consistent with fiscal sustainability,” without being specific about what that means, but a type III law would actually state the debt limit as a percentage of GDP. Similarly on deficits, the fiscal objective for deficits could
progress from “achieving a balanced budget over the economic cycle” to a specific balance, or structural balance target, as a percentage of GDP.

Objectives can differ significantly in whether they are planned objectives or objectives for actual realization. This is sometimes referred to as the *ex ante or ex post targeting* issue. Requiring a budget deficit to be balanced at the time of budget submission is, of course, quite different from, and much easier than, realizing a balanced budget at the end of the year. The German and Swiss debt-brake rules can be considered the most advanced form of targeting in that they introduce a form of fiscal accounting ensuring that any missed ex post fiscal targets are compensated for in later years (see Chapter 3 and Mayer and Staehler, 2009).

The decision to be specific about fiscal objectives needs to be aligned with the political will in society and the development of the PFM system. If fiscal objectives are more ambitious than society is willing to pursue, the FRL is likely to be breached earlier rather than later. It is thus important to accurately assess popular willingness to abide by fiscal objectives and to align the design of the FRL with the level of political will. The statement of fiscal objectives also has to be manageable by the country’s PFM system. If in-year monitoring of fiscal aggregates is difficult, then obviously an ex post target will be hard to manage. Debt and deficit targets as percentages of GDP also assume that estimation of budget year GDP is accurate. In fact, the margin of error is often considerable. In many developing countries, GDP figures are also only available with a considerable time lag.14

*Escape Clauses*

Escape clauses in FRLs are perhaps the most important and difficult elements to design. As FRLs become more specific, clearly articulated escape clauses may be needed. The role of such clauses is to validate breaching of the FRL in times of severe economic crisis or when a natural catastrophe has occurred. Although an FRL should ensure fiscal discipline, expecting a highly specific legal framework to be appropriate even during a once-in-a-generation economic crisis is unrealistic. However, during the normal business cycle or when unexceptional economic shocks hit the country, the FRL should remain operational. For example, the fiscal framework of a resource exporter should be able to accommodate, and indeed stabilize, the impact of price fluctuations of the main export commodity.

The relative tightness and clarity of the escape clause is thus an essential design consideration. Who decides when the escape clause is to be activated is also important. Is executive decision sufficient, or is approval by parliament necessary? Other options include rules-based activation or decision by an independent fiscal council (see Chapter 6). The great benefit of escape clauses is that they can safeguard the institutional capital of the FRL. Invoking a realistic escape clause will cause much less damage to the long-term effectiveness of an FRL than will an unauthorized breach of its rules or procedures.

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14This could result in only the numerator of a debt- or deficit-to-GDP ratio being targeted ex post.
Sanctions

To help prevent the executive or the legislature (or both) from not complying with the FRL, some FRLs incorporate sanctions as a design element. Ministries of finance are often particularly eager to include sanctions in FRLs on the grounds that sanctions increase the political cost of breaking the law and thus would make such occurrences less likely. Sanctions can be budgetary, procedural, or reputational, and they can be applied to government as a whole, to individual state entities, or to state officials.15

In the euro area, through early 2012, countries that did not adhere to the deficit ceiling of 3 percent of GDP could, if considerable efforts to rectify the situation were not effective (through the so-called excessive deficit procedure), be fined a maximum sanction of half a percent of GDP. This sizable fine was, however, not automatic but subject to political decision. Thus, in practice, despite repeated violations of the 3 percent rule (by almost all of the euro area membership), financial sanctions were never invoked under the Maastricht Treaty. The EU’s new Fiscal Compact and Six Pack framework have changed these rules. The size of the sanctions has decreased, to 0.1 percent of GDP, and their application has become somewhat less political and more rules based. Chapter 3 provides further details of the new EU Fiscal Compact and the Six Pack.

Sanctions pertaining to the budget have also been attempted at the national level. Some countries have experimented with automatic expenditure cutbacks, for example, across-the-board spending cuts, withholding of transfers, and wage freezes for civil servants. These measures kick in if a certain rule in the FRL is violated. Borrowing limitations have also been imposed.

The success of actual monetary sanctions has been limited. In many cases those bearing the burden would not be the ones breaching the fiscal rules (often the previous government), making the instrument politically unattractive. The penalty in the Maastricht Treaty was so high that it became less credible and probably did not increase compliance as much as a less-onerous sanction might have. The design challenge is to develop a sanction that is painful and embarrassing for the executive but still credible.

Many countries have chosen the “name and shame,” or reputational, approach to sanctions in FRLs. If a fiscal rule is breached or, even better, expected to be breached, the government is required to notify the legislature and report to it on the extent of the breach, the causes of the breach, and the measures the government is to take to reestablish compliance with the fiscal framework. The requirement can be toughened by stating the period within which compliance needs to be reestablished. The effectiveness of such “reporting and redress” sanctions depends on the political system, the power of an

15 The most creative example of a procedural–state official sanction is perhaps Suriname, where the Minister of Finance is to be put in prison when the debt ceiling of 60 percent of GDP is exceeded. The Finance Minister who developed this law assumed that his fellow politicians would be too embarrassed to put him in jail and thus that the sanction would be highly effective.
independent press and academia, and possibly the existence of an independent evaluator of the government’s actions, such as the supreme audit institution or a fiscal council. The German and Swiss debt-brake laws specify the redress period and even require government to compensate in future years for overspending in the year in question.

There is a fundamental discussion in the literature of whether sanctions, which are often not credible and are consequently ignored, are actually helpful in FRLs. Some argue that by opening up the possibility of sanctions (for events not covered by an escape clause) the possible breach of the FRL is actually facilitated. It is noteworthy in this context that fiscal rules that are enshrined in the constitution usually do not include sanctions.

The view of this chapter is that sanctions should be aligned with the political will in the country to enforce fiscal procedural or policy rules. Sanctions should be as painful as possible, but they should also remain credible. Again, ministries of finance are often overly optimistic about the fiscal pain that politicians will be willing to impose to avoid breaking the letter of the law. To protect the credibility of the legal framework the sanctions need to be discussed extensively with the political level. There is considerable room for creativity if monetary sanctions are combined with the name and shame approach. Automatic cutbacks and tax increases should be considered if the name and shame approach by itself proves ineffective.

The EU’s new fiscal arrangement system is complex but still internally consistent. Several elements of the design, such as the new sanctions regime and placing enforcement in domestic law, should strengthen its enforceability. However, planning, monitoring, and enforcement of the framework will require substantial coordination and communication between the European Commission and the member countries. The complexity of the framework provides scope for differing interpretation and application. Maintaining the integrity of the new system from the start and building societal support will be crucial.

Transitional Requirements

Transitional requirements are often needed in FRLs, especially for countries that are outside a fiscal rules framework that they wish to enter. During a severe fiscal crisis when the political willingness to agree to an FRL is highest, it is at the same time often unrealistic to enter a long-term fiscal framework because fiscal aggregates may be considerably outside the intended fiscal limits. Transitional requirements can help specify the path to the long-term fiscal framework. The main design issue is the specificity of the transition path. Without any transitional requirements, countries often wait too long to begin consolidation efforts and fail to reach their fiscal targets in the first year. This will cause maximum damage to the reputation of the nascent FRL. Conversely, a strictly defined transition path may not provide enough policy discretion to exit the economic downturn at an optimal pace. Clearly, the relative uncertainty of the transition path will be influenced by the policy flexibility of the country, that is, what is the “maximum”
speed of fiscal consolidation, and are short-term fiscal considerations more, or less, important than long-term ones.

Obviously, a country could delay adopting an FRL until it has brought its fiscal parameters back into the fiscal framework prescribed by the proposed FRL and returned to “normal” economic circumstances. This delay, however, could leave unexploited the opportunity to signal to markets that the government is attempting to return to fiscal sustainability. Such a signal, if credible, could help lower interest rates marginally and ease the transition process. Moreover, as discussed above, the political will to introduce an FRL may also have waned by the time the economy returns to normal.

2.3.1. Design of the Fiscal Policy Process

Although the design elements discussed above are important parts of FRLs, the more fundamental design elements in FRLs are those that underpin the fiscal policy process. These design elements are linked to the country’s ambition to improve fiscal outcomes. Higher ambitions signal a need for more complexity in the FRL design, but also for more political will and a stronger PFM system to support implementation of the law.

Although improving fiscal outcomes is an overarching objective of an FRL, a number of intermediate objectives can also be identified (see Table 2.1). This chapter maintains that these intermediate objectives explain the gradual progression of FRLs from focusing on fiscal transparency, to fiscal process, and finally to fiscal rules.

The intermediate objectives described in Table 2.1 are important determinants of the final characteristics of an FRL. There is a clear progression in the described objectives with regard to the ambition level for improving fiscal outcomes. Requirements just to publish fiscal data accurately and timely both at the end of the year and in-year are not effective by themselves in controlling expenditure nor do they require excessive technical capacity. However, for developing countries timely publication of fiscal data can already pose substantial issues and require further development of fiscal reporting systems. Publishing medium-term fiscal forecasts, defining fiscal objectives, and reviewing past achievements relative to targets would have a stronger impact on fiscal discipline. Setting a fiscal framework including fiscal forecasts, objectives, and policy measures for the medium term is often a quite onerous requirement. Ensuring adherence to a set of fiscal rules within such a framework is usually complex, even for advanced economies.

As the progression is made through the described intermediate objectives, not only do the PFM requirements increase, but the government and legislature also constrain themselves more in the setting of fiscal policy. Thus, the political will needed to progress through these intermediate objectives also should increase. As stated before, in situations of limited PFM capacity or political will, a new FRL being drafted by a ministry of finance must not exceed by too much the realities of both PFM capacity and political will.
### TABLE 2.1

<table>
<thead>
<tr>
<th>Intermediate fiscal objective</th>
<th>Examples of requirements in fiscal responsibility law</th>
</tr>
</thead>
</table>
| 1. Improve fiscal transparency | • Publish accurate and timely midyear and end-of-year fiscal outcomes  
                                • Develop and publish fiscal forecasts for the medium term |
| 2. Improve political accountability for fiscal and budgetary outcomes | • Publish fiscal policy objectives and strategy  
                                • Require government to report to legislature on achievements  
                                • Require the state auditor to independently report on fiscal policy achievements |
| 3. Define a medium-term fiscal process | • Develop a fiscal strategy document presenting macro and fiscal forecasts, defining fiscal objectives for the medium term, and stating planned policy measures |
| 4. Ensure that fiscal policy guides budgetary policy | • Require that fiscal policy decision making precede budgetary decision making  
                                • Present a formal medium-term fiscal framework at the start of budget preparation, including decision making on expenditure ceilings for the budget  
                                • Constrain the amendment rights of parliament within agreed-on fiscal policy parameters |
| 5. Ensure fiscal discipline and sustainability | • Enact limits to key fiscal aggregates (debt- and deficit-to-GDP limits)  
                                • Require in-year rules on the use of revenue and expenditure windfalls, and on redress of overspending and lower-than-expected revenues |
| 6. Ensure macrofiscal stability | • Ensure appropriate and symmetric fiscal policy responses through the use of fiscal rules aimed at stabilizing macroeconomic shocks (more complex rules, expenditure growth limits, cyclical deficit targets, rules-based stabilization funds) |
| 7. Address intergenerational equity concerns | • Implement a rules-based framework that defines intergenerational equity and sets up a transfer rule from budget to sovereign wealth fund |

Source: Authors’ compilation.

An important part of enhancing fiscal policy processes is providing the ministry of finance the necessary authorization and powers. Presenting fiscal forecasts and calculating necessary policy measures to stay within the confines of MTFF or fiscal rules are tasks that must be given to the ministry of finance. In a number of developing countries, cabinet or parliamentary committees unilaterally change revenue forecasts, oil price assumptions, or other key elements of the fiscal or budgetary framework, undermining the credibility of fiscal policy setting. In calculating the impact of new policy measures on the ongoing costs of existing policies (the baseline), it is also extremely important that the ministry of finance have the final say on such estimates. If not, the estimates can be prone to political manipulation. Of course, this role of the ministry of finance does not preclude criticism by an independent evaluator such as the supreme audit institution or a fiscal council if these estimates are found to be systematically biased.
van Eden, Khemani, and Emery

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(see Chapter 6). Such criticism would strengthen the objectivity of the overall fiscal policymaking process.

2.3.2. FRL Development: A Gradual Process

Countries with the ambition to use legislation to improve fiscal outcomes need to view implementation of this legislation as a developmental process. Starting in a simple manner is vital for both developed and developing countries. In a first phase, only transparency and oversight requirements would be included in an FRL.

In a second phase, fiscal and budget process requirements would be added. The number of elements to be added in this second phase can be extensive. A basic requirement is the development of a medium-term fiscal outlook document that presents projections of fiscal aggregates under unchanged policy. A next step in this phase is expansion of the fiscal outlook document to a fiscal statement that includes fiscal objectives, strategy, and a rough indication of policy measures over the medium term. This fiscal statement presents the resource envelope available for the upcoming budget preparation process. It is a considerable step, however, to subsequently enforce in the FRL that the cabinet must set binding resource envelopes and sectoral expenditure ceilings according to a formal MTFF. This step could require that the MTFF be formally approved by the cabinet and approved, or perhaps even enshrined in law, by the legislature. Sending the MTFF to parliament for information is more common. In any case, FRLs that have progressed to this stage often formally include the requirement that the annual budget must fit into the fiscal limits set in the MTFF. Thus, parliament’s amendment rights must be constrained, for example, by a requirement that any budget amendment should propose additional funding sources or compensatory spending cuts.

The third phase in the development of FRLs can be characterized by the setting of numerical rules for fiscal objectives. Numerical fiscal rules can have considerable benefits. If set appropriately, fiscal rules provide an anchor for fiscal policy that can help ensure fiscal sustainability. Depending on the type of rules and the extent to which they constrain decision making, they “objectify” fiscal policy, taking it out of the political debate. If limits to fiscal aggregates to ensure fiscal sustainability are distant from the actual parameters (for example, the debt limit is 60 percent of GDP, but the actual debt is 40 percent) some discretion to discuss fiscal policy remains. Countries take a further step when fiscal rules become the mechanism for stabilizing the effects of economic shocks or for addressing intergenerational equity concerns. In such countries, fiscal policy becomes largely rules based.

The use of fiscal rules requires substantial capacity for fiscal forecasting and monitoring. It also requires the capacity and political will to take required policy measures (and to adequately cost these measures over the medium term—a requirement that is often neglected). In general, using fiscal rules will require the
Developing Legal Frameworks to Promote Fiscal Responsibility: Design Matters

ministry of finance to be able to identify baseline expenditure. In FRLs with more complex fiscal rules, flexibility in fiscal policy is seriously constrained. Still, for countries with sophisticated macroeconomic analysis and fiscal forecasting capacity, the benefits of, for example, structural deficit rules could enhance the counter-cyclicality of fiscal policy considerably.

This chapter does not discuss the appropriate rules for specific countries or specific economic circumstances. However, fiscal rules should reflect those circumstances. Numerical, strictly binding fiscal rules should be used only by countries with reasonable levels of economic stability that have the political will to follow through on the implied commitment and have PFM systems that ensure that fiscal parameters stay within accepted limits. Political will can be strengthened if less-restrictive FRLs function successfully for a number of years. More complex and constraining FRLs could be built upon initially less restrictive FRLs. Countries should see FRLs not as an unchanging element of the legal framework, but as an element that adapts to the fiscal policy challenges facing the country, society’s commitment to fiscal discipline, the reputational capital built up by the existing legal framework, and the technical capacity to use complex fiscal policy rules.

Advanced economies enter the process of improving fiscal outcomes at a different point than developing countries. Their organic budget laws are often already quite strong; accordingly, some advanced economies have chosen to include accountability and process rules in their existing legal frameworks (Lienert, 2010). Consequently, fiscal rules have been left outside the legal framework, or integrated into more basic FRL legislation focusing only on fiscal rules. In advanced economies, the use of the constitution or international treaties is also more widespread. Again, such mechanisms are often rather narrowly focused.

2.4. PFM REQUIREMENTS FOR AN EFFECTIVE FRL

As discussed above, the ambitions of the FRL in containing and controlling fiscal aggregates should be aligned with the relative strengths of the PFM system. The experiences of a number of countries, including Australia, Brazil, and New Zealand, highlight the important role played by a well-developed PFM framework in assisting these countries to introduce the higher standards of transparency and accountability required by an FRL. In contrast, weak PFM systems and procedures limit government’s ability to monitor and control fiscal outcomes and undermine the successful implementation of an FRL. Although it can be argued that a basic FRL can induce meaningful reforms just by promoting fiscal prudence despite a weak PFM system, a sufficiently developed PFM system is essential for the benefits of more sophisticated FRLs to be fully reaped. For example, an FRL that requires policymakers to determine the exact amount of fiscal adjustment obviously needs a PFM system with the requisite forecasting, costing, and monitoring tools.
A PFM system covers a broad range of processes and institutions. From a process point of view, the system starts with strategic planning, fiscal strategy, and budget preparation, then extends to budget execution, accounting, reporting, and external audit. On the institutional side, the ministry of finance is the main manager, supervisor, and standard setter for the PFM process. The basic elements of a good PFM system are a well-formulated medium-term fiscal strategy development process, clear and credible budget formulation, effective budget execution procedures, timely and accurate accounting and reporting, a strong independent audit institution, and transparent oversight by the legislature. These elements can improve an FRL’s effectiveness and credibility by creating and facilitating a policy environment that binds government to sound fiscal criteria. A PFM system should, depending on the ambition level and complexity of the FRL (which are interrelated), be progressively capable of meeting requirements in the areas discussed in the following sections.

### 2.4.1. Monitoring and Reporting Fiscal Data

Fiscal reporting systems should be able to provide fiscal data that are accurate, reliable, and available on a timely basis, and include end-of-year financial reports and in-year budget execution reports. Information should also be available on outstanding debt, contingent liabilities, and other fiscal risks in line with the reporting requirements prescribed in an FRL. This information may be explicitly required by an FRL, but even an FRL that requires only a statement of fiscal policy objectives and reports on their achievement would benefit from this information.

The requirements of advanced, type III FRLs for monitoring fiscal policy and budget developments need to be supported by strong monitoring and reporting systems to provide a reliable basis for tracking implementation of the law. Budget monitoring and reporting should cover a comprehensive set of aggregates and should be sufficiently developed for gauging compliance with the fiscal rules to produce timely in-year and end-year reports. It is necessary to monitor and report regularly on fiscal developments and budget implementation against the objectives and targets of the fiscal strategy and approved budget.

Combining the various stages of the budget process into an integrated, or interlinked, financial management information system helps manage public monies better; allows greater financial control; and leads to better monitoring of the government cash position, better cash planning, and better fiscal reporting. Fiscal data should meet accepted quality standards. Systems integration is also important for establishing accountability for appropriate responses to changing economic or fiscal circumstances and is critical for fiscal transparency.

The reporting system will also help to ensure legislative and administrative compliance. The system should produce reports of commitments and payments that have been made against each legal and administrative control point, in any dimension, and report information on available budget balances at all points throughout the budget execution cycle. This level of detail will
ensure that budget planners and managers are able to exercise control and allocate resources efficiently throughout the cycle. The recording of transactions against each budget line also provides a proper basis for assurance testing and reporting by internal and external audit. Another important requirement served by the financial reporting system is the control of compliance with other fiscal legislation, in particular, the statutory controls over spending from the consolidated fund, loan fund, capital fund, contingency fund, and all other special funds.

To enforce the aggregate control required by fiscal adjustment, the budget execution procedures must do more than simply ensure compliance with the approved budget; they must also be able to adjust to intervening changes and any within-year shocks and still enable operational efficiency. The budget system should ensure effective expenditure control and be supported by (1) a complete budgetary and appropriations accounting system that tracks transactions at each stage of the expenditure cycle; (2) effective controls at each stage of the expenditure cycle; (3) a system for managing multiyear contracts and forward commitments; (4) a personnel management system that controls staff levels and personnel costs; and (5) adequate and transparent procedures for managing procurement and outside contracting. The efficiency of the expenditure execution process also relies on an effective treasury and cash management system. An efficient cash management system would help in aggregate control of spending and efficient implementation of the budget, as well as minimizing the cost of government borrowing and optimizing the use of government cash balances with the help of a treasury single account (see Chapter 9).

Monitoring of fiscal policy developments and budget implementation should encompass government agencies such as the finance ministry, the external audit agency, and the parliamentary finance committee, as well as research organizations, think tanks, and international organizations such as the IMF.

### 2.4.2. Fiscal Forecasting

Countries that adopt FRLs with a requirement to present fiscal objectives should have reasonable capacity to forecast macroeconomic and fiscal aggregates to determine whether fiscal objectives are realistic and to estimate needed policy adjustments. Because FRLs usually require fiscal objectives to be set for the medium term, forecasting also needs to be extended to the medium term to assess fiscal parameters over a longer time horizon.

The framing of robust fiscal projections is an issue in a number of countries, as is having the necessary skill and capacity to produce accurate forecasts that provide a dependable basis for the fiscal framework, budgeting, and expenditure control for the medium term. Studies have shown an optimistic bias in the forecasts of economic growth and budgetary projections produced by government in some countries. This bias may arise because governments overestimate growth to avoid the political cost associated with the implementation of difficult fiscal correction measures.
Although corrective measures can be avoided ex ante, the ex post deficit may then turn out to be larger than forecasted because growth is lower than projected. In some countries, economic and budgetary forecasts prepared by independent institutions provide benchmarks against which the plausibility of government projections can be assessed and thus help limit or eliminate the source of optimistic bias. All possible efforts need to be made to produce reliable forecasts for a fiscal framework.

2.4.3. Fiscal Policymaking Capacity

If an FRL aims to ensure fiscal sustainability, the country should have the ability to assess sustainable limits for the public debt and deficit. If the FRL requires fiscal targets to be set to help stabilize the economy, policymakers should have an idea of the necessary fiscal policy stance. Many FRLs require production of a fiscal strategy note at the start of the budget process, providing a macroeconomic and fiscal forecast, fiscal policy targets, and policy measures to attain them.

The fiscal strategy has a vital role at the front end of the budget process and needs to be used for developing credible medium-term budget ceilings that reflect government policies and priorities. Discipline in the budget process is indispensable for achieving fiscal control, and budget comprehensiveness is a key ingredient in this. The budget needs to encompass all fiscal operations undertaken by government, including those of extrabudgetary funds and the quasi-fiscal activities of parastatal agencies and state-owned enterprises. It is important to ensure that fiscal policy decisions are based on a comprehensive framework of public activities.

2.4.4. Independent Review of Fiscal Policy

To give more credibility to the outcome of fiscal policy, and in more advanced FRLs, to assess if and for what reasons fiscal limits have been breached, state auditors have the task of reviewing fiscal policy objectives and outcomes. An independent assessment can provide assurance of the executive’s compliance with the FRL, but most supreme audit institutions are presently not well placed to assess fiscal policy because this topic has been outside their core competency. This would mean that considerable capacity building would be required. As an alternative, countries sometimes assign this task to a fiscal council (as discussed in Chapter 6) or to a special support unit of the budget committee of parliament. Obviously, if these entities need to be set up, capacity building may be required for them, too. An advantage is that such entities are fully focused on assessing fiscal and budgetary policies.

External audit can be important in other ways for the effectiveness of an FRL. It can (1) detect weaknesses in management controls and bring out irregularities in the use of public funds, (2) determine the reliability of accounting and fiscal data, and (3) identify areas of waste and inefficiency and suggest ways of improving the efficiency of budgetary operations. These tasks will help support the
transparency and control of government expenditure. The credibility of an external audit requires that the supreme audit institution and its staff be independent of the government units being audited and have unrestricted access to required information.

2.4.5. MTFF Development

As FRLs become more ambitious, they tend to prescribe development of full-blown MTFFs. An MTFF requires a more disciplined approach to fiscal policy-making by formalizing the development of a medium-term fiscal strategy and medium-term orientation within the budget process through a combination of (1) a medium-term macroeconomic framework that provides multiyear projections of macroeconomic variables such as GDP, inflation, exchange rates, and the balance of payments; (2) a framework that produces a set of multiyear targets or ceilings on fiscal aggregates, such as overall government expenditure, borrowing, and debt; and (3) identification of concrete policy measures that translate the projected overall resource envelope and the government’s fiscal objectives into a set of credible and binding multiyear expenditure ceilings and policies.

An MTFF is a mechanism for setting multiyear fiscal objectives and having the cabinet make decisions that ensure that these objectives are met in budget formulation, approval, and execution. Hard budget constraints are needed to ensure that fiscal policy execution is consistent with macroeconomic stability objectives. Explicit medium-term expenditure ceilings consistent with overall fiscal objectives should be framed in the early stages of budget preparation. Therefore, expenditure allocations to sectors should be based on clear prioritization of policy objectives, guided by discussions between the ministry of finance and line ministries. Expenditure ceilings need to be based on separate assessments of the cost of current policies and of new measures. Ceilings derived from this process should be endorsed at the cabinet level to ensure that an adequate policy discussion governs the process.

Enhancing the top-down approach to preparing the budget also strengthens overall fiscal discipline. Expenditure ceilings should be applied as a means of controlling fiscal outcomes and compliance with fiscal rules. Expenditure control requires that expenditure ceilings for government as a whole and for individual ministries be firmly respected.

Although MTFFs strongly support fiscal discipline, extending the level of detail of budgetary planning would further enhance this discipline. Once an FRL begins prescribing medium-term budget frameworks (MTBFs), its capacity requirement again expands considerably. An MTBF requires development of a fully costed expenditure baseline, and costing of all new expenditure and revenue measures for the medium term (see Chapter 4). Such costing can be complicated if the budget is still structured by economic classifications. For better linkage between policy and the budget and for
more accurate costing of program expenditure, countries often shift to pro-
goram budgeting during the introduction of an MTBF. Thus, an FRL that
requires a full MTBF will often require capacity in both baseline develop-
ment and program budgeting. Capacity requirements to operate an MTBF
extend to line ministries.

Both MTFFs and MTBFs require prudent risk management and contingency
planning to ensure that government keeps sufficient capacity in reserve to meet
reasonable risks from unforeseen and urgent events that emerge after the budget
strategy has been approved. This could take the form of including planning or
contingency reserves in the framework.

2.4.6. Intergovernmental Coordination

To establish overall fiscal control in countries with strongly decentralized expen-
diture assignments, it makes sense for FRLs to cover the whole of general govern-
ment. Thus, additional PFM capacities, such as a well-designed system of inter-
governmental fiscal relations supported by a functioning PFM system at the
subnational level, are required. For fiscal adjustments to work for the country as
a whole, subnational finances must be controlled in parallel to those of central
government. In countries with large vertical imbalances arising from mismatches
between expenditure and revenue responsibilities, an FRL would not be helpful
unless these imbalances are accommodated by a rules-based system of transfers or
borrowing rights. Similarly, if subnational governments have accumulated a large
stock of debt, an FRL needs to be complemented by fiscal adjustment or debt-
rescheduling programs with the national government.

2.4.7. A Strong Ministry of Finance

Fiscal policy does not materialize in a vacuum. A government cannot simply
decide to adjust the fiscal deficit; public institutions need to put in place to sup-
port the decision. Without well-functioning fiscal institutions, even the best-
designed fiscal measures risk failure. Key fiscal institutions for achieving and
sustaining fiscal consolidation were discussed above and include those that fore-
cast revenues; develop fiscal policy; plan, execute, and monitor the budget; and
manage intergovernmental fiscal relations. These functions are primarily per-
formed by the ministry of finance. A strong ministry of finance is critical to the
success of an FRL. Again, as the ambition level of the FRL increases, so does the
need for the ministry to develop additional capacities.

2.4.8. A Strong Institutional and Legal Framework

Implementing an FRL, even a basic one, will be greatly helped by a sound
institutional and legal framework with strong transparency and account-
ability requirements, public oversight, and enforcement procedures. Of
course, many FRLs themselves aim to increase transparency and accountability of the fiscal process. However, if general principles are already included in the budget system law, advancing to a more complex FRL will be easier.

A PFM system's effectiveness depends on its being well grounded in law and benefiting from supportive regulations and administrative practices. Many countries have public finance or organic budget laws that provide the legal framework for budget formulation, approval, and execution. Such laws are often supported by specific laws and regulations governing treasury operations, accounting, and reporting on management of the public debt. It is useful to have a comprehensive public finance law that establishes (1) clear roles and responsibilities for the key entities and offices involved in management of public finances; (2) an open and credible budget preparation process; (3) effective and disciplined budget execution; (4) reporting requirements that mirror the budget presentation; (5) transparency requirements and timing and audit requirements for financial accounts; and (6) accountability and compliance provisions. A budget system law is the foundation on which an effective FRL will be built. If a budget law is underdeveloped, the functioning of the FRL will be suboptimal. The development of adequate institutional and administrative capacity to enforce PFM laws and regulations is equally important.

Box 2.2 summarizes the main PFM requirements for progressively more sophisticated FRLs.

**BOX 2.2  Key Public Financial Management Requirements to Support a Fiscal Responsibility Law**

Depending on the scope and complexity of the fiscal responsibility law, a public financial management system should be progressively capable of meeting requirements in the following areas:

- Accurate, timely, and dependable fiscal monitoring and reporting
- Credible budget planning
- Effective and disciplined budget execution
- Reasonably reliable macroeconomic and fiscal forecasting
- Fiscal policy analysis and ability to set fiscal targets
- Independent review of fiscal policy outcomes (external audit, parliament, or fiscal council)
- A credible medium-term fiscal framework and a monitorable fiscal strategy describing the path of fiscal deficits and public debt resulting from government’s revenue, expenditure, and financing policies
- Ability to cost new and existing policy measures over the medium term, that is, definition of the baseline
- Setting and executing fiscal policy in line with tightly defined numerical limits
- Well-structured cabinet decision making over the medium term
- As fiscal rules become more complex, sophisticated macroeconomic modeling to determine the structural growth rate, deficit, and resource revenues
2.5. CONCLUSION

FRLs can play a useful role in strengthening fiscal outcomes. Given the almost universal pressures to increase government spending, FRLs should be part of the institutional toolkit of any ministry of finance. However, adoption of an FRL is not a priority in all circumstances—if fiscal policy is under control and the political will is strong to keep it that way, this institutional innovation may not be a priority. Most countries are, however, not in that happy situation.

A legal framework that encompasses principles of transparent, accountable, and sustainable fiscal policy, a type I FRL, would seem desirable in any country. Whether that objective requires a separate law depends on the prominence fiscal policy has achieved in the political debate. Type II FRLs, focusing on fiscal process rules (concrete reporting guidelines, limitation of budget amendment rights, MTFF development), could also be adopted in most countries if tailored to the capacity of the local PFM system. For type III FRLs, which include numerical fiscal rules, economic and fiscal circumstances, the political appetite for fiscal discipline, and the capacity of the PFM system to operate the FRL are crucial factors. A common mistake is that ministries of finance are often too ambitious and overestimate what a type III FRL can achieve in a society that does not yet fully appreciate the importance of sustainable fiscal policy.

An FRL can gradually discipline the political debate, especially once it has built up reputational capital. The distance between the aspirations of the law and political reality should not become too large, otherwise the law will be breached. Sometimes compromise needs to be accepted, and FRLs may have to start with modest ambitions, encompassing, for example, only specification of principles of transparency, accountability, and sustainability. In such cases, FRLs are clearly not the whole answer to improving fiscal policy outcomes.

FRLs should not, however, be seen as static legislation. As economic circumstances change and as political acceptance grows, FRLs should adapt. As the reputational capital of these laws increases, the possibility of imposing tighter requirements arises, and the introduction of more sophisticated fiscal rules should be explored. Both emerging market economies and advanced economies have squandered opportunities to regularly strengthen their FRLs. A number of emerging market economies are now in a position to introduce FRLs with binding numerical rules without too much economic pain. Advanced economies have neglected to make their FRLs more sophisticated by, for example, introducing structural deficit limits.

Development of FRLs should be seen as a gradual process in which the requirements of the fiscal policy process gradually expand from following good practice principles, to transparency and process rules, and ultimately to numerical fiscal rules. During this process of becoming more sophisticated and prescriptive, it is important to define precisely a number of issues such as coverage, escape clauses, sanctions, and transition requirements. These elements can function as pressure valves that can serve countries well in times of extreme fiscal crisis. Again, the most strenuous FRL requirements will not always be the best and the longest lasting.
REFERENCES


## APPENDIX 2.1. FISCAL RESPONSIBILITY LAWS IN SELECTED COUNTRIES: MAIN FEATURES

<table>
<thead>
<tr>
<th>Country</th>
<th>Law (year)</th>
<th>Procedural rules</th>
<th>Numerical targets in FRL Coverage</th>
<th>Escape clauses¹</th>
<th>Sanctions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Federal Regime of Fiscal Responsibility (2004)²</td>
<td>Yes</td>
<td>ER; DR</td>
<td>CG</td>
<td>No Yes</td>
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<tr>
<td>Australia</td>
<td>Charter of Budget Honesty (1998)³</td>
<td>Yes</td>
<td>—</td>
<td>CG</td>
<td>No No</td>
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<td>Brazil</td>
<td>Fiscal Responsibility Law (2000)</td>
<td>Yes</td>
<td>ER; DR</td>
<td>PS</td>
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<td>Chile</td>
<td>Fiscal Responsibility Act No. 20-128 (2006)</td>
<td>Yes</td>
<td>BBR</td>
<td>CG</td>
<td>No No</td>
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<td>Colombia</td>
<td>Original Law on Fiscal Transparency and Responsibility (2003)</td>
<td>Yes</td>
<td>BBR</td>
<td>NFPS</td>
<td>Yes No</td>
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<tr>
<td>Ecuador</td>
<td>Fiscal Responsibility Law (2010)</td>
<td>Yes</td>
<td>ER</td>
<td>PS</td>
<td>No No</td>
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<td>Jamaica</td>
<td>Fiscal Responsibility Law (2010)</td>
<td>Yes</td>
<td>BBR; DR</td>
<td>CG — ⁴</td>
<td>Yes No</td>
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<td>Nigeria</td>
<td>Fiscal Responsibility Act (2007)</td>
<td></td>
<td>BBR</td>
<td>CG</td>
<td>No No</td>
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<tr>
<td>New Zealand</td>
<td>Public Finance (State Sector Management) Bill (2005)³</td>
<td>Yes</td>
<td>—</td>
<td>GG</td>
<td>No No</td>
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<td>Pakistan</td>
<td>Fiscal Responsibility and Debt Limitation Act (2005)</td>
<td>Yes</td>
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<td>CG</td>
<td>Yes No</td>
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<td>Panama</td>
<td>New Fiscal Responsibility Law (2009)</td>
<td>Yes</td>
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<td>NFPS</td>
<td>Yes No</td>
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<td>Peru</td>
<td>Fiscal Responsibility and Transparency Law (2003)</td>
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<td>NFPS</td>
<td>Yes Yes</td>
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<tr>
<td>Romania</td>
<td>Fiscal Responsibility Law (2010)</td>
<td>Yes</td>
<td>ER</td>
<td>GG</td>
<td>Yes Yes</td>
</tr>
<tr>
<td>Serbia</td>
<td>FRL provisions introduced in the 2009 Budget System Law (2010)</td>
<td>Yes</td>
<td>BBR; DR</td>
<td>GG</td>
<td>No No</td>
</tr>
<tr>
<td>Spain</td>
<td>Budget Stability Law (2007)</td>
<td>Yes</td>
<td>BBR</td>
<td>NFPS</td>
<td>Yes Yes</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Fiscal Management Responsibility Act (2003)</td>
<td>Yes</td>
<td>BBR; DR</td>
<td>CG</td>
<td>No No</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Budget Responsibility and National Audit Act (2011)</td>
<td>Yes</td>
<td>BBR; DR</td>
<td>PS</td>
<td>No No</td>
</tr>
</tbody>
</table>

Source: IMF staff and national authorities.

Note: BBR = budget balance rules; CG = central government; DR = debt rule; ER = expenditure rule; FRL = fiscal responsibility law; GG = general government; NFPS = nonfinancial public sector; PS = public sector.

¹Includes only well-specified escape clauses.
²The FRL has de facto been suspended since 2009.
³These countries operate de facto rules that are not spelled out in an FRL.
⁴Also includes public bodies.