Fiscal Responsibility Laws

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The search for more comprehensive institutional arrangements to improve fiscal policy outcomes intensified during the last decade. Analogous to the monetary policy debate, while discussions initially centered on the general issue of rules versus discretion, more recently they have turned into a search for broader institutional arrangements that would help ensure the desired fiscal policy outcomes. Recognizing the limited scope for improvement that stand-alone fiscal rules can provide, and the frequent lack of immediate results from enhanced transparency alone, fiscal responsibility laws (FRLs) have been enacted in many countries as permanent institutional devices aiming to promote fiscal discipline in a credible, predictable, and transparent manner. New Zealand was at the forefront of these reforms, adopting an FRL in 1994. More recently, FRLs have been implemented in several countries in Latin America, Europe, and Asia.

This chapter discusses the main advantages and disadvantages of FRLs based on experiences in selected countries (up to 2005). As noted below, the content of FRLs varies greatly from country to country, and some countries that do not have an FRL, in fact legislate typical FRL provisions in other pieces of legislation. This chapter, however, concentrates on cases where FRL provisions are contained in a single law and does not cover other public finance legislation, such as budget laws or stand-alone legislated fiscal rules.¹ It mainly

focuses on factors and preconditions that can increase the chances of success of FRLs. The success of FRLs is analyzed along several dimensions, including fiscal outcomes, the degree of compliance with its requirements, and whether they have led to changes in fiscal policy design and implementation.

The chapter first discusses general characteristics, advantages, and disadvantages of FRLs. It then reviews the experience with FRLs in selected countries. Next, it draws some policy lessons, particularly with respect to the conditions that emerge as favorable to the effective implementation of FRLs and best practices regarding their design. The last section of the chapter offers some concluding remarks.

Characteristics, Advantages, and Disadvantages of Fiscal Responsibility Laws

FRLs aim to improve fiscal discipline by requiring governments to declare and commit to a monitorable fiscal policy objective and strategy. Often, a driving force behind FRLs is the wish to make fiscal policies more predictable and credible, by establishing rules and procedures the government must follow in the design and implementation of fiscal policy, and by setting up transparent mechanisms by which others can judge if the government is complying with established goals and priorities. While a well-designed FRL can achieve this goal, it is not obvious that the mere introduction of an FRL will be sufficient, nor that the absence of an FRL will make it impossible to do so. By reviewing the experience with FRLs in different countries, this chapter aims to identify those design characteristics and preconditions that may contribute to the success of FRLs.

The introduction of an FRL is one approach governments have used to try to alleviate problems in fiscal management. As noted earlier, policy discretion may be beneficial under a number of circumstances, but there is growing evidence that discretion can be misused, leading to deficit bias, or the implementation of procyclical fiscal policies. Recognizing that stand-alone fiscal rules may provide limited scope for improvement, and the frequent lack of immediate results from enhanced transparency alone, governments have increasingly enacted FRLs as permanent institutional devices.

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2Policy discretion would be useful, for instance, in the presence of unexpected shocks that require speedy policy action, or under rigid monetary frameworks that do not allow monetary policy to play a stabilizing role in macroeconomic management.

3A deficit bias is a tendency to run fiscal deficits that are not consistent with medium-term fiscal sustainability.
aiming to promote fiscal discipline in a credible, predictable, and transparent manner.

FRLs can be classified according to a number of different characteristics. A first distinction can be made between FRLs that emphasize procedural and transparency issues, and those that focus more on numerical fiscal rules. Other distinctions can be made according to the jurisdictional scope, the extent of sanctions, the applicability of escape clauses, and the inclusion of cyclical considerations. These will be discussed in turn.

Procedural Rules Versus Numerical Rules

Both procedural rules and numerical rules are common features of FRLs. Procedural rules define the attributes and interaction of participants in the budget process, aiming to enhance transparency, accountability, and fiscal management. The IMF’s Fiscal Transparency Code (IMF, 2001b) emphasizes four general transparency principles: (1) clarity of roles and responsibilities with respect to the structure and functions of different levels of government, and the relationship of government and the rest of the economy; (2) public availability of information, with comprehensive and periodic reporting; (3) open budget preparation, execution, and reporting, requiring disclosure of information about the budget process; and (4) assurances of integrity regarding the quality of fiscal data and independent scrutiny of fiscal information.

A recent study by the International Budget Project (2004) on developing and transition countries concludes that, while in most surveyed countries documents related to the executive’s budget are routinely released to the public, serious shortcomings in the information provided are not uncommon. In addition, governments typically fall short of international best practices regarding publishing intra-year and final budget implementation reports. Finally, most countries surveyed fail to provide information to the public and to legislatures that can help make the budget (and the policies it embodies) more understandable.

The FRLs in Australia, New Zealand, and the United Kingdom place great emphasis on procedures, outlining principles of responsible and transparent fiscal management, reporting requirements, and accountability. Australia’s FRL, the Charter of Budget

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Honesty Act, does not specify any numerical rule. New Zealand’s Fiscal Responsibility Act aims at maintaining public debt at “prudent” levels by running appropriate operating balances. The U.K. Code for Fiscal Stability is supported by two numerical rules that are not part of the code itself. In contrast to FRLs that emphasize procedures, Panama’s FRL focuses almost exclusively on numerical fiscal targets. Most FRLs typically incorporate both elements. For example, Brazil’s FRL sets a comprehensive framework for budgetary planning, execution, and reporting and also includes numerical fiscal limits for selected indicators. The FRLs of India and Sri Lanka provide for a broad framework for fiscal policy design and reporting, with numerical targets set in a multiyear context. Other FRLs (e.g., Argentina and Peru) also contain procedural and transparency provisions, with numerical targets set in an annual context. Table 5.1 presents a summary of the key components of FRLs in different countries. Further details on the content of the laws can be found in Appendix 1, while Appendix 2 describes the experience with the implementation of FRL provisions.

Procedural and transparency rules in FRLs can be instrumental in improving fiscal management. While they may be insufficient to strengthen fiscal policies in and by themselves, they may help by making the budget process more “hierarchical,” concentrating power in the hands of those who have incentives to deliver fiscal discipline, identifying weaknesses in fiscal institutions and procedures, and limiting agency problems by increasing accountability to voters. Thus, in addition to improving governance and transparency, these rules can play an important role in creating consensus for fiscal reforms.

Numerical fiscal rules embedded in FRLs have several potential advantages. First, they may help contain a deficit bias and address problems of time

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6The rules followed by the United Kingdom, set in the Finance Act (1998), are (1) the “golden rule,” stating that over the economic cycle, the government should borrow only to invest and not to fund current spending; and (2) the “sustainable investment rule,” stating that the public sector’s net debt-to-GDP ratio be maintained at a prudent and stable level over the economic cycle (currently interpreted as under 40 percent of GDP).

7It should be noted that some FRLs currently in existence mandate certain provisions that are still to be fully implemented (e.g., anticyclical funds in Argentina; adjusting the primary balance by the cycle in Colombia).

8At the drafting stage of the budget, more hierarchical rules are those that give more power to the finance minister rather than the spending ministries; at the approval stage, they limit the power of the legislative body to modify the size of the budget; and at the execution stage they restrict the legislative body’s initiative to amend the budget once it has been approved.

9For instance, Wallack (2004) argues that more accurate and transparent public information is associated with faster fiscal reform. Inaccurate or missing economic statistics affect both the mean and the variance among policymakers’ assessments of the correct policy. Governments, responding to distorted perceptions of a situation, may implement the wrong policy even if driven by good intentions.
## Table 5.1. Summary of Characteristics of Fiscal Responsibility Laws (FRLs) in Selected Countries

<table>
<thead>
<tr>
<th>Country and Current Law</th>
<th>Original Laws</th>
<th>Procedural Rules</th>
<th>Numerical Rules&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Scope&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Sanctions&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Escape Clauses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia: Charter of Budget Honesty, 1998</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil: Fiscal Responsibility Law, 2000</td>
<td>Yes</td>
<td></td>
<td>E; D</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colombia: Organic Law on Fiscal Transparency and Responsibility, 2003</td>
<td>1997, 2000</td>
<td>Yes</td>
<td>PB; E; D</td>
<td>NFPS</td>
<td>P; I</td>
<td>No</td>
</tr>
<tr>
<td>Ecuador: Fiscal Responsibility Law, 2005</td>
<td>2002</td>
<td>Yes</td>
<td>NOB; D; E</td>
<td>PS</td>
<td>P; I</td>
<td>No</td>
</tr>
<tr>
<td>India: Fiscal Responsibility and Budget Management Act, 2003</td>
<td>Yes</td>
<td></td>
<td>CB (MY)</td>
<td>NG&lt;sup&gt;3&lt;/sup&gt;</td>
<td>R</td>
<td>National security or calamity; or such other exceptional grounds</td>
</tr>
<tr>
<td>New Zealand: Public Finance (State Sector Management) Bill, 2005</td>
<td>1994&lt;sup&gt;6&lt;/sup&gt;</td>
<td>Yes</td>
<td>OPB (MY)</td>
<td>GG</td>
<td>R</td>
<td>No</td>
</tr>
<tr>
<td>Pakistan: Fiscal Responsibility and Debt Limitation Act, 2005</td>
<td>Yes</td>
<td></td>
<td>CB; D (MY)</td>
<td>NG</td>
<td>R</td>
<td>National security or calamity; low levels of social spending</td>
</tr>
<tr>
<td>Panama: Law No. 2 on Economic Activity Promotion and Fiscal Responsibility, 2002</td>
<td>No&lt;sup&gt;7&lt;/sup&gt;</td>
<td></td>
<td>OB; D (MY)</td>
<td>NFPS</td>
<td>R</td>
<td>No</td>
</tr>
<tr>
<td>Peru: Fiscal Prudence and Transparency Law, 2003</td>
<td>1999</td>
<td>Yes</td>
<td>OB; E; D</td>
<td>NFPS</td>
<td>I</td>
<td>Several</td>
</tr>
<tr>
<td>Spain: Budget Stability Law, 2001</td>
<td>Yes</td>
<td></td>
<td>OB</td>
<td>NFPS</td>
<td>I</td>
<td>Exceptional circumstances</td>
</tr>
<tr>
<td>Sri Lanka: Fiscal Management Responsibility Act, 2003</td>
<td>Yes</td>
<td></td>
<td>OB; D (MY)</td>
<td>NG</td>
<td>R</td>
<td>Exceptional circumstances</td>
</tr>
<tr>
<td>United Kingdom: Code for Fiscal Stability, 1998</td>
<td>Yes</td>
<td></td>
<td>CB (MY)&lt;sup&gt;8&lt;/sup&gt;</td>
<td>GG</td>
<td>R</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: National fiscal responsibility laws; and various IMF staff studies. Based on information up to 2005.

<sup>1</sup> CB = current balance; D = debt; E = expenditures; NOB = non-oil balance; OB = overall balance; OPB = operating balance; and PB = primary balance. MY = rule set in a multiyear period.

<sup>2</sup> GG = general government; NFPS = nonfinancial public sector; NG = national government; and PS = public sector.

<sup>3</sup> I = institutional; P = personal; and R = reputational.

<sup>4</sup> Also adopted by 18 provinces (out of 23) and the city of Buenos Aires.

<sup>5</sup> Also adopted by 18 states (out of 29).


<sup>7</sup> The FRL states that the ministry of finance is accountable for implementing the provisions in the law.

<sup>8</sup> Numerical rule not specified in the FRL.
inconsistency; second, they can help address the expenditure bias, in particular in highly fragmented political systems and in highly decentralized countries; third, if targeting cyclically adjusted indicators, they may reduce the procyclicality of fiscal policy; fourth, they could serve as a useful market signal in countries vulnerable to contagion and sudden shifts in investor confidence; and, finally, they can help reduce borrowing costs and output variability.11

Potential disadvantages of numerical fiscal rules include lack of flexibility in fiscal policy and incentives to rely on low-quality measures to meet the targets. It has been suggested that numerical fiscal rules can limit the scope for countercyclical policies. Although this is a valid claim, this may not be a specific feature of countries that follow fiscal rules. Other factors beyond the direct control of the authorities may dictate the fiscal policy stance, because of limited financing availability, high borrowing costs, or other macroeconomic reasons (e.g., large current account imbalances and high inflation). However, numerical fiscal rules may contribute little to improving the quality of fiscal adjustment12 and could even foster the adoption of creative accounting and low-quality measures. Practices to circumvent numerical rules have included reclassifying expenditures from current to capital items to escape current balance budget rules; using off-budget public entities to perform government operations; using debt instruments not covered in debt limits; fiddling with cash-accrual adjustments to meet targets defined in accrual terms; accumulating arrears to suppliers to meet targets monitored on a cash basis; and reclassifying expenditure as acquisition of financial assets to circumvent rules based on net lending indicators.13

10 Rules-based fiscal policy is supposed to be effective in decentralized countries to the extent that it creates incentives to reduce profligacy at the subnational level caused by inadequate resource-sharing schemes and principal-agent problems. Theoretical models show that the success of these rules in large part depends on the degree of cooperation among government levels.

11 For instance, Fatás and Mihov (2003) argue that restrictions on fiscal policy can be justified on the grounds that discretionary changes in taxes and spending can lead to unnecessary volatility and lower economic growth.

12 For instance, despite important strengthening of fiscal performance in Brazil after the adoption of the FRL, the quality of fiscal adjustment has been fairly poor, also reflecting significant budgetary rigidities.

13 In Indonesia, the rule preventing domestic borrowing to finance the deficit was bypassed by relying on external financing and nontransparent operations such as creating contingent liabilities with off-budget entities. In Panama, the numerical fiscal rules did not specify whether they would be monitored on a cash or accrual basis, providing incentives to accumulate arrears to meet the targets. In Denmark and Hungary, local governments used sale-and-lease-back operations to circumvent borrowing restrictions (Pedersen, 2002). Also, von Hagen and Wolff (2004) provide empirical evidence of creative accounting in the European Union to meet rules under the Stability and Growth Pact.
Other Distinguishing Features of Fiscal Responsibility Laws

**Jurisdictional Scope**

The application of FRLs can be limited to the national government (e.g., Australia, Pakistan, and Sri Lanka) or can also include other levels of government and public enterprises (e.g., Brazil, Peru, and Spain). When subnational governments are included, provisions can be adopted either with a top-down or a bottom-up approach. In a top-down approach, FRLs are national laws that also apply to subnational levels of government. In a bottom-up approach, the national government passes an FRL only for itself, setting incentives for subnational governments to follow.\(^{14}\) Brazil, Colombia, and Peru are examples of a top-down approach, while India and Argentina have followed a bottom-up approach. The differences in the approach typically reflect varying federal institutional and constitutional settings.

**Sanctions**

Some FRLs contain well-defined sanctions for noncompliance; others rely only on reputation as a commitment device. There are two broad types of sanctions: (1) “institutional,” applying to the noncomplying jurisdiction (e.g., withholding of transfers, credit restrictions, and fines); and (2) “personal,” applying to the responsible official (e.g., fines, dismissal, and penal prosecution). For example, the FRL in Brazil specifies comprehensive institutional sanctions and is complemented by the Fiscal Crimes Law, which outlines stringent personal sanctions that can escalate up to penal prosecution. The FRLs in Colombia and Ecuador also contain both types of sanctions, while the FRLs in Peru and Argentina only rely on institutional sanctions.\(^{15}\) Spain’s FRL does not specify sanctions per se, but if the general government deficit were to exceed 3 percent of GDP, lead-

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\(^{14}\) Ter-Minassian and Craig (1997) argue that top-down control is necessary for subnational fiscal discipline in developing countries. More recently, Ter-Minassian, Albino-War, and Singh (2004) propose imposing fiscal rules for subnational governments, accompanied by a comprehensive definition of debt, reduction of state intervention in financial markets, introduction of common standards of financial reporting and budgeting, strong resistance to providing bailouts, tight control over external borrowing, and cooperation of all tiers of government in formulating fiscal adjustment programs under a clear leadership of the central government. Rodden and Eskeland (2003) see prospects for combining hierarchical control with market discipline, gradually letting the latter take on more importance.

\(^{15}\) A distinguishing feature of Argentina’s FRL is that the federal government retains discretion in the application of sanctions. Peru’s FRL does not contain personal sanctions but requires that officials comply with the FRL according to the rules and principles of the Law on Ethics of Public Service.
ing to the application of European Union (EU) sanctions, noncomplying jurisdictions would be required to contribute to the payment of fines in proportion to their contribution to the overall deficit. Other FRLs rely solely on reputational sanctions (e.g., India and Panama). While the FRLs in Australia and New Zealand do not specify sanctions either, they clearly define accountability of different actors engaged in fiscal policy.

**Escape Clauses**

FRLs typically include explicit escape clauses that limit or suspend their application during exceptional circumstances, such as natural disasters and severe recessions. Some FRLs contain multiple escape clauses that are vaguely defined and would allow suspending the law under a variety of circumstances. For example, the application of the FRLs of Spain and Sri Lanka can be suspended in exceptional circumstances. Similarly, in India, the FRL does not apply in the presence of a natural calamity, security emergency, or “such other exceptional grounds.” In most FRLs, escape clauses can only be evoked with approval from the legislature.

**Cyclical Considerations**

Some FRLs incorporate cyclical considerations. For example, the FRL in Peru established fiscal stabilization funds aiming to mitigate cyclical variations. Argentina’s law also envisages setting up anticyclical funds by all participating jurisdictions, but does not specify deadlines or requirements. In India and Sri Lanka, numerical targets are defined over multiyear horizons, leaving some wiggle room for setting annual fiscal targets. New Zealand’s FRL requires that operating balances be maintained “on average, over a reasonable period of time.” Australia’s FRL mandates that fiscal policy aim to moderate cyclical fluctuations, among other objectives. The escape clauses in FRLs of Brazil and Peru allow deviations from numerical rules during periods of low growth. The numerical rule in Panama’s FRL required more stringent fiscal savings during periods of high growth. Although not required in the FRL, two rules defined over the economic cycle have been followed in the United Kingdom since 1998.

**Review of Fiscal Responsibility Laws and Fiscal Outcomes in Selected Countries**

Empirical studies frequently suggest that the strength of fiscal institutions, broadly defined, does matter for fiscal performance. For the United States, several studies in the mid-1990s found a significant and positive
correlation between the existence of balanced-budget rules at the state level and the size of state budget deficits. Studies have also found a significant correlation between the strength of fiscal institutions and state borrowing costs. For OECD member countries, cross-section regressions suggest that tighter budget rules are associated with lower deficits and borrowing, particularly in budget processes focused on procedures as opposed to numerical targets. For central and eastern European countries, the strength of budget institutions was found to be correlated with fiscal performance. In particular, institutions granting strong powers to finance ministers and senior cabinet committees, and constraining the discretion of presidents and parliaments, were associated with more fiscal discipline. For Latin America, studies also seem to support the notion that laws or binding constraints on the permissible size of fiscal deficits, top-bottom voting procedures during the budget process, and budget transparency and control are associated with greater fiscal discipline. Recent research points to the importance of hierarchical and transparent budget procedures and the use of medium-term fiscal frameworks.

Still, while ascertaining correlations is straightforward, it is difficult to establish causality. The adoption of good budget institutions may simply reflect society’s consensus for prudent fiscal policy, leading to an endogeneity bias in empirical studies that try to relate fiscal outcomes to institutional factors. In addition, changes in budget institutions have often been accompanied by other fiscal institutional reforms that also affect fiscal policy, and it is difficult to disentangle the various different effects. For instance, in the case of the United States, Poterba and Reuben (1999) argue that estimates of the impact of balanced budget rules on fiscal outcomes turn insignificant when controlling for endogeneity: states in which voters support fiscal consolidation are more likely to adopt and enforce budget rules. Also

17See, for instance, Lowry and Alt (2001), Poterba and Rueben (1999), and Johnson and Kriz (2005).
20See, for instance, Alesina and others (1999); and Stein, Talvi, and Grisanti (1999).
21Filc and Scartascini (2004) conclude that the presence of fiscal rules and budget procedures affect fiscal outcomes. In particular, the existence of medium-term fiscal frameworks and rules that allow the executive to manage cash expenditures appear to explain significant differences in primary fiscal balances. Hameed (2005) concludes that countries with more transparent budget practices, particularly those related to fiscal risk disclosure and medium-term budget frameworks, have better fiscal discipline, better credit ratings, and less corruption.
for the case of the United States, de Figueiredo (2003) highlights that the choice of budgetary institutions is endogenous to the political process.

This is supported by recent research pointing to the problems in establishing clear links between FRLs and fiscal outcomes. Using a panel of both developed and developing countries, Manasse (2006) suggests that fiscal rules and FRLs tend to reduce the deficit bias on average, but that these frameworks do not exert independent effects once the quality of institutions is accounted for. Even when causality issues are not considered, Caceres and Corbacho (forthcoming) argue that traditional econometric approaches may provide misleading conclusions regarding the link between FRLs and fiscal outcomes. A key challenge is to establish the correct timing of the potential effect of FRLs. Using high frequency time series data for Australia, Brazil, Colombia, India, Peru, and the United Kingdom, Caceres and Corbacho (forthcoming) develop a methodology to estimate consistently the appropriate timing of structural breaks in fiscal outcomes (including in the level, trend, and volatility of fiscal balances). They conclude that it is difficult to establish a clear and strong link between FRLs and improvements in fiscal outcomes.

Despite these challenges, some common patterns emerge by reviewing fiscal performance, the content of FRLs, and issues faced in selected countries. Table 5.2 presents averages of key fiscal indicators in the five years prior to the adoption of the FRL, and in the years that followed (up to 2004). FRLs in Argentina, Colombia, and Peru have undergone substantial revisions since first introduced, and therefore the table also reports fiscal indicators for the intermediate period up to the most recent FRL. A more detailed account of events leading up to and following the adoption of the FRL in each country is presented in Appendix 2. The following patterns have been observed:

- In Australia, New Zealand, and the United Kingdom, fiscal performance, measured by the primary and overall balances and public debt, has been strong since the FRL was adopted, although the turnaround occurred already a few years prior to the FRL’s implementation, suggesting that the FRL was an outcome of a change in society’s preferences for tighter fiscal policies. A broadly similar conclusion also holds for Brazil, which had achieved significant fiscal adjustment prior to introducing its FRL in 2000. The FRLs in all these countries

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22This section does not draw conclusions on Pakistan’s case, since the FRL was approved in June 2005, after this study was completed. Appendixes 1 and 2 contain further details on the law.

23Still, during the 2002 crisis, Brazil’s net debt position increased sharply, but has continued its downward path since then, in light of continued high primary surpluses.
Table 5.2. Fiscal Performance Before and After the Fiscal Responsibility Law (FRL)\(^1\)
(In percent of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>Approval Date</th>
<th>Pre-FRL</th>
<th>Between FRLs</th>
<th>Post-FRL</th>
<th>Pre-FRL</th>
<th>Between FRLs</th>
<th>Post-FRL</th>
<th>Pre-FRL</th>
<th>Between FRLs</th>
<th>Post-FRL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina(^2)</td>
<td>1999, 2001, 2004</td>
<td>–0.3</td>
<td>1.6</td>
<td>...</td>
<td>–2.8</td>
<td>–7.0</td>
<td>...</td>
<td>41.0</td>
<td>111.0</td>
<td>...</td>
</tr>
<tr>
<td>Australia</td>
<td>1998</td>
<td>0.0</td>
<td>1.7</td>
<td></td>
<td>–2.0</td>
<td>0.9</td>
<td></td>
<td>22.0</td>
<td>6.0</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2000</td>
<td>1.1</td>
<td>4.1</td>
<td></td>
<td>–5.9</td>
<td>–4.0</td>
<td></td>
<td>43.0</td>
<td>58.4</td>
<td></td>
</tr>
<tr>
<td>Colombia(^3)</td>
<td>1997, 2000, 2003</td>
<td>0.8</td>
<td>0.0</td>
<td>2.6</td>
<td>–1.7</td>
<td>–4.2</td>
<td>–2.0</td>
<td>21.2</td>
<td>42.0</td>
<td>51.0</td>
</tr>
<tr>
<td>Ecuador(^4)</td>
<td>2002, 2005</td>
<td>3.8</td>
<td>4.8</td>
<td></td>
<td>–7.8</td>
<td>–4.8</td>
<td></td>
<td>73.9</td>
<td>46.8</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>2003</td>
<td>–3.7</td>
<td>–2.2</td>
<td></td>
<td>–9.6</td>
<td>–8.5</td>
<td></td>
<td>76.9</td>
<td>86.1</td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>1994, 2005</td>
<td>2.1</td>
<td>4.5</td>
<td></td>
<td>–2.5</td>
<td>1.9</td>
<td></td>
<td>47.5</td>
<td>21.3</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>2005</td>
<td>2.0</td>
<td>...</td>
<td></td>
<td>–2.8</td>
<td>...</td>
<td></td>
<td>76.6</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Panama</td>
<td>2002</td>
<td>2.2</td>
<td>–0.4</td>
<td></td>
<td>–1.7</td>
<td>–4.8</td>
<td></td>
<td>50.2</td>
<td>55.3</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>1999, 2003</td>
<td>0.9</td>
<td>–0.3</td>
<td>0.7</td>
<td>–1.6</td>
<td>–2.6</td>
<td>–1.4</td>
<td>47.0</td>
<td>46.5</td>
<td>46.3</td>
</tr>
<tr>
<td>Spain</td>
<td>2001</td>
<td>1.9</td>
<td>1.9</td>
<td></td>
<td>–1.2</td>
<td>–0.1</td>
<td></td>
<td>40.8</td>
<td>33.4</td>
<td></td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>2003</td>
<td>–2.6</td>
<td>–1.3</td>
<td></td>
<td>–8.8</td>
<td>–7.8</td>
<td></td>
<td>98.3</td>
<td>98.8</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1998</td>
<td>–3.3</td>
<td>0.9</td>
<td></td>
<td>–5.4</td>
<td>–0.6</td>
<td></td>
<td>36.5</td>
<td>36.2</td>
<td></td>
</tr>
</tbody>
</table>

Sources: IMF, World Economic Outlook, 2005; and IMF staff estimates.
1Pre-FRL corresponds to the average in the five years prior to the introduction of the FRL. Post-FRL corresponds to the average up to 2004. Coverage and definitions vary by country. The table should be used to assess within country trends rather than to carry out cross-country comparisons.
2Fiscal performance has improved since 2001 at both the national and subnational levels.
3Data on fiscal balances correspond to the nonfinancial public sector. Fiscal balances of subnational governments have improved since 2000. For public debt, pre-FRL reports the average in 1995–97 only. For the rest of the indicators, pre-FRL reports the average in 1993–97.
4The table reports the non-oil overall balance. Since the introduction of the FRL in 2002, Ecuador’s public finances have benefited from the upsurge in oil prices.
have a strong emphasis on procedural and transparency rules, apply to all relevant levels of government, and are supported by well-developed public expenditure management and accounting systems. Many critical reforms had occurred in advance of the adoption of the FRL. The experience in Spain is too recent to provide a full assessment, although fiscal indicators have shown an improvement since the adoption of the FRL in 2001, which came into force only in 2003. Still, the FRL was helpful in promoting a culture of fiscal stability, although clear problems remain at the subnational level. The government is attempting to address this issue in a new draft law currently before parliament.

• With the exception of Brazil, FRLs in Latin America have had a generally poor start. In Argentina, Colombia, and Peru, the FRLs were modified repeatedly since first adopted, with fiscal performance continuing to deteriorate up until the last FRL revision. Argentina’s first FRL, introduced in 1999, failed to provide a comprehensive framework for fiscal policy: subnational governments were not covered by the law, despite being responsible for a large share of the consolidated fiscal deficit. Fiscal outcomes in Argentina continued to worsen notwithstanding the FRL, and the law was modified in 2001 to allow for longer convergence periods to established numerical targets. The FRL became completely unenforceable shortly after the financial crisis. With numerical targets continuously breached since 1999, the law was modified again in 2004. The revised law also followed a bottom-up approach for subnational finances, but has already been adopted by 18 (out of 23) provinces and by the city of Buenos Aires. Fiscal performance has improved in the most recent period at all levels of government. In the case of Peru, the lack of sanctions in the first law of 1999 weakened credibility, particularly as the law was not complied with immediately following its adoption, and as several ambiguous escape clauses proved ineffective for implementing fiscal adjustment. The law was subsequently strengthened and fiscal performance improved in more recent years, although the numerical target on the real growth of nonfinancial expenditures was breached in 2003 and 2004. In Colombia, the early laws aimed to improve subnational finances but failed to control growing indebtedness of local governments. An FRL applicable to all levels of government was adopted in 2003, containing both procedural and numerical rules. Fiscal outcomes at the subnational level have improved recently, but imbalances at the central government level still remain. In Panama, the numerical target on the overall
deficit was missed by a large margin already in the first year of the FRL (2003), and the law was suspended afterward. In all of these countries, fiscal performance had continued to worsen in the years preceding the adoption of the law. The early FRLs failed to substitute for political commitment and society’s support for needed fiscal consolidation. Numerical targets were successively breached, undermining credibility in the fiscal framework established in the law. The experience in Ecuador is too recent to provide a complete assessment, although the government has already introduced modifications to the FRL approved in 2002.

- The FRLs in India and Sri Lanka have also not shown significant success so far. In both countries, fiscal balances improved the year after adopting the FRL, but debt continued to increase. Also, only a year after adopting their FRL, both countries postponed the requirement to meet the FRL’s numerical targets. Similarly, in both India and Sri Lanka, numerical targets apply only to the central government, and have provided an incentive to engage public enterprises in quasifiscal activities not covered by the FRL. Particularly in India, compliance with the targets by the central government may not bring about overall fiscal consolidation, as states continue to account for a large share of fiscal imbalances. Still, it is encouraging that many states have already adopted or are in the process of adopting fiscal responsibility legislation. Also, the FRLs have helped to increase transparency (not least by requiring that governments acknowledge fiscal policy was not on track to meet targets), but further efforts are still needed to conform with standards of good practice.

Fiscal Responsibility Laws: Some Lessons from Experience

Since, in most countries, FRLs have not been around for more than a few years, evidence on their effectiveness is still preliminary. Recent studies suggest that it remains difficult to establish a clear empirical link between FRLs and fiscal outcomes. Still, there seems to be broad agreement that the quality of fiscal institutions does matter for fiscal performance. In this

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24Recently, this has been a critical problem for the oil companies, in light of high international oil prices and the suspension of automatic price formulas, leading to substantial losses not captured in FRL indicators.
sense, a well-designed FRL holds the potential of improving fiscal management, if supported by strong political commitment to fiscal prudence and sufficiently developed fiscal institutional frameworks. The country experiences to date offer some early lessons for timing, implementation, and design of FRLs.

FRLs require broad political consensus to be successful and are not a substitute for political commitment. In countries where FRLs have had the most success (e.g., in Australia, Brazil, New Zealand, and the United Kingdom), fiscal performance already started to improve several years before the implementation of the law, suggesting that a fair amount of consensus for the need for fiscal prudence was already at play. In countries where fiscal outcomes had been deteriorating, suggesting a lack of a broad consensus for fiscal consolidation, a fundamental change in the direction of fiscal performance has yet to be seen.

Although FRLs can potentially serve as a catalyst for meaningful reforms promoting fiscal prudence, broad support for fiscal prudence seems a precondition for their success. Designing an FRL takes time—for instance, three years in India and two years in Brazil—and should be geared toward addressing country-specific weaknesses in fiscal management that lie at the root of poor fiscal outcomes. This will generally require improving fiscal transparency and fiscal management, providing the right incentives for the different actors involved in designing and implementing fiscal policy. These requirements may not be met in countries facing large macroeconomic imbalances or political instability, as they may be forced to rush into their initial fiscal consolidation efforts. While political consensus for fiscal prudence is a precondition for a successful FRL, its effective implementation is tested only when the consensus breaks down.

The fiscal institutional framework, in particular public financial management (PFM) systems, should be sufficiently developed to support FRLs. Weak preexisting institutions and poor implementation capacity may undermine the credibility of FRLs. In particular, countries with weak PFM systems and weak budget procedures are unlikely to be able to monitor and control effectively a fiscal target. PFM systems and budget procedures should be sufficiently well advanced to help implement the procedural and numerical rules embedded in FRLs in a credible and enforceable manner; where this is not the case, improving fiscal institutions should be a precondition for introducing an FRL. The experiences of Australia, Brazil, New Zealand, and the United Kingdom highlight the importance of a sufficiently well-developed PFM framework that paved the way for introducing even higher standards of transparency and accountability in an FRL in a credible manner. Countries that are already undergoing reforms to
improve PFM may want to focus efforts in this area, rather than on introducing new legislation like an FRL. If the fiscal institutional framework is not sufficiently well developed when an FRL is introduced, it may be advisable to establish a transitional period until the full application of all FRL requirements become binding. This would give time to improve budget formulation, execution, and reporting, and strengthen accounting and statistical standards.

Following good practices in transparency and accountability is critical for the success of FRLs. Clear and open budget formulation and execution procedures, an independent audit mechanism and institution, and transparent oversight are highly desirable. Also, transparency and medium-term fiscal frameworks can enhance the strength of fiscal rules by creating a policy environment that binds future governments to sound fiscal criteria. The monitoring by public bodies that are outside the budgetary process is useful for imposing hard budget constraints on the public sector as a whole, particularly if coupled with sanctions for noncompliance. Finally, clear accountability improves the law’s effectiveness and credibility. Countries that have not been successful in implementing their FRL have also, in general, failed to implement good practices in fiscal transparency.

FRLs should cover all relevant fiscal (and quasifiscal) operations of the public sector. The application of a consistent fiscal framework to all levels of government and to public entities and public enterprises that are engaged in significant fiscal activities\(^\text{25}\) limits the scope for shifting fiscal policy implementation “off budget.” Fiscal rules that target narrow fiscal indicators or aggregates run the risk of being overcome by moving expenditure to off-budget entities such as extrabudgetary funds, state enterprises, and/or to subnational governments. For instance, the limited coverage provided in the early FRLs in Argentina did not allow for effective control and oversight on subnational government operations not covered by the FRL, and led to the rapid accumulation of contingent liabilities for the national government. In India and Sri Lanka, incentives prevail to engage public corporations not covered by the FRL in quasifiscal activities.

In decentralized countries, FRLs cannot substitute for well-designed systems of intergovernmental fiscal relations. In countries with large vertical imbalances, reflecting mismatches between expenditure and revenue responsibilities, the introduction of an FRL is unlikely to lead to a more responsible fiscal behavior by subnational governments unless these imbalances are corrected. This is exemplified, for instance, by the early experi-

\(^{25}\text{IMF (2005) sets out revised criteria for assessing fiscal risk from public enterprise operations.}\)
ence of Colombia, where the institutional development lagged behind the relatively aggressive and large-scale decentralization, and subnational finances continued to deteriorate notwithstanding controls established in the early laws. Also, introducing hard budget constraints at the subnational government level can adversely affect the quality of public services if the mismatch between revenue and expenditure responsibilities persists. In cases where subnational governments have accumulated a large stock of debt, the success of an FRL can be increased by complementary fiscal adjustment or debt rescheduling programs with the national government, as suggested by the Brazilian experience. In countries where the national government does not have the constitutional authority to apply a single comprehensive FRL with top-down rules for all levels of government, the national-level law and practice must set a proper example and provide incentives for subnational governments to adopt prudent fiscal policies. In particular, the central government must credibly commit not to bail out subnational governments in difficulty, allowing market-based enforcement mechanisms to operate. High standards of transparency and accountability are also necessary for effective monitoring by citizens and for reputational sanctions to work.

Numerical fiscal rules in FRLs can undermine a fiscal consolidation effort if poorly designed, not adequately enforced, or easily reversed. Any stipulation contained in an FRL—numerical or procedural—needs to be monitorable and enforced systematically, which in many countries will require sanctions for noncompliance. In addition, however, a numerical fiscal rule that is to be included in an FRL should be (1) well defined regarding the specific fiscal indicator to be targeted, the institutional coverage, and the applicable escape clauses, if any; (2) simple and transparent, to serve as an effective instrument of communication of government policy objectives; and (3) monitorable, so that noncompliance can be easily detected and addressed. The adoption of “twin” indicators for numerical rules may reduce the scope for creative accounting, for instance by requiring compliance with both cash- and accrual-based fiscal deficit indicators, cash-based deficit and net borrowing requirements, and net borrowing and changes in the stock of debt. A clear link between numerical rules, accountability, and sanctions is necessary. Proper monitoring, in turn, requires sufficiently advanced PFM systems. Where these are not in place, focusing on procedural rules might be more beneficial.

Numerical deficit rules contained in FRLs may often either be inconsistent with the use of fiscal policy to stabilize output or lack transparency. Simple numerical rules tend to be procyclical and therefore amplify economic fluctuations. Possible improvements include defining the rule to
apply over the business cycle, or targeting a cyclically neutral balance. This, however, requires discretionary judgments, which complicate the rule and make it less easily accessible and transparent to the public. A complicated rule also creates more scope for creative accounting. Finally, in countries with poor economic statistics, cyclically adjusted indicators may be increasingly difficult to apply, owing to significant lags in access to key data (e.g., GDP) and large standard deviations from estimates and projections (e.g., on potential output). Some FRLs have incorporated escape clauses to limit the application of numerical rules during periods of low growth or in the presence of external shocks affecting key industries or commodity prices. The experience so far (e.g., in Peru’s early FRL) suggests that escape clauses should only apply in truly exceptional circumstances, be clearly defined, and require objective analysis and scrutiny to invoke their application to ensure that credibility in the FRL is not undermined.

Effective enforcement mechanisms are key in FRLs. Some countries, particularly industrial countries, have relied primarily on reputational sanctions for noncompliance, supported by high transparency and accountability standards. However, in countries with a long history of noncompliance with budget targets, reputational sanctions alone may be ineffective, and additional incentives may be necessary to promote fiscal discipline. These could include institutional sanctions for noncomplying jurisdictions, or personal sanctions for noncomplying public officials. To be credible, sanctions should be applied automatically when fiscal targets are missed and/or budget procedures are not followed, and the roles, functions, and accountability of different actors involved in fiscal policy design and implementation should be clearly and transparently defined. As stressed before, independent monitoring and oversight is necessary. Political interference and governance issues may easily undermine credibility in the enforcement mechanisms.

Finally, FRL provisions should, over time, be integrated with public finance legislation. More specifically, a case can be made for consolidating all or some of FRL provisions into umbrella budget or public finance laws, since FRLs are for the most part a response to shortcomings of such laws. For example, the FRL in Sri Lanka addressed several existing shortcomings, including the lack of codified rules for the formulation and execution of the budget. As noted in the introduction, some countries that do not have an FRL legislate typical FRL provisions, especially well-functioning procedural rules, in other pieces of legislation. For instance, frameworks in many European countries follow key FRL provisions, but without a formal FRL. Incorporating the procedural rules of an FRL into a budget or public finance law certainly would be a step in the direction of streamlining and
simplifying legislation, constituting good transparency practice. New Zealand has recently done this. In general, numerical rules, and particularly precise quantitative targets that may need revisions over time (e.g., in light of changing macroeconomic conditions), are best incorporated into medium-term budget frameworks and annual budget laws.

Concluding Remarks

FRLs potentially promise better fiscal management and policy outcomes by improving coordination and enforcement mechanisms, but they should not be considered as a magic bullet to improve fiscal performance. A well-designed FRL may help contain fiscal deficits and expenditure biases, address issues of time inconsistency, help reduce borrowing costs and output variability, and enhance transparency and accountability. However, in practice, it remains difficult to establish a clear empirical link between FRLs and fiscal outcomes. In countries where fiscal performance has remained strong, important reforms and political commitment to fiscal prudence have supported the effective implementation of FRLs. In other countries, FRLs have yet to show a substantial effect on fiscal performance. In particular, compliance with numerical fiscal rules has often been weak or achieved through low-quality policy measures or creative accounting, undermining other reform efforts that the FRL was to bring about. Also, the credibility of FRLs has been reduced in many countries by liberal escape clauses and noncredible sanction and enforcement mechanisms. Finally, weak fiscal institutional frameworks have limited effective monitoring. Lessons from experience highlight the need to cover all relevant fiscal (and quasifiscal) operations of the public sector, strengthen procedural and transparency rules, follow best practices in the design of numerical fiscal rules, and ensure that public expenditure management systems are sufficiently developed to monitor and enforce FRL requirements and sanctions. FRLs cannot buy credibility. Credibility ultimately depends on society’s consensus and support for prudent fiscal policy.
### Appendix 1. Summary of Fiscal Responsibility Laws in Selected Countries

<table>
<thead>
<tr>
<th>Country and Date</th>
<th>Procedural Rules and Transparency Requirements</th>
<th>Numerical Targets</th>
<th>Scope</th>
<th>Sanctions</th>
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<tbody>
<tr>
<td>Argentina: 1999, 2001, and 2004</td>
<td>Creates a Federal Council for Fiscal Responsibility. The federal government must present to the council before end-August the macrofiscal framework for the budget year, including targets and debt limits for each level of government, wage and tax policy, and revenue projections. Describes minimum reporting requirements for the budgets of all levels of government, which have to be published on the website, along with quarterly budget execution and debt reports. Extrabudgetary funds are prohibited. Budgetary expenditures are an authorized maximum, with their implementation subject to revenue performance. Privatization revenues can only be used for capital spending. Higher expenditures can only be approved if additional revenues become available and current spending cannot increase at the expense of a reduction in capital spending. Tax policy measures resulting in lower revenues must be compensated by other higher revenues or lower expenditures. Debt guarantees must be periodically updated and disclosed.</td>
<td>Primary expenditures cannot grow more than nominal GDP or at most stay constant in periods of negative nominal GDP growth. Capital spending and current spending financed by international financial institutions (IFIs) are not covered by the limits. Debt service cannot exceed 15 percent of net revenues for states and the city of Buenos Aires. The federal government market debt as a ratio to GDP must decline over a three-year horizon after debt restructuring. All jurisdictions are required to balance revenue and expenditure, excluding investment in basic social and economic infrastructure and IFI-financed spending.</td>
<td>NG</td>
<td>Publication of noncompliance indicators; restriction from voting in the Federal Council of Fiscal Responsibility; restrictions on granting tax benefits; limits on guarantees and new credit operations from the national government for subnational governments; limits on voluntary transfers from the national government. The federal government has some discretion in the application of sanctions.</td>
<td>Higher expenditures allowed under social and economic emergencies; as determined by law.</td>
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Fiscal policy must conform to principles of sound fiscal management. The budget economic and fiscal outlook report must be released with each budget, a mid-year outlook report must be released by the end of January in each year or within six months after the last budget, whichever is later, and a final report must be presented within three months of the end of each financial year. The government is required to present fiscal strategy statements and intergenerational reports. Special provisions apply when a general election is called. Requires setting short- and medium-term objectives and targets, consistent with sound fiscal management principles.
Appendix 1 (continued)

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<th>Country and Date</th>
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<tr>
<td>Brazil: 2000</td>
<td>The law sets detailed provisions on the formulation and implementation of the budget and regulates inter-governmental relations. The law also requires transparent fiscal reporting. The government has to present a brief account of budget execution every two months and report on budget management every four months, identifying remedial policies to achieve fiscal targets if needed.</td>
<td>The ratio of total personnel expenditures to net revenues cannot exceed 50 percent for the federal government, 60 percent for states, and 60 percent for municipalities. There are also limits by branch within each level of government. Permanent spending mandates cannot be created without a corresponding increase in permanent revenues or cuts in other permanent spending. The ratio of net public debt-to-net revenues cannot exceed 3½ for the federal government, 2 for states, and 1.2 for municipalities. States and municipalities have 15 years to comply with the targets. While exceeding the limits, the FRL establishes strict constraints to debt operations and financing (see sanctions). Drastic changes in monetary policy as specified by the senate allow longer terms to comply with debt limits.</td>
<td>PS</td>
<td>If wage expenditures reach 95 percent of the ceiling, wage increases, overtime, and new hiring (except in health, education, or social security) are suspended. If debt limits are not complied with, members of the federation are prohibited from receiving voluntary transfers, obtaining direct or indirect guarantees from other members, and contracting credit operations except aimed at refinancing securities debt and reducing personnel expenditures. Public officials can be sanctioned for noncompliance through dismissal, fines, and even jail, according to the Fiscal Crimes Law.</td>
<td>Low economic growth (negative or below 1 percent in the previous four quarters), national catastrophe, state of siege.</td>
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</table>
Colombia: 1997, 2000, and 2003

The government must present a medium-term fiscal framework before the budget, stating fiscal and macroeconomic objectives and explanations and deviations from previously set targets. A report on quasifiscal activities is required.

The ratio of primary surplus to interest rate payments has to be equal to or higher than 100 percent. The last law reinforces liquidity and solvency indicators introduced in earlier ones: a maximum 40 percent ratio of interest payment to operational savings. Primary current expenditures must be exclusively financed by nonearmarked current revenues and should not exceed a fixed percentage, depending on the state or municipality category. There are explicit limits on expenditures for state legislatures, local councils, and state and municipal comptroller offices, and caps on wages of legislators and comptroller officials. The primary surplus adjusted by the cycle cannot be lower than the structural primary surplus that stabilizes debt. The ratio of debt stock to current revenues should not exceed 80 percent.

NFPS

If one of the three rules is breached by a subnational entity, its debt level is classified as non-sustainable and any debt contraction must be approved by the ministry of finance. The subnational government has to present a medium-term macroeconomic framework including an adjustment program to seek eventual compliance with all three indicators. Official guarantees for debt refinancing purposes apply only to subnational governments undergoing adjustment programs and under a full set of requirements. In the event of failure to comply with the adjustment program, the subnational entity may be reclassified and merged with another. Personal sanctions for public officials also apply according to the Disciplinary Law.
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<tr>
<td>Ecuador: 2002 and 2005</td>
<td>The government must present a four-year plan with goals and strategies and report periodically on progress.</td>
<td>Yearly reduction in the non-oil deficit of the central government until a balanced position is achieved. At the subnational level, the ratio of debt service to total revenues cannot exceed 40 percent, and the ratio of total liabilities to total revenues should not exceed 100 percent. The real growth of central government current primary spending cannot exceed 3½ percent. There is an oil revenue stabilization fund financed with 20 percent of heavy crude oil revenues. Public debt must be reduced by at least 16 percentage points of GDP during a four-year period until it reaches 40 percent of GDP.</td>
<td>NFPS</td>
<td>The institution that fails to maintain updated information cannot access domestic or external credit. Failure to provide information within 15 days of the deadline imposed by the FRL will result in the suspension of the transfer of budget appropriations (in addition to other sanctions that may apply). In addition to the civil and criminal penalties that may derive from other laws, officials who violate provisions of the FRL are subject to varying administrative sanctions, depending on the official’s rank.</td>
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<td>India: 2003</td>
<td>The central government has to present before both houses the Medium-Term Fiscal Policy Statement, the Fiscal Policy Strategy Statement, the Macro-economic Framework Statement, as well as quarterly reports on fiscal development. The Medium-Term Fiscal Policy Statement must contain three-year rolling targets for key fiscal parameters that underpin the government’s fiscal correction trajectory.</td>
<td>The central government “revenue deficit” (essentially the current balance deficit) must be eliminated by March 2009 (originally by 2008). Beginning with fiscal year 2004–05, the annual reduction in the revenue deficit must be at least ½ percent of GDP and in the fiscal deficit at least 0.3 percent of GDP. The act caps the level of guarantees and total</td>
<td>NG</td>
<td>Reputational.</td>
<td>On the grounds of unforeseen demands on the budget due to national security emergencies or a national calamity.</td>
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liabilities that the government can assume each year and prohibits the government from borrowing from the Reserve Bank after April 2006.

New Zealand: The law sets principles of responsible fiscal management that must be adhered to in the formulation and implementation of fiscal policy. The government must also present in May–June a Fiscal Strategy Report assessing the consistency of the budget policy statement with long-term policy goals for the next three years and the fiscal strategy, as well as a budget strategy for the next three years at least three months before the start of each financial year. The government has to publish a budget policy statement with long-term objectives, strategy priorities, and fiscal goals for the next three years, as well as a budget statement with the economic outlook and 10-year and 3-year economic and fiscal update, as well as half-year and current-year updates.

Only temporary departures, with detailed reporting of reasons.
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<tr>
<td>Panama: 2002</td>
<td>Designates the ministry of finance as accountable for implementing the FRL provisions.</td>
<td>The nonfinancial public sector (NFPS) deficit cannot exceed 2 percent of GDP. The law also sets a portfolio of investments of the Fiduciary Fund and priority expenditures. Net public debt must be below 50 percent of GDP and net external debt below 35 percent of GDP. Targets should be reached within 15 years. A transitory regime applies until the targets are achieved: (1) if real GDP growth exceeds 1½ percent, total debt nominal growth cannot exceed 80 percent of nominal GDP growth or the 2 percent NFPS deficit rule applies, whichever delivers lower debt levels; and (2) if real GDP growth falls under 1½ percent, the 2 percent NFPS deficit rule applies.</td>
<td>NFPS</td>
<td>Reputational.</td>
<td></td>
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<tr>
<td>Pakistan: 2005</td>
<td>The law sets principles of sound fiscal and debt management aiming to eliminate the revenue deficit and reduce the debt burden. The federal government must present to the national assembly a medium-term budgetary statement, a fiscal policy</td>
<td>The “revenue deficit” (essentially the current balance deficit) must be eliminated by June 2008, maintaining a surplus thereafter. Total public debt must be reduced to 60 percent of GDP by 2013, keeping debt under that</td>
<td>NG</td>
<td>If the federal government fails to meet the debt reduction target, it must take all necessary measures to return to the debt reduction path, including the curtailment of sums authorized to be paid and applied</td>
<td>National security or natural calamity. Fiscal policy can deviate from the rules if social and poverty-related expenditures were to fall under 4.5 percent</td>
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statement, and a debt policy statement. The medium-term budgetary statement must be presented on July 1, contain three-year rolling fiscal estimates, and specify key fiscal measures and risks. The fiscal policy statement must be presented at end-January, and contain key fiscal indicators, an explanation on how they accord with the principles of sound fiscal management and the medium-term budget statement, strategic priorities, and key measures. The debt policy statement must be presented at end-January, explaining the success or failure in meeting debt targets, borrowing strategies and costs, analysis of foreign currency exchange exposure, and information on debt and guarantees. The statements must be accompanied by a statement of responsibility and be publicly available free of charge.

Each year debt must be reduced by no less than 2½ percent of GDP. New guarantees cannot exceed 2 percent of GDP from the Federal Consolidated Fund. Social and poverty reduction expenditures, and expenditures under Article 81 of the Constitution are protected from such cuts. Of GDP or education and health expenditures are not doubled in terms of GDP within 10 years.
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<th>Country and Date</th>
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<tr>
<td>Peru: 1999 and 2003</td>
<td>The government must prepare a Multiannual Macroeconomic Framework, containing three-year macroeconomic assumptions, and revenue, expenditure, public investment, and public debt projections. The Council of Ministers can modify the framework, but without increasing the deficit or nonfinancial expenditures. The final version must be submitted to Congress, with the Annual Budget Law, no later than August 30. Within 60 days of the end of a semester, the government has to publish a report reevaluating the framework.</td>
<td>The NFPS deficit cannot exceed 1 percent of GDP and real growth of nonfinancial expenditure of the general government cannot exceed 3 percent. During the first seven months of an election year, nonfinancial expenditure of the general government cannot exceed 60 percent of the annual amount and the fiscal deficit in the first semester of an election year cannot exceed 40 percent of the annual deficit. For subnational governments, the three-year average primary balance must be positive, the total debt service-to-current revenues ratio must be below 25 percent, and the total debt-to-current revenues ratio must be below 100 percent. Subnational governments need the central government’s guarantee to contract external debt, which must be allocated to finance infrastructure.</td>
<td>NFPS</td>
<td>In case of noncompliance, subnationals are restricted from access to intergovernmental funds. The National Decentralization Council can deny access for 90 days to conditional transfers to regions not complying with the fiscal rules during two consecutive years. The central government could intervene with a regional government that is placing in danger the nonfinancial public sector finances. There are no specific individual sanctions, but officials must comply with the FRL according to the rules and principles of the Law on Ethics of Public Service.</td>
<td>Three-year suspension in the application of the deficit ceiling, in case of negative economic growth (with a maximum deficit of 2½ percent of GDP), or national emergency or international crisis (with ceiling to be approved by congress).</td>
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<td>Spain: 2001</td>
<td>The law sets four basic principles to guide formulation and implementation of fiscal policy and a detailed budgetary process. The government must release aggregate budgetary documents.</td>
<td>All levels of government must have a balanced or in-surplus budget. In addition, fiscal targets are set for each level of government and imposes NFPS.</td>
<td>NFPS</td>
<td>In cases of noncompliance, the law requires the region in question to present a financial adjustment plan. This plan must be approved by the Fiscal and Rates and Accounting Committees.</td>
<td>Exceptional circumstances.</td>
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</table>
objectives and distribution for each subsector with medium-term projections in the first quarter of each year. Parliamentary debate and approval report on fulfillment must follow before September 1. If, due to exceptional circumstances, the budget is not balanced, a justification and three-year correction plan are required. The law sets the foundations for multiyear program budgeting and for performance budgeting.

limits on central government expenditure for a three-year period. Surpluses realized by the central government should be used to reduce debt. Surpluses realized by the social security system should be accumulated in the reserve fund.

Sri Lanka: 2003 The government must present to Parliament a statement containing four-year fiscal policy goals, short-term objectives, strategic priorities, and key fiscal measures (on the day of the second reading of the Appropriations Bill). A Mid-Year Fiscal Position Report is due at the end of June and a Final Budget Position Report is due five months after the end of the financial year.

Financial Policy Council. If the fiscal behavior of a region were to cause Spain to breach fiscal rules under European Economic and Monetary Union, that region would have to take care of sanctions by the European Union (EU), including contributing to paying EU fines. The Council establishes, by the first quarter of every year, the borrowing limits for each region for the following three years. In addition, there are restrictions on public debt, including for example, that long-term debt may be issued only to finance capital spending.
Appendix 1 (concluded)

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<tr>
<td>United Kingdom: 1998</td>
<td>The law sets principles of responsible fiscal management that must be adhered to in the formulation and implementation of fiscal policy. The government must publish (1) a Pre-Budget Report at least three months prior to the budget, including proposals for any significant changes in fiscal policy under consideration for introduction in the budget, economic and fiscal projections, and an analysis of the impact of the economic cycle on key fiscal aggregates; (2) a Financial Statement and Budget Report at the time of the budget, providing economic and fiscal projections, an explanation of key policy measures in the budget, and fiscal policy objectives and rules; and (3) an Economic and Fiscal Strategy Report, setting out the government’s long-term economic and fiscal strategy, including, among other requirements, long-term objectives of key fiscal aggregates and estimates of the cyclically adjusted position. The government must also report annually on the structure of its borrowing and the cost of government debt, providing sufficient information to allow the public to scrutinize the debt management policy.</td>
<td>Supported by numerical rules not contained in the FRL.</td>
<td>GG</td>
<td>Reputational.</td>
<td></td>
</tr>
</tbody>
</table>

Sources: National fiscal responsibility laws; and various IMF staff studies. Based on information up to 2005.

¹GG = general government; NFPS = nonfinancial public sector; NG = national government; and PS = public sector.
Appendix 2. Review of Country Experiences with Fiscal Responsibility Laws

This appendix describes individual country experiences with fiscal responsibility laws (FRLs), focusing primarily on the context and goals of the laws, their main content, and outcomes and events following their implementation up to 2005.

Argentina

Argentina first adopted an FRL in 1999 to help maintain confidence in the currency board arrangement in an environment of significant fiscal pressures and poor growth prospects.

The 1999 FRL was applicable to the national government and contained both procedural and numerical rules. It adopted a three-year budget framework, set ceilings for the central government fiscal deficit in 1999–2002, capped the real growth of expenditures, and required transparent fiscal reporting. The law also created a countercyclical fund to smooth fiscal policy over the business cycle. The FRL followed a bottom-up approach, inviting subnational governments to pass their own fiscal responsibility legislation. The law was modified in 2000 to provide for a longer period of convergence to fiscal balance (by 2005 instead of 2003 as in the original law). In July 2001, congress passed a law sanctioning the government’s “zero deficit” policy, which was meant to ensure the observance of the 2001 fiscal target in the FRL by mandating a zero balance during the second semester of the year.

However, the FRL failed to provide a comprehensive framework for fiscal policy. While some provinces followed the example of the national government and adopted fiscal responsibility legislation, the largest provinces and the city of Buenos Aires, accounting for over half of Argentina’s GDP, did not pass an FRL. Along with a mismatch between revenue assignments and expenditure responsibilities, this led to the accumulation of large liabilities for the central government and contributed to making the law less enforceable. The numerical rules established in the national FRL and in the subnational laws were never respected, and fiscal performance continued

1Webb (2004) argues that institutions aiming to constrain subnational debt and deficits only work if the governments in question start from or are brought to a position where they do not have a debt overhang. Otherwise, fiscal adjustment or debt rescheduling programs must complement or precede the implementation of an FRL. In the case of Brazil, debt rescheduling agreements and fiscal adjustment programs for subnational governments preceded the adoption of the FRL, which in turn institutionalized the enforcement, monitoring, and sanctions for noncompliance.
to deteriorate. By the end of 2001, Argentina faced the deepest crisis in its history and the FRL became completely nonoperational.

The law was modified again in 2004 (called the Federal Regime of Fiscal Responsibility). The revised law creates a Federal Council for Fiscal Responsibility, improves expenditure management practices, and fosters harmonization of fiscal statistics. The law establishes limits on expenditures and debt service and contains some sanctions for noncompliance. Most capital spending (and some current spending financed by international financial institutions), however, is not covered by the targets. The revised law also follows a bottom-up approach, creating a federal regime, inviting other levels of government to participate rather than directly imposing fiscal targets on subnational governments. The success of the revised FRL will clearly depend on the adherence by subnational governments, on the ability to constrain incentives for creative accounting (given the limited coverage of the numerical targets), on appropriate monitoring of fiscal data, and on the operation of the sanctions for noncompliance. By 2005, the law had been ratified by 18 provinces (out of 23) and the city of Buenos Aires, representing around 80 percent of the population and a similar share of total provincial spending.

Australia

Australia’s Charter of Budget Honesty (the Charter) was approved in 1998, with the goal of improving fiscal policy outcomes and maintaining ongoing economic prosperity. Fiscal outcomes had deteriorated in the early 1990s, but had already started to improve a few years before the introduction of the Charter. There was also growing concern about the fiscal implications of an aging population; the institutional framework was already advanced; and the budget process had traditionally worked well with a strong emphasis on transparency. Several states had also adopted fiscal responsibility legislation ahead of the Charter, which regulated the fiscal operations of the Commonwealth.

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2In contrast to Brazil’s FRL, Argentina’s FRL contains only institutional sanctions, which are loosely defined, and can be applied with certain discretion by the federal government.
3The law requires that provinces present balanced budgets according to a modified golden rule, but there is no explicit coordination mechanism to ensure that the sum of the provinces’ individual budgets be consistent with the consolidated overall and primary balances set forth by the federal government. Compliance with targets by subnational governments has been difficult to assess in light of less than adequate fiscal reporting.
4See Brooks (1997) for further details.
The Charter has a strong focus on transparency and does not include numerical fiscal targets. It provides a framework for the conduct of fiscal policy, by requiring that the fiscal strategy be based on principles of sound fiscal management and by facilitating public scrutiny of fiscal policy and performance. The principles of sound fiscal management were modeled in line with New Zealand’s FRL, but go further by requiring that fiscal policy contribute to national savings, moderate cyclical fluctuations, and take account of the financial impact on future generations. The Charter requires the government to set short- and medium-term fiscal objectives consistent with the established sound principles and specifies clearly the content and timing of government reports, including the government’s fiscal strategy statement, the budget economic and fiscal outlook report, the midyear budget report, and the final budget outcome report. The Charter also requires the preparation of intergenerational reports and preelection reports. While the Charter does not specify sanctions for noncompliance, the responsibilities of involved ministries are clearly set out.

Fiscal outcomes continued to improve after the adoption of the Charter. Initially, there was a concern that the limited coverage of the Charter, excluding state operations, would provide incentives for Australia to meet its fiscal objectives by cutting support to the states. However, the high standards of transparency applied to the reporting of fiscal operations of the central government under the Charter, and the continued publication of the National Fiscal Outlook (on consolidated operations) provided for checks on such behavior.

Brazil

The introduction of Brazil’s FRL in May 2000 was preceded by a long process of consensus building in society and among key political actors. The law aims to consolidate gains from fiscal adjustment efforts started earlier and following important improvements in the institutional framework. These included reforms of the public financial management system and legislation governing the fiscal relations between the federal and subnational governments. In particular, the FRL was preceded by the subnational debt restructuring program launched in 1997, involving the consolidation of domestic liabilities of subnational and federal governments. The debt restructuring arrangements have reinforced the fiscal rules enshrined in the FRL, and promoted transparency in subnational government finances. Embedded in the debt restructuring contracts are provisions for the reporting of subnational fiscal data based on a common methodology, facilitating...
the reporting of fiscal data by subnational governments and the monitoring of compliance of FRL requirements.

Brazil’s FRL puts strong emphasis on procedural and transparency rules, and also contains numerical ceilings on selected fiscal indicators. The FRL sets a framework for budgetary planning, execution, and reporting that is applicable to all levels of government. Its 75 articles constitute a “code of behavior” for better fiscal management. It is a complementary law, requiring a qualified (two-thirds) majority of congress to be modified. The law calls for a sustained structural adjustment of public finances and for constraining public indebtedness. The law also calls for transparent fiscal reporting and has detailed provisions on budget preparation and execution practices. It requires the preparation and dissemination of transparent fiscal reports; the presentation of a fiscal policy annex to the government’s multiyear plan with multiyear fiscal targets; and the presentation of a fiscal policy annex to the Annual Budget Guidelines Law with targets for the primary balance, projections for revenues, expenditures, nominal balances and public debt, and a description of fiscal risks with an assessment of contingent fiscal liabilities. The law includes numerical fiscal limits for selected fiscal indicators; corrective institutional mechanisms in the case of noncompliance; and institutional sanctions for noncompliance. It has few escape clauses that can only be invoked with congressional approval. Also, the FRL is supported by a Fiscal Crimes Law.

Fiscal performance in Brazil remained strong after adopting the FRL, although it had already started to improve before the implementation of the law. The consolidated primary balance improved from a deficit of 1 percent of GDP in 1997 to a surplus of over 4.5 percent of GDP in 2004. However, the overall deficit has been volatile, reflecting the still poor composition of debt, which is sensitive to interest rate shocks. In addition, several states and municipalities are still under a transitional period to comply with the numerical fiscal targets, and political pressures exist to weaken the interpretation of applicable sanctions. While the improvement in fiscal outcomes in Brazil cannot be attributed solely to the adoption of the FRL, the FRL has certainly contributed to sustaining fiscal prudence.

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6The more recent period of economic stability has allowed significant progress in reducing these vulnerabilities, and Brazil’s net debt, while still at about 55 percent of GDP in 2004, has been on a downward trend since end-2002. The government has also been able to improve on the composition of debt, particularly by reducing the share of domestic debt linked to the foreign exchange rate.
quality of fiscal adjustment, however, has been poor, relying on increasing an already high tax burden, while tilting the allocation of expenditures to current items at the expense of investment.

**Colombia**

Colombia’s early FRLs, applicable only to subnational governments, aimed to strengthen central government’s control over subnational debt, within a context of increasing political decentralization accompanied by greater freedom for subnational domestic borrowing.

The first law, the so-called traffic light law, was passed in 1997, and introduced a rating system for territorial governments based on debt indicators, banning borrowing for highly indebted local governments (red light) and requiring authorization from the ministry of finance for intermediate cases (yellow light). Local entities with poor ratings were required to implement fiscal stabilization plans. The law was not effective and many red light local governments were able to incur new debt, including by presenting defective financial information.\(^7\) Subnational debt still grew by 15 percent a year in 1998–2000. The 2000 law established a set of rules for subnational governments, limiting operating expenditures based on the entity’s freely disposable revenues, and also requiring fiscal adjustment plans in case of noncompliance with the laws, to be monitored by the ministry of finance.

An FRL applicable to all levels of government (the Organic Law on Fiscal Transparency and Responsibility) was passed in 2003, containing both procedural and numerical rules. For instance, the government is required to present a medium-term fiscal framework before the budget, stating fiscal and macroeconomic objectives and explanations of deviations from previously set targets. Quasifiscal activities must also be reported. On numerical rules, the law reinforces liquidity and solvency indicators established in previous legislation (e.g., ceilings on debt service, debt stock, and expenditures) and requires that fiscal management at all levels of government be consistent with a medium-term macroeconomic framework. Noncomplying entities continue to be required to implement fiscal adjustment plans. Colombia also fosters market enforcement mechanisms by applying bankruptcy procedures to municipalities (Law 550) and requiring main municipalities and departments to obtain credit ratings from private companies.

Local governments ran deficits through the 1990s, but posted a small surplus in 2001 and achieved a surplus of 1.3 percent of GDP in 2004.

\(^7\)See Webb (2004) and Adenauer (2005) for further details.
However, the deficit of the central government has remained large, fluctuating around 5 percent of GDP in recent years. There is still scope for further developing the institutional framework, which has lagged behind the relatively aggressive and large-scale decentralization, and to improve the accountability and reporting of subnational finances. A certain degree of fragmentation of different levels of government remains.\(^8\)

**Ecuador**

Ecuador’s FRL was passed in late 2002, with the main goals of establishing numerical rules limiting expenditure growth, dictating the saving of fiscal revenues from the new oil pipeline, and improving the transparency of the budget process. The fiscal position stabilized after the crisis of the late 1990s, with the non-oil fiscal deficit falling to about 5 percent of GDP in 2002, from nearly 11 percent in 1999. Despite this overall improvement, preannounced fiscal targets were not always attained.

The law is broadly applicable to the nonfinancial public sector,\(^9\) and contains both procedural and transparency requirements, as well as numerical fiscal rules. In particular, the law requires the reduction of the public debt to 40 percent of GDP, sets ceilings on the real growth of expenditures, and prescribes a decline in the non-oil deficit of at least 0.2 percent of GDP a year. Procedural rules include guidelines to develop multiyear budget plans to be presented to congress at the beginning of each administration, based on consistent macroeconomic assumptions, and disclosure rules for monitoring better the implementation of the budget. The law contains sanctions for noncompliance.

Several modifications to the law were introduced in mid-2005, changing the numerical rule on expenditure growth to apply only to current primary spending rather than to overall primary spending, and eliminating the provision requiring that most of the heavy crude oil export revenues flowing to the oil stabilization fund be used to reduce public debt. There were also other changes to the oil stabilization fund, with 20 percent of heavy crude oil allocated to the revenue stabilization fund and the remainder earmarked to social spending, economic reactivation, and other purposes.

The experience in Ecuador is too recent to provide a full assessment, but developments are not encouraging. The revision of rules after only a short period since the adoption of the law weakens its credibility. The limited coverage of the numerical rule on expenditures also raises

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\(^8\)Based on Adenauer (2005).

\(^9\)As noted in Appendix 1, different rules apply to different levels of government.
concerns regarding incentives for creative accounting. Also, since the numerical rules apply ex ante and not to the actual fiscal outturns, there is always room to adhere to the letter of the law while violating its spirit. So far, only the fiscal rule on public debt has been met consistently ex post, benefiting from the high oil revenues. In addition, after the 2005 revisions, a larger share of the oil export revenues is earmarked for several uses, including social spending and projects to “reactivate the economy,” aggravating existing budget rigidities. While the law may help reduce public indebtedness, long-standing weaknesses in expenditure management remain in need of attention.

India

Following over a decade of large fiscal deficits, and three years of discussion, India’s Fiscal Responsibility and Budget Management Act (FRBMA) was enacted in 2003. Its key goal is to restore and safeguard fiscal sustainability by setting a medium-term target to guide fiscal policy. The inherited institutional setup is strong and hierarchical, and the FRBMA strengthens this setup by incorporating numerical fiscal rules, improving transparency and monitoring requirements, and incorporating medium-term considerations in budget formulation.

India’s law is applicable to the national government only, but 18 (out of 29) states have also adopted FRLs that are in line with the national law. India’s FRBMA contains both procedural rules and numerical targets set in a multiyear period. It puts emphasis on transparency, requiring for instance that the government present before both houses a Medium-Term Fiscal Policy Statement, a Fiscal Policy Strategy Statement, a Macroeconomic Framework Statement, as well as quarterly reports on fiscal developments. Central to the law is the requirement that the central government eliminate its current deficit. The FRBMA originally set the deadline to March 2008, but it has now been postponed to 2009. The law also establishes caps on the level of guarantees and total liabilities, and prohibits borrowing by the government from the Reserve Bank after April 2006. Escape clauses are limited to national security emergencies or a national calamity.

10Zermeño (2003) argues that the law would help reduce the public debt to below 40 percent of GDP and would gradually eliminate the non-oil deficit.
11Of the 18 states, 6 adopted an FRL prior to the national FRL. By 2005, the remaining 11 states were in the process of establishing FRLs.
12In an attempt to ensure progress toward this target, the annual reduction in the current deficit is required to be at least ½ percent of GDP (and in the fiscal deficit at least 0.3 percent of GDP) starting in 2004–05.
India's FRBMA remains too recent to provide a full assessment. Still, some considerations can be offered. The law was adopted with a bottom-up approach. However, fiscal imbalances at the subnational level remain substantial, accounting for nearly half of the general government deficit. As noted in Hausmann and Purfield (2004), a sustained reduction in the overall debt burden in India will depend crucially on achieving fiscal consolidation at the subnational level. The large number of states that have already adopted an FRL or are in the process of adopting one is an encouraging development in this regard. Yet, consideration could be given to further strengthening the legal framework. For example, the FRBMA excludes state companies, which provides incentives to shift fiscal operations off the covered indicators. Monitoring these operations closely will be important to evaluate the fiscal position in a broad sense. In addition, by establishing targets on the current balance, the FRBMA increases the incentives for creative accounting. Finally, the law relies only on reputation sanctions for noncompliance, which may prove to be too weak to ensure enforcement, and does not guarantee consistency between FRBMA and the budget.

New Zealand

New Zealand’s FRL, the Fiscal Responsibility Act (FRA), was passed in June 1994 (with some marginal amendments in 1998), aiming to signal a policy change to address the country’s history of poor fiscal performance, reduce public debt, and improve fiscal management. The government also wanted to reassure debt holders that fiscal performance would change for the better in a long-lasting way and reduce uncertainty generated by the shift in the electoral system. The FRA was founded on two key elements: increased transparency and greater accountability. By the end of the 1980s, the institutional framework was fairly advanced: generally accepted

13After the automatic oil price formula was suspended in the light of high international oil prices, the quasifiscal losses of the state oil company, which are not covered by the law, have significantly increased. Therefore, while central government outcomes have complied with FRBMA targets, the consolidated position of the general government and state enterprises would not show a meaningful improvement.

14See Hausmann and Purfield (2004) for details and proposals to strengthen further India's fiscal framework.

15Gross public debt had risen from about 20 percent of GDP at the beginning of the 1980s to nearly 70 percent a decade later.

16The electoral system changed from “First Past the Post” to “Mixed Member Proportional” in 1995, following a referendum in 1993.
accounting practices were already being followed, and budget reporting was already implemented for a three-year period, allowing appropriate monitoring of the FRA requirements. In addition, the State Sector Act 1988 and the Public Finance Act 1989 paved the way for New Zealand’s output-oriented budget system.

New Zealand’s law focuses mainly on procedures. The FRA dictates that governments must follow a legislated set of principles of responsible fiscal management, announce their strategic priorities, state their short- and long-term fiscal objectives, and publicly assess fiscal policy against those principles. Governments may temporarily depart from the principles but must do so publicly, explain why they have departed, and reveal how and when they intend to conform to the principles. One of the advantages of New Zealand’s FRA is that it allows fiscal policy to be formulated in terms of its medium-term implications, although the authorities are still required to set short-term targets for a range of fiscal indicators. There is also strong support from established fiscal institutions, such as the Debt Management Office and the independent Reserve Bank. In addition, high accounting and statistical standards are key elements. The FRA does not include any sanctions for noncompliance, but accountability rules are very precise, establishing the responsibilities of the minister of finance and the secretary of the treasury.

In December 2004, the FRA was repealed and integrated into the Public Finance Amendment Act 2004, consolidating the legislation on public finances. The goal was to strengthen these fundamentally sound acts by improving the flexibility for the executive branch in managing public finances, while retaining and improving accountability mechanisms to par-

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17The government began producing its financial statements in compliance with Generally Accepted Accounting Practice (GAAP) in 1989. This system is accrual based but also reports on cash flows. Since 1994, the New Zealand Accounting Standards Review Board, a body independent of the government, is in charge of setting accounting standards under GAAP applying to both the public and private sectors.

18See Cangiano (1996) for a description of major reforms in public administration since the mid-1980s.

19The act requires that the government run annual operating surpluses until “prudent” levels of debt are achieved, and to maintain these levels by ensuring that “on average, over a reasonable period of time, the operating expenses do not exceed operating revenues.” The act further requires the government to create a “buffer” against adverse future events, ensuring that in critical cases the government has the ability to borrow without undue risk of moving into an unsustainable net worth position, and to recognize and reduce future risks in advance, where possible, through more cohesive fiscal management and stable tax policies.

20See New Zealand Treasury (1996) for further details.

liament. New reporting requirements, with the goal of enhancing transparency further, included for instance: (1) a statement on the long-term fiscal position, to ensure that issues such as the possible fiscal impact of demographic changes are reported periodically; and (2) an annual statement on new government tax decisions, to ensure that new tax expenditures are reported at the time of the budget. The lack of publication of tax expenditures had been identified as a shortcoming in New Zealand’s framework.

Fiscal outcomes improved markedly after the adoption of the FRA, although they had started to improve a few years before the enactment of the law. The fiscal balance has remained in surplus since 1994, reaching nearly 3 percent of GDP in 2003, and net debt declined to 12 percent of GDP, from over 50 percent a decade earlier.

Pakistan

Pakistan’s Fiscal Responsibility and Debt Delimitation Act (FRDD) was approved in June 2005, three years after the draft law was made publicly available, inviting public comment. The law aims to achieve the elimination of revenue deficits and a reduction of public debt to prudent levels by following principles of effective public debt management, while at the same time protecting social and poverty-reducing expenditures.

The FRDD contains both numerical and procedural rules that apply to the federal government. Numerical rules include (1) lowering public debt to 60 percent of GDP by 2013; (2) reducing public debt by at least 2 1/2 percent of GDP each year; (3) eliminating revenue (i.e., current) deficits by June 2008; and (4) limiting new guarantees to 2 percent of GDP. Fiscal rules can be suspended if social and poverty-reducing expenditures fall under 4 1/2 percent of GDP, or health and education spending fail to double in percent of GDP in a period of 10 years. Escape clauses also comprise national security emergencies or natural calamities, to be declared by the National Assembly. Procedural rules include the presentation and publication of an annual medium-term budgetary statement, a fiscal policy statement, and a debt policy statement, containing multiyear projections of key fiscal and macroeconomic indicators, a description of policies and objectives, analysis of risks, and an evaluation of compliance with fiscal targets. These statements must be accompanied by a statement of responsibility signed by both the minister of finance and the secretary of finance. If the federal government fails to meet the debt reduction target, it must take all necessary measures to return to the debt reduction path within two years, including the curtailment of sums authorized to be paid and applied from the Federal Consolidated Fund. These constraints cannot be applied to
social and poverty reduction expenditures, which are protected from such cuts, or to expenditures under Article 81 of the Constitution. The act also mandated the establishment of a debt policy coordination office.

Pakistan’s law is too recent to assess its implementation. Several of the principles in the law follow good practices of transparency. Still, existing shortcomings in fiscal management need attention. Some concerns in the design of the law include (1) the fact that intrayear reporting on fiscal outcomes is not required; (2) the arguably liberal nature of escape clauses, requiring large increases in social spending that can trigger the suspension of the rules and may not foster an efficient and appropriate targeting of such spending; and (3) the incomplete coverage of the law, excluding subnational governments (despite the expectation of increasing devolution in coming years) and public enterprises (e.g., power utilities in need of restructuring and continuing to represent significant liabilities for the federal budget).

Panama

Panama’s FRL (Law No. 2 on Measures on Economic Activity Promotion and Fiscal Responsibility) was approved in 2002, following several years of rising fiscal imbalances and a deceleration in economic activity. The worsening of the fiscal position reflected mainly negative cyclical factors that exacerbated existing negative structural trends in both tax revenue and the finances of the social security system. Problems with expenditure overruns also highlighted still weak expenditure control procedures.

Panama’s FRL focuses almost exclusively on numerical fiscal targets. It establishes limits on net public and external debt to be complied with within a period of 15 years, and on the annual nonfinancial public sector deficit. During the transition to achieving the debt target limits, the law requires faster debt reduction during periods of high growth.

Fiscal performance had been deteriorating in the years prior to the FRL and continued to do so afterward. The nonfinancial public sector deficit reached nearly 4 percent of GDP in 2003, the first full year of application of the FRL, almost double the numerical target established in the FRL. The FRL did not specify whether deficit targets were to be monitored on an accrual basis or on a cash basis, providing incentives to interpret the law in an opportunistic way and to accumulate arrears. The FRL also lacked procedural rules, monitoring systems, and enforcement mechanisms. Fiscal imbalances remained large during the first part of 2004, leading to the suspension of the FRL by the administration that took office in September, as compliance in the short run seemed out of reach. The government is considering sending an amended FRL to congress.
Peru

Peru’s Fiscal Prudence and Transparency Law was first approved in December 1999 and came into effect in 2000. The law was passed with the aim of establishing guidelines to improve public finance management and contribute to economic stability. Fiscal performance had improved up until the mid-1990s, with the overall balance of the nonfinancial public sector reaching a surplus in 1997. However, fiscal performance deteriorated in the years prior to adopting the FRL: the overall surplus achieved in 1997 had turned into a deficit of 3 percent of GDP by 1999, with public debt rising to nearly 50 percent of GDP.

The 1999 law contained both procedural and numerical rules. It envisaged the preparation of a multiannual macrofiscal framework and established numerical targets on the overall fiscal deficit and a cap on nominal expenditure growth. The FRL also created a fiscal stabilization fund to limit the procyclical fiscal stance. The original FRL established a ceiling on the nonfinancial public sector deficit of 1 percent of GDP. The lack of sanctions weakened credibility after noncompliance immediately following the adoption of the law, and several ambiguous escape clauses proved ineffective for the implementation of fiscal adjustment.

In 2003, the law was modified to include a gradual convergence to the deficit target by 2005, a ceiling of 3 percent in real expenditure growth, and sanctions on noncompliance by subnational governments (including reduced access to intergovernmental funds). The fiscal deficit was also required not to exceed 40 percent of the projected annual deficit during the first semester of an electoral year.

While fiscal performance improved in the most recent periods, the numerical target on the real growth of nonfinancial expenditures was breached in 2003 and in 2004. However, on current policies, the FRL numerical targets are expected to be achieved.

Spain

Spain’s Budgetary Stability Law (BSL) was approved in 2001 and entered into effect in 2003. It aimed to consolidate earlier gains from fiscal adjustment, which started in the mid-1990s, and place fiscal policy within a transparent and sound framework in a context of growing fiscal decentralization. Fiscal outcomes in Spain had deteriorated up until the mid-1990s, with debt climbing to nearly 50 percent of GDP. Since 1995, however, fiscal performance has improved, aided by several years of strong economic activity.

Spain’s BSL, applicable to the general government and some aspects of public enterprises, has a strong emphasis on procedural and transparency
rules, and also legislates numerical fiscal targets. The BSL replaced the earlier system of bilateral negotiations for the determination of deficit and debt ceilings of different regions, establishing a common target (budget balance or surplus) for all regions, and formalizing and regulating provisions for coordination between different levels of government attained before through domestic stability pacts. The BSL sets out four principles to guide the formulation and implementation of fiscal policy. These include (1) budgetary stability, (2) medium-term budget horizon, (3) transparency, and (4) efficiency. The BSL envisages a detailed budgetary process, requiring, among other things, a rolling three-year fiscal framework, consistent with budgetary balance or surplus at each level of government. Any region arguing for a deficit would need to present a detailed justification and a credible three-year fiscal adjustment program to bring the budget back to balance. Similar requirements are stipulated for municipalities. Surpluses realized by the central government should be used to reduce public debt, and surpluses realized by the social security system should be accumulated in the reserve fund of the system. The budgets must include a general contingency line item, equivalent to 2 percent of the annual spending ceiling, to meet unforeseen nondiscretionary spending during the execution of the budget. In the event that an (overall) deficit of over 3 percent of GDP were to be recorded, leading to the application of sanctions by the European Union, noncomplying jurisdictions would be required to contribute to the payment of fines in proportion to their contribution to the excessive deficit.

Fiscal outcomes remained strong after the introduction of the BSL. However, 11 out of the 17 regional governments ran a deficit in 2003, despite the requirement of balanced budget or surplus at the subnational government level. The consolidated regional deficit remained relatively contained in terms of national GDP, but the relatively widespread violation of the budget target in the first year of application of the law raised questions regarding the effectiveness of the framework in promoting fiscal discipline. The government is, therefore, reconsidering the present legal framework, aiming to increase ownership and observance by the regions, and to provide explicit room for countercyclical action.22

Sri Lanka

Sri Lanka adopted the Fiscal Management Responsibility Act (FMRA) in 2003, following a long history of fiscal imbalances leading to a crisis

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in 2001, when the central government debt-to-GDP ratio exceeded 100 percent. The FMRA addressed several existing shortcomings, including the lack of codified rules for the formulation and execution of the budget. The law aims to strengthen transparency requirements and places the budget within medium-term considerations.

As in India, Sri Lanka’s law sets numerical fiscal targets for the medium term applicable to a narrow coverage of the public sector—the central government. The law also sets caps on government guarantees. The FMRA originally required the central government overall deficit not to exceed 5 percent of GDP by 2006, but the government economic statement to parliament accompanying the 2005 budget already announced that targets would not be met before 2008.

Sri Lanka’s FMRA remains too recent to provide a full assessment, but the narrow coverage of the targets, and the rapid postponement of the scheduled reduction in fiscal deficits, diminishes the credibility of the law. There are significant quasifiscal activities by commercial public corporations, which are only partially monitored and have intensified in recent periods.23 In addition, Sri Lanka’s accounts only report operations on a cash basis. This increases incentives to move fiscal operations off the covered indicators, intensifying the reliance on quasifiscal activities, and to accumulate arrears to meet numerical fiscal targets measured on a cash basis. Also, the FMRA relies solely on reputation sanctions, which may prove ineffective, especially given the country’s long history of noncompliance with budget targets. Finally, the FMRA’s escape clause is loosely defined.

### United Kingdom

The U.K. Code for Fiscal Stability was approved in 1998, aiming to address weaknesses in the fiscal policy framework, which had been an important source of economic instability. As discussed in H.M. Treasury (1997), the sharp deterioration of the fiscal balance between the late 1980s and early 1990s highlighted the importance of keeping a prudent approach when making fiscal projections and of being open and transparent in the design, implementation, and monitoring of fiscal rules. The design of the code was motivated by three key considerations: (1) a stable economic environment is vital for prosperous growth and employment; (2) the con-

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23This has been particularly true for the Ceylon Petroleum Corporation and the Ceylon Electricity Board, which have been operating under administered prices for oil and electricity, respectively. See IMF (2002) for further details, including on other identified weakness in complying with the Fiscal Transparency Code.
duct of fiscal policy critically influences economic stability; and (3) the preceding fiscal framework was inadequate to deliver a stable economic environment.

The U.K. code specifies principles of fiscal management and transparency standards. The code requires the government to set out its fiscal policy objectives and the fiscal strategy it intends to implement over the life of the parliament. The government's fiscal policy and strategy must follow five principles of fiscal management set out in the code, including transparency, stability, responsibility, fairness, and efficiency. The government is also required to report on a regular basis on progress towards meeting its fiscal goals, so that Parliament and the public at large can monitor and scrutinize the government’s fiscal plans. Although the code does not oblige the government to use specific fiscal rules, two have been adopted since 1998: (1) the “golden rule,” stating that over the economic cycle, the government should borrow only to invest and not to fund current spending; and (2) the “sustainable investment rule,” stating that the public sector net debt-to-GDP ratio be maintained at a prudent and stable level over the economic cycle (currently interpreted as under 40 percent of GDP). These rules aim to correct a possible anti-investment spending bias and to ensure fairness across generations. The fiscal framework is also supported by a regime for planning and controlling spending, requiring that three-year plans be set for all the main government departments through departmental expenditure limits.24 The government must ensure that accounts be produced for the whole public sector and adopt a resource accounting and budgeting approach for planning and accounting based on Generally Accepted Accounting Practice. The code does not specify sanctions for noncompliance, but sets clear accountability. The Treasury must invite the National Audit Office to audit any changes to the key assumptions and conventions underlying the fiscal projections. The Comptroller and Auditor General must ensure that any advice is communicated to the Treasury and laid before Parliament.

The implementation of the principles set out in the code are considered to have been successful in promoting fiscal discipline. Rules were able to offset political pressures toward higher deficit levels and improve the credibility of government’s commitments, while transparency allowed scope for flexibility in the conduct of fiscal policy.25 For instance, Emmerson, Frayne,

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25Compliance with the golden rule will be critically assessed at the end of the economic cycle, which the H.M. Treasury estimates will span from 1999/2000 to 2005/2006. Koeva (2005) reports that the safety margin for meeting the rule has shrunk and the risk of breaching it has become nontrivial.
and Love (2004) conclude that the code has raised standards, particularly with respect to the disclosure of information, without causing a deterioration in those areas in which the government’s current practice exceeds the code’s minimum requirement. They highlight, however, that the code could be strengthened further, particularly in the area of responsibility. In particular, they suggest more emphasis should be put on accurate forecasts (rather than cautious forecasts), complemented by a discussion of the errors and uncertainty surrounding fiscal aggregates. This would allow the government to move from a rigid hit-or-miss interpretation of its fiscal rules to a softer interpretation based on probabilities without a loss of credibility. This in turn may allow for greater tax and spending smoothing. A similar proposal is put forward in Koeva (2005).

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