CHAPTER 10

# Recent Experiences with Fiscal Responsibility Frameworks

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## INTRODUCTION

Policy efforts to strengthen fiscal prudence, gain credibility, and ensure fiscal sustainability have long been priorities for policymakers in CAPDR countries. Some countries in the region have introduced fiscal responsibility frameworks to meet these objectives, while others are considering similar legal structures. Taking stock of the main characteristics and results so far, both in CAPDR and in other emerging market economies, reveals key challenges for countries considering embarking on the journey to fiscal responsibility.

Fiscal responsibility laws are a special type of budget system legislation.[1] They focus on three guiding principles: accountability, transparency, and stability (Lienert 2010). They cover the executive power's accountability to the legislature on fiscal policy performance and regulations to meet public desire for transparency about government fiscal responsibility and the need to ensure that annual budgets are aligned with this goal. The laws require disclosure of a country's main fiscal targets. Usually, though not necessarily, such a legal act involves setting numerical rules. The common thread in all these attributes is that they can support economic growth.

The general record of laws governing fiscal responsibility in emerging market economies is instructive for policymakers, as is a focus on specific details about CAPDR's experience with fiscal frameworks, including their rationale, key features, and the conditions that ideally should be in place for their introduction. These aspects of fiscal responsibility frameworks and laws will be examined. Hence, with a view to highlighting the particular characteristics and institutions of CAPDR economies necessary for effective fiscal responsibility frameworks, the chapter begins with a scene-setting description of their various forms and functions.

[1]Following Lienert and Fainboim (2010), this chapter understands budget system law as any law defining elements of the national budget system. Some examples are organic budget laws, public debt laws, budget equilibrium laws, and public financial administration managing laws, among others.

## DEFINITIONS AND CHARACTERISTICS

Van Eden and others (2013) define three types of fiscal responsibility laws: (1) regulating only principles without including specific restrictions or rules, (2) focusing on procedural rules, which often include medium-term fiscal frameworks, and (3) laws imposing restrictions on fiscal policy guided by achieving fiscal sustainability, usually using numerical rules. The first type is common in advanced economies with strong fiscal institutions and sound records of fiscal policy, such as the UK and New Zealand. Examples of the second type are Brazil and Colombia (until 2011), while Chile, Honduras, and Peru exemplify the third type.

Often fiscal responsibility laws are part of a comprehensive fiscal framework, including a medium-term macro-fiscal framework and some form of stabilization mechanism (usually a stabilization fund). In more advanced economies, the macro-fiscal is complemented by frameworks to make expenditure and the management of public investments explicit. For practical considerations, this chapter focuses on laws that codify numerical fiscal rules. These impose restrictions on one or more of the following fiscal variables: deficit, debt, borrowing, or spending. In this context, a fiscal rule is defined as "a permanent constraint on fiscal policy" (Kopits and Simansky 1998).

Fiscal responsibility laws have become increasingly popular, particularly in emerging economies. Since the seminal introduction of New Zealand's Fiscal Responsibility Act in 1994, use of the laws has increased steadily. By November 2017, 30 countries, mostly emerging market economies, had adopted fiscal responsibility legislation (Annex 10.1).[2] Two regions—Latin America and eastern Europe—account for about 60 percent of them. Among emerging market economies, Peru was the first to introduce a fiscal responsibility law in 1999. The laws gained popularity after the global financial crisis of 2008. Overall, 16 new sets have been adopted in emerging markets economies since 2010.

In most cases, the laws were introduced to limit the deficit bias (the historical tendency to generate fiscal deficits), gain credibility, and improve poor fiscal records. Currently, 26 have one or more numerical fiscal rules, which generally are aimed at limiting the deficit bias. Among these, rules based on observed variables are more common (18 cases) compared with rules based on structural variables (eight cases).[3]

Fiscal responsibility laws often include provisions to create budgetary procedures and institutions. The most common is the obligation to include a fiscal policy paper in the annual budget bundle. In most cases, the paper introduces a medium-term view, with specific targets for the budget under preparation and

[2]Not including three cases where fiscal responsibility laws were enacted, but are currently repealed (Argentina, India, and Hungary).

[3]Structural estimations seek to separate permanent and temporary components of fiscal variables. The latter are usually related to short-term cyclical movements, one-off operations, and so on. See Bornhorst and others (2011) for details.

indicative targets for subsequent years. In some countries, the tax expenditure and contingent liabilities are disclosed. Other common institutions are fiscal stabilization funds (eight cases), pension reserve funds (Chile), or contingency funds (Mexico). Some countries have introduced fiscal councils, while others are considering them.[4] Just a few countries include formal sanctions, with Brazil being the only case with envisaged criminal persecution. In countries where the streamlining of tax exemptions is a critical challenge, the laws incorporate provisions to handle them.[5]

## BASIC PRECONDITIONS FOR IMPLEMENTING A FISCAL RESPONSIBILITY LAW

Countries considering the introduction of fiscal responsibility legislation should ideally meet some minimum preconditions for the economic/political environment, public financial management, and institutional framework. Focusing on CAPDR, critical areas are likely to include:[6]

- *A stable macroeconomic environment.* When the economy is in a downturn it is difficult to introduce adjustment measures. Nevertheless, where a fiscal responsibility law is enacted, there is high risk that the targets will be missed, with devastating effects for the credibility of the new law. That said, in some cases, the law can be used to demonstrate firm commitment to prudent fiscal policies in a fiscal crisis scenario (Peru and Honduras).
- *Sound public financial management.* The basic components are a Medium-Term Fiscal Framework (MTFF), a clear and credible budget formulation (including adequate supervision from the legislature), clear and enforceable budget execution procedures, transparent and credible reporting, and a strong and independent auditing process (Van Eden and others 2013).
- *Good monitoring, accounting, and reporting systems.* An adequate information system is especially important when the fiscal responsibility law involves rules. A regular monitoring of the fiscal targets would not be possible without comprehensive budget information. Weak reporting reduces the credibility of fiscal outturn projections, and constant revisions undermine the value of the law. An integrated financial management system is usually a good starting point to strengthen reporting. However, a quality system can only be guaranteed if enforceable regulations exist for all spending units and if the system covers a meaningful range of fiscal operations. That does not

[4]Fiscal councils are independent bodies that oversee the fulfillment of fiscal rules.

[5]That is the case of Honduras, which has one of the largest amounts of tax exemptions in the region (7 percent of GDP). See IMF (2017b).

[6]This section draws on Kapsoli (2017). For a more detailed discussion see Ter-Minassian (2010) or Van Eden and others (2013).

happen in countries with a large number of extra-budgetary operations. Commonly in the CAPDR region, these operations involve the use of special funds (Allen and Radev 2010).

- *A transparent and publicly available reporting system.* In best-practice countries, the integrated financial management system is available through the finance ministry website. Some countries even have transparency laws stating the obligation to disclose all information related to the budget. This is a powerful accountability mechanism as it allows independent researchers and other stakeholders to verify and analyze the fiscal data. Also, such practices prevent attempts to rely on creative accounting when reporting the fulfilment of the laws' targets.
- *An MTFF in place.* Implementation of an MTFF requires that finance ministry staff have the technical skills to prepare a medium-term policy scenario and an annual budget consistent with it. These skills would also be critical to determine meaningful legal parameters.[7] Implementing the medium-term framework involves the preparation and dissemination of a fiscal policy paper for stakeholders, such as academia, think tanks, international organizations, and others to discuss the law's proposed fiscal parameters.
- *Strong institutions.* In countries with weak rule of law, whether there is a fiscal responsibility law or not makes no difference. In some cases, the law is enacted but officials do not commit and legal provisions that ensure compliance cannot be enforced. A clear discussion on how much discretion the authorities are willing to concede then becomes essential to help choose the more feasible rule. Deficit or spending rules have an immediate impact on fiscal policy, while debt rules, when not accompanied by other types of rules, could entail more discretion (depending on how far the initial debt stock is from the target).

## LESSONS FROM INTERNATIONAL EXPERIENCES

Experiences over the past decade with the implementation of laws on fiscal responsibility across the world provide useful insights, but also point to potential pitfalls and key challenges for countries thinking about upgrading their fiscal frameworks. Some of these lessons have general application, while others may be relevant for specific country groups, such as the CAPDR region.

- *Fiscal responsibility laws should not be considered a substitute for prudent fiscal policy*. Laws cannot magically create institutions where absent, nor can they create accountability in countries with a tradition of weak rule of law. Econometric evidence shows that the link between their introduction and improvements in fiscal outcomes is weak (Cáceres, Corbacho, and Medina 2010). Alternatively, countries can have sound fiscal policies without a fiscal

[7]If the fiscal responsibility law is based on structural rules, additional technical skills are required.

responsibility law, or introduce one after a period of sound economic policies (Chile).

- *Fiscal responsibility laws can be used to "signal" a trend for fiscal policy.* If a country does not meet the preconditions described above, it can still benefit from the introduction of laws to govern fiscal responsibility. The literature suggests that a fiscal responsibility law could contribute to the development of fiscal institutions by promoting political consensus on prudent fiscal policies. This literature emphasizes the role of accountability to discourage the violation of rules by politicians (for example, Debrun and Kumar 2007).
- *Preconditions need to be assessed carefully before fiscal responsibility laws are introduced*. Special attention should be given to public financial management conditions, which are indispensable for implementation. Without a comprehensive and transparent information system, it would be impossible to monitor targets. Also, fiscal outturns can be misreported where information is incomplete. Where the information system is not transparent, outturns cannot be credible, which creates suspicion of manipulation or creative accounting. A comprehensive MTFF is also critical as targets in the law are usually dependent on fiscal sustainability parameters or other medium-term fiscal targets commonly stated in the fiscal policy papers that accompany MTFFs.
- *Gradual implementation is advisable*. The regional experience shows that fiscal responsibility laws have been introduced at times of weak fiscal positions, amid concerns that fiscal sustainability cannot be achieved. Under these circumstances, it is critical to preserve the credibility of the law by not targeting onerous short-term fiscal objectives. The new institutional framework embedded in the laws also requires time to mature. Budget operators in line ministries need to learn a new rationale for budget preparation, while civil society needs time to understand the implications of the new framework, the way to evaluate it, and the procedures for making policymakers accountable.
- *Structural components should be avoided at the initial stage*. Although theoretically attractive, structural targets are easy to manipulate because they involve several ad hoc adjustments, and econometric estimations that require specialized technical skills and would not be easy to discuss with legislators and stakeholders. Discussions could be jammed in methodological details instead of focusing on the targets and their implications for fiscal sustainability.
- *Appropriate escape clauses should be included*. For instance, escape clauses are needed for cases that require a countercyclical fiscal response. When introduced in line with best practices, such provisions would avoid the scenario where the law is violated or there is pressure to change it because the limits become unattainable due to a natural disaster, significant recession, or other emergencies. Box 10.1 summarizes the common structure of fiscal responsibility laws in emerging economies and low-income countries.

**Box 10.1. Common Contents of a Fiscal Responsibility Law in Developing Economies**

1. **Scope, coverage, and objectives**
   a. Coverage of the law (central government, general government, NFPS, and so on).
   b. Main principles (such as long-term sustainability, short-term budget balance).
2. **Rules**
   a. Rules limiting one or more of the following fiscal aggregates: overall balance, debt, and spending. Some countries have limits to other variables, such as primary balance, current balance "golden rule".
   b. If structural targets are involved, the methodology to estimate them should be clear and transparent.
3. **Fiscal policy paper**
   a. The fiscal policy paper is a critical part of the medium-term macro-fiscal framework, which should be part of the annual budget bundle.
   b. Contents of the paper. For example: how many years will be included in the projection horizon; which ones will be binding and which ones indicative. In best-practice countries, the policy paper also include debt sustainability analysis (including contingencies). In some countries, it also includes the disclosure of the amount of tax exemptions, PPP guarantees, and the like.
4. **Transparency and accountability**
   a. Provisions for regular reviews of the projections using public reports.
   b. Statement that, in cases of significant slippage, the report should contain corrective measures.
5. **Escape clauses**
   a. Clear rules for using escape clauses, including whether they require authorization from the legislature.
   b. Indication of a path to return to the law's limits after the use of escape clauses.
6. **Sanctions**
   a. Include administrative sanctions.
7. **Other provisions**
   a. A stabilization fund with a clear rule for the use of its resources. Some countries also have contingency funds or pension reserve funds (useful in cases where private pension funds have public guarantees).

## RATIONALE AND PRECONDITIONS FOR ADOPTING FISCAL RULES IN CAPDR

Several economic similarities are relevant for the design of fiscal rules in CAPDR countries. Their economies are small. They experience frequent shocks because of limited size, susceptibility to natural disaster, and exposure to volatile commodity prices. Their economic structures are similar: net petroleum importers with significant dependence on agricultural exports and remittances (except for Costa Rica and Panama) and, like other Latin American countries, high informality and wide inequality. Partly reflecting the prevalence of the informal sector, the quality of their data and economic institutions is generally poorer than in advanced economies and other emerging markets. These similarities highlight the scope for comparison: good proposals and examples in any CAPDR country could be powerful beacons for others.

The case for legislating fiscal rules in CAPDR should be carefully weighed. Many of the common features—particularly susceptibility to shocks and their under-resourced institutions—may prompt caution over a premature adoption of fiscal rules. The risk is that fiscal rules could quickly lose credibility or even become counter-productive if poorly managed. At the same time, the risks of adopting fiscal rules should be set against their benefits in substantially upgrading fiscal discipline and fiscal policy frameworks—especially since these can improve both fiscal positions and economic growth. Policymakers in each country would have to internalize these tradeoffs, and account for the political and societal issues involved. Many of these risks can be handled through properly designed fiscal rules, including having transition phases toward full implementation.

The main rationale for introducing fiscal responsibility laws in CAPDR countries appears to be fiscal sustainability. Three economic objectives are typically behind the introduction of fiscal rules (IMF 2009): (1) achieving fiscal sustainability, (2) reducing procyclicality, and (3) optimizing government size. In CAPDR, discussions of fiscal rules were primarily motivated by fiscal sustainability. It was the key rationale in early debates about fiscal rules in Panama, El Salvador, Honduras, and Costa Rica.[8] Issues of cyclicality and government size were less relevant, although they gained importance over time (for example, in Panama). Some CAPDR countries appear to have mitigated the problems of economic procyclicality that used to characterize much of Latin America (Klemm 2014). Costa Rica and El Salvador were judged to have shifted to countercyclical policies, while no major concerns were raised in other CAPDR countries.[9] On the size of government, there is no clear-cut rationale for most CAPDR countries to reduce (or increase) the state's role in the economy.[10]

"Political procyclicality" has been a contributing factor to the fiscal sustainability problems of CAPDR countries. Comparing fiscal performance suggests that in years with elections, deficits and spending tended to be higher as a percent of GDP than in other years (Figure 10.1). In turn, this added an upward drift to public debt, other things equal.[11] This problem affects all Latin American countries, but is more pronounced in CAPDR countries. Fiscal rules are considered potentially beneficial in mitigating this political procyclicality bias. In this context, the larger LA countries had fiscal rules in place for the bulk of 2000–14) and

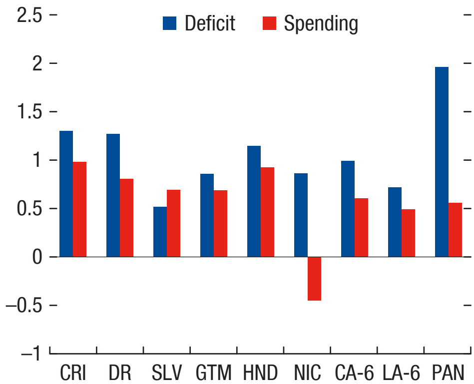
[8]While the main perceived fiscal risks in Panama and El Salvador were high public debt ratios (over 60 percent of GDP in both when the fiscal rules were adopted), in Honduras and Costa Rica it was high fiscal deficits that prompted sustainability concerns and the discussion of the fiscal rules to mitigate them.

[9]The assessment of cyclicality in Klemm (2014) is based on a purely technical analysis of fiscal policy outcomes that may not necessarily be confirmed through more detailed assessment of underlying policy drivers. For example, some CAPDR country authorities viewed their own fiscal policies as countercyclical by chance rather than by design.

[10]The country that truly stands out in this regard is Guatemala, which has very low public revenue and spending ratios, but where the issue of fiscal rules was relatively little debated.

[11]A similar picture emerges if, instead of the headline fiscal outcomes, balances adjusted for the economic cycle are used.

**Figure 10.1. Fiscal Outcome Differences in Election versus Non-election Years, 2000–14**
*(Percent of GDP)*



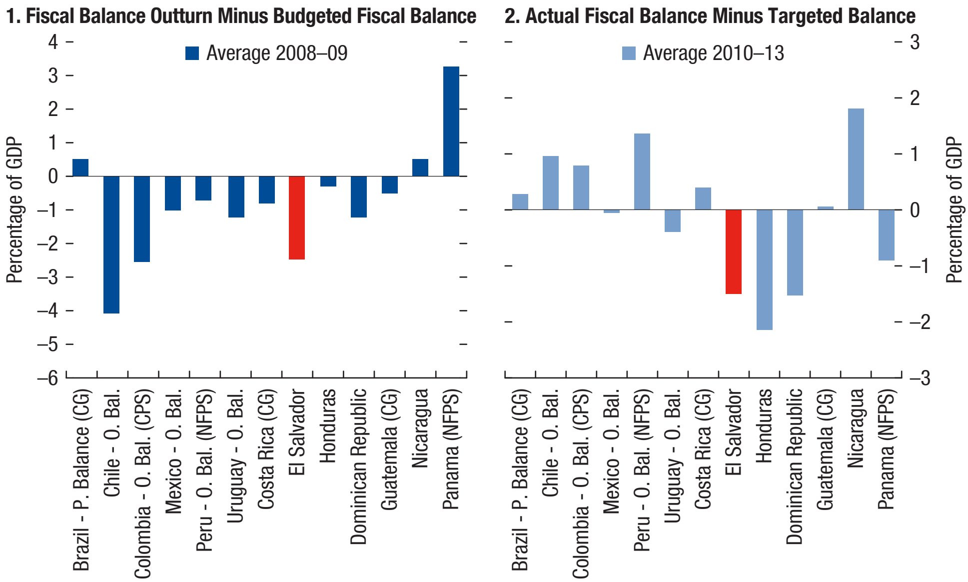

Source: IMF staff estimates.
Note: CA-6 = the 6 countries of Central America; LA-6 = Latin America 6: Brazil, Chile, Colombia, Mexico, Peru, and Uruguay; CRI = Costa Rica; DR = Dominican Republic; GTM = Guatemala; HND = Honduras; NIC = Nicaragua; PAN = Panama; SLV = El Salvador.

this may have mitigated the problem there. However, the presence of fiscal rules is not a “magic bullet” as the difference is quite small.

As discussed, key basic preconditions for adopting fiscal rules revolve around fiscal “implementation capacity.” This includes such factors as sound public financial management and strong fiscal institutions. In practice, implementation capacity is difficult to gauge in an operationally useful way: many of its elements cannot be captured by reliable data and are heavily influenced by judgment. Even in cases where data exist, it is unclear what can be deemed “sufficient” in fulfilling preconditions for implementing fiscal rules. Importantly, such preconditions cannot be fully assessed independent of the specific rule design. Therefore, it would be useful to gauge available data in assessing readiness for fiscal rules and what elements of implementation capacity should take priority in adopting them.

A useful measure of implementation capacity is achieved by comparing annual budget deficit targets and outcomes. Key advantages of this measure are that it relies on hard data and reflects objective indicators of macro-relevance. The disadvantage is that it lacks granularity and hinges on careful interpretation: for example, comparing fiscal plans to outcomes produces useful information only if proper account is made of changes in economic circumstances (for example, the economic cycle), fiscal policy plans, and (external) shocks that could not be anticipated. With these caveats, comparisons of targets and outcomes offer a useful summary measure of whether a budget law—as a key instrument of fiscal

**Figure 10.2. Fiscal Balance: Targets and Outturns**



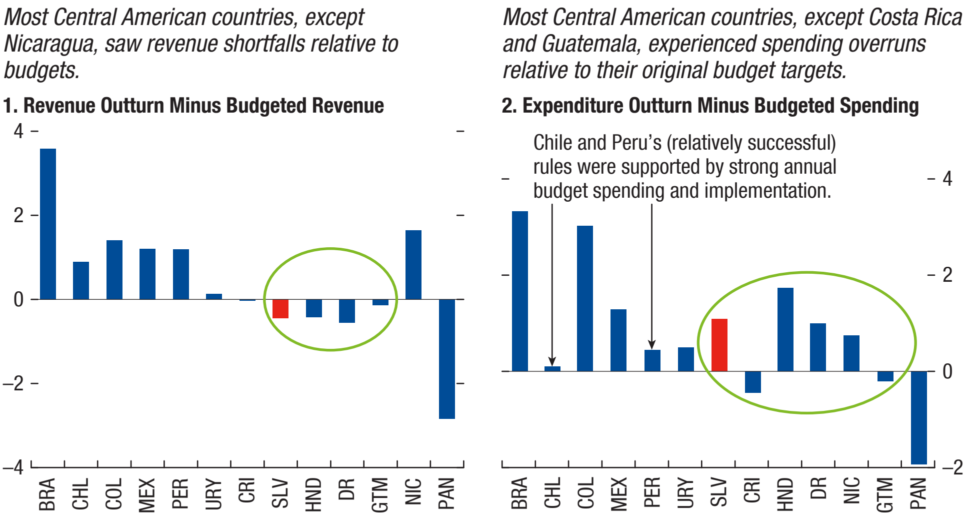

Sources: Country authorities and IMF staff estimates.
Note: CG = central government; CPS = consolidated public sector; P.Balance = primary balance; O.Bal = overall balance; NFPS = nonfinancial public sector.

policy—is likely to be effective in steering macroeconomic policy and supporting the fiscal rules. To assess this, budget implementation data were assessed for Argentina, Brazil, Chile, Colombia, Mexico, and Peru (the six biggest Latin American economies) and CAPDR countries for 2008–13. While some differences in data definitions exist (for example, coverage of the level of government), comparisons of targets and outcomes are consistent across each country and are chosen to denote the most relevant measure of fiscal policy available.

That some CAPDR countries have consistently struggled to meet budget deficit targets (Figure 10.2) helps highlight the priorities to fix in making fiscal rules effective. To adjust for the effect of changing economic circumstances, 2008–13 was split into two periods. During the first, the 2008–09 global financial crisis, most Latin American and CAPDR countries missed their headline deficit objectives.[12] Nonetheless, in 2008–09 these deviations were justifiable due

[12]It was decided to measure the deficits in headline and not structural terms given the complications of calculating real-time structural balances for several Latin American and CAPDR countries and the need for consistency in interpreting targets and outcomes.

**Figure 10.3. Revenues and Expenditure: Budgets versus Outturns, 2010–13**
*(Percent of GDP)*




Sources: Country authorities and IMF staff estimates.
Note: BRA = Brazil; CHL = Chile; COL = Colombia; CRI = Costa Rica; DR = Dominican Republic; GTM = Guatemala; HND = Honduras; MEX = Mexico; NIC = Nicaragua; PAN = Panama; PER = Peru; URY = Uruguay; SLV = El Salvador.

to the need for countercyclical policy responses to the crisis.[13] The 2010–13 postcrisis period, which saw robust economic recovery, offers a better metric: in most countries in the region, postcrisis growth was broadly in line with potential growth (with the notable exception of underperforming Brazil). El Salvador, Honduras, the Dominican Republic, and to a lesser extent Panama stand out for their significant deficit slippages during 2010–13. Absent one-off or other special factors, these slippages are indicative of potential problems in fiscal rule implementation if their underlying reasons are not addressed.

The CAPDR deficit slippages can be traced through looking at revenue and spending, with expenditure issues playing the larger role. During 2010–13 El Salvador, Honduras, and the Dominican Republic experienced persistent revenue shortfalls and expenditure overruns (Figure 10.3). Other CAPDR countries avoided overspending (except Nicaragua, where overruns were offset by revenue overperformance). That larger Latin American countries avoided revenue shortfalls during the period may reflect their more conservative projections and that

[13]If anything, observance of nominal fiscal deficit targets during such a crisis would be a sign of suboptimal fiscal policy, as exemplified by Brazil, which attempted to stick to a nominal budget balance rule at the time.

revenue performance benefited from the continuing commodity super-cycle through 2013.

While the analysis of targets and outturns offers a little guidance, a more granular analysis is needed to properly assess the adequacy of implementation capacity for fiscal rules and corrective steps. Various underlying reasons may exist for budget execution problems such as revenue shortfalls (such as the independence of revenue projections from political influence) and spending overruns (such as rigidity of spending processes and incentives to underbudget). These need to be diagnosed on the basis of a deeper analysis of institutional quality, perhaps partly using indexes of institutional quality such as those in IMF (2014) and partly on country-specific conditions. Such detailed analysis for CAPDR countries is beyond the scope of this chapter but would be essential in preparation for the adoption of fiscal rules. Also, it is now considered essential to extensively test and calibrate specific fiscal rules and their parameters using counterfactual simulations and similar modeling techniques.

## KEY FEATURES OF FISCAL RESPONSIBILITY FRAMEWORKS IN CAPDR

Several CAPDR countries have introduced fiscal responsibility laws and fiscal rules. Until 2015, Panama was the only economy in the region to have formally adopted a numerical fiscal rule, enacted in 2002 and substantially revamped in 2008, with several adjustments after. Honduras and El Salvador adopted fiscal responsibility laws with numerical rules in 2016. Debates about the merits of introducing frameworks are ongoing in Costa Rica and more faltering in other CAPDR countries.

The motivations and basic elements of the rule-based frameworks vary substantially among the three CAPDR (CAPDR-3) countries that enacted them. This reflects a combination of country-specific macroeconomic circumstances, idiosyncratic factors shaping rule design, and international best practices.

- In **El Salvador**, the underlying reasons for enacting fiscal rules were political. The fiscal responsibility law's adoption was a condition of the main opposition party, which threatened denying approval of sovereign financing without a commitment to fiscal responsibility. In design, the key elements of the law were influenced by Colombia's fiscal framework in place during the 2000s, which centered on achieving a debt-stabilizing primary balance over a 10-year horizon under the new Medium and Long-term Fiscal Framework.[14] In the final discussions about the law several other enhancements were made, based on international best practices. These included: (1) introducing the primacy of the debt anchor, (2) increasing coverage by

[14]Experts who initially advised El Salvador on the fiscal rules framework were Colombian. In 2011, Colombia significantly amended its fiscal rule framework, shifting to a structural fiscal balance target.

**TABLE 10.1.**

Selected Features of Fiscal Responsibility Frameworks in Central America

| | El Salvador | Honduras | Panama |
|---|---|---|---|
| **Time of adoption** | November 2016 | April 2016 | May 2002, June 2008 |
| **Debt anchor** | Gross debt target of 45 percent of GDP without pension debt and 65 percent of GDP with pension debt | No legislated debt anchor | Net debt target of 40 percent of GDP |
| **Key operational target(s)** | Positive primary fiscal balance<br>Floor on tax/GDP ratio (17 percent), ceiling on current spending/GDP ratio (18.5 percent) | Non-financial public sector (NFPS) deficit cannot exceed 1 percent of GDP<br>Nominal growth of central government (CG) current spending in the budget law limited to real growth observed over the previous 10-years, augmented for central bank's target for inflation | Limit on NFPS adjusted overall balance starting from 2015, which is gradually lowered to 0.5 percent of GDP in 2018; balance is adjusted by deviation of Canal contributions and the threshold of 3.5 percent of GDP, with shortfalls expanding the deficit target |
| **Other numerical rules** | Sub-rules limiting growth of the wage bill and goods and services spending to GDP growth<br>Limit on short-term debt made permanent and tightened to 20 percent of current budget revenues (versus 30–40 percent in the past few years) | Limit on floating debt at 0.5 percent of GDP | |
| **Transparency and medium-term orientation** | Medium- and long-term fiscal framework (MLTFF) (10-years) submitted with all annual budgets<br>Extensive publication requirements | Medium-term fiscal framework (MTFF) (4 years) submitted with all annual budgets<br>Extensive periodic publication requirements<br>Requirement of publishing ex-post analysis of compliance with the rules | 5-year medium-term MT fiscal plans expected to be published<br>Extensive publication requirements<br>Requirement of publishing ex-post analysis of compliance with the rules |
| **Sanctions for non-compliance** | Ministry of Finance's personal responsibility and possibility of interpellation in Congress and recommendation of dismissal<br>Ministry of Finance's statement under oath on comprehensive inclusion of all spending and compliance with fiscal rules | Need for formal declared statement of compliance with fiscal responsibility | General provision for non-compliance without specification of the sanction mechanism. |

*(continued)*

**TABLE 10.1.** ***(Continued)***

| Selected Features of Fiscal Responsibility Frameworks in Central America | | | |
|---|---|---|---|
| **Transitional provisions** | Based on a 10-year horizon, consisting of 3-year initial "adjustment period" (with active measures of 3 percent of GDP) and subsequent 7-year "sustainability period" | Deficit limits gradually converging to 1 percent of GDP in 2019 and thereafter, after 1.5 percent in 2017 and 1.2 percent in 2018 | Gradual convergence of the non-financial public sector (NFPS) deficit target from 2.9 percent of GDP in 2012 to 0.5 percent of GDP starting from 2018 |
| **Coverage of level of government** | Non-financial public sector NFPS (there are exclusions from liabilities in the calculation of gross debt) | Non-financial public sector NFPS (central government for expenditure rule) | Non-financial public sector NFPS (there are exclusions from assets and liabilities in the calculation of net debt) |
| **Escape clauses** | Yes, significant discretion is given to the executive (for example, no predefined thresholds for economic weakness) to define extent of deviations and convergence path | Yes, with predefined thresholds and a specified gradual convergence path | Yes, with predefined thresholds and a pre-specified gradual convergence path |
| **Stabilization mechanism** | Not included | Not included | Panama' Sovereign Wealth Fund (FAP) established with double objective to:<br>—provide a stabilization mechanism for cases of emergency or sharp economic deceleration<br>—long-term savings fund |
| **Fiscal council** | No | No | Draft Law establishing a fiscal council under consideration by the National Assembly (since October 2017) |
| **Key departures from best practices** | Lack of full consistency between multiple rules<br>Large executive discretion in escape clauses<br>Some definitions ambiguous | No | Lack of enforcement mechanisms for debt<br>Deficit bias due to a systemic shortfall of Canal contributions below the assumed threshold<br>No corrective mechanisms (except for escape clauses |

including pension debt, (3) adding escape clauses, and (4) partially streamlining the multiple subrules. However, substantial scope remains for further aligning the law with these best practices.

- In **Honduras**, adoption was motivated by intensifying concerns that the high fiscal deficit, which reached 7.6 percent of GDP in 2013, would hurt the economy. The authorities embarked on an ambitious adjustment strategy underpinned by an IMF-supported program that helped the deficit fall by 6 percentage points over three years. The fiscal responsibility law aimed at institutionalizing prudent fiscal policy by locking in gains from the consolidation. It was closely aligned with international best practices through: (1) adoption of an expenditure-based operational target, (2) inclusion of the MTFF view in budget documents, (3) modernized escape clauses envisioning a clear convergence path for returning to target, and (4) a transitional period with slightly looser fiscal deficit objectives (over 2016–17) to help smooth convergence to the rule and protect its credibility.[15]
- In **Panama,** the rule-based framework was largely shaped by its own long-standing experience. The original rule adopted in 2002 was prompted by concerns about high debt, and targeted a declining debt path (from 65 to 50 percent of GDP) and a fiscal deficit target of 2 percent of GDP. The framework was radically reformed in 2008, setting more prudent debt and deficit objectives to lock in the debt reduction progress and enhancing countercyclical elements through escape clauses. In 2012, the rule was strengthened with a country-specific feature designed to protect the rule from volatile contributions from the Panama Canal.

The key common building blocks (see Table 10.2) of fiscal rules in CAPDR-3 can be described along the following lines:

- **Fiscal anchors.** El Salvador's and Panama's fiscal responsibility laws include explicit debt-related targets as debt anchors (65 and 40 percent of GDP respectively). In El Salvador's case, the debt limit is higher than the estimated prudent level in a dollarized economy (IMF 2015b). However, enforcement mechanisms for these rules in both countries are weak.[16] While the Honduran law does not legislate an explicit public debt objective, the 1 percent of GDP deficit operational target is consistent with prudent steady state (IMF 2017b).
- **Operational targets.** The operational frameworks vary substantially across countries, with many pros and cons. The Honduran framework appears to be relatively more in line with the most recent international best practices (a

[15] Although the law's targets were widely overperformed in the first two years of application.

[16] In Panama, the debt objective is "an indicative target" and there is no explicit corrective mechanism if it deviates. In El Salvador, while the debt target is the primary anchor, the Ministry of Finance has discretion over corrective measures while the operational targets on the primary balance and revenue and expenditure ratios do not necessarily ensure the debt target would be observed.

combination of a broad expenditure rule and an overall deficit rule), thereby compensating for the absence of an explicit debt anchor. El Salvador's operational framework—while an improvement over the initial proposal—suffers from excessive numerical fiscal rules and a still-insufficient hierarchy among them, which likely causes inconsistency problems. Panama's framework has the advantage of a single operational target, but the target has become excessively complicated and difficult to communicate and monitor, while its consistency with the debt anchor is not directly assured. Given that the contributions from the Canal are not likely to reach the threshold of 3.5 percent of GDP anytime soon, the rule would imply a higher deficit than intended earlier.[17] Since no mechanism exists to correct the debt path, this could hit debt dynamics, particularly if economic growth declines from current buoyant levels.

- **Escape clauses.** On paper, Honduras and Panama appear in line with best practices on escape clauses, which are based on principles of: (1) deviations from operational target justified on the basis of predetermined thresholds for economic weakness (for example, real growth being lower than 2 percent during two consecutive quarters in Panama and being negative in Honduras) and other events (national emergencies), (2) caps on the size of deviation in the operational target (cap on the absolute maximum deficit would be 2.5 percent of GDP in Honduras and 2 percent of GDP on *additional* deficit in Panama), and (3) a return to the original path on a set horizon (three years in both countries, in most circumstances).[18] By contrast, El Salvador does not have predetermined escape clauses on the extent of deviations and the path of return to target, leaving almost everything to the discretion of the executive.
- **Sanctions.** The sanctions elements are relatively weak in CAPDR-3, except possibly for El Salvador. In the latter, circumstances were quite special in that introducing substantial sanctions was a key requirement of the opposition, which had substantial financial and political leverage at the time of adoption. Honduras' fiscal responsibility law envisions only reputational sanctions, while Panama's envisages unspecified sanctions for public officials who do not comply with its provisions. Earlier drafts for El Salvador and Honduras contained substantial sanctions that were scaled down in the final version. The lack of sanctions highlights substantial implementation risks, but it also underscores their sensitive nature and the practical difficulties inherent in introducing sanctions for public servants.

[17]The initial estimates at the time the provision was introduced placed average annual Canal contributions at about 4 percent of GDP. However, the delays in Canal expansion, faster-than-expected GDP growth, and the upward revision with rebased national accounts imply the threshold of 3.5 percent of GDP will not be reached in the foreseeable future.

[18]Earlier escape clauses introduced in 2009 in Panama allowed the NFPS deficit to increase up to 3 percent of GDP in case of national emergency or a domestic growth shock and 2.5 percent of GDP in the case of a world growth shock. See Yang (2016) for details on these provisions.

- **Medium-term orientation.** Among the CAPDR-3, El Salvador has the longest framework horizon, of 10 years, which would be updated on a rolling basis. Horizons in Honduras and Panama are 4 and 5 years respectively. The 10-year horizon, which El Salvador appears to have introduced based on the Colombian experience, is preferable in offering greater transparency. However, it may be overly ambitious for the limited implementation capacity of CAPDR countries, though the difficulties can be assessed during implementation. An important element of the medium-term orientation involves examining whether the fiscal responsibility law helps to eliminate policy drift in medium-term fiscal targets. This also remains to be gauged, particularly in El Salvador and Honduras.
- **Transparency improvements.** The fiscal responsibility laws for CAPDR-3 contain extensive provisions enhancing reporting, publication, and other requirements. All seem to go in the right direction. However, the implementation record of these requirements has so far been mixed. For example, many important enhancements have not yet been introduced despite being required under existing laws (for example, submission and publication of the MTLFF together with the budget proposal in El Salvador or an ex-post analysis of compliance with the fiscal rules and fiscal targets and reasons for their deviations in Panama).

## ASSESSING THE EFFECTIVENESS OF THE FRAMEWORKS

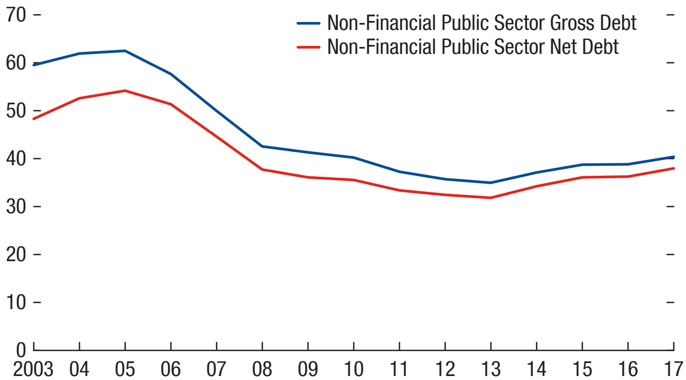
The previous section highlighted the multitude of objectives, design features, scope, and coverage of the fiscal responsibility frameworks introduced in CAPDR. This section moves on to assess their effectiveness. However, in El Salvador and Honduras they are quite recent, which considerably limits the scope to evaluate performance. Frequent changes to different elements of Panama's framework complicate any assessment of its effectiveness. With these caveats in mind, some initial insights are provided.

### Panama

One of the key objectives of Panama's fiscal responsibility framework has been to lower public debt. Largely because of its stellar growth performance, Panama significantly reduced debt to below targets in the mid-2000s, despite its mixed record on achieving deficit targets before. Two large upward nominal GDP revisions helped shrink the debt ratio further. Notwithstanding some growth deceleration and fiscal slippages a few years ago, Panama has kept the non-financial public sector (NFPS) net debt-to-GDP ratio (Figure 10.4) below the 40 percent indicative target stipulated in its Social Fiscal Responsibility Law.

Multiple amendments have been made to the deficit ceilings since the current law came into force in 2009. While repeated modifications signal some weakness in both the accountability framework and the original design, it also

**Figure 10.4. Panama: Non-Financial Public Sector Debt**
*(Percent of GDP)*




Sources: Panamanian authorities and IMF staff calculations.

points to the need to adjust legal provisions to fit changing circumstances. Following the modifications of 2012, the fiscal deficit was consistently below the maximum allowed by law. For instance, the overall deficit in 2015 and 2016 was significantly smaller (Figure 10.5). Such outcomes suggest the authorities refrained from using the "deficit bias" that arose due to systemic shortfall of Canal contributions below an assumed threshold of 3.5 percent of GDP. Moreover, the fiscal rule has played an important role in guiding the authorities' consolidation strategy, one of the key objectives of the recent modification to the Social Fiscal Responsibility Law.

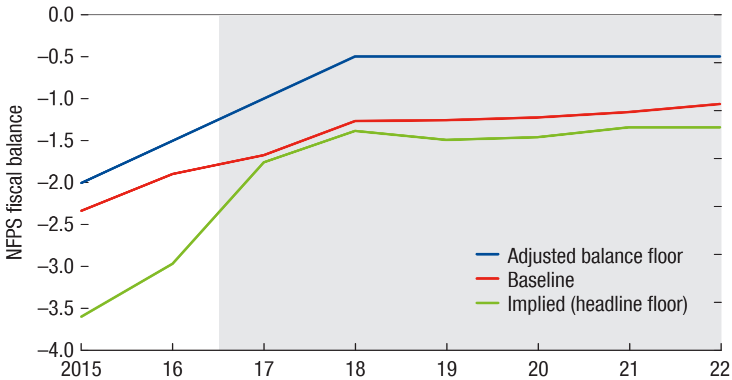
There is mixed evidence about the impact of Panama's fiscal responsibility framework on cyclicality of fiscal policy. Figure 10.6, panel 1, shows that episodes of countercyclical fiscal policy are found around the time of introduction of the initial rule (2001–04) and in the aftermath of the global financial crisis (2009–11), while procyclicality was at least as common after the law was introduced as it was before. Countercyclicality may not have been a key policy objective in light of the Panamanian economy's strong performance.

Fiscal policy had a slightly contractionary impact on economic activity, as the consolidation in 2015–16 coincided with a deceleration of growth and widening of the output gap (Figure 10.6, panel 2). Nonetheless, this procyclical stance demonstrates that a commitment to fiscal discipline helped strengthen the credibility of a fiscal framework that was damaged by waivers and amendments several years before (IMF 2017a).

## El Salvador

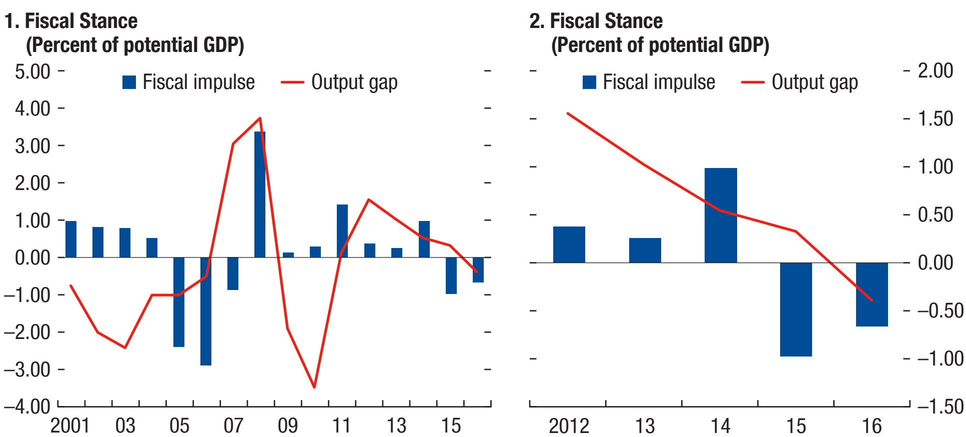
The country's fiscal responsibility law was passed late in 2016, with 2017 its first year of application. Many of the law's key provisions could not be tested in 2017,

**Figure 10.5. Panama: Performance under the Fiscal Rule**
*(Percent of GDP)*




Sources: Panamanian authorities and IMF staff calculations.
Note: "Adjusted balance floor" corresponds to the maximum deficit if Canal contributions equal the threshold in the fiscal rule (3.5 percent of GDP). "Implied (headline floor)" refers to the maximum fiscal deficit implied under the modified Social Fiscal Responsibility Law (SFRL) with projected Canal contributions falling below the threshold. The difference between these two lines depicts the extra fiscal space created by the over-optimistic threshold stated in the fiscal rule. The "baseline" projects that only a part of this extra space is actually used. NFPS = Non-financial public sector.

**Figure 10.6. Fiscal Policy Stance**




Sources: Panamanian authorities and IMF staff calculations.
Note: Fiscal impulse is calculated as the change in the cyclically adjusted primary balance of the non-financial public sector.

since the budget for that year was submitted before it was adopted. The law had no binding targets for 2017 fiscal aggregates: its numerical parameters are binding after 2019. Therefore, a comprehensive analysis of its impact is premature. At the same time, the law increased the focus on fiscal policy targets and outcomes in debates between the government and its political opponents and so had an important impact on fiscal decisions.

The fiscal responsibility law was a factor in a Supreme Court decision that September to declare the 2017 budget unconstitutional, which resulted in the government resubmitting the budget law a few weeks later with the inclusion of unbudgeted or underbudgeted outlays improving its comprehensiveness and transparency. In the context of the 2018 draft budget, the fiscal responsibility law had an impact possibly due to the sanctioning provision contained in Article 28 whereby the minister of finance could interpellate in Parliament in case the budget submission was insufficiently realistic or comprehensive, with a possibility of issuing a parliamentary recommendation to the president for his dismissal. The draft 2018 budget marked a big improvement over preceding years because its revenue projections were more realistic and it was more comprehensive since it included all appending obligations. While it is premature to say whether the fiscal responsibility law is an effective fiscal policy anchor, it incentivized the improvement of several budgetary procedures.

### Honduras

The fiscal responsibility law in Honduras was introduced amid considerable effort to consolidate the fiscal position, with the NFPS deficit reduced by more than 6 percentage points of GDP over 2013–17. Beyond institutionalizing a hard-won fiscal consolidation, the law is expected to support medium-term fiscal sustainability and catalyze second-generation fiscal reforms. Fiscal performance in 2017 is estimated to have been in line with the law's targets, with NFPS deficits projected to be below its implied ceiling. In addition, aiming to support the implementation and fulfill rules limiting increases in current spending, the authorities introduced a module into their information management system that verifies compliance with the annual spending target in real time. Over the next few years, an important challenge for the Honduran authorities will be to consolidate the law as the cornerstone of macroeconomic policies. It will be essential to develop institutions, strengthen commitment, and foster transparency and accountability at all government levels to achieve that objective.

## CONCLUSIONS AND POLICY RECOMMENDATIONS

Several fiscal responsibility frameworks have been implemented recently in the CAPDR region, mainly to strengthen fiscal prudence. While their objectives are similar, their designs differ somewhat, each with its own advantages and disadvantages. This chapter has pointed out several aspects likely to be crucial for such frameworks in the region to succeed.

Given relatively weak preconditions, it is important that institutional upgrades be accelerated to improve the credibility of fiscal responsibility frameworks. Efforts to ensure compliance may end up futile if left unsupported by a strengthening of institutional structures.

Improvements in transparency and communication with the public are essential for the frameworks to raise fiscal accountability. In turn, such efforts are key to mobilizing support, increasing public scrutiny, and helping attain objectives.

In light of the local circumstances, fiscal responsibility frameworks eschew complicated elements such as structural balances. The most recent are increasingly focused on expenditure rules (for example, in Honduras and El Salvador), which appear to fit local conditions and are in line with best practices. While the current expenditure rules would be key for proper operation, powerful interest groups, weak institutions, and large social needs are likely to provide an important test.

Recent experience also suggests that further fine-tuning of the rules is necessary to tackle new policy challenges and incorporate best practices. As such, examples from other emerging markets suggest that improvements to fiscal transparency and responsibility happen in an evolving process instead of a finite term.

Finally, limited experience of the application of fiscal responsibility laws in CAPDR countries allows only for very preliminary conclusions to be drawn. So far, the three countries involved have tended to comply with their new frameworks, but this may largely reflect two of them having been adopted very recently and still enjoying "honeymoon" periods in which compliance requirements are not too onerous and the political incentives to comply are strong. The long history of fiscal profligacy in the region underscores the need for continual work to strengthen the credibility and resilience of the new fiscal frameworks.

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**ANNEX 10.1.**

## Fiscal Responsibility Laws in the World

| | Country | Date | Rules | Other |
|---|---|---|---|---|
| 1 | New Zealand | 1994 | No rules | |
| 2 | United Kingdom | 1997 | Achieve balance or surplus in the cyclically adjusted current budget (excluding investment spending) during a five-year window | An independent body evaluates the fulfillment of fiscal targets |
| 3 | Australia | 1998 | No rules | |
| 4 | Peru | 1999 | Gross debt cannot be higher than 30 percent of GDP, NFPS deficit cannot be higher than 1 percent of GDP, general government real spending growth cannot be higher than the average of 20-year GDP growth | Fiscal stabilization fund, escape clause, and fiscal council |
| 5 | Colombia | 2000 | Structural balance of central government should be lower than 2.3 percent of GDP in 2014 converging toward 1 percent of GDP in 2022 | Fiscal stabilization fund and escape clause |
| 6 | Brazil | 2000 | Personnel expenses should be below 50 percent of current revenues for the federal gov. and 60 percent for states and municipalities | A companion law includes administrative and criminal sanctions |
| 7 | Panama | 2002 | Non-financial public sector (NFPS) deficit cannot be higher than 1 percent of GDP, net debt of the NFPS should be below 40 percent of GDP | Fiscal stabilization fund and escape clause |
| 8 | Ecuador | 2003 | Real primary spending growth cannot be higher than 3.5 percent, and fiscal deficit (not including oil revenues) should be reduced annually by 0.2 percent of GDP until it reaches zero | Fiscal stabilization fund and sanctions (fines) |
| 9 | Sri Lanka | 2003 | Fiscal deficit should be lower than 5 percent of GDP, and debt should be below 60 percent of GDP | |
| 10 | Pakistan | 2005 | Fiscal deficit should be reduced by at least 2.5 percent of GDP per year until the debt-to-GDP ratio reaches 60 percent | |
| 11 | Mexico | 2006 | Central government should be balanced on cash basis. Budget oil price equals the average of historic prices and futures with a prudence factor | Stabilization and contingency funds, escape clause |
| 12 | Chile | 2006 | No rules | Stabilization and pension reserve funds |
| 13 | Nigeria | 2007 | Fiscal deficit should be lower than 3 percent of GDP | Escape clause in case of security emergencies |
| 14 | Liberia | 2009 | No rules | |
| 15 | Romania | 2010 | State personnel expenditure limits as a percent of GDP in the medium-term fiscal framework (MTFF). Nominal growth of spending should be below nominal GDP growth | Escape clause |
| 16 | Jamaica | 2010 | Debt should be lower than 60 percent of GDP in 2026 | |
| 17 | Mongolia | 2010 | Expenditure growth cannot exceed the growth of non-mineral GDP, structural deficit cannot exceed 2 percent of GDP, net present value (NPV) of public debt cannot exceed 40 percent of GDP | |

**ANNEX 10.1. *(Continued)***

Fiscal Responsibility Laws in the World

| | Country | Date | Rules | Other |
|---|---|---|---|---|
| 18 | Serbia | 2010 | Deficit-to-GDP ratio is equal to $d(t)=d(t-1)-0.3[d(t-1)-d^*]-0.4[g(t)-g^*]$ where $d^*$ is the medium-term deficit (1 percent of GDP), g is the real GDP growth rate, and $g^*$ is the medium-term GDP growth (4 percent) | |
| 19 | Croatia | 2012 | The general government cyclically adjusted primary balance should be in equilibrium or in surplus | |
| 20 | Spain | 2012 | All public administrations cannot generate structural deficit, debt should be below 60 percent in 2020, and spending growth rate should be below the medium-term growth rate. | |
| 21 | Maldives | 2013 | Debt should be lower than 60 percent of GDP in 2026 | |
| 22 | Bulgaria | 2013 | Structural deficit of the general government should not exceed 0.5 percent of GDP | |
| 23 | Russia | 2013 | Fiscal deficit should be lower than 4.7 percent of GDP | Fiscal stabilization and sovereign wealth funds |
| 24 | Kosovo | 2013 | Deficit cannot be higher than 2 percent of GDP | Escape clause |
| 25 | Malta | 2014 | General government balance is in surplus or balance and debt should be lower than 60 percent | Independent fiscal council |
| 26 | Latvia | 2014 | Structural general government balance lower than 0.5 percent of GDP | Escape clause |
| 27 | Grenada | 2015 | Real spending capped at 2 percent, primary surplus target of 2.5 percent until debt reaches 55 percent of GDP, wage bill targets 9 percent of GDP, and public-private partnerships (PPP)-related contingencies are capped at 5 percent of GDP | Escape clause in emergency cases |
| 28 | Lithuania | 2015 | Structural general government balance positive; if not growth of public spending should be capped at half of the growth rate of revenues | Escape clause in emergency cases |
| 29 | Honduras | 2016 | NFPS deficit cannot be higher than 1 percent of GDP, nominal current spending growth cannot be higher than the average of the 10-year GDP growth plus the inflation projection | Escape clause |
| 30 | El Salvador | 2016 | In 2019, NFPS primary balance should be positive, tax burden should be at least 18.5 percent of GDP, and current spending should be below 18.5 percent of GDP. NFPS debt should be below 65 percent of GDP | Escape clause |

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