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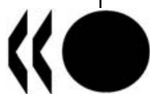

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POSTCRISIS FISCAL RULES:
STABILIZING PUBLIC FINANCE WHILE RESPONDING TO ECONOMIC AFTERSHOCKS

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POSTCRISIS FISCAL RULES: STABILIZING PUBLIC FINANCE WHILE RESPONDING TO ECONOMIC AFTERSHOCKS

by Allen Schick

INTRODUCTION

1. Fiscal rules have been among the most widely-adopted budget innovations during the past two decades. In 1990, the International Monetary Fund (IMF) had estimated only seven countries had such rules; now 80 countries do.[1] Many rules have been adopted by national governments on their own initiative; others have been imposed by supranational authorities such as the European Union (EU) and other regional bodies. This paper is grounded on the expectation that the still-smoldering economic crisis will impel governments that have fiscal rules to adjust them on the basis of lessons derived from experiences with first-generation rules, and that additional countries will join the fiscal rules bandwagon.

2. Fiscal rules are numerical targets that constrain key budget aggregates. The constraints can apply to the deficit or the debt, to total revenues or expenditures or to other aggregates. Enforcement can range from legal sanctions against violation to reliance on information and transparency. The lack of a single template for fiscal rules indicates that they still are undergoing conceptual as well as trial-and-error development; and that fiscal rules must be consonant with a country's political culture. Political factors are especially salient in determining the means of enforcing constraints, and the actions taken (or not taken) when breaches occur.

3. The pervasiveness of fiscal rules derives from several sources, and may be influenced by a country's development. Advanced countries tend to be concerned about elevated tax burdens and expenditure levels, as well as the pressure on public finance from their ageing populations. Some also are sensitive to the sustainability of fiscal trends and believe that tougher budgetary discipline will improve long-term prospects. Emerging countries have been among the most enthusiastic rule adopters, largely because they believe that a sturdy fiscal framework will give investors and entrepreneurs confidence in the government's capacity to manage public finance. In fact, some emerging countries have been rewarded with lower interest rates and longer maturities on public debt. Finally, low-income countries have begun to embrace rules, sometimes under pressure from international financial institutions, sometimes because of self-realization that loose fiscal policies have impeded development.

[1] International Monetary Fund, "Fiscal Rules – Anchoring Expectations for Sustainable Public Finances," December 2009. The 80 countries are listed on pp. 59-68 and their rules are summarized.

4. Studies by the IMF and the European Commission have concluded that rules have a positive impact on fiscal outcomes, particularly in countries that make large adjustments in revenue or spending policies.[2] However, it is difficult to discern whether the positive effects are due to political commitment, which is expressed in adoption of rules and maintenance of fiscal discipline, or to the constraints imposed by the rules. Whether or not a country adopts formal limits on fiscal policy, it is certainly the case that political commitment to manage public finances prudently is essential. In the absence of political commitment, rules are not likely to make much of a difference.[3]

5. Rather than only look back at how fiscal rules have worked during the relatively brief time they have been in operation, this paper also looks forward to how the rules might evolve in the period ahead. This focus is premised on two expectations: rules will continue to be a prominent feature of fiscal management; and future rules are likely to deviate in significant ways from first-generation rules. One should not be surprised if having fiscal rules comes to be regarded as standard practice, even if the types of rules in effect are not standardized. Although the paper focuses on the future, intelligent rulemaking requires that governments base changes in practice on past experience. Accordingly, in contemplating the future evolution of fiscal rules, the paper tries to glean relevant lessons from the rules that have been adopted thus far. The discussion is in general terms, though specific countries may be cited from time to time.

6. Section 1 frames the discussion in terms of the economic crisis that has ravaged the budgets of most developed countries. A key concern is whether conditions have sufficiently stabilized to permit governments to introduce next generation rules. Section 2 is the main part of the paper. It examines a series of issues that may arise as governments reengineer or introduce fiscal rules. Discussion of each issue begins with lessons from existing rules and concludes with observations on the design of new rules. The final section takes account of the focus of this meeting and briefly considers the role of national legislatures in designing and implementing fiscal rules.

[2] Ibid., pp. 16-19

[3] See Allen Schick, “The Role of Fiscal Rules in Budgeting,” in OECD, Evolutions in Budgetary Practice, 2009, pp. 319-41.

SECTION 1: RULES VERSUS CRISIS

7. In many countries, fiscal rules have been vitiated, at least temporarily, by the global economic crisis. Burdened by high unemployment and declining output, many national governments have adopted stimulative budget policies that purposefully breach established deficit or debt ceilings. The European Commission, which actively monitored compliance with the European Union's Stability and Growth Pact (SGP) before the crisis, abstained from demanding fiscal restraint, thereby encouraging member countries to pursue an expansionary fiscal course. The IMF has set aside its characteristic constraining role and has urged governments to take stimulative actions. However, to this writer's knowledge, no government has formally rescinded existing rules because of the crisis. Rather they have put the rules in hibernation, expecting that they will be reactivated once conditions stabilize.

8. The fear of economic collapse has been so great that governments have not relied solely on automatic stabilizers – the automatic fall in tax collections and rise in public spending when the economy swings from recession to growth or from growth to recession. Many have also adopted bold discretionary policies that have boosted expenditures and slashed revenues. The combination of automatic responses and discretionary stimulation has produced large fiscal imbalances in many countries, far in excess of the levels allowed by their fiscal rules. Although national governments have differed significantly in their fiscal responses to the crisis, almost all advanced countries have sought to rebalance their economies by unbalancing their budgets. Table 1, drawn from recent IMF data, shows the sharp swing in the fiscal fortunes of advanced G-20 countries.

TABLE 1

FISCAL BALANCES AND GENERAL GOVERNMENT DEBT G-20 COUNTRIES

(in percent of GDP)

	Fiscal Balance			Gross General Government Debt		
	2007	**2009**	**2014**	**2007**	**2009**	**2014**
Argentina	12.1	-3.9	-1.7	68	61	46
Australia	1.5	-4.3	-1.1	10	17	28
Brazil	-2.8	-3.8	-1.0	67	69	59
Canada	1.8	-4.9	0.0	64	78	69
China	0.9	- 3.9	-0.8	20	20	20
France	-2.7	- 8.3	-5.2	64	78	96
Germany	0.5	- 4.2	0.0	63	79	89
India	-4.4	-10.4	-5.7	81	85	79
Indonesia	-1.2	- 2.6	-1.3	35	36	27
Italy	-1.5	- 5.6	-5.3	104	116	129
Japan	-2.5	-10.5	-8.0	188	219	246
Korea	3.5	- 2.8	2.6	30	35	35
Mexico	-1.4	-4.9	-3.1	38	48	44
Russia	6.8	-6.6	2.2	7	7	7
Saudi Arabia	15.7	5.0	14.5	19	15	9
South Africa	1.2	-4.4	-2.5	29	31	35
Turkey	-2.1	-7.0	-4.8	39	48	53
United Kingdom	-2.6	-11.6	-6.8	44	69	98
United States	-2.8	-12.5	-6.7	62	85	108

Source: International Monetary Fund, "The State of Public Finances Cross Country Fiscal Monitor," November 2009, Annex, Table 1.

9. In the aftermath of the crisis, governments and international institutions are moving to devise new rules that, they hope, will be sturdier than the old ones. Notably, some EU countries, such as Germany and Hungary, have adopted their own rules to supplement the Community-wide STP. Some governments have been impelled to act by the conviction that credible rules will help stabilize public finance and restore confidence in financial markets. It is highly probable that the decade after the crisis will be as rule-saturated as the decade before, and that fiscal constraints will target some of the key aggregates that the old rules purported to limit, as well as some new ones.

10. A simple reading of the foregoing paragraphs in this section suggests a tension between the impact of the crisis on fiscal rules and the emergence of a rule-based response to the crisis. On the one hand, recent experience attests to the futility of fixed rules when crisis strikes: on the other hand, in the face of crisis, governments are resorting to rules to bolster public finance. The former leads to the conclusion

that, at least during upheavals, fiscal outcomes are largely driven by economic force majeure; the latter is premised on the notion that sound rules and disciplined political leadership can effectively dictate fiscal outcomes. The first bows to the real-economik of oversize deficits and steeply rising debt levels, well above target, during crisis, the latter to future deficits that will be constrained within challenging targets.

11. Despite this clash, both views coexist as vital guideposts to contemporary fiscal policy. To paraphrase the traditional greeting for a new monarch: “the rules are dead, long live the rules”. The two views can be reconciled by distinguishing between normal economic times and periods of profound shock and instability. The pursuit of new rules is grounded on the expectation that economic conditions will soon normalize to approximately pre-crisis levels, thereby allowing governments to reassert fiscal discipline. Arguably, therefore, economic order must return before new rules can do much good. If, however, unemployment were to persist at an elevated level while output and income remain depressed and fiscal institutions still are in distress, it would not be feasible or prudent to adopt a constrictive fiscal course. (See Table 2)

TABLE 2

UNEMPLOYMENT RATE AND CHANGE IN REAL GDP: SELECTED COUNTRIES

	Real GDP		Unemployment Rates	
	2007	2009	2007	2009
Argentina	4.0	0.7	4.4	6.0
Austria	3.5	-3.8	4.4	5.3
Canada	2.5	-2.5	6.0	8.3
Denmark	1.6	-2.4	2.7	3.5
Finland	4.2	-6.4	6.8	8.7
France	2.3	-2.4	8.3	9.5
Germany	2.5	-5.3	8.4	8.0
Greece	4.0	-0.8	8.3	9.5
Ireland	6.0	-7.5	4.5	12.0
Iceland	5.6	-8.5	1.0	8.6
Italy	1.6	-5.1	6.1	9.1
Japan	2.3	-5.4	3.8	5.4
Korea	5.1	-7.0	3.3	3.8
Netherlands	3.6	-4.2	3.2	3.8
Norway	3.1	1.9	2.5	3.3
Portugal	1.9	-3.0	8.0	9.5
Spain	3.6	-3.8	8.3	18.2
Sweden	2.6	-4.8	6.1	8.5
Switzerland	3.6	-2.0	2.5	3.5
United Kingdom	2.6	-4.4	5.4	7.6
United States	2.1	-2.7	4.6	9.3

Source: International Monetary Fund, World Economic Outlook, October 2009, Table 2.1

12. An alternative view would reverse the cause-effect relationship and argue that stabilizing public finance by establishing tough realistic fiscal targets will accelerate economic recovery. Those supporting this position point to the fact that countries which have strong fiscal regimes generally have weathered the crisis more favorably than those which lack strong regimes. They point to the experiences of countries such as Brazil, Chile, and Norway as evidence that effective rules mitigate economic dislocation. Moreover, although these countries differ in their fiscal rules, in all three the rules have survived the crisis. Brazil targets the primary balance, Chile the structural balance, and Norway a budget surplus. The difference suggests that committing to a stable fiscal course is an essential element in prudently managing public finance. Brazil is a particularly noteworthy case because it adopted fiscal responsibility rules before the economy had stabilized. Its recent robust economic performance has been spurred by the government's disciplined fiscal posture.[4]

13. A third approach rests on the argument that many pre-crisis rules failed because they were defective. The main problem is that by setting a ceiling on the deficit that does not vary with changes in economic conditions, many rules have a pro-cyclical bias that enables governments to lower taxes and boost spending when the economy is expanding, but demands austere policies when the economy falters. According to this line of reasoning, seeds of fiscal instability were sown by targeting nominal rather than structural deficits. When economic conditions deteriorated during the crisis, many governments were locked into higher expenditures but had less revenue and deeper fiscal holes than would have occurred if they had maintained structural balance during the good times.

14. The three interpretations differ in the paths they chart for devising next-generation fiscal rules. The first approach would advise governments to defer constrictive policies until recovery is well underway and unemployment has receded well below the crisis-induced peak. The second would counsel governments to forthrightly promulgate new fiscal constraints, but to schedule full implementation several years in the future when economic conditions are projected to be more favorable. The third approach would encourage governments to adjust rules to economic cycles, so that fiscal deficits would rise when the economy is weak, and recede when growth produces a surge in revenues. The key idea is that governments should save rather than spend a significant portion of the dividends from economic growth.

15. The competing approaches pertain to the cross pressures currently besetting many advanced countries. As growth resumes, governments are urged to restore fiscal discipline while still dealing with the aftershocks of the crisis. On the one hand, the fiscal imbalances and public debt accumulated during the crisis speak to the need for fiscal consolidation. Automatic stabilizers might not suffice in some countries to reduce deficits to prudent levels or to halt the rise of the debt/GDP ratio. Governments will have to take additional discretionary, politically-difficult actions, not only in countries where there is elevated risk of sovereign debt default, but also in countries which risk fiscal contagion spreading to their own borders.

16. On the other hand, the decline in national output and rise in unemployment indicate a need for continuing stimulus, even if the result is large deficits in the medium-term or beyond. The quandary facing many countries can be summed up as follows: the resumption of economic growth will not

[4] See Lee Alston, Marcus Melo, Bernardo and Carlos Pereira, "Presidential Power, Fiscal Responsibility Laws, and the Allocation of Spending: The Case of Brazil" in Mark Hallerberg et al, Who Decides the Budget?, Inter-American Development Bank, 2009, pp. 57-90.

liquidate budget deficits or lower unemployment to pre-crisis levels. Governments need expansionary policies to generate employment and contractionary policies to curtain deficits.

17. For countries severely impacted by the crisis, a nuanced policy seems to be the appropriate course – continuing stimulative policies while preparing an exit strategy that should include credible commitments to rein in future deficits. This is the path urged by the IMF in its January 2010 World Economic Outlook Update:

> Due to the still fragile nature of the recovery, fiscal policies need to remain supportive of economic activity in the near term. The fiscal stimulus planned for 2010 should be fully implemented. However, countries facing growing concerns about fiscal sustainability should make progress in devising and communicating credible exit strategies. In many cases, durable exit will require not only unwinding crisis-related fiscal stimulus but also substantial improvements in primary balances for a sustained period. [5]

18. Invigorated rules can bolster a government's transition from stimulus to discipline and enable it to define a responsible fiscal path that recognizes the need for short-term anti-recession measures and for medium-term belt-tightening. Ideally, stimulative measures should have an immediate impact that fades away as recovery accelerates. Temporary cuts and spending increases that expire in one or two years fit this specification; they enable the government to establish medium-term fiscal targets that constrain future deficits and debt. In the present crisis, however, some governments have enacted permanent tax cuts and launched spending initiatives whose impact will continue well into the future. In these cases, the fiscal rules will not be of much benefit; they will be neither credible nor realistic.

19. Establishing a fiscal target that cannot be attained or runs counter to government policies does not give confidence to markets or guidance to budget makers. Rules never are effective substitutes for sound fiscal policy. Rules work only when they are fortified by actions that demonstrate commitment to stabilize public finance by making out year targets politically and financially attainable.

[5] International Monetary Fund, "World Economic Outlook Update," January 2010, p. 2.

SECTION 2: LESSONS FROM THE PAST, RULES FOR THE FUTURE

20. A logical starting point for constructing new fiscal constraints is to apply lessons from pre-crisis experience with first-generation rules. All rules are not equally effective; in fact, some have defects that doom them from the start. This section discusses issues that will arise in designing or implementing new rules to discipline public finance. In considering each issue, key lessons are culled from past experience, along with implications for future rule makers. Because the purpose of this exercise is to avoid mistakes that were made in the past, the emphasis is on uncovering deficiencies. The conclusions are cast in general terms; they do not apply to all countries that have fiscal rules.

(1) What should be targeted?

21. Although rules have not been standardized across countries, the most common approach is to limit the budget deficit, often together with a limit on public debt. Targeting the budget deficit makes political sense because it is the most widely-reported measure of the government's financial condition; targeting the debt makes fiscal sense because it is a critical measure of the sustainability of the government's financial condition. Coupling them in a set of targets also is sensible because it is difficult to directly control the stock of public debt. These targets typically are stated as proportions of the gross domestic product (GDP), which means that deficits and debt can rise as the economy expands in nominal terms. The original Maastricht rules, which set an annual ceiling on deficits at three percent (3%) of GDP and a ceiling on public debt at 60%, exemplifies this approach.

22. Some governments establish expenditure limits; others apply ceilings or floor to revenues. These measures target the budget components that determine deficit and debt trends. When targeting expenditures, some governments deem it necessary or expeditious to distinguish between mandatory spending which is authorized in permanent law and discretionary spending which is determined in annual budget decisions. The United States experimented with deficit limits in a 1985 law, and then shifted to revenue and expenditure limits in the early 1990s. The deficit targets were ineffective, both because they were unrealistic and had faulty enforcement mechanisms; the revenue and spending limits, in contrast, are generally adjudged to have been somewhat effective during the 1990s, but much less so during the first decade of the 21st century.[6]

23. Deficit and debt ceilings appear to be most effective when the debt burden is at a sustainable level. When it is not, a more appropriate target might be the primary balance, which is conventionally defined as the balance between total revenues and expenditures excluding debt service. To reduce the existing level of debt, a government should accrue a primary balance that is sufficiently large to cover interest payments and a portion of principal. Brazil has had notable success with this strategy. Its fiscal responsibility process centers on achieving a primary balance close to five percent (5%) of GDP. It achieved a high primary balance through most of the past decade; the balance declined during the crisis period, but Brazil has been rewarded with lower borrowing costs, improved access to capital markets, and a lower debt/GDP ratio. It is likely that countries coming out of the crisis with elevated debt levels will have to run-up large primary balances to strengthen their fiscal position.

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[6] See Allen Schick, The Federal Budget: Politics, Policy, Process, 3rd Edition, The Brookings Institution, 2007. pp. 23-25 and 105-51.

24. Nominal deficit targets have a critical flaw: they do not distinguish between periods of economic growth and decline. They allow the government to incur the same deficits when the economy is overheated and in need of contraction, and when it is stagnating and in need of stimulus. This procyclical bias is especially damaging during asset bubbles, when a surge in revenues gives politicians license to cut taxes and increase spending. It also has adverse effects when the bubble bursts, and the government is required to take constrictive actions that add to social misery and risk further damage to the economy. Of course, many national governments simply disabled the rules during the recent crisis, but they would have been in a much more favorable fiscal position if prudent policies had been in place during the boom years.

25. Next generation rules are more likely to have counter-cyclical features that target the structural deficit or are adjusted to accommodate cyclical swings in economic conditions. Countercyclical rules allow the automatic stabilizers in the budget to operate when economic conditions vary from the target or trend. Ideally, deficits incurred during downturns would be offset by surpluses accumulated during expansion, and the budget would be balanced over the course of the cycle. If desired, the rule can be engineered to produce a sufficiently large surplus over the cycle to reduce the debt/GDP ratio. Chile has successfully applied a structural balance rule during the past decade that initially targeted a one percent (1%) GDP surplus but was lowered to zero percent during the crisis. It is based on estimates of revenue if the economy were at full employment, the trend price of copper, and long-term interest rates.

26. Chile's model is based on the gap between estimated and potential output. An alternative structural rule, similar to Chile's treatment of copper revenue, is to base structural balance on the trend of GDP or of revenues over a period of years. This approach does not require estimates of potential GDP, and has the advantage that it would inhibit government from spending "bubble-derived" revenues that will vanish when the bubble bursts. However, this method might allow governments to adopt excessively stimulative budgets during the beginning of an economic upturn or unduly constricted budgets at the start of a downturn.

27. As countries move from fixed, nominal targets to structural rules, they are likely to try different methods. This aspect of fiscal rules will be contoured to suit both economic conditions and political needs. Standardization is a long way off.

(2) Frameworks for Rules

28. In some countries, fiscal rules are free-standing targets that are established independent of the budget process or of other recurring procedures. The targets are fixed in law or a policy pronouncement, or imposed by supranational authority. In this situation, the task of budgeting is to comply with the pre-determined constraints. In other countries, fiscal rules are integrated into a fiscal responsibility process that dictates how the government sets targets each year and how they are linked to the budget. Where this approach is used, budgeting may be divided into two distinct phases, each with its own legal basis, and sometimes several months apart. During the framework stage, the government tables macroeconomic forecasts, establishes targets, and (in some countries) tables these actions in parliament for debate or approval. Typically, this framework is incorporated into a medium-term expenditure or fiscal process covering the next three to five years. During the budget phase, the government presents estimates and parliament votes appropriations, with procedures in place to ensure that budget decisions are within the targets established by the framework.

29. The International Monetary Fund and others have found that fiscal rules tend to be more effective in countries that embed them in frameworks. 7 It is not hard to discern why frameworks strengthen rules. For one thing, framework-based rules are generated by a process that takes account of economic conditions and political preferences. They, therefore, may be vested with stronger commitment than free-standing rules, which usually are set without regard to a particular year's circumstances. Second, because they are adjusted annually (biennially, in some countries), frameworks are more sensitive to shifts in political sentiment. Finally, frameworks usually include means of enforcement and are connected to ongoing budget processes.

30. There is, however, another side to frameworks: the very ease of adjustment tempts politicians to mold them to their preferences. There is a risk that pliable rules become accommodating rather than constraining. If governments comply with frameworks, it may be because they make the rules to suit their interests, not because frameworks tie their hands. Transparency is the principal instrument for establishing fiscal discipline in framework-based countries. Politicians, the reasoning runs, pay a price if they opportunistically reset targets. The media would broadcast that deficit targets have been raised or debt reduction targets lowered. It may be that frameworks work best in countries that have attentive media and special interest groups, and where changes to targets are widely publicized. This has been the case in framework countries such as Australia, Brazil, and New Zealand. But where these supportive conditions are lacking, frameworks may lack sufficient muscle to bring fiscal policy into line.

31. Looking to the future, it is likely that framework-centered rules will gain ground, and will be increasingly integrated into the machinery of budgeting. If this expectation is valid, it has important implications for supranational rules, such as the European Union's Stability and Growth Pact (SGP), which are imposed from without and bereft of frameworks. One possibility which appears to be emerging is for countries subject to supranational constraints to add their own rules, along with a process or framework for making and enforcing fiscal policy.

(3) Geographic Scope

32. Federated countries and countries that have assigned significant revenue and expenditure authority to subnational governments face the question of whether rules should cover only the national government or the entire public sector. In these countries, it might not suffice to constrain only the national government; limiting their scope can lead to easy circumvention of the rules, for example, by shifting some expenditures to local or regional authorities. Moreover, in some countries, subnational governments have authority to issue debt that is explicitly or implicitly guaranteed by the national governments. In these situations, the financial posture of the national government, including its access to capital markets and interest rates, risks being affected by the fiscal behavior of lower governments.

33. The intertwinement of national and local governments has been propelled by the rapid spread of fiscal decentralization, even in small countries. Although the form and reality of decentralization differ from country to country, in most a whole-of-government perspective is necessary to gauge or regulate public finance. Most early rules, which were issued before decentralization was fully underway, covered only the central government. Recent rules have tended to have a broader scope, though many countries still target only central government finances. According to a recent IMF survey, slightly more than half of the countries with fiscal rules cover general government finances. However, few cover the entire public sector; thus, state-owned enterprises and special or trust funds are excluded in most countries.

[7] International Monetary Fund, "Fiscal Rules", Ibid. note 1.

34. Extending fiscal rules to subnational authorities requires a uniform accounting system spanning all levels, as well as capacity at the center to review budget and other financial projections and to monitor revenue and spending outturns. Trying to standardize financial reporting and to monitor all levels of government may be viewed in some countries as a power grab by the central government. But it is feasible to operate such a system. Brazil's comprehensive fiscal responsibility process covers central, state and local governments, and entails detailed bimonthly reports from all levels that are consolidated into a government-wide statement of fiscal results.

(4) Expenditure Impacts

35. Fiscal rules have differential impacts on public expenditures. They almost always have a greater effect on discretionary expenditures that are decided every year through budget and appropriations actions than on mandatory entitlements that are prescribed in standing legislation and continue from one year to the next without change unless new substantive decisions are forthcoming. Consequently, when government risks breaching expenditure or deficit constraint, its simplest recourse may be to curtail discretionary accounts without altering mandatory programs.

36. This built-in double standard may be a positive feature of fiscal rules, provided they are structured to produce countercyclical outcomes. Entitlement expenditures function as automatic stabilizers, in contrast to discretionary spending which normally has procyclical tendencies. Governments tend to expand discretionary programs when the economy is expanding and revenues are escalating, but spend less when the economy trends down and revenues become scarcer.

37. However, most entitlement expenditures are driven by demographic trends, not by cyclical swings in the economy, and by price and utilization trends in health services and certain other programs. It is thus often the case that entitlements are indifferent to cyclical changes. They rise when the economy is weak, as well as when it is strong. If fiscal rules put pressure on discretionary programs, but not on entitlements, they deepen this bias and lead over time to allocation of larger shares of the budget to mandatory programs.

38. Budget officials have an array of tactics for constraining discretionary expenditure within a fiscal limit. Frequently used tactics are across-the-board cuts, a freeze on discretionary spending or on public sector wages, deferring maintenance on public facilities, and accumulating arrears by slowing the disbursement of funds. None of these stands the test of good budget practice; all pass muster as good political tactics.

39. One of the most expedient tactics is to cancel or postpone infrastructure projects. In many countries, investment expenditure functions as a fiscal balance wheel: government spends more on infrastructure when funds are plentiful and less when the budget is tight. Stop-go financing has only one virtue; it keeps low-income governments solvent and more affluent governments within fiscal parameters. But this pattern is procyclical, impairs budget planning, adds to the cost of projects, retards national development, and generates significant variances between authorized and actual expenditures. These pathologies tend to be most damaging to low and middle income countries that have large infrastructure deficits. In these countries, public investment may have high priority in national plans, but low priority in national budgets. The problem predates the emergence of fiscal rules, but it should be evident that enforcing a fiscal constraint may more adversely affect investment expenditure than other parts of the budget. The impact has been less pronounced in affluent countries that have unfettered access to capital markets.

40. One way of protecting public investment is to wall it off from the rest of the budget in a special fund. In fact, when donors earmark funds to low income countries for specific projects, they often demand that the money be channeled to a special fund. As low-income countries come under the sway of fiscal rules, they face the question of how to sustain public investment while maintaining a disciplined budget policy. One option is to adopt a "golden rule" that requires a balanced budget for current revenue and expenditure but permits government to finance investment with borrowed funds and external aid.

41. Fiscal rules may be among the pressures that have induced national governments to finance expensive infrastructure investments through public-private partnerships (PPPs). Although they shift expenditures off the government's books and beyond the reach of fiscal limits, PPPs usually come with various guarantees that contingently expose government to future expenditures. Ideally, PPPs should substitute for direct public expenditures only when they generate efficiencies in construction or operation, not because they offer an escape from budget discipline.

(4) Timeframe

42. Rules that are bounded by the time frame of an annual (or even biennial) budget can be easily evaded by shifting expenditures to future years, or through one-off maneuvers that yield short-term increases in revenues or reductions in expenditures but do not improve the longer-term fiscal outlook. The effectiveness of some first-generation rules, such as the European Union's Stability and Growth Pact (SGP), has been impaired by their single year span. The obvious solution is to embed fiscal decisions within a medium-term framework (MTEF) that indicates the implications for each of the next three to five years. The MTEF reduces incentives to shift revenue or expenditures within its time frame, but each fiscal year still serves as a discrete time unit for making budget decisions and reporting financial results.

43. It is questionable, however, whether medium-term frameworks significantly strengthen fiscal discipline. One problem is the habit of projecting more favorable fiscal outcomes in the out-years than may be warranted. It is a rare government that forecasts a future recession or even slippage in the growth rate. Of course, when the economy performs below forecast, the government may be left with an elevated deficit that exceeds agreed fiscal limits. A related problem may be embedded in the MTEF process itself. Governments have a tendency to set specific escalating levels of expenditure for each year covered by the MTEF, more for the second year than the first, more for the third year, and so on. In the politicized world of budgeting, these amounts are regarded as floors – no as ceilings – for future spending.

44. Although MTEF is widely considered one of the success stories of contemporary budgeting, there has been inadequate consideration of its impact on budget behavior and fiscal outcomes. It may be that MTEF works best in countries experiencing sustained economic growth, such as Australia, and not as well as in those that have modest or halting growth. Yet, MTEF-type budgeting is here to stay, if only because a single year is inadequate for programming government policy and regulating public finance. Improving next generation fiscal rules may hinge on remedying deficiencies in MTEF, for example, by baseline outyear decisions on independent economic forecasts, changing the methods and assumptions used to construct baseline projections or forward estimates, and strengthening the treatment of outyear expenditures as ceilings rather than as provisional amounts that will be adjusted upward when the MTEF is rolled forward.

(5) Coverage

45. In most countries, fiscal rules have the same scope as the budget. In the handful of countries that have accrual budgets, fiscal rules also can be based on accruals, and thereby cover liabilities that have been incurred for which payment has not been made as well as revenues earned but not yet received. Most countries have cash budgeting and cash-based rules, which provide some opportunity for complying with fiscal constraints by manipulating the timing and recognition of cash flows. The accrual basis also offers opportunity for manipulation, by manipulating the assumptions that underlie reported revenues and expenditures. [8]

46. Neither cash nor accruals deal adequately with government exposure to risks that may come due to future years. Contemporary governments hold massive amounts of risk, often in the form of contingent liabilities that compel expenditures if certain events occur. Innovative governments have begun to devise new tools for reporting and recognizing contingent liabilities and other risks, ranging from listing them and estimated exposure in supplemental financial statements to expensing some contingent liabilities in the budget. As budget and financial reports evolve, so too will accounting for fiscal risks. It is highly probable that future rules will constrain either the new contingent liabilities assumed by government or aggregate stock of contingent liabilities.

47. Constraining risk-taking behavior through fiscal rules will be a challenging task. One set of issues pertains to the types of risks covered by fiscal constraints, another to how risks should be costed. Resolution of these issues will depend on how various risks are accounted for in budgets and financial statements.

(6) Enforcing Fiscal Constraints

48. Fiscal rules constrain government; they deter it from policies that it prefers and compel actions that it would otherwise forgo. Yet political commitment is critical at all stages of the rules process, from issuing economic and budget projections that are objective, to establishing realistic targets and accurately reporting fiscal results, and ultimately to taking corrective actions when warranted by the rules. Political leaders must have a hand writing and enforcing the rules, but the rules must also bind their hands.

49. At least three different enforcement models are at work in various countries. The framework model discussed earlier builds enforcement into the recurring process of setting targets and compiling and implementing the budget. In this model, government establishes the framework either as part of an MTEF or as a separate policy statement, and requires that the budget and its fiscal implications be consistent with the framework. A second model is for key enforcement tasks to be vested in a supranational authority, such as the European Commission or the IMF. Government leaders continue to have responsibility for framing the country's budget, but external authorities monitor their policies and may intervene with advice or sanctions.

50. The third model has recently gained some currency in Hungary and other countries. It calls for establishing an independent authority within the country to manage the rules process. The authority may have responsibility for macroeconomic forecasts, setting targets, monitoring outturns, and demanding

[8] Allen Schick, "Performance Budgeting and Accrual Budgeting: Decision rules or Analytic Tools," In OECD Evolutions in Budgetary Practice, pp. 379-402.

corrective actions. Some regard recourse to independent bodies as essential to maintain fiscal probity in countries that face intense resistance to tax increases and to benefit cuts; others see it as abdication of a core responsibility by government. Some view an independent fiscal authority in the same light as an independent central bank; some regard it as stripping government of one of its basic tasks.

51. Comparing the three models, one readily perceives fundamental differences in approach. Frameworks politicize the rules process: at every stage, political leaders have their fingerprints on key policies and actions. The potency of frameworks derives from the fact that they are invested with political importance. It is the government that establishes the framework and transparent reports that hold it to account. Supranational rule-setting and enforcement takes some responsibility away from political leaders, but they still have free rein in deciding the budget. Advice and sanctions are ex post, after the government has charted its fiscal course. Independent fiscal authorities depoliticize the rules process, taking key tasks away from elected leaders and putting tough decisions beyond the reach of populist pressures.

52. There is yet another model for fiscal enforcement that operates through all three versions but has its greatest impact on countries that rely on frameworks. Financial markets have a prominent influence on government fiscal behavior, especially in the post-crisis environment when the threat of sovereign default boosts risk premiums on government debt and makes it difficult to finance budget deficits. How fiscally-stressed countries deal with the after effects of crisis will influence future fiscal rules.

SECTION 3: WHERE DOES PARLIAMENT FIT IN?

53. The issue of political involvement spills over to the legislature's role in the rules process. The same considerations which shape the debate on the three models of enforcement pertain to the question of whether the national legislature should have a voice in setting fiscal targets, monitoring compliance, and assuring compliance. When government opts for an independent authority or a supranational entity establishes targets, the legislature will have little or no say, though it still may have a monitoring or oversight role.

54. The framework process offers the broadest scope for legislative participation. Legislative involvement can occur at all stages, when the framework is established, when the budget is tabled in parliament, and when the budget is executed and results are audited. However, the legislature's role must be viewed in a larger context – its overall relationship with government. Among democratic governments, this relationship ranges from the confined role of parliaments in Westminster-type systems to the virtually unbridled independence of the United States Congress. It is useful to consider the main types of parliaments in contemplating next generation rules.

- Westminster government confine but do not eliminate the legislature's role. Although the legislature cannot amend the budget tabled by the government, it can debate the fiscal parameters and actively oversee government performance, including fiscal results. It would not be untoward for members of parliament to question the government's economic assumptions or fiscal policy. Formal action on the fiscal framework would certainly be regarded as a matter of confidence, so party discipline would prevail if the issue were put to a vote.
- Parliamentary systems which permit amendments to the government's budget differ in their degree of independence. Although there is a marked trend toward greater legislative activism, as measured by the number of budget amendments offered each year, these changes tend to be small and do not significantly affect the overall fiscal posture, though they do strongly influence political behavior. As legislatures become more active and independent, fiscal frameworks become more valued, if only to deter parliament from adopting changes that would destabilize fiscal policy. When the legislature formally votes the framework, it commits itself to that policy and bars budget changes that would break agreed limits. One difficult issue, however, is the propensity of some national legislatures to open space in the budget for additional expenditures by estimating more revenue than is projected in the budget. Doing this enables the legislature to spend more, but to maintain, at least on paper, the fiscal balance proposed by government.
- Divided systems in which the President and Legislators are separately elected broaden the legislature's scope for independent action. It is important to note that in some countries with divided government, law or tradition give the president great sway and the legislature exercises less independence than in some parliamentary regimes. But, in countries where the legislature has real independence, it may be appropriate to assign it a formal role in the framework process, at least to the extent of debating the framework and possibly voting on it. This possibility raises difficult questions concerning what should be done if the legislature is unable to muster a majority in favor of the framework, or if it amends the rules submitted by government. One proposed solution is for the government's framework to take effect if the legislature fails to act. In this writer's view, it would be highly undesirable for separated governments to model fiscal practices after those of the United States, which provides for the

President and Congress to independently adopt their own frameworks. Two frameworks are not better than one, and in certain political circumstances can be worse than none.

- Separated and some parliamentary systems must reckon with the question of what authority can be reposed in the president to guard against breach of the framework during implementation of the budget. This is a sensitive political issue, especially in countries which allow the legislature to increase expenditures. Most such countries empower the president to withhold appropriated funds, but a small number (most prominently the United States) restrict his authority.[9]

55. One trend that is common to all parliamentary types is likely to influence future fiscal rules. In a growing number of countries, the legislature has established its own budget staff, either as a free-standing entity or attached to the budget or finance committee. Over time, these staffs will almost surely enlarge the legislature's role in budgeting and fiscal policy and alter traditional relationships between it and the government. In the immediate future, however, the urgent need to deal with the after effects of economic crisis will make many affected legislatures compliant to government policies. Assuming that economic order is restored, this will just be a blip in the long march of national legislatures toward greater independence. If it isn't, legislatures and government will both be trapped in the undertow of the new millennium's Great Crisis.

[9] Allen Schick, The Federal Budget: Politics, Policy, Process, pp. 248-89