OECD Journal on Budgeting
Volume 2010/2
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Post-Crisis Fiscal Rules: Stabilising Public Finance while Responding to Economic Aftershocks

by
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This article discusses the economic crisis that has ravaged the budgets of many developed countries, and whether conditions have sufficiently stabilised to permit governments to introduce next-generation fiscal rules. The article examines a series of issues that may arise as governments re-engineer 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 considers the role of budgeting in designing and implementing fiscal rules.

Rules are never effective substitutes for sound fiscal policy. One of the most important lessons from past experience is that unduly rigid rules tend to be unworkable and are not effectively enforced. Paradoxically, more flexible rules may arm government with greater capacity to constrain fiscal policy than do rules that are insensitive to economic or political circumstances. The necessary solution, this article argues, is to integrate fiscal and budgetary institutions, substantive and procedural constraints.

JEL classification: H500, H800

Keywords: Fiscal rules, budget institutions, financial crisis, medium-term expenditure framework

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1. Introduction

Fiscal rules have been among the most widely adopted budget innovations during the past two decades. Many rules have been adopted by national governments on their own initiative; others have been imposed by supranational authorities such as the European Union and other regional bodies. This article is grounded on the expectation that the still-smouldering 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.

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 are still 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.

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 finances 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-realisation that loose fiscal policies have impeded development.

Studies have concluded that rules have a positive impact on fiscal outcomes, particularly in countries that make large adjustments in revenue or spending policies. However, it is difficult to discern whether the positive effects are due to political commitment, which is expressed in the 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 (see Schick, 2009).

Rather than only look back at how fiscal rules have worked during the relatively brief time they have been in operation, this article 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 standardised. Although the article focuses on the future, intelligent rule making requires that governments base changes in practice on past experience. Accordingly, in contemplating the future evolution of fiscal rules, the article 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.

Future fiscal institutions will resemble and differ from existing ones. The main similarity is that the new institutions will impose numerical constraints on government fiscal actions or outcomes; the main differences are that the targets will be more pliable, but enforcement will be tougher. One of the most important lessons from past experience is that unduly rigid rules tend to be unworkable and are not effectively enforced. Paradoxically, more flexible rules may arm government with greater capacity to constrain fiscal policy than do rules that are insensitive to economic or political circumstances.

Section 2 frames the discussion in terms of the economic crisis that has ravaged the budgets of many developed countries. A key concern is whether conditions have sufficiently stabilised to permit governments to introduce next-generation rules. Section 3 is the main part of the article. It examines a series of issues that may arise as governments re-engineer 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 considers the role of budgeting in designing and implementing fiscal rules.

2. Rules *versus* crisis

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 set aside its characteristic constraining role and urged governments to take stimulative actions. However, to this writer's knowledge, no government has formally rescinded existing rules because of the crisis. Rather, some have put the rules in hibernation, expecting that they will be reactivated once conditions stabilise.

The fear of economic collapse has been so great that governments have not relied solely on automatic stabilisers – 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 OECD data, shows the sharp swing in the fiscal fortunes of member countries.

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 SGP. Some governments have been impelled to act by the conviction that

Table 1. **General government financial balances and gross financial liabilities**

Per cent of GDP

	Financial balances				Gross financial liabilities			
	2007	2009	2010	2011	2007	2009	2010	2011
Australia	1.8	–4.0	–3.5	–2.6	15	16	20	23
Austria	–0.7	–4.3	–5.5	–5.8	62	73	78	83
Belgium	–0.2	–5.7	–5.6	–5.2	88	101	105	109
Canada	1.6	–4.8	–5.2	–4.5	65	83	86	89
Czech Republic	–0.7	–5.7	–5.6	–5.0	38	47	53	60
Denmark	4.5	–2.5	–5.4	–4.0	32	45	49	53
Finland	5.2	–2.3	–4.8	–5.2	42	44	52	62
France	–2.7	–8.2	–8.6	–8.0	70	85	93	99
Germany	0.2	–3.2	–5.3	–4.6	65	77	82	86
Greece	–4.0	–12.7	–9.8	–10.0	104	115	123	130
Hungary	–5.0	–4.3	–4.1	–3.6	72	85	90	91
Iceland	5.4	–15.7	–10.1	–5.8	54	118	143	146
Ireland	0.2	–12.2	–12.2	–11.6	28	66	81	93
Italy	–1.5	–5.5	–5.4	–5.1	113	124	127	130
Japan	–2.5	–7.4	–8.2	–9.4	167	189	197	204
Korea	4.7	–1.8	0.4	1.1	26	33	37	41
Luxembourg	3.7	–2.3	–4.3	–3.6	11	18	25	31
Netherlands	0.2	–4.5	–5.9	–5.3	52	71	77	82
New Zealand	5.0	–1.2	–3.3	–3.9	26	27	31	36
Norway	17.7	9.6	9.9	10.8	58	60	59	61
Poland	–1.9	–6.4	–7.8	–6.8	52	58	63	66
Portugal	–2.7	–6.7	–7.6	–7.8	71	84	91	97
Slovak Republic	–1.9	–5.9	–6.3	–5.0	32	37	43	48
Spain	1.9	–9.6	–8.5	–7.7	42	59	68	74
Sweden	3.8	–2.0	–3.0	–2.0	48	53	55	58
Switzerland	1.6	–0.7	–1.3	–1.3	47	44	45	45
United Kingdom	–2.7	–12.6	–13.3	–12.5	47	71	83	94
United States	–2.8	–11.2	–10.7	–9.4	62	84	92	100

Source: OECD Economic Outlook, No. 86, November 2009, Annex Tables 27 and 32.

credible rules will help stabilise 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.

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.

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 normalise 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 are still in distress, it would not be feasible or prudent to adopt a constrictive fiscal course (see Table 2).

Table 2. **Real GDP growth has stagnated**

Per cent change from previous year

	2007	2008	2009	2010	2011
Australia	4.2	2.3	0.8	2.4	3.5
Austria	3.4	1.9	–3.8	0.9	2.2
Belgium	2.8	0.8	–3.1	0.8	1.7
Canada	2.5	0.4	–2.7	2.0	3.0
Czech Republic	6.1	2.6	–4.4	2.0	2.8
Denmark	1.6	–1.2	–4.5	1.3	1.8
Finland	4.1	0.8	–6.9	0.4	2.4
France	2.3	0.3	–2.3	1.4	1.7
Germany	2.6	1.0	–4.9	1.4	1.9
Greece	4.5	2.0	–1.1	–0.7	1.6
Hungary	1.0	0.6	–6.9	–1.0	3.1
Iceland	5.6	1.3	–7.0	–2.1	2.6
Ireland	6.0	–3.0	–7.5	–2.3	1.0
Italy	1.5	–1.0	–4.8	1.1	1.5
Japan	2.3	–0.7	–5.3	1.8	2.0
Korea	5.1	2.2	0.1	4.4	4.2
Luxembourg	6.5	0.0	–3.9	2.4	3.4
Mexico	3.3	1.4	–8.0	2.7	3.9
Netherlands	3.6	2.0	–4.3	0.7	2.0
New Zealand	2.9	–1.1	–0.7	1.5	2.7
Norway	3.1	2.1	–1.4	1.3	3.2
Poland	6.8	5.0	1.4	2.5	3.1
Portugal	1.9	0.0	–2.8	0.8	1.5
Slovak Republic	10.4	6.4	–5.8	2.0	4.2
Spain	3.6	0.9	–3.6	–0.3	0.9
Sweden	2.7	–0.4	–4.7	2.0	3.0
Switzerland	3.6	1.8	–1.9	0.9	1.9
Turkey	4.7	0.9	–6.5	3.7	4.6
United Kingdom	2.6	0.6	–4.7	1.2	2.2
United States	2.1	0.4	–2.5	2.5	2.8

Source: OECD Economic Outlook, No. 86, November 2009, Annex Table 1.

An alternative view would reverse the cause-effect relationship and argue that stabilising public finance by establishing tough realistic fiscal targets will accelerate economic recovery. Those who support this position point to the fact that countries which have strong fiscal regimes have generally weathered the crisis more favourably than those which lack strong regimes. The supporters 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 stabilised. Its recent robust economic performance has been spurred by the government's disciplined fiscal posture (see Alston *et al.*, 2009).

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.

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 under way 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 favourable. 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.

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 stabilisers 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 actions that are politically difficult, not only in countries where there is elevated risk of sovereign debt default, but also in countries which run the risk of having fiscal contagion spread to their own borders.

On the other hand, the decline in national output and the 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 liquidate budget deficits or lower unemployment to pre-crisis levels. Governments need expansionary policies to generate employment and contractionary policies to curtain deficits.

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 International Monetary Fund in its *World Economic Outlook Update* of January 2010:

> 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 (IMF, 2010, p. 5).

Invigorated rules can bolster a government's transition from stimulus to discipline and enable it to define a responsible fiscal path that recognises 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.

Establishing a fiscal target that cannot be attained or that 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 stabilise public finance by making out-year targets politically and financially attainable.

3. Lessons from the past, rules for the future

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.

Governments and international organisations face a number of issues in redesigning fiscal institutions:

- What should be limited?
- Should rules be established by individual countries or by supranational authorities?
- Should limits be free-standing or encapsulated within a fiscal framework?
- Should rules cover only the national government or sub-national entities as well?
- Should governments adjust limits for different categories of expenditure?
- Should the time frame be one year, the medium term, or longer?
- Should the accounting basis be cash or accruals?
- What should be the means of enforcing agreed limits?

3.1. What should be limited?

Although they may be framed as short-term objectives, fiscal institutions serve long-term ends – principally the sustainability of the public debt burden, conventionally measured as the ratio of debt to GDP. Ideally, therefore, fiscal institutions should constrain the stock of public debt. It is difficult, however, to target the debt ratio as the sole limit because it is not controlled directly but is the by-product of revenue and spending

decisions, as well as of other conditions such as interest and exchange rates. For these reasons, debt limits are often coupled with constraints on the overall budget balance. The SGP 3% deficit target and 60% debt limit exemplify this dual approach.

To be effective, a budget balance target must have broad scope, covering any extrabudgetary or off-budget funds. If it does not, limits can be easily disabled by shifting transactions outside its scope. Some innovative financial arrangements, such as derivatives and quasi-fiscal activities of central banks, raise questions about the reach of fiscal institutions.

Because they also served as political statements, early targets relied on simple measures such as the nominal deficit as a fixed per cent of GDP. However, fixed targets have a critical flaw: they do not distinguish between periods of economic growth and decline. They enable the government to incur the same deficit when the economy is overheated and in need of restraint, as when it is stagnant and in need of stimulus. This pro-cyclical bias is especially damaging during asset bubbles, when a surge in revenue gives governments licence to cut taxes and increase spending. It also has adverse effects when the bubble bursts and the government is compelled by preset limits to take constrictive actions that add to social misery and risk further damage to the economy. Of course, during crisis many governments have avoided this plight by simply disregarding the rules. But they would have been in stronger fiscal positions during the crisis if they had maintained a prudent counter-cyclical posture during the boom years.

Next-generation rules are likely to emphasise counter-cyclical features that target the structural balance or have built-in adjustments that accommodate cyclical swings in economic conditions. Counter-cyclical rules would allow automatic stabilisers to operate when the economy deviates 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. Temporary surges in the debt/GDP ratio during recession would be eliminated during growth periods. Moreover, fiscal institutions can be engineered to produce a sufficiently large surplus over the cycle to reduce the debt/GDP ratio. This has been the course taken by Chile, which (prior to the crisis) targeted a structural surplus of 1% of GDP. Its structural rule – which is based on estimates of full employment revenues, the trend price of copper, and interest rates – enabled Chile to accumulate large surpluses.

Operationalising a structural rule can give rise to problems in estimating the economy's potential and in taking corrective action when the budget out-turn varies significantly from the target. It is exceedingly difficult for a government to claw back money in the next budget when the prior year's budget balance falls short of the target. An alternative rule would shift the limit to trend GDP or revenues. This approach does not depend on estimates of potential GDP (or revenues) and might deter governments from spending "bubble-bloated" revenues that vanish when the economy cools. However, trend-based targets might allow a government to maintain unduly stimulative budgets in the first years of an economic upturn, and require it to adopt excessively constrictive policies at the start of a downturn.

Because of multiple difficulties in operating a deficit rule, some have argued that fiscal discipline should be tied to expenditure. Anderson and Minarik (2005) have mounted a strong case for an expenditure rule that would limit discretionary expenditures and tax expenditures, as well as policy changes in revenues and mandatory expenditures. The big advantage of an expenditure rule is that it is independent of any other variable. It does not depend on projections of future economic conditions or deficits, nor does it require

adjustments if those projections turn out wrong. An expenditure ceiling is easy to explain, is likely to have strong political support (except when particular programmes are adversely affected), and can be designed to distinguish between automatic stabilising changes in spending and those due to new policies. The case for expenditure ceilings may also reflect the conviction that, because of already-high tax burdens, most fiscal consolidation will have to occur on the expenditure side of the budget. In urging this approach, the authors may have been swayed by the experience of the United States, in particular the failure of deficit rules in the 1980s and the perceived success of expenditure limits during the 1990s (Schick, 2007). They may also have been influenced by Sweden and a few other countries that have had effective expenditure rules for an extended period. Yet, expenditure rules may give wide berth for manipulation to opportunistic politicians who can spend more but keep within the limits by making temporary adjustment or manipulating the timing of revenues or outlays.

Many countries target more than one fiscal indicator. An expenditure rule can be combined with targets for the structural balance and the debt ratio. There may be some prudence in multiple targets, provided they are consistent and do not unduly complicate fiscal management.

3.2. Should fiscal institutions be country-specific or regional?

The earliest targets were adopted by individual countries, and applied to them alone. Even when the IMF or other supranational bodies conditioned assistance on fiscal limits, each affected country acted on its own. Maastricht opened the door to rules that blanket all member countries of a regional authority with a uniform set of rules, and regional bodies in Africa and other regions now have fiscal targets for their countries. At present, more than half of the 80 countries that have rules are bound by regional treaties: Europe's SGP; the West African Economic and Monetary Union; the Central African Economic and Monetary Community; and the Eastern Caribbean Currency Union. Twenty of these countries also have their own rules.

Uniformity is both the main advantage and main shortcoming of supranational rules. They impel recalcitrant countries to accept fiscal constraints, but they lack strong monitoring and enforcement mechanisms. They impose the same limits on all covered countries, but are not sensitive to differences among the countries. They override political objections, but cannot count on political commitment to make tough choices when the limits are threatened. They favour simple targets that can be marketed to each country, but are likely to have pro-cyclical tendencies. Combining national and supranational rules eases these problems, and may provide the most effective formula for linking countries in a fiscal treaty while being sensitive to country-specific circumstances.

Of course, combining both types of rules makes sense only when the country rules are more stringent than the supranational ones. Differences between coexisting rules indicate the distance between countries that want tough fiscal regulations and those that prefer less. Germany's recent constitutional rules go much further in restricting fiscal manoeuvre than some other EU countries want. There is some prospect, however, that the lingering crisis and the risk of sovereign debt default will induce some fundamental rethinking of the boundaries between national and supranational institutions. Lax supranational standards can invite new kinds of moral hazard if countries shelter imprudent fiscal behaviour within the protective ambit of regional rules. One should not be surprised if next-generation supranational rules have tougher monitoring provisions that allow regional bodies to intervene when a member country strays from agreed limits.

3.3. Frameworks for rules

In some countries, fiscal rules are free-standing targets that are independent of the budget process or other recurring procedures for establishing government policy. The targets are fixed in law or in a policy pronouncement, or imposed by a supranational authority. In these situations, the assigned task of budgeting is to comply with the pre-determined constraints. In other countries, rules are integrated into a fiscal responsibility process that dictates how the government sets targets each year (for a multi-year period), how the targets are linked to the budget, and the manner in which they are enforced. The framework allows the government to remake the targets each year, or more often if warranted by circumstances.

Where this approach is used, budgeting may be divided into two discrete stages, each with its own legal basis and sometimes several months apart. During the framework phase, the government presents economic forecasts, establishes targets for budget aggregates and possibly for sectors as well, and (in some countries) presents its framework to Parliament for debate or approval. Typically, the framework is incorporated into a medium-term expenditure or fiscal process covering the next three to five years. During the budget phase, which may occur months later, the government compiles estimates and Parliament votes appropriations, with procedures in place to check whether budget actions are within the targets set by the framework.

Fiscal rules tend to be more effective when countries embed them in a framework. It is not hard to discern how 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 and greater feasibility than free-standing rules, which usually are set without regard to a particular year's circumstances. And because they are adjusted annually (biennially, in some countries), frameworks are more sensitive to shifts in political sentiment. Finally, frameworks typically involve some means of enforcement that are connected to the budget process.

These considerations bolster the conclusion that supranational institutions are weaker than country-specific arrangements. The former always lack frameworks, the later sometimes have them. It is feasible, however, to compensate for this imbalance by adding more muscle to supranational enforcement. Over time, this is certain to happen, perhaps beginning with stronger budget accounting rules, then closer oversight of countries' actions, and eventually giving supranational bodies some corrective powers.

There is another side to frameworks: the very ease of adjustment may tempt politicians to mould them to their preferences. There is substantial risk that pliable rules will be more accommodating than constraining. If governments comply with framed rules, it may be because of their power to bend rules to their interests, not because frameworks tie their hands. Transparency and political accountability are the principal instruments for establishing fiscal discipline in framework-centred countries that lack fixed rules. Politicians, the argument runs, pay a price at the polls if they opportunistically reset targets in disregard of fiscal realities. The media would broadcast that deficits have been raised or debt reduction targets lowered. It may be that frameworks work only in countries that have attentive media and leaders who tether themselves to limits. To some extent, this has been the case in framework countries such as Australia, Brazil and New Zealand. But where these supporting conditions are absent, frameworks may lack sufficient muscle to whip fiscal policy into line.

Frameworks link fiscal and budget institutions. They demonstrate the dependence of fiscal policy on budget rules and practices that fortify substantive rules and give them teeth. A medium-term expenditure framework is obviously the most relevant budget institution because it frames fiscal rules over a 3-5 year horizon. But other budget institutions also contribute to fiscal discipline. This issue is discussed in the next section.

3.4. Government scope

Fiscal institutions are established and maintained at the national level for the obvious reason that fiscal policy is a national responsibility. Nevertheless, in federated countries and in countries that have decentralised significant revenue and expenditure authority, sub-national governments have a large impact on the overall fiscal posture. In these countries, it may not suffice to constrain only the national government; limiting the geographic scope of rules can lead to easy circumvention – for example, by shifting some expenditures to local or regional authorities. Moreover, some countries authorise sub-national governments to issue debt that is explicitly or implicitly guaranteed by the national government. In these situations, the fiscal position of the national government risks being affected by the actions of lower governments.

The interdependence of national and local governments has been propelled by fiscal decentralisation, which often has been promoted without considering the country's financial posture or the capacity of newly empowered governments to manage their finances. Extending fiscal institutions to sub-national governments requires uniform accounting and reporting systems covering all levels, as well as capacity at the centre to process vast amounts of financial information and to closely monitor local revenue and spending actions. Standardising financial reports and monitoring local compliance with constraints may be viewed in some countries as a power grab by the central government. There is little doubt that "whole-of-government" fiscal institutions transfer political and financial power to the centre. Yet it is feasible to recentralise fiscal institutions. As a federal country, Brazil has powerful states but its comprehensive fiscal responsibility process, which is anchored in law, covers central, state and local governments, and operates through detailed bimonthly reports from all state and municipal governments that are consolidated into a government-wide fiscal statement.

3.5. Expenditure impacts

Fiscal rules have differential impacts on public expenditures. The rules almost always have a greater effect on discretionary items that are decided, annually in most countries, through budget and appropriations actions than on mandatory entitlements that are prescribed in standing legislation and continue from one year to the next unless policy changes are enacted. When a government risks breaching deficit or expenditure limits, its simplest response may be to curtail discretionary accounts, most of which are allocated for public consumption and investment, without altering mandatory programmes, most of which are for income transfers.

This double standard can be regarded as a positive feature of fiscal institutions to the extent that it allows automatic stabilisers on the expenditure side of the budget to function. Discretionary spending, by contrast, has pro-cyclical tendencies: it is increased when the economy is growing and constrained when the economy trends down. This is certainly the pattern in those sub-national governments that cannot debt finance current expenditure. Governments have an array of devices for constraining discretionary

spending within a fiscal limit. Some of the more popular tactics are across-the-board cuts, freezing discretionary spending or public sector wages, deferring maintenance or investments, and accumulating arrears. None of these devices stands the test of good budgeting; all pass muster as good political tactics. Another way of stating this point is that, if the brunt of fiscal discipline falls on discretionary programmes, it may induce inefficiencies that distort priorities and degrade public services.

Public investment often is the most adversely affected portion of the discretionary budget. Investment expenditure functions as a fiscal balance wheel: projects are started when funds are abundant and halted or slowed when the budget is tight. Stop-go financing has only one virtue: it keeps low-income countries solvent and more affluent countries within fiscal parameters. But this pattern is pro-cyclical, impairs project planning, adds to their costs, retards national development, and generates significant variances between authorised and actual expenditures. These pathologies can be very damaging to low and middle-income countries that have large infrastructure deficits. In these countries, public investment often has high priority in national plans and low priority in national budgets. The problem predates the emergence of fiscal rules, but a fiscal constraint may more adversely affect investment than other parts of the budget.

Public investment can be shielded from cutbacks by adopting a "golden rule" that requires a balanced budget for current revenue and expenditure, but permits governments to finance investment with borrowed funds or external aid. A similar approach has been taken in the African monetary treaties which exempt investment expenditure from fiscal rules.

Fiscal rules may be among the pressures that have induced some national governments to finance expensive projects through public-private partnerships (PPPs). Although they shift certain expenditures off the government's books and beyond the reach of fiscal limits, PPPs are usually structured with guarantees that contingently expose governments to future expenditure. This practice gives rise to a question that warrants consideration: should fiscal rules constrain the volume of contingent liabilities accumulated by government?

3.6. Time frames

Fiscal institutions that are bounded by an annual (or biennial) time frame can be easily evaded by shifting expenditures to future years, or through other one-off manoeuvres that yield short-term increases in revenues or reductions in expenditures but do not improve long-term fiscal prospects. The obvious solution is to embed fiscal constraints within a medium-term framework (MTEF) that sets a ceiling on expenditure for each of the next 3-5 years. If it works as designed, an MTEF would dampen incentives to shift revenues or expenditures within its time frame, but each fiscal year would still be a discrete period for allocating resources and reporting financial results.

It is questionable, however, whether medium-term frameworks significantly strengthen fiscal discipline. One problem is the tendency to project more favourable outcomes in future years than is 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 the forecast, the government may be left with a "no fault" deficit that exceeds agreed fiscal limits. A related problem may be inherent in the MTEF process itself. Governments are inclined to set escalating levels of expenditures for each year covered by the MTEF: more for the second year than for the first, more for the third year, and so on. In the politicised world of budgeting, these amounts often are regarded as floors – not as ceilings – for future spending.

Although the MTEF is widely considered one of the success stories of contemporary budgeting, there has been inadequate consideration of its political and fiscal impacts. It may be that the MTEF works best in countries experiencing sustained economic growth, such as Australia, and not as well in those that have modest or halting growth. Yet, MTEF-style budgeting is here to stay, if only because a single year is an inadequate span for programming policy initiatives and regulating public finance. Improving next-generation fiscal rules may hinge on remedying deficiencies in the MTEF – for example, basing estimates of future fiscal space on independent economic forecasts and treating out-year expenditure targets as firm ceilings rather than as provisional amounts that will be adjusted upward when the MTEF is rolled forward.

A fiscal rule that spans the medium term does not have a sufficiently long time horizon to address issues of sustainability, which may lie 30-50 years ahead. It may be feasible for innovative governments that produce long-term projections to devise an intertemporal fiscal rule that would constrain current revenue and expenditure decisions on the basis of their long-run impacts. One version of such a rule might bar a government from taking current action that increases the present value of the long-term fiscal gap. Alternatively, the government could extend its medium-term framework from 3-5 years to a 7-10 year horizon (or longer).

3.7. The accounting basis

In most countries, fiscal rules have the same basis as the budget. In the handful of countries that have accrual budgets, fiscal limits cover accrual liabilities for which payment has not been made, as well as revenues earned but not received. In these countries, it would be sensible to establish a parallel constraint on cash flows. Most countries have cash budgeting and cash-based rules which provide some opportunity for complying with fiscal rules by manipulating the timing and recognition of receipts and disbursements. It should be recognised, however, that the accrual basis is also vulnerable to manipulation, principally by altering the assumptions that underlie accrued revenue and liabilities.

One of the critical challenges for public sector accounting is to devise standards for recognising government exposure to risks that may come due in the future. Innovative governments have begun to devise tools for estimating and reporting contingent liabilities and other risks. It is highly probable that future rules will constrain either the volume of contingent liabilities assumed by a government during a fiscal period or the stock of such liabilities.

3.8. Enforcing fiscal rules

A robust fiscal institution should have two main elements: a numerical constraint, and means of enforcing the constraint (*ex ante* through monitoring or *ex post* through penalties or intervention). 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, compiling the budget, and implementing expenditure plans. This model requires that the budget be consistent with the framework. The main strength of this model is integration of the fiscal rule and the budget; its corresponding weakness is that the government may bend the rules in formulating the budget.

A second model is for enforcement responsibility to be vested in a supranational authority, such as the European Commission or the International Monetary Fund. A country's government retains custody of the budget and related processes, but external

agents monitor policies and intervene with advice or sanctions. A critical flaw in this approach is that external enforcers might not have timely or accurate information, especially if a rule-violating country is determined to veil its true fiscal position.

The third model calls for empowering an independent agency within the country to manage the rule-making and enforcing processes. This authority would have responsibility for macroeconomic assumptions and projections, monitoring out-turns, and demanding corrective action. Proponents of this approach regard independent enforcement as a prerequisite for fiscal probity in countries that have fiscal imbalances but face intense resistance to tax increases or benefit cuts. Others view an independent agency as an encroachment on a core responsibility of government.

The three models differ in the extent to which political influences affect fiscal rules. Frameworks incorporate politics into 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 those who have political responsibility are also assigned fiscal responsibility. Supranational rule setting and enforcement limit the scope of political action, but political leaders retain the authority to decide the budget, except in those circumstances when the country lacks access to financial markets and must solicit external assistance. Independent fiscal authorities depoliticise the process, take key fiscal tasks away from elected leaders, and put tough policy decisions beyond the reach of populist pressures.

4. Fiscal rules depend on supportive budget procedures

Fiscal rules do not operate in isolation; they need supporting institutions, principally political commitment and disciplined budget procedures, to be effective. This may be one of the reasons why supranational rules, such as the Stability and Growth Pact, are potentially weaker than country-specific rules. When fiscal rules lack institutional support, they may become vacuous pronouncements that have little or no impact on budget decisions and outcomes.

In many OECD countries, the introduction of fiscal rules has been associated with innovation in budget institutions. Most of these limit the procedural freedom of budget makers.

Despite their interdependence, procedural innovation is not a substitute for substantive institutions, nor can it remedy deficiencies in fiscal policy. The case for explicit fiscal rules rests on the argument that sound budget procedures do not assure sound policies, and it is therefore prudent to prescribe substantive limits on budget actions. Budgeting is an open process whose outcomes can be swayed by opportunistic politicians who curry favour from today's voters by damaging the country's future fiscal posture, by voters and groups who demand more benefits but resist paying more taxes, by media reports on shortcomings in public programmes, by shifts in economic conditions, and much more. Tinkering with budget institutions will not eliminate the pressures that drive governments to fiscal imprudence.

The notion that sound budget institutions suffice to assure sound substantive outcomes flies in the face of a century of budget reform. During the 20th century, many national governments significantly improved their management of public finance by standardising accounts, establishing reliable internal or external control systems, strengthening the audit function, improving the quality and flow of relevant data to policy makers, installing integrated financial information system, boosting the capacity to evaluate programmes and

results, emphasising outputs and outcomes, and lengthening the time horizon of budgeting. Yet, during the same century, public spending soared in real per capita terms and as a share of national income, deficits became more common and larger, and expenditures became more rigid. Governments had better budget processes, but not necessarily better fiscal outcomes.

There is no linear relationship between a procedural adjustment in budgeting and a change in fiscal outcomes. If there were, governments would have no need to superimpose fiscal rules. The budget is clay in the hands of politicians and bureaucrats who mould it in accord with their interests, the pressures they face, and the outcomes they seek. Just as handling clay can be regulated to deter certain behaviours and encourage others, budget procedures can be adjusted to spur spenders to change the actions they take. The principal adjustment is in the information content of budgets: data on 3-5 years rather than on one, classification of outputs rather than inputs, accounts of revenue earned rather than received and of liabilities incurred rather than payments made, and so on. In budgeting, this information is refracted through the perspective of controllers and spenders who may be influenced to alter their behaviour, but might persist in their preferred ways.

If budget institutions are substantively neutral, does it matter which procedures are used? Have decades of innovation in budgeting been a futile sideshow? Can it be said that one set of procedures is superior to another? The sufficient answer to these questions is that having relevant information and analysis is better because not having them biases outcomes. Not having information on the future spurs budget makers to disregard the future; a lack of data on results gives them incentive to ignore results; and so on. Information levels the playing field in budgeting: myopia is not rewarded, nor is disregard of contingent liabilities or of the quality and quantity of public services.

Making the process procedurally neutral might not suffice, however, to produce efficient allocations or prudent totals. Politics gets in the way, as it should in a democracy, as do the common pool problem, incremental biases, asymmetries in information, the concentration of programme benefits and dispersion of costs, and other conditions that weigh heavily on budget decisions. Because budgeting is an open system, its outcomes can be influenced as much by outside pressures as by internal procedures.

This argument can be restated as follows: budget procedure is neutral, budget outcomes often are biased. The basic remedy is to counter the biases through fiscal institutions that deter or preclude unwanted outcomes. If the process is biased to yield deficits, a fiscal rule can demand balance; if it is tilted in favour of higher expenditure, a fiscal rule can limit spending growth. But just having fiscal institutions does not suffice, because critical decisions are processed through the machinery of budgeting. The necessary solution, this article argues, is to integrate fiscal and budgetary institutions, substantive and procedural constraints. Neither alone can assure the preferred outcomes.

This point can be illustrated by examining three budget institutions often used as criteria for assessing the quality of budget work: top-down budgeting, medium-term frameworks, and a performance orientation. All three enrich the supply of budget information, and all three can be deployed to constrain or increase public expenditure. Tethering them to constrictive fiscal rules via the budget framework diminishes their expansionary tendencies.

When top-down budgeting emerged decades ago, during the post-war growth spurt, it was an instrument of programme expansion. The core idea was that political leaders should lay claim to incremental resources at the start of the annual budget cycle, before spending units submit bids. Policy guidance from the top should shape budget priorities and enable leaders to dictate to subordinates how incremental funds are to be used. This was the logic of PPBS (planning-programming-budgeting system): governments should plan and programme before they budget. Today's version of top-down budgeting is constrictive only if it is accompanied by a fiscal rule that limits aggregate and sectoral spending. The role of those at the top is to communicate and enforce limits for those below them in the political-administrative chain.

The most popular contemporary budget innovation has been the medium-term expenditure framework (MTEF) but, as already discussed, it can be an expansionary process, even though its generic purpose is to constrain current expenditure decisions by requiring government to take account of the impact on future budgets. When it is applied properly, which has not often been the case, an MTEF establishes a "hard constraint" on future expenditures and measures compliance through baseline projections of the space available for policy initiatives. Many countries that claim to have an MTEF have treated out-year constraints as floors for future spending, not as ceilings, which defeats their purpose and can adversely affect the government's fiscal positions.

The popularity of the MTEF may be due to the ease with which it can be deployed for different ends. Although initially devised (in Australia) during a period of austerity, the MTEF can be used to protect or enlarge space in future budgets and to plan and finance spending initiatives when resources are plentiful. In fact, this was the manner in which Australia used an MTEF during more than 15 years of uninterrupted economic growth beginning in the early 1990s (Wanna *et al.*, 2000).

When a medium-term constraint is soft, spending units regard the amounts specified for future years as minima and use the budget process to wrest more money from the government. In fact, baseline projections (or forward estimates) legitimise this expansionary tendency of the MTEF by using current spending levels, adjusted for price and workload changes, as the starting point for budget work. To counter this tendency, it is necessary for governments to adopt fiscal rules that harden the MTEF constraint so that it is treated as a ceiling rather than as a floor.

Finally, a performance orientation complicates the task of cutting or holding the line on expenditure. Input-based budgeting obscures the impact of spending cuts on services; performance budgeting highlights these impacts. This is why austerity programmes favour across-the-board cuts and similar ploys, and it partly explains why performance-based systems rarely explicitly link increments of resources to increments of results. It is difficult to frame a rule that would require a government to spend on higher-performing activities rather than on lower-performing ones. Without such a rule, performance budgeting struggles, more than half a century after it first appeared, to be little more than stuffing budget documents with information on what spending units do with appropriated funds.

The implications of these arguments are that, independent of one another, fiscal and budget institutions can facilitate consolidation or accommodate political demands. They can bend to political pressure, as has happened often enough in recent times, or fortify governments that want to discipline public finance, as has also happened from time to time. When effectively integrated by means of a framework, they are more likely to be

consolidating institutions. For example, a fiscal rule that is built into a medium-term budget framework has a higher probability of effectiveness than a free-standing rule. Moreover, a budget framework without a fiscal rule is likely to exert upward pressure on public finance by having the government make forward commitments. In other words, budget institutions that are disconnected from fiscal constraints can have adverse fiscal effects, and institutions that fortify fiscal rules can, and probably should, be part of a package of measures to stabilise public finance.

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From:
OECD Journal on Budgeting

Access the journal at:
https://doi.org/10.1787/16812336

Please cite this article as:

Schick, Allen (2010), "Post-Crisis Fiscal Rules: Stabilising Public Finance while Responding to Economic Aftershocks", *OECD Journal on Budgeting*, Vol. 10/2.

DOI: https://doi.org/10.1787/budget-10-5km7rqpkqts1

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