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The Role of Fiscal Rules in Ensuring Fiscal Discipline

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Abstract

The necessity to devote serious attention to the issue of fiscal discipline in many countries of the world, raised the question for implementation of adequate tools in order to control the irresponsible fiscal policy through emphasizing the importance of fiscal rules and fiscal councils. The purpose of this paper is to analyze the advantages and disadvantages of these fiscal rules, as well what the states should undertake to improve the prudence of fiscal policy, credibility of state institutions and reduce the level of indebtedness. This paper enlightens the problems that face many of the countries which implement some kind of fiscal rule especially in bad economic conditions. Also, the authors in this paper elaborate several cases of countries who implement different types of national, subnational or supranational fiscal rules and determines the effectiveness or restrictions of specific kind of rules.

Keywords: fiscal rules; fiscal discipline; fiscal councils; public debt; budget deficit.

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1. Introduction

The emergence of the European debt crisis and the need to stabilize the large fiscal imbalances and high budget deficits of countries which implemented comprehensive fiscal package of measures, led to extensive application of fiscal rules as institutional instrument to support fiscal discipline and sustainability of public finances [1].

In the economic literature, three stages are stressed out in the development and implementation of fiscal rules. The first stage was during the 1990's in response to the bank (Finland and Sweden) and debt crises (Brazil and Peru) and the need for fiscal adjustment of accessing countries in the euro area (Belgium). The second stage was at the beginning of 2000, when many developing countries modified their fiscal frameworks and introduced more than one fiscal rule in order to stabilize the excessive budget deficits and unsustainable public debt (the Netherlands and Switzerland). The third stage rise as consequence of the global and the debt crisis and represents a so-called *new generation of fiscal rules* [2].

Fiscal rules are defined as permanently (long-term) restrictions on fiscal policy by limiting the values of the relevant budget parameters [3]. The purpose of these rules is to ensure greater fiscal responsibility, credibility and sustainability of public debt through fiscal discipline which will lead to efficient and effective management of public finances and avoiding excessive public spending in good and prosperous times, which leaves little room for countercyclical response in terms of bad and unfavorable times. Each element of fiscal rules definition is relevant. The rule describes the target value of the budget indicators (numerical target) over a long period of time about the direction of fiscal policy. It specifies the final operating fiscal indicator on which can be applied and the rule is simple that it enables rapid implementation, public communication and monitoring.

2. Types of fiscal rules

Fiscal rules have different properties in terms of objectives, operational guidelines and transparency. Therefore, the primary purpose of these rules is to promote fiscal sustainability. According to the type of budget indicators that are limited, fiscal rules are divided into four groups*: rules of public debt, the budget deficit rules, rules of public spending and tax rules.*

The rules of public debt set explicit limits or targets for public debt as a percentage of GDP. By definition, this type of rules are the most effective in terms of ensuring convergence to the target level of debt, and better communication with the public. Due to the time delay in the implementation of these rules, they do not provide a clear short-term direction for the policy makers. In addition, the rules of debt can be affected by events beyond the control of the government, such as changes in interest rates, exchange rates and "below-the-line" funding, leading to large and unrealistic fiscal adjustments and violation of the rules of debt.

The rules of the budget deficit limit those variables that primarily affect the indicator of debt and are largely under the control of policy makers. Hence, these rules provide a clear direction and operational support for debt sustainability. The rules of the budget deficit can be specified as the rules of the total, structural or adjusted budget deficit and the deficit "over the cycle." Cyclic adjusted budget deficit includes changes in fiscal policy that are not related to the effects of the economic cycle on the budget. Structural budget deficit includes

additional one-off factors and other non-discretionary changes in the budget that are not related to the economic cycle. While these targets specify annual target, the rule "over-the-cycle" ("over the cycle") requires the maintenance of the nominal budget deficit to average levels over the economic cycle. While the first kinds of rules do not qualify as economic stabilization, the last three rules are explicitly used for the occurrence of economic shocks. *The rules of the primary budget deficit* relate poorly towards debt sustainability, because the increase in interest payments does not cause budget adjustments, even in the case of potential impact on the budget deficit and public debt. The "golden rule", which targets the overall budget deficit net of costs for capital investment is less associated with debt. The rule "pay-as-you-go" stipulates that any measure in the form of additional expense or reduced revenue which increases the deficit must be compensated by another measure with neutral effect on the deficit, and also is considered to be procedural rule and is not included in the base of numerical fiscal rules, because it sets no limits on the values of budget indicators.

The rules of public spending pose constant restrictions over total, primary or current expenditures in absolute terms, the growth rate or a percentage of GDP. These rules are not directly related to the sustainability of debt, because they do not restrict the expenditure side. However, in combination with the rules of the debt or the deficit, they can provide an operational tool for achieving the necessary fiscal consolidation that is consistent with debt sustainability.

The rules of public revenues set upper and lower restrictions on the revenues in order to increase revenue and prevent excessive tax burden. Also, these rules are not directly related to the control of the public debt, because it contains no restrictions on the expenditure side.

In order to overcome the limitations of the rules and to achieve greater convergence with debt sustainability, many countries decided to implement a combination of two or more rules. In the beginning of 2009, the most countries had a combination of rules on debt and deficit rules [4].

According to the territorial coverage, rules are divided into: national, sub-national and supranational rules. Moreover, about 52% of the active fiscal rules are at national level, while others are involved in four supranational agreements: the Stability and Growth Pact in Europe, the West African Economic and Monetary Union, the Central African Economic and Monetary Community and the Eastern Caribbean Currency Union. In currency unions, supranational rules have basic goal to internalize the costs of regional fiscal indiscipline and form a framework for better coordination of fiscal and monetary policy. By the end of March 2012, 76 countries had adopted national and supranational fiscal rules [5].

Effective rules of fiscal policy consist of three components. *First*, stable and unambiguous link between the numeric target and the ultimate objective, such as debt sustainability. *Second*, bigger flexibility in response to a shock, so that the rule does not allow further deterioration of macro-economic stability. Depending on country conditions, flexibility is particularly needed in terms of variability of output, interest rates, exchange rates and other unanticipated shocks (natural disasters). *Third*, a clear institutional mechanism that includes corrective action in case of violation of the rule.

The legal basis of the fiscal rules differs according to the type of rules and country. Most of the rules of expenditure, debt and deficit are embedded in legislation. The smaller number of rules of income is implemented through a combination of political commitment, the coalition agreement and legal norms (Table 1). Generally, most of the rules of the deficit and debt supranational rules are established by international treaties. Only a small number of countries in its constitution have built fiscal rules (Table 2). However, the rules which are built on higher legal basis have long lasting character, because it is very difficult to revoke or modify them, even when the government changes.

Table 1. Statutory basis of fiscal rules

	Type of fiscal rule 1/			
	Expenditure	Revenue	Balance	Debt
Political commitment	4	2	3	4
Coalition agreement	4	1	3	4
Statutory	12	2	21	14
International treaty 2/			41	47
Constitutional	0	1	2	1
Total	20	6	70	70

Source: National Authorities and IMF staff assessment.

Note: 1/ Based on fiscal rules in effect by end-March 2012. The sum across columns can yield a higher number then the countries with rules as multiple rules are in place in many countries. All rules are national fiscal rules unless otherwise noted. 2/ these are all supranational fiscal rules.

Table 2. Countries with constitutional legal basis

Country	Type of rule	Year of adoption
France	Revenue	2006
Germany	Budget balance	1969, 2009
Poland	Debt	2004
Spain	Budget balance, debt, expenditure	2011
Switzerland	Budget balance	2003

Source: National authorities; and IMF staff assessment.

Note: Includes only rules that took effect by end-March 2012. Other countries that have adopted fiscal rules in their constitution but operational details are still being determined or include a long transition path until implementations are Italy, Hungary, and Spain. For the latter the expenditure rule has already taken effect, while the structural budget balance rule takes effect from 2020.

Most supranational rules for debt and deficit ratios cover the general government, which is not the case for less than half the national rules. In the case of supranational rules, higher legal status increases the probability of covering the performance of the general government. National rules on spending and budget deficits often cover performance of the central government. For the national rules of income and debt, coverage of general and central government is pretty equal. There are countries with fiscal rules which deduct certain revenues and expenses of the targeted indicator, such as capital investment that corresponds to the well-known "golden rule" (Table 3). Few countries, also, deduct interest payments and cyclically-sensitive costs of target indicator. Costs of capital investments are deducted as they contribute positively to the long-term growth, but negatively to the relationship with the total debt. By contrast, interest payments and cyclically-sensitive costs in the short term are not under the control of the state and lead to short-term adjustments in other cost categories, mostly cuts in capital spending has a negative impact on growth.

Table 3. Coverage of aggregate

Item most frequently excluded	Countries where exclusions apply (Type of rule)
Interest payments	Finland (ER), France (ER), Spain (ER), Sweden (ER)
Cyclically-Sensitive expenditure	Denmark (ER), Finland (ER), Switzerland (BBR)
Capital expenditure	National: Brazil (ER, DR), Ecuador (ER), Hong Kong SAR (BBR), Japan (BBR) Supranational: WAEMU and CEMAC (BBR, DR, foreign financed capital spending excluded)

Source: National authorities; and IMF staff assessment.

Note: Based on fiscal rules in effect by end-March 2012. BBR=budget balance rule; DR=debt rule; ER=expenditure rule.

The biggest concern about fiscal rules is that there is little room for adjustment to shocks, risks relating to backsliding from the priorities of spending and undermining the credibility due to certain interest groups. Hence, in order to increase the flexibility of the rules, it began active application of escape clauses (exit), which should include: (1) a limited number of factors that allow the activation of these exit clauses in the legislation; (2) clear guidelines regarding the interpretation and determination of the events; and (3) specification of the way back to the rule of the law and treatment of accumulated deviations. These clauses are rules on budget deficits (and the rules of debt) in Brazil, Colombia, Germany, Mauritius, Mexico, Jamaica, Panama, Peru, Romania, Slovakia, Spain and Switzerland (Table 4). In all cases, the provisions of clauses output allow temporary deviations from the rules in case of recession or significant slowdown, natural disaster (Brazil, Germany, Jamaica, Mauritius, Panama, Peru, Slovakia, Switzerland) and the bank bailout system (Slovakia). However, the main problem associated with these clauses is the vague definition of the events on which activated clauses out. For example, until a constitutional change in 2009, the German rule allowed deviations in case of "macroeconomic balance disorders" as commonly applied to justify exceeding the upper limit of the deficit. In India, clauses allow the

government to deviate from the target in exceptional circumstances "such as the Central Government may determine." This ambiguity significantly reduces the transparency of fiscal rules and clauses.

Table 4. Fiscal rules with escape clauses coverage

Country and Date	Natural disaster	Economic recession	Banking system bailout, guarantee	Change in Government	Change in budget coverage	Other events outside govt. control	Voting mechanism defined	Transition path defined
Brazil (since 2000)	x	x	-	-	-	-	x	-
Colombia (since 2011)	-	x	-	-	-	x	-	-
Germany (since 2010)	x	x	-	-	-	x	x	x
Jamaica (since 2010)	x	x	-	-	-	x	-	-
Mauritius (since 2008)	x	x	-	-	-	x	-	-
Mexico (since 2006)	-	x	-	-	-	-	-	-
Panama (since 2008)	x	x	-	-	-	x	-	x
Peru (since 2000)	x	x	-	-	-	x	-	x
Romania (since 2010)	-	x	-	x	x	x	-	x
Slovakia (since 2012)	x	x	x	-	-	x	-	-

Spain (since 2002)	x	x	-	-	-	x	x	x
Switzerland (since 2003)	x	x	-	-	-	x	x	x
EU member states/ euro area (since 2005)	-	x	-	-	-	-	-	x
WAEMU (since 2000)	-	x	-	-	-	-	-	-

Source: National authorities; and IMF staff assessment.

The implementation of the rules can be strengthened by incorporating *mechanisms for automatic correction of deviations.* For example, the rules of the structural budget deficit of Switzerland and Germany contain mechanisms for automatic correction ("debt brake") that are activated in case of exceeding the upper limit of the deficit, which is different for a separate country (1.0% of GDP for Germany by ordinary law and statutory 1.5% and 6% of the cost of Switzerland). Also, the new agreement on fiscal sustainability "Fiscal Compact", which was signed by 25 member states of the EU on March 2, 2012, includes specific guidelines by the European Commission to create automated mechanisms for stabilization of potential deviations from the rules. "Fiscal Compact" or the Treaty on Stability, Coordination and Governance in the EMU, if implemented effectively, should be an effective tool for ensuring fiscal sustainability. This agreement introduces some new elements to the fiscal rules at the national level and strengthens the framework for fiscal management implied in the Pact for Stability and Growth (SGP), which should start to apply from 2014 year. This settlement includes: targeting the structural budget deficit of 0.5% of GDP, the introduction of mechanisms for automatic correction of deviations from the value of fiscal rules, a new rule for debt, the annual path of debt reduction must not be below 1/20 of the distance between the observed level and the target, new criteria for the expenditure, more effective automatic process of starting the Excessive Deficit Procedure and the formation of national fiscal councils which should contribute to achieving the sustainability of public finances.

Within the global financial crisis, many countries put their fiscal rules on hold and received numerous countercyclical stimulus measures in response to the sharp decline in production and demand. An example of inflexible character of supranational fiscal rules was the Pact for Stability and Growth of EMU, which in 2003 was put on hold due to the inability to predict the adverse effects of a prolonged three-year decline in economic activity, resulting in high budget deficit and extremely pro-cyclical fiscal policies, which significantly exceeded the prescribed level of budget deficit of 3%. This example serves as a reminder that, in general, it is impossible

to anticipate all the situations in which it would be desirable to suspend a rule. Those countries that had built out clauses in fiscal rules were able to provide some flexibility and mild violation of the rule in the direction of higher economic stabilization. In contrast, many countries after the crisis passed new fiscal rules or reformed the existing ones. For example, Germany introduced a structural budget deficit rule in the constitution (0.35% of GDP for the federal government and the states) to have an official application from 2016 for the federal government and 2020 for individual countries. Many countries such as Italy, Spain, Portugal, Austria, and Colombia defined the rules of structural budget deficits in order to provide a degree of flexibility in bad times and credible commitment in good times.

The new generation of fiscal rules explicitly combines the goal of sustainability of public finances with greater flexibility to adapt in terms of economic shocks.

3. Fiscal councils

Given the wide range of fiscal rules and their special features that correspond to the specific characteristics of each country, there is difficulty in identifying the general effectiveness of fiscal rules. However, numerous empirical studies have confirmed the positive effects of the introduction of national fiscal rules through improved fiscal performance of certain countries [6]. According to Wyplosz, the Fiscal Council is the second best solution for ensuring fiscal discipline and sustainable path of public finances. It represents an independent public institution whose primary responsibility is to monitor the compatibility of fiscal policy to the prescribed fiscal rules, as well as evaluating the possible need to take corrective action in order to strengthen fiscal discipline [7]. The first wave of establishing Fiscal Councils was in Belgium, Denmark, the Netherlands and the United States, which was then followed by a second wave led by Sweden in 2007, Ireland, Portugal, Slovenia and the United Kingdom. It is encouraging that a number of countries in the Eurozone already have fiscal councils formed or are in process of establishment. Namely, today, 19 Member States have active Fiscal councils, which is four times more than in 2007 [8]. The number of these institutions is expected to grow in the coming months. The only EU countries that do not have specific legislative initiative for the establishment of fiscal council are Czech Republic and Poland, because they are not under the authority regulations of both the EU pacts.

In some countries, these fiscal councils are an integral part of other public institutions, such as central banks, national audit houses or parliament. However, it is difficult to assess the effectiveness of Fiscal councils. Their effectiveness will largely depend on whether they are independent of political influence and possession of functional autonomy. Fully independent and credible fiscal councils tend to increase political costs of the governments for deviating from their obligations and responsibilities. It is especially important that the political impact is strictly prohibited and the election of members of these councils to be based on their qualities and expertise, and not political preferences. In many countries, members of the councils are academics or experts outside the government. An example of a fiscal council composed of senior and proven experts is Sweden in 2007, where 6 member Council is consisted of persons with high academic abilities in the economy and people with significant practical experience in the implementation of policy. In November 2011, the council is composed of 5 academic economists and one outside economist with Norwegian ancestry.

Fiscal councils are divided into soft, hard and very soft fiscal advice. Soft councils have extremely advisory function, suggest a certain level of budget deficit each year and governments are not obliged to adhere to their advice. The effectiveness of this arrangement depends exclusively from public debate. This kind of fiscal council exists in Belgium, Denmark, Chile, the Netherlands and Sweden. Hard fiscal councils determine the level of budget deficit every year, which is binding on governments and parliament. Because of their great power, they are not very desirable by the fiscal authorities. The last forms of councils are very soft fiscal councils that rely exclusively on expert assessments that are incorporated into the budget process only as input to the government and parliament. Examples of such councils are: the German Council of academic experts, the Council of the fiscal system in Japan and the Office of Congressional Budget in US [9].

However, the time will show what will be the positive effects of the establishment of the Fiscal Council and their combination with the fiscal rules, and commitment and determination of governments to implement credible and prudent fiscal policies aimed at achieving sustainability of public debt and macroeconomic stability.

4. Conclusions

The last debt crises in the world had raised the question for debt sustainability and fiscal discipline all around the world. There are two effective instruments for achieving sustainable debt situation and improving the awareness of the policy makers for rational public spending. One of the instruments is fiscal rule which can be placed on several economic variables, such as public debt, budget deficit, public spending and public revenues. The first two have shown, in the case of EU, that when the countries intend to implement one or several rules, they must pay attention to their flexibility [10]. This is very important and obvious in time of economic crises or external shocks, floods, etc. where these kinds of rules limit the countercyclical fiscal policy. Therefore a lot of countries in the world especially those who implement supranational rules intend to break them for short period of time until they achieve economic stability. Most of those countries intend to implement some of those rules in the constitution in order to secure long term commitment towards fiscal convergence. One of them is Macedonia. The Maastricht treaty rules for public debt and budget deficit are incorporated in the Macedonian constitution in order to secure long-term fiscal discipline and to raise the public awareness between all political parties for the issue of prudent fiscal policy. Normally, there are countries that implement rules on expenditure like additional support to the first two rules, such as USA. Those limits are presented through absolute numbers on the expenditure side. Never the less, a lot of countries after the deep recessions tend to improve the existing rules or even create some new ones which should resolve some issues that were obviously difficult in these times of crises. Other the rules, fiscal councils are the alternative for achieving effective management with public finance. Since 2007 the number of these kinds of institutions tends to rise. There is tendency the members of these councils to be elected as independent experts in their fields and not for their political preferences. Depending of the level of fiscal autonomy varies the role and importance of these councils in many states. More autonomy means more fiscal discipline and opposite.

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