Chapter-IV

International Experience of Fiscal Policy Rules

4.1. Introduction

The virtue of fiscal discipline has been admired, for at least two millennia, yet, occasionally, departures from discipline have been justified politically most notably, aftermath of great depression. In the 1980s, deficit bias, and its contribution to public indebtedness as well as its adverse repercussions on private investment, prompted some government to introduce medium-term fiscal consolidation to restore macroeconomic stability and fiscal sustainability. More recently, this was increasingly followed by a shift to fiscal policy rules. According to (Peach, 2001), the first law incorporating a provision that can be interpreted as a “fiscal rule” was enacted in 1917 in U.S. Under this law, the Liberty Bond Act established a statutory limit on the gross indebtedness of federal government.

4.2. Evolution of Fiscal Policy Rules at International level

According to (Kopits, 2001) formal attempts at casting the virtue of fiscal discipline into permanent rules, through constitutional or legal provisions, at various levels of government, span over a century and a half. During this period three fairly distinct waves can be identified. In the first wave sub-national government in some federal system adopted autonomously the golden rule. Under this rules most states in the US since the mid 90th century and several cantons in Switzerland since the 1920s assumed an obligation to maintain current budget balance. In the second wave, after World War II, several industrial countries like Germany, Italy, Japan and Nether Land introduced balanced budget rules. That rules underpinned their stabilization programmes following monetary reforms. Most of these were of golden rule type. Other rules such as those of Indonesia, CFA franc zone in 1960s were assumed to limiting or prohibiting the financing of budget deficits from specified domestic sources like from central banks.
Nevertheless, under all these rules, considerable scope remained for creative accounting and other nontransparent practices that could undermine compliance.

The current wave, starting with New Zealand’s Fiscal Responsibility Act of 1994 and after the pioneering introduction of inflation targeting in that country, many industrial and emerging economies introduces fiscal policy rules. Fiscal policy rules in emerging market economies are of recent vintage, mainly since the late 1990s. Most of the existing rules are expressed as benchmarks for a broad performance indicator, such as the government balance (in flow terms) or the public debt (in stock terms), usually as a proportion of GDP. In practically all these countries, fiscal policy rules have been embedded in a rules-based monetary framework. The latter includes an inflation targeting regime (Brazil, Chile, Colombia, Mexico, Peru, Poland), a currency board arrangement (Estonia, and until recently Argentina), or a dollarized regime (Ecuador). In this sense, fiscal rules can be viewed as means to reduce or eliminate fiscal dominance in macroeconomic policy. In contrast to the previous waves, a common denominator of the recent rule is that they are supported by more transparency standard consisting of accounting conventions, timely and regularly reporting requirements and a medium term macro budgetary frameworks. Generally all these elements are enshrined in broad legislation or international treaty, with careful spelled out accountability obligations.


Present fiscal policy rules are fairly diverse in both design and implementation. Considering the international experience recent institutional reform can be classified into three board groups: formal deficit and debt rules, expenditure limits and transparency. The main examples of this approach are European countries bound by the Maastricht Treaty as supplemented by the stability and Growth Pact. The U.K since 1997 has operated a Golden Rule whereby borrowing is done only to finance capital spending and the limit on net debt is 40 per cent of GDP over a cycle In Continental Europe (EMU stability and Growth Pact, Switzerland) and emerging economies (Argentina, Brazil, Colombia, Peru and India) rely far more on a set of numerical reference values (target or limits) on performance indicators. Rules on budget vary, in a few cases as numerical
limits on the overall deficit (Argentina, Peru, India), or a floor for the overall surplus (1 percent of GDP in Chile). Observance of a current-balance rule, also called the “golden rule” (Brazil, Mexico, India, Venezuela), can prevent a crowding-out of much needed public investment. In some countries, the budget-balance rule is accompanied by additional limits on total government expenditures (Venezuela), primary (non interest) outlays (Argentina, Ecuador, Peru), interest payments (Colombia), and the wage bill (Brazil, Colombia), in order to contain the fastest growing components of fiscal imbalance.

Several countries have deficit and debt rules at sub national level. In the U.S, all but two states have laws requiring balanced budgets and limiting the states to raise debt. Nine provinces and territories of Canada have fiscal rules with balanced budgets requiring them to take on debt only for the purpose of financing investment projects. Canada has also focused on instituting a rigorous expenditure review process. Debt ceiling can serve as a useful adjunct to deficit rules. In practice debt ceiling have been driven not by calculations based on theory, but run by concern about reducing high debt level and are thus generally chosen on the basis of experience of the individual countries.

The U.S places relatively greater emphasis on expenditure and deficit rules. Expenditure rule typically emphasize ceiling on specific areas of expenditures like discretionary expenditure as opposed to non discretionary expenditure and in some cases with respect particular programmes.

Anglo-Saxon countries place primary emphasis on transparency (Australia, Canadian provinces, New Zealand, U.K). The key elements in this approach are an explicit legal basis, elaboration of guiding principles of fiscal policy, requirement that objectives are clearly stated, and emphasis on the need for long term focus to fiscal policy, and fiscal reporting to public. The U.K, U.S, and New Zealand have enacted legislations for transparency with require statements providing the objectives for deficits and debt.
In some countries, under the budget-balance rule, escape clauses are provided in the form of a contingency fund (also called stabilization or countercyclical fund) and/or a multiyear definition of the rule in order to accommodate shocks or cyclical fluctuations in activity. The countercyclical contingency fund is intended to release resources to finance a cyclically induced deficit or to withdraw them from a cyclically generated surplus (Argentina, Estonia, and Peru). More directly, the rule may be defined in terms of structural or cyclically adjusted balance (Chile). A multi-year or medium-term balanced-budget requirement (Ecuador, Venezuela), which allows not only for the operation of automatic stabilizers but also for some countercyclical discretionary action, performs a similar function. To cushion the budget from output changes, some countries (Ecuador) specify ex-ante the real growth of primary expenditure in terms of a constant rate, broadly in line with trend or potential GDP growth. Either in conjunction with a budget-balance rule, or simply with the goal of securing medium to long-term fiscal sustainability, several countries have established for a targets for the phased reduction of the debt–GDP (Poland) or debt-revenue ratio (Brazil). The debt-ratio target or ceiling usually presupposes, either implicitly or explicitly (Brazil), an annual operational target in terms of a minimum primary surplus.

Generally, the institutional coverage of rules depends on the degree of fiscal decentralization and autonomy of various levels of government. In a relatively centralized fiscal system the rules are imposed only on the central government (Chile, Peru) without much loss of control. However, in federal systems, rules must encompass at the national and sub-national levels of government. Depending on the degree of sub-national autonomy, uniform rules are imposed top-down on all sub national governments (Brazil, Colombia, Mexico, Poland) or differentiated rules are voluntarily self-imposed from the bottom-up by some sub national governments (Argentina, India). Fiscal policy rules can be specified in a constitutional provision (Mexico, Poland), high-level legislation (Brazil), or ordinary legislation (India) that applies to governments over successive electoral cycles.
Whatever the statutory form, at present most policy rules are supported by institutional arrangements encompassing the budget process (possibly in a rolling medium-term budget framework), accounting conventions, periodic reporting, projection requirements, and penalties for noncompliance. Also, there is an assignment of responsibilities for implementation versus monitoring and audit the latter usually to be undertaken by an independent authority. Legal sanctions for noncompliance (treated as a criminal offense in Brazil) may exist as well, though typically these remain untested in the courts. Rarely, in the case of top-down sub national government rules (Colombia), deviation from the rule is subject to financial penalties. However, in most countries, noncompliance, especially by the national government, is punished with loss of reputation toward the electorate or financial markets.


(A) Legislative Fiscal Policy Rules

(i) Deficit, Expenditure and Debt Rules

United States: In United States during 1950-75, the public debt to GDP ratio declined continuously, while the budget deficit remained low. In 1975, public expenditure began to increase rapidly, mainly due to expanding entitlement programmes. Initially, the deficits were partly covered by growing tax revenues, as high inflation moved individual into higher income tax brackets. However, the introduction of inflation indexing in the tax code, tax relief introduced through the Economic Recovery Tax of 1981. Increase in defense spending, and an adverse cyclical position resulted in substantial increase in public deficit, which reached more than 6 per cent of GDP in 1983. After the mid-1980s, the deficit was reduced due to stronger economic activity and legislative initiatives. In the mid 1990s mild recession resulted in a new increase in the budget deficit. The public debt to GDP ratio rose from approximately 25 per cent in the early 1970s to just fewer than 45 per cent in the early 1990s.

To bind governments to fiscal rectitude the United States has long experience with fiscal rules. Rules were introduced through a series of laws enacted since the mid-1980s. The Balanced Budget and Emergency Deficit control Act of 1985, known as Graman –
Rudman- Hollings I specified declining annual targets for the budget deficit, ending with budgetary equilibrium in 1991. The targets were to be enforced by uniform percentage reduction in selected mandatory and most discretionary spending programme. This was ruled unconstitutional because its implementation violated the separation of powers. In 1990, because of unexpected expenditures arising from war with Iraq and major flood, and faced with prospect of substantial expenditure cuts, the president and the congress, agreed to postpone balancing the budget until 1993. This was followed in 1987 by the Balanced Budget and Emergency Deficit control Reaffirmation Act, also known as Graman–Rudman-Hollings II, which revised the deficit targets established by in 1985 and extended them through 1993. This triggered a change in fiscal framework, which the 1990 Budget Enforcement Act reflects.

The goal of Graman–Rudman-Hollings I and II was to increase fiscal discipline by reducing the public deficit and to control the increase in the public debt. The Graman–Rudman-Hollings laws did not produce the targeted decline in deficit because of mistakes in establishing the potential rate of growth of GDP and flaws in the determination of targets. As a result, the sequestrations required to achieve the goals proved to be unworkably large. In 1990, as part of a major deficit reduction package the congress approved the Budget Enforcement Act of 1990, which replaced the deficit targets with expenditure ceilings or caps and established for the period 1990-95 a Pay As You Go system (PAYGO) for revenues and direct spending. Direct spending included entitlement programmes established through legislation. For these programmes, outlays were determined not by annual appropriations but by eligibility criteria and benefits formulas specified to each. Under PAYGO system, all changes in taxes and direct spending had to be deficit neutral over one and five year horizons. In 1993, the Omnibus Budget Reconciliation Act extended the provision of the 1990 law until 1998.

The Budget Enforcement Act of 1997 extended again the provisions of the 1990 law until 2002. Budget Enforcement Act (1990 and1997) shared the objective of controlling the fiscal deficit and the public debt, but changed the fiscal framework used to achieves the goal. The Budget Enforcement Act of 1990 and its subsequent modification in 1993 and
1997 established more realistic targets, so fiscal restraint was more easily maintained. Nonetheless, an important part of the improvement in fiscal accounts during 1990s was due to the favorable position of the U.S.

**Sweden:** Fiscal rules in Sweden came after a period of high fiscal deficits and a substantial increase in public debt to GDP ratio in the early 1990s. This fiscal deterioration caused due to the severe recession and banking crisis. In 1994 fiscal deficit became 10.5 per cent of GDP and a ratio of public expenditure to GDP of about 65 per cent. Gross public debt as a proportion of GDP almost doubled between 1990 and 1994, reaching almost 75 per cent of GDP. Government reacted by introducing fiscal consolidation programme in 1994-95 and approved fiscal policy rules in 1996 which was implemented in 1997.

The rules aimed at achieving the government long term goal of budget surplus of 2 per cent GDP over the cycle to prepare the public finances for population aging. This goal was intended to need no further tax increases. Budgetary planning is made on a rolling three year basis based on economic forecasts viewed by both the parliament and the government. The basic fiscal targets were a binding nominal ceiling for central government expenditure and the general government net borrowing. The spring fiscal policy bill contained the government’s forecast for revenues and expenditures and the allocation of total spending among 27 expenditure areas. The latter were excluded as being beyond public sector control. As a result, the expenditure ceiling covers approximately two-third of total expenditure. In the budget bill of 1997, when the expenditure ceilings were first set, the budgetary margins for the period 1997-99 were established at 1.5, 2.0 and 2.5 per cent of total expenditures, respectively. In practice, the margins had been used to finance discretionary increase in public expenditure.

The government had to inform the parliament of substantial deviations from expenditure ceilings, including reasons for such deviations. Any overrun had to be financed by reducing other areas of spending, through differences between ex ante and ex post outcomes were not formally sanctioned. In the case of limited expenditure over runs, a
borrowing possibility was allowed, but the amount borrowed was automatically deducted from the budget appropriation of the following year. National Audit office carried out annual audits and efficiency audits. The annual audits examined whether an agency’s annual reports gives a true picture of financial situation and performance, while the efficiency audits concentrated on how government activity was carried out.

Even though the rules have been in place only since 1997, it is clear that results are positive. Although favorable economic growth has also contributed to this outcome, government expenditure as a percentage of GDP decreased to below 53 per cent of GDP in 2002 from around 60 per cent in 1996. The fiscal balance has shown steady surpluses since 1998.

**Switzerland:** Upto 1980s public debt to GDP ratio was substantially low in Switzerland. In the first half of 1990s the Swiss economy experiences a protracted recession. As a result of this the growth rate of GDP reduced from 1.8 per cent in 1970-90 to zero percent in 1990-96. This also resulted in heavy spending and deficit. The public debt GDP ratio increased from 31 per cent in 1990 to a peak of 54.5 per cent in 1998, especially because of an increase in the debt of federal government.

In 1998, constitution amended to establish the obligation to balance the federal budget by 2001 implemented a fiscal rule. In order to achieve the goal, the authorities cut military spending, rail road budget and increased social security payments. The recovery of the economy in 1999-2000 allowed Swiss government to balance the budget one year earlier.

In 2000, the Swiss government proposed another, constitutional that introduced rules to control the fiscal accounts of federal government. It aims at preventing structural deficit in the federal budget and allowing scope for countercyclical fiscal policy. It imposed a ceiling on federal government expenditure.

The introduction of the rule in a period of structural deficit has made compliance difficult in particular, as sharp adjustment was required to abide by the rule. Technical
implementation problem emerged. Another problem with Swiss rule is that it covers only the relatively small federal budget.

**Netherlands**: has a long history of carefully planned fiscal policy. In 1960s, the Dutch government adopted a structural fiscal policy based on the principle that the budget deficit should be constant as a proportion of trend GDP. The system performed well until the early 1970s, when unrealistic forecasts about trend GDP increased expenditure far beyond actual revenues, resulting in a substantial increase in fiscal deficit. By 1982, the general government deficit was around 7 per cent of GDP. As a result of this situation, the government abandoned the previous fiscal policy and adopted a multi year deficit reduction target. The new policy, however, was strongly procyclical, and the deficit reduction path had to be frequently revised. Despite these drawbacks, the fiscal deficit returned to more sustainable level.

In 1994, trend based fiscal policy established. It aimed at transparent and orderly decision making in budgetary process, increasing efficiency and improving financial control of public sector activities, reducing the ratio of structural sector spending to GDP, and permitting a more effective use of public budget as a countercyclical tool in order to stabilize GDP around its potential. Finally the fiscal framework was intended to strengthen the budgetary process. The budgetary framework of 1994 established a specific expenditure ceiling for central government spending like social security, and health care on a four year basis. In 2002 the rule became more tightened and transfer was allowed only in exceptional circumstances.

Under the budget framework established by two Kok administrations, Dutch public accounts improved substantially; and both public spending and the tax burden were reduced. The fiscal deficit of 4.2 percent of GDP in 1995 became a surplus of 1.5 per cent of GDP in 2000. The gross public debt to GDP ratio was reduced to 56.1 per cent in 2000 from more than 75 per cent in 1995. A favorable position in business cycle also contributed to these outcomes and by 2002 a deficit had reemerged. The use of a cautious economic scenario and unexpectedly strong economic growth produced large revenue
windfalls during the second Kok administration, which should have resulted in large tax cuts according to the rules. In order not to further stimulate the economy, tax cuts remained below what would be implied by rules for distribution of the revenues windfalls. The spending rules, on the other hand, remained binding.

**Indonesia:** Fiscal policy rules in Indonesia introduced in the mid 1960s in the wake of an external payments crisis and high inflation. Under this policy there was prohibition on domestic government borrowing. The coverage excludes certain off-budget operations, particularly those financed with oil export receipts or borrowing from abroad.

**Poland:** The central government in Poland is bound by two rules. The nominal deficit in the approved annual budget can not be exceeded without going back to parliament, and the national public debt has a constitutional limit of 60 per cent of GDP. Special prudential measures are triggered when public debt exceeds 50 per cent of GDP. Specifically, the deficits of sub-national governments must be lowered, the council of ministers must submit a fiscal consolidation plan to parliament, and issuing of new state guarantees is limited.

(ii) **Transparency Rule:**

**New Zealand:** Fiscal management of New Zealand was orderly during the 1960s and early 1970s. Government expenditure was around 30 per cent of GDP and the public budget was close to balance. However, during the most of the 1970s and 1980s, tax revenues lagged spending growth, with the latter being led by increasing transfers, higher debt services caused by persistent fiscal deficits, and higher interest rates following financial liberalization. By the early 1990s, government spending had reached 40 per cent of GDP. Debt peaked at 74.5 per cent of GDP in 1987, from level of around 40 per cent of GDP in the mid-1970s. As a consequence of the poor fiscal performance, New Zealand’s debt rating was downgraded in the early 1990s, increasing the cost of financing the continuing fiscal imbalances.
In this context, the authorities began a process of institutional reform. Fiscal Responsibility Control Act became effective in July 1994. It aimed at improving fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirement to achieve more transparent decision making by the government. The law intended to increase accountability by promoting a more informed public debate about fiscal policy, and it facilitated the independent assessment of fiscal policies. Provision of Fiscal Responsibility Control Act established five principles of responsible management. First, to reduce public debt by achieving operating surpluses every year until prudent level are reached. Second, to maintain public debt at prudent levels by ensuring that on an average, total operating expenses do not exceed total operating revenues over a reasonable period of time. Third, to achieve levels of public sector net worth that can provide a buffer against adverse shocks. Fourth, to take reasonable steps in order to manage the risks which public sector is facing. Fifth to pursue policies that is consistent with reasonable predictability.

In addition to these principles, an annual budgetary policy statement and a fiscal strategy report to be published. The budgetary policy statement must include the government broad strategic priorities for the upcoming budget, its fiscal intention for the next three years, and its long term fiscal policy objectives. The government must also make clear the consistency of its plans and objectives with the principles of responsible fiscal management set out in the act. In turn, the fiscal strategy reports analyzes the consistency between the economic and fiscal projections included in the budget and government’s short term fiscal plans set out in the most recently published budget policy statement. Three year economic and fiscal update to be published depending upon the circumstances, 14 to 42 days prior to any general election. The reports are to be made using generally accepted accounting practice on an accrual basis. In the case of difference between ex ante and ex post outcomes no formal sanctions are established. The government can depart from the principles, but reasons for the departure and when and how it expects to return to them must be stated explicitly.
In addition non legislated fiscal practices concerning expenditure management have been introduced. These involve giving spending department’s fixed nominal baselines, which can be adjusted demand driven changes. Until fiscal year 2002-03, any changes or new initiatives within the three year parliamentary cycle had to be met from a fund called fiscal provision, which limited the amount available for new spending. In the 2002 budget this set of practices was replaced by an explicit medium-term framework, which became operational in 2003-04. The medium-term objective was to achieve an average operating surplus over cycle sufficient to cover contribution to New Zealand Superannuation Fund (covering old age pensions) and ensure that gross public debt remains below 30 per cent of GDP. Short-term operating and investment expenditure plans will have to be consistent with these objectives and regularly adjusted in line with fiscal outlook.

New Zealand’s fiscal position improved substantially during the 1990s, but the direct contribution of the present fiscal framework has to be weighted against cyclical improvements. Nevertheless, most estimates indicate a clear shift toward lower structural public deficits during the second half of the 1990s. Furthermore, by requiring all levels of government to be explicit about their short term intentions and long term objectives; the Fiscal Responsibility Control Act establishes a more transparent framework for annual budget decision.

**South Africa:** Since 1994 the fiscal situation had deteriorated sharply in the run-up to the 1994 elections and the political transition it entailed. Government debt was rising fast and the associated interest burden had risen to more than 5 per cent of GDP. So serious was the situation that all parties to the political negotiations of 1993 countersigned a standby facility for the government with the IMF, with the hope that policy credibility might be acquired in this way with a view to stabilising domestic and international markets dealing in South African assets.

In 1999 Public Finance Management Act was implemented which legislated the need for regular financial reporting, sound expenditure controls and a strengthened system of
supervision and audit. Public finance Management Act, 1999 incorporates many salutary features of responsible fiscal management such as budget disclosure of intentions regarding borrowing and other forms of public liability during current and future financial years, provision of giving projections of multi-year budget to parliament with key macro economic projections, borrowing power limited to budget deficit. Ministers’ responsibility regarding guarantees, to be defrayed in the first instance from the funds budgeted for the department issuing the guarantee, percentage limits for re appropriations and unbudgeted expenditure etc.

Together with the multi-year budgeting approach adopted from December 1997 onwards with the publication of the Medium Term Budget Policy Statement (MTBPS) and the Medium Term Expenditure Framework (MTEF) the South African fiscal authorities have taken considerable strides towards the use of targets, monitoring and the transparency often associated with modern fiscal rules.

The non-interest government expenditure was successfully contained relative to output growth until 2000-01, but has since been allowed to expand faster than output. Interest payments remained stubbornly high relative to total expenditure until late 1990s following which the debt-GDP ratio started on a sustained downward trend in the year 2000 Total (domestic and foreign) debt declined from a maximum of 50 per cent of GDP in 1995 to 35 per cent in 2006. Finally, government revenue has been growing even more rapidly than the accelerated GDP growth of recent years.

(iii) Growth and Stability Pact Fiscal Policy Rules:
Maastricht Treaty of European Union: high and persistent budget deficits, rising stock of public debt; a tendency to run a pro-cyclical policy which, instead of smoothing the business cycle, contributed to accentuate its swings. All these factors led European Union to implement Maastricht Treaty in 1992. The main goal of the Maastricht Treaty in terms of fiscal policy is to ensure fiscal discipline in member countries in order to prevent fiscal crises that would negatively affect other countries.
Under the Treaty, fiscal discipline is to be judged on the basis of two main criteria: (1) whether the government deficit as a percentage of GDP exceeds the reference value of 3 per cent of GDP; and (2) whether the ratio of gross government debt to GDP exceeds the reference value of 60 per cent of GDP. Exceptions may be made with respect to the deficit criterion if the ratio of the deficit to GDP has declined significantly and is close to the reference value, or if the excess is only temporary and the ratio remains close to the reference value. Exceptions may be made with respect to the debt criterion if the debt-to-GDP ratio is diminishing at an acceptable pace. The Maastricht Treaty provisions were strengthened by the Stability and Growth Pact (SGP), which ensures that countries sustain their commitment to fiscal prudence once they have joined the EMU. The SGP was adopted in 1997 and took effect when the euro was launched on January 1, 1999. In addition to the Treaty’s debt and deficit rules, the SGP requires that member states set medium-term objectives of budgetary positions close to balance or in surplus, in order to provide sufficient flexibility to allow the operation of automatic fiscal stabilizers while remaining within the 3 per cent deficit limit. The SGP also provides for increased monitoring, with an annual review of the stability programmes of countries participating in the euro area (and convergence programmes of those not participating in the euro area). The programmes set out medium-term targets and the adjustment path toward the targets. The Council of EU-member Finance Ministers (ECOFIN) assesses and delivers an opinion on each programme, based on the recommendation of the European Commission. In addition, the Council and Commission regularly monitor the implementation of the programmes and can recommend corrective action if a significant divergence from the medium-term budgetary objective or the adjustment path is identified. In the case of an excessive deficit in a country participating in the euro area, a course of remedial action will be proposed, which must be implemented within ten months. Otherwise, the country may be subject to sanctions in the form of a mandatory non-interest bearing deposit, which varies in size with the magnitude of the excessive deficit, up to a maximum of 0.5 per cent of GDP. If the excessive deficit is eliminated within two years, the deposit will be returned to the country. If it is not eliminated within that time frame, the deposit will become a fine.
Recently, ECOFIN approved the European Commission’s suggested changes in the interpretation of the SGP. The changes neither alter the existing reference levels for debt and deficits, nor eliminate the pact’s requirement that budgetary balances be close to balance or better. Rather, the reforms refine the interpretation of these requirements, allowing greater flexibility to promote growth, while at the same time reinforcing rules to ensure the soundness and sustainability of public finances in preparation for population ageing. In practical terms, this implies an increased focus on the level of debt and cyclically-adjusted budget balances, likely resulting in some exceptions to the “close to balance” requirement. Generally speaking, the changes aim to provide greater fiscal flexibility to countries with low levels of debt while increasing controls on countries with high debt levels. By 1998, eleven of the fifteen EU member states had met the convergence criteria and agreed to participate in EMU. The Maastricht Treaty fiscal criteria are generally credited with having accelerated fiscal consolidation in the EU countries. For example, France faced a fiscal crisis in the early 1990s, with the total government deficit peaking at 6 per cent of GDP in 1993. However, the fiscal situation improved significantly over the following years, largely due to discretionary policy undertaken by the government in order to comply with the Maastricht Treaty. By 1998, the deficit was under 3 per cent, consistent with the convergence criteria. All member states budget deficits declined substantially since 1993, the year which marked the entry into force of the Maastricht Treaty and in which the euro area registered the historically high deficit ratio of 5.5% of GDP. However, in some countries, public debt started to decrease only when primary surpluses became high enough to compensate the snow-ball effect.

**Germany:** In Germany, a constitutional rule was introduced in 1969 which required a balanced, but allowed borrowing for investment expenditure (golden rule). In addition, some states’ constitutions included golden rule. The size of government and public debt in Germany grew rapidly after 1970s. Further more fiscal policy was often conducted in a pro-cyclical fashion. In Germany, the federal government and many of the regional governments were constitutionally obligated to adhere to the “golden rule” that borrowing should only finance capital expenditure. However, the rule has imposed little
budgetary discipline because it was usually applied ex ante rather than ex post. In addition, investment at the federal level was broadly defined, including financial as well as non financial assets and excluding privatization and depreciation. It excluded special funds and can be suspended if the government determines that economy was not operating at the “national equilibrium”. However, rules to deal with spending overruns were not specified. The new draft of Article 51 came into force in January 1, 2005. It specified that all level of governments will be responsible for avoiding the excessive deficit procedure and proclaimed the overall aim of deficit reduction to meet the close-to-balance target of Stability Growth Pact (SGP). More recently German stability programmes have undertaken to keep annual nominal spending growth at below 2 percent at the level of the general government.

**Italy:** In Italy, no fiscal rule exist other than Stability Growth Pact (SGP). In 1999 Italy introduced Internal Stability Pact (ISP) requiring regional and local governments to reduce their deficits and debt. Deficit was defined as the difference between total revenues net of state transfers and total expenditure net of investment and interest payments. The sanctions were not credible because they could result in excessive penalties for sub national governments. In 1999, only half of the fiscal consolidation projected in the ISP was achieved. The pact was therefore modified in late 1999. First a more ambitious target was set for sub national government for 2000. Second, overall balance was defined to include receipts from the sale of real estate assets as part of public revenues. Third, sub national governments meeting the objectives of the ISP would be granted a reduction in the interest on their outstanding debts to the Cassa Depositi Prestiti. For 2000, it appears that local governments compiled with these revised targets, while the regions breached their deficit ceilings. For the year 2001, it was established that the targeted balance could not worsen by more than 3 per cent from 1999. Successive ISP modifications were adopted to constrain the increase in planned current spending by Ordinary Statue Regions and municipalities in 2002 and with the budget law for 2003 for example, establishing that municipality’ deficits should be no worse than 2001 level.
Spain: In 1991, the central and regional governments agreed to the so called Budget Consolidation Scenarios (BCSs) for 1992-96. Based on bilateral negotiations, this agreement specified the maximum deficit and debt for each region. These programmes were publicly announced and became the main coordination tool for budgetary and debt policies of the central and regional governments. Because of the 1992-96 recessions, no region compiled, but the scenario represented a turning point in the evolution of regional debt (Vinuela, 2001). The BCS were revised in March 1995, following revision of the convergence program in July 1994, and again in 1998 with the approval of the first stability program. While the former agreements were respected, the deficit and debt levels specified in the previous agreement are unknown to public, and no transparent sanctioning mechanism exists. Therefore, it is impossible to assess compliance. The Law of Budgetary Stability, first implemented in 2003, required that all levels of government formulate, approve and execute a budget in balance or in surplus. It strengthened reporting requirements, especially at the regional level. This law was expected to ensure that decentralized public finances would not jeopardize the central government's consolidation objective, as well as greater transparency of each region’s contributions.

Belgium: Cooperation agreements under the national Stability program set permissible fiscal targets for the federal and other level of government. In 1994, the federal government and the communities and regions reached a first cooperation agreement. Subsequent intergovernmental agreements covered 1996-99, 1999-2002, and 2001-05. These agreements established permissible Entity I and Entity II deficit targets according to the recommendations of the High Council of Finance, Which was also in charge of monitoring and reporting on compliance. The corporation agreement did not include formal sanctioning procedures for deviations from permissible deficits. However, the federal government could restrict the borrowing of communities and regions for upto two years upon recommendation of High Council of Finance once regions involved had been consulted.

Austria: In 1995, the federal, state, and local governments agreed to achieve budget balance primarily through expenditure reduction. During subsequent negotiations on the
intergovernmental transfer system in 1997, they agreed on the maximum deficit that each will incur. The federal government was assigned a deficit of 2.7 per cent and the Lander and local government were assigned 0.3 per cent of GDP. In the 1998 Austrian Stability Pact, all levels agreed to internally allocate the Maastricht Treaty deficit limit mainly on the basis of population. This internal stability pact established proportional contribution of the federal government and Lander to the sanction payment in the case of an excessive deficit. Local governments in any Lander collectively share the responsibility for the deficit; their contribution to sanction payments would be deducted from their sanction payments would be allowed to partially assign their permissible deficit to other entities. No sanctions were established for noncompliance with the deficit ceiling. In 2000, the domestic stability pact was amended through 2004. Landers targeted an average budget surplus over the period of no less than 0.75 per cent of GDP, with allowable temporary overruns of 0.1 per cent of GDP. The monitoring and enforcement system included fines subject to unanimous decision of all interested parties.

(iv) Sub-national Fiscal Policy Rules:

**Argentina:** Prior to 1991 the provinces borrowed heavily, largely from their own provincial banks, which then went to the central bank to discount loans, effectively giving provinces a share in the seigniorage and inflation tax. These banks provided more than 60 per cent of the credit needs of the provincial government at low or zero interest rates. But the central bank charter, which was revised in September 1992, ended the access of provinces to seigniorage and inflation tax. The 1991 convertibility plan fixed the dollar exchange rate of the Argentine currency. This eliminated the possibility of central bank financing of government deficits, and thus impose a relatively hard budget constraint on the public sector. Moreover, by time of stabilization in 1991, a combination of hyper inflation and centre-state negotiations left the provinces with virtually no debt to the federal government. Since then, total provincial debt has declined as a share of GDP and provincial revenues. In 1999 Argentina Fiscal Solvency Act was introduced. It was applied only to the central government. It established a path for reduction of federal budget deficit leading to its elimination by 2005. Besides establishing numeric limits for the central government’s fiscal deficit, it limited the growth of expenditures, stipulated
the adoption of pluri-annual budgeting, created a Countercyclical Fiscal Fund, and implemented transparency measures regarding public finances the features favored by the recent literature on fiscal rules. The Law required reaching fiscal balance no later than 2003 and set nominal ceilings for the national-level non-financial public sector deficit between 1999 and 2002. But they were broken in every year.

Although the national law did not include conditions for sub-national governments, it invited the provinces to pass similar laws of their own, and several did. The provisions of the laws differ across provinces, as did the degree to which they were adhered to, even before the economic crisis in 2001. All the provincial FRLs had limits on the deficit or overall debt, and most have both (Braun and Tomassi, 2003). In 2001 the FRLs stopped working because of the extreme mismatch between the national government’s fiscal and monetary policies in the context of a fixed exchange rate. Although the federal government’s FRL lacked enforcement power, the more fundamental problem was the government’s many legally inflexible spending obligations, most notably debt service and provincial transfers. Federal-provincial agreements in 2000 had set nominal peso (= US dollar) floors on transfers to the provinces that would last several years during a transition to a long-term arrangement of moving-average calculations that were more favorable to the federal government. Unfortunately the recessions of 2001 and thereafter reduced revenues to the point that the federal government could not make the promised transfers and defaulted on those and other obligations, paying them with debt that circulated as money (Gonzalez, Rosenblatt and Webb, 2003). Even with stronger enforcement procedures on paper, the FRL could not have solved the problem.

The provincial FRLs also had shortcomings that would have been problematic even if the collapse at the top had not come first. They lacked enforcement power and a critical mass of states had not passed them. The Compromiso Federal of 2000 did not have contingencies to assure fiscal sustainability in down-side scenarios of growth. It arranged to share benefits of growth but not to share the cost of recession. All the governments were benefiting from the public asset of a stable currency and using it to access credit markets, but they failed to appreciate the fragility of the asset and the need to coordinate
efforts ex ante controls to avoid overusing it. The attachment of co-participaciones at Banco de la Nacion looked so much like a federal guarantee of the provincial debt that most lenders did not fear ex post consequences, and there were no ex ante constraints from their side.

**Brazil:** Brazil states have a history of running deficits, and then seeking and obtaining federal bail outs. After three decades of sub-national debt crisis, a new Fiscal Responsibility Law (FRL) was introduced in 2000 to make break with the past. It was probably the most comprehensive and toughest in the history of FPRs. It applied to all levels of government (union, states, federal districts and municipalities) and to all three branches (executive, legislative, and judicial). It aimed at maintaining current balance, limiting all personal expenditure, including pensions, under 60 per cent and limiting the ratio of debt to current revenue within the limits set for each year by the President. In addition, the law prescribed detail rules for offsetting any unanticipated increase in expenditures and any increase in tax preferences, for granting guarantees and for own financing of any increase in public pension benefits.

The fiscal performance of Brazil’s Sub-National Governments (SNGs) improved markedly over the last few years. The average ratio of debt to net revenue declined from 3.8 in 1998 to 1.9 in 2001 (Alfonso, 2002). At the end of 2000, 10 states still had deficit ratios above the FRL target; by the end of 2001 only six were out of compliance. They adjusted personnel expenditure, including public pensions, even faster; of the 18 states that were out of compliance with FRL targets in 2000, 13 managed to comply by the end of 2001. (BNDES, 10 May 2002) Adjustment by SNGs continued in 2002 and 2003. How much of this is due to the FRL one cannot specify a fraction, because the states as a group seem to have jumped from a bad equilibrium to a relatively good one.

**Peru:** In Peru, the law on Fiscal Prudence and Transparency, enacted in December 1999, declared as a general principle that the government should adhere to balanced or surplus position over the medium term. While coverage that extended practically to the entire general government, the rules resemble closely those of Argentina. Specifically, the law
obliged the authorities (a) to maintain overall balance, subject to ceiling equivalent to 1 per cent of GDP and (b) to limit the annual nominal growth of primary expenditure to 2 per cent above the annual rate of inflation. The rules could be waived in the event of national emergency or international crisis: on evidence of contraction of GDP, the deficit would be allowed rise to 2 per cent of GDP. Also, the Law provided for a stabilization fund, constituted from a portion of excess revenues and privatization receipts, to be drawn to compensate for a cyclical shortfall. Any net accumulation above 3 per cent of GDP would be used for retiring public debt.

Although the initial law improved transparency and helped reduce national-level deficits, it had two main problems: first, it did not keep national government deficits within the legal limits, and second it did not make provisions for the sub-national governments. In April 2003 the government passed a new law, making several amendments intended to rectify these problems. Their success depended on enforcement, the first steps for which was the issuance of regulations. The new law made four key improvements for fiscal prudence at the national level. A new clause prohibited any administrative or legal norm that interfered with the correct execution of the Marco Macroeconómico Multianual (MMM), called for in the original law, especially with respect to the fiscal deficit targets. In election years, the government may only spend up to 60 per cent of the annual spending allocation in the first 7 months and could only use 40 per cent of the annual limit on the deficit in the first semester. Quarterly monitoring of the fiscal performance was required and, in case of revenue shortfall, adequate remedies to revenues and/or expenditures started in the next quarter. If the fiscal deficit limits were relaxed, as under circumstances allowed in the law, then the transition to return to the regular rules was better specified. The new law made five key provisions for the SNGs:

1) Each regional government must prepare and published an annual development plan that was consistent with the national MMM (including the size of fiscal deficit).
2) All SNGs had to keep a non-negative primary balance on average in the last 3 years in office.
3) The overall public-sector deficit limit in the law applied to the sub-national as well as national levels an important ex ante constraint. Regulation needed to define the procedure for translating the aggregate fiscal limit into an allocation of borrowing limits for each of the governments, national and sub-national.

4) The FRL had set some ex ante constraints for sub-national borrowing; SNGs could only borrow internationally with the guarantee of the national government. The guarantee for any loan required compliance with the Annual Debt Law and demonstration of the capacity to pay, which provisions gave the national government the authority to veto SN borrowing.

5) If an SNG violated the targets in the law, the national government must withhold some transfers to make the required payments of debt an important ex post consequence, if well enforced.

Peru is decentralizing quickly, as have other countries, but it is unique in the passage of an FRL so early in the process, even before the sub-national governments are fully defined or established. It is still too soon to know the results, but if the FRL is well enforced, it will help establish a culture of fiscal prudence in these new governments (Webb, Steven 2004).

**Mexico:** Mexico has no FRL at the national level. Many states have laws, or traditions, regarding the build-up of deficits or surpluses (rainy-day funds), but none has what we call an FRL. Nonetheless, new institutions of SN fiscal discipline have emerged in Mexico since the late 1990s, which seemed to be achieving by other means some objectives of FRLs. To avoid a recurrence of the fiscal crisis, each state had to agree to a fiscal adjustment program designed in the Secretariat of Finance (SHCP), which monitored compliance prior to disbursement of the annual tranches of assistance, set a precedent of fiscal consequences, and brought most states to a good financial situation by the end of the 1990s. The indexed debt that the banks were force to accept helped them avert total ruin and collapse of the system, but illiquidity of the assets and low return inflicted some penalty on the borrowers as well. The government also ended its policy of formally guaranteeing sub-national debt, although as a transition it agreed to accept and
execute contractual mandates by which the borrowers pledged their revenue-sharing transfers as collateral for the debt service. By 1999, the federal government saw the need for change toward a more traditional hard-budget constraint for SNGs and so brought in a whole new system, starting in 2000. The new borrowing framework had four key elements: 1. Giving commercial and development banks ex ante signals about the riskiness of state debt, by making the debt subject to the same borrower concentration limits as other debt and by requiring that capital-risk weighting reflect riskiness, based on international credit ratings. 2. Giving strong incentives for borrowers to publish their fiscal and financial information. 3. Eliminating discretionary transfers from the federal government, at least those at the discretion of the executive. 4. Ending SHCP’s role as fideicomiso for collateralizing debt with participaciones. Lenders and the SN borrowers typically organize their own fideicomisos for this purpose, and the absence of direct federal government involvement aims to reduce the administrative ease and thus the likelihood of any bailouts.

Although Mexico does not have a national FRL, state governments have incentives now to make their budgets and balance sheets attractive to voters, credit rating agencies, and lenders taking the sort of measures that an FRL might demand. Nonetheless, the FRL features for transparency and medium-term fiscal management would benefit the federal as well as sub-national governments in Mexico (Webb, Steven; 2004).

**Colombia:** passed Law 617 in 2000, which functioned in many ways as a Sub-national FRL. It is also still too early to tell whether the law brings about a structural change in fiscal outcomes, but the provisions appear to move in the right direction: 1) Primary current expenditure may not exceed non earmarked current revenues, and should not exceed a fixed percentage, depending on the state or municipality category; governments must make across the board cuts whenever effective non-earmarked current revenues are lower than budgeted. 2) Expenditure for state legislatures is limited. 3) State and municipal central administrations are not allowed to make transfers to their public entities. 4) Strict limits apply to creation of new municipalities, and municipalities proven non-viable have to merge. 5) When sub-national governments do not comply with the
limits imposed by the Law, they have to adopt a fiscal-rescue program to regain viability within the next two years. 6) To promote transparency, there is an extensive list of characteristics and requirements for the election of governors, majors, legislators and their relatives.

In June 2003 the government passed a Fiscal Responsibility Law, labeled as such and applying to the national as well as the sub-national governments. It specified a process for setting budget targets and linking them to target ranges for debts and deficits. Regulations for the law build on the current practice of publishing quarterly fiscal results, defining deficits on the basis of cash revenue and accrual of spending obligations, and defining debt to include floating debt. The FRL had set a target to eliminate reservas presupuestales in two years. The other part of floating debt, cuentas por pagar, was counted as regular debt and thus controlled by the fiscal/financial plan. To help with fiscal discipline at all levels, the FRL prohibited the national government from lending to an SNG or guaranteeing its debt if it was in violation of Ley 617 of 2000 or Ley 357 of 1997, or if it is in arrears on any debt service to the national government. Indeed, a sub-national government with those fiscal violations could not legally borrow from anyone. To discourage electoral cycles in fiscal policy, the FRL also prohibited any government from committing future spending (vigencias futuras) or increasing personnel spending in an election year. For the sub-national governments there were additional restraints on deficits: eliminating the intermediate category in Ley 357 (thus putting tight fiscal restraints immediately on SNGs that show signs of problems), and required that departments and large municipalities get satisfactory credit ratings from international rating agencies before they borrow. While some of these legal measures needed further refinement, such as through their regulations, they represented important advances as long as they are enforced well.

The strategy for fiscal control in the proposed FRL differed between the national and Sub-national levels, because of the different constitutional constraints they faced on fiscal policy. For the sub-national governments the Constitution specified most of their revenue, via transfers, and gave them little leeway to raise more own revenue, so the
proposed FRL strengthened the ex ante restraints on sub-national deficits to complement the existing restraints on sub-national spending, mostly in Ley 617. For the national government, where most of the fiscal problems had centered, the FRL increased transparency but still does not give the Ministry of Finance a hard budget constraint with which to enforce fiscal discipline in the face of special-interest demands, including those coming through SNGs on behalf of teachers and others. The Constitution, debt obligations, pensions, and other legal entitlements specified almost all outlays for the national government, so the FRL focused on limiting the deficits so that the adjustment will have to concentrate on the tax side and thus eventually motivate political restraint on spending. Control over spending would improve only if less spending was legally pre-committed to special interests and if the new budget law (drafted in 2003, to be discussed and ) gave the Ministry of Finance the authority in case of a revenue shortfall to curtail spending in order to meet the fiscal balance in the approved budget. The draft did not make this provision, however, and the FRL alone cannot control the national deficits (Webb, Steven; 2004).

Denmark: emphasized on expenditure restrained in 2004. It adopted a cooperative approach to policy coordination, whereby the central and sub-national governments negotiated fiscal targets, which then become binding. Starting from 2003, the counties became legally bound to comply with the budget targets (negotiated with the central government and expressed in nominal terms), but expenditure overruns at the local level remain an issue. A broader reform of governance at the sub-national level involving a drastic reduction in the number of municipalities was agreed. It will come into force in 2007. Cyclically adjusted primary fiscal balance improved by about 2.9 percent of GDP over 2004–05. Expenditure restraint accounted for approximately half of the improvement. Tax revenues exceeded expectations, largely owing to rising oil and gas prices, in spite of a reduction in personal income tax rates in 2004, and a "tax freeze" in effect since 2002. Caps on expenditure growth in real terms led to a gradual reduction in the expenditure-to-GDP ratio. Recent fiscal consolidations in Denmark and New Zealand were facilitated by the previous successful consolidations of the 1990s, which laid the
foundations of medium-term budgeting, incorporation of long-term fiscal projections, and improved expenditure control.

(B) Non Legislated Fiscal Policy Rule

United Kingdom: The United Kingdom’s fiscal policy was highly volatile during 1970s, with deficits averaging around 3.3 per cent of GDP from 1979 to 1996 and reaching over 4 per cent of GDP in 1997. When the authorities attempted to control the budget deficit, fiscal policy turned pro-cyclical, with the main burden of the adjustments falling on public investment. The bias against capital investment resulted in underinvestment in public assets and in formation below in other G-7 countries. In this context, in 1997 the authorities introduced a new framework, including measures to ensure a clear separation between monetary and fiscal policy. In U.K the fiscal framework introduced in 1997, the code for fiscal stability was set of principles and guidelines that received statutory backing through the finance Act of 1998. Thus, it also tided the future governments. The fiscal framework intended to achieve efficiency and effectiveness of taxation and spending, it also aimed at supporting monetary policy. It intended to ensure sound public finances and fair allocation of taxation both within and across generations. It avoided unsustainable increase in public debt by balancing current expenditures with current revenues over the cycle. In this way, the new framework removed bias against capital spending.

The code of fiscal stability was based on three pillars: a set of principles, fiscal rules, and specific reporting and auditing guidelines that received. There were five principles of the code fiscal stability. The first one was transparency in the setting of objectives and implementation of fiscal policy and in the publication of public accounts. The second one was stability in the fiscal policy making process and in how fiscal policy affects the economy. Third one was responsibility in the management of public finances. The fourth one was fairness, including a fair treatment among different generation. The fifth one was efficiency in the design and implementation of policy and managing both sides of public sector balance sheet.
Two general rules accorded with these principles. The first, the golden rule specified that the government will borrow only to invest. The second, the sustainable investment rule, established that the public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

The code also specified reporting and auditing requirements. It mandated a financial statement and budget reports to disclose the key budget decisions and the short term and fiscal outlook; an economic and fiscal strategy report outlining the government’s long term goals, its strategies for the future, and progress towards meeting its fiscal objectives; and debt management plans. Furthermore, the government had to publish its economic and fiscal projection, including estimates of the cyclically adjusted fiscal position and long term projection. It had to assess the sustainability of policies, including disclosure and quantification, where possible, of decisions and circumstances that could have a material impact on the economic and fiscal outlook.

To support fiscal framework all spending department had departmental expenditure limits, which will be set in nominal terms for three years on a two years rolling basis. The expenditure limits were only adjusted if inflation forecasts differ significantly from the original projection. Unspent funds could be carried over to the next year, but over runs were not allowed. Departmental expenditure limits covered most non cyclical primary expenditure, approximately half of total expenditure and they included central government transfers to local governments. Current and capital expenditures were treated separately in order to be consistent with golden rule established in code.

Following the introduction of the new framework, fiscal accounts improved markedly, with the public debt to GDP ratio declining from 43.7 per cent in 1996 to 31.5 per cent in 2001. At the same time, the general balance switched from a deficit of 4.4 per cent of GDP in 1996 to 0.9 per cent of GDP in 2001. Over the same period the structural balance also improved, suggesting the part of fiscal improvement was not attributable to the positive position of the U.K economy in the business cycle. Although fiscal balances weakened in 2002, they remained consistent with the fiscal rules. The public debt to GDP
ratio edged up to 31.9 per cent in 2002, and the general government balance deteriorated by about 2 percentage points. Meanwhile, the structural balance turned from a surplus of 0.5 per cent in 2001 to a deficit of 1.2 per cent in 2002, reflecting mainly an increased spending on education, health, and transportation, and a loss of corporate tax revenues.

**Australia Fiscal Policy Rules:** Poor fiscal performance over more than two decades, which led to marked build up in public debt, prompted the Australian authorities to adopt Budget Honesty Act enacted in 1998. Under it government must laid out its short–term fiscal objectives and targets, as well as its medium strategy in each annual budget.

The act established general principles for formulating sound fiscal policy. Fiscal strategy was based on following principles. First, financial risks must be managed prudently, including the general government debt maintained at prudent levels. Second, fiscal policy should help achieve adequate national saving and moderate cyclical fluctuations in economic activity, taking in to account the economic risks and impact of those risks on fiscal position. Third, spending and taxing policies should be consistent with a reasonable degree of stability and predictability in the level of tax burden. Fourth, the integrity of tax system should be maintained. And fifth, policy decisions should be fair from an intergenerational point of view.

Government was required to release a fiscal strategy statement at or before the first budget. The statement was intended to increase public awareness of fiscal strategy and to establish a benchmark for evaluating its conduct. Additionally, the act required government to release reports of Budget Economic and Fiscal Outlook, Mid year Economic and Fiscal Outlook and Final Budget Outcome. The treasurer also had to publicly release an intergenerational report every five years that assesses the sustainability of government policies for next 40 years, including the financial implications of demographic change. To increase the transparency of the budget process in election years, the government had to publish a pre-election Economic and Fiscal Outlook. Budget Honesty Act did not specify particular numerical targets, but it requires
government to set operational targets on three year basis and publish them in fiscal strategy statement.

The new framework contribute to a significant turn around in the federal fiscal position, which shifted from a deficit of about 4 per cent of GDP (on a cash basis) in 1992-93 to a surplus of 2 per cent of GDP in 1999-00. Spending has increased only slightly, and tax burden has remained constant. Moreover, transparency has improved through the new reporting requirements established in the act.

**Canada:** In Canada, federal government debt fluctuated around 35-40 per cent of GDP in the 1980s; but the decline in economic growth during the early 1990s led to dramatic increase in the deficit, which reached around 6 per cent of GDP in 1993. By 1994, debt reached 70 per cent of GDP. The authorities responded through legislated spending restrained beginning in 1992.

The Fiscal Spending control act of 1992 established a nominal expenditure limit for 1992-96. In addition since 1994 the government introduced several policy rules that were not formally legislated.

The main objectives of the act were to control public expenditure growth, reduce fiscal imbalances, and stop the increase in public debt. The non-legislated policy rules were directed at minimizing the use of overly optimistic economic assumptions for budgeting, reducing public debt to cope with population-aging costs, increasing the planning horizon for public sector activities, and improving the transparency of public operations.

The Fiscal Spending control act set nominal limits on programme spending from 1991 to 1995. “Programme spending” included all public expenditures except those associated with the service of debts, payments of employment insurance, expenditures related to farmer protection act, and expenditures arising from emergencies and payments in satisfaction of court judgment against government. The expenditure limits were legislated and thus legally binding: therefore the government was not permitted to present a budget
proposal inconsistent with established expenditure. Overspending in one year could be offset in the following two years, including the financial year stipulated in the law. Additionally, spending could be increased in a year with unexpected revenues, or if spending during the previous year had not reached the limit. Two year rolling deficit targets were adopted with the goal of balancing the budget and, as part of pre-budget consultation process, mid year fiscal updates describing deficit target and revised economic assumptions began to be published. In 1995 a contingency reserve was set up to finance forecasting errors and unpredictable events. In 1998, the government committed itself to a debt repayment plan implying balanced budgets the following two years.

In 2000, Government added a new element to debt repayment plan in addition to setting aside a contingency reserve each fall it announces whether more of that years’ surplus than anticipated in budget would be devoted to debt reduction. In the future, the effect of “prudent assumption” on budget projections would be identified explicitly in order to facilitate the evaluation of fiscal strategy. This implies that the public budgets starts by establishing the degree of economic prudence required to cushion pressures on government finances, such as higher than-expected interest rates or lower than forecast growth. This helps to ensure that the government meets it’s to balanced growth.

The Fiscal Spending control act was successful. Actual spending remained within limits in all year except 1993, when overspending offset under spending in the preceding fiscal year. Furthermore, the deficit of 5 per cent of GDP in 1995 became a surplus of 1 per cent of GDP by 1999. Although this improvement partially is cyclical, most of it reflects structural gains. Additionally, the ratio of net public debt to GDP was reduced from around 70 per cent in 1995 to 52 per cent in 2000.

Japan: Japan had a legislated fiscal rule since 1947, which prescribes that bond issuance be limited to raising funds for financing public works. The rule covered only the general account budget of the central government, which represented only about 25 per cent of the central government’s total budget. However, since 1975, deficit-financing bonds had
been issued on a regular basis in addition to construction bonds, which were exclusively for public works. Moreover, the distinction between construction and deficit-financing bonds became less clear as constructions bonds were issued to cover more and more spending categories. As such, the fiscal rule had not proven to be a binding constraint since 1975. In order to address the deficit which had persisted through the early to mid-1990s, especially in light of future ageing-related pressures, the government engaged in fiscal tightening and passed the Fiscal Structural Reform Law in 1997. The legislation provided that the sum of the central and local government deficits as a percentage of GDP should be reduced to 3 per cent or less by 2003 (from around 6 per cent in 1997). Furthermore, it provided that the amount of deficit-financing bonds should be reduced every fiscal year and issuance of such bonds should cease by 2003. The legislation also required that numerical limits be set for expenditures in each major programme from 1998 to 2000. Finally, it specified that the sum of taxes, payroll contributions and the deficit should not exceed 50 per cent of GDP. However, the fiscal tightening initiated in 1997 was too much for the economy to bear. Under pressure from the Asian economic crisis and the failure of some major Japanese financial institutions, the economy fell into recession. In response, the government revised the Fiscal Structural Reform Law in May 1998 to introduce more flexibility, and then formally suspended its application in November 1998. Since that time, the government has followed expansionary policies and the general government gross debt-to-GDP ratio has skyrocketed, reached 133 per cent in 2001. Again in 2003 a new Fiscal policy rules proposed from 2003. It was defined in terms of current balance- government limited borrowing capital expenditure only.

**Chile:** Chile did not impose specific rules requiring fiscal balance until 2000, but other long-standing institutional factors played useful roles in maintaining discipline. These included giving more power to the finance ministry than to other ministries; prohibiting the central bank from extending credit to the government; and preventing lower levels of government from borrowing, thereby eliminating sub-national free-rider problems. As net debt declined, its composition became more stable. Most debt is now denominated in local currency and inflation indexed, although un-indexed instruments are being increasingly promoted. Long-term instruments pay a real return of about 3 percent,
similar to the yield in industrial countries. The public sector has positive net foreign assets, since official reserves exceed foreign currency debt; short-term external debt is less than 2 per cent of GDP. Since 2000, the government has committed to an annual target for the central government structural balance, adjusted for cyclical effects and copper-price movements, thus allowing automatic stabilizers to work. This is central to the design of each year’s budget. The target currently aims for a surplus of 1 per cent of GDP. To further boost credibility, an expert committee determines the methodology used to calculate the structural balance. Challenges remain, however, to sustaining a strong fiscal performance. The structural budget target has been introduced at a time of cyclical weakening in the overall budget position. Preserving sound policies will require distinguishing temporary from permanent shocks in real time, a notoriously difficult task. An important challenge will be to ensure that any errors in estimating the structural balance average out over time.

4.5. Conclusion

A review of the experiences of various countries as well as sub-national levels of government suggests that fiscal rules can be useful tools for fiscal retrenchment, if properly designed. Fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient at the both national and sub national levels otherwise it may in fact worse than useless, as it invites “creative fiscal accounting.”

Countries experience both with and without fiscal rules shows that fiscal rule fiscal rules may be helpful in achieving fiscal success and may even be necessary in certain countries, but they are clearly not necessary in all countries. Governments with a strong reputation for fiscal prudence do not need to be constrained by rules. Countries that lack such a reputation, fiscal rules can indeed provide a useful policy framework that is conducive to stability and growth.

In nineties many counties around the world were able to achieve fiscal consolidation, attaining primary surpluses. Widespread reforms including debt ceilings and deficit targets have strengthened fiscal frame works. Expenditures rules and transparency in the
fiscal management has also been emphasized in these fiscal frameworks. Evolution of
these fiscal consolidation efforts have identified certain factors that account for reliable
and durable adjustments. Accordingly, fiscal consolidation is more likely to be successful
when based on cuts in expenditures, particularly when undertaken by countries with high
level of debt widespread reform in fiscal frame work require institutional reforms aimed
at achieving and maintaining fiscal consolidation, while leaving room for fiscal policy to
respond to business cycle through automatic stabilizers and policy actions. The main
criticism of the deficit rules in general and balanced budget rules in particular is that they
are irrelevant and therefore tends to be pro-cyclical. This is a more important
consideration for national governments as compared to sub national governments. For
this reason the deficit rules in national government have increasing been defined in terms
of a cyclical adjusted deficit measure or an average over the economic cycle. Thus the
rules allow the operation of domestic stabilization and to some extent also provide room
for discretionary policy with in the cycle.
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