**PEMPAL 2016 BCoP Plenary Meeting**

**FISCAL RULES FOR EFFECTIVE AND SUSTAINABLE BUDGETING**

**February 24-26, 2016, Minsk, Belarus**

**SUMMARY NOTE**

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**General Comments**

1. The meeting, attended by BCoP Representatives from eighteen PEMPAL countries[[1]](#footnote-1), focused on: i) key concepts in fiscal rules, ii) different approaches and their pros and cons, iii) general global trends, including OECD experience and experience in PEMPAL countries iv) current trends, and v) more detailed country cases for five countries, including three PEMPAL countries (Albania, Russian Federation, and Belarus) and two countries with more advanced experience (Sweden and Latvia).

The objectives of the meetings were to share PEMPAL and international approaches on the use of fiscal rules, their impact, and lessons learnt, as well as to provide the opportunity for BCOP member countries to exchange experiences and discuss possible approaches and options to using fiscal rules in the context of discussion groups.

This note provides a summary of the key issues and lessons discussed during the plenary meeting, while the presentations and other meeting material is available on the PEMPAL website[[2]](#footnote-2)

 **Key Concepts**

1. Presentations from the IMF and the World Bank provided the participants with comprehensive background on the definitions, rationale, and different types of the fiscal rules. Based on the wealth of research and knowledge on fiscal rules accumulated in these two organizations, presenters discussed possible pitfalls and success factors of different approaches to fiscal rules, offering both theoretical (macro-fiscal) and practitioners’ perspective.
2. Fiscal rules are defined as permanent constraints on fiscal policy, expressed as a fiscal indicator - budget position (balance, surplus or deficit), expenditure, debt, or revenue. Fiscal rules can also be used to specifically target resource issues, such as fiscal balance excluding revenues from commodities. Introduction of fiscal rules signal commitment to fiscal discipline (sustainable and stabilizing policies) and are positively perceived by capital markets, thus ensuring more favorable sovereign borrowing conditions.
3. Rules range from very simple (e.g. budget balance) to increasingly complex (e.g. cyclically adjusted balance and structural balance), with the complexity being introduced in order to take into account correlation between fiscal policy and economic growth (i.e. to prevent pro-cyclical fiscal policy). While these more complex fiscal rules sound theoretically, their actual application is complicated by the difficulties in estimating and projecting potential GDP and exact business cycle position.
4. Recent global trends indicate increased usage of fiscal rules, both in terms of countries that have them, as well as the number of fiscal rules in one country. Most frequent type of fiscal rule is balance budget rule, followed by debt rule. Expenditure rules are more present in advanced countries than in non-advanced countries. Recent trends also show a shift towards more flexibility (to take into account cyclicality).
5. Main complaints about the fiscal rules include: i) low compliance rate, ii) complexity, iii) too many fiscal rules in a single country with overlapping objectives, (as in EU), iv) multiple and vague loopholes combined with weak enforcement mechanisms, v) difficulties in estimating data on output gaps and cyclical position with frequent data revisions, and vi) difficulties to react promptly in application of escape clauses in terms of budget revisions given time lag of macroeconomic data on output, output gaps, and cyclical position.

**Why Countries Introduce Fiscal Rules**

1. General main rationale for introduction of fiscal rules is an attempt to depoliticize fiscal policies by balancing long-term development objectives (economic growth and employment generation, macroeconomic stability, and debt sustainability) with the short-term political objectives (political business cycle and popularity incentives).
2. Specific motivation for introducing fiscal rules include: depoliticization of economic decision, protection of long-term fiscal sustainability, signaling fiscal credibility to improve government borrowing conditions and improve private sector’s expectations, preventing pro-cyclical fiscal policies (including to prevent expansive fiscal policy in good times), and to be better equipped to deal with external environment trends that have uncontrollable influence on revenues (e.g. commodity producing countries or small open economies with foreign trade vulnerabilities).

**What Should Be Taken into Account When Introducing Fiscal Rules**

1. Desirable characteristics of fiscal rules are given in Figure below**[[3]](#footnote-3)**.

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| **1. Simplicity** | The rule should be understood by decision-makers and the public. |
| **2. Sustainability** | Compliance with the rule should ensure long-term sustainability. |
| **3. Stabilization** | Following the rule should not add to economic volatility. |
| **4. Operational Guidance** | It should be possible to translate the rule into clear guidance in the annual budget process. |
| **5. Stability and Robustness** | Rule should be in place for a sustained period of time to build credibility, and be robust to shocks |
| **6. Verification** | It should be possible to verify if the government has complied with the rule within regular intervals. |

1. None of the fiscal rules satisfy all of these six desirable characteristics listed above and there are numerous trade-offs in choosing a specific rule. Trade-offs include:
	1. simple vs. flexible
	2. easily monitored vs. growth-stabilizing
	3. a signal easily communicated to public vs. a more sophisticated signal which is more likely to be positively perceived by the capital market.
2. It is thus essential that each country choose the design of fiscal rules based on its own specificities and needs. The following general specificities of PEMPAL countries were identified (including through extensive discussion groups held during the plenary) as being important to take into account:
	1. structure of economy (e.g. the more vulnerable the economy is to external environment, the more prudent fiscal policy and rules are needed to avoid outside shocks)
	2. fiscal policies and processes (e.g. what type of fiscal pressures most often occur and how strictly applied are medium-term expenditure frameworks, if any)
	3. political landscape/maturity (e.g. how strong the legal basis for the fiscal rule needs to be in order to ensure compliance), and
	4. institutional capacities (e.g. what are the capacities of agencies/departments in charge of macroeconomic projections and what institution would monitor the compliance with the fiscal rules)
3. Decision on the level of fiscal rule complexity (i.e. the degree to which to introduce cyclical and structural elements) and type(s) of fiscal rule (budget position, expenditure, revenues, and/or debt) to be introduced should be made based on a careful consideration of all pros and cons of different fiscal rule types against the above-listed six desirable characteristics of fiscal rules, while having in mind country’s specificities.
4. When deciding on the type and design of legal basis for the fiscal rules, the following should be considered:
	1. Grounding rules within primary legislation may serve to broaden political support and alleviate some of the risk of constant changes of fiscal rules with changes of governments. However, at the same time, this limits the flexibility of swiftly adjusting the fiscal rules if needed, as the procedures for changing the primary legislation are complex and lengthy.
	2. Having all fiscal accountability/discipline provisions in one piece of legislation makes it easier. Some countries have decided to have fiscal rules provisions within the organic budget law, while others adopt a separate law dealing with fiscal rules (sometimes combined with fiscal accountability).
	3. Countries should adopt the legal basis and format based on what it assesses as having highest chances for compliance.
	4. The coverage of general government expenditures by fiscal rules should be maximized in terms of covering all government levels. Monitoring of implementation at sub-national level is challenging, but at minimum expectations should be clearly communicated to lower government level units with strong focus on coordination in the budget planning stage. Building in the buffer for sub-national levels within the central government budget should also be considered, especially in the cases where fiscal discipline of sub-national level is an issue.
5. Rules should allow for short-term flexibility in the time of exceptional economic circumstances, and also be in line with macroeconomic objectives.
6. Design of escape clauses and enforcement mechanisms should clearly define exceptional circumstances that trigger escape clause, designating an institution/body that will be in charge of monitoring governments’ compliance with fiscal rules, and clearly defining the sanctions if fiscal rules are not abided by (in order to avoid the common global problem with fiscal rules historically – non-compliance). Monitoring of compliance with the fiscal rule(s) must be constant, not just during budget adoption. An “independent” body (Fiscal Council) can assist in increasing credibility by not only monitoring/verifying compliance with fiscal rules, but also by reviewing macroeconomic projections and assumptions for revenue projections.
7. When introducing fiscal rules, consideration should be given to minimizing the bias towards cutting the most productive expenditure (investment).

**Additional Success Factors**

1. Expectations about what fiscal rules can deliver should be managed, as they are only one tool to contribute to fiscal discipline, by providing a benchmark of prudence and foresight. However, they cannot on their own fix damaged public finances and ensure fiscal stability and sustainability. Fiscal rules cannot replace political commitment to fiscal discipline.
2. Fiscal rules should not be introduced pre-maturely, but rather towards the final stages of public finance management (PFM) systemic reform. Overall budget process must be effective and credible first, and fiscal rules then used within a broader PFM Strategy.
3. Fiscal rules cannot replace political commitment, but (even in their simplest forms) they can signal the existence of commitment and serve to put fiscal discipline into the public discussion and shift focus to more of a long-term perspective.
4. The ultimate guard of fiscal discipline is the public that holds political decision-makers more accountable. Fiscal rules can assist to generate such public interest and a virtuous cycle of fiscal discipline supply and demand: i) generating political will for fiscal discipline, ii) choosing appropriate fiscal rules and independent oversight, and iii) the broader public demand for stability and sustainability. Media can be a key partner in this process.
1. Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Kyrgyz Republic, Macedonia, Moldova, Montenegro, Romania, Russian Federation, Serbia, Tajikistan, Uzbekistan, and Ukraine. [↑](#footnote-ref-1)
2. <https://www.pempal.org/events/plenary-meeting-budget-community-and-meeting-budget-literacy-and-transparency-working-group> [↑](#footnote-ref-2)
3. From presentation Fiscal Rules: Key Concepts and Approaches, given by Jason Harris, IMF at the plenary meeting (available at the link given in Footnote 2). [↑](#footnote-ref-3)