सत्यमेव जयते

Department of Economic Affairs
Ministry of Finance
Government of India

Volume-II
International Experience

FRBM Review Committee

January 2017

FRBM REVIEW COMMITTEE REPORT

RESPONSIBLE GROWTH
A FISCAL FRAMEWORK FOR 21ST CENTURY INDIA

VOLUME-II
INTERNATIONAL EXPERIENCE


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CONTENTS

SECTION 1:

INTERNATIONAL EXPERIENCE WITH FISCAL RULES

Fiscal Responsibility Laws:
Lessons from International Experience

Teresa Curristine
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, June 24-25th 2016

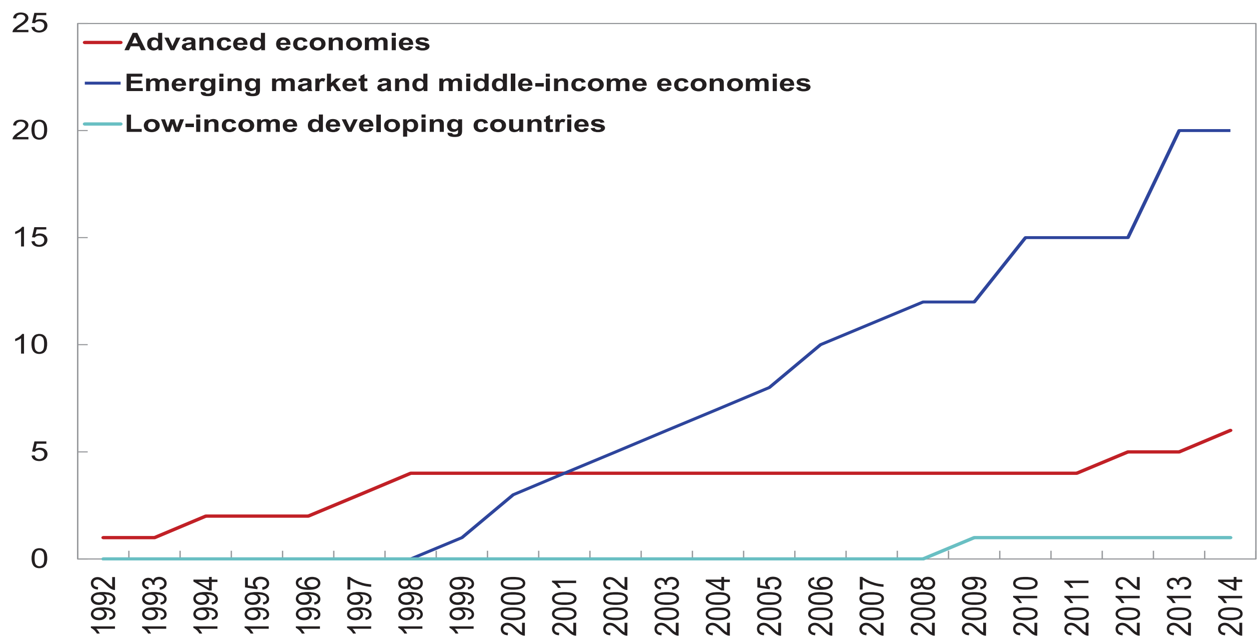
Outline

1. Definition, Rational ,and Key Features of FRLs
2. Key Choices in FRL Design
3. Lessons Learned from Crisis
4. Issues for Discussion

1. Considerations in Reviewing Laws

1. **Codify good practices**
   - i. Preserve fiscal responsibility post crisis (Turkey 2004 PFM Law)
   - ii. Fiscal transparency (Australia: 1998 Charter of Budget Honesty Act)
2. **Change bad practices**
   - i. Close loopholes (Greece: 2010 Fiscal Responsibility & Management Act)
   - ii. Protect investment (UK 1998: Code for Fiscal Stability)
3. **Drive financial management reform**
   - i. Accrual accounting (Iceland: 1997 Fiscal Reporting Act)
   - ii. Program budgeting (France: 2005 LOLF)
4. **Alter the financial balance of power**
   - i. Central vs. sub-national government (Spain: 2003 General Budget Law)
   - ii. Executive and fiscal council (UK: 2011 Budget Responsibility Act)
5. **Applying lessons from crisis and improving enforcement**
   - i. Improve transparency and discipline (Ireland: 2012 Fiscal Responsibility Act)
   - ii. Revised structural balance (Peru: 2013 Fiscal Responsibility Law)

Number of Countries with FRLs, 1992–2014 expanded rapidly in emerging market countries



I. What are the key features of FRLs?

How FRLs address systemic problems in fiscal policy-making

Problem		FRL Features
a. Time-inconsistency	→	a. Fiscal Rules
b. Short-sightedness	→	b. Medium-term Budget Frameworks
c. Information asymmetry	→	c. Transparency
d. Principal - agent	→	d. Sanctions
e. Exogenous shocks	→	e. Escape Clauses

1. New and Revised FRLs– Key Features

- **Peru – 2013 Fiscal Responsibility and Transparency Law**
  - Medium Macroeconomic framework – setting 3 year projections for main macro-economic and fiscal variables.
  - Numerical fiscal Rules – a structural balance rule and debt rules, includes sanctions.
  - Fiscal Stabilization fund for national government
  - Established a Fiscal Council
  - Require Fiscal Risk Statement
- **Ireland 2012 Fiscal Responsibility Act**
  - Fiscal Rules -General budget balance and debt rules consistent with Stability and Growth PAC (SPG) – includes corrective mechanisms and sanctions.
  - Medium term budgetary objectives
  - Increased fiscal reporting
  - Established a fiscal council

1. Preconditions for FRLs

- **Political commitment**
  - lack of commitment can undermine an FRL.
- **Adequate public financial management**
  - Reliable data and technical forecasting capacity
  - Comprehensive and timely budget reporting
  - Internal and external audit systems
  - Transparency -public release of data

2. Key Choices in FRL Design

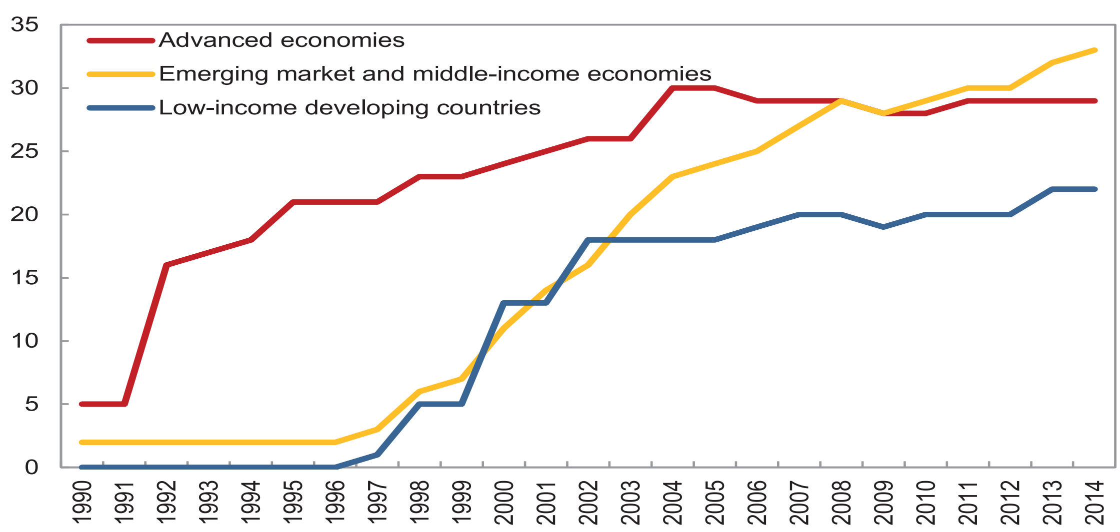
FRL Features	Design Choices
a. Fiscal Rules	Procedural rules Numerical rules
b. Medium-term Budget Frameworks	Fixed ceilings Rolling estimates
d. Transparency	Fiscal reporting Fiscal councils
e. Sanctions	Administrative Financial Criminal
f. Escape Clauses	Trigger mechanism Transitional arrangements

2. Fiscal Rules: Types of numerical rules

Objective	Type of Rules	Country Example
Debt Reduction	Debt Brake	Switzerland
Debt Sustainability	Debt Ceiling	SGP
Deficit Reduction	Overall Balance	SGP
Countercyclical Policy	Structural Balance	Chile
Reduce Expenditure	Expenditure Ceiling	Sweden
Reduce Taxes	Revenue Ceiling	Denmark
Protect Investment	Golden Rule (1997-2008)	UK

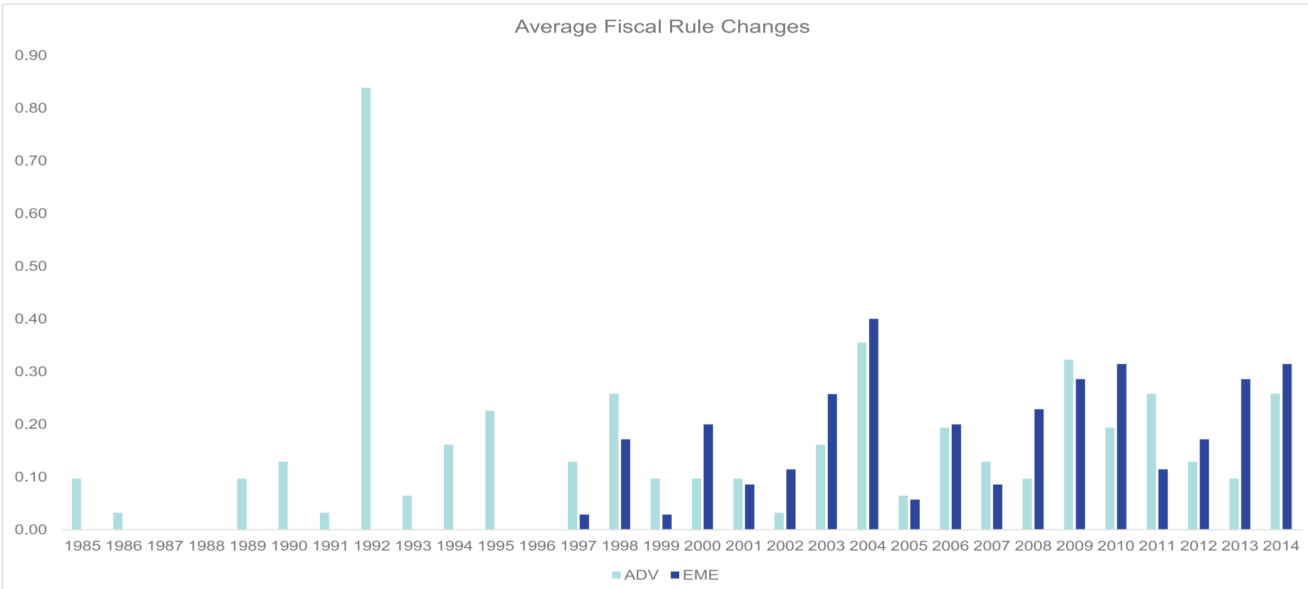
2. Fiscal Rules: Trends by Income Group

Number of Countries Using Fiscal Rules, 1990-2014

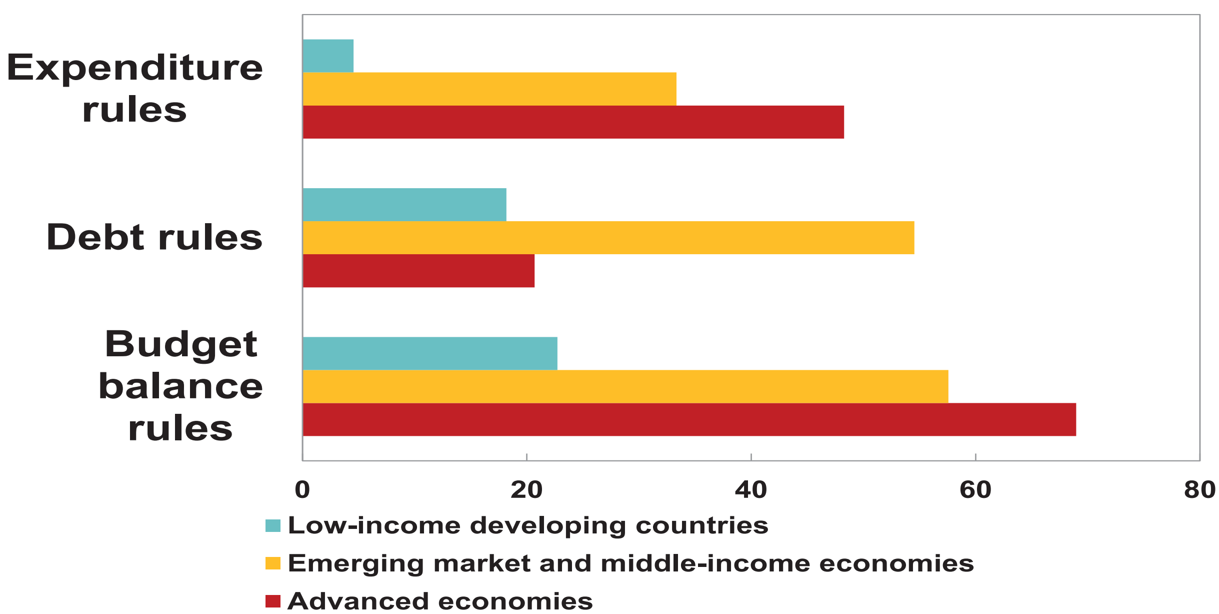


Source: FAD Fiscal Rules database.
Notes: Figure includes both national and supranational fiscal rules.

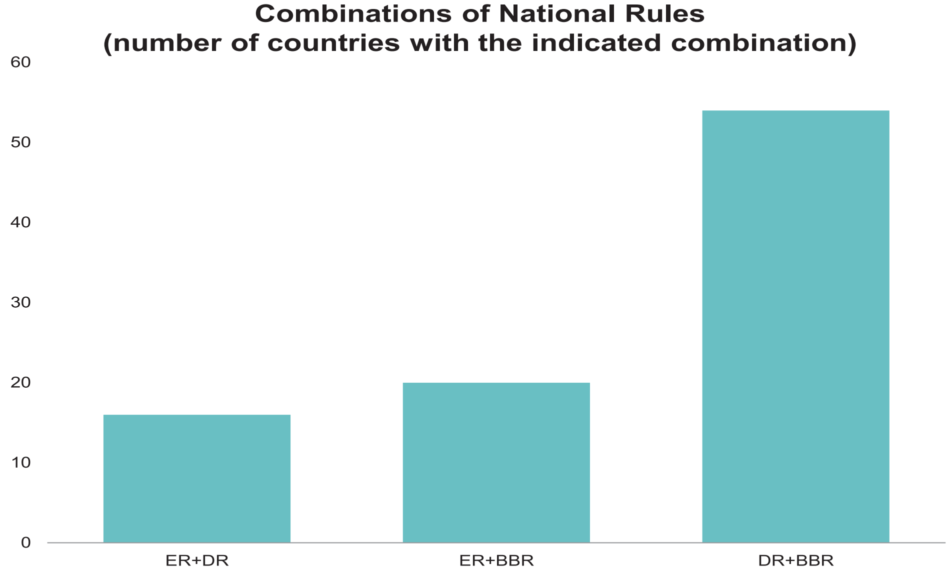
2. Fiscal Rules: Average Number of Changes in Rules per Year by Income Group



2. Fiscal Rules: Type of National Fiscal Rules by Income Group, 2014 *(Share of countries with rules)*



2. Fiscal Rules: National FRs Most Frequent Combination of Debt and Deficit



Source: FAD Fiscal Rules database

2. Fiscal Rules: Characteristics of Good Fiscal Objectives/Rules

Characteristic	Rationale	Examples
Medium-term horizon	• Separate fiscal policy and budget decisions in time • Allow flexibility to deal with volatility or shocks	• Over the cycle (UK) • Over the Parliament (NL)
Comprehensive in scope	• Limit scope for burden shifting or creative accounting	• General govt (SGP) • Public sector (UK, NZ)
Binding on outturn	• Reduce optimism bias in forecasts • Ensure deviations are made up in future	• "Debt brake" rule (Swiss) • Maintain debt below 40% of GDP (UK)
Stable over time	• Build public support • Raise reputational cost of breaking the rule	• Procedural FRLs (Aus, NZ)
Precise & transparent	• Provide clear guide for policy-making • Facilitate evaluation of compliance	• 1% surplus over the cycle (Sweden)

2. Fiscal Rules: Taking account of the cycle

Option	Avoid Pro-cyclicality	Legitimacy with the Public	Clear Guide for Policy-Making	Limited Scope for Cheating	Country Example
Frame objective over fixed period	✗	✓	✓	✓	**Netherlands:** Surplus of 1% of GDP by end of Parliament
Frame objective over the cycle	✓	✓	?	?	**UK:** Balance current budget on average over economic cycle
Cyclically adjusted target	✓	✓	?	?	**Swiss:** Debt-brake rule

Implementing Fiscal Rules:
Issues for Consideration

OBJECTIVES	LESSONS FROM EXPERIENCE	ISSUES FOR CONSIDERATION
Flexibility	Inflexible rules need flexible budgetary frameworks	• How much caution in revenue projections? • How much headroom against the rule itself? • How big a contingency margin in spending projections? • Can earmarking of revenue be reduced? • How much more flexibility to give line ministries?
Transparency	Need a clear line of sight from fiscal rules to expenditure plans down to budgetary controls	• What fiscal aggregates to target? • Can fiscal rule be easily translated into an expenditure path? • Can rule be translated onto SS and LG systems? • Does monthly reporting give a clear picture of performance?
Planning	Trade-off between discipline, coverage and detail in MTEF design	• Can number of sectors be consolidated? • Which sectoral projections could become multi-year ceilings? • Should coverage of MTEF be expanded? • How can accuracy of costing and forecasting be improved?
Discipline	Rule is only as good as government's commitment to uphold it	• Are ministries prevented from making unfunded promises? • Is there a single, comprehensive and definitive process for prioritizing expenditure requests? • Does the MoF have the information to publish a comprehensive reconciliation from budget to budget?

2. Fiscal Rules: Successful / less Successful

Depends on the design of the rule - all rules have trade offs.

Relatively successful

- Under stable/good economic conditions (but not pre EU-crisis)
- For controlling local government finances

Less successful

- With lack of societal support
- During severe economic crisis
- Some rules limit flexibility with pro-cyclical stance in bad times
- When they bite: seem to induce avoidance/creative accounting, fragmentation of budget process
- Complex rules can reduce transparency

2. Medium-term Budget Frameworks: Objectives and Common features

Objectives

- Instill greater fiscal discipline
- Facilitate more strategic prioritization of expenditure
- Encourage efficient inter-temporal expenditure planning

Common Features

- **Early political commitment to expenditure ceiling(s)**
  - Coalition Agreement (NL, Finland)
  - Parliamentary Vote (Sweden, France)
  - Government White Paper (UK)
- **Ceilings broken down by ministry or program**
- **Estimates reflect full costing of all tax and spending policies**
- **Ceilings becomes budgets in the absence of agreed**
  - Forecast changes
  - New policies
- **Margins built into multi-year forecasts to deal with the above**

2. Transparency: Fiscal Reporting

EX ANTE	EX POST
• **Macroeconomic assumptions** • **Budget plans** • **Policy costs** • **Fiscal risks** • **Forecast methodology**	• **Deviations from fiscal targets due to** – Macro-economy – Revenue – Expenditure • **Reasons for deviations broken down into:** – Forecast changes – Policy changes – Accounting changes • **Compliance w/ fiscal rules**

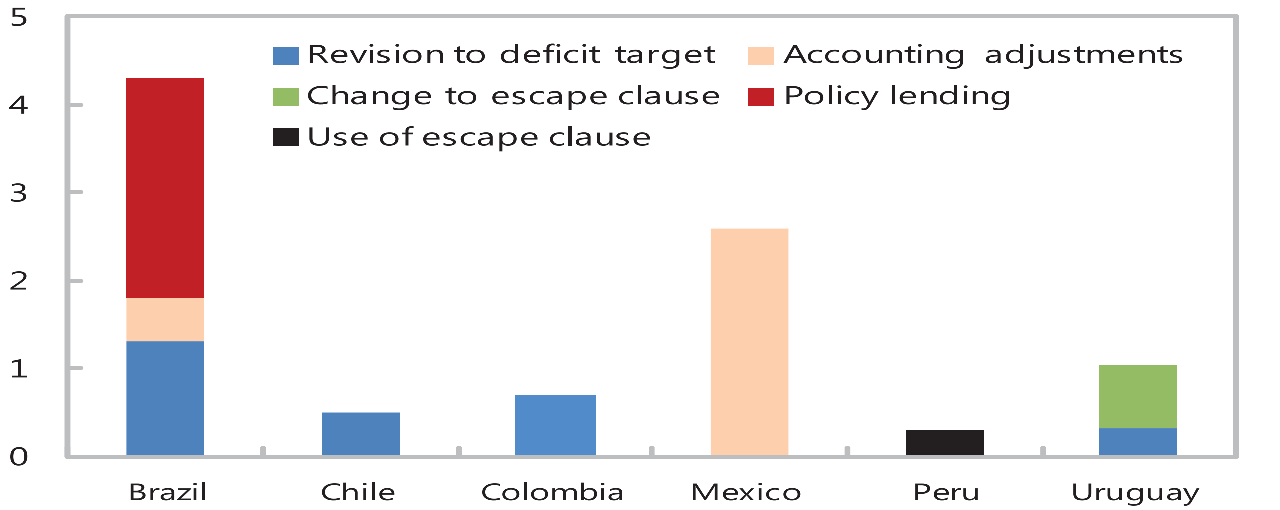
All in a multi-year perspective

3. Lesson Learned- FRs Before and During the Crisis

- Before crisis compliance varied with country and region
  - Low in Euro area in 2000s targets became floors not ceilings
  - High in Latin America with major countries meeting their key targets from 2002–2007 (LA6: Brazil, Chile, Colombia, Mexico, Peru, and Uruguay).
- During crisis relatively rigidity of rules did not allow relaxation of fiscal policy within the fiscal framework –LACs used buffers
- Countries resorted to ad-hoc adjustments
  - revised or missed targets
  - used and or changed escape clauses
  - changed coverage and/or used creative accounting.
  - suspend FRs
- Relaxation of fiscal frameworks became permanent in many LA6 countries and many Euro countries have yet to achieve targets

3. Revisions to FRs: During Crisis in Selected Latin American Countries

Figure 2. Policy Relaxations Relative to Fiscal Rules, 2009
(Percent of GDP)



Sources: IMF, country reports; and national authorities.

3. Lesson Learned- Post-Crisis (1/2)

- **Highlight Design Issues with Rules:**
  - Reliance on nominal rules reduced flexibility
  - fiscal targets were too easily changed;
  - the escape clauses lacking or not fully comprehensive
  - coverage of the fiscal rules too narrow
  - Poor fiscal reporting and understanding of underlying fiscal position
- **Broader institutional issues**
  - Insufficiently independent fiscal expertise
  - Imperfect budget execution controls
  - Lack of multi-year budget frameworks
- **Post-Crisis EU revised FRs and supporting institutions**
- **LA countries revised FRLs to take account of lessons- e.g. Peru, Mexico, Colombia, and Ecuador.**

3. Lesson Learned- Post-Crisis (1/2)

- **Fiscal rules increase in number post crisis but changing in nature**
  - New generation explicitly combine sustainability objectives with more flexibility to accommodate shocks either by setting cyclically adjusted targets or better defined escape clauses
  - Recognize need for integrated framework and supporting budgetary institutions
- **Comprehensive and transparent fiscal reporting needed to understand the size of the fiscal challenges.**
  - Stress on understanding and managing fiscal risks- important for market confidence.
  - New IMF Fiscal Transparency Assessment
- **Importance of medium term budget framework (MTBF) for showing creditability of budget plans**
  - During crisis countries with advanced MTBF used it to show markets how it will implement plans to achieve sustainable fiscal targets.
- **Renewed emphases on efficiency and value for money- Countries adopting spending and efficiency reviews.**

3. FRLs Obtaining buy-in by politicians and the public

- **International experience: FRLs do not create credibility by themselves.**

Buy-in is needed at three levels:

1. Within the Government:

- Is a constrained/ top-down spending process accepted by the President, other Ministers of the Cabinet?

2. At Parliament:

- What procedures are in place to constrain parliament's understandable constituency concerns?
- What happens when shortfalls in revenue or grant support occur? Should debt rise to finance shortfalls?

3. With the Public and Civil Society:

- Public hearings/consultations increase chances of FRL's successful adoption and implementation.
- Fiscal Council can help communicate on FRLs

4. Issues For Discussion During Next Two Days

- What are the main objectives for revising FRs? What type and combination of FRs would help achieve these objectives?
- What is needed in terms of institutional framework to support FRs and ensure they are linked to annual and medium term budget and fiscal frameworks?
- What type of escape clauses and sanctions are needed in the Indian context? What type of procedures would be needed to enforce them?
- Will these FRs cover sub-national governments? What transparency and reporting requirements for sub-national governments would need be incorporated into the FRL?
- What are the major fiscal risks and contingent liabilities that could undermine achieving of the FRs? What processes are in place for recognizing and mitigating these risks?
- What role could a fiscal council play in improving transparency and explaining FR to the public? How could a fiscal council's independence be promoted?
- Can transparency be increased by requiring more explicit publication of documents and presentation to Congress? If so what documents? What is the timing? What level of detail?

References

- **Public Financial Management and Its Emerging Architecture 2013, Chapters 2 and 3**
- **Budina and others, *Fiscal Rules at a Glance: Country Details from a New Dataset*, IMF Working Paper 12/273.**
- **Schaechter and others, *Fiscal Rules in Response to the Crisis. Toward the "Next Generation" Rules*, IMF Working Paper 12/187.**
- **International Monetary Fund, *Fiscal Rules: Anchoring Expectations for Sustainable Public Finances*, 2009.**
- **http://www.imf.org/external/datamapper/FiscalRules/map/map.htm**

Fiscal Rules in Emerging Markets: Overview and Key Messages

SANJEEV GUPTA
FISCAL AFFAIRS DEPARTMENT, IMF
INDIA MOF/IMF WORKSHOP
NEW DELHI, AUGUST 18, 2016

Context

- Follow-up on the presentations made at June FAD workshop on the international experience with:
  - Analyzing and managing fiscal risks
  - Implementing fiscal responsibility laws
  - Design and operation of fiscal councils
  - Designing second generation fiscal rules
- Address the specific questions raised by the committee in the letter to the MD and during the previous workshop

IMF Fiscal Affairs Department 2

Outline

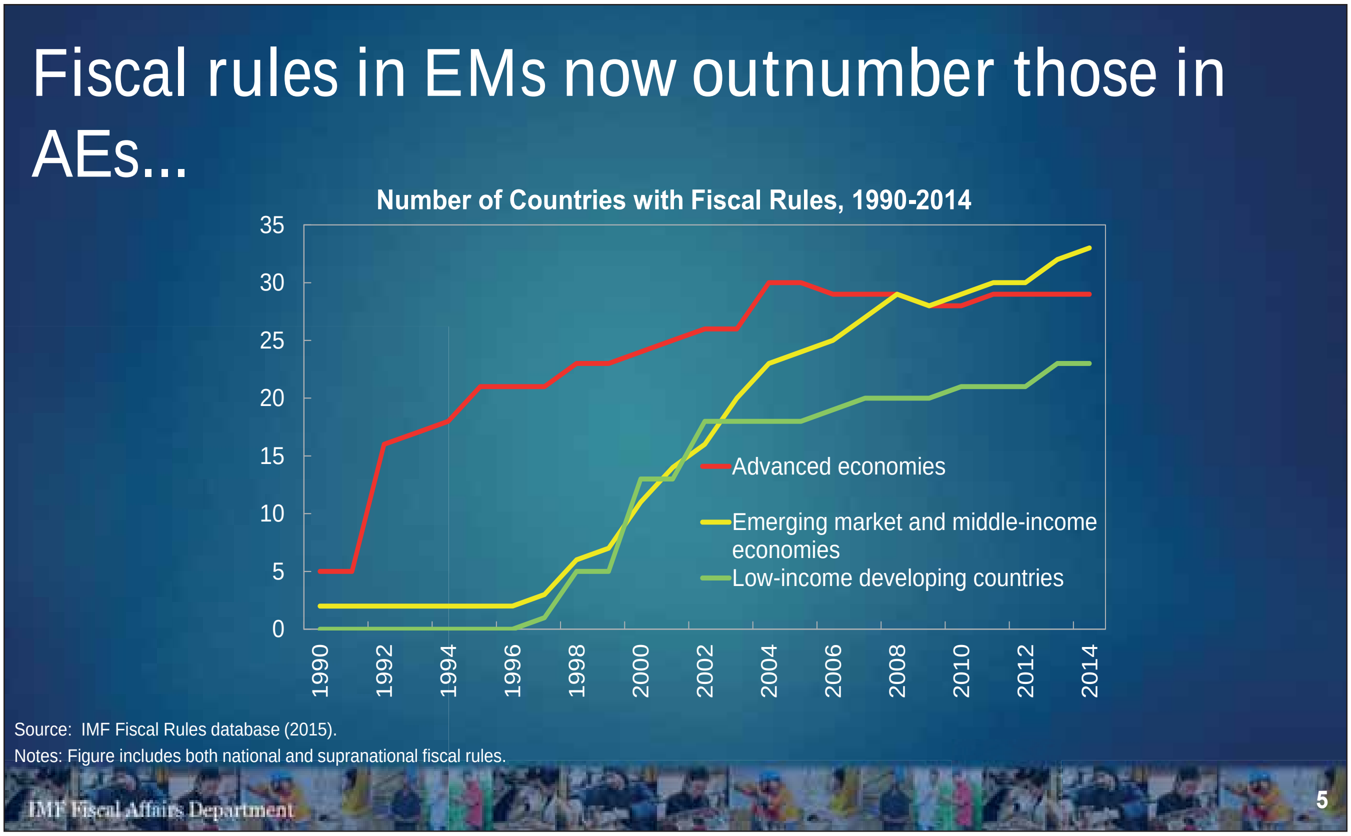
1. Fiscal Rules in Emerging Markets: Overview

2. Key Messages from the Presentations

IMF Fiscal Affairs Department 3

1. Fiscal Rules in Emerging Markets: Overview

IMF Fiscal Affairs Department 4


Fiscal rules in EMs now outnumber those in AEs...
Number of Countries with Fiscal Rules, 1990-2014
35
30
25
20
15
10
5
0
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Advanced economies
Emerging market and middle-income economies
Low-income developing countries
Source: IMF Fiscal Rules database (2015).
Notes: Figure includes both national and supranational fiscal rules.
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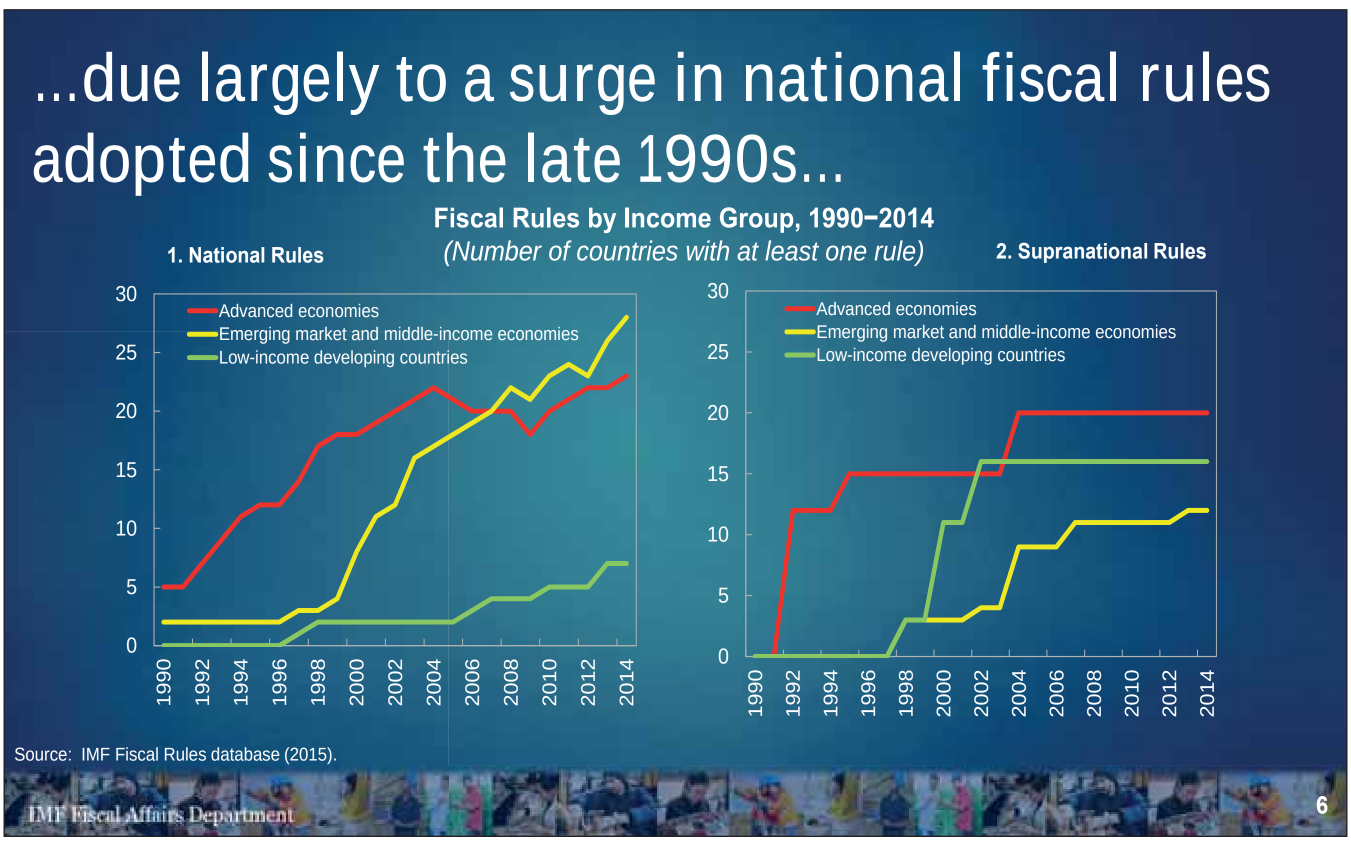
5


...due largely to a surge in national fiscal rules adopted since the late 1990s...
Fiscal Rules by Income Group, 1990–2014
(Number of countries with at least one rule)
1. National Rules
2. Supranational Rules
30
25
20
15
10
5
0
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Advanced economies
Emerging market and middle-income economies
Low-income developing countries
Source: IMF Fiscal Rules database (2015).
IMF Fiscal Affairs Department
6

... in order to signal commitment to fiscal adjustment or to solidify fiscal discipline

National Fiscal Rules Initially Adopted by Emerging Markets								
Country	**Year**	**Rule**	**Country**	**Year**	**Rule**	**Country**	**Year**	**Rule**
Malaysia	1959	DR	Chile	2001	BBR	Malta	2004	BBR+DR
Indonesia	1967	BBR	Costa Rica	2001	BBR	Pakistan	2005	BBR+DR
Lithuania	1997	DR	Namibia	2001	DR	Mexico	2006	BBR
Antigua & B.	1998	BBR+DR	Eq. Guinea	2002	BBR+DR	Romania	2007	BBR+DR
St. Kitts & N.	1998	BBR+DR	Panama	2002	BBR+DR	Russia	2007	BBR
St. Lucia	1998	BBR+DR	Botswana	2003	ER	Armenia	2008	DR
Poland	1999	DR	Bulgaria	2003	DR	Mauritius	2008	DR
Argentina	2000	ER+BBR	Ecuador	2003	BBR+DR	Croatia	2009	DR
Brazil	2000	ER+DR	Sri Lanka	2003	BBR+DR	Jamaica	2010	BBR+DR
Colombia	2000	ER	Hungary	2004	BBR+DR	Serbia	2011	BBR+DR
Peru	2000	ER+BBR	India	2004	BBR	Georgia	2013	ER+BBR+DR

Source: IMF Fiscal Rules database (2015).

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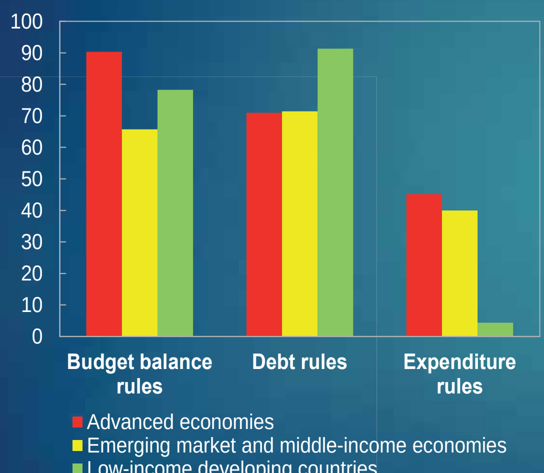
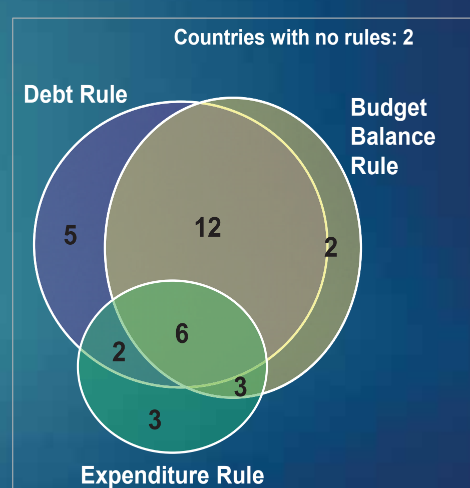
As in AEs, budget balance and debt ceilings, often combined, are the most common fiscal rules in EMs

Type of National Fiscal Rules by Country Group, 2014 *(Share of countries with rules)*



Emerging Markets: Number of Countries with Multiple Fiscal Rules, 2014



Source: IMF Fiscal Rules database (2015).

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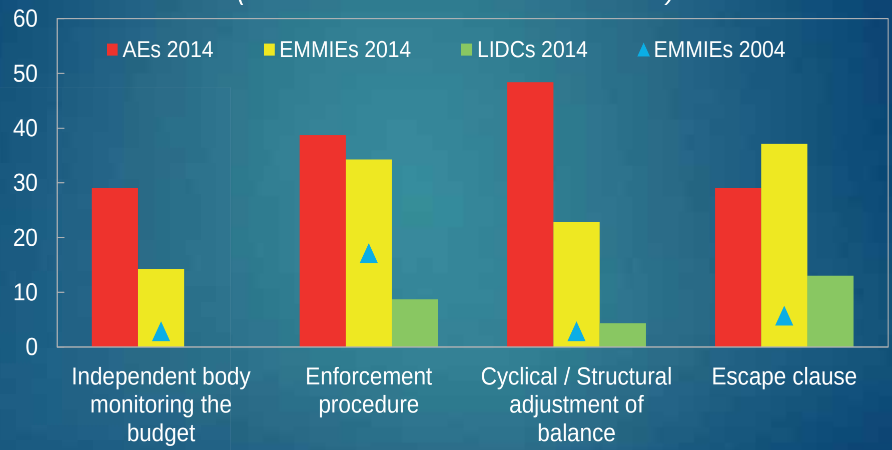
Despite progress, rules-based fiscal frameworks in EMs are still weaker than in AEs

Fiscal Rule Features by Type of Country, 2014

(Share of countries with rules that has:)



Source: IMF Fiscal Rules database (2015).

Note: AEs = Advanced Economies; EMMIEs = Emerging Market Middle-Income Economies; and LIDCs = Low-Income Developing Countries

IMF Fiscal Affairs Department 9

2. Key Messages from the Presentations

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Questions received from the Committee

- We have organized the questions in 4 main categories:
  - How can fiscal rules support growth? (**Tigran Poghosyan**)
  - Synergies between fiscal rules and inflation targeting regimes (**Rene Tapsoba**)
  - How to calibrate fiscal rule thresholds? (**Luc Eyraud and Andreas Bauer**)
  - How to set fiscal targets with a medium-term perspective as part of an MTBF? (**Sandeep Saxena**)
- Subnational finances and informality covered by WB colleagues

Key messages (1)

- Fiscal rules can support growth by fostering counter-cyclicality, improving expenditure composition, and facilitating structural reforms. From a stabilization perspective, an expenditure rule may be more appropriate than a cyclical/structural balance rule in EMs, in particular because of measurement issues. A MTBF rather than a golden rule can protect investment
- Adopting fiscal rules and inflation targeting jointly has great benefits, but requires coordination between monetary and fiscal policies, including at the operational level (targets, time horizons)

Key messages (2)

- Fiscal rule calibration is an art, not a science. Preliminary results suggest that a GG debt threshold of 50-70 percent of GDP would be appropriate for India. Beyond this range, the economy would become vulnerable. There are various ways to derive the other fiscal targets from the debt ceiling depending on the policy objectives, including coping with age-related pressures

- A medium-term fiscal framework (MTFF) (of three years) starting with the central government can improve compliance with fiscal rules. But is has to be fully integrated into the annual budget process. Prudent macro-fiscal forecasts (including for revenues) and a suitable margin to absorb unanticipated shocks will provide the flexibility to fiscal policy and impart credibility to it. The 2012 amendment to FRBM requires presentation of a medium-term framework which is yet to be fully institutionalized.

The experience of Internal Stability Pacts in the EU

European Commission
DG Economic and Financial Affairs

1

Fiscal surveillance in the EU

- *The EU seeks to enforce Treaty-based objectives in the economic field that grant paramount importance to sustainable fiscal finances*
- *The Excessive Deficit Procedure (EDP) lays down sanctions in case of non-compliance (EU Treaty level)* ***for each and every EA Member State***
- *The EDP is embodied in procedural terms by the Stability and Growth Pact (SGP) that encompasses a broad and comprehensive mechanism of fiscal surveillance (EU legislative level)*

2

Protocol 12 makes governments responsible for fiscal outcomes

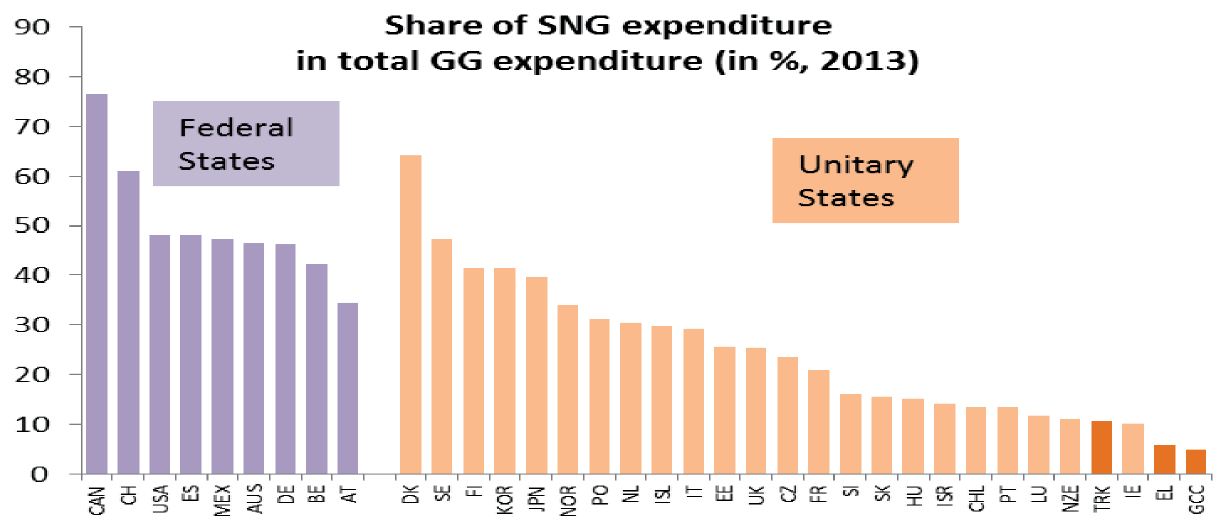
Text of Protocol 12

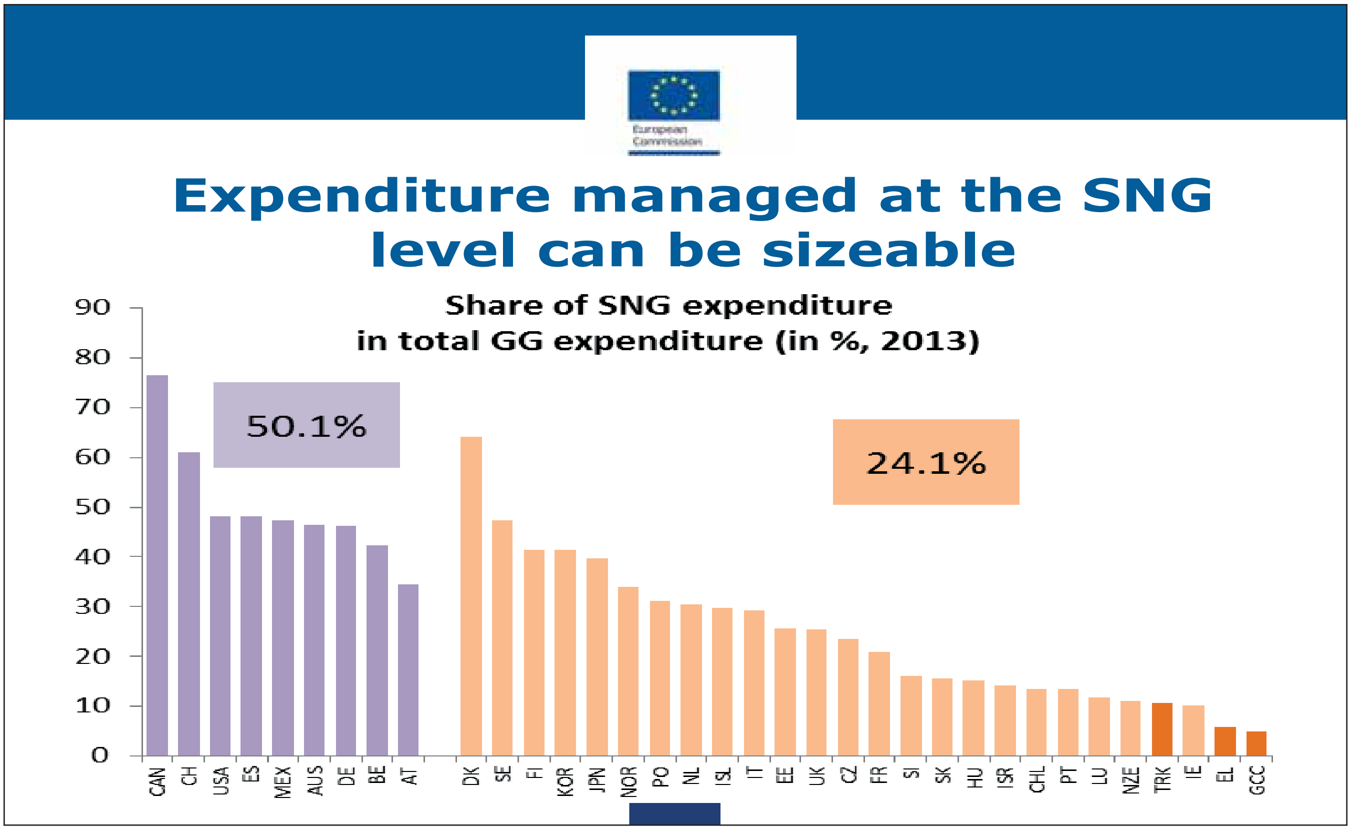
*"In order to ensure the effectiveness of the excessive deficit procedure, **the governments of the Member States shall be responsible** under this procedure for the deficits of general government as defined in the first indent of Article 2."*

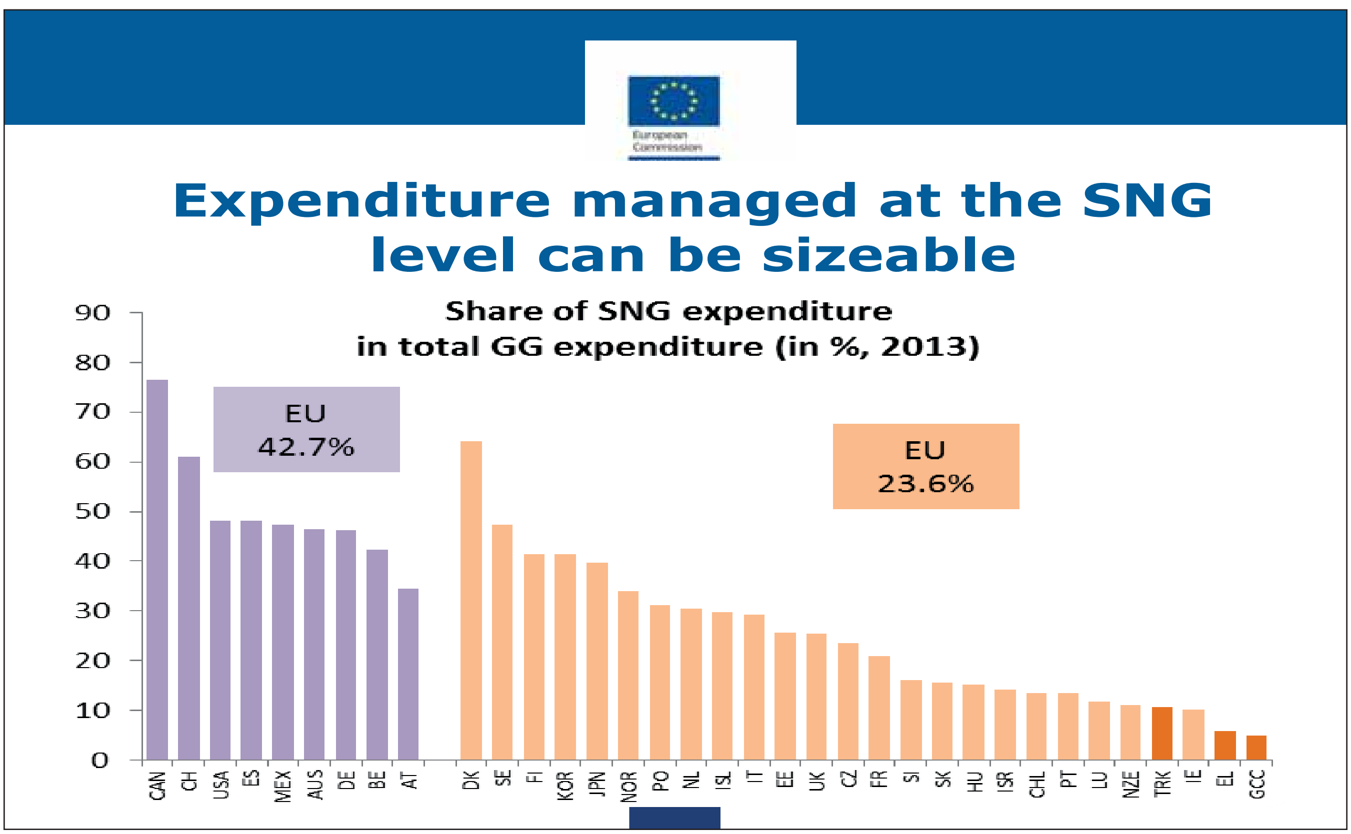
*"The Member States shall ensure that **national procedures in the budgetary area enable them to meet their obligations** in this area deriving from these Treaties."*

3

Expenditure managed at the SNG level can be sizeable




European Commission
Expenditure managed at the SNG level can be sizeable
Share of SNG expenditure
in total GG expenditure (in %, 2013)
50.1%
24.1%
90
80
70
60
50
40
30
20
10
0
CAN CH USA ES MEX AUS DE BE AT DK SE FI KOR JPN NOR PO NL ISL IT EE UK CZ FR SI SK HU ISR CHL PT LU NZE TRK IE EL GCC


European Commission
Expenditure managed at the SNG level can be sizeable
Share of SNG expenditure
in total GG expenditure (in %, 2013)
EU
42.7%
EU
23.6%
90
80
70
60
50
40
30
20
10
0
CAN CH USA ES MEX AUS DE BE AT DK SE FI KOR JPN NOR PO NL ISL IT EE UK CZ FR SI SK HU ISR CHL PT LU NZE TRK IE EL GCC

National fiscal arrangements guided by principles at the EU level

Member States have latitude to define the means to manage their public finances domestically …

… however national procedures can be subject to minimum standards defined at the EU level (e.g. Directive 2011/85/EU on Budgetary Frameworks)

7

Budgetary framework requirements of Directive 2011/85

Council Directive 2011/85/EU of 8 November 2011

Recital 24: A significant number of Member States have experienced a sizeable fiscal decentralisation with the devolution of budgetary powers to sub-national governments. The role of such sub-national governments in ensuring that the SGP is complied with has thereby increased considerably, and ***particular attention should be paid to ensuring that all general government sub-sectors are duly covered by the scope of the obligations and procedures laid down in domestic budgetary frameworks****, in particular, but not exclusively, in those Member States.*

Article 13:

1. ***Member States shall establish appropriate mechanisms of coordination across sub-sectors of general government*** *to provide for comprehensive and consistent coverage of all sub- sectors of general government in fiscal planning, country- specific numerical fiscal rules, and in the preparation of budgetary forecasts and setting-up of multiannual planning as laid down, in particular, in the multiannual budgetary framework.*

2. In order to promote fiscal accountability, ***the budgetary responsibilities of public authorities in the various sub-sectors of general government shall be clearly laid down****.*

8

Challenges to fiscal discipline at the sub-national level

Sub-national governments are by no means immune to fiscal profligacy:

- Dependence on transfers from higher government levels:
-> free riding on the commons

- Risk of fiscal myopia

- Risk of weaker counterweights at sub-national level

- Risk of insufficiently-skilled local/regional administration

- Closer to citizens or closer to vested interests?

A fragmented power structure must ensure responsibility.

9

Integration vs. autonomy (1)

Integration		
• **Revenue dependence on transfers from higher levels** • **Tax sharing** • **Fiscal equalisation**		
• Blurred spending responsibilities • Lower share of SNG in total government spending		
• Emergency assistance		
• SNG borrowing restrictions		

11

Budgetary relations between government levels within a State: between integration and autonomy

10

Integration vs. autonomy (2)

		Autonomy
		• Tax autonomy
		• Subsidiarity – spending autonomy • Higher share of SNG in total government spending
		• **Bankruptcy exposure**
		• Borrowing autonomy

12

Integration vs. autonomy (3)

Integration		Autonomy
• Revenue dependence on transfers from higher levels • Tax sharing • Fiscal equalisation		• Tax autonomy
• Blurred spending responsibilities • Lower share of SNG in total gov. spending		• Subsidiarity – spending autonomy • Higher share of SNG in total gov. spending
• Emergency assistance		• Bankruptcy exposure
• SNG borrowing restrictions		• Borrowing autonomy

13

Integration vs. autonomy (4)

Integration	Responsibility	Autonomy
• Revenue dependence on transfers from higher levels • Tax sharing • Fiscal equalisation	**• Constitutional review of budget laws • Fiscal rules • Fiscal council • No-bailout provisions**	• Tax autonomy
• Blurred spending responsibilities • Lower share of SNG in total government spending		• Subsidiarity – spending autonomy • Higher share of SNG in total spending
• Emergency assistance		• Bankruptcy exposure
• Borrowing restrictions		• Borrowing autonomy

14

EU Member States with a federal structure have integrated fiscal constitutions

- EU Member States with a federal structure have integrated fiscal constitutions ensuring basic cooperation between government levels (soft coordination)
- Soft cooperation is conducive to insufficient fiscal discipline against the background of increased fiscal rule intrusiveness (EU and national) and fiscal consolidation needs
- **Perceived need for increased fiscal responsibility** -> the creation of Internal Stability Pacts

15

Basic features of Internal Stability Pacts

- Regular high-frequency meetings between representatives of central, regional and local governments
- Representatives entrusted with clear mandate from their constituents
- Basic task: "two-ways" exchange of information about policy intentions, reforms, aggregate fiscal stance, commitments taken at the EU level
- ...But main purpose: **going beyond soft coordination**

16

Core functions of Internal Stability Pacts

- **Setting fiscal objectives** for each gov't sub-sector/level, consistent with general government objectives (twinning the functioning of ISPs to the functioning/monitoring of fiscal rules)
- **Sharing technical information** pertaining to the preparation of budgets
- **Monitoring jointly** public finance developments

17

Prerequisites for an efficient functioning of Internal Stability Pacts

- Availability of timely and comparable statistics and a common "budgetary vocabulary" (accounting standards, budgetary accounting)
- Synchronisation of national budgetary calendars
- Clear arrangements as to revenue/expenditure assignments
- Joint forecasting for main revenue components
- A role in monitoring agreed fiscal objectives
- An independent referee (e.g. fiscal council) should be embedded into the ISP, provide analyses/assessments and potentially suggest solutions
- And last but not least…

18

...ISPs should encompass an enforcement dimension

- ISP main coordination instance should exert effective surveillance on parties including:
  - ☛ identifying deviations and stating them publicly;
  - ☛ agreeing on the need for corrective process (with corrective path);
  - ☛ providing its assessment on the suitability of corrective measures;
  - ☛ monitoring their implementation;
  - ☛ and declaring sanctions in case of the non-respect of the jointly-agreed consolidation path.

19

ISPs country cases

20

Internal Stability Pacts in practice

- Elements of ISP exist in the federal States of the EU: Austria, Belgium, Germany and Spain
- Label ('*Domestic Stability Pact*') also used in Italy
- Rationale for introduction: coordination arrangements have been strengthened in the post-crisis environment due to:
  - **the strengthening of EU legislation**
  - **fiscal slippages and need to correct them**

21

Germany: sizeable integration between government levels...

- Three levels of government (Federation, federated states (16 *Länder*), municipalities)
- Federalism anchored in Constitution (States represented in second legislative chamber); subsidiarity principle (Art.30 of Constitution)
- Areas of concurrent legislation
- Expenditure competences are intertwined
- Federal legislation impacts *Länder* expenditure
- High percentage of shared taxes across government levels (72% of total revenue)
- Reallocation of VAT partially re-oriented to *Länder* with below average per capita
- Fiscal equalisation scheme across *Länder*
- Supplementary federal grants to poorer *Länder*
- Possibility for the Bund to grant temporary financial assistance to SNGs (vetted by Constitutional court in 1992)

22

...with recent efforts to instil responsibility at SNG level

- Against the background of high debt level of the *Länder* (21% of GDP), establishment of Stability Council in 2010
- Composition: Federal MoFin and MoEcon + MoFins of 16 *Länder;* take decisions at a two-third majority + the federal government
- Joint monitoring every six months with fiscal indicators; Stability Council may launch fiscal consolidation procedure with regular monitoring twinned with assistance payments
- Inclusion of the objective of a balanced budget in the Constitution for the federation (structural deficit ceiling of -0.35% of GDP from 2016 onwards) and *Länder* (2020) – the German "debt brake"
- Creation of Independent Fiscal Advisory Board to the Stability Council
- EU-SGP sanctions to be shared between Federation and federated States (65%-35%)

23

Lessons learnt: increased responsibility led to encouraging developments...

- Deficit of *Länder* receded (-0.8% of GDP in 2010; - 0.1% in 2013; balanced in 2015)
- General consensus at the Stability Council to pursue consolidation course

Success to be qualified:

- Favourable macro-economic situation in Germany
- Consolidation in high-deficit *Länder* helped by consolidation assistance
- *Länder* are governed by representatives of national political parties
- Consensus in civil society over the need for fiscal discipline

24

...but still unfinished business in fiscal federalism

- Fiscal equalisation remain the subject of recurrent public debates between rich and poor *Länder*
- Attempts to disentangle federal and *Länder* through constitutional reforms in 2006 and 2009 => however areas of joint/concurrent funding remain numerous
- Limited / not timely access of German fiscal council to SNG fiscal data

25

Austria: strong integration between government levels

- Three levels of government (Federation, federated states (9 *Länder*), municipalities)
- Federalism anchored in Constitution
- Large discrepancy between SNG expenditure and own-resources
- Decision-making, funding and spending responsibilities are shared by different levels of government: complexity of arrangements (co-financing)
- Fiscal equalisation scheme across government levels (every six years)

26

Initial unsuccessful attempts at coordination

- Austrian Stability Pact launched in 1996
- Law setting fiscal nominal targets within a multi-annual setting
- Sanctions in the form of interest-bearing deposit
- Performance assessed over 4 years, with option that surpluses can be carried over
- Recurrent slippages at all government levels after 2002; attempts at creative accounting at SNG level; sanctions never used
- Discrepancy between targets and outcomes too large -> fiscal objectives eventually revised in 2011

27

The revised Austrian Stability Pact

- Released in 2012
- Consolidation path until budget balance in 2017
- Fiscal targets: structural deficit ceiling of -0.45% of GDP (-0.35% for federal State; 0.1% for *Länder* and municipalities)
- Recast of the sanction mechanism: early warning reports by the National Statistical Institute, to be backed up by a public assessment from the National Court of Auditors
- If deviation is confirmed, the party has to suggest correction measures within two months to a conciliation body (composed of all government levels) that can impose fines (up to 15% of the deviation); representatives of concerned government level do not vote

28

Tentative lessons from the Austrian experience

- Recent targets for SNG have been met
- However cyclical developments may have facilitated compliance
- Austrian fiscal council points to insufficient availability and timeliness of statistical information concerning SNGs
- Lack of transparency due to variance in accounting/budgeting methods across *Länder* -> harmonisation of accounting methods adopted, to be implemented
- The issue of complex interactions between national and subnational policy strategies in key policy areas remains unaddressed

29

Spain: struggling with fiscal federalism arrangements

- Federal Constitution (1978); autonomy of management of regional/local authorities (Art.137) -> 17 autonomous communities
- Increased devolution of expenditure prerogatives (from 20% to 50%) -> health, social spending and education
- Ample tax autonomy with own and shared taxes
- 75% of regional taxes pooled and reallocated according to criteria linked to actual expenditure needs
- Tradition of successive bailouts by the central government

30

Loose coordination before the crisis failed

- Main coordination instance: the Fiscal and Financial Policy Council (Ministry of Economy and Finance and representatives of Autonomous Communities)
- Central gov't defined every year 3-year targets for all regions in spring (assessment of compliance of t-1 outcomes in autumn)
- Long-term indebtedness subject to approval by central government
- Role for rating agencies and market participants to assess financial health of regions
- FFPC mostly about exchange of information; little comparability between regional budget systems
- Regions conducted pro-cyclical policies; tax revenues plummeted after 2007 and deficit increased to -3.2% of GDP (2010)
- SNGs shunned from market access after unexpected release of large budgetary overruns at SNG level

31

The government reaction

- Emergency funding for local authorities (regional liquidity fund, suppliers' payment scheme)
- Balanced-budget rule in organic law (from 2020 onwards for regions) with transition path
- Reinforced monitoring: MoF reports in April and October may trigger corrective measures if deviation spotted
- Role for Independent Fiscal Institution (AIReF) which can also call for corrective measures (gov't must comply or explain)
- Additional sanctions at the disposal of central gov't: audits, expenditure freezes, interest-bearing deposits, SNGs may be put in receivership
- In practice, rebalancing plans at regional level (remove expenditure overlaps, staffing cuts, rationalisation of expenditure)
- Improvement in SNG data access

32

Tentative lessons from the Spanish experience (1)

- Improvement in SNG finances partial and largely accounted for by circumstances
- Central government caught off-guard and slow to use its new prerogatives
- Still quid pro quo: bailout against reforms
- Additional funding from the central government to SNGs in late 2014, weakening further fiscal responsibility
- Active role of the independent fiscal institution in providing early warnings and individualised recommendations for regions -> not always followed
- Future of equalisation system weakens the credibility of the layout

33

Tentative lessons from the Spanish experience (2)

- Spain currently in the corrective arm of the SGP
- Fiscal effort and headline targets were missed in 2014 and 2015
- In 2015, most regions and the social security sector fell significantly short of meeting their domestic fiscal targets.
- The reduction of the deficit in 2016 relative to 2015 continues to rely to a large extent on the positive macroeconomic outlook, which supports tax revenues and keeps social transfers in check.
- Spain is not projected to correct the excessive deficit by 2016 as recommended by the EU Council -> EU country-specific recommendation to "*implement at all government levels the tools set out in the fiscal framework law*"

34

Overall lessons from experience gained so far

- Internal Stability Pacts are a necessary feature for ensuring compliance with fiscal targets applicable to general government
- Experience gained still limited as existing arrangements have not been put to the test in times of severe budgetary stress
- Not all prerequisites for an efficient functioning of ISPs are practically met
- In particular, the effectiveness of enforcement procedures remains an open question
- Role of central government reinforced…as provider of funding
- Judgement of the public instrumental in making sure that slippages are duly corrected and all players abide by the common rules

35

Thank you

36

The Stability and Growth Pact: Presentation and critical assessment

Lucio R. Pench

Director, Fiscal Policy

European Commission
DG Economic and Financial Affairs

Videoconference with the FRBMC (New Delhi) – 16 September 2016

Outline

- Rationale
- Historical background
- The preventive arm
- The corrective arm
- Critical assessment of the rules

2

THE EU FISCAL FRAMEWORK: RATIONALE

3

Fiscal policy in the EU

EMU as a unique model of economic integration

- Centralised monetary policy, decentralised national fiscal policies
- No central fiscal authority, no revenue-raising capacity
- Very small EU budget for the Union as a whole (about 1% of EU GDP), not specifically for the euro area

Fiscal policy within a monetary union

- Irrevocable fixing of exchange rates
- Single monetary policy reacting to common shocks
- Fiscal policy at the country level: stabilisation in case of country-specific shocks (within allowed limits)
- Existence of spillovers via trade and confidence effects

4

Why EU-level fiscal rules?

"Deficit bias" (political economy theory)

- Governments have an incentive to increase spending and/or cut taxes without corresponding financing measures ➔ increases deficits
- Supra-national rules help to tie governments' hands via a binding agreement

"Free-riding" in a monetary union and spillovers

- Generally less market-based discipline in a monetary union (loss of exchange rate)
- In normal times, temptation for Member States to run profligate fiscal policies without facing consequences on the bond market, due to a common pool problem (reinforces the deficit bias)
- Financial risks (e.g. risk of sovereign default) may spill over to other Member States

5

The rationale for sound public finances in EMU

PRICE STABILITY AND SUSTAINED GROWTH → Not interfere with/support ECB monetary policy, lower interest rates, more private investment

SMOOTHING THE CYCLE → Common monetary policy, more responsibility for national fiscal policies

STRUCTURAL REFORMS → Room to implement reforms with short-term costs for public finances

6

Fiscal policy in EMU: Who does what?

Member States	The European Commission	The Council of Ministers
• Decide on tax and spending levels, which drive borrowing and debt • But this must be compatible with the rules of the Stability and Growth Pact (SGP) • Fiscal Compact: enshrines the EU fiscal framework in national law	• Implements the SGP: are Member States compliant with its provisions? • Prepares the analysis to guide the Council • Two-Pack: Opinions on Draft Budgetary Plans and Autonomous Commission Recommendations	• Takes the decisions on the application of the SGP

7

The SGP: A rules-based framework

Framework within which Member States make their budgetary decisions and compliance is assessed

- Required fiscal effort
- Metrics for assessing outcomes
- Procedures

Aims to ensure sound public finances

- Avoidance of **excessive deficit** (>3% of GDP) and **excessive debt** (>60%)
- Country-specific **medium-term budgetary objectives**
- Economic cooperation and surveillance

Two arms, set up to be consistent:

- The **preventive arm** to ensure strong underlying public finances
- The **corrective arm** to correct gross policy errors

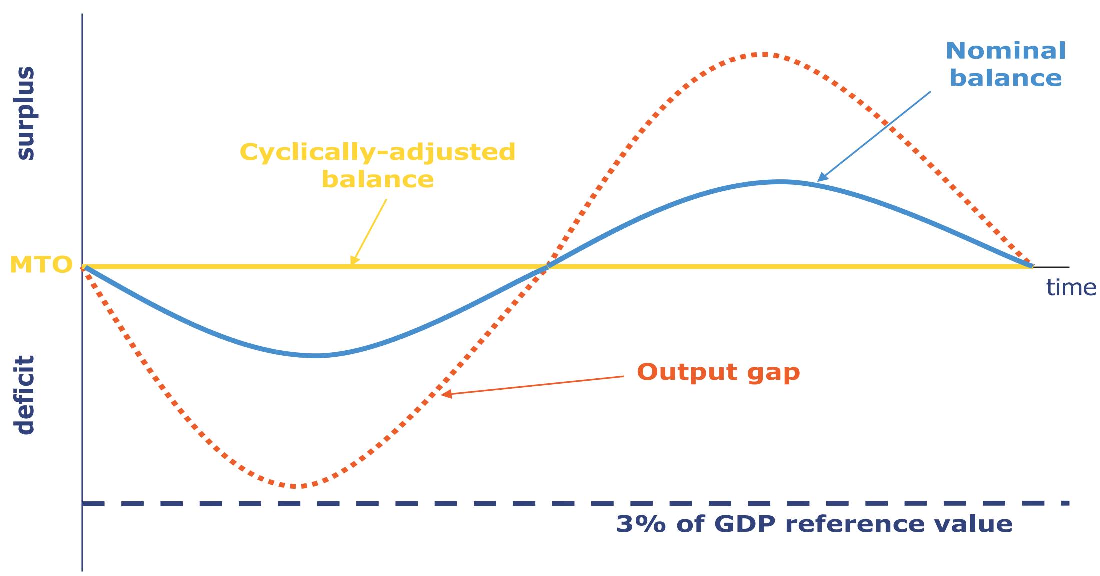
8

The preventive arm in a nutshell

- Pursuit of a country-specific **medium-term budgetary objective** (MTO) which should ensure a safety margin against breaching the 3% of GDP limit for the nominal deficit (see next slide)
- Multi-annual budgetary plans presented by Member States in their **stability and convergence programmes (SCPs)**, updated on an annual basis
- **Commission assessment + Council opinion** on the SCPs (peer support)
- Procedure in case of a **significant deviation** of budgetary positions from the MTO or the adjustment path towards it

9

The budget balance over the cycle



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The corrective arm in a nutshell

- Specifies the steps of the **excessive deficit procedure** (EDP) if the deficit-to-GDP ratio exceeds the 3% threshold and/or the debt ratio exceeds the 60% threshold

- Sets up a timetable for the **correction** of excessive deficits

- Specifies metrics for assessing outcomes

11

A BRIEF HISTORY OF THE STABILITY AND GROWTH PACT

12

The rules of the SGP – some history

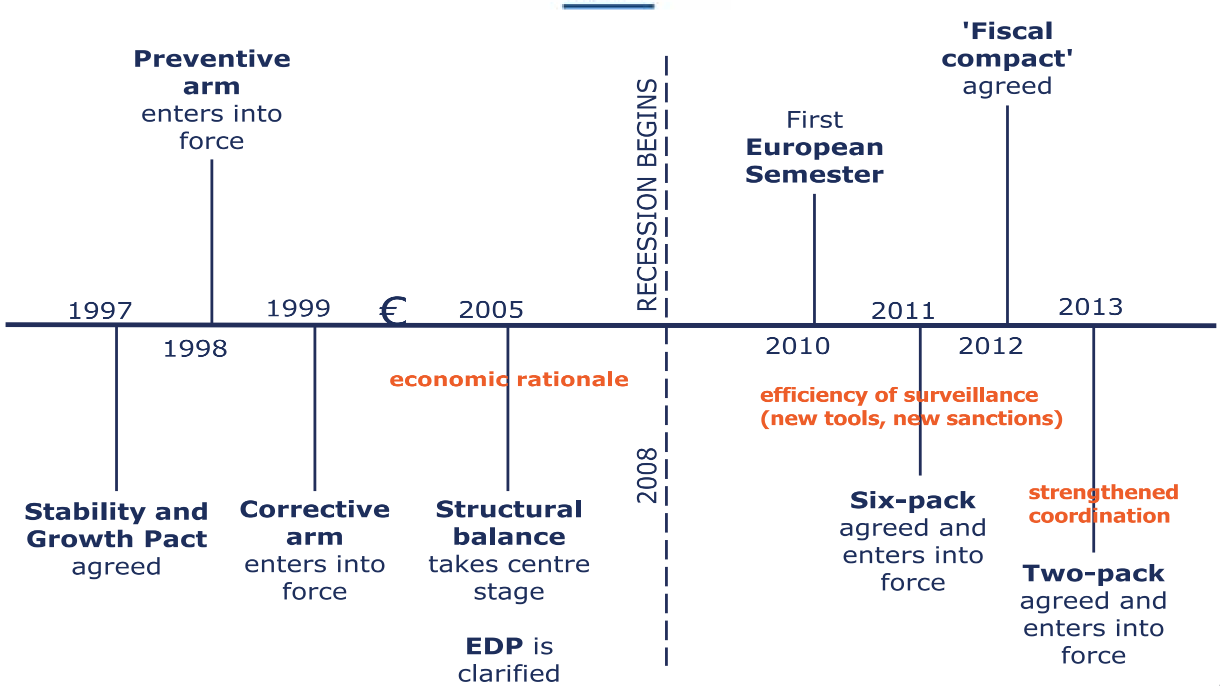
- Pact signed by all EU Heads of State in Amsterdam in 1997

- Two complementary texts of EU law
- Regulation 1466/97
- Regulation 1467/97

- Reforms and changes:
- 2005: improved economic rationale (structural balance, MTO)
- 2011: increased efficiency of surveillance (Six-pack)
- 2013: enhanced coordination within the euro area (Two-pack)

13

Timeline of changes and reforms



14

2011 – The Six-pack: first governance reform

"Six-pack" = 5 regulations + 1 directive

Targeted scope and nature of surveillance

- ***wider***, especially on macro-financial issues and competitiveness/macroeconomic imbalances
- ***deeper***, especially on debt sustainability and key growth-enhancing reforms
- ***better integrated***, to avoid partial and fragmented approaches

Improving follow-up and enforcement

- stronger enforcement instruments
- influence on economic policy debates at the national level
- take account of the euro area dimension
- in parallel, development of tools for emergency financial assistance in the euro area and coordination with the operation of EU fiscal rules

15

2011 – The Six-pack

Fiscal rules

Prevention of gross policy errors:
introducing the concepts of expenditure benchmark and significant deviation procedure

Focus on debt on top of deficit:
explicit benchmark for a sufficiently diminishing debt ratio

Strengthening the national level:
minimum requirements for budgetary frameworks of the Member States

Enforcement

New sanctions toolbox:
financial fines

And also (not fiscal)

Macroeconomic surveillance

New rules for the prevention and correction of macroeconomic imbalances: "Macroeconomic Imbalance Procedure"

Enforcement

New enforcement measures:
financial fines

16

The Two-pack (2013): additional economic governance reform

Three goals on the fiscal side:

- Strengthening budgetary policy **surveillance** and **coordination** in the euro area, through the submission of draft budgetary plans
- Improving the **monitoring** and **correction** of excessive deficits
- Enhancing **national budgetary frameworks** (national fiscal councils, independent forecasts underpinning fiscal plans)

17

The Two-pack

Enhanced fiscal monitoring for all euro area Member States

Common provisions for:

- **monitoring and assessing draft budgetary plans**
- **ensuring the correction of excessive deficits**

And also

Enhanced surveillance for financially fragile Member States

Threatened with financial difficulties

Receiving precautionary financial assistance

Receiving loans

Exiting a programme

18

Two-Pack: assessment of draft budgetary plans

Lessons learned	Innovation
Need to integrate EU guidance in national budgetary preparations	National draft budgetary plans submitted by 15 October by all euro area Member States (except programme countries)

Draft budgetary plan - Content

Outlines for the forthcoming year:

- budgetary targets
- detailed measures
- assumptions used to build the budget

Focused on measures to reach the targets

Based on independent macroeconomic forecasts

19

THE PREVENTIVE ARM

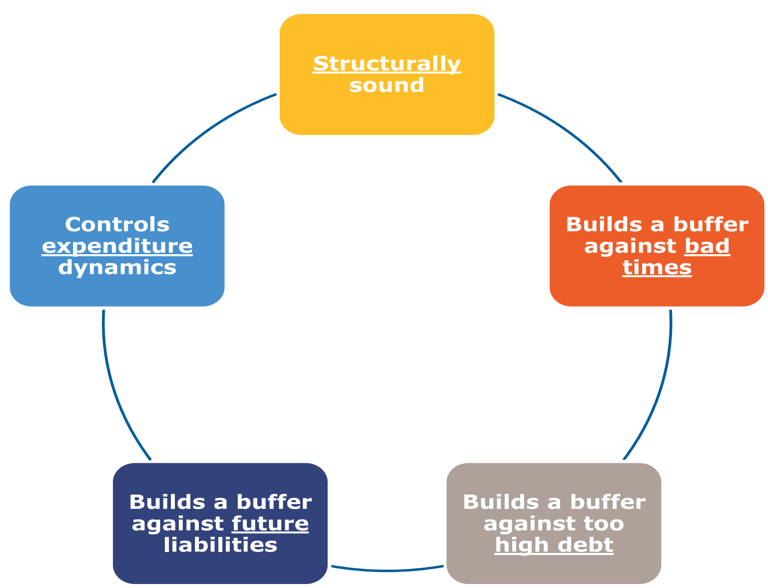
20

The preventive arm: overview

Aim	Member States run prudent fiscal policies over the medium term
Legal basis	Art. 121 TFEU, Regulation 1466/97
Objective	"Close to balance or in surplus"
Operationalisation	Medium-term budgetary objectives (MTOs)
Requirement	At the MTO or on the path towards it
Assessment	Structural balance + expenditure growth
Process	European Semester; SCPs
Enforcement	Significant deviation procedure

21

What is a prudent fiscal policy?



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The MTO

Country-specific fiscal target for the structural balance

Defined in structural terms

Requirements (Regulation 1466/97)

(i) Safety margin with respect to the 3% → BAD TIMES
(ii) Sustainability of public finances → DEBT & FUTURE LIABILITIES
(iii) Allow room for stabilisation over the cycle → STRUCTURAL

Lower limits

- Euro area and ERM2 Member States: -1%
- Fiscal compact: -0.5% unless debt << 60% and sustainability risks are low

Process

- Attain their MTO or be on the adjustment path towards it
- Annual adjustment higher in good times, lower in bad times

23

The structural balance: definition

Structural Balance (SB) = nominal budget balance (BB) adjusted for the business cycle and for one-offs and temporary measures

$$SB = \underbrace{\frac{BB}{Y} - \varepsilon . Output\,Gap}_{Cyclically\ adjusted\ budget\ balance\ (CAB)} - oneoffs$$

24

The minimum MTO

- A minimum MTO is computed for each Member State:

$$MTO_{min} = \max(MTO^{MB}, MTO^{ILD}, -1^{€/ERM})$$

Minimum **B**enchmark: BAD TIMES

Implicit **L**iabilities and **D**ebt: DEBT and FUTURE LIABILITIES

Limit for euro area and ERM2 Member States

- Regular updates: at least every 3 years or after reforms with a major impact on sustainability

25

Adjusting towards the MTO: two pillars

The change in the structural balance (SB)

- **Progress towards the MTO** defined as a country-specific numerical target for the SB

The Expenditure Benchmark (EB): circumvent uncertainty surrounding the structural balance

- **Expenditure rule** to avoid unsustainable expenditure trends

Two pillars: the change in the SB and the EB

- Calibrated to be the consistent
- But based on different concepts and possibly capturing different dynamics

→ both taken into account in the **overall assessment**

26

The Expenditure Benchmark (EB)

Rule that limits annual *net* expenditure growth

- Net expenditure growth = Δ (adjusted) total expenditure – discretionary revenue measures

Requirements (Regulation 1466/97)

- For Member States **at MTO**, net expenditure growth should not exceed the medium-term growth of potential GDP
- For Member States **not at MTO**, net expenditure should grow at a lower rate

Objective

- Ensure that increases in expenditure are properly financed
- The EB does not constrain the size of government

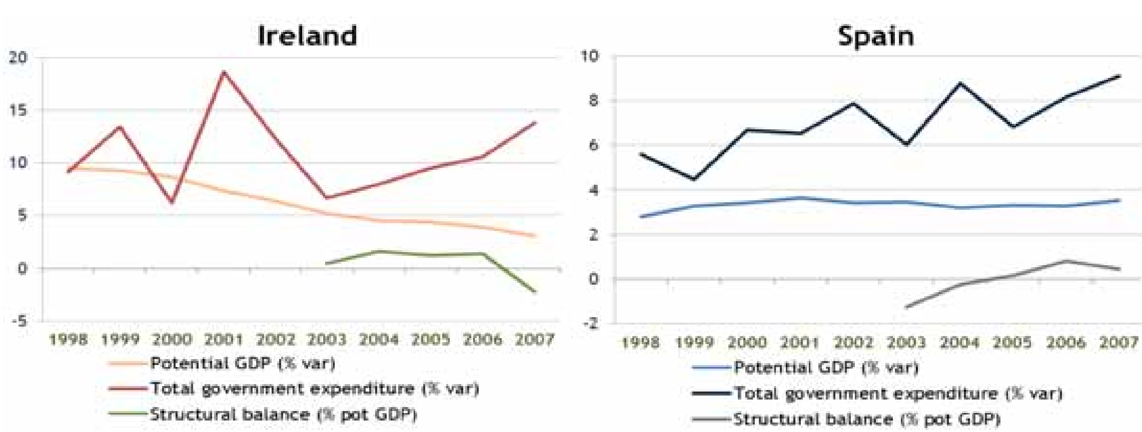
Process

- Net expenditure growth is assessed every year: once for all Member States and twice for euro area Member States

27

EB: the rationale

Unsustainable trends of expenditure in view of potential GDP growth not reflected in the structural balance



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The components of the EB

The net expenditure aggregate under consideration:

- **Non-discretionary** expenditure items (including interest payments) are removed
- **Expenditure matched by EU funds** is removed
- **Gross fixed capital formation is smoothed** over four years
- **Discretionary revenue measures** and revenues mandated by law are netted out (→ "net" expenditure)

The benchmark growth rate against which it is compared:

- For Member States at MTO, **medium-term potential output growth** ("reference rate")
- **For Member States not at MTO, net expenditure should grow at a lower rate** (reference rate minus convergence margin), which is calibrated to deliver a specific annual improvement in the structural balance, thus ensuring consistency between the two pillars

29

Requirements under the preventive arm

Member States **choose their MTO**, subject to compliance with a minimum level meeting three criteria (see background slide)

<u>Compliance with the SB pillar:</u> either **remain at the MTO or progress towards it**, by a benchmark amount of 0.5% of GDP per year

- The required adjustment is modulated :
  - more in good times and less in bad times,
  - more if debt > 60%
- Waiver in case of exceptional circumstances or overall downturn
- Also considering the costs of structural reforms, public investment expenditure, unusual events outside the control of the government

<u>Compliance with the EB pillar:</u> control **expenditure growth**

30

Assessment of compliance

A Member State significantly deviates from its requirements if:

- **the deviation from the MTO or the adjustment path towards it** exceeds 0.5% of GDP in a single year or 0.25% of GDP in two consecutive years
- **the deviation from the EB** has a total impact on the budget balance of at least 0.5% in a single year or cumulatively in two consecutive years

➔ Both the change in the SB and the EB are assessed against requirements

➔ An **overall assessment** is conducted, as each indicator provides a partial description of the medium-term direction of budgetary policy

31

THE CORRECTIVE ARM

32

The corrective arm: overview

Aim	Correct excessive deficit or debt ratios
Legal basis	Art. 126 TFEU and Protocol 12, Regulation 1467/97
Objective	• Deficit: 3% of GDP • Debt: 60% of GDP or sufficiently diminishing and approaching 60% at a satisfactory pace
Assessment	Effective action methodology
Process	Excessive Deficit Procedure (EDP): Opening – Regular monitoring - Abrogation
Enforcement	Sanctions

33

Compliance with the deficit criterion

Rule:

General government deficit must not exceed 3% of GDP

Flexibility: the rule can be waived in certain cases:

- **If the deficit is <u>close</u> to 3% + the deviation is <u>temporary</u> and <u>exceptional</u>**

  Temporary = Commission forecasts show the deficit coming back to/below 3%

  Exceptional = excess results from (i) an unusual event outside the control of the Member State and with a major impact on the financial position of the general government, or (ii) a severe downturn

- **Relevant factors can also be taken into account**

  Whatever the level of the deficit if debt <60% of GDP

  Only if the deficit is close to 3% and the excess is temporary if debt >60%

34

Compliance with the debt criterion

Rule:

Debt < 60% of GDP or sufficiently diminishing and approaching 60% at a satisfactory pace

Debt requirements operationalised with the Six-pack:

- Definition of **sufficiently diminishing** = complying with the debt reduction benchmark
- **Debt reduction benchmark** = reduction by 1/20th per year, on average over 3 years, of the gap to 60% (also taking into account the impact of the economic cycle)
- **Transition period** for 3 years after the correction of the excessive deficit: <u>no "full" implementation of the rule but sufficient progress to be made</u>

Relevant factors are also taken into account (no automatic triggering)

35

Sanctions toolbox – euro area

When?	What?
Opening of the EDP →	Non-interest-bearing deposit *(if this follows a significant deviation under the preventive arm or if the breach is particularly serious)* 0.2% of GDP
Failure to take effective action to correct the excessive deficit →	Fine 0.2% of GDP
Repeated failure to take effective action to correct the excessive deficit →	Fine 0.2% of GDP + variable component

For all Member States except the UK: suspension of commitments or payments under the EU Structural Funds

36

CRITICAL ASSESSMENT

37

Assessment against the Kopits-Symansky criteria

1. Well-defined

- In a sense, the SGP is **redundant**: aiming for a balanced budget over the cycle should be enough to ensure that the deficit remains below 3% of GDP and debt below 60%
- The problem is that an **unobservable variable** is at the centre of the SGP – namely the structural balance, which depends on the output gap
- Even metrics based on observable variables (e.g. expenditure benchmark) may be in **need of more precise definitions** (e.g. for discretionary revenue measures)
- The **3% of GDP deficit threshold** remains the rule that is best understood by politicians and public opinions

38

Assessment against the Kopits-Symansky criteria

2. Transparency

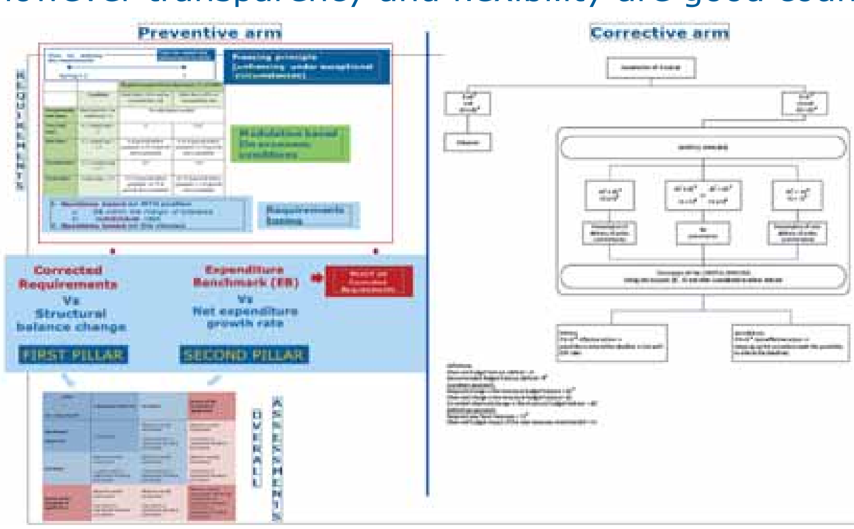
- **High transparency of inputs**: all the procedural steps and the calculations are available
- Vs. **low transparency of outcomes**: the link between inputs and decisions is less transparent
- Despite efforts to increase transparency, the construction is not easy to read due to its complexity: it is **not transparent to the non-expert**

39

Assessment against the Kopits-Symansky criteria

3. Simplicity

- The SGP is undoubtedly **very complex**, for historical and institutional reasons – however transparency and flexibility are good counterbalances



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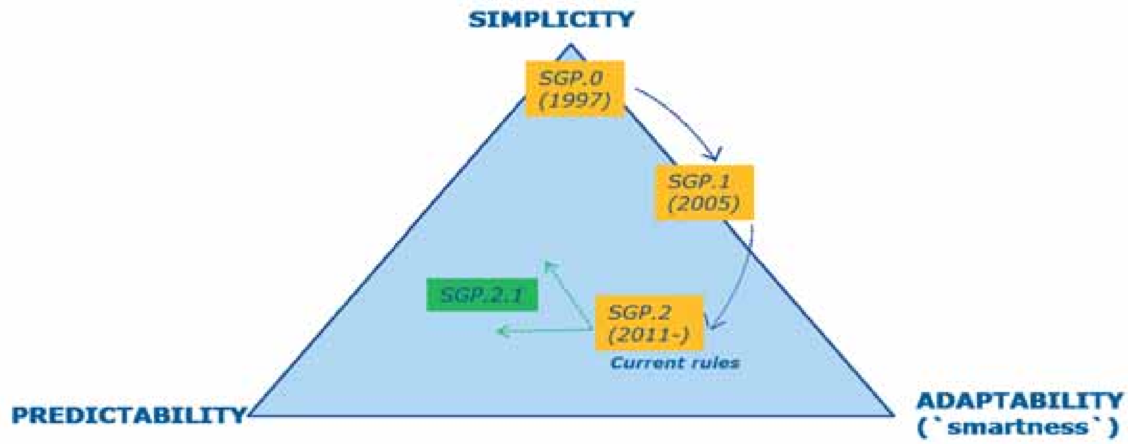
Assessment against the Kopits-Symansky criteria

4. Flexibility

- The history of the Pact is a quest for **constrained flexibility**
- **Flexibility without discretion implies high complexity**: either flexibility is introduced via judgement, or the framework ends up having to



41

Assessment against the Kopits-Symansky criteria

5. Adequacy with respect to the goals

- It depends on the objective: what is meant by adequacy may have changed.

Objective	Adequate rule	SGP assessment
Avoid fiscal dominance over monetary policy	**Prohibit** excessive deficits, the monetary financing of government deficits and direct government bailouts	**Current SGP more constraining than necessary**
Macroeconomic stabilisation in normal times *(monetary policy being the instrument of choice for common shocks)*	Achieve a **sound structural position** and let **automatic fiscal stabilisers** operate to absorb asymmetric shocks	**The SGP gives prominence to sustainability over stabilisation**; it does not recognise a role for discretionary policy until the MTO is achieved
Macroeconomic stabilisation in the current context *(monetary policy transmission impaired, fiscal multipliers higher, at the same time debt still very high)*	**Consolidate** where needed; **use fiscal space** where available, taking **country needs** and **spillover effects** into account	**The SGP is asymmetric**: only proscribing, not prescribing, i.e. requiring consolidation until the MTO is achieved but legally unable to impose discretionary expansion → **cannot fully deliver**

42

Assessment against the Kopits-Symansky criteria

6. Enforceability

- The history of the SGP shows that **the rules have not often been strictly enforced.**

  J.C. Juncker (28 November 2014): "*I made the choice not to sanction because that would have been easy: you have rules, apply the rules, sanctions, penalities, fines. I made another choice*".

  German Ministry of Finances (30 July 2015): "*What's important here is that the Commission keeps the right balance between its political function and its role as the guardian of the treaties*".
- **Lax implementation** is the result of several factors, including:
  - Difficulty of enforcing rules on **fiscal sovereigns** (Wyplosz 2013, Mody 2014)
  - **Very small size of the EU budget** compared to national budgets (partly because this is in line with the subsidiarity principle) and **absence of fiscal transfers** across Member States for stabilisation purposes
  - **Limited credibility of the no-bailout clause**
- Six-pack: **more automaticity,** graduated response – still to be tested
- An element of **market pressure is also needed** to enforce fiscal discipline, although not a panacea (financial markets tend to overreact and react too late)

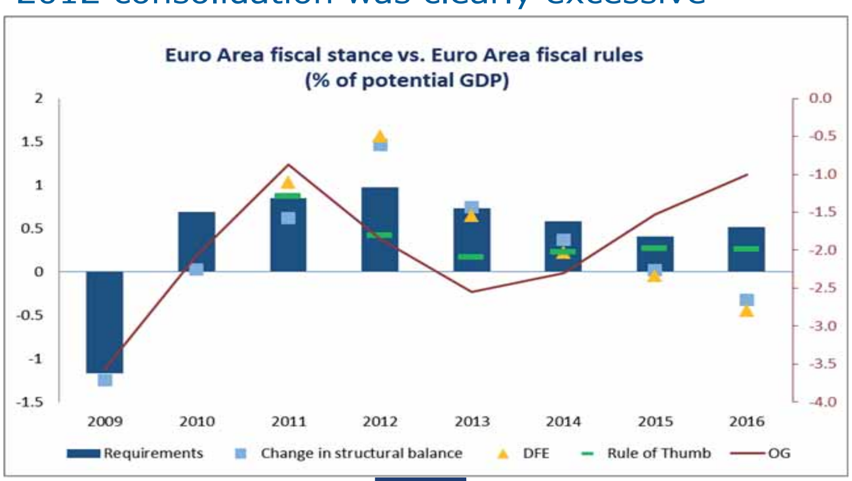
43

The importance of market-based discipline

Member States did more consolidation than required by the SGP in 2012, under strong pressure from financial markets

→ Lesson: unless a central power can take over and impose discipline, there may be a need for more market-based discipline

→ Caveat: 2012 consolidation was clearly excessive



44

Assessment against the Kopits-Symansky criteria

7. Internal consistency

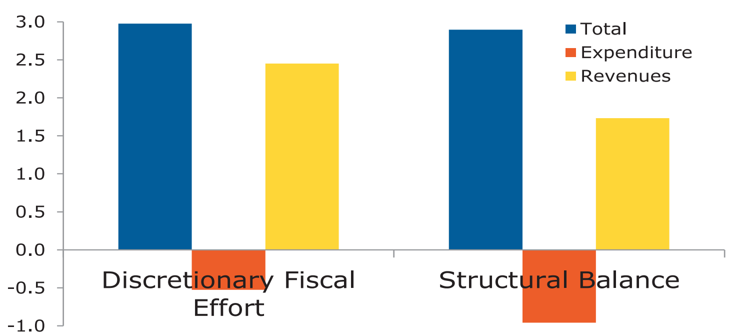
- Big effort to achieve internal consistency by way of interpretation
- Discussions are taking place to reinforce the internal consistency between the tools used in the preventive and corrective arms
- Lack of longitudinal and cross-country consistency

45

Assessment against the Kopits-Symansky criteria

8. Efficiency

- The SGP **does not always encourage the right type of adjustment**



Composition of consolidation in the euro area, 2011-2016: (% GDP)

Mainly tax-based with standard methodology (SB), and even more so with refined methodology (DFE)

+ Expenditure cuts often **at the expense of investment**

- But entering the composition of adjustment means (further) intrusion into the budgetary sovereignty of Member States

46

Thank you for your attention

47

BACKGROUND SLIDES

48

Criteria for independent fiscal bodies

Requirements for independence :

- statutory regime **grounded in national laws / regulations / binding** administrative provisions
- not taking instructions from any public or private body (incl. MoF)
- **capacity to communicate publicly** in a timely manner
- procedures for **nominating members on grounds of experience** and **competence**
- **adequate** resources and **appropriate** access to information

Role:

- **monitor compliance** with all fiscal rules (in the sense of the Directive)
- produce or endorse **macroeconomic forecasts**

49

For further information:

SGP legislation on the ECFIN website

http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm

Vade mecum on the Stability and Growth Pact

Institutional Paper 021 (March 2016)

http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip021_en.pdf

50

SECTION 2:

INTERNATIONAL EXPERIENCES WITH SUB-NATIONAL FISCAL RULES

Fiscal Rules and Fiscal Discipline

October 6, 2016

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1

Outline

- Key Messages
- Institutional Framework: Comprehensiveness and Transparency
  - Fiscal rules: between policies and politics
  - The importance of comprehensiveness and transparency
  - Role of fiscal councils and similar institutional arrangements
  - Placing the FRL in a medium-term fiscal framework
- A Framework for Fiscal Responsibility
  - Navigating the rigidity vs. flexibility trade-offs in different types of fiscal rules
  - Setting the fiscal anchor
  - Expenditure plus debt rules and a framework for fiscal responsibility
- Fiscal Rules in a Federal Structure
  - Incentives and institutions to ensure sustainable debt levels for subnational governments
  - Managing off-balance sheet transactions (“non-debt liabilities”)
  - Balance of the burden of economic shock absorption between the center and the states
- An assessment of India’s experience
  - FRBM contributed to fiscal sustainability and increased transparency in fiscal management
  - Contingent liabilities served as an escape valve and additional transparency is possible
  - A mixed record of enforcement and compliance, but this may reflect the center taking responsibility for counter-cyclical policy
  - A role in developing bond markets, but greater differentiation desirable

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Key messages

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A fiscal rule or fiscal responsibility law needs to be part of India's overarching development strategy

- The development strategy entails a medium-term vision of the size of the Indian state, based on
  - what services it will need to deliver;
  - what priority infrastructure needs it has to meet;
  - what capacity the state has to spend effectively in these areas; and
  - how much the state can raise in revenues
- A medium-term expenditure framework can be useful in operationalizing the vision by helping prioritize expenditures and ensure fiscal policy remains on a sustainable path given
- Fast growth keeps debt levels in check and public spending (such as infrastructure) can be growth-enhancing, but
  - implementation capacity needs to be boosted to justify higher debt-financed expenditure
  - growth is driven primarily by policies and institutions that promote private, rather than public, investment and consumption

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The main objective of a fiscal rule is to build the credibility for the long-term sustainability of fiscal policy

- The primary objective of a fiscal rule for India is not to achieve counter-cyclical policy…
  - India is a fast-growing, non-commodity emerging economy, for which business cycles (or commodity cycles) are less economically important compared to advanced or commodity-dependent economies
  - Due to the large size of India's informal economy, macroeconomic data is also 'noisier', making counter-cyclical fiscal policy especially challenging
  - This lack of accurate and timely macroeconomic data is more acute in the states; therefore, any counter-cyclical fiscal policy should be implemented by the center
- …but rather to build and maintain credibility of macroeconomic policy, thus providing a solid foundation for growth
  - India needs to build credibility of fiscal policy as a foundation of economic growth. As the Economic Survey argues, "the loss of expenditure control and hence fiscal space contributed to the near-crisis of 2013."
  - Credibility will require managing moral hazard and time consistency challenges, and avoiding the 'tragedy of the commons' bias towards overspending in states because some of the burden can be shifted to the center

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A comprehensive, transparent and simple rule builds credibility

- Comprehensiveness of the target is more important than the specific number
  - A commitment to target and monitor liabilities from the consolidated public sector ensures that there are no 'skeletons in the closet'; it builds credibility and strengthens institutions by reducing scope of creative accounting
  - The consolidated public sector includes PPPs, PSUs, SPVs for urban development, and in the case of states, DISCOMs
- Fiscal transparency requires accurate and timely fiscal reporting
  - Timely reporting of fiscal data reduces scope for deviations from fiscal responsibility and permit rapid course correction
  - Reducing gaps between revised and final estimates of spending at the state level
  - Enhancing disclosure of contingent liabilities, implicit and explicit, at all government levels
- Simple numerical targets are still useful for accountability and transparency
  - Targets will realistically be derived from considerations of what is politically feasible in terms of debt reduction or stabilization in the medium-term
  - Targets can include the consolidated liabilities of the public sector, borrowing requirements of the consolidated public sector, or the overall level of expenditures

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Credibility requires incentive-compatible enforcement

- Fiscal rules are tools to help 'depoliticize' fiscal policy
- An independent, technically capable and reputable institutional structure (an 'advisory board') that scrutinizes fiscal projections and reports on the targets may be similarly useful
  - For example, RBI would be well-placed to report on the consolidated public sector requirements in a given year by looking 'below the line'
- A comprehensive, transparent and simple rule would support political and market enforcement of fiscal responsibility, which are the only incentive-compatible enforcement mechanisms at the union level
- For the states, fiscal discipline can be enforced by strictly controlling sources of funding (and indirectly the accumulation of consolidated public sector liabilities)…
  - This would extend to state-owned enterprises such as DISCOMs, which would have its borrowing scrutinized
- …and, in the medium term, by introducing market differentiation

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7

Institutional Framework: Comprehensiveness and Transparency

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Fiscal rules operate between policy and politics

- Fiscal rules are tools to help 'depoliticize' fiscal policy and solve time consistency and moral hazard problems:
  - It is difficult for politicians to commit to fiscal restraint since the political costs of spending less today are immediate, while the political costs of spending more today will only be borne out in the future, and only if the politician is still in office when the adjustments are required
  - For states, the costs of spending more today is further dampened by the implicit guarantee from the center
  - FRLs and MTEFs attempt to introduce an intertemporal dimension to fiscal policy by creating an explicit commitment to a path for fiscal variables and actions to achieve this path and by providing greater transparency on fiscal policy
- If political incentives are misaligned, fiscal rules will be subject to 'gaming', changes of goal posts and other budgetary implementation risks:
  - Governments may ignore the fiscal rules openly;
  - Non-transparent conduct: lack of budget credibility (e.g., over-optimistic growth and revenue projections), and "creative" accounting;
  - Politicization of data-generating institutions (especially statistical institutes in charge of nominal GDP compilation);
  - Recourse to arrears financing; and
  - Rearrangement of budgetary structure to the detriment of (growth-stimulating) public investments

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Fiscal rules are most effective when they help reinforce political commitment to fiscal responsibility

- Making public commitments to a fiscal path and increasing transparency through more comprehensive coverage of fiscal targets can help make good politics out of good policy by
  - creating an easily-observed benchmark that the Government can be held (politically) accountable for, and
  - reducing the scope for creative accounting
- ...but building strong institutions that will not always serve the short-term interests of the government of the day requires strong and visionary political leadership
- Well-designed FRLs and MTEFs need to be incentive compatible and politically sustainable across the political cycle and across mandates of governments led by different political parties or coalitions, taking into account local political circumstances
  - Indonesia example: restrictions on borrowing to be repaid during the current term of the local executive are more relaxed than those on borrowing where repayment will take place in a future mandate

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10

Examples of commitment challenges posed by fiscal rules

In 1986, courts struck down as "unconstitutional" the *Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act* of 1985 (the first binding spending constraint on the US budget).

In 2003, Germany and France were the first euro area countries breaking the 3-per cent-of-GDP fiscal deficit criterion, the principal anchor of the Maastricht criteria underpinning the common currency.

New Zealand sought to anchor fiscal policy on the "operating balance excluding revaluations and accounting changes" (OBERAC)—ignoring the fact that it is not an accurate definition of "cash surplus" as the indicator of what Government has to spend.

In Indonesia (like many other developing and emerging countries having anchored their policies), fiscal rules have led the Government cut back its investment spending to bring the budget deficit into the range covered by the fiscal rule.

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Comprehensive coverage and transparency are key features of effective fiscal rules

- Effective implementation of fiscal rules requires a comprehensive, accurate and timely picture of consolidated public finances
  - All levels of Government (center, states, local governments)
  - Public sector undertakings (PSUs)
  - Other entities with an implicit public guarantee (municipal development corporations, SPVs, extra-budgetary funds)
- In India, there are challenges along the three dimensions
  - No consolidated financial statements for the 'whole of government'
  - Audited accounts at both the central and states take about 10-12 months to be produced
  - PSUs are not consolidated and, at the state level, audited accounts are often not available on a timely basis
- Consistency in applying acceptable accounting standards is required to ensure accuracy and comparability of fiscal data across government entities and over time
  - In India, accounting standards are still being developed and currently do not meet internationally acceptable practice across all government levels

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Comprehensive coverage and transparency are key features of effective fiscal rules (cont.)

- Comprehensiveness means that fiscal targets should cover the consolidated public sector, including state-owned enterprises, especially if they run chronic deficits
- Comprehensiveness also requires that all fiscal risks and contingent liabilities need to be accounted and disclosed
  - Normally, only guarantees (explicit liabilities) systematically disclosed
  - But fiscal risks and contingent liabilities extend beyond explicit guarantees
  - The International Public Sector Accounting Standard (IPSAS) requires inclusion of the expected fiscal cost of a CL in government's financial statement, if it can be measured and its probability of realization exceeds 50%; disclosure in notes to the statement, if its probability is less than 50%, but "not remote"
- Although work has been done at the union level to recognize contingent liabilities, additional efforts are required at the state-level
- A lesson from the Chinese experience is that a high-level coordinating agency may be necessary to manage a target on the consolidated public sector
  - Alternatively, separate targets can be specified for the government (and states) and the PSUs

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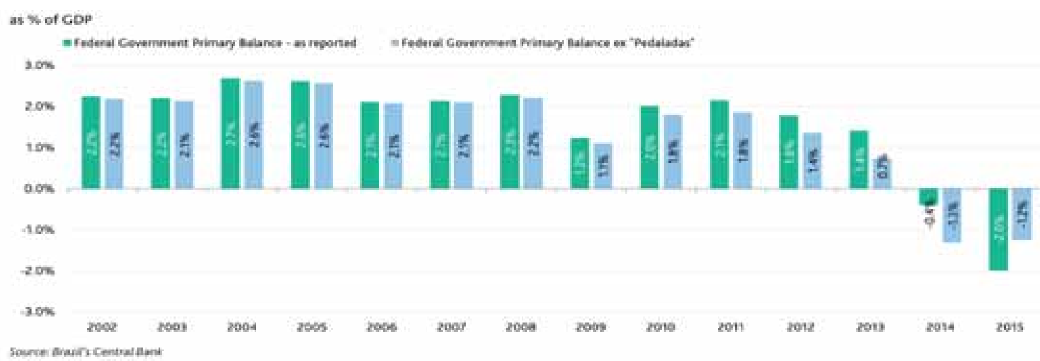
13

In Brazil, comprehensiveness and transparency ensured deviations were eventually spotted

- Brazil example: off-budget spending and fiscal maneuvers to circumvent the FRL...



- ... but transparency of fiscal reporting and binding nature of FRL on all public sector entities ensured that deviations were eventually spotted
- Colombia and Peru are examples of developing countries that target balances of the non-financial public sector
- In Argentina, provinces were not covered by the fiscal responsibility law of 2000, despite being responsible for a large share of the consolidated fiscal deficit, rendering the rule less effective at preventing the subsequent debt crisis

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Role of fiscal councils (or similar bodies)

- An independent body (Fiscal Council) can help increase credibility of Ministry of Finance
  - By monitoring and verifying compliance with fiscal rule
  - By reviewing macroeconomic forecasts and assumptions for revenue projections
- Fiscal councils are widely used
  - The EU now recommends member states have a fiscal council
  - In Colombia, an independent fiscal council provides advice to the Government, and based on its recommendations (and the fiscal laws) the Government decides on the level of the target
  - Chile established an independent fiscal council to evaluate the fiscal rule methodology, provide assumptions and projections for variables required to calculate the cyclical adjustment, assess medium-term and long-term sustainability, evaluate cases when exit clauses are invoked, etc.
  - Hungary instituted a fiscal council to monitor compliance with a new fiscal rule, introduced as part of the Fiscal Responsibility Law adopted in November 2008. The Council is mandated to facilitate the law's enforcement and to provide independent macroeconomic and budgetary forecasts although these are not binding for budget preparation
- Other institutions – such as Accountant Generals or Courts of Accounts – can play an important role, provided they are independent and timely
  - In the case of Brazil, while reporting and transparency were improved by the FRL, the work of the Courts of Accounts was relatively slow in identifying and punishing creative accounting and the circumvent of the rules, and many of the state-level accounts tribunals were not effectively independent

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In the Indian context, a 'fiscal advisory board' may be useful

- Original recommendation of fiscal council in India rejected…
  - A Fiscal Management Review Committee was to be chaired by the Prime Minister and had the Finance Minister, Speaker, Chairman of the Lok Sabha, the Leaders of the Opposition in both houses of Parliament, the Comptroller and Auditor General (CAG) of India and the Governor of the Reserve Bank of India as its members.
  - The CAG immediately disagreed with the creation of such a committee stating that "the proposed committee will be an encroachment on the prerogative of the finance minister"
- …but a different, less formalized, but independent institutional structure that reports on the achievement of fiscal targets may be helpful to build credibility
  - Role for RBI or similarly independent agency/body in tracking information on fiscal rules
  - In Brazil the Central Bank played a role in reporting on the outcomes of fiscal policy by looking at movements in bank accounts of all public entities ('below the line')
- Revenue projections have tended to be overly optimistic – a 'fiscal advisory board' may endorse forecasts and enforce greater realism

Deviations between revenue targets and actual out-turns - FY2000-FY2016*

	Range		Instances of			
	min	max	BE>Act	Act>BE	Average	StdDev
Total Revenues	82%	113%	11	6	97%	9%
Total Revenue Receipts	83%	113%	13	4	96%	7%
Tax Revenues	83%	108%	12	5	97%	7%
Corporation Tax	83%	123%	14	3	97%	10%
Personal Income Tax	79%	117%	11	6	97%	11%
Wealth Tax	68%	124%	7	8	102%	15%
Customs	73%	122%	11	6	96%	13%
Union Excise Duty	79%	124%	15	2	94%	9%
Service Tax	68%	132%	8	9	100%	15%
Non Tax Revenues	83%	140%	13	4	96%	17%
Interests	85%	123%	7	10	103%	12%
Dividends and Profits	89%	122%	3	14	109%	10%
Non Debt Capital Receipts	46%	621%	11	6	127%	141%
GDP	93%	111%	8	9	101%	5%

*FY16: RE in lieu of actuals

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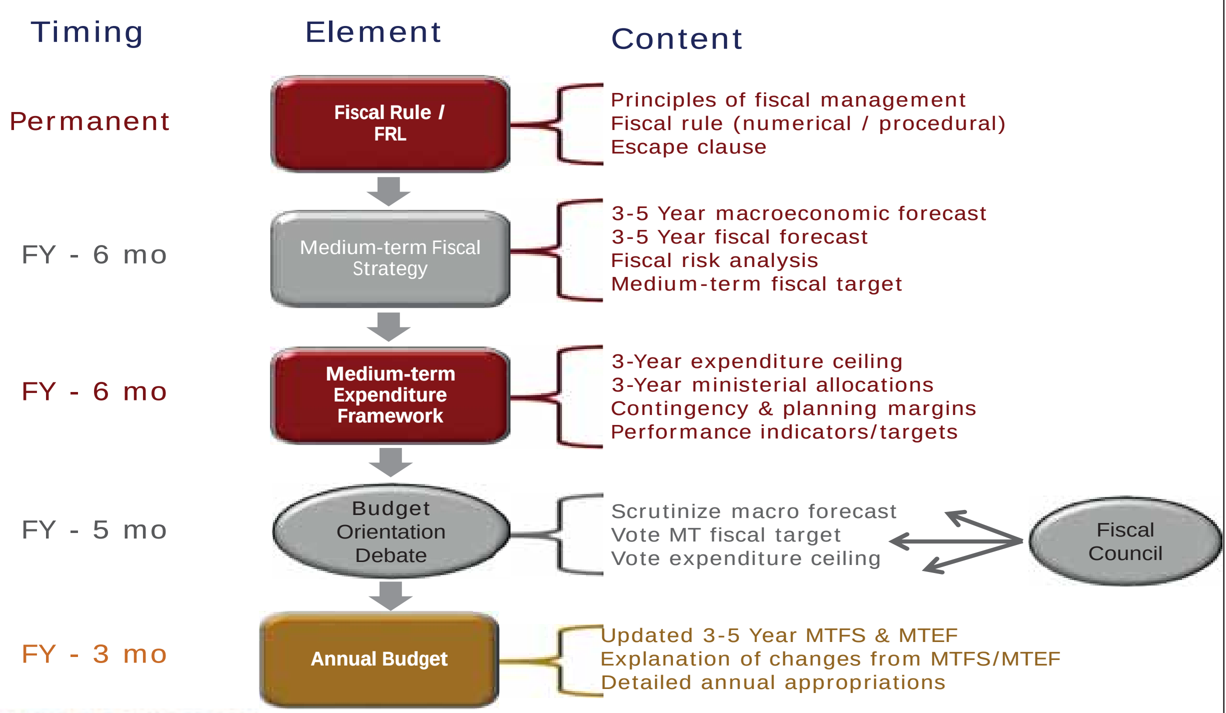
16

Fiscal rules can be strengthened when used in the context of a medium-term expenditure framework

- A medium-term *expenditure* framework (MTEF) is a tool to enforce fiscal discipline, ensure inter-temporal consistency of fiscal policies, and prioritize spending across sectors
- A MTEF typically includes:
  - A medium-term *fiscal* framework (MTFF), which are macroeconomic and fiscal estimates, informed by debt sustainability analysis for a (minimum) three year period (t+1, t+2, t+3)
  - Sectoral (agency-level) aggregate *budget ceilings* for years t+1, t+2, t+3, including allocations for recurrent and capital spending, issued in a budget circular early in the fiscal year
- Medium-term expenditure ceilings are a key disciplining mechanism in MTEFs
  - The ceilings draw from macro-fiscal projections and fiscal policies, where year t+1 is a hard budget constraint for agencies and years t+2 and t+3 (these are the outer-years) are indicative
  - The ceiling for year t+2 acts as the starting point for budget discussions that year. While adjustments are expected to be made to reflect the actual out-turns of year t+1 and new economic and fiscal forecasts, the earlier ceiling provides a benchmark
  - Ceilings can also be set conservatively and interpreted as a commitment (e.g. as in Australia) to spending agencies, although in most jurisdictions it is not legally binding
- MTEFs and fiscal rules are mutually-reinforcing tools of fiscal sustainability
  - Fiscal sustainability is ultimately about building the credibility of the Government's fiscal policy, in the sense that its trajectory is not *expected* (by market participants) to require disruptive adjustments; lack of credibility tends to precipitate disruptive adjustments as financing costs spike
  - Credibility is driven by (i) a track record of prudent policies, (ii) fiscal plans consistent with macro stability ...as well as (iii) communicating these plans to the markets
  - Both MTEFs and fiscal rules are tools that can contribute to these drivers and they reinforce each other by providing legal backing (via FRLs) to the expenditure ceilings (whether driven by a deficit or expenditure rule)

17

FRLs and MTEF: putting it together



Source: IMF

18

A Framework for Fiscal Responsibility

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19

Different flavors of fiscal targets

- Primary or overall fiscal balance
  - does not respond to high debt levels, which may require temporary fiscal surplus to bring down debt levels fast enough
  - may lead to pro-cyclical fiscal policy even when country has low debt and fiscal space to use fiscal policy to smooth out the cycle
  - Can be manipulated by moving spending off-budget
- Cyclical balance
  - Difficult to calculate (potential output, relation to expenditures and revenues, one-off factors to exclude)
  - Often ends up being cyclical as well (potential output estimation can itself be cyclical)
  - If calculation method is not tightly constrained by formula, this can be prone to manipulation (opinions on potential output differ)
    - EU uses full formulaic approach to define the minimum Medium Term Objectives (MTOs) for Member States, but the equations are very cumbersome.
- Expenditure
  - Doesn't cover revenues, or by extension, debt
  - Gives relatively less flexibility on how to meet target
- Debt
  - If not comprehensive, can be manipulated by running up arrears or increasing guarantees
  - Banking sector bail-out could lead to debt jump, which would require drastic fiscal consolidation to meet debt target
    - In practice, such shocks could lead the debt target to be ignored for a prolonged period of time, undermining its credibility and relevance
- Many combinations possible – and often desirable
  - Fiscal balance plus debt
  - Expenditure plus debt
  - Debt is used as the medium-term anchor, which is to be achieved through short-term targets on fiscal balances or expenditures

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20

Which target and institutional framework to achieve the proper balance of 'flexible rigidity'?

- Ideal rule: short-term fiscal flexibility and medium-term fiscal discipline

Goals of fiscal policy rules		Medium-term fiscal discipline	
		Yes	No
Short-term fiscal flexibility	Yes	Ideal fiscal framework	Counter-cyclical but anchorless fiscal framework
	No	Overly rigid, pro-cyclical fiscal framework	Poor fiscal framework, policy drift

Source: Annet and Jaeger (2004).

Navigating the Rigidity vs. Flexibility Trade-offs

- Some level of rigidity is required to achieve medium-term fiscal discipline, which:
  - reduces uncertainties about the Government's future borrowing and fiscal adjustment path, thus reducing risk perceptions and financing costs throughout the economy
  - forces greater prioritization (and thus effectiveness) of expenditures
- Excessive rigidity will have different negative implications according to country characteristics:
  - In countries subject to regular business cycles, rigid rules prevent Governments from engaging in counter-cyclical fiscal policies to stabilize aggregate demand and bring the economy back to potential
  - In countries where a significant share of revenues (and overall economic activity) is linked to the performance of certain commodities, rules that do not adapt to changes in commodity prices will amplify the volatility of commodity prices in the economy, in detriment of macroeconomic stability
  - In fast-growing emerging countries where demands on Government are also increasing, strict targets may slow down growth and contribute negatively to inter-temporal solvency
- Excessive rigidity also increases the temptation to circumvent rules, thus undermining the medium-term fiscal discipline objective
- In India's case, avoiding the negative implications of excessive rigidity would include (i) ensuring that the state can grow to deliver the services necessary for growth, and (ii) avoiding the temptation to circumvent rules

Cyclically-adjusted balances: flexibly rigid?

- Many countries, especially those with high dependence on natural resource revenues, have experimented with fiscal rules around a cyclically-adjusted (or structural) balance, which would be counter-cyclical by nature
    - Economic and fiscal cycles revolve around commodity prices
    - Purpose of rules and institutions tends to be two-fold: avoiding excessive appreciation of the real effective exchange rate due to high inflows from commodities in boom years, and fiscal stabilization
- In Chile the target is the cyclically adjusted fiscal balance
    - Once the target is set, expenditures are a fraction alpha of the *cyclically adjusted* revenues (where alpha has changed from 0.99 in 2001-07 to around 1.01 in recent years).
    - The actual implementation of the rule over the past 15 years in Chile has witnessed a deterioration of the structural balance from 1.0% positive on average during 2001-07, to minus 2% on average during 2008-10, and to minus 0.8% on average during 2011-15.
    - The initial +1% was justified because of the need to repay debt, recapitalize the CB and other contingent liabilities (ex.: future pension obligations). The 2008-10 change was because of the global financial crisis.
    - Currently, at the beginning of their terms in office governments set a target (path) for the structural or cyclically adjusted fiscal balance. The past two administrations started with a structural deficit which they have been trying to close. The low initial debt has allowed Chile to maintain low/decreasing structural deficits.
- In Norway the target is set for the cyclically adjusted non-oil central government deficit, equal to the return on the oil fund (currently at 4% of the Fund)
- In Colombia, a 2012 revision to the fiscal rule called for a *structural deficit* target of 1% of GDP from 2022. The structural deficit target, which is monitored by a fiscal council, allows for fiscal response to cyclical fluctuations in output and oil revenue. Savings generated with the operation of the fiscal rule are saved in a sovereign wealth fund.

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23

The Russian experience with cyclically-adjusted balances

- In 2004, the Government converted Russia's financial reserves into a formal Stabilization Fund.
    - The Fund was designed to accumulate resources during years of high world oil prices and to support spending during years of low oil prices. Oil customs duties received by the budget in excess of a cut-off price were channeled to the Stabilization Fund. The cut-off price was originally set at US$20 a barrel and in 2006 increased to US$27 a barrel. In 2005–2007, the government tapped into the fund to repay a portion of the country's external debt and cover the deficit of the Pension Fund. Nevertheless, the balance of the Stabilization Fund grew from the US$18.7 billion at the end of 2004 to US$156.7 billion at the end of 2007.
- In 2008, the Stabilization Fund was split into a Reserve Fund and a National Welfare Fund, and the fiscal rule was adjusted.
    - The Reserve Fund was set up to protect the budget from fluctuations in energy prices, with an upper limit established at 10 percent of GDP and additional surplus revenues accruing to the National Welfare Fund
    - The new fiscal rule, the so-called permanent income fiscal rule, was designed to sustain Russia's non-oil and gas deficit at a level not exceeding 4.7 percent of GDP starting in 2011 (with 3.7 percent of GDP coming from transfers from the Reserve Fund and 1 percent of GDP from debt issuance).
- During the global financial crisis the fiscal rule was suspended. Savings accumulated in the Reserve Fund allowed the government to finance a deficit of 6.3 percent of GDP in 2009 without significant deterioration in the debt-to-GDP ratio.
- In 2013, a new fiscal rule was introduced. It set a ceiling on federal expenditures equal to the sum of (1) oil revenues at the base oil price, (2) non-oil and gas revenues, and (3) net borrowing of 1 percent of GDP.
    - Any excess oil revenues would be used to replenish the Reserve Fund up to a ceiling of 7 percent of GDP, beyond which proceeds would be split between the National Welfare Fund and priority development projects.
    - Any shortfall caused by the oil price dropping below the base price would be covered by the Reserve Fund. While the base oil price was initially set as the average price over the previous five years, the reference period was to be extended progressively by one year and was supposed to reach 10 years in 2018.

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24

Challenges with cyclically-adjusted balances

- The Russian case illustrates the difficulty of setting up cut-off prices for commodities
- Structural/cyclically-adjusted balance rules are dependent on the reliable estimation of economic cycles, a very challenging task even in the absence of discretionary manipulation and in countries with adequate capacity
- Onder and Ley (2013) show that there are substantial measurement errors in GDP estimations in real time
  - Using within year (real-time) GDP estimates of 175 countries between 1990 and 2011, we see that in more than one-third of the observations even the sign of the output gap estimate is wrong, e.g. the government estimated that the economy was in a downturn whereas in reality it was overheating and vice versa. As expected, Low Income Countries are more prone to incur such errors
  - Thus, caution is recommending before implementing structural balance rules in countries with weak administrative capacity and a high degree of informality, both of which could aggravate the measurement error problems
- India is relatively not dependent on commodity prices for revenues or economic activity, and managing business cycles is arguably secondary to ensuring the country stays in a long-term fast-growth trajectory

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25

Other paths to flexibility: Exclusions from Coverage

- Capital expenditures: this is the most common exclusion from fiscal rules; for example, India has an effective revenue balance rule that excludes capital grants from its revenue balance rule. Croatia, Ecuador, Peru and Japan are other examples of countries that exclude capital expenditures from their fiscal rules.
  - The concern with this type of exclusion is the disconnect between the capital expenditure and the associated recurrent expenditures: it can be as costly to run a hospital for a year than to build it
  - In addition, marginal capital expenditures will only be growth-enhancing if there is matching capacity for implementation of infrastructure investments
- Interest payments: Finland, France, Japan and Brazil exclude interest payments by focusing on the primary balance. The focus on primary balance is less about providing flexibility (since if anything it declines during recessions when monetary policy is relaxed) but more about having a target that links more directly with debt sustainability
- Cyclically-sensitive expenditures: Finland, Poland and the US exclude ‘automatic stabilizers’ such as unemployment insurance from the fiscal targets. The rationale is sensible since these are by design expenditures that increase during economic downturns. However, the risks are that many types of expenditures get reclassified as ‘cyclically-sensitive.’
- Security-related expenditures: Peru and Israel are examples of countries that exclude security expenditures
- While exclusions from coverage can serve legitimate objectives, they carry a substantial risk of reducing transparency and create incentives for ‘creative accounting’

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26

Other paths to flexibility: Escape Clauses

- Economic downturns: relaxing the fiscal rule is allowed in the case of recessions
  - Example from Peru: The law allowed for a temporary (up to three years) relaxation of the target in case of national emergency or international crisis. It had to be approved by Congress at the request of the Executive. Moreover, when there was sufficient evidence (with a report from the Minister of Economy and Finance) that the GDP was declining or could decline in the following fiscal year, the deficit target could be missed (never exceeding 2.5 per cent of GDP).
- Other common escape clauses include natural disasters and 'events outside the government's control'
- Escape clauses need to be well-specified in order to avoid undermining commitment to medium-term fiscal sustainability

	Natural disaster	Recession	Banking system bailout, guarantee	Change in Government	Change in budget coverage	Other events outside control
Brazil	x	x				
Colombia		x				x
Jamaica	x	x				x
Mauritius	x	x				x
Mexico		x				
Panama	x	x				x
Peru	x	x				x
Romania		x		x	x	x
Slovakia	x	x	x			x

» Source: Schaechter et al., 2012

27

For emerging economies, fiscal rules should be embedded in an overarching development strategy

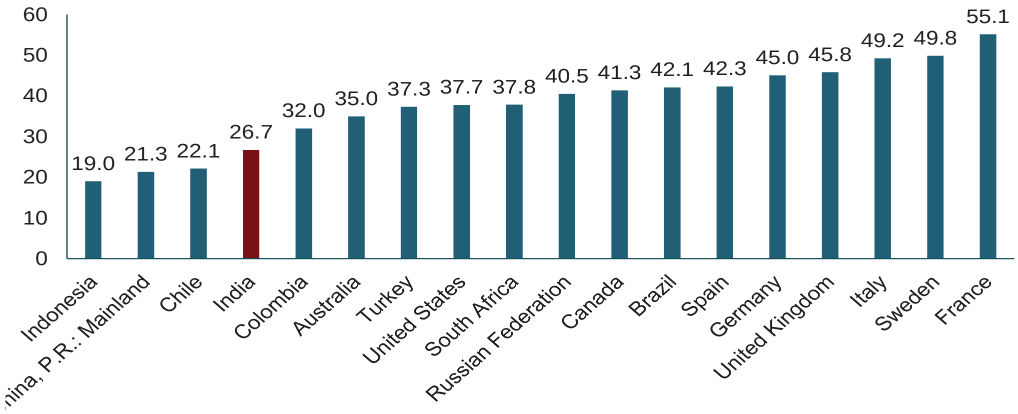
- Fiscal targets need to be forward-looking and consistent with India's growth trajectory as well as a broader development vision that allocates proper roles to the government and the private sector, and provides for a proper institutional framework to implement it
  - What is the vision of the size of government needed to provide services in the next 10 or 20 years? What are the large-scale expenditure programs? For example, will India introduce large-scale health insurance or pensions? What are priority infrastructure needs? What is the scope for enhancing expenditure efficiencies and boosting revenues?
- Intertemporal aspects of "fiscal solvency": restricting investments in productive public assets (to limit deficits) can entail significant costs in terms of a country's permanently foregone growth potential…
- …however the quality and capacity for implementation of public investment program become key to the credibility of a more relaxed fiscal stance
  - The World Bank's own experience of the challenges in the implementation of infrastructure investments in India suggests caution in justifying a relaxation of fiscal targets for investment before bottlenecks to infrastructure implementation were addressed; otherwise, there would be a loss of credibility on the fiscal side, without much impact on the ground
- 'Ex-ante' flexibility in the sense that fiscal targets should take into account the needs and circumstances of a growing economy

28

Embedding fiscal policy in an overarching development strategy: a vision of the medium-term size of the state

As India grows, so will its government

Expenditure of the General Government as % of GDP (2005-2014 average)



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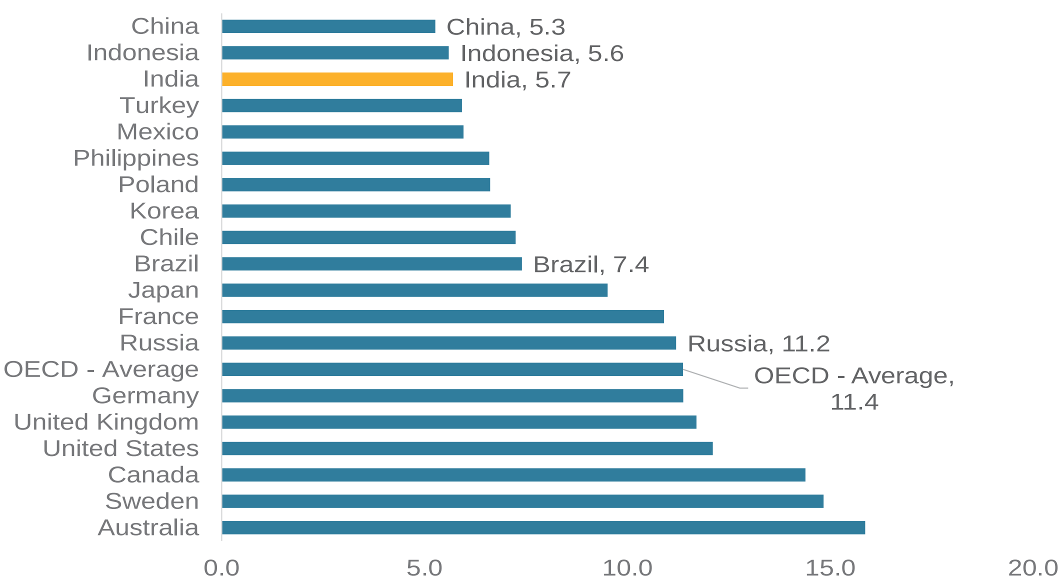
29

Significant room to increase revenues, especially from income taxes

Revenues from taxes on income and profits, percent of GDP



Source: OECD, Ministry of Finance (India), National Bureau of Statistics of China

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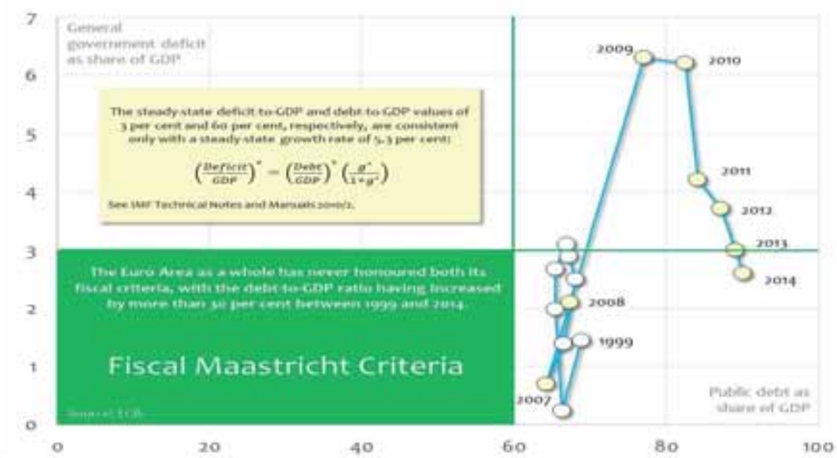
30

Fiscal policy anchors

- Solvency – or the stabilization of debt at ‘safe’ levels – is the main driver of fiscal anchors
- The Euro Area illustrates the intrinsic difficulties of fiscal rules providing the long-term policy anchor of debt sustainability



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What is a ‘safe’ level of debt?

- Kraay-Nehru (WB-IMF debt sustainability framework): safe level of debt dependent on policies and institutions, liquidity and solvency risks

	PV of PPG external debt as percent of			PPG external debt service as percent of	
	GDP	Exports	Revenue	Exports	Revenue
Weak	30	100	200	15	18
Medium	40	150	250	20	20
Strong	50	200	300	25	22
Probability	14%	13%	15%	14%	15%

Source: Table A3, Annex I, "Revisiting the Debt Sustainability Framework for Low-Income Countries," IMF and World Bank 2012.

  - Thresholds correspond to probability of debt distress greater than 15 percent
  - But this applies only to external debt – excessive domestic debt carries other risks

- Analyses of public debt thresholds confounded by market microstructure (nature of debt holders), inflation levels, among others
- In most countries, debt target conforms to political-economy considerations of what may be feasible to achieve within a 5-10 year period

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What is a 'safe' level of debt? (cont.)

- Do countries grow more when they avoid excessive debt levels – or are debt levels kept manageable by fast growth?
- Gil Sander (2009) finds that countries experiencing fast growth were less likely to enter an episode of debt distress;
  - No evidence that high debt levels affect future economic growth
  - Rather, high debt levels were more likely the result of growth slowdowns
- Better policies and institutions reduce the probability of debt distress for a given debt level in two ways: directly, through enhanced commitment to fiscally sustainable policies; and indirectly, through the effect on growth
- Some ways in which these findings can be relevant for India's fiscal rules:
  - While the lack of a causal relationship between high debt levels and future economic growth would argue against aggressive short-term debt reduction, it has been nonetheless the case that fast-growing countries reduced their debt levels as growth accelerated, suggesting that a degree of debt reduction should be built into a medium-term debt target
  - The reduction of debt levels induced by fast growth takes place over time; therefore, an adjustment period for reaching a given debt target may be warranted
  - Reforms critical to sustain fast growth and create fiscal space

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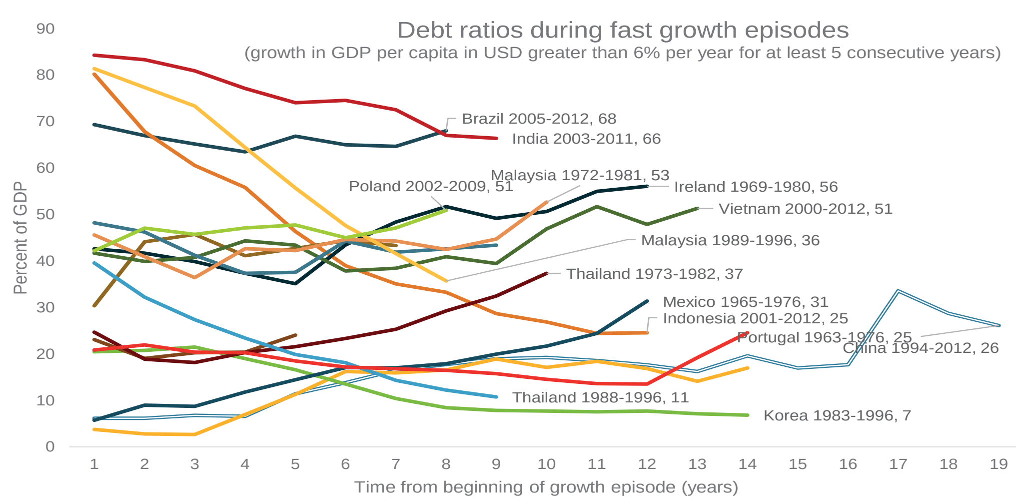
What is a 'safe' level of debt? (cont.)

- Although some countries (including India) experienced a growth episode starting with debt levels over 60% of GDP, in most cases growth episodes started with debt levels below 50 percent of GDP
- In the four cases of growth episodes starting at levels over 60 percent of GDP, debt ratios declined
- Excluding three cases of starting debt ratios of less than 10 percent of GDP, in 10 out of 15 cases debt ratios declined for most of the growth episode period



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Source: WDI, IMF Historical Debt database, and staff calculations

34

Expenditure (and debt) rules

- Expenditure rules target the growth rate of expenditures and have the advantage of being less pro-cyclical compared to deficit rules since they allow for large deficits in years when economic shocks reduce revenues
- Easily monitored, though less intuitive than deficit rules since it will be consistent with varying levels of deficits
- Usually combined with a medium-term debt target, with the growth rate of expenditures periodically re-calibrated based on revenue growth to achieve the medium-term debt target
- Consistent with a long-term growth strategy that targets a certain 'steady-state' size of Government expenditures
- Effectively implemented in the context of a medium-term expenditure framework
- If the definition of expenditures is comprehensive, an expenditure rule reduces incentives for under-estimation of revenues and creative accounting

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Example: Brazil's proposed new expenditure plus debt rule

- Aggregate expenditure ceiling, set at last year's expenditures plus CPI inflation, to be in place for 20 years
  - After 10 years it can be modified by parliament only (changes by decree prohibited)
  - Context: fiscal crisis, with debt levels increasing sharply
- Target: debt/GDP ratio between 50-55%
  - However, because the rule is linked to a time-frame of 10 or 20 years rather than debt levels, this may lead to unnecessarily high levels of the primary surplus
- Seven automatic measures to block new expenditures in case the ceiling is violated, including
  - Salary freeze for civil servants
  - Civil service hiring and post-creation freeze
  - Expenses with subsidies cannot exceed last year's expenditures, and
  - Tax incentives are prohibited
- Rule does not address Brazil's context of high expenditure rigidity (revenue earmarking, indexed mandatory spending, growth in pensions)
  - A key lesson is that before enacting rules on spending it is necessary to tackle spending rigidities

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A fiscal responsibility framework with endogenous targets

- Numeric targets are helpful for transparency and accountability.
- However, they can be incorporated in fiscal responsibility laws in at least two different ways:
  - In a fiscal responsibility law itself (e.g. Maastricht criteria, India's FRBM)
  - On a rolling basis, as part of a medium-term fiscal framework (e.g. Brazil 2000 FRL, Colombia)
- Brazil did not have any numerical targets for the primary deficit written in the 2000 fiscal responsibility law; rather the Government had to propose a three-year path of primary surpluses consistent with debt sustainability
  - The Government would then be held accountable to the path it proposed
  - Separate targets for states and the union, similarly-derived
- Since 2003, Colombia's central government prepares an annual Medium Term Fiscal Framework that sets a numerical target for the primary balance of the Non-Financial Public Sector for the following year as well as some indicative targets for the subsequent ten years, so that public indebtedness remains in line with a sustainable path

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Fiscal Rules in a Federal Structure

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Application of fiscal rules to states

- In a federal country, fiscal rules are required to address the 'common pool' or 'soft budget constraint' problem whereby states expect the center will prevent them from becoming insolvent
- Many subnational fiscal rules include numerical ceilings on a variety of fiscal indicators of the subnational entity
  - Peru restricts the debt stock at 100 percent and debt service at 25 percent of current revenues for each subnational government
  - In Brazil, there are 7 fiscal targets rolling over for 3 years, including: primary surplus, debt, personnel expenditures and own revenue collection
  - In Colombia and India, current expenditures cannot exceed current revenues (zero revenue balance)
- Numerical rules are primarily enforceable through restrictions on the state's ability to acquire liabilities (borrowing regimes)

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A range of borrowing regimes

Borrowing regime	Definition
Prohibited	No subnational borrowing is allowed.
Administrative	Central government direct control over sub-national borrowing decisions.
Centrally imposed rules	Use indicators and rules as constraints on choices by sub-national governments in order to guarantee desirable fiscal outcomes.
Cooperative	Borrowing controls are designed through negotiation/consensus between central and lower levels of government.
Self-imposed rules	Rules and constraints based on local jurisdictional laws and regulations.
Market Discipline	Financial markets regulate the behavior of borrowers and lenders through interest rates.

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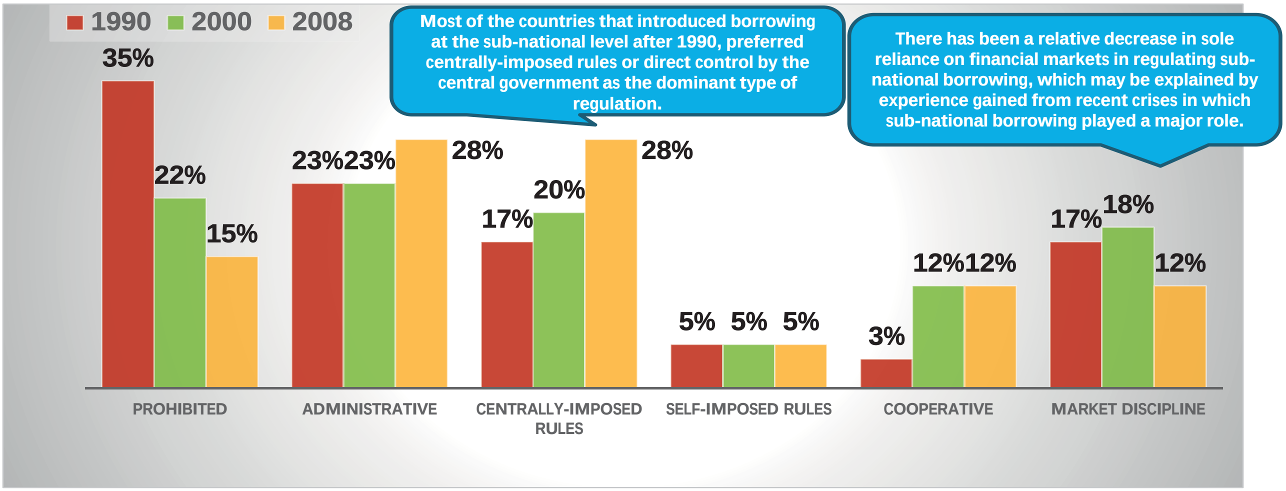
Borrowing regimes - prevalence

(relative frequency in the sample)



Source: Martinez-Vazquez & Vulovic ; [1] Sample consist of 60 industrialized, developed and countries in transition

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Key tradeoffs of different borrowing regimes

- More restrictive borrowing regimes place the burden of raising financing on the central government, curtail local government fiscal autonomy, and may also lead to the higher incentives for the proliferation of non-debt liabilities
- More liberal borrowing regimes require a credible commitment by the center to avoiding bailouts, which is usually not politically sustainable
- A second pre-requisite for a borrowing regime that relies on market enforcement is the presence of a well-established insolvency regime for subnationals
  - Best known example is Chapter 9 in the US, which deals with the bankruptcy of local governments; few other well-functioning examples globally

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A balanced approach to fiscal discipline

- The 'ideal' rule provides a degree of fiscal autonomy (thus allowing subnationals to borrow) and strikes a balance between market and central controls on the amount or conditions for borrowing
- Central controls are prevalent, especially in developing countries
  - Indonesia, where local governments were essentially prevented from borrowing, is developing a subnational borrowing regime to allow provinces to borrow
  - Brazil implemented tighter restrictions on borrowing by states, which previously were able to borrow from the center and from banks they controlled
  - In India, states must obtain central permission for market borrowings
- But mechanisms for credit differentiation of subnational entities can provide an important supplement to administrative controls
  - Colombia and Mexico are moving to systems with a creditworthiness rating system that influences the costs of subnational borrowing directly, as well as the price of sovereign guarantees, thus creating a role for market enforcement
  - Credit differentiation in the markets requires a move towards developing an insolvency framework for subnationals
  - Fiscal transparency and independent (private) credit ratings are also critical

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Nigeria: enforcement through loan-by-loan restrictions

- The federal government controls both external and domestic borrowing of state and local governments.
- Every State must execute a Subsidiary Loan Agreement with the Federal Government which may include an Irrevocable Standing Payment Order (ISPO) that allows the Office of the Accountant General of the Federation (OAGF) to deduct amounts on a monthly basis from the State's gross allocation.
- Domestic borrowing of sub-nationals is in general guaranteed by the federal government.
- The total amount of loans outstanding at any particular time including the proposed loan shall not exceed 50% of the actual revenue of the body concerned for the preceding 12 months

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Brazil: Legal and administrative restrictions on the supply of credit to the public sector

- From soft budget constraints to hard and (more) credible rules: Credit supply restrictions (1999-2003)
- National Council Monetary restrictions
  - Banks should have less than 45% of their net equity allocated to public sector financial entities (this affected in particular public financial institutions)
  - Temporary credit rationing measures (US$ 1 billion for the entire subnational level between 2002-2004)
- External credit restrictions:
  - Borrowing operations with International Financial Institutions needed to be approved by the Ministry of Finance National Treasury (PAFs and any other request to obtain the guarantee from the Union) and the Federal Senate involved

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Mexico: the Fiscal Discipline Law for SNGs (2016)

- Main Fiscal Rule: Net Financing Ceiling associated to a traffic light system

Green	Yellow	Red
Debt/Non earmarked revenues < 50%	50<Debt/Non earmarked revenues <100%	Debt/Non earmarked revenues > 100
Debt service/Non earmarked revenues<7.5%	7.5<Debt service/Non earmarked revenues<10	Debt service/Non earmarked revenues>15
Short term debt/Total Revenue<5%	5<Short term debt/Total Revenue<10	Short term debt/Total Revenue>10

- States in red – Net Financing Ceiling 0 (balanced budget)
- States in yellow – Net Financing Ceiling 5% of non earmarked revenues
- States in green – Net Financing Balance of 15% of non earmarked revenues

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The challenge of central-government discretionary transfers in Mexico and Brazil

- Central government discretionary transfer generates soft budget constraints which undermines FRLs
- This is perhaps the main challenge for the recently approved FRL in Mexico
- The solutions that are being implemented in Brazil in the face of the current fiscal crisis, which also affects states, harms the credibility of the fiscal rules going forward
  - transfer to state of Rio under a state of (fiscal) emergency
  - renegotiation of the 1997 debt agreement terms,
  - debt service interruption until 2018,
  - authorization of credit operations to Northeast states, etc

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Additional sanctions for non-compliance

- **Canadian provinces**
  - In British Columbia, members of the executive council face a 20 percent pay cut when fiscal targets are not met; the cut can be partially or fully reversed when fiscal targets are met.
  - In Manitoba, ministerial salaries are cut by 20 percent in the first year of a deficit and by 40 percent in the second year if the deficit continues.
  - Ontario has similar sanctions of cutting the salary of Executive Council members when deficit target is missed.
- **Brazilian states**
  - If the debt of a state is over the legal limit the state would no longer receive "voluntary" transfers from the federal government (transfers not from tax-sharing participations).
  - Debt and labor contracts in violation of the FRL are not legally valid.
  - The Fiscal Crimes Law (LCF), a companion law to the Fiscal Responsibility Law specifies criminal penalties—fines and even jail—for officials who violate the rules. The LCF applies to public officials of all branches of government at all levels. The LCF provides for detention of up to four years for a public official who engages in credit operations without prior legislative authorization, incurs unauthorized expenditure commitments (including any in the last two quarters in office that cannot be repaid during the present term of office), extends loan guarantees without collateral of equal or higher value, increases personnel expenditures during the final 180 days of the term of office, or issues unregistered public debt.

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Avoiding excessive micro-management of fiscal rules

- Another balancing act is to ensure compliance by the states without excessive micro-management
- If a large number of regulations (some of them unimportant) are not observed, the credibility of FRLs is undermined
- The Brazil and Mexico subnational legislations arguably have too many regulations, which complicate fiscal management and make it difficult for the central government to monitor and enforce the rules

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Non-debt liabilities

Fiscal discipline, including at the sub-national level, requires monitoring the creation of non-debt liabilities, often described as contingent liabilities or off-balance sheet transactions

I. Explicit contingent liabilities: guarantees

II. Infrastructure financing mechanisms

- Loss-making public enterprises
- Land and other asset sales
- SPVs/PPPs

III. Other liabilities

- Pension liabilities
- Litigation
- Deficit financing through arrears

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Land transactions for infrastructure financing

- Land transactions in the past few years in cities such as Cairo, Cape Town, Istanbul, and Mumbai have generated revenues much greater than the prior annual capital spending of the city.
  - In Malaysia, states generate most revenues through land transactions
- However, land transactions also pose significant fiscal risks
  - Unlike the regulations on direct borrowing, there is a general lack of regulatory frameworks for managing fiscal risks from land financing in many developing countries.
  - Revenues from the sale of land assets exert a much more volatile trend and could create an incentive to appropriate auction proceeds for financing operating budgets, particularly at a time of budget shortfalls during economic downturns.
  - Land sales often involve less transparency than borrowing. When sales are conducted off-budget, it is easier to divert proceeds into operating (noncapital) budgets.
  - Transactions by different development agencies and public entities may be ad hoc without a coherent city- and region-wide medium-term capital investment framework.
  - Bank loans for financing infrastructure are often backed by land collateral and expected future land-value appreciation. This can lead to excessive borrowing, and the volatility of land and real estate markets can create risk of nonperforming loans, which, in turn, can create contingent liabilities and macroeconomic risks for national governments.

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Land transactions for infrastructure financing (cont.)

- It is critical to develop ex ante prudential rules, comparable to those governing borrowing, to reduce fiscal risks and contingent liabilities associated with land financing of infrastructure.
- Key guiding principles would include
  - asset sale proceeds must be used to finance investment, with exceptions given only for key, one-time institutional reforms;
  - collateral-to-loan ratios linked to prudential banking regulations;
  - linking of land financing with medium-term fiscal framework and capital budgeting;
  - All information on public land inventories, public land valuations, land sales, and land contributions to public-private joint ventures or subsidiaries to be conducted through standardized instruments, be reflected in the budget or its annexes and financial statements

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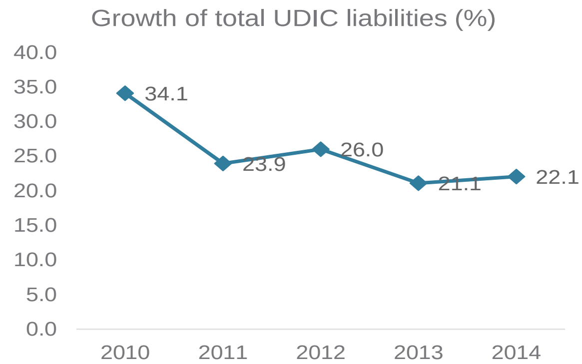
China's Subnational Fiscal Framework: Before the Budget Reform

- China's subnational governments could generally not borrow on budget
- Strong incentives on local officials to achieve GDP growth targets
- Local Governments set up off-budget Urban Development Investment Corporations (UDICs) to secure debt-financing for large-scale public investment



Source: Wind Database & WB calculations

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China's Subnational Fiscal Framework: The Budget Reform

- Budget reform of 2014:
  - On-budget borrowing allocations for subnational governments (but with strict quotas)
  - UDIC financing for new public investment projects prohibited
  - Existing UDIC liabilities linked to public investment swapped for government bonds at lower interest rates
  - National audit to stock-take contingent liabilities
- Given concerns that the budget reform forces too abrupt fiscal tightening, clarifications were subsequently issued:
  - UDICs can continue financing on-going public investment projects
  - Public-Private Partnerships (PPPs) with explicit limited government liability encouraged
- Ongoing efforts to develop debt management framework in subnational governments, including sustainable medium-term fiscal strategy

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In Brazil, states found ways around fiscal rules

RLGs have used various mechanisms to circumvent the FRL

Item	Practices	Impact	Selected past examples
Personnel expenses	Deduct withholding income tax from salary calculation	Improves the ratio of personnel expenses to current revenues	Reported by various states including Rio Grande do Sul, Espirito Santo (unrated) Rio Grande do Norte (unrated)
Personnel expenses	Excludes payment to employees contracted as third party service providers	Improves the ratio of personnel expenses to current revenues	Reported by various states including Santa Catarina (unrated), Parana (Ba3 stable), Mato Grosso do Sul (unrated)
Personnel expenses, revenues	Excludes from personnel expenses pension contribution funded by oil-based royalties. Includes those royalties as current revenues.	Improves the ratio of personnel expenses to current revenues and debt to current revenues	Implemented by the state of Rio de Janeiro from 2008.
Debt	Transfer of judicial deposit on private legal disputes considered as current revenues instead of credit operations	Improves the ratios of personnel expenses to revenues and debt to revenues by overstating operating revenues and understating reported debt.	Implemented through state laws by states of Rio de Janeiro, Minas Gerais, Rio Grande do Sul – Similar state laws were blocked by Supreme Court decision in five other states

Source: Moody's

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Balance of burden of economic shock absorption between the center and the states

- "countercyclical policy is the responsibility of the federal government and not of subnational governments. If at all the fiscal deficit targets are to be relaxed to overcome cyclical downturns, then that should be done by the federal government, which can increase its borrowing and pass it on via higher devolution and grants to the subnational governments. This means that the sub-nationals' fiscal deficit targets are unchanged."
  - Ragarajan and Prasad, 2012
- Countercyclical policy at the state level requires an advanced degree of market discipline that is not commonly observed
  - Moral hazard problems can be severe: is additional borrowing by a given subnational due to specific macroeconomic challenges, or due to lack of discipline?
  - Bond yields in Greece prior to the crisis were similar to other European countries

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An assessment of India's experience

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Objectives of the FRBM

- to introduce transparent fiscal management systems in the country
- to introduce a more equitable and manageable distribution of the country's debts over the years
- to aim for fiscal stability for India in the long run

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FRBM contributed to enhancing fiscal stability

- Revenue deficit declined
- States: fiscal deficit declined and own revenues increased
- Growth has been robust
  - At a minimum, FRBM did not deter the expansion of 2002-2008 and possibly helped by strengthening macroeconomic stability
- But "the loss of expenditure control and hence fiscal space contributed to the near-crisis of 2013" (Economic Survey 2015)
  - Too much flexibility?

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Transparency in fiscal management improved, but more possible

- Having a simple rule helps auditors benchmark and increase transparency
  - Audit accountants are at a comparative advantage in explaining why target indicators went up or down against a clearly defined benchmark for the target indicator
  - Further boost to transparency with the 2015 amendment to the FRBM Rules that mandate the CAG to carry out an annual compliance review of the FRBM Act beginning from FY2014-15
- GSDP forecasting mechanical and rules-based, avoids gaming and supports fiscal discipline
  - The 13th Finance Commission laid down clear rules to project GSDP
- Additional documentation welcome, but not extensively used
  - FRBM statement, including MTFF
  - MTFF does not include ministry-level ceilings and not used as starting point of next year's budget
- Monitoring of headline figures helped by simple target, but hampered by lack of timely and comprehensive data
  - States actual data comes with 2 year lag; often large differences between RE and actuals
  - comprehensiveness: data does not include PSUs

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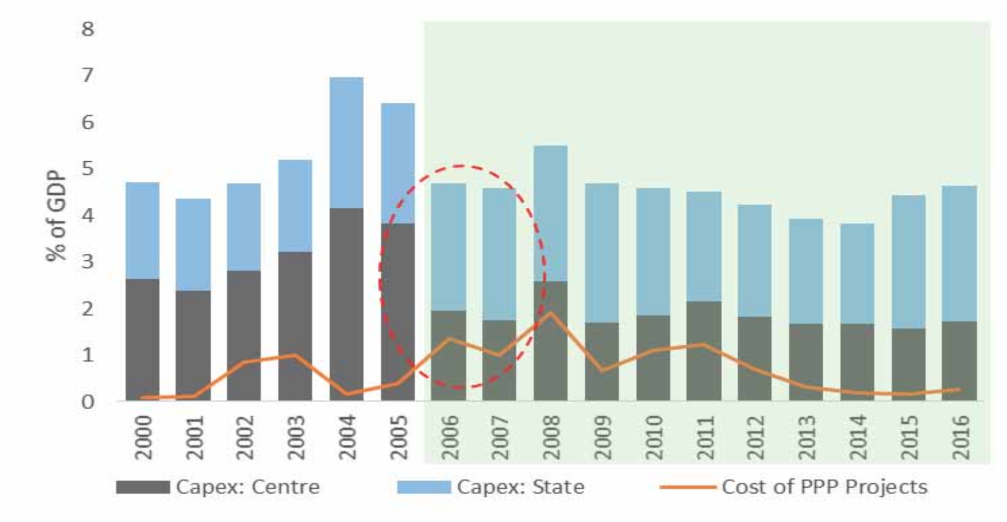
Contingent liabilities served as an escape valve

- Meeting deficit targets implied a decline in capital expenditures and a move towards a PPP model



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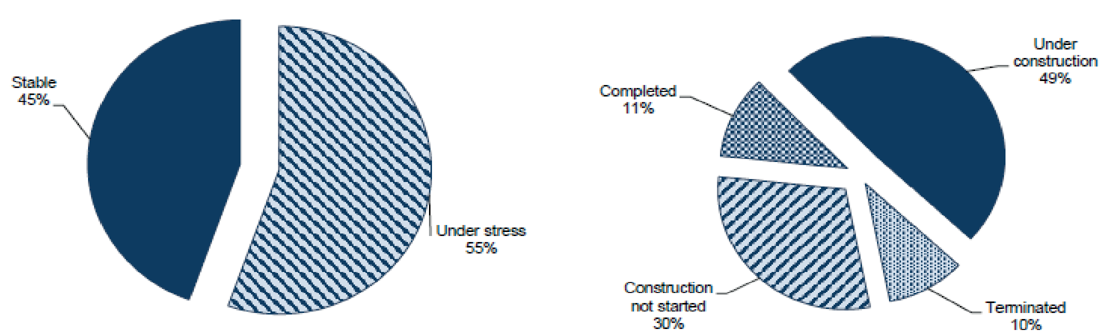
And most infrastructure PPPs now under stress

- Public banks did not have adequate incentives or capacity for financing large-scale infrastructure

Portfolio under stress by km (includes completed and under development); Status of stressed contracts (by km)



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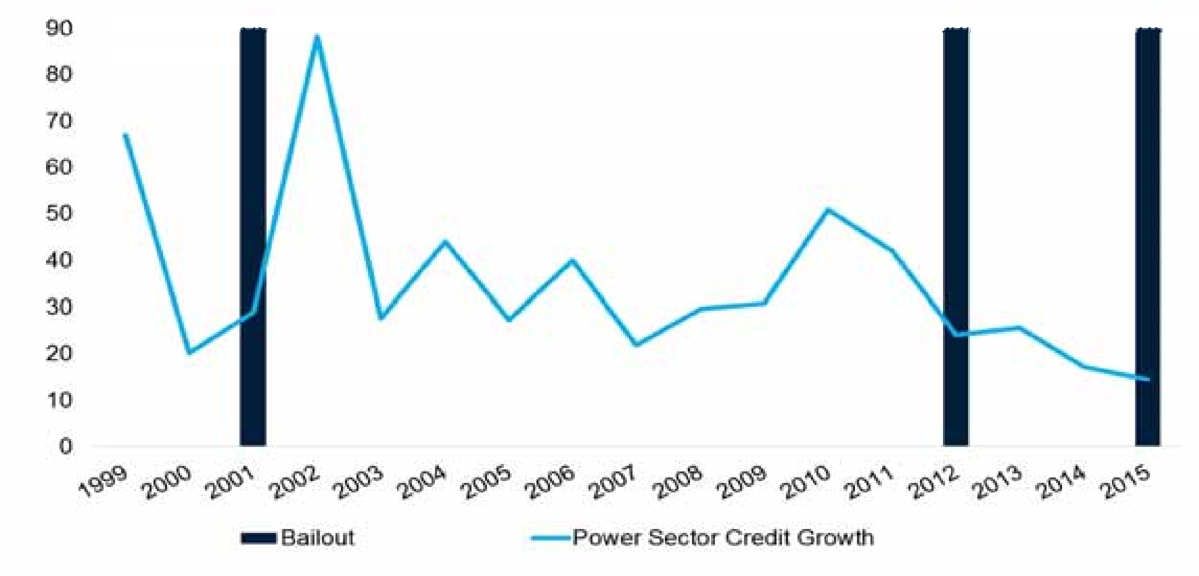
Similarly in the case of the power sector, the sector has now been bailed out thrice



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Mixed record on enforcement and compliance

- FRBM enforcement on states worked relatively well given control over borrowing
  - No more borrowing from the center
  - Shift states to market borrowing
  - Requirement of authorization to borrow from the center
- but insufficient market differentiation of states
  - Limited market discipline
- Center – no enforcement except market enforcement and lack of clearly specified corrective measures when targets missed
  - Rating agencies
- Lack of a risk monitoring and compliance function that makes mid-year adjustments

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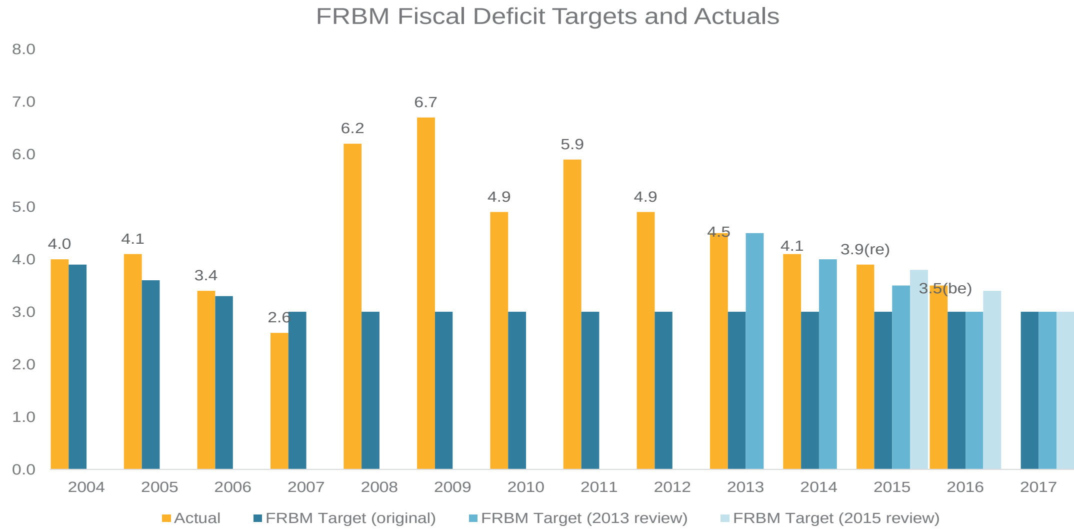
The center has generally been unable to meet its targets



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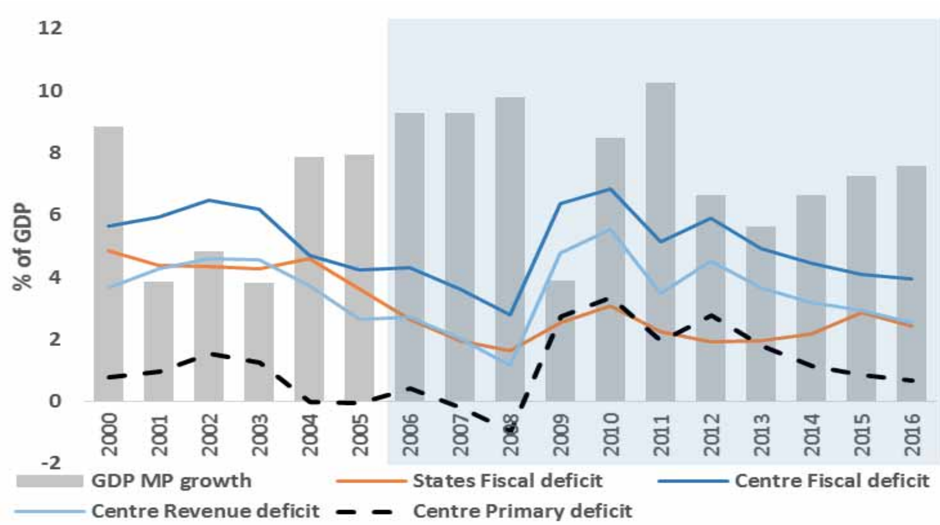
Limited compliance or countercyclical policy as the responsibility of the center?

- Center has taken most of the brunt in absorbing shocks, helping the states maintain fiscal discipline



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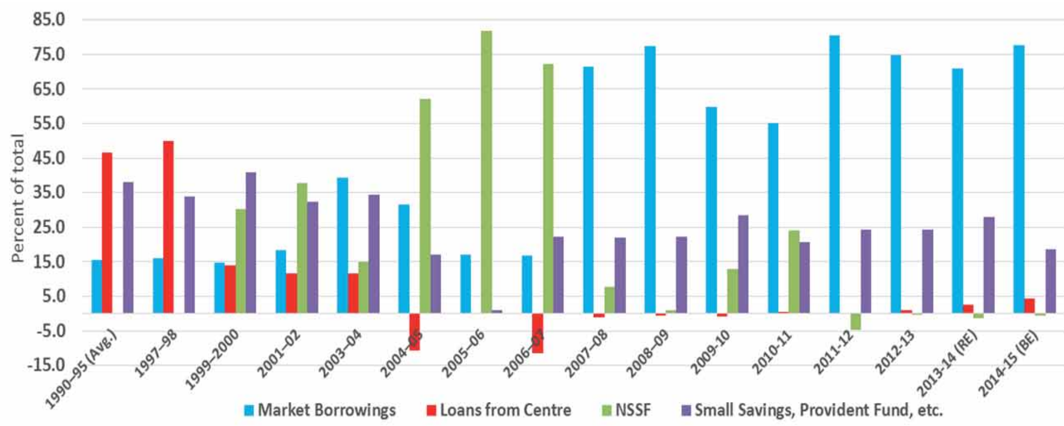
FRBM supported the development of the bond markets

- RBI cannot subscribe in the primary market
- States cannot borrow from the center and must go to the market
- SDLs a new asset class
- Deepening the bond markets is likely to enhance market discipline
  - Lack of independent DMO may be hampering the development of bond markets



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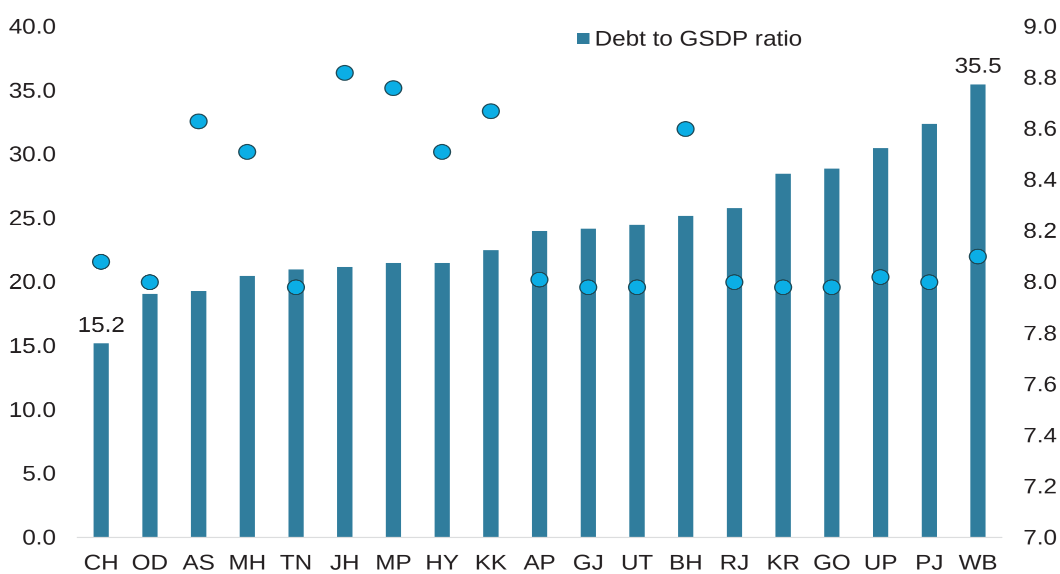
But limited market differentiation of SDLs suggest implicit guarantee from the center



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68

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SECTION 3:

FISCAL POLICY, GROWTH AND EMPLOYMENT

Fiscal consolidation, growth and employment: international evidence and implications

This version: 18 August, 2016

Presentation to FRBM Review Committee, Government of India
On behalf of ILO
By
Iyanatul Islam, Adjunct Professor, Griffith Asia Institute, Griffith University, Brisbane, Australia and former Chief, Employment and Labour Market Policies Branch, ILO, Geneva
New Delhi, India, 23 August

1

Outline

- Preamble: fiscal consolidation as a global agenda
- Fiscal consolidation: definition and scope
- Fiscal consolidation: rationale
- Debts and deficits: are there tipping points?
- Fiscal consolidation, growth and employment: international evidence
- Fiscal rules, growth and employment: evidence from low and middle income countries
- Beyond fiscal consolidation: regulatory/structural reform vs a holistic approach
- Lessons learnt

2

Preamble

- Fiscal consolidation is a key part of global policy agenda
- An ILO-supported review (2016) of 100 IMF Article IV surveillance reports (2014-2015) found that fiscal consolidation was recommended for 91 cases
- The synchronized and controversial fiscal consolidation exercise in the Eurozone between 2011 and 2013 is well known
- One should also note G20 proclamations, especially 2010, on the design of appropriate fiscal policy

3

Fiscal consolidation: definition and scope

- Fiscal consolidation entails the use of multiple instruments to reduce public debt and budget deficit
- Exercise guided by targets pertaining to debts and deficits over a given time period
- Eurozone's Maastricht Treaty a prime example of target-driven approach to fiscal policy
- Long-run fiscal targets for Eurozone countries specified as 3% budget deficit and 60% debt to GDP ratio

4

Fiscal consolidation: definition and scope

- Some low and middle income countries have adopted fiscal targets that are very similar to those specified in the Maastricht Treaty
- Examples include
- India
- Indonesia
- Economic unions in Sub-Saharan Africa as part of their convergence criteria

5

Fiscal consolidation: definition and scope

- OECD (2015) has released some guidelines on fiscal targets based on ranges rather than point estimates
- For high income countries: public debt should not exceed 70 to 90% of GDP
- For Eurozone: 50 to 70% of GDP
- For emerging economies: 30 to 50% of GDP

6

Fiscal consolidation: rationale

- High debt and deficit ratios (relative to thresholds) lead to loss of market confidence
- Borrowing costs rise sharply, private investment falls, growth declines
- Fiscal consolidation – entailing tax increases and spending cuts to meet fiscal targets – in such cases both desirable and expansionary
- Why?
- Boosts market confidence, reduces borrowing costs, stimulates private investment and thus revives growth

7

Debts and deficits: Are there tipping points?

- Consider the case of prudential thresholds for public debt
- The Maastricht Treaty target (60% debt to GDP ratio) and similar targets in middle income countries (such as Indonesia) are not based on any robust point estimates
- Also not derived from any theory of 'optimal debt'
- A widely noted study by Rogoff and Reinhart (2010) popularized the idea that beyond 90% debt to GDO ratio growth declines sharply

8

Debts and deficits: Are there tipping points?

- The Reinhart-Rogoff study was invoked by a former EU Commissioner on Economic amd Monetary Affairs to justify large-scale fiscal consolidation
- BUT…. many subsequent studies have not been able to establish that a tipping point exists at the 90% debt threshold (Cobham, 2016; Islam and Chowdhury, 2014; Islam, 2014)
- Estimates using debt sustainability analysis suggest a debt limit in excess of 100% for developed countries (Ostry et al, 2010)

9

Debts and deficits: Are there tipping points?

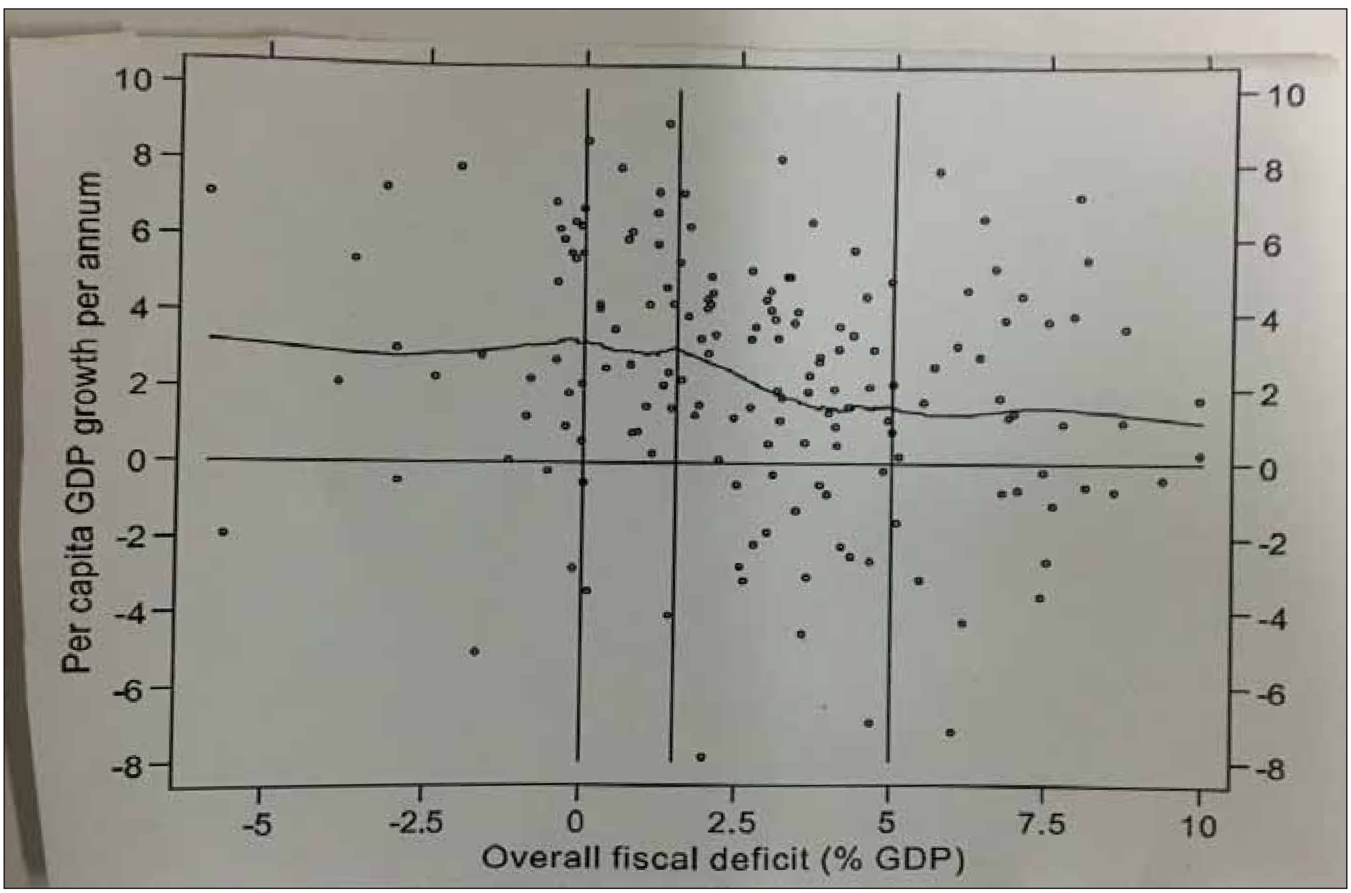
- Consider now the case of fiscal deficits
- A ‘tipping point’ for fiscal deficits beyond which growth declines makes sense if there is robust point estimate
- This was suggested to be 1 to 2% fiscal deficit in original paper by Williamson (1990) on ‘Washington consensus’
- No evidence was provided
- Easterly (2004) suggests a growth collapse after fiscal deficit reaches 5% of GDP based on scatter plot of data for low and middle income countries

10

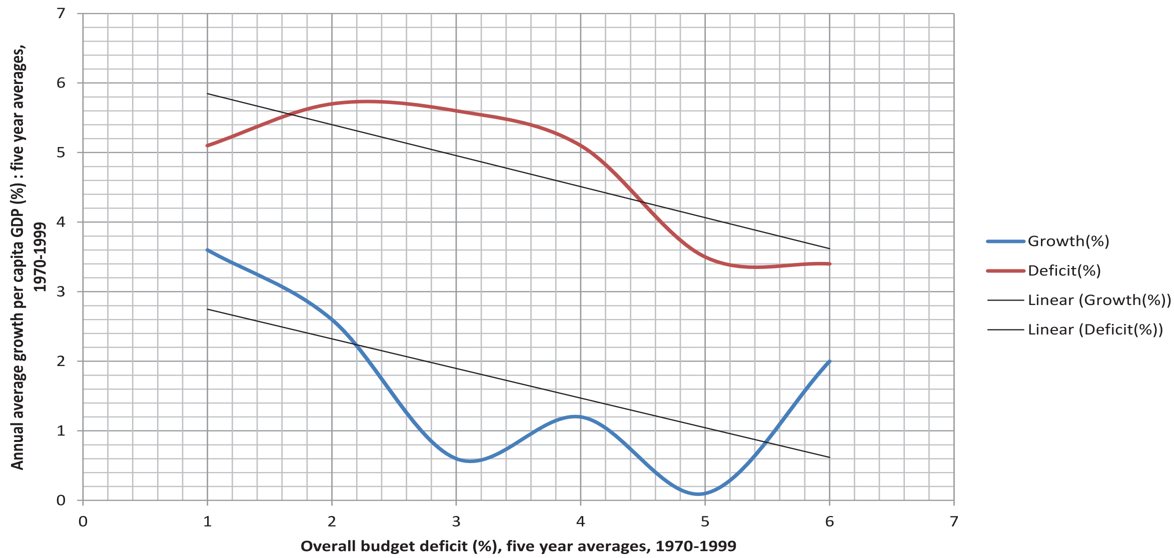
Debts and deficits: Are there tipping points?

- Maastricht Treaty deficit targets (1992) based on historical data, not rigorously derived from first principles
- Adam and Bevan (2005) find an optimal threshold at 1.5% fiscal deficit using model-based estimates
- BUT…interpretation not obvious if one inspects the actual data (45 non-OECD low and middle income countries:1970-1999)

11



Co-movements between fiscal deficit and growth derived from Adam and Bevans (2005) for 45 non-OECD countries (1970-1999)



13

Fiscal consolidation, growth and employment: international evidence

- Some early estimates for OECD countries suggest that fiscal consolidation was associated with growth recoveries in 19 per cent of cases reviewed (Islam and Chowdhury, 2014, drawing on Dermott and Wescott, 1996)
- Even where growth recoveries took place along with fiscal consolidation, a holistic policy approach played a key role
- Thus, fiscal consolidation was combined with supportive monetary policy and competitive exchange rate regimes
- There was also conducive global growth environment

14

Fiscal consolidation, growth and employment: international evidence

- Even ardent advocates of 'expansionary' fiscal consolidation (e.g. Alesina and Ardagna, 2009) are at best able to show that it appears to hold in minority of cases (25%)
- In any case, studies by such scholars of fiscal consolidation have been heavily criticized on methodological grounds
- Another way of assessing 'expansionary' fiscal consolidation is to use estimates for (expenditure) fiscal multipliers – which should be negative in case of fiscal consolidation

15

Fiscal consolidation, growth and employment: international evidence

- Fiscal multipliers are frequently close to 1 or in excess of unity, especially during downturns in developed economies
- Emerging economies show lower fiscal multipliers – around 0.4 (Hory, 2016; Kaay, 2014), but capital expenditure multiplier much higher (close to 1.0)
- Some evidence of negative fiscal multipliers in developing countries with respect to current expenditure in debt-constrained situations (Estevao and Samake, 2013; IMF 2008), but evidence contested (Mason and Jayadev, 2013)
- Evidence on fiscal multipliers for India suggest that front-loaded fiscal consolidation that cannot protect capital expenditure is likely to impose high short run costs (Tapsoba 2013, Bose and Bhanumurthy, 2013).

16

Fiscal multipliers: Indian evidence

Author(s)	Sign and size of (impact) fiscal multipliers	Comments
Bose and Bhanumurthy (2013)	Capital expenditure:2.45 Transfers: 0.98 Other revenue multipliers: 0.99	Based on a structural macroeconomic model and applied to annual data for the 1991-2012 period
Tapsoba (2013)	Government spending: 0.6 to 0.9 Government revenue: 0.4	Based on calibrations of IMF multi-region DSGE model and also using VAR model

17

Fiscal consolidation, growth and employment: international evidence

- Large scale fiscal consolidation (4% of GDP) in Eurozone in 2011 to 2013
- GDP declined by 3.5% due to fiscal consolidation (Ranenberg, 2015)
- In UK, all evaluations suggest that fiscal consolidation in 2010 to 2012 led to reduced growth and employment (Wren-Lewis, 2015)
- Greece worst hit and suffered a depression as a result of historically unprecedented fiscal austerity

18

Fiscal consolidation, growth and employment: international evidence

- Some studies move beyond the impact of fiscal consolidation on growth
- They highlight the consequences of fiscal consolidation along multiple dimensions
- They show that fiscal consolidation is associated with rising inequality, reduction in wage share, increasing long-term unemployment

19

Fiscal consolidation, growth and employment: international evidence

- More specifically….
- Data from 17 OECD countries (1978-2009) period suggest that fiscal consolidation episodes lead to the following long run consequences (Ball *et al* 2013, Loungani *et al* 2016):

(a) inequality goes up by 3.4 per cent

(b) wage share declines by 0.8 percentage points

(c) long run unemployment goes up by 0.5 per cent

20

Fiscal rules, growth and employment: evidence from low and middle income countries

- Fiscal targets are often embedded in fiscal rules (>50 developing countries, including India, as at 2014)
- Do these rules promote growth and employment friendly policies ?
- An ILO-supported study examined these issues (Ray, Velasquez and Islam, 2015)
- Generally found statistically insignificant differences in ILO-based labour market indicators between low and middle income economies that adopt fiscal rules and those that do not
- Regression estimates also do not support a strong case for fiscal rules as an enabling condition of growth and employment

21

Fiscal rules, growth and employment: evidence from low and middle income countries (1997-2013)

Variable	With fiscal rules	Without fiscal rules	Statistically significant difference (yes/no)
Working poor (% earning less than 2 USD)	42.3	42.4	No
Vulnerable employment (% of work-force)	58.4	57.1	No
Labour productivity (USD, 2005 as base year)	6785.5	5054.7	Yes
Unemployment rate (%)	8.3	8.8	No
Employment rate (%)	60.3	60.0	No

22

Fiscal rules, growth and employment: evidence from low and middle income countries (732 observations, 35 with fiscal rules)

Explanatory variables	Statistically significant at 5% level (yes/no)	Statistically significant at 5% level (yes/no)
	Regression with time effects	Regression without time effects
Initial per capita GDP	Yes	Yes
Investment	Yes	Yes
Years of schooling	Yes	Yes
Population growth	Yes	Yes
Balanced budget rule (BBR)	Yes, but with wrong sign, suggesting BBR associated with negative growth	No
Debt limits	No	No

23

Beyond fiscal consolidation: regulatory/structural reform vs a holistic approach

- Fiscal consolidation per se will not respond to key policy agenda of private sector-led inclusive growth
- The standard prescription is to increase ease of doing business by implementing regulatory or structural reforms, including tax reforms
- BUT…this depends on whether private sector perceives regulatory reforms and tax burden to be critical
- Survey results do not seem to support this view

24

World Bank enterprise survey results on the significance of business regulations and tax administration vis-a-vis other factors

Major constraints to business operations as perceived by more than 135,000 firms in more than 100 countries (2009-2014)	% of firms that agree with survey question
Corruption	36.8
Crime, theft and disorder	26.5
Access to finance	30.8
Electricity	36.3
Transportation	22.3
Tax administration	21.9
Business licensing and permits	14.8
Customs and trade regulations	18.4
Labour regulations	12.3
Inadequately educated work-force	27.4

25

World enterprise survey: India

Major constraints to business operations as perceived by more than 9000 firms in India (2014)	% of firms that agree with survey question
Corruption	19.9
Crime, theft and disorder	-
Access to finance	11.7
Electricity	15.3
Transportation	-
Tax administration	3.7
Business licensing and permits	-
Customs and trade regulations	-
Labour regulations	4.9
Inadequately educated work-force	3.4

26

Beyond fiscal consolidation

- Latest evaluations (IMF, 2015; 2016) suggest that regulatory/structural reforms have high short run output costs that might offset ex-ante long run gains
- In the case of India, short run output and employment losses might persist *for four to five quarters* following labour market reforms (Anand and Khera, 2016)
- So, a holistic approach is needed

27

Beyond fiscal consolidation

- As noted, tax reforms are also part of regulatory/structural reforms
- Suppose a government engages in tax reform by cutting income and corporate taxes in a bid to boost growth and employment.
- What is the likely outcome?
- OECD data suggest that a 1% cut in corporate and income taxes will boost employment by only 0.05 per cent at best (Bova et al 2014)

28

Beyond fiscal consolidation

- Tax reforms associated with growth accelerations in minority of cases (IMF Fiscal Monitor, 2015)
- But …tax reforms combined with spending initiatives on health, education, infrastructure, social protection, ALMPs significantly increases prospect of growth acceleration
- Hence, a broader approach to both tax reform and fiscal policy is required

29

Lessons learnt

- Tipping points pertaining to debt and deficit rely on ratios in which GDP is the numerator
- Hence, growth slow down will be associated with worsening debts and deficits even in the absence of profligate fiscal policies
- Point estimates pertaining to specific debt/deficit threshold based on ratios not reliable
- Should use a range reflecting country-specific circumstances suggesting use of discretion and judgement

30

Lessons learnt

- There are short run outputs losses associated with fiscal consolidation
- There are long run costs of fiscal consolidation in terms of with higher unemployment and greater inequality
- Debt to GDP ratio at the end of a fiscal consolidation exercise could be paradoxically higher
- In Eurozone, debt to GDP ratio in 3rd qtr of 2015 was 91.6% while in 2011 it was 86.0%

31

Lessons learnt

- Pay attention to how debt is financed and used
- Prudent borrowing, especially when there is ample fiscal space and low borrowing costs, is desirable if directed towards productive investment
- Ensure 'productive expenditure', such as public investment, is protected during fiscal adjustment exercises – but this is often ignored (Serven, 2007; Easterly et al, 2007)

32

Lessons learnt

- Role of market confidence in supporting the case for fiscal consolidation has been misinterpreted
- Markets care about the fiscal stance of governments
- BUT…they also care about growth
- Market confidence will not be boosted if growth prospects low and made lower by fiscal consolidation
- Of course, fiscal consolidation becomes desirable and unavoidable if a country has an unsustainable fiscal situation
- Even here, ‘gradualism’ rather than ‘big bang’ is desirable

33

Lessons learnt

- Move beyond fiscal consolidation
- Develop a sustainable resource mobilization strategy to invest in health, education, infrastructure and social protection
- Pay attention to financial inclusion
- Invest in active labour market policies (ALMPs)
- Use due diligence to assess policy interventions

34

Lessons learnt

For example….

On ALMPS, meta evaluations (including by the ILO) suggest that ….

- Employment services and skills training have positive effect on employment outcomes and earnings
- Public employment programmes have mixed results
- Wage and employment subsidies have mixed results, being effective in some cases, but not necessarily in others
- Insufficient evidence on effectiveness of self-employment/small business assistance

35

Lessons learnt

- Such meta evaluations are not infallible, but they provide a way of developing an evidence-based approach to policy design
- So, in the case of ALMPs, we are reasonably confident that some work better than others
- This means one should take care in designing the appropriate mix of ALMPs as part of a holistic policy framework

36

Can Fiscal Rules Support Economic Growth and How?

Tigran Poghosyan
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, August 18, 2016

Fiscal Rules and Growth: Key Channels

I. Fostering stabilization

II. Supporting public investment

III. Facilitating structural reforms

3

Questions raised by the Committee on fiscal rules and growth

- Should fiscal targets be based on cyclically adjusted positions?
- How are cyclically adjusted fiscal positions calculated in other countries? In particular, for countries where there may be uncertainty around estimation of output gaps?
- How is output gap estimated?
- How should the effects of fiscal policy on growth and employment figure in developing the framework?

2

Channel 1. Fostering stabilization

4

Alternative rules to foster stabilization

- **Nominal balance rule is widely used, but can lead to procyclicality**
- **Alternative rules**
  - Structural balance rule (and its variations)
  - Expenditure rule

5

1. Structural balance rule

$$b_t = b^* + \alpha * GAP_t$$

- **Allows automatic stabilizers to work**
- **But, requires estimating unobservable output gaps…**
  - Multiple methodologies
  - Frequent revisions/"positive bias", leading to a procyclical stance
- **…with specific challenges in emerging markets**
  - Data requirements
  - Volatility of potential output

6

Variations of a structural balance rule

- **Growth-based balance rule**
  - Use deviations between actual and potential output growth instead of the output gap
- **Over-the-cycle balance rule**
  - Target average overall balance ratio over a certain period corresponding to the full economic cycle
- **Correction for the commodity price cycle**

7

2. Expenditure rule

$$\Delta exp_t < g^*$$

- **Pros:**
  - More robust to the mis-measurement of cyclical stance
  - Expenditure expansion is limited in good times (g>g*)
  - Automatic stabilizers work fully on the revenue side
- **Cons:**
  - Capital spending could be cut disproportionally to meet the rule
  - Does not prevent procyclical revenue policy stance
  - Requires reliable inflation forecasts

8

Forecast errors: Levels versus differences

- **One-year ahead revisions in output gaps are more volatile compared to potential growth rates**

	Standard deviations		
	Advanced economies	Emerging and low-income economies	Total sample
Output gap (%)	1.66	1.95	1.75
Potential growth (%)	0.89	0.56	0.81

Source: WEO, IMF staff calculations.

Note: The sample includes 30 advanced and 39 emerging and low income countries. Sample period: 2008-2015.

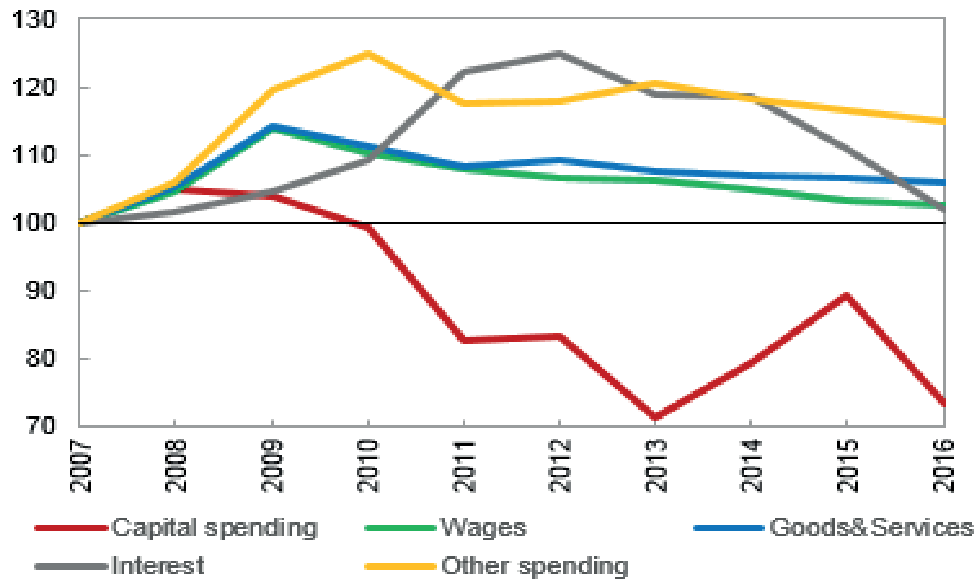
9

Channel 2. Supporting public investment

10

Fiscal rules can adversely affect expenditure composition during consolidations

Euro Area: General Government Expenditure Composition, 2007–16
(Rebased ratio to GDP, index 2007 = 100)



11

Golden rule

- **Design**
  - Target overall balance net of capital spending
  - Finance capital spending through borrowing to ensure intergenerational equity
- **Golden rule examples (Budina et al., 2012)**
  - UK (1997-2009): current balance should be in balance/surplus over the cycle
  - Brazil: golden rule principle set in the constitution, new borrowing should be at most equal to public investment
  - Costa Rica: modified golden rule, financing of gross investment by borrowing is permitted due to cash accounting
  - Japan: current expenditure shall not exceed domestic revenues
  - Malaysia: government borrows only for development/capital spending

12

Golden rule (cont-ed)

- **Drawbacks**
  - Weakens the link with the ultimate target of debt burden
  - Current spending can be mislabeled as capital
  - Not all capital spending raises productivity in the long run
- **Stronger medium-term budget frameworks work better (IMF, 2015a)**
  - Transparent project appraisal, selection, and management
  - Active pipeline of approved projects
  - Standardized procedures for project adjustment

13

Channel 3. Facilitating structural reforms

14

Fiscal rules and structural reforms

- **Structural reforms can enhance long-term growth (WEO, April 2016)**
- **Why are countries reluctant to implement structural reforms?**
  – Fiscal costs (direct and indirect)
  – Political costs
- **Smart fiscal rules could address these concerns by**
  – Flexibility to accommodate fiscal costs (e.g., Italy, 0.5% of GDP in 2015)
  – “Sweeteners” to compensate those affected by the reform

15

Example: SGP

- **Criteria**
  – Major reform, must be fully implemented
  – Long-term positive budgetary effects
- **Examples:**
  – *Pension reform*: introduction of a fully-funded pillar
  – *Labor market reform*: active labor market policy, reduction in the tax wedge
  – *Healthcare reform*: optimization of hospital networks
- **Conditions:**
  – Costs of up to 0.5 percent of GDP (more for pension reforms)
  – Sufficient safety margin under 3 percent deficit target

16

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20

OECD ECONOMIC OUTLOOK

and INDIAN FISCAL CHALLENGES

Delhi, 26.7.2016
Piritta Sorsa, Head of Division, OECD Economics Department

www.oecd.org/economy/economicoutlook.htm
ECOSCOPE blog: oecdecoscope.wordpress.com

OCDE
DES POLITIQUES MEILLEURES POUR UNE VIE MEILLEURE

Uncertain and potentially volatile external environment complicates fiscal policy making

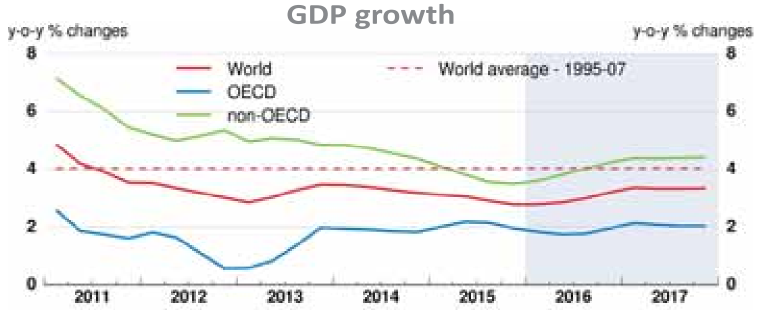
2

Global GDP growth is low

Global GDP growth in 2016 projected to be about the same as 2015; 2017 only a little stronger

Growth is flat in advanced economies, slower in many EMEs

GDP growth



Projections

Real GDP, Annual percentage changes

	2014	2015	2016	2017
World[1]	3.3	3.0	3.0	3.3
United States	2.4	2.4	1.8	2.2
Euro area	1.0	1.6	1.6	1.7
United Kingdom	2.9	2.3	1.7	2.0
Japan	0.0	0.6	0.7	0.4
China	7.3	6.9	6.5	6.2
India[2]	7.2	7.4	7.4	7.5
Brazil	0.1	-3.9	-4.3	-1.7

1. Moving nominal GDP weights using purchasing power parities. 2. Fiscal years starting in April.
Source: OECD June 2016 Economic Outlook database.

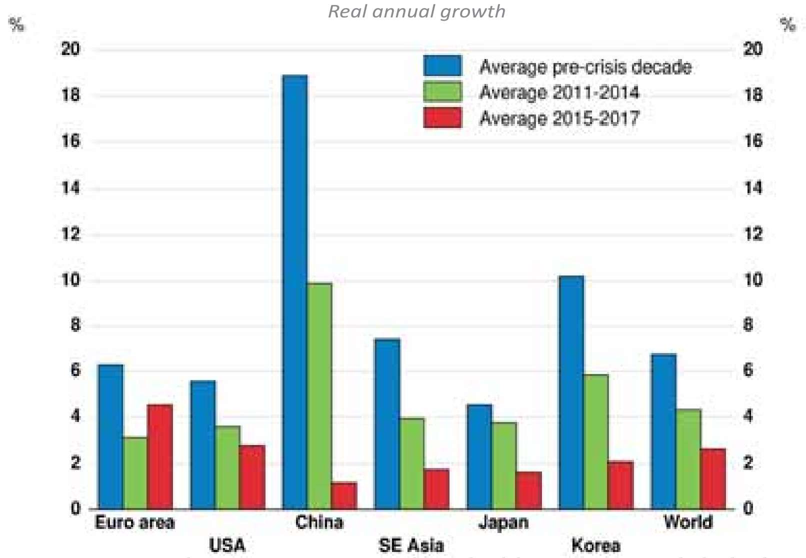
3

Global trade growth is weak, particularly in Asia

A return to pre-crisis trade growth would boost productivity by 1 per cent on average after 5 years

Trade in goods and services

Real annual growth

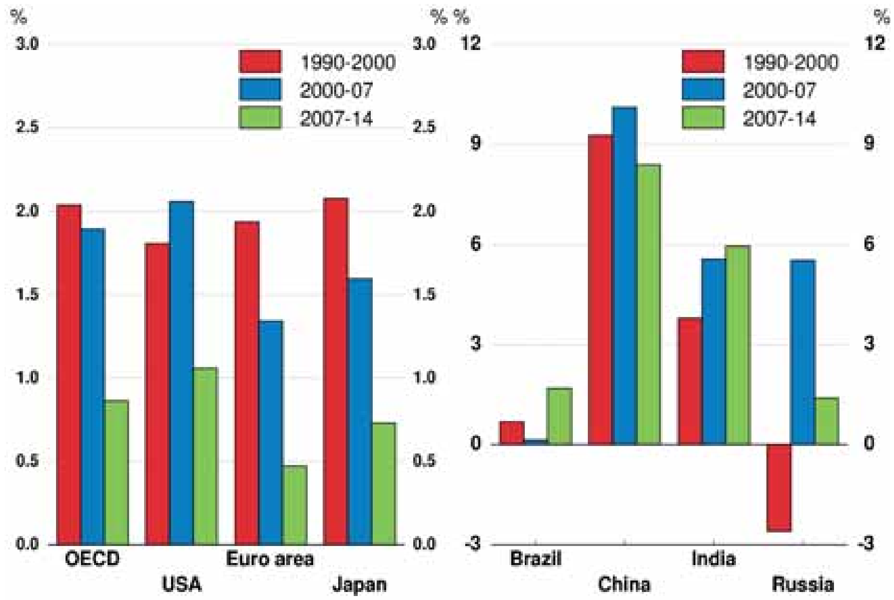


Note: SE Asia includes Chinese Taipei, Hong Kong, Malaysia, the Philippines, Singapore, Thailand and Vietnam. Euro area and SE Asia include intra-regional trade.
Source: OECD June 2016 Economic Outlook database; OECD calculations.

4

Declining productivity growth is widespread in advanced economies and some EMEs

Labour productivity growth

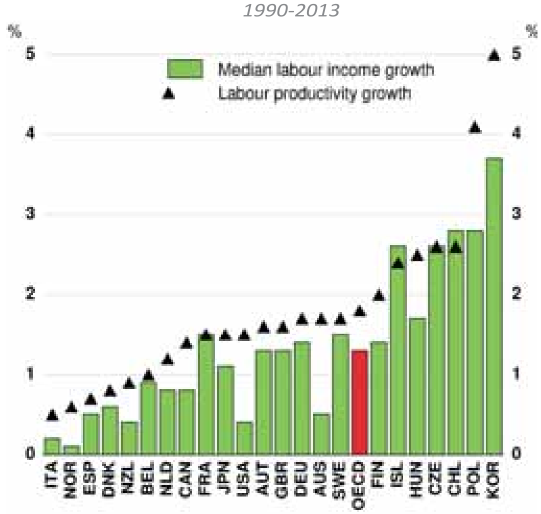


5

Incomes are rising very slowly for most workers, increasing inequality

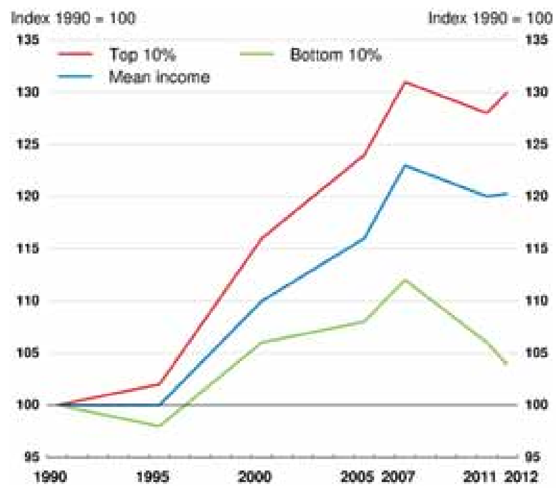
Wages growing less than productivity

Annualised real growth rates, per hour worked, 1990-2013



Inequality in income is rising in the OECD

Real household disposable income, total population



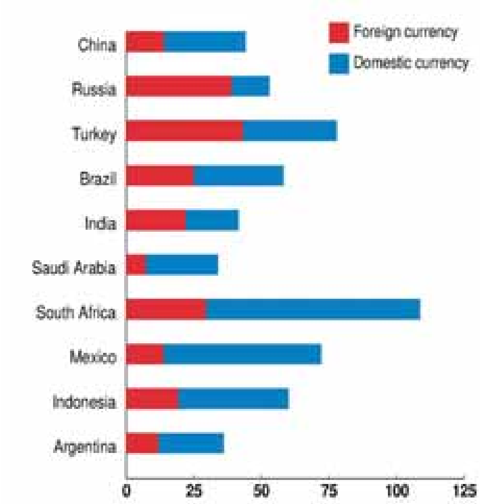
Note: OECD is the unweighted average of the countries for which data are available.
Source: OECD estimations based on Kappeler et al. (2016), "Decoupling of Productivity and Median Wage Growth: Macro-Level Evidence", OECD Economics Department Working Papers, forthcoming; OECD National Accounts database; OECD Earnings database; OECD Income Distribution database; OECD calculations.

6

Risks: Some EMEs are vulnerable to exchange rate shocks and high domestic debt

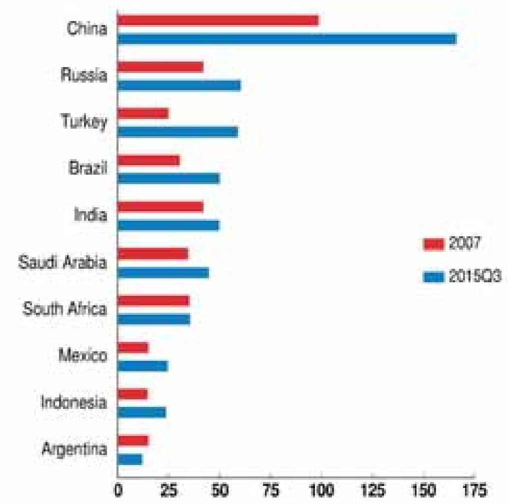
External liabilities

Per cent of GDP, 2015 Q3 or latest available



Credit to corporations has increased

Per cent of GDP



Note: Credit to non-financial corporations. For South Africa, 2008 Q1 instead of 2007.
Source: OECD June 2016 Economic Outlook database; BIS; IMF; and OECD calculations.

7

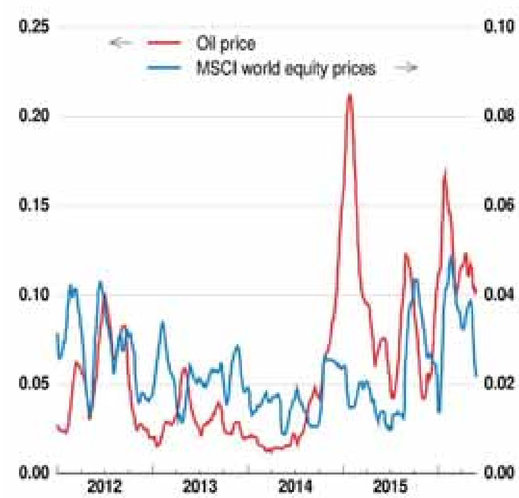
Increasing financial market volatility

Recovery only in US equity markets compared with summer 2015

Source: Thomson Reuters.

Volatility in asset markets has increased

Rolling 3-month standard deviations

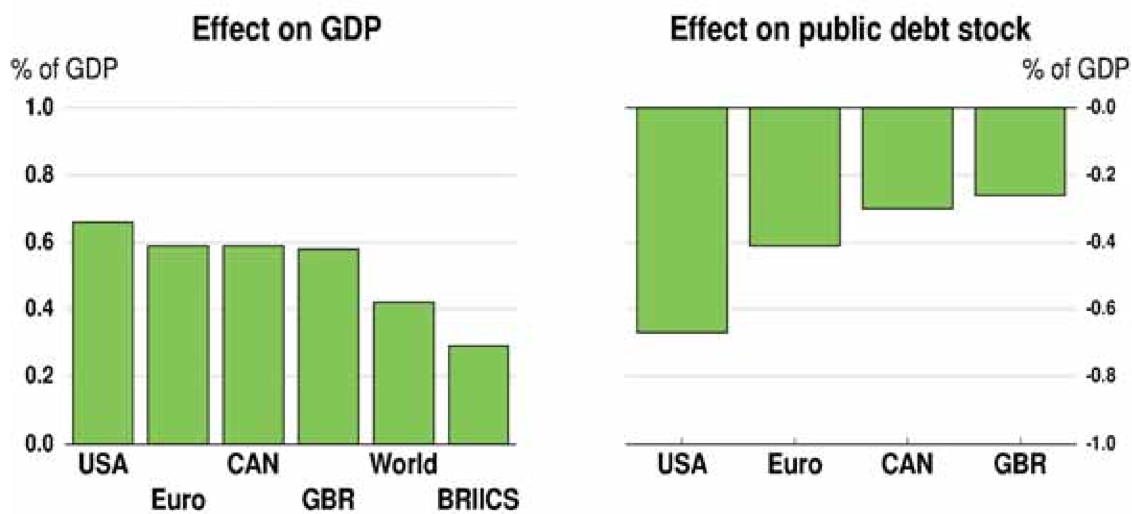


8

Getting out of the low growth trap, dealing with the risks: Fiscal policy: use the opportunity to lock-in low borrowing costs and boost growth

1st year effects of a ½ per cent of GDP public investment increase by all OECD economies

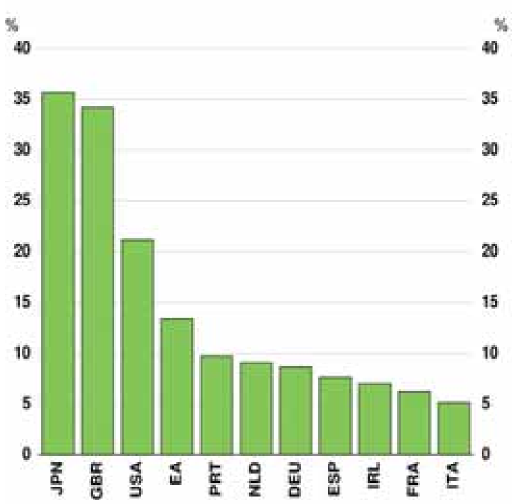
Change from baseline



Relying on monetary policy alone risks less effectiveness and harmful side effects

Some central banks are the dominant holders of government bonds

Share of total government debt securities



Source: Central banks; Thomson Reuters; and OECD calculations.

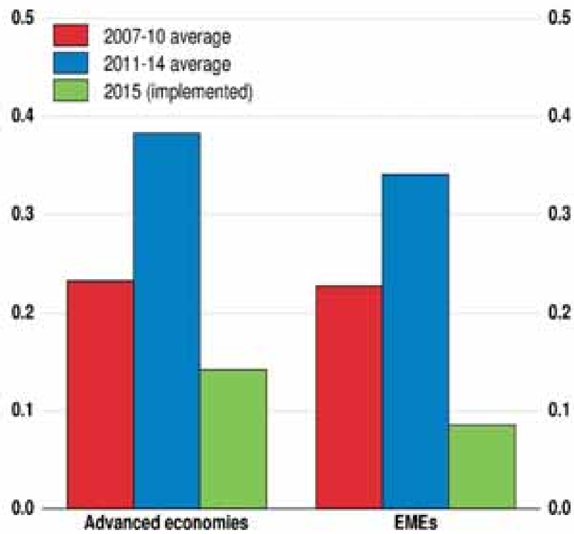
Falling bank share prices

Per cent decline over the year to May 2016

Structural policies to increase productivity can also boost demand and employment

Unique package for each country:

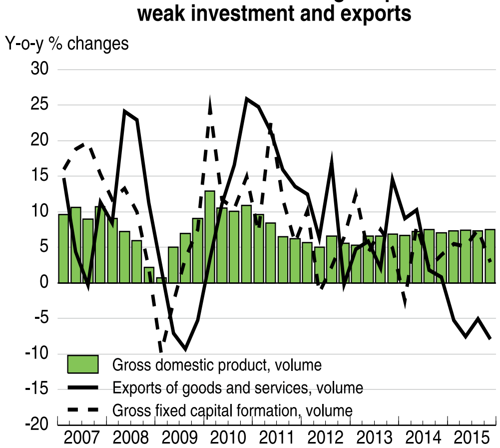
- Shift the composition of public spending to investment
- Encourage firm entry and investment in service sectors
- Reduce barriers to geographic and jobs mobility
- Package simultaneous labour and product market reforms
- Improve function of financial system and access to credit



11

India is doing better but with many challenges (exports, investment, jobs)

Growth remains strong despite weak investment and exports



Job creation in the organised manufacturing sector has languished[1]

12

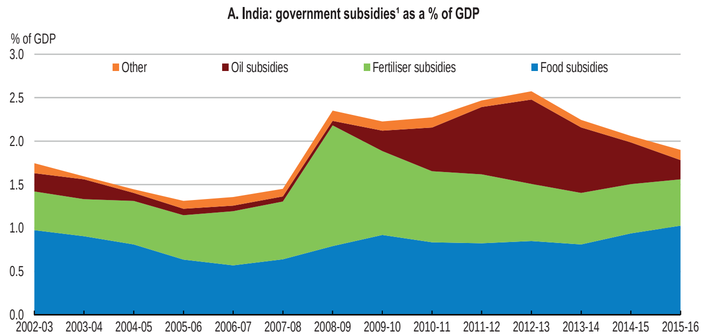
Rule based monetary policy framework and low commodity prices have helped reduce inflation and macroeconomic stability

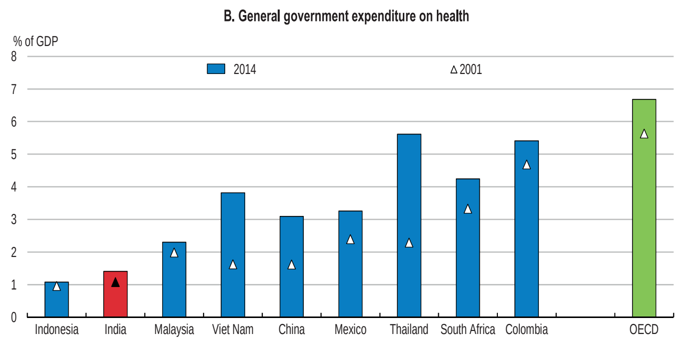
13

Fiscal policy has been prudent, but debt remains high and state deficits persistent...

14

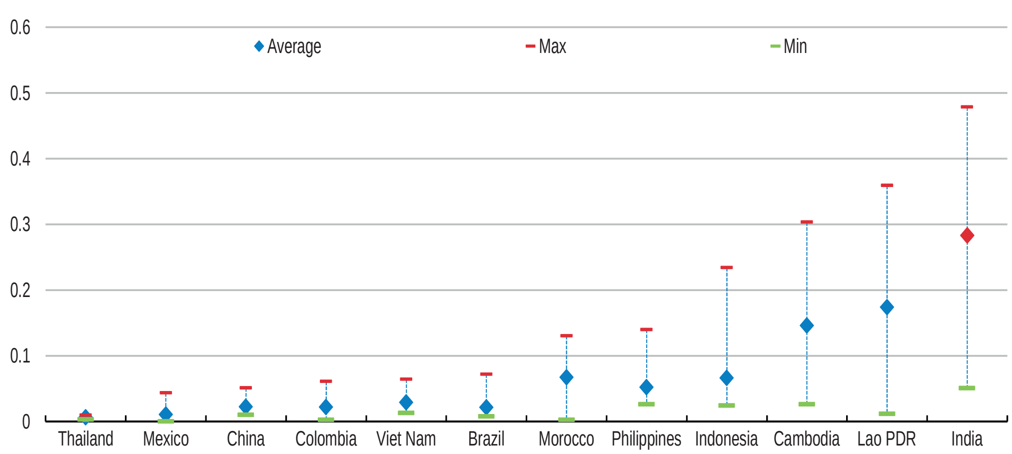
…but spending is too low to meet social and physical infrastructure needs, and poorly targeted to reduce inequalities





15

Access to public services is highly unequal between regions



16

Revenues rely too much on volatile corporate and sales taxes

Tax revenue as a % of GDP

	Brazil	China	India*	Indonesia	Russia	South Africa
	2013	2011	2013	2013	2012	2012
Taxes on income	7.6	4.8	6.3	5.6	7.9	14.6
Individuals	0.5	1.3	2.3	2.2	3.6	8.8
Corporations	3.7	3.5	4.0	3.4	3.9	5.8
Unallocated	3.4	0.0	0.0	0.0	0.4	0.0
Social security contributions	8.8	4.1	0.0	..	6.4	0.7
Taxes on payroll	0.7	0.0	0.0	0.0	0.0	0.4
Taxes on property	2.1	2.0	0.1	0.3	1.1	1.5
Taxes on goods and services	14.7	13.2	12.9	5.9	15.4	11.6
Other taxes	1.1	0.2	0.1	1.3	0.0	0.0
Total tax revenue	35.0	24.4	19.4	13.1	30.8	28.6

17

Fiscal challenges

- Reduce debt to more sustainable levels
- Raise more revenue with less distortive taxes and broader base
- Raise social (health, education, poverty) and infrastructure spending while reducing inefficient spending (subsidies)
- Revisit state-federal fiscal relations to reduce regional inequality

⇨ ***Role of fiscal rules***

18

Monetary and fiscal policy nexus

- Bank liquidity reserve – weakens monetary transmission
- High NPLs fiscal risk
- Similarity of shocks from commodity prices in fiscal and monetary policy
- Inflation
  - Excess demand from large deficits
  - Support prices and overproduction of grains versus other products in demand can increase price pressures?
  - Commodity price movements complicate fiscal policy (subsidies of food and energy)
  - tax increases

19

OECD Economics Department Work on India

Economic Survey
every two years
(next one due for publication at the end of 2016)
covers macro aspects, regional disparities and direct taxes

web

http://bit.ly/2aolV6X

Economic Outlook
bi-annual projections,
Section on India

web

http://bit.ly/2a8VtHA

Economic Policy Reforms
'Going for Growth':
Section on India -

web

http://bit.ly/2aopJ8i

20

SECTION 4:

MANAGING FISCAL RISKS

Managing Fiscal Risks

Mario Pessoa
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, June 24-25th 2016

Why Fiscal Risk Management is Relevant

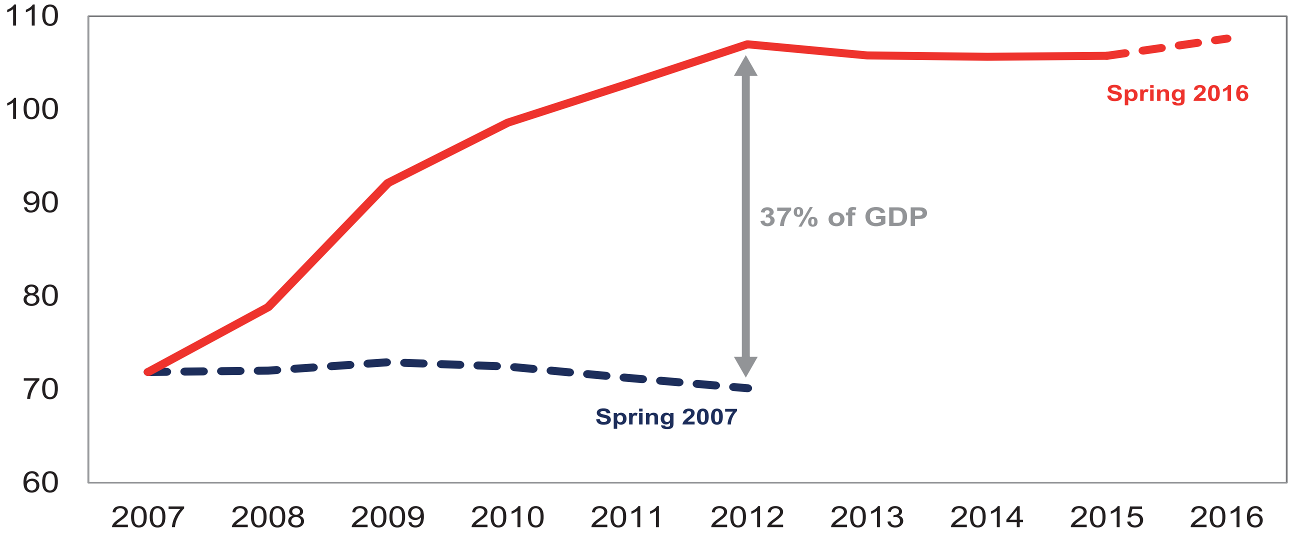
- *Fiscal outturns often differ substantially from budget or other fiscal projections*
- Shocks related to deviations of economic growth from expectations, terms of trade shocks, natural disasters, calls on government guarantees, unexpected legal claims on the state, and other situations can be very disruptive
- Unexpected spending pressures or revenue losses often require disruptive ad hoc adjustments during the fiscal year
- Failure to identify, measure, disclose, and prepare for such risks has caused additional government obligations, larger public debts, and, occasionally, refinancing difficulties and crises

2

Motivation for Studying Fiscal Risks

Advanced Economies: Public Debt

(2007-2016, Percent of GDP)



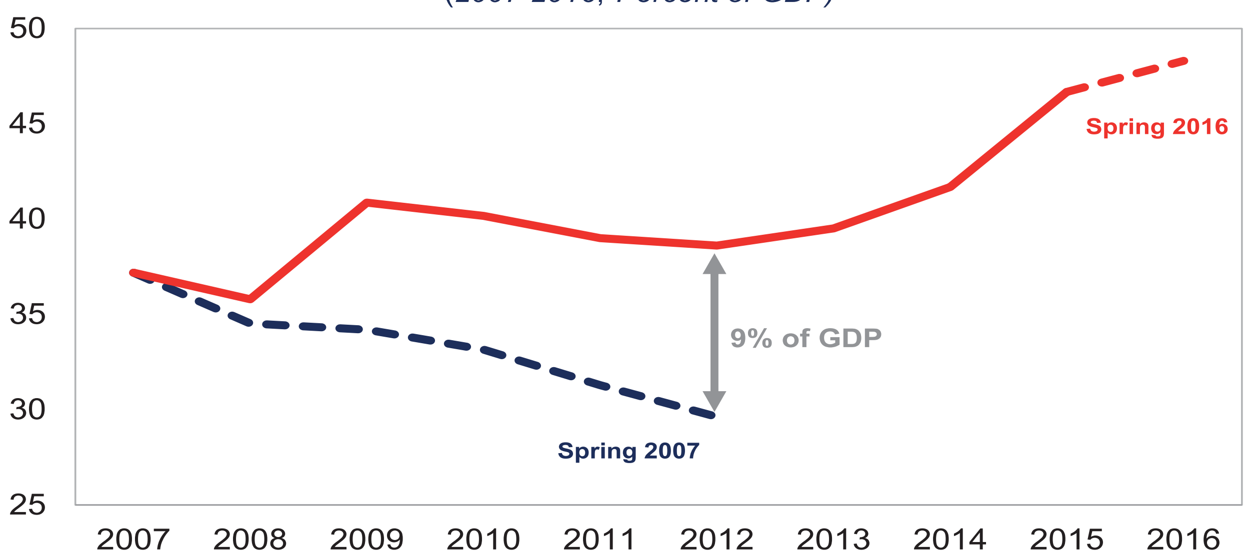
Source: *Fiscal Monitor* Database and staff estimates.

3

Motivation for the Paper

Emerging Economies, Excluding China: Public Debt

(2007-2016, Percent of GDP)



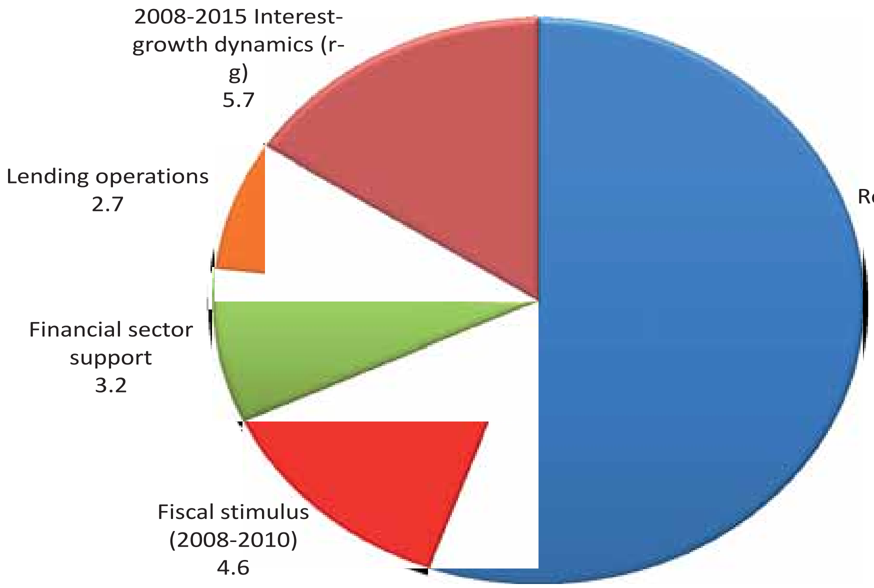
Source: *Fiscal Monitor* Database and staff estimates.

4

General Government Debt Decomposition

Advanced G-20 Economies: Change in Debt-to-GDP Ratio, 2007-15

(Total increase: 36.2 percentage point of GDP; 2009 PPP-GDP weighted)

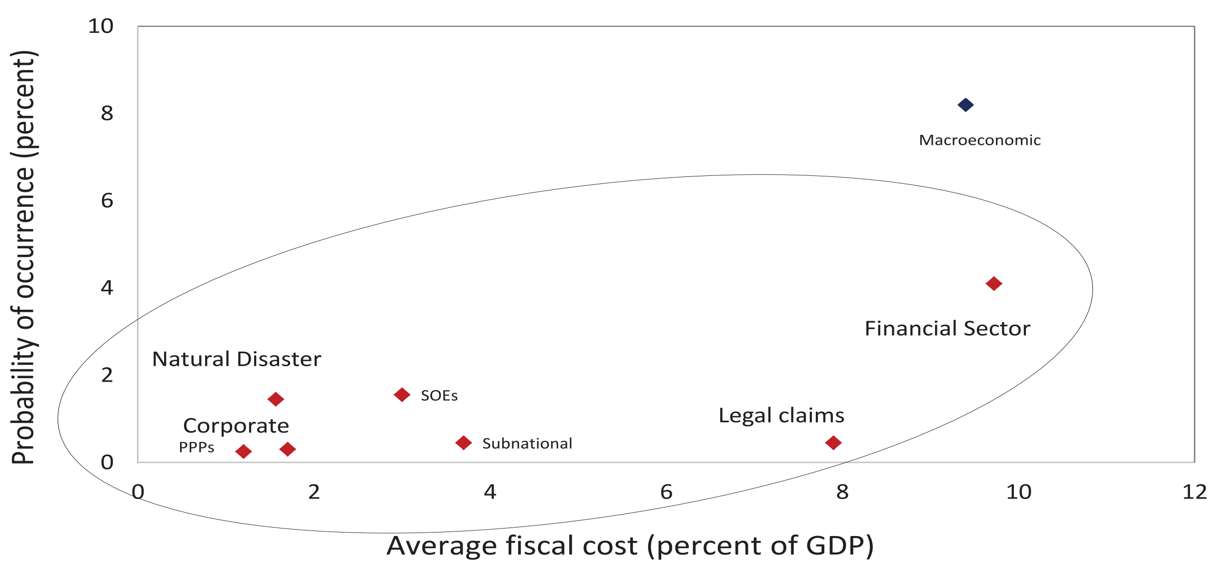


Source: IMF April 2011 *Fiscal Monitor* and staff estimates.

5

Sources of Fiscal Risk
Fiscal risks large, under-estimated, non-linear and...

Size and likelihood of fiscal shocks by type

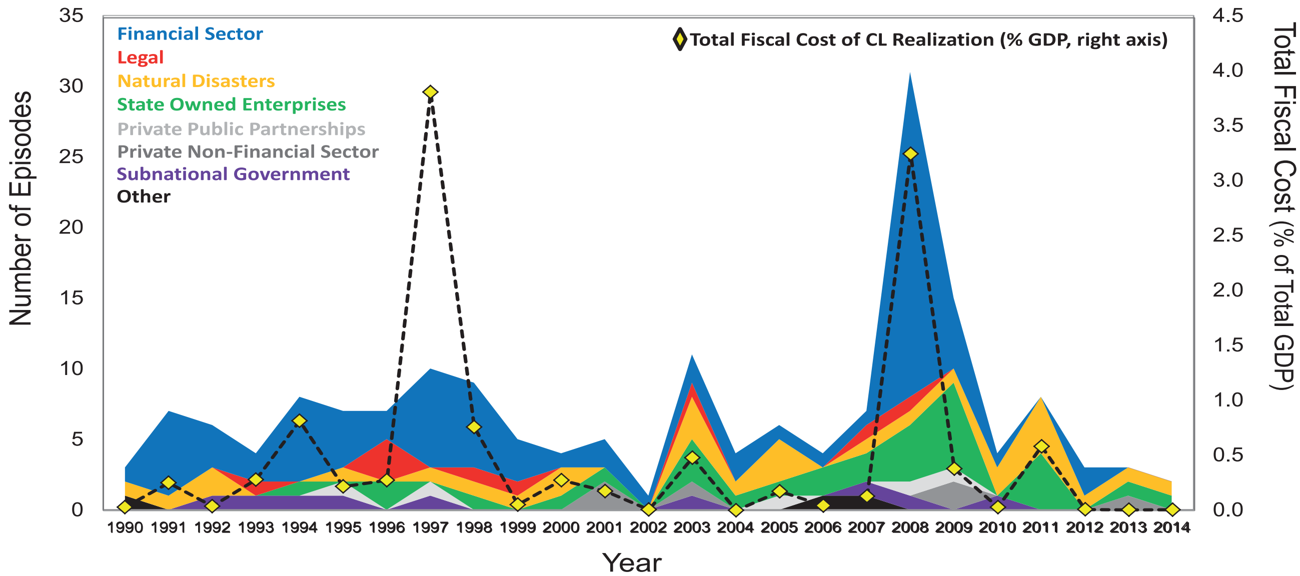


Source: Bova et al. (2016)

6

Sources of Fiscal Risk
...highly correlated

Contingent Liability Realizations

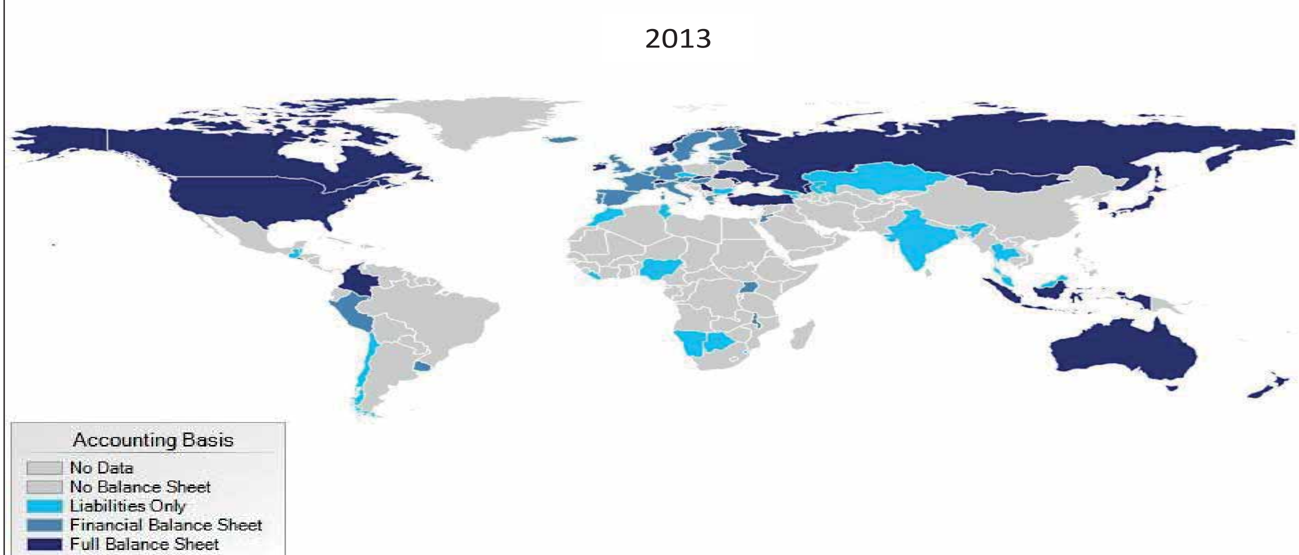


Source: Bova et al. (2016)

7

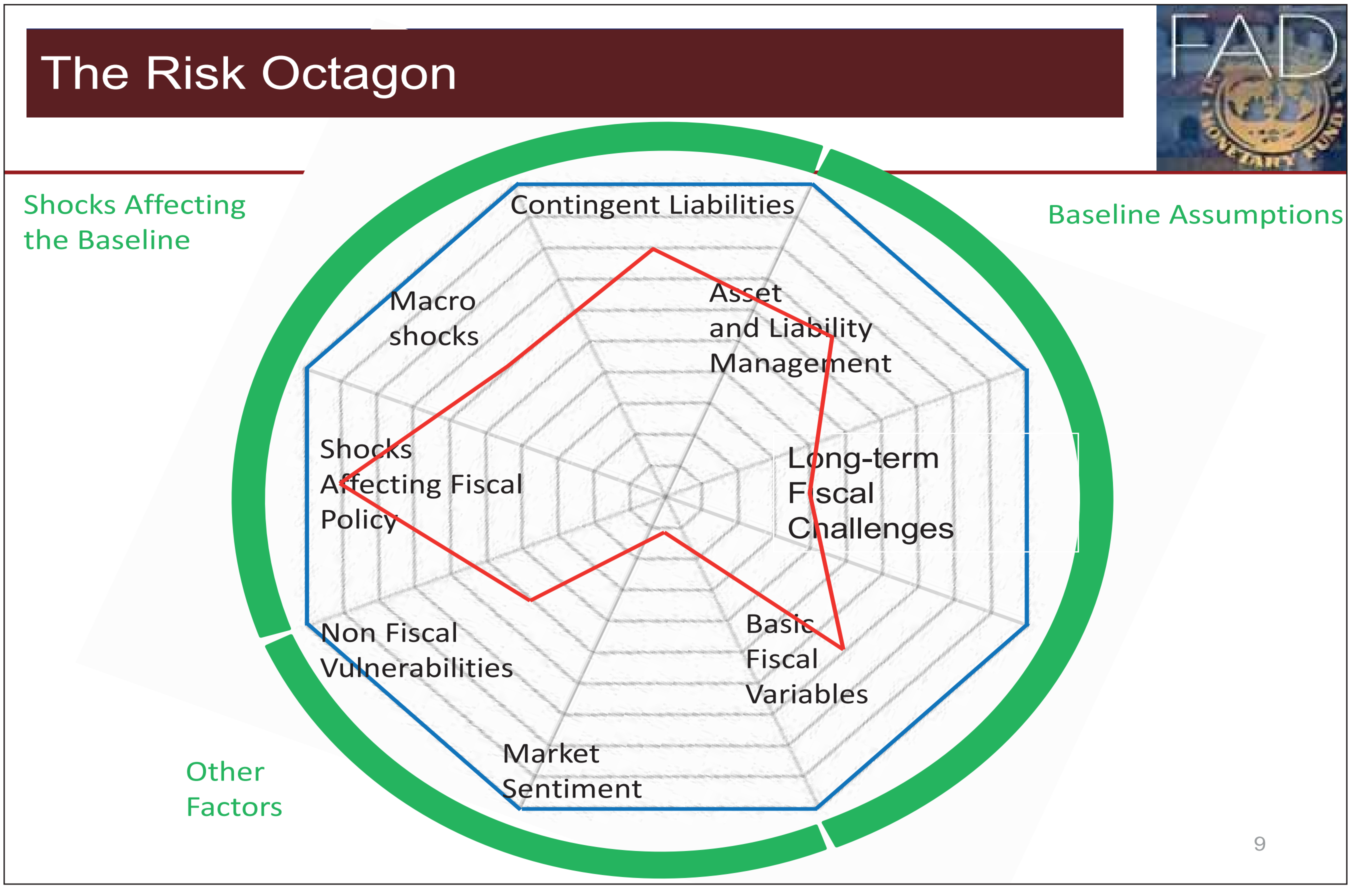
Fiscal Risk Analysis
Disclosure of risks has improved...

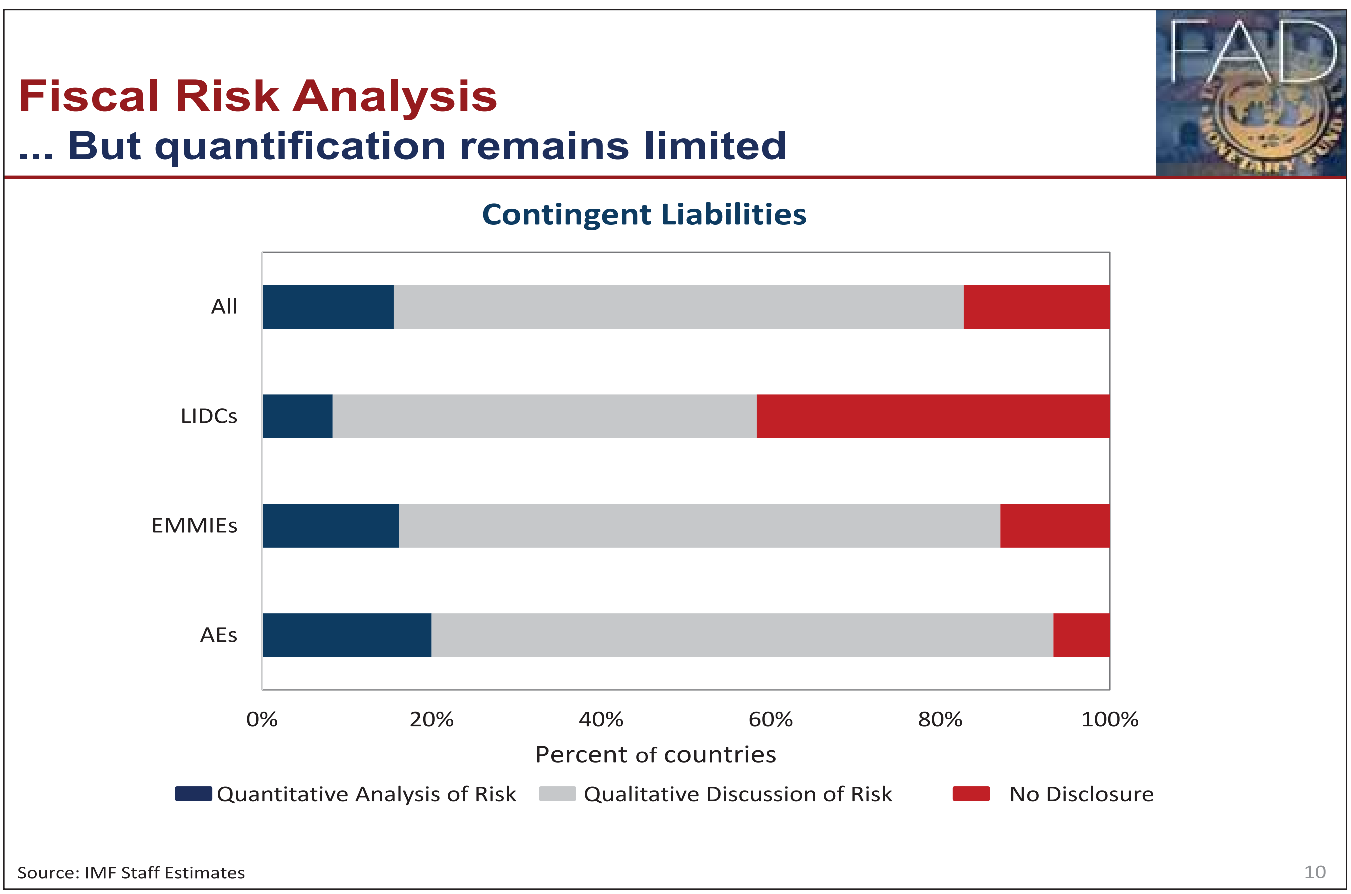
Coverage of Balance Sheet Data (GFS)



Source: COFA Database

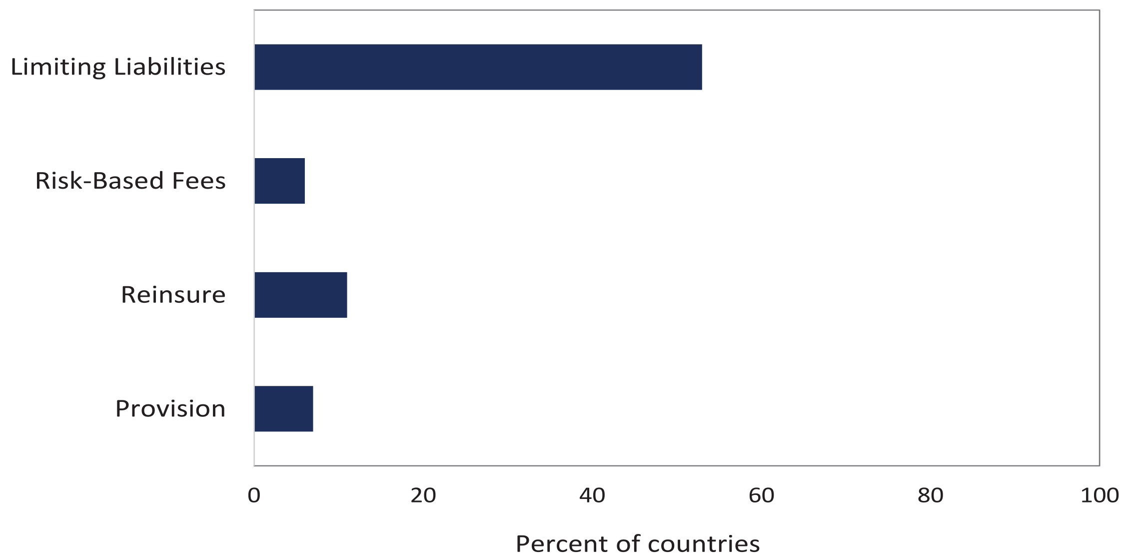
8


The Risk Octagon
FAD
Shocks Affecting the Baseline
Baseline Assumptions
Contingent Liabilities
Asset and Liability Management
Macro shocks
Shocks Affecting Fiscal Policy
Long-term Fiscal Challenges
Non Fiscal Vulnerabilities
Basic Fiscal Variables
Market Sentiment
Other Factors
9


Fiscal Risk Analysis
... But quantification remains limited
FAD
Contingent Liabilities
All
LIDCs
EMMIEs
AEs
0%
20%
40%
60%
80%
100%
Percent of countries
Quantitative Analysis of Risk
Qualitative Discussion of Risk
No Disclosure
Source: IMF Staff Estimates
10

Fiscal Risk Management
Mitigation efforts are ad hoc and fragmented

Current Practice for Guarantees

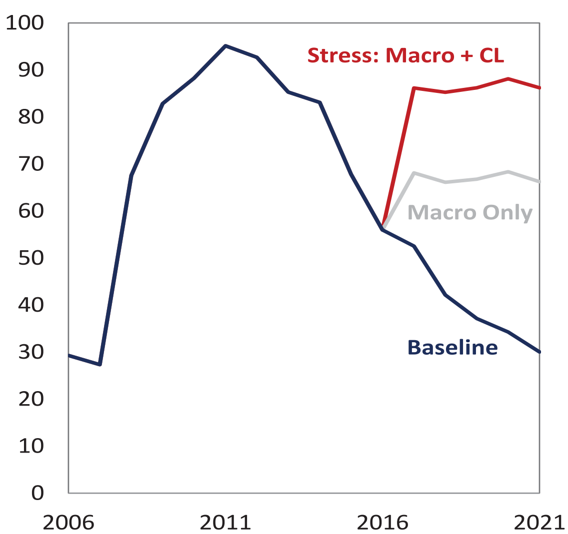


Source: IMF Staff Estimates

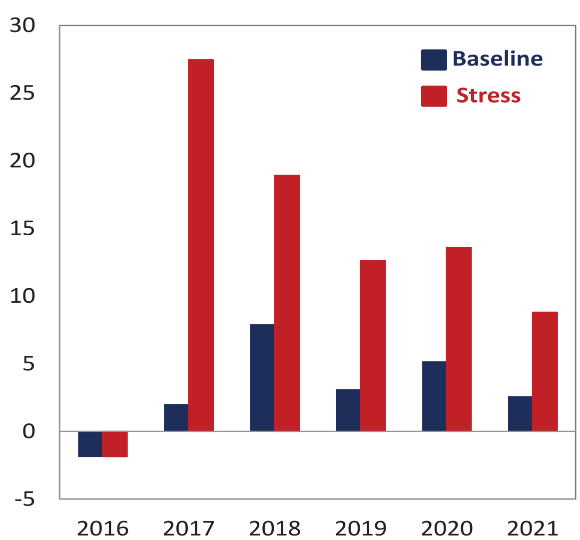
11

Fiscal Stress Test
More integrated analysis of fiscal risks: Iceland

Public Debt
(Percent of GDP)



Liquidity: Gross Financing
(Percent of GDP)



Source: IMF Staff Estimates

12

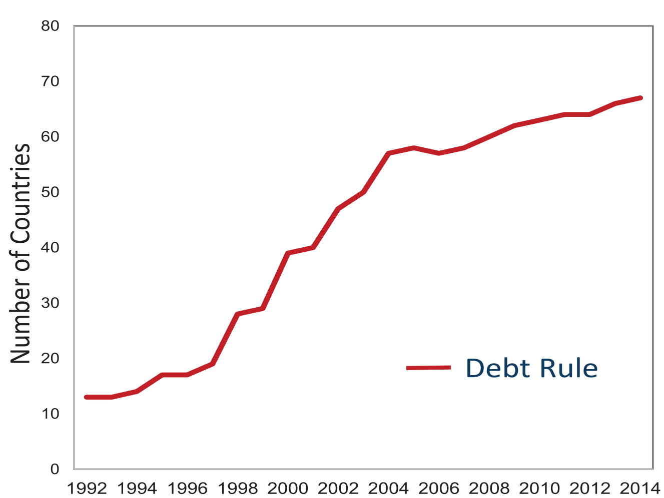
Fiscal Risk Management Toolkit
Guidance on risk mitigation strategies

STEP 1: IDENTIFY AND QUANTIFY	• Identify risks • Calculate exposure and likelihood • Weigh costs and benefits of intervention
STEP 2: MITIGATE	• Cap Exposure • Regulate • Transfer
STEP 3: PROVISION	• Expense • Budget contingencies • Buffer funds
STEP 4: ACCOMMODATE RESIDUAL	• Account for in setting fiscal objectives

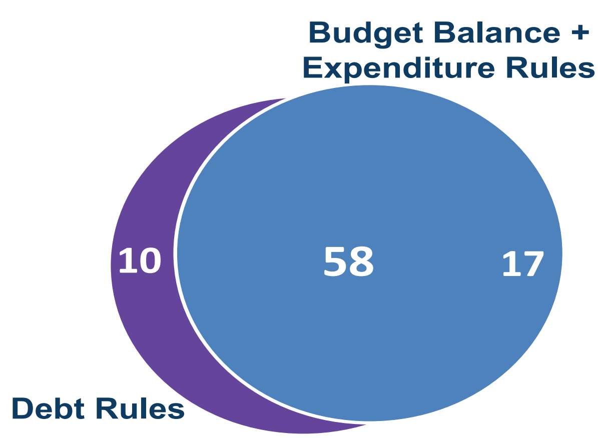
13

Fiscal Risks and Public Debt Ceilings
Adoption of debt and other fiscal rules

Evolution over time (1990-2014)



Combination of rules (2014)

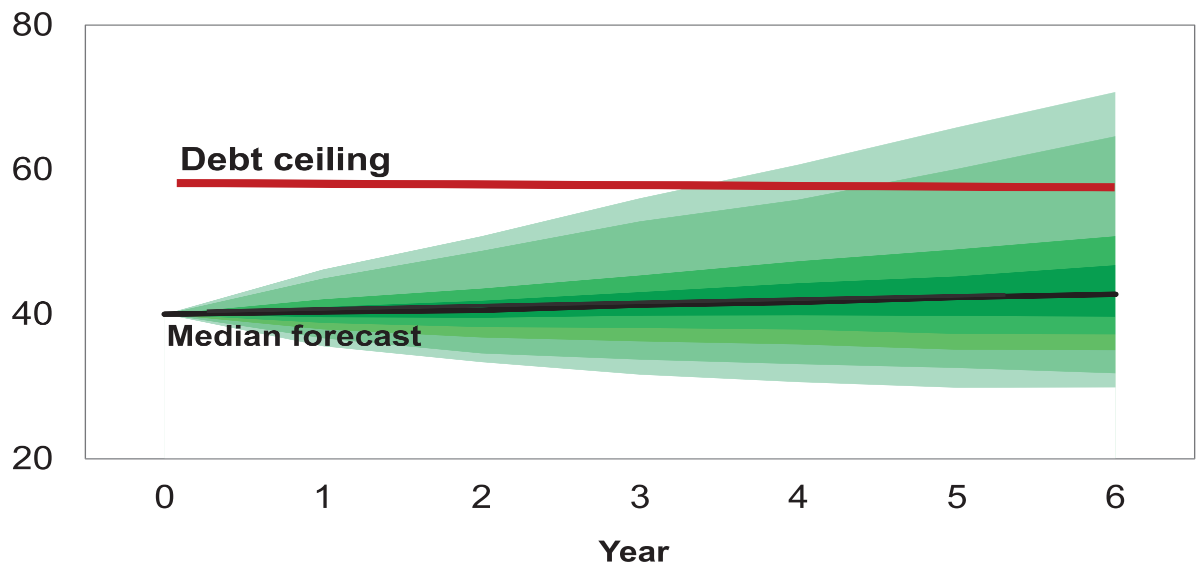


Source: IMF Fiscal Rules Database (2015)

14

Fiscal Risks and Public Debt Ceilings
Probabilistic assessment of public debt: Illustration

European Emerging Market Economy
(In percent of GDP)



Source: IMF Staff Estimates

15

Budget Institutions for Fiscal Consolidation:
10 Key Institutions

a. Understanding the Fiscal Challenge

1. Fiscal Reporting
2. Macro-Fiscal Forecasting
3. Fiscal Risk Management

b. Developing a Consolidation Strategy

4. Fiscal Objectives
5. Medium-term Budget Framework
6. Independent Fiscal Agency
7. Performance Orientation

c. Implementing through the Budget Process

8. Top-Down Budgeting
9. Parliamentary Approval
10. Budget Execution

16

Contingent Liabilities – Accounting Standards

- Under *accrual accounting, contingent liabilities (in the accounting* sense of possible payments linked to events that are less than likely to occur) are not recognized as liabilities and expenses in government accounts.
- However, for each class of contingent liability the government is required to disclose in notes to financial statements (except when the possibility of any payment is remote) a description of the nature of the contingent liability and, where practicable: (i) an estimate of the financial effect, e.g., the present value of any payments; (ii) an indication of the uncertainties about amounts or timing; and (iii) possible reimbursement.
- On the other hand, if the probability that payments would have to be made is more than 50 percent, and the payments can be reliably estimated, then the government is required to recognize in its accounts a liability (referred to as *provision) and a corresponding expense.*
- Disclosure requirements include: (i) stocks at the beginning and end of the period; (ii) breakdown of the flows during the period; (iii) description of the nature of the obligation and the timing of payments; (iv) indication of uncertainties regarding amount and timing; and (v) the amount of any reimbursement.1 Under *cash accounting, standards allow, but do not require, disclosure of* information about contingent liabilities along the lines set out above.

17

Statement of Fiscal Risks

- **Macroeconomic Risks and Budget Sensitivity**
- **Public Debt**
- **Contingent Central Government Expenditure**
  - *Contingent Liabilities*
  - *Financial Sector*
  - *Legal action against the state*
  - *Natural Disasters*
- **Public Private Partnerships - PPPs**
- **State-Owned Enterprises - SOEs**
- **Subnational Governments**

18

Risk Management
Four approaches to dealing with uncertainty

1. Exclusion

Excluding volatile/non-discretionary items from the ceiling, such as:
- debt interest
- unemployment benefits
- social security
- earmarked revenues
- local government (own resources)

2. Adjustment

Adjusting ceilings to accommodate real economy effects, such as:
- inflation (Finland, Netherlands)
- volume changes (Sweden, Australia)
- revenue windfalls (Netherlands, Canada)

3. Reserves & Margins

Building contingency margins into expenditure projections or ceilings*:
- Netherlands: 0.25%
- UK: 0.75 – 1%
- Canada: 1.5 – 2%
- Sweden: 1.5 – 3%
- Australia: 1.5 – 5%

4. Budget Architecture

Designing budgets so that pressures can be absorbed within them:
- maximum of 20-30 main budget headings
- each budget a mixture of discretionary and non-discretionary items
- maximum flexibility to reallocate within those budgets
- mandatory expenditure recycling targets

* Share of total budget

19

Policy Implications
Fiscal risk analysis

- All countries should seek to *increase their use of probabilistic methods*
- Low capacity countries should focus on
  - *macro-fiscal sensitivity analysis*
  - *financial balance sheet*
  - *disclosing explicit contingent liabilities*
- Intermediate capacity countries should prioritize
  - *alternative macro-fiscal scenarios*
  - *full balance sheets*
  - *disclosing all contingent liabilities*
- High capacity countries should concentrate on
  - *disclosing the size and probability of contingent liability realizations*
  - *periodic fiscal stress tests*

20

Policy Implications
Fiscal risk management

- All countries should *strengthen their institutional frameworks and centrally manage their risks*

- Low capacity countries should look to *strengthen direct controls and centralize approval of explicit contingent liabilities*

- Intermediate capacity countries should prioritize *more effective use of risk mitigation and transfer tools*

- Advanced capacity countries should *build risk exposure into fiscal plans*

21

Further Reading

- IMF Policy Paper – *Analyzing and Managing Fiscal Risks: Best Practices*, 2016
- IMF Working Paper 11/2012 - *A Toolkit to Assessing Fiscal Vulnerabilities and Risks in Advanced Economies.*
- IMF (2011) Fiscal Monitor. *Addressing Fiscal Challenges to Reduce Economic Risks*, September.
- IMF FAD Paper (2008) – *Fiscal Risks: Sources, Disclosure, and Management*, Aliona Cebotari et al.

22

Questions and Answers

Thank you!

23

SECTION 5:

INTERACTION OF FISCAL AND MONETARY POLICY

Fiscal Rules and Inflation Targeting

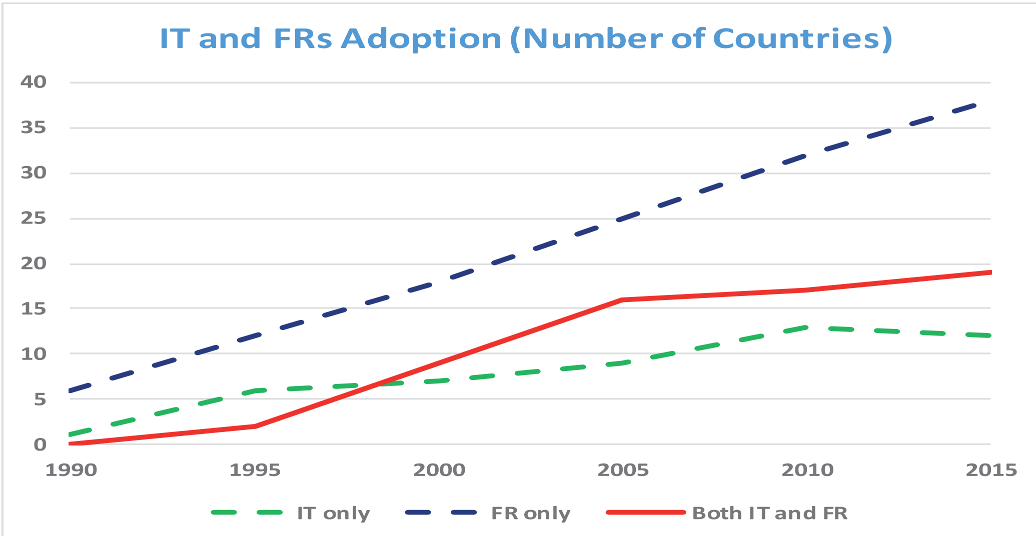
Rene Tapsoba
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, August 18, 2016

Objective

- The presentation revolves around the relationship between FR and IT regimes.
- It will address the questions received from the FRBM Review Committee:
  - What are the relationships between FRs and IT?
  - How should medium-term fiscal targets be determined in the context of inflation targeting regimes?
  - What can be learnt from other country experiences in coordinating fiscal and monetary policies, in light of RBI's inflation target announcement in 2016?

2

Growing reliance on Fiscal Rules (FRs) and Inflation Targeting (IT)



3

I. Why FRs and IT Work Best Together?

4

I. Why FRs and IT Work Best Together? (1/2)

"*In the realm of inflation control, it is generally true that it is the joint behavior of monetary and fiscal policy that matters, even in normal times*" (Leeper, 2009)

- **Higher risk of breaching the inflation target in the absence of FRs:**
  - Pressure on the Central Bank to monetize public debt and set sub-optimal interest rates (fiscal dominance).

No FRs → Fiscal dominance → Inflation

  - Fiscal indiscipline can lead to current account pressures and currency depreciation and, in turn, higher inflation.

No FRs → Fiscal indiscipline → Currency depreciation → Inflation

5

I. Why FRs and IT Work Best Together? (2/2)

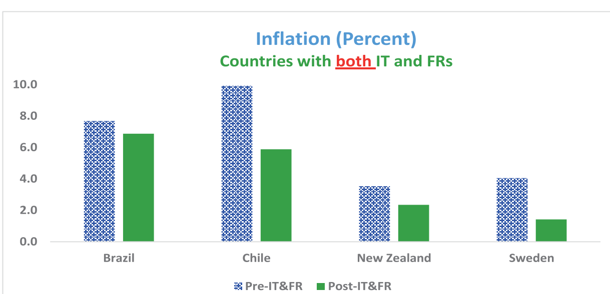
- **Higher risk of missing fiscal targets in the absence of IT:**
  - A good forward-looking framework for inflation projections can help set credible **expenditure targets**.
  - IT-driven price stability makes it easier to meet **revenue targets**:
    - ✓ Low inflation improves revenue collection when tax brackets are not indexed.
    - ✓ Low inflation volatility helps stabilize and improve predictability of the tax base.

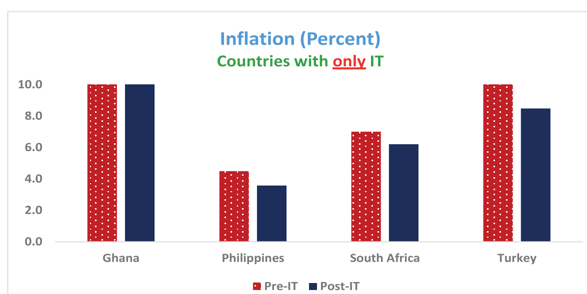
6

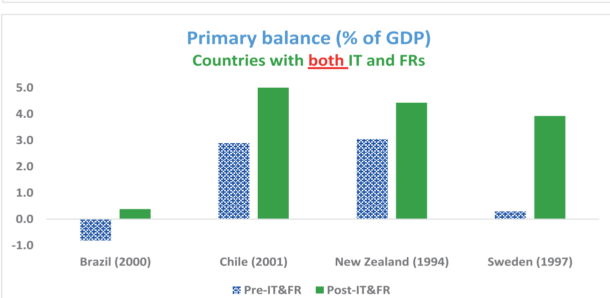
II. Empirical Evidence on Benefits of Joint IT and FR Adoption

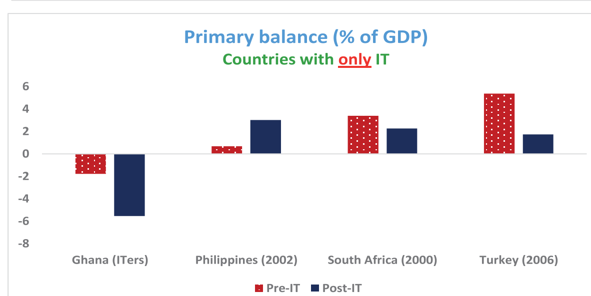
7

II. Preliminary Evidence Based on Correlations









Pre-IT&FR: average of 5 years preceding 2nd regime adoption
Post-IT&FR: average from 2nd regime adoption until 2008 (excl. Great Recession)

Pre-IT: average of 5 years preceding IT adoption
Post-IT: average from IT adoption until 2008 (excl. Great Recession)

8

II. Econometric Results

- **Self-selection bias.** Disciplined countries tend to adopt IT and FRs: does it mean that disciplinary outcomes are not due to IT and FRs?

- **Results** (Minea and Tapsoba, 2014; and Combes and others, 2014):

	Effects on Inflation rate	Effects on Primary Balance (% GDP)
Adopting IT only	Reduces by 2-3 %	Improves by 1 percentage point
Adopting FR only	Not statistically significant	Improves by 1-2 percentage points
Adopting both IT and FR	Reduces by 4-5 %	Improves by 2-3 percentage points

  – The impact also depends on the **nature** of the FR: **stronger** complementarity effect when IT is backed with a combination of **ER and DR** or **BBR and DR** (compared to DR only).

9

III. Operational Considerations

10

III. Institutional Coordination: Joint Agreement on Targets

- **Inflation Target**: Central bank and ministry of finance should set jointly the inflation target—or at least be jointly committed to reaching the target (e.g. Australia, Canada, Indonesia, New Zealand, etc.).

- **Fiscal Targets**: the budget, along with its accompanying macroeconomic framework, should incorporate the inflation forecasts from the IT framework.

11

III. Consistency of Targets

- IT targets (level or range) should be consistent with the medium term fiscal targets.

- Avoid loose IT target with tight FR or the opposite.

- The FR could include a correction mechanism for inflation deviation (as in Israel).

12

III. Other operational considerations

- FRs should be accompanied with legislations **prohibiting public debt monetization** by the central bank, to back the IT regime (e.g. **Brazil**, **Chile**, **Israel**, **Norway**, **United Kingdom, etc.**).
- **Changes in administered prices**: strong coordination is needed between the central bank and the government on timing and magnitude.
- In case of large deviation from the inflation target, an **escape clause** could be considered if conditions for its activation can be clearly defined.
- **Sequencing**: introducing first FRs before adopting IT yields stronger benefits. This was the case in India.

13

References

14

References

- Blanchard, O. (2005). Fiscal Dominance and Inflation Targeting: Lessons from Brazil. NBER. WP #10389.
- Combes, J-L., Debrun, X., Minea, A. and Tapsoba, R. (2014). Inflation Targeting and Fiscal Rules: do Interactions and Sequencing Matter?, IMF WP #14/89.
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- Minea, A. and Tapsoba, R. (2014), Does Inflation Targeting Improve Fiscal Discipline?, *Journal of International Money and Finance*, 40, 185-203.
- Mishkin, F. (2000). Inflation targeting in emerging-market countries. *American Economic Review,* 90, 105–109.
- Roger, S. and Stone, M. (2005) On Target? The International Experience with Achieving
- Inflation Targets, IMF WP #05/163.
- Sargent, T. and Wallace, N. (1981). Some unpleasant monetarist arithmetic. *Federal Reserve Minneapolis Quarterly Review*, 5, 1–17.
- Sims, C. (2005). Limits to inflation targeting. In: Bernanke, B., Woodford, M. (Eds.), The Inflation Targeting Debate. The University of Chicago Press, 283–308.
- Woodford, M. (1994). Monetary policy and price-level determinacy in a cash in-advance economy. *Economic Theory*, 4, 345–348.

15

Case Studies

16

Case Studies

	CHILE: IT adopted while inflation still at Double-Digits	NEW ZEALND: IT adopted while inflation at Single-Digit
Interaction Features (between monetary and fiscal policy)	1) Soft IT backed by drastic fiscal reforms: budget surplus required from 1991 to 1997, after which fully-fledged IT takes place in 1999. In 2001, formal FR adoption (SB of 1% of GDP for 2001-07; SB=0.5% of GDP in 2008; SB=0% of GDP with escape clause in 2009). 2) Law enacted in 1990 to grant central bank independence	1) Fully-fledged IT and joint negotiation of a Policy Targets Agreement (PTA) between the Governor and the MOF. 2) Fiscal Responsibility Act in 1994 to back the IT regime (public debt should not exceed prudent levels, about 20% of GDP).

SECTION 6:

SECOND-GENERATION FISCAL FRAMEWORKS: KEY ISSUES

International Experiences: Designing Second Generation Fiscal Rules

Mario Pessoa
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, June 24-25th 2016

Outline

1. Types of Numerical Rules and Pros and Cons
2. Second Generation Fiscal Rules
3. Designing and Tailoring Second Generation Rules
4. Fiscal Rules, Legal Framework, Coverage, Escape Clauses, and Sanctions
5. Conclusions

2

1. Types of numerical fiscal rules and Pros and Cons

- **Debt Rules**
  - Set an explicit limit for the *stock* of public debt. The purpose is to signal to the market that debt level and cost of the debt service is sustainable over time.
  - *Examples*:
    - **Kosovo:** Debt ceiling of 40 percent of GDP.
    - **Poland:** Debt ceiling for general government of 60 percent of GDP, established in Constitution and Public Finance Act.
    - **Panama:** Debt ceiling of 40 percent of GDP.
    - **Slovak Republic:** Debt ceiling of 60 percent of GDP.
    - **EU:** debt ceiling of 60 percent of GDP.

3

1. Types of numerical fiscal rules and Pros and Cons

- **Budget Balance Rules**
  - Constrain the size of the deficit and thereby control the *evolution* of the debt ratio.
  - May account for the business cycle and one-off factors (structural budget balance rule).
  - *Examples:*
    - **EU:** Limit for overall balance of 3 percent of GDP, limit on structural balance of -0.5/-1 percent of GDP.
    - **Germany:** Deficit of no more than 0.35 percent of GDP in structural terms.
    - **Sweden:** Surplus of 1 percent of GDP over the cycle.
    - **USA:** Most of the States have a zero deficit rule.

4

1. Types of numerical fiscal rules and Pros and Cons

- **Expenditure Rule**
  - Limit total/primary/current spending.
  - Either limit on ratio to GDP/revenue/other spending, nominal growth, or real growth.
  - *Examples:*
    - **Brazil:** Personnel expenditure is limited to 50 percent of net current revenue for the federal government and 60 percent for states and municipalities. Permanent spending mandates cannot be created without permanent revenue increases or spending cuts. Recent discussion is to limit the increase the primary expenditure to the level of inflation for 20 years with a review after 10 years (not approved yet)
    - **Belgium** (1993-98): Real growth of primary spending equal or less than 0 percent for central government.
    - **Sweden:** Binding ceilings for nominal expenditure for next three years that are consistent with a budget surplus of 1percent of GDP in structural terms.

5

1. Types of numerical fiscal rules and Pros and Cons

- **Revenue Rule**
  - Set ceiling or floor on revenues.
  - Determine use of windfall revenues.
  - *Examples:*
    - **Denmark (2001-11):** Don't raise direct or indirect taxes.
    - **Kenya:** Maintain revenues at 21-22 percent of GDP.
    - **France:** Determine ex ante the allocation of higher than expected tax revenues.
    - **Guatemala:** Revenues of at least 12% of GDP.

6

1. Types of numerical fiscal rules and Pros and Cons

DEBT RULES

Set an explicit limit for public debt

+ Direct link to debt sustainability

+ Easy to communicate and monitor

- No clear short-term guidance

- Can lead to pro-cyclicality

BUDGET BALANCE RULES

Constrain the evolution of the debt ratio

+ Clear operational guidance

+ Easy to communicate and monitor

- Can lead to pro-cyclicality

But: Structural budget balance rule

- More complicated, less transparent

EXPENDITURE RULES

Limit total / primary / current expenditure

+ Clear operational guidance

+ Allows for economic stabilization

+ Rel. easy to communicate / monitor

- No direct link to debt sustainability

- Could lead to manipulation and changes in composition (capital vs current)

REVENUE RULES

Set ceilings or floors on revenues

+ Steers the size of government

+ Can improve revenue policy and administration

- No direct link to debt sustainability

- Can lead to pro-cyclicality

7

1. Types of numerical fiscal rules and Pros and Cons
Two Key Trade-Offs

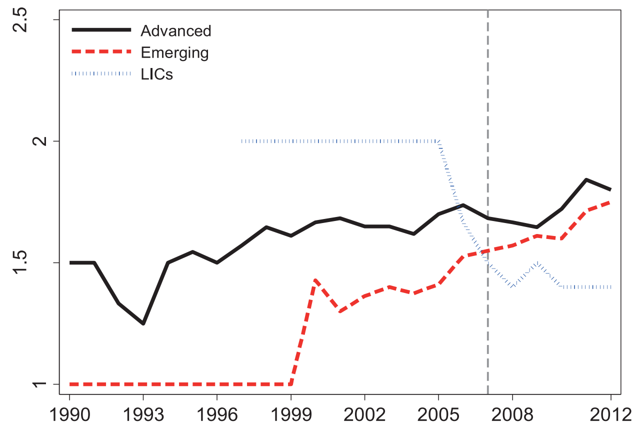
- **Credibility-flexibility:** allowing for greater responsiveness to shocks could undermine credibility of attaining the final goal.

- **Flexibility-simplicity:** combinations of rules or more elaborated rules can relax somewhat the credibility-flexibility trade-off, at the cost of simplicity and transparency.

2. Second Generation Fiscal Rules

- More countries are operating with more than one numerical fiscal rule. This helps to mitigate the cons of individual rules.
- However, this may come at the risk of inconsistent targets and too many rules that may complicate fiscal policy making.

Average Number of National Fiscal Rules



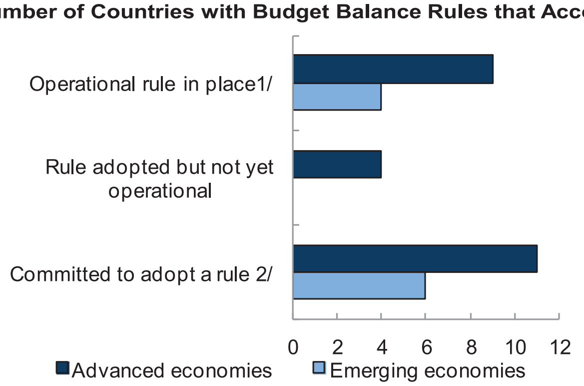
Sources: Schaechter and others (2012).

9

2. Second Generation Fiscal Rules

- More countries are adopting rules that provide flexibility to deal with the ups and downs of the business cycle. These can take the form of cyclically adjusted or structural budget balance rules.

Number of Countries with Budget Balance Rules that Account for the Economic Cycle



Sources: Schaechter and others (2012).

1/ Includes those with a clearly specified transition path.

2/ Includes those EU member states that have signed the Fiscal Compact but have not yet adopted a rule that accounts for the cycle.

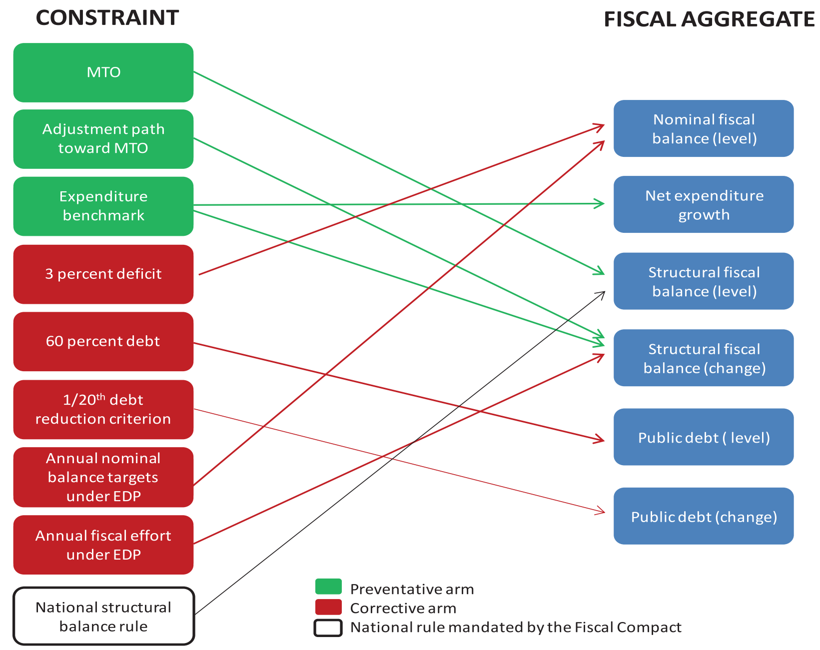
10

2. Second generation of fiscal rules

→ To allow for more flexibility many of these rules are becoming increasingly complex, which poses problems in terms of compliance and monitoring;

→ *Smarter* rules can be associated with loopholes which could make it easy to circumvent the rules

Fiscal rules in the EU



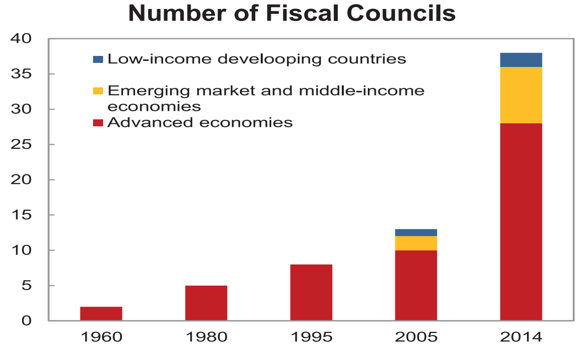
Source: Eyraud and Wu, 2014.

11

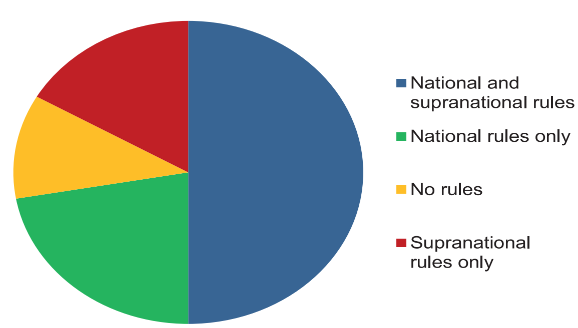
2. Second Generation Fiscal Rules

- **Some countries are strengthening enforcement mechanisms, including through the use of automatic correction mechanisms (debt brakes).**
- **A growing number of countries are also introducing fiscal councils as complements to fiscal rules.**

Number of Fiscal Councils



Fiscal Councils and Fiscal Rules



Source: IMF Fiscal Councils Dataset and staff estimates.

12

3. Designing Second Generation Fiscal Rules

- **There is no one-size-fits-all fiscal policy rule that is always and everywhere ideal. Much depends on:**
  - Constellation of shocks prevalent in the economy.
  - Nature and magnitude of policy bias under discretion.

- **In principle, a good rule should be:**
  - …simple,
  - …coherent with the final goal,
  - …but mindful of other goals of public policy :
    - Not discouraging structural reforms,
    - Allowing for fiscal stabilization (time frame, cyclical adjustment),
    - Avoiding low-quality adjustments (undue tax hikes, cuts in quality/priority spending).
  - …transparent.

  (Kopits and Symansky, 1998)

13

3. Designing Fiscal Rules Objectives

1. Simplicity	The rule should understood by decision-makers and the public.
2. Sustainability	Compliance with the rule should suffice to ensure long-term sustainability. (Final goal)
3. Stabilization	Following the rule should contribute to macroeconomic stability, or at least not add to volatility. (Other goals)
4. Operational Guidance	It should be possible to translate the rule into clear guidance in the annual budget process. (Simplicity and transparency)
5. Resilience	To build credibility, a rule should last and be robust to shocks. (Other goals)
6. Verification	It should be possible to verify if the government has complied with the rule. (Simplicity and transparency)

14

3. Key Design Considerations for Rules

- **Legal basis:** constitutional, statutory, coalition agreement, political commitment
- **Coverage:** level of government and budgetary items
- **Flexibility:** Structural balance and escape clause
- **Enforcement:** automatic correction mechanisms, sanctions, and reputational costs

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)

Sources: 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.

15

4. Pros and Cons of Different Legal Bases

- **Constitutional**
- **Statutory**
- **Coalition agreement**
- **Political commitment**

Pros for higher-level legislation

✓More difficult to reverse fiscal rules or modify even with a change of government.
✓Reflects a broad consensus.
✓Rules tend to be longer lasting.
✓Confers more stability to the framework.

Cons for higher-level legislation

– More difficult to adopt.
– Can often not be rapidly implemented.
– May not enhance effectiveness if enforcement mechanisms and accountability procedures are weak.
–More difficult to adapt to changing circumstances

16

4. Government Coverage: What to include?

- When different levels government are responsible for fiscal policy, central government rules are often combined with sub-national rules (*Example:* Brazil).
- Alternatively, general government rules are apportioned to the different government levels (*Example:* Germany).
- Public sector aggregates (comprising nonfinancial enterprises that play key policy functions) should be considered when quasi-fiscal activities of these enterprises are large (fiscal rules in many Latin American countries cover the non-financial public sector) (*Example:* Mexico, Panama, Peru).

17

4. Economic Coverage: Pros and Cons

	Exclude	Include
Interest payments	• Not under the control of the government in the short run. • May be highly volatile and require short-term adjustments in other expenditure categories, with capital spending often the easiest to be cut.	• Compatible with objectives for overall public debt and tax burden.
Cyclically-sensitive	• Not under the control of the government in the short run. • May weaken the countercyclicality of fiscal policy and require short-term adjustments in other expenditure	• Compatible with objectives for overall public debt and tax burden. • Avoids political discussion on what items to exclude. • Most cyclical sensitivity is on the revenue side not the expenditure side.
Capital expenditure	• It is politically easier to be cut than current expenditure and thus short-term ad hoc adjustments in capital spending may negatively impact long-term growth prospects ("golden rules" exclude capital expenditure).	• Compatible with objectives for overall public debt and tax burden. • More transparent. Excluding capital spending could lead to reclassification of • Not all capital spending raises productivity and long-run growth. • Other spending on human capital investment could be as or more effective in stimulating growth as public

18

4. Flexibility in Fiscal Rules- Escape Clauses

- **Structural balance**
  - Provides room for maneuver when economy is weak.
  - Require well defined cycle, less transparent.
  - Require accurate calculation of output gap which can be problematic in developing countries

Escape clauses provide flexibility to rules in dealing with rare events outside of the government's control.

- **Well-specified escape clauses** → should include:
  - Limited range of factors that allow such escape clauses to be triggered in legislation (emergencies, natural disasters).
  - Clear guidelines on interpretation and determination of events (including voting rules).
  - Specification on path back to the rule and treatment of accumulated deviations.

19

4. Cross-country evidence: Flexibility

Some examples of escape clauses

Country and Date	Natural disaster	Economic recession	Banking system bailout, guarantee schemes	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

Source: FAD Fiscal Rules Dataset.

20

4. How to Enforce Fiscal Rules?

- **Automatic correction mechanisms**
- **Personal or institutional sanctions**
- **Independent fiscal institutions ("Fiscal Councils")**
  - help effective functioning of rule by issuing early warnings, independent forecasts and ensuring enforcement of rule.
- **Other Mechanisms maximizing reputational cost**
  - Obligation to publicly explain deviations
  - Publication of violation in an official journal, website, public hearings in the Parliament

21

4. Automatic Correction Mechanisms

- **<u>Automatic correction mechanisms</u>: They specify in advance (in legislation) when and how to correct deviations from the rule. Now a requirement for EU countries that have signed the "Fiscal Compact."**
- **Supports the rule's enforcement and credibility.**
- **Examples:**

Germany, Switzerland: Deviations (positive or negative) are stored in a notional account; when the accumulated deviation exceeds a threshold, improvements in the structural balance are required within a pre-defined timeframe to undo these deviations.

Poland, Slovakia: Actions are triggered when certain debt thresholds are reached (e.g., MoF explanation to parliament and suggest measures; cabinet to adopt measures and freeze wages; cabinet to submit a balanced budget; expenditures to be cut by 3 percent).

22

4. Escape Clauses

Circumstances, triggers & interim requirements

	Circumstances	Trigger	Interim Requirements
United Kingdom	Not specified	None	Statement setting out: • reasons for departure from rules • period of time to return to rules • temporary operating rule
New Zealand	Temporary circumstances	MoF statement to Parliament	Statement setting out: • reasons for deviation from principles • plan for returning to principles • time before return to principles
Brazil	• Low economic growth • National disaster • State of siege	Acknowledgement by National Congress or State Legislature	None
Germany	• Natural disaster • Other emergencies outside state control • "disturbance to macro-economic equilibrium"	Affirmative vote by simple majority of Bundestag "seats"	Binding adjustment plan to return borrowing below limit within reasonable timeframe

23

4. Sanctions

- **Personal sanctions**
  - Criminal proceedings for specified alleged breaches
  - Disciplinary procedures that lead to pay reductions or dismissal
- **Institutional sanctions**
  - Suspension of budget payments to other spending authorities until breach situation is rectified
  - Denial of rights to borrow or issue guarantees
  - Adjustment program for government: requirement to follow an adjustment program that is automatically triggered by specified breaches of fiscal rules
  - Close monitoring of adjustment measures (as in EU)

24

4. Enforcement: Sanctions—Examples

- **Personal sanctions:**

  Brazil: Public officials who breach the Financial crimes law can be fined, dismissed or jailed. Estimated that there are 64 violations for omission or fault that give rise to penal sanctions.

- **Institutional sanctions:**

  Ecuador: Failure to provide information by an institution can result in denial of access to credit, suspension of transfer of budget appropriations.

- **Reputational costs:**

  Australia, New Zealand, United Kingdom: Results are published and commented on. Poor results can affect credibility of government.

25

4. Pros and Cons of Sanctions

Pros

- ✓ Could promote effectiveness of rule by ensuring that cost of breaking it is higher than benefit of doing so.
- ✓ Could promote compliance when all levels involved follow strict procedures.

Cons

- ✓ Require third party enforcer.
- ✓ Formal sanctions generally difficult to implement and likely come with delays.
- ✓ May lead to political instability.

26

5. Conclusions

- **There is no "one-size-fits-all" approach**
  - Fiscal rules need to be tailored to country specific economic and institutional characteristics
  - Reflected in diversity of fiscal rules that are in place
- **Wide range of choices potentially available, need to think about:**
  - Objectives the rule should address
  - Coordination with other macroeconomic policies
  - Desired degree of flexibility
  - Other design features
  - Challenges: how to enforce rules?

27

5. Conclusions

- **Coordination with other macroeconomic policies**
  - Monetary policy and exchange rate regime
  - Consider state of financial system (potential bailouts required in future)
- **Desired degree of flexibility**
  - Decide on whether to use structural/cyclically adjusted balance rule
  - Need for flexibility higher the greater the exposure to external shocks
  - But requirements even more demanding than for other type of rules (more complex, cycle needs to be well defined)
  - Alternative may be to use expenditure rule

28

Further Reading

- Kopits, G. and S. Symansky (1998), Fiscal Rules, IMF Occasional Paper 162.
- Daban, T. and others (2003), *Rules Based Fiscal Policy in France, Germany, Italy and Spain*, IMF Occasional Paper 225.
- IMF Working Paper (2008) WP 08/87 *A New Fiscal Rule: Should Israel "Go Swiss"?*
- IMF (2009), *Fiscal Rules: Anchoring Expectations for Sustainable Public Finances*.
- Schaechter, A and others (2012), *Fiscal Rules in Response to the Crisis: Toward the "Next-Generation" Rules*. A New Dataset. IMF WP 12/187.
- Eyraud and Wu, (2014), *Playing by the Rules: Reforming Fiscal Governance in Europe*, IMF WP 15/67.

29

Questions and Answers

Questions and Answers

Thank you!

Thank you!

30

FISCAL FRAMEWORKS: BEST PRACTICES AND THE WAY FORWARD

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OCDE
DES POLITIQUES MEILLEURES POUR UNE VIE MEILLEURE

Outline

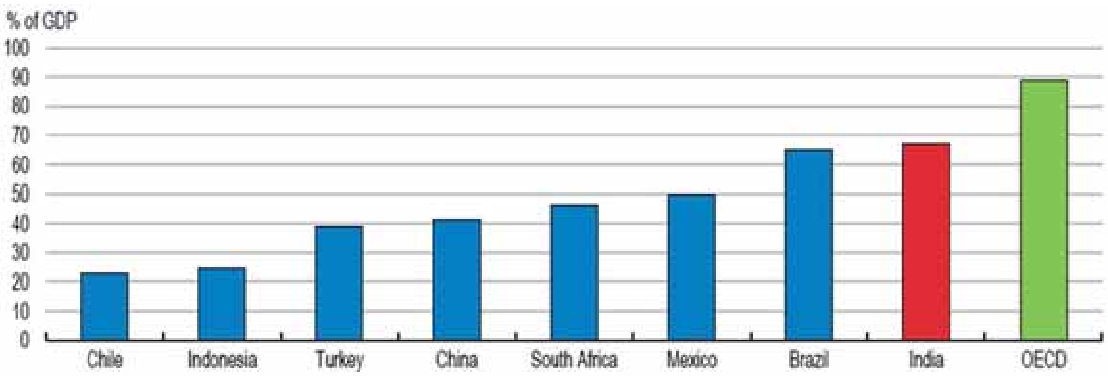
- Main objectives of a fiscal framework:
  - keeping debt to a prudent level for the economy to grow and to ensure intergenerational equity
  - leading to an efficient and inclusive tax and spending level and mix
- Fiscal rules in practice
- New fiscal framework: main elements
- Fiscal federalism considerations

2

India's debt is high compared to other EMEs

Main objectives

Public debt, 2014 or latest available year



3

Level and composition of spending and revenue

Main objectives

- It matters for **growth** → it matters for **sustainability** $\downarrow \frac{Debt}{GDP \uparrow}$
- It matters for **equity:** horizontal, vertical, intergenerational
- It matters for **the environment** (e.g. reliance on fossil fuel subsidies)

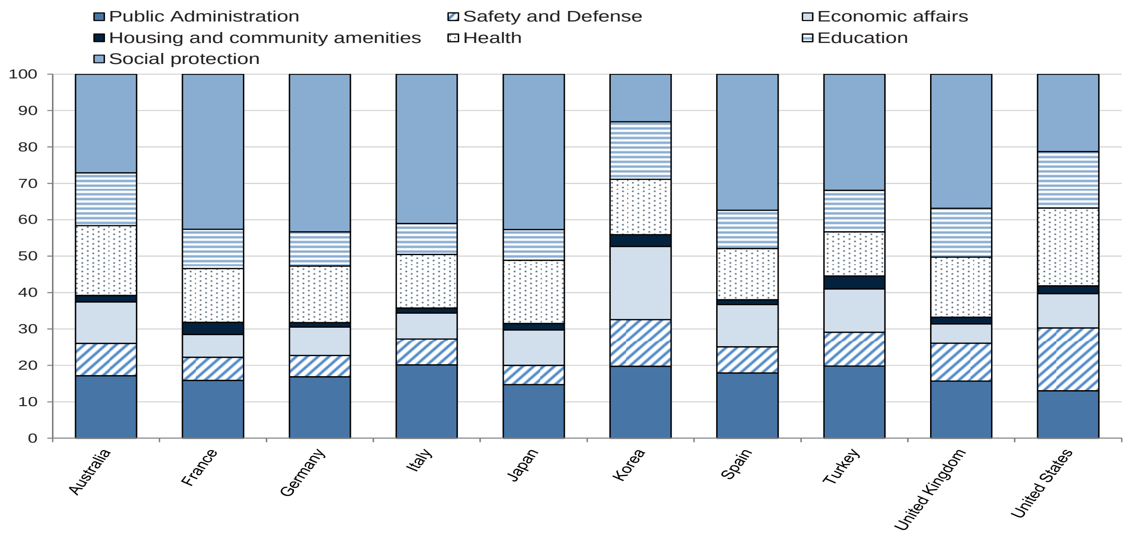
✓ **India** needs to increase **growth-, equity- and environment-friendly spending** on physical and social infrastructure, health, education etc.

✓ This needs to be offset by **a sustainable increase in tax revenue**

4

Main objectives

Governments make different choices about how to spend



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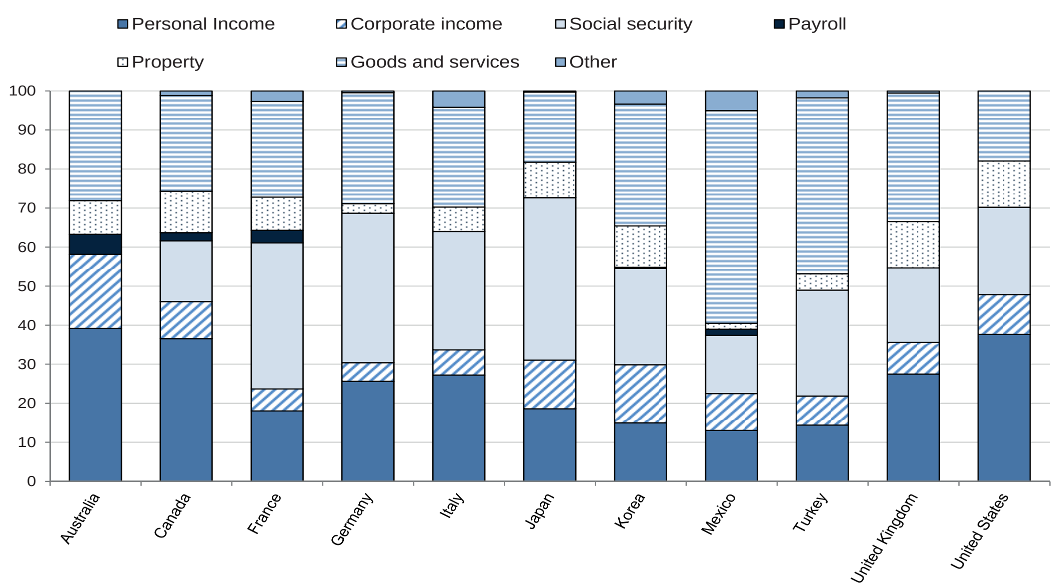
Main objectives

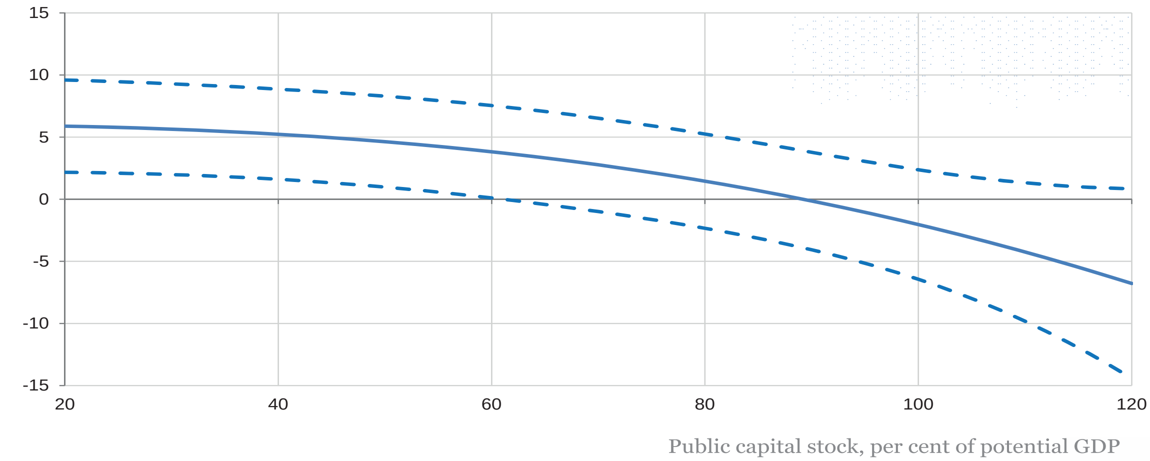
Different choices about how to tax: levels, composition, tax structures



Main objectives

The quality of spending also matters

GDP gain of one spending point increase of **public investment**, in per cent



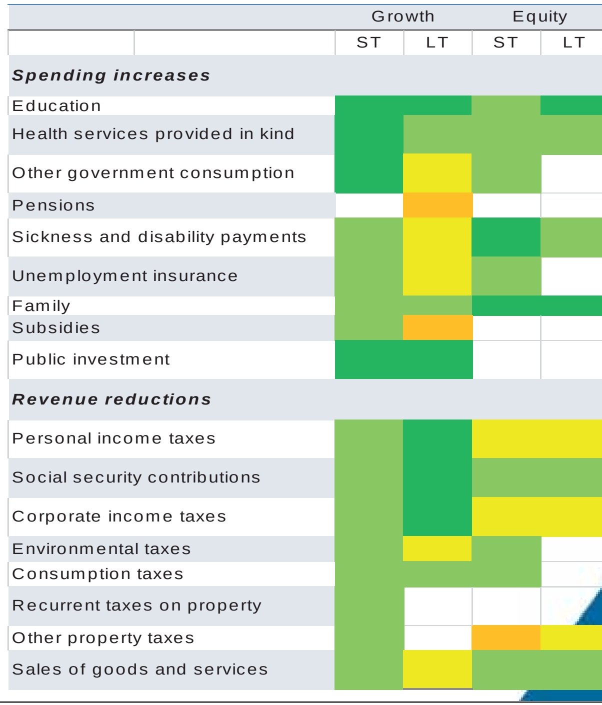
Public sector salary negotiations and determination of pay, 2010

	No salary negotiation (based on a committee or similar recommendation)	Centralised collective bargaining	Decentralised collective bargaining	Individual bargaining	Pay indexed to	Frequency of salary negotiations
Australia			x			
Austria		x				annual
Belgium		x			inflation+other	annual
Canada		x				other
Chile		x				annual
Czech Republic		x				every 2 years
Denmark		x				other
Estonia			x			annual
Finland		x				other
France		x				annual
Germany		x				every 2 years
Greece	x					
Hungary		x	x		inflation	annual
Iceland		x			inflation	other
Ireland		x				other
Israel		x			other	other
Italy		x			inflation	other
Japan	x					annual
Korea	x				other	annual
Mexico		x			inflation	annual
Netherlands		x			other	every 2 years
New Zealand			x			other
Norway		x				annual
Poland	x				other	
Portugal		x				annual
Slovak Republic		x			other	annual
Slovenia		x			inflation	annual
Spain					inflation	annual
Sweden		x	x	x	other	annual
Switzerland		x			inflation	annual
Turkey		x			inflation	annual
United Kingdom			x			other
United States	x				inflation	annual
Brazil		x				
Russian Federation	x				inflation	other

8

Fiscal choices for inclusive growth

- Growth and equity impacts can be assessed
- Short- and long-term
- Some trade-offs
- Some synergies



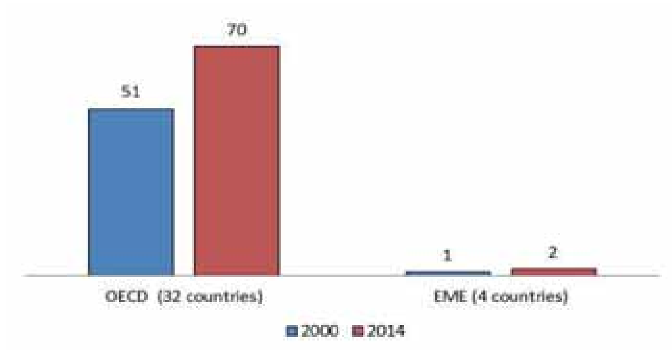
Green indicates beneficial effect, **dark green strong effect**
Yellow indicates harmful effect, **dark yellow strong effect**
Source: Cournede et al., 2015

EXISTING FISCAL RULES

Existing fiscal rules

The number of rules has markedly increased in OECD countries

Number of fiscal rules



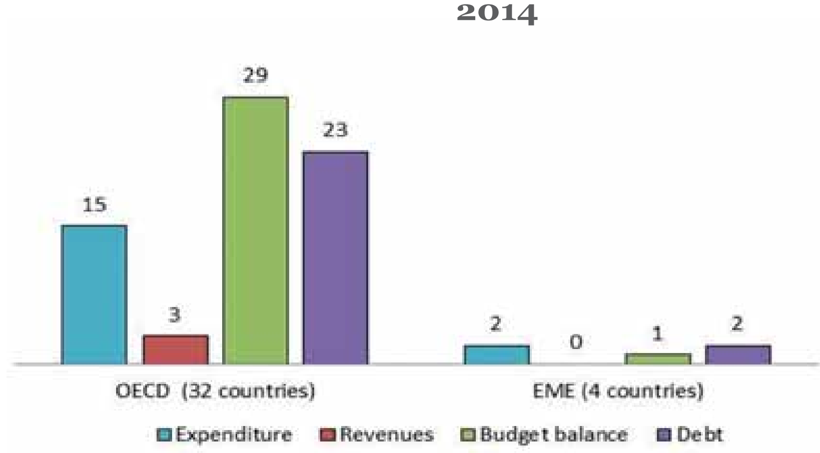
Note: EME includes Brazil, India, Indonesia, Russia
Source: IMF database (April 2015)

11

Existing fiscal rules

Deficit and debt rules are the most prevalent

Number of fiscal rules, by category 2014



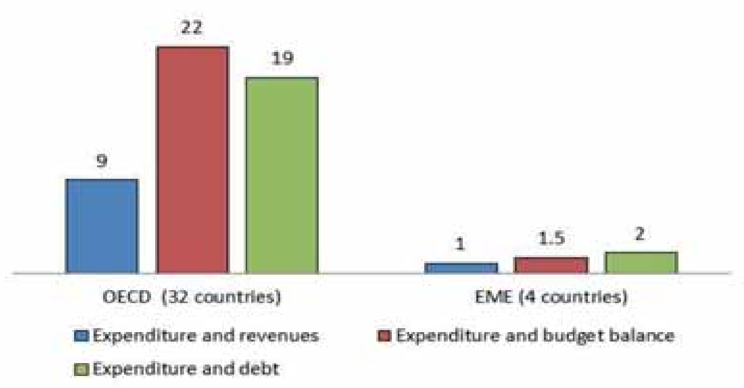
Note: EME includes Brazil, India, Indonesia, Russia
Source: IMF database (April 2015)

12

Existing fiscal rules

Often more than one rule applies

Number of combined fiscal rules 2014



Note: EME includes Brazil, India, Indonesia, Russia
Source: IMF database (April 2015)

13

Existing fiscal rules

Country experience: Germany

German debt brake:

- **Structural budget balance** of both the **central government** (max. 0.35% of GDP deficit) and each of the **states** (0% of GDP deficit; fully operational from 2020),
- Deviations booked on a **control account** which cannot exceed 1% of GDP and have to be reduced by max 0.35% of GDP annually
- **Escape clause** : Natural disaster and emergency situations
- Even though the central government and the states are autonomous, a **Stability Council** brings together finance ministers of the federation and each of the states for **mutual budgetary surveillance**

14

Existing fiscal rules

Country experience: Austria

Austrian Stability Pact:

Similar provisions apply as in Germany;

- the structural budget balance (-0.1% of GDP) applies to **the sum of structural budget balances of the states and municipalities**,
- the shares of each state in this balance is given by its share of inhabitants in total;
- the central government can have a structural deficit up to 0.35% of GDP

15

Existing fiscal rules

Country experience: Switzerland

Swiss debt brake:

Federal expenditure may not exceed receipts over an economic cycle. The annual expenditure ceiling is linked to the amount of receipts, which are adjusted using a factor that takes the economic environment into account. Over- and underspending is recorded in a **compensation account**, its deficits have to be eliminated

In **extraordinary circumstances**, e.g. severe recessions or natural disasters, the expenditure ceiling can be raised by a qualified majority of both chambers of parliament. Extraordinary expenditure has to be paid off in subsequent years.

16

EU fiscal rules

Existing fiscal rules

	Rule / ***Correction mechanism if rule not met***
Headline deficit rule	< 3% of GDP
	improvement in structural balance of min 0.5% of GDP per year
Debt rule	<60%
	reduction of the excess debt by ≈1/20th per year
Structural balance rule	≥ -0.5% of GDP
	0.5% of GDP per year adjustment towards it or deviation from it
Expenditure rule	growth of primary expenditure net of revenue discretionary measures ≤ medium-term potential GDP growth rate

17

MAIN ELEMENTS OF NEW FISCAL FRAMEWORK

Basic requirements for an effective fiscal framework

New framework

- **Data**:
  - Transparent, accessible, comprehensive
  - Presenting a full national overview of the public finances – **encompassing central and sub-national levels of government**
- **Accrual budgeting:**
  - Accounting that shows the full financial costs and benefits of budget decisions, including the impact upon financial assets and liabilities
- **Budgetary forecasts:**
  - Unbiased, realistic, transparent
  - Identifying and managing risks (e.g. sensitivity analyses)

OECD Budgeting Principles, covering these and other good budgeting practices:
http://www.oecd.org/gov/budgeting/Recommendation-of-the-Council-on-Budgetary-Governance.pdf

19

Designing effective fiscal frameworks

New framework

Question: How can fiscal frameworks be designed to achieve sustainability while providing scope to respond to the economic cycle?

Sustainability target: effective in anchoring expectations about future fiscal policy. The prudent debt target serves as the reference point to define numerical fiscal rules.

Fiscal rules:

- Role: Promote fiscal discipline, long-term growth and intergenerational equity
- Objectives: (1) Anchor fiscal policy expectations by targeting a prudent debt level and (2) allow for macroeconomic stabilisation.
- Challenges: the trade-off between reducing recession risks and debt trajectory uncertainty.

20

New framework

Designing debt targets

Debt limit

breaching it leads to default

Debt threshold

debt starts to have an adverse effect on growth and the ability to stabilise the economy

Prudent debt level

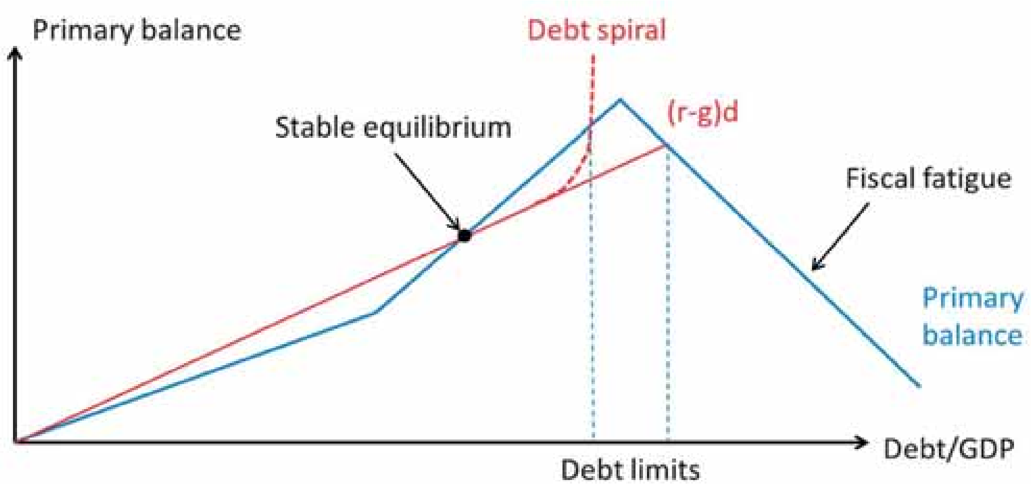
set to avoid overshooting of the debt threshold;

the reference point to define numerical fiscal rule

21

New framework

Limits to debt sustainability

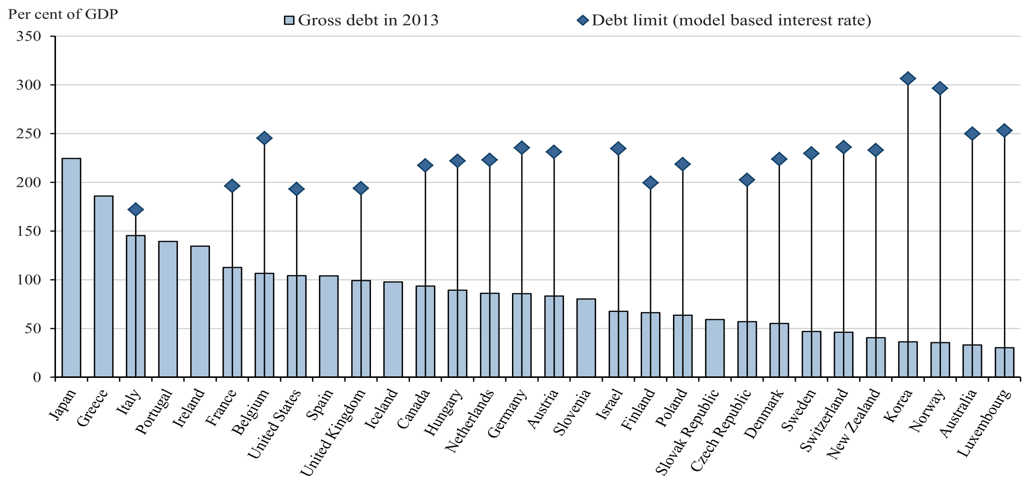


22

Sustainability limits may look high, but countries should steer clear of them

New framework

Debt limits cannot be the anchor for fiscal policy



Source: Fournier and Fall (2015)

23

Defining a debt threshold as the anchor of prudent debt targets

New framework

- The debt threshold takes into account:
  - the impact of debt on growth;
  - the effectiveness of fiscal policy in stabilising the economy; and
  - the link between debt and the provision of public infrastructure.
- Debt thresholds:
  - Advanced economies: 70-90% of GDP
  - Euro area countries: 50-70% of GDP
  - **Emerging economies: 30-50% of GDP**

24

New framework

Designing prudent debt targets

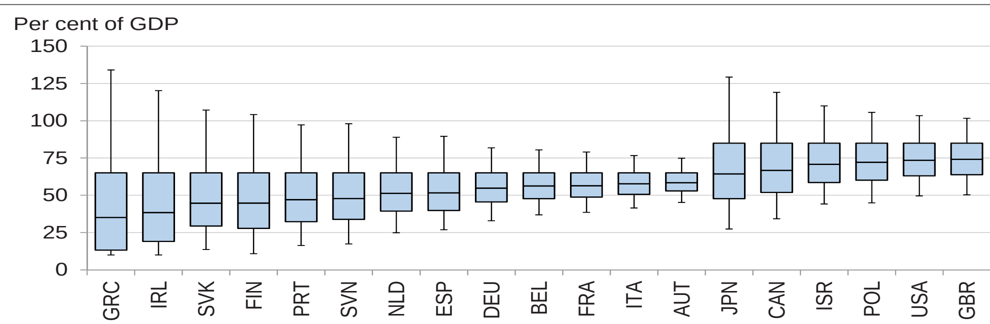
- A stochastic debt analysis to **quantify the uncertainties** surrounding the main macroeconomic variables and therefore debt dynamics was performed.
- The **cushion** that is needed to stay below debt thresholds **in the case of adverse shocks** was calculated.
- The prudent debt target is the median debt by 2040 such that there is less than a 25% risk to go beyond the debt threshold.

25

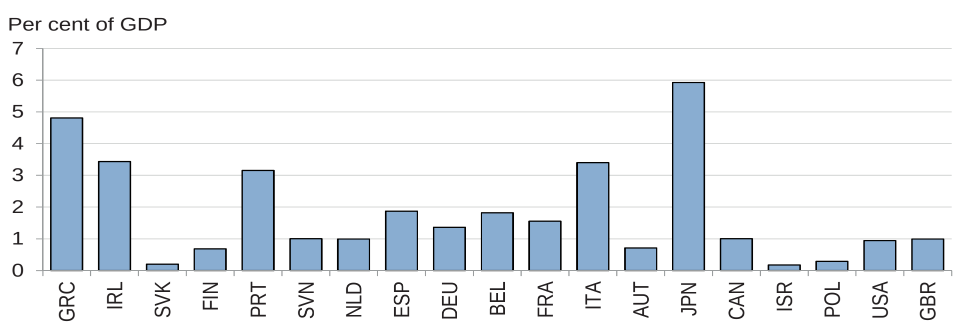
New framework

Country by country prudent debt target

Prudent debt levels



Average annual fiscal effort (primary balance surplus)



26

New framework

Benchmarking existing rules

	Budget balance	Structural balance	Expenditure rule	Revenue rule
Fiscal stabilisation	-	+	+	-
Fiscal discipline	++	+	+	-+
Side-effects and risks	-	--	-	-

A **budget balance rule complemented by an expenditure rule** suits most countries well:

- A budget balance rule ensures **hitting the debt target**.
- Well-designed expenditure rules appear decisive in ensuring the effectiveness of a budget balance by **limiting pro-cyclicality and too dynamic spending**.

New framework

The pros and cons of adjusting deficits for the cycle for emerging-market economies

A structural balance rule provides **flexibility** as it allows the **automatic stabilisers** to play in full.

However estimating a structural balance for India is challenging:

- **Standard measures of output gap capture the cycle only imperfectly** (issues of data reliability, production in unorganised sectors)
- **The cycle has only little effect on the budget**: the public sector is small; the commodity price cycle has an impact as subsidies for energy, food and fertilizers are sizeable; and the monsoon has a considerable impact on the budget.

28

Escape clauses : basic principles

New framework

- They provide flexibility in case of **unforseeable events**, but these have to really be **exceptional**, to prevent misuse.
- Their triggers and the path back to normal need to be **clearly specified.**
- This is **challenging**, since they are by definition unforseeable.

29

Escape clauses : some examples

New framework

Country and Date	Natural disaster	Economic recession	Banking system bailout, guarantee schemes	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: Schaechter et al (2012), Fiscal Rules in Response to the Crisis--Toward the "Next-Generation" Rules. A New Dataset. IMF WP No. 12/187.

30

Fiscal councils

New framework

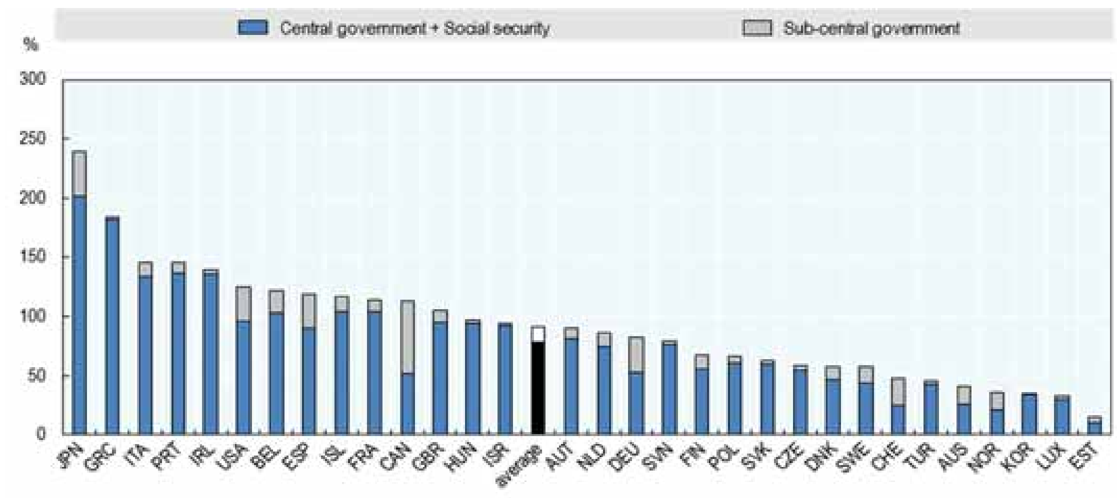
- Fiscal councils are expected to **foster fiscal discipline**, underpin **transparency** and thus **credibility**.
- They exist in 25 OECD countries. New fiscal councils have recently been created in the European Union.
- Their **mandate** differs widely:
  - **assessment of** macro-economic and budgetary **projections** underlying the Budget (in a few case production of economic forecast);
  - opinion on **exceptional circumstances** (Portugal);
  - examine **impact of specific measures** (Slovenia, Italy) or assessment of **long-term sustainability** (Sweden)
- The mere existence of councils is only loosely related with fiscal outcomes. **But characteristics matter**: those are **strict independence**, **adequate funding and presence in the public debate**.

31

FISCAL FEDERALISM ISSUES

Fiscal federalism

Sub-national debt: an issue in a few countries and jurisdictions



33

Fiscal federalism

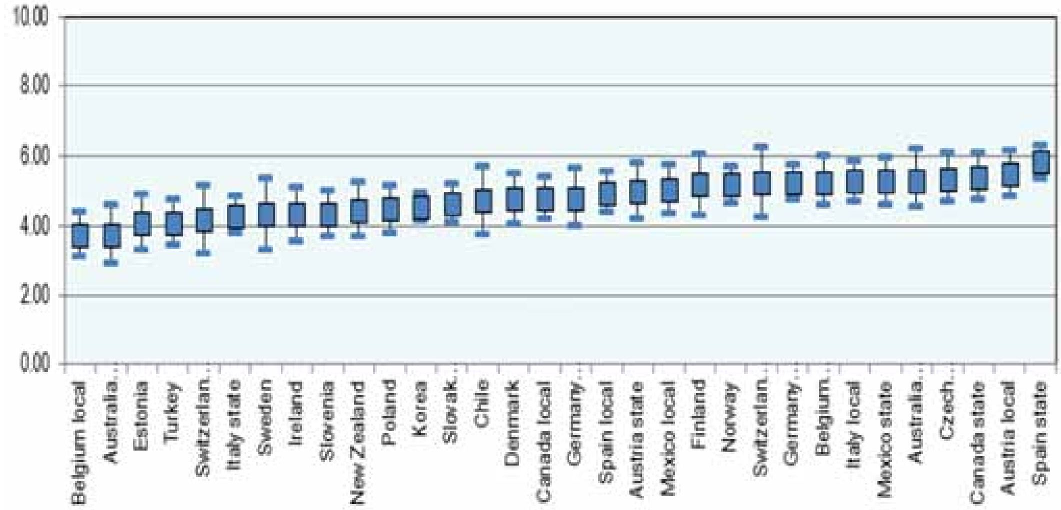
Fiscal rules for sub-national governments (SNGs)

- SNG rules are common but vary a lot across countries as intergovernmental fiscal frameworks vary strongly. Most countries apply **more than one SNG rule.**
- The most common fiscal rule is an **annual budget balance** requirement, often a **zero-deficit** or **balanced budget rule** . Structural or cyclically-adjusted deficit rules are rare yet.
- Many SNGs also face constraints on their ability to borrow. **Borrowing and debt limits** are often expressed in terms of SNG revenue, exacerbating **pro-cyclical** fiscal behaviour.
- **Limits on SNG spending are rare**, because of the politically sensitive nature of local spending since SCGs are often in charge of providing education and health care services.

34

Fiscal federalism

Measuring the quality of SNG fiscal rules: the OECD indicator



35

Fiscal federalism

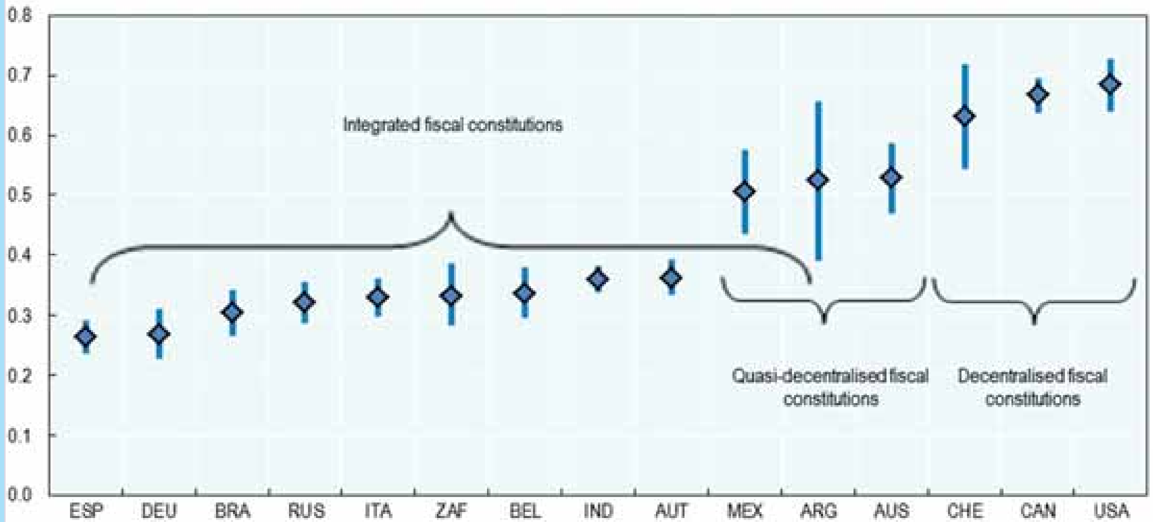
Towards SNG fiscal rules for India

- Rules should **allow for flexibility** and help **avoid pro-cyclical SNG behaviour** (cyclically-adjusted rules, escape clauses for large natural disasters or output shocks) (eg. Germany).
- Rules should be **based on medium- to long term SNG debt targets**. As for central government, **a combination of budget balance and spending rules** may suit Indian SNGs well.
- Given large SNG infrastructure needs, **investment** could be **exempt from spending or deficit rules** ("golden rule") (eg. Switzerland).
- SNG rules might be **imposed by the central government** (eg. Spain), **negotiated** (eg. Austria) or **self-imposed** (eg. Canada). The latter may strengthen states' fiscal responsibility.
- **Coordination across government levels** should ensure that governments do not undermine each others' fiscal policy objectives

36

Overall, India's fiscal federal constitution is moderately decentralised and quite coherent

Fiscal federalism



37

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38

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Strengthening fiscal governance: International practices

FRBM Review Committee
Delhi, 26 July 2016

Luiz de Mello
Deputy Director
Public Governance and Territorial Development

OECD
BETTER POLICIES FOR BETTER LIVES

Overview

- **Strengthening fiscal governance**
  - *From policy principles to operational rules and supporting institutions*
- **Designing and implementing fiscal rules**
- **Improving multi-level fiscal governance**
  - *Fiscal rules and institutions in decentralised settings*
- **Identifying good international practices**
  - *The cases of budgeting, IFIs, investment*

2

FROM HIGHER LEVEL PRINCIPLES TO RULES AND INSTITUTIONS

3

From higher-level principles to rules and institutions: the broad context

- Better understanding of, and growing body of evidence on, the negative effects of high government debt on the macroeconomy and growth in both advanced countries and EMEs
- Context of fragile public finances, ageing-related pressures on spending, which calls for renewed attention to longer-term fiscal sustainability in several countries
- Recognition of several drivers of poor fiscal performance, even if policymakers are well intentioned (eg, short sightedness, common pool problems, time inconsistency), but also rent seeking
- Acceptance of superiority of rules to discretion (but parallel with monetary policy is superficial!) and, increasingly, of a need for governance and institutions to underpin rules

4

DESIGNING AND IMPLEMENTING FISCAL RULES

5

The design of fiscal rules has evolved over time…

First Generation	Second Generation
EU – 1999-current Netherlands – 1982-1994 USA – 1985-1990	Finland – from late 1980's Netherlands - from 1995 Sweden - from 1997 US - 1991-2002
Deficit-Based	Spending-Based
Annual	Multi-Year
Irrespective of business cycle	Adjustment for cyclical conditions, escape clauses
Narrow coverage (central government, golden rule)	Broader coverage as goal (general government)

6

… with key lessons to be highlighted

- **The legacy of "first generation" rules**
  - Early fiscal rules generally had fixed, nominal annual deficit targets that did not adjust for changes in economic conditions. They turned out to be pro-cyclical, especially at sub-national level
  - It is difficult to adjust deficit rules for the cycle "in real time" in practice, due to forecast errors, difficulty in "timing" the business cycle, uncertainty over elasticities, etc.
  - Non-compliance with deficit rules can be "hidden", especially with cyclical adjustments, but also creative accounting when coverage is limited (eg, golden rule, off-budget operations)

  => The result is lost credibility and bad fiscal outcomes; evolution in design and implementation towards second-generation rules and fiscal responsibility legislation more generally

7

- **"Second generation" rules are still evolving**
  - Modern fiscal rules focus increasingly on multi-annual spending targets (eg Netherlands, Austria), counter-cyclicality (eg Chile, Sweden) and broader coverage (eg EU, UK, New Zealand)
  - Spending rules are inherently counter-cyclical. When the economy is strong, they work especially well in limiting otherwise unconstrained spending rises (eg Sweden, under discussion in BRA)
  - Specific categories of spending that are especially cyclical in nature – such as unemployment benefits – can be excluded from a fixed spending rule in order for the automatic stabilizers to operate (eg Austria).
  - Explicit escape clauses can be included in a spending rule. Criteria to trigger their use need to be very clear (*i.e.* recession, major natural disasters) (eg Germany, Slovak Republic)

  => Spending-based rules bring to the fore the need to review quality and cost-effectiveness of spending and make discussion on policy trade-offs explicit

8

The bottom-line…

— Deficit and/or spending-based rules need to be set in line with higher-level objectives related to the root causes of poor fiscal performance and evolution of public finances

— Debt sustainability considerations need to guide the setting of specific numerical targets that underpin fiscal rules based on sound analysis of debt dynamics, merging pressures and reasonable risks

— When different rules apply, only one can be binding (eg, EU-wide Deficit Rules/National Spending Rules)

— Not only targets and rules matter, but also the institutional architecture within which they operate (eg budget practices, oversight arrangements, intergovernmental relations)

9

… it is also essential to embed fiscal rules in the regular budget process

- **Responsibility for the implementation of fiscal rule needs to rest with the same organisation that prepares the annual budget**
  - Separate organisational responsibilities undermine the effectiveness of the rule

- **A comprehensive medium-term expenditure framework is a prerequisite for implementing a fiscal rule.**
  - Provides a baseline of multi-year expenditures and needs to be constantly updated
  - Indicates amount of fiscal space available in future year, consistent with the fiscal rule, and acts as an "early warning" for potential issues needing attention
  - In principle, should be at the same level of detail as the budget. Each successive year rolls over and becomes the basis for next year's annual budget
  - Can also include expenditure legally provided for in separate legislation than the general budget to provide a more comprehensive view of public finances

10

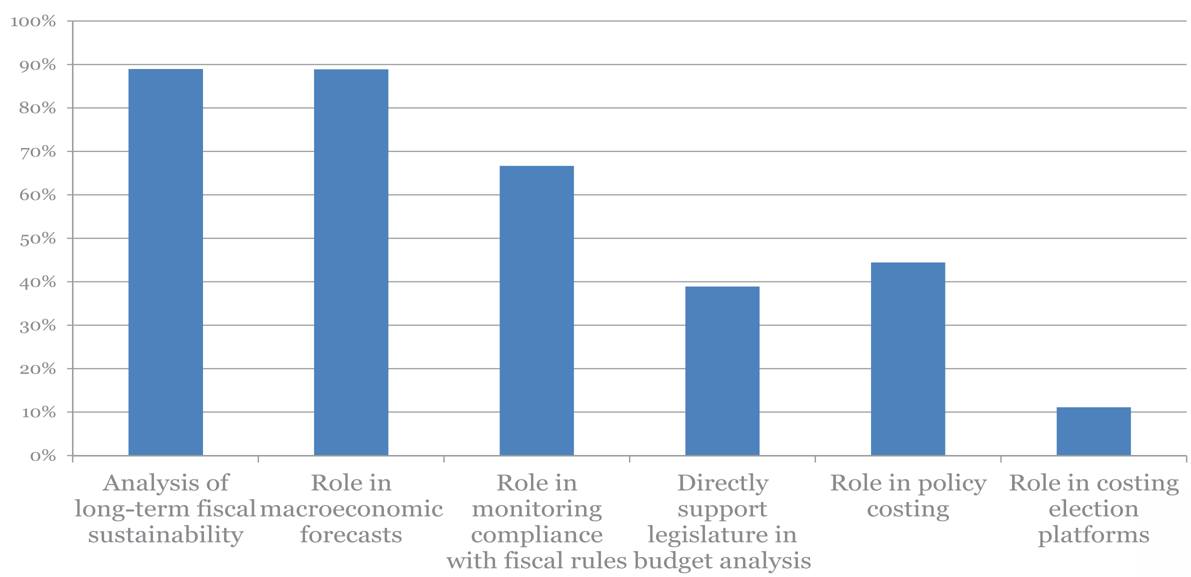
Several countries are setting up independent fiscal institutions

- IFIs, or Fiscal Councils, have diverse arrangements, mandates and resources
  - Overall mission is to promote and encourage compliance with fiscal rules; IFIs don't have executive powers
  - Some are attached to the legislature (eg US, Australia, Korea, South Africa), while others to the government (eg Sweden, Germany, Chile), but they remain independent in their work and operations
- Key tasks include providing (eg UK, Netherlands)/promoting (eg Spain, France) unbiased economic forecasts and realistic costing of government programmes (eg US)
- IFIs also foster political commitment to fiscal rules and sound policies by raising the reputational and electoral costs of non-compliance

=> Broad recognition that IFIs need to be independent – and seen to be independent – from government and with access to all relevant information

11

IFIs: Core Tasks



Source: OECD Database (2016), based on 18 countries with IFIs

12

IMPROVING MULTI LEVEL GOVERNANCE

13

Fiscal governance is particularly complex in decentralised settings

- In decentralised settings, poor fiscal performance may arise from failure to deal with externalities and common pool resource allocation problems; fragmentation and heterogeneity
  - Strong enough evidence of deficit bias, requiring MLG arrangements, coverage of subnational governments in fiscal rules and FRLs (eg Brazil)
- Balanced budget provisions, constraints on debt issuance and asset management are common features of subnational fiscal rules
  - Pro-cyclicality is common feature of subnational finances (eg US)
- But broader institutional arrangements are needed to foster multi level cooperation on fiscal targets (eg Austria), revenue sharing and grants (eg Australia, India, South Africa), tax coordination (eg Brazil) and policy design (eg Belgium, Canada)

14

GOOD PRACTICES ARE EMERGING IN SEVERAL AREAS

15

OECD instruments cover areas, such as IFIs, …

- Importance of designing enabling environment conducive to good performance and long run viability

- Key principles cover
  - Local ownership
  - Independence and non-partisanship
  - Mandate and resources
  - Relationship with the legislature
  - Access to information
  - Transparency and communications
  - External evaluation

16

… budgetary governance, and …

Several principles have been identified

- Budgeting within fiscal objectives
- Alignment with medium-term strategic plans and priorities
- Performance, evaluation and VFM
- Quality, integrity and independent audit
- Transparency, openness and accessibility
- Participative, inclusive and realistic debate
- Fiscal risks and sustainability
- Capital budgeting framework
- Comprehensive budget accounting
- Effective budget execution

17

… multi level governance of investment

The OECD Recommendation on Effective Public Investment Across Levels of Government

Pillar 1 **Co-ordinate across governments and policy areas**	• Invest using an integrated strategy tailored to different places • Adopt effective co-ordination instruments across levels of government • Co-ordinate across SNGs to invest at the relevant scale
Pillar 2 **Strengthen capacities and promote policy learning across levels of government**	• Assess upfront long term impacts and risks • Encourage stakeholder involvement throughout investment cycle • Mobilise private actors and financing institutions • Reinforce the expertise of public officials & institutions • Focus on results and promote learning
Pillar 3 **Ensure sound framework conditions at all levels of government**	• Develop a fiscal framework adapted to the objectives pursued • Require sound, transparent financial management • Promote transparency and strategic use of procurement • Strive for quality and consistency in regulatory systems across levels of government

18

Examples of good practices and recent developments disseminated through the web Toolkit

19

To sum up

- There is broad agreement on the key features of effective fiscal rules, and they are evolving towards spending-based, counter-cyclical, broad-coverage arrangements
- Of particular importance is the need to underpin targets and rules by deeper analysis of root causes of poor fiscal performance and debt sustainability considerations
- Broader institutional and governance elements can strengthen and support rules-based fiscal policy, including IFIs and broader FRLs; multi level governance arrangements are important

20

International Experiences with the Design and Operation of Fiscal Councils: Lessons Learned

Teresa Curristine
Fiscal Affairs Department, IMF
India MOF/IMF Workshop
New Delhi, June 24-25th 2016

Overview of Presentation

1. Definition and Rational
2. Trends and Institutional Models
3. Roles, Remits, and Tasks
4. Fiscal Councils and Fiscal Rules
5. Lessons Learned For Designing and Operating Effective FCs
6. Issues for Discussion

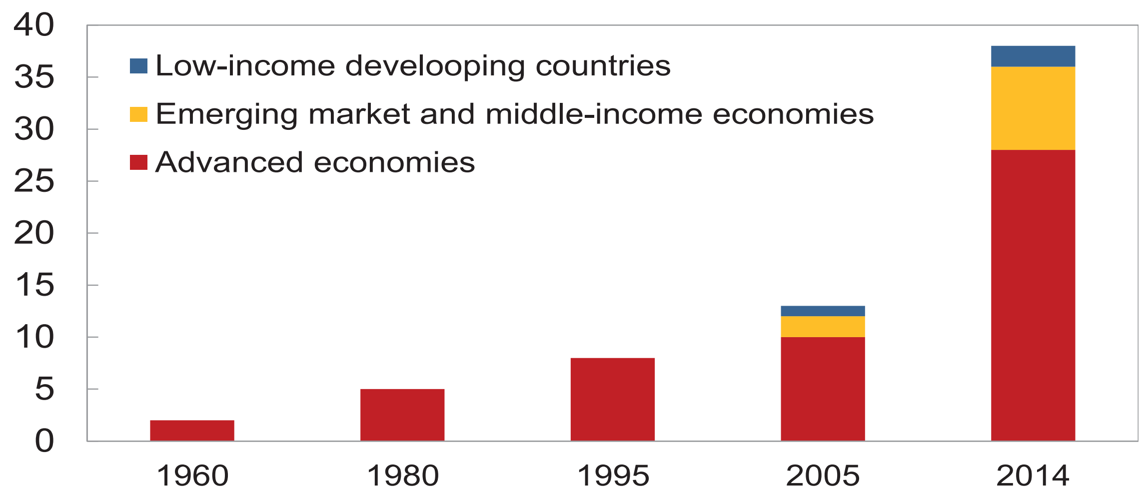
1. Definition and Rational for Fiscal Councils (FCs)

A fiscal council is a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against stated objectives.

- Provide transparent and independent analysis of public finances which can:
  - Reduce bias in macro-fiscal forecasts and policy costings
  - Improve accountability of decision makers for performance against fiscal objectives
  - Increase public awareness of the benefits of sound fiscal policy -Better informed and educated voters on fiscal policy- can create political costs for undisciplined fiscal policies
- But, they do not make policy decisions

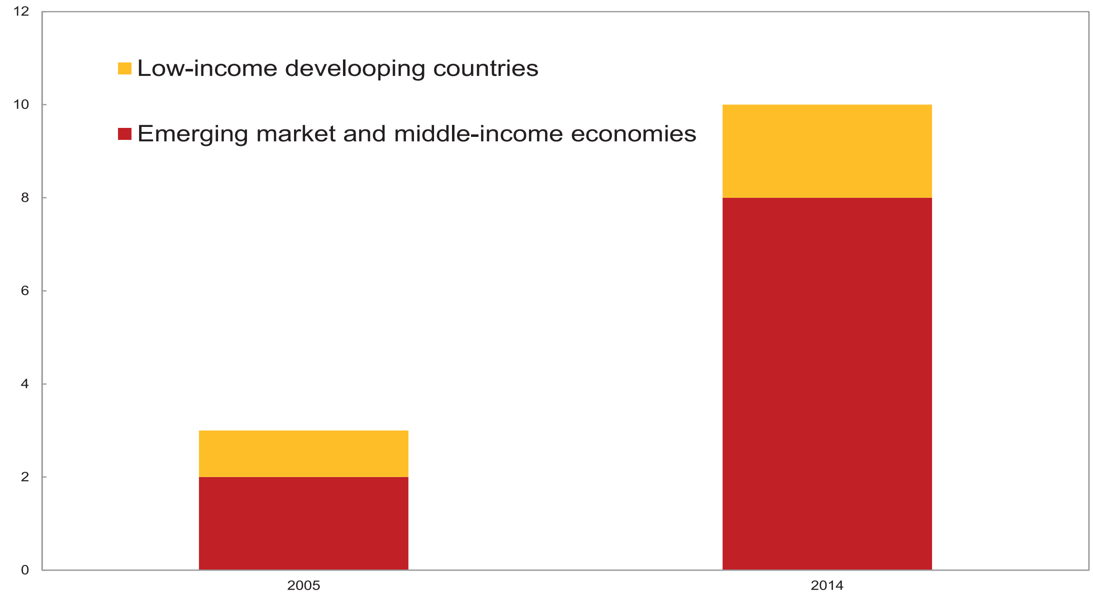
2. Trends and Institutional Models Growing Number of Fiscal Councils

- Since crisis increase number of countries establishing non-partisan ("independent") agencies.
- Trend likely to continue (Fiscal Compact, "two-pack" in EU, recent examples in emerging markets).

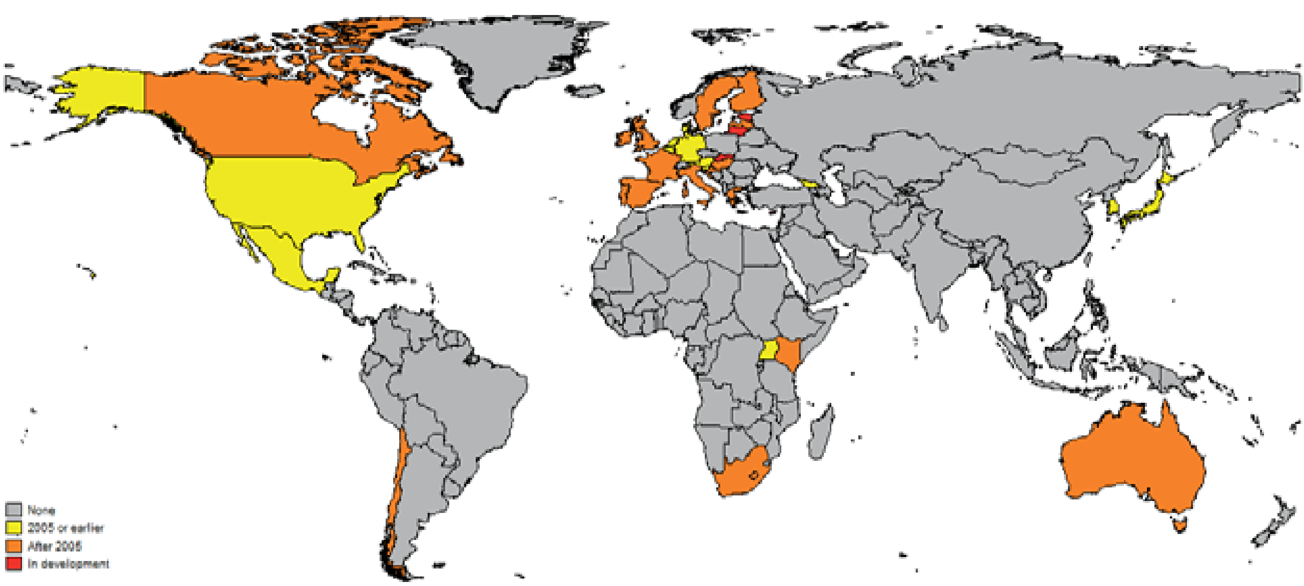


Source: IMF Fiscal council dataset.

2. Trends and Institutional Models
Number of Fiscal Councils By Income Groups



2. Trends and Institutional Models
Map of Fiscal Councils



2. Trends and Institutional Models
New Euro Area 'model'

- EU now requires independent body to "monitor compliance" with rules and "produce or endorse" macro forecasts
- Remits of new EU councils have been focused on these tasks
- Staffing at the lower end of the scale (i.e. 5-20) with couple of exceptions
- Institutional structure varies

2. Trends and Institutional Models
Diversity of Institutional Models

- **Stand-alone institutions**
  - Often part of FRLs. Germany, Hungary, Ireland, Portugal, Romania, Serbia and Slovak Republic
- **Under legislative branch**
  - Parliamentary budget offices (PBOs) traditionally in presidential political systems (United States, Korea and Mexico)
  - More recently Australia, Canada, Italy, Georgia, Kenya and South Africa).
- **Under executive branch**
  - In Belgium, Croatia, Denmark, Japan, Netherlands, Slovenia, the United Kingdom and Chile.
- **Paired with other independent institutions**
  - In France and Finland
- **Regardless of location operational independence is essential → reputation of professionalism and non-partisanship.**

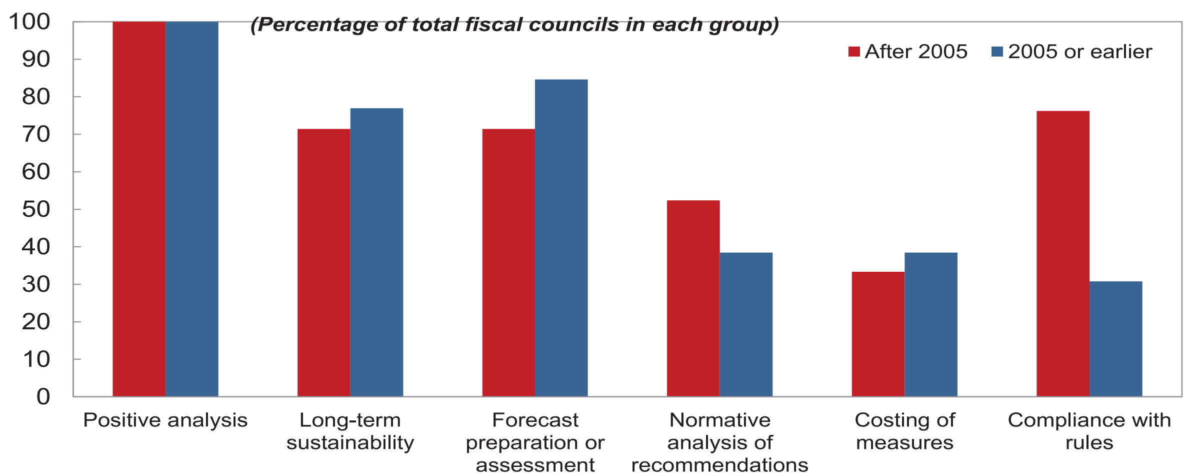
3. Roles, Remit and Tasks
Roles and Functions of FCs

Promoting fiscal responsibility, improve transparency and the quality of the public debate on fiscal policy

- A fiscal council can perform one or several of the following functions:
  - Producing independent forecasts and/or reviewing government's forecasts and/or assumptions
  - Monitoring governments' fiscal performance including adherence to fiscal rules
  - Provide advice on fiscal policy or identify sensible fiscal policy options, and possibly, formulating recommendations
  - Costing of measures this can include costing of new policy proposals and/or electoral platforms
  - Long-term sustainability analysis

3. Remit of Fiscal Councils Varies

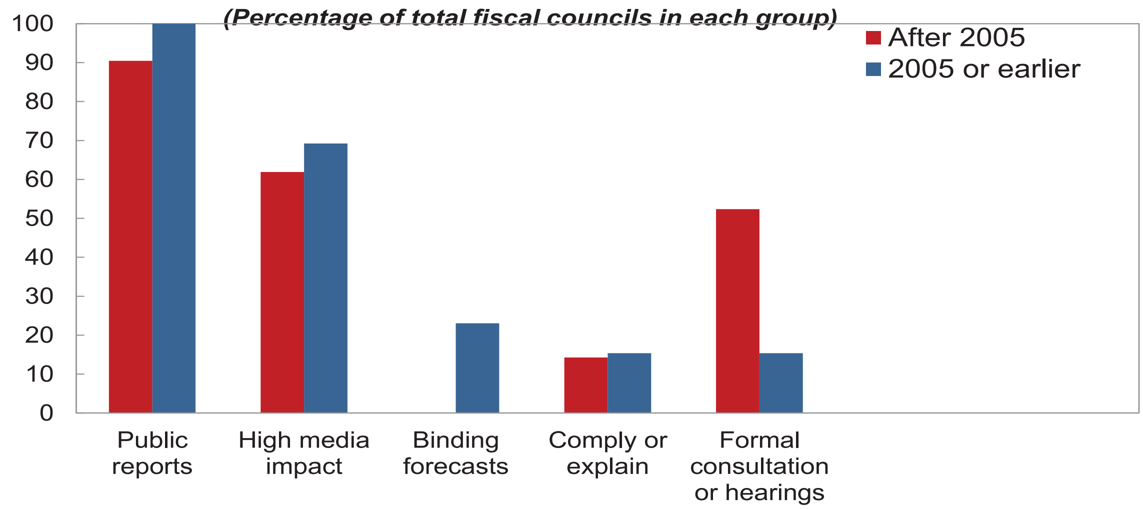
- **Positive analysis, long-term sustainability assessments and forecasting (assessment or production) are the most frequent missions of fiscal councils.**
- **Evaluating compliance with fiscal rules is a feature of more recently established councils.**



Source: IMF Fiscal council dataset.

3. Tasks of Fiscal Councils (FCs)

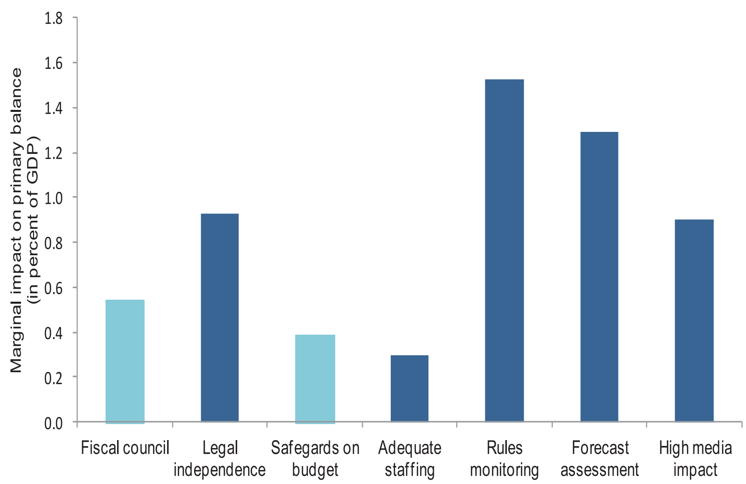
- **Preparing public reports to influence the public debate is the main task.**
- **Formal consultations with decision-makers are a more recent feature.**



Source: IMF Fiscal council dataset.

3. Evidence on Impact of FCs on Fiscal Outcomes

Marginal impact of fiscal council with a given characteristic on average primary balances.



Estimated, dynamic LSDVC panel model, 1990-2011. Controlled for persistence, public debt, output gap, national fiscal rules, and fixed-effects. Dark blue = statistically significant.

- **Evidence suggests fiscal councils can improve fiscal outcomes and forecast accuracy**
- **When independent, with media profile, and role on fiscal rules and forecasts**

4. Fiscal Councils and Fiscal Rules Complementarities: FC can help Fiscal Rules (1/2)

FC can prevent strategies to circumvent rules:

– FC can discourage or prevent the use of optimistic forecasts that help only ex-ante compliance.
– FC can alleviate government's incentives to twist estimates of structural balance rules, or avoid expenditure reclassifications associated with golden rules, or provide independent estimate of the impact of certain structural reforms on budgets, growth, and long-term sustainability.
– FC can limit or prevent abuse of escape clauses.

FC reduces the loopholes associated with "smarter" rules, expanding the set of feasible rules ex-ante.

4. Fiscal Councils and Fiscal Rules Complementarities: FC helps FR (2/3)

FC can play a role in formal enforcement mechanism:

- If judicial enforcement, FC can provide expert economic opinion to Judiciary.
- If automatic error correction (e.g. "debt brake"), FC can manage the system (e.g. by deciding when correction is required and at what pace).

FC can make the rule more incentive-compatible for well-intended government:

- FC can foster the rule's status as a sensible benchmark for good policy in the public debate.

FCs can facilitate sensible amendments to fiscal rules without fearing excessive damage to credibility:

- Example: FC could be tasked to provide medium-term reviews of fiscal rules and propose amendments.

5. Lessons From International Experience

- **Councils can improve forecast performance and fiscal outcomes if well-designed:**
  - **Design remit and structure for country-specific contexts**
  - **Strong and clear legal basis for independence is important**
  - **Political and operational independence is central to success**
  - **Resources need to be commensurate to the FC's remit.**
  - **Clear benchmarks for fiscal policy (e.g. fiscal rules) increase the traction of fiscal councils**
  - **Transparency, accountability and strong media presence is vital**

5. Design Remit and Structure for Country-Specific Context

- Adjust design to country-specific contexts
  - United States' CBO a model for Korea, Canada, and Hungary FCs
  - Successful adaptation in Korea to lesser extent in Hungary and Canada
- One size does not fix all

  Impetus for creating FCs both economic and political
  - Economic crisis – newer councils
  - Strengthening legislative oversight – Korea, United States, Canada

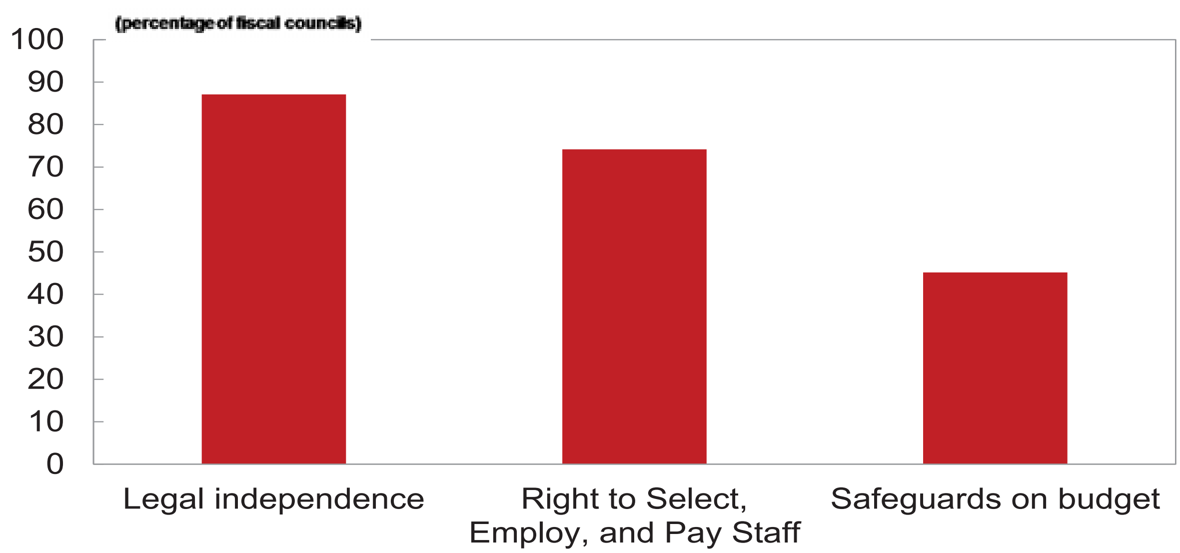
  Diverse remits and functions
  - Extensive US and Dutch CPB- forecasting, assessment, and costing.
  - Limited Sweden - assessment of fiscal policy

  Different institutional context
  - Sweden and Belgium more than one FC playing a role.

5. Legal and Operational Independence

- Legal guarantees important for new institutions to give them time to built a track-record of independent and credible analysis.
  - Important to have clarity on the remit
  - Politically independent appointment, tenure length, and dismissal processes
- Operation independence is critical for the FC to perform its duties and entails having:
  - Secured resources,
  - Freedom to hire staff with expertise
  - Determining own work agenda within remit,
  - Freedom to access media.
- Activities must be perceived as non-partisan and the FC needs a reputation of technical competence.
  - Successful examples in actively developing non-partisan credentials: US CBO, Dutch CPB, Sweden

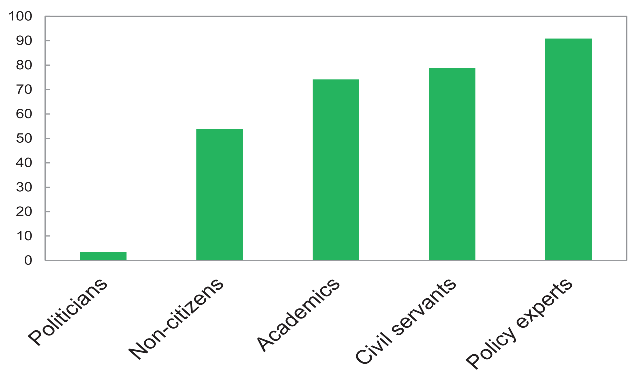
5. Selected Independence Dimensions (1/2)



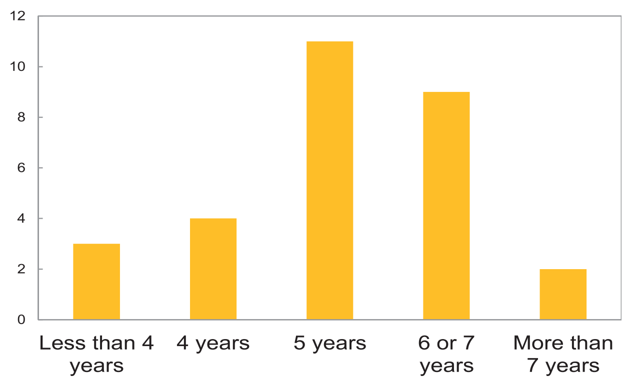
5. Selected Independence Dimensions (2/2)

- **Long terms for FC members going over political administrations**
- **Right expertise and skills mix for staff**

Composition of Fiscal Councils' High-Level Staff (percentage of fiscal councils)

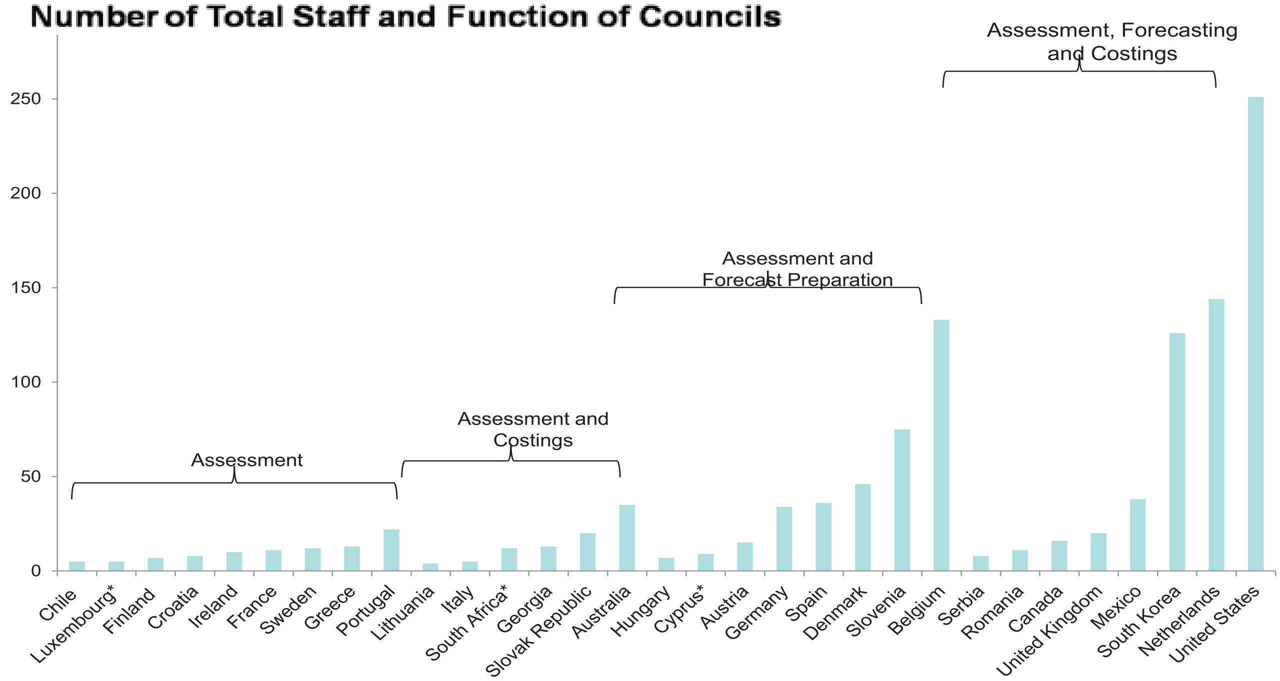


Term Length of Councils' Members (number of fiscal councils)



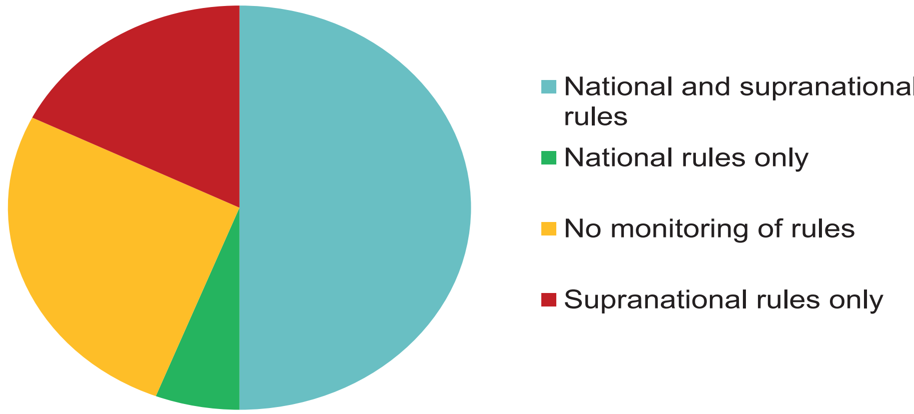
5. Resources Need to Match Remit

Number of Total Staff and Function of Councils



5. Clear Benchmark for Fiscal Policy

FCs Monitoring Fiscal Rules



FCs have stronger impact when there is political and public consensus on sound public finances e.g. Canada and Sweden

5. Strong Media Presence

- A strong media presence is essential to inform the public and to impact policies - especially when FCs need to raise the alarm
- Getting the message out at right time-coordination with the budget cycle
- Appearances matter for independence reputation– e.g. separate offices, website, stand-alone press conferences

5. Independence Vital But Not Easy to Establish

- Formal legal safeguards needed
- Independent appointment process and longer tenure
- Balancing act for all FCs
  - Need cooperation and support of politicians and MOF officials and to be integrated into policy process to have influence.
  - Not so close as to compromise independent or to be subject to political interference but not so far as to be disconnected and politically irrelevant.

5. Using the Law and Other Documents to Formalize FC's Role and cooperation

- **In legislation:** clarification of binding issues – independence, remit, minimum requirements, timing of key reports, appointment and dismissal processes and tenure.
- **MoU with Ministry of Finance**: detail on working process/timetable – process for preparation of reports, exchange of information, terms of access to information
- **Internal governance:** governance/management structure, staffing, accountability for use of public money, reporting requirements e.g. audit

5 . Successful Council Could Benefit the MOF and the Public

- Provides independent backing for MOF's projections and plans
- Can help explain if fiscal plans are thrown of track for unavoidable or justifiable reasons
- Should raise public awareness of benefits of sound fiscal policy
- Can strengthen your hand in internal negotiations

6. Issues for Discussions

13th Finance Commission recommend creation of FC

- Does an independent FC have a role to play in India?
- What institutional model would be most suitable – would it be under in legislature, executive or stand alone?
- What remit could be adopted to support the enforcement of FRs?
- How could independence be guarantee?
- How would it fit in with existing institutional bodies?
- What are the challenges in establishing an FC India?

ADDITIONAL SLIDES

COUNTRY CASE STUDIES

Country Example: UK's New Fiscal Council

- Office of Budget Responsibility established in 2010 by new government
- Remit: designed primarily to address forecast optimism bias, with secondary role monitoring fiscal rules:
  - Produce the official economic and fiscal forecasts
  - Assess Government's chances of meeting its fiscal targets
  - Certify cost of all tax and welfare policies
  - Analyze long-term fiscal sustainability
- Structure: Committee of three (BRC) supported by staff of 18. Office of the executive.
- Establishment: Initially a temporary non-statutory body. Followed by legislation and permanent appointments.

Country Case UK - Initially strong criticisms for lack of independence

- So Independence became a focus in forming permanent OBR
  - Independence enshrined in legislation
  - Legislative veto over appointments to the BRC
  - Permanent staff reporting to the BRC and fixed multi-year budget
  - Statutory right of access to information
  - Independent internal governance structure
- But other factors also important
  - Appointing the right committee members and staff with technical skills and knowledge
  - Physical location, branding: website, communications, Negotiated terms of engagement with Government (Memorandum of Understanding)
- Most importantly: built a track-record of transparent, credible analysis

Country Examples: Belgium

- High Council of Finance (HCF) established in 1937 but reformed several times
- Strong mandate – several tasks but key is to help promote coordination and fiscal discipline in federal system and provide independent assessments of budget policy. Recommends the budget targets for the general government and its subsectors and individual federal entities
- 24 members appointed for five year renewable terms (12 proposed by Federal ministries and 12 by governments of the region)
- Bureau: prepares and organizes the work but in practice large degree of autonomy for sub-entities
- 2 Permanent sub entities:1)Tax policy and 2) public sector borrowing requirements (PSBR). This section has 12 members and produces 2 reports a year.
- Studies conclude HFC effective in promoting fiscal consolidation during period 1990-1998 the run up to entry to the euro but effectiveness has declined since (Coene 2010).

Country Examples: USA

- Congressional Budget Office established in 1974
- Independent agency of the legislative branch agency does not report to the president or directly to any congressional committee. It is nonpartisan.
- Mandate is broad- to assist congress in putting together budget resolution, which means developing independent macroeconomic forecast and an alternative fiscal outlook to the President's budget, providing cost estimates of legislation proposed by Congress, and conducting studies of issues related to economy and budget
- Staff of approximately 240 with a high level of expertise.
- Reputation as objective and credible source of information.
- Influence comes from cost estimating function, plays a key role in public education and the media relies on CBO as a key source of information on the budget. (source: IMF (2013) Joyce and Hemming (2011).

References

CASE STUDIES OF FISCAL COUNCILS—FUNCTIONS AND MPACT IMF 2013

http://www.imf.org/external/np/pp/eng/2013/071613a.pdf

THE FUNCTIONS AND IMPACT OF FISCAL COUNCILS IMF 2013

http://www.imf.org/external/np/pp/eng/2013/071613.pdf

Medium Term Expenditure Frameworks

Sandeep Saxena
Fiscal Affairs Department

MoF/IMF Fiscal Rules Workshop
New Delhi
August 18, 2016

Introduction

- This presentation focuses on the mechanisms for operationalizing fiscal rules.
- Fiscal rules are effective when supported by appropriate institutional arrangements for translating fiscal policy objectives into budget aggregates.
- Well-designed MTEFs complement fiscal rules by providing a mechanism for achieving this objective.
- There is some empirical evidence of MTEF' effectiveness in constraining expenditure and maintaining fiscal discipline.
- This may be an opportunity to review the MTEF introduced by the 2012 amendments to the FRBM Rules.

2

Some Clarifications/Caveats

- The term “MTEF” is used here to refer to not just multi-year budget estimates, but a wider set of underlying arrangements and processes.
- The term “MTEF” is used to refer to a decision-making tool, and not a set of forward estimates presented for information only. It subsumes “MTFF” and “MTBF”.
  - An MTEF must drive the budget process, and not exist in isolation.
- Effectiveness depends on political readiness for budgetary decisions over a medium-term horizon, else they remain a burdensome technical exercise.
- Phased introduction, starting with its most simplistic form, is more likely to have political and technical acceptance.

3

Mechanics of an MTEF
a. Setting Medium-Term fiscal targets

- MT macroeconomic projections
- MT revenue projections

Estimate of available resources

- MT fiscal strategy
(Anchored by the fiscal rules)

Aggregate expenditure envelop/limits

- MT cost of existing policies
(Expenditure baseline projections)

Room for new policies / size of adjustment required

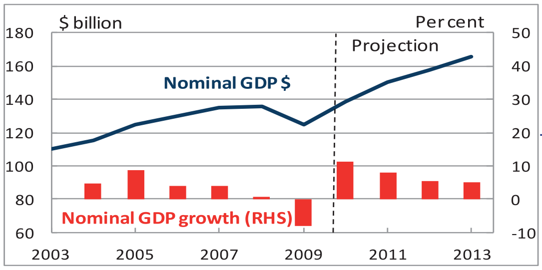
- MT costs of new policy proposals

Prioritized allocation of fiscal space

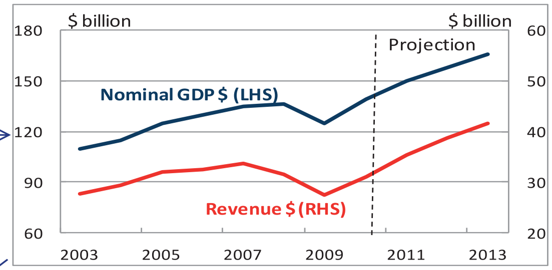
4

Mechanics of an MTEF
b. An illustration

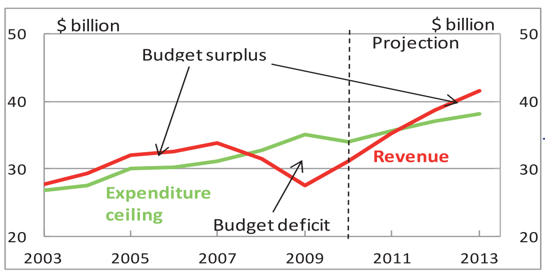
Nominal GDP forecasts



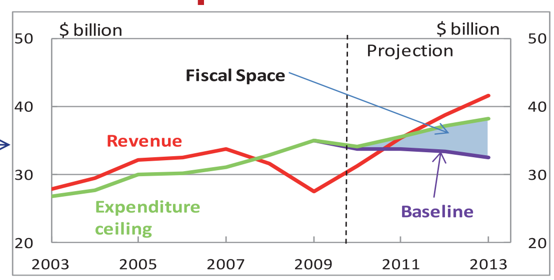
Nominal Revenue forecasts



Application of fiscal rule



Composition of expenditure

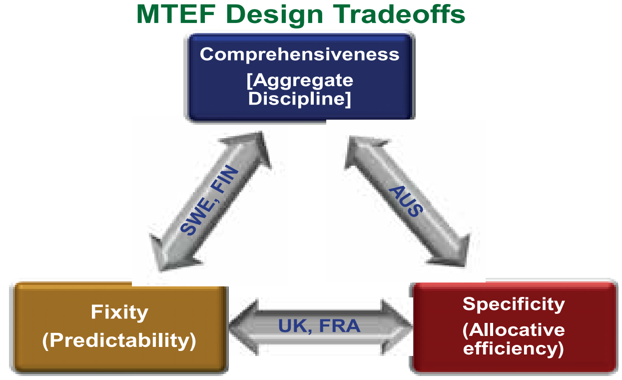


5

Designing MTEFs
a. Design choices

1. **Comprehensiveness** of coverage
   - Comprehensiveness promotes fiscal discipline, but may need balancing for other policy objectives (e.g. stabilization), scope of authority, and operational reasons.
     - Not uncommon to exclude one or more of the following: non-discretionary, highly volatile, automatic stabilizers, and fiscally neutral items.
2. **Specificity:** Aggregate or granular
   - Granularity could be at the level of sector, ministry, program, or economic type.
   - Specificity promotes strategic allocation; but is more demanding and makes the framework less flexible.
3. **Fixity:** Fixed or rolling
   - Fixity promotes funds predictability, but also makes the framework less flexible.

MTEF Design Tradeoffs



Designing an MTEF involves balancing these three objectives.

6

Designing MTEFs
a. Design choices..

4. **Type of limits**
   - **Nominal limits** easy to convey and enforce, more transparent and improve predictability, counter-cyclical, no automatic accommodation of inflation shocks; less flexible
   - **Real limits** more flexible; less transparent and predictable, pro-cyclical
5. **Time horizon**
   - Typically 3 to 5 years; in some countries concurrent with the government's term
   - Needs to consider realism of forecasts: forecasting capacity and the dynamism of the economy
6. **Frequency of revision**
   - To recalibrate for changes in macroeconomic assumptions
   - Discretionary changes by reallocation or altering the size

7

Designing MTEFs
b. Dealing with Uncertainties

- Conservative (but realistic) revenue forecasts
- Budget margins (or buffers)
  - Unallocated reserves within the expenditure limits to absorb uncertainties
    - Variations in forecast parameters (Macroeconomic risks)
    - Planning margins to accommodate any pressing demands arising in forward years
  - Typically about 1% of total expenditure for the budget year, progressively increase in size in forward years (between 1.5% - 3%)
- Limited carry over

8

India: Supporting Fiscal Rules
a. A Possible MTEF Design

- A fiscal strategy that considers general government
- A three-year rolling fiscal framework (MTFF) for the Central Government with:
  - Nominal limits on aggregate expenditure
    - Possible exclusion - debt service
  - Suitable budget margin increasing over the time horizon
  - Cabinet approval to medium-term expenditure limits and the policy package
  - Annual updates in accordance with clear revision rules; transparent reconciliation with original limits
- State's to have their own MTFFs
- Progressive development into an MTBF with more granularity based on bottom up baseline expenditure estimates

9

India: Supporting Fiscal Rules
b. Implications: Fiscal Policy Statement

	RE	BE	Projections	
	2015-16	2016-17	2017-18	2018-19
Fiscal Deficit	3.9	3.5	3.0	3.0
Revenue Deficit	2.5	2.3	1.8	1.3
Effective Revenue Deficit	1.5	1.2	0.6	0.0
Gross Tax Revenues	10.8	10.8	10.9	11.1
Net Tax Revenues to Center	7.0	7.0	7.1	7.2
Total Resources available to Center				
Expenditure Limit				
Baseline Expenditure	-			
Budget Margin				
New Expenditure Policies	-			
Total Liabilities	47.6	47.1	46.8	44.4
Nominal GDP Growth	7.6	11.0	12.0	13.0

10

India: Supporting Fiscal Rules
c. Implications: Budget Process

- A two-phase budget process
  - MT aggregate expenditure ceilings and policy package
  - Annual binding ceilings for line ministries, with indicative out-year estimates
- Intensified cooperation between macro-fiscal and budget functions

11

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12

SECTION 7:

IMPLICATION FOR FISCAL FRAMEWORKS FOR INDIA

Calibrating Fiscal Rules

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Asia Pacific and Fiscal Affairs Departments, IMF

India MoF/IMF Workshop

New Delhi, August 18, 2016

Introduction

- **More attention paid to rule selection than rule calibration**
  - Extensive discussions on pros and cons of various rules…
  - …but very basic methods for rule calibration
  - Calibrations are often ad hoc
- **Holistic approach**
  - Need to ensure consistency between thresholds of fiscal aggregates
  - Sequencing between anchor and operational targets
- **Risk-oriented approach**
  - Fiscal buffers are necessary to accommodate shocks
  - Need to set prudent debt and deficit ceilings

2

Questions raised by the committee

- How do other countries decide on fiscal targets? Advanced economies? Emerging economies?
- Should fiscal targets be based on the idea of public "debt sustainability analysis" (DSA)?
- How have countries defined their numerical fiscal targets? What is the rationale behind the 3% deficit ceiling in Europe?
- How to define adequate levels of debt?

3

Outline of the Presentation

I. Fiscal anchors and fiscal targets

II. International experience

III. Calibrating the fiscal balance

IV. Calibrating the debt anchor

I. Fiscal anchors and fiscal targets

- Analogy with monetary policy: two-pillar approach to fiscal frameworks
  - Fiscal anchor (final objective of fiscal policy; MT-LT; guide expectations)
  - Operational target (intermediate objective; ST; under direct control of government)
- Public debt is a natural choice for the anchor, as the final objective of fiscal policy is to preserve fiscal sustainability
- Open debate about the appropriate operational target(s)

5

I. Anchors and targets need to be mutually consistent

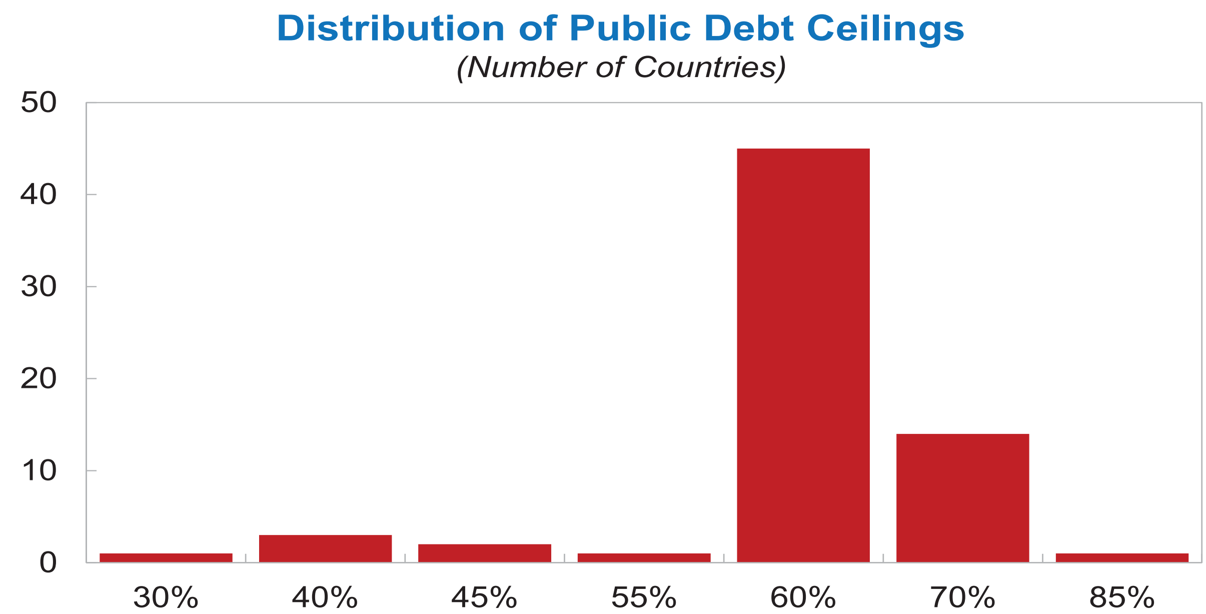
- Analytical framework: DSA and debt dynamics equations (Escolano, 2010)
- Example: $b^* = -\frac{\gamma}{1+\gamma} d^*$

  EU framework: 3% of GDP deficit = 5% nominal growth times 60% of GDP debt

- Generally approach: set a debt threshold, then retrieve the budget balance target
- Caveat: the framework needs to be adapted if anchor and target apply to different levels of government

6

II. International experience



Sources: IMF Fiscal Rules Dataset

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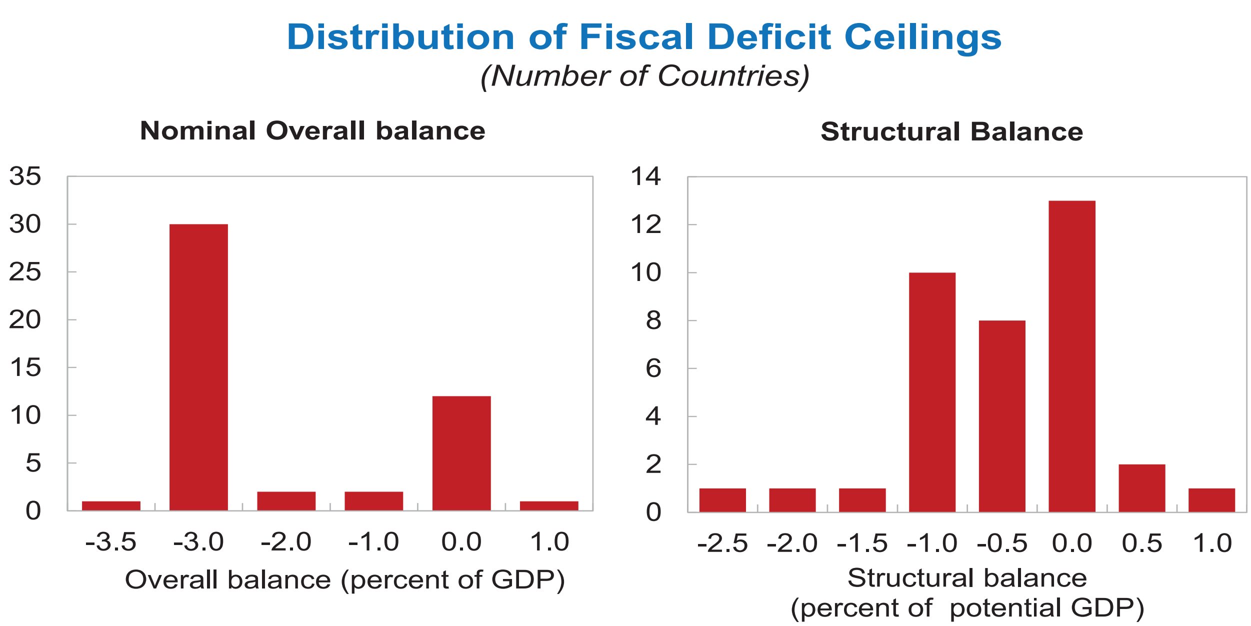
II. International experience



Sources: IMF Fiscal Rules Dataset

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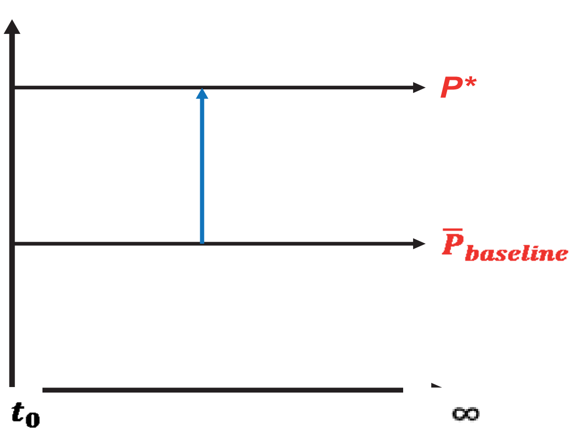
III. Deriving the balance target from the debt target

- For a given debt ceiling, the (primary) balance ceiling can be calculated as (Escolano, 2010):
  - Constant balance ratio that brings the debt ratio to d* *in the long-term* (but convergence may be too slow)
  - Constant balance ratio that brings the debt ratio to d* *by a certain da*te
  - Constant balance ratio that brings the debt ratio to d* by a certain date *following an initial period of fiscal adjustment*
  - Balance ratio which, if kept constant in the medium-term and then *subject to upward pressure due to ageing cost*s, would bring the debt ratio to d* by a certain date. The constant balance ratio should be sufficiently favorable to absorb ageing costs and secure debt sustainability in the long-run

9

III. Illustration: gap models

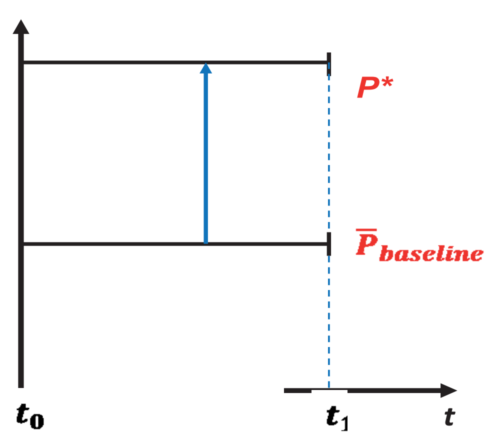
Gap model (infinite horizon)



$$p^* = \lambda d^*$$

$$b^* = \frac{-\gamma}{1+\gamma} d^*$$

Gap model (time-bound)



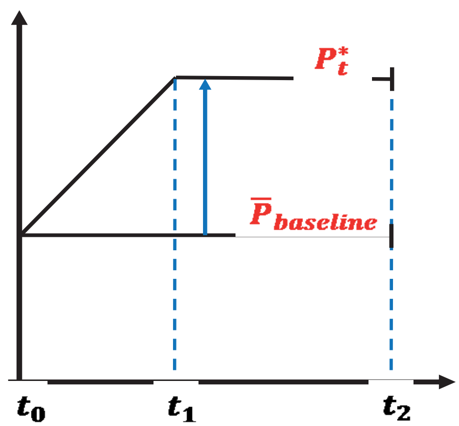
$$p^* = \frac{\lambda}{(1+\lambda)^{-N}-1}\left((1+\lambda)^{-N} d^*_N - d_0\right)$$

$$b^* = \frac{-\gamma}{(1+\gamma)((1+\gamma)^N-1)}\left((1+\gamma)^N d^*_N - d_0\right)$$

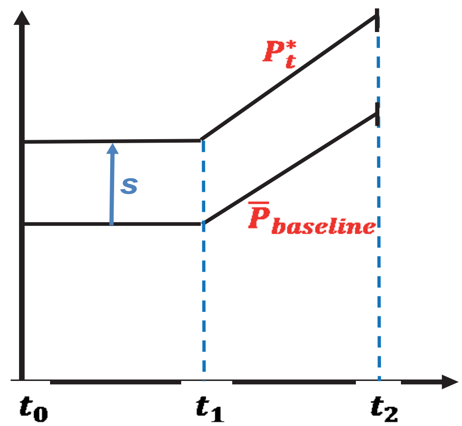
10

III. Illustration: non-linear models

Model with transition period



Ageing cost model



$$s = \lambda d_0 - p_0 - \lambda \sum_{t=1}^{\infty} (1+\lambda)^{-t} \delta p_t$$

11

III. From the cyclically-adjusted to the nominal balance ceiling

- Previous formulas are implicitly based on the cyclically-adjusted balance (when output gap is closed)
- To derive **the nominal balance ceiling**, one needs to take into account a safety margin ensuring the nominal ceiling is not breached during a normal economic cycle due to OG fluctuations

$$CAB = OB - \propto OG \Rightarrow OB = CAB + \propto OG \Rightarrow OD = CAD - \propto OG$$

Example: EU: 3% nominal overall deficit = 0.5% cyclically-adjusted deficit -0.5*(-5%) with a budget semi-elasticity of 0.5 and a maximum deterioration of the OG of 5%

12

IV. Calibrating the Debt Anchor

- **In principle**, there are several ways to calibrate the debt threshold
  - Various theoretical approaches: solvency, debt stabilization
  - Various empirical methods: debt level that undermines growth; jeopardizes the ability to access market; or results in debt distress
  - In any case, debt anchor should be sufficiently below the debt limit. Need a safety margin

- **In practice**:
  - Debt ceilings are often based on current data (60% for EU in 1992, 40% for UK in 1997)
  - Ceiling on gross (rather than net) debt

13

IV. Calibrating the Debt Anchor

Deterministic Approach

14

IV. Debt intolerance and safe debt levels

- Debt intolerance = inability of EMs to manage levels of debt that are manageable by advanced countries (Reinhart et al., 2003). Can be explained by a few variables, mainly default and inflation histories
- Non-monotonic relationship between debt intolerance and debt-to-GDP ratio suggests existence of country-specific debt thresholds at which a country switches from having access to capital markets to losing such access (an issue that is particularly relevant for EMs)
- Building on this concept, we estimate safe levels of public debt, following Topalova/Nyberg (2010) and Saxegaard (2014), that would allow India to remain well below a maximum sustainable debt limit, maintaining a high degree of market access, while leaving some margin for uncertainty

15

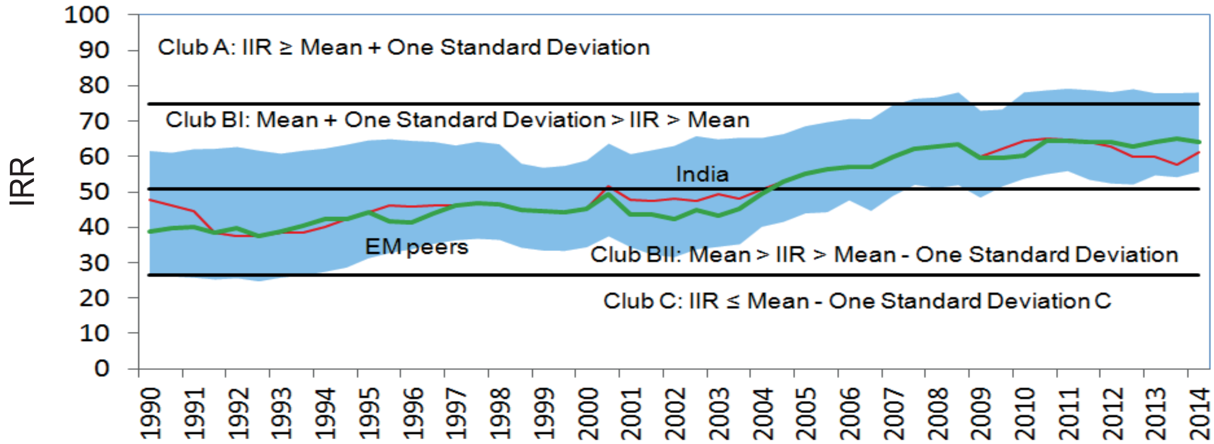
IV. Methodology

- Objective: Estimate relationship between debt intolerance (proxied by Institutional Investor Rating (IRR)) and public debt-to-GDP ratio to derive safe debt threshold
- Step 1: Group countries in 3 “clubs” (with “little”, “intermittent” and “continuous” access to capital markets) based on mean IIR and STD
- Step 2: Estimate relationship between the countries’ IRR and the public debt-to-GDP ratio, controlling for inflation history, allowing the relationship to vary by “club”
- Step 3: Use estimated regression coefficients to establish the maximum debt threshold that will keep India from dropping to a more debt intolerant “club” (with more intermittent market access)
- Sample: 110 countries, Period 2000-2014

16

IV. India Institutional Investor Rating (IIR)

India's IIR has been in the "intermittent-high" club (BI) since 2004. Up to the last two years, the IIRs of India and its EM peers moved quite closely.



Source: Institutional Investor

17

IV. Predicting debt thresholds for India

Based on this analysis, India's predicted debt-to-GDP threshold lies in the range of 65-70 percent of GDP. Inclusion of some buffer to account for uncertainty suggests a level of safe debt of **60-65 percent of GDP**

Debt/GDP	Predicted IIR	Club
45	53.9	Club BI
50	53.2	Club BI
55	52.5	Club BI
60	51.7	Club BI
65	51.0	Club BI
70	50.3	Club BII
75	49.5	Club BII
80	48.8	Club BII
85	48.1	Club BII

Specification: Model 1

18

IV. Calibrating the Debt Anchor

Stochastic Approach

19

IV. A probabilistic approach

- **Fiscal cliff and fiscal buffer**
  - Cliff: point beyond which government solvency or liquidity is put into question, constraining the use of fiscal policy. Loss of control over debt dynamics
  - Buffer: countries are subject to shocks (macro, fiscal). Thus, the guardrail for fiscal policy needs to be set far enough from the cliff

- **A debt anchor should be such that there is a low probability of reaching the cliff over a given time horizon if bad shocks occur** i.e. debt is in "safe" territory

- **Implementation: 2 methods depending on how the cliff is defined** (IMF, 2016; Debrun and others, forthcoming)
  - Critical debt threshold can be agreed upon → Cliff = debt distress
  - No relevant debt threshold exists → Cliff = loss of policy room

20

IV. Debt anchor with known critical threshold

- **Debt anchor = critical threshold – buffer**
  - Low probability (5%) of exceeding threshold within 6 years

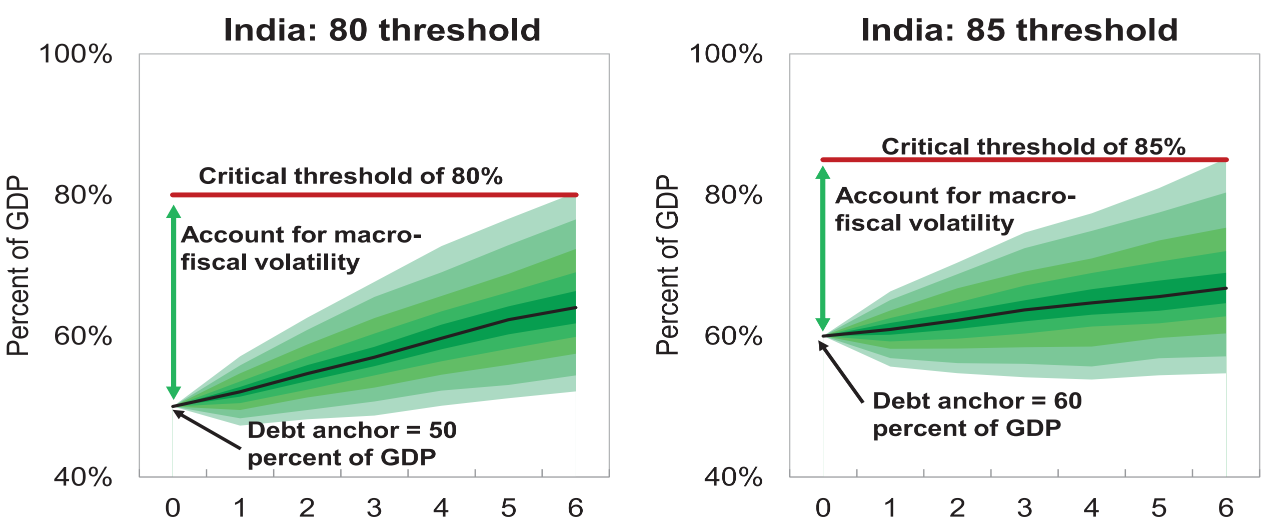
- **What critical threshold?**
  - Debt level above which debt dynamics become explosive proxied by PBmax/(r-g) under stress. Application to India: 85% of GDP
  - Debt level above which growth decelerates: 85% according to Cecchetti and others (2011) but some papers point to lower thresholds in EMs: 50% for Fall and others (2015).

- **Types of shocks** (high frequency): macro, exchange rate, policy…Generated from past data

- Fiscal policy reaction function is estimated over historical data and responds to past debt and OG

21

IV. Debt anchor with known critical threshold



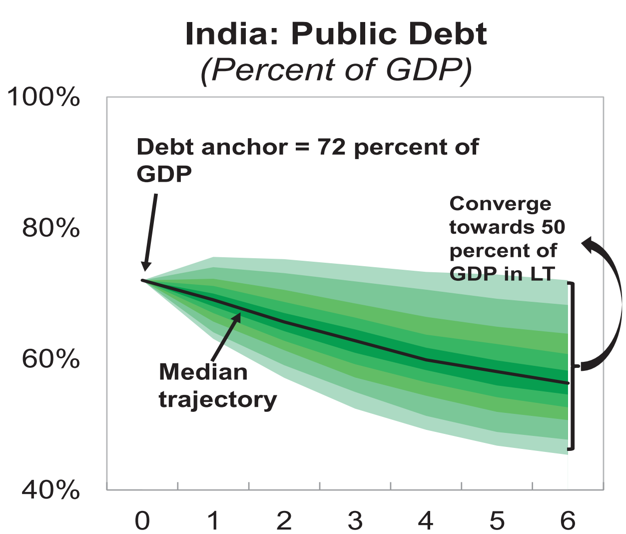
22

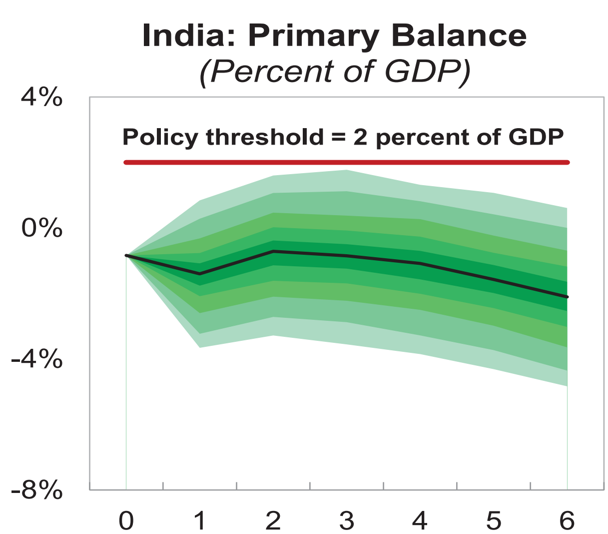
IV. Debt anchor with unknown threshold

- **Limits of previous method**
  - No agreement on critical debt threshold
  - Reaction function based on past behavior, which may have been imprudent
- **Pragmatic alternative**
  - Primary surplus is bounded → optimal fiscal response (countercyclical and secures convergence of debt trajectory towards a given LT level) may require unrealistically high surpluses→ risk of "policy stress"
  - Debt anchor ensures that the probability of policy stress is low even in the presence of negative shocks
- **Implementation**
  - Policy threshold: max primary surplus = 2% of GDP (Escolano and others, 2014)
  - Assumes "good" fiscal policy: normative reaction function with LT debt convergence towards 50%
  - Initial debt level is calibrated so that 95 percent chance not to breach the policy threshold

23

IV. Debt anchor with unknown threshold





24

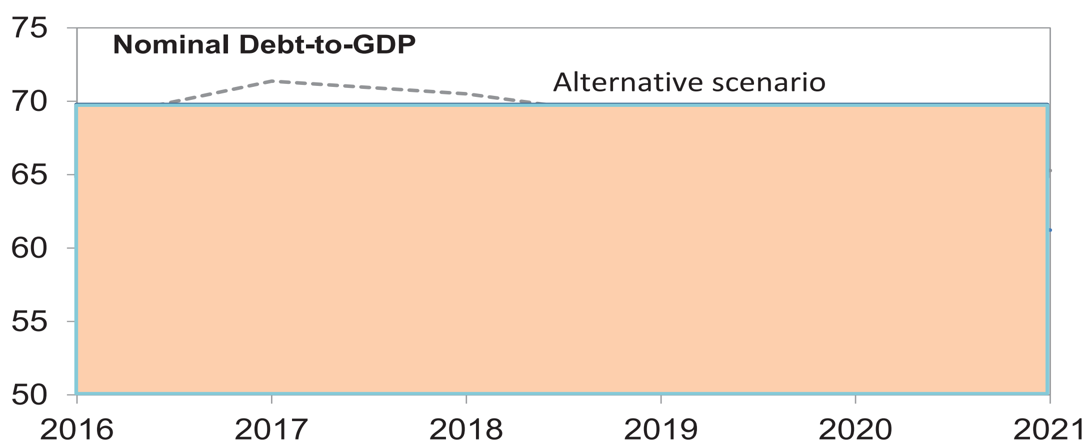
IV. Debt anchors: no one size fits all (1)

- Debt anchors should be set to **keep debt within a "safe" zone** i.e. with reduced risk of losing control over debt dynamics (and the ability to pursue countercyclical policy) if negative shocks occur
- **Debt ceilings differ across countries** depending on their exposure to macro and fiscal shocks, degree of risk aversion, and their past fiscal behavior
- Balance cost and benefit of insurance. Ensuring headroom for **contingent liabilities (banking recapitalization) or uncertainty about subcentral finances** may require additional buffers

25

IV. Debt anchors: no one size fits all (2)

- **In India**, preliminary analysis suggests an appropriate GG debt anchor in the range of **50-70 percent of GDP**
- The 2016 debt ratio, projected at 69 percent of GDP, is close to the upper bound, confirming the appropriateness of fiscal consolidation



26

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28

India's Public Debt: Key Considerations

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India Ministry of Finance/IMF Workshop
New Delhi, August 18, 2016

Plan of presentation

A. International experience of debt thresholds

B. Application of debt intolerance analysis

C. Debt sustainability and contingent liabilities

D. Debt sustainability in federations

E. Conclusions

2

A. International experience of debt thresholds

Debt thresholds: Wide range of analytical approaches

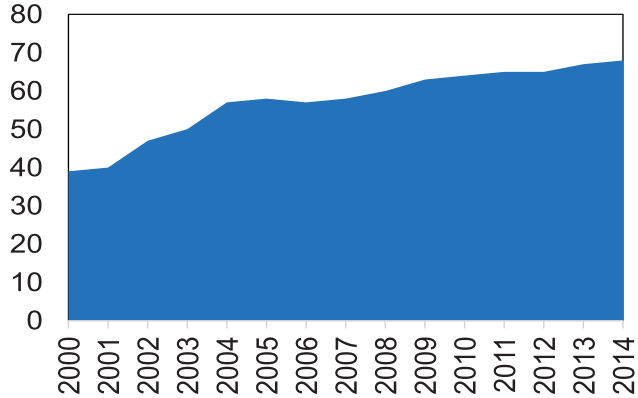
- Determining **optimal public debt in agent models** (e.g. Aiyagari and McGrattan, 1994). Models calibrated for advanced economies provide a wide range of results depending on baseline assumptions.
- Deriving benchmark level of public debt based on **relationship between primary deficit and debt ratio** (e.g. IMF, 2003).
- Deriving benchmark level of public debt by focusing on the **country's ability to access capital markets** (e.g. debt intolerance work by Reinhart et al., 2003).This approach, mainly used for emerging markets, will be considered later in the presentation.

4

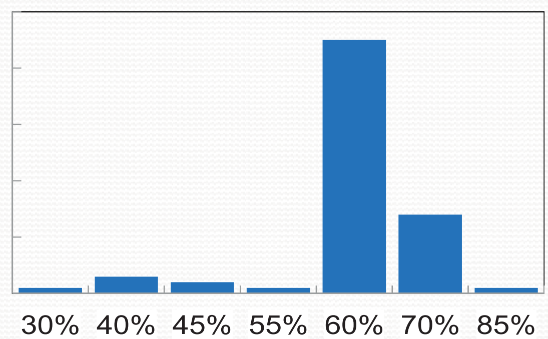
Debt rules: Cross-country experience I

An increasing number of countries have been using a debt rule, mainly targeting 60 percent for the debt-to-GDP ratio.

Number of countries with debt rules



Distribution of Public Debt Ceilings
(Number of Countries)

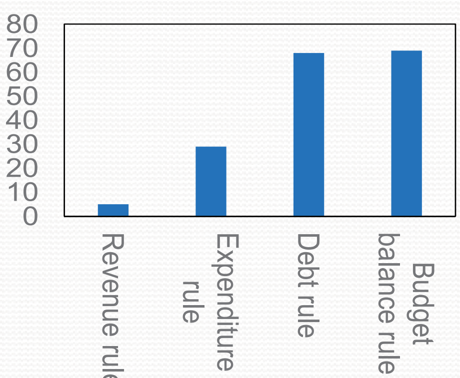


Sources: IMF Fiscal Rules Dataset

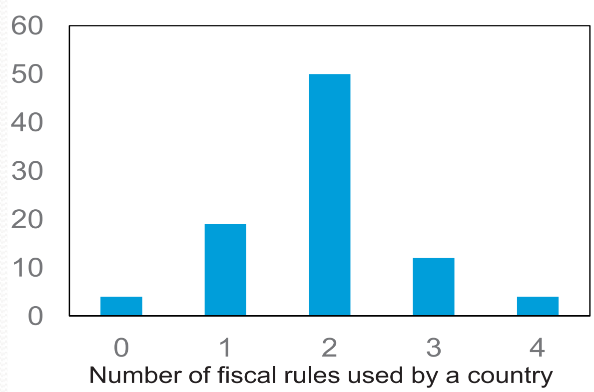
Fiscal rules: Cross-country experience II

Currently, countries use different types of fiscal rules, often in combination.

Number of countries with different fiscal rules, 2014



Distribution of countries with multiple fiscal rules, 2014



Sources: IMF Fiscal Rules Dataset

B. Application of debt intolerance analysis

What is debt intolerance?

- Debt intolerance is the inability of emerging markets to manage levels of external debt that are manageable by advanced countries (Reinhart et al., 2003).
- Debt intolerance can be explained by a small number of variables, mainly default and inflation histories.
- A non-monotonic relationship between debt intolerance and the public debt-to-GDP ratio suggests the existence of country-specific debt thresholds, at which a country switches from having access to capital markets to not having such access.

8

What is a safe public debt level for India?

- This study follows Topalova and Nyberg (2010) and Saxegaard (2014) in estimating a safe public debt level that would allow countries to remain well below a maximum sustainable debt limit, maintaining a high degree of market access, while taking into account the impact of uncertainty.

- As argued by Mendoza and Oviedo (2009), a sustainable fiscal position is one in which government can commit to servicing its debt even when the economy is buffeted by shocks, or when fiscal risks materialize. This implies that fiscal policy should target a debt level well below the debt ceiling to allow space to absorb shocks that are likely to hit the economy.

Country grouping based on debt intolerance

Following Reinhart et al. (2003), debt intolerance is proxied by the Institutional Investor Rating (IIR), where each country is given a rating from 0 to 100 for its attractiveness as an investment destination (100=least chance for default).

Club A: *Continuous market access*
IIR> Mean +1 StD

Club B: *Intermittent market access*

Club C: *No market access*
IIR< Mean -1 StD

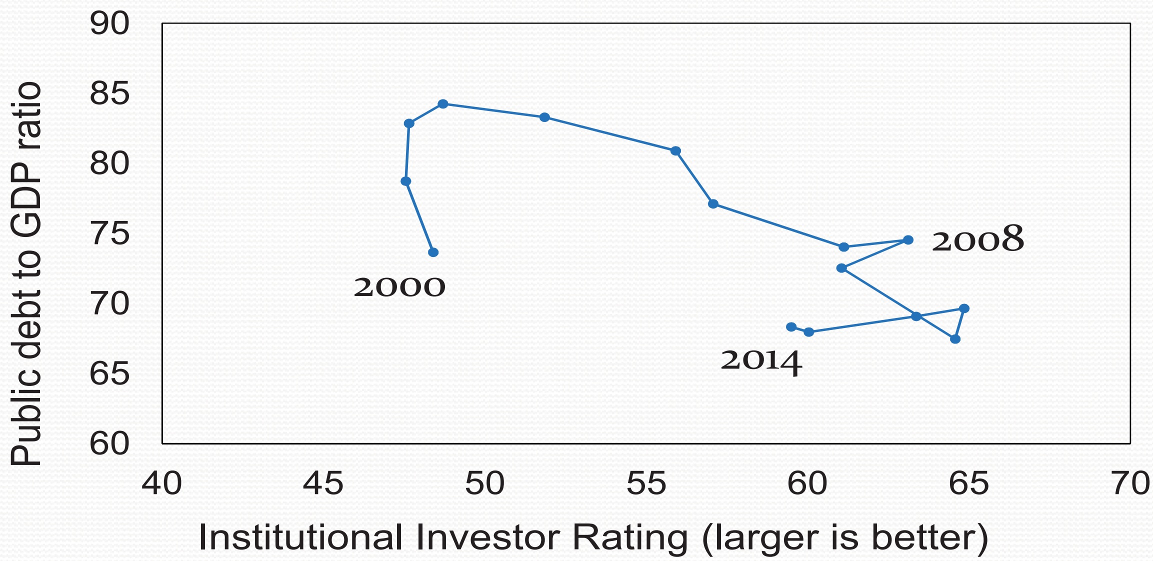
Club BI
Mean+1 StD>IIR>Mean

Club BII
Mean>IIR>Mean-1StD

Less debt intolerant (larger IIR) ↔ More debt intolerant (smaller IIR)

India: IIR and Government Debt

As India's public debt decreases, its IIR has improved.



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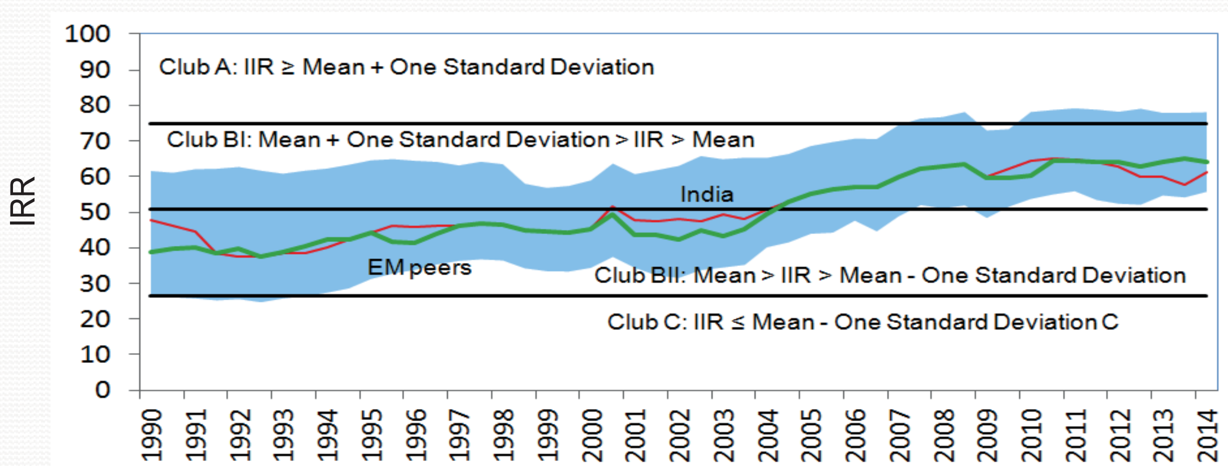
India: Institutional Investor Rating (IIR)

India's IIR has been in the "intermittent-high" club (BI) since 2004. Up to the last two years, the IIRs of India and its EM peers moved quite closely.



Source: Institutional Investor

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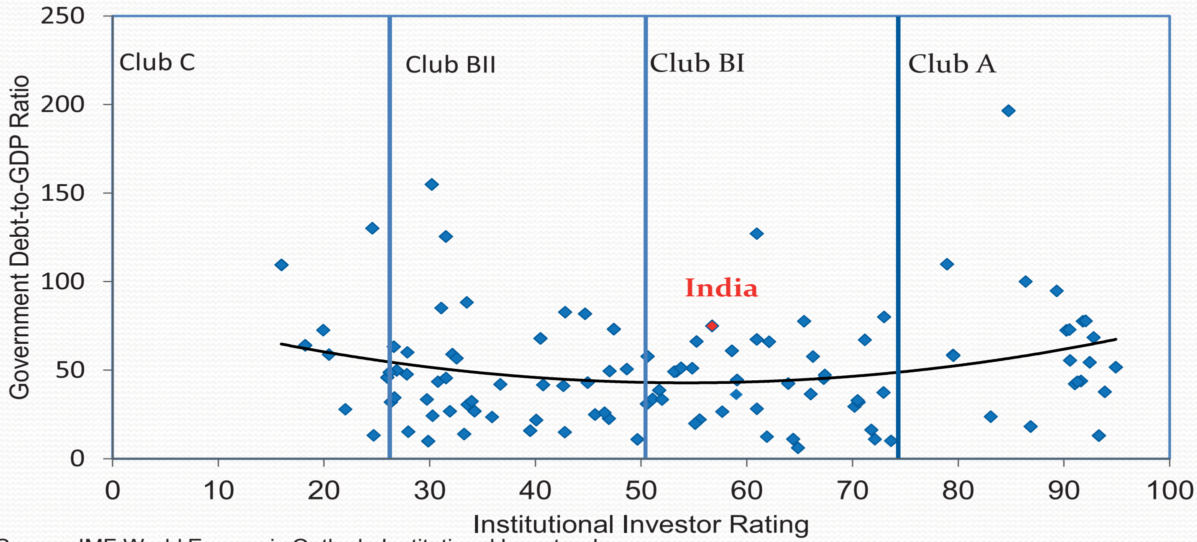
Institutional Investor Rating and Government Debt

India is a part of Club BI despite having relatively higher debt when compared to other countries in it.



Source: IMF World Economic Outlook, Institutional Investor, Inc.

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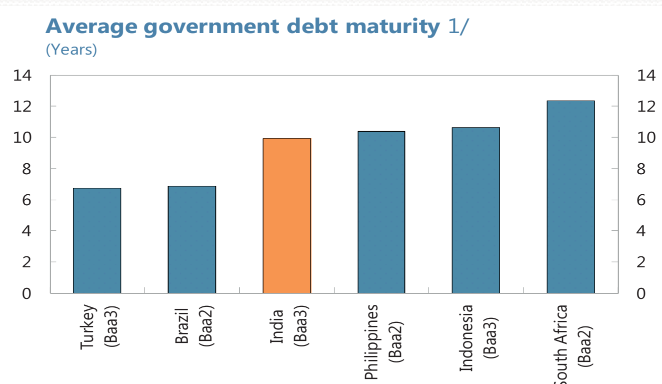
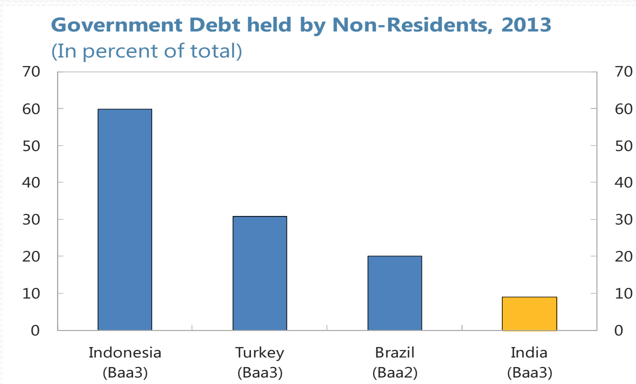
India: Comparison of debt profile

While the debt level is relatively high, roll-over risks are mitigated by the long average maturity and limited exposure to non-residents.



Source: Bloomberg.
1/ As of November 3, 2015.



Source: Moody's and IMF staff estimates.

14

Explaining debt intolerance

High inflation and debt reduce the IIR (ie. raise debt intolerance).

Table 1: Debt Intolerance and Debt 1/

	Model 1	Model 2	Model 3	Model 4
Debt x Club A	0.312***	0.300***	0.311***	0.299***
	[0.053]	[0.054]	[0.053]	[0.054]
Debt x Club B	-0.146***	-0.163***	-0.150***	-0.169***
	[0.054]	[0.054]	[0.054]	[0.055]
Debt x Club C	-0.365***	-0.363***	-0.367***	-0.364***
	[0.077]	[0.077]	[0.077]	[0.078]
Inflation 2/	-15.104***	-0.869***	-15.006***	-0.871***
	[3.471]	[0.214]	[3.489]	[0.214]
India			7.936	11.987
			[14.898]	[14.994]
Constant	60.522***	63.050***	60.551***	63.157***
	[2.837]	[3.140]	[2.848]	[3.148]
R^2	0.590	0.582	0.591	0.585
Adjusted R^2	0.575	0.566	0.572	0.565
N	110	110	110	110

1/ Numbers in square brackets are standard errors. *** indicates significance at the 1 percent level, ** at the 5 percent level, and * at the 10 percent level.
2/ Models 1 and 3 have inflation defined as a dummy showing if average inflation exceeds the 75th percentile. Models 2 and 4 use average inflation.

15

Predicting debt thresholds for India

Based on our analysis, India's predicted debt-to-GDP threshold lies in the range of 65-70 percent of GDP. Inclusion of some buffer to account for uncertainty, suggests a safe level of debt of **60-65 percent of GDP**.

Debt/GDP	Predicted IIR	Club
45	53.9	Club BI
50	53.2	Club BI
55	52.5	Club BI
60	51.7	Club BI
65	51.0	Club BI
70	50.3	Club BII
75	49.5	Club BII
80	48.8	Club BII
85	48.1	Club BII

Specification: Model 1

16

Comparison of with previous analyses

- **Topalova and Nyberg (2010)**: Thresholds for **India's** public debt-to-GDP ratio are estimated in the ranges of 40-45 percent (54 countries in the sample) and 70-75 percent (142 countries).
- **Saxegaard (2014)**: Thresholds for **South Africa's** public debt-to-GDP ratio are estimated in the range of 50-60 percent.
- **Important caveats**: Results of debt intolerance approach depend on the specific regression and sample period used, and confidence intervals around these point estimates.

17

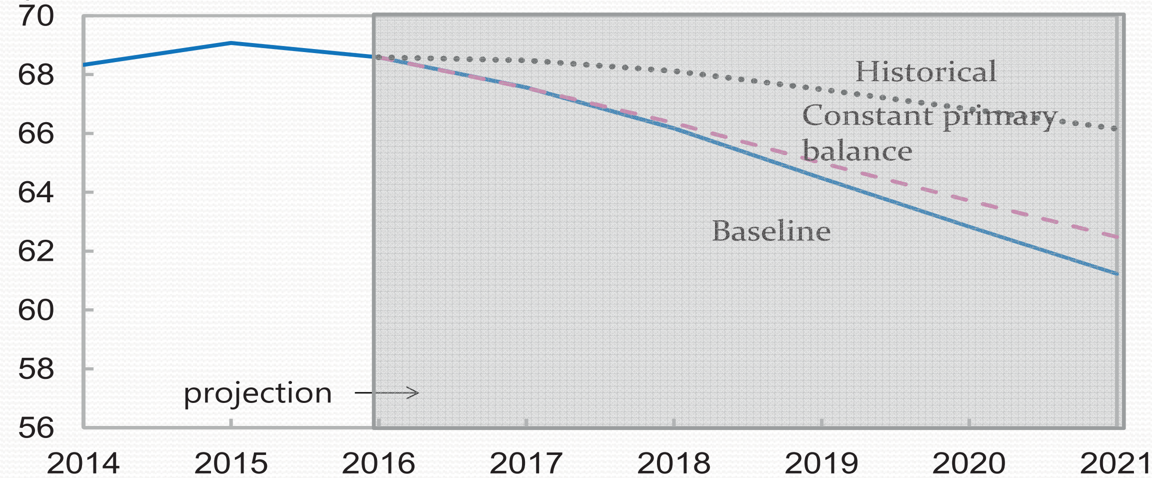
C. Debt sustainability and contingent liabilities

Debt Sustainability Analysis (based on IMF 2016)

India's 2016 public debt is projected at about **69 percent of GDP** on a consolidated (general government) basis.

Gross Nominal Public Debt

(in percent of GDP)



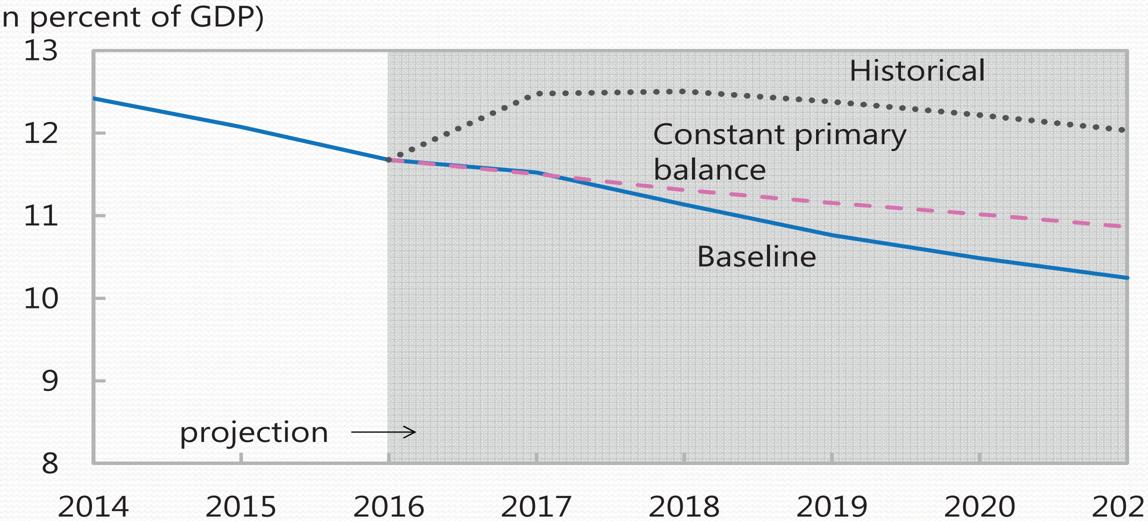
19

Debt Sustainability Analysis (based on IMF 2016)

India's 2016 public gross financing need is projected **at about 12 percent of GDP** on a consolidated (general government) basis.

Public Gross Financing Needs

(in percent of GDP)



20

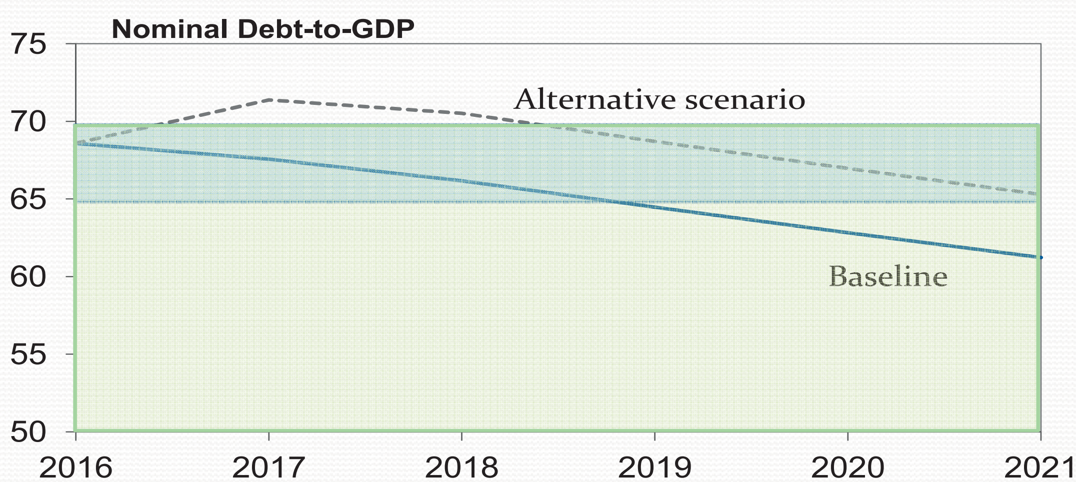
Main risks to public debt outlook: Banking sector

- Some public sector banks (PSBs) may require re-capitalizations in the near term, which may involve larger central government deficits and/or increased public debt.
- Recapitalizations would be needed to increase PSBs' capital base, to both: (i) help meet Basel III capital adequacy requirements; and (ii) absorb higher losses due to shifts of restructured loans into NPAs.
- Calculations in the last Article IV Staff Report (IMF 2016) indicate that under an adverse stress scenario involving an increase in PSB non-performing assets, bank recapitalization costs are moderate, but could involve about 3 percent of GDP of additional public borrowings to cover both (i) and (ii) above.

21

Debt sustainability under alternative scenario (based on IMF 2016)

If risks materialize, public debt could go outside the predicted debt threshold range (shaded area below).



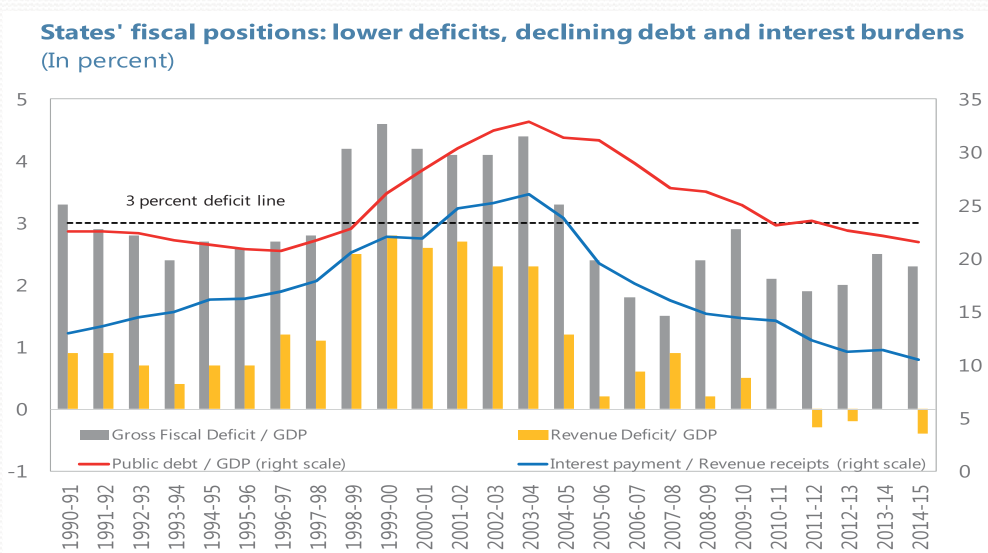
22

D. Debt sustainability in federations

the role of the states

India's subnational governments' fiscal positions

States account for roughly half of India's general government fiscal deficit, and nearly one-third of its public debt. Accordingly, the strength of state FRLs and finances are paramount to ensure sustainability of India's public finances.

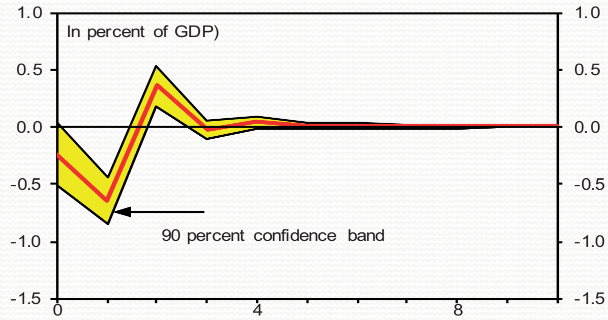


24

Main risks to debt outlook: states vulnerable to shocks

- Budget deficits are hovering close to upper bound in many states
- Evidence (panel VAR) shows that a one STD GSDP growth shock results in cumulative state deficit widening by 1 percent of GSDP over two years.

Response of gross fiscal balance to GSDP growth shock



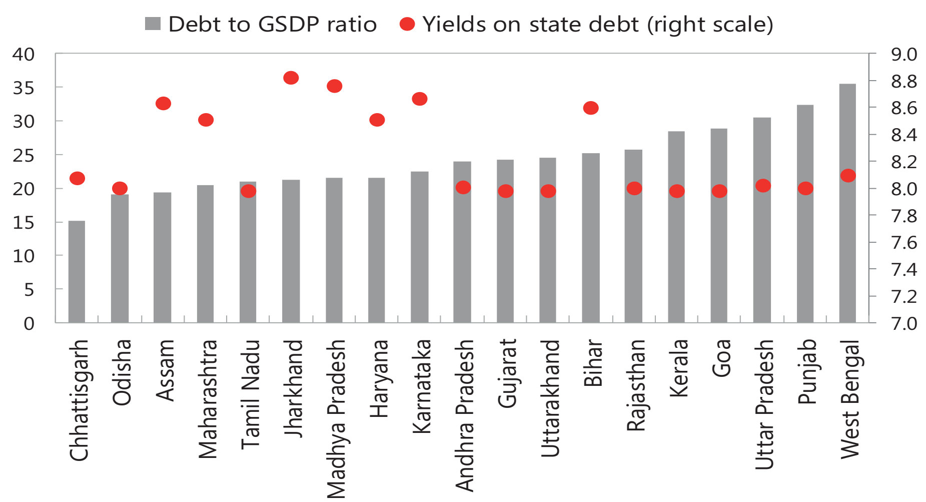
Source: IMF staff estimates.
Note: 1 standard deviation GSDP growth shock is about 5 p.p. which also points to high growth volatility in states.

- Without space under ceiling, states may either breach the ceiling or need to engage in procyclical adjustment.

25

Limited role at present for market discipline on state finances

Challenges of market discipline: little differentiation of borrowing costs
(in percent)



26

E. Conclusions

Conclusions

- A number of approaches for calibrating fiscal anchors exist, each with their pros and cons.
- Countries currently use a number of different fiscal rules, both separately and in combination. Budget balance and debt-to-GDP rules are the most common.
- Based on our analysis, India's predicted debt-to-GDP threshold lies in the range of 65-70 percent of GDP. Inclusion of some buffer to account for uncertainty (including for the materialization of contingent liabilities, e.g. for the banking sector and/or Indian states), suggests a safe level of debt of 60-65 percent of GDP.
- As India's 2016 public debt is currently at 69 percent of GDP, close to the upper bound of the predicted debt intolerance range, any relaxation of ongoing fiscal consolidation would be inadvisable.

28

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29

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(2016 Article IV Staff Report and 2016 Selected Issues Papers, and associated Working Papers)

Opportunities and challenges with India's fiscal framework: some views from the OECD Economics Department

Despite consolidation efforts at the central government level, India's deficit and debt are high

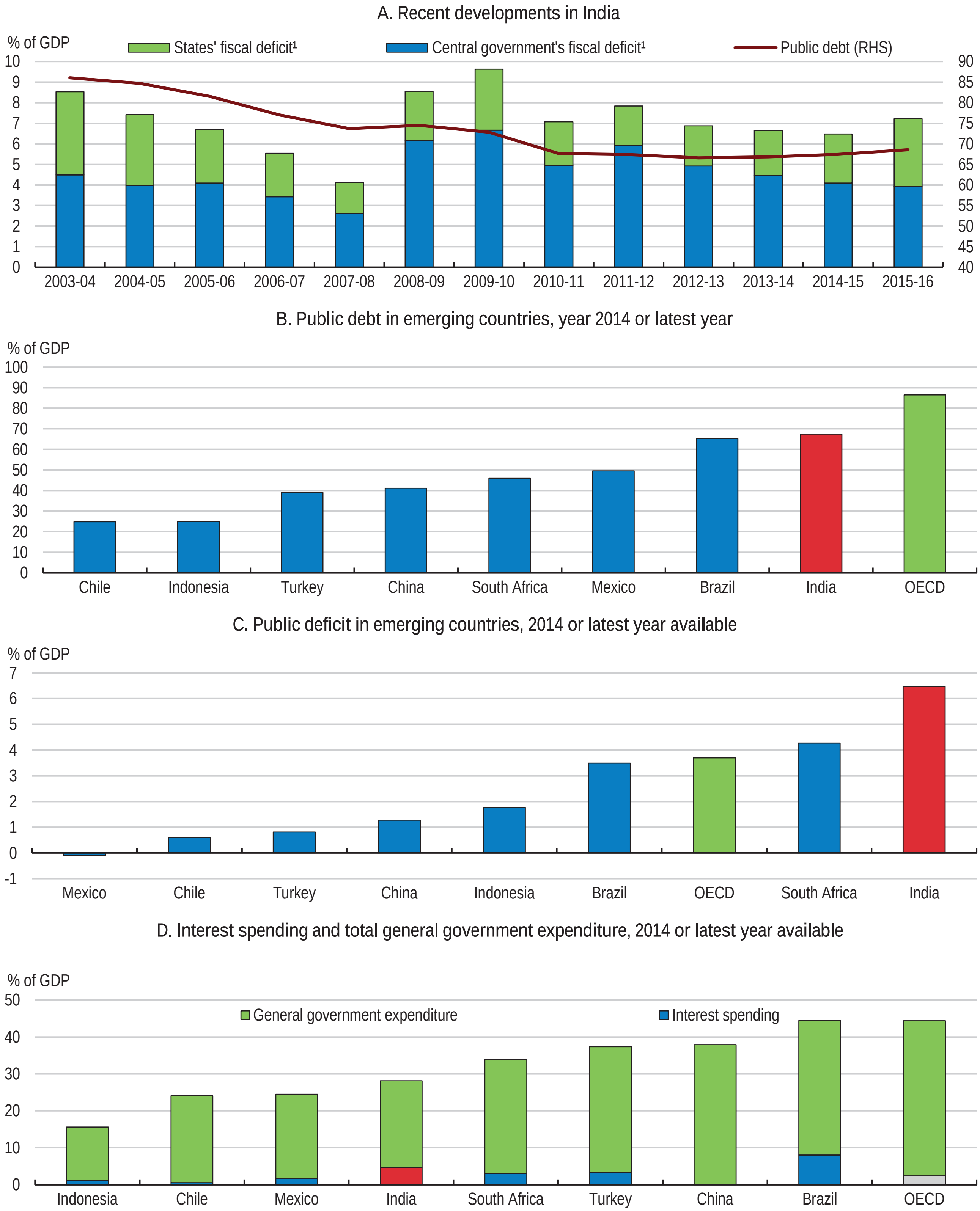
1. Fiscal consolidation has been pursued by central government since FY 2012/13 and its deficit declined from 4.9% in FY 2012/13 to 3.9% in FY 2015/16. The government took advantage of low oil prices to eliminate diesel subsidies, to better target other subsidies (in particular for cooking gas) and to raise excise duties on petrol, diesel and coal. The service tax rate was raised from 12 to 15%. Dividends paid by public enterprises were also up. At the same time, the central government raised infrastructure spending. However, the deficit at the state level has risen and resulted in an increase in the combined deficit and debt to GDP ratio since FY 2012-13 (Figure 1.A).

2. The central government Budget for FY 2016/17 targets a further reduction in the central government deficit to 3.5% of GDP while supporting domestic demand and meeting the needs for social and physical infrastructure. The 16% increase in public wages and 23% in public employees' pensions, following the 7th Pay Commission, from January 2016 will increase central government spending for FY 2016/17 by an estimated 0.4% of GDP. Priority on the spending side has also been given to the rural sector, recapitalising banks, and raising infrastructure spending on nuclear and renewable energy, roads, railways and ports. A large share of public investment is to be financed off-budget through public enterprises. At the state level, wage adjustment will likely take place. Combined with the takeover of 75% of the existing debt of states' electricity companies (3½ % of GDP in total), spending pressures may make it difficult to keep the deficit in check without cutting investment spending.

3. India's public deficit and debt remain high compared with other emerging economies. Risks and costs, however, seem relatively low. Public debt is largely denominated in rupees, reducing external vulnerabilities. The requirement for banks to hold the equivalent of 21.5% of deposits in government securities (the so-called statutory liquidity ratio, SLR) reduces debt servicing costs, although it has the downside of entangling the public finances with the banking system which could amplify a financial crisis as happened in some European countries. With interest costs on government debt significantly below GDP growth in nominal terms, simulations suggest that the debt-to-GDP ratio will decline gradually. Bringing it to a "prudent level" would, however, require some further fiscal consolidation, in line with plans by the central government (Box 1).

4. A number of risks surround this benign scenario. First, the government faces contingent liabilities, reflecting large financial losses in public enterprises and non-performing loans in public banks. Recapitalisation needs for public banks were estimated by the government at close to 2% of GDP in 2015. Second, a reversal in commodity and food prices would raise the cost of subsidies, undermining fiscal health. Third, financial repression – in particular through the SLR – raises the cost of capital for other borrowers, crowds out private investment and reduces medium-term income growth (Government of India, 2015a). On the other hand, the government holds large shares in public enterprises. Potential privatisation receipts and revenue from spectrum auctions are relatively large.

Figure 1. Fiscal challenges



1. The data for the fiscal year 2015-16 are provisional.

Source: OECD Economic Outlook 99 database; Reserve Bank of India; and World Bank World Development Indicators database.

Box 1. India's public debt: is it sustainable?

The concept of "debt threshold" and "prudent debt target"

When debt is used to finance either hard or soft (basic research and education) infrastructure projects, it can support growth, at least up to a certain point. However, if government debt is too high, it can undermine economic activity and the ability of the authorities to stabilise the economy. If debt is used to finance unproductive current spending, it can also weigh on intergenerational equity.

The empirical cross-country evidence suggests that debt thresholds exist, beyond which negative effects of debt on the economy kick in (Fall et al., 2015). For emerging economies, the threshold is lower than for higher income countries as they are more exposed to capital flow reversals, and health and pension systems are maturing. The debt threshold ranges between 30 and 50% of GDP.

For India, the debt threshold is set at 45% of GDP by the OECD Secretariat, i.e. relatively close to the 50% upper limit of the debt threshold range, since India is less vulnerable than many other emerging economies: it benefits from low foreign currency-denominated debt, high currency reserves, long debt maturity (which reduces rollover risks), healthy margins for raising additional tax revenue (see tax chapter) and high potential revenue from asset sales as the government owns large shares in public enterprises and envisages auctioning spectrum licenses. On the other hand, contingent liabilities associated with public enterprises and banks exist and abrupt changes in commodity and food prices increase risks to the public finances, though they do not seem particularly large.

To reduce the risk of going beyond the 45% of GDP debt threshold, a prudent debt target needs to be set. A stochastic debt analysis was developed to quantify the uncertainties surrounding key macroeconomic variables and the risk of overshooting the debt threshold, and to calculate the cushion that is needed to stay below it in the case of adverse shocks (Fall and Fournier, 2015). The prudent debt target embodies the assumption that the public authorities wish to keep the probability of breaching the debt threshold below 25%.

An estimate of the "prudent debt target" for India

Uncertainties surrounding key macroeconomic variables, in particular GDP growth and inflation, and/or their impact on debt are relatively limited in India. As a result, the "prudent" debt target is estimated at around 40% of GDP, i.e. relatively close to the 45% of GDP debt threshold. Were the Indian society had a higher risk aversion, the prudent debt target would be lower (e.g. at 35% of GDP when the probability to breach the debt threshold is set at below 10% instead of 25%).

Recent developments and four scenarios for future debt developments

General government debt declined from 86% of GDP in FY 2003-04 to 69% in FY 2015-16, despite relatively large primary deficits (Figure 1.A). The favourable debt dynamics is due to the large gap between interest rates and GDP growth -- in other words, a robustly growing economy reduces the debt/GDP ratio from below, e.g. from the denominator. The effective interest rate on public debt is relatively low -- public bonds face a captive market as the statutory liquidity ratio forces banks to hold the equivalent of 21.5% of their deposits in government securities – and the average maturity is high.

For the future, the sustainability of India's general government debt can be assessed based on stylised assumptions for growth, inflation, interest rates and fiscal policy up to 2040. They reveal that:

- Under a "no-policy change and high growth scenario", the primary deficit to GDP ratio is assumed to be 2.5% GDP, inflation at 4%, long-term interest rates in real terms at 2¾% (i.e. the average level over 2015 and the first half of 2016), and economic growth is assumed to remain high at 7.5%. The debt to GDP ratio declines to 55% of GDP in 2040, which is still above the "prudent 45% target".a Bringing the debt to GDP to 45% in 2040 would require reducing the primary deficit by about 1 percentage point of GDP.
- If instead financial repression were eliminated and consequently nominal interest rates were to rise gradually to 12.5% (nominal growth plus 1%), the debt to GDP ratio would rise to close to 90% of GDP in 2040 and be on a rising trajectory unless the government achieves a moderate primary surplus.
- With economic growth gradually declining towards 5%, and no policy changes, the debt-to-GDP ratio would stand slightly above 70% of GDP 2040. The other scenario assumptions are as in the first scenario.

a. In recent years, inflation measured by the consumer price index has been consistently higher than measured by the GDP deflator. In FY 2015/16, CPI inflation stood at 4.9% while the GDP deflator suggested inflation at 1%. The simulation exercise uses CPI inflation and may thus overestimate nominal GDP growth if the gap between CPI and GDP inflation were to persist. Overall, the debt dynamic may be less favourable than shown.

The fiscal framework should aim at bringing debt to a prudent level and raising core spending

5. Ensuring macroeconomic stability and providing fiscal space to finance key social and physical infrastructure requires a strengthening of the fiscal framework. Debt targets can serve as a fiscal policy anchor to ensure the sustainability of fiscal policy and that there is sufficient policy room to cope with adverse shocks (Fall et al., 2015). Prudent debt targets provide the commitment tool that reassures markets and thereby diminishes government risk premia. The decline in debt to the prudent level will also allow the SLR imposed on banks to be phased out, thus reducing the cost of capital for private investors.

6. Public spending is low. Interest payments account for a relatively large share of overall spending (Figure 1.D, Table 1), while many Indians lack access to quality public services and social insurance. Public spending on infrastructure, health, education and other programmes which support inclusive growth should be given priority over less productive current spending and be allowed to increase over the medium term. Multi-year spending targets should guide fiscal planning. The planning horizon could match the parliamentary cycle so as to enhance government accountability, as is done in Finland and the Netherlands which are also often ruled by coalition governments. To finance the additional spending while bringing debt to a prudent level and reducing financial repression, India will have to raise more tax revenue (chapter 2) and step up privatisation.

Table 1. Key public finance data for combined central government and states % of GDP

	2005-06	2010-11	2014-15	2015-16
Total spending	26.8	28.4	25.1	28.2
Current spending	22.2	23.9	21.1	22.9
Interest payments	5.7	4.6	4.6	4.7
Capital spending	3.7	3.6	3.3	4.0
Total receipts[1]	20.1	21.3	18.7	20.9
Tax revenue	16.1	16.6	15.7	16.9
Privatisation receipts	0.0	0.3	0.3	0.2
Fiscal deficit	6.7	7.1	6.5	7.2
Central government	4.1	4.9	4.1	3.9
States[2]	2.6	2.1	2.4	3.3

Note: Data for 2015-16 are revised estimates.

1. Total receipts are calculated as the difference between total spending and fiscal deficit.

2. The fiscal deficit of the states is calculated as the difference between the consolidated fiscal deficit and the deficit of the central government.

Source: Reserve Bank of India.

Committing to multi-year fiscal targets while allowing for a stabilisation role

7. The 2003 Fiscal Responsibility and Budget Management Act (FRBMA) required the central government to commit to multi-year fiscal targets. The FRBMA targets were, however, suspended to allow fiscal policy to react to the global financial crisis. Although India's public sector is relatively small, the heavy reliance on the corporate income tax makes revenues sensitive to the business cycle. Fluctuations in commodity and food prices affect India's public spending through the large subsidy programmes for food, energy and fertilisers (over 4.2% of GDP).

8. Recognising a stabilisation role for fiscal policy requires taking into account temporary economic and commodity price shocks, as well as the impact of weather conditions on activity and poverty, in a transparent and credible manner. One option that would permit fiscal rules to respond to temporary shocks is to set a range around the medium-term deficit reduction target, allowing for short-term deviations similar to the monetary policy target (4% +/- 2 percentage points for CPI inflation). International experience, however, suggests that

the upper end limits for debt and deficit targets often become the effective ceiling, leaving no fiscal space to deal with cyclical shocks (Fall et al., 2015). An alternative is to implement cyclically-adjusted fiscal targets which allow the automatic stabilisers to work in full and in a symmetric manner. However, using cyclically-adjusted budget balance targets is difficult, because output gap estimates are often revised sharply, which raises implementation and communication challenges.

9. The best option would be to rely on a spending rule, with a prudent debt objective to anchor the medium-term deficit path to reach the debt objective. A spending rule would allow the automatic stabilisers to work fully on the revenue side where in most countries they are the most powerful. But a structural increase in future spending would have to be accompanied by a structural increase in revenues. If the spending increase is planned, the revenue to pay for it should be pre-programmed. Clear escape clauses should be set, conditional on exceptional events such as natural catastrophes or a sharp output contraction. To cope with "tail" events, a "rainy day" fund can underpin the respect of the rule over the medium term and would allow greater room for fiscal stabilisation. Unexpected surpluses would be saved and used later to finance unexpected deficits and/or short-term stabilisation policies. As it is virtually impossible to enumerate all the exceptional events that might justify a departure from the rule, political backing for the fiscal framework is key.

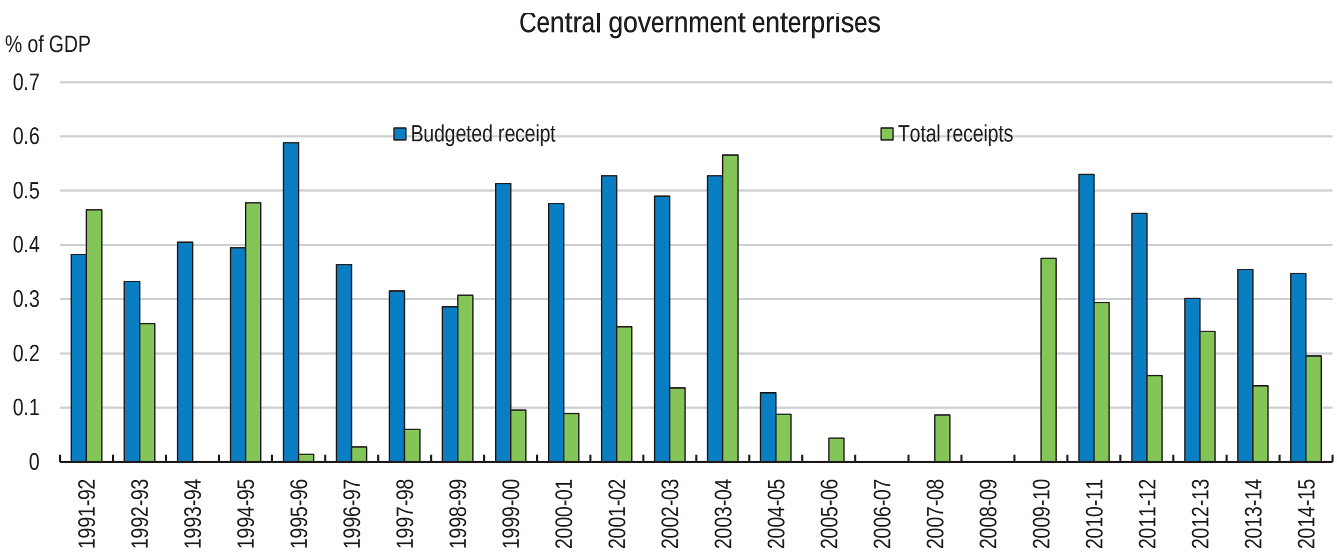
10. Most states have their own fiscal rules (Buiter and Patel, 2010) which, in many cases, require the deficit to remain below 3% of the state's GDP (Kerala has a 2% limit). In addition, states cannot borrow on the market without central government approval. In FY 2015/16, the gross fiscal deficit for the states stood at 3.3% of GDP, indicating some slippage at least in some states. In 2016, states have been given more flexibility in complying with the 3% deficit to GDP ratio rule, if they have a relatively low debt and debt service ratio in the preceding year. The change in financing pattern for the states from FY 2015/16 – a larger share in the general government "divisible tax pool" and less reliance on earmarked grants – should give states more autonomy to prioritise growth-enhancing spending items, such as hard and soft infrastructure. In recent years, states accounted for over 60% of total government investment spending. In the coming years, however, spending on these items may be squeezed by likely wage hikes and the partial takeover of the debt of electricity companies. Given the states' wide-ranging spending responsibilities and the large share of tax revenue apportioned to the states, medium-term fiscal targets should cover the states, or at least should be made consistent with states' fiscal rules.

Improving fiscal policy credibility

11. Enhanced fiscal data help to contain fiscal risks and improve government accountability (Rastogi, 2015). In some areas, progress has been made and India fares relatively well. As an example, a Statement of revenue foregone with estimates on tax expenditure by key categories has been presented annually to parliament since the mid-2000s in the context of budget discussions. And in 2016, the government published information on the number of taxpayers per tax brackets. More needs to be done, however. First, fiscal accounts for local governments are lacking. Second, spending and receipts are recorded on a cash basis,

rather than on an accrual basis as prescribed by the national accounts. Postponing payments (e.g. for subsidies) and anticipating receipts (e.g. dividends from public enterprises) have been used in the past, undermining the credibility of the public finances (Buiter and Patel, 2010). Third, autonomous bodies, extra-budgetary funds and contingent liabilities should also be estimated and reported systematically. Fourth, India counts privatisation receipts and other asset sales as revenue, while most other countries follow the system of national accounts (SNA 93) and record them below the line. And privatisation receipts have been overestimated (Figure 2), often requiring across-the-board spending cuts by the end of the fiscal year to hit fiscal targets. In FY 2016/17, the government plans to launch a large auction of telecom spectrum, with estimated revenue amounting to 4% of GDP. To shelter public net wealth, these sale receipts should be used to pay down public debt or to finance infrastructure investment.

Figure 2. Privatisation receipts have often fallen below projections



Source: Department of disinvestments.

12. To improve the government's credibility and accountability, and watch over the implementation of the fiscal rules, India should establish a non-partisan, independent fiscal council. This institution could carry out fiscal sustainability analysis and produce independent growth, inflation and public finance projections. It would also monitor the implementation of the fiscal strategy, and in particular the consistency of the annual budgets with the medium-term path, and assess when a correction is required and at what pace. Most fiscal rules include escape clauses and the fiscal council should verify whether they are exercised in an appropriate way. It should also advise the government on how to improve the fiscal data, accounting and fiscal risk assessment. Many other countries have created such an institution, with a positive impact on fiscal outcomes (Beetsma and Debrun, 2016; Debrun and Kinda, 2014; Debrun et al., 2013; Hagemann, 2011). International experience suggests that independence of the fiscal council and a presence in the public debate are important for their effectiveness.

FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT IN INDIA

A REVIEW AND RECOMMENDATIONS FOR REFORM

by

Çi dem Ak n, Bruno Carrasco, Sudipto Mundle and Abhijit Sen Gupta

November 2016

The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank (ADB) or its Board of Governors or the governments they represent. The authors appreciate the comments and suggestions from Hun Kim, Teresa Kho, Johanna Boestel, Hiranya Mukhopadhyay, and Navendu Karan.

ABBREVIATIONS

ADB	–	Asian Development Bank
BBR	–	Budget Balance Rules
DCRF	–	Debt Consolidation and Relief Facility
DR	–	Debt Rules
ER	–	Expenditure Rules
FPS	–	Fiscal Policy Strategy
FRBM	–	Fiscal Responsibility and Budget Management
GDP	–	Gross Domestic Product
GSDP	–	Gross State Domestic Product
GOI	–	Government of India
IGRs	–	Intergenerational Reports
MEF	–	Macro-economic Framework
MTEF	–	Medium-Term Expenditure Framework
MTFF	–	Medium-Term Fiscal Framework
MTFP	–	Medium-Term Fiscal Policy
OECD	–	Organisation for Economic Cooperation and Development
RBI	–	Reserve Bank of India
RR	–	Revenue Rules
SBBR	–	Structural Budget Balance Rules
VAT	–	Value Added Tax

Table of Contents

List of Figures

Executive Summary

1. This paper provides an assessment of the fiscal consolidation experience in India based on the framework and operations of the Fiscal Responsibility and Budget Management (FRBM) Act and reviews the international best practices in achieving fiscal stability and optimal debt management. The paper is structured as follows:

2. The introduction is followed by Section 2 that assesses India's experience and performance with FRBM legislation at the central level and in the states. The review indicates that the introduction of FRBM rules helped a great deal in consolidating the finances of both Government of India (GOI) and the states, however, the key challenges under the FRBM Act remain such as (i) a weak linkage between policy setting and operational framework in the budget processes and the budget implementation, (ii) insufficient coverage or assessment of fiscal risks; and (iii) inadequate course correction under the transparency and accountability framework when fiscal objectives went "off-track".

3. Section 3 reviews international experience and global best practices on fiscal rules, types of rules, the introduction of fiscal councils with a special focus on countries in the Asia Pacific region. Section 4 assesses the Indian experience of fiscal rules against the background of international experience and global best practices. It includes how India's FRMB framework compares against properties of fiscal frameworks in other countries including fiscal balance, capital spending, optimal debt levels, cyclical considerations, and underlying budget processing and implementation. India's fiscal rules are found to be mainly in the realm of traditional balanced budget rule with no debt ceiling law while emerging best practices have moved towards a structural budget deficit rule or an expenditure rule. As a consequence, the fiscal framework in India has been less flexible to manage the dual goals of stabilization and debt sustainability. Limited coverage, vague escape clauses and lack of independent fiscal institutions to monitor compliance with fiscal rules also led to inefficiencies in implementation.

4. Section 5 analyzes various reform options based on quantitative fiscal rule simulations. These include fiscal rules that combine fiscal prudence with counter-cyclical stabilization, anchoring fiscal rules in a debt target vs. a fiscal deficit target, implications of different aggregate debt targets and harmonizing fiscal rules with adequate public investment to stimulate private investment. An interesting result from the simulations is that fiscal deficit, primary deficit and public debt ratio all gradually decline as a result of higher capital expenditure through the interactions of the model, indicating the scope for India to reorient public expenditures towards growth-enhancing investment while maintaining overall fiscal discipline.

5. Section 6 presents recommendations on (i) strengthening the enforcement of fiscal rules, including the establishment of independent fiscal councils and possible role of fiscal performance ratings, (ii) improving linkages between fiscal policy and budget processes, (iii) reviewing the escape clauses, (iv) addressing contingent liabilities, and (v) fiscal and debt rules for states. Section 7 concludes.

I. Introduction

1. Fiscal rules are widespread across economies. They respond to a large extent for ensuring sustainability of public finances. Two important factors underpin the advent of fiscal rules, namely the recognition of the role of sound fiscal policy to overall macroeconomic stability, and the rules vs. discretion debate. The Washington Consensus together with the time inconsistency literature spurred greater interest in the importance of hard rules to ensure greater predictability of macroeconomic outcomes and as a means to strengthen economic fundamentals.

2. A fiscal rule in its very essence is a legislated numerical limit on a budgetary aggregate. By enshrining the rule under legislation, it serves to anchor fiscal policy and holds back governments from changing the rules at their discretion. With the adoption and adherence to fiscal rules, governments commit to maintaining aggregate spending in line with aggregate revenue mobilization capacity including through taxation, other non-tax revenue measures, and borrowing. More generally, fiscal rules seek to keep the public debt at sustainable levels.

3. Over time, adhering to the targets under fiscal rules is believed to confer greater government credibility in maintaining sound economic management vis-a-vis market participants. This credibility is supported by a wider framework that supports fiscal rules and that includes strengthening transparency and accountability by the fiscal authorities. The stronger the government's ability to convincingly communicate and explain any temporary deviations from the subscribed targets, the lower will be the level of uncertainty on the part of economic agents and the greater is the level of government credibility. For example, greater predictability on future tax liabilities allows households to better account for their disposable income and plan their consumption behavior. Similarly, greater predictability of future interest rates facilitates their investment decisions.

4. This paper responds to an invitation by the Fiscal Responsibility and Budget Management (FRBM) Act Review Committee appointed by the Government of India to the Asian Development Bank (ADB) to review the framework and operations of the FRBM Act in line with best practices and in particular Asian experience. A presentation was delivered to the Committee chaired by Mr. N.K. Singh on 20 September 2016. The present paper has been prepared to supplement the presentation.

5. This paper is structured as follows. This introduction is followed by Section 2 that reviews India's experience and performance with FRBM legislation and its implementation at the central level and in the states in the context of India's federal structure. It also highlights briefly some of the more recent challenges. Section 3 reviews international experience and global best practices on fiscal rules, types of rules, the introduction of fiscal councils with a special focus on countries in the Asia Pacific region. Section 4 assesses the Indian experience of fiscal rules against the background of international experience and emerging global best practices. It includes how India's FRMB framework compares against properties of fiscal frameworks in other countries including fiscal balance, capital spending, optimal debt levels, cyclical considerations, and underlying budget processing and implementation. Section 5 analyzes various reform options based on some quantitative fiscal rule simulations. These include fiscal rules that combine fiscal prudence with counter-cyclical stabilization, anchoring fiscal rules in a debt target vs. a fiscal deficit target, implications of different aggregate debt targets and harmonizing fiscal rules with adequate public investment to stimulate private investment. Section 6 presents recommendations on strengthening the budget process, addressing contingent liabilities, review of escape clauses, fiscal rules for states, including the possible role of fiscal performance ratings, and the establishment of an independent fiscal council. Section 7 concludes.

II. India's FRBM Experience

6. India is a federal country, with a clearly defined constitutional assignment of taxation and expenditure responsibilities for the union (or central) government and the state governments. India's fiscal framework and its experience with fiscal rules therefore need to be reviewed separately for these two tiers of government.

A. Central Government Experience

7. At the central level, a medium term fiscal policy, with specific three year targets for the fiscal and current deficit, was introduced as early as the mid-1980s. However, these were discretionary targets adopted by the Finance Ministry and not a mandate legislated by Parliament. Fiscal rules for Government of India (GOI) were first legislated by Parliament in the Fiscal Responsibility and Budget Management Act (henceforth FRBM Act) in August 2003, and became effective from July 2004. Following on the FRBM Act, many states enacted their own FRBM Acts (see Section B)

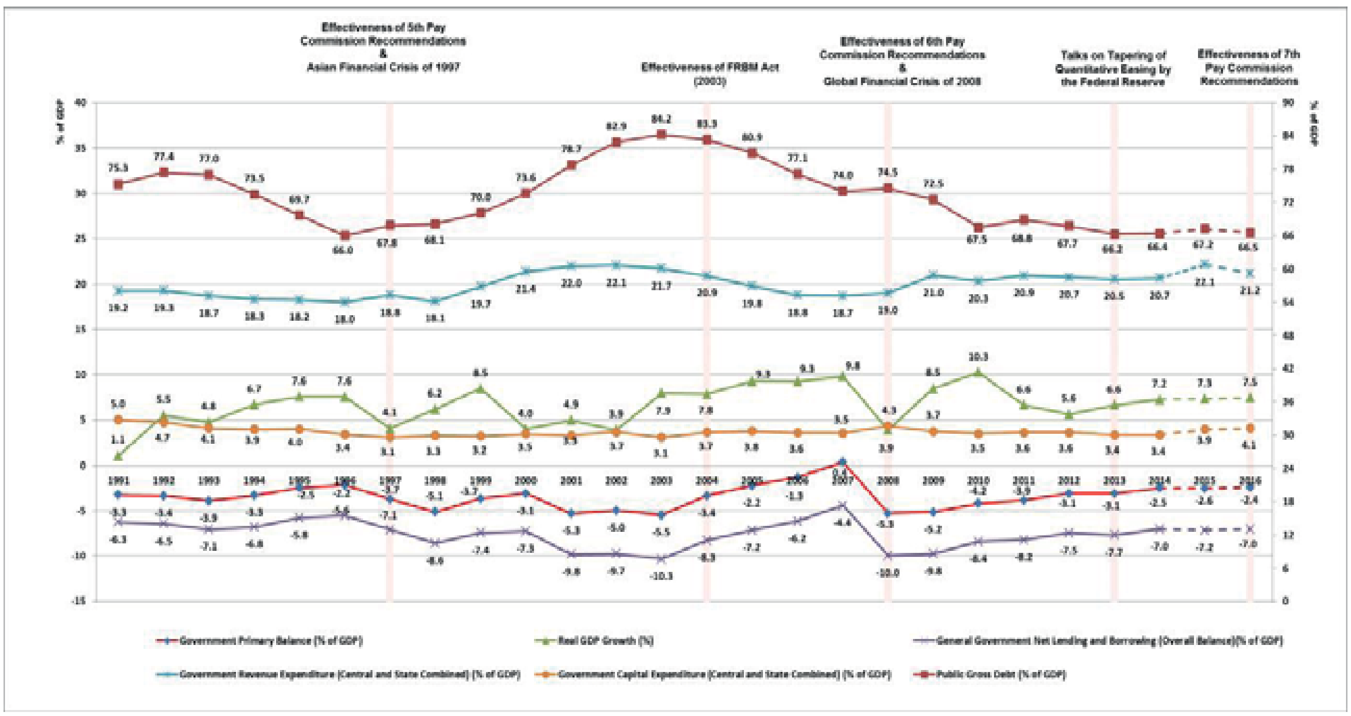
8. The FRBM Act did not itself lay down any fiscal targets, but required GOI to set these targets every financial year in a 3-year rolling plan called the Medium-Term Fiscal Policy (MTFP) Statement. These targets include revenue receipts, revenue expenditure, the current deficit and borrowing for capital expenditure, hence the total fiscal deficit. The Act also required the central government to produce annually a Fiscal Policy Strategy (FPS) Statement which would, among other things, specify the annual policy and underlying rationale relating to tax and non-tax revenue e.g., administered prices, market borrowing and other direct liabilities, contingent liabilities such as guarantees, investment, lending, expenditure (including subsidies), and the strategic priorities of the government and their consistency with the MTFP. The Act further required GOI to annually provide a Macro-economic Framework (MEF) Statement incorporating its assessment and assumptions relating to gross domestic product (GDP), revenue balance, gross fiscal balance, and the current account in the balance of payments.

9. Emphasizing the need for fiscal prudence and transparency, the FRBM Act also required that the MTFP, FPS and MEF statements be presented in a specified format. The three documents have since been included in the official set of budget documents presented along with the annual budget. Further, though the Act did not specify annual targets, it specified that GOI should specify, through fiscal rules presented to Parliament, annual targets for elimination of revenue deficit and reduction of the fiscal deficit during the 3-year period ending on 31 March 2008. It also required GOI to specify annual targets for assuming contingent liabilities in the form of guarantees and total liabilities as a percentage of GDP. In case the MTFP targets are exceeded due to exceptional conditions of national security or natural calamity specified by the government, the Act required these exceptions to be approved by Parliament. Finally, the FRBM Act disallowed the central government to borrow from the Reserve Bank of India except for temporary cash management purposes under specified limits and conditions.

10. Introduction of the FRBM regime initially led to significant improvement in GOI finances. Thus, compared to 6.2% of GDP in 2001–2002, GOI fiscal deficit declined to 4.0% in 2004–2005 and further to 2.5% in 2007–2008. Though GOI current deficit could not be eliminated, it declined from 4.4% in 2001–2002 to 2.5% in 2004–2005 and further to 1.1% by 2007–2008. Thereafter, the program of fiscal consolidation was disrupted following the global financial crisis of 2008 and subsequent growth slowdown. The GOI fiscal deficit shot up to 6% of GDP, with the current deficit rising to 4.5% in 2008-2009. GOI capital expenditure, which was low even earlier at around 2% to 3% of GDP, shrank further to only 1.5% in 2008-2009. Interestingly, there was a slight decline in GOI public debt from 40.2% of GDP in 2005-2006 to 38.1 % in 2008-2009. Internal public debt amounted to 35.9% of GDP in 2008-2009. Total liabilities, which include liabilities on public account such as deposits under provident fund and National Small Savings scheme in addition to public debt also continued to decline from 61.2% in 2005-2006 to 56.1% in 2008–2009 and further below 50% by 2013–2014.

11. Three FRBM objectives are explicitly stated in the Act, namely (i) ensure inter-generational equity in fiscal management, (ii) achieve fiscal sustainability necessary for long-term macro-economic stability, and (iii) improve transparency of central government fiscal operations. Comparing the actual performance against each of these objectives individually, we observe that under (i) gross debt (center and states combined) declined from 83.3% of GDP in 2004 to 66.5% in 2016; under (ii) fiscal deficit declined from 8.3% of GDP in 2004 to 7% in 2016 and GDP growth rates remained robust at 7%–8% per annum and under (iii) there has been improved transparency of fiscal operations at the central level although there remains room for improvement. Indeed original targets were postponed twice, the framework does not envisage a definitive timeframe for addressing deviations from target and off-budget items such as reporting on contingent liabilities could be stronger. To sum up, the view is that measured against these objectives the FRBM framework has been broadly positive.

Figure 1: Fiscal Performance and Key Milestones in India 1991–2016



Source: Reserve Bank of India; IMF World Economic Outlook; Authors' Calculations. 2015 and 2016 figures are estimates.

12. Figure 1 traces the major fiscal aggregates from 1991–2016 as measured against important milestones. Since the introduction of FRBM, public debt has declined as stated earlier and despite the deterioration in the primary balance in 2008, the overall trend on primary balance and overall fiscal balance has been positive. Going back in time, the largest "shocks" have reflected internal Pay Commission salary increase awards both in 1997 and 2008,lathough in the latter instance it also coincided with the advent of the global financial crisis and the general call by the G20 for fiscal stimulus. An important feature is that government capital spending has been rather moderate and generally stable although accommodative to fiscal consolidation needs.

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[1] In the context of India, current deficit refers to revenue deficit.

[2] Source: Indian Pubic Financial Statistics, various years.

[3] Source: Government Debt- Status Paper, Ministry of Finance, Government of India, various years

13. Against this background, there were modifications in the MTFP targets for 2008–2009 and 2009–2010 to accommodate the fiscal stimulus introduced to cope with the financial crisis. The changed circumstances were also taken into account by the 13th Finance Commission in its award for the period 2010–2011 to 2014–2015. Finally, the FRBM Act itself was amended through the Finance Act of 2012. Among the significant amendments, the amended FRBM Act incorporated the revised fiscal consolidation path recommended by the 13th Finance Commission, in effect shifting the targets of the original FRBM Act from 31 March 2009 to 31 March 2015. In addition to the three then existing FRBM documents, the amended Act also asked for a Medium Term Expenditure Framework (MTEF) to be presented to Parliament in the session following the Budget session. The MTEF introduced a new concept of the effective revenue deficit, which is defined as current (revenue) deficit reduced by grants given to states for the creation of capital assets. The new MTFP targets required only the effective revenue deficit to be eliminated by 31 March 2015, with a corresponding current deficit target of 2% of GDP. The amended FRBM Act also mandated the Comptroller and Auditor General to periodically review compliance with FRBM and present the review to Parliament.

14. The award of the 14th Finance Commission covering the period 2015–2016 to 2019–2020 is currently under implementation. This award has incorporated the fiscal targets in the 2014–2015 MTFP, setting the Central Government Fiscal Deficit target at 3% of GDP from 2016–2017 onwards. It has recommended that the concept of effective revenue deficit, which is not recognized in standard accounting practices, be given up. However, it has adopted a relatively liberal target for the current deficit, allowing for a gradual decline to 0.93% by 2019–2020. The MTFP 2016–2017 has set the fiscal deficit target at 3.5% for the current year and 3% from 2017–2018 onwards. The current deficit target has been set at 2.3%, 1.8% and 1.3% for 2016–2017, 2017–2018 and 2018–2019, respectively.

B. State Government Experience

15. Prior to the introduction of state level FRBMs, the picture across states was quite mixed. Several states had already started setting medium-term fiscal consolidation targets, and introduced measures to enhance revenues or contain expenditure, cap contingent liabilities, set up sinking funds to finance debt repayment, and guarantee redemption funds. Some states had even introduced their own fiscal consolidation laws. At the other extreme, some states were continuing to borrow imprudently instead of strengthening their tax effort. A concerted effort towards introducing FRBMs for all states followed from the recommendations of the 12th Finance Commission in FY 2004–2005.

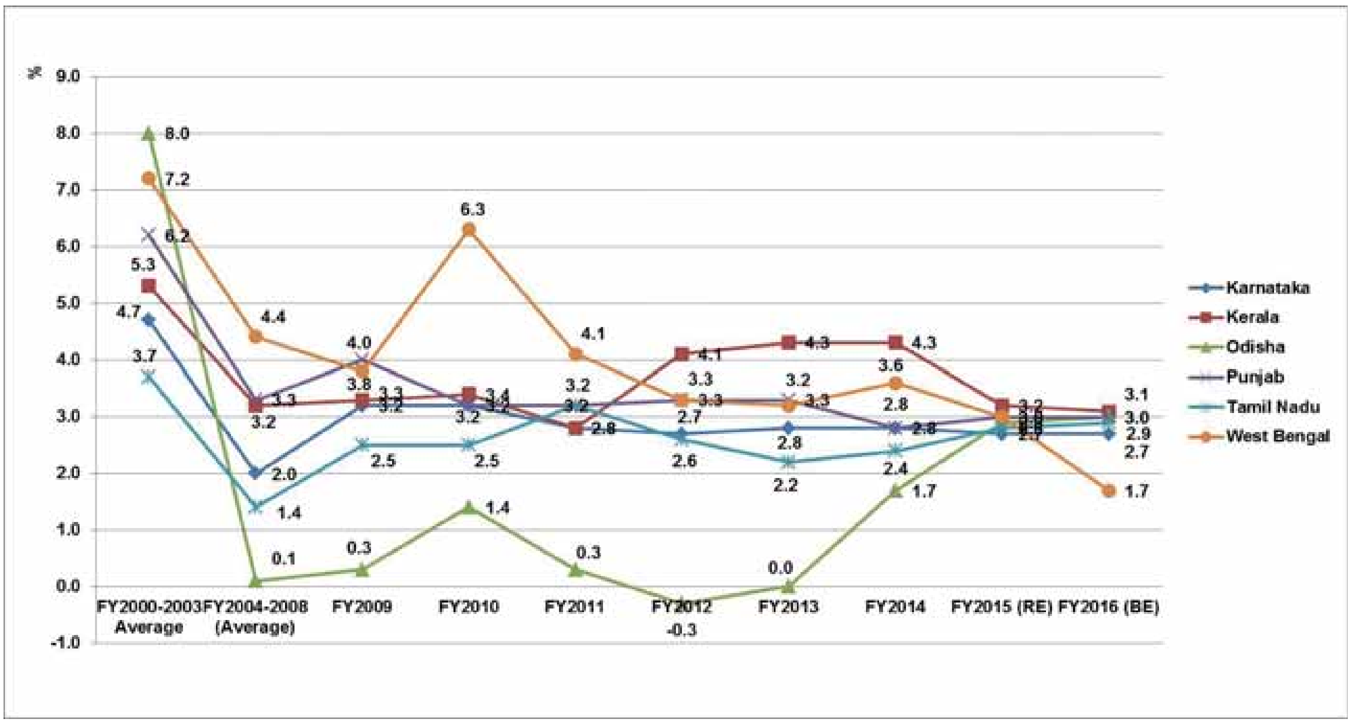
16. The 12th Finance Commission recommended that states should discontinue borrowing from the central government, and instead directly borrow from the market. In the case of states with weak finances, which find it difficult to borrow from the market, the Centre could borrow on their behalf and pass on the proceeds to the concerned states at interest rates aligned to the marginal cost of loans for the central government. External loans were also passed on to the states, along with the interest cost, with GOI acting as intermediary. Most importantly, the Commission recommended the creation of a Debt Consolidation and Relief Facility (DCRF) which would consolidate the outstanding Central loans to a state as on 31 March 2004 and reschedule them for a fresh 20 year term at 7.5% interest, along with a significant debt write off. However, access to the DCRF was made conditional on a state enacting its own FRBM law, and setting a target to eliminate its current deficit by 2008–2009 and reduce its fiscal deficit to 3% of state gross domestic product (GSDP) by this date.

17. Access to the DCRF gave considerable relief to the states, with the debt write off and rescheduling substantially reducing their interest burden. There was also increased devolution from the GOI due to buoyant revenues in a period of high growth. States also undertook significant fiscal consolidation measures as required by their FRBMs. By 2010–2011 all states had introduced their state specific

FRBMs. States also introduced value added tax (VAT), retired high cost debt under a GOI debt swap scheme, and undertook expenditure rationalization. This process of fiscal consolidation was reinforced by recommendations of the 13th Finance Commission. It recommended a revised road map taking into account the impact of the 2008 financial crisis shock, such as reduction of excise duties and slower revenue growth, as well as the impact of the Sixth Pay Commission recommendations, which were introduced in most states in 2009–2010 or 2010–2011.

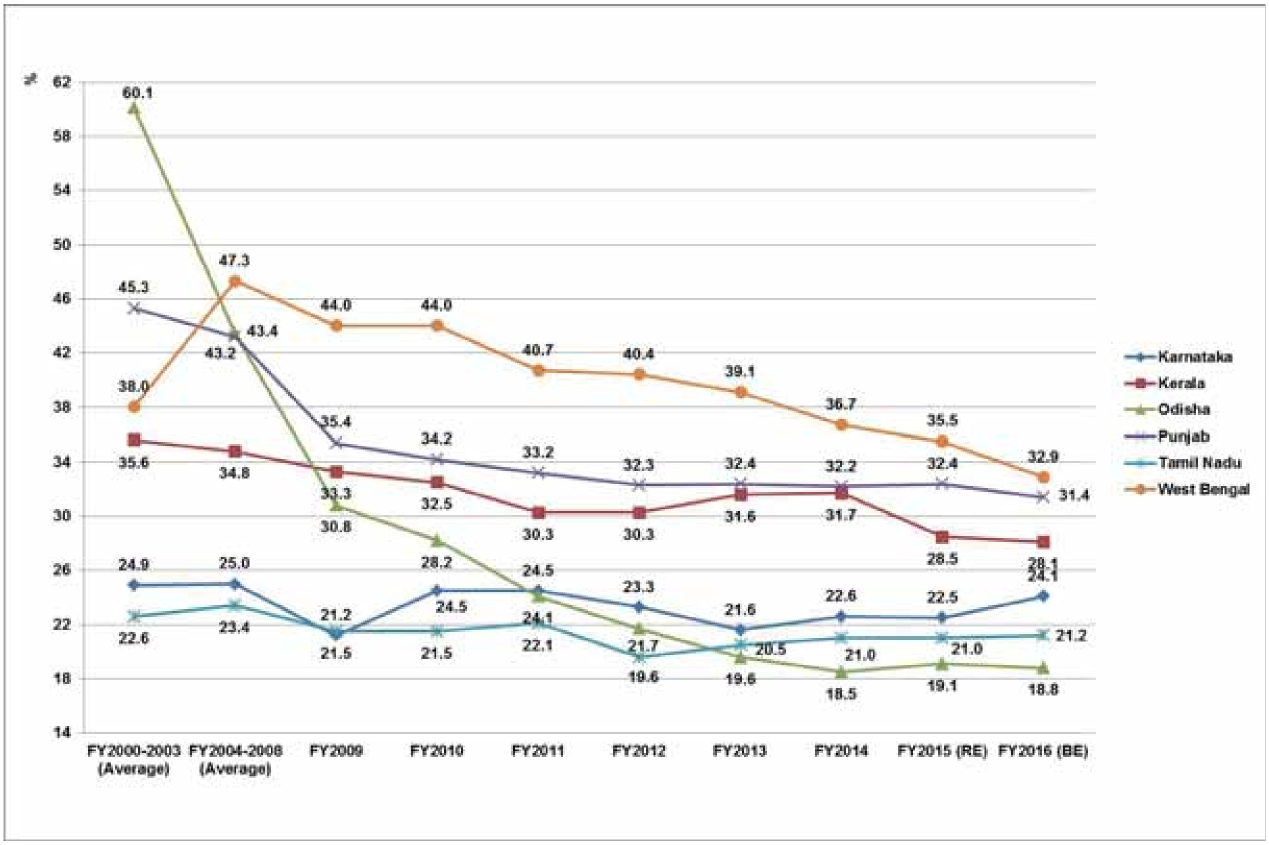
18. As a consequence, in its review of states finances in 2013–2014, the 14th Finance Commission noted a sustained and significant improvement in states' finances. Thus, their combined gross fiscal deficit has been well below the target of 3% of GSDP since 2006–2007. Their combined current deficit had also been eliminated by the same year, though a small current deficit has re-appeared in some years (Figure 2). Of course, there are large variations across states. A number of states still have fiscal deficits in excess of 3% of GSDP and Punjab, Kerala, and Bengal have had current deficits in some years. To help the lagging states, GOI has facilitated ADB support for fiscal consolidation in states such as Assam and West Bengal. Similar support has also been considered for Punjab.

Figure 2: Gross Fiscal Deficit/GSDP



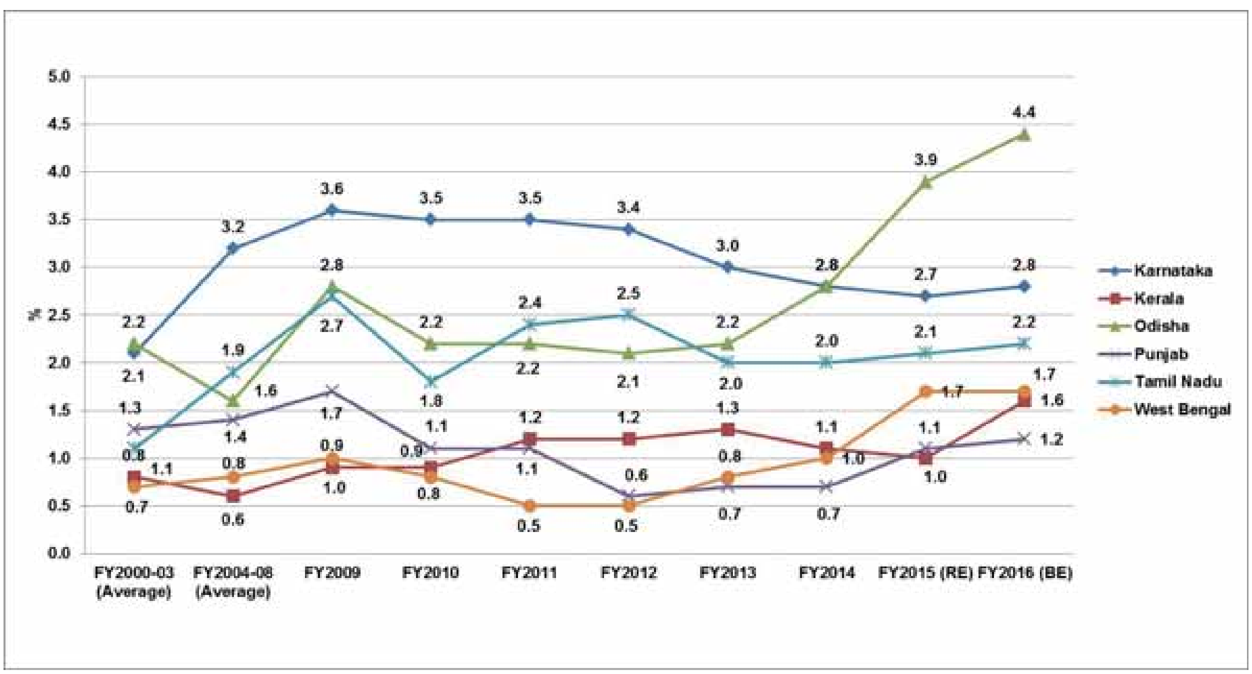
Source: Reserve Bank of India, State Finance, A Study of Budgets. Various Years.

Figure 3: State-Wise Debt/GSDP



Source: Reserve Bank of India, State Finance, A Study of Budgets. Various years.

Figure 4: Capital Outlay/GSDP



Source: Reserve Bank of India, State Finance, A Study of Budgets. Various years.

19. Under the Indian federal structure, states have a preponderance of expenditure assignment relative to own revenues thereby resulting in a vertical imbalance in the fiscal federal framework. Indian states have introduced state level fiscal rules in different time periods. For example, Karnataka introduced it preceding India's FRBM Act of 2004, while in other states such as West Bengal, it followed over 10 years later. However, the general trend across all states has been one of fiscal consolidation and reduction in state level debt-to GSDP ratios. From Figure 2, we observe that the largest improvement in gross fiscal deficit as a share of GSDP across selected states has been in Odisha since early 2000s. More importantly, from Figure 3, debt-to-GSDP has declined across all states in the sample during this period with the exception of Karnataka and Tamil Nadu which remained stable. Finally, from Figure 4, there has even been recent evidence of fiscal consolidation that has not been driven by cutbacks in growth of capital spending from the budget including in Odisha and West Bengal.

C. Consolidated Overview of FRBM Experience

20. A consolidated overview of the combined finances of the central and state governments indicates that the introduction of FRBM rules helped a great deal in consolidating the finances of both GOI and the states. However, the impact of the 2008 financial crisis disrupted the fiscal consolidation process in the case of GOI, leading to a progressive loosening of fiscal targets and eventually an amendment of the FRBM Act itself in 2012. As a consequence, GOI has fallen well short of the original FRBM target of eliminating the current deficit by 2007–2008. It still has a substantial current deficit that is likely to continue till 2019–2020. And its fiscal deficit target of 3% of GDP has not yet been achieved even in 2016–2017. The performance of the states is quite different. Taken together, they have achieved a revenue surplus in most years since 2006–2007 and also maintained a gross fiscal deficit well below the target level of 3% of GSDP since then.

21. Sovereign debt has remained at prudent levels for both GOI and the states, and gradually declined in both cases, which is in line with prevailing views about optimal debt policy (Escolano and Gaspar, IMF, 2016). In the case of the latter, outstanding liabilities have come down from a peak of over 31% of GDP in 2005–2006 to less than 22% at present (Table 2). In the case of GOI, total outstanding liabilities have come down from 61.2% in 2005–2006 to 48.9% in 2015-2016 (BE). Public debt as percentage of GDP amounts to 40.1% and external sovereign debt is 2.7% in 2015-2016 (BE). Total liability of all governments, adjusted for states' liabilities to GOI, is close to around 67% in 2015-2016 (BE) [See Figure 1].

22. However, the FRBM Act has proven deficient across three areas namely: (i) a weak link between policy setting and operational framework where the budget processes and procedures and the budget implementation has not been able to adapt changes to fiscal policy in a more timely and clean manner; (ii) the transparency and accountability framework has not been able to provide sufficient coverage or assessment of fiscal risks; and (iii) the same transparency and accountability framework has not identified or pointed to a path for effectively meeting the targets when the fiscal objectives went "off-track". On (i) above, it has reflected the fact that the medium-term fiscal framework and especially the medium-term expenditure framework was initially not tied closely to the fiscal strategy and the fiscal stance. On (ii), there was no attempt to include an analysis of the potential fiscal risks either domestically—such as the impact of the announcement of the Pay Commission, or externally such as the increase in commodity prices and the implications on fiscal policy. Similarly, there was little sense of the off budget items such as contingent liabilities. Finally on (iii), the ambiguity reflected some

[4] Source: Government Debt- Status Paper, Ministry of Finance, Government of India, various years

uncertainty in terms of the real time magnitude of the shock and hence avoiding a commitment to make time dependent ex-ante fiscal corrections.

III. Fiscal Rules: International Experience with Special Attention to the Asia Pacific Region

A. Background

23. A fiscal rule imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules aim at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability. Although all fiscal rules attempt to promote consistency with the intertemporal budget constraint, they take varied forms depending on the emphasis on long term sustainability or on reducing procyclicality of fiscal policy.

24. The first kind of rules aim to signal a commitment to fiscal sustainability, and such rules are based on numerical targets, which are imposed on (i) the public debt defined in terms of revenues, debt service costs of GDP, and/or, (ii) flow indicators of fiscal performance like fiscal deficits, primary deficits, total revenue, total expenditure or specific spending categories. In some cases, countries opt for a "golden rule" in which investment spending is excluded to prevent any crowding out of much-needed public investment.

25. The second set of fiscal rules allow fiscal policy to respond countercyclically to changing macroeconomic circumstances and are based on (i) a balanced budget requirement specified in a multiyear context of public deficit over the cycle, and (ii) numerical targets for the structural or cyclically-adjusted balance for each year taking into account cyclical variables critical to the public deficit. However, the definition of a medium-term objective leads to the temptation to take some leeway in the short term and count on correction at the end of the cycle.

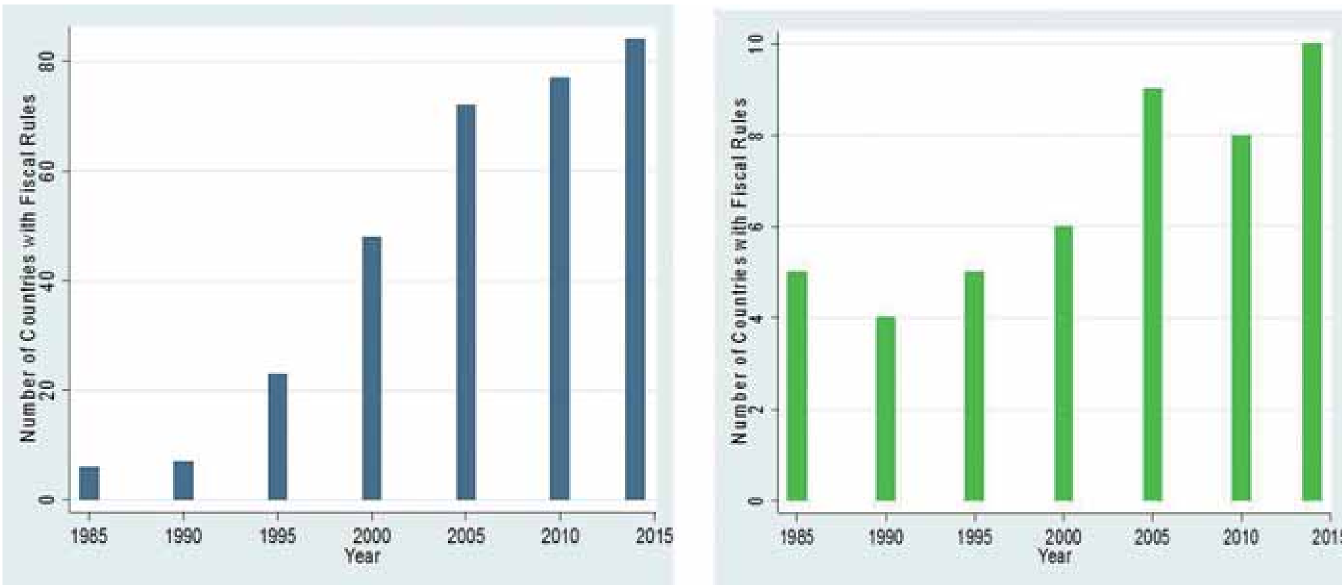
26. Consequently, there are trade-offs between the above two main types of fiscal rules. Firstly, the objective of transparency and simplicity, argues for the choice of first set of fiscal rules that are simple and easily monitored. Nonetheless, such rules do not provide adequate flexibility to accommodate large unexpected shocks nor may they help avoid procyclicality of budgetary policies. Moreover, at times they even encourage practices to circumvent numerical rules like reclassification of expenditures from current to capital items, using off-budget public entities to perform government operations, deferring expenditure, and creative accounting.

27. On the other hand, cyclically adjusted fiscal balances are constrained by the fact that budgetary targets are seldom framed in cyclically adjusted terms. This is driven by the relative complexity of estimating such rules given that a number of analytical issues emerge as it requires having a reliable indicator of the cyclical position of the economy (output gap), the equilibrium price of some commodities and the extent to which individual budgetary items react to fluctuations in output (budgetary elasticities) and commodity prices. Moreover, with time, subsequent computation of structural measures for a given period can give different results as revisions are made to past data, which can be large in the case of emerging markets. Such rules are also difficult to communicate to the public and market.

28. Consensus and political commitment to the rules are vital for their success. Rules with no broad social and political agreement are unlikely to be effectively implemented and in cases of major political volatility can easily end up being ignored. Moreover, the political and social acceptability of a fiscal rule is also likely to be enhanced if they are included in fiscal responsibility laws. These laws extend the concept to rules of procedure that govern the fiscal policy-making process and transparency rules that determine what fiscal information has to be made public and provide accountability mechanisms. The political costs of breaching the rule will also increase if an impartial body is charged with overseeing

its implementation as it significantly reduces the risks of politically motivated manipulations of the rule. This is especially the case with rules like structural balance based ones, which involve complex and technically demanding calculations.

Figure 5: Prevalence of Fiscal Rules



Source: Bova et. al (2015)

29. As per Figure 5, over the last 3 decades, there has been a steady increase in the number of countries adopting some form of a fiscal rule. At the global level, these have increased from less than 10 in mid-1980s to 89 in 2014. Over the same time, number of countries in Asia Pacific having some form of fiscal rules more than doubled from 5 to 11.

30. Fiscal rules can be classified into four main categories depending on the type of budgetary aggregate that they attempt to constrain.

31. Budget Balance Rules (BBR). These rules constrain those variables that primarily influence the debt ratio and that are largely under the control of policymakers. Such variables provide clear operational guidance and help ensure debt sustainability. BBR can be specified as overall balance, structural or cyclically adjusted balance and balance "over the cycle." While the first type of rule does not have economic stabilization features, the others explicitly account for economic shocks. However, estimating the adjustment, typically through the output gap, makes these rules more difficult to communicate and monitor. A balance "over the cycle rule" has the added disadvantage that remedial measures could be put off to the end of the cycle.

32. Debt Rules (DR). These rules set an explicit target for public debt in percent of GDP, and are most effective in terms of ensuring convergence to a debt target. They are easy to communicate but do not provide clear short-term guidance as debt levels take time to be impacted by budgetary measures. Factors outside the control of the government like interest and exchange rate also impact debt levels and result in large fiscal adjustments. Moreover, fiscal policy may become procyclical when the economy is hit by shocks and the debt target, defined as a ratio to GDP, is binding.

33. Expenditure Rules (ER). These rules set limits on various types of spending and are not linked directly to the debt sustainability objective since they do not constrain the revenue side. They are relatively

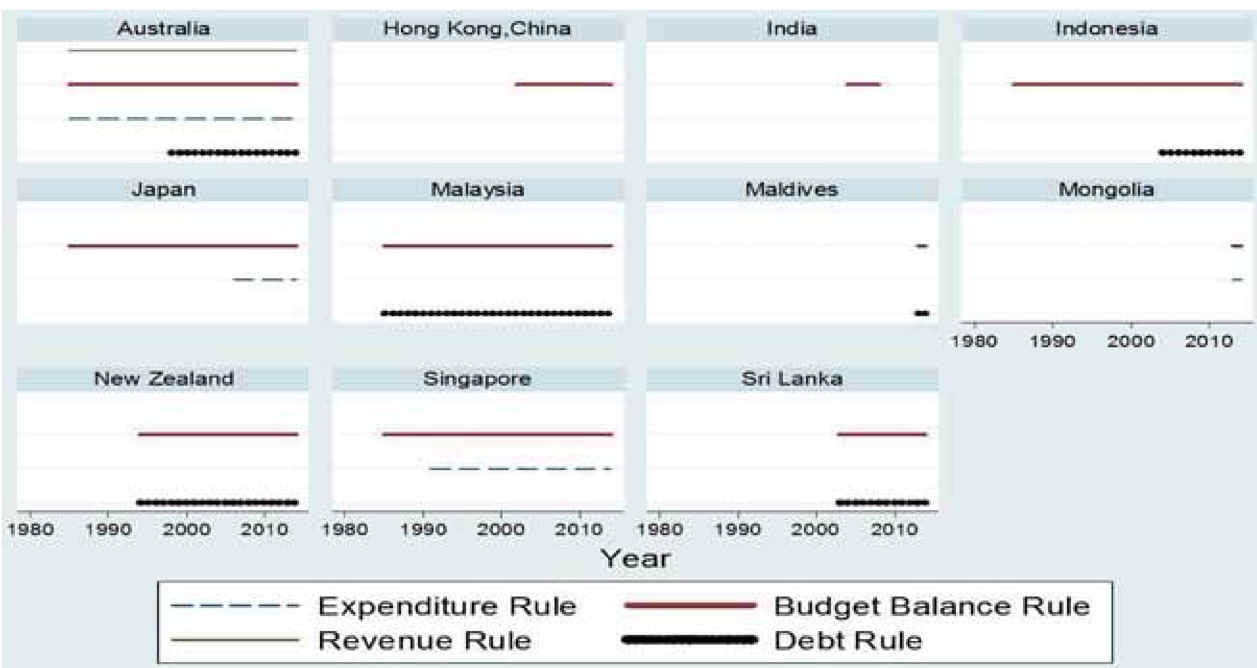
easy to communicate and monitor. However, when accompanied by DR or BBR, they provide an operational tool to trigger the required fiscal consolidation consistent with sustainability. Moreover, expenditure rules do not restrict the economic stabilization function of fiscal policy in times of adverse shocks as they do not require adjustments to cyclical or discretionary reductions in tax revenues. Also, expenditure rules are not consistent with discretionary fiscal stimulus.

34. Revenue Rules (RR). These rules boost revenue collection or prevent excessive tax burden by imposing a ceiling or floor on government revenues. Since they do not constrain the expenditure side, they are unable to directly impact debt levels. Revenue rules alone could result in procyclical fiscal policy, as floors do not generally account for the operation of automatic stabilizers on the revenue side in a downturn, or ceilings in an upturn. However, like expenditure rules, they can directly target the government size.

B. Fiscal Rules in Asia Pacific

35. Within the Asia Pacific, there are 11 major economies that have adopted some form of a fiscal rule. While some countries such as Australia, Indonesia, Japan, Malaysia, New Zealand, and Singapore have several decades of experience with fiscal rules, South Asian economies like India and Sri Lanka have had these rules only since the 2000s. All the countries in Asia Pacific, which have adopted a fiscal rule, implemented some form of a Budget Balance Rule (BBR). In several countries, including Australia, New Zealand, Indonesia, Malaysia, and Sri Lanka, the Budget Balance Rule was accompanied by a Debt Rule, which imposes a ceiling on the ratio of debt-to-GDP. While Australia, Singapore, and Japan had an Expenditure Rule accompanying the Budget Balance Rule for a part of the period, in Australia, these rules were additionally supplemented with a Revenue Rule (see Figure 6).

Figure 6: Countries Adopting Fiscal Rules in Asia Pacific

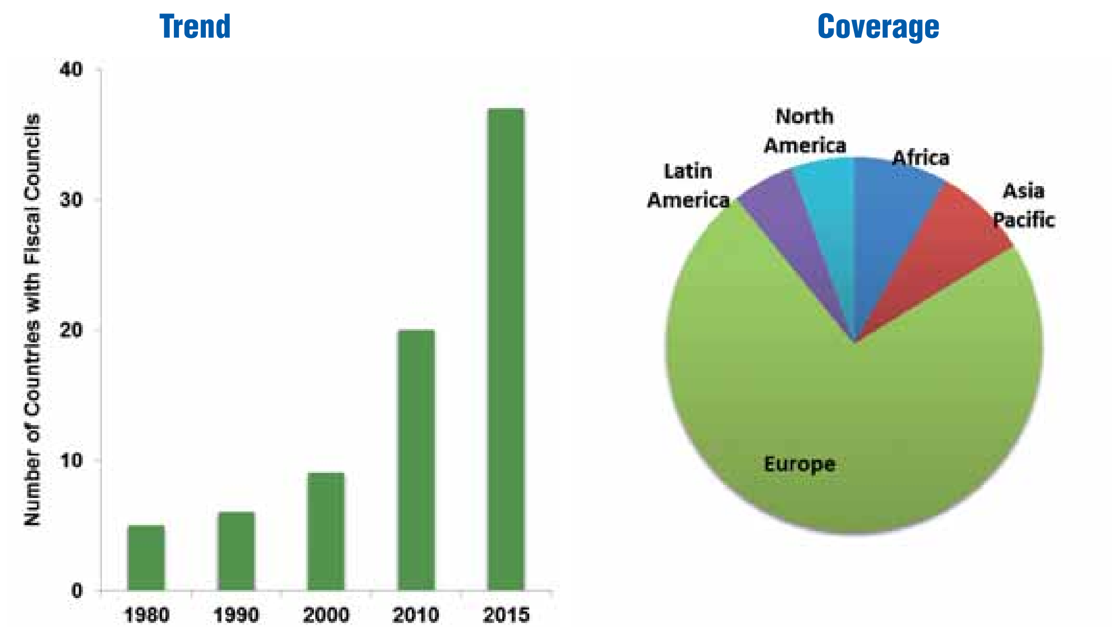


Source: Bova et. al (2015).

36. Over the last decade and a half, a rapidly growing number of countries have established independent fiscal councils that aimed at promoting sound fiscal policies (Figure 7). While all of them share the ultimate objective of promoting sound fiscal policies through independent oversight, the councils vary greatly in terms of their remit, tasks, and institutional forms, which are driven by country-specific

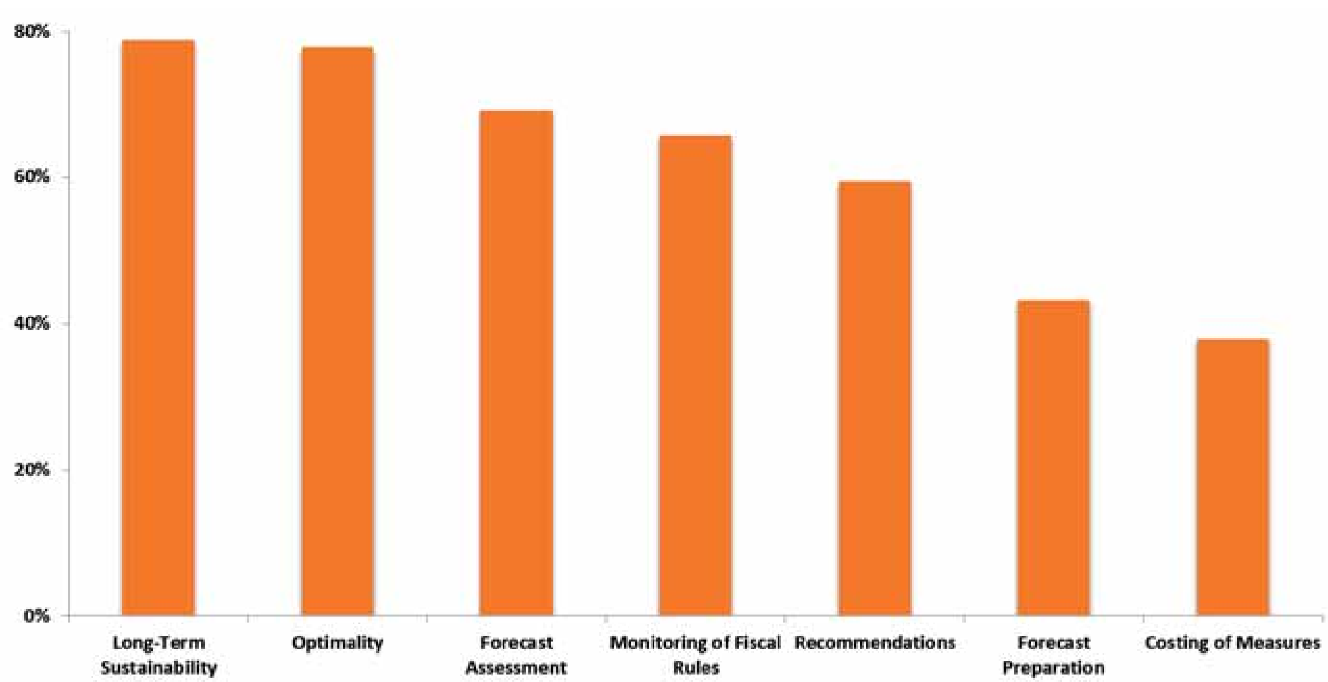
characteristics, such as available human and financial capacities, political traditions, and the causes for excessive deficits and debts. Traditionally, the majority of the fiscal councils have been established in Europe although, there has been growing interest in emerging markets and developing economies.

Figure 7: International Experience with Fiscal Councils



Source: Debrun et. al (2013); Debrun and Kinda (2014).

Figure 8: Remit of Fiscal Councils



Source: Debrun et. al (2013); Debrun and Kinda (2014).

37. From Figure 8, most fiscal councils analyze and evaluate long-term sustainability issues, and prepare or assess macroeconomic forecasts with the third party credibility that is often needed to better understand and give greater objectivity to what can be very complex issues.

38. We describe the experience of fiscal rules in three major Asia Pacific economies viz. Indonesia, Japan, and Australia below. While Japan had a fiscal rule since 1947, Indonesia introduced a budget balance rule in 1967 and Australia initiated a rule since 1985. However, the extent of compliance under these rules varies a lot across the three countries and even over different time periods.

1. Japan

39. Japan enacted the "Public Finance Law" in 1947 which stipulated that the government could issue bonds only for financing public works, investments, and loan repayments (Golden Rule). The government adhered to this rule until 1964, and kept a balanced budget without issuing any bonds. However, after 1965, the government started to issue "construction bonds". In 1975, to deal with the worldwide recession after the first oil crisis, the government requested a waiver of this rule by enacting a special law, which enabled the government to issue special "deficit-financing bonds" during the specific single fiscal year in order. Subsequently, the government enacted this law every year, along with target year of achieving issuance of no such bonds. The government also introduced yearly "ceilings" to contain expenditures and sold the equities of public corporations to obtain revenues. It was only between 1990 and 1993, due to growth of tax revenue and rise in asset prices, the government stopped issuing "deficit-financing bonds".

40. However, fiscal management became unstable in the middle of 1990s with the collapse of the "bubble economy" and the aging population. Under such a situation it was recognized that a legislative framework for fiscal consolidation was crucial to keep multi-year commitments. The "Fiscal Structure Reform Act" was enacted in 1997, and it specified fiscal consolidation targets including (i) reduction of fiscal deficit to less than 3% of GDP by 2003, (ii) steady reduction in the issuance of "deficit-financing bonds" every year and termination by 2003, and (iii) the ratio of bond issuance to the total budget in 2003 to be less than that in 1997. However, after the enforcement of the act, Japan faced severe economic downturn due to bankruptcies of large financial institutions and the Asian Financial Crisis, and the government had to change its fiscal stance toward an expansionary one. The government had to finally suspend the Act in 1998.

41. Thereafter between 2001 and 2006, the government introduced "Basic Policies for Economic and Fiscal Management and Structural Reform" to attain proper balance between economic growth and fiscal consolidation. In 2006, the "Basic Policy 2006" stipulated a fiscal consolidation target of primary surplus in 2011 and numerical multi-year expenditure framework. The framework also included restraining social security expenditures along with reforms of the systems, nominal reduction rate in public investments, and other expenditure ceilings. While the framework and ceilings were applied till 2008, the global financial crisis forced the government to formulate an expansionary budget in 2009.

42. A change in government led to adoption of the "Fiscal Management Strategy" in June 2010. This strategy stipulated fiscal consolidation targets for primary balance of government and for outstanding public debt. It was stipulated that the government should halve the primary deficit ratio relative to GDP from 6.4% in 2010 to 3.2% by 2015, and achieve primary surplus by 2020. At the same time, it was stipulated to achieve steady reduction of public debt ratio to GDP after 2021. In order to achieve

[5] A pay-as-you go rule implies that any measure that involves increases in expenditure or decreases in revenue need to be compensated by permanent reductions in expenditures or permanent revenue-raising measures.

these fiscal targets, the strategy contained the "Medium-Term Fiscal Framework" (MTFF) for 3 years and the "Basic Rules on Fiscal Management" as cabinet decisions. The framework was planned to be rolled over year by year, and yearly budget was formulated along with it in 2011 and 2012. The revised version of MTFF in 2012 set the primary expenditure targets of 71 trillion yen for three consecutive years. As for the basic rules, the strategy included "Pay-As-You-Go Rule," "Fiscal Deficit Reduction Rule" and the statement of "Securing Revenue Sources for Structural Expenditures."

2. Indonesia

43. Indonesia originally adopted a balanced budget rule in 1967. The difficult economic situation inherited from the previous regime prompted the new government to adopt a conservative fiscal policy to reduce government debt and inflation. This led to Indonesia having a conservative fiscal policy prior to the 1997 Asian financial crisis. Post Asian financial crisis, the rising deficit reflected the cost of shoring up the banking sector and the government's limited access to domestic and international credit, due to political instability. Consequently, Indonesia established a fiscal rule, set out in the State Finance Law and Government Regulation 23/2003. The two main features of the law were (i) limit the general government deficit to a 3% of GDP, and (ii) constrain the cumulative government debt to a maximum of 60% of GDP. Implicitly, the rule has been interpreted to cap central government fiscal deficits at 2.5% of GDP, and allow a buffer for regional government cash deficits of up to 0.5% of GDP.

44. These rules are simple and easy to understand and have become closely associated with a track record of fiscal prudence and rapid debt burden reduction over the 2000s. The government debt burden fell significantly from 87% of GDP in 2000 to a low of 23% in 2012. The rapid reduction was driven by consistent surpluses of revenue, notably natural resource related revenue over non-interest spending, coupled with rapid nominal GDP growth.

45. The macroeconomic conditions since 2012 became more challenging, with a slump in global commodity prices and sluggish external demand. This led to weakening of external balances, and slowing down of the economy. In the post-2012 period, Indonesia's fiscal stance became more expansionary with the primary balance swinging into modest but sustained deficits, and the government debt burden inching up by 2% in 2014 to 25% of GDP. Overall, Indonesia's fiscal management has remained prudent as fiscal deficits and debt levels have been capped at low levels, compared to its peer economies.

46. However, these rules have also had some adverse consequences. The first is significant under spending in infrastructure. Aggregate investment in infrastructure in Indonesia by central government, sub-national governments, state-owned enterprises, and the private sector has remained at only 3% to 4% percent of GDP over the past decade. This is far below the rates of above 7% of GDP before the 1997 Asian financial crisis and the 10% and 7.5% spent by PRC and India, respectively. For much of the period 2005–2014, the central government's spending on infrastructure was significantly crowded out by large energy subsidies. In 2014, spending on energy subsidies accounted for more than one-fifth of the central government's budget. This was more than three times the allocation for infrastructure such as roads, water, electricity and irrigation networks, and three times government-wide spending on health.

47. The second consequence has been significant in-year and year-to-year volatility in major budget components, especially energy subsidy and capital expenditures, and natural resource-related revenues. For many of the expenditure items, the final outturn typically deviated significantly from initially budgeted amounts for the year, as evidenced by considering the changes adopted as part of annual revised budgets (APBNP), promulgated around the middle of each year. The pattern has been for capital expenditures to be revised up in revised budgets, only for the final outturn to be below the original budget allocation.

48. This volatility can be explained by the fact that that ministries purposely underspent their capital budgets to meet the fiscal rule or that ministries have been allocated additional money too late in the year for them to execute investment spending. Thus the need to cap fiscal deficit at 3% of GDP has led to volatility of capital expenditures and especially reduced capital spending at times of higher than expected energy subsidy spending or lower than expected revenues.

3. Australia

49. Australia adopted a "trilogy" of fiscal rules in its 1985–1986 budget, which were applicable to the 1985–1986 financial years and over the 3-year term of the then Parliament. These commitments included (i) not to raise tax revenue as a share of GDP (ii) not to raise government expenditure as a share of GDP, and (iii) reduce the budget deficit in absolute terms and relative to GDP. The government had substantial success with the second and third commitment as expenditure share declined from 27.4% of GDP in 1985–1986 to 23% in 1989–1990, and underlying cash balance improved from a deficit of around 2.6% of GDP in 1984–1985 to a surplus of 1.5% of GDP in 1989–1990. The government was unable to meet the first commitment as tax share of GDP rose from 22.6% in 1985–1986 to 23.3% in 1986–1987 as stronger economic conditions added to growth in revenue. Although not part of the formal trilogy of fiscal policy commitments, net debt fell from a peak of 10.3% of GDP in 1985–1986, close to the same ratio as in 2012–2013, to 4% by 1989–1990.

50. The improvement in the fiscal health achieved during the second half of 1980s witnessed a quick turnaround during the recession that followed in 1991. Apart from the recession, the discretionary fiscal stimulus introduced in the February 1992 led to considerable deterioration in the fiscal outcomes.

51. In its 1993–1994 Budget, the government adopted a target of reducing the budget deficit from 3.9% of GDP to a deficit of 1% of GDP by 1996–1997. This target was achieved, albeit with a reliance on tax increases that contributed to raising the tax share of GDP by over two percentage points and with a change of government in 1996, when the newly elected government implemented a substantial fiscal consolidation in its first budget.

52. Subsequently, in 1996, the government adopted the federal fiscal responsibility legislation which set the stage for a substantial fiscal consolidation. The Charter of Budget Honesty Act 1998 was passed by the federal Parliament in 1998, although the government had been adhering to its principles from the time it assumed office in 1996. The Act includes general principles of sound fiscal management but is non-prescriptive as to fiscal targets or outcomes. The Act mandates regular fiscal strategy statements that include fiscal objectives and targets for the next three years as well as a longer-term fiscal strategy.

53. In line with the Charter of Budget Honesty Act, the government committed to achieving and maintaining a balanced budget over the course of the economic cycle (usually interpreted as an underlying cash surplus of around 1% of GDP). However, the Act allowed for temporary fiscal stimulus measures to address cyclical conditions. The Act also mandated several regular fiscal and economic updates. The aim of the regular updates was to increase fiscal transparency and accountability and to ensure better informed public debate on fiscal issues. A major innovation contained in the Charter was a requirement for the government to prepare Intergenerational Reports (IGRs) at least every 5 years to assess the sustainability of federal fiscal policy over a 40-year horizon. Successive IGRs have highlighted a large prospective fiscal gap at a 40-year horizon based on the technical assumption that the tax share of GDP remains constant while expenditures continue to grow under current policy settings.

[6] Even during the Global Financial Crisis, Indonesia maintained its non-cyclically adjusted budget deficit at only 1.5% of GDP, despite slower growth.

54. When a new government assumed office in November 2007, it came out with a public commitment to increasing budget surpluses to 1.5% of GDP and paying surpluses above that figure into the future fund. However, this did not happen, partly due to the economic downturn during the global financial crisis and the associated discretionary fiscal stimulus introduced in 2008 and 2009, but also the cumulative effect of structural spending commitments.

55. In its fiscal strategy statements, the government committed to holding the tax share of GDP below the 2007–2008 level on average. This target has been met, although largely for cyclical rather than structural reasons. The 2010–2011 budget set out a "deficit exit strategy" that included 'holding real growth in spending to 2% a year until the budget returns to surplus. This was later modified to 2% "on average". Based on actual fiscal outcomes to the end of 2012–2013, this commitment was met, although it largely reflected the rolling-off of temporary fiscal stimulus measures and window-dressing of the underlying cash balance. Federal spending rose 0.4% per annum on average between 2010–2011 and 2012–2013, coming off very large increases in spending in the immediately preceding years.

56. Since 2014, the government's medium-term fiscal strategy has been to achieve budget surpluses, on average, over the course of the economic cycle with a surplus of at least 1% of GDP by 2023–2024. The strategy is underpinned by certain policy elements including (i) redirecting public spending to quality investment to boost productivity and workforce participation; (ii) controlling expenditure to reduce the government's share of the economy in order to free up resources for private investment to drive jobs and economic growth; and (iii) strengthening the government's balance sheet by improving net financial worth over time.

IV. An Assessment of India's FRBM Framework and Fiscal Rules

57. Best practices emerging from several decades of international experience in implementing fiscal rules provide a useful benchmark against which to assess the Indian experience (Kopits and Symansky, IMF, 1998, Schaechter et.al, IMF, 2012, Bova et.al, IMF, 2015). A set of ten criteria is identifiable: types of rules are they well defined, simple, flexible, adequate, consistent, transparent, enforceable, efficient, and independently monitored? The assessment based on these criteria should serve as a guide to future directions of reform starting from conditions as they exist in India at present. The following is an assessment from this perspective.

A. Fiscal Rules in India

58. As presented in paras. 31-34 there are different types of fiscal rules. Increasingly, countries combine more than one type of rule. Typically a DR is combined with either a BBR or, increasingly, a SBBR or ER. The Indian FRBM act only applies one rule, a BBR. The original act adopted the "golden rule", i.e., to achieve zero current deficit by a target date and a corresponding limit on the fiscal deficit, i.e., borrowing only for capital expenditure. This was set at 3% of GDP for GOI and at 2.8% of GDP (3% of GSDP) for all states combined, totaling 5.8% for all government.

59. However, the original target date has been repeatedly shifted forward and the zero current deficit target has been abandoned in the case of GOI, undermining the credibility of this fiscal rule. In the case of the states the story is different. Their combined fiscal deficit has remained well below the 3% of GSDP target since 2005–2006. They had also collectively eliminated the revenue current deficit by 2006–2007, though a small current deficit has reappeared in the last couple of years. Thus, the states' commitment to enforcing fiscal rules seems much more credible at present, though this is partly because they face a hard budget constraint unlike GOI. This is discussed further below.

60. As noted above, total public liabilities have remained at prudent levels and are gradually coming down. This is in line with prevailing views on the optimal inter-temporal debt path (Escolano and Gaspar,

IMF, 2016). However, the FRBM laws themselves do not provide any debt ceiling either for GOI or the states, though such a ceiling is required under the Indian constitution.

61. The FRBM laws also do not provide any SBBR targets, though the 13th Finance Commission report recognized the need for countercyclical fiscal policies and this has also been recognized in some official documents like the recent Economic Survey. One of the reasons cited for countries not moving on from BBRs to SBBRs is the complexity of estimating output gaps for setting the SBBR targets. However, in India's case technical exercises have been undertaken in the Reserve Bank of India (RBI) and elsewhere on estimating trend growth paths, fiscal response elasticities and the structural deficit (Pattnaik et.al. 2006; Ghosh and Misra, 2016).

62. Expenditure targets (ER) and revenue targets (RR) are also not included in India's existing FRBM laws.

B. Are the Laws Well Defined?

63. The Indian FRBM laws are well defined to the extent that they set specific BBR targets and every state is covered by its own FRBM law, which is also consistent with the national FRBM law. However, coverage is still limited because it does not extend to public enterprises and contingent liabilities in the form of guarantees. Finally, the escape clause from the FRBM, clause 7(3) (b) is quite vague, referring to "unforeseen circumstances". It is left to the discretion of the government to determine what qualifies as "unforeseen circumstances".

C. How does FRBM Compare with Standard Properties?

64. Simplicity. FRBM laws of the central government and the states specify a ceiling for the fiscal deficit and require the current deficit to be eliminated or reduced by a target date. This is quite simple and straight forward compared to, say, a cyclically adjusted fiscal deficit.

65. Flexibility. Lack of flexibility is a major limitation of traditional budget balance rules, e.g., setting a fiscal deficit target as a fixed proportion of GDP. It makes the fiscal policy stance automatically procyclical, when in fact it should be countercyclical. GOI, which is primarily responsible for macroeconomic management, along with the RBI, has accordingly found it difficult to pursue countercyclical fiscal policy within the constraints of the FRBM target. This has led the Ministry of Finance to try to manoeuver in various ways to get out of the FRBM straight jacket since the 2008 crisis. It postponed the target dates in the MTFP, introduced a concept of effective revenue deficit, which is not recognized in standard budgeting practices, and eventually amended the FRBM Act, abandoning the zero current deficit goal and further postponing the date for achieving the fiscal deficit of 3% of GDP.

66. Other creative ways to artificially reduce the deficit have also been reported. Expenditures are sometimes shifted past the end of the financial year to stay within the deficit limit. On the revenue side, the use of one off measures, such as sale of public sector assets, to shore up receipts has been a standard strategy. Off budget transactions through public sector enterprises, e.g., on oil subsidies, has also been a popular technique. Refund of excess tax collections have often been delayed till after the end of an accounting year. According to reports, a major public sector bank was recently asked to pay excess advance tax before the end of the financial year and refunded the excess demand after the close of the financial year. When bank staffs were penalized, there were protests that this was well established practice! These manoeuvers have weakened the robustness of the budget process and undermined the

[7] However, it has been pointed out that the 3 percent fiscal deficit target is derived from the debt target. See the 13th Finance Commission for a detailed discussion.

credibility of the FRBM law. However, it has to be recognized that the problem originates with an inflexible fiscal rule that forces fiscal policy into a procyclical stance.

67. Adequacy. Are India's FRBM rules commensurate with the goals? The primary goal of fiscal rules is debt sustainability, with a supplementary goal of macroeconomic stabilization. So India could adopt direct rules on debt ceiling, which would also fulfill a constitutional mandate. Certainly, debt sustainability can also be approached indirectly through fiscal deficit targets, but that can lead to other adverse consequences for macroeconomic stabilization policies as explained above. The challenge is to identify fiscal rules that can address both goals at the same time.

68. Consistency. Fiscal rules need to be consistent internally, as well as with other macroeconomic policies. Particularly important in this context is consistency between fiscal and monetary policies. If there is more than one fiscal rule, then the two have to be consistent, e.g. a fiscal deficit target with the debt target if there is one, time consistency. This does not apply in India's case since it so far does not have a debt target rule. Consistency across fiscal and monetary policies would require coordination between the two. For example, a fixed 5.8% of GDP fiscal deficit target (center plus states) can lead to a sharp increase in the absolute volume of borrowing during a period of rising growth, and this could crowd out private investment unless it is matched by an accommodating monetary policy stance. On the other hand, an accommodating monetary policy combined with a sharp rise in the volume of deficit could build up inflationary pressures. Therefore, fiscal rules and monetary policy need to be closely coordinated. The RBI and the Finance Ministry do meet regularly to coordinate fiscal with monetary policy, and this has now been formalized through the monetary policy framework.

69. Transparency. Reference was made above to the various manoeuvers the central government has tried to somehow square the circle, i.e., meet the requirements of countercyclical fiscal policy within the straitjacket of procyclical FRBM rules, the fixed fiscal deficit and current deficit targets. These manoeuvers were intended to show that fiscal rule targets were being met when in fact they were being breached. Eventually, the FRBM law itself was amended in 2013 to bring in the concept of the "effective revenue deficit", a concept not recognized in conventional budgeting practices. Revised FRBM targets are being set in terms of this concept. It excludes grants to states for capital expenditure from the computation of the central government revenue expenditure, though these appear in state budgets as receipts on the revenue account. Though the compulsions underlying such manoeuvers are understandable, the erosion of transparency arising from such moves has, as noted above, weakened the robustness of the budgeting exercise and eroded the credibility of fiscal rules in India.

70. Enforcement. The FRBM laws in India are not backed by any legal sanctions or penalties for breach of targets.

71. In the case of states, enforcement of targets is nevertheless effectively accomplished through central government control of states borrowing program under article 293 clause (3) of the Constitution, which requires the states to seek consent of the central government for any borrowing if the state has any outstanding loan from the center.

72. With the 12th Finance Commission having barred the states from borrowing from the central government, the stock of outstanding central loans for the states is rapidly declining. Two states will cease to have any outstanding central government loans by 2025, and several others by 2030. The central government will cease to have effective control of states' borrowing at that point of time. The states will then no longer face a hard budget constraint unless there is fresh state legislation to introduce a debt ceiling under article 293 (1) of the Constitution. With states having to increasingly rely on market borrowing to finance their deficit, market discipline will become the main driver of

states' fiscal prudence in the future. An important issue that arises in this context is the need to have a transparent system of fiscal performance and debt rating for the states.

73. In the case of GOI there are no real levers to ensure enforcement. There is no debt ceiling legislated to date, although this is mandated under article 292 of the Constitution, there are no sanctions or penalties for breaching targets except reputational risk. The rolling deficit targets under the MTFP can be and are revised from time to time. And there is no independent Fiscal Council to monitor GOI compliance with FRBM. The fact that GOI seeks to meet its FRBM targets and that debt levels are declining is therefore attributable to fiscal prudence of the government and improving GDP growth and interest rate differentials rather than enforcement provisions under the FRBM Act. Two important reform issues that arise here are (i) the introduction of a debt ceiling rule as mandated under article 292, and (ii) the importance of an independent fiscal council to assess compliance with fiscal rules, fiscal marksmanship and the costing of expenditures.

74. Efficiency. This issue relates to whether or not the tax provisions and expenditure programs are such that they enable the fiscal targets to be met in a sustainable manner, without special one-off measures in annual budgets to meet the gap. A key requirement for this is a rolling medium-term expenditure framework (MTEF), which is produced annually since the 2012 amendment of the central FRBM law. Nevertheless, one-off measures are routinely introduced to meet the FRBM targets, such as sale of public enterprise equity, imposition of dividend demands on them, and especially large dividend demands from the RBI. Several amendments are also introduced every year in tax laws through the annual Finance Acts.

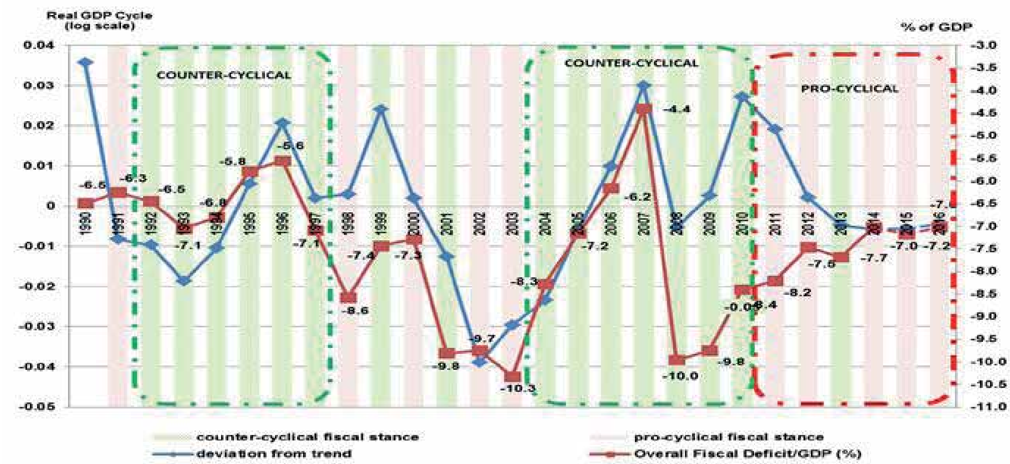
75. A related issue is the soundness of the MTEF and how well it is integrated with the bottom up costing of programs and projects prepared by the line departments, in other words the need for a tightly integrated and robust budgeting process thorough different tiers of government.

D. Independent Fiscal Council

76. The review of international experience presented above indicates that independent fiscal institutions, often called Fiscal Councils, now exist in many countries in Europe, the United States, and several emerging market economies. There has been no move in this direction so far in India. The 13th Finance Commission had recommended that GOI should institutionalize independent review and monitoring of its own FRBM process. The 2012 amendment to the FRBM Act incorporated a section requiring the Comptroller and Auditor General to periodically review the implementation of the FRBM Act. However, this is more in the nature of a periodic post facto review. What is required is a continuing ex ante monitoring and assessment of the internal consistency of FRBM revenue, expenditure and deficit targets, their realism and effective implementation. Hence, the 14th Finance Commission made out a strong case for legally institutionalizing an independent fiscal institution for this purpose.

E. Cyclicality Considerations

Figure 9: Deviation from Trend GDP and Overall Fiscal Deficit/GDP



Source: IMF World Economic Outlook, Authors' Calculations. 2015 and 2016 are estimates

77. Fiscal indicators are highly correlated with the state of the business cycle in the economy. As such procyclical fiscal stance by the government is characterized by increase in public spending and reduction in taxes during an economic boom, but reduced spending and increase in taxes during a recession. A countercyclical fiscal stance on the other hand refers to the opposite approach whereby spending is reduced and taxes are raised during a boom period, and spending is increased and taxes are cut during a recession.

78. Figure 9 illustrates characteristics of the overall fiscal deficit (total government revenue minus expenditure, indicating net lending/borrowing of the government) as a share of GDP in India in comparison to the cyclical GDP fluctuations, which are measured by deviation from trend GDP using Hodrick-Prescott filtering method. The fiscal deficits before the introduction of FRBM Act (2004) display countercyclicality during 1992–1997 period and mixed characteristics during 1998–2003 with procyclicality observed in 1998, 2002, 2003 and countercyclicity in 1999 and 2001. With the introduction of FRBM Act in 2004, fiscal deficits became primarily countercyclical during 2004–2010. Fiscal deficit is procyclical during the period 2011–2016, except for 2013.

Fiscal Reaction Function

$$\Delta \log G_t = \alpha + \beta\, \Delta \log Y_t + \Upsilon\, D2008 + \xi\, D1997 + \varepsilon_t$$

	Central and State Government (Combined) Aggregate Expenditure			Central and State Government (Combined) Revenue Expenditure			Central and State Government (Combined) Capital Expenditure		
	1991-2014	1991-2003	2004-2014	1991-2014	1991-2003	2004-2014	1991-2014	1991-2003	2004-2014
β	0.710*	0.966	-0.028	0.707	1.094*	0.019	0.533	-0.088	-0.22
γD2008	0.046	-	0.017	0.009	-	-0.014	0.218**	-	0.169
ξD1997	0.018	0.223	-	0.034	0.038	-	-0.083	-0.076	-

*, **, *** indicate significance of coefficients at 1%, 5% and 10% level using OLS estimation

Source: Reserve Bank of India; World Bank World Development Indicators; Authors' Calculations

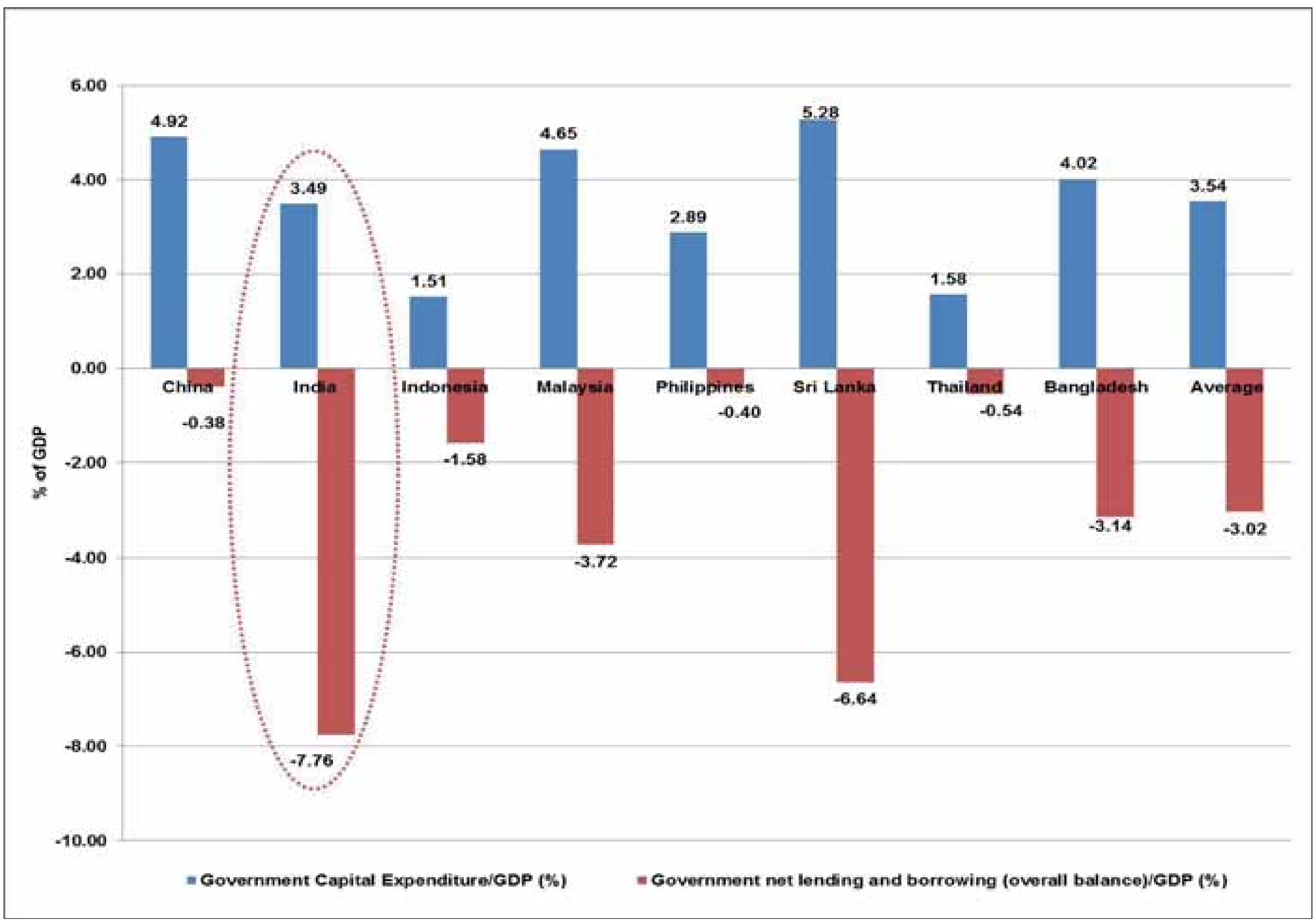
79. In order to understand the relationship between GDP growth and GOI's expenditures as a fiscal policy instrument, a regression analysis is conducted to estimate the fiscal reaction function using OLS method. To improve the robustness of the analysis, alternative definitions of combined central and state government expenditures i.e. aggregate expenditure, revenue expenditure and capital expenditure, were used as a dependent variable.

80. In addition, control variables are introduced for the year 1997 corresponding to the effectiveness of 5th Pay Commission recommendations and the Asian Financial crisis, and the year 2008, corresponding to the effectiveness of 6th Pay Commission recommendations and the global financial crisis. The regression estimate is conducted for the entire sample period of 1991–2014 and the sub-samples of pre-FRBM period of 1991–2003 and post-FRBM period of 2004–2014 to test the structural breaks in the fiscal reaction function.

81. The results show that there is some evidence of procyclicality ($\beta>0$), whereby GDP growth increases the growth of aggregate expenditures during the entire sample period of 1991–2014 and the growth of revenue expenditures during pre-FRBM period. There is no structural break in the fiscal reaction function post-FRBM. Capital expenditures do not show any reaction to the GDP fluctuations and acyclical across all sample periods.

F. Fiscal Balance and Capital Spending

Figure 10: Government Capital Expenditures and Fiscal Balance As a share of GDP (Average of 2010–2014)



Source: ADB Statistical Database System; OECD National Accounts; IMF World Economic Outlook; Reserve Bank of India; and Philippines Statistics Authority

82. Figure 10 illustrates the government capital expenditures to GDP and fiscal balance (government net lending/borrowing) to GDP ratios of various Asian economies. During 2010–2014, India's public capital expenditure (central and states combined) is slightly lower than the Asian average, despite higher fiscal deficit.

83. Simulation results under Section V show that there is a possible scope for reorienting the government expenditures from current spending and subsidies, to capital expenditures while improving the fiscal discipline by stimulating the GDP growth and enhancing the revenues of the government due to the growing economy under a debt ceiling rule.

G. Optimal Debt

84. A question often raised when analyzing public policy is "what is the optimal level of public debt for a country?" There is no standard rule in this regard. The European Union has adopted the Stability and Growth Pact which sets a desirable maximum of 60% of GDP for EU countries. On the other side of the spectrum, 90% is considered the outer limit where likelihood of macro-instability sets in [Reinhart and Rogoff (2010)]. Comparing advanced economies with emerging ones, conventional wisdom points to lower debt tolerance levels in emerging economies given that they are likely to have more volatile GDP and a more limited revenue base (Simone and Topalova, 2009). In addition, when factoring in the net position on the capital accounts, advanced economies tend to have stronger cross-border investments often resulting in net debt levels significantly below gross levels (see Japan for example).

85. However, it often makes more sense to review countries individually based on key determinants that can influence and hence are critical in identifying a prudent level of debt tolerance and overall sustainability. Figure 11 presents such an analysis for India. Improvements in key determinants (i.e., more green colored factors) would allow higher levels of debt tolerance and lower adjustment costs to achieve sustainability.

Figure 11: Determinants of Debt Tolerance and Debt Sustainability Assessment for India

DETERMINANTS	KEY FACTORS	EFFECT	INDIA
FISCAL PERFORMANCE	Size and Stability of Government Revenue Base	+	WEAK
	Efficiency of Tax System	+	WEAK
	Fiscal Discipline	+	MODERATE
	Large Size of Informal Sector	-	WEAK
DEBT STRUCTURE	Low Level of Existing Debt Stock	+	MODERATE
	Low Share of Foreign Currency Denominated Debt Relative to Reserves	+	STRONG
	Low Share of Short-Term Debt	+	STRONG
	Risks Related to Contingent Liabilities	-	MODERATE

[8] India's average government capital expenditure to GDP ratio during 2007–2014 is slightly higher at 3.6%.

DETERMINANTS	KEY FACTORS	EFFECT	INDIA
MACROECONOMIC STABILITY	High GDP Growth	+	STRONG
	Low Inflation	+	MODERATE
	Stable Exchange Rates	+	MODERATE
	Low Interest Rates	+	MODERATE
	Quality of Fiscal and Monetary Policies	+	MODERATE
FINANCIAL SECTOR DEVELOPMENT	Development of Domestic Financial Markets	+	MODERATE
TRADE OPENNESS	Favorable Terms of Trade Shocks	+	MODERATE
	Current Account Balance (Export Orientation)	+	MODERATE
GLOBAL ECONOMY	Global Economic Growth	+	MODERATE
	Increase in Developed Country Interest Rates	-	MODERATE
	Reversals in Global Capital Flow Cycle and Financial Conditions i.e. Crises in Center Countries	-	MODERATE
RISK PREMIUMS	Political Stability	+	STRONG
	Quality of Institutional Development and Rule of Law	+	MODERATE

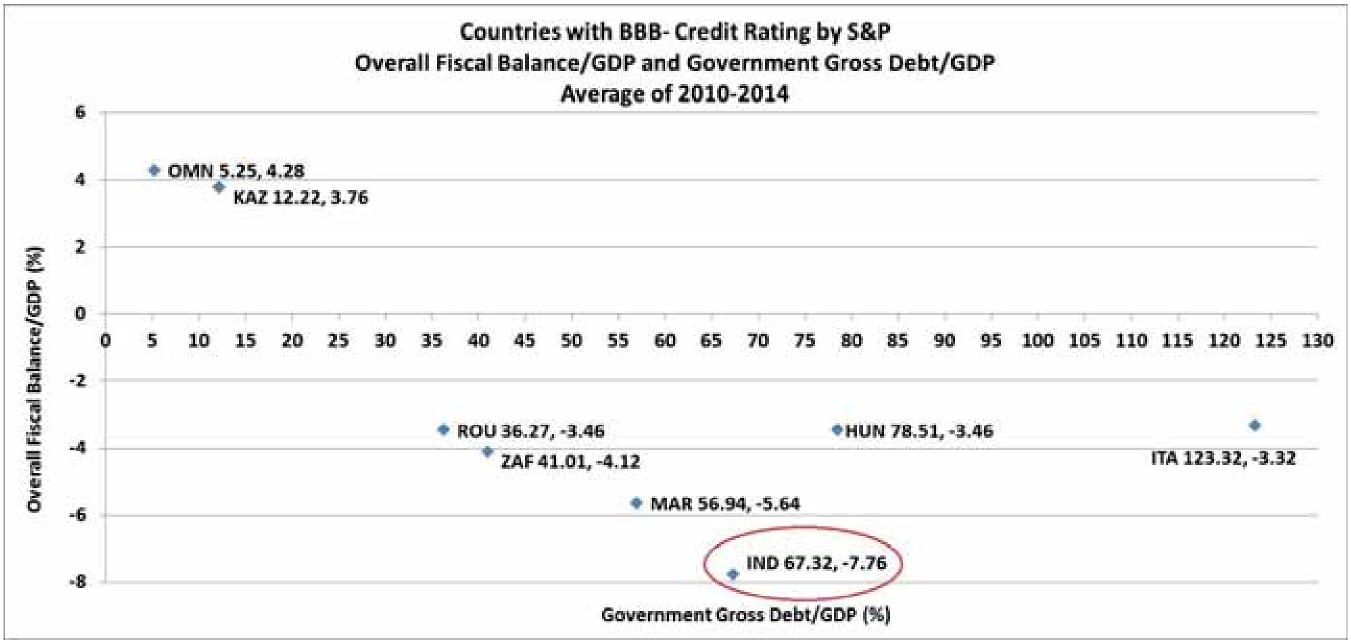
Source: IMF World Economic Outlook. 2003; Authors' Assessment for India.

86. Other important considerations on optimal debt size would need to factor in interest, price and income elasticities in the economy. For example, the wage and salaries bill is more sensitive to inflation and this result in a need to accommodate these increases during a pay commission year. If we consider how the subsidies bill in India varies, it is largely driven by changes in inflation and income that defines the segment of the population that is below the poverty line. If increases in inflation lead to a reduction in the purchasing power of those near the poverty line this could lead to an increase in those falling below the poverty line and with it an increase in the overall subsidy bill. When analyzing debt repayments, the debt bill is most sensitive to changes in interest rates and to the extent that it may be denominated in different currencies it is also sensitive to exchange rate fluctuations. Similarly, given the large infrastructure and housing deficits in India, public investment tends to be more sensitive to interest and commodity price increases.

87. Finally, accounting for debt on a net vs gross basis may also highlight some important findings. Accordingly, a thorough fiscal analysis would be able to determine what proportion of public debt is held by quasi fiscal institutions as well as what the level of actual government liability vs. contingent liabilities is.

88. It is important to compare how countries within the same sovereign rating group compare with one another. India is classified by Standard and Poor's at BBB-, which is the lowest category of investment grade. Figure 12 plots a scatter diagram of countries classified as BBB- across fiscal deficits and public debt. It is interesting to note that among the BBB- rated countries, India stands out as having the largest fiscal deficit while having a debt level slightly above the average.

Figure 12: Scatter Diagram of Fiscal Deficit and Gross Debt and Sovereign Ratings



Source: IMF World Economic Outlook; Standard and Poor's.

H. Underlying Budget Process and Implementation

89. One of the weakest links in fiscal management is linking the fiscal strategy and overall fiscal policy to budget process and implementation. Throughout the first 8 to 9 years since FRBM was enacted, the link at the national level was missing. However in 2012–2013 with amendment to the FRBM Act, the MTEF statement was made mandatory and that provided a bridge between firmed up intentions on the strategy side with a commitment on the operations side. If all components of the fiscal framework are operating effectively and are well synchronized, a fiscal policy strategy statement should be consistent with the overall path to fiscal consolidation and achieving the stated fiscal target in the legislation consistent with the budget (Appropriation Act) but all allowing for fiscal breaks to be deployed intelligently on budget implementation (see Figure 13).

Figure 13: What's Under the Hood?

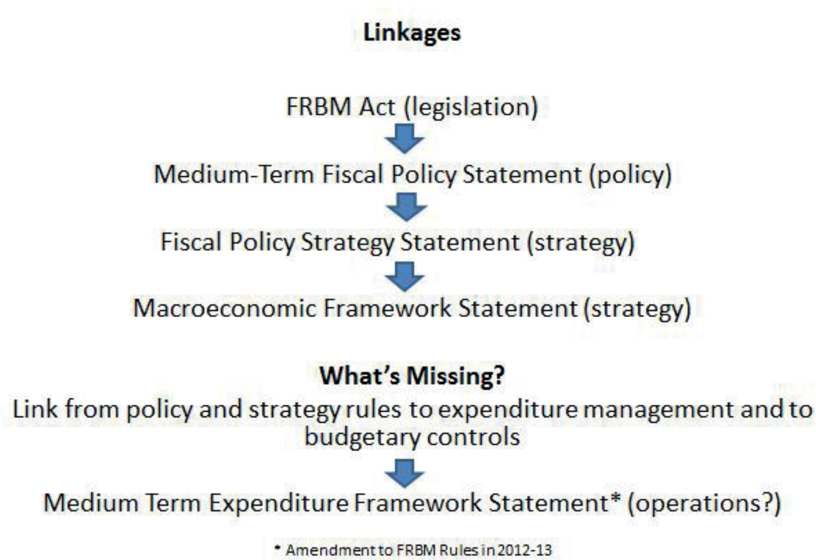
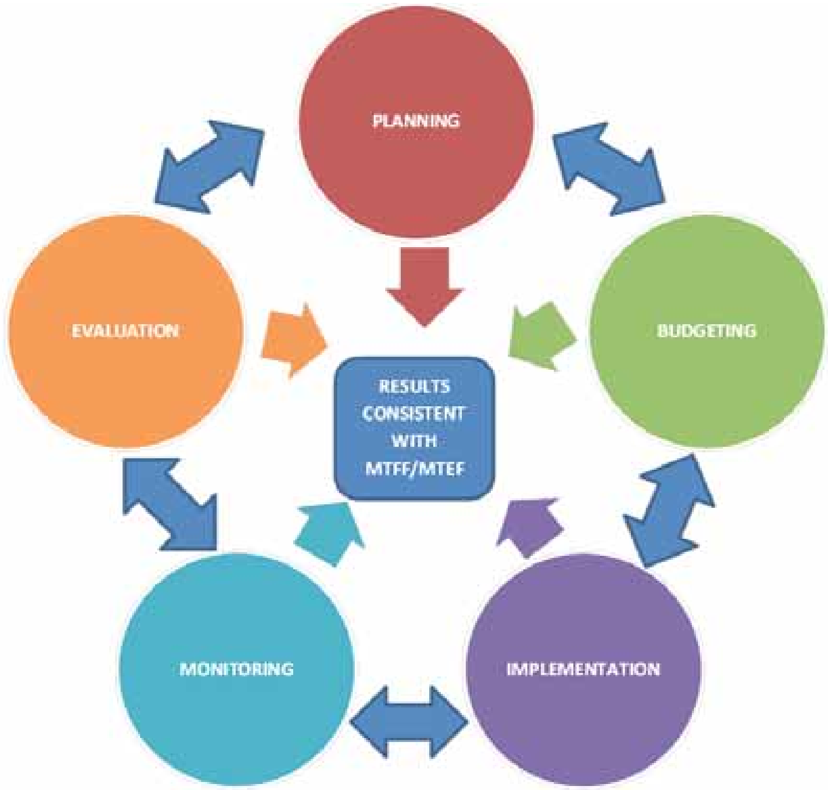


Figure 14: The Budget Process



90. More generally, for a proper articulation of fiscal goals and their overall results in terms of the outcome of public spending, there has to be a check of what lies underneath the hood and what the state of engine parts is. A typical budget process can be broken down along the lines of Figure 14. The idea is to make sure that the budget process is fully aligned with the Planning and Budgeting stages of the budget cycle. In this case, the 3-year rolling MTFF (top-down approach) and informed by the fiscal policy strategy should be reconciled with the consolidation of the aggregate revenue and spending estimates in order to arrive at a common medium-term budget or expenditure framework (bottom-up approach). In the absence of a full reconciliation, what ultimately happens is that the MTFF is part of a top-down approach and implementation becomes an ad-hoc, blunt and rudimentary exercise devoid of consideration for results on the use of public resources.

91. Along these same lines of strengthening the inter-linkage between budgeting and implementation in any fiscal federalism, there has to be a stronger realization of the interdependence between central and state budgets. With the significant share of the spending at the state level and the large share of the revenues mobilized at the national level, there is a natural tendency for vertical imbalances to arise. As such, the transfer programs from the national to the state level play a very important role. A better recognition of the division of labor between the state and the national level could lead to improved outcomes particularly in distinguishing short-term stabilization roles—falling under the national fiscal policy and longer-term debt sustainability considerations—falling under the responsibility of state budgets.

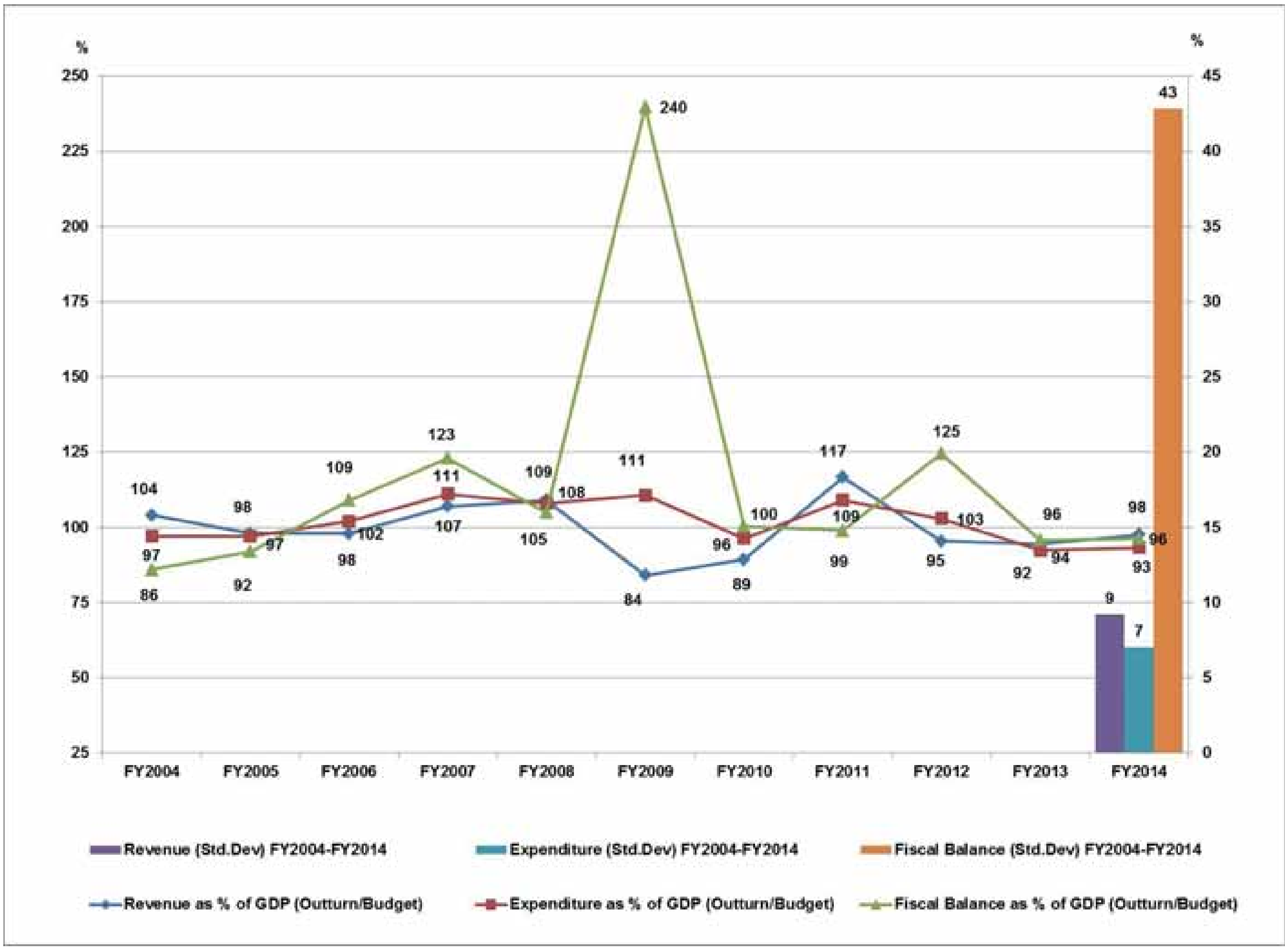
[9] Two important ADB programs that aim at strengthening such linkages in India are (i) ADB. 2012. Report and Recommendation to the Board of Directors: Proposed Policy-Based Loan and Technical Assistance Grant for the West Bengal Development Finance Program in India. Manila (Loan 2926 and TA 8203); and (ii) ADB. 2014. Report and Recommendation to the Board of Directors: Proposed Policy-Based Loan and Technical Assistance Grant for the Punjab Development Finance Program in India. Manila (Loan 3187 and TA 8759).

92. Existing ADB operational work on state level development finance programs has carried out assessments in the context of Figure 14 and in particular the strength of the linkages between the five components of the budget process. Based on this work, strengthening of these linkages remains a work in progress in many states.

93. A quick check on how well the budget process is operating entails assessing budgeted (ex-ante) vs actual (ex-post) performance. The larger are these differences outside of any unanticipated shock, the more work required to clearly link strategy to budget outcomes. In the case of India, there are deviations in the budget estimates and actual out-turns, indicating a clear scope for improving the linkages. (Figure 15)

Out-turn vs. Budget

Figure 15: Central Government Budget Performance (FY2004–FY2014)



Source: IMF and Indian Public Finance Statistics, Authors' Calculations.

I. Summary of Assessment

94. The introduction of an FRBM law in 2003 was a landmark event in the recent history of fiscal reforms in India. However, the foregoing review of India's experience with fiscal rules indicates that it has stayed with what are described as first generation fiscal rules. It has no debt ceiling law and only a traditional balanced budget rule. At one stage, this was supposed to be a "golden rule", allowing borrowing only for capital expenditure beyond a target date. But that has now been given up. To date there has been no change in adopting the emerging best practices such as structural budget deficit rule

or expenditure rule though there is demonstrated technical capacity for introducing such rules. As a consequence, the fiscal framework is quite inflexible and inadequate to handle the dual goals of debt sustainability and stabilization.

95. Targets are well defined and simple both for GOI and the states. However, coverage is limited—it does not include public enterprises and other public institutions and the escape clause is very vague. The two together make the fiscal framework somewhat soft and malleable. It is also not efficient, frequently requiring one-off measures to enable compliance. Further, while the fiscal rules can and are enforced for states by the center under Article 293 of the constitution, no such restraints, sanctions or penalties apply in case of the central government and there is no independent fiscal institution to monitor compliance with fiscal rules on behalf of Parliament and the public as is the case in many advanced and emerging market economies. Finally, with the states being required to borrow directly from the market, following the recommendations of the 12th Finance Commission, there is a need for independent and transparent credit rating of states, which is currently missing.

V. Reform Options for India Based on Simulations

96. The foregoing assessment of India's experience with fiscal rules suggests a range of possible reforms that could bring India abreast of emerging global best practices. These are briefly discussed below. As a prelude to that discussion some quantitative fiscal rule simulations are presented to illustrate the implications of different options. These simulations are run using a Klein-Goldberger type macroeconomic simultaneous equations model that was used by the National Institute of Public Finance and Policy, New Delhi, for its presentation to the 14th Finance Commission (Bhanumurthy, Bose and Adhikari 2015). It is a medium-sized flexible model with four blocks (real sector, fiscal, monetary, and external), which can be adapted to address different policy questions.

97. The model has been used for four types of simulations. The first simulation demonstrates countercyclicality of structural deficit rule with growth shock. The second simulation demonstrates countercyclicality of expenditure rule with growth shock. The third simulation shows the impact of 25% increase in public capital expenditure from 4% to 5% of GDP. The fourth set of simulations demonstrates the impact of debt-GDP ratio gradually moving to 55%, 60% and 70%, respectively. The third and fourth simulations incorporate the 7th Pay Commission Shock.

A. Fiscal Rule Simulations

98. The challenge here is to choose fiscal rules that simultaneously meet the dual policy goals of debt sustainability and macroeconomic stabilization. The latter requires a countercyclical fiscal policy stance, whereas traditional BBRs aimed at ensuring debt sustainability were procyclical. Many countries have adopted structurally adjusted balanced budget rules, which set a primary deficit target, net of interest liabilities, corresponding to trend growth that is compatible with a sustainable debt stock.

99. The first simulation (Figure 16) demonstrates how a structural deficit target acts as a counter-cyclical automatic stabilizer along with a stationary debt-to-GDP ratio. Positive and negative shocks have been applied to the base case by raising or lowering the assumed global growth rate, which is exogenously given in the model. However, the time path of the fiscal deficit target (center + states) has been maintained as in the base case, assumed to be the trend growth path. Countercyclicality is demonstrated by a primary deficit rate that is 13 percentage points lower on average with a positive growth shock and 15 percentage points higher in the case of a negative growth shock.

100. The second simulation (Figure 17) illustrates that a simple expenditure rule can also act as an automatic stabilizer. In fact, countercyclicality is more pronounced in this case than with a structural deficit rule

and with public debt stationary at about the same level as with the structural deficit rule. The same positive and negative growth shocks are applied to the base case as before, but with the expenditure level following exactly the same target path as in the base case. The primary deficit shrinks by 55 basis points on average with a positive shock and it increases by 66 basis points when there is a negative shock.

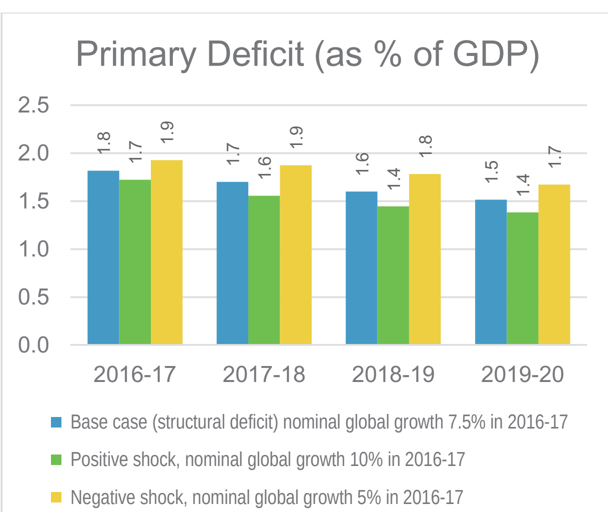
101. The third simulation (Figure 18) demonstrates the impact of a capital expenditure preserving expenditure rule by gradually raising public capital expenditure from 4% of GDP in the initial year, 2016–2017, to 5% by 2019–2020, a 25% increase over the 4 years. The interesting result is that fiscal deficit, primary deficit and public debt ratios gradually decline as the impact of the higher capital expenditure works its way through the interactions of the model. The public debt ratio in this case ends up at 57.1%.

102. The fourth simulation (Figure 19) compresses "transfers" (defined to include subsidies), a component of revenue expenditure, thereby gradually reducing the fiscal and primary deficit ratios. The debt-to-GDP ratio accordingly declines to 55% or 55.3% to be precise, by 2019–2020. Capital expenditure rises to 5% of GDP by 2019–2020 in this scenario, while growth and inflation are also significantly higher compared to the base case. It is the higher level of nominal growth, hence the denominator of the debt-to-GDP ratio that drives down this ratio.

103. The fifth simulation (Figure 20) also illustrates a debt ceiling rule, a ceiling of 60% of GDP in this case. The compression of expenditure on "transfers" under revenue expenditure is now re-calibrated to decline from 5.6% of GDP in 2015–2016 to 4.4% in 2019–2020. The fiscal and primary deficit levels, GDP growth and inflation all adjust accordingly to generate a debt-to-GDP ratio of 60%, 60.18 to be precise, by 2019–2020. The compression of revenue expenditure is partly offset by an increase in capital expenditure.

104. The sixth simulation (Figure 21) demonstrates the impact of a more liberal debt ceiling rule that allows the debt-to-GDP ratio to rise to 70%. In this case, "other revenue expenditure", which was already bumped up to capture the Pay Commission shock in the new base scenario, is pushed up by another 17% in 2015–2016. The fiscal and primary deficits increase accordingly, along with some increase in the average growth rate and inflation rate over the reference period, with a net effect of raising the debt-to-GDP ratio to 70%, more precisely 69.52%, by 2019–2020. Capital expenditure, however, is maintained at just over 4% of GDP.

Figure 16: Countercyclicality with Structural Deficit Rule



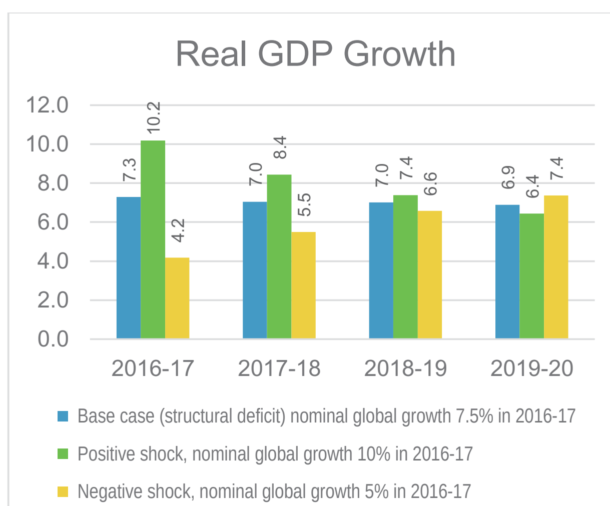
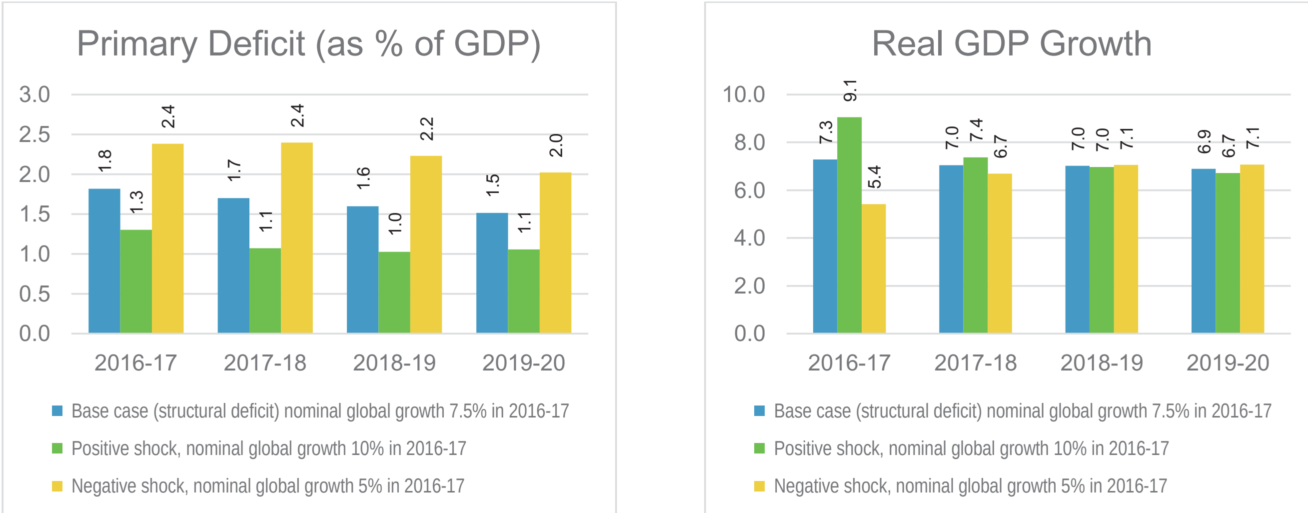


Figure 17: Countercyclicality with Expenditure Rule



Source: Authors' Calculations

Figure 18: Impact of 25% Increase in Public Capital Expenditure to GDP (Incorporating 7th Pay Commission Shock)

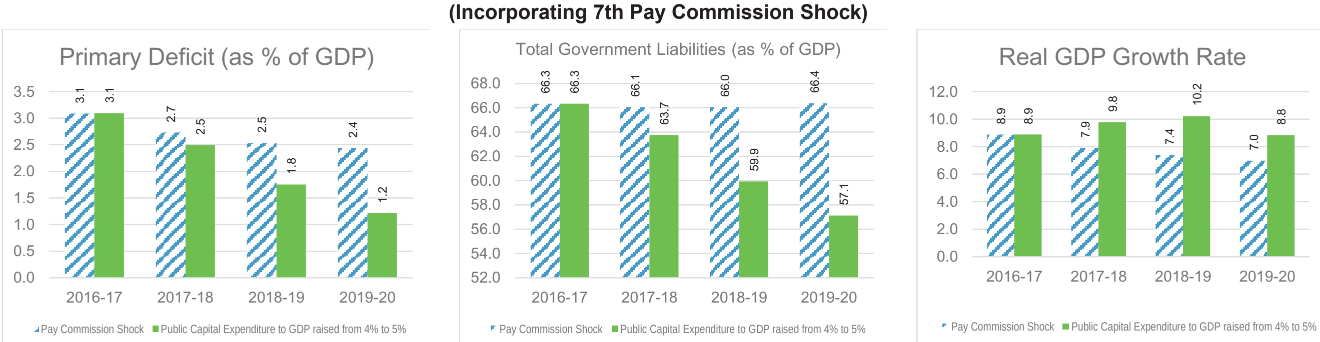
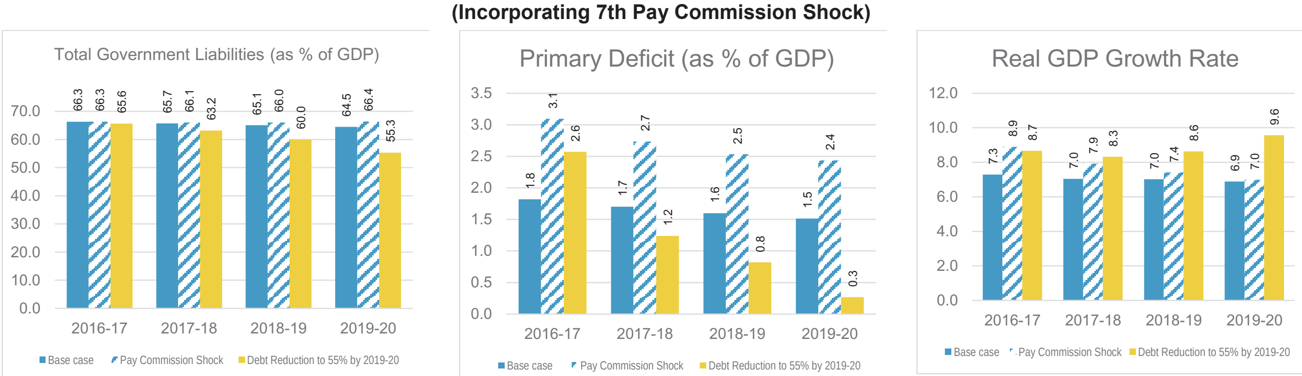


Figure 19: Impact of Debt/GDP Gradually Moving to 55% (Incorporating 7th Pay Commission Shock)



Source: Authors' Calculations

Figure 20: Impact of Debt/GDP Gradually Moving to 60% (Incorporating 7th Pay Commission Shock)

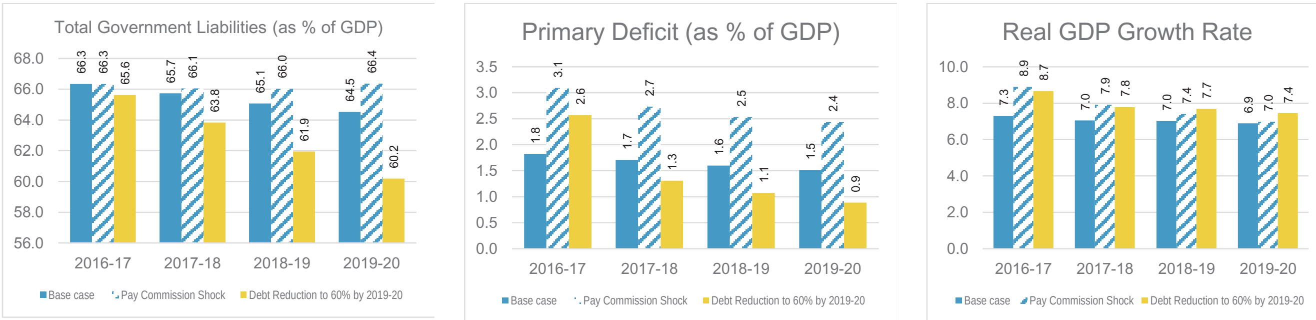
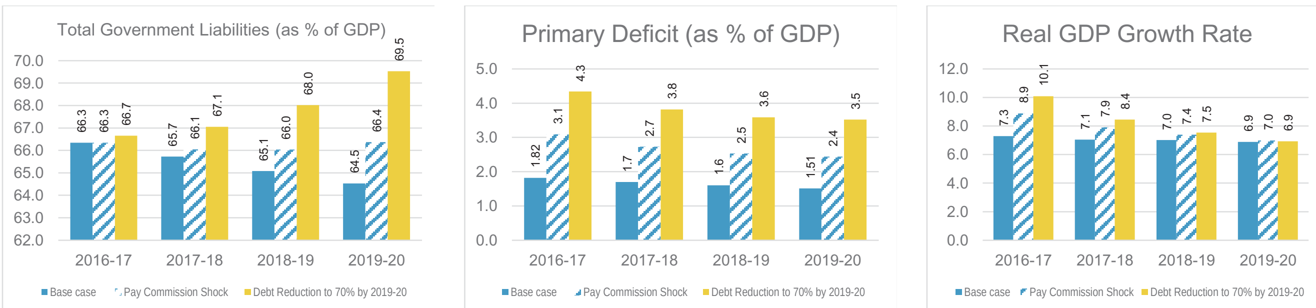


Figure 21: Impact of Debt/GDP Gradually Moving to 70% (Incorporating 7th Pay Commission Shock)



Source: Authors' Calculations

VI. Recommendations

Recommendation 1: Target Multiple Fiscal Rules or a Numerical Range and Recommendation 2: Adopt a Golden Rule

A. Fiscal Rule Options

105. Based on the simulation results presented above, two alternative combinations of fiscal rules can be considered for the next generation of fiscal reforms in India.

1. Option A

106. The first option is to adopt:

(i) an expenditure rule which sets MTFP and MTEF expenditure targets that are consistent with a desirable, stationary or declining public debt ratio, and

(ii) a supplementary capital expenditure preserving rule that can be achieved by setting a minimum threshold for the share of capital expenditure, e.g., 5% of GDP. Alternatively, capital expenditure can also be preserved by a rule that specifies that public borrowing will only be allowed for capital expenditure, which is equivalent to the traditional "golden rule" where current deficit is zero.

(iii) The model simulations show that raising the share of capital expenditure reduces the fiscal deficit and primary deficit as well as public debt ratios if it is financed by compressing other components of revenue expenditure. However, capital expenditure may also be financed through loans. If there is a concern that this could lead to a rising debt ratio despite rule (i), as a matter of abundant caution, it would be desirable to add a rule that explicitly sets a ceiling on the permissible level of debt. This would also fulfil a constitutional mandate.

[1] There are measurement problems in calculating structural balance such as estimation of the potential output and output gaps, adjustment of fiscal revenues for the effect of business cycle using estimated revenue elasticities and adjustment for national income reflecting asset price cycles. (IMF, 2011).

107. The present FRBM law can be replaced by a new Debt Ceiling and Fiscal Responsibility Act under Article 292 of the Constitution, along the lines suggested by the 14th Finance Commission. The states can be encouraged to bring in similar legislation under Article 293(1).

2. Option B

108. If legislation to explicitly set a ceiling on debt is not considered suitable, the objective of combining debt sustainability with countercyclicality can also be achieved through a second option, i.e.,

   (i) a fiscal rule that sets a target for the level of structural deficit consistent with a desired, stationary level of public debt, plus

   (ii) either of the capital preserving fiscal rules discussed under Option A.

109. This can be accomplished by amending the existing FRBM Act, at the same time, dropping the concept of an effective revenue deficit that is not in line with standard budgeting practices.

110. The issue of setting targets in the form of bands, whether for expenditure level or fiscal deficit, to accommodate shocks has sometimes been raised. The difficulty with this approach is to determine the width of the band without knowing the severity of shocks ex ante. If the shock is too severe relative to the band, special interventions would be required, possibly disrupting the whole fiscal consolidation effort, as happened in 2008. By contrast, under the two options suggested above, the rules come into play as automatic countercyclical stabilizers calibrated to the severity of a negative or positive shock. The safety net of a well-defined escape clause in case of exceptional circumstances needs to be articulated.

111. A vague escape clause, referring to "unforeseen circumstances" was identified earlier as one of the limitations of the existing FRBM law. A tightly defined escape clause, which specifies ex ante the circumstances under which fiscal rule may be breached, is now a standard component of best practice fiscal rules. Without such specification, breaching of fiscal targets can become an ad hoc affair, left to the discretion and convenience of the incumbent government. The authority that permits such an "escape" should also be specified. The suggested new Debt Ceiling and Fiscal Responsibility Act or, alternatively, an amended FRBM should incorporate such a well-defined escape clause.

112. We suggest that the breach of fiscal rule may be allowed only for a very limited range of factors e.g. a major natural disaster, significant growth slowdown or recession, out-of-ordinary events with temporary but significant impact on deficit, and significant change in scope of the budget. Each of these triggers should be clearly defined, preferably quantitatively, in terms of deviation from normal. For example, growth slowdown can be defined as a fall in annual GDP growth rate by more than three standard deviations from the trend growth rate. Similarly, out-of-ordinary events of financial significance can be defined as those that ceteris paribus cause a deterioration of 0.5% or more in the ratio of fiscal deficit to GDP.

113. The escape clause should also indicate the conditions under which fiscal rules should come back into play along with the corresponding timelines. For events that cause a sustained impact on growth and deficits, we can consider shifting the transition path by the number of years that the impact remains "significant", as per the standard definitions included in the Act. Further extension can be granted based on clear justification of the circumstances warranting a relaxation.

114. With regard to fiscal rules for the states, macro-economic stabilization is not their responsibility constitutionally. That is the responsibility of the central government. Considering the states'

[2] These definitions are suggestive and would need further detailed empirical analysis for confirmation of quantitative trigger levels.

responsibilities, all states are not in the same economic or fiscal situation, and their fiscal rules need to take this into account.

115. One issue here is the constraints and needs of the poorer states. Instead of dealing with this in an ad hoc manner for individual states, it is best to address this as a systemic issue, based on the principal of equal fiscal treatment of all entities within the same national tax jurisdiction. The 14th Finance Commission did this in its devolution formula and its post-devolution current deficit grant. Normatively assessed needs and revenue capacity were factored into the devolution formula, taking into account the disadvantages of the poorer states. States that were assessed to fall short of the average per capita public expenditure post devolution by more than 80% in 2019–2020, the terminal year of the award, were given a special current deficit grant to meet the gap. Should the government wish to push the principal of equalization further, it can do so through centrally sponsored schemes or even suggest it as a term of reference for the next Finance Commission.

116. The second issue is differentiation in the fiscal rules applicable to individual states to take into account their different fiscal situations. States in a more comfortable fiscal situation should be enabled to raise more loans, especially to finance capital expenditure. With the fiscal deficits of all states anchored at 3% of GSDP, the 14th Finance Commission has allowed an additional 0.25% fiscal deficit for states which have a debt-to-GSDP ratio of less than or up to 25% in the reference year. It has also allowed an additional 0.25% fiscal deficit for states with interest payments amounting to less than 10% of their revenue receipts in the reference year. Thus, states in a comfortable fiscal situation may be allowed fiscal deficits of up to 3.5% of their GSDP.

117. In this context, it is noted that following the award of the 12th Finance Commission, states are now required to directly borrow from the market. That raises the need for a transparent system for rating the fiscal performance of states. It is possible that rating institutions are already providing such assessments privately to potential lenders. However, such rating systems need to be objective, standardized and available in a transparent platform for public scrutiny.

B. Enforcement of Fiscal Rules

118. The Indian FRBM system does not at present have any specific instruments to enforce fiscal rules such as sanctions and penalties for GOI other than the reputational risk of the government. In the case of the states, Article 293 clause (3) of the constitution requires them to seek permission of GOI to raise loans so long as they have outstanding liabilities to GOI. This effectively enforces a hard budget constraint on them. However, with states' liabilities to the central government progressively declining, following the award of the 12th Finance Commission, this clause will gradually cease to apply. Thus, both for the central government as well as the states, it is desirable that debt ceilings be legislated as envisaged under articles 292 and 293. This would serve a powerful enforcement tool, since breaching the debt ceiling would be tantamount to breaking a law.

119. A second effective enforcement instrument would be the establishment of an independent financial institution to monitor fiscal rule compliance. This is discussed further below.

Recommendation 3: Establish an Independent Fiscal Institution

120. The establishment of an independent fiscal institution to monitor the government's compliance with fiscal rules, its fiscal marksmanship and its costing of public expenditure is an important feature of second generation fiscal rules. Many OECD countries and emerging market economies have set up such institutions with a variety of institutional features.

[3] Excluding interest payments, pensions, and grants under centrally sponsored schemes.

121. In the Indian context, several institutional models can be considered. The institution can be established as a constitutional body but that will require a constitutional amendment. It can be established as an institution reporting to Parliament, somewhat like the Congressional Budget Office in the United States. It can also be established by the Ministry of Finance as an independent body. Whichever format is adopted, the institution should be established by legislation, not just through executive order, and it should be adequately funded through a charged item in the budget and not by annual budget appropriations approved by Parliament. These safeguards are necessary to ensure the independence of the institution.

122. It is suggested that such an institution be established as part of the next generation of fiscal reforms in India, either under the suggested Debt Ceiling and Fiscal Responsibility Act or an amendment of the existing FRBM Act.

Recommendation 4: Introduce a Fiscal Stability Report

123. Similar to advent of financial stability reports generated by central banks and particularly those that have to explain risks to inflation targets, there is an increasing view of the importance of having fiscal authorities improve their overall communication strategy by issuing an annual reporting on fiscal risks and outlook to fiscal stability including better reporting on contingent liabilities. The Indian FRBM does not spell out this requirement and this would be important as a means to explain the headwinds or tailwinds facing the economy—perhaps building from the Economic Survey—and translating these to assess the impact on the underlying fiscal path. The improved analysis could take off from the Fiscal Challenges section of the Economic Survey to expand into a full-fledged report including better coverage of the balance of risks, off-budget liabilities, and overall fiscal outlook. This would be a valuable contribution in guiding expectations on the government's fiscal position. As governments have increasing access to off-budget financing through special purpose vehicles, borrowing through state-owned enterprises, and quasi fiscal operations, and there may be increasing demands on guarantees as the economy turns to greater involvement of PPPs, other risk sharing arrangements and the possible support for bank recapitalization, there is an increasing importance for this type of fiscal analysis under a dedicated Fiscal Stability Report. A similar consideration could apply to the states.

Recommendation 5: Improve the Linkage between Fiscal Policy and Strategy and Budget Operations

124. In order for the government to have a more effective framework to make changes to the fiscal stance over the short term while allowing for a convergence to a sustainable fiscal target over the medium term, a close and strong link between fiscal strategy and the budget process, in particular the expenditure framework would be recommended. While fiscal breaks are a blunt tool and more conventional measures of expenditure consolidation generally require long lead times, a better integration with the budget process would allow for greater finessing of revisions to the fiscal stance with an improved outcome in terms of budgeting results. Under the circumstances, the strategy and policy rules would have to dovetail with the MTEF. In addition, efforts should focus on strengthening adherence to the four principles of sound budgeting viz. transparency, predictability, credibility, and comprehensiveness. There should be clear linkages between the MTEF as it is articulated with the budget and the links

[4] It is recognized that both the central government and state governments acquire contingent liabilities, mostly in the form of sovereign guarantees for public enterprises. The question is - how are these contingent liabilities to be valued? The 14th Finance Commission suggested that the government should use the concept of extended debt, which includes some valuation for the guarantees given to public enterprises. However, it did not propose any particular rule for valuing guarantees in the case of the central government. In the case of state governments, the commission proposed a formula of counting 90% of power guarantees, which account for the bulk of guarantees, and 10% of the value of guarantees given in other sectors. While efforts should clearly be made to resolve the valuation question, it may be premature at this stage to factor contingent liabilities into fiscal rules.

between budget planning, budgeting, implementation, monitoring and evaluation. This would once again apply at both the central and state levels. To supplement this work, efforts should also focus on continuing to improve fiscal accounting framework to commit to well defined targets and statistical standards, reducing possible leakages in the accounting process, and ensuring timely and reliable reporting of fiscal operations.

Recommendation 6: Better Sharing of Responsibilities for Stabilization and Sustainability

125. In a federal union, fiscal responsibility requires a balancing between the short-term economic stabilization goals and medium-term goals of sustainable public finances. Considerations such as the average size of the national vs. subnational budgets, the degree of vertical imbalance based on expenditure and revenue assignments help shape the division of responsibilities. Ensuring that states are able to contribute to national fiscal goals is critical to overall fiscal outcomes and this requires clearly articulated rules that allow for incentives at the state level to keep to the agreed goals. While there is no specific challenges to point to, promoting a better articulation of fiscal responsibilities in a federal union between stabilization measures and fiscal sustainability at the federal level is an agenda that can always be improved upon and similarly a division between the types of public spending as well as the off-budget liabilities will help in terms of cross-government coordination.

Recommendation 7: Introduce State Credit Ratings

126. Over the longer term, if subnational entities evolve as we have seen across other federal jurisdictions in advanced economies, i.e., Australia and Canada, we are likely to see a similar pattern in India where states become less wholly reliant on central transfers to supplement own revenue assignments and where sub-sovereign borrowing is one more funding source available to the state. This will be important as part of efforts to ensure that states have built in incentives to keep to a desired level of fiscal prudence but more generally give them greater decision making power in how they would like to borrow and spend. While in India this may still be something to consider over the medium-term, it would be important to begin promoting the idea of having states selectively build a credit rating culture. This would help in establishing a discipline for good fiscal housekeeping and in-turn allow the market through credit rating agencies to form an opinion on the creditworthiness of states. The states, in turn, by having "skin in the game" would have their own incentives to improve their ratings over time as that would reduce cost of borrowing and also foster greater prudence and encourage accountability.

VII. Conclusion

127. This note has been prepared in response to a request from the Chairman of the FRBM Review Committee for a submission from ADB on global best practices relating to the next generation fiscal framework. Accordingly, this note has assessed India's FRBM experience against the background of emerging global best practices on fiscal rules and other allied issues. The note points out that the introduction of an FRBM Act in 2003 was a landmark event in fiscal reforms in India, subsequently followed by similar acts in all the states. However, the assessment also indicates that India has stayed with what are called traditional first generation fiscal rules, with their associated challenges. Meanwhile many advanced and emerging market economies have moved on to a second generation of fiscal rules. The note has therefore presented a set of detailed options for consideration as a package of second generation fiscal rules for India. It is hoped that the FRBM Review Committee will find these proposals helpful.

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