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Building Countercyclical Fiscal Policies in Latin America

The International Experience

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Abstract

This paper reviews the international experience of developed and underdeveloped economies in reducing the pro-cyclicality and deficit bias of fiscal policies and promoting the adoption of effective countercyclical fiscal policy actions. The paper draws lessons and best international practices for building fiscal policy frameworks and adopting feasible countercyclical fiscal policies in Latin America. The authors review the main arguments regarding the proper role and limitations of countercyclical fiscal policies, and offer an evaluation of the international evidence demonstrating the typical pro-cyclicality and deficit bias of fiscal policy. The paper analyzes the international experience with fiscal frameworks, budgetary rules, and other mechanisms for implementing countercyclical fiscal policies, and describes the necessary preconditions for building a stable and effective countercyclical fiscal policy framework in Latin America. The authors review the international best practices for establishing a reliable and effective countercyclical fiscal policy in the region.

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Building Countercyclical Fiscal Policies in Latin America: The International Experience.

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1 Introduction

There is a consensus in the literature and practical experience that fiscal policy should not be pro-cyclical, except when forced by the necessity of stabilizing market sentiment and reassuring foreign investors about the political commitment of the country to fiscal sustainability. There is widespread consensus among economists that governments should adjust their spending and savings decisions to offset the effects of the business cycle, working to smooth long-term growth and avoid fostering the series of booms and crashes that are all too familiar to both developing and industrialized nations. Increased spending during recessions can be used to mitigate unemployment, stabilize aggregate demand, and fund key capital investments designed to promote recovery and support future economic growth. Limiting spending increases and resisting the temptation to cut taxes during expansions are crucial to make possible sustainable countercyclical fiscal actions. Pro-cyclical spending not only threatens the fiscal balance, but may unsustainably accelerate expansions and exacerbate the overall volatility of business cycles.

Yet despite the unanimous view among economists and policymakers that pro-cyclical fiscal policies should be avoided, countercyclical fiscal policies are far from being the norm in most countries. Indeed the evidence shows that the use of pro-cyclical fiscal actions is extensive in industrialized and developing countries alike: increases in discretionary spending and tax cuts during "good times" contribute to unsustainably rapid cyclical expansions while simultaneously limiting governments' ability to soften recessions through increased public spending in "bad times" because of deficit growth, diminished access to credit, and long-term debt sustainability problems. Moreover, fiscal adjustment programs in a context of foreign borrowing constraints have in many cases contributed to the pro-cyclicality of fiscal policy during downturns in developing countries (Gavin *et al.* 1996 and Balassone and Kumar 2007).

The ongoing global financial crisis has provided an immediate and dramatic demonstration of the value of establishing countercyclical fiscal frameworks as a hedge against unforeseen external shocks. However, faced with sudden, massive demands on public resources, even the wealthiest countries find themselves struggling to maintain sufficient countercyclical expenditures to maintain employment, shore up aggregate demand, assume toxic private sector liabilities, and execute costly corporate restructuring initiatives—in some cases even calling on multilateral lenders more used to serving the needs of the world's least developed and most fragile economies. The current financial crisis has made it clear that nations at all levels of economic and institutional sophistication must use fiscal policy to mitigate the economic contractions and social disruptions resulting from externally originated crisis, which extend far beyond the scope of the typical cyclical downturn. Establishing well designed rules-based countercyclical fiscal frameworks represents a key step toward making possible the implementation of credible countercyclical fiscal policies in industrialized and developing economies.

Given the challenges faced by monetary policy institutions in open economies subject to high capital mobility, the evidence of globalization has shown that fiscal policy

plays a key role in the attenuation of economic slowdowns and in the stabilization of market sentiment. In Latin America the history of poor fiscal discipline has prevented policy makers from using fiscal policy for stabilization goals; and the weakening of market sentiment and corresponding limitations on access to affordable credit have required in most instances the adoption of pro-cyclical fiscal policies during economic downturns. The improvement of fiscal discipline and credibility in fiscal management has made possible the gradual adoption of countercyclical fiscal stances in some countries in the region as the cases of Brazil and Chile have shown in the 2000s.

The strengthening of fiscal discipline in certain countries in the region since the 1990s allowed for the generation of substantial public savings and the reduction of public debt (and the associated country risk), which in turn opened the necessary room for fiscal stimulus polices during the late 2008-2009 financial crisis. Some governments were able to avoid cutting expenditures, while others were able to raise expenditures to provide a boost to domestic demand and GDP (see also Eyzaguirre *et. al* [2009]). Moreover, countries that had already adopted more sustainable fiscal policies before the crisis enjoyed greater fiscal space in which to establish countercyclical fiscal policy stances and thereby reduce the negative output effects experienced by many countries during 2009; among the leaders in the use of effective, responsible countercyclical policy were Chile, Colombia, Mexico, and Peru (see International Monetary Fund [2009]).

Since the 1990s several industrialized countries have adopted fiscal frameworks designed to promote rules-based countercyclicality through procedural and numerical policy rules, and a handful of developing nations are gradually beginning to follow suit. In Latin America, Chile has been successfully managing its fiscal policy within the framework of a structural budget rule that has enabled the government to establish an effective, transparent, and credible countercyclical fiscal policy stance. Fiscal frameworks and/or rules have been designed to reflect the particular conditions of a specific country or community of countries aimed at correcting the deficit bias of fiscal policies and at the same time making it possible the operation of more efficient automatic countercyclical stabilizers (targeting the cyclically-adjusted budget) and the adoption of discretionary countercyclical policies when needed (e.g. escape clauses). The effectiveness of countercyclical fiscal policy has also been reinforced in several cases by making the operation of automatic stabilizers more effective such as: tax reforms, reduction of tax evasion; lengthening the maturity of the public debt; issuance of contingent debt instruments and bonds denominated in local currency to hedge against exchange rate volatility; and stabilization funds that increase the stabilization role of fiscal policy.

The adoption of successful countercyclical fiscal policy frameworks has, however, required the presence of a record of transparent and credible fiscal institutions and fiscal policy, a political commitment to fiscal discipline, and a consolidated position of medium-term fiscal sustainability. Without these preconditions market sentiment and fiscal accounts would be adversely affected as past experience with expansionary fiscal policies have shown in Latin America in the 1970s and 1980s. These are challenges that

countries need to overcome before assigning a more active countercyclical role to fiscal policy.

The objective of this paper is to review the international experience of developed and underdeveloped economies in reducing the pro-cyclicality and deficit bias of fiscal policies and in promoting the adoption of effective countercyclical fiscal policy actions. The paper draws lessons and best international practices for building fiscal policy frameworks and adopting feasible countercyclical fiscal policies in Latin America. In Section 2 we review the main arguments regarding the proper role and limitations of countercyclical fiscal policies. Section 3 offers an evaluation of the international evidence demonstrating the typical pro-cyclicality and deficit bias of fiscal policy. Section 4 analyzes the international experience with fiscal frameworks, budgetary rules, and other mechanisms for implementing countercyclical fiscal policies. Section 5 describes the necessary preconditions for building a stable and effective countercyclical fiscal policy framework in Latin America. Section 6 reviews the international best practices for establishing a reliable and effective countercyclical fiscal policy in the region.

2 The Role and Limits of Countercyclical Fiscal Policies

In discussing fiscal policy issues an important analytic distinction should be made between discretionary changes in taxes and spending, and changes in taxes and spending due to the response of automatic stabilizers such as the countercyclical response of tax revenue and unemployment benefits to changes in economic activity Both types of fiscal induced changes have a countercyclical impact on aggregate demand, but the fiscal response induced by automatic stabilizers is faster as they are not subject to implementation lags and are more predictable than a discretionary fiscal action.

Although there is disagreement in the literature about the role fiscal policy should play in reducing output and employment fluctuations, there is consensus among Keynesian and Classical economists that fiscal policy should not be pro-cyclical except in cases when fiscal austerity is forced by market conditions in order to stabilize market sentiment and reassure investors about the political commitment of the country to a sustainable fiscal policy.[1]

In the Keynesian view, the government should adopt discretionary fiscal actions to offset demand shocks and stabilize employment. The discretionary role is stronger when automatic stabilizers are too weak to effectively stabilize the economy, a factor which becomes especially relevant in the case of emerging economies that suffer from low income tax progressivity, high incidence of tax evasion, lack of unemployment benefits, and weak government institutions. Discretionary fiscal policy actions appear to

[1] Fiscal policy is considered pro-cyclical if the primary balance-to-GDP ratio rises by less than output during upturns and falls by less than output during downturns. Similarly, a fiscal policy is considered countercyclical when the primary balance-to-GDP ratio rises by more than output during upturns and falls more than output during downturns (see Kaminsky *et al.* 2004 and Manasse 2006).

be especially useful when monetary policy cannot play a countercyclical role because of exchange rate and balance-of-payments constraints.

In the neoclassical view, fiscal policy should remain neutral over the business cycle as discretionary fiscal actions are considered ineffective. Expansionary fiscal actions are considered to have little impact on aggregate demand because they are offset by increases in private savings as people save the future increase of tax liabilities (hypothesis known as Ricardian Equivalency). For Ricardian economists recommend discretionary fiscal policies should be avoided but the government should rely on automatic stabilizers to even out deficits and surpluses over the cycle (for more on tax smoothing models see Barro 1979 and Bernheim 1989). Expansionary fiscal policies could also conduct to persistent fiscal deficits and high real interest rates as a result of a crowding out of private investment by the government (Blanchard and Perotti 1999). Extreme Ricardian Equivalency relies, however, on two assumptions that may its applicability, especially in the case of developing and emerging economies. First, because future tax burdens may fall on subsequent generations of taxpayers rather than the current generation Ricardian Equivalency requires a perfect concern for intergenerational equity. Yet there is a great deal of evidence (e.g. in the areas of energy and environmental policy) that this concern is highly imperfect, and particularly so in developing countries. Second, since private savings are required to offset public spending Ricardian Equivalency implies the existence of stable, trustworthy, and universally-accessible financial institutions of a type which are simply not present in many developing nations.

Despite the unanimous view among economists and policymakers against pro-cyclical fiscal policies, countercyclical fiscal policies, whether based on pre-established fiscal rules or left to the discretion of policymakers, are still far from being the norm in most countries (European Commission 2006).

Fiscal consolidation through a pro-cyclical fiscal stance has contributed in many cases in the region to improving investor confidence, lowering the country's risk premium, and lessening exchange rate pressures (see also Perotti 2002 and Mohanty 2003).. A pro-cyclical fiscal response to a negative external shock has helped in several cases to reassure financial markets about the commitment of the country to medium-term fiscal sustainability. A lower public debt has helped to stimulate investment and growth by lowering real interest rates and the credit risk premium on international bonds. During 2001-2002 Brazil responded to external financial volatility by exceeding its primary surplus target despite a considerable slowdown of economic activity. This fiscal tightening helped to lower its country risk premium and restore investor confidence in Brazil.

The evidence shows that fiscal policy may have non-linear effects on aggregate demand. At low levels of public debt, fiscal expansions would generate usual Keynesian expansionary effects, but at high public debt fiscal expansions are likely to be contractionary as fiscal policy is perceived to be unsustainable (Perotti 1999). The experience in the region has shown that under conditions of low fiscal credibility and a

high degree of exposure to external borrowing fiscal expansions have destabilized exchange rate expectations, lower investment and growth In this context expansionary fiscal policies have threatened long-run debt sustainability, raised inflation expectations, and weakened investor such as in the cases of Argentina in 2001 and Brazil from 1999 to 2000 (see also Fischer, Sahay and Vegh 2002; and Kaminsky, Reinhart and Vegh 2004).

3 The International Experience Demonstrating the Inherent Pro-cyclicality and Deficit Bias of Fiscal Policies

Although in almost every case the goal of economic stabilization would justify the adoption of countercyclical fiscal policies, the international evidence points to an extensive use of pro-cyclical fiscal actions in both industrial and developing countries: increases in discretionary spending coupled with tax cuts during "good times" have represented a failure to save public resources in anticipation of future downturns, limiting the use of countercyclical fiscal policy in "bad times" because of deficit and debt sustainability problems.[2] The tendency to adopt a pro-cyclical stance in good times has been an important underlying cause of poor fiscal discipline, as governments are often under considerable pressure to direct their newly-increased revenues to political constituencies and interest groups rather than hold those revenues in reserve for future countercyclical spending (Kumar and Ter-Minassian 2007).

There is also evidence that a pro-cyclical fiscal policy stance has in many cases exacerbated output volatility and damaged fiscal sustainability (De Ferranti *et al.* 2000 and Gavin *et al.* 1996). The international experience points to an inverse relationship between output volatility and economic growth, reflecting in part the adverse effect of volatility on capital investment and human capital formation (Balassone and Kumar 2007).

A pro-cyclical fiscal policy in "good times" has fueled debt accumulation as deficits incurred in downturns are not compensated for by surpluses during upturns. The international experience in both emerging and developed economies shows that fiscal policy has been frequently pro-cyclical, especially during upturns, and has exhibited a deficit bias.[3] Political and financial factors have been found to be the major explanatory causes: (1) lags in the formulation and implementation of policy combined with difficulties in assessing the current state of the business cycle in relation to the long-term growth of potential GDP; (2) heavy spending pressures during good times, with fiscal expansion in upturns; (3) borrowing constraints and limited access to international capital markets in developing economies making pro-cyclical fiscal tightening the only choice during economic downturn; (4) common pool problems inducing the use of public resources by a particular group or subnational government inconsistent with the overall

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[2] Sustainability of public debt means maintaining a level of fiscal solvency that satisfies the government's intertemporal budget constraint. A sustainable fiscal policy requires a stable or declining public debt-to-GDP ratio. When interest rates exceed GDP growth a primary deficit leads to an explosive path for the public debt-to-GDP ratio, endangering the solvency of the public sector.

[3] The deficit bias is the tendency to run fiscal deficits that are not consistent with medium-term fiscal sustainability and is reflected in a growing pubic debt-to-GDP ratio over time.

budgetary constraint of the whole country; (5) moral hazard spending behavior of subnational government reflecting implicit or explicit bailout insurance by the central government; (6) free rider behavior of subnational governments taking advantage of market access conditions of the country as a whole, but failing to adhere to the fiscal rules established by the central or federal government; and (7) time inconsistency problems of policies agreed *ex-ante* but not adhered *ex-post*.[4]

The literature is near-unanimous in its description of the fundamental difference between developing countries and industrial countries in terms of fiscal policy. While fiscal policies in industrial countries have typically been a-cyclical or countercyclical, fiscal policies in developing countries—including most of Latin America—have been pro-cyclical (see for example Gavin and Perotti [1997] and Talvi and Vegh [2005]). In a study analyzing data on government consumption for 49 developing countries during the period from 1960-2006, Ilzetzki and Vegh (2008) found evidence that not only has fiscal policy in developing countries been pro-cyclical, but expansionary as well, with fiscal policy exacerbating the effects of the business cycle.[5] Their results regarding pro-cyclical fiscal policy in high income countries are inconclusive, but they do confirm that fiscal policy has been expansionary as well.

The international evidence also has shown interference with the operation of automatic stabilizers: the cyclical sensitivity of fiscal balances has been lower than what would have been expected from the action of automatic stabilizers alone, implying an offsetting impact from discretionary fiscal policy actions (Balassone and Kumar 2007). The main cause of the deficit bias of fiscal policy, in both industrial and developing countries discretionary policy, has been the asymmetric response of fiscal policy with pro-cyclicality occurring in good times. During upturns the effect of automatic stabilizers has typically been offset by discretionary fiscal expansions while during downturns the fiscal balance deteriorates setting a deteriorating fiscal balance trend (see Manasse 2006). In some European countries during the period from 1970 to 2000 deficits increased in downturns but did not fall in periods of high growth as a result of countries offsetting the effects of automatic stabilizers via tax cuts or expenditure increases. The pro-cyclicality of fiscal policy in also a stylized fact in Latin American countries, but in this case the fiscal policy has also generally been pro-cyclical in bad times, reflecting borrowing constraints and the overall pro-cyclicality of capital flows (see Haussman 2004; and Kaminsky et al., 2004).

The literature also points to institutional arrangements as a factor in the pro-cyclical bias of fiscal policy. Fiscal pro-cyclicality appears to be more pronounced in more corrupt democracies because of a political agency problem that leads voters to reduce the political rents. As voters observe the state of the economy but not the rents appropriated by corrupt governments during a boom they demand more government

[4] The fundamental problem of time inconsistency in government policy is that a policy that is optimal at a certain point in time becomes suboptimal later on. As individuals realize that the government has an incentive to deviate from its previously announced policy they behave accordingly. The solution to time inconsistency is a credible commitment by the government to adhere to its policy actions despite changing circumstances.

[5] The study by Ilzetzki and Vegh (2008) included eight Latin American countries: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela.

spending or lower taxes, inducing a pro-cyclical bias in fiscal policy (Alesina, Campante and Tabellini [2008]).

Patronage may also help to explain the prevalence of pro-cyclical fiscal policies in developing countries, as the governing party's favored constituency benefits from state spending but does not internalize the corresponding tax burden. The pressure to direct public resources to its supporters induces governments to spend all available revenues and exploit all available lines of credit during expansions, making fiscal policy both pro-cyclical and deficit-biased (Ilzetzki, 2009).

Public spending plays a key role in the cyclical asymmetry of fiscal policy in both industrial and Latin American countries, with spending rising in good times and either remaining constant or declining in bad times. The latter has been a stylized fact in the case of Latin American countries (see European Commission 2006; Budnevich 2002; Debrun 2007; and Gavin *et al.* 1996).

Weak fiscal discipline has complicated monetary and exchange rate policies. In some cases the monetization of fiscal deficits has raised inflationary expectations, weakened investor confidence, fueled capital outflows and depreciation of the exchange rate, and slowed investment and economic growth, further deteriorating the fiscal accounts. In other cases the tightening of monetary policy had lead to higher interest rates, appreciation of the exchange rate, crowding out of private investment, and negative repercussion on investment and growth, also adversely affecting the fiscal accounts (see also Mohanty 2003).

The international experience has also shown that country risk premiums are sensitive to fiscal policy in the case of developing and Latin American countries and, in particular, to the size of the public debt. An increase in the fiscal deficit and public debt-to-GDP ratio has raised the probability of default, leading to high interest rates and depreciation of the exchange rate. The evidence has shown that weak fiscal positions and the high exposure to external borrowing have been key factors triggering balance of payments and financial crises in the region. A strong commitment to fiscal sustainability has become critical in these cases and a pro-cyclical fiscal policy stance has been required to restore market sentiment and capital flows, and to reduce country risk premiums (Foster and Kaminsky 2007; and Kaminski and Reinhart 1999). In deciding on a countercyclical fiscal policy stance policymakers must assess the effect of the deteriorating fiscal stance on the financing conditions of the country and interest rates, as an increase in the government demand for funds would raise the public debt and put pressure on interest rates. This effect is stronger in emerging economies such as those in Latin America because fiscal credibility is weaker, borrowing uncertainties and constraints are more severe, financial markets are thinner and monetary policy is less accommodative than in developed economies (see also Eyzaguirre, Clements, and Canales-Krijenko, 2009).

Fiscal frameworks and rules constitute an institutional self-insurance mechanism, yet the international evidence shows that success is contingent on political-economy

factors, as well as the specifics of their design and implementation and the government's policy track record (especially regarding credibility and transparency). These conditions pose a considerable challenge for developing countries: in good times it is often difficult for the government to gain sufficient political support to conserve resources for the future instead of spending more on immediate social priorities such as infrastructure, education and health, especially if expenditure in these areas has been restricted during bad times. Sustainability Councils have been proposed as alternative to fiscal rules, but disagreements would inevitably arise about the impact of investment spending versus savings, the cyclical position of the budget and how it should be determined, and the objectivity and methodology of fiscal sustainability assessments. Political considerations are also very likely to affect the performance of these Councils, especially in developing countries (Perotti, 2007).

4 Fiscal Frameworks, Fiscal Rules and Other Mechanisms to Prevent Pro-cyclicality and Support Countercyclical Fiscal Policy Actions

Since the 1990s, several countries have put in place frameworks aimed at promoting fiscal discipline and guiding fiscal policies toward medium-term sustainability. In several cases the frameworks have included rules for countercyclical fiscal policy responses (automatic or discretionary). This period has also seen increased awareness of the crucial role play by fiscal sustainability as a central piece of a sound macroeconomic management in the context of the current globalization process.

Targeting the public debt-to-GDP ratio has been viewed as a critical method for judging fiscal sustainability in the medium term and has become especially relevant in the case of developing and Latin American countries because of their lower levels of "debt tolerance" as perceived by international investors (Reinhart, Rogoff and Savastano 2003).[6] The perception by economic agents that the government is committed to fiscal sustainability avoiding an unbearable level of public debt is crucial for establishing fiscal credibility and maintaining macroeconomic stability. Monetary and exchange rate policies have been more effective when the private sector believes that the government would not be forced to curb the growth of public debt through inflationary financing techniques.

Most fiscal frameworks have taken the form of Fiscal Responsibility Laws (FRLs), which set budgetary rules designed to prevent the misuse of discretionary fiscal policy—one of the main sources of deficit bias and overall pro-cyclicality of fiscal policies—and promote credibility, predictability, and transparency to show the government's commitment to fiscal discipline and fiscal sustainability.

Some fiscal frameworks have emphasized procedural rules for execution of the budget, while others focus more on numerical fiscal rules related to the budget balance

[6] The evidence shows that debt thresholds are much lower for emerging economies with records of debt defaults and high inflation. Debt intolerance, as perceived by international markets, has been a common problem in emerging economies with weak fiscal and financial systems (Reinhart, Rogoff and Savastano 2004).

targets, though the two are complementary: procedural rules have been found to be necessary for enforcing numerical rules. Other key features of FRLs and fiscal rules in general include their jurisdictional scope, the extent of sanctions, the applicability of escape clauses, and other cyclical considerations such as rules applied to structural budgets or to budgetary balances over the cycle (Corbacho and Schwartz 2007).

Policy rules (procedural and numerical) have been found to make discretionary policy actions possible while at the same time signaling the commitment of the government to medium-term fiscal discipline, therefore helping to help solve the time inconsistency problems of government policies. Fiscal frameworks and rules have helped governments to credibly commit to a disciplined fiscal course, limiting the scope for capricious policy changes while allowing for flexibility and adaptation in specific circumstances (Mersch 2006).

The adoption of a fiscal framework has also important implications for debt sustainability and the efficacy of monetary policy institutions. When fiscal policy has not been anchored by a medium-term rule the public debt has often developed an explosive path, increasing the probability of a government default and inflation (Woodford 2001). By contrast, in countries where fiscal discipline has been anchored by rules that prevent the formation of explosive public debt path, an independent central bank has been more effective to respond to an increase in the deficit by raising interest rates and thereby forcing a fiscal adjustment. Fiscal frameworks and rules that reflect a broad consensus on sound policies can play a useful role in signaling a strong commitment to fiscal responsibility and sound macroeconomic management. As such, they can also contribute to support democratic accountability, rewarding good fiscal behavior by the electorate that fiscal discipline and macroeconomic stability (see Debrun 2007 and Posen 1995).

Reflecting the particular conditions fiscal frameworks and/or rules have been designed make possible a more efficient operation of automatic stabilizers (targeting the cyclically-adjusted budget) and allow the adoption of discretionary countercyclical policies when needed (e.g. escape clauses) (Kopits 2001).

Table 1 contains a list of selected countries that have applied countercyclical fiscal frameworks and rules; in each case the framework and/or rules has been in place for a number of years and the institutions tasked with implementing it have established some reputation for credible enforcement. The list includes the European Union as a group, seven European Union member countries that have individually implemented guidelines or rules in addition to those established by the Maastricht Treaty, and five non-European Union countries. All are developed economies, with the exception of Chile.

Most fiscal frameworks described in Table 1 aim at correcting pro-cyclicality and establishing the necessary latitude for countercyclical fiscal responses, whether automatic or discretionary. They include procedural and/or numerical rules that target the structural budget balance (e.g. Chile setting a target for the structural budget surplus), place ceilings on the fiscal deficit and the public debt (e.g. European Union policies), aim at balancing the budget over the cycle (e.g. Australia, New Zealand, Norway, Spain Switzerland, and

United Kingdom, where deficits during downturns are required to be compensated for by surpluses during upturns), or regard government spending on a multiyear basis (e.g. Canada, Denmark, Finland, and The Netherlands, where rules limiting government expenditure growth are set for more than one year at a time).

Some fiscal frameworks only provide for countercyclical fiscal responses during downturns (the "one-sided" type), such as in the European Union, while others mandate countercyclical responses in both good and bad times (the "two sided-type"), including Canada, New Zealand, Switzerland, Chile, and some European Union countries. Some frameworks are supported by the operation of stabilization funds (as in Norway and Chile) and in some cases the frameworks include rules for subnational governments (such as in Australia, Canada, Germany, Spain and Switzerland) or governments belonging to a community of nations (the European Union).

The particular economic and political circumstances of each country or community of countries are reflected in the specific framework features that have been considered convenient or necessary to signal the political commitment to fiscal discipline. In most cases the fiscal frameworks are enshrined in civil law or in the national constitution. Transparency and monitoring are ensured by requirements to report to the national legislature, or the European Commission in the case of EU countries. Some countries, particularly industrialized nations, have relied primarily on reputation-based sanctions [7] for noncompliance supported by high transparency and accountability standards. In the case of Latin America countries the long history of noncompliance with fiscal discipline and budget targets implies that reputation-based sanctions alone would not be effective and additional sanctions are required to promote sustainable fiscal policies, such as institutional sanctions for noncompliant subnational governments or personal sanctions for noncompliant government officials, incorporated in the FRLs in the cases of Brazil and Chile.

Evidence of the success of frameworks and rules for improving fiscal discipline and countercyclicality is presented in Table 2 for the same countries and groups included in Table 1. We present data on GDP growth and volatility, gross public debt-to-GDP ratios, the overall government balance, and country risk indicators. We compare the averages from five years before the establishment of fiscal rules with the averages for all years after the rule for which data are available. In the case of the country risk indicators shown in the table we compare five years before the rule, the year of the rule, and five years after the rule. We also use a relevant benchmark to compare performance in each case: we selected a benchmark for each comparable group of countries using available statistics from the World Development Indicator and World Economic Outlook databases.

In all the cases we observe that fiscal discipline was already improving before the frameworks and rules were established, which shows that some building of reputation with fiscal discipline becomes essential to make the frameworks and rules credible.

[7] Reputation-based sanctions include the potential loss of credibility by government institutions and the loss of political support from certain constituencies or from the electorate at large.

Fiscal discipline continued to improve in most cases after the frameworks and rules were established, suggesting they became devices that formalized a preexisting commitment by the governments to maintain fiscal discipline. The evidence also indicates that these frameworks and rules have become key mechanisms to maintain fiscal discipline beyond the political cycles and changes in the political leadership of the country such as in the case of Chile or community of nations such as in the case of the European Union. The evidence in Tables 1 and 2 supports suggests that a record of fiscal discipline would be required to put in place a credible fiscal framework, and that such a framework would serve to reinforce that initial commitment.

The results for the volatility of GDP growth show that in seven out of twelve cases volatility declined after the rule and in nine cases volatility declined compared to same data for the indicated control groups (called benchmarks in Table 2). The results are even more powerful for the public debt and government balance. In eleven out of twelve cases the ratio of public debt to GDP fell in the years after the rule and in ten cases the ratio fell compared to the benchmarks.[8] The government balance improved in all cases after the rules were established and also improved in all cases compared to the benchmarks.

The results for the country risk indicators suggest that foreign investor sentiment improved in all cases after the rule and also when compared to the benchmarks. This is in line with the evidence pointing to the positive correlation between the perceived credibility in the country commitment to fiscal discipline and positive market sentiment (see also Kopits 2004b; and Kaminsky and Reinhart 1999).

Although the evidence suggests that effective fiscal frameworks and rules contribute to reducing the public debt, improving the fiscal accounts, and strengthening foreign investor sentiment the degree of success that has accompanied the adoption of fiscal frameworks and countercyclical fiscal policies has been mixed.

Chile's structural budget surplus framework and fiscal rules have strengthened the effects of its automatic stabilizers and open room for countercyclical fiscal actions. In 2001, Chile experienced a slowdown in economic growth and the structural surplus rule allowed its budget balance to deteriorate to accommodate a cyclical downturn. Its country risk indicators demonstrate that despite adverse external developments market confidence in Chile's economic policies improved during this period. The new fiscal rules have strengthened the response of fiscal policy to economic fluctuations and provided the conditions for a more stable monetary regime (Marshall 2003). Chile has also been able to adopt an expansive discretionary fiscal policy during 2009 in order to

[8] The data are in most cases for the general government gross debt according to the System of National Accounts (SNA) definition. Gross debt according to the Maastricht criteria differs from the SNA data. Gross debt in the Maastricht definition does not include trade credits and advances, or shares and insurance technical reserves, and government bonds are recorded at nominal values. According to the SNA methodology government bonds are valued at their market price or at their issue price plus accrued interest. Accordingly the gross public debt data in Table 2 is higher compared to the Maastricht criteria. The differences vary between from about 1 percentage point to about 10 percentage points in some cases, such as France in 2006 (OECD Economic Outlook 82 Database).

attenuate the negative effects of the global financial crisis that begun in the last quarter of 2008. Chile's record of fiscal credibility allowed the country to uses copper export revenue saved during the pre-crisis years of high copper prices to finance a countercyclical fiscal policy with a parallel improvement of market sentiment. The downward trend in Chile' country risk after the fiscal framework has been in place has yielded lower cost of foreign borrowing for the private sector (through lower sovereign spreads) and contribute to stabilize investors sentiment, with positive implications for private investment and growth.[9]

The international experience suggests however, that fiscal frameworks and budgetary rules that have relied on nominal deficit ceilings or medium-run fiscal targets have played a weaker role in correcting policymakers' temptation to raise government expenditure or cut taxes during economic expansions. Fiscal frameworks, rules-based or not, that do not prevent pro-cyclical actions in good times (such the Stability and Growth Pact of the European Union) or are specified in terms of averages over the cycle (Australia, New Zealand, United Kingdom) have been relatively less effective than stricter rules such as multiannual expenditure ceilings (Canada, Denmark, Finland, and The Netherlands) in correcting the deficit bias of fiscal policy. In some cases these frameworks have caused adjustments to be postponed until toward the end of the reference period and have limited the room for countercyclical fiscal actions during bad times.

Laxity in constraining pro-cyclical behavior during good times has weakened the overall credibility of the frameworks and rules. Evidence of this problem was seen in the case of the European Union during 2002-2003, when several member countries, faced with an adverse external environment, reported fiscal deficits above the limit established in the Maastricht Treaty after 2001 (Corbacho and Schwartz 2007).[10] Although we have seen a round of more expansionary fiscal policies during the current global financial crisis there could be the temptation to resume the pro-cyclicality of fiscal policies in good

[9] As part of its effort to improve its fiscal credibility Chile introduced a new fiscal policy framework in 2000 aimed at achieving and maintaining a structural surplus in the central government budget beginning in 2001. The objective of the rule is to anchor long-term fiscal expectations and allow automatic stabilizers on the revenue side to play an effective countercyclical role. The central government's structural revenues are computed using estimates of potential output and the long-run price of copper, a key export commodity. Expenditures are budgeted so as to achieve the targeted structural surplus of 1% of GDP up to 2007 and 0.5% of GDP for 2008-2012. This target is consistent with a projected moderate and stable gross public debt-to-GDP ratio. In the event that GDP and copper prices deviate from their potential and long-term values, the cyclical budget balance is allowed to adjust accordingly. To promote transparency in the estimation of the structural surplus, the government has established a commission of experts who recommend the reference copper price and the output gap each year. Continued adherence to the fiscal rule, despite the change in government in 2006, has allowed the authorities to avoid a pro-cyclical fiscal stance in an environment of historically high copper prices while delivering a reduction in the public debt, which has recently enabled Chile to become a net creditor. The Fiscal Responsibility Law, enacted in 2006, enshrined these fiscal rules in Chilean civil law.

[10] The different status between the 3 percent of GDP ceiling set for the annual nominal deficit and the medium term objective of "close to balance or in surplus" could have induced an augmenting factor. While the former is defined in the Maastricht Treaty and sanctions are provided for in case of noncompliance, the latter is defined in the Stability and Growth Pact and is not backed by similar incentives. This asymmetry has allowed attention to focus on the nominal deficit ceiling at both the policy and the monitoring levels, thus reducing pressure against the adoption of pro-cyclical policies in good times. The 60% target for the public debt-to-GDP ratio is also an indicator, not an enforceable target.

times when economic growth recovers in the next years if the deficit bias present if upper limits to expenditure are not introduced in the current "one-sided" frameworks and rules that prescribe countercyclical fiscal policies only during recessions.

The "one-sided" types of frameworks have not been very effective in correcting the deficit bias when they have lacked the political commitment to prevent discretionary pro-cyclical policies during expansions. Chile provides an example of a successful fiscal framework based on a "two-sided" countercyclical rule, targeting the cyclically-adjusted surplus on a yearly basis, which allows for the free operation of automatic stabilizers. The advantage of the "two-sided" rules and frameworks is that reduce the room for using government expenditure for political purposes. Experience has further shown, however, that effective countercyclical fiscal frameworks have required adequate transparency, monitoring, and accountability standards. Frameworks and rules can be easily broken if weak designed or subject to low credibility, transparency, and weak enforcement such as in the cases of frameworks adopted in Argentina in 1999 two years its largest historic debt default (Hallerberg, Strauch and von Hagen 2001; Hallerberg 2004; and Corbacho and Schwartz 2007).

Fiscal frameworks and rules that target public spending can be an important instrument to support countercyclical fiscal policies in the context of medium-term fiscal sustainability such as in the cases of Canada, Finland, Spain, Sweden, Switzerland, and The Netherlands). It is important to ensure, as mentioned above, that the pro-cyclical bias is not transferred to the revenue side of the budget as governments might be tempted to cut taxes or increase tax exemptions (also called tax expenditures) when economic growth is on the upswing (Balassone and Kumar 2007 and IMF 2008).

In the case of countries where the budget decisions of subnational governments are important to the consolidated public finances, adapting institutions to deal with the common pool problem has been necessary to stabilize market confidence and make the adoption of countercyclical fiscal policies possible. The application of top-down rules to enforce fiscal discipline by government institutions and sub-national governments is especially relevant in the case of developing economies (Balassone and Kumar 2007). Brazil, for example, has been required to established top-down subnational rules to ensure compliance with the national fiscal objective of reducing the public debt. In the case of Switzerland the high degree of budgetary interdependence among the various levels of governments has limited transparency and complicated the implementation of the fiscal framework and rules at the "Confederation" level.[11]

In addition to fiscal frameworks and rules, other instruments have been used or proposed to reduce the pro-cyclicality of fiscal policy: (1) reforming the tax system and

[11] Because of the federal structure of the Swiss government and the fact that certain social outlays are administered by compulsory contributions to private insurance schemes it is difficult to attain a coherent view of overall budget trends and prospects. At the national level, discussions focus mainly on the federal finances, which account for only one-third of the total budget. Also, because the accounts of the Confederation, the cantons, the communes and public and private social insurance schemes are interdependent, decisions taken at one level of government may affect spending of other levels of government, forcing ad-hoc cuts elsewhere to meet the deficit targets (OECD 2006).

reducing tax evasion to allow for the more effective operation of the automatic stabilizers; (2) lengthening the maturity of the public debt; (3) issuing contingent debt instruments linked to the ability of the country to service its debt and GDP-indexed bonds (Borensztein and Mauro 2004); (4) issuing commodity-linked bonds to hedge against adverse fluctuations in export earnings (Chamon and Mauro 2005; and Atta-Mensah 2004); (5) issuing international bonds denominated in local currency to hedge against exchange rate volatility; and (6) creation of stabilization funds (commodity or macroeconomic funds) to promote fiscal savings during economic expansions.[12]

Initiatives designed to improve the tax system in order to enhance the working of automatic stabilizers have been an important tool for less developed countries since the 1990s. Fiscal reforms have in most cases included measures for reducing tax evasion on personal and corporate income and efforts to make the income tax system more progressive. Although unemployment benefits play an important role as automatic stabilizers in developed countries, in developing countries public unemployment schemes are less common. In many emerging economies adapting debt management to reduce the pro-cyclicality of fiscal policy has also been an important strategy for reducing exposure to volatile capital flows; this was particularly true for Brazil and other Latin American countries during the 2000s, where measures included a lengthening of debt maturities and increased reliance on local financial markets.

Although important as a countercyclical fiscal device, the use of GDP- or commodity-indexed bonds and local currency-denominated international bonds has been limited. The use of GDP-indexed bonds has raised concerns as to the quality and transparency of the national accounts, especially relevant for emerging economies. Low liquidity and pricing problems, less developed regulatory frameworks, high exchange rate volatility and frequent changes in the exchange rate systems and inadequate hedging markets have also presented crucial challenges. Burger and Warnock (2006), for example, argue that US-based investors that participate in local-currency bond markets worldwide have historically avoided returns with high variance. For these investors, currency hedges play a key role since the variance of local currency bond returns is dominated by exchange rate volatility.

In some cases fiscal frameworks have been complemented by the establishment of a stabilization fund. Stabilization funds allow governments to save government revenues to finance future countercyclical spending. The funds accumulated in a stabilization fund may represent excess tax revenue resulting from an economy wide expansion, in which case investing revenues in the fund represents an alternative to finance recurrent

[12] Some economists have also proposed the use of discretionary countercyclical adjustments in taxes, public spending, and pension contributions (Budnevich 2002). The literature and international experience, however, do not support this approach. In addition to the inherent uncertainty and time inconsistency problems, market sentiment and investment would most likely be adversely affected by this type of policy. Finland has implemented two stabilization funds (called EMU buffer funds): an unemployment fund and a pension fund. They are financed by additional contributions from employees and employers during upturns. This is to prevent an increase of contributions during downturns to finance social security programs (as happened in the early 1990s). These schemes are unlikely to succeed in developing countries because unemployment schemes are in many cases nonexistent and pension schemes are often unfunded. In addition, in emerging countries raising contributions during upturns would face problems of social equality and distributive justice (see Table 1).

expenditures that could lead to unsustainable deficits during subsequent recessions, and thereby counteracts the deficit bias of fiscal policy. In other circumstances the funds saved may originate revenues from lucrative primary commodities exports in which case the fund may be used to mitigate “Dutch disease” effects or to finance net imports during depressed commodity prices. Given the typically pro-cyclical, deficit-biased and government borrowing trends of developing-country governments these funds provide a useful mechanism for supporting countercyclical fiscal policies by obviating the need for future borrowing.

As long as the stabilization funds cover a limited portion of government revenue they cannot guarantee that fiscal policy will not be pro-cyclical during expansions, as was the case with Colombia in the 1990s and Venezuela in the 2000s: in both instances resources were accumulated into stabilization funds while the overall fiscal accounts continued to deteriorate. Moreover, the use of savings for countercyclical fiscal policy in recessions requires a transparent rule, as the market may not distinguish between a responsible countercyclical policy and an unsustainable deterioration of the fiscal balance. To correct for this problem an aggregate public expenditure rule would help or, as in the case of Norway which stated a rule requiring non-oil deficits to be limited to the interest revenues of the oil fund (Perry 2005).

As with all fiscal frameworks and rules, however, the success of stabilization funds has depended on the transparency, credibility, and accountability associated with the administration of the fund’s assets along with the credibility and sustainability of fiscal policy in general. If these conditions are not met, the funds are at risk of being misused or made to serve particular political interest at the expense of the general public.

5 Preconditions for the Adoption of a Countercyclical Fiscal Policy

A number of preconditions can be inferred from the international experience to avoid the pro-cyclicality and deficit bias of fiscal policy and strengthen its countercyclical stabilizing role. The evidence shows that anchoring fiscal policy to medium-term objectives of fiscal discipline and medium-term sustainability supported by well designed fiscal frameworks and rules have contributed to improvements in macroeconomic management and in market sentiment. In a number of cases these frameworks and rules have been crucial steps to open sufficient budgetary room for an effective countercyclical fiscal policy. Government savings during expansions leave resources available to finance countercyclical fiscal actions and thereby make borrowing constraints during recessions less binding. Table 3 synthesizes the most important preconditions derived from the international experience and documented in the selected literature.

The use of countercyclical actions requires the prior existence of a solvent and sustainable fiscal policy. Otherwise a countercyclical fiscal action during a recession could raise inflationary expectations, put pressures on interest rates and the exchange rate, crowd out private investment, encourage capital flight, and generally contribute to,

rather than mitigate, an economic downturn. This is especially relevant in the case of emerging markets such as those in Latin America (Eyzaguirre, Clements and Canales-Krijenko 2009).

An accurate assessment of the economic cycle and its impact on the budget is critical to the pursuit of countercyclical policies. In the absence of a reasonable and credible judgment of the state of the cycle and its implications for revenues and expenditures, a countercyclical policy cannot be effective. Targeting cyclically-adjusted or structural fiscal balances can assist in the design and monitoring of fiscal policies by focusing on the discretionary component of the budget. The cyclically-adjusted fiscal balance (CAB) is obtained by removing the cyclical component of the budget from the observed fiscal balance.

Fiscal policy frameworks and rules designed on the basis of CABs need to be supported by transparent and credible techniques for the estimation of output gaps and budgetary elasticities, and must reflect a strong political commitment to fiscal sustainability. Credibility and transparency in fiscal institutions and budgetary rules supported by a meaningful political commitment to fiscal sustainability are crucial to stabilizing market sentiment (Corsetti, Guimaraes and Roubini 2004).

Although the evidence has shown that it is difficult to establish causality between fiscal institutions and fiscal performance, improving fiscal institutions is generally considered a precondition to enforcing fiscal frameworks and rules. Countries with weak fiscal institutions and budgetary systems are unlikely to be able to effectively monitor compliance with the established fiscal framework and rules (e.g. Argentina FRL established in 1999). The experiences of Australia, New Zealand, and the United Kingdom highlight the importance of having in place a well-developed system of fiscal institutions to promote transparency and accountability. If the fiscal institutional framework is not sufficiently well developed when an FRL is introduced, it may be advisable to establish a transitional period until the full application of all FRL requirements becomes binding (Corbacho and Schwartz 2007).

A record of sound fiscal management should also be in place before the establishment of a countercyclical fiscal framework. This includes reducing the public debt to sustainable levels. In countries where these frameworks and rules have been successful, such as Australia and Chile, fiscal performance was already improving and the public debt had been reduced to market-tolerable levels before the implementation of the frameworks and rules. A consensus about the need for fiscal prudence and improvements in market sentiment as reflected by country risk indicators were already in place when the frameworks and rules were adopted.

In the cases of several Latin American economies in which a moderate public debt-to-GDP ratio has not yet been achieved, and where public debt sustainability projections depend heavily on progress on key fiscal reforms (social security, and the tax and expenditure systems), stabilizing market sentiment through the use of countercyclical government expenditure during downturns would remain limited for some years. In

some cases annual primary surpluses may be required for some time in order to reduce the public-debt-to GDP ratio to moderate levels. Allowing the fiscal accounts to fall into deficits during recessions may destabilize market sentiment as the public debt rises and fiscal sustainability weakens, further complicating the recession and recovery. A fiscal expansion in recessionary periods would force the tightening of monetary policy in order to discourage capital outflows, but would also have negative repercussions for investment, economic growth, and the fiscal accounts.

A reasonable degree of progress with fiscal reforms is required for medium-term fiscal sustainability, especially reforms to expenditure, tax and social security systems, as well as building stable and predictable relations between different levels of government in the case of a federal system. In a federal system the central government must establish a reputation for not bailing out subnational governments in order to suppress common pool and moral hazard problems. A record of fiscal discipline by subnational governments is critical for the non-bailout policy to be credible (Kopits 2004a). Federal governments also need to adapt institutions to deal with the common pool problem and, if necessary, establish top-down rules to enforce fiscal discipline by subnational governments and make the adoption of coordinated countercyclical fiscal policies possible (see also Balassone and Kumar 2007).

Broad support for fiscal prudence is a crucial precondition for successful countercyclical fiscal frameworks. This requires improving fiscal transparency and management and oversight systems. These requirements may not be met in countries facing large macroeconomic imbalances or political instability. In such cases a discretionary deterioration of the fiscal balance during recessions may encourage capital outflows and exacerbate the economic downturn, exposing the economy to potentially serious disruptions. In these circumstances the restoration of market confidence may require that pro-cyclical fiscal policies continue during an economic downturn in order to reinforce the political commitment to addressing an unsustainable fiscal stance.

6 International Best Practices for Establishing a Countercyclical Fiscal Policy

There is broad agreement in the literature that fiscal frameworks and rules are important mechanisms to support fiscal discipline and allow for the adoption of effective and credible countercyclical fiscal policies. Other mechanisms, such as stabilization funds and debt-contingent instruments, could also serve to complement and reinforce counter cyclicality. There is further consensus that fiscal frameworks, rules and other mechanisms must accommodate the particular economic, political, and cultural conditions of each country and reflect international standards of best practices. Table 4 summarizes the most successful practices gleaned from the selected literature and from the international experience for the use of fiscal frameworks and rules (including stabilization funds and coordination with subnational governments), for promoting countercyclical fiscal policies both automatic and discretionary.

For countercyclical frameworks and rules to be credible they should operate symmetrically, allowing budget deficits during downturns and accruing surpluses during upturns, otherwise fiscal pro-cyclicality in economic expansions and the deficit bias of fiscal policy would continue, while the credibility of the frameworks and rules would be gradually eroded i.e., it is recommended the adoption of "two-sided" fiscal frameworks and rules that operate symmetrically for downturns and upturns. Countercyclical fiscal policy actions cannot be properly implemented outside a medium-term fiscal framework that takes into account the evolution of the public debt.

There is agreement that procedural and transparency rules should complement the use of numerical rules. Procedural rules should include provisions for making the budget process more "hierarchical," concentrating power in the hands of those with direct responsibility for ensuring fiscal discipline. They should also include provisions for identifying weaknesses in fiscal institutions and for limiting principal-agent problems by increasing public accountability.

Countercyclical fiscal rules in emerging economies should be based on a structural balance framework. If adjustments for the cyclical component of interest rates are not feasible, the cyclically-adjusted fiscal balances (CABs) and rules should apply at the level of the primary balance (Perry 2005). Moreover, CABs need to be used with some flexibility where structural breaks, output volatility, and national statistical systems complicate the task of estimating potential output and the state of the business cycle. However, the role of CABs should not reduce the importance attached to the monitoring of nominal balances and debt dynamics.

Targeting an overall balance rule is not considered a good practice for countercyclical fiscal policy in the Keynesian view, nor does it allow automatic stabilizers to function freely over the cycle, as the Neoclassical view would recommend. Targeting the primary balance is preferable because it provides a better measure of the stance of fiscal policy. In emerging economies, and in particular in Latin America—given the typical volatility of government revenue and debt service—targeting the overall balance would lead to highly volatile primary spending (Hausmann 2005).

Numerical rules embodied in fiscal frameworks such as the FRLs have several potential advantages: (1) they help contain the deficit bias of fiscal policy and address problems of time inconsistency; (2) they help address the expenditure bias in decentralized countries when top-down rules are imposed; (3) they help reduce the pro-cyclicality of fiscal policy and make countercyclicality possible when cyclically-adjusted indicators are targeted; (4) they serve as a useful market signal in countries vulnerable to contagion effects and sudden shifts in investor confidence; and (5) they help to reduce borrowing costs and macroeconomic volatility, as they contribute to improved investor confidence (Fatás and Mihov 2003; and Kopits 2004b).

Numerical rules need to be consistent with economic conditions and backed by a strong political commitment to adhere to those rules, otherwise they will lack credibility and may encourage officials to subvert them by, for example, reclassifying expenditures

from current to capital spending for current balance budget rules ("golden rules") or by using off-budget public entities to perform government operations.

Medium-term fiscal frameworks such as those embodied in FRLs can strengthen fiscal rules with mechanisms to enhance transparency, monitoring, and accountability. Monitoring by public bodies outside the budgetary process is useful for imposing hard budget constraints on the public sector as a whole, particularly if coupled with sanctions for noncompliance (Corbacho 2007). Following best practices in transparency and accountability is critical to ensure the success of FRLs and related budgetary rules. Clear and open budget formulation and execution procedures, an independent audit mechanism, and transparent oversight procedures are key elements of best practices.

Independent fiscal agencies (fiscal councils) can contribute to enhancing the credibility and transparency of fiscal frameworks and rules by providing technical support for the estimation procedures used in the CABs, by assisting in identifying key fiscal reforms, and by helping to ensure medium-term fiscal sustainability (Debrun, Hauner and Kumar 2007).

In decentralized governments with a record of subnational fiscal indiscipline it is preferable to establish a top-down approach for enforcing discipline and ensuring that rules are adhered to. Rules-based fiscal policy is supposed to be effective in decentralized countries to the extent that it creates incentives to improve fiscal discipline at the subnational level, and alleviates difficulties caused by inadequate resource sharing schemes and principal-agent problems (as in the case of Switzerland).

Where the national government does not have the constitutional authority to apply a single comprehensive fiscal framework to all levels of government, federal law and practices must set a proper example by providing incentives for subnational governments to adopt responsible fiscal policies. The success of these rules in large part depends on the degree of cooperation between different levels of government. In countries where subnational governments have fiscal autonomy, expenditure targets for the central government should be complemented by intergovernmental agreements.

Subnational rules are recommended when countries are confronted with major fiscal adjustments that cannot be met by the central government alone, and where fiscal indiscipline by subnational governments is a major issue. The smaller the central government's relative role in the total fiscal process the greater the need for applying subnational rules to counter common pool and moral hazard problems. If the diffusion of efforts among different subnational governments attempting to comply with collective objectives is significant, the incentive for free-rider behavior requires enforceable sanctions and mechanisms for ensuring correction (Kopits 2001).

Some a-cyclical fiscal frameworks have incorporated escape clauses to permit countercyclical actions during periods of low growth or in response to external shocks affecting key industries or commodity prices. International experience suggests that

escape clauses should be avoided and applied only in exceptional circumstances so as to ensure that credibility in fiscal policy is not undermined.

Effective enforcement mechanisms are crucial for establishing effective fiscal frameworks and rules. Industrialized countries have relied primarily on reputation-based sanctions such as bad performance evaluations and transferring of responsible government officials for noncompliance. In countries with a long history of noncompliance with budget targets, stronger sanctions would be required to enforce fiscal discipline, such as institutional sanctions for noncompliant subnational governments and fines and judicial sanctions for noncompliant public officials (Corbacho and Schwartz 2007).

Expenditure frameworks aimed at capping the growth of public spending over the medium term are effective in expansionary periods and allow automatic stabilizers to play a stronger countercyclical role. There is evidence that countries that adopted expenditure frameworks exhibited more moderate growth of public spending, especially during expansions (European Commission 2006).

The use of comprehensive aggregates for targeting public expenditures prevents governments from bypassing expenditure ceilings by increasing public spending in categories not included in the targeted aggregate or by expanding the budgets of government entities outside the scope of the fiscal target (Balassone and Kumar 2007). Some expenditure items may be transferred to the capital account to avoid rules applied to current spending, or local-government spending may increase to compensate for restrictions on the budget of the central government.

Setting multiyear public expenditure ceilings has the advantage of making the government's fiscal objectives explicit and would contribute to build consensus around them. Multiyear expenditure frameworks also contribute to reducing the tendency for expenditures to grow faster during expansions.

Revenue rules that determine *ex-ante* the share of revenue windfalls to be saved, as well as the establishment of stabilization funds, can contribute to strengthening the commitment of governments to save extra revenues generated during expansionary periods. In this case rules designed to ensure a consistent fiscal policy are required, as the market may fail to distinguish between a responsible countercyclical policy and a deterioration of fiscal discipline (Perry 2005).

Finally, Latin American economies could greatly benefit from the use of additional devices to reduce fiscal pro-cyclicality resulting from borrowing constraints or the dependence of fiscal revenues on a primary export commodity. The structure of debt can be lengthened and financial instruments can be developed and used more intensively to reduce the budgetary impact of sharp changes in economic and international market conditions, while automatic stabilizers could be made more effective through tax and social security reforms that include measures for reducing tax evasion, increasing the progressivity of personal income and corporate taxation, and extending the use of

unemployment benefits. Policymakers involved in public debt management should consider lengthening debt maturities and increasing their use of local financial markets.

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Table 1: Countercyclical Fiscal Rules: Selected countries.

Country	Date	Policy Rule / Mechanism	Planning Horizon	Counter-cyclicality
Australia	1998	Charter for Budget Honesty • Budget and debt rules: **Budget Balance Over the Cycle** and Debt Ceiling No legislated numerical rules. The Charter requires the government to spell out objectives and targets but places no constraints on their nature. **Subnational level:** Cooperative approach. Federal and state borrowing is coordinated by the Loan Council. Most states have adopted some sort of balanced-budget rule.	Over the cycle	2 sides
Canada	1991 to 1996	Federal Spending Control Act • Expenditure rule: Limits on all spending except self-financing programs. **Overspending in one year permitted if offset in following two years**. • Debt Repayment Plan - No legislated rules at the federal level, but the government follows a "balanced budget or better" policy. - Contingency Reserve implemented (1995) by the government in its budget planning to protect against adverse changes in the economy or forecasting errors. The reserves may be devoted to debt reduction if not needed. **Escape clauses** : In the event of a serious economic slowdown **Subnational level:** No formal co-ordination: Most sub-national governments have balanced-budget rules and / or legislation. Borrowing: No restriction on provincial and territorial borrowing. Municipal borrowing is subject to a golden rule (fiscal current account balance).	Multiannual permitted	2 sides
Chile	2000	**Stabilization Fund** • Budget Rule: **Structural** surplus of 1% of GDP • Revenue Rule: Fiscal Revenues adjusted for Output Gap and deviation of copper prices for long time trend	Over the cycle	2 sides
New Zealand	1994	Fiscal Responsibility Act • Budget Rule: **run operating surpluses on average over a "reasonable" period of time**. • Debt Rule: Maintain debt and net worth at "prudent" levels (gross debt below 30% of GDP). (Each government sets its own numerical targets consistent with these principles). **Subnational level:** Co-operative approach through inter-governmental consultations. Balanced-budget (on accrual basis) rule at sub-national level. Borrowing: No restrictions.	Over the cycle	2 sides
Switzerland	2001	• Budget Rule: Capped the federal deficit at 2 per cent of revenues. • Debt Rule: **Sets a ceiling for expenditures, equal to total revenues adjusted for the cycle** and for ex post deviations of out-turns linked to the public debt. **Escape clauses:** Exceptional circumstances require an absolute majority in both houses of Parliament. **Subnational level:** No formal co-ordination. Borrowing: Sub-national borrowing is subject to a golden rule and popular referenda. Cantonal and communal accountability involves the access to own revenue sources together with the right of the Cantons and the communes to borrow.	Over the cycle	2 sides

Table 1 (cont.)

Country	Date	Policy Rule / Mechanism	Planning Horizon	Counter-cyclicality
Euro zone and European Union	1992 and 1997	**General Rule – Maastricht Treaty (1992): Convergence criteria and Growth Stability Pact (GSP)**(1997 – took effect on 1999 at Euro launching). • 3 per cent of GDP ceiling on general government net borrowing. **GSP added a "close to balance or surplus" guideline**. • below 60 per cent of gross government debt-to-GDP ratio norm (or be declining towards the 60% norm at a satisfactory rate). **Escape clause:** Exceptional circumstances: if output falls by over 2 per cent during the year the deficit is allowed to exceed the limit. **Reform 2005**: the EU Stability and Growth Pact prescribe a medium-term position of close to balance or surplus for high-indebted members while allowing a deficit of up to 1% of GDP for high-growth low-debt members. * Until 2005. Since this date, EU members States have to indicate their medium term objectives.	Not settled	1 side* except specific countries below
Euro zone (Specific Countries rules)				
Netherlands	1994	Multi-year expenditure agreements Use deliberately cautious growth projections. • Expenditure Rule: Ceilings on central government, social security and health care spending Net real expenditure ceilings for the whole term of government (4 years) **- The ceilings on real government expenditure levels defined for different sub-sector of the central government and set for the length of a legislature limit the use by the national government of budgetary windfalls for additional expenditure in good times.** - Signal value for the general government deficit of 2 or 2.5% GDP. Surpassing this signal value implies that additional measures are to be taken and that the expenditure ceilings do not apply anymore (this may result in pro-cyclical policy). • Revenue rule: Defines ex-ante which share of higher than expected revenues could be spent or redistributed to citizens via tax cuts and which share should be used for the purpose of reducing the deficit. (medium term framework). From 1999 to 2002: If the balance exceeded -¾ per cent of GDP, half of the revenue windfalls can go to tax cuts and half is used for deficit reduction. If the general government deficit was more than 0.75% GDP, then 75% of the windfall was to be used for deficit reduction and 25% for additional tax relief. **Since 2002, to strengthen automatic stabilizers and improve the budget position, the revenue windfalls can only be used for deficit reductions.** • An **investment fund** is financed via 40% of the natural gas revenues (FES fund); the remainder of the natural gas revenues are used for debt reduction. The FES is not included in the expenditure framework and its role is to **dampen the impact of fluctuations in the gas price on the budget**. An estimate is made of expected gas revenues during the cabinet term, based on an estimate of the oil price (to which the price of gas is linked) derived from CPB's cautious scenario (see Table 1a). This additional investment is included into the multiyear budget (but not in the expenditure framework) as additional public investment to strengthen the economy. Extra expenditure is then allowed because FES distributions are not included in the expenditure framework. **Subnational level:** Cooperative approach through intergovernmental consultations. Balanced budget (on accrual basis) rule at subnational level. Borrowing: No restrictions.	Multiannual (4 years)	2 sides
Spain	2003	Fiscal Stability Law • Budget Rule: **Accounts should balance or show a surplus over the cycle** at all levels of government (central, social, territorial and local) as well as for public enterprises and corporations. • Expenditure Rule: A cap is set on government expenditures and a contingency fund (2% of total expenditures) is set up to cover unscheduled expenditure. **Escape clauses: Possibility of running deficits restricted to temporary and exceptional situations**. Two-to-three-year plans to restore the accounts to balance will have to be discussed in Parliament. **Subnational level:** Fiscal rule: All levels of government subjected to a balanced-budget constraint. Borrowing: Subject to a golden rule and ministerial approval depending on the debt service burden.	Over the cycle	2 sides

Table 1 (cont.)

Country	Date	Policy Rule / Mechanism	Planning Horizon	Counter-cyclicality
Others European Union (Specific Countries rules)				
Denmark	1998	• Budget rule: **Structural Budget Balance** (Target as a % of GDP in **structural terms** (European Accounting Standards)) • Expenditure rule: Limit on real expenditure growth rate (European Accounting Standards) • Revenue rule: Limits on direct or indirect tax rates (tax freeze) **Subnational level:** Cooperative approach: Formal cooperation between the central government and the Local Government Association. Subnational governments subjected to a balanced-budget ceiling but have substantial taxing rights. Borrowing: Long-term borrowing is allowed up to a ceiling. Municipalities subjected to a golden rule.	Multiannual	2 sides
Finland	2001	• Budget balance rule: Budget balance as % GDP (European Accounting Standards) Central government fixes a maximum ceiling of 2.75% of GDP and requires a balance position in periods or normal growth conditions, **admitting however short-term deviations related to cyclical conditions**. • Expenditure rule: Real expenditure ceiling (multi-annual framework) **Exclusions of cyclically-sensitive items from the expenditure ceilings in order to favor the free operation of automatic stabilizers.** • Revenue rule: Budget balance as % GDP (European Accounting Standards). **This revenue rule prevents increased spending or tax cuts in good times.** **The revenue rule stipulates that unemployment security contributions as well as earnings-related pension contributions are stabilized over the cycle with the help of two EMU-buffer funds (introduced in 1997), which work as a stabilization fund:** - unemployment benefit EMU buffer fund: during periods of relatively strong growth, contributions are higher than is necessary to finance unemployment benefit expenses during periods of relatively weaker growth. The buffer fund produces counter cyclical variations in the unemployment insurance contribution rate. - occupational pensions EMU buffer fund: employers and wage earners pay a higher occupational pension contribution during periods of relatively stronger growth to help finance pensions during years when growth is weak. In both of these cases, the buffer funds slow down the increase in contributions in a downturn and support domestic demand leveling out cyclical fluctuations. • Debt rule: Debt to GDP ratio has to be reduced. (Budgetary accounting) **Subnational level:** Fiscal rule: Municipalities face a balanced-budget rule over the medium term. Borrowing: No explicit restrictions on local borrowing, which is not guaranteed by the state.	Multiannual (5 years)	2 sides
Norway	2001	**Stabilization Fund** Fiscal Stability Guidelines • **Structural non-oil central-government budget deficit should equal 4 per cent of the Government Petroleum Fund over the cycle. Discretionary easing or tightening during the cycle is allowed**. • **In the event of non-compliance due to extraordinary circumstances** (major revaluations of the Fund's capital or statistical revisions of the structural deficit), **corrective action should be spread over several years**. **Subnational level:** Fiscal rule: Counties and municipalities are not allowed to run operational deficits. Ex post deficits can be carried over for up to two years. Borrowing: No restrictions	Over the cycle	2 sides

Table 1 (cont.)

Country	Date	Policy Rule / Mechanism	Planning Horizon	Counter-cyclicality
Sweden	1996	Fiscal Budget Act • Budget Rule: **Maintain a general government surplus of 2 per cent of GDP on average over the business cycle**. • Expenditure Rule: Set nominal expenditure limits on 27 expenditure areas (including social security and transfers to other levels of government) for a 3-year period. **Subnational level:** Fiscal rule: Balanced-budget rule with two-year carry-over for local governments. Borrowing: No restrictions	Over the cycle	2 sides
United Kingdom	1997	Code for Fiscal Stability • Golden rule: over the business cycle the Government will borrow only to invest and not to fund current spending. • Sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (defined as below 40 per cent of GDP) **Subnational level:** Limited fiscal autonomy at the sub-national level. Borrowing: Subject to central government approval	Over the cycle	2 sides

Table 1A: Countercyclical Fiscal Rules for selected countries: Government Level; Statutory Base; Monitoring; and Sanctions

Country	Date	Government Level	Statutory Base	Monitoring	Sanctions / Enforcement
Australia	1998	General Government (The Charter requires the government to spell out objectives and targets)	Law	Requires the Government to prepare an annual fiscal strategy statement outlining long-term fiscal policy objectives and fiscal targets for the following three years. **External auditors assess the statement and performance**.	General Government: No sanctions Subnational level: Market discipline: State borrowing is not guaranteed by the central government. Peer pressure: The states are required to explain overruns in the borrowing allocations set by the Loan Council
Canada	1991 - 1996	General Government and Provinces	Policy Guideline	Compliance with the Federal Spending Control Act is assessed by Auditor General.	General Government: No explicit sanctions. Most Provinces: Sanctions that may include salary cuts for cabinet members or forced elections. Non-compliance fines are reimbursed if compliance is restored within one year, or allocated across the complying jurisdictions, otherwise.
Chile	2000	National Government	Policy Guideline / Law[1]	Independent Monitoring	No sanctions
New Zealand	1994	General Government	Law	Statement of contingent liabilities (on annual and semi-annual basis). All financial statements, including those on contingent liabilities, are submitted to parliament as well as published on the web.	General Government: No sanctions Subnational level: Market discipline: Sub-national loans are not guaranteed by the central government
Switzerland	2001	Central Government	Constitution	Low Federal control: High degree of budgetary interdependence between the various levels of government.	General Government: Budget: • Expenditure excess to be financed by tax increase. Debt: • No explicit sanctions. However, deviations from the rule must be corrected within three years. Subnational level: Sub-national fiscal policy is subjected to social control through referenda.
Euro zone	1997	General Government	International Treaty	Member States are required to report twice a year to the Commission their planned and actual deficits and their debt levels under the excessive deficit procedure. Once a year they must also submit a stability (euro area "ins") or convergence ("outs") program, which is subject to an opinion from the Council.	• Non-remunerated deposits with a fixed component equal to 0.2 per cent of deficit and a variable component rising with size of excessive deficit. • Financial sanction applies only in case of non-respect of deficit rule, although peer pressures can be exerted in the form of policy recommendations on the basis of the Commission's assessment
European Union	1992 and 1997	European Commission	International Treaty	Idem Euro zone	Excessive Deficit Procedure. Recommendations given by the Council (Commission) to the member state concerned to take the necessary measures to reduce the deficit. Sanctions applied only for Euro zone countries (See below)

Table 1A (cont.)

Country	Date	Government Level	Statutory Base	Monitoring	Sanctions / Enforcement
Euro zone (Specific Countries rules)					
Netherlands	1994	General Government	Coalition Agreement	Government (Ministry of Finance) Netherlands Bureau for Economic Policy Analysis (CPB). The CPB is formally attached to the Ministry of Economic Affairs, but works in full independence. It monitors the implementation of budget plans; quantifies short term and long term effects of measures and reforms and checks compliance with budgetary rules. The CPB is generally consulted (no obligation) by the government in the course of the budgetary process. The government is not obliged to publicly respond to the analysis prepared by the CPB. Its forecasts are used for budget preparation, even if there is no legal obligation. If this would not be the case, an explanation would be expected	General Government: No sanctions The Ministry of Finance proposes correctives measures. Subnational level: Administrative sanctions. Central authorities can assist municipalities in distress if they give up their financial autonomy.
Spain	2003	General Government for Budget balance Regional Gov. for Debt ceilings and local for Debt in percent of revenues.	Law	Government (Ministry of Finance). National Committee of local administration (CNAL) (attached to the Ministry for Public Administration). The CNAL issues recommendations in the area of fiscal policy concerning local government finances and fosters cooperation between State and local governments. The government has to consult the CNAL in the course of the budgetary process concerning the articles related to local governments' finances. Court of Auditors. It analyzes (ex post) the budget execution and monitors implementation, verifies whether budgetary outcomes are in compliance with existing budgetary rules, assesses the quality of government finances and issues recommendations and normative statements in the area of fiscal policy. The government is not obliged to publicly respond to the analysis prepared by the Court, but generally takes into account the recommendations	General Government: No sanctions Subnational level: Administrative sanctions. A fiscal consolidation plan is required for non-complying jurisdictions. Financial sanctions: European sanctions are shared with noncomplying jurisdictions.
Others European Union (Specific Countries rules)					
Denmark	1998	General Government	Political Agreement	Government Danish Economic Council (DEC) (independent body attached to the Ministry of Economic and Business Affairs) It analyses the overall functioning of the public sector, the sustainability of government finances, and the fiscal stance. It issues recommendations and normative statements on fiscal policy. The government is not obliged to respond to the analysis of the DEC but can comment on the report. The recommendations by the DEC affect the decisions process via their impact on the public debate	General Government: No sanctions Subnational level: Peer pressure and financial sanctions. The agreement between the central government and the Local Government Association is not legally binding. In the event of violation of the tax freeze, all additional net tax revenues will be confiscated through a reduction in block grants.
Finland	2001	General Government	Political Agreement	Government (Ministry of Finance)	No pre-defined action (political pressure to ensure compliance). All Government levels.

Table 1A (cont.)

Country	Date	Government Level	Statutory Base	Monitoring	Sanctions / Enforcement
Norway	2001	General Government	Policy Guideline	Budget documentation reports the structural fiscal balances including and excluding oil revenues. This is complemented with an annual update of long-term projections.	General Government: No sanctions Subnational level: Administrative sanctions. Borrowing and long-term contracts (e.g. tenancy agreement) are not allowed while in breach of the deficit provisions.
Sweden	1996	General Government	Law / Policy Guideline	National Institute of Economic Research (NIER) (Economic research institute under the Ministry of Finance). It analyzes fiscal policy developments of the whole of the general government sector and its sub-sectors. The government is not obliged to publicly respond to the analyses prepared by the NIER and has no obligation to follow the recommendations.	No sanctions at all Governments levels
United Kingdom	1997	General Government	Policy Guideline	National Audit Office (NAO) (independent institution under the Parliament). the NAO audits changes in key assumptions and conventions underlying fiscal projections for the whole of the public sector; the NAO's conclusions and recommendations are confined to the assumptions underpinning the fiscal projections, not the overall stance of fiscal policy or performance against the Government's fiscal rules. The government has to consult the NAO in the course of the budgetary process. The Treasury is not obliged to follow the NAO's recommendations concerning the key assumptions underpinning the fiscal projections (in practice generally does).	General Government: Judicial and Financial Subnational level: No (Cf. Table 1)

[1] Enacted into law in 2006.

Sources:
Australia: IMF(2008), IMF (2006), OECD (2003).
Canada: Kennedy and Robbins (2001), OECD (2002), OECD (2003)
Chile: OECD (2002), Kopits (2007)
New Zealand: OECD (2002), IMF (2005), Kopits (2007), OECD (2003)
Switzerland: OECD (2002), IMF (2008), OECD (2006), OECD (2003).
European Union: OECD (2002), European Commission (2006)
Netherlands: Bos (2007), IMF (2006), OECD (2002), European Commission (2006), OECD (2003).
Spain: OECD (2002), IMF (2008), OECD (2003).
Denmark: IMF (2004), IMF (2008), OECD (2003).
Finland: European Commission (2006), HM Treasury (2003), OECD (2003).
Norway: OECD (2002), OECD (2003).
Sweden: Kopits (2007), OECD (2002), OECD (2003).
United Kingdom: HM Treasury (2003), Kopits (2007), OECD (2002), OECD (2003).

Table 2: Stylized Facts: Selected Countries with Countercyclical Fiscal Frameworks

		Real GDP Growth Rate						Public Debt/GDP (General Government)[5, 6]			General Government Balance (Cash)			EMBI Global Diversified			Rating – Sovereign Foreign Currency LT		
		Average			Coefficient of Variation			Average			Average								
Countries	Rule date	5 Years before Rule	All Years after Rule	Ratio after / before Rule	5 Years before Rule	All Years after Rule	Ratio after / before Rule	5 Years before Rule[4]	All Years after Rule	Ratio after / before Rule	5 Years before Rule[10]	All Years after Rule	Diff 8	5 Years before Rule	Year of the Rule	5 Years after Rule	5 Years before Rule	Year of the Rule	5 Years after Rule
Australia	1998	4.4	3.1	0.7	0.1	0.3	2.7	38.2	20.5	0.5	-1.1	1.6	2.7	-	-	-	AAA	AAA	AAA
Benchmark: Advanced Economies[1, 6, 7]	*1998*	*3.0*	*2.6*	*0.9*	*0.1*	*0.5*	*5.0*	*71.2*	*73.5*	*1.0*	*-2.9*	*-2.1*	*0.8*	-	-	-	-	-	-
Ratio Country / Benchmark		*1.5*	*1.2*	*0.8*	*1.1*	*0.6*	*0.5*	*0.5*	*0.3*	*0.5*	*1.8*	*3.7*	*1.9*	-	-	-	-	-	-
Canada	1996	2.5	3.5	1.4	0.6	0.4	0.6	97.6	81.6	0.8	-6.5	0.9	7.4	-	-	-	AA	AA	AA+
Benchmark: Advanced Economies[1, 6, 7]	*1996*	*2.5*	*2.6*	*1.0*	*0.3*	*0.3*	*1.0*	*68.0*	*73.4*	*1.1*	*-4.2*	*-2.0*	*2.2*	-	-	-	-	-	-
Ratio Country / Benchmark		*1.0*	*1.3*	*1.4*	*2.0*	*1.2*	*0.6*	*1.4*	*1.1*	*0.8*	*-2.3*	*2.9*	*5.2*	-	-	-	-	-	-
Chile	2000	4.2	4.2	1.0	0.8	0.4	0.5	13.6	11.1	0.8	0.4	2.0	5.0	n/a	102	173	A-	A-	A
Benchmark: Latin America	*2000*	*3.1*	*3.0*	*1.0*	*0.6*	*0.9*	*1.4*	*44.2*	*53.8*	*1.2*	*n/a*	*n/a*	-	*72*	*180*	*315*	-	-	-
Ratio Country / Benchmark		*1.4*	*1.4*	*1.0*	*1.2*	*0.4*	*0.4*	*0.3*	*0.2*	*0.7*	-	-	-	-	*0.6*	*0.6*	-	-	-
New Zealand	1994	2.3	3.0	*1.3*	1.5	0.5	0.3	60.9	36.8	0.6	-1.6	2.9	4.5	-	-	-	AA	AA	AA
Benchmark: Advanced Economies[1, 6, 7]	*1994*	*2.3*	*2.7*	*1.2*	*0.4*	*0.3*	*0.8*	*67.6*	*73.0*	*1.1*	*-4.1*	*-2.3*	*1.8*	-	-	-	-	-	-
Ratio Country / Benchmark		*1.0*	*1.1*	*1.1*	*3.7*	*1.7*	*0.5*	*0.9*	*0.5*	*0.6*	*2.5*	*5.2*	*2.7*	-	-	-	-	-	-
Switzerland	2001	2.1	1.3	*0.6*	0.5	0.9	*1.9*	52.5	56.9	1.1	-0.5	-0.6	-0.1	-	-	-	AAA	AAA	AAA
Benchmark: Advanced Economies[1, 6, 7]	*2001*	*2.9*	*2.4*	*0.8*	*0.4*	*0.3*	*0.7*	*71.5*	*75.3*	*1.1*	*-1.1*	*-2.9*	*-1.8*	-	-	-	-	-	-
Ratio Country / Benchmark		*0.7*	*0.5*	*0.8*	*1.3*	*3.4*	*2.6*	*0.7*	*0.8*	*1.0*	*0.6*	*2.3*	*1.7*	-	-	-	-	-	-
Euro Zone (Specific rules countries)[2]																			
Benchmark: Euro Zone[11]	*1997*	*1.7*	*2.2*	*1.3*	*0.9*	*0.5*	*0.5*	*72.8*	*79.0*	*1.1*	*-4.6*	*-2.2*	*2.4*	-	-	-	-	-	-
Benchmark: Advanced Economies[1, 6, 7]	*1997*	*2.8*	*2.6*	*0.9*	*0.3*	*0.3*	*1.0*	*70.0*	*73.5*	*1.1*	*-3.6*	*-2.0*	*1.6*	-	-	-	-	-	-
Netherlands	1994	2.3	2.4	1.0	0.6	0.6	1.0	90.4	69.6	0.8	-3.7	-1.0	2.7	-	-	-	AAA	AAA	AAA
Benchmark: Euro Zone[11]	*1994*	*1.0*	*2.2*	*2.5*	*1.6*	*0.4*	*0.3*	*62.3*	*76.1*	*1.2*	*-5.2*	*-2.6*	*2.6*	-	-	-	-	-	-
Ratio Country / Benchmark Euro Zone		*2.3*	*1.1*	*0.4*	*0.4*	*1.5*	*4.0*	*1.5*	*0.9*	*0.6*	*1.5*	*1.6*	*0.1*	-	-	-	-	-	-
Spain	2003	3.8	3.5	0.9	0.3	0.1	0.4	62.4	50.2	0.8	-0.6	0.9	1.5	-	-	-	AA+[12]	AAA	AAA
Benchmark: Euro Zone[11]	*2003*	*1.2*	*2.1*	*1.8*	*0.5*	*0.3*	*0.6*	*75.2*	*75.8*	*1.0*	*-2.0*	*-2.4*	*-0.4*	-	-	-	-	-	-
Ratio Country / Benchmark Euro Zone		*3.2*	*1.7*	*0.5*	*0.6*	*0.4*	*0.7*	*0.8*	*0.7*	*0.8*	*1.4*	*3.3*	*1.9*	-	-	-	-	-	-
Other EU (Specific rules countries)[3]																			
Benchmark: European Union[8, 12]	*1997*	*2.1*	*2.6*	*1.2*	*0.9*	*0.3*	*0.3*	*70.0*	*73.5*	*1.1*	*-4.7*	*-1.9*	*2.8*						
Benchmark: Advanced Economies[1, 6, 7]	*1997*	*2.8*	*2.6*	*0.9*	*0.3*	*0.3*	*1.0*	*70.0*	*73.5*	*1.1*				-	-	-	-	-	-
Denmark	2001	2.4	1.9	0.8	0.5	0.7	1.4	63.6	47.5	0.7	0.9	2.3	1.4	-	-	-	AA+	AA+	AAA
Benchmark: European Union[8, 12]	*2001*	*2.9*	*2.2*	*0.8*	*0.2*	*0.4*	*1.6*	*71.5*	*75.3*	*1.1*	*-1.4*	*-2.5*	*-1.1*	-	-	-	-	-	-
Ratio Country / Benchmark EU[8]		*0.8*	*0.9*	*1.0*	*2.3*	*1.9*	*0.9*	*0.9*	*0.6*	*0.7*	*2.3*	*4.8*	*2.5*	-	-	-	-	-	-
Finland	2001	4.1	3.2	0.8	0.5	0.5	0.9	56.4	49.1	0.9	2.8	3.0	0.2	-	-	-	AA	AAA	AAA
Benchmark: European Union[8]	*2001*	*2.9*	*2.2*	*0.8*	*0.2*	*0.4*	*1.6*	*71.5*	*75.3*	*1.1*	*-1.4*	*-2.5*	*-1.1*	-	-	-	-	-	-
Ratio Country / Benchmark EU[8]		*1.4*	*1.5*	*1.0*	*2.2*	*1.3*	*0.6*	*0.8*	*0.7*	*0.8*	*4.2*	*5.5*	*1.3*	-	-	-	-	-	-
Norway	2001	3.1	2.1	0.7	0.4	0.5	1.3	32.1	50.3	1.6	9.2	12.2	3.0	-	-	-	AAA	AAA	AAA
Benchmark: European Union[8, 12]	*2001*	*2.9*	*2.2*	*0.8*	*0.2*	*0.4*	*1.6*	*71.5*	*75.3*	*1.1*	*-1.4*	*-2.5*	*-1.1*	-	-	-	-	-	-
Ratio Country / Benchmark EU[8]		*1.1*	*1.0*	*0.9*	*1.8*	*1.4*	*0.8*	*0.4*	*0.7*	*1.5*	*10.6*	*14.7*	*4.1*	-	-	-	-	-	-
Sweden	1997	1.9	3.0	1.6	1.3	0.4	0.3	82.8	65.3	*0.8*	-6.6	1.1	7.7	-	-	-	AA	AA-	AA
Benchmark: European Union[8, 12]	*1997*	*2.1*	*2.6*	*1.2*	*0.9*	*0.3*	*0.3*	*70.0*	*73.5*	*1.1*	*-4.7*	*-1.9*	*2.8*	-	-	-	-	-	-
Ratio Country / Benchmark EU[8]		*0.9*	*1.2*	*1.3*	*1.5*	*1.3*	*0.9*	*1.2*	*0.9*	*0.8*	*-1.9*	*3.0*	*4.9*	-	-	-	-	-	-
United Kingdom	1997	3.1	2.8	0.9	0.3	0.3	1.0	50.7	45.3	0.9	-5.3	-1.3	4.0	-	-	-	AAA	AAA	AAA
Benchmark: European Union[8, 12]	*1997*	*2.1*	*2.6*	*1.2*	*0.9*	*0.3*	*0.3*	*70.0*	*73.5*	*1.1*	*-4.7*	*-1.9*	*2.8*	-	-	-	-	-	-
Ratio Country / Benchmark EU[8]		*1.1*	*1.3*	*1.2*	*0.3*	*1.0*	*2.9*	*0.7*	*0.6*	*0.9*	*-0.6*	*0.6*	*1.2*	-	-	-	-	-	-

Footnotes:

n/a: non available

[1] Advanced economies is the 30 countries benchmark established by the IMF in the World Economic Outlook Database (October 2007) : Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, United States.
[2] Countries using the Euro; subject to sanctions for breaking the GSP; and having additional specific countercyclical fiscal rules
[3] Other EU countries not using the Euro; not subject to sanctions to the GSP rules; and having specific countercyclical fiscal rules.
[4] Except for New Zealand (2Y)
[5] General government consolidated gross debt. We used SNA concept. Gross debt according to the Maastricht criterion which differs from the SNA based general government gross financial liabilities concept of the OECD: (1) gross debt in the Maastricht definition does not include trade credits and advances, and shares and insurance technical reserves; and (2) government bonds are valued at nominal values according in the Maastricht definition, but at market value or at issue price plus accrued interest in the SNA definition. Consequently, gross debt according SNA is higher than according Maastricht criterion. The difference fluctuates between 1 % to 10 % of GDP (for example about 10 % for France for the last years). Gross debt data are not always comparable across countries due to different definitions or treatment of debt components. Notably, they include the funded portion of government employee pension liabilities for some OECD countries, including Australia and the United States. The debt position of these countries is thus overstated relative to countries that have large unfunded liabilities for such pensions. The Maastricht treaty set a ceiling of 60% for the gross debt of the general government and 3% for the deficit of the general government (Kennedy and Robbins 2001).
[6] For debt data, we considered OECD benchmark.
[7] For Gross Debt / GDP ratio, the benchmark is OECD countries
[8] General Government Balance all years after the rule minus General Government Balance 5 years before the rule
[9] Except for Netherlands (3Years)
[10] 4 Years before rule
[11] This Euro Zone aggregate is composed of 13 countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovenia, Spain.
[12] This European Union aggregate is composed of 27 countries: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Romania, United Kingdom.

Sources:

Fitch (Rating).
International Monetary Fund - World Economic Outlook (General Government Finance data (except Chile), Benchmarks Advanced Economies, European Union and Euro Zone data (except Public Debt data).
Institute of International Finance (IIF) (for Chile government finance and public debt; and Latin America public debt benchmark)..
JP Morgan (EMBI).
World Bank - World Development Indicators (GDP data – countries data and Latin America benchmark).
Economic Outlook database - OECD (Public Debt data except Chile).
Authors' own calculations for Latin America Benchmark for Public Debt data based on data from the Institute of International Finance (IIF)..

Table 3: Preconditions for Countercyclical Fiscal Policy

Political Will	- Depoliticized framework for fiscal policy. - Fiscal frameworks and rules would be reflecting the voters' preferences for sound fiscal policies: broad political consensus, supported by strong political commitment to fiscal prudence. - Society's consensus and support for prudent fiscal policy - Creating a policy environment that binds future governments to sound fiscal criteria. -- Political commitment to fiscal discipline embraced over time by a succession of governments.
Transparency and Institutions (Improving fiscal institutions)	- Strength of fiscal institutions (broadly defined). - Fiscal statistics must be timely, accurate, relevant and reliable. - Easy to monitor and difficult to manipulate. - The monitoring by public bodies that are outside the budgetary process is useful for imposing hard budget constraints on the public sector as a whole, particularly if coupled with sanctions for noncompliance. - Developed fiscal institutional frameworks.
Credibility and Feasibility	- Have a track record of satisfactory compliance. - Be supported by well-specified future policy measures including, if necessary, deep structural reforms. - Improve budget formulation, execution, and reporting, and strengthen accounting and statistical standards.
Technical Capacities	- Availability of a reliable indicator of the cyclical position of the economy and of its impact on the budget (notably to promoting countercyclical fiscal policy in good times). - Capacity to use contingent debt instruments to reduce the budgetary impact of sharp changes in the economic and market environment (GDP and Commodity indexed bonds). - Capacity to accommodate the structure of debt to reduce pro-cyclicality of fiscal policy.
Solvency and macroeconomic stability	- Fiscal policy should remain consistent with government solvency (public debt sustainability). - Public finances should be resilient in the face of unexpected shocks (established record of contained fiscal risk). - Implementation of major structural reforms, most importantly in the area of social security and tax system. For this, necessity of an early consensus for reforming public pensions, health care program, and tax sharing in case of decentralized governments. - Sustainable fiscal accounts. Fiscal policy should be designed to avoid sustained increases in the public debt-to-GDP ratio.
Solvency of subnational governments	- Require a system of intergovernmental fiscal relations (in decentralized countries) - Require to adapt institutions to deal with the "common pool problem" (required to stabilize market confidence and make possible the adoption of countercyclical fiscal policy. - Require to establish top-down rules to enforce fiscal discipline by subnational governments with record of fiscal indiscipline. - Necessary to establish a reputation of no-bail of subnational governments by the federal government to suppress common pool and moral hazard problems. (Reputation requires to be sustained by a record of fiscal discipline by subnational governments for the non-bail out policy to be credible).
Precondition for use of Stabilization Funds	- Need to begin Stabilization Fund in a good time period. - Transparent and symmetric rule: Rules should enforce savings in good times and disavings in bad times as the market may not distinguish between a responsible countercyclical policy and a deterioration of fiscal discipline - Stabilization funds require to be consistent with global fiscal policy

Sources: Balassone and Kumar (2007), Budnevich (2002), European Commission (2006), Fiess (2002), Kopits (2004a and 2004b), Kopits and Symansky (1998), Kumar and Ter-Minassian (2007), Perry (2005).

Table 4: International Best Practices for Countercyclical Fiscal Policy

Supporting institutional arrangements	- Legal basis required to improve fiscal discipline and for countercyclical fiscal policies is required: Procedural rules structured in fiscal frameworks (FRLs) is the standard practice. - Procedural rules should complement countercyclical fiscal policy and fiscal sustainability rules. - Establishment of fiscal agencies providing analytical inputs, notably high-quality independent macroeconomic forecasts and an assessment of the budgetary impact of measures would improve the effectiveness of national-level rules aimed at addressing the pro-cyclical bias in good times. - Establishment of stabilization funds could help governments to credibly commit not to spend or give away via tax cuts better than expected budgetary outcomes emerging during good times. However, the operation of the funds should be coherent with global fiscal discipline and countercyclical fiscal rules.
Structure of fiscal frameworks and rules for countercyclical fiscal policy and fiscal sustainability.	- A good countercyclical and fiscal discipline rule should be simple, transparent, coherent with the final goal, and consistent with other goals of public policies. - Fiscal frameworks and rules should cover all relevant fiscal (and quasifiscal) operations of the public sector. This limits the scope for shifting fiscal policy implementation "off budget" and moving expenditure to off-budget entities (extrabudgetary funds, state enterprises, and/or to subnational and local governments). - High standards of transparency and accountability are necessary for effective monitoring by citizens and for reputational sanctions to work. - Clear link between numerical rules, accountability, and sanctions. - Procedural and transparency rules included in fiscal frameworks are highly desirable in order to make the budget process more "hierarchical," concentrating power in the hands of those who have incentives to deliver fiscal discipline, identifying weaknesses in fiscal institutions and procedures, and limiting agency problems by increasing accountability to voters.
Transparency, credibility and enforceability of fiscal frameworks and rules	- Rules should be viewed as enforceable and permanent. - Setting of revenue rules defining ex-ante which share of revenue windfall materializing in good times are to be saved. - Escape clauses should only apply in truly exceptional circumstances, be clearly defined, and require objective analysis and scrutiny to invoke their application to ensure that credibility in the fiscal frameworks and rules is not undermined. - Sanctions should be enforceable: In countries with a long history of noncompliance with budget targets, reputational sanctions alone may be ineffective, and additional incentives may be necessary to promote fiscal discipline. These could include institutional sanctions for noncomplying jurisdictions, or personal sanctions for noncomplying public officials. - To be credible, sanctions should be applied automatically when fiscal targets are missed and/or budget procedures are not followed, and the roles, functions, and accountability of different actors involved in fiscal policy design and implementation should be clearly and transparently defined. - Independent fiscal agencies can contribute to enhance credibility and transparency of the fiscal frameworks and rules by providing technical support for the estimation procedures used in the CABs and advice for ensuring medium term fiscal sustainability.
Subnational and local government rules may be required	- In countries where the national government does not have the constitutional authority to apply a single comprehensive fiscal framework with top-down rules for all levels of government, the national-level law and practice must set a proper example and provide incentives for subnational governments to adopt prudent fiscal policies: Borrowing of subnational governments from commercial banks may be subject to either quantitative limits or prudential regulations, borrowing restricted to capital expenditures (golden rule). - Budget balance rules and borrowing constraints must be also applied at lower levels of government (pro-cyclical behavior depend also on the cyclical behavior of the type of expenditures delegated to local governments and on the source of their finances).
Stabilization Fund promote savings in good times.	- Useful to save funds in good times and prevent "Dutch disease" problems. . - Management of the Funds should be consistent with global fiscal policy: May need implementation of an aggregate public expenditure rule (Norway: rule that requires non-oil deficits to be limited to the interest revenues of the oil fund).

Table 4 (cont.)

Countercyclicality - Flexibility	- Need to develop a Reliable indicator of the cyclical position of the economy and of its impact on the budget. - If adjustments for the cyclical component of interest rates are not feasible the CABs and rules should apply at the level of the primary balance. - Targeting the cyclical adjusted balance is preferable: In emerging countries, given the volatility of government revenue and debt service, targeting the overall balance would imply a very volatile primary spending - Countercyclical rules should be consistent with medium term fiscal sustainability. - Setting cyclically adjusted limits or targets contribute to reduce the risk of a pro-cyclical bias and make possible a transparent countercyclical fiscal policy.. - Budgetary developments assessed in cyclically-adjusted terms (although targets remain unadjusted), and attention is paid to qualitative aspects of fiscal policy, including the costs of specific structural reforms. (EU's Stability and Growth Pact). - Expenditure rules to implement a budget-balance rule. Expenditure rules can be an effective tool to curb the tendency for expenditures to grow faster during good times. The effectiveness of such rules depends on their design. Multi-year expenditure frameworks capping the growth of relatively broad expenditure aggregates on the basis of realistic macroeconomic assumptions would be the most effective instrument. (Sweden).
Improving effectiveness of Automatic Stabilizers	- Actions for adapting the tax system for a more effective working of automatic stabilizers: Reduce tax evasion on personal and income taxes, make the tax system more progressive, and introduce unemployment insurance schemes if possible.
Improving Debt management	- Adapting debt management to reduce the pro-cyclicality of fiscal policy (mainly in many emerging countries) to reduce exposure to volatile capital flows (Brazil and other Latin American countries during 2000s): Lengthening of debt maturities, increased reliance on local financial markets, issuance of contingent debt instruments (GDP indexed bonds and commodity indexed bonds.

Sources:
BIS (2003), European Commission (2006), Fiess (2002), Hausmann (2005), IMF (2008), Kopits and Symansky (1998), Kumar and Ter-Minassian (2007), Perry (2005).