CROATIA POLICY NOTES

Fiscal Responsibility Framework in Croatia: Lessons from the Past, Rules for the Future

The World Bank

Fiscal Responsibility Framework in Croatia:
Lessons from the Past, Rules for the Future

July 2011

The World Bank Document

Table of Contents

Tables

Figures

Boxes

Fiscal Responsibility Framework in Croatia: Lessons from the Past, Rules for the Future

Executive Summary

To help deal with a prolonged recession, in April 2010 the Croatian government adopted an Economic Recovery Program to safeguard macroeconomic stability and support faster recovery of the private sector. Central to this program was adoption of a fiscal responsibility law (FRL) to ensure long-term fiscal sustainability, discipline, and transparency. The Croatian Ministry of Finance (MoF) asked the World Bank to provide support for its design.[1]

The key recommendations stemming from the review of the law are the following:

- The temporary fiscal rule that the authorities plan first is appropriate. It calls for expenditure-based consolidation with clear annual spending reduction targets because revenue generation cannot be counted on to balance the budget over the medium term. The rule should be in place until the general government balance is reached because it would help reduce the debt-to-GDP ratio.
- Over the longer run it would be appropriate for Croatia to target a cyclically adjusted balanced budget so as to stabilize output and reduce public debt, provided such a rule can be implemented effectively. However, because cyclical adjustments are technically demanding and data-intensive, the authorities might consider the alternative rules discussed below.
- For simplicity of monitoring implementation, the fiscal rule and the fiscal reporting should rely on the European System of Accounts 95 (ESA) definitions[2]. This would also facilitate eventual compliance with Maastricht or Stability and Growth Pact criteria. Incorporating pre- and co-financing-related costs of EU projects into the fiscal rule would also be important for reducing the fiscal deficit and the debt to GDP ratio. Otherwise, sizable adjustments might be necessary at the time of EU accession.
- Setting up a legally and effectively independent authority to transparently monitor compliance with all elements of the fiscal responsibility framework—especially the fiscal rule, the three-year budget plan, and fiscal forecasts—is highly recommended.

---

[1] This note was prepared by Bank staff (Emilia Skrok, Sanja Madzarevic Sujster) based on official information in December 2010. It also benefited from the advice of the IMF. The team would like to thank Satu Kahkonen, Roumeen Islam and Eduardo Ley for their useful comments. The team reviewed the draft law on fiscal responsibility and presented its findings to counterparts in October 2010. The note is intended to encourage discussion of ways to improve the law.

[2] The Fiscal Board that has been established by the Government in March 2011 has decided on its 1st session in July 2011 to rely on the ESA95 definition to monitor the fiscal rule application.

- If the fiscal rule is to be effective, it should be supported by meaningful and enforceable sanctions.

- Also, the proposed FRL should bind not only the current government and parliament but also future ones. Thus, as some other countries have done, the authorities could have considered enacting the FRL as an organic law with a two-thirds majority.

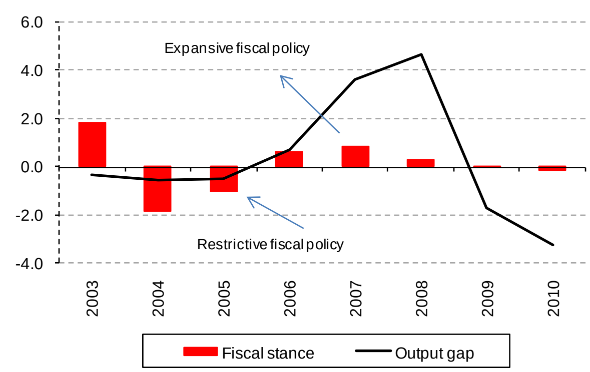
A. Introduction

1. **The Croatian Parliament enacted the FRL in November 2010.** The law is designed to ensure long-term fiscal sustainability, fiscal discipline, and transparency, which have so far not been successfully enforced in previous legislation. The purpose of this note is to (i) review efforts to enhance fiscal management and stability in Croatia; (ii) present relevant international experience; and (iii) make recommendations for improving the FRL.

2. **The EU accession process has provided impetus for better management of public finances in Croatia.** Harmonization with the EU, in both legislation and practice, has been satisfactory, and Croatia is about to close Chapters 32 and 33 of the *acquis*. It has implemented both the INTOSAI[3] auditing standards and the IPSAS[4] accounting and reporting standards for the public sector; enacted the Public Internal Financial Control Law; established internal audit and control functions across the public sector; and steadily built up the budget execution process by consolidating separate public accounts into the treasury single account. The MoF in 2009 began to integrate line ministry financial management information systems. Tighter financial management processes and control have strengthened fiscal discipline and increased the transparency of public finances.

3. **Nevertheless, when the global financial crisis hit in 2009, Croatia had high public debt (above 50 percent of GDP) and rigid public spending levels (above 44 percent of GDP), which rendered any fiscal stimulus infeasible.** Since 2003 the annual budget has regularly been revised to accommodate spending increases. Until 2008 as revenues over-performed the general government deficit was contained at relatively low levels. However, fiscal policy was not counter-cyclical (Figure 1) and led to further build-up of public debt. The recession further worsened fiscal outcomes, which are now threatening achievement of the Maastricht euro zone entry requirement of a deficit below 3 percent of GDP and public debt below 60 percent.

Figure 1. Croatia: Cyclically Adjusted Balance, % of GDP



Source: Croatian MoF, World Bank staff estimates.

[3] The International Organization of Supreme Audit Institutions.
[4] International Public Sector Accounting Standards.

B. Croatia’s Public Finances and Budgetary Process

4. **Several formal and informal fiscal rules are already embedded in the existing legislation, but they have not been consistently enforced.** The 2008 organic budget act envisaged that at the end of the year the ratio of government debt to GDP might be higher than the previous year‘s ratio only if that ratio did not exceed 60 percent of GDP. The organic budget law also mandates that if during the budget year expenditures increase or budget revenues/receipts decline because of occurrence of new liabilities or changes in economic developments, the government may, at the request of the MoF, suspend the execution of specific expenditures. If the budget cannot be balanced during temporary suspension, the government proposes a budget revision within this period. This rule has never been applied so far.

5. **Equally important, any legislative proposal adopted within a fiscal year cannot become effective unless the proposal specifies funds for it** based on a fiscal impact assessment (FIA) that the MoF has previously approved. Furthermore, a nominal expenditure ceiling and a rule for the budget balance as a percentage of GDP were introduced in the –Medium-Term Economic and Fiscal Guidelines” (Guidelines). The Guidelines are revised annually and are endorsed by the Cabinet. Once expenditure ceilings are set in the Guidelines, controls for budget preparation are embedded in the Treasury system, and budget managers cannot change them. However, the Cabinet may, at the MoF‘s proposal, establish new expenditure ceilings and also breach its own fiscal targets by enacting a law without MoF approval of the FIA.

6. **Over the last five years Croatia has made consistent efforts to improve the rules and relevance of multiyear fiscal planning, but efforts are needed to make planning more credible.** The previous efforts were driven by the need to introduce a three-year perspective for the Pre-Accession Economic Program (PEP) and to improve the quality of macroeconomic forecasting and fiscal planning. The 2008 Organic Budget Law introduced mandatory three-year rolling budgets to make the Medium-Term Expenditure Framework (MTEF) more relevant and reinforced the link between budgeting and strategic planning. The introduction of strategic medium-term plans with performance indicators is expected to reinforce the program budgeting introduced earlier. Budget preparation starts with preparation of a Medium-Term Government Strategy followed by adoption of the Guidelines for the three-year period. Meanwhile the PEP, which sets out fiscal and economic targets consistent with the Guidelines, is submitted to the European Commission (EC). All these documents are adopted by the Cabinet; and although publicly available, they are not submitted to Parliament. The documents also provide an analytical and strategic basis for the three-year rolling budget, of which the budget for the first year is mandatory but projections for the following two years are not binding. The latter factor reduces political commitment to achievement of the targets set.

7. **The fiscal targets adopted in the Guidelines are not respected when the three-year rolling budget is being prepared.** Deviations from the fiscal targets, adopted in the Guidelines and PEP and presented in the budget for parliamentary approval, are common and significant (Figure 2). For 2006–2009 deviations from the planned fiscal deficit reduction averaged to 3.5 percentage points of GDP for t+3 year, and budgeted fiscal deficits were higher than the planned deficits by 1.2 percentage points of GDP for t+1 and 2.3 percentage points for t+2. Deviations of public spending from planned levels almost matched deficit deviations. In other words, spending patterns so far have mostly determined deficit patterns, except that first-year budgeted spending is mostly respected. Although the Guidelines and the budget proposal contain projections for outer years, in the case of deficit projections not even the first year fiscal target in the Guidelines is respected (Figure 3).

Figure 2. Planning and Forecasting Accuracy, Average 2006-2009

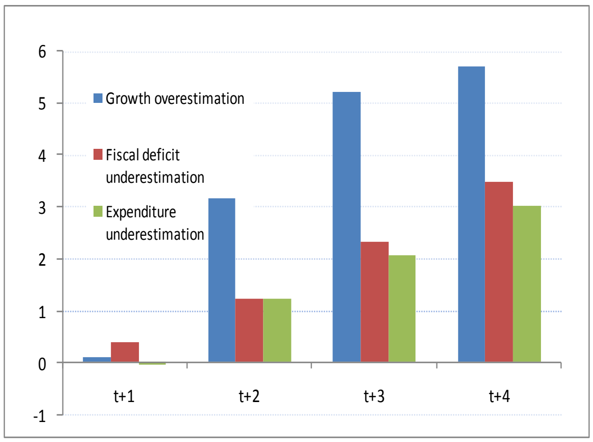
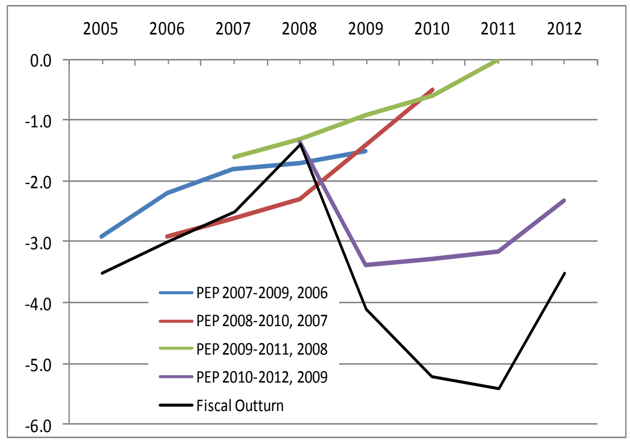


Figure 3. Fiscal Plans – Potential Loss of Credibility



Source: Croatian Ministry of Finance; European Commission.

8. **Parliamentary interventions do not cause deviations from initial fiscal targets; in fact, Parliamentary debate has almost no impact on formulation and execution of the budget.** The draft state budget, the consolidated budget, and the budget execution law are submitted to Parliament by mid-November for approval by mid-December, which does not leave much time to analyze the budget and formulate an informed opinion about it. Amendments proposed by Members of Parliament are rarely accepted. In any case, an amendment proposing an increase in expenditure may be accepted only if it is proposed along with a commensurate cut in another expenditure item, so that amendments adopted may not exceed the proposed balance of the consolidated government budget.

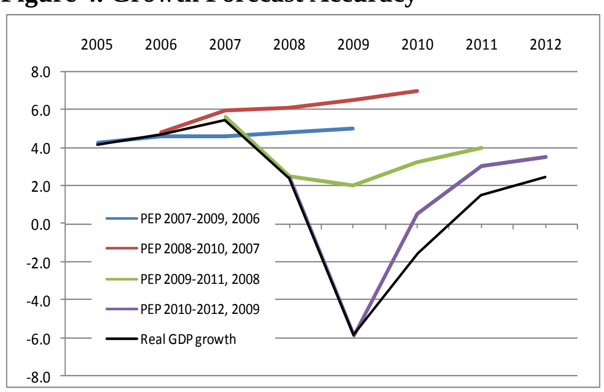
9. **Various Parliamentary committees do consider budget documentation**, but the Finance and Budget Committee is the only one obliged to issue a formal opinion. The committee does not employ professional analysts but does engage six experts from scientific and professional institutions (mainly unions and employer associations). To date it has never recommended that Parliament not approve the budget or sought a resubmission after detecting shortcomings in the budget proposal. Further, the first report on budget execution reaches

Parliament only at the beginning of August; too late in the year to request a change in the course of action to ensure that fiscal targets are achieved. For all these reasons, Parliament finds it difficult to assess whether the Cabinet has met the fiscal targets.

10. **Local and regional self-governing units (LGUs) cannot influence the overall fiscal targets either.** LGUs prepare and execute their budgets independently, but there are rules through which the central government controls their budgets. The MoF issues ―Instructions for the Preparation of the Local and Regional Self-Government Unit Budgets" for a three-year period and provides basic macro and fiscal assumptions in line with the Guidelines. The annual budget execution law sets the overall borrowing limit for all LGUs, in addition to the rule whereby annual amortization repayment by individual LGUs cannot exceed 20 percent of their own revenues. There are firm rules for delegated functions, which are funded by shared tax revenues, and equalization of fund resources. Additional capital transfers planned for upgrading the physical and social infrastructure of LGUs are budgeted in the state budget. Municipalities thus may reallocate only their own resources for their own spending on compensation of employees, current spending, other transfers, and remaining capital spending. For 2006–2009 the deficit of LGUs stayed within 0.2–0.4 percent of GDP; which is in line with the average target of 0.3 percent of GDP.

11. **The discrepancy between planned and budgeted fiscal targets is due to the mediocre quality of macroeconomic forecasting and more importantly due to a lack of full political commitment to fiscal targets**. For the 2006–2009 period, overestimates of real growth in the PEP, which is approved in the last months of the fiscal year, for t+3 year averaged 5.7 percentage points of GDP (3.2 percentage points for t+1 and 5.2 percentage points for t+2) (Figure 4). Macro forecasting failure accounted for around one-third of the missed deficit target; spending above planned levels accounted for the rest. Spending and fiscal deficit deviations from Guidelines' targets are rarely explained. Neither Parliament nor external reviewers have yet raised the issue of their relevance for policy planning. The EC does regularly ask for an explanation, which is provided in the PEP.

Figure 4. Growth Forecast Accuracy



Source: Croatian MoF, EC.

12. **Although Croatia has several fiscal rules, it lacks an explicit, enforceable fiscal responsibility framework.** Over the last four years, the MTEF has aimed to reduce the consolidated general government deficit to below 3 percent of GDP—a Maastricht criterion for entering the Economic and Monetary Union. However, deviations from expenditure and deficit targets have been typical, and were amplified by the recession. Enforcing aggregate

expenditure ceilings and ensuring that fiscal policy be sustainable have, as the FRL suggests, thus became priorities for decision-makers.

C. International Experience

13. **Recent history gives evidence that fiscal authorities around the world suffer from a deficit bias that shows up in persistent deficits and growing public debt.** And fiscal policy often seems to be procyclical, in good times and bad, in spite of a general consensus that a neutral or countercyclical stance would be preferable. There is growing agreement that the deficit bias and the procyclical bias are rooted in political economy factors, especially in the system of incentives and rewards that shape the behavior of fiscal authorities.[5] Governments, concerned about re-election are inherently concerned about short-term issues and do not fully take into account the longer-term implications of deficits. Groups in society that benefit from public spending have a tendency to free-ride on such government behavior and on others' contributions. This ―common-pool problem" is a source of overspending and accumulation of deficits and debt over time. Moreover, it can also lead to procyclical budget behavior because spending pressures tend to be stronger in ‗good times', when government revenues are buoyant[6].

14. **Policies for tackling the deficit bias often focus on improving fiscal governance through design of effective fiscal responsibility frameworks.**[7] Well-designed and implemented fiscal responsibility frameworks can promote policy credibility, enhance investor confidence, help maintain macroeconomic stability, restore fiscal sustainability, promote sustained growth, and improve transparency and intergenerational efficiency. Nonetheless, while they provide ―training wheels" for fiscal discipline,[8] they are no panacea. To succeed, they require social consensus, political commitment, and continuous adjustments and vigilance.

15. **The main elements of fiscal responsibility framework that have proven to increase the chances of success are**[9]:

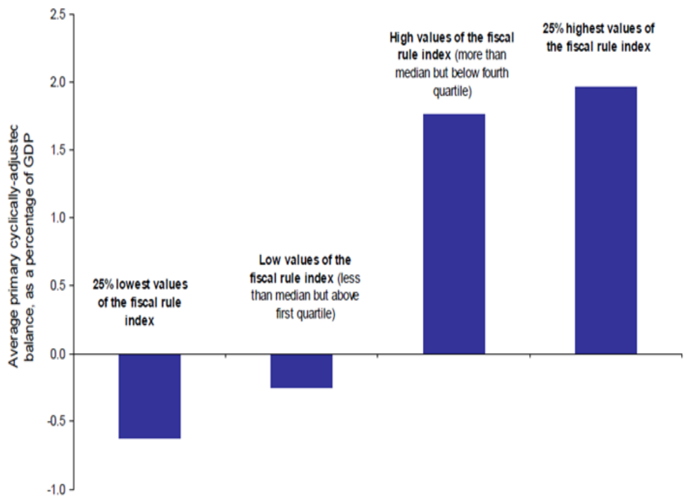
- *Fiscal policy rules*—fixed numerical targets and ceilings for fiscal aggregates (such as fiscal balance, debt, expenditures, or taxation levels) or set benchmarks for the conduct of fiscal policy. To be effective, a fiscal rule should ideally be well-defined (stating the specific fiscal indicator to be targeted and the institutional coverage), simple and

[5] See Persson and Tabellini (2001) and Drazen (2000).
[6] Tornell and Lane (1999).
[7] An FRL is the legislative expression of an FRF. It aims to improve fiscal discipline by requiring governments to commit to a monitorable fiscal policy and strategy. Often, the driving force behind an FRL is the wish to make fiscal policies more predictable and credible by establishing procedures the government must follow in designing and implementing fiscal policy, and by setting up transparent mechanisms by which others can judge if the government is following those procedures.
[8] Kopits (2009).
[9] IMF (2005).

transparent, flexible, adequate to the government's final goal, credible, and enforceable.[10] A fiscal policy rule removes discretion from fiscal authorities.

- *Fiscal procedural rules*—rules that govern the elaboration and implementation of the annual budget law. They incorporate the principles of transparency[11] and accountability and set out practices to be followed in designing and implementing fiscal policy. Thus, they provide the structure for budgetary planning, execution, and reporting (e.g., medium-term and top-down budget planning, pay-go requirement, escape clauses). Their main objective is to reduce the extent of the common pool problem.

Figure 5. Fiscal Rule Index and Average Primary Cyclically Adjusted Balance in the EU27, 2000–2008



Recent European Commission analysis shows the positive impact of fiscal discipline on budgetary outcomes in the EU27 Member States. Those EU Member States with the highest fiscal index values on average show better budgetary outcomes as measured by the cyclically adjusted primary balance (CAPB). Country groups that score higher on the fiscal rule index also tend to register higher CAPB in the most recent years. That is confirmed for the EU27 by econometric estimation. All else being equal, an increase in the value of the index (broader coverage, stronger features of fiscal rules, or both) leads to lower deficits or higher surpluses.

Source: EC 2008.
Note: Fiscal rule index captures (i) the statutory base of the rule; (ii) the body in charge of monitoring performance against the rule; (iii) the body in charge of enforcing the rule; and (iv) enforcement mechanisms relating to the rule.

- *Surveillance mechanism*—to be established under the authority of an institution independent of the government. This is crucial to ensure transparency and compliance with the rules. The idea is to delegate specific tasks of fiscal policy-making to independent bodies that are less likely to be affected by distorted incentives.

16. **When deciding when to adopt an FRL, it is important to keep in mind that:**

- Rules are more effective when they are put into force after basic fiscal consolidation is completed;

- Rules should not be introduced when the macroeconomic environment is uncertain; and

[10] Kopits and Symansky (1998).
[11] The IMF Fiscal Transparency Code (2001) stresses four general transparency principles: (i) clarity of roles and responsibilities with respect to the structure and functions of different levels of government and the relationship of government to the rest of the economy; (ii) public availability of information, with comprehensive periodic reporting; (iii) open budget preparation, execution, and reporting, with disclosure of information about the budget process; and (iv) assurances of the quality of fiscal data and independent scrutiny of fiscal information.

- A robust financial management infrastructure (i.e., high-quality medium-term macroeconomic and fiscal forecasts) is a prime requisite for credible implementation of fiscal rules.

17. **Preferably, the FRL should be grounded in social and political consensus**. In some countries the FRL has been actively supported by major political forces and enacted as an organic law with a two-thirds majority. Certainly the law should be sure of survival over several political cycles, binding not only the current government and Parliament but also changes in their political composition over time.

18. **Pre-crisis experience with FRLs and fiscal rules demonstrated that rules have a positive impact on fiscal outcomes** (Figure 5), particularly in countries that made major adjustments in revenue or spending policies. However, it is difficult to discern whether the positive effects are due to political commitment or to the constraints imposed by the rules. Whether or not a country adopts formal limits on fiscal policy, it is certainly clear that political commitment to manage public finances prudently is essential.[12]

19. **In the aftermath of the crisis, faced with both fiscal problems and the need to stabilize output,** an increasing number of advanced as well as emerging market economies—most recently Latvia, Romania, Turkey, and the United Kingdom—has reformed, adopted, or drafted rule-based fiscal frameworks (Table 1).

Table 1. Selected Countries: Fiscal Responsibility Frameworks

	Date	Type of rule	Medium term	Coverage	Binding character	Monitoring	Sanctions
Fiscal Responsibility Framework							
Argentina	1999, 2001	B, E, D		NG, SG	L	I	R
Australia	1998	Procedural	Y	NG			R
Brazil	2001	B, E, D		NG, SG	C, L		O
Colombia	1997, 2000	B; E; D		NG, SG	L		O
Ecuador	2002	NOB; D; E		NG	L		O
India	2003	B	Y	NG, SG	L		R
New Zealand	1994, 2004	B	Y	GG	L		R
Peru	1999, 2000	B, E, D		NG	L	I	O
Venezuela	2004	B, E	Y	NG	C, L	I	R
Recent Changes in Fiscal Frameworks: EU and Candidate Countries							
Austria	1999, 2005, 2009	E, B	Y	GG	L	Gov, MF	R
Germany	1990, 2007, 2009	B, E, D	Y	GG	C, L	I	O
Hungary	1996, 2007, 2010	E, D, B	Y	GG	L	I	O
Latvia 3)	*1994. 2010*	B, D	Y	GG	L	Gov	R
Poland 1)	1997, 2006, 2010	D, B, E		NG, SG	C,L	MF, Gov	R
Romania	1990, 2000,2010	E, B	Y	GG	L	I	O
Slovenia	1990, 2000, 2009	D, *E*	Y	GG	L	I	O
Spain2)	1990, 2006 ,2009	B, D	Y	GG	L	MF, Gov, P	R
Turkey 3)	*2010*	B	Y	GG	L	I	O
United Kindom	1997, 2010	B, D	Y	GG	L	I (P)	O

[12] See Schick (2009), EC (2007) Debrun and Kumar (2007).

Source: World Bank staff, Kopits 2007, IMF 2005, EC 2010.

Note: GG = General government; NG = national (central, federal) government; SG = subnational governments; L = Legal act (Public finance act, FR); C = constitution-based; D = debt rule; E = expenditure rule; B = balance rule; NOB = non-oil balance; O = other sanctions; R = reputational; P = parliament; G = government; MF = finance ministry; italics = not yet approved.

1/ Envisages introduction of a permanent expenditure rule. 2/ No details are available on the number and type of rules adopted in 2010. 3/ New FRL prepared.

20. **Pre- and post-crisis experience reveals a number of rules of thumb for drafting FRLs:**

- *Less ambitious framework but functional*: If the political reality is not ready for a restrictive fiscal framework, it could break down easily at the first cyclical downturn. It is thus better to have a less restrictive framework that functions than an ambitious one that does not. The former could be gradually strengthened by tightening the key parameters of the FRL at regular intervals, for example at the start of a new government‘s term in office.
- *Flexible but comprehensive*: Fiscal policy that does not explicitly encompass all government operations and incurred liabilities will not be very useful because spending units find ways to evade the fiscal rule by setting up alternative spending vehicles, such as extra-budgetary funds or guarantees to public enterprises and financial institutions. But although the framework should be able to withstand normal cyclical and price fluctuations, there is good reason to have escape clauses for natural and economic disasters. For those cases, however, there should be a well-defined process for returning to the framework.
- *Accountability:* In a number of countries the fiscal policy framework has been given special status by being approved by both government and parliament, which appears to have increased its effectiveness.
- *A credible penalty regime:* As FRLs mature, the political capital invested in them increases, and the political costs of breaking the law rise. Because FRLs tend to be relatively weak at first, they should specify a wide variety of penalty clauses. Penalty regimes need to be credible and enforceable (e.g., a mandatory civil service wage freeze in certain circumstances, dismissal from the office, etc).
- *Based on "smart rules":* Given the sensitivity of fiscal outcomes to economic shocks, the recent crisis has led to some rethinking of how fiscal rules should be designed. Early fiscal targets relied on such simple measures as targeting the nominal deficit as a fixed percent of GDP. This often led to procyclical fiscal responses and biases in the composition of government expenditures (e.g., causing a relative increase in current spending relative to investment). These experiences have underscored the need to move away from simple rules to ―smart" and more complex ones along two dimensions: First, the rules should emphasize countercyclical features that target the cyclically adjusted

balance (CAB)[13] or have built-in adjustments that accommodate cyclical swings in economic conditions (e.g., an expenditure rule[14]). Countercyclical rules would allow automatic stabilizers[15] to operate when the economy deviates from the target or trend. Ideally, deficits incurred during downturns would be offset by surpluses accumulated during expansion, so that the budget would be balanced over the course of the cycle. Second, simple rules should be made more sophisticated to deal with differences in various components of the budget (e.g., investment). There is a potential composition bias associated with rules that look only at budget balances. When a government risks breaching deficit or expenditure limits, its simplest response may be to curtail discretionary accounts, most of which are allocated for public consumption and investment, but not mandatory programs, most of which are for income transfers.

21. **A CAB rule is most effective in instilling fiscal confidence**. This rule would allow for full operation of automatic stabilizers to cushion the impact of output shocks[16] and control the stock of debt. With annual targeting, the government would project the cyclically neutral revenue level for the following year and limit expenditure to this level. With multiyear targeting, the rule would try to balance the budget over the output cycle. The rule would also allow for policy flexibility, e.g., via discretionary measures, where there is coalition government or economic uncertainty. However, effectiveness would come at the cost of simplicity.

22. **Because the CAB, unlike the actual balance, is not observable concept, operationalizing it has proved difficult:**

- First, determining whether or when public deficits act as automatic stabilizers is ambiguous because the stabilization properties of the budget depend on the type of economic disturbance. Automatic stabilization of output almost always refers to stabilization of demand. When there is a fall in aggregate demand, fiscal stabilizers unambiguously act as a shock absorber: the higher the automatic stabilizer, the more the output gap is stabilized. The conclusions are different, however, if the economy is affected by a supply shock. A temporary negative supply shock leaves long-term potential GDP unchanged, so the output gap deteriorates. Automatic stabilizers do smooth output, but at the cost of higher inflation. A long-lasting supply shock pushes down potential GDP.

---

[13] The CAB captures changes in fiscal policy not related to how the economic cycle affects the budget. The structural balance, in addition, controls for additional one-off factors and other nondiscretionary changes in the budget unrelated to the cycle.

[14] Mills and Quinet (2001) argue that “a spending rule is in essence close to a cyclically-adjusted balance target” but more transparent and avoiding the pitfalls of cyclical adjustment.

[15] Automatic stabilizers are nondiscretionary responses of budget components to the cycle and the economic environment (e.g., progressive income tax receipts, unemployment transfers, and interest payments).

[16] Other options, such as targeting the overall/primary balance, would risk procyclicality in fiscal policy, given the reliance of the economy on domestic consumption and a tax structure that favors indirect taxation.

- Second, cyclical adjustments are technically difficult. To make the CAB concept operational, it would be necessary that (i) the economic cycle, and hence the output gap, be reasonably well estimated in real time; and (ii) any cyclically driven component be totally removed from the estimated CAB—which requires reasonably good estimates of the ―cycle elasticities" for different budget items. Unfortunately, it is well-documented that estimates of output gaps in real time are rarely accurate; ex post revisions of the gap are of the same order of magnitude as the gap itself.[17]

- Third, there are two sources of uncertainty permeating concurrent estimation of the output gap: (i) Output data available in real time can only be preliminary. Data revisions, which are typically non-negligible, will naturally cause revisions of the output gap. (ii) Virtually all known methods for estimating trend or potential output require observations for a number of periods beyond today (i.e., they are based on backward- and forward-looking filters). In practice, therefore, we must use truncated filters, which are suboptimal, and as observations become available the past trend (and gap) are revised, often substantially. Moreover, CAB estimates are usually based on the assumption that revenue and expenditure elasticities are constant over time. The income elasticity of budget items used to perform the cyclical adjustment reflects the average cyclical responsiveness of these items over the sample period, but actual year-on-year sensitivity may differ substantially from the average. Certainly, there is widespread evidence that tax elasticities are sensitive to the business cycle, with tax revenues falling faster than GDP during a downturn and rising faster during an upswing.[18]

23. **Given the challenge of implementing cyclically adjusted budget rules they are used mostly in highly developed countries.** Some form of the CAB rule is applied in Australia, Denmark, Finland, and Germany (in the last only recently).

24. **Simpler alternatives to the CAB rule have recently been applied in the Central and Eastern European region:** (i) a growth-based rule has been proposed in Turkey and Latvia; (ii) a simple expenditure rule combined with budget balance rule is in place in Romania, and Poland is considering such a rule combined with a debt brake mechanism.

25. **A growth-based balance rule calls for setting a nominal deficit below its medium-term target when real GDP growth exceeds trend GDP growth.** In other words, the deficit increases automatically when output growth is below its long-term trend. The rule is smart in that it implicitly makes allowance for the impact of the economic cycle on the budget, but it is also quite simple in that it does not rely on any measure of the output gap. However, it cannot provide an operational tool for triggering expenditure-led fiscal consolidation. In some circumstances, however, applying the rule could lead to a procyclical fiscal response.[19] To deal with that, the rule can include an adjustment mechanism, as was done in Turkey (Box 1).

[17] Orphanides and van Norden (2002).
[18] Mills and Quinet (2001).
[19] For instance, during the early phase of economic recovery actual growth may exceed trend growth and the rule might call for fiscal adjustment even while the output gap is still highly negative.

By design the rule should stabilize or reduce the public debt ratio because it is linked to the cyclically adjusted fiscal target chosen in terms of long-term fiscal sustainability objectives.

Box 1. Turkey: New Fiscal Rule

The fiscal rule the authorities announced in May 2010 can be classified as a growth-based balance rule. It sets a ceiling for the general government budget deficit as a percent of GDP in relation to (i) the previous year's deficit; (ii) the deviation of that deficit from the long-term deficit target (this is a benchmark consistent with declining public debt: to meet the Maastricht criterion, public debt as a share of GDP is planned to decrease to about 30% in the long term); and (iii) deviations of GDP growth from benchmark GDP growth rate in the current year. The rule therefore seeks to ensure convergence to the target deficit while allowing for automatic stabilizers.

The rule is formally given by

$$bt+1 = b^* + a\,(gt+1 - g^*) + e\,(bt - b^*),$$

where *a* is the semi-elasticity of the budget balance with respect to the output gap (0.33);

and the annual adjustment is given by

$$Adj= -0.\ 33(gt+1 - 5) + 0.33\ (bt - 1).$$

The benchmark general government deficit/GDP ratio (b*) is set at 1% and the benchmark GDP real growth rate (g*) at 5%. When the overall balance in the previous year, bt, deviates from the medium-term target, b*, the coefficient determining speed of adjustment in the general government balance (*bt+1*) is set at 0.33. The coefficient providing room for extending the deficit if the current year's GDP growth deviates from the trend growth rate is also set at 0.33. This reflects the share of general government revenues in GDP and makes it possible to offset revenue losses arising from the deviation (automatic stabilization). Policymakers have three windows for adjusting year t's fiscal policy and outcomes to the rule: (i) in the spring of year t, when the background medium-term economic framework for the draft budget for year t+1 is prepared; (ii) in the fall of year t, when the budget is finalized before submission to Parliament; and (iii) in the spring of year t+1, when growth and fiscal projections become more precise.

Source: OECD 2010b. and draft of the Turkish FRL.

26. **A simple spending rule combined with a balance rule or debt brake mechanism** sets an expenditure ceiling in accordance with the medium-term budget deficit target (the structural target consistent throughout the cycle) and supplements it with a mechanism that constrains deviations of the overall balance from the medium-term target (the debt brake mechanism).[20] The spending rule tends to be compatible with automatic stabilizers, which operate mainly on the revenue side (Box 2). However, a simple expenditure ceiling is not anchored in the deficit or debt because the rule does not cover the revenue side. Over time this could lead to significant pressures on deficits and debt without triggering any reaction from the rule. Thus, combining an expenditure rule with a balance rule or a debt brake mechanism ensures that debt stays sustainable.

[20] A basic correction mechanism would be to register any deviations of the headline deficit from the benchmark (or its structural target) in a theoretical account. Once the amount accumulated in this account exceeds a predetermined threshold, an automatic correction would bring the cumulative deficit back below the threshold. A very sophisticated example of the debt brake mechanism is a called a Swiss debt brake.

Box 2. Romania: New Fiscal Responsibility Law

Romania's Parliament approved an FRL in March 2010. The law sets up a binding medium-term budgetary framework (for a three-year period, but approved by Parliament[1] each year before the annual budget is presented); establishes limits on budget revisions during the year; introduces sound fiscal rules; and creates a fiscal council to give independent scrutiny of public finances. The council provides forecasts and budgetary analysis. The law is also supported by new law for the management of guarantees and other collateral obligations and by the Unitary Pay Law. The FRL introduces new rules for total expenditure, the wage bill, and the budget balance.

The following fiscal rules apply to the general government sector:

- For each of the three years covered by the fiscal strategy, total expenditure growth should be kept below the annual rate of nominal GDP growth forecast for that budgetary year until the preliminary balance budget is in surplus in the year preceding the year for which the draft budget is elaborated.
- For each of the three years the annual rate of growth of budget expenditures will be at most equal to the annual rate of nominal GDP growth forecast for that year when the preliminary balance budget is in balance or surplus in the year preceding the budget year t.
- If tax rates increase, a nominal increase of expenditures shall not exceed a nominal increase of budgetary revenues and shall not lead to deterioration in the balance set out in the fiscal strategy.
- Ceilings for expenditures, balance, and public wages, expressed as percents of GDP, are set for two years ahead.
- The public wage bill trajectory as a percent of GDP is set through 2015 by the Unitary Pay Law.
- If the positive balance of the budget for the three consecutive years is higher than forecast, the difference will be used to reduce debt incurred in previous years.
- If the six-month report finds that the budget balance has deteriorated by more than 0.5 percent of GDP from the budget target, the government must implement corrective measures.

Finally, the new law entails regular reporting and monitoring that should increase transparency (e.g., performance of the fiscal targets are checked quarterly; compliance with the stated fiscal strategy is monitored by annual and biannual progress reports).

[1] Any revision of the medium-term strategy has to be approved by Parliament upon the government's proposal.

Source: Romania FRL.

27. **An expenditure rule does not depend on projections of future economic conditions or deficits;** nor does it require adjustments if those projections prove wrong. It can also be an instrument to control and reform public expenditure, both quantitatively and qualitatively. An expenditure ceiling depends primarily on a policy objective to reduce the size of the public sector or the targeted level of debt. Expenditure growth can be set at different rates that refer to actual, potential, or trend GDP growth. The rule should be comprehensive, though perhaps excluding the most volatile items, such as interest payments, public investment, or unemployment-related transfers, to keep the rule stable and avoid ad hoc adjustments in other budgetary items. On the other hand, leaving out important expenditure items can lead to ―creative" accounting that reclassifies spending items and weakens the link to debt sustainability. For instance, domestic co-financing for EU funds should not be excluded from the spending rule because it affects the deficit, debt, and fiscal sustainability.

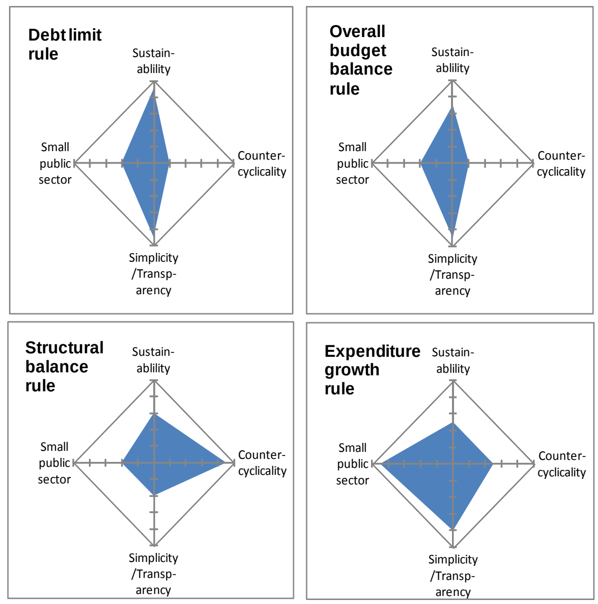
28. **The choice of any policy rule necessarily involves tradeoffs between government objectives** (Box 3). There is an obvious conflict between flexibility and credibility. Credibility demands rigidity. However, a rule that is too rigid may become nonviable if it is perceived as unsustainable. Perry (2002) points to a dichotomy in objectives between fiscal

policies concerned exclusively with avoiding deficit bias and those concerned exclusively with reducing procyclical bias. A fiscal rule that emphasizes avoiding a deficit bias and ignores the potential effects of shocks and the economic cycle may accentuate the procyclicality of fiscal policies. On the other hand, a rule that attempts to support countercyclical fiscal policies but is not designed to achieve long-term debt sustainability will be equally nonviable and indeed not credible.

Box 3. Performance Criteria for Selecting a Fiscal Rule

The selection of any rule unavoidably involves tradeoffs between performance criteria and objectives. These tradeoffs are illustrated by the charts, where the shaded area within a diamond indicates benefits accruing from adoption of a particular rule. For the structural balance and the balance rule, as can be seen, there is a tradeoff between policy flexibility and simplicity. There seem to also be some tradeoff between reducing the size of the public sector and ensuring sustainability.

Source: IMF 2010b.



D. Fiscal Responsibility Framework for Croatia

29. **Internationally accepted criteria for FRL design make it possible to evaluate Croatia's FRL**. As no existing FRLs can fully meet all the criteria, each country has to make a strategic choice based on its own circumstances and objectives. This explains why there is no universally applicable FRL model. By applying best-practice FRL elements, however, it is possible to make the following observations about Croatia's law:

30. **Objectives**: The authorities have clearly spelled out their goals and priorities: ensuring long-term fiscal sustainability, transparency, and fiscal discipline.

31. **Definition:**[21] The fiscal policy rule combines a temporary and a permanent rule. The temporary rule consists of a constraint on a general government spending of 1 percentage point of GDP reduction a year until the primary balance reaches equilibrium in nominal terms. The permanent rule aims to ―sustain the long-term cyclically-adjusted primary balance" with the objective of stabilizing and reducing the public debt to GDP ratio. It is not clear whether the permanent rule was chosen to meet long-term fiscal sustainability objectives.[22] Also, given

---

[21] Based on Kopits (2008); fiscal indicators, time-frame, and institutional coverage seem to be well-specified.

[22] For a semi-elasticity of the overall balance to the output gap in the range of 0.3 to 0.5, the structural target at 0 percent of GDP over an economic cycle should accommodate output gaps of –2 to –4 percent, thus stabilizing

that in most countries the ultimate objective of fiscal sustainability relates to long-run trends in stocks, the rule could potentially lead to stock-flow inconsistencies, i.e. with targeting the CAPB the wanted reduction in the public debt to GDP ratio might not necessarily be achieved.

32. Based on the national methodology fiscal targets are calculated on a cash basis, which differs from the ESA 95 definition. This, and relying on the primary balance target, may complicate compliance with the Maastricht or the SGP criteria in the medium term.

33. In line with best practice, the fiscal rule spans the medium term (three years, in rolling terms). Still, as described earlier, the current medium-term framework as set in the Guidelines has some weaknesses. For example, it is poorly aligned with the annual budget process, is not formally monitored, and lacks pre-defined correction mechanisms in case of noncompliance with fiscal targets.

34. The spectrum of institutions covered by the fiscal rules has been broadened to cover the general government. However, the rules exclude pre- and co-financing costs of EU grant-funded projects until the third year after accession. Although these costs are not yet large, they could rise upon accession to about 2 percent of GDP and derogate the purpose of the law.

35. Unconventionally, the legislation introduces a ―statement of responsibility" obligating budgetary and extra-budgetary users to maintain fiscal discipline under MoF supervision. This would better fit in the Organic Budget Law, which deals with internal control, financial management, and budget execution at the individual user's level.

36. **Adequacy**[23]**:** The temporary rule does not do a good job of addressing debt sustainability: Over the next three years public debt would rise (Figure 6) as the primary deficit closes. Although the rule is expenditure-based, it is not adequately linked to debt aggregates. In addition, the long-term CAPB (cyclically-adjusted primary balance) rule does not ensure that the debt ratio will converge toward its target. According to the rule, increases in interest payments would not require an adjustment even if they affect the budget balance and public debt.

37. **Flexibility**[24]**:** The permanent rule allows for full operation of automatic stabilizers. Certainly, it gives the authorities sufficient flexibility to react to unforeseen shocks, but a cyclically adjusted target is neither simple to define nor easy to monitor. Cyclical adjustment is not a serious problem for mature economies; it is of more concern for transition economies like Croatia that still face substantial structural changes. The escape clauses embedded in the law are so vague they would allow the law to be suspended in a variety of circumstances (Art 8, point 2, 4, including suspension of EU project pre- and co-financing).

---

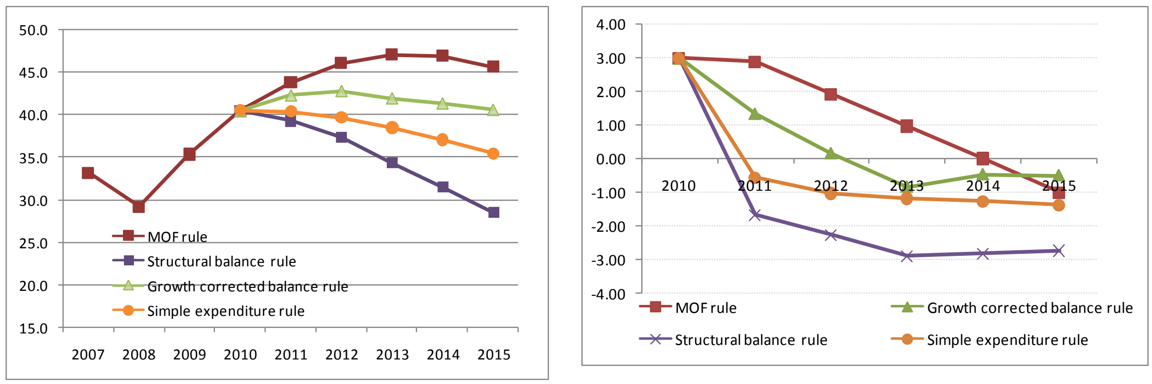
the debt to GDP ratio. (The largest negative output gap Croatia recorded over the last decade was about –3 percent.)

[23] This looks at the question of whether rules are likely to achieve their objectives.

[24] This looks at whether the rules can accommodate business cycles and exogenous shocks or aggravate their macroeconomic impact.

Figure 6. Response of Debt and Deficit under Different Rules (% of GDP)

Panel A. Debt to GDP (%) **Panel B. Primary Deficit to GDP (%)**



Source: World Bank staff calculations, IMF (2010b).

Note: Baseline projections for these simulations are taken from the MOF Guidelines, October 2010, as extended by two years (assuming real GDP growth at 3% and both revenue and spending growth in line with nominal GDP). The growth-corrected rule assumes an output semi-elasticity of the overall balance of 0.4; an adjustment parameter of 0.3; a medium-term cyclically adjusted deficit target of 0.0 percent of GDP; and a declining output gap that closes in 2013. The expenditure rule stipulates annual expenditure growth below nominal growth, which is consistent with the general government balance that ensures declining debt to GDP ratio. The structural balance rule limits general government expenditure to the estimated cyclically neutral revenue level, which implies balancing the budget over the output cycle.

38. **Consistency[25]:** The FRL is not well coordinated with public finance reforms because it does not provide a stable link to debt aggregates. Nor is it fully compatible with the Maastricht criteria; as an example, fiscal deficit at 3 percent of GDP might be missed in case interest payments grew above that level.

39. **Simplicity[26]:** As noted, the suggested rule will be difficult for its constituents to understand as well as monitor. However, there are unavoidable tradeoffs between simplicity and other criteria (especially flexibility and adequacy) that could be partially overcome by describing both the methodology and the expected impact. The law as well as its decree is very precise on how the methodology is to be applied.

40. **Transparency[27]:** The FRL could strengthen the mechanisms by which others can judge whether the government is complying with goals and priorities. There are notable deficiencies in the fiscal reporting requirements (ex ante and ex post) embodied in the current legislation. For example, the medium-term forecasts specified in the Guidelines do not fully describe the underlying macro assumptions and forecasting methodology; they are based on national cash methodology; and they do not elaborate the fiscal risks. Thus the FRL would benefit from reinforcement of the requirement of regular quarterly monitoring (semi-annual does not allow enough time to make corrections) and reporting on deviations from fiscal

[25] This examines whether fiscal policy rules are consistent with each other and with other economic policy instruments.

[26] This looks at whether politicians, citizens, and investors find the rules easy to understand.

[27] This examines whether there is scope for creative accounting and forecasting, and whether compliance with the rules can be monitored in real time.

targets, including reasons for deviations (e.g., changes in macro forecasts, policies, or accounting standards).

41. **Enforceability[28]:** The legislation makes the MoF responsible for surveillance and enforcement. Best-practice examples elevate the role of independent institutions. On the other hand, if heads of budgetary and extra-budgetary beneficiaries of the state budget or of LGUs violate the FRL, their mandates should be reviewable by the Prime Minister or the appointing body—a much stronger enforcement mechanism than the pecuniary fees.

42. **There is scope to improve the legislation to meet internationally accepted FRL standards.** Based on the relevant lessons that can be distilled from the international experience as well as the above observations on the proposed legislation, Croatia could:

- **Extend the coverage.** The rules-based framework should cover all budget operations and possible losses of state-owned enterprises. Given the objective of compliance with Maastricht criteria in the medium term, regular fiscal reporting should be accompanied by information on general government fiscal performance consistent with the ESA 95 methodology. The rule should cover co-financing for EU projects because that would provide incentives to free up resources for co-financing, which would be in line with the goal of reducing the size of government over time.

- **Integrate current fiscal rules.** The complex system of formal and informal fiscal rules stipulated by the organic budget law, the Guidelines, and the FRL need to be replaced with a single well-designed rule[29] that is transparent and responsive to the ultimate goals of the authorities. As Box 3 indicates, the choice of any suitable permanent rule would depend both on how the properties of the fiscal rule relate to criteria predefined by the authorities and on tradeoffs between objectives (e.g., flexibility and transparency). The following alternative fiscal policy rules are worth considering:

  (i) A growth-based rule (as currently proposed in Turkey and Latvia)

  (ii) A simple expenditure rule combined with a budget balance rule (in place in Romania) or a debt brake mechanism (being considered in Poland)

  (iii) A CAB rule from the first year of the implementation.

  All these rules perform relatively well in terms of stabilizing the debt ratio in the medium term.[30] They provide for a more sustainable reduction in the debt to GDP ratio than the rule suggested in the FRL. If the temporary fiscal rule is put aside, the debt ratio would decline more and faster with a CAB rule. However, fiscal adjustment in year one would be

[28] Are the rules enforceable in practice?

[29] A rule expressed in unequivocal and verifiable terms, flexible, and relatively simple to implement.

[30] Scenarios presented should be interpreted with caution because they are based on a simplistic DSA framework and assumptions derived from recent MOF Guidelines and IMF Article IV. They are illustrations only.

higher by about 5 percent of GDP than with the currently planned consolidation.[31] Also, because cyclical adjustment is technically demanding and data-intensive and would require sophisticated analytical skills, in practice it may be unworkable.

- **Reinforce procedural rules,** with strict interpretation and enforcement of medium-term aggregate fiscal policy objectives. Rigorously enforced medium-term targets should be reflected in the annual budget process. Improved budget preparation processes (such as top-down budgeting[32]) would help application of the FRL to succeed.

- **Set up a legally and effectively independent surveillance authority** to continuously and transparently monitor compliance with all elements of the FRL, especially fiscal rules, the three-year budget plan, and fiscal forecasts. The FRL would greatly benefit from nonpartisan fiscal surveillance mechanisms, e.g., fiscal council to (i) monitor developments in real time and assess whether the rule is being followed; (ii) prepare recommendations for fiscal planning, forecasting, and impact assessment; (iii) provide unbiased medium-term macro and fiscal forecasts; (iv) help identify reforms to keep the framework viable over the medium term; and (v) recommend corrective steps and sanctions if there are slippages in FRL compliance. One option would be to strengthen the recently established Fiscal Board with making it responsible to the legislature (e.g., the Parliamentary Budget Office in Latvia or the Commission of the Grand National Assembly of Turkey) as well as include an enhanced surveillance role (considered in Hungary and applied in Poland at the subnational level[33]).

[31] How well all the rules perform would also depend on the type of shock. It would be worth considering how all would behave if there were an adverse shock (not assumed in the scenarios). Would they place the debt ratio on a clear downward path? Simulations to answer such questions are beyond the scope of the note.

[32] In top-down budgeting, the starting point of budget preparation is a decision on how much will be spent. Aggregate expenditure is determined by autonomous consideration of the size of the budget rather than being the sum of proposals from line ministries and spending agencies (as is characteristic of the bottom-up approach).

[33] Regional Audit Chambers in Poland.

References:

Ayuso-i-Casals, Gonzalez Hernandez, Moulin, and Turrini [European Commission]. 2007. ―Beyond the SGP Features and Effects of EU National-Level Fiscal Rules,” 9th Banca d‘Italia Workshop on Public Finance, March 2007. Milan: Bank of Italy.

Debrun, X. and M.S. Kumar. 2007. ―The Discipline-Enhancing Role of Fiscal Institutions: Theory and Empirical Evidence.” IMF Working Paper 07/171. Washington, DC: International Monetary Fund.

Drazen, A. 2000. ―Political Contagion in Currency Crises.” In *Currency Crises*, 47–70. Cambridge, MA: National Bureau of Economic Research, Inc.

European Commission. 2008. ―Analysis: Numerical Fiscal Rules in the EU Member States in 2008,” *Report on Public Finances in the EMU—2009*, Part II, chapter 4.2 pp. 45ff. Brussels, Belgium: EC.

__________. 2010. ―National Fiscal Governance Reforms across EU Member States.” Occasional Papers 67. Brussels, Belgium: EC.

__________. 2010, ―Proposal for a Council Directive on Requirements for Budgetary Frameworks of the Member States,” COM(2010) 523 final. Brussels, Belgium: EC.

International Monetary Fund (IMF). 2001. Fiscal Transparency Code. Washington, DC: IMF.

__________. 2005, ―Fiscal Responsibility Laws.” Washington, DC: IMF.

__________. 2008.”A New Fiscal Rule: Should Israel ‗Go Swiss‘?” Working Paper 08/87. Washington, DC: IMF.

__________. 2009. ―Fiscal Rules—Anchoring Expectations for Sustainable Public Finances, December. Washington, DC: IMF.

__________. 2010a. ―Strengthening the Fiscal Framework in Poland” (unpublished.) Washington, DC: IMF.

__________ 2010b. ―Republic of Croatia: 2010 Article IV Consultation—Staff Report.” DC: IMF.

Kopits, G. 2007. ―Fiscal Responsibility Framework: International Experience and Implications for Hungary.” MNB Occasional Paper 62.

Kopits, G. and S.A. Symansky. 1998. ―Fiscal Policy Rules”, Occasional Paper 162. DC: IMF.

Mills, P., and A. Quinet. 2001. ―The Case for Spending Rules.” In *Fiscal Rules* (papers presented at the Bank of Italy workshop in Perugia, February 2001), 319–330. Milan: Bank of Italy.

OECD. 2010a. ―OECD Economic Surveys – Turkey.” Paris: OECD.

__________, 2010b. ―OECD Journal on Budgeting Post-Crisis Fiscal Rules: Stabilising Public Finance while Responding to Economic Aftershocks," Vol. 2010/2. Paris: OECD.

Orphanides, A. and S. van Norden. 2002. „The Unreliability of Output Gap Estimates in Real Time", Review of Economics and Statistics, 84(4), 569-583, November 2002.

Persson, T., and G. Tabellini. 2001. ―Political Institutions and Policy Outcomes: What Are the Stylized Facts?" CEPR Discussion Papers 2872. London: Centre for Economic Policy Research.

Perry, G. 2002. ―Comments to Crisis, political institutions and reform by Mariano Tommasi". DC: World Bank.

Pina, Á.M. 2006. ―Fiscal Policy in Portugal: Discipline, Cyclicality and the Scope for Expenditure Rules." In *Fiscal Rules* (papers presented at the Bank of Italy workshop held in Perugia, April 2006). Milan: Bank of Italy.

Schick, A. 2009. ―The Role of Fiscal Rules in Budgeting." In *Evolutions in Budgetary Practice*, 319–341. Paris: OECD Publishing.

Tornell, A., and P. Lane. 1999. ―Are Windfalls a Curse? A Non-Representative Agent Model of the Current Account and Fiscal Policy." NBER Working Papers 4839. Cambridge, MA: National Bureau of Economic Research.

World Bank. 2009. ―Performance-based Budgeting and Medium-term Expenditure Frameworks in Emerging Europe." Washington, DC: World Bank.