Fiscal Responsibility and Fiscal Discipline

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Motivation

• Since the 1990s many Governments have intensified search for mechanisms to curb Fiscal populism.
• Unsustainable fiscal policy can jeopardize service delivery, safety of financial system, creditworthiness and overall macroeconomic stability.
Instruments to strengthen Fiscal Discipline

• One instrument to control profligate behavior is to pass an FRL for National and Sub-national Governments (eg. Argentina, Brazil, Colombia, India, New Zealand, Peru, Russia and South Africa).

• An alternative to FRL is to develop institutions, credible fiscal rules for obtaining prudent behavior (eg. MOUs on fiscal targets with monitoring, balanced budget rules, autonomous central banks, no bailout policies, legislative oversight etc.)
Fiscal Responsibility Rules - Purpose

• FRL is a commitment device- controls impulse of an individual government to run excessive deficits.
• For a group it enforces a mutual agreement that each one of them would avoid running excessive deficits.
Purpose Continued

- The agreement to protect the common interest would have to restrain the behavior of the federal government and sub-national governments.
  - Some arrangements (revenue sharing, Constitution etc.) may constrain federal Government’s power over sub national governments.
  - Sometimes political considerations may bias decisions of federal government away from the optimal.
Channels for strengthening fiscal discipline

- Deficit and Debt Controls (ex ante and ex post)

Deficits and Debt arise from joint decisions of Governments and creditors based on rules governing debt issuance and ex ante expectations of who will lose money or who will be forced to adjust in case of payment difficulties.
Channels continued……

- There are two dimensions of control of government borrowing:
  - type and timing (ex ante or ex post)
  - whether they act on borrowers or lenders.
- Relying only on ex ante constraints allows irresponsible borrowers and lenders to get around initial hurdles.
- Relying only on ex post consequences allows irresponsible entities to build up large debts rendering enforcement of consequences difficult.
Ex Ante Controls

- For Government (debt ceiling, deficit target, restriction on international borrowing, regulation of sub national borrowing based on fiscal capacity criteria).
- For Lenders (regulation by central bank, no direct central bank financing, restrictions on international borrowing, credit rationing to sub nationals, increased capital requirements for lending to risky sub nationals).
Ex Post Consequences

• For Borrowers (No bailouts, limits on Central Bank financing, no debt workout without conditionalities, debt service withheld from transfers to sub nationals, central government does not accept sub national debt)
• For Lenders (Strong supervision of banks, capital write-offs for losses from Sub national debt).
• Ideally any lending/borrowing should have restraints ex ante and ex post on borrowers and lenders.
Two types of fiscal restraints

- The constraint on Borrowers (Constitution, FRL, other laws) can be distinguished between several institutions that encourage fiscal restraint. Some set specific fiscal targets whereas others emphasize procedures for setting targets and monitoring their implementation.
Fiscal Responsibility Laws

• Could be National Laws that apply to all levels of Government or at least to National and Provincial levels. (eg. Brazil, Peru, Colombia). These are top down systems.

• In the bottom up system the National Government passes an FRL for itself providing a framework and incentive for sub national governments to do likewise. (eg. Argentina and India until TFC).
Budget Law and Fiscal Transparency

- It sets out five principles of responsible fiscal management: reducing public debt to prudent levels; requiring an operating balance to be maintained on average over a reasonable time; maintaining a buffer level of public net worth; managing fiscal risks; and maintaining predictable and stable tax rates.
- Recommended publication of a ‘Budget Policy Statement’ containing strategic priorities and fiscal objectives with a three year forecast.
- To present all financial information according to GAAP. Example, forecast financial statements including projections of fiscal trends over 10 years, an operating statement, balance sheet, cash flow statement, statement of borrowings, contingent liabilities and statements of the government’s commitments and specific fiscal risks.
- These are referred to a parliamentary select committee.
- Other examples of similar legislation are Australia’s Charter of Budget Honesty and United Kingdom’s Code for Fiscal Stability.
Country Case: Brazil

- Brazil has had three sub national debt crises in 1989, 1993 and 1997.
- Agreements to resolve them tried to limit future SN deficits and financing.
- But characteristics of the agreements made the next crisis more likely.
- The agreements reinforced perception of federal Government support of debt relief. Debt relief was in the nature of rescheduling rather than forgiveness so debt stock kept growing. Debt relief bought out foreign and private creditors to sub national governments (without penalties) and left federal government holding the debt.
- The 1997 bail out was conditional upon compliance with fiscal adjustment and structural reform. These included decline in debt and deficit rations, growth in own revenue, ceiling on salaries and investment and privatization. Ex post consequences included denying Federal guarantees on state debt, interest rate penalties on existing state debt with federal government and garnishing of debt service from central transfers.
- On the lending side, the Central bank limited each bank’s total lending to public sector and prohibited bank lending to any state that was in violation of debt and deficit ceilings of the Senate resolutions or in default to the federal government or to any other bank. Privatization included state owned banks giving them autonomy and removing them as a source of financing.
• With this background a new FRL was passed in 2000.
• One FRL for all levels of Government (Federal State and Municipal).
• Uses both ex ante rules and legal penalties.
• Reinforces restrictions on personnel spending, deficits and debt.
• Prohibits debt refinancing operations between different levels of government.
• All 1997 conditions apply except primary surplus which is negotiated separately.
• Senate Resolution to determine level of constraints.
• Contains specific provisions for authorities in the last year of office (No contracting obligations to pay within last six months in office unless these can be paid off in the remainder of the term)
• Provides for interdiction/garnish from central transfers any money owed to the federal government and agencies.
Brazil Continued.....

- All Sub National Governments must submit budgets with fiscal targets over a three year period, promoting predictable fiscal policy and prove annual compliance.
- Governments that do not comply cannot access credit markets.
- Debt and labor contracts in violation of the FRL are not legally valid.
- Any borrowings over the Senate determined threshold are required to be repaid n full without interest. In the interim governments are not eligible for discretionary federal transfers, federal guarantees or contracting new debt.
- Close supervision of agreement by federal treasury every quarter.
- Companion law to FRL provides for criminal penalties (fines and jail) for officials who violate rules.
Case: Argentina

- In the 1980s provinces borrowed a lot much of it from state owned provincial banks.
- Subsequent stabilization centered on the Convertibility Plan of 1991 fixing the exchange rate to the US$.
- The agreement also required that the monetary base not exceed the US$ value of international reserves hardening budget constraint for federal and provincial governments.
Argentina Background

• Quick resumption of growth after 1995 downturn took away most of the pain and provinces resumed borrowing (eg. Buenos Aires).
• By end of the 1990s the absence of ex ante controls had allowed a number of provinces to over borrow.
• Faced with deteriorating budget balance and growing debt payments at the national level the Argentine Congress approved a Fiscal Solvency Law in 1999.
Fiscal Solvency Law-Argentina

• The FSL set numeric limits for the central government’s fiscal deficit, limited growth of expenditure, created a countercyclical fiscal fund, multi year budgeting and fiscal transparency measures. The law required fiscal balance to be attained by 2003 and set nominal ceilings for non-financial public sector deficit between 1999 and 2002.

• But these were broken every year.
The national law invited provinces to pass similar laws of their own and several did with varying provisions and degree of adherence before the crisis of 2001.

The big three provinces and Buenos Aires did not and they were 50% of the nation’s economy undercutting the FRLs.

In fact 16 out of 24 provinces had constitutional limits on the ratio of debt service to total revenue (20 to 25%) but only 10 provinces were in compliance.
Fiscal Solvency Law Failure

• In 2001 the FRL’s stopped working because of the mismatch between fiscal and monetary policies in the context of the fixed exchange rate.
• The federal government had legally inflexible spending obligations (e.g., debt service and provincial transfers).
• Recession in 2001 dropped federal revenues to the point that the federal govt. could not keep promised transfers and other obligations and replaced them with debt.
• The provincial FRLs lacked enforcement power, a critical mass of states had not passed them.
• The Compromiso Federal of 2000 did not have contingencies to assure fiscal sustainability in down side growth scenarios.
Case: Mexico

- No FRL at national level.
- Debt and economic crisis of 1995 sparked reform. In 1995 states got relief through rescheduling debt into long term inflation indexed debt with four years of assistance payments from the federal government.
- States had to agree to a fiscal adjustment program with the Finance Ministry with fiscal consequences for non-compliance.
- Government ended its policy of formally guaranteeing sub national debt but agreed to borrowers pledging revenue sharing transfers as collateral for debt service.
- In 2000, a new borrowing framework was introduced to tighten the budget constraint.
Mexico’s Borrowing Framework

• The new borrowing framework had four elements:
  - Introducing exposure norms, risk weights and credit ratings for sub national debt.
  - Publishing fiscal and financial information of borrowers.
  - Eliminating discretionary transfers from the federal Government.
  - Ending the Finance Ministry (SHCP) role for collateralizing debt.

• Basing sub national borrowing regime on incentives alone works best in a non-crisis environment. Therefore there is requirement for a provision for institutional vetoes to prevent bailouts in a crisis that would undermine the incentives.
India: A large number of states have now passed FRAs

**Before 12^{th} FC:**

**After 12^{th} FC:**
Maharashtra, Orissa, Rajasthan, Assam, Haryana, AP, H.P. Bihar etc. Most states (22) have enacted FRA.
Assessment of design: targets

- Prescriptive with *ex post* quantitative targets
  - This is appropriate for governments *under adjustment*.
- Non-cyclical
  - May be appropriate for sub-national governments. Certainly helps keep it simple.
- All have time-bound targets for revenue deficit elimination and most fiscal deficit containment.
- Some have annual, intermediate goals.
- Some consolidate with off-budget borrowing.
- Some limit guarantees.
- Some use GSDP as denominator; some revenue receipts.
- All have escape clauses: some limited.
- *In general, state acts are more prescriptive than the national act, and the model Act adopts the more prescriptive and comprehensive features of the national Act.*
Assessment of design: reporting mechanisms

• All have an annual reporting requirement to set out a 3-4 year fiscal perspective
  – Some require 1: Medium Term Fiscal Plan/Policy Statement

• All have intra-year reporting requirements: some quarterly, some half-yearly.

• Various other reporting requirements (accounting changes, subsidies, pension projections).

• Some give option to Government for advisory council.

• Again, model Act is on the demanding side: 3 annual reports, and quarterly intra-year reviews.
Corrective mechanisms

• None of the Acts have sanctions - except Assam
• All have corrective mechanisms.
  – **Triggers**: if within the year you are off-target, you have to cut expenditure or increase revenue to get back on target.
  – **Neutralising measures** for policy changes during the year (outside the budget cycle)
Assessment of implementation: targets (wrapping up)

• The initial scepticism that FRAs shouldn’t be passed because they will only be flouted has been belied by events.
• Too early to say whether states with FRAs have done better than states without.
  – Cf Haryana & overall fiscal improvement.
• Did states which passed the FRA after they began reforms (Karnataka, UP, Kerala) do better than states which passed the FRA at the start of their reform process (TN, Punjab)?
  – Again difficult to say. There doesn’t seem to be any close link, but some states have taken the Act more seriously than others.
• Overall, the picture seems similar to the one derived from international experience:
  – FRAs are neither necessary nor sufficient for fiscal adjustment, but they are useful.
Assessment of implementation: reporting mechanisms

- Picture here is not as good.
- TN and Karnataka have faithfully produced annual medium term fiscal plans:
  - The Karnataka one has been distributed and are very useful template.
  - Karnataka one is not produced at the time of budget due to capacity constraints.
- Kerala not as regular
- Punjab’s first MTFP was not consistent with its FRA, but the second MTFP is.
- Only TN has produced the mid-year report regularly.
- These reports have not generated much media or academic interest; nor has there been much independent scrutiny.
- No state which has given itself an option to set up an advisory/reporting council has taken up that option!
Assessment of implementation: corrective measures

- Notable by their absence.
- Hindered by lack of timely data.
- These may (marginally) have helped the state stay on track (controls on supplementary budget) but have not been applied when state is off-track (triggers).
Making greater use of FRA potential: going beyond the basics

- Making greater use of FRA potential
  - for fiscal prudence
  - for better public expenditure quality
Making greater use of FRA potential: going beyond the basics: *protecting the fisc from electoral shocks*

- The Punjab FRA
  - “Subsequent to the announcement of the general elections by the Election Commission of India to the Punjab Legislative Assembly, the leaders of the two largest political parties in the State may request the Secretary of the Department of Finance of the State Government to prepare approximate expenditure of the publicly announced proposals of either party with a view to facilitate the public debate.”
  - “No act which may lead to an increase in the expenditure on Government employees, remission in State revenue or which may result in credit operations based on future revenues, other than the normal open market and other borrowings of the State Government conducted through the Reserve Bank, shall be undertaken with a period of six months before the general elections to the Punjab Legislative Assembly become due.”
Making greater use of FRA potential: going beyond the basics: improving public expenditure management

- A key PEM problem in India is that budget making is a year-round activity. FRAs can make it harder to introduce initiatives outside of the budget cycle:
  - The model Act
    - “Any measure proposed in the course of the financial year, which may lead to an increase in revenue deficit, either through increased expenditure or loss of revenue, shall be accompanied by a statement of remedial measure, proposed to neutralize such increase or loss and such statement shall be placed before the House/Houses of Legislature.”
  - Karnataka FRA:
    - “Whenever one or more supplementary estimates are presented to the Houses of Legislature, the State Government shall also present an accompanying statement indicating the corresponding curtailment of expenditure and/or augmentation of revenue to fully offset the fiscal impact of the supplementary estimates in relation to the budget targets of the current year and the Medium Term Fiscal Plan objectives and targets for the future year.”
Moving to a more flexible model?

- Shift to structural balance approach (UK approach)?
- Replace targets by principles (NZ approach)?
- Curtail spending in election year?
- This would be much too premature:
  - (i) 12th FC has laid down minimum conditions
  - (ii) Flexibility requires credibility which state government do not yet have.
“Autonomous” approach or “Coordinated” approach

• India has already moved in this direction by the 12th FC imposing “minimum conditions” on the state FRAs.
• Forcing states to get credit-rated, to go to the market on their own, subject only to global borrowing ceilings
• Judging state performance by their compliance to FRA targets.
• Annual “FRA compliance reports” by RBI/CAG?
  – There is an urgent need for getting cross-state fiscal data into the public domain much earlier: we now know the central government deficit of 2004/05 but we still don’t know the state fiscal deficit of 2003/04!
• Doing away with the Plan/non-Plan distinction.
• Set a good example vis-à-vis GoI FRBMA.
Summing up

- FRAs neither necessary nor sufficient for achieving fiscal prudence. Useful as mechanisms to coordinate and sustain commitment to fiscal prudence but are no substitute for commitment.
- Works best when FRAs start from a position where there is no debt overhang. In debt overhang situations fiscal adjustment programs and debt rescheduling programs must already be in place before FRA.
- FRAs cannot do the job alone. Must be complemented by rest of the institutional framework.
- Effectiveness of FRA’s depends on how well it can be enforced.
- Assessment of Implementation in India. States have by and large been able to meet their FRA targets. Consistent with international experience, FRAs in India do indeed appear to be useful instruments of fiscal reform.
- Future Challenges. The public finance challenges today faced by states are different from 5 years ago. There are two:
  - The risk of moving back into crisis
  - The need to improve PEM
FRAs can be helpful for both. But the potential of FRAs, especially to improve PEM, has hardly been tapped as yet.
Combined state deficit (% GDP)

2003-04 (actuals); 2004-05 (r.e.); 2005-06 (b.e): based on 11 large states
Thank You!