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The Role of Fiscal Rules in Budgeting

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Budgeting is a rule-driven process that regulates the raising and spending of public money. Detailed rules govern the submission of bids for resources by spending units, review of these bids by the Finance Ministry or another central organ, compilation of the annual budget, legislative action including the voting of appropriations, expenditure of funds during the financial year, and reporting on financial stocks and flows. Why have many national governments adopted new budget rules when they have a plethora of old ones? The new rules do not replace – although they may modify – existing rules, thereby adding to the complexity of established budget processes, and often adding as well to the time it takes to complete the main steps in the annual budget cycle. Why add to the complications of an already difficult process? If it is because the old rules do not work, why is it expected that new ones will make much of a difference?

Furthermore, the old rules generally empower budget-makers by enabling them to allocate resources according to the preferences of government. Fiscal rules, by contrast, constrain budget-makers, taking away much of their authority to decide aggregate revenue and spending policy. These rules typically prescribe the balance between revenue and spending policy. Every fiscal rule is a limit on the exercise of political will. Why have democracies accepted or imposed fiscal limits on themselves, and why should we expect these limits to be effective when they run counter to the preferences of voters and politicians?

Some fiscal rules have been adopted by national governments on their own initiative; some have been imposed by international agreements such as the European Union's Stability Pact or by conditionalities dictated by the International Monetary Fund (IMF) and other international financial institutions. Some are embedded in fiscal responsibility laws that require the national government to establish fiscal targets in advance of annual budget work; others arise out of the process of preparing and approving the budget. Although most national governments still operate without pre-set fiscal constraints, the number of countries employing them is likely to increase in the years ahead. Compared to past budget reforms that had little success, the fiscal rules movement has altered budget practices in the countries that have taken the rules seriously.

Fiscal rules are effective only when they are supported by other changes in budgeting including:

- lengthening the time frame from a single year to the medium term;
- baseline projections (or forward estimates) of future budget conditions;

- estimates of the impact of policy changes on future budgets;
- procedures for monitoring budget out-turns and for taking corrective action when necessary; and
- enforcement mechanisms to assure that opportunistic politicians do not breach the rules.

Fiscal rules will not make much of a difference if the budget horizon is limited to a single year, monitoring and enforcement are weak, and future impacts are ignored when budget decisions are made.

Fiscal rules also depend on political leaders who are willing to operate within the constraints, even when they are thereby compelled to take unpleasant actions such as reducing services or boosting taxes. When political will is lacking, as is often the case, compliance will be weak. But if political rules work only when politicians want them to, why have them at all? If political support is forthcoming, rules are unnecessary; if it is not, rules will not work. I will return to this issue later in the paper. For the present, however, it suffices to aver that rules serve to fortify politicians who want to make hard budget choices.

This paper offers a preliminary assessment of fiscal rules. A key question, addressed in the next section, is: why have fiscal rules emerged as an attractive budget innovation? What is it about contemporary public finance that has prepared the ground for this reform? Section 2 inquires whether the type of fiscal rule makes a difference. Some rules are stated in absolute terms, others are indexed to GDP or another measure. Does the type of constraint influence budget outcomes, or is the manner in which it is applied paramount? Section 3 considers the budgetary arrangements that facilitate or impede compliance with fiscal rules. The concluding section assesses fiscal rules in the light of the economic and political conditions under which they operate.

This paper does not address the staying power of fiscal rules. Do they gain legitimacy and strength the longer they are in place, or do rules weaken as claimants for public resources learn how to beat the system? My sense is that fiscal rules have a limited effective life and must be reinvigorated or replaced from time to time. However, because these rules have been applied for barely a decade, more experience is needed before their long-term effects can be evaluated.

1. The age of fiscal rules

Fiscal rules are a response to alleged shortcomings in budgeting that produce outcomes that politicians and voters do not want and would reject if they had a fair opportunity to do so. The shortcomings lead to expansionary government that consumes a rising share of national wealth, elevates tax and debt burdens, and produces large, chronic budget deficits. Proponents of fiscal rules argue that the fundamental problem is that conventional budgeting is an open-ended process that permits government to accommodate demands by spending more than it has. Fiscal rules aim to counter this tendency by compelling budget-makers to tax and spend within fixed constraints that do not waver with shifts in political sentiment or economic conditions.

Four interlocking lines of reasoning feed into the fiscal rules movement. One is the argument that sound budget procedures often produce unsound budget outcomes. The second is burgeoning evidence that budgeting in democratic countries is inherently biased to produce expansionary outcomes. The third is the realisation that abandonment of strict balanced budget rules has left budget-makers without firm guidance on appropriate fiscal aggregates. The final strand is a body of research which argues that differences in budget outcomes among countries are due to differences in the rules under which governments make tax and spending decisions. These strands have fused together to build a strong case for fiscal constraints to offset the perceived defects of conventional budgeting.

1.1. Good procedures do not assure good budget outcomes

Fiscal rules deal with substantive budget outcomes, in contrast to procedural rules, which deal with how the tasks of budgeting are carried out. Every national government prescribes budget procedures that cover the many steps in the annual cycle. Over time, the procedures have been hardened into routines that are repeated year after year with little or no change. Budget procedures define the roles and relationships of participants in the process, how the various tasks are done, the information required, and deadlines for action. The routines of budgeting ease the tensions and conflicts that are inherent in the competition for scarce resources.

As a set of routines, budgeting differs in some particulars from one venue to another. Each government has distinctive terminology and rules, but the differences tend to be small. Early in the development of budgeting, the basic routines were codified in principles that were recognised as good practice. The most important principles were: *i)* comprehensiveness (the budget should include all revenue and expenditure); *ii)* accuracy (the budget should accurately record transactions); *iii)* annularity (each budget should span a single fiscal year); *iv)* authoritativeness (public funds should be spent as authorised in law); and *v)* transparency (the government should publish timely information on receipts and expenditures).

The procedures and the principles that underlie them constitute due process in budgeting. The term "due process" connotes that if the procedures are proper, the outcomes that ensue from them are right. In the same way that the judgment of a court is governed by due process, the legitimacy and soundness of budget decisions are measured by the procedures used, not by substantive objectives or criteria. Whatever results from a budget process that applies proper procedure is correct. If, for example, the budget is comprehensive and all bids for resources are submitted in proper order and are reviewed by the appropriate budget authority, the allocations made to spending units and the budget totals should be deemed correct.

Due process is indifferent to outcomes. It has no preference for more or less spending, balanced or unbalanced budgets, rising or stable public debt burdens, higher or lower taxes, or other budget outcomes. What matters is that the procedures are followed. In this regard, due process in budgeting is analogous to due process in litigation. If proper judicial procedure is applied, the ensuing verdict must be accepted. Due process in budgeting is based on the same premise.

Due process in budgeting is politically neutral. It can accommodate both left and right-of-centre governments, as well as politicians who want to contract or expand government. It is quite common for an incoming government that has a markedly different political agenda than the government it has replaced to retain the inherited budget procedures. Because due process is neutral, actual budget outcomes vary with shifts in political or economic conditions. As these conditions differ from one country or time to another, so, too, do spending decisions and fiscal outcomes. Due process gives politicians free rein to mould budgets according to their preferences. Political will is unconstrained, provided it is exercised through prescribed procedures.

Due process has made budgeting into a self-contained activity, with its peculiar language, rituals and forms. In most countries, budgeting has its own ways of counting money which differ from the accounting principles used for financial statements. In all but very small governments, due process is in the custody of central staff that makes the procedural rules, oversees compliance, and has sufficient institutional memory and administrative authority to maintain due process. Over time, the procedural requirements have accreted, giving budget controllers more things to do and orienting the process more to compliance than to outcomes.

No government can effectively manage its finances if due process is materially impaired. Nevertheless, due process is an inadequate basis for regulating public finance because it generates or permits unwanted, adverse outcomes. The unsatisfactory fiscal performance of many developed and developing countries impels the conclusion that sound budget procedures often produce results at variance with those sought by the government or deemed appropriate by outside experts. For decades, international organisations have assisted developing countries in installing sound budget systems, but in most cases fiscal outcomes have persistently been sub-par. Most developing countries now have formal budget systems that meet basic standards. What they do not have are disciplined budgets, effective programmes or efficient operations. Improving budget procedures will not suffice to alleviate the deeply rooted problems these countries face.

Budget results generally appear to be more favourable in affluent countries, but the differences may owe more to the abundance of resources than to the quality of budget practices. A fair reading of fiscal trends over the past half-century supports the conclusion that fiscal discipline often has been lax in the developed world. In OECD member countries, public spending now averages 20 percentage points higher relative to GDP than it did in the early 1960s. During this extended period, developed countries have had many more deficits than surpluses, despite the surge in revenues due to economic growth and tax increases. Fiscal imbalances have been more pronounced during periods of economic weakness, but they have regularly occurred during expansionary times as well. Because developed countries generally do not face the capital flight and economic destabilisation that periodically beset poor and emerging market countries, they have been able to finance budget imbalances without much difficulty. Rich countries like to credit their good fortune to fiscal discipline, but the truer explanation may lie in economic plenitude, not in budget rules and procedures.

1.2. Biases and rigidities in budget decisions

Why is it that generally accepted budget practices do not assure disciplined fiscal results? Part of the explanation may lie in biases embedded in budgeting that spur higher spending in excess of available resources. Although budgeting is a process for rationing resources, it invites spending units to demand more money each year. Some governments have rules that limit the amount spenders may request, but most permit them to ask for as much as they want. It is a rare spending unit that requests only as much or less than it obtained for the previous year. The common pattern is for spenders to seek increases, to have a portion of the requested increase denied by the Finance Ministry (or the budget agency), and to get more than it had last year. This arrangement tranquilises the budget process by giving major participants much of what they want. Central budget officials get power and spenders get money. Budget officials get credit for cutting the budget and spending units get money to continue or expand programmes.

It is not only that spenders want more; government leaders and a phalanx of interest groups want to give them more. Little opprobrium attaches to a government that tables a budget with spending increases; this is a normal occurrence, built into the expectations of budgeting and the behaviour of participants. Government leaders often point to spending increases as evidence of the good they are doing. It is the budget that cuts which stirs political unrest and analytical curiosity, not the one that adds this year's increases to last year's and to those of the years before that. In this situation, the budget totals become pliable, accommodating constraints that can be adjusted as needed to fit the spending pressures facing government.

These pressures are unbalanced, and they unbalance the budget. One of the well-known biases of budgeting is that the benefits of expenditure are concentrated while the costs of taxes are dispersed. The more concentrated the benefits, the greater the share that beneficiaries gain, giving them strong incentive to campaign for even more from government. On the other hand, taxes are dispersed among the paying population and each taxpayer's share is miniscule, leaving each with only a weak incentive to oppose spending demands. Add to this the proliferation and activism of interest groups, and government is exposed to near-irresistible demands for public money.

Everywhere, budgeting is an incremental process that extends the past into the future by focusing on marginal adjustments. Almost all governments format the budget to concentrate on changes from the previous year's base. The budget and the supporting documents typically show spending for one or more past fiscal years, the year in progress, and the next fiscal year. This structure formalises incrementalism by concentrating budget decisions on the amount by which each programme or account varies from the previous year. Incrementalism undermines fiscal discipline by impelling governments to accommodate fresh demands by spending more, not by substituting new priorities for old ones. Incremental budgeting is a process of allocating increases, not of reallocating money from less to more effective uses. Arguably, if budgeting were less incremental and more open to a review of "base" expenditures, governments and deficits would be smaller.

Attempts to uproot incrementalism through zero-base budgeting and other innovations have been unsuccessful. Incrementalism thrives because it simplifies the process by significantly reducing the number and scope of decisions that have to be made within the constricted timeframe available for compiling the budget, and because it reduces conflict by protecting spenders and groups against deep cuts in existing programmes. When the budget is incremental, conflict normally is confined to small deviations from previous spending levels. But the price of budgetary peace is elevated spending levels.

Budget outcomes also are biased in many countries by the stickiness of public expenditure. In most developed countries, more than half of central government expenditure is mandated by permanent laws that entitle citizens to ongoing payments from government. These entitlements must be paid regardless of the condition of the budget or of other demands for public funds.

In some years, statutory increases in expenditure consume all of the incremental resources available for allocation. Typically, spending on entitlements is driven by demographic and economic trends, such as the age structure of the population and unemployment rates, rather than by annual budget decisions. In countries where benefits are linked to price changes, the government may have no margin for policy initiatives unless it spends more than it takes in.

The spread of entitlements has weakened fiscal discipline and budgetary due process. Typically, entitlements have been enacted without due consideration of downstream budget impacts and without adequate information on their prospective cost. In contrast to standard budget estimates and appropriations that are for fixed amounts, entitlements tend to be open-ended, with expenditure determined by exogenous factors. Much of the procedure of budgeting is irrelevant to statutory entitlements; as they grow in prominence, these pre-determined expenditures transform budgeting from a means of deciding future expenditures to one of accounting for past decisions.

Despite the damage they do to budgetary due process, entitlements can be regulated through the budget. It is not uncommon for financially stressed governments to trim entitlements at the margins in order to generate savings that would reduce the deficit or free up money for other purposes. Less frequently, they make fundamental changes that reduce the long-term impact of entitlements on future budgets. However, the usual course of action at budget time is to leave entitlements in place and to provision resources in the budget for mandated payments.

To sum up this discussion, upward spending biases are grounded in the political imbalance between concentrated benefits and dispersed costs, the sway of interest groups, incrementalism in budget decisions, and sticky expenditure. Unless governments constrain the fiscal aggregates, the budget's totals will stretch to accommodate spending demands. Good procedures are not an adequate defence against these pressures.

1.3. Changes in fiscal policy

Even where due process reigns, substantive policies often influence budget outcomes. Many governments have formal rules or political understandings that define the acceptable budget balance or constrain either the tax burden or spending levels. International organisations often impose fiscal conditionalities on countries receiving assistance. Political expectations and imposed conditions may be reinforced by substantive budget rules that are not policy neutral but predispose budget outcomes in certain directions. Indeed, the fiscal posture of many developed countries has gone through three distinct stages – the balanced budget norm, dynamic fiscal management, and currently, fiscal targets. These stages are discussed in the paragraphs that follow.

Prior to World War II, virtually all democratic countries embraced the balanced budget rule, including some that often breached the rule or did not have any legal constraint on unbalanced budgets. The operative norm was that spending during a fiscal year should not exceed that year's revenue. Governments differed in applying this rule; some applied it only to current revenue and expenditure, others to investment income and expense as well. Some counted money carried over from previous fiscal years, others included cash received during the year. The balanced budget norm did not distinguish between periods of economic growth and stagnation, nor did its time horizon extend beyond a single year to a full economic cycle. Because it was rigid, the balanced budget rule often was breached. Few national governments kept total spending within revenue during wartime or recession; some even had difficulty during good times. But although the norm often was dishonoured in practice, most governments paid homage to it as the right thing to do. Moreover, even when the budget was unbalanced, governments used the norm to constrain spending demands and the size of the deficit.

The balanced budget norm was superseded after World War II by a flexible rule that allowed the totals to accommodate cyclical changes in economic conditions and secular changes in government policy. The new rule came in several versions. One was that government should maintain balance over the course of the economic cycle rather than in each year; another was that government spending should not exceed the revenue that government would take in if the economy were at full (or high) employment. In other words, governments that have cyclical deficit should still have structural surpluses. Governments differed in the extent to which dynamic fiscal response should result from built-in stabilisers (such as the automatic fall in revenue or rise in unemployment payments when the economy weakens), or from discretionary policy changes. Over time, dynamic fiscal policy was applied in various countries to mean that government should act to reduce the gap between actual and potential output.

Even when the economy was strong, however, deficit spending was common in many democratic countries, as was a steady up-drift in the ratio of public expenditure to GDP. With aggregate constraints loosened, claimants had the upper hand in demanding more from government. It was deemed more important to balance the economy than to balance the budget and it was not difficult to make a strong case for additional spending on the ground that it would have beneficial stimulative effects. But whatever its virtues, an accommodating fiscal posture was called into question by the deterioration in economic performance of many industrial countries after the oil shocks in the mid-1970s and early 1980s. High, persistent deficits came to be seen as a structural problem that does not disappear when the economy recovers. But high tax burdens and weaker economic growth led governments to conclude that they could not restore fiscal balance simply by raising taxes, as they had often done during the post-war years. Instead, they had to exert stronger discipline over the budget aggregates, especially over total expenditure.

In striving to reassert fiscal discipline, governments had to devise new approaches that differ from the balanced budget norm and accommodating fiscal policy. A strict, unyielding balanced budget rule is unworkable because the budget is highly sensitive to economic fluctuations and cannot be kept in balance when output falls and unemployment rises. A zero deficit rule would be violated during most years of an economic cycle, not only during recession, but also in its aftermath when the country is struggling to regain its economic strength. But if the balanced budget norm is an unworkable policy guide, so too is an accommodating fiscal stance. Some governments have come to the conclusion that active demand management is not a viable option, and that policy should be oriented to the long-term prospect instead. Many now regard chronic fiscal imbalance as a drag on the future economic capacity. Almost all perceive that the once-accepted distinction between structural and cyclical deficits is misguided because one year's cyclical deficit worsens future structural imbalances.

1.4. The impact of fiscal institutions on budget outcomes

Faced with the impracticality of a strict balanced budget rule and the adverse outcomes of accommodating budgets, some countries, international financial institutions, and the European Community have gravitated to fiscal targets which permit constrained deficits but are set in advance of budget decisions by the affected government or outside authorities. Like the balanced budget rule, the targets are fixed rather than elastic, but unlike this norm, they permit outcomes that deviate from strict balance. When they work as intended, the targets constrain the fiscal options available to budget-makers.

Fiscal targets have been propelled by a body of research showing that institutions – the term used by economists in referring to fiscal rules – affect budget results. One of the most influential studies was conducted by Jorgen von Hagen for the European Commission in the early 1990s, but his findings have been replicated in other regions. Von Hagen classified each EC country in terms of whether it has centralised or fragmented institutions at each of the three main stages of budgeting: compilation of the government's budget, legislative spending actions, and implementation of the budget. He defined budgeting as centralised if the Finance Minister has a strong role in setting and enforcing fiscal targets and in resolving conflicts over spending, the legislature is barred from amending the budget or increasing aggregate expenditure, and the Finance Minister has authority to block expenditure and to assure that actual spending does not exceed authorised levels. Applying this scheme to EU countries, von Hagen found that budgetary arrangements that give the Prime Minister or Finance Minister strategic dominance over sectoral ministers, limit the amending powers of Parliament, and allow little opportunity for modification during implementation are "strongly conducive to fiscal discipline, *i.e.* relatively small deficits and public debt". Similar conclusions have been drawn in subsequent studies that used somewhat different variables. Reviewing the findings that emerged from a decade of research, Poterba and von Hagen argued, "Large deficits may be avoided by strategic design of the budget process, that is, by institutions that distribute authority and facilitate agreement on the efficient outcome. Effective institutional design of the budget process to reduce the spending and deficit bias of government promotes a comprehensive view of the costs and benefits of public policies. If centralisation of the budget process relies on delegating power to an individual decision-maker, the key is that this individual be driven by particular spending interests than by the spending ministers. If centralisation relies on common agreements on fiscal targets, the key is that these targets be agreed upon early in the budget process, that the agreement is negotiated by all parties involved, and that the agreement is backed by strong enough punishments to make it binding throughout the budget process." These conclusions suggest that the type of fiscal rule and the manner in which it is developed and enforced determine its effectiveness. All fiscal rules are not created equally, and all are not equally effective. Determining why some rules work and others do not is a difficult but necessary task.

Research on fiscal rules has had a definite impact on budget practice. It has influenced both the Maastricht Treaty and the Stability Pact. And it was cited by Sweden when the government reformed its budget machinery in the mid-1990s. The notion of fiscal constraints has obvious appeal at a time when national economies are linked to regional and global forces, and when economic growth and budget increments are less robust than they once were. With or without fiscal rules, contemporary governments are operating in a more constrained environment than was the case during the post-war boom. Arming them with rules may make the task of regulating public finance somewhat easier. But having rules is not the same as living with rules. The test of all rules is not whether they are adopted but whether they produce the expected behaviour. In the case of fiscal rules, having a constraint and enforcing it involves different actors and different politico-economic considerations.

2. Variations in fiscal rules

All fiscal rules share a key characteristic: they must be set before the budget is decided. If they are not, the rules cannot constrain revenue and spending actions. Beyond this common feature, fiscal rules branch off in many different directions. This section considers four sets of issues in formulating and operating fiscal rules:

i) Are they hard or soft constraints?

ii) Who sets and enforces them?

iii) Which fiscal aggregates do they regulate?

iv) What should be the accounting basis applied in making and enforcing rules?

2.1. *Hard* versus *soft constraints*

A constraint is hard when it cannot be modified by the government in response to changing economic conditions or political preferences; a soft constraint is one that the government may adjust when it prefers to change fiscal course. There are varying degrees of hardness or softness, but these polar definitions point to basic choices that a government must make in entering a fiscal regime. A parallel issue is whether fiscal rules should be permanent and continue from year to year without having to be readopted, or should be decided anew each year before the budget is adopted. Hard constraints tend to be permanent, soft constraints usually are recalibrated annually or after a change in government. Both types of rules may be prescribed by constitution, statute, international agreement, or some other binding decision. Temporary rules may be set in coalition agreements, medium-term frameworks, fiscal responsibility laws, or the annual budget law.

The Maastricht criteria and the Stability Pact are leading examples of hard, ongoing constraints. Although they have escape clauses, these rules continue in effect from year to year and are intended to be firm constraints on the budget policies of the affected governments. A somewhat more flexible approach is to decide the rules each year (or every few years) and to budget within the newly agreed constraints. Countries that budget within a medium-term expenditure framework (MTEF) generally take the more permissive approach. In Australia, which pioneered the MTEF model, multi-year forward estimates are the starting point for considering departmental bids for resources. These bids must be within the resource framework set by government. In Sweden's reformed budget process, the totals are decided by government and Parliament each year before work commences on the annual budget. The fiscal responsibility model developed by New Zealand and adopted by a number of developed and developing countries also relies on a soft constraint. Each year, the government presents a policy statement setting forth its medium- and long-term fiscal objectives several months before it tables the annual budget. The fiscal responsibility model does not dictate a particular outcome, but it does require that government be accountable for changes in fiscal course. The central idea is that political leaders should be free to make fiscal choices, but they should do so in an open manner.

Seen in this light, the key issue is not the hardness of the constraint but the extent to which fiscal rules restrict political action. One view is that the very purpose of the rules should be to counter the bias of politicians to act in a fiscally undisciplined manner; the other is that rules are sturdier when they are made and enforced through the working of democratic politics. In practice, the differences between the two approaches may be narrower than the labels suggest. Fixed constraints are rarely as hard as they purport to be, as the Eurocrats monitoring compliance with the Maastricht Treaty and the Stability Pact have come to learn; and politically-set targets can be strong constraints on government, as New Zealand experienced near the end of the 20th century when the coalition government maintained a disciplined fiscal posture despite economic weakness. It may be that politically set targets are effective only when democratic institutions are robust and government is held to account by voters. In countries where accountability is weak, the government may find it expedient to abandon targets set through fiscal responsibility mechanisms.

At first consideration, it may appear that permanent constraints, which do not bend with shifts in political or economic winds, are more effective than annually set ones which may be moulded to suit the preferences of the government of the day. Yet, there may be circumstances where annual constraints have greater impact than permanent ones, as well as instances in which indicative policies carry greater weight than constrictive rules. This argument rests on two premises: first, annually reset policies tend to be more realistic and achievable than permanent rules; second, annually (or periodically) established constraints may have more political support than permanent rules which have not been endorsed by current office-holders. No matter how hard they are, constraints cannot work if they are fundamentally at variance with current economic or budgetary realities, or if they lack political support. When constraints are political orphans, opportunistic politicians may conspire to evade them by delaying payments, devising extra-budgetary arrangements, building up contingent liabilities, and using other bookkeeping tactics.

The choice between constrictive and indicative rules depends on institutions, which differ from country to country. Indicative constraints may suffice to control budget aggregates when institutional arrangements promote fiscal prudence. On the other hand, hard rules may be appropriate in countries that have experienced fiscal laxity. If this generalisation is valid, the designers of fiscal rules must come to grips with an anomaly: when hard constraints are most needed, they may be least workable; and where conditions are most hospitable to fiscal constraints, they may be least needed.

2.2. How are fiscal rules set and enforced?

Ideally, democratic governments should establish and enforce their own fiscal rules, but in at least two prominent situations, they are now set and monitored externally. One is in the European Union, where fiscal rules have been set by treaty and are overseen by Commission staff; the other is in countries that are subject to conditionalities imposed by the IMF or other international organisations. Although a handful of European countries have been found in violation of the Maastricht Treaty and the Stability Pact, it is fair to conclude that the fiscal posture of most EU countries was more disciplined both prior to and since the launch of the Euro than it would likely have been in the absence of external constraints. However, it is an open question whether EU enforcement will be as effective when member countries are pulled by political or economic conditions to go their own way. In the case of developing and emerging market countries, the impact of external conditions may vary with the extent to which they are dependent on external aid or risk capital outflows.

Externally-imposed rules change the balance of political power within affected countries and enable politicians to shift the blame to outsiders for taking unpleasant measures. Nevertheless, external pressure may be a weak substitute for self-discipline. It is the affected government that must act to uphold the rules; if it does not, outside enforcers will not be able to make the rules work. Opportunism and deception are rife when politicians are pressured to act against their self-interest. They have numerous opportunities to conceal the government's true financial condition. As fiscal rules have become more widespread and stringent, outside enforcement has intensified. EU experts review budget submissions by member countries to assess compliance with the EU's accounting rules; IMF staff closely oversees financial actions by countries subject to its conditionalities. Nevertheless, even when outside monitors detect budgetary legerdemain, their only viable option may be to let the affected country breach the rules.

Self-imposed rules also are only as effective as the political arrangements, which generate them, permit. The early fiscal rules literature concluded that majoritarian regimes (in which one party controls the government) are more disciplined than coalition governments, which divide power among two or more parties. But contrary to this expectation, coalition regimes sometimes are more disciplined than those run by a single party. For example, the Netherlands, which has never had a single-party government throughout its democratic history, had extraordinary success in the 1990s in fulfilling self-imposed fiscal rules. To explain why coalition governments may be more successful, researchers have distinguished between rules adopted through delegation of power and those developed through political commitment. Governments that rely on delegation typically empower the Finance Minister to set the fiscal targets and assure that budget estimates and spending results are consistent with them. This arrangement is not suitable for coalition governments where the Finance Minister may come from one party and sectoral ministers from other parties. When, as is likely, the coalition partners have conflicting views on government policies and finances, they will not entrust final budget authority to the Finance Minister. Instead, if they are determined to act in a disciplined manner, they may negotiate a coalition agreement that sets out the boundaries of the budget, including fiscal aggregates, for the life of the government. It is the commitment of the coalition parties to stay within this framework that gives discipline to fiscal rules. During the 1990s, coalition agreements became more detailed in some countries and contributed to their success in regulating the budget. Coalition agreements are effective only when they are credible commitments, that is, the parties to the agreement have a strong incentive to abide by the terms, because if they do not, the government will collapse. Some governments have introduced new budget procedures to assure compliance with the coalition agreement during formulation and execution of the budget. New Zealand, which is a newcomer to coalition government, has established a "fiscal provisions" system for calculating the budgetary impact of policy initiatives and assessing whether they are consistent with the agreement.

A fiscal commitment is worth no more than the willingness of those who make it to comply with its terms. Although the parties to an agreement may pay a political price for violating it – new elections and a potential backlash from voters – politicians may judge it better to break the constraints than to live with them even when they are predisposed to abide by the agreements. One year's understanding may turn into a future year's misunderstanding. All budget commitments are at risk of being overtaken by changing conditions such as a weakening economy, shifts in public sentiment, an international crisis, and so on. Arguably, therefore, commitments (like coalition agreements) covering only the three or four years of a government may have a better chance of being honoured than those that span a longer timeframe.

2.3. Which fiscal aggregates are regulated?

In managing public finance, a government produces at least four fiscal results: total revenue, total spending, the deficit (or borrowing requirement), and the public debt. Governments that budget on an obligation basis also report on the total obligations issued or outstanding. Additional aggregates may be calculated for contingent liabilities, and annual changes in total revenue or outlays. Governments that publish consolidated financial statements also report on total assets, liabilities, and net worth. The various aggregates may pertain only to the central government, or may cover other portions of the public sector as well – social security, public enterprises, sub-national governments, and extra-budgetary funds. Each aggregate has the potential to be limited in a fiscal rule, but the most common rules pertain to the balance between revenue and expenditure.

The various fiscal aggregates can be targeted in different ways: in absolute terms, as a percentage of the gross domestic product or of another index, in real (inflation adjusted) terms, or as a rate (or amount) of change over a previous fiscal period. Expressing public expenditure or other aggregates as a proportion of GDP facilitates trend analysis and comparison among countries, and recognises that the sustainability of a government's fiscal position depends on the volume of national output. Nevertheless, focusing only on the deficit (or revenue or expenditure) as a percentage of GDP may bias fiscal outcomes. If government seeks to stabilise revenue or spending as a share of GDP, it may accept real spending increases when the economy is expanding but find it difficult to contract spending when the economy is weak. Over the course of an economic cycle, this pattern may lead to a progressive rise in the fiscal aggregates relative to GDP.

Constraining only a single fiscal aggregate may distort budgetary behaviour. If the deficit were the aggregate targeted, the government might contrive to meet the constraint by selling assets, deferring expenditure, or relying on non-recurring revenue. A broad set of fiscal rules may discourage this type of response, especially if the targets include the government's net worth, a measure that is not affected by asset sales or by the shift in receipts or payments from one fiscal period to another. Few governments, however, now produce comprehensive financial statements that are sufficiently timely and reliable to provide a basis for fiscal control.

In devising fiscal rules, the key consideration should be the sustainability of the government's financial position; that is, whether its policies can be continued in the future, especially if economic conditions become adverse. Sustainability has led developed countries to concentrate on the debt to GDP ratio and developing/emerging market countries to focus on the primary balance. In contrast to the deficit that measures financial balance within a single year, the debt ratio signals changes in financial strength over an extended period. A rise in the ratio may indicate that this trend cannot be sustained indefinitely because the debt burden is increasing faster than national output. Maintenance of a minimum primary balance has become a popular fiscal rule for developing and emerging market countries because they need a large surplus to finance external debt and to discourage capital flight.

The specific form the fiscal rule takes may be of less consequence than the manner in which it is adopted and enforced, and the number of years it covers. There is currently no basis for concluding that a rule limiting the deficit is more or less effective than one limiting the debt or total expenditure. A fiscal rule is effective if it is realistic, enforced and covers several years. A rule that lacks these characteristics will be weak regardless of whether it pertains to one or another of the budget aggregates.

2.4. What should be the accounting basis?

Although the form may not matter, the accounting basis used in applying the rule certainly does. Fiscal rules are vacuous if they are not under-girded by clear accounting standards that determine how the aggregates and the actions that feed into them are calculated. Not surprisingly, the fiscal rules movement has been accompanied by the elaboration of accounting standards for budget documents. While the cash *versus* accruals issue has received most of the attention, other issues also arise in defining and enforcing fiscal rules. Fiscal rule-makers generally prefer the accrual basis because cash transactions are subject to manipulation. Key differences between cash and accruals, such as the timing of transactions, asset sales and contingent liabilities, affect the aggregates reported in budgets. The cash basis gives politicians wide opportunity to defer or accelerate the recognition of receipts and payment, to sell assets and book the income as current receipts, and to shift from direct to contingent liabilities. To avert these ruses, the EU and IMF have shifted to a modified accrual basis that purportedly enables stricter enforcement of fiscal rules. It should be noted, however, that the accrual basis is not a failsafe mechanism against deception. Accounting scandals in the business sector, where the accrual basis prevails, teach us that all accounting rules are subject to manipulation and evasion. Moreover, the accrual basis may be particularly vulnerable to distortion because it relies on complex, often hidden, assumptions for calculating financial stocks and flows. The most prudent course may be to rely on both cash and accrual measures in devising fiscal rules and monitoring compliance.

Cash *versus* accruals is related to a second accounting question: should budget aggregates be reported on a gross or net basis? In the gross basis, inflows and outflows are accounted for separately; in the net basis, certain inflows may offset outflows. The debt to GDP basis usually is computed on a gross basis; it measures the total owed by the government. This ratio is not reduced by the amount owed to the government or by other assets held by it. In contrast to the balance sheet which reports net worth (assets minus liabilities), the gross debt measures only liabilities, and only those liabilities that are in the form of debt. Arguably, the net basis is superior because the aggregates would not be affected by the sale of financial assets. Government can lower the gross debt by selling assets, but this transaction would not change the government's net worth, though it would alter the volume of assets and liabilities.

Grossing *versus* netting also pertains to rules that constrain total expenditure. Most national governments obtain revenue from user charges, state-owned enterprises, and other commercial-type activities. If it accounts for finances on a gross basis, this money would be booked as revenue. If it uses the net basis, some or all of this income might be budgeted as an offset to expenditure. Netting *versus* grossing does not affect the reported size of the deficit, but it does affect total revenue and spending; hence, the issue is important when the fiscal rules limit these totals. The net basis is popular in some countries because it gives spending units an incentive to charge users for services. Sweden, however, opted for the gross basis in the 1990s when it established a system to regulate total and sectoral spending. In Sweden's current system, total spending limits are disaggregated into 27 sectors, each with its own sub-limit. In this arrangement, amounts paid by Sweden to the European Community are budgeted as expenditures and amounts received from the Community appear as revenue. The two flows are not netted out. Sweden selected the net basis because it provides stricter limits on total spending. In the net basis, the limits are elastic because the total spent can be increased by generating offsets.

3. Adjusting budget practices to enforce fiscal rules

Fiscal rules are only as good as their enforcement. Inasmuch as the rules are not self-enforcing, spenders can be expected to stretch or evade them when opportunities are at hand. A key element of enforcement is to empower independent overseers to review budget actions and to point out actual or potential violations. This model is used by both the EU and IMF, as well as by governments that subject fiscal policies and outcomes to independent audit. Enforcement that relies on intervention after the breach has occurred is inherently less effective than arrangements that deter violations before they occur. For this reason, some governments that take fiscal discipline seriously have restructured their budget processes to promote fidelity to the rules.

One of the most prominent adjustments has been to extend the timeframe of budgeting from one year to three or four years. An annual budget process is an invitation to evasion, for it encourages opportunists to defer expenditure until the next year or to accelerate receipts to the current year. It is not difficult for creative budget-makers to dress up one year's accounts so that they appear more favourable than they really are. When pressured to abide by fiscal constraints, some governments have shortened the fiscal year to 11 months or lengthened it to 13; some have made spending or revenue provisions temporary in order that the current budget fit into the constraints; some have used one-off revenue gains or spending cuts to defer the bad news to the future. These ploys are somewhat more difficult and less attractive when fidelity to the rules is measured over the medium term rather than for a single year. The medium-term expenditure framework (MTEF) or some similar arrangement has been introduced in various countries to assure that the budget's path is consistent with the rules.

Along with an MTEF, governments have introduced means of measuring the budget impact of policy changes. This capacity is essential because of the tendency to under-estimate future impacts when policy initiatives are taken. Measuring impact is itself a two-step procedure. First, it is necessary to estimate future budget conditions if policies were continued without change; this step entails the use of baselines or forward estimates that project the revenue or spending that will ensue in future years from current policy. Second, the government must have technical skills and procedures to estimate the changes in spending or revenue that may flow from policy changes. This is an exceedingly difficult task, for the estimates must consider behavioural responses in addition to the direct consequences of policy shifts.

Compliance with fiscal rules may be strengthened when government splits the budget process into two separate phases – a framework stage during which the aggregates (and possibly major sectoral allocations) are decided, and an estimates stage when detailed budgets are prepared. When the two tasks are combined, the budget's totals may be hostage to its parts; that is, pressure to accommodate spending demands impels government to set the totals higher than it prefers or the rules allow. By separating the two actions, the government sets the aggregates first without adding up expenditures for each account or spending unit. The totals are decided in a framework that focuses on fiscal rules and conditions, rather than on the amounts needed for each activity financed in the budget. Once the aggregates have been set, detailed estimates are prepared under rules that limit them to the amount provided in the framework.

Fiscal rules have arrived at a time when national legislatures are increasingly independent and active on budget matters. Legislative amendment of the budget submitted by the government is now common, except for countries still operating within the Westminster framework. As legislative changes become more frequent, the risk that the totals will be breached increases. To counter this, a few countries now provide for the legislature to vote the fiscal aggregates, either in tandem with its consideration of the budget or in a separate framework stage. Countries that permit legislative amendment are introducing means of providing parliamentarians with timely information on the future budget impact of these changes. As legislatures enhance their budget role, one of the challenges facing budget architects will be to balance the impulse for independence with the need to be fiscally responsible. The future of legislative-governmental relations will be strongly influenced by the manner in which this balance is maintained.

Strictly-enforced fiscal rules may constrict government's capacity to respond to new needs and priorities, especially when the economy is sluggish and ample increments are not available for allocation. To counter this tendency, some governments operating under fiscal rules have introduced means of encouraging spending units to reallocate resources from lower to higher priorities. An MTEF is well suited for this purpose, for the framework gives each sector a resource envelope for each of the next several years. Within this envelope, sectoral ministers have scope for shifting resources with low risk that their budgets will be cut. Of course, if proposed reallocations expose spending ministers to cutbacks, they will adjust to this reality by freezing old priorities into the budget.

When they are realistic and are anchored in political commitments and budget procedures, fiscal rules constrain government's capacity to respond to spending demands. Two prominent types of contemporary spending, however, may be resistant to these constraints. One is entitlements mandated by law, the other is contingent liabilities. Entitlements are essentially a political problem and are discussed in the next section in the context of the political and economic conditions under which fiscal rules are made and implemented. The contingent liabilities problem arises out of the fact that conventional budgets cover only direct liabilities; contingencies enter budget accounts at the point that payment must be made (such as pursuant to default on a guarantee), when it is too late for the budget to effectively control the amount spent. In some cases, governments that appear to have behaved in a fiscally prudent manner face enormous pressure on their budgets because of previously unrecognised contingent liabilities. Apparently, this has recently been the case in Argentina and some other developing and emerging market countries.

Contingent liabilities come in many forms, and every national government has them. Some contingent liabilities are explicit (they are established in law or contract) while others are implicit (they are grounded on expectations of government behaviour). Obviously, government knows less about these implicit risks than about explicit liabilities, but the budget impact may be greater. To maintain fiscal discipline, governments must regulate contingent liabilities. Doing so is difficult because practices have not been standardised and contingent liabilities usually are taken outside the budget process. Several approaches have emerged over the past two decades including: *i)* setting aside money in the budget for estimated calls on guarantees; *ii)* limiting the volume of guarantees outstanding or issued during the year; *iii)* reporting on contingent liabilities in the budget or financial statements; *iv)* sharing risk with recipients of guarantees by charging fees or other payments; *v)* reviewing guarantees in tandem with bids for direct expenditure; and *vi)* budgeting for estimated future cost when the guarantee is authorised. It is likely that, as fiscal rules are applied more extensively, new tools will be devised for regulating guarantees and bringing them within the ambit of budget control.

Fiscal rules are not simply a matter of adding aggregate targets to the stockpile of budget procedures. Where they work, the rules transform both the formal practices of budgeting and the behaviour of participants in the process. The changes discussed in this section have been introduced in the early years of fiscal rules. For these rules to become fully embedded in budgeting, additional changes will be introduced in the future. While the details of future budget innovations are presently unknown, their direction is clear. Budgeting will adapt to protect the aggregates from pressure to spend or borrow more, to assure that in both preparing and implementing the budget, government operates within pre-set constraints, and to require legislatures to be more disciplined at the same time that their budget role is augmented.

4. The impact of politics and economics on fiscal rules

Fiscal rules operate at the crossroads of politics and economics. The relationship between rules and political and economic conditions is bilateral. Every rule has the potential to redistribute political power, alter budget outcomes and other policies, and influence economic conditions. But the reverse also holds: political and economic conditions influence the effectiveness of budget rules. This concluding section explores a neglected issue in the fiscal rules debate. Can rules be effective when politicians do not want them or when economic conditions are unfavourable? If the answer to this question is "no", then why have rules at all? The short answer is that although rules cannot ignore political and economic pressures, they may affect the way these pressures are processed in budget decisions. Fiscal rules have effect, even when they are not effective.

Budget rules are political rules; they are made by political leaders and are enforced or breached by them. The effectiveness of fiscal constraints depends on the willingness of politicians to abide by them. When the rules work, it may be because voters and politicians have a preference to be fiscally disciplined; when they do not, it may be because they prefer more spending or lower taxes. Poterba and von Hagen recognise this pattern in noting "that budget rules are not randomly assigned to nations … but rather are the product of deliberate choice by voters or their elected representatives. This makes it difficult to evaluate observed correlations between budget rules and budget outcomes; perhaps the observed relationships are simply due to a correlation between a third factor, voter preferences, and the observed manifestations of voter preferences".

Recent work by von Hagen and others recognises the importance of political commitment in regulating budget outcomes, but they define commitment as a key element of fiscal rules rather than as an enabling condition that gives the rules effect. In so doing, their reasoning comes close to being tautological: commitments are budget rules that constrain spending or deficits; when these are not constrained, it is because commitment is lacking. This circular reasoning leads to the conclusion that rules are always effective. A more balanced view is that rules matter when politicians are predisposed to act in a fiscally-disciplined manner by making it easier for them to resist revenue spending or borrowing pressures. The rules fortify politicians who want to be fiscally prudent, but they do not stand in the way of those who are determined to spend more or tax less than the rules allow.

A fiscal commitment is worth no more than the willingness of those who make it to comply with its terms. When commitment wavers, fiscal discipline erodes. It may be the natural fate of such commitments to degrade over time as pent-up pressure for money overwhelms the rules. In the end, all budget rules may be inherently weak and made to be broken, either explicitly or through accounting tricks, and governments therefore have difficulty maintaining a disciplined fiscal posture for an extended period. If this is so, sooner or later, every country faces a need to reinvigorate its fiscal rules.

Case studies of fluctuating budget results indicate the fragility of fiscal rules. In the early 1990s, the United States General Accounting Office examined the experiences of five countries reputed to have moved from large deficits to budgetary balance. The five countries (Australia, Germany, Japan, Mexico and the United Kingdom) restructured their budget rules, established top-down, multi-year limits on aggregate spending, and took steps to curtail the public sector wage bill and some social benefits. A few also reduced payments to sub-national governments or trimmed capital spending. In all of the countries, political leaders actively promoted fiscal discipline by defining the acceptable parameters of fiscal policy and persuaded politicians and voters to accept budgetary austerity. GAO concluded that the experiences of these countries "indicate that eliminating deficit is possible in modern democracies and that leaders can succeed in mounting the case for prompt action before crisis ensues". But it also found that sustaining the sense of urgency and the fiscal balance over the longer term is difficult. In fact, by the time GAO published its study, four of the five countries had reverted to budget deficits. Recent experience in the United States tracks that of other countries. It moved swiftly from a large budget deficit in the early 1990s to a large surplus at the end of the decade, and back to an even larger deficit a few years later. The shift from deficit to surplus was abetted by fiscal rules that constrained spending increases and tax reductions. But once the surplus arrived, politicians contrived to spend more and tax less than the rules permitted. The rules remained the same but political behaviour did not. In the American case, political will to live by the rules was broken by surpluses; in other countries it has been broken by deficits. This has been Germany's fate over the past decade. In the run-up to the Euro, it insisted on tough fiscal rules, but it was the first country to be castigated by the European Commission for breaching the rules. The financial burden of unification and protracted economic weakness broke Germany's traditional adherence to fiscal discipline.

Sometimes the sequence is reversed and a country that once lacked the political capacity to discipline its finances acquires the will to do so. The Netherlands once was deemed to be hopelessly mired in deficits; it was the nesting ground of the "Dutch Disease", a term that referred to an affluent country that lives well beyond its means. Over the past decade, however, the country has maintained one of the strongest fiscal positions in Europe and it is now celebrated for the "Dutch Model", structural reforms that corrected many of the imbalances in the economy and stabilised the government's finances. For the most part, the Netherlands acted on its own initiative, not because it was pressured by the Maastricht Treaty or Stability Pact rules. As mentioned earlier, the Netherlands perfected the coalition agreement as a powerful means of staying on course during the full term of each government. What mattered was not that each incoming government negotiated a coalition agreement, but that it took the terms seriously and produced annual budgets consistent with the agreed fiscal targets. The government of the day did not relax fiscal discipline during good economic times. It did not use the surge in tax collections to finance programme expansions that would burden future budgets. One can explain the success story of the Netherlands as due to either new fiscal institutions or to political resolve. But the Dutch experience makes it clear that without sustained political commitment, renewed by five consecutive governments over a span of two decades, coalition agreements would have been mere scraps of paper, stringent budget rules would have been violated, and fiscal outcomes would have been much less favourable than they actually were.

Political commitment is especially important in today's budgetary environment, which differs in at least two critical ways from past conditions. One difference is the prominence of mandatory accounts in national finance; the other is the activism and influence of interest groups. These developments have combined to make it much more difficult to maintain fiscal discipline, regardless of the political orientation of the party (or parties) in power. In the past, politicians had an easier job acting in a disciplined manner because almost all spending was discretionary and budgeting was a closed process in which interest groups had relatively little influence. Politicians did not need explicit fiscal rules to be disciplined; nowadays, they need rules, but the rules may not suffice.

When spending is dominated by entitlements, increases automatically result from demographic and economic trends; they do not require an explicit budget decision. In contrast to traditional budgeting, therefore, in which the normal role of politicians is to allocate increases, a budget of entitlements may require them to allocate cutbacks by disentitling beneficiaries to payments prescribed in law. This is a much more onerous budgetary chore, one that few politicians are temperamentally suited for. Fiscal rules might not ease their plight. However, with entitlement spending rising automatically, it does not suffice for government to resist demands for more money; it must also roll back these increases.

Entitlements make fiscal rules necessary; they may also make them ineffective. The ultimate test of fiscal rules may be their impact on entitlements. If these rules are implemented by political leaders with determination to curtail entitlements, they will be effective. If, however, governments prove unable or unwilling to challenge entitlements, fiscal rules will not make much of a difference.

The political task of bringing entitlements within the ambit of budget control has been greatly complicated by the vigilance of organised groups in protecting their interests. Not only do contemporary democracies have many more active groups than was the case one or two generations ago, but many groups have greater access to budget-makers than they once did. While most national budgets are not yet fully open, they are much more transparent than before, and the process is more exposed to outside influence. Contemporary politicians often are cross-pressured by budget guardians who want them to take the steps necessary to uphold fiscal rules and interest groups that oppose the curtailment of benefits. When the rule enforcers are outside the political system, as is the case in the EU and IMF, they may be insensitive to the political difficulties facing the government. In some countries, the only way for the fiscal rules to survive is for the government to put its own continuation on the line.

4.1. Economic cycles

The political cost of adhering to fiscal rules is largely a function of economic conditions. The task is reasonably easy when the economy co-operates, challenging when it does not. Can government maintain fiscal discipline under adverse economic conditions? Judging from experience in developed countries, the answer is yes and No. Yes, in terms of discretionary fiscal stimulus; no, in terms of the impact of built-in stabilisers on key budget aggregates. During the post-war period, it was common for governments in developed countries to counter economic weakness by cutting taxes or raising expenditures. The enlarged budget deficit was justified on the ground that it would stimulate economic recovery. Developed countries generally do not actively manage the economy this way anymore. Many have found that the added costs (such as higher interest payments) approved when the economy is weak continue to burden the budget when the economy recovers. Fiscal rules offer additional deterrence against undertaking stimulative budget action when the deficit is rising because of economic weakness.

But if governments' enthusiasm for discretionary policy has been dampened, built-in stabilisers still register on budget outcomes. An automatic drop in revenue or rise in social benefits can produce large, unplanned deficits in excess of the levels permitted by fiscal rules. A government can try to stay on fiscal course by raising taxes or trimming payments, but it generally is inopportune to do so when the economy is stagnant. Governments that stick to fiscal rules in these circumstances may unwittingly deepen or prolong the recession and still fall short of what is demanded by the rules. Developing and transitional countries also face unstable budgets during economic difficulty, but it is during these times that they are most dependent on external aid and may therefore be subject to conditionalities imposed by international organisations. These countries also risk capital flight, illiquid financial institutions, and political instability. To the extent they are dependent on capital inflows to stabilise or develop their economies, these countries may be compelled to constrain public spending or raise taxes in the hope that fiscal discipline will be rewarded by long-term improvement in economic conditions.

The status of fiscal rules when the economy is weak has roiled the European Union. Several countries have been cautioned by Brussels that their budget path violates the Maastricht criteria and the Stability Pact and that corrective policy changes are necessary to bring the deficit within acceptable limits. At one point, the President of the European Commission was quoted as characterising the EU's rigid rules as "stupid" because they do not adequately allow for slippage when the economy is weak. Some member countries have suggested that a review of the EU's fiscal rules would be appropriate. The issue has not yet been resolved, and member countries may have difficulty devising a substitute rule that is both disciplined and accommodating. Moreover, the problem of what to do during unfavourable economic times will not go away even if the rules are relaxed. The only fiscal rules that do not generate economic problems are those that have no teeth. But rules that do constrain government action – which, after all, is the purpose of having rules – can neither be ignored not fulfilled during bad times.

4.2. Economic shocks

Shocks are far more destabilising than cyclical downturns, for they jar government off its fiscal course and the after-effects linger for an extended period. When the shock is truly severe, government may never have the option of restoring the *status quo*, and it may face pressure for fundamental political or economic change. Although the line between shocks and cyclical disturbances is difficult to draw, the distinction between the two is useful, for there is no prospect of a country upholding fiscal norms when the underpinnings of the economy have been uprooted. Shocks may be due to war or the collapse of political order, or to any other event that causes profound, lasting transformation in a country's economic structure. Arguably, the drive to unify the country has been a shock for Germany, for though it began as a bold decision to fully integrate the Eastern states into national economic and political systems, the effort has been far more difficult, costly and time-consuming than had been expected at the outset. Large deficits, mountains of public debt, and the uprooting of Germany's fiscal prudence have been legacies of unification.

Shocks are much more prevalent in developing and emerging market countries that have inadequate slack to counter economic adversity. In developing countries, a steep drop in commodity prices or exchange rates or sudden capital flight can unhinge the government's fiscal plans. Yet, it is when budget deficits are spiralling out of control that these countries are most in need of the discipline that fiscal rules bring. It is when things are falling apart that a disciplined approach to public finance is most urgent. In these circumstances, constraining expenditures and generating more tax revenue will not produce fiscal balance, nor will these moves assure that the government achieves pre-shock targets. But they may moderate and shorten the after-effects on political and economic order.

In dealing with shocks or cyclical problems, it is essential to distinguish between fiscal balance and fiscal discipline. Losing the former may be unavoidable, but holding on to the latter is feasible, even under stressful conditions. It is in this predicament that well-developed fiscal rules that focus on sustainability of the country's fiscal position may be most valuable. But while the feasibility of rules usually is raised in periods of economic weakness, this writer is persuaded that the true test of rules occurs in good times when economic plenitude spurs voters and interest groups to demand more of government and politicians respond with tax cuts or spending increases. The seeds of most fiscal collapses are sown during good times when the possibility that resources will not be as plentiful in the future and that the government's fiscal path is not sustainable is crowded out by the exuberant expectation that economic growth, buoyant tax collections, and other favourable conditions will continue endlessly. When they do not, the revenue forgone and the spending commitments made during spurts of growth generate fiscal turmoil when the government's coffers are empty and it lacks the means to fulfil its promises.

Some governments try to assure that they will be able to make it through periods of weakness by setting aside money in stabilisation or "rainy day" funds when their economy is strong. These funds rarely accumulate sufficient resources to cover shortfalls due to recession or shock. The reason for this is that government decides how much to set aside in these funds in terms of what is left over after taxes have been cut or programmes expanded. The amount is inadequate because it is determined in the context of today's politics, not tomorrow's need. In other words, stabilisation funds are not sufficiently counter-cyclical, nor do they take account of the sustainability of the government's financial policy.

Counter-cyclical policy is an old concept that has not been heard much in recent times. This concept is worth reviving, if only because fiscal rules may strongly encourage pro-cyclical behaviour. The Maastricht criteria and the Stability Pact rules open the door for government to tax less and spend more in good times and to do the reverse when the economy weakens. Even though the rules permit the fiscal imbalance to widen when the economy is weak, the adjustment is too small to accommodate the fiscal swings resulting from cyclical changes in economic performance. To put the matter bluntly, a government that is permitted to run a 1-3% deficit when the economy is strong will not be able to hold the line at 3% when the economy weakens. A government that wants to live by the rules through all the ups and downs of an economic cycle must have rules that produce surpluses when the economy is strong.

How big should the surplus be? Or to put the question differently, how much of a projected surplus should be surrendered through tax cuts or spending increases that will persist when the surplus vanishes? Here's where the concept of sustainability can contribute to counter-cyclical policy. Government should not increase spending or reduce revenue in good times that it will not be able to afford in bad times. In measuring sustainability, government should engage in sensitivity or risk analysis by estimating whether it would be able to afford the loss of revenue or the higher expenditures under adverse economic scenarios. In my view, fiscal rules should be set with this counter-cyclical, sustainable objective in mind.

This approach would counter the pro-cyclical, expansionary bias in fiscal rules and put public finance on a prudent, sustainable course. Fiscal rules should have most of their bite when the economy is strong; if they do not, they may do much harm and little good when the economy is weak.

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