

How Did Fiscal Rules Hold Up in the Commodity Price Crash?

David Mihalyi and Liliana Fernández

Fiscal rules—permanent quantitative constraints on government finances—are an important tool to help mitigate the macroeconomic challenges associated with managing natural resource revenues. They can act as a commitment mechanism, binding successive governments to a long-term budgetary ceiling or target and helping politicians fight the urge to overspend during election years. They can also help prevent fiscal crises and can encourage governments to save or pay down debt in good times so that they have fiscal space to spend during recessions, an issue of vital importance in natural resource-dependent countries.

Our full-length paper reviews national-level fiscal rules in countries assessed in the Resource Governance Index. Out of the 79 countries covered by the index, 34 have at least one fiscal rule in place. Countries with stronger resource governance are much more likely to also have a fiscal rule. The most common types of rules are debt ceilings and various types of budget balance targets.

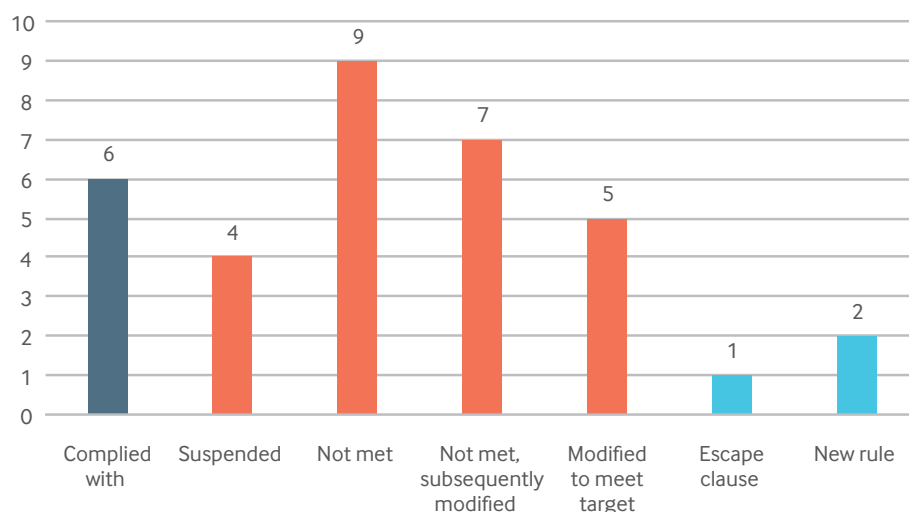


Figure 1. Number of Resource Governance Index countries in compliance with fiscal rules in 2015 and 2016

Our review of compliance with fiscal rules in 2015 and 2016, the years directly following the commodity price crash, found that governments adhered fully to the rules in only six countries. (See Figure 1.) These are Botswana, Colombia, Indonesia, Liberia, Malaysia and Norway. In 25 cases, governments either suspended, modified or disregarded their rules. Governments breached rules in a wide range of countries, rich and poor, including Brazil, Chad and the U.K. Only one country, Peru, invoked a well-defined and justified escape clause, rather than modifying or breaking its fiscal rule. Two countries, Uganda and Tanzania, adopted their rules in 2015, so are only beginning implementation now. This means that governments complied with rules in roughly one in five country cases.

Some key lessons emerge from the very low level of compliance observed. First, many of the fiscal rules reviewed are not appropriately designed. For example, in many resource-dependent countries, the fiscal rules allowed expenditures to rise pro-cyclically during the boom, and then forced abrupt fiscal adjustments (e.g., Nigeria). Also, some rules (especially debt ceilings) were easy to accommodate and made compliance trivial (e.g., Liberia), while other rules prove very constraining given the shock precipitated by the commodity price drop (e.g., Kyrgyz Republic). Few governments have well-defined escape clauses, such as Peru, to evoke when faced with the commodity price shock.

Second, a number of countries did not follow their rules in good times either (e.g., CEMAC members), or used questionable practices to modify or disregard their fiscal rules (e.g., Ecuador). Compliance was especially weak in countries with limited or no national oversight of fiscal rules. No countries complied with supranational rules in the period reviewed.

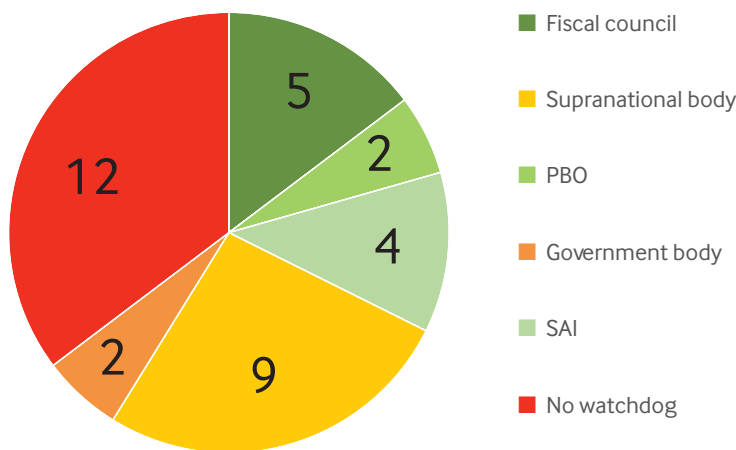


Figure 2. Oversight institutions monitoring fiscal rules compliance across Resource Governance Index countries

Only a third of the countries with fiscal rules have a national oversight organization monitoring observance of these rules. (See Figure 2.) The most common are supreme audit institutions, fiscal councils or parliamentary budget offices. These institutions vary considerably in their independence and capacities, and not all of them produce reports that clearly show whether governments are observing the rules.

Across the countries we reviewed, there is often limited and only technical public information on fiscal rules and whether governments are complying with them. The lack of public engagement on fiscal issues ultimately makes them easy for governments to discard. This limits the effectiveness of these long-term commitments, which governments often sacrifice in favor of short-term political gains.

Based on the country experiences reviewed and the evidence from the literature reviewed, we recommend that:

- 1 Resource-dependent governments or new producers without fiscal rules should consider adopting them as a useful tool to promote fiscal sustainability and promote counter-cyclical spending. When doing so, they should tailor them to their resource endowments, economics situation and countries' governance contexts; there is no one-size-fits-all solution for fiscal rules.
- 2 Fiscal rules in resource-dependent countries should generally be strongly counter-cyclical. This enables countries to avoid boom and busts cycles, and will yield rules that governments are more likely follow. To do this, governments must avoid overall budget balance rules; or just setting a debt ceiling as a percentage GDP. Expenditure rules, non-resource balance or structural balance rules are generally more appropriate and targets should be set in absolute numbers or as a percentage of non-resource GDP.
- 3 Fiscal rules should be simple to calculate and easy to monitor and enforce, especially in countries where there is no established oversight actor with strong technical capacity. All fiscal rules need good public financial management and fiscal transparency. Only countries with exceptionally strong capacity and institutional independence should use structural balance rules.
- 4 Governments should incorporate reasonable and well-specified escape clauses into fiscal rules. These could explicitly include commodity shocks over a certain size. However, if governments do not specify these escape clauses or detail operational guidance, they can become a source of ambiguity and abuse, undermine the rule's credibility and raise questions of accountability.
- 5 Governments should consider adopting supranational fiscal rules into domestic law and establishing domestic oversight of these rules, given the limited compliance with supranational fiscal rules.
- 6 Strong political support is key for success. Governments should build consensus around fiscal rule adoption or modification. They can do this by requiring large parliamentary majorities for major changes, seeking support from multiple political parties and engaging with the public when designing the fiscal rule.
- 7 Soft penalties that require public hearings or additional reporting when the rules are violated may be useful for encouraging compliance. Oversight bodies can use harsher penalties more severe violations, such as trying to circumvent procedural aspects of the rule: unauthorized borrowing, off-budget spending or fraudulent statistics relating to numerical targets.

-
- 8 Government oversight organizations should play an important role in bringing accountability to public finances. They should have the independence, legal mandate and resources they need to monitor fiscal rule compliance routinely. Attaching them to parliament might be a fruitful avenue in countries with low capacity but strong parliamentary tradition, rather than establishing new institutions.
 - 9 Fiscal rules need strong awareness and oversight from followers of public policy. Governments could do more in informing citizens about the rules through the budgetary process (e.g., citizen's budget). The media, parliament, civil society organizations, think tanks, financial sector institutions and credit rating agencies should also play a role in monitoring the rules.
 - 10 The international community and economists/experts should do more to inform stakeholders as to why counter-cyclical and sustainable fiscal policy is key to growth and diversification. More effort should go into supporting implementation rather than codifying new fiscal rules.