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Challenges and Reform Opportunities for Emerging Markets

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Abstract[*]

Fiscal rules have gained popularity as tools to strengthen debt sustainability by constraining policy discretion. However, their track record in the case of emerging markets is mixed, as setting up a fiscal rule has been no guarantee of debt stabilization. International experience and empirical evidence regarding the working of fiscal rules suggest that paying attention to the quality of rule design, the mechanisms behind better compliance, forward guidance on return to the rule, and the impacts on different dimensions of public finances (particularly spending composition) is key to enhancing fiscal rule performance. In addition, fiscal rules should be complemented with credible medium-term fiscal frameworks and independent fiscal councils that together set relevant policy anchors to support effectively the goal of safeguarding fiscal sustainability.

JEL classifications: E61, H54, H63
Keywords: Fiscal rules, Debt sustainability, Emerging markets

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1. Introduction

Fiscal rules have become a widespread policy tool. They started to be implemented mostly in advanced economies in the 1990s and have gained traction since, extending to emerging markets (EMEs). The surge in debt after the global financial crisis in 2008 has accelerated fiscal rule adoption and prompted changes in their design. The global recession associated with policy responses to the COVID-19 pandemic triggered the suspension of rules, but as countries recover from the pandemic, governments are taking the opportunity to rethink and reform their rules-based fiscal frameworks once again.

Fiscal rules impose a long-lasting constraint on fiscal policy by introducing numerical limits on budgetary aggregates (Kopits and Symansky, 1998). If governments followed the textbook prescription of running fiscal deficits during bad times and reverting to surpluses during booms, then rules would not be needed. In practice, however, fiscal deficits often accumulate when the economy is growing, and deficits generated during recessions are not usually compensated by surpluses during booms. A key reason is that policymakers often have incentives to pursue policies that increase budget deficits, leading to debt accumulation over time. For example, when making budget decisions, lawmakers usually draw upon a common pool of resources financed from a general tax fund to generate concentrated, specific, public spending (Hallerberg et al., 2009). During the budget-making process, each legislator may wish to increase expenditures that benefit their constituency without internalizing the costs on others. Consequently, overall spending is higher than under full internalization.[1] Persistent fiscal deficits accumulate into growing public debt stocks, which can eventually threaten debt sustainability.

The prevalence of the "deficit bias" provides a rationale for introducing institutional mechanisms to contain it. Fiscal rules are one policy tool that was designed with the purpose of constraining policy discretion and, therefore, of strengthening debt sustainability.[2] Adopters expect that by limiting discretion through a rule-based framework, fiscal policy will become more

[1] This is the well-known common pool problem that arises when there are several policymakers (ministers, parties, lobby groups) involved in setting the budget, as formalized by scholars in the political economy tradition, such as Velasco (2000), among others.

[2] This paper focuses on numerical fiscal rules, a key type of budget institution. More broadly, budget institutions affect fiscal policy outcomes by either imposing restrictions on the results of the budget process (fiscal or numerical rules), by distributing agenda power and responsibilities among the various actors that participate in budget negotiations (procedural rules), or by increasing access and quality of information (transparency rules). See Alesina and Perotti (1999).

transparent and predictable, and therefore, debt-to-GDP ratios will not grow over time. In addition, fiscal rules can serve other purposes, such as mitigating the procyclical bias in fiscal policy (e.g., tax rate hikes in recessions, or large public spending expansions during periods of high economic growth). There are often tradeoffs between some of these objectives, and fiscal rule design can contribute to striking a balance between them (Eyraud et al., 2018; Ter-Minassian 2021).

This paper discusses selected issues related to the working of fiscal rules in emerging markets.[3] It offers stylized facts on the adoption and key design features of numerical fiscal rules. It then compares fiscal performance between rules adopters and non-adopters in terms of public debt accumulation. The document ends with a discussion on the key challenges that emerge from the implementation of rules-based fiscal frameworks in emerging markets and on policy options to address them.

Our main message is that, despite the relative popularity of fiscal rules, they are no panacea for improving fiscal performance. Critical areas to improve fiscal rules can be found in the quality of rule design, the mechanisms behind better compliance, forward guidance on return to the rule, and the impacts on different dimensions of public finances (particularly spending composition). While certain design features of fiscal rules can help in moderating the "deficit bias," their effectiveness is often hindered by a lack of explicit or relevant policy anchors, low compliance, and lax guidance on how compliance or return to the rules will be achieved in the aftermath of negative shocks. These challenges call for reforming rules-based fiscal frameworks.

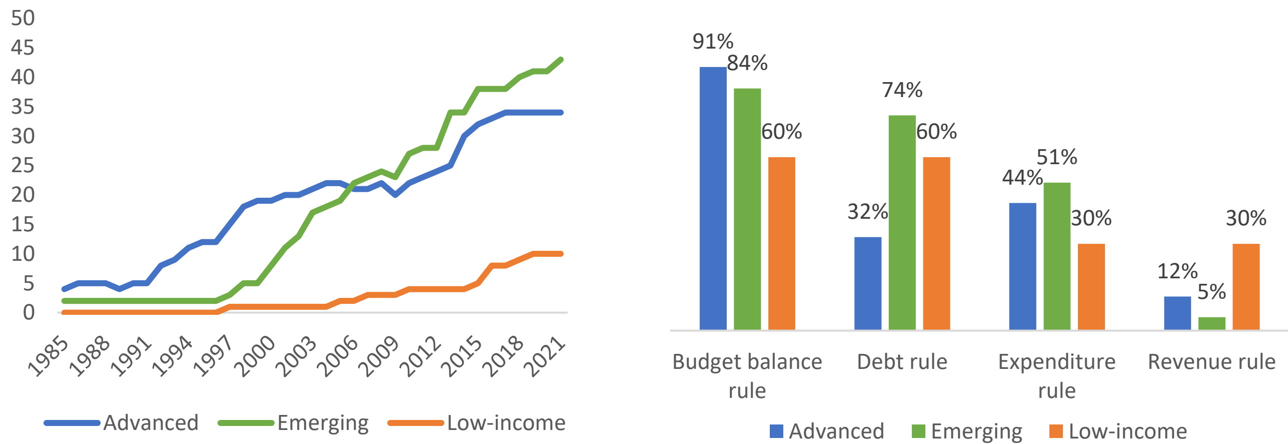
2. Stylized Facts about Fiscal Rules in Emerging Markets

Fiscal rules have become an increasingly popular policy tool. While advanced economies pioneered their use in the 1990s, fiscal rules in emerging economies and low-income countries started gaining traction in the 2000s. By 2021, 106 countries had adopted rule-based fiscal frameworks. Of those, 34 developed, 43 emerging and 10 low-income countries had at least one *national* fiscal rule in place (Figure 1a).[4]

[3] In doing so, we do not offer a comprehensive review of the literature on fiscal rules bur rather draw on some its main insights to shed light on the actual functioning of fiscal rules across emerging economies. For reviews of the vast theoretical and empirical literature on fiscal rules, see for example, Yared (2019), Alesina and Passalacqua (2016) and Wyplosz (2013).

[4] The scope of this document considers *nationa*l fiscal rules. Supranational rules have been adopted in the European Union (EU), Eastern Caribbean Currency Union (ECCU), East African Monetary Union (EAMU), West African Economic and Monetary Union (WAEMU), and Central African Economic and Monetary Community (CEMAC).

Figure 1a. Countries with National Fiscal rules **Figure 1b. Share of Countries with Each Type of Rule**



Note: Authors' compilation based on IMF Fiscal Rules Dataset: 1985–2021.

There are different types of fiscal rules, depending on the budgetary aggregate that is subject to control.[5] Budget balance rules (BBR) are the most common (see Figure 1b). Among emerging economies, debt ceiling or anchor rules (DR) are also common, much more than in developed economies. Expenditure rules (ER), commonly imposed as limits on expenditure growth, are also popular in both emerging and developing economies.[6] Importantly, different rules are often used in combination. While in advanced economies BBR are usually combined with ER, the most frequent combination in developing countries is DR with BBR. Expenditure rules are rarely used on their own, but typically combined with BBR or DR across emerging economies.

Some relevant features of rules include the following:

- *Statutory basis*: National fiscal rules can be stated as a government commitment or they can be written into law, or even in the Constitution.

[5] Debt rules set a limit on the stock of public debt, expenditure rules can limit the growth of total or certain categories of public spending, balanced budget rules can apply to the observed fiscal balance or the cyclically adjusted or structural balance and impose caps on the size of deficit, revenue rules can be set as ceilings to prevent excessive tax burdens or floors to encourage revenue collection (Corbacho and Ter-Minassian, 2013).

[6] Revenue based rules are barely used in emerging markets.

- *Institutional coverage*: Some rules cover only the fiscal operations of central governments. Other rules cover other levels of governments and even public sector entities such as nonfinancial enterprises.[7]
- *Monitoring and enforcement mechanisms*: While some rules foresee formal enforcement mechanisms, such as those triggering financial sanctions in case of noncompliance, others do not stipulate formal sanctions, relying only on reputational costs. To raise such reputational costs, fiscal rules are often accompanied by supporting institutions such as autonomous fiscal agencies or councils that verify whether rules are being complied with.
- *Mechanisms to accommodate shocks*: Flexibility provisions in fiscal rules allow fiscal policy to accommodate unexpected shocks and involve different features. Clearly defined escape clauses refer to exceptional circumstances that merit the suspension of the fiscal rule, such as natural disasters or severe recessions.[8] Some rules can be defined in cyclically adjusted terms (i.e., that account for the output cycle and other relevant exogenous influences, such as commodity price developments). Public investment-friendly provisions refer to rules that exclude capital expenditures from the numerical targets imposed on fiscal aggregates.

Table 1 presents an overview of the main features of fiscal rules in selected emerging markets.

[7] Fiscal rules that target narrow fiscal indicators run the risk of being made ineffective by moving operations to parts of the public sector not covered by the fiscal rule

[8] For instance, an escape clause should have i) a limited and clearly defined set of events triggering the operation of the clause, ii) time limits on how long fiscal policy can deviate from the targets in the rule, and iii) a requirement for fiscal policy to return to the targets after the operation of the escape clause is terminated and possibly offset the accumulated deviations.

Table 1. National Fiscal Rules in Selected Emerging Market Countries, 2021

Region	Country	Type of rule			Year[1]	Coverage[1]	Legal basis[1]	Flexibility features		
		ER	BBR	DR				Escape clause[2]	Structural target	Investment protection
Latin America and the Caribbean	Brazil	✓			2016	GG	C			
	Chile		✓	✓	2001/2022	CG	S		✓	
	Colombia		✓	✓	2011/2021	CG	S	✓	✓	
	Jamaica		✓	✓	2010	GG	S	✓		
	Peru	✓	✓	✓	2000/2016	CG	S	✓		
Europe	Bulgaria	✓	✓	✓	2006/2003	GG	S	✓		✓
	Croatia	✓	✓	✓	2012/2009	GG	S	✓	✓	✓
	Poland	✓	✓	✓	2011/2006/ 1997	GG	S/C	✓		
	Romania		✓	✓	2013	GG	S		✓	
Asia and Pacific	India		✓	✓	2004/2018	CG/GG	S	✓		
	Malaysia		✓	✓	1985	CG	S			✓
	Thailand	✓		✓	2018	GG	S/PC			✓
Middle East	Azerbaijan	✓		✓	2019	GG	S	✓		
	Georgia		✓	✓	2013	GG	C	✓		
Africa	Botswana	✓	✓	✓	2003/2005	CG	PC/S			
	Mauritius			✓	2001	GG	CA	✓		

Source: Authors'compilation based on IMF Fiscal Rules Dataset: 1985–2021 and national sources.
Notes: ER- expenditure rule; RR-revenue rule; BBR-budget balance rule; DR-debt rule; GG-general government; CG-central government; C-constitutional; S-statutory; CA-coalition agreement; PA-political agreement. [1] Year of introduction. When rules differ, implementation year, coverage and legal basis are given for ER, RR, BBR, DR respectively. [2]Marked if at least one rule has an escape clause.

3. Fiscal Rules and Public Debt Performance

Fiscal rules have been growing in popularity, but how effective have they been in stabilizing debt-to-GDP ratios?[9] We tackle this question by analyzing a large panel dataset covering the period 2000-2019, and comparing the impact of *national* fiscal rules on debt performance.[10] For each country, we separate periods with no fiscal rule from periods of at least one national fiscal rule in place and analyze three characteristics: average yearly growth rate of debt-to-GDP ratios (in percent), average yearly changes in debt-to-GDP ratios (in points of GDP), and the volatility of the debt-to-GDP ratio throughout each period. Countries with no fiscal rules throughout the whole sample period are also included in the comparison group.

[9] The effectiveness of fiscal rules in shaping fiscal outcomes has been studied extensively on both national, subnational, and supranational level (See Heinemann et al., 2018, for a meta-analysis of the empirical literature). Given that the primary focus of fiscal rules is fiscal sustainability, this analysis concentrates exclusively on debt performance. However, as shown later in this document, fiscal rules can have an impact on other relevant dimensions of fiscal policy, such as cyclicality, and on the composition of public expenditures.
[10] Highly Indebted Poor Countries (HIPC) are excluded from the sample as they underwent significant debt relief processes, which obscures the impact of fiscal rules on debt performance.

Results are presented in Figure 2a with a box plot and reported means for each of the three attributes described above. At first glance, there does not seem to be much difference in average debt growth between periods of no fiscal rule and periods with at least one rule (Figure 2a.1). As a matter of fact, average debt growth for countries with at least one rule is larger than for countries with no rule. Something similar occurs for the average change in debt expressed in points of GDP (Figure 2a.2). There is some reduction in debt growth volatility when periods of fiscal rule are in place (Figure 2a.3). However, mean tests do not account for significant differences in most of these dimensions.

How can this be reconciled with perceptions of better performance with fiscal rule implementation? Figure 2b provides an answer: debt performance in all three dimensions improves with better quality of fiscal rules (see panels 2b.1 through 2b.3). Considering an index that captures a continuous measure of fiscal rule strength based on *de jure* characteristics, periods of fiscal rule implementation are divided into high, medium, and low quality. The quality index captures relevant design features of fiscal rules: broad institutional coverage, statutory or legal basis, existence of supporting monitoring arrangements, enforcement procedures, and flexibility mechanisms to respond to shocks.[11]

Significant differences are uncovered once design quality is considered, particularly when considering differences between low and high levels of rule quality (see Table 2).[12] Average debt-to-GDP growth falls by more than 3 percentage points with strong quality fiscal rules, compared to low quality fiscal rules. Similarly, the average debt change falls by almost 1.4 points of GDP per year with strong quality rules relative to low-quality rules. Moreover, volatility in debt-to-GDP growth rates falls under strong quality rules to one third of the volatility under low quality rules.

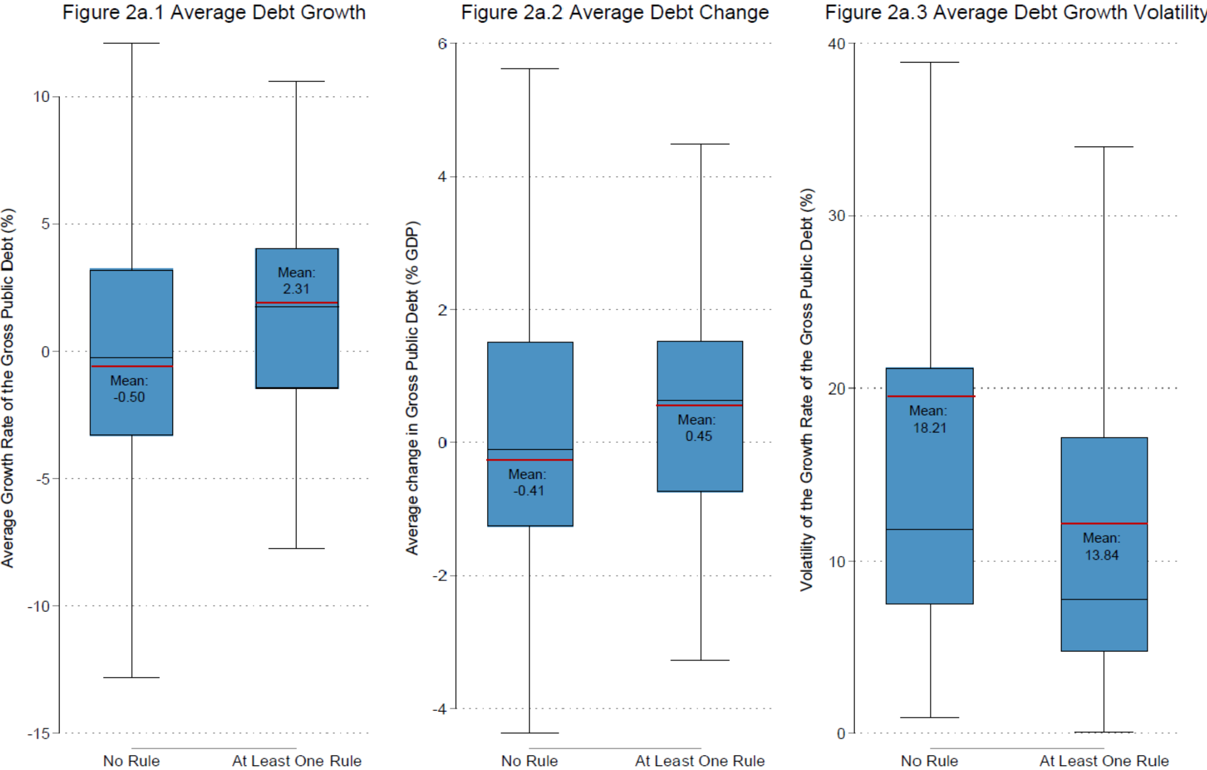
A conclusion emerging from this empirical analysis is that fiscal rule adoption is not per se a guarantee of success when it comes to stabilizing—or even reducing—debt-to-GDP ratios. In other words, thinking that fiscal sustainability will be dealt with by only imposing any type of fiscal rule is a false premise. Debt sustainability improves when the quality of fiscal rules is considered and enhanced sufficiently. Although this analysis does not provide proof of causation, it suggests that debt sustainability and the quality of fiscal rules go hand in hand. The next section

[11] See Schaechter et al. (2012) for details.

[12] These results are consistent with previous studies on the relationship between the quality of rules and fiscal performance using cross-country regressions (Andrián et al., 2023; Caselli and Reynaud, 2020).

will cover aspects of fiscal rule design, compliance and guidance that may work in raising the quality of fiscal rules.

Figure 2a. Fiscal Rules and Debt Performance



Source: Authors' compilation using IMF WEO data and IMF fiscal rule database.
Note: Heavily Indebted Poor Countries (HIPCs) are excluded. Only national fiscal rules are analyzed (supranational rules are excluded). Means shown in red.

Figure 2b. Fiscal Rule Quality and Debt Performance

Source: Authors' compilation IMF WEO data and IMF fiscal rule database.
Note: Heavily Indebted Poor Countries (HIPCs) are excluded. Only national fiscal rules are analyzed (supranational rules are excluded). Means shown in red.

Table 2. Mean Tests of Differences between Strong and Low Fiscal Rule Quality

Variable	Fiscal Rule Quality: Minimum (A)	Fiscal Rule Quality: Strong (B)	Difference (A) - (B)
Average Growth of Debt (%)	2.4673	-0.7654	3.2327*
Observations	20	36	
Average Change of Debt (% GDP)	0.7002	-0.6727	1.3729**
Observations	20	36	
Average Volatility of the Growth of Debt (%)	15.8557	5.9517	9.9040***
Observations	19	36	

Source: Authors' compilation using IMF WEO and IMF fiscal ruled data.
* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$.
Note: Heavily Indebted Poor Countries (HIPCs) excluded. Supranational rules excluded.

4. Challenges in the Implementation of Fiscal Rules and Reform Opportunities

While the specific motivations to adopt fiscal rules vary from country to country, and the timing of adoption is driven by idiosyncratic factors, the overarching objective of adopters is to strengthen governments' commitment to macro-economically sound and fiscally sustainable policies and thus improve creditworthiness. Still, the devil is in the details when it comes to implementing a credible rule-based fiscal framework, and the track record shows a mixed performance in terms of limiting public debt growth.

International experience and empirical evidence regarding fiscal rule implementation over the last decades suggest the following elements must be considered for successful performance: quality of rule design, the mechanisms behind better compliance, forward guidance on return to the rule, and the impacts on different dimensions of public finances (particularly spending composition). We cover each of these issues and propose reform opportunities to address them.

4.1 Getting Fiscal Rule Design Right

"First-generation" fiscal rules introduced in the 1990s and early 2000s prioritized simplicity. Therefore, they were anchored on nominal budget balances that are easy to verify and understand. However, such rules came under scrutiny for limiting policymakers' ability to respond to unexpected shocks. They also facilitated procyclical policy responses because they did not require saving revenue windfalls during booms and did not allow deficits (even when financeable) during recessions (Ter-Minassian, 2021). In response to these concerns, several countries started introducing rules that consider the output cycle and other relevant exogenous influences, such as commodity prices.[13]

Colombia and Chile provide a case in point on the challenges of implementing more complex fiscal rules in emerging markets. Both adopted structural balance rules and, while successful in complying with the rules, they were unable to stabilize debt levels. In Colombia, a fiscal rule was implemented in 2011 with the objectives of improving the country's credit rating and reducing fiscal policy procyclicality. The rule at inception targeted a declining path for the structural primary fiscal deficit between 2012 and 2022. From then on, the structural primary

[13] Fiscal rule features such as cyclically adjusted targets and well-defined escape clauses have been shown to constrain procyclical behavior (Ardanaz et al. 2021a; Guerguil et al., 2017; Bova et al., 2014).

deficit would not exceed 1 percent of GDP. The estimation of the structural balance hinged on two variables: potential GDP growth, and the long run price of oil, which is Colombia's main commodity export. Given that the two variables are unobservable, then assumptions about their respective values were used to compute the structural fiscal balance. Ex post, those assumptions turned out to be exceedingly optimistic and as a result, fiscal policy was on average significantly more expansionary than what it should have been, and the rule did not prevent debt from growing during the period as originally intended. Moreover, fiscal policy remained procyclical even after the rule was implemented (Arbeláez et al., 2021).

Chile adopted a fiscal rule in 2001 that targeted a structural fiscal balance. While in the case of Chile the estimation of the structural balance itself has been less biased than in Colombia, other features of the rule have proven to be problematic. One feature of the Chilean rule is that every administration can set its own target for the cyclically adjusted balance at the beginning of a four-year term. This has encouraged successive administrations to change the target as needed to pursue more expansionary fiscal policies during crises, without internalizing the behavior of their predecessors. Given that there are no specified mechanisms to offset deviations, or to reverse targets once the crisis ended, the fiscal rule itself became a less binding constraint on fiscal policy over time. As a result, public debt increased from about 10 percent of GDP in 2010 to almost 30 percent by end 2019, despite compliance with the fiscal rule (Fuentes et al., 2021).

The cases of Colombia and Chile illustrate how difficult it is to generate and maintain countercyclical buffers and stabilize debt-to-GDP ratios even under sophisticated rules-based fiscal frameworks. In particular, the cases illustrate that implementing a fiscal rule is not sufficient to prevent debt-to-GDP levels from growing, even when the rules target structural fiscal balances and those targets are met. The consequence of an increasing debt-to-GDP ratio is that, if not eventually stabilized or reversed, it could threaten fiscal sustainability—indeed the main motivation for implementing a fiscal rule in the first place.

Reform options to address this challenge include incorporating a medium-term debt anchor as a key policy objective or target for fiscal rules. Setting the ceiling of the fiscal anchor requires identifying a maximum debt threshold for sustainability and calibrating a "prudent" debt level so that there is a safety margin or buffer ensuring that debt remains below the maximum limit with high probability, even in the presence of adverse shocks (Caselli et al., 2022; IMF, 2018). Once the debt ceiling is obtained, operational fiscal rule targets should be defined to gradually guide

public debt to its desired level. For example, the rule should incorporate how structural fiscal balance targets should respond according to the distance between current debt levels and the debt limit, setting more ambitious targets the closer current debt is to the limit. Both Chile and Colombia have recently enhanced their fiscal frameworks along these lines, by providing a feedback mechanism from the stock of public debt to the cyclically adjusted fiscal balance to prevent debt from growing to levels that could undermine fiscal sustainability (Betancur et al., 2022; Ministerio de Hacienda, 2022).

4.2 Beyond Design: Compliance Problems and Forward Guidance

Even well-designed fiscal rules will turn out ineffective in improving fiscal outcomes if they are consistently violated. While previous research on fiscal rule effectiveness has traditionally looked at the impact of *de jure* features of fiscal rules, there is emerging evidence emphasizing the relevance of compliance behavior. Overall, the evidence shows that deviations of fiscal outturns from targets are common (Davoodi et al., 2022a; Blanco et al., 2020). For example, during the years preceding the pandemic, more than half of emerging market and low-income countries with BBRs saw their deficits exceed the rule limits, with the median deviation exceeding 2 percent of GDP (Davoodi et al., 2022a). More specifically, in a sample of Latin American economies, average compliance with some type of rules was as low as 30 percent, meaning that countries are compliant less than a third of the time (Valencia and Ulloa-Suárez, 2022).

While some rules include formal sanctions in cases of non-compliance, these are of limited effectiveness when political incentives are not aligned with fiscal discipline. This creates the need to build complementary institutions oriented toward strengthening enforcement. One such institution is fiscal councils, often non-partisan, technical bodies entrusted as a public finance watchdog to strengthen credibility of fiscal policies with a variety of mandates (IMF, 2013). Fiscal councils have mostly materialized in emerging markets in the aftermath of the global financial crisis of 2008/9, and they oversee compliance with fiscal rules, providing opinions on a government's fiscal performance and adherence to fiscal rules, among other tasks.[14] Their statements are public and, as such, may inflict some reputational costs for non-compliance. However, and in contrast to central banks—whose compliance with inflation targets has clear

[14] As of 2021, fiscal councils are operating in 21 emerging and low-income countries (Davoodi et al., 2022c).

implications for the general public—the consequences of government compliance with fiscal rules are less well understood. Thus, there is a limited disciplining effect. Moreover, oftentimes resources and technical capacity are not commensurate to the formal tasks assigned to fiscal councils in emerging markets, further limiting their effectiveness.[15] Strengthening the tools, resources, and staff available to councils in emerging markets for better enforcement would improve their role and the discipline on fiscal policy. Councils could, for example, participate in the preparation of forecasts and perhaps even intervene in recalibrating targets after a prolonged period of non-compliance.

Fiscal authorities could also benefit from another feature that has been adopted by central banks in recent times: "forward guidance." Market expectations are key when assessing the impact of policy, so guiding markets in terms of plans for fiscal policy can be useful for anchoring expectations. Such is the role of medium-term fiscal frameworks (MTFF), which extend the horizon for fiscal policymaking beyond the annual budgetary calendar. This is the tool which should identify and communicate the changes or reforms looking forward that will ensure a path to fiscal sustainability, and fiscal rules should translate such plans into policy actions through the budget process. A key pre-condition for MTFF to work is that they provide credible projections of main macroeconomic and fiscal variables, and it has been found that independent fiscal councils can play a role in reducing the size of forecast errors typically observed in fiscal policymaking (Caselli et al., 2022). Across emerging markets, while most fiscal councils oversee producing or assessing macroeconomic forecasts, the latter are not actually used during the budget process. Using independent forecasts provided by fiscal councils could help in strengthening the credibility of MTFF and a forward-looking orientation of fiscal policy.

4.3 Unintended Consequences for Public Spending Composition and Space to Enhance Flexibility Provisions

Fiscal rule compliance can have unintended and sometimes adverse consequences on public spending composition. For example, fiscal rules have come under scrutiny for unintendedly encouraging large cuts in public investment (Blanchard and Giavazzi, 2004). This is so because pressure to comply with aggregate numerical targets provides incentives for policymakers to cut

[15] Half of the fiscal councils in emerging and low-income countries lack budget safeguards to guarantee their operational independence.

spending items that may be less salient to voters but that may have long-term payoffs, such as productive public investment, the adjustment variable by default despite its large fiscal multiplier. Moreover, governments in emerging economies often tend to increase current expenditures above trend in the positive phase of the cycle, only to contract spending during the negative phase of the cycle using public investment, introducing a bias against the latter (Ardanaz and Izquierdo, 2022).[16]

In response to these concerns, countries have been incorporating flexible features into their fiscal frameworks. Specifically, those features consist of cyclically adjusted fiscal targets, well-defined escape clauses to address unanticipated shocks, and rules that exclude capital expenditures from numerical targets (Ardanaz et al., 2021a; Guerguil et al., 2017). While in 1995 only seven countries had adopted at least one such flexible feature (out of a total of 14 countries that had adopted a fiscal rule), by 2021 that figure had increased to 69 countries (i.e., 79 percent of the 87 countries that had adopted a national fiscal rule). Sometimes there is more than one flexible feature operating at the same time, generating overlaps in their use.

How do flexible features help in protecting public investment from budget cuts? Investment-friendly provisions do so directly because investment is largely exempted from the rule, thus protecting capital spending from excessive cuts during busts or fiscal adjustment episodes. Fiscal rules in which targets are defined in cyclically adjusted terms also allow policymakers to delink public spending (and thus, investment) from the cycle. The inclusion of well-defined escape clauses in fiscal rules contributes to enhancing the reaction of fiscal policy to unexpected shocks by allowing temporary deviations from the rules' targets. Those clauses give policymakers room to implement discretionary fiscal stimulus in response to shocks. Public investment is the quintessential example of such a countercyclical response. Thus, while achieving compliance with a rigid rule may require the compression of public investment during downturns, the activation of an escape clause could stimulate it. In fact, Ardanaz et al. (2021a) show that flexible fiscal rules have been instrumental in protecting public investment from budget cuts during fiscal consolidation episodes.[17] This is important, particularly during recessions, as it has been

[16] In addition to the business cycle, fiscal policy reacts to the electoral cycle, and evidence shows fiscal rules can contribute to tame the political budget cycle across both advanced and developing countries (Bonfatti and Forni, 2019; Eklou and Joanis, 2019).
[17] Moreover, Ardanaz et al. (2021b) show that penalizing public investment during fiscal adjustments is costly: a consolidation of 1 percent of GDP reduces output by up to 0.7 percent within three years of the consolidation's onset.

shown that private investment is a complement of public investment—and the reason why public investment multipliers tend to be large (Izquierdo et al., 2019)—meaning that flexible fiscal rules are indeed growth-friendly. Another route followed to protect public investment has been the adoption of limits to current expenditure growth. For example, Peru amended its fiscal rule in 2018 to include an additional rule limiting real current expenditure growth, net of maintenance spending, to that of real GDP (Mendoza Bellido et al., 2021). Counterfactual simulations in other Latin American countries suggest that complying with such rules could open up fiscal space for increasing capital expenditures (Artana et al., 2021; Bonomo et al., 2021).

Despite substantial progress in fiscal rule flexibility—and its benefits for public investment protection—little attention has been paid to re-entry to the fiscal rule following departure during shocks. Most escape clauses to date offer little guidance, if any, as to how governments should return to compliance in post-crisis contexts. This is a rule design issue that requires attention, particularly in the aftermath of the COVID-19 crisis, as all emerging markets that had an escape clause made use of it to deal with the pandemic (see Box 1).

The size of adjustment as well as the speed of adjustment to return to compliance with the rule should be set depending on the size of the shock and its impact on both budget deficits and public debt levels. Smaller shocks should call for faster convergence than larger shocks, which may require more time for compliance. Such mechanisms should be part of the rule or should be in the hands of institutions safeguarding compliance with fiscal rules, such as fiscal councils.

By contrast, protecting public investment from budget cuts can mitigate contractions in the short run and can even lead to economic expansion in the medium term.

Box 1. Fiscal Rules during the COVID-19 Crisis

Emerging countries with rule-based fiscal frameworks took different approaches to manage fiscal policy in response to the COVID-19 shock. Most countries with national fiscal rules turned to their escape clauses to lift spending, debt, and/or deficit limits. This occurred mainly in 2020, when the pandemic initially hit, but some countries have made use of their escape clauses during 2021 and even 2022, depending on the country's regulations. Other governments decided to suspend fiscal rules to cope with the fiscal shock; this decision depended on each country's unique set of conditions, such as the lack of an escape clause or the impossibility of complying with the conditions stated by the clause. In others, the unprecedented conditions forced governments to reframe their fiscal rules, some by modifying limits and/or the periods established to achieve them, others by introducing new fiscal rules either for the first time or to replace previous ones. Some examples of measures that countries took during COVID-19 regarding fiscal measures are summarized below.

Measure	Examples
Activation of escape clause	The Bahamas used its escape clause to suspend deficit and debt goals between 2019 and 2021, not only to address the COVID-19 emergency, but also to respond to the effects of Hurricane Dorian. The Brazilian government requested the congress to declare a state of "public calamity," which allowed the exclusion of COVID-19-related spending from the expenditure limit, in addition to lifting the primary balance goal. Costa Rica has a well-defined escape clause in case of a national state of emergency, which was declared by executive decree in 2020 due to the pandemic. The spending growth cap was suspended for the institutions supporting the COVID-19 emergency. In Russia, authorities activated the escape clause for its expenditure rule in 2020 and 2021, which allowed the government to deploy significant fiscal support. In India, clarifications were made on the escape clauses in which the government was allowed to breach the deficit targets.
Suspension of fiscal rule	Paraguay has an escape clause which allows the deviation of the deficit target from 1.5 percent to 3 percent of GDP in case of recession, national emergency, or international crisis; the government made use of this feature in 2019 to address the effects of extreme weather conditions. In 2020, the fiscal rule was suspended due to the impossibility of meeting the escape clause's limit after 2019's fiscal deterioration. The Peruvian government suspended it fiscal rules during 2020-2021 by legislative decree, instead using the escape clause that sets forth conditions regarding the trajectory to reinstate the rules.[1] In Indonesia, fiscal rules were suspended by law in 2020. In Azerbaijan, fiscal rules were suspended in 2020 and were expected to be revised and reinstated in FY2022.
Revision of fiscal rules	The fiscal balance rule in Chile does not have well-defined escape clauses, therefore, the structural deficit target was modified three times during 2020, from -1.4 percent to -3.2 percent of GDP. Meanwhile, Panama's fiscal law contains an escape clause to relax the fiscal deficit limit from -1.5 percent to -2 perecent of GDP; however, a law modifying the Fiscal Responsibility Law to allow broader deviations was approved. The Indonesian government raised the debt limit in 2020 from 55 percent to 60 percent of GDP, and again to 65 percent of GDP until 2022. In Uruguay, a new fiscal rule was introduced in 2020 with the approval of Urgent Consideration Law, which is based on three pillars: i) a structural deficit limit, ii) a net debt ceiling of up to 30 percent of GDP in exceptional circumstances, and iii) a growth limit for real primary spending tied to potential growth. In Thailand, the public debt limit was revised from 60 percent to 70 percent of GDP in 2021 to provide more space for COVID-19-related measures.

5. Conclusions and Policy Lessons

The policy lessons drawn from international experience and empirical evidence on fiscal rule effectiveness discussed in this paper suggest that fiscal rules on their own are not enough to stabilize debt-to-GDP ratios and ensure fiscal sustainability. However, given ample heterogeneity in design features, improving fiscal rule quality is key for achieving successful debt performance. Evidence suggests that the following features are necessary to improve fiscal rule effectiveness in emerging markets:

- In terms of fiscal rule design:
    - Introducing debt anchors or setting debt limits that allow the gradual build-up of fiscal buffers as well as feedback mechanisms in operational rule targets that are consistent with those limits.
    - Allowing for rule flexibility and/or limitations to current spending that will protect public investment, adding a growth enhancing dimension to the sustainability concerns that have typically been the focus of fiscal rules.
    - Setting clear paths of return to the fiscal rule when escape clauses are invoked.
- In terms of compliance and forward guidance:
    - Establishing fiscal councils with power to increase incentives for fiscal rule enforcement, both by impinging reputational costs on governments that deviate from the rule, and by having a say following periods of non-compliance on how the rule will be enforced.
    - Strengthening medium-term fiscal frameworks that provide "forward guidance" as to how fiscal targets will be achieved in the future, thus contributing to anchoring expectations and providing a path of government reforms for compliance with the rule.

Fiscal rules are one component of a comprehensive fiscal framework, and hence their design cannot be improved in isolation from the quality of the overall policy framework. A well-designed fiscal policy framework should have a clear long-term objective, that is, an explicit anchor that guides fiscal policy, and a rule that orients policy towards that objective. Credible medium-term fiscal frameworks and independent fiscal councils are complementary fiscal institutions that, together with numerical rules, can support the goal of safeguarding fiscal sustainability.

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