TECHNICAL NOTE Nº IDB-TN-3028

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A Future at Risk?

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November 2024

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Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library

Ulloa-Suárez, Carolina
Sustaining compliance with fiscal rules: a future at risk? / Carolina Ulloa-Suárez, Oscar Valencia.
p. cm. — (IDB Technical Note ; 3028)
Includes bibliographic references.
1. Fiscal policy-Latin America. 2. Fiscal policy-Caribbean Area. 3. Economic policy-Latin America.
4. Economic policy-Caribbean Area. 5. Coronavirus infections-Economic aspects-Latin America.
6. Coronavirus infections-Economic aspects-Caribbean Area. I. Valencia Arana, Oscar. II. Inter-American Development Bank. Fiscal Management Division. III. Title. IV. Series.
IDB-TN-3028

Códigos JEL: H60, E61, E62
Palabras clave: fiscal rules, numerical compliance, macroeconomic policy

http://www.iadb.org

Sustaining Compliance with Fiscal Rules: A Future at Risk?

Carolina Ulloa-Suárez[†] & Oscar Valencia[*]

Abstract

Fiscal rules in Latin American and Caribbean (LAC) countries rarely have fixed objectives, exhibiting significant heterogeneity in design and implementation. This document analyzes how different factors influence the ease or difficulty of compliance with these rules and introduces an update of the Compliance dataset, highlighting new trends. The updated dataset shows that fiscal rule compliance in the region is sensitive to economic conditions, with a notable peak in 2022 due to favorable circumstances. However, the seemingly high compliance in 2022 was largely driven by favorable conditions, masking underlying vulnerabilities, as evidenced by the decline in 2023 and the emerging risks of non-compliance in 2024. This pattern suggests that compliance can sometimes misrepresent both short-term and long-term fiscal health. The analysis underscores the need to rethink fiscal rule frameworks to ensure long-term discipline and coherence with fiscal commitments. A new classification of rules in LAC can help understand compliance dynamics, close the gap between short- and long-term fiscal objectives, and identify specific characteristics to improve. This document emphasizes the necessity for targeted reforms to enhance the resilience and effectiveness of fiscal frameworks in the LAC region.

JEL codes: H60, E61, E62
Keywords: fiscal rules, numerical compliance, macroeconomic policy

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The authors are grateful to Luiza Antoun de Almeida, Juan Pedro Treviño, and the FISLAC team for useful comments that helped improve the document and to Daniela Gallo, who provided excellent research assistance. The findings and interpretations in this paper are those of the authors and do not necessarily reflect the views of the Inter-American Development Bank or the governments it represents.

1. Introduction

Latin American and Caribbean (LAC) countries have increasingly implemented fiscal rules since the early 2000s as essential tools for macroeconomic policy. These rules signify a strong commitment to achieving and maintaining sustainable public finances. Over the past 20 years, many LAC countries have adopted at least one fiscal rule to constrain a macroeconomic aggregate by setting specific targets. The most common types of rules include targets for fiscal balance (budget balance rule, BBR), fiscal balance adjusted by the cycle (structural balance rule, SBR), expenditure ceilings (expenditure rule, ER), debt limits (debt rule, DR), and minimum fiscal revenues (revenue rule, RR).

However, even the most well-designed fiscal rule can be ineffective if not consistently complied with. While there is mixed evidence regarding the effectiveness of fiscal rules (Andrián et al., 2024; Debrun & Jonung, 2019; Eyraud et al., 2018), compliance with these rules has shown significant benefits (Barbier-Gauchard et al., 2021; Larch et al., 2023; Reuter, 2019; Ulloa-Suárez, 2023). Studies indicate that adherence to fiscal rules correlates with a lower probability of debt accelerations, reduced EMBI spreads, and higher credit ratings (Ardanaz et al., 2024). The Compliance with Fiscal Rules dataset by (Ulloa-Suarez & Valencia, 2022) highlights the high heterogeneity in fiscal rule design and compliance across LAC countries. This diversity poses challenges in measuring compliance and evaluating whether fiscal rule frameworks contribute to fiscal discipline and commitment in the short and long term.

The recent economic upheavals, especially the COVID-19 pandemic, have exposed weaknesses in fiscal institutions. The pandemic and the challenging macroeconomic conditions in recent years revealed the flexibility and adaptability required in fiscal rules. However, this flexibility often compromised long-term fiscal discipline and introduced complexities jeopardizing public finance sustainability. The interplay of unexpected economic developments and structural changes has raised significant concerns about compliance sustainability.

Although compliance rates appeared high in 2022, they were largely driven by temporary favorable conditions, design flaws in the flexibility of fiscal rules, and measurement approaches that focused too heavily on short-term macroeconomic aggregates. These factors masked structural imbalances that pose risks to long-term compliance. The GDP rebound and positive output gap dynamics temporarily facilitated meeting fiscal targets but reduced fiscal space for future downturns. Unexpected inflation increased allowable expenditure limits, masking underlying fiscal vulnerabilities. Additionally, measuring compliance, especially with convergence targets, often provided a false sense of security, as countries appeared compliant despite very high levels of debt or deficits. Consequently, as macroeconomic conditions normalized, compliance decreased in 2023, and 2024 already shows risks of non-compliance, underscoring the urgent need for more resilient fiscal frameworks.

The risks of overreliance on favorable economic conditions for compliance are significant. This reliance can lead to complacency, delaying essential structural reforms and increasing the risk of fiscal imbalances when conditions worsen. The uncertainty and unpredictability of the post-2020 economic landscape further complicate accurate forecasting of GDP growth, output gaps, and inflation. Fiscal targets tied to these volatile conditions can mask underlying vulnerabilities, creating a false sense of security and potentially leading to higher deficits and debt accumulation over time.

This problem is particularly evident in countries where fiscal rules allow substantial deviations in deficit calculations based on estimations of structural versus observed revenues, such as those related to volatile commodity prices. These rules, while providing flexibility, can lead to significant fiscal imbalances when projections do not materialize as expected.[2] Therefore, there is a need to understand and disentangle not only compliance with fiscal rules but also why countries are (not) complying. This deeper insight is crucial to ensure that short-term efforts are aligned with long-term fiscal sustainability targets. Developing more resilient fiscal rules that can withstand economic fluctuations and incorporating a focus on structural reforms will be key to maintaining fiscal health and resilience over the long term.

This policy note examines recent compliance trends in fiscal rule frameworks across LAC countries, focusing on the rebound in high compliance rates and their connection to recent macroeconomic conditions. It explores the procyclical nature of compliance, the effects of economic recovery on fiscal targets, and the risks associated with forecast errors. By highlighting these trends, the note underscores the need to improve the design of fiscal rules to enhance their credibility and effectiveness, ensuring that short-term compliance supports long-term fiscal sustainability and resilience.[3].

This note has seven sections. Following the introduction, the second section delves into the methodology of measuring compliance with fiscal rules. The third section presents recent compliance trends, particularly highlighting the 2022 peak and its underlying factors. The fourth section examines the heterogeneity and evolution of fiscal rule targets. The fifth section explores unusually high compliance in 2022 and the factors contributing to this result. The sixth section discusses the implications of non-rigid and adaptive fiscal rule targets, focusing on the associated risks. Finally, the seventh section provides policy recommendations to strengthen fiscal frameworks in LAC countries.

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[2] For example, in some countries, fiscal rules permit deviations in the deficit due to differences between observed and structural revenues, often tied to fluctuating commodity prices. These allowances can result in significant disparities between projected and actual fiscal outcomes, leading to challenges in maintaining fiscal discipline over time (Andrian et al., 2023).

[3] The rigidity of certain fiscal rules, as observed in some countries, can create challenges in maintaining consistency and credibility in fiscal policy, particularly when these rules do not allow sufficient flexibility to adjust to changing economic conditions or priorities (Andrian et al., 2023).

2. Measuring compliance

Numerical Compliance with fiscal rules is essential for assessing their effectiveness, especially in maintaining economic stability and sustainability. To measure numerical compliance, the target set for a given macroeconomic aggregate is compared with its executed value. This approach clearly evaluates whether a country has adhered to its fiscal commitments or deviated from them.

Ulloa-Suarez & Valencia, 2022 employ an archival data collection method, gathering information from various official sources. These sources include Fiscal Responsibility Laws, Medium-Term Fiscal Frameworks, national budgets, statistical series, and reports from each country's Ministry of Finance and Fiscal Councils. This dataset uses officially published data to assess whether countries have complied with or deviated from their fiscal rules. Compliance is represented as a binary variable:

$$\text{compliance}_{\text{i,r,t}} = \begin{cases} 1 \text{ if country } i \text{ complied with rule } r \text{ at time } t \\ 0 \text{ otherwise} \end{cases}$$

Numerical compliance is calculated by contrasting the target set and the executed value[4] for 14 countries from 2000 to 2023, considering the various fiscal rules in force. Each country's compliance rate is determined using a weighted average based on the number of years each rule has been in place (e.g., the length of time the rule has been active). This rate is calculated by summing up each rule's compliance period, weighted by length, and dividing by the total number of periods of all rules. The implementation periods of each rule are assumed to be independent, though compliance depends on the target type (e.g., debt or deficit reduction, debt or expenditure ceiling) (see Appendix A for details).

Most fiscal rule frameworks do not set fixed and precise targets. For example, a budget balance target allowing a maximum deficit of 2% of GDP does not necessitate that the country runs a deficit of exactly 2%; a lower deficit, such as 0.5% of GDP, would also be considered compliant. This flexibility reflects the pragmatic approach adopted by many LAC countries to account for economic fluctuations and unforeseen circumstances.

[4] The calculation of compliance is based on the fiscal target established at the beginning of the fiscal year. Adjustments made during the year (e.g., mid-year changes) are not considered for measuring compliance within the current year, as this could lead to automatic compliance. Instead, the original target remains the reference point, even if a legal modification occurs during the year. Starting from the following fiscal year, the new targets are applied. (continues)
For example, a country may have a fiscal rule with a fixed deficit target of -1.5%. Suppose that in year t, it is already projected that the deficit will be -1.8%. If the rule is modified during year t to allow a deficit of up to -2%, we still consider the original target of -1.5% for compliance that year to avoid automatic compliance. However, starting in year t+1, the new target of -2% would be applied.

Based on the methodology employed by Ulloa-Suárez and Valencia (2022), an update to the Compliance dataset is now publicly available on the Latin American and Caribbean Compliance Hub of FISLAC[5]. This dataset allows tracking compliance over time and assessing the effectiveness of different fiscal rules. As in this note, by understanding the patterns of compliance and non-compliance, stakeholders can better evaluate the strengths and weaknesses of existing fiscal frameworks in LAC.

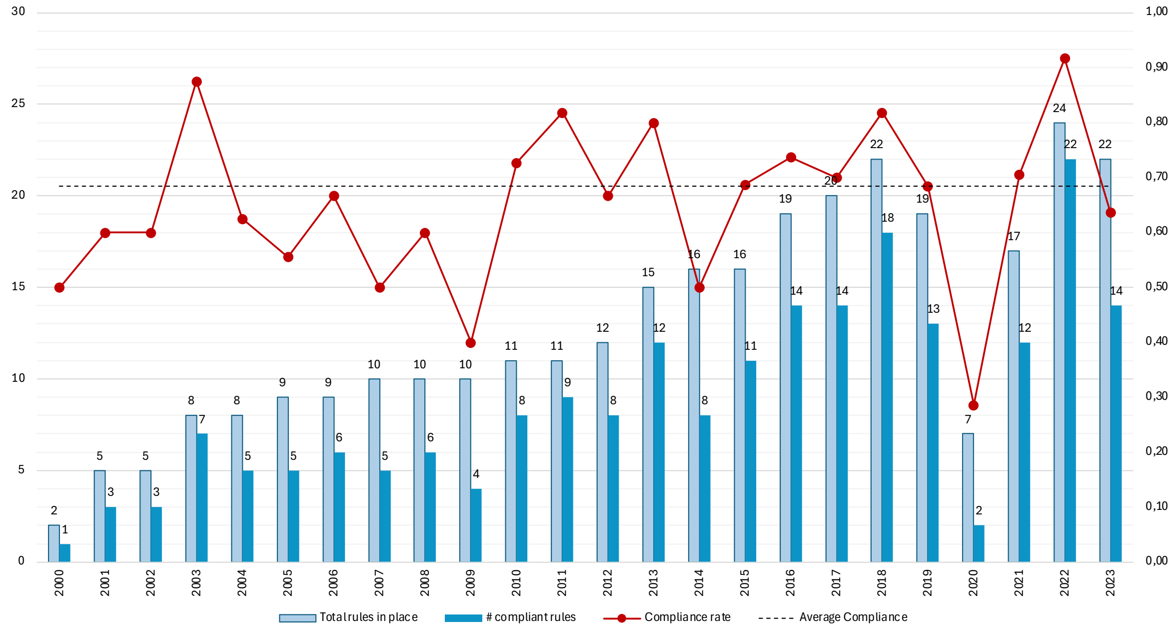
3. Compliance trends

The latest update extends the compliance data to 2023, revealing trends in fiscal rule adherence during and after the COVID-19 pandemic. The dataset provides a nuanced view of how LAC countries have navigated their fiscal policies through various economic cycles, reflecting the impact of external shocks and domestic policy adjustments.

Figure 1 illustrates the evolution of fiscal rules and compliance from 2000 to 2023. The number of fiscal rules in the region has grown significantly, from 2 in 2000 to 21 in 2023, peaking at 23 in 2022. This increase indicates a growing recognition of the importance of fiscal discipline and the adoption of formal frameworks to achieve it. It's important to note that the total number of rules exceeds the number of countries studied because, over time, the 14 countries in the sample have implemented more than one fiscal rule. However, compliance data reveals that fiscal rule adherence is sensitive to periods of economic stress. This is evidenced by an average compliance rate of 68% over the period, with notable declines in compliance during economic crises such as the Global Financial Crisis (GFC), the end of the commodity cycle, and the COVID-19 pandemic, followed by substantial rebounds in compliance as economies recover.

[5] The Latin American and Caribbean Compliance Hub of FISLAC gathers detailed information on the implementation and evolution of fiscal rules across LAC countries. The Hub features an interactive dashboard that provides users with access to this data, enabling them to explore and analyze fiscal rule compliance over time. Additionally, it empowers LAC policymakers with a Multidimensional Compliance Indicator (MCI), a tool designed to assess various dimensions of fiscal management.

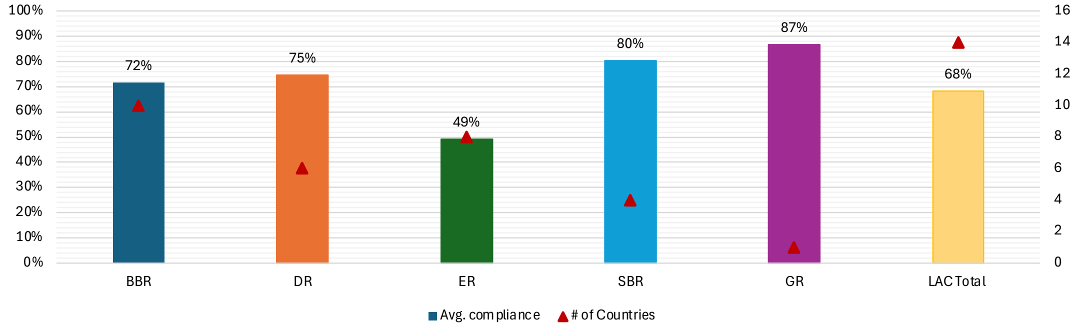
Figure 1. Evolution of fiscal rules in place



Source: author's calculation with compliance data.
Note: the light blue bars represent the total fiscal rules in place considering that a country could have implemented more than one rule in a given year. The dark blue bars represents how many rules of the implemented ones were complied. The red trajectory represents the compliance rate measured as the total number of rules complied divided by the total number of rules implemented. The horizontal dotted line represents the weighted average compliance rate over 2000-2023.

Figure 2 highlights compliance rates by rule type. The ER is the least adhered to, with a compliance rate of about 49%. This low adherence suggests challenges in controlling expenditures, possibly due to political pressures or unexpected economic shocks. Conversely, the Golden Rule and SBR exhibit the highest compliance rates, though fewer countries implement them. These rules' higher compliance rates might be due to their design, which often includes mechanisms to adjust for economic cycles or accounting for public investment.

Figure 2. Compliance by type of rule, 2000-2023

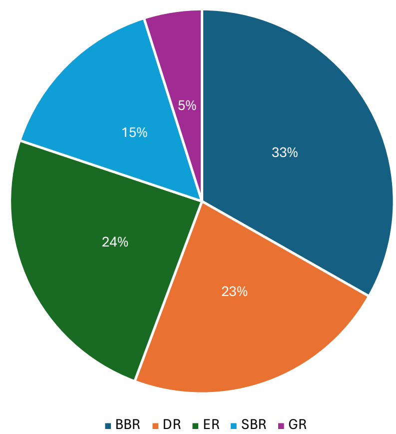


Source: author's calculation with compliance data.

Note: the triangles represent the number of countries that have implemented a given rule at least once over the period (right axis). Compliance is assessed by calculating the ratio of the number of periods during which the rule was complied with, to the total number of periods the rule was implemented across various countries from 2000 to 2023.

Only Brazil has implemented a Golden Rule (GR).

Figure 3. Type of rule implemented as percentage of total number of rules (average 2000-23)



Source: author's calculation with compliance data.

Note: The pie chart illustrates the percentage of each fiscal rule that has been implemented at least once across all countries from 2000 to 2023, represented as a proportion of the total number of rules implemented.

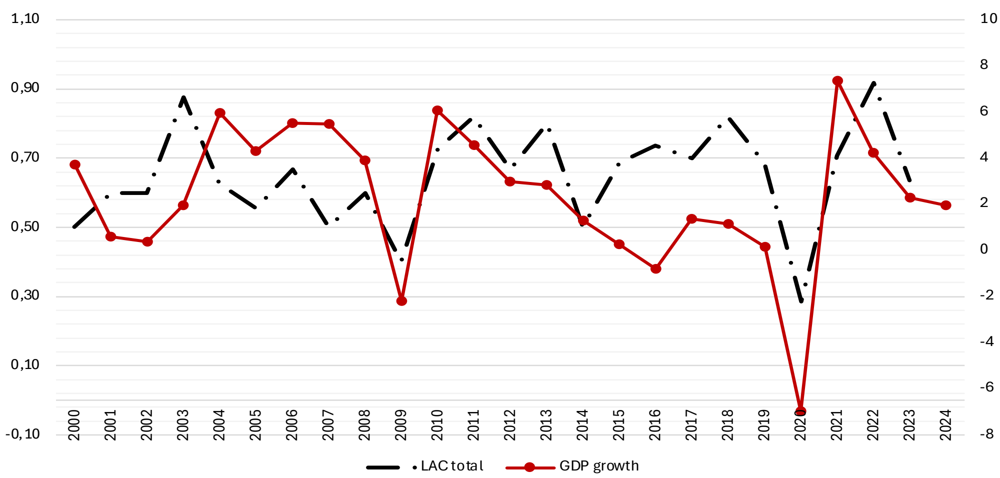
The relationship between fiscal rule compliance and economic growth in LAC countries reveals a pattern of procyclicality (Figure 4, Panel A). The observed trends suggest compliance rates tend to rise during periods of economic expansion, where higher GDP growth facilitates better fiscal outcomes, making it easier for governments to meet their fiscal targets. Conversely, compliance rates typically decline during economic downturns, as reduced economic activity leads to lower revenues and increased fiscal pressures, making it more challenging to adhere to established fiscal rules. While not implying direct causality, these patterns highlight the cyclical nature of fiscal rule compliance, with compliance rates and economic growth moving in tandem, illustrating the difficulties in maintaining fiscal discipline across different phases of the economic cycle.

The BBR and DR exhibit cyclical compliance patterns, reflecting the broader economic cycles (Figure 4, Panel B). During periods of economic growth, compliance with these rules improves as revenues increase and deficits are easier to control. Conversely, compliance rates drop during economic downturns as countries struggle to maintain fiscal discipline. This cyclical nature underscores the need for fiscal rules that can adapt to economic conditions while maintaining long-term fiscal stability.

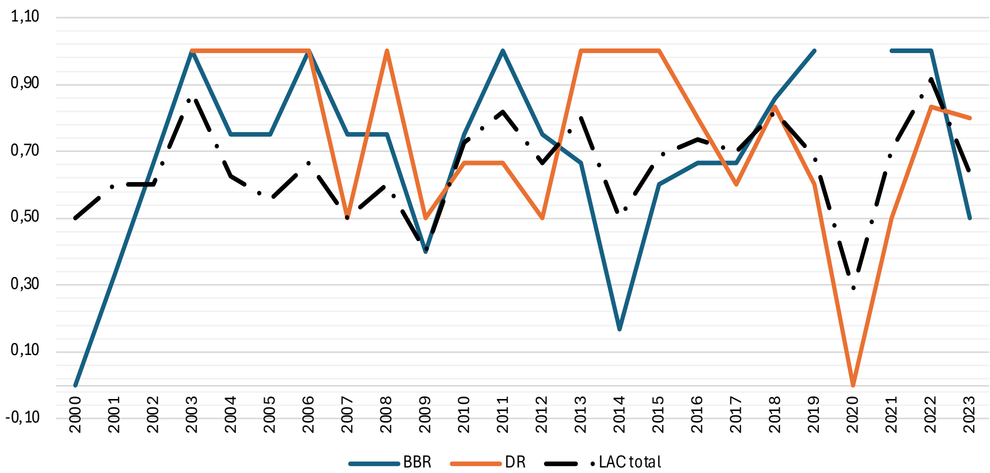
The ER and SBR display more erratic compliance patterns (Figure 4, Panel C). Towards the end of the commodity cycle, compliance with these rules peaked and remained above 50%, driven by more stringent structural deficit targets. This peak suggests that during periods of economic adjustment, countries may temporarily improve compliance as part of broader fiscal consolidation efforts. However, the erratic patterns also indicate that sustaining compliance over time remains challenging, significantly when external economic conditions fluctuate.

A deeper examination of compliance trends reveals an important asymmetry in how compliance responds to economic cycles. While compliance rates do increase during periods of economic expansion, the magnitude of improvement is often smaller than the corresponding deterioration during downturns (Ardanaz et al., 2024). In other words, compliance tends to fall significantly more during bad times than it rises during good times. This asymmetry underscores the challenges governments face in maintaining fiscal discipline during recessions

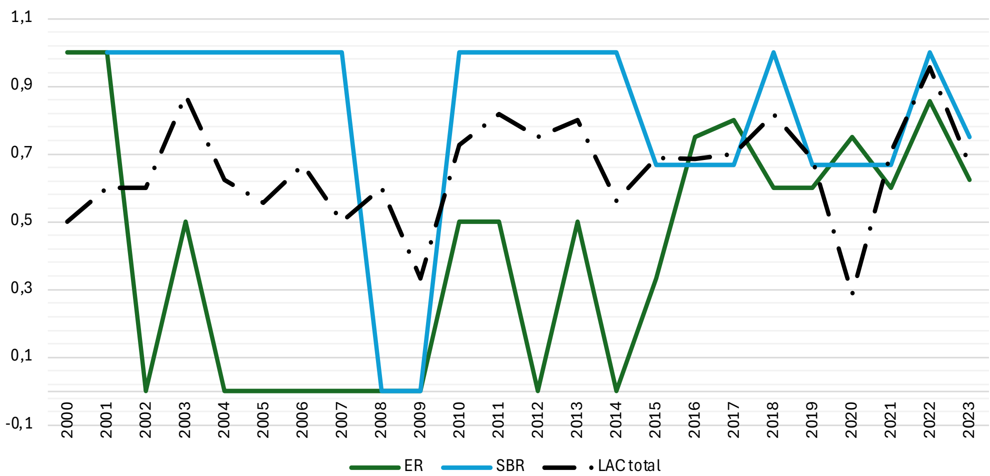
Figure 4. Average compliance rate, type of rules
Panel A. Average compliance rate and GDP growth



Panel B. Budget Balance and Debt Rule



Panel C. Expenditure and Structural Balance Rule



Source: Author's calculations using compliance data and GDP growth data from the World Economic Outlook (WEO) April 2024.
Note: The annual compliance rate is calculated by dividing the number of rules that have been complied with by the total number of rules in place for that year.

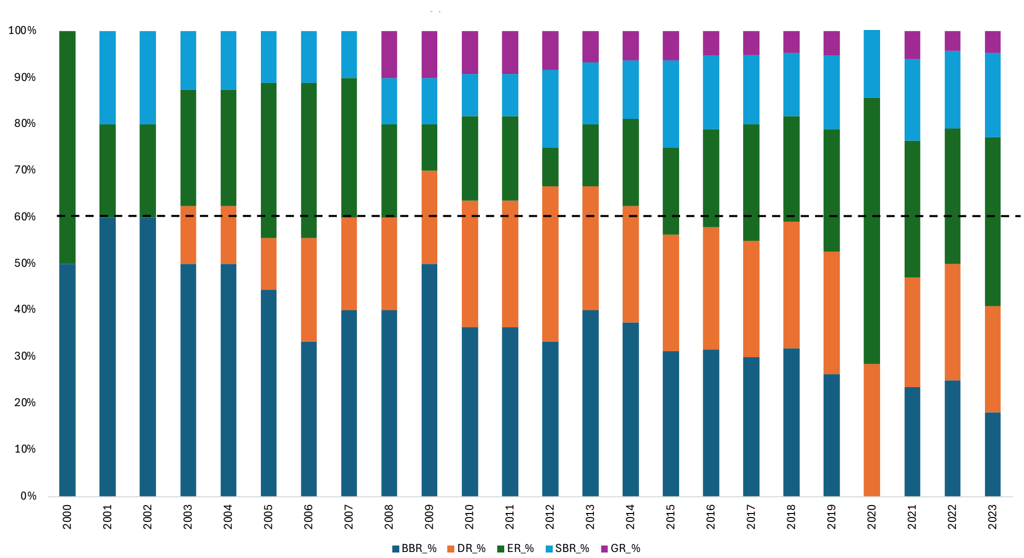
Although fiscal rule compliance is often described as procyclical, the targets themselves do not exhibit strict procyclicality. Instead, the evolution of individual targets shows that, in most cases, they have become more lenient following economic crises. This relaxation of fiscal discipline post-crisis helps explain the rebound in compliance rates seen in the aftermath of economic downturns (see Section 5). For example, during the commodity boom preceding the GFC, fiscal targets were more stringent, yet compliance was still relatively high. In contrast, post-GFC, many countries adjusted their fiscal rules to allow for larger deficits or higher debt ceilings, contributing to a temporary peak in compliance (and subsequently higher levels of compliance) as governments adapted their targets to accommodate slower growth and higher fiscal pressures (see Figure 1).

The trend of increasingly flexible targets raises concerns about long-term fiscal sustainability. Our data indicate that between 2000 and 2023, 71% of BBRs have increased their allowable deficit limits, and 67% of DRs have raised their debt ceilings. This shift suggests that, in the face of economic challenges, countries opt for greater fiscal space rather than reverting to pre-crisis levels of fiscal discipline. While this may alleviate short-term pressures, it poses a risk of fiscal imbalances if stricter rules are not reinstated as economic conditions improve.

In contrast, SBRs appear to offer a more disciplined approach. These rules have generally maintained or even tightened their targets over time. Countries adhering to SBRs have seen more consistent improvements in their fiscal health, with allowed structural deficits gradually decreasing. This trend points to the potential effectiveness of SBRs in fostering long-term fiscal discipline, even as other fiscal rules have become more flexible in response to economic conditions.

A final observation is that countries increasingly implement multiple fiscal rules over time (Figure 5). This trend reflects a strategic approach to fiscal management, combining different types of rules to address various aspects of fiscal policy. The BBR is the most commonly implemented, likely due to its straightforward focus on balancing revenues and expenditures. In contrast, the SBR and GR are the least implemented, possibly due to their complexity and the technical expertise required for their effective application.

Figure 5. Compliance by type of rule, 2000-2023



Source: author's calculation with compliance data.
Note: The graph shows the evolution of the implementation of different types of rules over the years, expressed as a percentage of the total number of rules implemented each year.

The compliance trends show a complex interplay between fiscal rule design, economic conditions, and policy implementation. The procyclical nature of compliance demonstrates that fiscal rules' effectiveness is influenced by broader economic cycles. The variation in compliance rates by rule type highlights the need for fiscal frameworks to endure economic shocks and ensure long-term sustainability.

To further understand these dynamics, it is important to examine the heterogeneity in fiscal rule design and the evolution of targets over time. This next section will explore the diversity of fiscal rule frameworks in LAC countries and how adjustments to these targets impact fiscal discipline.

4. Heterogeneity and target evolution

Understanding the design of fiscal rule targets is crucial for comprehending compliance trends, especially the rebounds and unusual results observed in 2022. Examining the specific design features of these targets helps identify why certain periods experience higher compliance and uncover the underlying factors contributing to these patterns. This analysis sheds light on the complexities of fiscal discipline in the region and the sustainability of short-term compliance peaks.

Fiscal rule targets in LAC countries exhibit significant heterogeneity, which impacts compliance outcomes. Adjusting targets over time can lead to relaxed fiscal discipline, a common feature in many fiscal rules across the region. Permissible deficits may increase, and debt or expenditure ceilings may be raised, especially when adjustments are tied to economic conditions. Ideally, once a fiscal rule is implemented, the restricted macroeconomic aggregate should converge towards or stabilize around the target, indicating effective fiscal management.

The LAC experience offers an opportunity to further categorize fiscal rules beyond the traditional classification by macroeconomic aggregates. While we already classify fiscal rules by the type of aggregate they target (e.g., deficit, debt, or expenditure), this new classification focuses on how those targets are restricted, which can significantly affect compliance outcomes. We identify five[6] types of fiscal rule restrictions: timeless fixed objectives, indexed targets, conditioned targets, hybrid targets, and convergence targets. Each of these categories has distinct characteristics that influence compliance and fiscal outcomes, offering valuable insights for understanding why compliance varies and how to design more effective fiscal frameworks for the future.

[6] While not categorized separately, some fiscal targets are adjusted annually, offering flexibility but limiting long-term stability. Although less common, these yearly revisions often occur through executive decrees and are typically tied to short-term political priorities. However, most countries align these adjustments with a 1- to 3-year fiscal planning horizon, ensuring they remain part of a broader fiscal framework. This flexibility, while beneficial for adapting to immediate economic conditions, can complicate the analysis of compliance and fiscal discipline over time.

Table 1 illustrates the different targets within fiscal rules in LAC countries, highlighting the diversity in target designs and their implications for fiscal discipline. Timeless Fixed Objectives offer stability and predictability but can be rigid, making them less adaptable to changing economic conditions. Indexed Targets provide flexibility by automatically adjusting based on specific economic indicators, adding complexity but ensuring the targets remain relevant. Conditioned Targets change based on predefined conditions, allowing for responsiveness but introducing conditional complexity. Hybrid Targets combine elements of indexed and conditioned targets, enhancing adaptability but requiring complex implementation. Finally, Convergence Targets focus on gradual adjustments towards a fixed objective, balancing long-term goals with current economic performance. This diversity in target types underscores LAC countries' varying strategies to maintain fiscal discipline and adapt to economic changes.

Table 1. Classification of targets based on possible adjustments

Type of Target	Definition	Characteristics	Examples
Timeless Fixed Objectives	Targets remain constant over time and do not adjust based on economic conditions.	Stability, Predictability, Rigidity	Fixed debt-to-GDP ratio; deficit ceiling.
Indexed Targets	Targets automatically adjust based on specific economic indicators or indices.	Automatic Adjustment, Flexibility, Complexity	Expenditure limits adjusted for inflation; revenue targets indexed to GDP growth.
Conditioned Targets	Targets change based on specific conditions or criteria.	Conditional Flexibility, Responsiveness, Conditional Complexity	Expenditure limits based on debt-to-GDP ratio; deficit rules with allowances during recessions.
Hybrid Targets	Combines elements of both indexed and conditioned targets.	Combination of Elements, Enhanced Adaptability, Complex Implementation	Expenditure rule with inflation adjustments and debt triggers.
Convergence Targets	Targets are set to achieve a fixed objective over time, with annual adjustments based on economic indicators.	Gradual adjustment, long-term focus, conditional on economic performance.	Debt-to-GDP ratio targets that decrease annually until reaching a specific goal.

A closer look at each rule and country reveals that specific rules restrict macroeconomic aggregates, similarly, highlighting more heterogeneity in the details rather than in the core design of each rule. For instance, around half of BBRs include convergence targets, while the other half have conditioned targets with fixed objectives. These rules aim to maintain a specific deficit level but are frequently adjusted by law. DRs primarily feature convergence targets as countries remain in the convergence phase, a period extended by the effects of COVID-19. Two-thirds of ERs are predominantly indexed to inflation and GDP, while the remaining third condition the target on potential GDP growth, debt, and revenue. SBRs, though varied, are typically conditioned on debt and potential GDP, showcasing diverse fiscal strategies.

One characteristic of debt and deficit rules is that they often consider a convergence period before maintaining or respecting a timeless fixed target. However, the prolonged convergence phase for DRs, exacerbated by the COVID-19 pandemic, indicates a reliance on flexible targets to achieve fiscal goals. This reliance may delay necessary fiscal consolidation and structural reforms. While aiming to maintain fiscal discipline, indexed Expenditure Rules depend on accurate and timely data. Forecast errors in inflation or GDP estimates can lead to inappropriate fiscal adjustments, complicating compliance further.

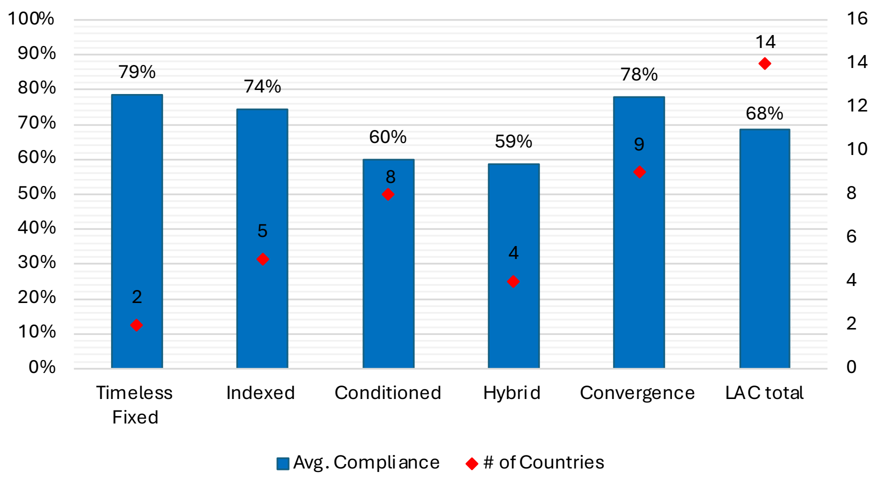
Recent trends show that rules such as the BBR, ER, and DR have seen their limits relaxed, particularly in recent years. This trend suggests a weakening of fiscal discipline. In contrast, countries with an SBR often maintain closer alignment with their targets, demonstrating improved fiscal health over time, such as a decreasing structural deficit, indicating a more effective and disciplined fiscal policy. In fact, 71% of BBRs have increased their deficit limits, indicating a trend towards greater procyclicality and potentially lax fiscal policies. Additionally, 67% of DRs have increased their debt ceilings, reflecting a relaxation in debt constraints and a potential risk of higher debt levels over time if the return to lower debt levels is not executed as intended. These figures highlight the need for effective debt management to avoid potential risks.

Interestingly, some SBR targets have become more stringent, with the trajectory of the restricted aggregates following stricter guidelines, indicating an improvement in fiscal discipline and adherence to objectives. These evolving targets raise questions about the nature of fiscal rules. The LAC experience shows that fixed objectives are rare, and countries often do not precisely meet these targets or even gravitate around them.

The proposed classification of target types incorporates a range of fiscal rules within each category, creating a more detailed framework than merely examining how countries restrict the same macroeconomic aggregates. While data limitations constrain the analysis of specific relationships, this framework enables an initial assessment of how different target designs influence compliance and debt dynamics. Two key assumptions often emerge: first, that more flexible targets are easier to comply with, and second, that stricter, fixed targets—despite being harder to meet—lead to better long-term fiscal outcomes, such as reduced debt accumulation. The initial results, however, clearly show that neither of these assumptions holds true, limiting the value of further analysis in this direction.

More flexible targets are not necessarily easier to comply with. While flexibility in fiscal rules suggests greater adaptability to changing economic conditions, the compliance rates in Figure 1 contradict this assumption. Indexed Targets, which automatically adjust to economic indicators, show relatively high compliance at 74%. However, Conditioned and Hybrid Targets, which are also designed for flexibility, present lower compliance rates at 60% and 59%, respectively. Conversely, Timeless Fixed Objectives and Convergence Targets—despite being more rigid—demonstrate the highest compliance rates at 79% and 78%. This variation confirms that compliance is not determined by the flexibility or rigidity of the targets but by the broader fiscal framework and enforcement mechanisms. A thorough understanding of compliance requires evaluating all target characteristics beyond their flexibility.

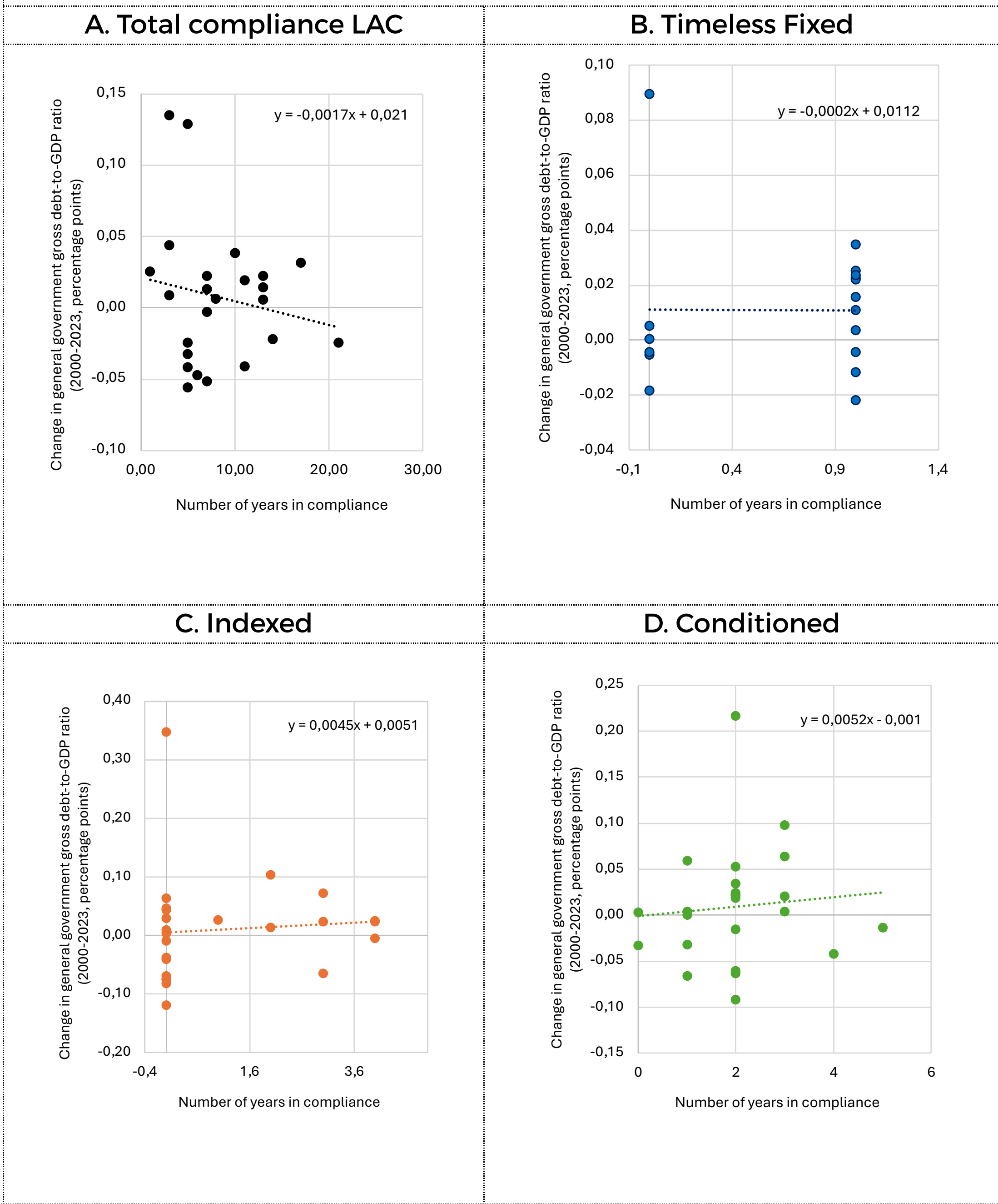
Figure 6. Compliance by type of target, 2000-2023



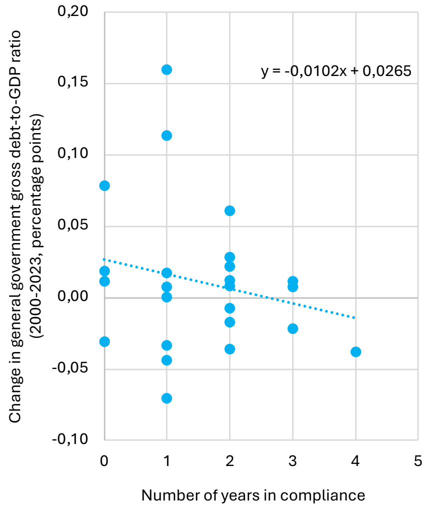
Source: author's calculation with compliance data. Number of countries is measured on the right axis.

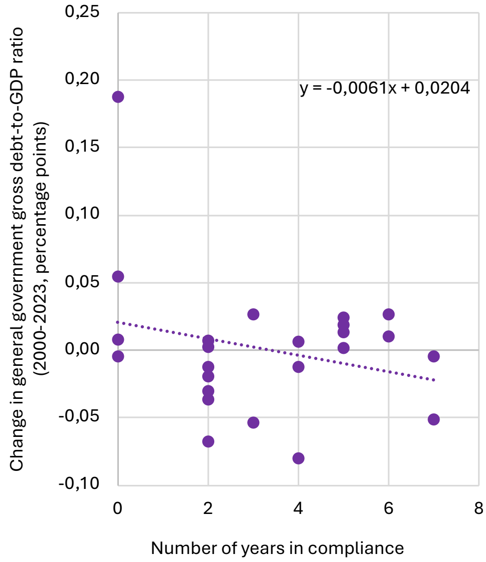
The relationship between stricter targets and debt variation is highly endogenous and inconclusive. While stricter targets, such as Timeless Fixed Objectives, might be expected to result in better long-term outcomes like lower debt growth, the data reveal that this relationship is far more complex. As shown in Figure 7, Hybrid and Convergence Targets display a negative correlation between compliance and debt variation, indicating their potential effectiveness in controlling debt. However, this pattern is inconsistent across other target types. Indexed and Conditioned Targets, despite their flexibility, show weaker or even positive correlations with debt accumulation, implying that their adaptability may sometimes undermine long-term debt management. Furthermore, the existing literature has consistently shown that debt levels are not a strong determinant of the probability of compliance with fiscal rules (Ardanaz et al., 2024; Reuter, 2019; Ulloa-Suarez & Valencia, 2022). Although stricter rules may offer better debt outcomes in certain cases, the endogenous nature of this relationship makes it difficult to draw firm conclusions. Further analysis is needed to fully grasp the underlying factors driving this dynamic.

Figure 7. Compliance by type of target and Change in debt-to-GDP ratio



E. Hybrid	F. Convergence





Source: author's calculation with compliance data and WEO.

5. Unusual high compliance rates

The procyclical pattern of regional compliance depicted in Figure 1 shows a strong rebound after every drop in compliance. In 2022, this compliance peak was abnormally high, significantly attributed to the interplay of unexpected economic developments and the structure of expenditure targets.

One significant factor was the unexpected inflation. Many fiscal rules index expenditure targets to inflation. The underestimation of inflation from 2020 to 2022 in many forecasts, as captured in the World Economic Outlook (WEO), meant that actual inflation rates were higher than projected. This higher inflation increased the allowable expenditure limits under indexed rules, making it easier for countries to stay within these limits without breaching fiscal rules' objectives (Inter-American Development Bank (IDB), 2023). Additionally, higher inflation reduces the real value of nominal expenditures. Consequently, while nominal spending may rise, its real value (adjusted for inflation) may remain within the target range, contributing to higher compliance.

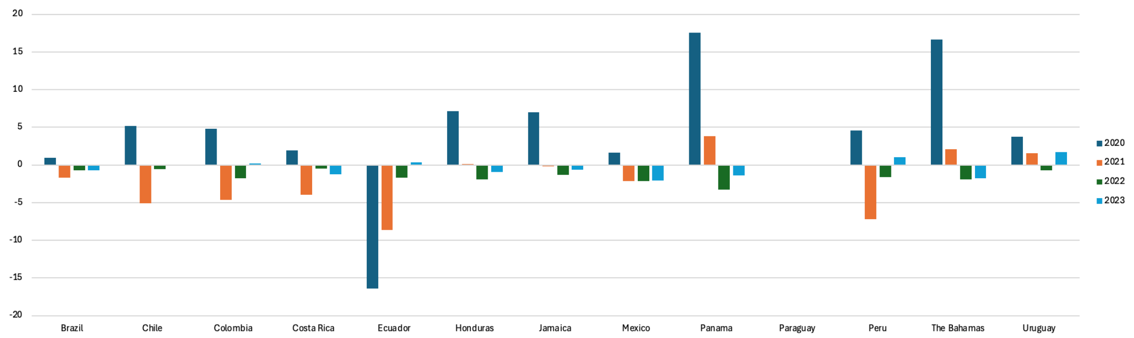
Another key factor was the GDP rebound. The significant GDP rebound in 2021 and 2022, following the 2020 contraction, raised the GDP baseline. This higher GDP allowed for increased expenditure ceilings, as rules often permit spending to grow in line with or slightly below GDP growth. The difficulty in predicting the exact magnitude of the economic rebound led to more conservative fiscal planning. When the actual GDP growth outpaced these conservative projections, the resulting higher GDP figures permitted more significant expenditures under the rules, thus facilitating compliance.

The dynamics of the output gap also played a crucial role. As the output gap decreased and turned positive in some countries, indicating that economies were operating closer to or above their potential output, aligning expenditure with GDP targets became more manageable. This positive shift made it easier for countries to comply with fiscal rules when their targets consider potential GDP growth. However, this improved compliance poses future risks. Relying on favorable economic conditions can lead to complacency, reducing the urgency for structural reforms and prudent fiscal management. Consequently, this may limit the fiscal space available for counter-cyclical policies during future economic downturns, compromising long-term fiscal sustainability.

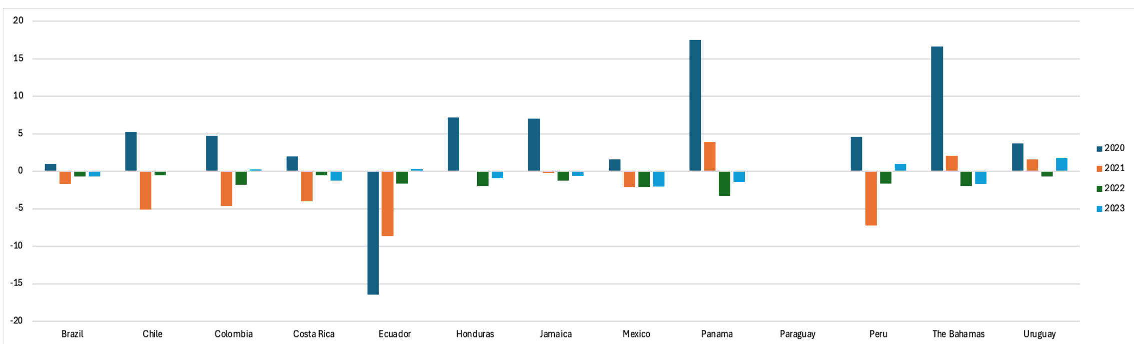
Figure 6 illustrates forecast errors of GDP growth rates, output gap, and inflation. Negative errors indicate that the observed value exceeded the forecasted value. Panel A shows that growth rates were underestimated, especially for 2021 and 2022, in almost all countries, while in 2023, forecasted growth was closer to actual values. This pattern is also observed for the output gap (Panel B) to a lesser extent and for inflation (Panel C), where the errors are slightly larger than for GDP growth rates. These forecast errors significantly influenced the 2022 compliance rate by making targets more achievable due to unexpected economic developments.

Figure 6. Forecast errors in macroeconomic variables

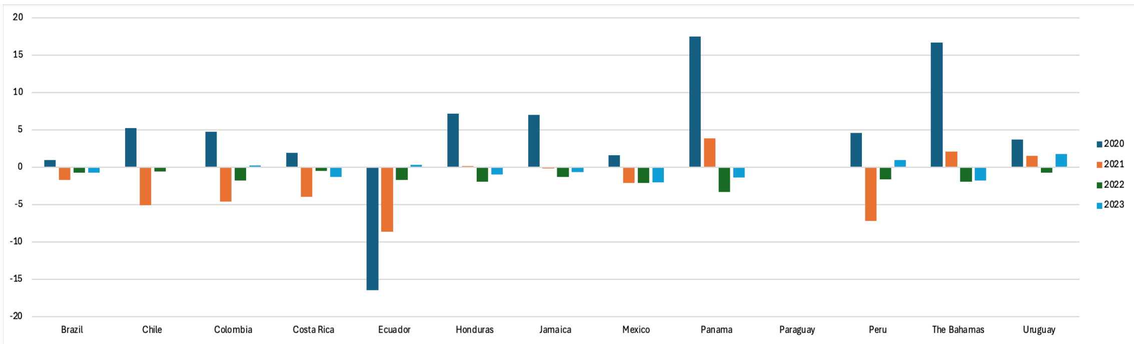
Panel A. Growth rates



Panel B. Output gap



Panel C. Inflation (average)



Source: World Economic Outlook
Note: The error variable is defined as the Forecasted Value minus the Observed (Actual) Value. Forecasted variables are retrieved from the October WEO of the previous year (t-1).

The risks associated with forecast errors are substantial. When growth rates, output gaps, or inflation are underestimated, it can lead to overly optimistic fiscal projections and planning. This optimism can result in setting expenditure targets that are easier to meet in the short term, thereby temporarily enhancing compliance rates. However, such errors can mask underlying fiscal vulnerabilities and lead to a false sense of security (Ardanaz et al., 2024; Frankel & Schreger, 2013; Picchio & Santolini, 2020).

Moreover, inaccurate forecasts can complicate fiscal policy adjustments. Governments may delay necessary structural reforms, believing they are on track to meet their fiscal targets. This delay can exacerbate fiscal imbalances when economic conditions change or when the actual output deviates significantly from potential output. In periods of economic downturn, the lack of prior adjustments can severely constrain fiscal space, limiting the ability to implement counter-cyclical measures effectively. Inaccurate inflation forecasts pose additional risks. Underestimating inflation can lead to higher-than-expected nominal expenditures, which may not be sustainable in real terms. This discrepancy can result in higher deficits and debt accumulation over time, further stressing fiscal sustainability. This challenge is particularly pronounced in countries with extractive industries, where fluctuations in commodity prices, such as oil or minerals, can lead to significant forecast errors. In such cases, the long-term price forecasts and the actual commodity price can result in temporary deviations from structural balances, complicating fiscal management even further (Andrian et al., 2023).

A critical limitation of existing fiscal rules is that they often do not incentivize the use of unexpected revenue surpluses to improve fiscal balance or reduce public debt over the medium to long term. Instead, the focus tends to be on addressing immediate fiscal targets, which limits the opportunity to build a fiscal buffer for future periods of economic stress. This short-term orientation can undermine efforts to achieve sustained fiscal stability and resilience. For example, in 2021, several countries in the region, facing a negative output gap, implemented tax reforms as a precaution against anticipated fiscal deficits in 2022. These reforms, combined with the positive output gaps experienced in 2022, led to increased revenue inflows, yet the opportunity to use these surpluses for long-term fiscal health was often missed.

While favorable economic conditions and positive output gaps can improve compliance with fiscal rules in the short term, the risks associated with forecast errors highlight the need for cautious and prudent fiscal management. Ensuring accurate economic forecasting and focusing on structural reforms are critical to sustaining long-term fiscal health and resilience.

How compliance is measured is also part of how to interpret these results. Compliance with debt and fiscal balance targets is often based on convergence to a fixed objective. The observed value remains high but is lower than the immediately previous period, which still constitutes compliance. Countries have been making efforts to reduce debt and deficits after the COVID-19 pandemic. While debt and deficit levels remain high, the convergence towards lower levels, supported by GDP rebound, has helped countries comply with fiscal rules. Economic recovery facilitates this procyclical compliance, making fiscal targets more attainable.

These factors reveal that economic conditions can enhance compliance rather than necessary adjustments in certain conditions. This situation creates a gap between short-term and long-term adjustments, impacting public finance sustainability and discipline. The evolution of fiscal objectives in recent years presents significant risks. Examining the broader consequences of non-rigid and adaptive fiscal rule targets is fundamental to fully understand these implications.

6. Implications of Non-Rigid and Adaptive Fiscal Rule Targets

The ability to frequently adjust targets can lead to a lack of long-term fiscal discipline. Governments might prioritize immediate compliance over sustainable fiscal health, undermining fiscal rules' fundamental purpose. Flexibility in targets can reduce the incentive for maintaining strict fiscal discipline. If governments know that targets can be adjusted, they may adopt lax fiscal policies, potentially leading to higher deficits and debt over time.

Moreover, the complexity involved in monitoring and calculating compliance with adaptive targets can result in transparency issues. The accuracy and reliability of economic indicators used for adjustments can be challenging to measure and verify. Implementing and managing flexible fiscal rules requires significant administrative capacity and resources, leading to inefficiencies and increased opportunities for mismanagement.

There is also a substantial risk that governments may manipulate or strategically interpret economic conditions to justify deviations from fiscal discipline. This risk is significant, as overestimating potential GDP growth or selectively interpreting economic data can weaken the enforcement of fiscal rules. The conditional nature of targets can lead to ambiguity and subjective decision-making, allowing governments to exploit loopholes and evade fiscal constraints under the guise of economic conditions.

Flexible fiscal rules may inadvertently promote procyclical fiscal policies, where governments increase spending during economic booms and cut back during downturns, exacerbating economic volatility and instability. If driven by unexpected revenue increases, high compliance rates may mask underlying fiscal vulnerabilities. Relying on positive revenue surprises can lead to complacency, ignoring the need for structural fiscal reforms and prudent financial management.

Finally, frequent adjustments to fiscal targets can undermine the credibility of fiscal rules. Stakeholders, including investors and international organizations, may lose confidence in a system perceived as overly flexible and susceptible to manipulation. The unpredictability of target adjustments can create uncertainty, making it difficult for businesses and investors to plan and make long-term decisions, which can negatively impact economic growth and investment.

7. Conclusions and Policy Recommendations

The COVID-19 pandemic and the challenging macroeconomic conditions in the aftermath of 2020 tested the resilience of fiscal institutions in LAC countries. These events underscored the need to reassess the role and objectives of fiscal rules. The implicit flexibility and adaptability of fiscal rules became apparent as governments faced unprecedented fiscal pressures. However, this flexibility often undermined long-term fiscal discipline, introducing complexities and opportunities for manipulation that jeopardized public finance sustainability. There is a pressing need to re-evaluate and strengthen these fiscal frameworks to ensure they serve their intended purpose effectively.

A "comply or explain" framework can enhance the credibility and effectiveness of fiscal rules, but its success is closely tied to the strength of a country's fiscal institutional framework. Governments should adhere to established fiscal rules or provide detailed explanations for any deviations. This transparency will hold governments accountable and ensure that deviations are justified and temporary. Establishing and strengthening independent fiscal councils can further ensure rigorous and unbiased compliance monitoring, providing an objective assessment of fiscal rules (Davoodi et al., 2022; Debrun & Beetsma, 2018). This approach addresses the risk of complacency and manipulation, promoting fiscal discipline even during economic fluctuations. However, the effectiveness of these frameworks also hinges on having solid fiscal institutions in place. Adequate public financial management systems, reliable fiscal statistics, and external scrutiny throughout the budgetary process are essential for ensuring that fiscal rules are not only adhered to but also contribute meaningfully to long-term fiscal sustainability (Corbacho &

Ter-Minassian, 2013; Ter-Minassian, 2010). Additionally, the "comply or explain" framework itself can play a crucial role in reinforcing fiscal institutional strength by fostering transparency and accountability within these institutions.

Transparency in fiscal policy is crucial for maintaining public trust and ensuring accountability. Enhanced reporting and public accessibility to fiscal data are necessary. Governments must commit to regularly publishing comprehensive fiscal reports that are easily accessible to the public. Strengthening the role of independent fiscal institutions can offer an objective evaluation of fiscal policies and compliance, further enhancing transparency and accountability (Beetsma et al., 2019; Caldera Sánchez et al., 2024). Transparency reduces the risk of mismanagement and ensures that fiscal policies are effectively monitored and evaluated.

Flexibility in fiscal rules is necessary to accommodate unforeseen economic shocks, but it needs to be framed within well-defined escape clauses. The use of escape clauses during the COVID-19 crisis allowed governments to effectively manage the fiscal demands of the health emergency, demonstrating the practical benefits of such flexibility (Davoodi et al., 2022). However, this also led to significant deviations from established fiscal targets, particularly regarding deficits and debt, which raises concerns about the sustainability of these fiscal strategies over the long term. To mitigate these risks, the conditions for activating escape clauses must be transparent and subject to independent scrutiny, preventing them from being misused as a way to circumvent fiscal discipline (Valencia et al., 2024). When escape clauses are triggered, governments should establish clear recovery plans and ensure continuous monitoring to guide a swift return to established fiscal targets. This balanced approach helps maintain fiscal discipline while allowing for necessary flexibility, reducing the risk of long-term debt accumulation that could be difficult to reverse (Davoodi et al., 2022).

Establishing specific debt anchors as fixed reference points for acceptable debt levels is crucial for maintaining fiscal sustainability. These anchors provide clear targets for debt management, helping to prevent excessive debt accumulation. Governments can demonstrate a commitment to long-term fiscal health and stability by defining and adhering to debt anchors. This mitigates the risk of rising debt levels and ensures fiscal policies align with sustainable debt management practices.

The recent trends in fiscal rule compliance, driven by favorable economic conditions rather than genuine fiscal adjustments, highlight the need for reform. The high compliance rates in 2022 were significantly influenced by the GDP rebound, positive output gap dynamics, and unexpected inflation. These factors made it easier to meet fiscal targets temporarily but also masked underlying vulnerabilities. In 2023, compliance was already lower than in 2022, and non-compliance risks in 2024 are high. Addressing these issues ensures fiscal rules effectively promote discipline, transparency, and long-term fiscal health. These recommendations can strengthen LAC countries' fiscal frameworks, enhance credibility, and ensure that fiscal rules serve their intended purpose of achieving and maintaining sustainable public finances. By focusing on these areas, LAC countries can build more resilient fiscal systems capable of withstanding economic shocks while maintaining fiscal discipline and sustainability.

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Appendix A: Methodology for Calculating Fiscal Rule Compliance

Ulloa-Suarez & Valencia (2022) calculate fiscal rule compliance by comparing the target established for a given macroeconomic aggregate—such as fiscal deficit, debt, or expenditure ceilings—with the actual executed value. For this analysis, they used data from official sources, including Fiscal Responsibility Laws, Medium-Term Fiscal Frameworks, national budgets, statistical series, and reports from Ministries of Finance and Fiscal Councils in each country. The dataset covers 14 countries between 2000 and 2022, considering the different fiscal rules in place during this period.

Compliance with a given fiscal rule is determined annually by assessing whether the target was met. If the country complied with the rule in a given year, it is marked as compliant (1); otherwise, it is marked as non-compliant (0). Compliance rates are then calculated as a weighted average, considering the length of time each rule has been in place. Each country's compliance rate is calculated by summing the compliance periods for all rules, weighted by their duration, and dividing this by the total number of periods across all rules. This methodology assumes that the implementation periods of different fiscal rules are independent of each other. Compliance rates depend on the type of rule, such as those targeting debt reduction, deficit ceilings, or expenditure limits. The average compliance rate for a country is calculated using the following formula:

$$\text{Average compliance rate} = \frac{\begin{array}{c}\textbf{years } \boldsymbol{r_1} \textbf{ in place} \times \text{Compliance rate } r_1 + \\ \textbf{years } \boldsymbol{r_2} \textbf{ in place} \times \text{Compliance rate } r_2 + \\ \textbf{years } \boldsymbol{r_3} \textbf{ in place} \times \text{Compliance rate } r_3 + \ \dots . +\end{array}}{\begin{array}{c}\text{total years } \boldsymbol{r_1} \text{ in place} + \\ \text{total years } \boldsymbol{r_2} \text{ in place} + \\ \text{total years } \boldsymbol{r_3} \text{ in place} + \ \dots .+\end{array}}$$

Where # **years $\boldsymbol{r_n}$ in place** is the number of years the n-th rule $\boldsymbol{r_n}$ has been implemented and Compliance rate r_n is the percentage of years in which the country complied with the n-th rule. As an example, the fictional country "Macondo" introduced three numerical rules. The corresponding compliance data for "Macondo" is summarized below:

Table A1. Compliance data for "Macondo"

Type of rule	From	# Years in place	Compliant	Non-compliant	Compliance rate
Expenditure rule (r_1)	2000	15	7	8	47 %
Budget Balance rule (r_2)	2000	22	13	9	59 %
Debt rule (r_3)	2016	6	6	0	100 %
Total		43			60 %

The fiscal rules in force were suspended in 2020 and 2021, though there is no record of the escape clause being activated. The compliance rate for "Macondo" is calculated as follows:

$$\text{Average compliance rate} = \frac{(15 \text{ x } 47\%) + (22 \text{ x } 59\%) + (6 \text{ x } 100\%)}{43} \approx 60\ \%$$

In this way, the weighted average prevents bias in the compliance rate calculation, which would rise to 69% if a simple average were used, primarily due to the higher compliance rate of the more recently implemented rule.