

LAWS FOR FISCAL RESPONSIBILITY FOR SUBNATIONAL DISCIPLINE: INTERNATIONAL EXPERIENCE

Lili Liu and Steven B. Webb**

Fiscal responsibility laws are institutions with which multiple governments in the same economy – national and subnational – can commit to help avoid irresponsible fiscal behavior that could have short-term advantages to one of them but that would be collectively damaging. Coordination failures with subnational governments in the 1990s contributed to macroeconomic instability and led several countries to adopt fiscal responsibility laws as part of the remedy. The paper analyzes the characteristics and effects of fiscal responsibility laws in seven countries – Argentina, Australia, Brazil, Canada, Colombia, India, and Peru. Fiscal responsibility laws are designed to address the short time horizons of policymakers, free riders among government units, and principal agent problems between the national and subnational governments. The paper describes how the laws differ in the specificity of quantitative targets, the strength of sanctions, the methods for increasing transparency, and the level of government passing the law.

Evidence shows that fiscal responsibility laws can help coordinate and sustain commitments to fiscal prudence, but they are not a substitute for commitment and should not be viewed as ends in themselves. They can make a positive contribution by adding to the collection of other measures to shore up a coalition of states with the central government in support of fiscal prudence. Policymakers contemplating fiscal responsibility laws may benefit from the systematic review of international practice. One common trait of successful fiscal responsibility laws for subnational governments is the commitment of the central government to its own fiscal prudence, which is usually reinforced by the application of the law at the national as well as the subnational level.

1 Introduction

As subnational governments (SNGs) in developing and developed countries have gained more fiscal autonomy – spending responsibilities, tax bases, revenue transfers from the center, and the capacity to incur debt – their fiscal behavior has become vital to the national interest. Subnational borrowing to finance social and economic infrastructure can generate positive net returns and spread the financing burden fairly across generations. When SNGs follow unsustainable fiscal policy, however, it can jeopardize the services they manage (but for which the central government may have ultimate political responsibility), the safety of the financial system, the country's international creditworthiness, and overall macroeconomic stability. Too often the central government then gets dragged in to provide bailouts, which can disrupt its own fiscal sustainability and reward the populist fiscal tactics of the recipient SNGs. The global financial

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Lili Liu is Lead Economist, Economic Policy and Debt Department at the World Bank; E-mail: lliu@worldbank.org

Steven Webb is a consultant with the World Bank; E-mail: stevenwebb1@gmail.com

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crisis of 2008-10 has tested the effectiveness of FRLs in maintaining fiscal discipline and has shown some downsides of rigidity in the face of macroeconomic shocks.

Since the 1990s many governments have intensified the search for mechanisms to escape from fiscal populism that had been used as a strategy for winning elections and retaining public office. National governments have tried various ways to avert these problems. One way has been to pass a fiscal responsibility law (FRL) that prescribes proper fiscal behavior for SNGs, provides guidelines for parameters of SNG fiscal legislation, or sets incentives – rewards for success or sanctions for failure in following the rules. Argentina, Brazil, Colombia, India, and Peru have done so. Some SNGs, as in Argentina, Australia, Canada, and India have imposed legal constraints on their own fiscal behavior, to reduce the temptation of state administrations to leave fiscal messes and to improve their creditworthiness in the markets.¹ Although having not formally adopted subnational fiscal responsibility legislation, other countries such as Mexico, Poland, and Turkey have established fiscal rules or debt limitations for SNGs.

In this paper, we focus on FRLs that are called fiscal responsibility laws or that perform the same function. They have frameworks for making the budget process transparent and may include quantitative fiscal targets and enforcement mechanisms. They aim to restrain SNG deficits by preventing them in advance and/or by imposing extra penalties that go into effect more quickly and in addition to the inherent consequences of fiscal imprudence. These include both institutions imposed by the national government on the SNGs and institutions imposed by the SNGs on themselves. FRLs often have the additional effect of restraining the federal or central government from running unsustainable deficits and of mitigating the consequences of subnational fiscal excesses. The paper does not focus on other public finance laws, such as budget laws and debt laws, which contain elements of FRLs, although it does consider such laws when discussing the broader context of fiscal prudence.

This paper analyzes the circumstances and character of FRLs that may make a positive contribution to better SNG fiscal behavior.² As FRLs do not operate in isolation, the paper also considers the broader context of other laws and rules aimed at obtaining prudent fiscal behavior by SNGs. The paper includes Brazil, Colombia and Peru, where a unifying FRL applies to all levels of the government including the SNGs. In some other countries such as Argentina, Australia, and India, the FRL framework includes a national FRL, and SNGs may choose their own FRL framework. Provinces in Canada went ahead with their own FRLs within the overall national move toward fiscal consolidation. Although the paper mainly concerns FRLs that apply to SNGs, the paper will include the analysis of the national FRLs to the extent that they affect the parameters and incentives for SNGs.³

The structure of the paper is as follows. The next section explains the historical origins of FRLs in the context of political and fiscal decentralization. Section 3 examines the purposes, incentives, and authority behind FRLs – which level of the government passes FRL and to which level of government the FRL applies. Section 4 summarizes the content of FRLs, covering procedural and transparency rules, and fiscal targets as well as sanctions and escape clause associated with the rules. Section 5 analyzes FRLs in broader institutional context for fiscal prudence and channels for strengthening subnational fiscal discipline. Section 6 explores

¹ This list includes countries with FRLs that apply to SNGs. The paper does not include countries with more recent and ongoing efforts (e.g., Nigeria and Pakistan) as the evaluation of the impact of the FRLs focuses on the period prior to the global financial crisis.

² This paper will not address the issue of whether subnational governments should borrow or not. This issue relates to broader questions of fiscal decentralization, political autonomy of subnational governments, and revenue base that can be used for collateralizing the debt. The paper covers a set of countries where subnational governments have the authority to borrow.

³ See Corbacho and Schwartz (2007) for a review of national level FRLs across countries.

preliminary assessments of the effects of FRLs. Section 7 concludes and points to areas for further research.

2 Historical origins of FRLs

Fiscal rules and legislation for SNGs are less important when a country has centralized political and fiscal institutions, as these centralized institutions can set rules and use political power to enforce discipline of SNGs. Decentralization, often associated with rise of regional powers, has reduced the central administrative control over subnational fiscal behavior.

Since the 1980s, a number of countries, including Argentina, Brazil, Colombia, India, Mexico, Nigeria, and Russia, have decentralized varying degrees of fiscal authority and resources to their SNGs. Often, in the absence of adequate *ex ante* fiscal rules, this contributed to subnational fiscal stress or debt crises; some were triggered by deteriorating macroeconomic environment. In some places that have been fiscally decentralized for a long time, like Australia and Canada, the SNGs also had experienced fiscal challenges. All of these countries have subsequently strengthened their frameworks for SNG fiscal sustainability, and several of them passed fiscal responsibility laws as part of that framework.

In each case, the features of the law, how it was passed, and its implementation reflected the particular political structure of the country and the nature of its fiscal crisis. This section summarizes those particularities, as prologue to the discussion of their FRLs – first the federal countries and then the unitary. The federal countries in our sample – Argentina, Australia, Brazil, Canada, and India – tend to be more fiscally decentralized; the key distinction, however, is that the constitutions of the federal countries give the states or provinces the right to make their own laws in many areas and restrict the range of areas for which the national government can legislate. Shifts in the allocation of taxing powers, for instance, have to be negotiated with the states; the national government cannot decide unilaterally.⁴ By contrast, in the unitary countries – here, Colombia and Peru – the constitution gives the national government power to legislate in all areas and to decide unilaterally what powers and fiscal resources it will delegate to the SNGs.

Federalism in **Brazil** in the 1980s revived with the return to democracy from military rule. From 1982 to 1989 there was a sequence of electing governors, then electing mayors, electing a new congress with constitution-making authority, completing the new constitution, and finally holding the first direct election of the president. Thanks to the strong representation of SNGs in the 1986 congress, the 1988 constitution gave states significant authority and resources, including a much broader revenue base for the state-level VAT, but did not specify their spending responsibilities or set rules for fiscal prudence.

From the beginning of Brazil's political opening through mid-1990s, there were two major subnational debt crises. Each initial agreement that tried to resolve a crisis actually made the next crisis more likely, because they reinforced the perception that the federal government would provide debt relief, they provided such relief in the form of rescheduling (allowing the stock of debt to keep growing), set ceilings on debt service and thus on the effective political cost, bought out (without penalty) the foreign and private creditors to the SNGs and left the federal government holding the debt. Thus the state politicians suffered minimal consequences for their imprudence and their creditors suffered almost none, and so until 1997 the *ex ante* constraints written in the rescheduling agreements were usually quickly evaded (Dillinger, 1997; Rodden, 2003).

⁴ The constitution of a country can also set forth the authority of taxation. For example, the India constitution places the main power of taxing the service sector with the federal government.

Then in the late 1990s, this vicious cycle of failure in discipline and cooperation came to a halt, as the deeper political and economic incentives had changed after a national macroeconomic adjustment program ended hyperinflation and stabilized the economy. In 1997-98 the federal government made debt restructuring agreements with 25 states, which was finally effective in making them cease unsustainable borrowing. Three of the four largest debtor states supported the reforms and formed the core of a critical mass of states ready to cooperate in fiscal restraint, making it worthwhile for additional states join at the margin of cooperation. Also, the large scale of the states' non-performing debt to the federal government strengthened the resolve of the federal Congress to enact the FRL. The federal government negotiated agreements with 25 states in 1997 and 1998.⁵ These agreements were sanctioned by Law 9496 of September 1997 to reschedule the states' debt conditioned on states undertaking fiscal reforms and compliance with fiscal targets. The FRL in 2000 codified fiscal adjustment programs sanctioned by various resolutions (Alfonso, 2002; Dillinger, 2002). At the time, many observers doubted whether the federal government would successfully enforce the debt restructuring agreement and sustain the stabilization, and this is why the extraordinary measure of the FRL may have been necessary, to reinforce the expectations of stability.

Argentine provinces in the 1980s had no hard budget constraint, borrowed a lot, and effectively could monetize this debt, contributing to hyperinflation. The subsequent stabilization in 1991 centered on the Convertibility Plan, which fixed the Argentine exchange rate to the U.S. dollar. Through the 1990s the national government mainly followed a market-based strategy for coordinating fiscal discipline between levels of government: the central government would enforce hard budget constraints *ex post* and force the provinces to pay their debts (Dillinger and Webb, 1999). By the end of the 1990s, the absence of the *ex ante* fiscal controls had allowed a number of Argentine provinces to over-borrow, party fragmentation had narrowed the scope for fiscal compromises, and the national government had overcommitted itself by setting floors on transfers, even if national revenues fell (Gonzalez, Rosenblatt and Webb, 2004).

At the national level, faced with a deteriorating budget balance and growing debt payments, in 1999 the Congress approved a Fiscal Solvency Law – its first try at an FRL. It aimed to and did inspire a third of the provinces to pass their own FRLs. In 2001, however, the FRLs stopped working because of the extreme mismatch between the national government's fiscal and monetary policies and because the provincial FRLs lacked enforcement power and most of the economically important provinces had not passed them. Only 5 out of 11 provinces that imposed a hard budget constraint actually fulfilled their commitment (Braun and Tommasi, 2004). In 2004, Argentina tried anew with a national FRL that applied to the provinces as well as the national government and capital federal district. It passed Congress hastily (Braun and Gadano, 2007; Laudonia, 2009), and it did not come out of a consensus building process with the provinces nor reflect a solid technical consideration of how the provinces might adjust their finances to meet the legal requirements. Although many provinces complied with some of the law's procedural requirements, almost none were meeting the quantitative targets even before the onset of the global crisis in 2009. After that the quantitative targets were put on hold, which further undermined the credibility of the FRL process in Argentina.

The **Indian** Constitution forbids states from borrowing abroad and requires them to obtain central permission for domestic borrowing. The central government places limits on states' borrowing through the annual discussions with states on financing state development plans. While limiting explosive growth of state debt, the system has not prevented deterioration of fiscal trends as indicated by high levels of debt over GSDP in many states in the late 1990s. Factors contributing to the deteriorating fiscal accounts across Indian states in the 1990s include: rapid increase in

⁵ Only two states (Tocantins and Amapá) did not have any bonded debt, and hence did not participate in the refinancing agreements.

expenditures on salaries, retirement benefits, and pensions and subsidies, increased borrowing to support the growing revenue deficit, and growth in contingent liabilities associated with fiscal support to the public sector units, cooperatives, and the statutory boards.

Since the early 2000s, the fiscal reform has focused on moving towards a more flexible, market-linked borrowing regime within sustainable overall borrowing caps imposed by the central government and self-imposed state-level deficit caps. The federal government enacted Fiscal Responsibility and Budget Management Act in 2003 which applies to the national government only, but some states had also adopted their own FRLs before the enactment of the federal FRL (e.g., Karnataka and Punjab in 2002) and many states have since 2003 adopted FRLs in line with the national law. FRL has become mandatory after the Twelfth Finance Commission (2005) and the federal government has offered a sizeable incentive to states for passing FRL.

The idea of legislating for fiscal responsibility gained considerable attention in the 1990s in **Australia**. At the federal level, the Business Council of Australia called for legislation requiring a surplus budget on average over the business cycle. It reiterated this theme during the 1996 federal election campaign. The adoption of the Charter of Budget Honesty Act in 1998 at the federal level followed years of improvement in fiscal outcomes. In fact, in the mid-1980s, Australia adopted its first set of explicit fiscal rules limiting the growth of expenditure, taxation and budget deficit. Although the recession in the 1990s saw the net debt of the country increased, never went beyond 20 per cent of GDP. The combined state and Commonwealth general government net debt had not exceeded 30 per cent of GDP in the 1990s (Simes, 2003).

Some states had adopted fiscal responsibility legislation prior to the federal government's adoption. New South Wales passed legislation in 1995 to commit itself and future governments to medium- and long-term fiscal responsible targets including the elimination of the net debt. Victoria passed the Financial Management Act in 1994, which was amended in 2000 through the Financial Management (Financial Responsibility) Act, which outlines principles of sound financial management, reporting standards and pre-election budget update. Minister must produce a pre-election budget update 10 days after the issue of a writ for an election. The Act broadly states what the update must contain and the principles upon which it must be based.

In **Canada**, in the 1990s both the federal and provincial governments needed serious fiscal corrections to reverse chronic fiscal deficits and growing debt burden after years of lax fiscal policy.⁶ The drive for restoring fiscal health was viewed as means to help accelerate economic growth. The deteriorating sovereign ratings⁷ increased the cost of borrowing, and private saving was not sufficient to finance both private investments and chronic fiscal deficits (Tractlet, 2004). The federal government undertook legislative reforms during the 1990s: enacting the Federal Spending Control Act (1991) setting limits on spending, and adopting a new framework to meet the medium-term fiscal balance and decrease debt ratio with rolling short-term deficit targets. Such measures succeeded in significantly reducing the national debt (IMF, 2002).

In this context, many provinces in the 1990s also adopted legislation to promote balanced-budgets and debt reduction (Millar, 1997),⁸ which may have helped increase the provincial finance ministers' bargaining power to promote unpopular fiscal measures (Kennedy and Robbins, 2003). These legislation set specific fiscal targets such as annual balanced budget and target year for debt elimination (Alberta), prohibited budget deficits in any year (Manitoba), set deadlines for achieving a balanced operating account (New Brunswick), and required net expenditures to decline by a

⁶ The fiscal correction was concurrent with monetary policy of inflation targeting. The attainment of announced targets has improved market and public confidence in the central bank's commitment to low and stable inflation (Tractlet, 2004).

⁷ Rating agencies downgraded the sovereign debt: in foreign currency in 1994 and in local currency in 1995 by Moody's and in foreign currency in 1993.

⁸ Alberta, Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia, Northwest Territories, the Yukon from 1993-1996.

certain percentage over a four-year period (Nova Scotia). Three more provinces enacted similar acts in 2000-04.⁹ For example, New Brunswick adopted Fiscal Responsibility and Balanced Budget Act in 2006 to cover the entire provincial budget, following the Balanced Budget Act in 1995. The province also enacted the Fiscal Stabilization Act in 2001 to stabilize the fiscal position from year to year and improve long-term fiscal planning and stability.

Colombia has traditionally been centralist, to offset the natural geographic fragmentation and to try to contain the centrifugal forces of strong special-interest groups. Overlying the natural geographic fragmentation, strong non-regional interests dominate the political dialogue – some operate within the legitimate political system, like teachers and producers of coffee, cattle and sugar, while others are outside and challenging it, namely two guerilla movements, the paramilitaries, and drug producers. Decentralization started in Colombia with the 1968 deconcentration of national revenues to subnational administrative units, with revenue sharing set by formula and mostly earmarked for specific sectors (Bird, 1984). The 1991 constitution (which also made the office of governor an elected post) and Law 60 of 1993 expanded the amount of revenues assigned to departments by broadening the base of the existing revenue-sharing system (the *situado fiscal*). The Constitution and Law 60 committed the national government each year to expand revenue sharing with SNGs until it would reach nearly half of all current revenues by 2002.

In the late 1980s and 1990s the trend toward political decentralization was accompanied by more freedom for subnational domestic borrowing, and hence a rise in their debt. To increase the central government's control over subnational debt, the so-called Traffic Light Law of 1997 introduced a rating system for territorial governments, based on the ratios of interest to operational savings and of debt to current revenues. Highly indebted local governments (red light) were prohibited from borrowing, and intermediate cases (yellow light) were required to obtain permission from the Ministry of Finance. The law often did not have the desired effect, however, as some governments with a red-light rating obtained new financing without permission of the Ministry of Finance, and departments often changed from yellow to red, rather than moving from yellow to green, as expected. In a new attempt to implement fiscal rules to stabilize subnational finances, Colombia passed Law 617 in 2000, which functioned in many ways as a Subnational FRL; despite the fiscal crisis at the national level in 2001-02, Law 617 had some success at the subnational level and laid the foundations for subsequent steps. In June 2003 the government passed the Fiscal Responsibility Law, which applied to the national as well as the subnational governments.

Peru is a unitary state, with even more of a centrist tradition than Colombia. Decentralization came relatively late to Peru, as part of a democratic reaction after Fujimori's exit in 2001. The 2002 decentralization law foresaw having half or more of public sector spending managed and to some extent allocated by subnational governments – districts, and municipalities – compared to the previous situation where SNGs managed less than 10 per cent of public spending. In contrast to the experiences of the other Latin American countries discussed here, the behavior of subnational public finances in Peru never deteriorated to the point where it adversely affected the country's financial sector or macroeconomic stability. As they contemplated fiscal decentralization and saw the macroeconomic problems that decentralized countries had had in the 1990s, the authorities passed the FRL and other measures to assure that fiscal decentralization did not lead to fiscal imbalances. As discussed below, the restraint measures in Peru succeeded perhaps too well, preventing effective fiscal devolution.

⁹ British Columbia, Ontario, and Newfoundland.

3 FRLs – purpose, incentives, and authority

Before delving into the content of FRLs (Section 4), we need to understand why governments might pass such laws, how they fit in the political context, how they address the timing of borrowing-lending decisions, which level of government passes them, and to which governments the FRL applies.

3.1 *Aligning fiscal incentives*

In a normative theory of good government, voters want to avoid the effects of a fiscal crisis – inflationary finance, sudden increase of taxes, disruption of service, and increased borrowing costs – so their government would equally want to avoid the crises. In practice, governments may fail to follow sustainable fiscal policies for a variety of reasons discussed in this section (see Alesina, 1994 for a survey and Saeigh and Tommasi, 2000 for applications to federations). Multiple levels of government multiply the possible reasons for failure of fiscal responsibility. To deal with these problems, governments have adopted various institutions to try to restrain themselves, including balanced-budget rules, autonomous central banks, and congressional oversight committees. Since the late 1990s, governments have added FRLs to the potential and actual toolkit.

Governments appear to be interested in FRLs to deal with four problems: i) short time horizons of policymakers; ii) free riders among SGNs; iii) principal agent and moral hazards problems between the national and SN governments; and iv) demonstrating commitments to be creditworthy. The first and fourth problems apply to governments at any level, whereas the second and third are relevant mainly in countries with multilevel government.

Short time-horizons of policymakers. A government may wish to institutionalize its commitment to control its impulses to run excessive deficits, in order to resist temptation in more pressing times that may come in the future. Policymakers often have shorter time-horizons than citizens, because they have shorter terms of office than citizens' life spans and policymakers face the risk of being voted out of office if results are painful in the short term. Also the mobility of citizens and businesses between local jurisdictions means that excess borrowing could drive residents away and leave those remaining with more debt per person than they had anticipated. So legislators can gain voter support by passing a law (e.g., FRL) that provides extra motivation for longer term fiscal sustainability.

Free riders. A group of governments in the same country may wish to make and enforce a mutual agreement that each of them would avoid running excessive deficits. To see the free-rider problem in this context, suppose that multiple governments share the same currency, central bank, domestic credit market, and (at least to some extent) international credit reputation. Then they will share a common interest in sustainable fiscal balances for the country in the aggregate, to maintain stable prices, a healthy financial system, and good access to international credit. Individual governments' interests would diverge from the common interest, however, in that factors such as electoral pressures would motivate them to follow fiscal behavior that is risky or unsustainable. An individual government would bear only part of the cost of its misbehavior, but would still receive all of whatever perceived benefit accrued. They could benefit from this, however, only if (most of) the other governments continued to follow good fiscal behavior. So, there might be prisoners' dilemma – a situation where the equilibrium of isolated individual choices leads to suboptimal outcomes for all.¹⁰ All the governments would, therefore, benefit from having a system of rules – an FRL – to discourage such defection and free-riding.

¹⁰ Inman (2003) develops the prisoners' dilemma model formally for this situation and shows how restrictive are the conditions under (continues)

In a country with multiple governments, the national government already exists for the purpose (among others) of protecting the common interests, has much greater fiscal weight than the others, and typically has special powers, like running the central bank and regulating the financial sector. The national government also provides transfers to the SNGs, which often are the main source of subnational revenue and give the national government additional leverage over them. But this may not be enough. Rules of revenue sharing and other rules of the system (like the constitution) may restrain the national government's power over the SNGs. Political considerations may bias the decisions of the national government away from the optimal; these could be the national political cycle or subnational ones (Braun and Tommasi, 2004). For instance when a state government of the same political party as the national government faces a close election, the national government might be inclined to condone the state's fiscal misbehavior by offering a debt bailout or rescheduling guarantee. Also, under some configurations of political institutions, the national executive might need to purchase blocks of legislative votes through provincial fiscal favors, in ways that also break the inter-temporal Wicksellian connection, by which voters demand fiscal discipline to protect their interest as taxpayers. Thus, the agreement to protect the common interest would not only need to restrain the fiscal behavior of the individual SNGs but also restrain the behavior of the federal government.

Principal-agent and moral hazard problems. When citizens or a higher level of government (the principal) entrusts a subnational government (agent) with resources and the responsibility to carry out a task, then there is the principal-agent problem in assuring that the agent government will maintain the requisite fiscal stability to carry out the task, without default or bailout. Subnational borrowers as agents have an incentive not to repay their lenders as principals because they perceive that they will be bailed-out by the central government in case of default, resulting in moral hazard. This hazard may increase when the central government is also the creditor, since rollover of the debt is often the easy way out when an SNG does not pay what it owes to the central government. The incidence of these agency problems varies considerably depending on the structure of the subnational debt market in each country. For instance, the credibility and prudence of a no-bailout commitment by the national government in the event of subnational default depends partly on whether the creditors to the defaulting SNG are foreign or domestic.

Demonstrating commitment to be creditworthy. Borrowers, including SNGs, have an incentive not to reveal negative characteristics about themselves to lenders, which results in adverse selection – lenders will therefore charge a risk premium above what is directly justified by the revealed information, even for a borrower who is not risky. So the asymmetrical information can lead to mispricing of risks. To improve its terms of borrowing, a government needs to show creditors that it is not like those other government units of lesser credit or that it has given up the fiscally irresponsible ways of its past. It can demonstrate this commitment by constraining itself with a FRL, its own or from the national level. Once one government demonstrates its commitment by passing an FRL, the pressure increases on other governments in the country to follow suit, in order not to stand out as *the* government that is not committed to fiscal responsibility. If the entire country has an FRL framework, then it will be the adherence to the fiscal targets that will become more important.

Fiscal responsibility laws have some downsides as well. Most importantly they tend to make aggregate fiscal policy more pro-cyclical. Although most FRLs have some escape clause for the eventuality of a recession and some call for stabilization funds, it has been difficult to set these up

which the market successfully establishes SN fiscal discipline if the central government takes a hands-off no-bailout approach. The conditions include competitive suppliers of local public services, a stable central government, clear and enforceable accounting standards, a well-managed aggregate economy, and an informed and sophisticated local government bond market. No developing country has these complete conditions, and the international financial crisis of 2008-09 will test whether any advanced economy has them.

in a way that are adequately countercyclical, while still demanding rigorous fiscal responsibility (Melamud, 2010).

3.2 Incentives in the political system for fiscal prudence

The political characteristics of the countries affect both the need for subnational fiscal-control institutions and their effectiveness. Indeed, to some extent the political factors that increase the need for an FRL also make it more difficult to pass one and to enforce it successfully. Several dimensions of political system are relevant: i) a majority party of the executive in legislature versus coalition (parliamentary) or divided government (presidential); ii) strong party identities and unity, including closed-list nominations for legislature, versus weak parties and open lists; iii) autonomy of SNGs constitutionally versus national government power to intervene and otherwise control; and iv) a strong role for the national legislature and strong influence of governors over legislators, versus strong national executive authority (Dillinger and Webb, 1999). To the extent that the constitution and party system lead to more centralized power, the country will have less need for special institutions to coordinate fiscal discipline across governments over time and between states. In some countries in our sample, however, the fiscal decentralization was part of a more general decentralization of power, which was linked with the restoration or establishment of democratic rule (Garman *et al.*, 2001). The party with centralist tendencies and strong public sector dominance may be more interested in pushing a certain development path through state control, central planning and a strong public sector than fiscal management. Subsequent decentralization and market decontrol have led to increasing need for central coordination of policies.

The national and SNGs are not always autonomous agents, as the previous section presumed. For instance they can be manifestations of the same political party. Such arrangements can reduce the free-rider and principal-agent problems described above, because the party aligns the incentives of the national and subnational politicians. The Argentine Justicialista (Peronist) Party in the mid 1990s and the Indian Congress Party in its years of dominance performed similar functions of harmonizing the incentives of policymakers at national and subnational levels. When the single-party dominance in these countries ended or diminished substantially, with the increase of democracy, the absence of the extra-constitutional (but legal) channels for inter-governmental coordination created the need for FRLs or other formal mechanisms for coordination.

Even without a strong party system, a powerful president can enforce subnational fiscal discipline.¹¹ President Cardoso in Brazil became a strong president in the late 1990s even in a context of weak party loyalties and used his office (and reputation as an inflation fighter, from when he was Minister of Finance) to press successfully for fiscal discipline at the national and subnational levels. The institutionalization of this discipline included the FRL but had already started with some previous measures. President Uribe in Colombia also used his political popularity, without a strong party base, to pass the FRL in 2003. This was in the context since the late 1990s of much weaker loyalties to the two traditionally strong parties, which had fought over many things but had agreed on maintaining macroeconomic stability.

These examples show the importance of the particular political situation in each country – with effects both on whether the country needs an FRL and whether it can gather the consensus to pass one. An FRL seems most likely when there is an intermediate degree of political cohesion – with a high degree of cohesion an FRL may not be needed, and with a low degree one cannot pass or enforce the FRL.

¹¹ Although a strong president usually creates a party of his followers, if the main unifying factor is the personality of the president, one cannot accurately call this a strong party system.

Table 1

Which Government Passed FRL and To Which Levels Does It Apply?

	National FRL Applies to All Levels, Usually More Strictly to SNGs	National FRL Applies Only to National Level	SNGs with Own FRLs
<i>Federal constitution</i>			
Brazil	X		
India		X	X
Argentina	X 2004	X 1999	X (some in 1999)
Canada ¹			X
Australia		X	X
<i>Unitary constitution</i>			
Colombia	X		
Peru	X		

¹ The national government passed a law controlling federal spending.

3.3 Authority: Which government passes the FRL? To which government does it apply?

The FRLs differ in terms of which government passes it and to which government(s) it applies but the content of the two types is similar. Some FRLs are national laws that apply to all levels of government, or at least to the national and intermediate (state, provincial) levels, as in Argentina (2004), Brazil (2000), Colombia (2003), and Peru (2003). From the SNG point of view, these are top-down systems.¹² In other cases, such as Argentina (1999), Australia, and India, the federal government passes an FRL only for itself, and this sets the framework, incentive, or example for the SNGs to pass their own FRLs voluntarily. In some cases, a SNG would enact its own FRL (e.g., the Indian states of Karnataka and Tamil Nadu and some Australian states) before the enactment of the federal FRL. A few Canadian provinces have passed their own FRLs to sustain fiscal discipline and to improve their credit ratings.¹³

Table 1 summarizes how various countries have handled the issues of which government passes the law and which it applies to. With either type of law, enforcement is an issue. There is difference, however, between a government trying to discipline itself with a law that it has the power to change and a higher-level government disciplines a lower-level government that has some political independence. In the latter type of arrangement, it remains uncertain whether the national government will have the tools and political determination to enforce the law. When the national government passes an FRL law that does not directly prescribe what the SNGs must do, a key question is whether the SNGs follow the federal example and pass and obey their own laws. Given the complex variety of intergovernmental systems, there is no single optimal recipe for which level of the government can or should pass the FRL and to which level of government it should apply.

¹² Ter-Minassian and Craig (1997) argue that such top-down control is necessary for SN fiscal discipline in developing countries. Rodden and Eskeland (2003), with more evidence to consider, see prospects for combining hierarchical control with market discipline, and gradually letting the latter take more weight.

¹³ West Bengal and Sikkim are the only two states out of 28 that have not enacted an FRL.

In the US and Canada the political tradition of state and provincial autonomy and independence, along with consistent no-bail policy by the center, has existed from the 19th century and has generally instilled subnational fiscal discipline through *ex post* consequences. The explicit institutional responses have been at the state and provincial level, with their own laws or constitutional amendments to set *ex ante* constraints to keep the subnational governments out of trouble (Inman, 2003; Wallis, Sylla and Grinath, 2004). Neither federal government has an FRL pertaining to the SNGs. No US state has an FRL, although most have more or less strict limits on state borrowing and deficits, with origins back to the 19th century. The federal government does not have enough sway to force an FRL upon them.

Brazil's FRL was passed by the national government for all levels of government; it uses both *ex ante* rules and legal penalties to contribute to the consolidation of a critical mass of consensus for fiscal prudence among powerful governors who had few party loyalties but strong influence over national legislators. Colombia, a unitary country of "autonomous" departments, already had various laws constraining subnational borrowing, and to get more institutional backing for fiscal balance at the national level they passed an explicit FRL in 2003. It adds to the *ex ante* constraints on SNGs and sets up transparency and accountability procedures for encouraging fiscal prudence at the national level.

Peru has had a national-level FRL since 2000, and then in 2002-03 municipal and regional governments got elections and obtained substantial *de jure* fiscal autonomy, including the right to borrow. Therefore, the government revised the FRL in 2003, with provisions for the SNGs as well as tighter constraints on national fiscal behavior. Argentina has gone through several FRL arrangements without success. The 1999 national government's FRL was only directly for the national government and called for provinces to pass their own FRLs, which some did but some others did not, including the largest province. In the fiscal crisis of 2000-01 and beyond, both the federal and SNGs missed the FRL targets and the laws seemed irrelevant. In 2004, the national government passed an FRL that applied to all levels. The federal government and SNGs were missing the targets even before the 2008-09 world financial crisis, however, and in 2009 the essential provisions of the law were suspended.

4 Content of FRLs

This section analyzes the content of FRLs relating to SNGs in Argentina, Australia, Brazil, Canada, Colombia, India, and Peru. The analysis is organized along three dimensions: procedural rules for transparency and accountability, fiscal targets – quantitative or qualitative, and enforcement and escape clauses. Annex 1 presents a more detailed summary of the content of FRLs along these dimensions.¹⁴ For Brazil, Colombia and Peru, the analysis is on the unified FRL that applies to the SNGs. For Argentina, Australia, Canada, and India, subnational FRLs are presented.

In general, there is greater convergence among countries on the procedural rules and fiscal targets, and more variability on the escape clause and enforcement. All FRLs call for the processes of budget formulation and execution that increase transparency and rationality. Many FRLs require medium-term fiscal frameworks. Almost all FRLs have explicit fiscal targets – fiscal deficit, debt, or both, or other variables such as operating budget balance. In some FRLs, additional variables are targeted, such as expenditure growth and composition.

¹⁴ Argentina, Australia, Canada, and India are the countries with subnational FRLs. Most Argentine provinces have adopted the FRL, which was drafted jointly with the Federal Government, except 3 out of 24 which have their own provincial one. Canada has 13 provinces. The discussion in the paper and Annex 1 covers 9 provinces, which account for over 99 per cent of population. Australia has six states and two major mainland territories. India has 28 states. As the content of FRL is broadly similar across 26 states that have enacted FRL, Annex 1 summarizes the content of FRL in eight states.

4.1 Procedural rules for transparency and accountability

All FRLs in the countries discussed call for processes that increase the transparency and rationality of formulating and executing the budget. Typically the FRL requires annual publication and legislative discussion of a fiscal plan and budget, and often this is for multiple years on a rolling basis. The presentation may have to include full costing of any new spending programs or tax changes. Fiscal transparency includes having an audit of subnational financial accounts, making periodic public disclosures of key fiscal data, or exposing hidden liabilities. The FRLs also vary in the extent to which they control arrears and the deficits of off-budget entities, like companies owned wholly or largely by SNGs.

The requirements for a medium-term fiscal framework and a transparent budgetary process aim to ensure that fiscal accounts move within a sustainable debt path and that fiscal adjustment takes a medium-term approach to better respond to shocks and differing trajectories for key macroeconomic variables that affect subnational finance. The transparent budgetary process affords debates by executive and legislative branches on spending priorities, funding sources, and required fiscal adjustments.

To a large degree the effectiveness of these requirements depends on how diligently the legislature and the press monitor these publications and compliance with them. The discipline and sanctions from the political pressures and the access to information about commitments and subsequent compliance can help enforce FRLs. Credit markets can also help with discipline by imposing risk premiums and raising the cost of borrowing if there is fiscal misbehavior. The countries with FRLs under discussion are all democracies, but they vary in how well their institutions function to achieve accountability.

Brazil's FRL sets minimum standards for state budgeting, personnel management, and debt management. The annual budget prepared by each SNG has to be consistent with its multiyear budget plan and with the federal fiscal and monetary program. The FRL systematizes and reinforces the restrictions on personnel spending, deficits and debt that were in the state debt rescheduling agreements and other earlier measures (Law 9496 and the Senate resolutions). The accrual accounting method for all levels of the government eliminates an important source of hidden liabilities: arrears. It also contains specific limits on spending commitments by governments in their final year in office.

In Brazil, moreover, article 48 of Brazil's Fiscal Responsibility Law (2000) enshrines fiscal transparency as a key component of the new framework. Proposals, laws, and accounts are to be widely distributed, including through the use of electronic media (all reports are on the government website). Article 54 requires that all levels of governments publish a quarterly fiscal management report that contains the major fiscal variables and indicates compliance with fiscal targets. Pursuant to article 57, this report is to be certified by the audit courts.

In **Colombia**, the FRL specifies the process for setting budget targets and linking them to target ranges for debts and deficits. Regulations for the law institutionalized the practice at the national level and in some SNGs of publishing quarterly fiscal results, defining deficits on the basis of cash revenue and accrual of spending obligations, and defining debt to include floating debt. The FRL set a target to eliminate *reservas presupuestales* (pre-committed expenditures) in two years, which was done. The other part of floating debt, accounts payable, were counted as regular debt and thus controlled by the fiscal/financial plan. To help with fiscal discipline at all levels, the FRL prohibits the national government from lending to an SNG or guaranteeing its debt if it is in violation of Law 617 of 2000 or Law 357 of 1997, or if it is in arrears on any debt service to the national government. Indeed, a subnational government with those fiscal violations may not legally borrow from anyone. To discourage electoral cycles in fiscal policy, the FRL prohibits any government from committing spending in future years or increasing personnel spending in an

election year. Departmental and municipal central administrations are not allowed to make transfers to their public entities. Strict limits apply to creation of new municipalities, and municipalities proven non-viable have to merge.

In **Peru** the 2003 FRL built upon the 2000 FRL (Fiscal Prudence Law), extending it to SNGs. It required that the annual fiscal deficit of the non-financial public sector not exceed the limit in the multi-annual fiscal framework and in any case would not exceed specific targets (discussed below). Each regional government must prepare and publish an annual development plan that is consistent with the national fiscal framework (including the size of total public sector deficit). Quarterly monitoring of the fiscal performance is required and, in case of revenue shortfall, adequate remedies to revenues and/or expenditures must start in the next quarter. Although the subnational fiscal frameworks have to fit within the national one – whereas in some other countries the SNGs fiscal frameworks merely have to be internally consistent and are not directly subordinated to the national government’s fiscal framework – this has not usually been a binding constraint in Peru, as the national government and the overall general government have not hit the limit and ran surpluses in 2006, 2007 and 2008.

Argentina’s Fiscal Solvency Law in September 1999 called for limits in the growth of expenditures, the adoption of multi-year budgeting, creation of a Countercyclical Fiscal Fund, and various transparency measures regarding public finances – the features favored by the recent literature on fiscal rules. The new FRL in 2004 applies to the provincial as well as national levels and has similar procedural requirements – rolling 3-year budget plan with projection of revenue and spending by destination, functional and economic categories. An intergovernmental commission coordinates the definitions of budget categories and evaluates budget proposals. The multiannual fiscal plans and results need to be published on the governments’ web pages (Melamud, 2010). The law does not spell out coordination on some key items, like the national government’s specification of salary increases for teachers, which provinces have to pay and which set the standard of pay demands by the rest of provincial workers. These unfunded mandates effectively derailed provincial spending plans, leaving provincial governments largely unable to control their fiscal situations. Discretionary transfers from the national government have allowed them to meet their payment obligations and kept made them more politically dependent.

In **India**, FRLs passed by states typically require the state government present its medium-term fiscal plan with annual budget to the state legislature. The fiscal plan should set forth multi-year rolling targets for key fiscal indicators. Some FRLs require that the state at the time of budget presentation disclose contingent liabilities created by guarantees provided to public sector undertakings, and some FRLs require the disclosure of borrowing from the Reserve Bank of India and liabilities on the state government for any separate legal entities. Most FRLs require disclosure of significant changes in the accounting policies.

In **Australia**, the procedural rules and transparency are expressed in varied terms across FRLs of states; this is in contrast to India where FRLs enacted by states have strikingly similar content. But the over-arching content of the FRLs across states in Australia centers on sound fiscal management, transparency in disclosing fiscal policy and accounts, and tabling of fiscal budgets to state legislature for oversight. For example, the Fiscal Responsibility Act (2005) of New South Wales lays out the fiscal principles and targets for the state. In application of fiscal principles, the government should report in annual budget papers: an assessment of past and prospective long-term average revenue growth; an assessment of the impact of budget measures in respect of expenses and revenue on long-term fiscal gaps; measures taken to reflect the fiscal principles; and the estimated impact of proposed tax policy changes. These principles are supported by the Public Finance and Audit Act 1983 that requires the treasurer to: release publicly monthly statement and half year review setting out projections and year-to-date balances for the budget;

table the annual budget in the Legislative Assembly; and present audited financial statements to the Legislative Assembly.

FRLs of provincial governments in **Canada** place responsibility and accountability with the provincial finance minister. The finance minister must present a budget plan and annual report to the legislature of the provincial government and make these available to the public, within prescribed deadlines. Variations exist about the exact nature of disclosure, for example, the public disclosure in Ontario includes mid-year review of fiscal plan, updated information about revenues and expenses, long-range assessment of fiscal environment two years after provincial election, and pre-election reports under certain regulation. In New Brunswick, each year the minister shall provide details as to how the public may participate in pre-budget consultations and shall make public a pre-budget consultation document that sets out the key fiscal issues for consideration.

4.2 *Fiscal targets*

In addition to procedural rules and transparency, most FRLs reviewed here spell out fiscal targets for SNGs with the most common target being the deficit, and there are differences in the degree of specificity about other targets such as debt stock, spending and guarantees.

Table 2 summarizes fiscal targets in the FRLs for SNGs in Argentina, Brazil, Colombia, India, and Peru. As can be seen, fiscal targets are uniform for SNGs in Brazil, Colombia and Peru; this is not surprising as these countries each has a unified FRL applied to all levels of government.

As can be seen from the table (and Annex 1), fiscal targets differ across countries, and in some countries differ across SNGs. There are two challenges in setting fiscal targets. First, how these targets relate to the threshold for fiscal and debt sustainability? To date, there are no agreed empirical thresholds for SNGs. Second, how can uniform adjustment targets be compatible with horizontal equity if SNGs are starting off from different levels of development and with a large mandate (and backlog) of expenditures? This question will need to be related to the system of fiscal transfers with the intent to reduce horizontal inequality in service delivery.

In the absence of market discipline, for national or SNGs to do this for themselves – passing a law stating what budget they have to pass – has the inherent weakness that the same legislative body that would pass an unbalanced budget (in violation of the law) could also vote to change the law. If the national FRL specifies fiscal ratios for the SNGs, however, this has more inherent strength, since it provides a legal basis for the higher level of government (and typically a source for fiscal transfers) to impose limits on the SNGs. These limits are typically about deficits, borrowing, debt stock, and/or debt service to fiscal revenue or GSDP. Revenue is likely to be a more effective basis, since it is known sooner and with more precision than GSDP.

Since the point of an FRL is to prevent the fiscal slippage from deterioration to insolvency, focus on ratios where the subnational government has more control over the denominator as well as the numerator (e.g., wage bill as a share of total spending) is more likely to have the desired effect than relying only on ratios, like debt service or debt stock to GSDP. These ratios are substantially influenced by exogenous factors (interest and exchange rate) and often go over the limit only after problems have gotten out of hand.

In **Brazil**, the debt restructuring agreements between the federal government and the states in 1997 established a comprehensive list of fiscal targets – debt-to-revenue ratio, primary balance, personnel spending as share of total spending, own-source revenue growth, and investment ceilings – as well as a list of state-owned enterprises or banks to be privatized or concessioned. The annual budget of each SNG has to be consistent with its multiyear budget plan and with the federal fiscal and monetary program. The FRL mandates Senate resolutions to set the specific targets for SNG

Table 2

Fiscal Responsibility Laws – Fiscal Targets for SNGs

Country	Fiscal Targets
Federal Constitution	
Argentina (2004)	<ul style="list-style-type: none"> • Primary spending growth at or below the growth rate of national GDP • Budget balances of provinces sufficient to bring debt service below 15 per cent of current revenue, net of municipal transfers
Brazil	<ul style="list-style-type: none"> • Personnel spending 60 per cent or less of net fiscal revenue for states and municipalities, with ceilings for each branch of government • Compliance with targets in mandatory limits set by the Senate
India (states)	<ul style="list-style-type: none"> • Annual reduction of revenue deficit • Elimination of revenue deficit by certain date • Annual reduction of fiscal deficit • Fiscal deficit/GSDP \leq 3 per cent of GSDP • Limits on guarantees • Total liabilities \leq 25-28 per cent of GSDP
Unitary Constitution	
Colombia	<ul style="list-style-type: none"> • Interest payment/operational savings • Debt/current revenue
Peru	<ul style="list-style-type: none"> • Fiscal deficit of total non-financial public sector including SNGs no more than 1 per cent of GDP • Real growth of public sector spending including SNGs no more than 3 per cent per year • Stock of debt for each SNG may not exceed 100 per cent of the current revenue, and the debt service (interest and amortization) may not exceed 25 per cent of the current revenue • The average primary balance of each SNG for the last 3 years may not be negative

Note: Revenue deficit in India is the difference between total revenue and current expenditure.

Sources: see Annex 1.

debt and fiscal balances. The FRL systematizes and reinforces the restrictions on fiscal variables such as personnel spending as a share of SNG net revenue and on borrowing (Annex A1). It also contains specific provisions for authorities in their final year in office. These restrictions on the borrowers' side were complemented by restrictions on the supply of credit from banks and international lenders.

In **Colombia**, the Fiscal Transparency and Responsibility Law (2003) in combination with a modified version of the Traffic-Light Law (Law 358 of 1997) rates SNGs according to the ratios of debt to payment capacity, and SNGs rated in the red-light zone are prohibited from borrowing, and those in the green-light zone are permitted to borrow up to limits based on debt sustainability

calculations. Departments and large municipalities must get satisfactory credit ratings from international rating agencies before they borrow (following the idea from a regulation in Mexico since 2000).

In **Peru**, the FRL limits the deficit of the total public sector 1 per cent of GDP (or the amount in the national fiscal framework, whichever is less), except in congressionally authorized cases of national emergency or international crisis, when the deficit could go to 2.5 per cent.¹⁵ In addition, each SNG has to keep a non-negative primary balance on average for the last 3 years, and they may not have debt service over 25 per cent of current revenue or debt stock over 100 per cent. In election years, the governments may not spend more than 60 per cent of the annual spending allocation in the first 7 months and may not use more than 40 per cent of the annual limit on the deficit in the first half of fiscal year.¹⁶ The FRL sets some *ex ante* procedural constraints for subnational borrowing, and SNGs can only borrow internationally with the guarantee of the national government. The guarantee for any loan requires compliance with the Annual Debt Law and demonstration of the capacity to pay, which provisions give the national government the authority to veto SNG borrowing.¹⁷

Fiscal targets adopted by **Indian** states are remarkably similar to each other with respect to fiscal and revenue deficits. Some states FRLs also place limits on guarantees. Basically, in the early 2000s, some states went ahead of the federal government in enacting Fiscal Responsibility and Financial Management Act (e.g., Karnataka in 2002). The federal act in 2003 has similar fiscal targets as those in these early reforming states. Subsequently, the 12th Finance Commission mandated fiscal responsibility legislation for all states, with revenue deficit (total revenue minus current expenditures) to be eliminated and the fiscal deficit to be reduced to 3 per cent of GSDP by fiscal year 2009. Some states issued additional legislation on fiscal targets, for example the Kerala Ceiling on Government Guarantee Act (2003) that was enacted the same year as its FRL. According to the guarantee act, the guarantee outstanding for any fiscal year shall not exceed rupees fourteen thousand crores,¹⁸ no government guarantee shall be given to private entity, and the Guarantee Redemption Fund shall be established.

In contrast to India where fiscal targets with respect to revenue and fiscal deficits are similar across states, states in **Australia** do not have similar fiscal targets. The fiscal targets in New South Wales differ from those in Queensland. The Fiscal Responsibility Act of 2005 in New South Wales sets forth the following targets: Reduce general government net financial liabilities to ≤ 7.5 per cent of GSDP by June 30, 2010; and to ≤ 6 per cent by June 30, 2015; maintain general government net debt ≤ 0.8 per cent of GSDP, and eliminate total state sector unfunded superannuation liabilities by June 30, 2020. The Charter of Fiscal Responsibility of 2009 in Queensland sets forth a quite different set of fiscal targets: the General Government sector meets all operating expenses from operating revenue; growth in own-purpose expenses in the General Government sector to not exceed real per capital growth; achieve a General Government net operating surplus no later than 2015-16; stabilize net financial liabilities as a proportion of revenue

¹⁵ The 2000 (pre-decentralization) version of the FRL had such a restriction on general government fiscal balances, implicitly including SNGs; the 2003 FRL made the application to SNGs explicit.

¹⁶ Subsequent legislation has made minor modifications to these limits, but not undermined their intent. For instance, in 2007 and 2008 (Law Nos. 29035 and 29144) the restriction on the growth of the non-financial expenditure was changed to “annual real growth of the consumption expenditure of the central government”, which may not exceed 4 per cent, using the inflationary target from the central bank.

¹⁷ SNGs are not prohibited from getting domestic credit without the guarantee, but this must come within the overall public sector deficit constraint. Thus, the national government could use the requirements for getting credit with the guarantee and other means to force SNGs to report their non-guaranteed borrowing and to keep it within the total deficit constraint. With multiple channels of control at their disposal, the national Ministry of Economics and Finance has kept SNG borrowing under tight control.

¹⁸ This amounts to about US\$3 billion assuming exchange rate 46.7.

in the Non-financial Public Sector; and target full funding of long-term liabilities such as superannuation in accordance with actuarial advice.

FRLs in the Australian states of Western Australia and Northern Territory have only one fiscal target stipulating that funding for current services to be provided by the current revenue generation. The states of Victoria and Tasmania do not have fiscal targets, but their FRLs have established financial management principles including: prudent management of financial risks; spending and taxing policies to be formulated to maintain a reasonable degree of stability and predictability; and ensuring that policy decisions have regard to their financial effects on future generations. These principles are also established by the states of Western Australia and Northern Territory.

Fiscal targets vary across **Canadian** provinces, as shown in Annex 2. Most provinces require a balanced budget. British Columbia requires only the balance budget rule while Quebec allows fiscal deficit but no more than the accumulated fiscal surplus in previous years. Other provinces such as Alberta, Ontario and New Brunswick also require additional fiscal targets relating to debt ratio, net assets, or contingency allowance.

In **Argentina** the FRL (2004) says that budgets for primary spending (current and capital, net of interest cost) may not grow faster than the rate of growth of the national GDP, as foreseen in the national macroeconomic framework (also called for in the FRL, as mentioned above). If GDP growth is negative, then the primary spending may not grow, but does not have to shrink. The limitation on primary spending is weakened by important exceptions: namely, any investment spending for basic social infrastructure, spending financed by international organization, and spending paid with unused revenue from previous years. Borrowing does have an aggregate limit in that debt service (projected) may not exceed 15 per cent of revenue (net of participation transfers earmarked for the municipalities). Nonetheless, the outcomes have been mixed and often less favorable than in the possibly optimistic projections, putting some provinces over the 15 per cent limit. Furthermore, as a result of the recession that accompanied the global downturn in 2009, Congress derogated key fiscal targets for 2010 and 2011; and in particular those setting ceilings on current primary spending growth, the overall primary fiscal balance, and new borrowing (Law 26,530). Such a temporary suspension reflects first the need to consider escape clauses in FRLs that would provide more flexibility to public spending when facing adverse external or domestic shocks; and second, the need to save in the counter-cyclical fund when the provincial economies are in expansion, which did not happen. This legal initiative was also accompanied by another *Programa Federal de Desendeudamiento* (Decree No.60/2010) that allows restructuring of eligible provincial debts, affected by the deterioration of their fiscal balances. Up to the end of August 2010, about eighteen provinces had benefitted from such programs.

4.3 *Enforcement and escape clause*

Rules are only as good as their enforcement, and FRLs vary in terms of the strength of enforcement called for in the law and in terms of how well the governments implement the law in practice. On the enforcement and escape clauses, there is great variability across countries, and within country in the case of Canada.

The enforcement ranges from no specific enforcement clause in the case of states FRLs in Australia and most provinces in Canada to strict enforcement in the case of Brazil, Colombia, Peru and three provinces in Canada. Indian states broadly follows the sanction clause in the national FRL that whenever there is a breaching of intra-year targets of revenues and expenditures, the state government should take appropriate measures for increasing revenues and/or reducing

expenditures, including curtailment of the sums authorized to be paid and applied from out of the Consolidated Fund of the state. However there is no specific timeframe for meeting the targets.

More strict sanctions on the SNGs can be found in Brazil, Colombia, Peru and three provinces in Canada. In **Brazil**, the FRL reiterates from earlier laws the requirement that if an SNG's debt is over the legal limit it may not borrow (except for refinancing) and would no longer receive "voluntary" transfers from the federal government (transfers not from tax-sharing participations). Debt and labor contracts in violation of the FRL are not legally valid, which would be a negative *ex post* consequence for any lender who thus would lose its money. The Fiscal Crimes Law (LCF), a companion law to the FRL specifies criminal penalties – fines and even jail – for officials who violate the rules. The LCF applies to public officials of all branches of government at all levels. Among other provisions, the LCF provides for detention of up to four years for a public official who engages in credit operations without prior legislative authorization, incurs unauthorized expenditure commitments (including any in the last two quarters in office that cannot be repaid during the present term of office), extends loan guarantees without collateral of equal or higher value, increases personnel expenditures during the final 180 days of the term of office, or issues unregistered public debt (IMF, 2001).

The **Colombia** unified FRL imposes strict sanctions on SNGs for their non-compliance with FRL. When SNGs do not comply with the limits imposed by the FRL, they will be prohibited from borrowing. They also have to adopt a fiscal-rescue program to regain viability within the next two years. The governments must make across the board spending cuts whenever actual non-earmarked current revenues are lower than in the budget estimates. Sanctions are also imposed on lenders. The law tightens the regulations on the supply side. It prohibits lending by the national government to a subnational entity or guaranteeing its debt if the subnational is in violation of Law 617 or Law 358 or if it has debt service arrears to the national government. Furthermore, lending to subnationals by financial institutions and territorial development institutions must meet the conditions and limits of various regulations such as law 358, law 617, and law 817. Otherwise the credit contract is invalid and borrowed funds must be restituted promptly without interest or any other charges (FRL, Art. 21).

In **Peru**, violation of the FRL targets or some other legal targets by SNGs will cause the temporary disruption of transfers from participatory funds, such as FONCOR, FONCOMUN, and FIDE, which are block grants to regional and communal governments and are set by a formula that favors localities with a higher share of low-income population.

The two **Canadian** provinces that have sanctions are British Columbia and Manitoba. In British Columbia, the members of the executive council are subject to a 20 per cent pay cut when fiscal targets are not met. The cut can be partially or fully restored when fiscal targets are met. In Manitoba, if fiscal balance at the end of year is negative, ministerial salaries are cut by 20 per cent in the first year and 40 per cent in the second year if the deficit continues. Ontario has similar sanctions of cutting the salary of Executive Council members when deficit target is missed.

In **Argentina**, the FRL (2004) does not have strong sanctions on the SNGs or their lenders. Furthermore, it allows the Federal Council of Fiscal Responsibility discretion to decide which of the possible sanctions to apply (Art. 32). If an SNG's debt service exceeds the limit, then it may not borrow except to rollover existing debt on more favorable terms and as part of a fiscal adjustment program, perhaps with a multilateral international lender. Provincial governments that miss the fiscal targets in their macro frameworks have faced little political fallout; it has been easy to shift blame to the overall macro situation and to unfunded mandates from the national government. As has been the case all along in Argentina, creditors can make a prior claim on the participation transfers to get the debt service due, which leaves them with little concern as to whether or not their provincial client is within the bounds of the FRL.

With regard to escape clauses, none of the Australian states contain it. Brazil and Peru FRLs and FRLs by Indian states have escape clause to relax fiscal targets and debt ceilings in the event of calamity and less than 1 per cent economic growth for the last four quarters (Brazil), negative growth and national emergency (Peru, Article 5), national security or natural calamity or exceptional grounds (Indian states). Escape clause differs across Canadian provinces, with some provinces do not have one, while some provinces has escape clause in the event of major disaster or extraordinary circumstances. Colombia's FRL does not have an explicit escape clause. Nor does Argentina's FRL, although the congress did suspend key provisions of the FRL during the 2008-09 global financial crisis.

Rules also need to take into account exogenous shocks – like a global recession – and allow some accommodation, without undermining the fiscal discipline. The ongoing global economic crisis has pressured sovereign and sub-sovereign finance, which has led some countries to apply the escape clause. The extent of the full response will need to be reviewed. A key question during a macroeconomic crisis, such as the 2008-09 global crisis, is whether it is more appropriate for the central government to do all of the fiscal stimulus or loosen the fiscal constraints for subnational governments. For example, the Thirteenth Finance Commission in India recommended that the central government be the one bearing the cost of the crisis and the states should receive assistance from the centre for providing the stimulus.

5 FRLs in broader institutional context for fiscal prudence

FRLs do not operate alone, nor are FRLs sufficient to enforce fiscal discipline. To understand the role of FRLs in enforcing fiscal discipline, it helps to know the range of institutional tools available for this purpose and to know what other institutions for fiscal discipline exist, including the overall incentive structure and enforcement capabilities for subnational and national governments and their creditors.

5.1 Lender-borrower nexus and timing of controls and sanctions

Deficits and debt arise from the joint decision of governments and their creditors (including suppliers allowing extended payments). These decisions are made in light of not only the rules governing issuance of the debt, but also the *ex ante* expectations about what will happen to the debtor and the creditors if payment difficulties arise – who will lose money or who will be forced into painful adjustment. The decisions of that lending moment become a *fait accompli* conditioning the subsequent decisions. This points to two important dimensions of control of government borrowing. First the type or timing – *ex ante* controls or *ex post* consequences; and second whether the *ex ante* controls and *ex post* consequences act on borrowers or lenders. Together these make a matrix with four cells, as in Table 3 overleaf.

Traditionally the fiscal discipline literature has focused on the first column – constraints and incentives of borrowers. *Ex ante* constraints on subnational borrowers include debt and deficit ceilings, restrictions on international borrowing, and regulation of SNGs' borrowing based on fiscal-capacity criteria. Typically an FRL includes these, but also includes more such as the public finance process and procedural rules that may lead to debt.

To complement the *ex ante* constraints and to make them credible, there need to be *ex post* consequences for failures in fiscal prudence. Practices to impose *ex post* consequences on SNGs include limits or prohibitions on central bank financing, no bailouts (from central government or from international community) or debt workouts without adequate conditionality, requirements to

Table 3

**Lender-Borrower Nexus and Timing of Controls and Sanctions
Channels for Control of Deficits and Debt**

	For Borrowers (typically part of FRL)	For Lenders
<i>Ex ante</i> Controls	<p>All governments</p> <ul style="list-style-type: none"> • Debt and deficit ceilings • Restrictions on international borrowing • Publication of detailed fiscal results <p>SNGs only</p> <ul style="list-style-type: none"> • Regulation of SNGs' borrowing, based on fiscal-capacity criteria (regulations by central government or SNG itself, central bank, or other institution) 	<p>All governments</p> <ul style="list-style-type: none"> • No direct central bank financing • Regulations by central bank or other financial supervision agency <p>SNGs only</p> <ul style="list-style-type: none"> • Cap on total borrowing by SNGs • Increased capital requirements for lending to risky SNGs
<i>Ex post</i> Consequences	<p>All governments</p> <ul style="list-style-type: none"> • Limits on central bank financing • No bailouts (from central government or from international community) and no debt workout without adequate conditionality • Publication of detailed fiscal results <p>SNGs only</p> <ul style="list-style-type: none"> • Central government does not accept SNG debt • Debt service withheld from transfers to SNGs • Insolvency system 	<p>All governments</p> <ul style="list-style-type: none"> • Strong supervision of banks <p>SNGs only</p> <ul style="list-style-type: none"> • Regulations require capital write-offs for losses from SNG debt • No central bank bailouts • Well-functioning financial market can increase risk premium for uncreditworthy borrowers

publish detailed fiscal results, refusal by the central government to accept SNG debt, and withholding debt service from transfers to SNGs.

Some countries have also a formal insolvency system for SNGs (Canuto and Liu, 2010, Liu and Waibel 2009). The experience of Brazil in the 1990s shows that *ex ante* constraints, which abounded, were not sufficient by themselves. Borrowers and lenders colluded extravagantly to evade the rules as long as *ex post* bailouts were forthcoming. The 1997 debt restructuring agreement between the federal government and 25 states had the federal government took over the states' debt but requiring states carry out far-reaching fiscal reforms and in compliance with the fiscal targets. In Argentina in the 1990s, on the other hand, there were few *ex ante* constraints, and the experience with pulling provinces into line in the fiscal crisis of the mid-1990s by use of *ex post* consequences – mainly withholding debt service from transfers – seemed to validate the government's choice to focus on *ex post* rather than *ex ante* measure. By the end of the 1990s, however, many provinces built up such debts and off-budget obligations that in the 2000s the government started opting for conditional bailouts, rather than pay the political cost of imposing hard consequences (Dillinger and Webb, 1999; Rodden, 2003; Webb, 2003).

Without lenders there is no borrowing or debt, so their constraints and incentives deserve equal attention. Lenders are not always automatically prudent enough, as many episodes reveal, including the financial crisis events unfolding in 2008. Banking regulations can restrain lenders behavior, but lenders would view government borrowers as riskless if the central government or central bank ultimately guarantees the debt, and passing the risk to others – taxpayers or nominal asset holders (subject to the inflation tax). In the case of Brazil, in addition to FRL, decisive factors include the debt renegotiation contracts and the constraints to the credit supply by banks and especially by public banks to SNGs.

Regulations as listed in the top right box attempt to constrain such moral hazards *ex ante*: no direct central bank financing, restrictions on international borrowing, increased capital requirements for lending to risky SNGs, and borrowing cap for lending to SNGs. Rules and practices can also punish risky lender behavior *ex post*, such as by having strong supervision of banks, raising capital ratios for loan from entities with poor capital ratings, requiring capital write-offs for losses from SNG debt, and providing no bailouts from the national treasury or central bank. Relying on constraints only on borrowers means that lenders still have incentives to push loans and may find reckless or desperate politicians willing to borrow despite the rules. This happened in the 1990s in Colombia, when laws aimed to constrain subnational borrowing, but financial sector regulation loosened for some years, and then some departments got excessive lending. In the 2000s, the government addressed the problem by tightening both the financial sector regulation and the legal controls on the SNGs, with the 2003 FRL and other measures.

Ex ante regulation may not be purely on the borrower side. To improve fiscal transparency, Mexico introduced a credit rating system for SNGs. Although subnational participation in the credit rating is voluntary, the requirements of the capital-risk weighting of bank loans introduced in 2000 and of loss provisions introduced in 2004 aim at imposing subnational fiscal discipline through the market pricing of subnational credit. In Colombia, the Fiscal Transparency and Responsibility Law (2003) also tightened the regulations on the supply side. Lending to SNGs by financial institutions and territorial development institutions must meet the conditions and limits of various regulations, such as Law 617 and Law 817. Otherwise, the credit contract is invalid and borrowed funds must be restituted promptly without interest or any other charges.

Ideally, any lending should be subject to at least some constraints in all four quadrants. Relying only on *ex ante* constraints, without *ex post* consequences, gives irresponsible borrowers and lenders a big incentive to get around the *ex ante* rules and do transactions that will later get bailed out, as happened in Brazil prior to the late 1990s. Relying only on *ex post* consequences allows irresponsible (and large) entities to build up such large debts that the national government will not have the political will to enforce the consequences, as it happened in Argentina in the late 1990s. *Ex ante* constraints are important in economies where banks and financial institutions are owned by governments or financial markets do not respond appropriately to indicators of risk. Under such conditions, credit-allocation decisions are driven more by considerations of political expediency than of fiscal prudence. The events of 2008 also showed the importance of *ex ante* constraints (or the cost of their absence) even with private and liberalized capital markets.

It must be emphasized that the purpose of *ex ante* and *ex post* controls is not to minimize the debt financing, instead they should be developed with the objective of promoting sustainable debt financing through a competitive and diversified subnational credit system. Such a system can help ensure the lowest cost and sustainable supply of credits. Debt financing is extremely important for infrastructure development where the maturity of assets often cannot be matched by the current terms of taxation and transfers.

5.2 Broader public finance legislation

In so far as FRL as a fiscal legislation, it is not the only legal framework that imposes fiscal discipline on SNGs. There are broader public finance laws such as a balanced budget law which various countries have adopted to the same effect.

As a federal country, each state in the United States sets limits for itself and for its local governments. Legal frameworks, laws, and regulations vary by state. Some of the common elements include: debt financing must be for a public (not private) purpose; debt limits are specified in laws/state constitutions to avoid excessive borrowing; debt limits may not apply to bonds payable from a “special fund”, but the issuance of such bonds follow a separate set of regulations; governmental accounting standards (GAAP) are established by the Governmental Accounting Standards Board (www.gasb.org) with each state determining what accounting standards they and their local governments will use; and all meetings of a majority of the members of a governing body of an issuer must be open to the public.¹⁹ In the United States, markets play a vital role in fiscal surveillance.

Another example is Poland, where the Public Finance Law (2005) specifies that: SNG debt as percentage of its total revenues no more than 60 per cent; SNG debt service as per cent of its total revenue no more than 15 per cent; if SNG debt as percent of revenue reaches 55 per cent, then the debt service as percent of revenues cannot be more than 12 per cent; and debt service needs to include guarantee payments for a given budget year even if the guarantees are not recalled.

The South African Municipal Finance Management Act, enacted in 2003, contains a new framework for municipal finance and borrowing. Chapter 13 of the Act spells out detailed criteria for interventions and recovery plans, specifies the role of national and provincial governments and courts in the insolvency mechanism, and outlines the fiscal and debt adjustment process. The act defines one set of fiscal indicators for “serious financial problems”, and another for “persistent material breach of financial commitments.” If the first set of triggers is met, the provincial government may intervene. Under the second set of triggers, provincial intervention is mandatory. Unsuccessful provincial intervention calls for national government intervention. Interwoven with these interventions, the municipal government can apply to the High Court to stay all legal proceedings against the municipal government, and to relieve, suspend or discharge financial obligations. Only courts can stay debt payments and discharge debt obligations.

From the experience of Australia, Brazil, Canada, and India, FRLs become an important institution as the previous existing public finance or other legislation had not been able to contain the fiscal risks including those of SNGs. FRLs become a vehicle of political debates in these countries where the broader macroeconomic environment and fiscal crises had made FRLs a more focused instrument for fiscal reforms. In the case of Colombia, various laws (e.g., 358, 617) were developed dealing with different aspects of fiscal frameworks, and later FRL (2003) became a unifying framework to include not only key elements of the previous laws but also new elements. In Peru, the beginning of the decentralization in the early 2000s incorporated the lessons in Argentina and Brazil, and the FRL was enacted with a key objective of preventing fiscal risks of decentralization. Argentina has tried to follow the South American trend in passing FRLs, but it has not developed the same national consensus in favor of fiscal sustainability.

¹⁹ Haines (2009).

6 Effects from an FRL

Since countries passed FRLs (some in the mid- to late 1990s and some in the 2000s), some evidence has accumulated on their effectiveness. Although political consensus for fiscal prudence is clearly a necessary condition to launch a successful FRL, the test of its effective implementation comes when another party comes to power or when the consensus otherwise breaks down, and then one sees whether the institution works to help the remaining stabilization champions restrain the fiscal excesses that the populists might want. The evidence at most allows us to see whether there is an association of FRLs and fiscal outcome, to see the extent to which FRLs have institutionalized commitments (often pre-existing) to fiscal responsibility, and to see some patterns in the relationship between national and subnational fiscal rules. Of course the fiscal outcomes depend on many factors besides the FRL – GDP growth, international interest rates, etc. – which this analysis does not reflect. There are not enough observations and degrees of freedom to use regression analysis to take account of these factors.

6.1 FRL and fiscal outcomes

Given the lender-borrower nexus and various channels that would influence government fiscal deficits and indebtedness, it would be difficult to precisely separate and measure the effects of FRL. Nonetheless, to the extent that FRL intends to improve government finance and avoid over-indebtedness, it is worthwhile to ascertain if the FRL has been associated with improved fiscal outcomes.²⁰

Here we choose the growth of public debt before and after the passing of subnational FRL in Australia, Brazil, Canada, Colombia, and India, as shown in Annex 3.²¹ As each SNG may have passed its FRL in different year, the measurement of the fiscal improvement/deterioration needs to be normalized. T represents the year when the FRL is passed. D_t represents total subnational (state or province) gross debt outstanding over gross subnational domestic product (GSDP) in year t . The growth of debt/GSDP in the pre-FRL period is measured as the difference between the debt/GSDP in year $t-1$ and the debt/GSDP in year $t-5$, before the passing of the FRL in year t . Similarly the growth of debt/GSDP in the post-FRL period is measured as the difference between the debt/GSDP in year $t+5$ and the debt in the year t when the FRL is passed. To leave out the impact of the global financial crisis of 2008-09, the post-FRL data will cover up to end 2007.²²

In **Australia**, the growth of debt/GSDP is negative for all the states in the sample in the pre-FRL five-year period as well as in the post-FRL period (Table 12). The debt/GSDP of Western Australia and Northern Territory continued to decline at faster pace and that for Victoria, Queensland and New South Wales continued to decline, although at a slower pace in the post-FRL period. The states in the table passed FRLs from 2000-05, but fiscal consolidation started in the 1990s (e.g., South Wales committing to long-term fiscal targets in 1994, and Victoria's Financial Management Act in 1994). As noted before, the combined state and Commonwealth general government net debt had not exceeded 30 per cent of GDP in the 1990s (Simes, 2003).

²⁰ Corbacho and Schwartz (2007) discuss the problems of determining the direction of causality. Their study compared national fiscal deficits in countries with and without FRLs, and found that the former had smaller deficits. Data on subnational deficits for such cross-country comparisons, however, are not readily available.

²¹ We are not evaluating the impact of FRL on Peru, as the country enacted the 2003 FRL that applies to SNGs at the same time as the decentralization. In the case of Argentina, extreme macroeconomic instability and changes in the price level make it difficult to use the debt ratio as an indicator of fiscal performance.

²² For a country with its fiscal year ending during the calendar year, the debt data will cover up to June 2008.

In **Brazil**, although the growth of debt/GDP for SNGs was positive for both the pre and post-FRL periods, the growth slowed down from 5.0 to 1.3 per cent (Table 13). The slowdown also happened to the federal government.

In **Canada**, all the provinces had declining debt as share of GSDP after the passing of the FRLs (Table 14). In British Columbia and Nova Scotia, this decline reversed the trend of rising debt as share of GSDP in the pre-FRL period, with British Columbia experienced the largest turnaround. The other three provinces already had declining debt share of GSDP for the FRL. The debt/GSDP of Newfoundland and Labrador continued to decline in the post-FRL period at a faster speed, and of Alberta, Ontario and New Brunswick continued the reduction but at a slower pace.

In **Colombia**, the debt/GSDP ratio rose from 2 per cent in 1996 (the year before the traffic light Law 358) to 3.5 per cent in 2001. The ratio steadily declined to 1.5 per cent by 2006 and stayed at this level since (Table 15, Figure 4).

In **Indian** states, the growth of debt /GSDP was slower in the post-FRL period than the pre-FRL period for 24 out of 26 states. Twenty one out of these 24 states had reversed the trend of increasing debt/GSDP in the pre-FRL period (Table 16).

From the above, FRL *per se* was not the pivotal moment for the turnaround of fiscal deterioration in Australia and Canada. In fact, legislating and regulating subnational debt was well underway before the enactment of various subnational FRLs. As noted before, the fiscal consolidation grew out of policy debates in Australia in the 1990s, before various states passing FRLs from 2000-06. In Canada, many SNGs adopted balanced-budget and/or debt reduction legislation in the 1990s (Millar 1997).²³ The entire country was seriously undertaking fiscal corrections after rating downgrades. In some provinces, FRLs later consolidated various prior laws (e.g., New Brunswick). In Australia, some states also enacted various public finance laws in the 1990s.

One common trait of successful FRLs for subnational governments is the commitment of the central government to its own fiscal prudence, which is usually reinforced by the application of the FRL to the national as well as subnational level. As shown in Annex 4, government debt as share of GDP declined, before the onset of the global financial crisis in 2008, for both the central and subnational governments as a whole since the early 2000 in Brazil and Colombia, since the late 1990s in Canada, and since the mid-1990s in Australia. Although important factors such as solid economic growth and prudent monetary policies contributed to the good macroeconomic performance in general, the commitment to FRLs is positively associated with the declining debt ratio. Similarly in India, the debt over GDP declined since the early 2000s to 2008, and the central government debt over GDP stabilized.

6.2 *FRL as a device to institutionalize fiscal responsibility*

As shown above, the post-FRL period has usually been marked by a positive turnaround in subnational fiscal performance (Brazil, Colombia, and India), or continuing improvement in fiscal consolidation (Australia and Canada). The FRL could serve as a device to institutionalize the commitment to fiscal reforms in order to have it persist over time and through changes of government and parties.

In Brazil, the FRL was passed in 2000 by a right-center national government with a strong commitment to fiscal stability for itself and with a need to push a similar commitment for SNGs. A key test has come and was passed when a Labor government subsequently came to power in 2002

²³ Alberta, Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia, Northwest Territories, the Yukon from 1993-96.

and maintained that commitment, both for the national government and for enforcing the FRL for SNGs. In 2009 Brazil achieved an investment-grade credit rating. The fiscal reform and consolidation in Brazilian states are embedded in both the annual Programs of Fiscal Adjustment (PAF) between the federal government and the states since 1998 and the FRL since 2000. In 2001, the debt of most major municipalities was restructured in an identical fashion to the 1997 state debt restructuring. The debt restructurings of 1997 and 2001 were successful in improving the fiscal balances of states and municipalities. Within 18 months the states' negative primary balances turned positive, averaging one per cent of GDP in recent years, thereby contributing to the improved macroeconomic conditions in Brazil. One state, Minas Gerais, challenged the FRL rules in 1999, provoking a crisis, but the national government carried out the prescribed sanctions and the state got back into line. Implementation of the PAFs and FRL played a vital role in maintaining macroeconomic stability and avoiding a systemic financial crisis in Brazil (World Bank, 2008).

In India, introducing FRLs at the state and central government levels is associated with fiscal adjustment since early to mid 2000s.²⁴ While institutional reforms such as the introduction of FRLs cannot substitute for the policies needed to realize fiscal adjustment, they can help catalyze and complement fiscal adjustment. The implementation of FRL at the center ushered in an era of rule-based management of public finances. The enactment of FRLs by states, through the federal incentives, brought an element of discipline into budget-making by the states. These reforms, together with higher economic growth, introduction of VAT, and increase in the states' share in net central taxes, contributed to the improvement in the finance of the center and states from 2004-05 to 2007-08 (India Thirteenth Finance Commission, 2009).

In Colombia, three periods are relevant: the period before the traffic-light law of 1997, the period with the traffic-light law but not the FRL, and the period after the passage of the FRL in 2003. The traffic-light law was passed in a moment of enthusiasm for better fiscal policy at local levels, but the enthusiasm did not last and subnational debt problems recurred, along with national level fiscal problems. The FRL in 2003 reflected a reinvigorated commitment to fiscal responsibility and institutionalized it. The president elected in 2010 is from the same party, and observers expect the new administration to continue the fiscal policy commitments of its predecessor.

In Peru a centrist government passed the FRL in 2003 in order to make sure that the new decentralization program did not lead to macro fiscal problems. The next government in 2006, headed by the president and left-leaning party that had led the country into hyper inflation in the late 1980s, but they have continued the same responsible fiscal policy that the FRL had started to institutionalize during the previous administration. Peru's sovereign foreign currency rating was upgraded to investment grade first by Fitch and Standard and Poor's in 2008 and then by Moody's in 2009, reflecting the strong growth performance, prudent fiscal and liability management, and the resulting improvement in solvency indicators.

In Argentina the 1999 FRL (and the provincial FRLs) stopped working in 2001 because of the extreme mismatch between the national government's fiscal and monetary policies in the context of a fixed exchange rate. Although the federal government's FRL lacked enforcement power, the more fundamental problem was the government's many legally inflexible spending obligations, most notably debt service and provincial transfers. The provincial FRLs also had shortcomings that would have been problematic even if the collapse at the top had not come first. They lacked enforcement power and a critical mass of states had not passed them. The 2004 FRL, while more comprehensive than its predecessor, again did not reflect a national consensus that fiscal prudence was worth political sacrifice. Compliance was incomplete from the start, sanctions

²⁴ Howes and Jha (2004) argued for FRLs with this rationale.

were weak, and the binding features of the law were suspended when an economic slowdown came in 2008-09.

Since an effective FRL is a means to institutionalize a consensus in favor of fiscal responsibility, it helps to have it grow out of a consensus-building process. Brazil did this explicitly through discussions with the states and because the President who put through the law came to office on the basis of his success in taming deficits and inflation while he was Minister of Finance. In India the Finance Commission played a key role in building consensus on the fiscal policy agenda. In Brazil, Colombia, and Peru the painful memories of past fiscal excesses gave impetus for a political mandate to assure fiscal responsibility in the future. It is unclear why this did not happen in Argentina, with its many painful macroeconomic failures, but the pro-stability consensus of the early 1990s had largely dissipated by the late 1990s and since.

The global financial crisis of 2008-09 will provide an important test on the long-term commitment to fiscal sustainability. Governments throughout the world have loosened the fiscal rules as part of counter-cyclical packages. For example, in Brazil, The three-year Programs of Fiscal Adjustments between the National Treasury and the 25 states adjusted the primary balances and indebtedness targets and broadened the fiscal space for new borrowing. Through its development bank, the federal government created a credit line for SNGs that had suffered loss of federal transfers. Given that some states were not in compliance with the requirements of fiscal responsibility legislation, this operation is considered to be exceptional and allows all states to access the line of credit. In India, the central government allowed the states to raise additional market borrowings, thus increasing the limit of gross fiscal deficit to 3.5 per cent of gross state domestic product in fiscal 2008/09, and to 4.0 per cent in fiscal 2009/10, exceeding the FRL targets.²⁵ The challenge will be to manage the exit from fiscal stimulus and to resume a commitment to fiscal sustainability.

Some FRLs were enacted more to guide a fiscal adjustment process than to set a framework for fiscal policy for long-term. The global financial crisis of 2008-09 brought to the fore the issues of fiscal policy over the economic cycles and the coordination of counter-cyclical fiscal policies across the different institutions of the government. It is not clear, however, the extent to which FRLs are suited to serve as the main legal basis for long-term fiscal management or are only one part of the overall institutional framework for long-term fiscal prudence.

6.3 *Subnational FRL in the context of national reform*

Macroeconomic developments and nationwide reforms can provide an overall impetus. Consistency with other parts of the macro-fiscal system, subnational fiscal reform often unfolds in the broader macroeconomic context. In Canada, macroeconomic deterioration in the 1980s to early 1990s led to major changes in monetary and fiscal policy. After suffering from a lack of credibility, the Bank of Canada since the early 1990s committed to low and stable inflation. The attainment of inflation targeting overtime improved market and public confidence (Perrier and Armano, 2000; Paulin, 2000; OECD, 2001). On the fiscal front, in the early 1990s, the importance of restoring sound public finances became increasingly clear at both the federal and provincial level. The fiscal framework adopted by the federal government and legislation by provinces were part of the move toward more sustainable public finances (Traçlet, 2004).

Establishing an FRL or other institution to constrain SNG debt and deficits works only if the governments in question start from or are brought to a position where they do not have extreme debt overhang. In other words, if the service on existing debt is already too large to pay realistically

²⁵ Government websites and World Bank country teams.

in the political economic situation, this attenuates greatly the incentive from an FRL to behave with fiscal responsibility. Consequently, a set of SNG fiscal adjustment and debt rescheduling programs often must complement or precede the implementation of an FRL. To work, the programs must strike a balance between being sufficient to eliminate the debt overhang and being so generous as to seem to reward fiscal irresponsibility of the past (or to fiscally hamstring the national government). Brazil, Colombia, and India undertook SNG debt restructuring, separate from or preceding the FRL.

The dynamics of subnational-central government interaction provides political momentum and stimulates discussion of fiscal reforms. Given the growing share of subnational finance in the consolidated public finance and the growing influence of political forces at the subnational level, often a subnational government can lead the fiscal reform which serves as demonstration effect on the national reform. In India, following the state fiscal crisis in the late 1990s to the early 2000s, the states of Karnataka and Punjab each enacted its own fiscal responsibility law in 2002, first in the country. The federal FRL followed in 2003, and other states soon after from 2003-07. In Australia, some states went ahead with fiscal reforms and enacted legislation committing to balanced budget or debt targets, prior to the federal enactment of Charter of Budget Honesty in 1998.

A national government can pass the FRL for itself and encourage SNGs to pass their own FRLs. In India, following the recommendation of the Twelfth Finance Commission in 2004, debt relief to a state offered by the Debt Consolidation and Relief Facility was based on a condition for the state to enact the FRL. The FRL should, at the minimum, provide for elimination of revenue deficit²⁶ by 2008/09 and reduction of fiscal deficit to 3 per cent of GSDP. 21 states put in place FRL beginning 2005/06. Five states already had enacted FRLs even before this condition was imposed by the Twelfth Finance Commission.²⁷ The framework intended to promote growth-expansionary fiscal consolidation by providing fiscal incentives for SNGs to eliminate their revenue deficits, thereby ensuring that net public borrowing is directed exclusively towards growth-enhancing public investment (India Thirteenth Finance Commission, 2009).

Since fiscal responsibility with multiple players (national and subnational governments) is a coordination problem with multiple possible equilibria (Braun and Tommasi 2004), it depends on having a critical mass of states that voluntarily obey the rules and politically support the national government when it applies sanctions to enforce the rules. Thus the fiscal sanction of Minas Gerais in 2000 assured that no other states would challenge the law and thus was a critical step in the success of Brazil's FRL.

7 Conclusions

Given the difficulties of determining causality of FRLs and fiscal outcomes, it will be difficult to say whether FRLs are necessary or sufficient for achieving fiscal prudence at multiple levels of government. Country examples reviewed in this paper show that FRLs can help coordinate and sustain commitments to fiscal prudence, but they are not a substitute for commitment and should not be viewed as ends in themselves. FRLs can make a positive contribution by adding to the collection of other measures to shore up a coalition of states with the central government in support of fiscal prudence. Although political consensus for fiscal prudence

²⁶ In India, revenue deficit is current expenditure net of all revenues.

²⁷ The Debt Consolidation and The Debt Consolidation and Relief Facility (DCRF) comprised consolidation of central loans contracted till March 2004 and outstanding on 31 March 2005, along with debt write-offs, linked to reduction of the revenue deficits of states and containment of fiscal deficit at the 2004-05 level. The five states are: Karnataka, Kerala, Tamil Nadu, Punjab and Uttar Pradesh. Thirteenth Finance Commission (2009), p. 49.

is clearly a necessary condition to launch a successful FRL, the test of its effective implementation comes when the consensus breaks down, and then one sees whether the institution works to help the remaining stabilization champions restrain the fiscal excesses that the populists might want.

In designing an FRL, defining fiscal targets poses a special challenge. Many factors that influence the fiscal accounts of the SNGs are exogenous to the SNGs, such as interest and exchange rates. The national governments also mandate expenditure items and the intergovernmental fiscal frameworks may limit the taxation power of SNGs. Focusing on ratios where the SNGs have control over the denominator as well as the numerator (e.g., wage bill as a share of total spending) is more likely to have the desired effect than relying on ratios that are substantially influenced by exogenous factors.

An important lesson is that a set of SNG fiscal adjustment and debt rescheduling programs often must complement or precede the implementation of an FRL. It is not realistic to expect SNGs with large debt overhang to comply with sustainable fiscal targets. On the other hand, in order for FRLs to provide credible incentives for fiscal prudence, the terms of restructuring cannot signal potential future bailouts. Therefore, there needs to be a balance between avoiding moral hazard and providing sufficient financial relief to ensure that the SNGs can realistically comply with FRLs.

Even when FRLs are effective, they cannot do the job alone. The potential contribution depends on how well it complements the rest of the institutional framework for SNG fiscal restraint – making labor and pension laws more flexible, giving subnational governments more taxing power, using rules for debt renegotiations to reduce the salary bill as a share of revenue, using financial sector regulation to restrain lending to SNGs, and commitment to hard budget constraints on SNGs. The experience shows the need to have both *ex ante* constraints on borrowing and *ex post* sanctions for over borrowing. Even beyond the network of specific fiscal rules, the deeper institutions and expectations need to motivate respect and enforcement of the rules, otherwise they do little good (Braun and Tommasi 2004).

SNG borrowing for financing social and economic infrastructure can generate positive net social returns. FRL framework is not meant to eliminate credit market access by SNGs. The challenge is to design fiscal rules and framework that will achieve the dual objectives of expanding market access by SNG for financing economic growth and containing the risks of excessive borrowing.

Future research might want to pursue the following questions: How to set subnational along with national fiscal targets, either in FRLs or other public finance laws? How these targets relate to the threshold for fiscal and debt sustainability? How to construct escape clauses that will not become convenient evasion clauses in case of severe global or regional downturns? What kind of enforcement mechanism would ensure fiscal discipline, particularly in the absence of effective market systems? Over the longer periods of business and political cycles, can the effect of fiscal legislation be more accurately measured? How can one design institutions for fiscal discipline – FRLs, etc. – so that they do not make fiscal policy excessively pro-cyclical?

**ANNEX 1
FISCAL RESPONSIBILITY LAWS**

Table 4

Argentina

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
National FRL – “Fiscal Solvency Law” – only for national government; intended as model for provinces	1999	Multiannual budgets; prohibition of extra budgetary funds; penalties for spending units if they spend over budget	Deficit limits in 1999-2002; balance budget thereafter; primary spending growth rate no higher than real GDP growth rate	None; Law called for stabilization fund, with inflow from sale of SOEs and 1-2 per cent of tax revenues	Penalties for national spending units if they spend over budget
National – “Zero Deficit Law”	2001		Zero deficit by 2002		
National “FRL” – applying to provincial as well as national governments. 21/24 provinces and City of Buenos Aires agreed to comply	2004	3-year multiannual budgets; Debt management needs to ensure (move toward) debt service less than 15 per cent of net revenue; new borrowing or guarantees need Min of Econ approval; no non-peso domestic bonds from SNGs; SNGs publish fiscal accounts and all debt related transactions in a standard format Established a Federal Council for Fiscal Responsibility, with membership from the national and all provincial ministries of finance	Nominal growth rate of primary spending by each government must be lower than projected national GDP growth; for SNG governments with debt less than 15 per cent of current revenue the restriction applies only to current spending. The national government budget must have an overall primary fiscal balance after, excluding five categories of spending (spending with loans from International Financial Institutions, capital spending for social infrastructure, subnational spending financed by non-automatic transfers, extra spending due to Education Financial Law, and payments on court rulings). SNGs have to budget primary surpluses adequate to bring their debt service gradually below 15 per cent of current revenues (net of transfers to municipalities) and may not do new borrowing if their debt service is over the ceiling	National and provincial governments must put money into stabilization funds. In 2004-05, Mendoza and Santa Fe started funds, but no data available on performance. In 2009, key fiscal targets in the law were suspended by Congress for 2009 and 2010...	

Source: Government legislation (Ley 25,152; Ley 25,453; Ley 25,917).

Table 5

Australia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
New South Wales	1983 1995 2005	<p>Public Finance and Audit Act 1983:</p> <ul style="list-style-type: none"> The treasurer is charged to publicly release monthly statement and half year review setting out projections and year-to-date budget balances. The Budget Papers for a budget year are to be tabled in the Legislative Assembly before the end of the prior financial year No later than 31 October after concluding a fiscal year, the Treasurer is to present the consolidated financial statements and general government sector financial statements as audited by the Auditor-General, and the opinions of the Auditor-General on those statements, to the Legislative Assembly <p>General Government Debt Elimination Act 1995 (repealed in 2005):</p> <ul style="list-style-type: none"> Within 3 months of the enactment of this act, the Treasurer is to table in Parliament a comprehensive financial management framework The progress reports of budget papers should include: Measures taken to fund employer superannuation liabilities, to maintain assets of the state and prudently manage the risks; The projected growth in net cost of services and expenses for a budget year and each year of the forward estimates period; impact of proposed tax policy changes <p>Fiscal Responsibility Act 2005:</p> <ul style="list-style-type: none"> The act lays out the fiscal principles and targets for the state. In application of fiscal principles, the government should report in annual budget papers: <ul style="list-style-type: none"> an assessment of past and prospective long-term average revenue growth an assessment of the impact of budget measures in respect of expenses and revenue on long-term fiscal gaps measures taken to reflect the fiscal principles. These measures include: measures taken to maintain or increase general government worth; measures taken to fund employer superannuation liabilities; measures taken to align physical asset management of government agencies with their service delivery priorities and strategies; measures taken to manage risks prudently The estimated impact of proposed tax policy changes 	<p>General Government Debt Elimination Act 1995 (repealed in 2005):</p> <ul style="list-style-type: none"> To achieve a sustainable surplus budget for the general government sector within 3 years after enactment of the Act To reduce, by 30 June 2005, the level of public net debt to a sustainable level, which are defined as a level at which the budget can absorb the economic cyclical impact without need for significant corrective action on the revenue and expenditure side To eliminate net debt of federal government sector by 30 June 2020 and eliminate the unfunded superannuation liabilities by 30 June 2030 <p>Fiscal Responsibility Act 2005:</p> <p>In the medium term:</p> <ul style="list-style-type: none"> reduce the level of general government net financial liabilities to ≤ 7.5 per cent of gross state product by 30 June 2010 maintain the level of general government net debt ≤ 0.8 per cent of gross state product (the level at 30 June 2005), unless an increase is required in net debt to reduce one or more components of general government net financial liabilities <p>In the long term:</p> <ul style="list-style-type: none"> reduce the level of general government net financial liabilities to ≤ 6 per cent of gross state product by 30 June 2015 maintain the level of general government net debt ≤ 0.8 per cent of gross state product (the level at 30 June 2005), unless an increase is required in net debt to reduce one or more components of general government net financial liabilities eliminate the total state sector unfunded superannuation liabilities by 30 June 2030 	N/A	<ul style="list-style-type: none"> Reputational

Table 5 (continued)

Australia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Northern Territory	1995 2001	<p>Financial Management Act 1995:</p> <ul style="list-style-type: none"> The Treasurer is to publish quarterly financial statements in the Gazette and audited annual reports which include the original estimates of budget, results in respect of the major Government Finance Statistics statements as reported by the Australian Bureau of Statistics, and explanation of significant deviations. The audited annual reports should be tabled in the Legislative Assembly <p>Fiscal Integrity and Transparency Act 2001:</p> <ul style="list-style-type: none"> The Treasurer must publicly release and table the first and each subsequent fiscal strategy statements for a particular Government at or before the specific time. Changes can be made by public release of a new fiscal strategy statement. Such a statement should: <ul style="list-style-type: none"> (a) specify medium-term fiscal objectives (b) explain the broad strategic priorities on which the budget is or will be based (c) specify the key fiscal indicators against which fiscal policy will be set and assessed (d) specify, for the budget year and the following 3 financial years: <ul style="list-style-type: none"> (i) the Government's fiscal objectives and targets; and (ii) the expected outcomes for the specified key fiscal indicators; and (e) explain how the fiscal objectives and strategic priorities relate to the principles of sound fiscal management The Treasurer must publicly release and table a fiscal outlook report at the time of each budget, mid-year outlook report and fiscal results report. The contents of these reports are specified in the Act The Under Treasurer must publicly release a pre-election fiscal outlook report within 10 days after the issue of the writ for an election 	<p>Fiscal Integrity and Transparency Act 2001:</p> <p>No specific numerical rules and targets. The principles of sound financial management are:</p> <ul style="list-style-type: none"> To formulate and apply spending and taxing policies with consideration of the effect on employment, the economic prosperity and development of the Territory and giving rise to a reasonable degree of stability and predictability To ensure that funding for current services is to be provided by the current generation To manage financial risks faced by the Territory prudently (having regard to economic circumstances), and maintain Territory debt at prudent levels 	N/A	<ul style="list-style-type: none"> Reputational

Table 5 (continued)

Australia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Queensland	1999 2009	<p>The 1999 amendment of Financial Administration and Audit Act (repealed in 2009):</p> <ul style="list-style-type: none"> • The Treasurer should prepare a charter of social and fiscal responsibility for the State and table it in the Legislative Assembly. The charter is to state the broad social and fiscal objectives of the Government and establish a framework for assessing the Government's performance in achieving the objectives • The charter must be based on the principles of: <ul style="list-style-type: none"> (a) Transparency and accountability in developing, implementing and reporting on the Government's social and fiscal objectives (b) Efficient and effective allocation and use of resources (c) Equity relating to the raising of revenue, delivery of government services, and between present and future generations (d) Prudent management of risk <p>Financial Accountability Act 2009:</p> <ul style="list-style-type: none"> • The act lays out principles, rules and procedures for fiscal management. The government should publish regular, informative reports on the outcomes of the activities, against previously announced objectives and release annual report on the efficiency and effectiveness of its activities in meeting the Government's objectives for the community. Specifically: <ul style="list-style-type: none"> (a) The premier must present to the Legislative Assembly on government's community objectives as well as fiscal objectives and outcomes regularly; (b) The Premier must table each half year report and full year report of ministerial offices expenses in the Legislative Assembly within specific timelines. Full year report should be audited by auditor-general • The Act requires from time to time, the Treasurer prepare and table in the Legislative Assembly a charter of fiscal responsibility giving details of the government's fiscal objectives and fiscal principles that support those fiscal objectives. The treasurer must report regularly to the Legislative Assembly on the outcomes the government has achieved against the objectives stated in the charter 	<p>Charter of Fiscal Responsibility 2009:</p> <p>The fiscal principles are set out broadly to maintain fiscal sustainability and a competitive tax regime, and manage the State's balance sheet. The principles are:</p> <ul style="list-style-type: none"> • In the General Government sector, meet all operating expenses from operating revenue • Growth in own-purpose expenses in the General Government sector to not exceed real per capital growth • Achieve a General Government net operating surplus as soon as possible, but no later than 2015-16 • Maintain a competitive tax environment for business • Stabilize net financial liabilities as a proportion of revenue in the Non-financial Public Sector • Target full funding of long-term liabilities such as superannuation in accordance with actuarial advice 	N/A	<ul style="list-style-type: none"> • Reputational

Table 5 (continued)

Australia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Tasmania	1990 2007	<p>Financial Management and Audit Act 1990:</p> <ul style="list-style-type: none"> The Treasurer is to publish in the Gazette a report, the half-yearly report, and an audited annual report which include the original estimates of budget, results in respect of the major Government Finance Statistics statements as reported by the Australian Bureau of Statistics, and explanation of significant deviations. The annual report should be laid before each House of Parliament and copies should be available to the public <p>Charter of Budget Responsibility Act 2007:</p> <ul style="list-style-type: none"> The Treasurer is to publicly announce and table the first fiscal strategy statement for a particular Government at or before the time of the Government's first budget. It may be changed at any time by announcing and tabling a new fiscal strategy statement. Such strategy should establish a benchmark for evaluating the Government's fiscal performance by specifying: <ol style="list-style-type: none"> the long-term objectives within which budgets will be framed the key fiscal measures against which fiscal policy will be set and assessed the fiscal objectives and targets for the budget year and the following 3 financial years How the fiscal objectives and strategic priorities relate to the principles of sound fiscal management The Leader of an Opposition party is to publicly announce a fiscal strategy statement, and provide a copy of the statement to the Secretary, within 15 days of the issue of a writ for an election for the House of Assembly Pre-election financial outlook report should be prepared 	<p>Charter of Budget Responsibility Act 2007:</p> <ul style="list-style-type: none"> No specific numerical rules and targets. The principles of sound financial management are to: <ol style="list-style-type: none"> ensure transparency and accountability in developing, implementing and reporting on fiscal objectives ensure the efficient and effective allocation and sustainable use of resources in achieving objectives ensure that policy decisions have regard to their financial effects on future generations formulate spending and taxation policies that ensure a reasonable degree of equity, stability and predictability manage financial risks prudently 	N/A	• Reputational
Victoria	2000	<p>Financial Management Act 1994, amended in 2000:</p> <ul style="list-style-type: none"> The act establishes a budgeting and reporting framework for sound public financial management. It specifies the purposes and contents of each government documents including the financial policy objectives and strategies statements, quarterly financial reports, mid-year reports, audited annual financial reports and budget update and requires the documents to be transmitted to or laid before each house of the Parliament on or before pre-specified date. The financial policy objectives statement should specify the financial objectives and targets of current year as well as those of three following years 	<p>Financial Management Act 1994, amended in 2000:</p> <ul style="list-style-type: none"> No specific numerical rules and targets. The principles are laid out to ensure sound financial management including prudent management of financial risks faced by the State, having regard to economic circumstances; pursuing spending and taxing policies that can maintain a reasonable degree of stability and predictability in the tax burden level; maintaining the integrity of the Victorian tax system; taking into account the impact of policy decisions on future generations; and providing full, accurate and timely disclosure of financial information relating to the Government and its agencies 	N/A	• Reputational

Table 5 (continued)

Australia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Western Australia	2000	<p>Government Financial Responsibility Act 2000: The act sets out a framework for public financial planning incorporating a set of principles and rules</p> <ul style="list-style-type: none"> • The Treasurer must release a Government Financial Strategy Statement at least once in each calendar year which sets out government's medium term fiscal strategy. Any significant change to fiscal strategies should be released as soon as possible • The Treasurer should release a Government Financial Projections Statement which includes projection for the budget year and next 3 years when the appropriation Bills and budget papers for a budget or supplementary budget are tabled in the Legislative Assembly • The Treasurer must release a Government Mid-year Financial Projections Statement and an audited annual report on state finance within prescribed date • The Under Treasurer should release a Pre-election Financial Projections Statement within 10 days after the Legislative Assembly is dissolved or expires • The Treasurer should release a Quarterly Financial Results Report for each quarter 	<p>Government Financial Responsibility Act 2000:</p> <ul style="list-style-type: none"> • There are no specific numerical rules and targets. However the financial management principles require current services to be funded by the current generation; spending and taxing policies to be formulated and applied so as to give rise to a reasonable degree of stability and predictability; financial risks to be managed prudently; spending and taxing policies are to be formulated and applied with consideration to the effects of these policies on employment and the economic prosperity of the State 	N/A	<ul style="list-style-type: none"> • Reputational
Australia (National)	1997 1998	<p>Financial Management and Accountability Act 1997:</p> <ul style="list-style-type: none"> • Finance Minister must publish monthly financial statements. <p>Charter of Budget Honesty Act 1998:</p> <ul style="list-style-type: none"> • Annual reports must be audited by Auditor - General. The government strategy should reflect sound financial management principles. The government should release and present to the parliament the following reports regularly based on prescribed timelines: the government's fiscal strategy statement, budget and mid-year economic and fiscal outlook reports, final fiscal outcomes reports and intergenerational reports. A pre-election fiscal and economic outlook report should be released if a general election is called, as well as policy costing upon request 	<p>Charter of Budget Honesty Act 1998: No specific numerical rules and targets. The principles of sound financial management are set out:</p> <ul style="list-style-type: none"> • prudent management of financial risks of the government by maintaining general government debt at prudent levels • to ensure that fiscal policies are to achieve adequate national saving and to moderate cyclical fluctuations in economic activity • consistent spending and taxing policies to ensure stability and predictability • the integrity of the tax system • Policy decisions to have regard to their financial effects on future generations 	N/A	<ul style="list-style-type: none"> • Reputational

Source: Various fiscal responsibility laws from websites of Australian state legislatures.

Table 6

Brazil

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clause	Sanction
<p>National FRL applies to all tiers of government</p>	<p>2000</p>	<ul style="list-style-type: none"> The law sets minimum standards for state budgeting, personnel management, and debt management The annual budget of each SNG has to be consistent with its multiyear budget plan and with the federal fiscal and monetary program The law explicitly prohibits debt refinancing operations between different levels of government <p>Strengthened transparency rules for all levels of government:</p> <ul style="list-style-type: none"> Proposals, laws and accounts must be widely distributed, including through electronic media Forecasts, objectives as well as targets and results need to be periodically published The Executive Branch of each Municipal Government must consolidate its accounts and send to the central government. The central government complies the accounts for entire federation A bi-monthly budget execution report should be published, containing budgetary balance sheet as well as summary of expenditures and revenues The heads of government branches must issue a Fiscal Management Report every 4 months and make it widely available to the public 	<p>Article 12: The estimated revenue for credit operation must not exceed the capital expenditures in the Annual Draft Budget law</p> <p>Article 19: For states and municipalities, Wage and salary cost may not exceed 60 per cent of current revenue</p> <p>Article 20: with the following minimums for each branch of government:</p> <ul style="list-style-type: none"> State: 3 per cent Legislative, 6 per cent Judiciary, 49 per cent executive, 1 per cent state prosecutor Municipal: 6 per cent legislative, 54 per cent executive <p>Article 23: If personnel expenditures exceed these limits, the excess percentages must be reduced within the next two 4-month periods, with at least one-third of the reduction coming in the first 4-month period</p> <p>Article 30: Requires the Federal Senate to set overall limits for federal and subnational debt</p>	<ul style="list-style-type: none"> Public calamities acknowledged by both houses of national Congress, including state of defense, siege and a low growth rate, defined as less than 1 per cent in last four quarters 	<ul style="list-style-type: none"> If total personnel expenditures exceed 95 per cent of the ceiling, new hiring, wage increases and contracting overtime work are suspended Officials who violate the rules will be subject to criminal penalties, fines and perhaps even jail, according to the law of Fiscal Crimes If the debt targets are not achieved, SNGs will be prohibited from: receiving voluntary transfers, obtaining guarantees from Federal government or other states and contracting credit operations unless used as refinancing securities debt and reducing personnel expenditures

Source: Government website.

Table 7

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Alberta	1993 1995 1999	<p>Government Accountability Act 1995:</p> <ul style="list-style-type: none"> The Minister of Finance should have consolidated fiscal plans, annual reports and ministry reports laid before the Legislature and available to general public within prescribed deadlines. The consolidated fiscal plan including the government business plan and capital plan among others should be for the fiscal year and the subsequent 2 fiscal years. The Minister of Finance must report publicly to the Lieutenant Governor in Council on the accuracy of the consolidated fiscal plan with respect to the first 3, 6, and 9 months of each fiscal year within prescribed dates. The contents of each report are specified 	<p>Deficit Elimination Act 1993 (repealed in 1995):</p> <ul style="list-style-type: none"> To achieve a deficit target of \$2.5 billion in 1993-94 and a balanced budget in 1996-97 <p>Balanced Budget and Debt Retirement Act 1995 (repealed in 1999):</p> <ul style="list-style-type: none"> Annual balanced budgets and conservative revenue forecasts are required Establishing a schedule to repay net debt by the end of 2012-22, or a 25 years limit <p>Fiscal Responsibility Act 1999:</p> <ul style="list-style-type: none"> Deficits and opening debt are not allowed; Actual expenses for a fiscal year must not be more than actual revenue for that year The Capital Account is established as an account within the General Revenue Fund, net assets of this account may not be reduced to an amount less than zero The consolidated fiscal plan must include a contingency allowance for each fiscal year set out in the plan equal to at least 1 per cent of revenue for fiscal policy purposes 	<p>Fiscal Responsibility Act 1999:</p> <ul style="list-style-type: none"> Alberta Sustainability Fund is established from which fund could be transferred to achieve balanced budget in the response to emergencies or special spending commitments 	<ul style="list-style-type: none"> Reputational
British Columbia	1991 2000 2001	<p>The Budget Transparency and Accountability Act 2000:</p> <ul style="list-style-type: none"> Regular disclosure of fiscal information by finance minister The minister must make public a budget consultation paper and present the main estimates for a fiscal year to the Legislative Assembly with the budget for that fiscal year as well as economic and fiscal forecasts and major capital investment information each year Make public any significant change to the estimates as soon as practicable, the public accounts for the previous fiscal year and quarterly report on or before prescribed date 	<p>Taxpayer Protection Act 1991 (repealed in 1992):</p> <ul style="list-style-type: none"> A five-year balanced budget plan was created; a tax freeze and prevention of new taxes; limitations on expenditure growth; a Debt Reduction Plan and an annual progress report <p>Balanced Budget Act 2000 (repealed in 2001):</p> <ul style="list-style-type: none"> Setting up progressively lower deficit targets between 2000-01 to 2003-04 and requiring balanced budget beginning in 2004-05 <p>Balanced Budget and Ministerial Accountability Act 2001:</p> <ul style="list-style-type: none"> The main estimates must not contain a forecast of deficit for a fiscal year, but it does not apply to 2009-10 and 2010-11 fiscal year 	<p>Balanced Budget Act 2000 (repealed in 2001):</p> <ul style="list-style-type: none"> The maximum deficits could only be exceeded in emergency and/or unexpected circumstances or for significant revenue declines <p>Balanced Budget and Ministerial Accountability Act 2001:</p> <ul style="list-style-type: none"> 2009-10 and 2010-11 fiscal year 	<p>Balanced Budget Act 2000 (repealed in 2001):</p> <ul style="list-style-type: none"> The members of the Executive Council were subject to a 20 per cent pay cut when targets are not met; The reduction could be partially or fully restored when certain targets are met <p>Balanced Budget and Ministerial Accountability Act 2001:</p> <ul style="list-style-type: none"> 20 per cent of salary of each Executive Council member is held back. The reduction can be partially or fully restored when collective and/or individual responsibility has been achieved

Table 7 (continued)

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Manitoba	1989 1995 2008	<p>Fiscal Stabilization Fund Act 1989:</p> <ul style="list-style-type: none"> To establish a fiscal stabilization fund with the purpose of stabilizing the fiscal position from year to year and improving long-term fiscal planning <p>Balanced Budget, Debt Repayment and Taxpayer Accountability Act 1995:</p> <ul style="list-style-type: none"> Major tax rate increases will be decided by Province-wide referendum A debt repayment plan is set up for general-purpose debt and unfunded pension liabilities Public hearings must be held before the Act can be amended or repealed and the Act prevents changes in accounting policy to meet balanced budget targets <p>The Balanced Budget, Fiscal Management and Taxpayer Accountability Act 2008:</p> <ul style="list-style-type: none"> At the time of tabling the budget, the minister must table in the Legislative Assembly a statement of the government's financial management strategy describing the government's objectives for measurable outcomes and containing a summary of core expenditure and revenue estimates After each fiscal year, the minister should table in the Legislative Assembly a report comparing the results to the financial management strategy laid before the fiscal year, while tabling the public accounts 	<p>Balanced Budget, Debt Repayment and Taxpayer Accountability Act 1995:</p> <ul style="list-style-type: none"> Balanced budgets are required from 1995-96 and onward <p>The Balanced Budget, Fiscal Management and Taxpayer Accountability Act 2008:</p> <ul style="list-style-type: none"> For each fiscal year, the budget for the government reporting entity laid before the Legislative Assembly must project a positive balance as at the end of that year. The balance as at the end of a fiscal year is determined as the average of the net results for the fiscal years within the four-year period ending at that time 	<p>Balanced Budget, Debt Repayment and Taxpayer Accountability Act 1995:</p> <ul style="list-style-type: none"> Deficits are permitted in the face of a natural disaster, war, or revenue reduction of 5 per cent or more that is not due to a change in tax laws <p>The Balanced Budget, Fiscal Management and Taxpayer Accountability Act 2008:</p> <ul style="list-style-type: none"> The net income or loss for a fiscal year may be adjusted by excluding a revenue shortfall or increase in expenses for the fiscal year that occurred because of <ul style="list-style-type: none"> (a) an unanticipated natural or other disaster (b) Canada being at war or under the apprehension of war (c) unusual weather or climate conditions not anticipated in the budget; or (d) a decision of another level of government or of a regulatory body that took effect after the budget for the fiscal year was tabled in the Legislative Assembly or within 30 days before it was tabled, the fiscal impact of which was not anticipated in the budget 	<p>Balanced Budget, Debt Repayment and Taxpayer Accountability Act 1995:</p> <ul style="list-style-type: none"> If a deficit occurs, it must be offset in the next fiscal year; in this case, penalties will be imposed in second year. Ministerial salaries are cut by 20 per cent in the first year of a deficit and by 40 per cent in the second year <p>The Balanced Budget, Fiscal Management and Taxpayer Accountability Act 2008:</p> <ul style="list-style-type: none"> If the balance as at the end of a fiscal year is negative, Ministerial salaries are cut by 20 per cent in the first year of a deficit and by 40 per cent in the second year If after the general election the party forming the government changes, the reduction would not apply to the new minister appointed by the new government

Table 7 (continued)

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
New Brunswick	1993 2001 2003 2006	<p>Fiscal Stabilization Fund Act 2001:</p> <ul style="list-style-type: none"> A fiscal stabilization fund was created with the purpose of stabilizing the fiscal position and improving long-term fiscal planning <p>Taxpayer Protection Act 2003:</p> <ul style="list-style-type: none"> Referendum approval is required for new taxes or increases of tax rates for certain taxes <p>Fiscal Responsibility and Balanced Budget Act 2006:</p> <ul style="list-style-type: none"> The Minister must lay before the Legislative Assembly the main estimates and capital estimates for the next fiscal year in each year. And each year the Minister shall provide details as to how the public may participate in pre-budget consultations and shall make public a pre-budget consultation document that sets out the key fiscal issues for consideration by the public 	<p>Balanced Budget Act 1993:</p> <ul style="list-style-type: none"> It is required that the cumulative ordinary balance for the three-year period up to 1995-96 and cumulative budgets for four-year periods thereafter be in balance <p>Fiscal Responsibility and Balanced Budget Act 2006:</p> <ul style="list-style-type: none"> Balanced budget: the total amount of the expenses should not exceed the total amount of revenue for each fiscal year Reduction in net debt ratio: the ratio of net debt to GDP at the end of each year should be less than at the end of the previous fiscal period 	N/A	<ul style="list-style-type: none"> Reputational
Newfoundland and Labrador	2004	<p>Transparency and Accountability Act 2004:</p> <ul style="list-style-type: none"> All government entities are categorized as either category 1, 2 or 3 government entities and are required to prepare strategic plans, business plans or activity plans respectively. These plans will set out goals and objectives of the government entity and objective performance measures for the period covered by the plan. The plans should also include a statement that the responsible minister or the governing body is accountable for the preparation of the plan A government entity shall each year prepare an annual report for the preceding fiscal year. The annual report of category 1 or 2 government entities shall compare the actual results with the projected results of its strategic plan or business plan and provide an explanation of any variance. The report of category 3 government entity shall represent information on the activities of the entity carried out during the preceding fiscal year. Annual report shall include a statement that the responsible minister or chairperson is accountable for the actual results reported The minister of Finance shall publish a 3 year fiscal forecast and shall, semi-annually, report on the economic and fiscal position of the province The Minister of Finance shall publish a 3 year forecast respecting the impact of government policies and economic development on the fiscal performance of the government and the performance of the province's economy When the requirement of reports and plans set out by the Act is not meet, the responsible minister shall make public a written statement giving reasons for the non-compliance 	N/A	N/A	<ul style="list-style-type: none"> Reputational

Table 7 (continued)

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Nova Scotia	1993 1996 2000	<p>Financial Measures Act 1996, amended in 2000:</p> <ul style="list-style-type: none"> The government should release four-year fiscal projections with major economic assumptions and their impact on government finances Until the proportion of public debt denominated in foreign currencies is equal to or less than 20 per cent of total public debt, financial transactions that increase foreign currency exposure are prohibited and refinancing of foreign currency debt must eliminate the foreign currency exposure New programs and services should be financed through existing budgets <p>Provincial Finance Act 1989, amended in 2000:</p> <ul style="list-style-type: none"> The minister should table a consolidated fiscal plan while tabling the estimates for a fiscal year in the House of Assembly. A consolidated fiscal plan shall include fiscal projections for the four-year period and underlying economic assumptions and a summary of government business plan for the fiscal year. The annual report on outcomes against business plan for the fiscal year should be submitted to the House of Assembly within prescribed date 	<p>Expenditure Control Act 1993:</p> <ul style="list-style-type: none"> Reducing net operating expenditures by 10 per cent and net capital expenditures by 20 per cent from 1994-95 to 1997-98 <p>Expenditure Control Act 1993, amended in 1996:</p> <ul style="list-style-type: none"> Requiring annual balanced budgets starting in 1996-97, with surpluses aimed at reducing the public debt and/or taxes Overspending in a fiscal year should not be more than 1 per cent of the appropriated expenditures from the House <p>Financial Measures Act 1996, amended in 2000:</p> <ul style="list-style-type: none"> Balanced budgets are required by 2002-03 <p>Provincial Finance Act 1989, amended in 2000:</p> <ul style="list-style-type: none"> Commencing 2002-03 fiscal year, no budget deficit can be proposed. When deficit occurs, it should be recovered by the end of next fiscal year 	<p>Financial Measures Act 1996, amended in 2000:</p> <ul style="list-style-type: none"> Deficits must be recovered in the next fiscal year, unless a deficit results from a natural or other disaster; losses associated with a sale, dissolution, closure or other restructuring of a government service organizations; or expenditure incurred by an unforeseen increase in debt service costs <p>Provincial Finance Act 1989, amended in 2000:</p> <ul style="list-style-type: none"> The deficit is not required to be recovered if it is the result of a natural or other disaster, losses associated with a sale, dissolution, closure or other restructuring of a governmental unit or government business enterprise that are not anticipated to have financial impact on future fiscal years or an expense incurred with respect to debt servicing costs that exceeds the amount budgeted for the fiscal year 	<ul style="list-style-type: none"> Reputational

Table 7 (continued)

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Ontario	1999 2004	<p>Taxpayer Protection Act 1999:</p> <ul style="list-style-type: none"> Requirement of voter's approval for tax increases <p>Fiscal Transparency and Accountability Act 2004:</p> <ul style="list-style-type: none"> The Budget Paper should be laid before the Legislation Assembly each year which addresses the fiscal plan for the fiscal year budgeted and the following two fiscal years Among others, the minister is responsible to have the following reports released within prescribed dates: mid-year review of fiscal plan, updated information about revenues and expenses, long-range assessment of fiscal environment two years after provincial election, and pre-election reports under certain regulation 	<p>Taxpayer Protection Act 1999:</p> <ul style="list-style-type: none"> Requirement of balanced budgets beginning with the 2001-02 fiscal year Expenditures must not exceed revenues in a given fiscal year plus the net accumulated surplus from the previous three fiscal years <p>Fiscal Transparency and Accountability Act 2004:</p> <ul style="list-style-type: none"> Maintain a prudent ratio of provincial debt to gross domestic product; For each fiscal year, the Executive Council should plan a balanced budget except extraordinary circumstances. If a deficit is planned, the Executive Council should also develop a recovery plan for achieving a balanced budget in the future. The recovery plan should specify the period within which a balanced budget will be achieved 	<p>Taxpayer Protection Act 1999:</p> <ul style="list-style-type: none"> Deficits are only permitted in very limited circumstances: such as a natural or other disasters, war or apprehension of war, or a revenue decline of at least 5 per cent for a reason other than a tax rate reduction A deficit of less than 1 per cent of revenue is permitted, but must be offset in the following year Voter approval is not required if the new or increased tax is 1) not designed to increase revenues, 2) a response to a change in federal tax laws or a restructuring of intergovernmental tax authority, or 3) required as a result of a reorganization or restructuring of a Crown agency <p>Fiscal Transparency and Accountability Act 2004:</p> <p>Extraordinary circumstances which are not specified</p>	<p>Taxpayer Protection Act 1999:</p> <ul style="list-style-type: none"> If a deficit is greater than 1 per cent of revenue or if a deficit less than 1 per cent is not offset in the following year, the salary paid to the members of the Executive Council is reduced by 25 per cent. If a deficit is incurred after either one of the two previous scenarios, salaries are reduced by 50 per cent for this and subsequent deficits
Quebec	1996 2001 2002	<p>Balanced Budget Act 2002:</p> <ul style="list-style-type: none"> The Minister of Finance is held responsible for the fiscal targets established in the Act. The Minister must report to the National Assembly in the Budget Speech on the fiscal objectives, on the achievement of those objectives and on the variance recorded, if any. The Minister must report annually to the National Assembly on the impact of accounting policy changes upon the financial results of the Government 	<p>Act Respecting the Elimination of the Deficit and a Balanced Budget 1996 (It was renamed as "Balanced Budget Act" in 2002):</p> <ul style="list-style-type: none"> Elimination of the deficit by 1999-2000 and maintenance of a balanced budget thereafter <p>Balanced Budget Act 2002:</p> <ul style="list-style-type: none"> The government may not incur a budgetary deficit. If an overrun of less than \$1 billion is recorded for a fiscal year, the Government must achieve an equivalent surplus in the next fiscal year. If the Government achieves a surplus in a fiscal year, it may incur overruns in subsequent fiscal years up to the amount of that surplus. In case that overruns are more than \$1 bn under special circumstances, the overrun should be offset by the Government with a maximum of 5 years 	<p>An Act to Establish a Budgetary Surplus Reserve Fund 2001:</p> <ul style="list-style-type: none"> Allow the reserve fund to be used to maintain a balanced budget under the circumstances of disaster, degradation of economic conditions or a reduction of federal transfer <p>Balanced Budget Act 2002:</p> <ul style="list-style-type: none"> The government may incur overruns more than \$1 billion in case of a disaster having a major impact on revenue or expenditure, a significant deterioration of economic conditions or a change in federal programs of transfer payments to the provinces that would substantially reduce transfer payments to the Government. However the overruns should be offset within 5 years 	<ul style="list-style-type: none"> Reputational

Table 7 (continued)

Canada

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Saskatchewan	1995 2000 2008	<p>Balanced Budget Act 1995:</p> <ul style="list-style-type: none"> The government must prepare a four-year financial plan and a debt management plan following each general election <p>Fiscal Stabilization Fund Act 2000:</p> <ul style="list-style-type: none"> A fiscal stabilization fund was established in order to fulfill long-term objectives by stabilizing the fiscal position from year to year <p>The Growth and Financial Security Act 2008:</p> <ul style="list-style-type: none"> The minister should, each year present the four-year financial plan and four-year public debt management plan to the Legislative Assembly at the same time that the minister presents the estimates for the first fiscal year The minister should present interim report containing revised forecast of revenues and expenses and setting out difference to the Lieutenant Governor in Council. The interim report of revised forecast of revenues and expenses should be laid before the Legislative Assembly before or on specific date 	<p>Balanced Budget Act 1995:</p> <ul style="list-style-type: none"> The government has to achieve a balanced budget over a four-year period. The sale of a Crown corporation and a change in accounting policies cannot be used to fulfill the balanced budget objectives. Budgetary surpluses must be used to repay debt <p>The Growth and Financial Security Act 2008:</p> <ul style="list-style-type: none"> Balanced budget or budget with surplus should be achieved Actual balance of revenue and expenses or surplus of revenues over expenses each year If a deficit results for a fiscal year from an special event described in the Act, the Government of Saskatchewan is required to achieve at least an offsetting surplus in the following fiscal year 	<p>Balanced Budget Act 1995:</p> <ul style="list-style-type: none"> Unanticipated and identifiable events that have a direct impact on expenses or revenues <p>The Growth and Financial Security Act, 2008:</p> <ul style="list-style-type: none"> The expense or revenue reduction may be excluded if it arises from a natural or other disaster of because Canada is under war or under apprehension of war as determined by the Lieutenant Governor in Council 	<ul style="list-style-type: none"> Reputational
Canada (National level)	1992	<p>Spending Control Act 1992:</p> <ul style="list-style-type: none"> The minister should not present a budget with the spending exceeding spending limits. If a certificate is issued to increase spending by the President of Treasury, it should be published with the main estimates or supplementary estimates for the year. The Public Accounts for each controlled fiscal year shall contain a statement by the Minister respecting compliance in that year 	<p>Spending Control Act 1992:</p> <ul style="list-style-type: none"> Sets the specific spending limits for each fiscal year from 1991-1992 to 1995-1996 which are subject to certain adjustments The minister may propose the spending of a particular year exceeding the limit. The spending in excess of the limit may be allocated to the two next years and the spending limits of the next two years should be reduced by the same amount 	N/A	<ul style="list-style-type: none"> Reputational

Sources: 1) Various Fiscal Responsibility Laws from a) LexisNexis, www.lexisnexis.com and b) CanLII, www.canlii.org. 2) Kennedy and Robbins (2003), The Role of Fiscal Rules in Determining Fiscal Performance.

Table 8

Colombia

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clause	Sanction
National FRL applies to all tiers of government	1997 2000 2003	<ul style="list-style-type: none"> The central administration and SNGs need to present a consistent 10-year macroeconomic framework each year. Both the central and decentralized budgets must also be in full compliance with the medium-term fiscal framework Any contingent liabilities associated with concessions, sovereign debt guarantees, and legal cases are to be reported annually to Congress as part of a medium-term fiscal framework 	<ul style="list-style-type: none"> The governments are classified as in: <ol style="list-style-type: none"> critically indebted (red light zone) if interest payment over operational saving more than 40 per cent of and debt stock over current revenues greater than 80 per cent, or Not over-indebted (green light zone) if interest over operational savings less than 40 per cent and debt stock over current revenue is less than 80 per cent. Only SNGs in the green light are allowed to borrow Primary surplus has to be at least 100 per cent of debt service, implying no borrowing except to repay principal The ratio of discretionary current expenditure over non-earmarked current revenue are set by law and varies across different categories of subnational entities 	N/A	<ul style="list-style-type: none"> Subnational government in red light zone is prohibited from borrowing Governments have to make across the board cuts whenever effective non-earmarked current revenue are under the budgeted amount Subnational governments that have excess debt must adopt a fiscal-rescue program in order to regain fiscal viability in two years

Note: 1997 fiscal legislation established fiscal targets of liquidity ratio and debt payment capacity ratio, which were subsequently incorporated into FRL in 2003.

Source: Government legislation.

Table 9

India

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Goa	2006	<ul style="list-style-type: none"> The Government shall lay in each financial year a medium term fiscal plan before the Legislative Assembly along with the budget. The medium term fiscal policy statement should set forth multi-year rolling targets for fiscal indicators The government should disclose a statement at the time of budget presentation including the significant changes in accounting policies and their effects and the contingent liabilities created by guarantees The Finance Minister should review the budget implementation and remedial measures taken to achieve the targets every half-year and explain any deviation as well as proposing remedial measures before legislature Any measure proposed which may lead to an increase in revenue deficit should be accompanied by remedial measures, which will neutralize such increase or loss and such measures shall be clearly mentioned In case the revenue deficit and fiscal deficit exceed because of unforeseen demands, the Government should identify the net fiscal cost arising due to natural calamity and such cost would provide ceiling for extent of non-compliance to the specified limits 	<ul style="list-style-type: none"> Eliminate revenue deficit by 31st March 2009; annual reduction of the ratio of revenue deficit to the total revenue receipt should be 1.5 per cent beginning on 1st day of April 2006 Reduce the ratio of fiscal deficit to GSDP to no more than 3 per cent by 31st March, 2009; annual reduction of the ratio should be 0.5 per cent beginning on 1st day of April 2006 Control the total outstanding guarantee within the specified limit by Goa State Guarantees Act, 1993; No fresh guarantee shall be given if outstanding risk weighted guarantees exceed the limits Ensure that the total liabilities do not exceed 30 per cent of GSDP by 31st March 2009 Ensure that the ratio of interest payment to total revenue receipt does not exceed 20 per cent by 31st March 2009 	<ul style="list-style-type: none"> On the grounds of unforeseen demand on public finance due to national security, natural calamities or other exceptional grounds specified by the government 	N/A
Haryana	2005	<ul style="list-style-type: none"> The government should in each year lay before the legislature Macroeconomic Framework Statement, the Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement. Medium Term Fiscal Plan should set forth three-year rolling targets for key fiscal indicators The government should disclose a statement at the time of budget presentation including significant changes in accounting policies and the corresponding impact, details of borrowings from the Reserve Bank of India and liabilities on the State Government for any separate legal entity The Minister of Finance should review the trend of revenue and expenditure half-yearly to ensure compliance and should lay results before legislature Whenever there is a breaching of intra-year targets of revenue or expenditure, the State Government should take appropriate measures for increasing revenue and/or for reducing the expenditure 	<ul style="list-style-type: none"> Annual reduction of revenue deficit from 2005-06 FY, so as to bring it down to zero by 2008-09 and maintain revenue surplus thereafter Annual reduction in fiscal deficit from 2005-06 FY, so as to bring it down to 3 per cent of GSDP by 2008-09 Ensure within a period of five years, beginning from the financial year 2005-06 and ending on 31st March, 2010, that the outstanding total debt including contingent liabilities do not exceed 28 per cent of the estimated GSDP of that year 	<ul style="list-style-type: none"> On the grounds of unforeseen demand on public finance due to internal disturbance, natural calamities or other exceptional grounds 	N/A

Table 9 (continued)

India

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Himachal Pradesh	2005	<ul style="list-style-type: none"> The Government shall lay in every financial year before the Legislative Assembly a medium term fiscal plan along with the annual budget. The medium term fiscal policy statement should set forth four-year rolling targets for fiscal indicators and assess the sustainability The government should disclose a statement at the time of budget presentation including significant changes in accounting policies, the contingent liabilities created by guarantees, actual liabilities and the number of employees of the public sector The Finance Minister should review revenue and expenditure trend every 6 months and lay outcomes before legislature Prior taking policy decision which potentially leads to breach of pre-specified fiscal targets, the State Government shall take measures to fully offset the fiscal impact for the current and future years by curtailing the sums authorized to be paid and applied from and out of the Consolidated Fund of the State 	<ul style="list-style-type: none"> Eliminate revenue deficit by March 2009 and maintain surplus thereafter Progressively reduce fiscal deficit to 3 per cent of GSDP Progressively reduce outstanding guarantees on long term debt, until it can cap outstanding risk weighted guarantees at 80 per cent of total revenue receipts in the preceding financial year 	<ul style="list-style-type: none"> On the grounds of the unforeseen demand of public finance due to national security, natural calamities or other exceptional grounds specified by the government 	N/A
Kerala	2003	<ul style="list-style-type: none"> The Government shall lay in every financial year before the Legislative Assembly along with the annual budget, a medium term fiscal policy statement and a fiscal policy strategy statement. The medium term fiscal policy statement should set forth three year rolling target for fiscal indicators and assess the sustainability The government should make disclosure at the time of budget presentation on the contingent liabilities, significant changes in accounting policies and the corresponding impact, and matters which have potential impacts on budget The government should specify the corrective measures to control deficit level beyond the target in annual budget. The Finance Minister should make a statement in the legislative Assembly explaining any deviation from the Act, assessing the potential impact and stating the remedial measures Whenever there is either shortfall in revenue or excess of expenditure over specified levels during the course of the year, the Government shall take steps either to make proportionate reduction in the voted expenditure or to increase the revenue 	<ul style="list-style-type: none"> Reduce the ratio of fiscal deficit to 2 per cent of GSDP within a four-year period commencing from 1st April, 2003 and ending on 31st March 2007 	N/A	N/A

Table 9 (continued)

India

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Maharashtra	2005	<ul style="list-style-type: none"> In each financial year, State Government should lay before both houses of the legislature the Medium-term Fiscal Statement and the Fiscal Policy Strategy Statement. Medium-term Fiscal Plan should set forth three year rolling targets for key fiscal indicators The Finance Minister should make quarterly review of compliance and lay the outcomes before both houses of the state legislature Whenever there is a breach of pre-specified level of expenditure or revenue during any period in a year, the government should take appropriate measures to offset the impacts, including curtailing the sum authorized to be paid or applied from and out of the Consolidated Fund of State 	<ul style="list-style-type: none"> Eliminate the revenue deficit by 31st March 2009 and maintain revenue surplus thereafter at the end of each year The State Government shall by rules specify the targets for reduction of fiscal deficit (which are not specified in this act) 	<ul style="list-style-type: none"> On the grounds of natural calamities or such other exceptional grounds the State Government may specify 	N/A
Tamil Nadu	2003	<ul style="list-style-type: none"> The Government shall lay a medium term fiscal plan before the Legislative Assembly along with the budget. The medium term fiscal policy statement should set forth multi-year rolling target for fiscal indicators The government should disclose a statement at the time of budget presentation including significant changes in accounting policies and their effects and the contingent liabilities created by guarantees The Finance Minister should review the budget implementation and remedial measures taken to achieve the targets every half-year and explain any deviation as well as proposing remedial measures before legislature Any measure proposed in the course of the financial year, which may lead to an increase in revenue deficit should be accompanied by remedial measures, which will neutralize such increase 	<ul style="list-style-type: none"> Reduce the ratio of revenue deficit to revenue receipt every year by 3 to 5 per cent, depending on the economic situation, so as to bring it down to below 5 per cent by 31st March 2008; adhere to it thereafter Reduce the ratio of fiscal deficit to GSDP beginning from 2002-03 financial year to not more than 3 per cent by 31st March, 2008 Cap the total outstanding guarantees to 100 per cent of the total revenue receipt in the preceding year, or at 10 per cent of GSDP; Cap the risk weighted guarantees to 75 per cent of the total revenue receipt in the preceding year, or at 7.5 per cent of GSDP 	<ul style="list-style-type: none"> On the grounds of the unforeseen demand of public finance due to national security, natural calamities or other exceptional grounds specified by the government 	N/A

Table 9 (continued)

India

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
Tripura	2005	<ul style="list-style-type: none"> The government should in each financial year lay before the legislature Macroeconomic Framework Statement, the Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement along with budget. Medium Term Fiscal Plan should set forth three-year rolling targets for key fiscal indicators and underlying assumptions The government should disclose a statement at the time of budget presentation including the contingent liabilities created by guarantees, significant changes in accounting policies and the corresponding impact The Minister of Finance should review the trend of revenue and expenditure every quarter to ensure compliance and should lay outcomes before legislature. Any deviation from the targets should be disclosed Whenever there is a breaching of intra-year targets of revenue or expenditure, the State Government should take measures for increasing revenue and/or reducing the expenditure Any proposed measure which leads to increase of revenue deficit should be offset by remedial measures. Such statement should seek approval for Revised estimates from the legislature 	<ul style="list-style-type: none"> Strive to remain revenue surplus Strive to reduce the fiscal deficit to 3 per cent by March 2010 Within a 5-years period, from 1st April 2005 to 31st March 2010, the total debt stock do not exceed 40 per cent of the estimated GSDP for that year Limit annual incremental risk weighted guarantees to 1 per cent of the GSDP of that year 	<ul style="list-style-type: none"> On the grounds of the unforeseen demand of public finance due to internal disturbance, natural calamities or the exceptional grounds the State Government may specify 	N/A
India (National FRL)	2003	<ul style="list-style-type: none"> The government should in each year lay before the legislature Macroeconomic Framework Statement, the Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement and report quarterly on fiscal development. Medium Term Fiscal Plan should set forth three-year rolling targets for key fiscal parameters Whenever there is a breaching of intra-year targets of revenue or expenditure, the State Government should take appropriate measures for increasing revenue and/or for reducing the expenditure 	<ul style="list-style-type: none"> To eliminate revenue deficit by March 2009; the annual reduction in revenue deficit must be at least 0.5 per cent of GDP and in the fiscal deficit at least 0.3 per cent of GDP Caps on the level of guarantees and total liabilities Prohibit the government from borrowing from the Reserve Bank after 2006 	<ul style="list-style-type: none"> On the grounds of the unforeseen demand of public finance due to national security or natural calamities 	N/A

Source: Various Fiscal Responsibility Laws from internet.

Table 10

Peru

Political Units	Date	Procedural Rules and Transparency Requirements	Numerical Targets	Escape Clauses	Sanctions
National FRL applies to all tiers of government	1999 2003	<ul style="list-style-type: none"> It is not allowed to enact legal or administrative rules interfering with fiscal rules The MEF should produce and publish Multiannual Macroeconomic Framework (MMF) every year, and approved by the council of ministers and the Congress. Regional development plan must be consistent with the MMF at national level All external debt operation by regional governments should be approved by the national government, and the proceeds should be used only for infrastructure A Fiscal Stabilization Fund was established from the NFPS fiscal surplus, privatizations and concession proceeds, and royalty of exploitation of national natural resources If the quarterly revenue is below the projected figure more than 1.5 per cent, expenditures of following quarters should be reduced by the same amount 	<p>For governments at all levels:</p> <ul style="list-style-type: none"> Fiscal deficit of the NFPS including SNGs cannot exceed 1 per cent of GDP Real growth of NFPS spending including SNGs no more than 3 per cent per year The total debt of the NFPS cannot exceed its fiscal deficit In electoral years, the non-financial expenditure executed in the first seven months of a year cannot exceed 60 per cent of the budgeted amount for the year; and, the fiscal deficit of the NFPS in the first half of the fiscal year cannot exceed 40 per cent of the projected deficit for the whole year <p>For each SNG:</p> <ul style="list-style-type: none"> The stock of debt may not exceed 100 per cent of the current revenue, and the debt service (interest and amortization) may not exceed 25 per cent of the current revenue The average primary balance for the last 3 years cannot be negative 	<ul style="list-style-type: none"> In the case of national emergency and international crisis with substantial impact, upon request of the executive, the Congress can suspend the application of fiscal rules If GDP is declining, the ceiling for NFPS deficit could (with proper authorization) rise to 2.5 per cent of GDP for a maximum of 3 years 	<ul style="list-style-type: none"> Violation of the targets by SNG will cause the disruption of transfers from participatory funds such as FONCOR, FONCOMUN and FIDE The national government may intervene in the operations of a regional government in the case of a breach of the fiscal targets set in the national MMF or any fiscal rule of the fiscal responsibility law

MEF: Ministry of Economy and Finance; NFPS: Non-Financial Public Sector.
Source: Government legislation.

ANNEX 2

**PROVINCIAL FISCAL RESPONSIBILITY LAWS IN CANADA:
FISCAL TARGETS**

Table 11

Provinces	Key Fiscal Targets
British Columbia	<ul style="list-style-type: none"> • Main budget estimates must not contain a forecast of deficit
Alberta	<ul style="list-style-type: none"> • Deficits and opening debt are not allowed • Net assets of Sustainability Fund may not be reduced to less than zero • Net assets of Capital Account is may not be reduced to less than zero • Contingency allowance => 1 per cent of revenue p.a. for fiscal policy purposes
Quebec	<ul style="list-style-type: none"> • No budgetary deficit. For an overrun of less than \$1 billion, an equivalent surplus must be achieved in the next fiscal year • If surplus is achieved in a fiscal year, overruns can occur in subsequent fiscal years up to the amount of that surplus • With overruns more than \$1 bn, it should be offset with a maximum of 5 years
Ontario	<ul style="list-style-type: none"> • Maintain a prudent ratio of provincial debt to gross domestic product • Plan a balanced budget except extraordinary circumstances • If a deficit is planned, the Executive Council should also develop a recovery plan for achieving a balanced budget within specified period
New Brunswick	<ul style="list-style-type: none"> • Balanced budget: the total amount of the expenses should not exceed the total amount of revenue for that fiscal year • Reduction of debt: Ratio of net debt to GSDP at the end of each year should be less than at the end of the previous fiscal period
Nova Scotia	<ul style="list-style-type: none"> • No budget deficit (from FY2002/03 onward) • When deficit occurs, it should be recovered by the end of next fiscal year
Saskatchewan	<ul style="list-style-type: none"> • Balanced budget or budget with surplus with 4-year financial plan • Actual balance of revenue and expenses or surplus of revenues over expenses each year • If a deficit results for a fiscal year, an offsetting surplus must be achieved the following fiscal year
Manitoba	<ul style="list-style-type: none"> • Presented budget must project a positive balance as at the end of that year • The balance as at the end of a fiscal year is determined as the average of the net results for the fiscal years within the four-year period ending at that time

Sources: 1) Various Fiscal Responsibility Laws from LexisNexis, www.lexisnexis.com and CanLII, www.canlii.org. 2) Kennedy and Robbins (2003).

ANNEX 3

GROWTH OF GROSS DEBT AS SHARE OF GSDP/
GDP IN THE PRE- AND POST-FRL PERIODS

Table 12

Australia

State	Date	Pre-FRL $(Dt-1)/GSDP - (Dt-5)/GSDP$	Post-FRL $(Dt+5)/GSDP - (Dt)/GSDP$
Western Australia	2000	-2.20%	-2.48%
Victoria	2000	-9.93%	-0.87%
Queensland	1999	-2.50%	-1.40%
Northern Territory	2001	-4.69%	-5.39%
New South Wales	2005	-1.69%	-0.32%

Note: To eliminate the impact of the recent financial crisis on our data set, our data stop at the first half of 2008.
Source: Australia Bureau of Statistics.

Table 13

Brazil

	Date	Pre-FRL $(Dt-1)/GDP - (Dt-5)/GDP$	Post-FRL $(Dt+5)/GDP - (Dt)/GDP$
Sovereign Debt	2000	15.13%	2.39%
Subsovereign Debt		4.99%	1.31%

Source: Instituto de Pesquisa Econômica Aplicada (IPEA).

Table 14

Canada

Provinces	Date	Pre-FRL $(Dt-1)/GSDP - (Dt-5)/GSDP$	Post-FRL $(Dt+5)/GSDP - (Dt)/GSDP$
Alberta	1999	-13.16%	-10.65%
British Columbia	2000	12.82%	-5.04%
Nova Scotia	2000	2.41%	-12.48%
Ontario	2004	-3.97%	-2.74%
Newfoundland and Labrador	2004	-23.81%	-26.54%
New Brunswick	2006	-6.04%	-0.26%

Notes: 1) Pre-FRL data of Alberta only date back 4 years before the enactment of FRL. 2) To eliminate the impact of the recent financial crisis on our data set, our data stop at first half of 2008.
Source: Statistics Canada.

Table 15

Colombia

	Date	Pre-FRL $(Dt-1)/GDP - (Dt-5)/GDP$	Post-FRL $(Dt+5)/GDP - (Dt)/GDP$
Subsovereign Debt	2003	0.58%	-1.07%

Source: Ministry of Finance and Public Credit.

Table 16

India

State	Date	Pre-FRL $(Dt-1)/GSDP - (Dt-5)/GSDP$	Post-FRL $(Dt+5)/GSDP - (Dt)/GSDP$
Karnataka	2002	3.80%	1.10%
Kerala	2003	8.70%	-3.50%
Punjab	2003	8.10%	-8.50%
Tamil Nadu	2003	7.40%	-3.90%
Uttar Pradesh	2004	12.90%	-3.90%
Andhra Pradesh	2005	7.30%	-4.50%
Chhattisgarh	2005	0.90%	-7.30%
Gujarat	2005	6.00%	-8.00%
Haryana	2005	0.20%	-7.70%
Madhya Pradesh	2005	4.50%	-2.70%
Maharashtra	2005	7.70%	-6.20%
Orissa	2005	7.10%	-15.90%
Rajasthan	2005	9.30%	-8.00%
Assam	2005	8.30%	-3.00%
Himachal Pradesh	2005	13.80%	-17.30%
Manipur	2005	11.90%	4.90%
Nagaland	2005	-2.20%	1.30%
Tripura	2005	12.70%	-20.90%
Uttarakhand	2005	12.20%	-2.90%
Bihar	2006	6.30%	-12.60%
Goa	2006	-3.30%	-2.80%
Arunachal Pradesh	2006	31.10%	-9.60%
Jammu and Kashmir	2006	10.90%	-0.60%
Meghalaya	2006	6.50%	0.50%
Mizoram	2006	39.80%	-2.80%
Jharkhand	2007	2.30%	0.00%

Notes: 1) 2009 data are budget estimates and 2010 data are revised estimates; 2) Due to limited data, Pre-FRL data of Chhattisgarh and Uttarakhand only date back 4 years before enactment of FRLs.

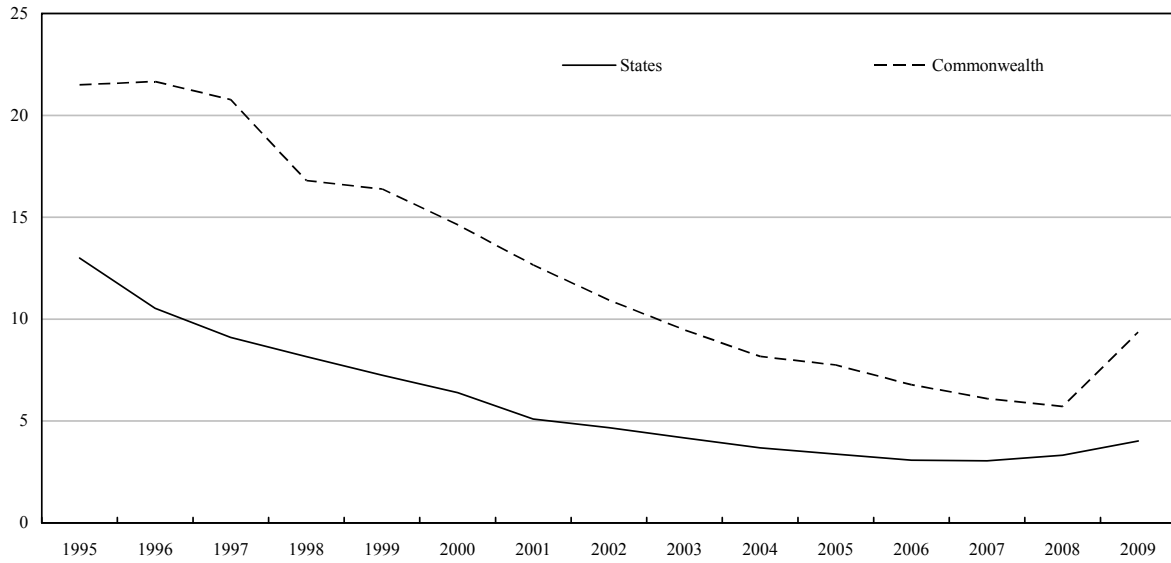
Source: Reserve Bank of India.

ANNEX 4

GOVERNMENT DEBT AS SHARE OF GDP

Figure 1

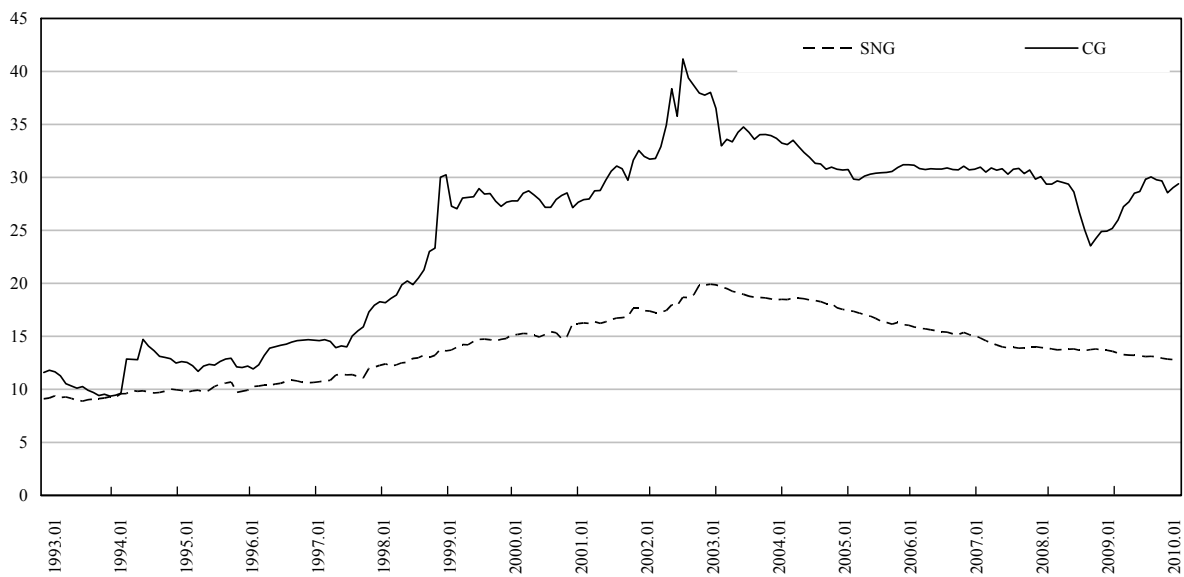
Australia – Gross Government Debt
(percent of GDP)



Source: Australian Bureau of Statistics.

Figure 2

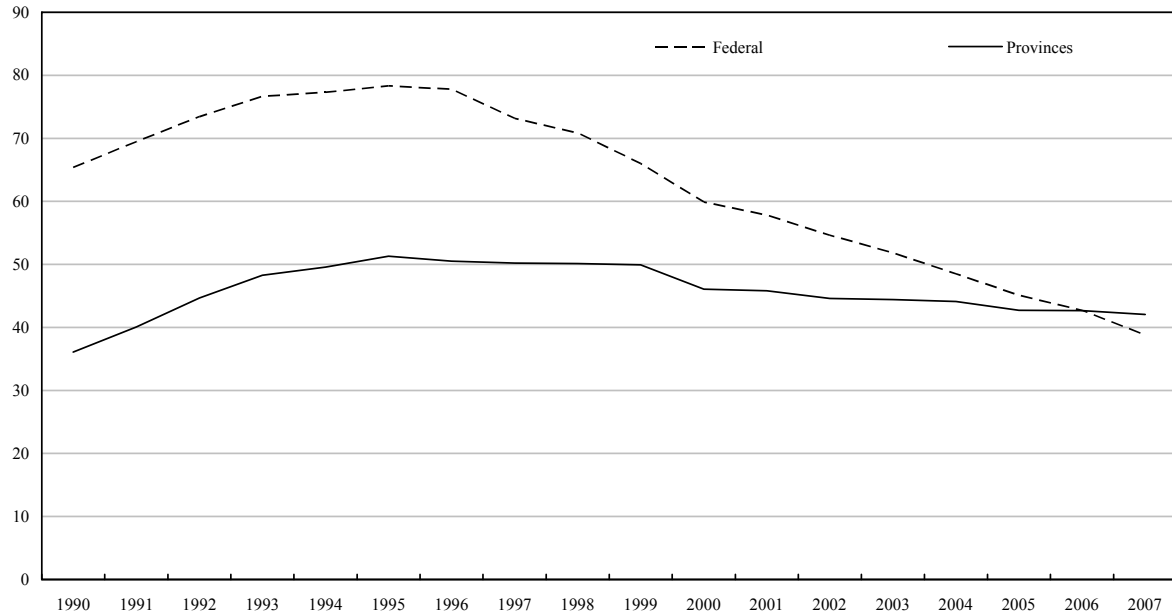
Brazil – Net Government Debt
(percent of GDP)



Note: SNG=Subnational Government, CG=Central Government.
Source: Instituto de Pesquisa Econômica Aplicada (IPEA).

Figure 3

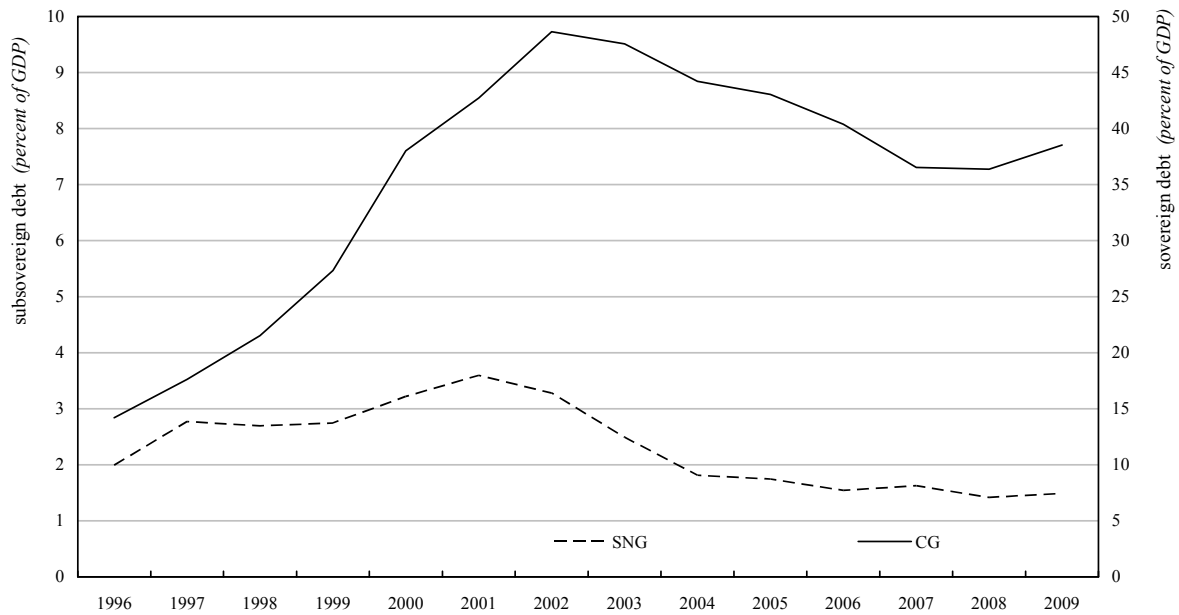
Canada – Net Government Debt
(percent of GDP)



Sources: Statistics Canada and IMF GFS.

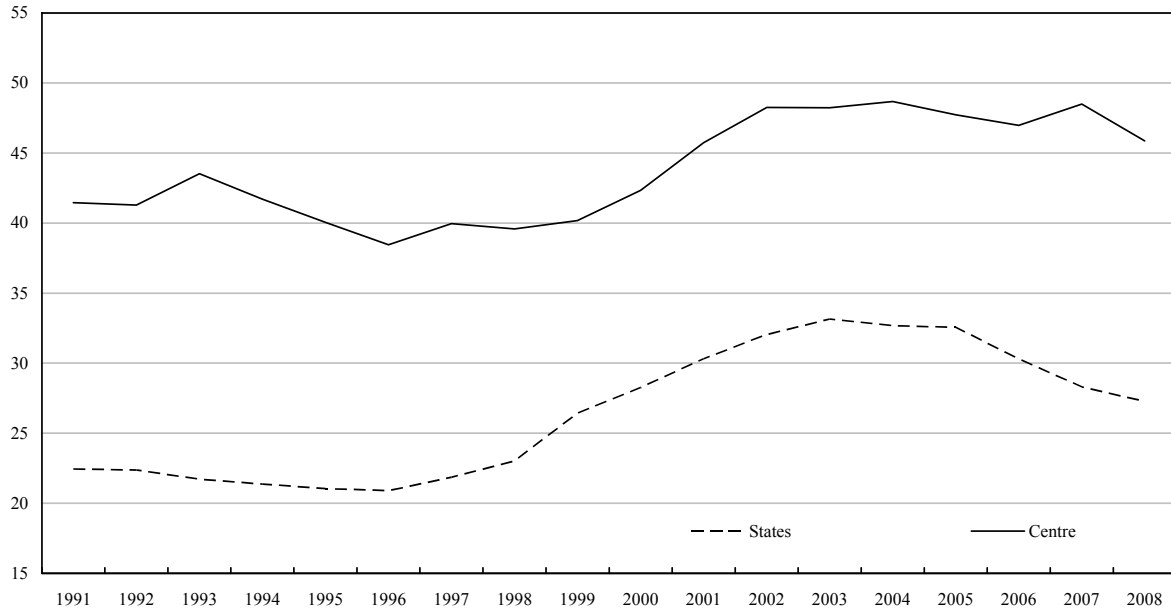
Figure 4

Colombia – Gross Government Debt
(percent of GDP)



Note: SNG=Subnational Government, CG=Central Government.
Source: Ministry of Finance and Public Credit.

Figure 5

India – Gross Government Debt
(percent of GDP)

Note: The amount of onlending from centre to states is netted out from the data of centre.
Source: Reserve Bank of India.

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