Special Section 2
Fiscal Responsibility and Debt Limitation Law (FRDLL)

Economic literature and empirical evidence clearly shows that the presence of large, persistent budgetary deficits in any economy is associated with significant macroeconomic negatives including high interest rates, crowding out of private investment, inflationary pressures, a slowdown in growth, etc. Unfortunately, despite the general acceptance of the negative impact of sustained fiscal indiscipline, governments' throughout the world have demonstrated an inability to rein-in their fiscal excesses in any given budgetary year, often due to negative short term political connotations. Consequently, the debt/GDP ratios for many countries have steadily risen over the years.

As a result, there is increasing interest, particularly in the more fiscally responsible developed economies, to legislate automatic, transparent, rule-based "poison pill" mechanisms in order to partially insulate the fiscal deficit decision from the relatively short-term compulsions of the annual budgetary exercise. It must be acknowledged that any piece of legislated self-discipline can, by definition, be reversed. However, in such an eventuality the government would typically be forced to defend its decision, in Parliament, and in the court of public opinion, thereby raising the political cost of inappropriate fiscal policies. Thus, even the very enactment of a Fiscal Responsibility law can, in theory, lend credibility to a government's commitment to fiscal discipline.

Such fiscal frameworks with legislative backing have been enacted in a number of countries in the recent years (see **Table 2.1**) and the recent fiscal consolidation in the OECD countries is attributed partly to such frameworks.[1]

1.1 Issues and Experiences with Fiscal Responsibility Laws

Two different views on the ability of these rules to improve fiscal finances are observed in economic literature. Proponents of the first view argue that the rule-based restrictions merely lead to changes in accounting practices rather than real changes in the fiscal behavior of governments. On the other hand, supporters of

[1]United States in the mid-1980s promulgated the Balanced Budget and Emerging Deficit Control Act, bound the federal government to reduce its deficit to zero within a stipulated time period. There are various other countries that have legislation on this subject i.e. Australia, Brazil, Canada, Japan and New Zealand. The UK is following a golden rule principle, borrowing only for the developmental purposes. In south Asia, India and Sri Lanka are also in the process of enacting the Fiscal responsibility law.

the “public choice” view hold that fiscal rules place important constraints on the behavior of political leaders. The empirical evidence is inconclusive.

A study by Kopitz and Symansky (1998) for advanced economies concluded that the implementation of such a law generally led to decline in inflation and interest rates, mitigated the crowding out of private investment and reduced external imbalances. A study on the United States concluded that exhibits that actual budget balance results rules are correlated with lower fiscal deficits and such limits do not affect output variability.

Table 2.1: Selected Countries: Summary of Fiscal Rules[1]

	Effective year	Coverage[2]	Basic rules[3]	Escape clause	Additional rule	Statue[4]	Sanction[5]
Budget Rule							
Argentina	2000	NG	OB/DL	CF	EL	L	J
Brazil	2001	NG, SG	CB		WL	L	J
Canada	Various	SG	CB			L	J
EU Members	1997	GG	OB/DL	MY		T	F
Germany	1969	NG, SG	CB			C	J
New Zealand	1994	GG	PB	MY		L	R
Peru	2000	NG	OB/DL	CF	EL	L	J
Switzerland	Various	SG	CB			C	J
United States	Various	SG	CB	CF		C	J
Debt Rule							
Brazil	2001	NG, SG	SL			L	J
Columbia	1997	SG	PL			L	J
EU Members	1997	GG	PL			T	J
New Zealand	1994	GG	SL			L	R
Pakistan	In process	GG	CB	MY		C	R

1 Excluding prohibition or limits on financing form specific resources.
2 General government (GG), national (central, federal) government or Sub national (including local) government (SG).
3 Budget rules restrict on overall balance (OB), operating balance (PB), or current balance (CB), subject to a prescribed limit on deficit (DL) as a proportion of GDP, applied on annual basis, except if specifies on a multiyear (MY) basis. Also, a contingency fund (CF) is provided in some cases. Additional rules consist of limits on primary expenditure (EL) or wage bill (WL). Debt Rules are specified as a limit for a given year (SL) or permanently (PL), as a proportion pf GDP or of government revenue.
4 Constitution (C), Legal provision (L), or international treaty (T).
5 Sanctions for noncompliance: reputation (R), Judicial (J) or Financial F).
6 the origins of the present rule can be traced to the Constitution of 1871, subject to modifications in 1919 and 1949.

However, another study by Suitz and Fisher (1985) suggested that forced compliance with such law led to distortions in the composition of government expenditures, particularly against public investment, or to tax increases. Moreover, the study found that in some instanced these rules have reduced the degree of fiscal transparency by promoting the delayed disbursement of accrued payments, the use of creative accounting practices, and the recourse to one-off measures such as financing from privatization receipts.[2] Similarly, in fact, a study on European Union countries by Balassone and Franco (2000) has cited a close relationship between fiscal consolidations and cuts in developmental spending in Europe during the 1980s and 1990s.

Poterba (1996) concludes from US experience and few other countries that the strict anti deficit rules can indeed curtail deficits and bring more speedy adjustment of taxes and spending to fiscal shortfalls.[3] However, the study indicates that the existing findings did not provide clear evidence on policy outcomes.

In short, even where that impact of Fiscal rule in reforming government fiscal finances is acknowledged, there are concerns about (1) the resulting inflexibility to pursue counter-cyclical fiscal policies; and, (2) the risk that such laws would lower developmental spending.

1.2 The Case of Pakistan

Keeping in view the above-mentioned outcomes, the government of Pakistan has prepared a draft of Fiscal Responsibility and Debt Limitation Law, which has been placed before the Parliament for approval.

1.2.1 Key features of the of the proposed law

The principles are as followed:

1) To eliminate revenue deficit till 30th June, 2007 and running a surplus after that.

2) To reduce the public debt to 60 percent of GDP till 30th June 2012;

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[2] Non-transparent application of fiscal rules had been observed by Suitz and Fisher (1985) for the states of Michigan and New York, and in Wellink (1996) for Netherlands. Please see the details in 1) Suits, D.B, and R.C. Fisher (1985), A Balanced Budget Constitutional Amendment: Economic Complexities and Uncertainties, *National Tax Journal*, Vol. 38 (December), pp. 467-477. (2) Wellink, A.H. (1996), Budgetray Control: Goodhart's Law in government Finances? In C. Kool, J. Muysken, and T.Van Veen (eds) Essays in Money, Banking and Regulation: Essays on Honor of C.J. Ort (Dosdrecht, Kluwer Academic Publishers).

[3] For details please see: Poterba, James M. (1996), "Do Budget Rules Work?", National Bureau of Economic Research, Working Paper 5550, Cambridge, Massachusetts: National Bureau of Economic Research.

3) To reduce public debt not less than two and a half percent of GDP in every year and keep poverty related expenditures minimum 4 percent of GDP.

4) No new guarantees will be issued, for any amounts exceeding 2 per cent of the GDP.[4]

5) The government can deviate from these rules on the basis determined by the National Assembly i.e., natural calamity, and national security.

6) To maintain transparency in the performance in each year by issuing the Economic Policy Statements (EPS).

7) The EPS shall incorporate to the fullest extent possible all government decisions, which have a material effect on the economic situation of the country.

8) A Debt Policy Coordination Office (DPCO) is proposed to be established and will prepare a ten-year debt reduction on the basis of which the performance of the government will be monitored and analyzed by the DPCO.

9) Where the government fails to meet the target of debt to GDP over a period of two years, it would be required to take steps to return to the debt reduction path given by the DPCO by the end of the next two years.

10) All the EPS shall be accompanied by a statement of the Finance Minister and Secretary Finance for ensuring integrity and consistency of the disclosures.

1.2.2 Implications and Objectives

Even though Pakistan's recent fiscal performance has been relatively disciplined, the considerably weaker track record in earlier years continued to cloud the credibility of the fiscal commitments, particularly in view of the country's expected exit from IMF lending programs by 2004. Thus, the enactment and implementation of a transparent, rule-based, fiscal framework, together with the limitations on the provision of conditional liabilities, could bolster business/investor confidence in the continuity of prudent fiscal policy and add to transparency of fiscal practices.[5]

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[4] Including those on rupee lending, bonds, rates of return, output purchase agreements and all other claims and commitments that may be prescribed from time to time.

[5] Transparency also may reduce the qausi-fiscal activities through concealed subsidies at below cost pricing or government guarantees, which are often used as an alternate for explicit budgetary operations.

In particular, the pre-determined (and pre-announced) multi-year annual targets, the requirements for regular performance updates counter signed by senior officials, would provide timely warning of slippages. Moreover, in the latter case, the mandatory requirement for remedial measures in case targets are consistently unmet, would help limit the long germ impact of fiscal imprudence.

The proposed law also attempts to address some key concerns regarding generic Fiscal responsibility laws

(1) It seeks to permit the government some flexibility in adjustment expenditures in the event of economic shocks. But, at the same, seeks to reduce the risk of misuse of the this clause by broadly restricting such exceptions to natural calamities and national security issues.

(2) Poverty-related spending has also been protected, by incorporating a floor, at 4 percent of GDP. However, in light of Pakistan unfortunate experience of the 1990s, when fiscal consolidation was achieved largely through lower development spending, it may have been more appropriate to include a floor on development spending, independent of the floor on anti-poverty expenditure.