

Contents

<i>List of Tables</i>	vii
<i>List of Figures and Box</i>	ix
<i>List of Contributors</i>	x
<i>Acknowledgments</i>	xi
<i>Foreword</i>	xii
1 Overview of Fiscal Policy Rules in Emerging Markets <i>George Kopits</i>	1
Part I Political Economy and Macroeconomic Setting	13
2 Fiscal Rules from a Political Economy Perspective <i>Allan Drazen</i>	15
3 Good Credit Ratios, Bad Credit Ratings: The Role of Debt Structure <i>Ricardo Hausmann</i>	30
4 Can Fiscal Rules Help Reduce Macroeconomic Volatility? <i>Guillermo Perry</i>	53
5 Fiscal Policy and High Capital Mobility <i>George Kopits</i>	66
6 Fiscal Institutions versus Political Will <i>Allen Schick</i>	81
Part II Design Issues at the National Level	95
7 EMU Fiscal Rules: What Can and Cannot be Exported <i>Marco Buti and Gabriele Giudice</i>	97
8 Fiscal Rules and Debt Sustainability in Brazil <i>Ilan Goldfajn and Eduardo Refinetti Guardia</i>	114
9 Fiscal Rules in Mexico: Evolution and Prospects <i>Andrés Conesa, Moisés J. Schwartz, Alejandro Somuano, and J. Alfredo Tijerina</i>	131
10 Fiscal Rules on the Road to an Enlarged European Union <i>Fabrizio Coricelli and Valerio Ercolani</i>	146

11	Fiscal Rules for Economies with Nonrenewable Resources: Norway and Venezuela <i>Olav Bjerkholt and Irene Niculescu</i>	164
Part III Design Issues at the Subnational Level		181
12	Subnational Fiscal Rules: A Game Theoretic Approach <i>Miguel Braun and Mariano Tommasi</i>	183
13	Rules-Based Adjustment in a Highly Decentralized Context: The Case of India <i>Kalpna Kochhar and Catriona Purfield</i>	198
14	Fiscal Rules for Subnational Governments: Lessons from the EMU <i>Fabrizio Balassone, Daniele Franco, and Stefania Zotteri</i>	219
15	Rules for Stabilizing Intergovernmental Transfers in Latin America <i>Christian Y. Gonzalez, David Rosenblatt, and Steven B. Webb</i>	235
	<i>References</i>	250
	<i>Author Index</i>	268
	<i>Subject Index</i>	271

1

Overview of Fiscal Policy Rules in Emerging Markets

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Introduction

In the past decade, several advanced economies have shifted from discretion-based to rules-based fiscal policies. This shift has taken place in countries such as New Zealand, Australia, and the United Kingdom, but perhaps most visibly in the European Union (EU) in support of monetary unification.² Thus, experience with fiscal policy rules, in the context of Europe's economic and monetary union (EMU), has been the object of extensive analysis.³ Also, there has been considerable research on the effects of much older subnational rules in the United States.⁴

In emerging market economies, the adoption of fiscal policy rules has been much more recent and limited mainly to Latin America. In some instances, the rules were introduced following a financial crisis; in others they were adopted to reduce vulnerability to a potential crisis. Often the immediate motivation has been to reverse the buildup of public debt, to restore fiscal sustainability and, more generally, to enhance the credibility of macroeconomic management. In addition, in some regions, mainly Central and Eastern Europe, rules are increasingly viewed as an anchor in the convergence to a broader monetary union.

The growing interest in rules-based fiscal policies in emerging market economies, stemming from an increasing realization that it is essential to correct the fundamentals, has not been matched until now by sufficient in-depth analysis.⁵ In the meantime, primary attention to the role of monetary policy, especially regarding the choice of an appropriate exchange rate regime, has gradually given way to the recognition of the importance of sound fiscal policy and robust institutions in these economies.⁶ Moreover, recent empirical evidence supports the view that discretionary fiscal policy has been detrimental to overall macroeconomic performance.⁷

Accordingly, fiscal policy rules – if well designed and properly implemented – are viewed as potentially useful commitment technology for emerging market economies exposed to macroeconomic volatility and high

capital mobility. From a political economy perspective, fiscal rules can be instrumental in avoiding the myopic policies that result from dynamic inconsistency and/or political distortions, especially in highly decentralized countries.⁸ Broadly speaking, fiscal rules can help depoliticize the macroeconomic policy framework.⁹

This volume of collected studies – intended primarily for policy analysts and practitioners – is comprised of three parts. The first part reviews the macroeconomic setting and rationale for rules-based policies in emerging markets, taking into account political economy aspects. The second and third parts are devoted to design issues respectively at the national and subnational levels of government, in the light of current country practices under a wide variety of circumstances and institutional conditions. In addition to focusing on emerging market economies in Latin America, Asia, and Central Europe, the relevant experience of advanced economies is also brought under scrutiny.

Current practices

With very few exceptions, the fiscal policy rules in emerging market economies are of recent vintage, mainly since the late 1990s (Table 1.1); thus actual experience has been relatively brief, unlike in some advanced economies.¹⁰ Most of the existing rules are expressed as a permanent constraint on a broad performance indicator, such as the government balance (in flow terms) or the public debt (in stock terms), usually as a proportion of GDP. In practically all these countries, fiscal policy rules have been embedded in a rules-based monetary framework. The latter includes an inflation-targeting regime (Brazil, Chile, Colombia, Mexico, Peru, Poland), a currency board arrangement (Estonia, and until recently Argentina), or a dollarized regime (Ecuador). In this sense, fiscal rules can be viewed as means to reduce or eliminate fiscal dominance in macroeconomic policy.

Rules on budget balance are subject to some variations: overall balance, current balance, and in a few cases numerical limits on the overall deficit (Argentina, Peru, India), or a floor for the overall surplus (1 percent of GDP in Chile). Observance of a current-balance rule, also called the “golden rule” (Brazil, Mexico, India, Venezuela), can prevent a crowding-out of much-needed public investment. In some countries, the budget-balance rule is accompanied by additional limits on total government expenditures (Venezuela), primary (noninterest) outlays (Argentina, Ecuador, Peru), interest payments (Colombia), and/or the wage bill (Brazil, Colombia), in order to contain the fastest growing components of fiscal imbalance.

In some countries, under the budget-balance rule, escape clauses are provided in the form of a contingency fund and/or a multiyear definition of the rule in order to accommodate shocks or cyclical fluctuations in activity. The contingency fund (also called stabilization or countercyclical fund) is intended to release resources to finance a cyclically induced deficit or to withdraw

Table 1.1 Emerging markets: summary of fiscal policy rules¹

Rule/Country	Effective date	Coverage ²	Basic rule ³	Escape clause ³	Additional rule ³	Statute ⁴	Sanction ⁵
<i>Budget rules</i>							
Argentina	2000	NG ⁶	OB, DN	CF	EN	L	R
Brazil	2001	NG, SG	CB		WN	C, L	J
Chile	2000	NG	SN	MY, CF		P	R
Colombia	1997, 2001	SG	CB		WN, RN	L	J, F
Ecuador	2003	NG	NB, DN	CF	EN	L	J
Estonia	1998	GG	OB	CF		P	R
India	2004	NG ⁶	CB, DN			L	R
Indonesia	1967	GG	DF			P	R
Mexico	1917	SG	CB			C	R
Peru	2000	NG	OB, DN	CF	EN	L	J
Venezuela	2004	NG	CB	MY, CF	TN	C, L	R
<i>Debt rules</i>							
Brazil	2001	NG, SG	FN			C, L	J
Colombia	2004	NG, SG	FN			L	R
Ecuador	2003	NG	PN			L	J
Poland	1998	GG, SG	PN			C, L	J

Notes

¹ Table excludes standard restriction or prohibition on financing from the central bank.

² General government (GG), national (central, federal) government (NG) or subnational governments (SG).

³ Budget rules consist of overall balance (OB), current balance (CB), or non-oil balance (NB); prohibition on domestic financing of deficits (DF); and/or numerical limits on deficit (DN) or numerical threshold for surplus (SN), as ratio of GDP. All rules are applied on an annual basis, unless specified on a multiyear (MY) basis; and/or a contingency fund (CF) is provided – besides the standard escape clause in event of war or natural calamity. Additional rules consist of numerical limits on total expenditure (TN), primary expenditure (EN), wage bill (WN), and/or debt service (RN), in terms annual growth or ratio of GDP. Numerical limits on debt stock targeted for a future year (FN) or permanently (PN) as ratio of GDP.

⁴ Constitution (C), legal provision (L), or policy guideline or target (P).

⁵ Sanctions for noncompliance: reputational (R), judicial (J), or financial (F).

⁶ Adopted also by one or several subnational governments.

them from a cyclically generated surplus (Argentina, Estonia, Peru). More directly, the rule may be defined in terms of structural or cyclically adjusted balance (Chile). A multiyear or medium-term balanced-budget requirement (Ecuador, Venezuela), which allows not only for the operation of automatic stabilizers but also for some countercyclical discretionary action, performs a similar function. To cushion the budget from output changes, some countries (Ecuador) specify *ex ante* the real growth of primary expenditure in terms of a constant rate, broadly in line with trend or potential GDP growth.

Either in conjunction with a budget-balance rule, or simply with the goal of securing medium- to long-term fiscal sustainability, several countries have established targets for the phased reduction of the debt–GDP or debt–revenue ratio (Brazil), or limits on the debt–GDP ratio (Poland). The debt-ratio target or ceiling usually presupposes, either implicitly or explicitly (Brazil), an annual operational target in terms of a minimum primary surplus.

Generally, the institutional coverage of rules depends on the degree of fiscal decentralization and autonomy of various levels of government. In a relatively centralized fiscal system the rules are imposed only on the central government (Chile, Peru) without much loss of control. However, in federal systems, rules must encompass the national and subnational levels of government. Depending on the degree of subnational autonomy, uniform rules are imposed top-down on all subnational governments (Brazil, Colombia, Mexico, Poland) or differentiated rules are voluntarily self-imposed from the bottom-up by some subnational governments (Argentina, India).

Fiscal policy rules can be specified in a constitutional provision (Mexico, Poland), high-level legislation (Brazil), or ordinary legislation (India) that applies to governments over successive electoral cycles. The most frequent statutory vehicle is a comprehensive Fiscal Responsibility Law (FRL) – named after the legal framework introduced by New Zealand in 1994. Alternatively, fiscal rules may merely consist of a policy guideline declared by a given government and not necessarily binding on future governments (Chile, Estonia, earlier in Indonesia).

In terms of contents, the statute may be very detailed (Brazil), specifying not only the nature of the policy rules, but also detailed procedural rules governing compliance. At the other end of the spectrum, it may define a broad framework (India), to be accompanied by regulations issued by the government in charge. Increasingly, countries enhance their credibility by implementing policy rules subject to transparency standards – in contrast to earlier opaque applications.

Whatever the statutory form, at present most policy rules are supported by institutional arrangements encompassing the budget process (possibly in a rolling medium-term budget framework), accounting conventions, periodic reporting and projection requirements, and penalties for noncompliance. Also, there is an assignment of responsibilities for implementation versus monitoring and audit – the latter usually to be undertaken by an independent

authority. Legal sanctions for noncompliance (treated as a criminal offense in Brazil) may exist as well, though typically these remain untested in the courts. Rarely, in the case of top-down subnational government rules (Colombia), deviation from the rule is subject to financial penalties. However, in most countries, noncompliance, especially by the national government, is punished with loss of reputation toward the electorate or financial markets.

Political economy and macroeconomic setting

From a survey of the literature, Drazen shows how fiscal policy rules can help address the problem of time inconsistency and the deficit bias. He indicates how properly designed fiscal rules can be a useful means for building reputation and serve as a disciplining device, as long as they are accompanied by various procedural rules – including those that prevent creative accounting practices. In particular, rules do not work when there are no real costs attached to deviating from or changing them. Drazen further argues that rules are more likely to be effective if they are enshrined in the constitution or other high-level legislation.

Given that emerging market economies are exposed to considerable macroeconomic volatility (in output, terms of trade, interest rates, and exchange rate), Hausmann observes that they suffer from a much higher risk premium than advanced economies, even with the same level of public indebtedness expressed in terms of GDP. An additional explanation for the risk differential lies in the excessive share of dollar-denominated, short-term maturities in emerging market government liabilities. A major implication is that emerging market economies would benefit from fiscal rules that aim not only at eliminating deficits and reducing debt ratios, but more important, also at containing the risk in the composition of the debt.

High macroeconomic volatility, experienced especially in Latin America, has been aggravated by the procyclical stance adopted under various fiscal adjustment programs. Thus, to mitigate volatility and to avoid procyclical adjustment, Perry argues, these countries ought to follow a rule that incorporates a countercyclical stance through a structural-balance target or a stabilization fund. Admittedly, however, limited access or loss of access to external financing precludes a countercyclical expansion during a recession in a highly indebted economy.

The openness of emerging market economies to high capital mobility, according to Kopits, underscores the case for predictable time-consistent macroeconomic policies, and in particular for well-designed fiscal policy rules. A review of crisis episodes points to the significant contribution of public sector indebtedness to capital account crises. In view of serious rigidities that prevent rapid fiscal response to currency crises – often precipitated by sudden shifts in market sentiment – it is important to signal early on a

commitment (as a precursor of the actual adjustment) to debt reduction. Thus, fiscal policy rules can be a useful signaling device if accompanied by strict transparency standards.

Fiscal policy rules do not guarantee sound fiscal management. Schick emphasizes the critical role of political will for the success of any fiscal policy rule (or of prudent fiscal policymaking in general), when supported by appropriate procedural rules. He notes that the recent literature on fiscal institutions and budgetary process neglects political will and fails to distinguish between formal rules and informal practices. Schick identifies innovations in budget procedures that are conducive to strengthening political will and enforcement of rules.

Design issues at the national level

In an attempt to draw some lessons from the experience of advanced economies, Buti and Giudice examine key elements of the EMU rules, as applied under the Stability and Growth Pact (SGP), particularly its collegially enforced mechanism of prevention of fiscal laxity and dissuasion from non-compliance with the rules. The authors argue that EMU rules cannot be exported unchanged to emerging market economies. Given the much greater macroeconomic volatility and stronger procyclical deficit bias in many of these economies, they should consider targeting a structural primary surplus and devising their own political economy incentives coupled with steps to strengthen national budget procedures.

In Brazil, the FRL prescribes for each level of government detailed policy rules, budget procedures, transparency standards, and judicial penalties for noncompliance. Following a review of past fiscal performance and the initial experience under the FRL, Goldfajn and Guardia simulate the government's financial position over the medium term. The simulation exercise suggests that, barring an unexpected deterioration of macroeconomic conditions (e.g. declining growth rate, real interest rate increase, or exchange rate depreciation), the FRL and associated innovations should ensure public debt sustainability. Two key structural measures are critical to this outcome: public pension reform and tax policy reform – both currently under way.

Besides the golden rule for state governments, in recent years Mexico has introduced procedural rules to enhance the effectiveness of budgetary control. At the federal level, contingent rules (measures specified *ex ante* to compensate for any excess or shortfall, relative to the budget deficit target) in operation since 1998 have contributed to fiscal discipline though at the expense of a procyclical stance. Besides assessing the existing rules, Conesa, Schwartz, Somuano, and Tijerina explore various options for a balanced-budget rule (including a structural variant) to ensure fiscal sustainability while allowing for revenue volatility, along the lines of a recent government

proposal. The authors discuss simulation results in terms of their fiscal and macroeconomic consequences.

Several emerging market economies in Central and Eastern Europe have just become, or are prospective, EU members on the path of convergence to the EMU fiscal reference values. Coricelli and Ercolani report that these economies have experienced much higher output volatility than older EU members, to which they have responded largely with a procyclical fiscal stance. To correct this anomaly, the authors suggest a modification of the existing EMU rules. The modified rule would call for a structural deficit target large enough to accommodate pending transition- or accession-related expenditures. According to the authors, the rule would be relatively easy to apply, based on an *ex ante* computation of the structural balance.

Emerging market economies endowed with nonrenewable resources face very high volatility in the world price of the resource, which often translates into extreme procyclicality of government expenditure. Bjerkholt and Niculescu compare the adequacy of two alternative approaches to cope with this situation: Norway's policy rule, limiting the cyclically adjusted nonresource budget deficit (i.e. exclusive of resource-related revenue) to the return on accumulated proceeds from resource extraction, and Venezuela's combination of fiscal rules and an oil stabilization fund, which allows for a sizable nonresource deficit. Major differences between the two countries – an aging population in the former and a significant current need for public spending in social programs and infrastructure in the latter – explain the differences between the selected approaches.

Design issues at the subnational level

Attempts to contain subnational government indebtedness in Latin America through the adoption of fiscal rules have been met with mixed success. In particular, Argentina's failure with subnational fiscal rules can be attributed to large vertical imbalances, lack of incentives for local revenue raising, easy access to and incentives for bailouts, and lack of enforcement of intergovernmental agreements. In a game theoretic context, Braun and Tommasi argue that lacking an outside enforcer, subnational rules can be effective only if supported by institutional arrangements that stimulate cooperative behavior by subnational governments. This requires mapping out a reform strategy taking into account key country-specific economic and political features.

At present, India is among the most indebted emerging market economies; also, it is running a very high fiscal deficit. Further external liberalization will require a major fiscal adjustment effort that poses an extraordinary challenge in the context of a highly decentralized system. Kochhar and Purfield explore the adequacy of the recently enacted FRL in meeting this formidable adjustment challenge over the medium term. On the basis of a set of quantitative simulations, the authors conclude that the public debt-GDP ratio is bound

to rise even further in the future, jeopardizing India's fiscal sustainability and macroeconomic stability, and dampening the prospects for economic growth, unless the federal FRL is matched by implementation of similar legislation by all state governments and is supported by key structural reforms.

Several fiscally decentralized EU member countries have introduced various forms of subnational rules, in order to support compliance with EMU rules – as the latter are applied to the general government as a whole. Balassone, Franco, and Zotteri examine practices in five EU countries (Austria, Belgium, Germany, Italy, and Spain). They find that although in principle explicit EMU-like subnational rules have distinct advantages over purely cooperative arrangements, in practice the strengthening of consensus-based institutions and procedures may be preferable not only in the EU economies, but also in emerging market economies. While cooperation has been effective for general government deficit reduction, it may be suboptimal as regards resource allocation and may not withstand stress situations in the future.

Traditionally, the central government is responsible for macroeconomic stabilization; in addition, the central government usually has cheaper and more stable access to financial markets than subnational governments do. In the context of Latin America, Gonzalez, Rosenblatt, and Webb discuss how stabilizing transfer rules (withholding transfers during upturns and releasing them during downturns) can protect subnational governments from the effects of economic cycles. They observe that, these rules can be risky, as the protection provided in a downturn becomes a contingent liability for the central government. A major precondition for success lies in the elimination of structural vertical imbalances.

Lessons for policy

To sum up, a number of lessons can be drawn from the analysis and experience presented in this volume. Although some of these lessons may be tentative, in general they affirm that emerging market economies can gain credibility by adopting a rules-based fiscal framework. However, there is nearly unanimous agreement that fiscal policy rules are not a magic wand that somehow will immunize the economy against macroeconomic volatility or financial crises and will sustain high economy growth. Clearly, the timing, design, circumstances, and overall institutional basis are critical for the success of the rules-based approach. The main lessons can be summarized as follows:

1. In emerging market economies, just as in advanced economies, fiscal rules need the support of the electorate. Without such support translated into political will by the authorities, fiscal rules are bound to weaken or collapse altogether (Argentina, Peru). As a first step, this requires a broad and deep consensus, built on a thorough and informed debate about the benefits and responsibilities associated with the rules, taking into account the legal and cultural specifics of the country (Brazil, Colombia, India).

2. As a corollary, although in principle it is preferable to enshrine fiscal rules in the constitution or in a high-level law or statute, informal rules might be equally (or even more) effective as long as they are backed by broad public consensus. Ironically, besides a promising case of formal rules (Brazil), the most successful rules in emerging market economies simply consist of a policy guideline (Chile and Estonia), applied with support across the political spectrum. By implication, governments should refrain from enacting a strong statutory obligation until after a period of experimentation with a self-imposed policy guideline.
3. Macroeconomic policy rules – whether in the fiscal or the monetary area – can be viable only if underpinned by strong procedural rules, including good practices in transparency and accountability (Brazil); by contrast, lack of transparency leads to the demise of any set of policy rules (Indonesia). A clear and centralized process of decision-making at all stages of budget formulation and execution, as well as an orderly legislative budget debate and oversight, are highly desirable. Finally, an independent audit mechanism is essential. For emerging market economies, this implies a major and relentless institution-building effort.
4. Markets have far lower tolerance for relatively high public debt-GDP ratios in emerging market economies than in advanced economies. Hence, to avert vulnerability to capital account crises, resulting in a possible loss of access to markets, it is essential for highly indebted governments to commit above all to a realistic reduction in the debt ratio through a rule that targets a primary balance consistent with the envisaged debt reduction path (Brazil).
5. In emerging markets, fiscal rules must be designed to take into account significant macroeconomic volatility (in output, terms of trade, interest rates, and exchange rate). Indeed, it is essential that balanced-budget or expenditure rules accommodate exogenous shocks and cyclical fluctuations by allowing for the operation of automatic stabilizers and, if necessary, their support with a mild discretionary countercyclical stance. However, for such rules to be credible, they must operate symmetrically, *permitting* budget deficits during downturns but *requiring* surpluses during upswings in activity. In any event, a structural or cyclically-adjusted balanced budget rule can be pursued only upon achieving a moderate debt ratio (Chile, Estonia).
6. As an alternative, particularly for economies with nonrenewable resources, a commodity stabilization fund that complements limits on the budget-deficit and expenditure can cushion pressures stemming from wide fluctuations in the terms of trade (Ecuador, Venezuela). In addition, in these economies a saving fund might be useful to accumulate reserves to finance infrastructure and social needs or to meet the eventual aging of the population.
7. Fiscal decentralization requires considerable care in the design and enforcement of rules. In a federal system, numerical policy rules need to

be enforced at the decision-making level, that is, at each level of government, rather than for the consolidated public sector or general government as a whole. In some countries, under a top-down approach (Brazil), there is scope for setting uniform policy and procedural rules for each level of government. It is far more difficult to establish consistent fiscal rules in a highly decentralized system through a bottom-up approach (Argentina, India), in which subnational governments voluntarily adopt binding rules – particularly when needed to support an economy-wide fiscal adjustment. This, of course, presupposes a credible no-bailout clause toward subnational governments. In addition, in a decentralized structure, rules for stabilizing intergovernmental transfers are necessary.

8. Finally, for fiscal policy rules to be credible, initiating key long-term structural reforms early on is indispensable, especially in areas such as taxation, social security, or intergovernmental relations (Argentina, Brazil, India, Mexico, Peru). In this regard, rolling medium- to long-term macroeconomic fiscal projections are useful for anticipating the need for reforms that will facilitate compliance with the rules.

Notes

1. Peter Heller, Guido Tabellini, and Julio Viñuela provided helpful comments. However, responsibility for all views expressed rests with the author.
2. See, for instance, Kopits and Symansky (1998) and papers collected in Bank of Italy (2001) with a primary focus on advanced economies.
3. For a recent set of articles on the experience with the EMU, including a review of the rapidly growing literature, see Allsop and Artis (2003).
4. See the broad survey and empirical analysis on institutions in US states by Besley and Case (2003).
5. Unlike the assessment of policy rules in advanced economies, in emerging market economies analysis has been limited mainly to procedural rules. See, for example, Poterba and von Hagen (1999) and Kopits and Craig (1998) on the effects of various institutional arrangements, as well as of their transparency, on fiscal performance.
6. Calvo and Mishkin (2003) and Kopits (2002) have stressed the importance of institutional arrangements and fiscal discipline as preconditions to viable exchange rate systems in emerging market economies.
7. In a large cross-country empirical study, Fatas and Mihov (2003) found that discretion-based fiscal policy contributes to significant output volatility and reduced economic growth.
8. For a comprehensive analysis of dynamic-consistency and common-pool problems, see Persson and Tabellini (2000).
9. In this regard, there are two types of policy rules (as distinct from procedural rules): direct constraints imposed on the elected policy makers and policy constraints delegated to nonelected authorities. Typically, in the monetary area, an example of the latter consists of an inflation-targeting regime delegated to an independent central bank. By contrast, the absence of delegated fiscal rules might be explained

by the difficulty of entrusting policy making to an agent (an independent fiscal authority) far removed from the principal (ultimately the electorate), as this would in fact obviate the involvement of elected executive and legislative bodies from budget formulation and debate. In fact, most of the fiscal literature, including this volume, deals with the first type of policy rules.

10. Exceptions of older rules are Mexico's current budget-balance requirement at the subnational level and Indonesia's prohibition on domestically financed deficits for the general government. Both have been applied in a highly opaque fashion, with mixed success. In Mexico, until recently the central authorities have enforced the golden rule through considerable discretion and control of state government finances. In Indonesia, the prohibition did not prevent (and even induced) excessive external borrowing by the public sector – including through guarantees extended to the private sector.

Author Index

- Acharya, S., 217
Aghion, P., 39
Ahluwalia, M., 203, 216
Albuquerque, P.H., 79
Alesina, A., 19, 22, 28, 78, 94, 107, 112,
113, 197, 218
Allan, W., 80
Allsop, C., 10
Alt, J.E., 184
Ardagna, S., 78, 217
Artis, M.J., 10
Aslaksen, I., 178
Aziz, J., 78
- Bacha, E.O., 129
Balassone, F., 8, 219–34
Barnhill, T., 52
Barrell, R., 233
Barro, R.J., 16, 52, 131, 164
Begg, D., 78
Bertola, G., 78
Besley, T.A., 10
Bevilaqua, A.S., 197, 218
Bier, A., 65
Bird, R.M., 241
Bjerkholt, O., 7, 65, 164–78
Blanchard, O., 80
Blejer, M., 78
Blondal, J., 222
Bohn, H., 184
Brailovsky, V., 178
Braun, M., 7, 61, 183–97,
206, 216
Brunila, A., 112, 163, 221, 233
Buchanan, J., 18
Buiter, W.H., 80, 146–7, 155, 160
Burnside, C., 78
Buti, M., 6, 21, 97–113, 149, 154, 158,
163, 220, 221, 233
- Caballero, R.J., 106
Cabral, A.J., 112, 221
Calvert, R.L., 185, 187
Calvo, G., 10, 51, 77, 78
Cappelen, Å., 178
- Cardoso, E., 129
Casella, A., 226
Cashin, P., 65
Catão, L., 34
Chamon, M., 39, 51, 52
Chari, V.V., 233
Coase, R., 225
Coelho, I., 79
Cole, H.L., 233
Conesa, A., 6, 131–45
Corden, W.M., 178
Coricelli, F., 7, 146–62
Corsetti, G., 23, 39, 78
Costello, D., 112
Courchene, T.J., 249
Craig, J., 10, 21, 80, 144, 197,
222, 233
Creel, J., 163
Csajbók, A., 163
Csermely, Á., 163
Cuddington, J., 65
Cukierman, A., 80
- Daniel, J., 79, 128
Darvas, Z., 163
Davis, J., 179
De Ferranti, D., 54–6
de Haan, J., 233
Detragiache, E., 34
Dillinger, W., 197, 248
Dixit, A.K., 197
Dooley, M.P., 78
Drzen, A., 5, 15–29, 78, 134, 188
Dury, K., 233
Dziobek, C., 79
- Easterly, W., 147
Eaton, J., 51
Echavarría, J., 197, 242
Eichengreen, B., 39, 52, 64, 99, 107,
113, 192, 217
Einaudi, L., 233
Elster, J., 20, 26, 29
Engel, E., 178
Ercolani, V., 7, 146–63

- Fatas, A., 10
 Favero, C., 129
 Fiess, N., 65
 Fischer, J., 99, 102, 227, 228
 Fischer, S., 78, 107, 113
 Fitoussi, J.P., 163
 Flood, R.P., 78
 Franco, D., 8, 219–34
 Friedman, D., 234
- Gamboa, R., 197
 Gavin, M., 51, 55, 64, 65, 80, 104–108,
 112, 113
 Gelb, A.H., 178
 Gersovitz, M., 51
 Ghosh, A., 78
 Ghymers, C., 109, 112
 Giavazzi, F., 129
 Gil-Díaz, F., 132, 145
 Giudice, G., 6, 21, 64, 97–113, 233
 Giugale, M.M., 243
 Gjelsvik, E., 178
 Guidotti, P., 112
 Goldfajn, I., 6, 114–130
 Goldstein, M., 128
 Gonzalez, C.Y., 8, 235–48
 Gordon, D.B., 16, 131
 Gourinchas, P.O., 112
 Grafe, C., 146, 147, 155, 160
 Grilli, V., 19
 Guardia, E.R., 6, 114–30
 Gylfason, T., 178
- Hagemann, R., 49, 64
 Hallerberg, M., 81, 87, 221, 228
 Harden, I.J., 22, 98, 99
 Hausmann, R., 5, 21, 28–52, 80, 107,
 108, 112–113, 178
 Heller, P., 10, 78
 Hemming, R., 78, 218
 Hercowitz, Z., 19
 Hernández-Trillo, F., 198, 233
 Hodrick, R., 163
 Huertas, M., 242
- Iaryczower, M., 197
 Inman, R.P., 103, 184
- Kennedy, S., 185
 King, G., 163
 Kletzer, K., 112
 Kneller, R., 78
- Knight, B., 233
 Kochhar, K., 7–8, 198–218
 Kopits, G., 1–10, 25, 28, 52, 66–80, 95,
 103, 113, 129, 130, 144, 163, 179,
 183, 197, 248
 Krueger, A., 65
 Krugman, P., 65, 77, 78
 Kydland, F.E., 80, 131
- Lahiri, A., 201, 204
 Lane, P.R., 106
 Lane, T.D., 222
 Levinson, B.A., 233
 Liuksila, C., 249
 Lowry, R.C., 184
- Mackenzie, G.A., 79, 80
 Manasse, P., 34
 Mancowizk, B., 39
 Manoel, A., 21, 144
 Marcel, M., 65, 145
 Marion, N.P., 78
 Marshall, W.J., 197
 Masson, P.R., 78
 Mayer, J., 178
 McCallum, B., 29
 McGranahan, L., 233
 McKinnon, R.I., 98
 Meltzer, A.H., 80
 Mihov, I., 10
 Milesi-Ferretti, G.M., 22, 23
 Mills, P., 163
 Mishkin, F.S., 10
 Monacelli, D., 233
 Montanino, A., 112
 Musgrave, P.B., 223
 Musgrave, R.A., 223, 235
 Mussa, M., 64
- Neary, J.P., 178
 Nicolini, J., 197
 Niculescu, I., 7, 65, 164–79
 Niskanen, W., 18, 28
 Norman, V.D., 178
 North, D., 197
- Oates, W.E., 235
 Obstfeld, M., 78
- Pagano, M., 78, 100
 Panizza, U., 39, 50–52
 Parry, T., 80

- Patashnik, E.M., 90
 Patnaik, I., 217
 Pazarbasioglu, C., 79
 Peltzman, S., 28, 197
 Perotti, R., 22, 28, 64, 94, 112, 113, 197
 Perry, G., 5, 53–65, 242
 Persson, T., 10, 19
 Pigou, A.C., 233
 Poterba, J.M., 10, 86, 87, 94, 98, 113, 129, 184
 Prasad, A., 218
 Prescott, E.C., 80, 131, 163
 Przeworski, A., 186, 187
 Purfield, C., 7–8, 198–218
- Quinet, A., 163
- Radelet, S., 78
 Rangarajan, C., 216, 217
 Rebelo, S., 147, 163
 Reinhart, C.M., 34, 51, 77
 Rezende da Silva, F., 128
 Robbins, J., 185
 Rodríguez, F., 178
 Rødseth, A., 179
 Rosenblatt, D., 8, 235–49
 Roubini, N., 23, 85, 94
 Rust, J., 233
- Saal, M., 79
 Sachs, J.D., 78, 85, 94, 178
 Saiegh, S., 193, 195, 197
 Saint-Paul, G., 106
 Sanguinetti, J., 197
 Sanguinetti, P., 248
 Santaella, J.A., 144
 Sapir, A., 98, 112, 149, 154, 233
 Schick, A., 6, 65, 77, 81–95, 134
 Schwartz, G., 113, 249
 Schwartz, M.J., 6, 131–45
 Servén, L., 54, 64
 Shah, A., 217
 Shome, P., 201
 Silva Filho, T.N.T., 130
 Simon, A., 163
 Singh, B., 218
 Smith, S., 227
 Somuano, A., 6, 131–45
 Spilimbergo, A., 34
 Spiller, P., 191, 193
- Srinivasan, T.N., 205
 Srivastava, D.K., 216, 217
 Stark, J., 112
 Stein, E., 107, 113, 144, 248
 Stourm, R., 94
 Strauch, R.R., 90
 Strawczynski, M., 19
 Suescún, R., 55, 64
 Summers, L., 78
 Sundelson, J.W., 94
 Sutton, B., 34
 Svensson, L.E.O., 19
 Symansky, S., 10, 25, 28, 80, 103, 129, 144, 183, 232
- Tabellini, G., 10, 19
 Talvi, E., 106, 113
 Tamirisa, N.T., 78
 Tanzi, V., 78, 79
 Teixeira, M., 51, 68, 79, 80
 Ter-Minassian, T., 110–13, 221, 222, 233
 Thirsk, W., 132
 Tijerina, J.A., 6, 131–45
 Tirole, J., 39
 Tommasi, M., 7, 61, 183–97, 206, 216, 248, 249
 Tornell, A., 106
 Treasury, H.M., 158
- Valdés, R.O., 178
 van den Noord, P., 163
 van Wijnbergen, S., 178
 Végh, C.A., 106, 113
 Verma, A.L., 218
 Vial, J., 80
 von Hagen, J., 10, 22, 81, 86, 90, 94, 98, 99, 100, 129, 163, 192
- Wagner, R.E., 18, 107
 Warner, A.M., 178
 Watts, R., 207
 Webb, S.B., 8, 191, 235–49
 Weingast, B.R., 197, 216
 Wildavsky, A.B., 84, 112
 Williamson, O.E., 90
 Wren-Lewis, S., 113
 Wyplosz, C., 64, 113
- Zotteri, S., 8, 219–34

Subject Index

- absorption rule, 139, 140, 141, 143
- accession countries (ACs) *see* EU
- accession countries
- accountability, 9, 83, 213
 - see also* transparency
- accounting, 98, 99, 110, 131
 - accrual, 75, 92, 93
 - cash, 93
 - India, 207
 - subnational rules, 232
 - see also* creative fiscal accounting
- acquired rights, 72–3, 74
- adjustment issues
 - constraints on adjustment, 72–3
 - Europe, 99–101
 - quality of adjustment, 71–2, 101
- allocative inefficiency, 190, 232
- Andean Community, 109–10
- Annual Budget Guidelines Law (LDO), Brazil, 123, 124, 125
- Argentina
 - budget deficit, 80n35, 237, 246
 - budget-balance rule, 2, 3, 4
 - consumption cycle, 108
 - currency board, 2, 69
 - debt ratio, 30, 41
 - decentralization, 4, 10, 132, 192
 - expenditure control, 72
 - external debt, 79n22
 - failure with subnational fiscal rules, 7, 63
 - federalism, 192–6
 - fiscal crisis, 56, 57, 68, 75, 191
 - fiscal discipline, 185
 - fiscal performance, 237–8
 - fiscal responsibility law, 59, 61
 - import gap, 44, 45
 - intergovernmental transfers, 63, 64, 236, 238–40, 245–6
 - optimal currency area, 52n17
 - pensions, 74
 - procyclical fiscal policy, 56, 63, 64
 - taxation, 79n30
 - uniform import surcharge, 80n32
- Asian financial crisis, 67, 69, 75, 120
- assets, 77n5, 129n9, 167, 168
- asymmetric information, 18, 56, 57, 58, 66, 67
- audit mechanisms, 4–5, 9, 21, 91, 158, 214
 - see also* monitoring
- Australia
 - budget restructuring, 88
 - monitoring mechanisms, 21
 - transparency, 132
- Austria
 - accounting practices, 232
 - federalism, 219–20, 227
 - subnational expenditure, 228, 229
- automatic stabilizers, 9, 48, 53, 57–8, 61, 63
 - balanced-budget rule, 76
 - capital account crises, 70
 - EMU stabilization, 221
 - EU accession countries, 147
 - Latin America, 108
 - Mexico, 135, 144
 - positive effects, 154
 - rule design, 59
 - Stability and Growth Pact, 102, 108, 220
 - structural balance rule, 137
 - structural deficit indicator, 150
- balanced-budget rules *see* budget-balance rules
- banking
 - Asian financial crisis, 69
 - Brazil, 119, 120
 - Colombia, 242
 - fiscal adjustment, 72
 - India, 203
 - Mexico, 140
 - structural reform, 73–4

Belgium

- debt ratio, 30
- decentralization, 231
- federalism, 219–20, 227
- subnational expenditure, 228, 229

benefits, 74, 84, 85

- see also* social security;
- unemployment benefits

booms, 56, 57, 58, 59, 64, 65n4, 236

Brazil, 114–30

- Annual Budget Guidelines Law (LDO), 123, 124, 125

banking supervision, 74

budget-balance rule, 2, 3, 137

capital account crisis, 68, 69

credibility, 49–50

debt ratio, 30, 32, 41, 65n14

debt rule, 3, 4

debt-restructuring package, 122, 213

decentralization, 4, 10, 119, 215

domestic currency debt, 43

enforcement penalties, 58

fiscal discipline, 185

fiscal impulse, 78n13

fiscal responsibility law, 6, 61, 93, 110, 115, 121–4, 128

inflation-targeting, 2

pensions, 74

primary surplus, 49, 65n13, 76, 79n21, 114, 116, 118–19, 121

quantitative targets, 132

sanctions, 5

state revenue, 248

subnational rules, 185, 215

taxation, 79n30

budget

- constraints, xii, 15, 30, 87, 99:
 - Brazil, 125; Colombia, 241, 242;
 - India, 213, 214; market-preserving federalism, 216; Mexico, 244

EMU rules, 219, 223–4, 225, 226

innovations, 91–2

maximization, 18–19

Mexico, 136, 244

process, 23, 24, 81, 82–5, 86, 98, 124, 214

resource-abundant countries, 166

solvency, 125

stabilizing transfer rules, 236

structural balance computation, 148–54

see also budget-balance rules; debt; deficit bias; government expenditure; primary balance

budget deficit, 9, 15

Argentina, 80n35, 237, 246

Brazil, 116

capital account crises, 66, 67, 69

EMU rules, 99, 107, 220, 221, 223–4

EU accession countries, 7, 146, 147, 151, 154, 155–6, 160

European countries, 97, 230–1

fiscal illusion, 18

fiscal stance, 78n13

Germany, 24, 88, 89–90;

and growth, 146–7

India, 199, 205, 206, 208, 209, 211, 215

Latin America, 104–6, 107, 109, 110

Mexico, 135, 243

Norway, 165

procedural restructuring, 88

procyclical fiscal policy, 57, 63

Stability and Growth Pact, 102–3, 146

structural balance rules, 62, 64, 157, 159

Venezuela, 170

see also debt; deficit bias

budget-balance rules, 2, 3, 9, 23

Argentina, 196

Brazil, 122–3

constitutional provision, 26, 27

cyclical adjustments, 49

debt structure, 50

Mexico, 6–7, 11n10, 136, 137, 141–2, 143, 144

political constraints, 91

resource-abundant countries, 169

signaling commitment, 76

structural close-to-balance rule, 156–8, 159, 160

subnational, 131

Bulgaria, uniform import surcharge, 80n32

business cycle, 40, 44, 97, 108, 131, 132

Canada

debt ratio, 30

equalizing transfers, 249n14

monitoring mechanisms, 21

- capital account crises, xii, 5, 9, 66–9, 72, 75, 76–7
 - see also* financial crises
- capital flight, 70, 74, 75, 84
- capital mobility, xii, 1–2, 5, 66–80
- Caribbean
 - procyclical fiscal policies, 53, 54–7
 - volatility, 53
- cash flow, 166, 167
- central bank autonomy, 131
- Central and Eastern Europe, 1, 7, 103
- Chile
 - budget-balance rule, 2, 3, 76
 - centralization, 4
 - commodity stabilization fund, 59, 60, 113n19
 - countercyclical fiscal policy, 56
 - debt ratio, 41
 - fiscal conservatism, 65n10
 - fiscal performance, 93
 - fiscal risk, 51
 - inflation-targeting, 2
 - institutional infrastructure, 80n37
 - policy guideline, 4, 9
 - structural balance rule, 4, 62, 63, 137, 145n16
 - structural surplus, 108, 145n14
- coalition regimes, 81, 87, 88, 89, 198
- Cohesion Fund, 146, 155
- Colombia
 - budget-balance rule, 2, 3
 - commodity stabilization fund, 59, 60, 113n19
 - debt ratio, 41
 - debt rule, 3
 - decentralization, 4, 240, 241
 - earmarking of revenue, 72
 - expenditure control, 72
 - fiscal crisis, 56, 57, 75
 - fiscal discipline, 185
 - fiscal performance, 240–1
 - fiscal responsibility law, 61
 - inflation-targeting, 2
 - intergovernmental transfers, 63, 64, 236, 240–3, 246–7
 - sanctions, 5
 - taxation, 79n30
- commitment, 24–5, 87–8, 89, 90, 91, 98, 123
- commodity stabilization funds, 9, 59–61, 113n19, 169, 178
 - Mexico, 133, 134, 135, 137–8
 - Norway, 60, 170, 171–2, 173, 174
 - Venezuela, 7, 59, 60, 165, 170, 174–7
- commons problem, 107
- compliance *see* enforcement
- comprehensiveness, 82
- constitutional provision, 4, 5, 9, 20, 26–7
 - Argentina, 195
 - Brazil, 129n4
 - Mexico, 136, 144
 - Venezuela, 174, 176, 177
- constitutionalism, 26–7, 29n12
- consumption
 - capital account crises, 70
 - Latin America, 106, 108
 - resources, 167, 168
- contagion, 109
- contingency funds, 2–4
- contingent liabilities, 69, 74, 75, 92, 94n2
 - India, 200, 217n4
 - Mexico, 144n5, 247
 - resources, 168
 - stabilizing transfers, 8, 61, 247
 - see also* hidden liabilities
- convergence
 - European, 7, 99, 100, 103
 - Latin America, 108–10, 111
 - see also* integration
- cooperation
 - determinants of, 191–2
 - fiscal game, 188
 - intertemporal, 191, 194
 - problems, 189
 - subnational rules, 8, 222, 227, 230, 231, 232
- corporate borrowing, 52n11
- corruption, 93
- Costa Rica
 - debt ratio, 41
- countercyclical fiscal policy, 5, 9, 50, 53, 57
 - commodity stabilization funds, 60
 - credibility, 58, 59
 - deficit bias, 19
 - discretion, 4, 9, 80n43
 - EU deficit threshold, 220
 - Latin America, 56
 - structural balance rules, 62, 157
 - subnational level, 235

- creative fiscal accounting, 15–16,
22, 23, 58, 98
EU candidate countries, 147
expenditure audit, 158
subnational government
finance, 222
- credibility, xii, 1, 8, 10, 20–1
Brazil, 49–50, 116, 122, 128
budget commitments, 87, 90, 91
capital account crises, 77
commitment to unchanging rules,
25–6, 27
constitutionalism, 26
countercyclical fiscal policy, 58
cyclical adjustments, 49
discretion, 16
fiscal discipline, 15, 25
fiscal expansion, 56
India, 215
Mexico, 135
monetary policy, 39
penalties, 29n8
predictability, 17
procyclical fiscal policy, 63
rule flexibility, 22–3, 58–9
signaling, 71, 76
structural balance rule, 62, 64
transparency, 4, 75, 77
- credit ratings, 30, 31–3, 38, 47, 49,
51, 107
- CSM *see* cyclical safety margin
- currency
crises, 5, 34, 66, 67–70, 73–4, 75, 104
depreciation, 40
domestic currency debt, 43–4, 50,
52n11, 201
foreign currency debt, 38–40, 47–8,
52n11, 75, 107
see also exchange rate
- currency boards, 2, 69, 79n22
- current-balance rule, 2
see also golden rule
- cyclical safety margin (CSM), 149–50,
151
- Czech Republic, capital account crisis,
67, 68, 69, 78n12
- debt, 1, 2, 5, 30–52, 190, 222
Brazil, 114–30
ceilings, 147
crises, 34
EU constraints, 24
euro area, 105
Economic and Monetary Union,
98, 107
GDP ratio, 4, 9, 30–2, 38, 40, 45–7:
Brazil, 114, 116–19, 123, 125–6,
128; India, 7–8, 208, 209, 212;
Latin America, 106; Maastricht
rules, 99, 100, 220; Mexico,
140, 142
golden rule, 20
growth of, 15, 28
India, 7–8, 198, 199–202, 208–13,
215, 217n4
Latin America, 7, 57, 105, 106,
107, 110
Mexico, 132, 137, 139–41, 142
national fiscal council, 111
net public debt concept, 129n9
political arrangements, 85
public debt management, 75
servicing: Brazil, 122; currency
devaluations, 73; Latin America,
30, 32, 34–5, 40, 43–4, 47–9, 50
stabilizing transfers, 247
structural balance rule, 64
subnational: Argentina, 7, 239, 240,
246; Brazil, 119–20, 121–2, 123,
128; Colombia, 240, 242–3, 246;
India, 206, 209, 213; Mexico,
133, 134, 143, 243,
244–50
sustainability, 76, 77, 160: Brazil, 6,
114–16, 119, 125–8; definition,
145n19; India, 208–13; Mexico,
137, 139–41, 142, 144
see also budget deficit; deficit bias;
public sector borrowing
requirement
- debt rules, 3, 4, 115
Brazil, 123
Mexico, 139–41, 143
signaling commitment, 76
- decentralization, 4, 222, 231
Argentina, 4, 10, 132, 192
Brazil, 4, 10, 119, 215
Colombia, 4, 240, 241
EMU fiscal rules, 219, 220, 224–5,
226, 230

- decentralization – *continued*
 enforcement, 9–10
 fiscal, 72
 India, 7, 132, 198–218
 Mexico, 4, 243
 see also federalism; subnational rules
- deficit bias, xii, 16–19, 22, 28, 53, 64n2
 Brazil, 123
 fiscal responsibility laws, 61
 Latin America, 57, 62, 108
 Mexico, 134, 136, 143
 political pressures, 60, 62
 procyclical fiscal policy, 56, 57, 62
 rule flexibility, 59
 Venezuela, 176
 see also budget deficits; debt
- deficit illusion, 18
- Denmark
 debt-revenue ratio, 31–2
 subnational expenditure, 228
- depletion policy, 167
- deregulation, 238–9
- devaluations, 67, 73
- discretion, 1, 16, 17, 108
 Argentina, 192, 195
 countercyclical, 4, 9, 80n43
 cyclical adjustments, 49
 intergovernmental transfers, 241, 242, 244, 245
 procyclical, 76
- dollarization, 2, 40, 48, 51
- downturns, 56, 57–8, 107, 151, 236–7, 240, 246
 see also recession
- due process in budgeting, 82–3, 85
- “Dutch disease”, 89, 166
- earmarking revenue, 72, 136–7, 241, 244
- ECB *see* European Central Bank
- ECLAC *see* Economic Commission for Latin America and the Caribbean
- ECOFIN *see* European Union Council of Economy and Finance Ministers
- Economic Commission for Latin America and the Caribbean (ECLAC), 113n22
- economic cycles
 EU fiscal adjustment, 146
 impact on budget, 148, 158
 Mexican fiscal rules, 143
 procyclical fiscal policies, 53
 stabilizing transfer rules, 8
 subnational governments, 229
- Economic and Monetary Union (EMU), 1, 6, 97–113
 Central and Eastern Europe, 7
 subnational rules, 8, 219–34
 see also European Union; Maastricht Treaty; Stability and Growth Pact
- Ecuador
 budget-balance rule, 2, 3, 4
 debt ratio, 41
 debt rule, 3
 dollarization, 2
 earmarking of revenue, 72
 fiscal crisis, 56, 67, 68, 69
 fiscal responsibility law, 61
 moral hazard, 74
 oil stabilization fund, 59, 60, 169
 taxation, 79n23, n30, n31
 value-at-risk methodology, 52n16
- EDP *see* Excessive Deficit Procedure
- education, 54, 55–6, 174, 247
- electorate support, 8–9, 18
- EMU *see* Economic and Monetary Union
- endowment funds, 169
- enforcement, 9–10, 21, 90, 186
 Argentina, 194
 budgeting principles, 82–3
 game theoretic approach, 186, 187–8
 India, 207, 214
 lack of, 183
 Maastricht Treaty, 27
 political commitment, 88
 self-enforcement, 185, 187–8, 214
 Stability and Growth Pact, 6
 subnational rules, 183, 184, 223
 targets, 92
 technologies of, 192;
 see also monitoring; penalties; sanctions
- entitlements, 85

- environmental pollution, 226
 equity, intergenerational, 168, 175
 Estonia
 budget-balance rule, 3, 4, 76
 currency board, 2
 fiscal performance, 93
 policy guideline, 4, 9
 ethical issues, 20
 European Central Bank (ECB),
 98, 156
 European Commission, 102, 104,
 113n22, 146, 147, 148–9,
 158–9, 221
 European Union Council of
 Economy and Finance Ministers
 (ECOFIN), 27, 29n13, 99, 102, 220,
 221, 223
 European Union (EU)
 countercyclical fiscal policy, 53
 deficit constraints, 23–4
 enlargement, 7, 146–63
 numerical targets, 29n9
 procyclical fiscal policy, 154
 quantitative targets, 132
 rule-based fiscal policy, 1
 subnational rules, 8, 185, 219–34
 see also Economic and Monetary
 Union; Maastricht Treaty;
 Stability and Growth Pact
 exceptionalism, 102
 EU accession countries, 146–63
 Excessive Deficit Procedure (EDP),
 21, 101, 102–3
 exchange rate
 Brazil, 114–15, 117, 125, 126–7,
 128, 130n20
 budget balance adjustments, 108
 debt servicing, 32
 dollarization, 51
 fiscal risk, 50
 fiscal sustainability, 78n9
 floating, 50–1
 foreign currency debt, 39, 40,
 52n11
 import gap, 44, 45
 instability, 109
 pegs, 66, 67, 69
 shocks, 45, 46, 47, 106
 volatility, 39, 40, 41–2, 47, 52n12
 see also currency
 expectations, 16, 67, 71
 credible commitments, 90
 due process, 83
 expenditure rules, 2, 9, 76, 115–16,
 123, 147
 see also government expenditure
 Federal Expenditure Budget (PEF),
 Mexico, 133, 134, 135, 136–7
 Federal Revenue Law (LIF), Mexico,
 135, 136
 federalism, 4, 89, 219–20
 Argentina, 192–6
 EMU fiscal rules, 220–4
 fiscal, 220–4, 235
 market-preserving, 216
 see also decentralization;
 subnational rules
 finance ministers, 23, 58, 81,
 86, 87, 89
 financial crises, 5–6
 contagion, 109
 procyclical fiscal policy, 56, 64
 vulnerability, xii, 1, 104
 see also capital account crises;
 shocks
 financial markets
 reputation, 76
 volatility, 55
 financial transactions tax, 74, 239
 Finland
 cyclical component of
 balance, 149
 subnational expenditure, 228
 fiscal discipline, 15, 16, 19,
 24–5, 81
 Brazil, 115, 125, 128
 budget practices, 82, 86
 EU accession countries, 159
 fiscal rules impact on, 183, 185
 Germany, 89
 Latin America, 104
 Mexico, 132, 134, 135
 Netherlands, 89
 political commitment to, 87, 98
 resource-abundant countries, 177
 Stability and Growth Pact, 103
 subnational governments, 221–2
 targets, 91
 fiscal illusion, 18

- fiscal impulse, 78n13, 166
- fiscal policy
- capital account crises, 66–9
 - capital mobility, 66–80
 - constraints, xii, 15
 - countercyclical, 5, 9, 50, 53, 57:
 - commodity stabilization funds, 60; credibility, 58, 59;
 - deficit bias, 19; discretion, 4, 9, 80n43; EU deficit threshold, 220; Latin America, 56;
 - structural balance rules, 62, 157;
 - subnational level, 235
 - execution procedures, 15
 - procyclical, 6, 28, 47, 48, 64, 106–7:
 - Argentina, 238; booms, 59;
 - capital flight, 70; causes of, 56–7;
 - credibility problems, 63; cyclical safety margin, 150; deficit limit, 155, 156; discretion, 76; effects of, 54–6; EMU fiscal rules, 223;
 - EU candidate countries, 7, 147, 151–4, 159–60; Europe, 97; fiscal responsibility laws, 61; Mexico, 243; resource-abundant countries, 164, 166; subnational rules, 225; volatility, 5, 53, 54, 55, 62
 - see also* fiscal rules; policy signaling
- Fiscal Responsibility and Budget Management Law (FRBM), India, 7–8, 199, 205–14, 216
- Fiscal Responsibility Law (FRL), 4, 61, 110–11
- Brazil, 6, 61, 93, 110, 115, 121–4, 128
 - flexibility, 59
 - India, 7–8, 199, 205–14, 216
 - Mexico, 6
 - New Zealand, 4, 80n43, 116, 131
 - structural balance rules, 63
 - see also* legislation
- fiscal rules, xii, xiii, 1–11
- Brazil, 114–30
 - commitment to, 87, 88
 - definition, 2, 15, 115, 131, 183
 - effectiveness, 19–22, 82, 184–5
 - EU enlargement, 146–63
 - European Economic and Monetary Union, 97–113, 219–34
 - India, 198–218
 - Mexico, 131–45
 - numerical, 9–10, 22–4, 98, 99, 111
 - origin of, 184, 185–6
 - policy rules, 1–5, 8–9, 22–3, 76, 115–16, 131, 137–43
 - political economy perspective, 15–29
 - political issues, 85, 87, 88, 91
 - procedural rules, 5, 15, 22–4, 81, 82–3, 98–9, 123, 131
 - reduction of macroeconomic volatility, 53–65
 - resource-abundant countries, 164–79
 - stabilizing transfers, 8, 10, 59, 61, 63–4, 235–49
 - volatility, 53–65
 - see also* budget-balance rules; debt rules; expenditure rules; “golden rule”; structural balance rule; subnational rules; targets
- fiscal stance, 78n13
- flexibility
- credibility of rules, 22–3, 58–9
 - EMU fiscal rules, 219, 220, 223, 224
 - intergovernmental transfers, 247
- foreign currency debt, 38–40, 47–8, 75, 107
- France
- debt, 100
 - deficit limit, 154
 - fiscal discipline, 99
 - subnational expenditure, 228
- FRBM *see* Fiscal Responsibility and Budget Management Law, India
- free-rider problem, 19, 221, 223
- FRL *see* Fiscal Responsibility Law
- game theory, 7, 183–97
- GDP *see* gross domestic product
- Germany
- balanced-budget rule, 131
 - budget deficit, 24, 112n7, 154, 155
 - budget restructuring, 88
 - debt, 100
 - federalism, 89, 219–20, 227
 - fiscal discipline, 99
 - subnational expenditure, 228, 229, 234n20

- golden rule, 2, 20, 228
 - Brazil, 122–3
 - “compensated”, 227, 230
 - EU accession countries, 151, 156, 159
 - India, 207
 - Mexico, 137
 - Venezuela, 176
- government expenditure
 - Argentina, 238
 - Brazil, 119, 121, 125
 - budgeting process, 82, 84
 - controls on, 72
 - cuts in, 100, 101
 - deficit bias, 18, 19, 60–1
 - emerging economies, 93
 - EMU fiscal rules, 223, 224
 - EU accession countries, 152
 - fiscal illusion, 18
 - “gap” plus elasticity approach, 148–9
 - Germany, 89–90
 - high spending, 190
 - India, 201, 202–3, 208–9, 212, 214–15, 216
 - Mexico, 132, 134, 135, 136, 138
 - Norway, 170, 174
 - stabilizing intergovernmental transfers, 61, 63, 235–49
 - structural close-to-balance rule, 156–7, 158, 159
 - subnational, 61, 63, 223–4, 228–9, 231–2, 235–49
 - Venezuela, 174–5
- see also* budget; expenditure rules; investment
- Gramm-Rudman-Hollings Deficit Reduction Act, 21–2, 25, 27
- Greece
 - fiscal adjustment, 100–1
 - investment, 223
- gross domestic product (GDP)
 - cyclical component of balance, 149
 - debt ratio, 4, 9, 30–2, 38, 40, 45–7:
 - Brazil, 114, 116–19, 123, 125–6, 128; India, 7–8, 208, 209, 212; Latin America, 106; Maastricht rules, 99, 100, 220; Mexico, 140, 142
 - deficit limit, 53, 146, 155, 220
 - EU accession countries, 151, 152, 153, 159
 - growth, 43, 54, 55, 139–40, 152, 204
 - revenue ratio, 150, 151, 154, 214
 - shocks, 45, 46, 47
 - social expenditures, 56
 - structural balance rule, 62
 - volatility, 37, 38
- growth, xii, 4, 55
 - Brazil, 116, 125, 126, 128
 - budget deficits, 146–7
 - India, 198, 199, 204–5, 209, 212–13 M4, 145n24
 - Mexico, 135, 139–40
 - Netherlands, 89
 - resource-abundant countries, 164, 177
 - structural close-to-balance rule, 157
 - volatility, 54
- guarantees, 237, 245, 248
- hidden liabilities, 114, 115, 117, 125, 128
 - see also* contingent liabilities
- Honduras, decline in GDP growth, 43
- human capital, 54, 55, 188
- Hungary
 - fiscal indicators, 150, 151, 152, 160, 161
 - uniform import surcharge, 80n32
- IFIs *see* international financial institutions
- IMF *see* International Monetary Fund
- implementation, 4–5
- import gaps, 44, 45
- import surcharge, 74–5, 80n32
- incrementalism, 84, 85
- India
 - budget-balance rule, 2, 3
 - debt ratio, 7–8, 30
 - decentralization, 4, 7, 10, 132, 198–218
 - Fiscal Responsibility and Budget Management Law, 7–8, 199, 205–14, 216
- Indonesia
 - budget-balance rule, 3, 11n10, 131
 - capital account crisis, 68, 75
 - moral hazard, 74
 - policy guideline, 4

- inflation
 - bias, 16–17
 - Brazil, 120, 127
 - debt servicing, 48
 - European Central Bank, 156
 - India, 201, 202
 - Latin America, 106
 - Mexico, 140
 - structural close-to-balance rule, 158–9
- inflation-targeting, 2, 10n9
 - Brazil, 116, 127, 128
 - European Central Bank, 156, 157
 - Mexico, 131
 - Norway, 174
- informal rules, 9
- information
 - asymmetric, 18, 56, 57, 58, 66, 67
 - budgeting principles, 82
 - incomplete, 24
 - transparency, 213
- innovations
 - budget, 6, 91–2
 - institutional, 81, 92–3, 119–25
- instability *see* volatility
- institutional infrastructure, xiii, 75, 77, 80n37
- institutionalism, 86, 90
- institutions, 85–90, 115
 - fiscal outcomes, 81, 82, 90
 - innovations, 81, 92–3, 119–25
 - institution-building, 9
 - international financial, 64
 - self-enforcement, 185
 - weak, 107
- integration
 - European, 27, 29n9, 111
 - Mercosur, 109
 - see also* convergence
- interest rate
 - Brazil, 114, 120, 125, 126, 128
 - capital account crises, 69
 - debt servicing, 32, 34, 43–4, 48, 50, 73
 - Economic and Monetary Union, 98, 103
 - fiscal risk, 34, 35, 36
 - India, 199, 201–2, 205, 209, 212, 213
 - Latin America, 106
 - Mexico, 139–40
 - shocks, 45, 46, 47, 106
 - structural close-to-balance rule, 158–9
 - volatility, 39, 41–2, 44, 47–8, 52n12
- intergenerational equity, 168, 175
- intergovernmental relations, 192, 193, 194, 195
- intergovernmental transfers, 8, 10, 59, 61, 63–4, 76, 235–49
- international financial institutions (IFIs), 64
- International Monetary Fund (IMF)
 - capital account crises, 70
 - cyclical adjustments, 49
 - fiscal rules, xii
 - Norway, 179n19
 - structural balance framework, 63, 64
 - structural close-to-balance rule, 160
 - transparency, 75
- investment
 - “compensated” golden rule, 227, 230
 - deficit limit, 156
 - EMU fiscal rules, 223
 - EU accession countries, 146, 147, 151, 152, 154, 159, 163n11
 - India, 201, 202–3, 205, 212, 215
 - Mexico, 245
 - permit system, 227
 - real assets, 168
 - Venezuela, 170–1
 - volatility, 54
 - see also* government expenditure
- investor sentiment, xii, 67, 69, 70, 71, 73
- Ireland, subnational expenditure, 228
- Israel, Deficit Reduction Law, 25
- Italy
 - balanced-budget rule, 131
 - debt ratio, 30
 - decentralization, 220, 227, 228, 229, 231, 232
 - subnational expenditure, 228–9

- Japan
 balanced-budget rule, 131
 budget restructuring, 88
 debt ratio, 30
- Jordan, debt ratio, 30
- Keynesian effects, 100
- Korea
 banking restructuring, 74
 capital account crisis, 68, 75
- Latin America
 debt, 7, 40, 45–7, 48–9
 fiscal performance, 104–7
 fiscal rules, 1, 59–62
 intergovernmental transfers,
 235–49
 procyclical fiscal policies, 53, 54–7, 62,
 64, 106
 stabilizing transfer rules, 8
 tax revenue shock, 38, 45, 46, 47
 volatility, 28, 47, 49, 53, 54–5,
 104–5, 107
- LDO *see* Annual Budget Guidelines
 Law, Brazil
- legislation, xii, 4, 5, 15, 20
 Argentina, 195, 196, 238–9
 Brazilian Annual Budget
 Guidelines Law, 123, 124, 125
 changing, 21, 25–7
 Colombia, 241, 242
 Indian Fiscal Responsibility and
 Budget Management Law, 7–8,
 199, 205–14, 216
 institutionalism, 86
 Mexican Federal Revenue Law,
 135, 136
 penalties for law-breaking, 20–1
 Venezuela, 174–5, 176, 177
see also constitutional provision;
 Fiscal Responsibility Law
- liability dollarization, 40, 48
- liberalization, 7, 198, 199, 201, 212
- LIF *see* Federal Revenue Law,
 Mexico
- Maastricht Treaty, 21, 27, 97, 99–101,
 103, 111, 220
see also Economic and Monetary
 Union
- macroeconomic policy, 2, 9
- majoritarian regimes, 81, 87
- market access, 28, 47, 49, 50, 216,
 222, 235
- maturities, 51
- MB *see* minimal benchmark
- medium-term budgetary frameworks
 (MBFs), 121, 123–4, 136, 206
- medium-term expenditure frameworks
 (MTEFs), 91–2
- Mercosur, 109
- Mexico, 131–45
 banking restructuring, 74
 budget restructuring, 88
 budget-balance rule, 2, 3, 6–7,
 11n10
 capital account crisis, 67, 68, 69,
 75, 132, 138, 243
 constitutional provision, 4
 cost of fiscal transition, 79n27
 debt ratio, 30, 32, 41
 decentralization, 4, 243
 decline in GDP growth, 43
 fiscal discipline, 185
 fiscal performance, 243
 fiscal risk, 51
 inflation-targeting, 2
 intergovernmental transfers, 236,
 243–5, 247
 Oil Stabilization Fund, 133, 134,
 135, 137–8
 pensions, 74
 PRONAFIDE program, 139–41, 142,
 143, 144
 state reserve funds, 248
- minimal benchmark (MB), 149, 150
- monetary policy, 1, 48
 Brazil, 120, 127, 130n20
 “fear of floating”, 39
 rules, 131
 Stability and Growth Pact, 157
see also inflation-targeting
- monetary union, 27
- monitoring, 4–5, 21, 22
 Mercosur, 109
 Stability and Growth Pact,
 102, 103
 subnational rules, 222, 227
see also audit mechanisms;
 enforcement; surveillance

- moral hazard, 47, 74, 189
 Brazil, 120
 India, 212
 intergovernmental transfers,
 242, 244
- MTEFs *see* medium-term expenditure
 frameworks
- multiple equilibria
 models, 67
 frameworks, 71
 games, 186–8
- national fiscal council (NFC), 111
- national interest, 97, 98
- natural resources, 7, 76, 137, 164–79
- “negative-spotlight” effect, 22, 27
- net worth, 166, 167, 177
- Netherlands
 balanced-budget rule, 131
 investment, 223
 political will, 87, 88, 89
 subnational expenditure, 228
- New Zealand
 Fiscal Responsibility Act, 4, 80n43,
 116, 131
 monitoring mechanisms, 21
 transparency, 132
- NFC *see* national fiscal council
- nonrenewable resources, 7, 76, 137,
 164–79
- Norway
 nonrenewable resources, 7, 164–5,
 170, 171–4, 177
 State Petroleum Fund, 60, 170,
 171–2, 173, 174
- OECD *see* Organization for Economic
 Cooperation and Development
- oil *see* commodity stabilization funds;
 nonrenewable resources
- OPEC *see* Organization of Petroleum
 Exporting Countries
- optimal currency areas, 52n17
- optimal tax smoothing, 147, 163n12
- Organization for Economic
 Cooperation and
 Development (OECD)
 debt, 45–7, 85
 GDP growth, 55
 tax revenue shock, 38, 45, 46, 47
- Organization of Petroleum Exporting
 Countries (OPEC), 165, 170
- original sin, 38–9, 40–3, 47, 48–9,
 52n12, n13, 201
- Ouro Preto, Treaty of, 109
- output gaps, 49, 50, 149, 152, 155
- Pakistan, debt ratio, 30
- Panama, debt ratio, 41
- Paraguay
 debt-revenue ratio, 31–2
 Pareto optimality, 186, 187
 peer pressure, 107, 109, 222,
 224, 227
- PEF *see* Federal Expenditure
 Budget, Mexico
- penalties, 20–1, 29n8, 58, 109
 EU accession countries, 146
 structural balance rule, 62
see also enforcement; sanctions
- pensions
 Brazil, 115, 127, 128
 India, 212
 structural reform, 6, 73, 74
see also social security
- permanent income, 168, 173, 175
- permit system, 226–7
- Peru
 budget-balance rule, 2, 3, 4
 centralization, 4
 debt ratio, 41
 fiscal responsibility law, 59, 61
 import gap, 44, 45
 inflation-targeting, 2
 procyclical fiscal policy, 63
 quantitative targets, 132
 taxation, 79n30
- Philippines, capital account crisis, 88
- Poland
 constitutional provision, 4
 debt rule, 3, 4
 decentralization, 4
 fiscal indicators, 150, 151, 152,
 160, 161
 inflation-targeting, 2
 uniform import surcharge, 80n32
- policy guidelines, 4, 9, 62
- policy signaling, 5–6, 24–5, 71, 76,
 80n39, 166
- political economy perspective,
 2, 15–29, 103, 111

- political issues
 - Argentina, 193, 194
 - cooperation, 191, 192
 - deficit bias, 17–19, 60, 62
 - political will, 6, 8, 25, 77, 81–94
 - procyclical fiscal policy, 57
 - reputation, 24
 - subnational rules, 183–4, 189
- Portugal
 - budget deficit, 112n7
 - fiscal adjustment, 100–1
- poverty, 54, 55–6, 171, 205, 212, 215
- prices
 - stability, 98, 131, 216
 - volatility of commodity prices, 165, 166, 167
- primary balance, 9, 48, 49–50, 100
 - Brazil, 123, 124, 128
 - India, 200
 - Mexico, 134
 - structural balance rule, 137
 - see also* budget
- primary surplus, 49–50, 55, 69
 - Brazil, 49, 65n13, 76, 79n21, 114, 116, 118–19, 121, 124–7
 - Latin America, 107–8
- principal-agent problems, 189
- privatization, 75, 80n33
 - Argentina, 238
 - Brazil, 122
 - Mexico, 132
- procyclical fiscal policy, 6, 28, 47, 48, 64, 106–7
 - Argentina, 238
 - booms, 59
 - capital flight, 70
 - causes of, 56–7
 - credibility problems, 63
 - cyclical safety margin, 150
 - deficit limit, 155, 156
 - discretion, 76
 - effects of, 54–6
 - EMU fiscal rules, 223
 - EU accession countries, 7, 147, 151–4, 159–60
 - Europe, 97
 - fiscal responsibility laws, 61
 - Mexico, 243
 - resource-abundant countries, 164, 166
 - subnational rules, 225
 - volatility, 5, 53, 54, 55, 62
- PRONAFIDE program, 139–41, 142, 143, 144
- public sector borrowing requirement (PSBR)
 - Brazil, 116
 - calculation of, 145n26
 - liabilities, 145n17
 - Mexico, 132, 133, 134–5, 137–8, 139–42, 144
- public sector liabilities, 73, 75, 77, 116–17, 120
- public services, 93
- public spending *see* government expenditure
- “quasi-stabilizers”, 108
- rainy-day funds, 222, 224, 225, 231, 233n15, 236, 245
- recession
 - Argentina, 237, 238, 239
 - countercyclical expansion, 5
 - debt service, 48
 - EMU deficit limit, 220
 - Latin America, 110
 - poverty, 56
 - procyclical fiscal policy, 55, 154
 - Stability and Growth Pact, 102
 - stabilizing transfers, 237, 247
 - structural close-to-balance rule, 157
 - structural deficit indicator, 150
 - see also* downturns
- reindustrialization, 166, 167
- reputation
 - fiscal discipline, 15, 16, 24–5
 - game theoretic approach, 188
 - noncompliance, 5
 - policy signaling, 76
- resources, 7, 76, 137, 164–79
 - see also* commodity stabilization funds
- revenue *see* taxation
- risk
 - cash flow, 166, 167
 - debt, 5, 34, 48, 49, 50–1, 107
 - fiscal, 34–8, 47, 50–1
 - interest rate, 48, 203
 - net worth, 166, 167, 177
 - oil wealth, 173, 175, 177

- risk – *continued*
 original sin, 40
 permit market, 226
 political, 168
 sharing, 248
 spreading, 168
 stabilizing transfers, 237
- Romania, fiscal indicators, 150, 151, 152, 160, 162
- rules *see* fiscal rules
- Russia
 capital account crisis, 67, 68, 69, 75, 120, 155
 expenditure control, 72
- sanctions, 5, 21
 Brazilian fiscal rules, 122, 124
 EMU rules, 97, 102–3, 221, 224–5
 fiscal responsibility laws, 110–11
 subnational rules, 222, 223, 230, 232
see also enforcement; penalties
- savings, 175, 203
- securities, 201, 203
- seignorage, 67
- self-enforcement, 185, 187–8, 214
- SGP *see* Stability and Growth Pact
- shocks, 9, 45–7, 50, 94, 131, 248
 commodity prices, 60
 EMU fiscal rules, 231
 India, 204
 intergovernmental transfers, 76, 240, 246
 Latin American debt structure, 106
 Mexican fiscal rules, 132, 135, 136, 143
 oil, 171
 revenue volatility, 38, 45, 46, 47
 rule flexibility, 59
 volatility, 55, 104
 vulnerability to, 93
see also financial crises
- signaling, 5–6, 24–5, 71, 76, 80n39, 166
- Slovakia, uniform import surcharge, 80n32
- Slovenia
 fiscal indicators, 147, 150, 151, 152, 153, 160, 162
 growth rate stability, 163n7
 social expenditures, 56, 62
- social impact of capital account crises, 66, 72, 77
- social security, 72–3, 168
 Brazil, 115
 Mexico, 140, 142
see also benefits; pensions
- social welfare, 16, 19, 20, 170
- Spain
 debt ratio, 30, 32
 decentralization, 220, 227, 229, 231, 232
 subnational expenditure, 228, 229
- spillovers, 97–8, 109, 223
- stability, xii, xiii, 1
 Brazil, 116
 capital account crises, 71, 72, 77
 central government responsibility, 223
 internal stability pacts, 228–9, 232
 Latin America, 104
 Norway, 173
 output, 103–4
 price, 98, 131, 216
 resource-abundant countries, 177
 stabilizing transfer rules, 8, 10, 59, 61, 63–4, 235–49
see also commodity stabilization funds; volatility
- Stability and Growth Pact (SGP), 6, 80n43, 97, 101–4, 116, 146
 cyclical stabilization, 108
 deficit limit, 220
 EU accession countries, 155
 Germany, 90
 medium-term equilibrium, 53
 sanctions, 21
 structural close-to-balance rule, 157
 structural deficit adjustment, 156
 subnational governments, 225, 227, 228, 230, 231
see also Economic and Monetary Union; European Union
- stabilizers, 9, 48, 53, 57–8, 61, 63
 balanced-budget rule, 76
 capital account crises, 70
 EMU stabilization, 221
 EU accession countries, 147
 Latin America, 108
 Mexico, 135, 144

- stabilizers – *continued*
 - positive effects, 154
 - rule design, 59
 - Stability and Growth Pact, 102, 108, 220
 - structural balance rule, 137
 - structural deficit indicator, 150
- state enterprises, 75, 93, 120
- structural balance rule, 64
 - Chile, 4, 62, 63, 137, 145n16
 - ex ante* close-to-balance rule, 156–8, 159, 160
 - Mexico, 137–9, 144
- subnational government debt
 - Argentina, 7, 239, 240, 246
 - Brazil, 119–20, 121–2, 123, 128
 - Colombia, 240, 242–3, 246
 - India, 206, 209, 213
 - Mexico, 133, 134, 143, 243, 244–5
 - see also* decentralization
- subnational rules, 4, 5, 131, 216
 - Argentina, 7, 192–6
 - Brazil, 215
 - European Union, 8, 219–34
 - game theoretic approach, 7, 183–97
 - intergovernmental transfers, 8, 10, 59, 61, 63, 64, 235–49
 - see also* decentralization; federalism
- supplementals, 86
- surveillance
 - Europe, 101, 102, 103
 - Latin America, 107, 109, 110, 111
 - see also* monitoring
- sustainability, xiii, 1, 53, 62
 - debt, 76, 77, 160
 - Brazil, 6, 114–16, 119, 125–8
 - definition, 145n19
 - India, 208–13
 - Mexico, 137, 139–41, 142, 144
 - definition, 80n38
 - EMU fiscal rules, 220
 - endowment funds, 169
 - exchange rate stability, 78n9
 - India, 199, 208–13, 215, 216
 - policy signaling, 76
 - quality of adjustment, 71
 - resource-abundant countries, 177
 - Stability and Growth Pact, 102, 103
 - Venezuela, 176, 177
- Sweden
 - cyclical component of balance, 149
 - subnational expenditure, 228
- Switzerland, balanced-budget rule, 131
- targets, 29n9, 91–2, 98, 99, 115, 132
 - Brazil, 124
 - changing the law, 27
 - creative accounting, 22
 - decentralized governments, 224, 230
 - fiscal responsibility laws, 111
 - India, 207–8
 - Latin America, 110, 111
 - Mexico, 141
 - Stability and Growth Pact, 102
 - see also* fiscal rules
- tax smoothing, 147, 154, 163n12
- taxation
 - Argentina, 195, 238, 239
 - Brazil, 6, 115, 127, 128
 - Colombia, 241
 - debt-tax ratio, 30–2, 37–8, 47
 - distortionary, 19, 70
 - Ecuador, 79n23, n31
 - financial transactions, 74, 239
 - India, 200–1, 204, 214
 - Latin America, 79n30, 106
 - Mexico, 132, 133, 138, 243, 244, 247
 - Norway, 170
 - progressive income tax, 70
 - quality of fiscal adjustment, 71, 72
 - reduction in revenue, 101
 - resources, 167
 - revenue volatility shock, 38, 45, 46, 47
 - structural close-to-balance rule, 158
 - subnational rules, 189, 193, 223–4, 225, 227, 229, 230, 231
 - weak administrative capacity, 73
- terms of trade, 9, 50, 204
 - budget balance adjustments, 108
 - Latin America, 28
 - primary balance, 49
 - volatility, 37, 38

- Thailand
 banking restructuring, 74
 capital account crisis, 68, 75
 fiscal impulse, 78n13
 time inconsistency, 16–17, 20, 57, 76
- trade
 India, 201, 203–4, 212
see also terms of trade
- transaction costs, 189
- transparency, xiii, 9, 131–2
 Brazil, 121, 123
 budgeting principles, 82
 commodity stabilization funds, 169, 178
 compliance, 23
 creative accounting, 22
 credibility, 4, 75, 77
 fiscal responsibility laws, 110–11
 India, 205, 207, 213, 214, 215
 Mexico, 134
 procedural rules, 15
 signaling, 6
 stability pacts, 232
 subnational accounting practices, 232
 Venezuelan savings norm, 175
see also accountability
- trust funds, 90
- Turkey
 capital account crisis, 67, 68, 69, 70, 75
 debt ratio, 30
 fiscal consolidation, 78n18
 fiscal impulse, 78n13
- UK *see* United Kingdom
- uncertainty
 Mexican fiscal rules, 131, 135
 resource earnings, 166, 167, 168, 173, 177
see also volatility
- unemployment
 compensation scheme, 70
 elasticity of, 148–9
 inflation bias, 17
 local, 235
 Norway, 173
- unemployment benefits, 148, 149, 150, 158
- uniform import surcharge, 74–5, 80n32
- United Kingdom (UK)
 budget restructuring, 88
 debt ratio, 30
 expenditure rule, 147
 monitoring mechanisms, 21
 structural close-to-balance rule, 158, 160
 subnational expenditure, 228
 transparency, 132
- United States (US)
 budget-balance rule, 131
 debt ratio, 30, 32, 40
 deficit restrictions, 98
 golden rule, 20
 Gramm-Rudman-Hollings Deficit Reduction Act, 21–2, 25, 27
 import gap, 44, 45
 subnational rules, 184–5
 transfers, 249n14
- Uruguay
 consumption cycle, 108
 debt ratio, 42
- US *see* United States
- Venezuela
 budget-balance rule, 2, 3, 4
 countercyclical fiscal policy, 56
 debt ratio, 42
 domestic currency debt, 43
 nonrenewable resources, 165, 170–1, 174–7
 oil price, 108
 oil stabilization fund, 7, 59, 60, 165, 174–7
 taxation, 79n30
- volatility, xii, 1, 5, 6, 9
 commodity prices, 165, 166, 167
 debt, 32–4, 35–7, 38, 39–40
 EU accession countries, 7, 147, 148, 151, 152, 155
 euro area, 105
 exchange rate, 39, 40, 41–2, 47, 52n12
 interest rate, 39, 41–2, 44, 47–8, 52n12

volatility – *continued*

Latin America, 28, 47, 49, 53,
104–5, 107
Mexico, 132–3, 135, 137
output, 7, 147, 148, 149, 151,
152, 155
reduction of macroeconomic, 53–65
resource earnings, 169, 174

revenue, 38, 45, 46, 47
see also stability; uncertainty

“Wagner’s Law”, 93

welfare maximization, 16–17

zero PSBR rule, 139, 140, 141, 143

zero-based budgeting, 26, 84