

Evaluating Fiscal Rules for Lesotho

Kingdom of Lesotho

Yibin Mu

SIP/2022/001

IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on June 15, 2022. This paper is also published separately as IMF Country Report No 22/162.

2022
December



IMF Selected Issues Paper
African Department

Evaluating Fiscal Rules for Lesotho
Prepared by Yibin Mu*

Authorized for distribution by Aqib Aslam
December 2022

IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on June 15, 2022. This paper is also published separately as IMF Country Report No 22/162.

ABSTRACT: A key challenge for Lesotho is the downward rigidity in public expenditure—which increases when SACU transfers are buoyant but fails to be pared back when they fall. Fiscal rules would be of value in Lesotho to help provide constraints on spending and resist political pressure to overspend, while embedding fiscal responsibility within the country’s macro-fiscal framework and ensuring debt sustainability. This paper evaluates options for fiscal rules for Lesotho, discusses the institutional framework required to help underpin a sound fiscal-rule framework, posits a possible fiscal-rule framework for Lesotho, and offers a roadmap to introduce the framework.

RECOMMENDED CITATION: Yibin Mu, Evaluating Fiscal Rules for Lesotho

JEL Classification Numbers:	E60 E61 H61 O23
Keywords:	Fiscal Rules, Fiscal Policy, Public Financial Management, Expenditure
Author’s E-Mail Address:	ymu@imf.org

* The author wants to thank Qiuyan Yin, Angela Mu, Andrew Mu for research assistance and Cecilia Prado for formatting the paper.

SELECTED ISSUES PAPERS

Evaluating Fiscal Rules for Lesotho

Kingdom of Lesotho

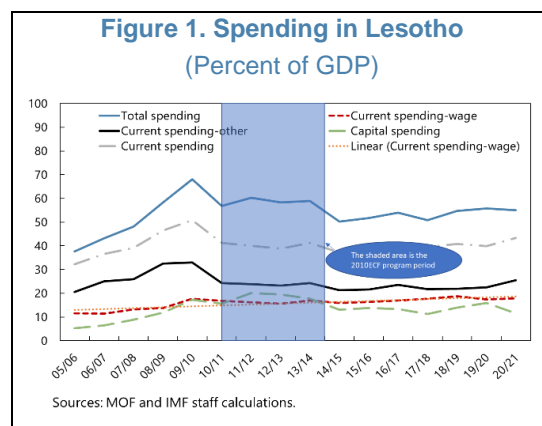
Introduction

1. Fiscal rules help set permanent constraints on fiscal policy and—with the appropriate institutions—reduce uncertainty about future fiscal policy developments. While recognizing that history, tradition, and preferences—in addition to economic factors—may cause the optimal size of government and public debt to vary, the political economy literature has shown how the political and institutional environment can lead to distortions in the conduct of fiscal policy, resulting in outcomes that may be undesirable from society's point of view. For this reason, fiscal rules have developed to help impose durable constraints on fiscal policy through numerical limits on key budgetary aggregates or debt indicators (Schaechter and others 2012, Basdevant 1993).

2. A key challenge for Lesotho is the downward rigidity in public expenditure—which increases when SACU transfers are buoyant but fails to be pared back when they fall. These outcomes are largely due to the difficult political context in Lesotho (Honda and others 2017). Fiscal rules would be of value in Lesotho to help provide constraints on spending and resist political pressure to overspend, while embedding fiscal responsibility within the country's macro-fiscal framework and ensuring debt sustainability.

3. Fiscal restraint has been exercised in the past, helping to halt the upward trend in overall spending and restoring fiscal sustainability, albeit only temporarily.

Following agreement over an IMF-supported medium-term arrangement in 2010, overall spending gradually declined up until FY14/15. However, following exit from the program and in the absence of durable institutions to provide strong check and balances, past bad behaviors—as well as political tensions in 2014—reemerged to erode fiscal restraint (Figure 1).



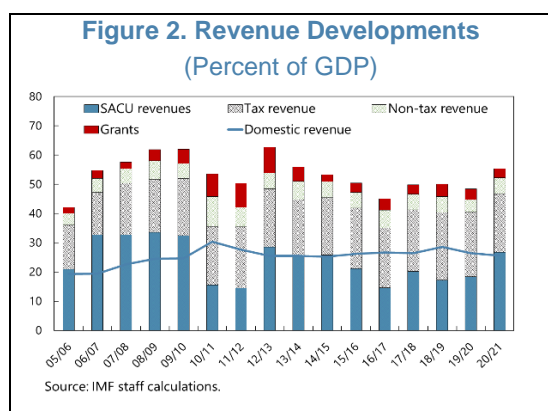
4. This paper evaluates options for fiscal rules for Lesotho. Section 2 provides some background on the fiscal situation in Lesotho and motivation for the importance of fiscal rules; Section 3 reviews the types of fiscal rules and their pros and cons. Section 4 discusses the institutional framework required to help underpin a sound fiscal-rule framework. Section 5 posits a possible fiscal-rule framework for Lesotho and offers a roadmap to introduce the framework.

Revenue and Spending in Lesotho

The Macro-Fiscal Context in Lesotho¹

5. Total revenues have been on a declining trend since their peak of 66.5 percent of GDP in FY06/07. SACU transfers contributed 44 percent of total revenues on average over the past 15 years and have accounted for 85 percent of the decline over the past 15 years. Domestic revenues have been relatively stable at just under 25 percent of GDP but fell as a share of GDP in FY20/21 during the pandemic (Figure 2).

¹ Please see SIP: *Addressing Fiscal Pressures*.



6. SACU transfers are the main driver of overall revenue volatility. Grants are also a significant contributor to overall revenue volatility. Table 1 shows two measures of variability by source of revenue over the past 15 years (King 2021):

- The average absolute contribution to total revenue year-over-year (y/y) change. SACU transfers contribute to growth four times more than the next largest revenue source (taxes on income, profits, and capital gains). With SACU transfers contributing 10.0 percentage points to revenue growth on average, all else equal, expenditure would have to rise or fall by 10 percent from the previous year to avoid any impact on the fiscal balance due to SACU transfers' volatility alone.
- The standard deviation of the absolute contribution to total revenue y/y changes (i.e., the volatility of those contributions which reflects the combined effects of the volatility of the underlying revenue stream and its size relative to total revenue). The variability (standard deviation) of the contribution of SACU transfers to overall revenue volatility is again over four times greater than the revenue item with the second largest variability (grants).

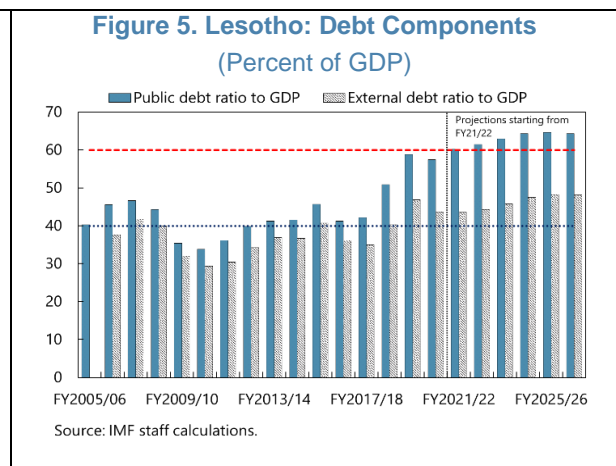
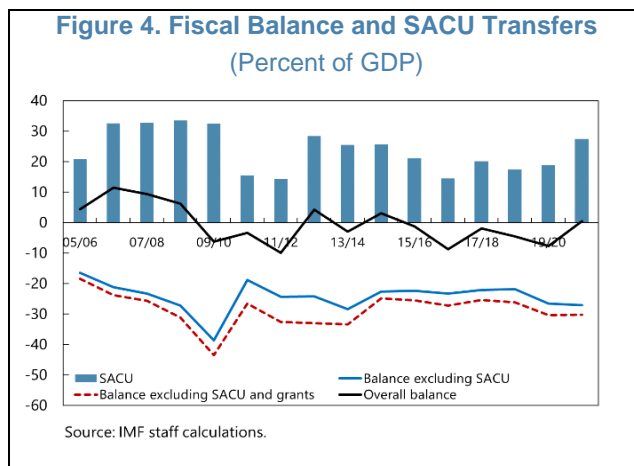
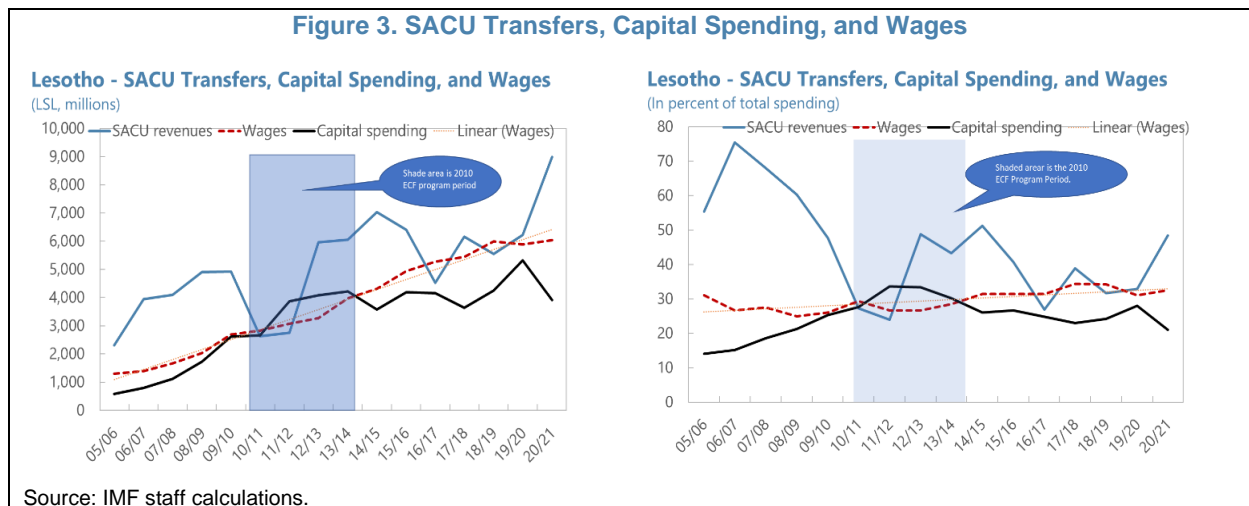
Table 1. Lesotho: Summary of Revenue Changes Contributions and Volatility

15 years from 2007/08 to 2021/22 (July 2021 forecast)	Level	Growth	
	Average share of total revenue (%)	Average absolute contribution (ppts)	Standard deviation of growth contribution (ppts)
Total revenues	100.0	10.6	13.1
<i>of which</i>			
SACU receipts	43.6	10.0	13.9
Non-SACU receipts	56.4	5.9	6.8
<i>of which</i>			
Taxes on income, profits, and capital gains	21.1	2.4	2.2
General Taxes on Goods and Services	13.9	1.5	1.4
Grants: From international organisations	7.2	2.3	2.9
Water Royalties - LHDA	5.0	0.8	1.2
Rent	2.3	0.9	1.4
Dividends	2.2	1.7	2.4
Excise taxes	1.9	0.6	0.7
Grants: From foreign governments	1.1	0.6	0.8
Electricity 'Muela	0.5	0.2	0.4
Other revenues	1.2	n/a	n/a

Source: King 2021.

7. On expenditure, certain key components have proven downwardly rigid over time. Wage spending is the largest component of both current spending (45 percent) and overall spending (30 percent) and has been on an increasing trend over time (Figure 3). Given the politicization of civil service employment, wages tend to be a protected spending item, with unsuccessful efforts to rein them in over time. As a result, when revenue constraints bind—for example, due to a dip in SACU revenues—other items of spending, typically capital spending, are cut to make room. As a result, the share of capital spending in the total spending has been on a declining trend since FY12/13.

8. With little adjustment in spending, the pattern of the overall fiscal balance is heavily impacted by volatile SACU transfers, with debt drifting upwards over time. However, the overall balance does not recover as quickly as SACU transfers on account of the rigidity in spending. For example, the overall balance in FY19/20 was still deteriorating while SACU transfers recovered (Figure 4). As a result, total public and external debt have been increasing over the past decade, reaching close to 60 percent and 50 percent of GDP, and projected to go beyond them in the next few years, respectively (Figure 5).



Existing Fiscal Principles and Targets in Lesotho

9. Lesotho has established several fiscal objectives and complementary fiscal targets, which are set out in the Budget Strategy Paper (BSP) (Table 2). The principles are a mix of the quantitative (ii.a, ii.b, and ii.c)—setting bounds or specific targets—and qualitative (i, iii, iv, v, vi)—setting out key priorities. Since FY09/10, only one of these principles have been met each year (Table 3). Under the authorities' current forward-looking medium-term fiscal framework, it would be very challenging to meet any of these principles in the coming three years.

10. Given current trends and the already high wage bill, ensuring wages do not grow as a share of GDP (principle ii.b) would be ambitious without specific targeted measures. More generally, the key drawback of expressing this rule in terms of GDP is that in practice it could be pro-cyclical and undermine fiscal sustainability as the wage bill could rise in years of strong GDP growth, but would then be difficult to reduce in absolute terms in years of weak GDP growth or economic contraction. This could therefore result in the wage bill actually rising as a share of GDP. Between FY09/10 to FY20/21, the rule would have been met five times and missed seven times (Table 3). In the FY22/23 Budget, it will be met once and missed twice over FY21/22-FY24/25.

Table 2. Lesotho: Existing Fiscal Principles and Targets in Lesotho

Principles	Target categories	Specifications	Where specified
(i)	Overall budget	Adopt a Budget that is affordable, sustainable, and yet responsive to the needs of the country over the medium-term."	BSP
(ii.a)	Overall fiscal balance	Over the medium-term, bring the overall fiscal deficit to below 3 percent of GDP consistent with long-term GDP growth	BSP
(ii.b)	Wage bill	The Government's expenditure on wage bill should not be seen growing as a percentage of Gross Domestic Product (GDP) and must be reduced over the medium term alongside measures to streamline the civil service.	BSP
(ii.c)	Ratio of recurrent to capital spending	Consistently constraining the Government's recurrent expenditure not to grow more than development expenditure.	BSP
(iii)	Public financial management	Improve monitoring, transparency, and accountability mechanisms to ensure expenditure efficiency.	BSP
(iv)	Arrears	Prioritize the elimination and curtailment of accumulation of arrears.	BSP
(v)	Domestic revenue mobilization	Expand domestic revenue mobilization to reduce reliance on volatile and shrinking transfers from SACU.	BSP
(vi)	Golden rule	Over the medium term, the Government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure.	BSP
	Safeguard the peg	Adopt a Budget that is affordable, sustainable, and yet responsive to the needs of the country over the medium-term.	BSP
	Debt limit	The ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of 5 percent of GDP.	Debt Management Policy Framework

Sources: Budget Strategy Paper 2021 (Ministry of Finance) and Debt Management Policy Framework (Ministry of Finance).

Table 3. Lesotho: Performance of Existing Fiscal Principles and Targets

	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Current expenditure to grow more slowly than development expenditure													
Current expenditure growth		13%	-10%	10%	7%	20%	4%	13%	10%	-4%	8%	3%	8%
Capital expenditure growth		51%	2%	46%	6%	3%	-15%	17%	-1%	-17%	22%	26%	-26%
Principle met?		Yes	Yes	Yes	No	No	No	Yes	No	No	Yes	Yes	No
Wage bill should not grow as a percentage of GDP													
Wage bill as % of GDP	13.8%	17.8%	16.6%	16.1%	15.6%	16.8%	15.8%	16.2%	16.9%	17.3%	17.9%	17.7%	19.1%
Year-on-year change		3.9%	-1.1%	-0.6%	-0.5%	1.2%	-1.0%	0.5%	0.7%	0.4%	0.5%	-0.2%	1.4%
Principle met?		No	Yes	Yes	Yes	No	Yes	No	No	No	No	Yes	No
Borrowing should only finance development expenditure (over the medium term)													
Net lending	575	-873	-499	-1,876	909	-697	856	-388	-2,729	-652	-1,385	-2,429	153
Capital expenditure	1,733	2,613	2,654	3,863	4,086	4,217	3,574	4,195	4,158	3,453	4,208	5,321	3,914
Principle met?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Deficit of less than X per cent of GDP													
Net lending	3.9%	-5.8%	-2.9%	-9.8%	4.3%	-2.9%	3.1%	-1.3%	-8.7%	-2.1%	-4.1%	-7.3%	0.5%
Principle met at 5% of GDP?	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes
Principle met at 3% of GDP?	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No	Yes	No	No	Yes

Sources: Ministry of Finance and IMF staff calculations.

11. Ensuring current expenditure does not outpace capital spending (principle ii.c) would require that the composition of total expenditure shifts towards development over time. This principle was introduced to help shift spending towards growth-enhancing investment. In theory, it should be straightforward to operationalize within overall budget ceilings and at the level of Ministries, Departments, and Agencies (MDAs). However, meeting it would not play a direct role in ensuring fiscal sustainability, since the composition of public expenditure does not determine the overall fiscal balance or the path of debt—although it does influence them indirectly to the extent that investment affects GDP growth and domestic revenues. Furthermore, while the BSP implicitly aims for public investment to rise as a share of total public expenditure (via the target for recurrent expenditure to grow more slowly than development expenditure), it does not set an explicit target or floor for public investment. Between FY09/10 and FY20/21, this principle has only been adhered to six times and missed six times. Over FY21/22–FY24/25, this principle will be met twice and missed once. As discussed in the next section, the extent of the misses in years where recurrent expenditure has grown faster than capital expenditure has been on such a scale that capital expenditure has fallen sharply as a share of total expenditure.

12. Principle vi is a classical structural “golden rule” that requires recurrent expenditure to be financed by revenues over the economic cycle. Very simply, the government aims to run (cyclically-adjusted) recurrent budget surpluses such that all public consumption benefiting the current generation should be paid for by that generation. The main drawback of this rule in Lesotho’s fiscal context is that it has typically been very far from binding, so would rarely constrain budget decisions, although that is not the case at present with the deficit historically high and capital expenditure relatively low. This principle has been met comfortably in every year between FY09/10 and FY20/21, given the large SACU transfers. But it is projected to be met over the period FY21/22–FY24/25.

13. The deficit rule (principle ii. a) in combination with the outlook for nominal GDP growth, would determine that profile of the debt-to-GDP ratio and fiscal sustainability. As a member of the SADC, Lesotho is committed to a public debt convergence criterion of 60 percent of GDP. The latest IMF WEO forecast for the next five years points to nominal growth recovering to around 5 percent a year, which is consistent with 3 percent of deficit. On this basis, a deficit limit of 3 percent of GDP is consistent with stabilizing public debt at 60 percent of GDP over the medium term (since $3/60=0.05$). However, the size and volatility of SACU transfers presents problems for a simple overall balance-based fiscal rule (see Section E).

14. Public debt limits and capital expenditure are not covered in the BSP and are set within the Debt Management Policy Framework (DMPF). This document states that “the ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of 5 percent of GDP. The government will not be able to borrow in the form of additional net borrowings or issue additional net guarantees beyond these ceilings”. It also states that “[t]o provide adequate fiscal flexibility with respect to debt ceilings, a trigger level of debt limit is being established for public debt, excluding guarantees, at 50 percent of GDP, for public external debt at 35 percent of GDP, and for government guarantees at 3 percent of GDP. When outstanding debt breaches this threshold, the government will be required to initiate a fiscal adjustment mechanism that will steer the debt below the threshold levels”. There are also older legislated limits still in force on external and domestic debt stemming from the 1967 Loans & Guarantees Act and subsequent Amendments (which place a very high limit on debt by stating that it must not exceed the past three years’ recurrent revenues).

15. The BSP does not set out ‘escape clauses’ or stipulate how quickly or by what means deviations from targets should be addressed. This may be reasonable for targets that can be revisited in each BSP and adjusted to reflect current economic conditions, but it would be problematic for fiscal rules that are established in legislation. This has been recognized in the draft PFM Bill, which incorporates a section on deviations from targets.

Fiscal Rules—Types and Practice Experience

Types of Fiscal Rule

16. Countries committed to a medium-term fiscal framework typically anchor fiscal policy on a numerical rule relating to the budget balance, public expenditure, and public debt (Davoodi and others 2022). The chosen rule needs to support, but need not be identical with, the ultimate objective of the policymaker. The literature on fiscal rules sets out 5 types (Table 4).

- **Expenditure rules set limits on total, primary, or current spending.** Expenditure ceilings directly define a limit on public resources that can be used by the government and are, in general, relatively easy to communicate and monitor. Such limits are typically set in absolute terms or growth rates, and occasionally in percent of GDP with a time horizon ranging from between three to five years. These rules are not linked directly to the debt sustainability objective since they do not constrain the revenue side. They can, however, provide an operational tool to trigger the required fiscal consolidation consistent with sustainability when they are accompanied by debt or budget balance rules. Furthermore, they can constrain spending during temporary booms, when windfall revenue receipts are temporarily high and headline deficit limits easy to comply with. Moreover, expenditure rules do not restrict the economic stabilization function of fiscal policy in times of adverse shocks as they do not require adjustments to cyclical or discretionary reductions in tax revenues. Even greater counter-cyclicality can be achieved by excluding cyclically-sensitive expenditure items, such as unemployment support, however, at the expense of creating a bigger distance to the sustainability target. Also, expenditure rules are not consistent with discretionary fiscal stimulus.
- **Revenue rules set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden.** However, setting ceilings or floors on revenues can be challenging as revenues may have large cyclical components, that fluctuate with the business cycle. Exceptions are those rules that restrict the use of “windfall” revenue for additional spending. Revenue

Table 4. Lesotho: Types of Fiscal Rules

Rules	Definition	Examples	Pros	Cons
Expenditure Rules	Limit total / primary / current spending, either by putting a ceiling on its growth, or on the relevant ratio to GDP.	<i>Namibia</i> : public expenditure levels below 33 percent of GDP. <i>Peru</i> : real growth of current expenditure ceiling of 4 percent.	<ul style="list-style-type: none"> ▪ Clear operational guidance; ▪ Steer the size of government; ▪ Allows for economic stabilization; ▪ Relatively easy to communicate and monitor. 	<ul style="list-style-type: none"> ▪ Not directly linked to debt sustainability as no constraints on revenue side; ▪ could lead to unintended changes in the distribution of spending, e.g., shifting to expenditure categories that are not covered by the rule.
Revenue Rules	Set ceilings or floors on revenues or determine use of windfall revenues.	<i>Kenya</i> : maintain revenues at 21-22 percent of GDP. <i>France</i> : determine ex ante the allocation of higher-than-expected tax revenues.	<ul style="list-style-type: none"> ▪ Can improve revenue performance; ▪ Steers government size; ▪ clear operational guidance; ▪ easy to communicate and monitor. 	<ul style="list-style-type: none"> ▪ Not directly linked to debt sustainability as no constraints on expenditure side; ▪ No economic stabilization feature (can be procyclical).
Overall Balance Rules	Constrain the size of the deficit and thereby control the evolution of the debt ratio.	<i>Indonesia, Israel</i> : overall deficit ceiling of 3 percent of GDP.	<ul style="list-style-type: none"> ▪ Clear operational guidance; allow for economic stabilization; easy to communicate and monitor; closely linked to debt sustainability. 	<ul style="list-style-type: none"> ▪ Could be procyclical; ▪ headline balance could be affected by development outside the control of the government (e.g., a major economic downturn).
Structural balance rule	Account for the business cycle and set up structural budget balance target.	<i>Sweden</i> : surplus of 1 percent of GDP over the cycle.	<ul style="list-style-type: none"> ▪ Countercyclical; linked to debt sustainability. 	<ul style="list-style-type: none"> ▪ Need to estimate the structural balance.
Debt Rules	Set an explicit limit on the stock of public debt.	<i>Liberia, Poland</i> : debt ceiling of 60 percent of GDP. <i>Kosovo</i> : debt ceiling of 40 percent of GDP.	<ul style="list-style-type: none"> ▪ Directly linked to debt sustainability; easy to communicate and monitor. 	<ul style="list-style-type: none"> ▪ No clear operational guidance as policy impact on debt limit is not immediate; ▪ rules could be met via temporary measures (e.g., below-the-line transactions). ▪ Can be procyclical. ▪ Debt could be affected by developments outside the government control.

rules also could result in procyclical fiscal policy, as floors do not generally account for the operation of automatic revenue stabilizers in a downturn nor ceilings in an upturn. However, like expenditure rules, they can directly target the government size. Most of these rules are also not directly linked to the control of public debt, as they do not constrain spending.

- **Budget balance rules constrain the key budget aggregate that drives the public debt ratio and are largely under the control of policy makers.**
 - **Overall balance or primary balance rules provide clear operational guidance by targeting well-specific quantities and can help ensure debt sustainability.** The main drawback of these rules is that they are less sensitive to the business cycle-leaving little room for maneuver in a period of significant economic upheaval-and difficult to adhere to in the face of spending rigidities. The inclusion of well-defined escape clauses in these rules can help enhance the reaction of fiscal policy to unexpected shocks by allowing for temporary deviations from targets (see below).
 - **Structural or cyclically-adjusted balance rules and balanced "over the cycle" rules explicitly account for economic shocks and are counter-cyclical.** By adjusting for cyclical fluctuations, these rules are more suitable for countries subject to large external shocks, such as unexpected changes in SACU transfers in Lesotho. The drawback is that these rules require significant data and knowhow to estimate the "structural" balance and can be difficult to communicate and monitor. There are several varieties in addition to the common structural balance rules:
 - a. An **"over-the-cycle"** balance rule requires the attainment of a given nominal budget balance ceiling on average over the cycle (IMF 2009). What distinguishes this rule from other budget balance rules is not the budgetary aggregate it constrains but rather how the limit constraining the budgetary aggregate is assessed. Instead of being defined and assessed annually, the limit is typically set and assessed as an average over the years encompassing all stages of the business cycle, including both expansionary and contractionary stages. Such rules tend to have stronger stabilization properties than cyclically-adjusted or structural balance rules (Caceres and Ruiz-Arranz 2010). Indeed, over-the-cycle rules can accommodate not only automatic stabilizers but also discretionary fiscal measures (stimulus or contraction). However, greater flexibility might come at the expense of credibility: these rules can lead to excessively loose or tight fiscal policy at various times during the cycle; that is, they might allow fiscal relaxation or tightening that is not warranted by cyclical conditions or that could be difficult to reverse later. More fundamentally, assessing compliance with the rule requires precise dating of the cycle, which hinges on the methodology used to identify business cycle turning points (peaks and troughs) and the stability of national accounts data (IMF 2018).
 - b. An investment-based **"golden rule"** which targets the overall balance net of capital expenditure, is less linked to debt. With a zero ceiling, borrowing is permitted to finance investment only; current spending must be covered by revenues. Golden rules are designed to promote and protect capital expenditure, which is seen as more pro-growth and politically easier to cut than other types of spending (IMF 2009). These rules are also more consistent with intergenerational equity than other budget balance rules, since they shift the burden of financing public investment projects from current to future generations, which will be the main beneficiaries of such projects. The potential shortcomings without a proper public investment

management framework, the possibility of borrowing for investment without restriction can lower incentives for proper cost-benefit analysis, resulting in the selection of projects with low social returns and revenues (Balassone and Franco 2000). In addition, monitoring and enforcement of golden rules is particularly challenging, because the exclusion of capital expenditure favors creative accounting and the reclassification of unproductive expenditures as investment to circumvent the rule (Servén 2007). A particular concern is that, by excluding capital expenditure, the golden rule can allow excessive borrowing and weaken the link between the aggregate targeted by the rule and debt dynamics, creating possible risks to debt sustainability. There are some precedents. In Mexico, for instance, the government excluded capital expenditures made by the national oil company and the state-owned electricity company from the nominal budget balance in 2009; this impeded an appropriate assessment of the fiscal stance and contributed to adverse public debt dynamics (Valencia 2015).

- c. **"Pay-as-you-go"** rules stipulate that any additional deficit-raising expenditure or revenue measures must be offset in a deficit-neutral way. Since they do not set numerical limits on large budgetary aggregates, they are typically considered procedural rules and thus not counted as numerical fiscal rules in the IMF fiscal rule dataset (Schaechter and others (2012)).
- Debt rules set an explicit limit or target for public debt in percent of GDP. This type of rule is, by definition, the most effective in terms of ensuring convergence to a debt target and is relatively easy to communicate. However, debt levels take time to be impacted by budgetary measures and therefore do not provide clear short-term guidance for policy makers. Debt could also be affected by developments outside the control of the government, such as changes in interest rates and the exchange rate, as well as "below-the-line" financing operations (such as financial sector support measures of the calling of guarantees), which could imply the need for unrealistically large fiscal adjustments. Moreover, fiscal policy may become procyclical when the economy is hit by shocks and the debt target, defined as a ratio to GDP, is binding. On the other hand, when debt is well below its ceiling such a rule would not provide any binding guidance.

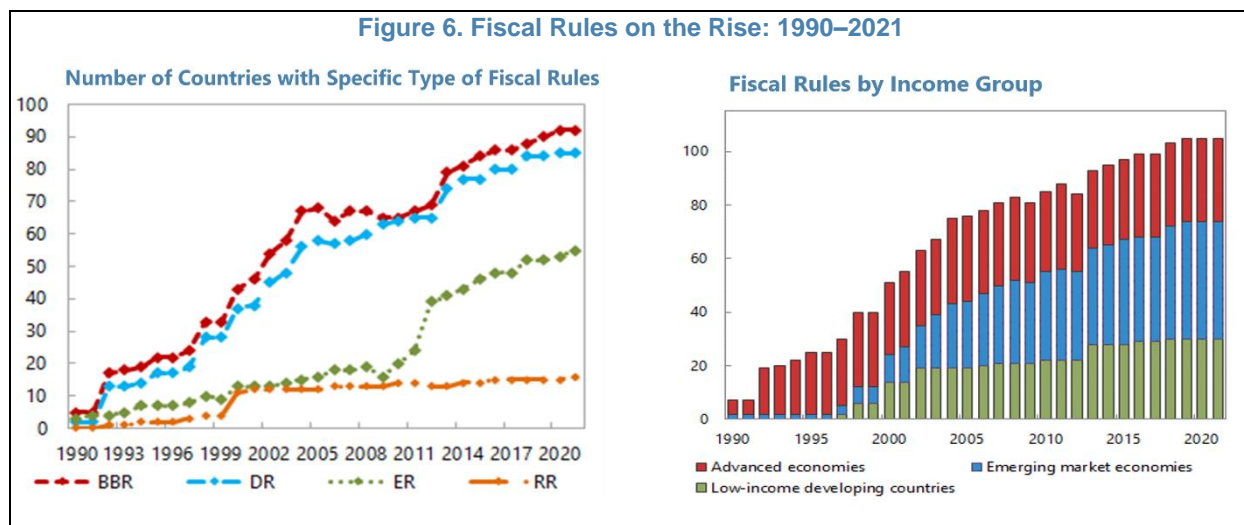
Fiscal Rules in Practice

17. During the past two decades, a growing number of countries across the world have adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule, 11 countries more than the last update in 2015 and 96 countries more than 1985, the beginning of the database period (Davoodi and others 2022).³ Advanced countries were frontrunners on the adoption of fiscal rules, but they are increasingly common in emerging market and developing economies especially since the late 2000s. As of end 2021, the number of EMDEs with fiscal rules were more than double the number of advanced economies.

18. The expansion in rules came in waves, driven largely by the adoption of rules in the aftermath of large shocks and the inclusion of supranational rules (Figure 6). For example, in the early 2000s, the increase was driven by the adoption of national rules in emerging markets as well as supranational rules in low-income

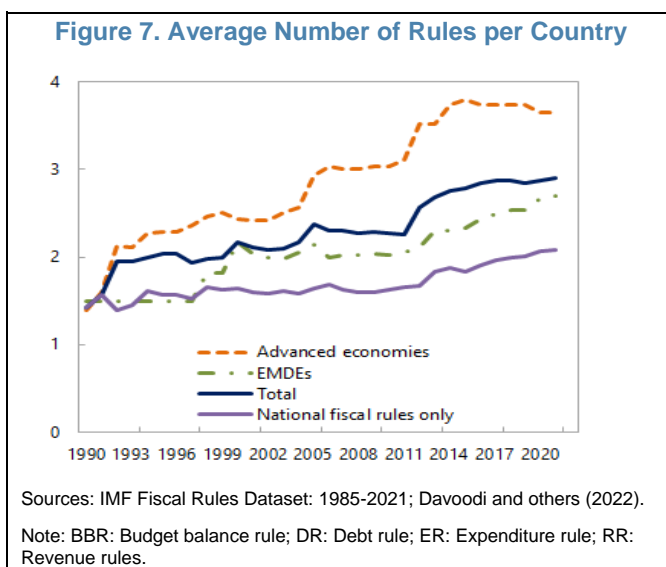
³ The fiscal rule dataset contains 106 economies (Canada was included as historically it had adopted fiscal rules) comprising four main types of fiscal rules: expenditure rules, revenue rules, budget balance rules, and debt rules. The fiscal council dataset covers more than 50 fiscal councils on a de-jure basis and describes their mandates, structure, and operational independence.

developing countries. National rules in emerging markets have often been adopted to commit to fiscal adjustments in the wake of a crisis (e.g., Colombia, Brazil, India), lock in gains from reforms (e.g., Chile, Mexico, Poland), or avoid procyclical spending owing to volatile natural resource prices (Mongolia, Russia).



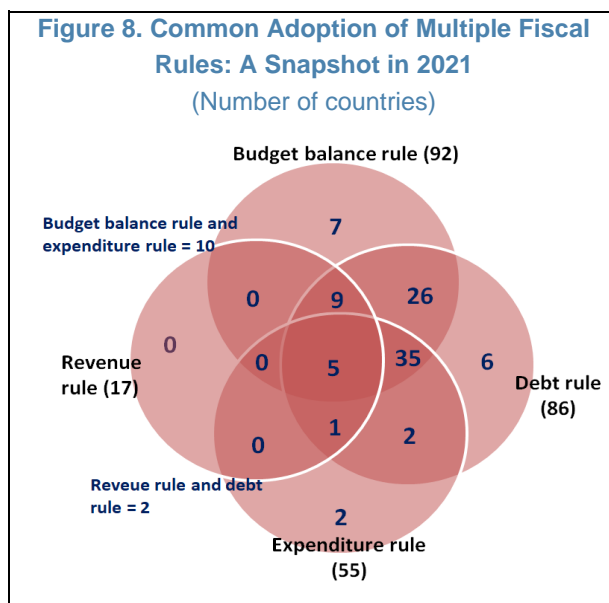
19. The average number of fiscal rules per country has also increased steadily during the last two decades (Figure 7).

Countries had an average of about three fiscal rules in 2021 up from about 2 in the early 2000s. Some have considerably more. The increase has been more pronounced in Europe, where many countries have adopted own national rules along with the supranational rules in European Union. The use of multiple rules in many countries was motivated by the need to achieve multiple fiscal objectives and constrain different budget aggregates. But multiple fiscal rules contribute to the complexity of the fiscal framework and can make compliance more difficult to explain and monitor. In some cases, the large number of rules was related to political difficulties in eliminating existing rules when introducing new rules (Caselli and others 2018).



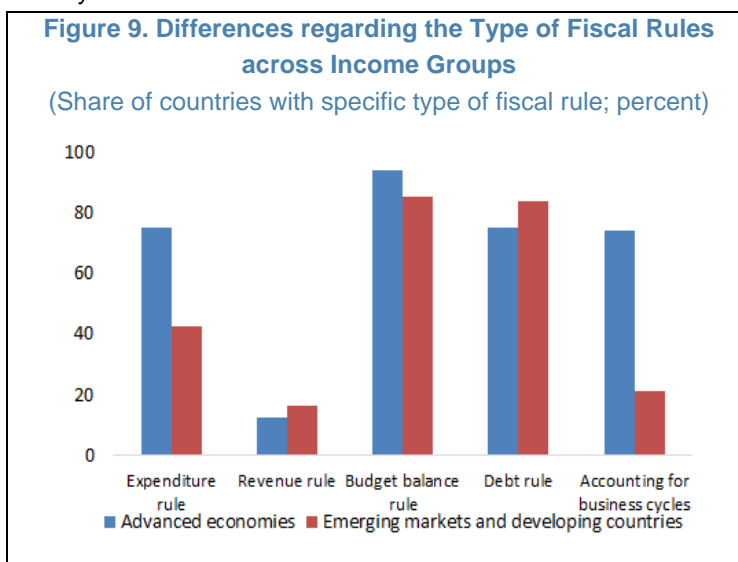
20. The most common combination is the use of a debt rule together with operational limits on expenditures and/or balanced budgets. About 60 percent of countries with fiscal rules have a debt rule combined with operational limits on annual budget aggregates. Specifically, out of the 105 economies with fiscal rules in 2021, one-third had a debt rule together with a deficit limit and an expenditure ceiling, while another quarter of economies had a debt rule combined with a budget balance rule. Expenditure rules are increasingly common, often set as a ceiling on annual expenditure growth. Revenue rules have been less used, partly reflecting the fact that revenues are more volatile over business cycles and revenue rules are less well suited for fiscal sustainability. Revenue rules are often set a ceiling on revenue-to-GDP ratio in advanced

countries (Belgium, Denmark) to avoid further tax hikes, while the rules are often set as a floor in low-income countries (such as the WAEMU) to encourage greater revenue mobilization (Figure 8).



21. Differences regarding the type of rules tend to persist across income groups.

- Expenditure rules are prevalent, but largely among advanced economies** (Figure 9). About three-quarters of advanced economies have expenditure rules, partly reflecting that several European countries (Austria, Croatia, Greece, Italy, Spain) adopted expenditure rules as part of their national fiscal framework, which aligned to the “expenditure benchmark” that set a ceiling on annual growth of primary spending in the European supranational framework in 2011. However, only less than a third of emerging markets and developing economies adopted expenditure rules (Brazil, Mongolia, Paraguay), possibly reflecting less developed institutional capacity in expenditure controls and the expected rise in spending financed by revenue mobilization efforts.



- **Debt rules are particularly common in EMDEs, with over 80 percent of EMDEs having adopted them.** The majority of debt rules is set as a debt limit or ceiling, while about 10 percent of national debt rules uses an anchor concept rather than a hard ceiling (Finland, Australia, United Kingdom). Countries could deviate from the anchor levels in an adverse shock and aim to return to the anchor levels over the medium-term. Most countries have the debt rule expressed in percent of GDP, and sometimes the debt rule is set in net present value terms for low income developing countries, as they receive a significant share of concessionary financing.
- **Budget balance rules accounting for business cycles are more predominant in advanced economies (Czech Republic, Estonia) than emerging markets (Chile, Colombia).** Even for the former group, assessing the output gap in real time for budget purposes is challenging. For those EMDEs that have deficit limits accounting for economic cycles, they often rely on thresholds on actual economic activity rather than an output gap concept.

Lessons Learned from International Experience

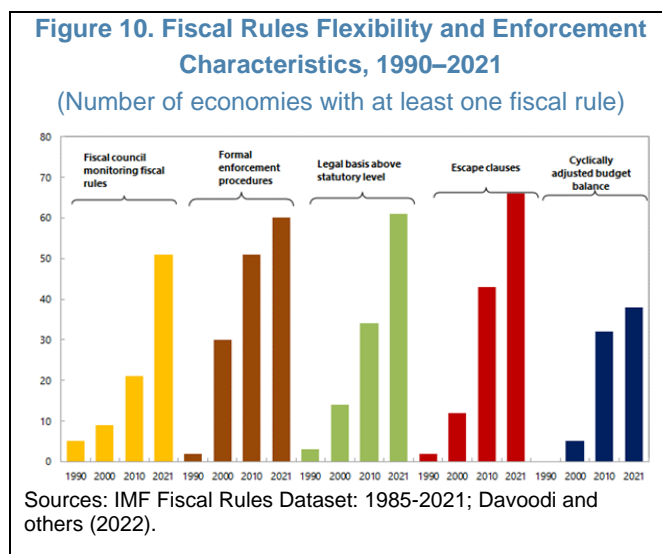
22. Some of the key lessons include on the use of fiscal rules include:

- An adequate public finance management (PFM) framework and political buy-in matter.
- A good fiscal rule needs to strike an appropriate balance between simplicity, flexibility, and enforceability (Caselli and others 2018).
- It is critical to cover a broad range of government fiscal activities to reduce the scope for (i) allocating spending to arrears that are not covered, or (ii) playing accounting tricks.
- It is important to incentivize building fiscal buffers during upturns and allowing for adequate fiscal support during downturns, i.e., ensuring rules are counter-cyclical.
- A good fiscal rule needs to be calibrated in line with sustainability and stabilization objectives, for example, deficits are consistent with stable or falling debt/GDP ratio.
- Given the trade-offs, many countries combine two or more fiscal rules. Not all types of fiscal rules are equally apt to support the sustainability, economic stabilization, and possibly the size of government objectives, even when its design features are fine-tuned. Using a combination of fiscal rules can help address the gaps. For example, a debt rule combined with an expenditure rule would provide a link to debt sustainability while also assisting policymakers with short to medium-term operational decisions, allowing for some countercyclicality and explicitly targeting the size of government. This could similarly be achieved through a combination of a debt and cyclically adjusted budget balance rule.

The Institutional Framework for Fiscal Rules

23. An institutional framework has been developed over time to enhance flexibility, enforcement, and monitoring of the fiscal rules (Figure 10). The global financial crisis in the late 2000s and the commodity price collapse in 2014–15 prompted countries to revise their fiscal rule frameworks. There were a range of reforms to improve flexibility and operational relevance of fiscal rules, as well as to enhance the monitoring and enforcement of the rules outside the government.

24. Effective implementation and monitoring of fiscal rules often require a number of supporting arrangements and good institutional framework. Fiscal rules should be underpinned by a set of institutional arrangements to convert the intent of the fiscal rule into the reality of budget policy and execution. Fiscal rules can be supported by fiscal responsibility laws (FRLs) which typically set out procedural and transparency requirements, and in some cases also numerical rules. An increasing number of advanced and some emerging economies are using independent bodies (e.g., fiscal councils) to further enhance the credibility of their fiscal rules.



25. A key component of the institutional framework is a strong legal basis for fiscal rules. An increasing share of countries have legal basis of their national fiscal rules above the statutory level. In 2000, only 30 percent of countries established fiscal rules in the legislation. The share has more than doubled by 2021, currently more than 60 countries have fiscal rules featured at or above statutory levels such as in the Fiscal Responsibility Law (Armenia, Jamaica, Paraguay) or in constitutions (Brazil, Denmark). As of 2021, over 40 percent of fiscal rules were supported by fiscal responsibility laws (typically specify the numerical rules and set out procedural and transparency requirement), doubled from a decade ago and particularly in EMDEs. Governments could have adopted stronger legal basis as an attempt to make fiscal rules more durable and credible.

26. The desirable legislative support depends on country-specific circumstances. Rules enshrined in higher-level legislation are more difficult to reverse and therefore tend to be longer lasting since they are more difficult to modify even with a change of government. While higher-level legislation thus tends to confer more stability to the framework, this may not necessarily enhance the effectiveness of the fiscal rules if enforcement mechanisms and accountability procedures are weak. For some countries, with weak institutions, the simplicity of adoption and rapid implementation may also be key factors in deciding which legislative framework to use.

27. Escape clauses can provide flexibility to rules in dealing with rare events. They should include (i) a very limited range of factors that allow such escape clauses to be triggered in legislation, (ii) clear guidelines on the interpretation and determination of events (including voting rules), and (iii) specification on the path back to the rule and treatment of accumulated deviations. Formal escape clause provisions exist for budget balance (and debt rules) in Brazil, Colombia, Germany, Mauritius, Mexico, Jamaica, Panama, Peru, Romania, Slovakia, Spain, and Switzerland (Table 5). In all cases, the escape clause provisions allow for temporary deviations from the rules in the event of a recession or a significant growth slowdown. Other triggers include, for example, natural disaster (Brazil, Germany, Jamaica, Mauritius, Panama, Peru, Slovakia, Switzerland), and banking system bailout (Slovakia).

28. Formal enforcement (e.g., automatic corrections of ex post deviations from the rule) can raise the rule's credibility and is increasingly built into fiscal rules. Like with other elements of rules, specifying

the mechanism clearly and anchoring it legislation, can help adherence but it is ultimately the political will that matters. Below some examples are summarized (Box 1).

Box 1. Some Examples of Correction Mechanisms

- The Swiss and German structural budget balance rules contain automatic correction mechanisms (“debt brakes”). In both countries, deviations from the structural budget balance rule (positive or negative) are stored in a notional account. When the accumulated deviation exceeds a threshold improvement in the structural balance are required within a pre-defined timeframe to undo these deviations. The main differences in both countries are the thresholds (1.0 percent of GDP in Germany per ordinary law and 1.5 percent per constitution; and 6 percent of expenditure in Switzerland), and the type of deviations that need to be corrected. In Germany, only those deviations that did not result from errors in real GDP growth projections enter the notional account, while in Switzerland all misses are tallied up. The latter is more transparent but provides less flexibility to accommodate errors outside the control of the government. In Switzerland the excess amount must be eliminated within the next three annual budgets. In Germany, overruns only need to be reduced during an economic recovery to avoid a procyclical tightening and can be corrected via expenditure and revenue measures.
- Poland’s and Slovakia’s debt rules, which set a 60 percent debt of GDP ceiling, include thresholds that trigger actions to avoid that the rule is missed. In the case of Slovakia, when debt-to-GDP ratio reaches 50 percent, the Minister of Finance is obliged to clarify the increase to parliament and suggest measures to reverse the growth. At 53 percent of GDP, the cabinet shall pass a package of measures to trim the debt and freeze wages. At 55 percent, expenditures would be cut automatically by 3 percent and next year’s budgetary expenditures would be frozen, except for co-financing of EU funds. At 57 percent of GDP, the cabinet shall submit a balanced budget. Ideally, the later trigger points would not be needed if effective action is taken earlier on. A caveat is that triggers do not account for the cyclical position of the economy.
- So-called sequesters are another form of automatic correction. In the United States, due to the failure of the Joint Select Committee on Debt Reduction to reach agreement on deficit-reduction proposals, automatic spending cuts (sequesters) are scheduled to take effect from January 2013. In this case, this would be a one-time adjustment to the expenditure path rather than a recurrent mechanism embedded in a fiscal rule framework. Also, sequesters tend to have the disadvantage of creating a bias against capital spending which is the easiest to cut quickly. This was the experience of the United States in the 1990s.
- Kenya’s correction mechanism is a bit light. Under the Fiscal Management Act of Kenya, the Minister of Finance needs to submit a compliance report to the National Assembly, which shall state (a) the reasons why fiscal objectives and targets were not met; (b) the remedial measures being undertaken to ensure that objectives and targets not met will be made good in the next quarter; and (c) any proposed Government policy decisions that may materially affect the objectives and targets in the budget statement of intent or the country’s overall fiscal and economic performance.

Source: Schaechter and others 2012.

Fiscal Rule Framework for Lesotho

Designing a Fiscal Rule Framework for Lesotho

29. The following key characteristics of Lesotho’s fiscal situation should be considered when deciding what rules are suitable for the country (see Section 2):

- (i) The importance of safeguarding the exchange rate peg;
- (ii) The volatility of SACU transfers;
- (ii) The downward rigidity of spending: current spending is driven by a large public sector wage bill;

- (iii) Insufficient room for capital spending, which is nonetheless very large and inefficient relative to SACU peers;
- (iv) Weak institutional capacity, and
- (v) Political instability.

These factors suggest a rule that is (i) countercyclical, and (ii) easy to operate, (iii) easy to enforce.

30. The authorities are considering including requirements to set fiscal principles, objectives, and numerical targets in primary legislation. These are to be included in the pending Public Financial Management and Accountability (PFMA) Bill, with the definition of those principles, objectives, and targets left to either underlying regulations or the BSP. In a difficult political environment characterized by upward drift in spending and a reliance on large, uncertain external transfers, it is advisable not to define objectives and targets in primary legislation, since the deviations would risk undermining the credibility of such laws and/or incentivize off-budget activities or other creative accounting techniques/tricks to meet the words but not the spirit of the law.

31. Given the importance of political buy-in to successful fiscal rules, a rule can build on existing targets that have already approved by the Cabinet with some modest changes. Specially, this SIP considers:

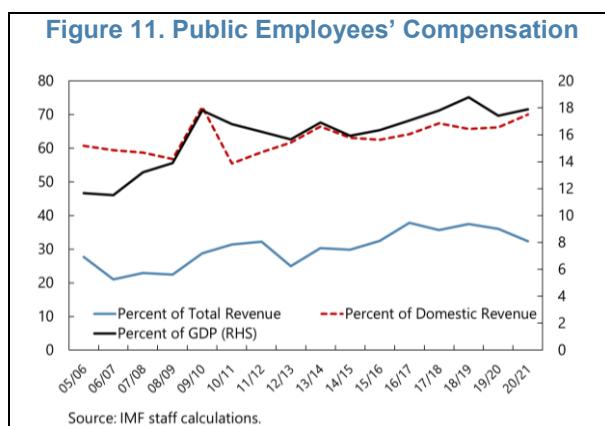
- **Some type of debt rule is necessary to safeguard the exchange rate peg.** The peg arrangement is an important nominal anchor and source of macroeconomic stability. Without debt sustainability, confidence in the peg will likely fade. To this end, the debt ceilings currently under the debt management framework can be converted into a fiscal rule, whereby the ceilings on total public debt, including guarantees, will be set at 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subject to an overall limit of 5 percent of GDP. The above should be set out in PFM regulations.
- **Some type of budget balance rule is also needed given that a solitary debt rule will be insufficient to guarantee fiscal discipline.** Debt levels take time to be impacted by budgetary measures and therefore do not provide clear short-term guidance for policy makers (Section 3). Here, we examine two options:
 - **Option A. Implement a structural balance rule.** Structural balance rules can be countercyclical and overcome the procyclicality of overall balance rules (Section 3). However, given the difficulty of estimating the structural balance for Lesotho, the overall balance excluding SACU transfers and external grants—the most cyclical components—could be a possible alternative to proxy for the structural balance. Assuming (i) SACU transfers and grants are expected to remain at around 14–16 and 2–3 percent of GDP, respectively, and (ii) a 3 percent overall balance is consistent with trend growth, a target overall balance excluding SACU and grants of around negative 20 percent of GDP could be a possible target. This target would have to be revisited at certain intervals as more information is available on the path of SACU transfers—which could change as SACU is integrated further into the African Continental Free Trade Area.

- **Option B. Implement an overall balance rule together with an expenditure rule.** SACU transfers are very volatile. When combined with rigid and steadily increasing spending, the overall balance will be both volatile and growing over time. To address the upward momentum (increasing) deficit over time, it will be necessary to include an expenditure rule that limits expenditure growth to less than nominal GDP growth or (current) expenditure to a certain percentage of GDP.

- **In addition, it is important to introduce a formal target for limiting domestic arrears to make the overall balance rule effective.** Arrears can be treated as an adjustor in calculating the budget balance. The budget balance should be adjusted upward (downward) by the amount of increase (decrease) of arrears.
- **Additional analysis should be undertaken to determine the most useful budget balance rule,** as well as to calibrate the appropriate numerical targets consistent with trend growth.

32. The above two rules could be complemented by two numerical targets to improve the quality of the spending. These targets could be set at the cabinet level such as in the BSP.

- Switch the wage bill target to a share of domestic revenue from a share of GDP. The benefits of setting the principle in this way are to avoid some of possible pro-cyclicality of a GDP-based target and to allow the target to be addressed via domestic revenue mobilization as well as by wage restraint. Over the past the decade, wage bill in domestic revenue has been increasing (Figure 11). The goal is to gradually reduce to and then not to exceed 60 percent of domestic revenue.



- Make the existing capital expenditure target explicit once fiscal position has been restored.

33. In a nutshell, given the nature of Lesotho's fiscal situation and characteristics of various fiscal rules, this SIP recommends two fiscal rules supplemented by two numerical targets to rationalize the composition of expenditures (Table 5). Once the fiscal position has been restored, the authorities could look again at the case for using a stabilization fund to manage volatility in SACU revenues.

Table 5. Lesotho: Suggested Fiscal Rule Framework

Rules/targets	Contents	Setting body
Introduce fiscal rule requirement	Establish requirements to set fiscal principles, objectives, and numerical targets	Parliament, primary legislation (PFMA)
Two fiscal rules		
Debt rule	The ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of [5] percent of GDP.	Parliament, e.g., PFM regulations
Option A: Structural balance rule (overall balance excluding SACU transfers and grants)	Reduce the structural fiscal balance (overall fiscal deficit excluding SACU revenue and grants) until it has increased above [-20] percent of GDP consistent with long-term growth trend. This target would have to be revisited at certain intervals as more information is available on the path of SACU transfers. Arrears should be treated as an adjustor to the efficacy of this rule.	Parliament, e.g., PFM regulations
Option B. Overall balance rule	Overall deficit below 3 percent of GDP plus total spending below a certain percent of GDP (to be calibrated).	Parliament, e.g., PFM regulations
Fiscal Targets		
Government deposits with the central bank	Ensure the level of government deposits with the central bank target for NIR.	Cabinet, e.g., BSP
Wage bill	Reduce the wage bill progressively until it has fallen to 60 percent of domestic revenues.	Cabinet, e.g., BSP
Capital expenditure	Once the fiscal position has been restored, consider setting an explicit target for capital or development expenditure (e.g., not to fall below "core" SACU transfers.).	Cabinet, e.g., BSP

A Roadmap to Introduce Fiscal Rules in Lesotho

34. Once the above fiscal rule framework has been agreed, next steps should include the following:

- a. Develop and enact PFM fiscal rule regulations that characterize the fiscal rules.**
 - **Include requirements to set fiscal principles, objectives, and numerical targets in primary legislation (notably, the new PFMA Bill) but leave the specification of those principles, objectives, and targets to PFM regulations.** In an unstable political environment, missing

targets that are specified in laws risk undermining the credibility of the legislation, incentivize off-budget activities, and encourage creative accounting to meet the letter but not the spirit of the law.

- **Calibrate the precise numerical fiscal targets** which are consistent with preserving debt sustainability and to safeguard the peg.

- b. Establish mechanisms to ensure fiscal policies are set consistent with fiscal rules.** Set up monitoring, transparency, and reporting arrangements to ensure fiscal outcomes are in line with fiscal rules.

- c. Define what should happen when rules are missed.**

- d. Ensure political buy-in.**

References

- Basdevant, O. 1993. "Fiscal Policies and Rules in the Face of Revenue Volatility within Southern Africa Customs Union Countries (SACU)." IMF Working Paper 12/93. International Monetary Fund, Washington, DC.
- Balassone, F. and D. Franco. 2000. "Public Investment, the Stability Pact, and the Golden Rule." *Fiscal Studies* 21(2): 207–29.
- Caceres, C., and M. Ruiz-Arranz. 2010. "What Fiscal Rule Would Work Best for the UK?" United Kingdom: Selected Issues Paper. IMF Country Report 10/337. International Monetary Fund, Washington, DC.
- Eyraud, L., X. Debrun, A. Hodge, V. Lledó, and C. Pattillo. 2018. "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability." IMF Staff Discussion Note No. 18/04. International Monetary Fund, Washington, DC.
- H. R. Davoodi, P. Elger, A. Fotiou, D. Garcia-Macia, X. Han, A. Lagerborg, W. R. Lam, and P. Medas. 2022. "Fiscal Rule and Fiscal Councils: Recent Trends and Performance during the Covid 19 Pandemic." IMF Working Paper No. 22/11. International Monetary Fund, Washington, DC.
- Honda J., F. Im, N. Koliadina, M. Morgan, M. Nose, C. Sosa Padilla, and J. Torres. 2017. "Fiscal Rules: Coping with Revenue Volatility in Lesotho and Swaziland." IMF African Departmental Paper. International Monetary Fund, Washington, DC.
- International Monetary Fund (IMF). 2009. "Fiscal Rules— Anchoring Expectations for Sustainable Public Finances." IMF Policy Papers. International Monetary Fund, Washington, DC.
- International Monetary Fund (IMF). 2018. "How to Select Fiscal Rules: A Primer" IMF Fiscal Affairs Department How-To Notes, No. 18/09. International Monetary Fund, Washington, DC.
- King, A. 2021. "Lesotho: Developing Fiscal Rules." IMF Fiscal Affairs Department, Technical Assistance Report. International Monetary Fund, Washington, DC.
- Ministry of Finance, Lesotho. 2021. "Budget Call Circular 2022/23–2024/2025 Budget Estimates." Maseru, Lesotho.
- Ministry of Finance and Ministry of Development Planning of Lesotho (2021), "2022/23–2024/25 Budget Strategy Paper." Maseru, Lesotho.
- Schaechter, A., T. Kinda, N. Budina, and A. Weber. 2012. "Fiscal Rules in Response to the Crisis. Toward the "Next Generation" Rules." A New Dataset, IMF Working Paper 12/187. International Monetary Fund, Washington, DC.
- Servén, L. 2007. "Fiscal Rules, Public Investment, and Growth." Policy Research Working Paper Series 4382. World Bank, Washington, DC.
- Tapsoba, R. 2012. "Do National Numerical Fiscal Rules Really Shape Fiscal Behaviors in Developing Countries? A Treatment Effect Evaluation." *Economic Modelling* 29(4): 1356–69.

Valencia, F. 2015. "Strengthening Mexico's Fiscal Framework." Selected Issues Papers. IMF Country Report 15/314. International Monetary Fund, Washington, DC.