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Fiscal Policy Rules and their Potential Benefits for Implementation in Lesotho

Prepared by:
Marethabile Hlaahla
Economist - GFS
Department of Research
Central Bank of Lesotho

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The views and opinions expressed in this article are those of the authors and do not necessarily reflect the official policy or position of the Central Bank of Lesotho (CBL).

1. Introduction

The instability in the public finances has recently drawn attention to fiscal arrangements such that most countries are committed to implementing different fiscal rules at different levels of government. The Kingdom of Lesotho is not an exception in this case. The revenues have been dwindling with the macroeconomic challenges experienced in the region. In particular, receipts from the Southern African Customs Union (SACU) have declined significantly, and thereby affecting total revenue. Consequently, public debt stock has been increasing, either due to the need to finance fiscal gap, or driven by the outstanding fiscal arrears. This has, therefore, called for adoption of prudent fiscal consolidation through mechanisms of fiscal policy rules. However, this is not the case of a hand a clove, where seemingly one could possibly determine which fiscal rule would be appropriate for Lesotho, given the current macroeconomic environment.

This paper seeks to highlight the fiscal policy rules that can be implemented in Lesotho and suggests conceivable benefits. The following sections will be elaborated in detail in this paper: definition of the fiscal policy rules, experiences of other countries on fiscal policy rules implementation and the conclusion and the recommendations.

2. Definition of Fiscal Policy Rules

The fiscal policy rules are fiscal management instruments that pressurize decisions on fiscal policy. They can be in the form of numerical and/or procedural fiscal policy rules which are fixed for a predetermined timeframe (Bova et al, 2015). For instance, some can be binding for a minimum period of three years. The European Commission (2015) pointed out that these rules are used to strengthen the fiscal governance of a country. They aim to aggregate fiscal discipline and macroeconomic stability, as evidenced by Kirchner (2013).

According to the International Monetary Fund (IMF, 2015) **the numerical fiscal policy rule** is defined as a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. There are four types of numerical fiscal policy rules:

i) budget balance rule;
ii) debt rule;
iii) expenditure rule; and
iv) revenue rule.

These fiscal policy rules encourage fiscal discipline that lead to debt sustainability. They have numerical targets on public finance aggregates covering at least central government, as a minimum level of government. Only de jure numerical fiscal policy rules are considered.

The procedural fiscal policy rules are rules that define the features and collaboration of participants in the budget process through effective fiscal management, transparency and accountability (IMF, 2015). They support the implementation of numerical fiscal policy rules, as such, need to be addressed first for numerical rules to be effective. They are usually embodied in the sound processes and systems of public financial management framework (Corbacho and Ter-Minassian, 2013). Examples include adoption of medium term expenditure framework, establishment of a buffer or stabilization fund, and adoption of international standards.

In general, the fiscal policy rules **(numerical and procedural)** contain various characteristics, which can serve different fiscal goals. They are characterised by their coverage and legal status. Consequently, they can be adopted by sub-national or national governments in different forms, such as, commitment, legislation, constitutional, or in the form of international treaties. These are mostly implemented by low-income countries, emerging market economies and advanced economies. Some countries deliberately legislate them in order to adopt legal binding fiscal policy rules through the fiscal responsibility laws, or constitutional amendments, in addition to the

international agreements (IMF, 2015).

3. Experiences of Other Countries

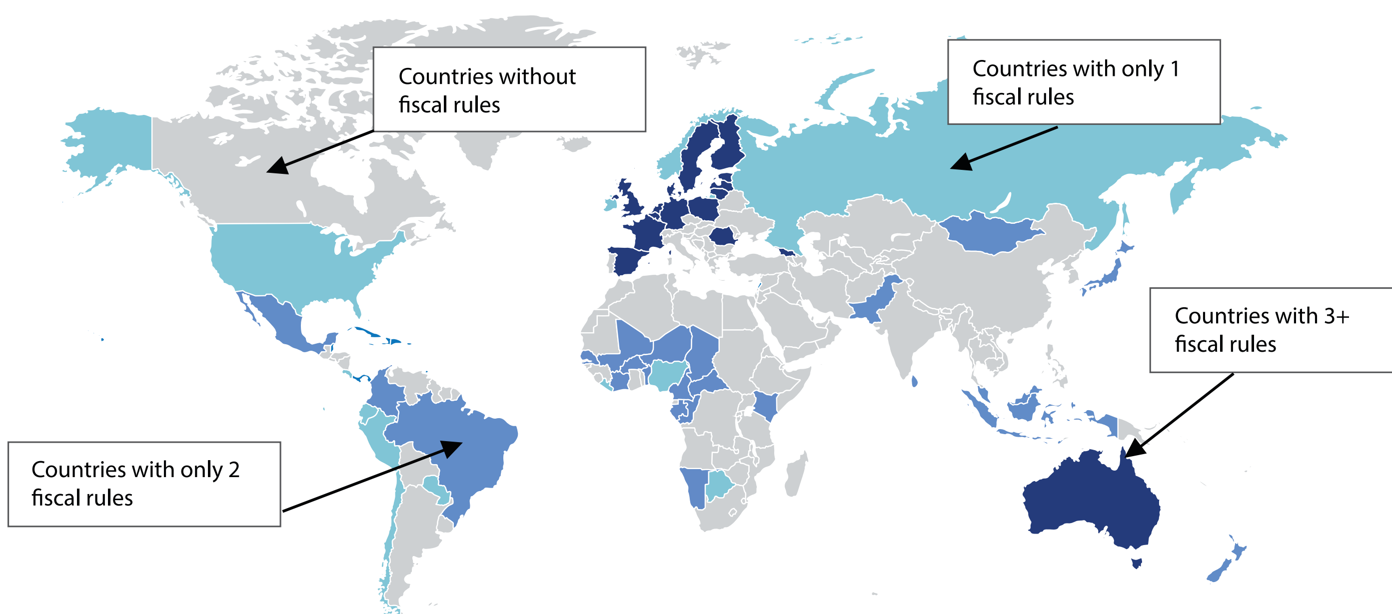
It is estimated that about 89 countries established at least one fiscal policy rule since 1985, either in the form of numerical or procedural rule. Regionally, Botswana and Namibia are the only SACU representatives that have, at some stage, adopted the fiscal policy rules (IMF, 2015).

The first countries to adopt numerical fiscal policy rules were Australia, Germany, Indonesia, Japan, Malaysia, and Singapore. Unlike the other five countries, Australia abandoned the fiscal policy rules for a period of 10 years between 1988 and 1998. As a result, the fiscal positions drastically deteriorated and negatively affected her credit ratings (IMF, 2015).

Kenya adopted the numerical fiscal policy rules in 1997, specifically targeting two such, debt rule; and revenue rule at national level. These enabled Kenya to maintain revenue to GDP ratio of 21 - 22 per cent on average since their adoption to date. However, the debt rule was left flexible to, amongst others, facilitate financial market development. Nonetheless, the debt indicators remained sustainable throughout the period. Though Kenya did not implement expenditure rule, it however, experienced weak co-movements between GDP and expenditure since fiscal policy rules involve very complicated administrative, institutional and political dimensions (IMF, 2015).

Out of 54 African countries as mentioned earlier, only 21 countries adopted and implemented numerical fiscal policy rules. However, none of these countries adopted more than two of fiscal policy rules. Figure 1 illustrates countries, which implemented fiscal policy rules while Table 1 is for those that only implemented the numerical rules.

Figure 1: Implementation of Fiscal Policy Rules by Countries in 2015



Source: IMF Fiscal Rules Database (2015)

Table 1: Number of Countries which adopted numerical fiscal policy rules as of 2014

	2014			
Countries	**3+ rules**	**2 rules**	**1 rule**	**Rules recently abandoned - targets remaining**
Advanced countries	13	13	4	2 (Canada & Iceland)
Emerging countries	7	13	11	2 (Argentina & India)
Low income countries	0	18	5	1 (Maldives)
African countries	0	16	5	0
SADC member states (Botswana, Republic of Congo, Namibia)	0	2	1	0
SACU member states (Botswana, and Namibia)	0	1	1	0

Source: IMF website (2015)

4. Benefits and Drawbacks of Fiscal Policy Rules Implementation

In 2013, Corbacho and Ter-Minassian further depicted that the adoption of fiscal policy rules instil fiscal discipline which translates into healthy fiscal positions and sustainable debt levels. This is demonstrated by the improved fiscal performance, leading to consolidation and adjustments. A more fiscal discipline has been experienced in terms of national fiscal policy rules at central government in a number of countries that adopted them. Moreover, strong legal-rule based and strict enforcement impact positively on fiscal performance.

For example, Australia increased revenue and contained expenditure growth to improved fiscal deficit. This also saw public debt levels being more sustainable due to implementation of fiscal policy rules. It must, however, be emphasised that this was made possible by legislating the adoption of the rules, the results of which was fiscal consolidation (Bova et al, 2015).

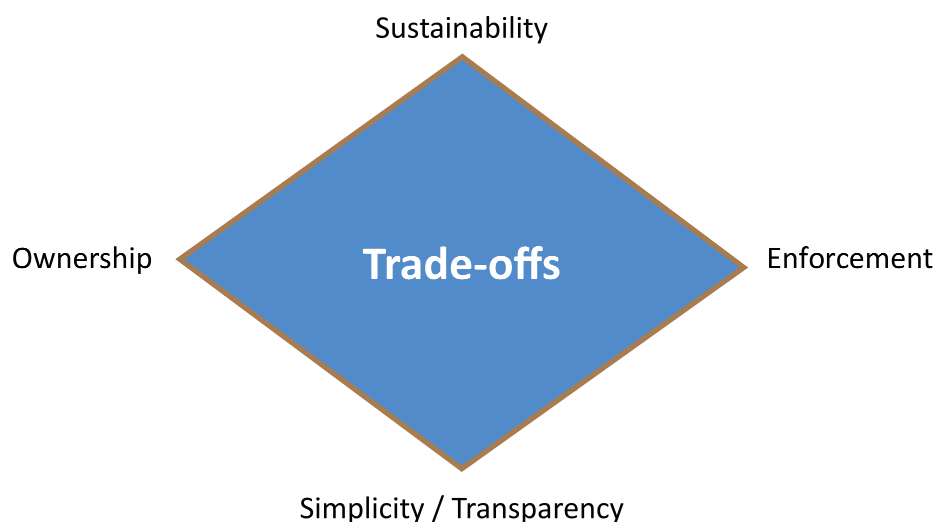
It can, therefore, be concluded that fiscal policy rules aid improvement of credit worthiness, confidence in the financial markets, and policy credibility.

It must, however, be noted that adoption of the fiscal policy rules has some gains and losses. For instance, government may not be able to use fiscal policy to contain inflationary pressures, neither can it be used for expansionary policy. *This means that during the economic downturn, the government will not be flexible to reverse the economy due to the rules and as a result, any abandonment of the rule may result in loss of fiscal policy credibility and investor confidence.*

These benefits and drawbacks form the basis from which countries willing to implement fiscal policy rules can draw lessons from including Lesotho with its current macroeconomic volatility where there is declining revenue, accumulating external debt and increasing unemployment.

More countries are operating with more than one numerical fiscal rule. This helps to mitigate the problems of individual rules. More countries are adopting rules that provide flexibility to deal with the ups and downs of the business cycle. More countries, as portrayed by Kirchner (2013), are strengthening enforcement mechanisms, including through the use of automatic correction mechanisms (debt brakes). Thus, there is a diverse list of trade-offs, including enforcement of fiscal rules, and with it, the fiscal policy may be sustainable in the long run.

Figure 2: The trade-offs of fiscal rules



5. Conclusion and Recommendations

Fiscal policy rules may be desirable for a small economy with limited scope on macroeconomic management. However, this have to be legislated for ease of adoption and clarity in roles and responsibilities.

There is a need to implement fiscal policy rules in Lesotho, ideally a combination of both numerical and procedural fiscal policy rules to mitigate ambiguity. Successful implementation of fiscal policy rules may facilitate attainment of fiscal consolidation through increased and or stable revenue streams, and managed expenditure that yields a healthy fiscal position. The adoption of the core principles (accountability, transparency, and stability) of fiscal management through statutory instruments, like fiscal responsibility frameworks may improve credibility.

Moreover, adoption of the fiscal rules may be in phases from short, medium and long-term fiscal strategies to enable improvement during implementation. The country further needs to maintain and regularly communicate fiscal and economic updates (for example, economic and fiscal outlook report, five-year fiscal sustainability report, and budget outcome report) to increase fiscal transparency and accountability so as to ensure that public is well informed of fiscal debates.

This article has benefited from the following:

1. Bova, E., Kinda, T., Muthoora, P., and Toscani, F. April, 2015. Fiscal Rules at a Glance. International Monetary Fund Background Paper, Washington D. C.
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3. Corbacho, A., and Ter-Minassian, T. (2013). “Public Financial Management Requirements for Effective Implementation of Fiscal Rules” The International Handbook of Public Financial Management ed. Richard, A., Hemming, R., and Potter, B. H. Palgrave Macmillan, 2013, 37-46 pp
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5. Kirchner, S. (2013). December, 2013. “Target30 Reducing the Burden for Future Generations” Strengthening Australia’s Fiscal Institutions. The Centre for Independent Studies, Australia

Central Bank of Lesotho, Corner Moshoeshoe
and Airport Roads, Maseru 100