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## Medium-Term Budgetary Frameworks – Lessons for Austria from International Experience

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**IMF Working Paper**

European Department

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**Abstract**

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The Austrian government is about to introduce a new fiscal management framework. The first step is to introduce a medium-term budgetary framework, including an expenditure rule. The paper focuses on this first step. The purpose is to describe and evaluate the Austrian model in light of other countries' experiences with their frameworks. An attempt is made to identify features that have proven to be effective elsewhere and that can be applied to the Austrian case. The paper also identifies potential challenges and possible trade-offs when implementing the framework.

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## I. INTRODUCTION

Austria is about to implement a medium-term budgetary framework (MTBF). An MTBF is broadly defined here as a framework that regulates policymakers' formulation and implementation of medium-term/multiyear fiscal policies. It may or may not include a fiscal policy rule that sets numerical restrictions on key fiscal policy objectives. The purpose is to promote fiscal discipline and address fiscal vulnerabilities through increased transparency, stronger accountability, and a more pronounced medium-term perspective. Many industrial countries, including in the EU (e.g., the Netherlands and Sweden), now have explicit MTBFs in place. There are also countries (e.g., Denmark) whose governments, while not formally having adopted such a budgeting framework, are setting and formulating fiscal policies along similar lines.

This paper sets out to describe the Austrian framework, set to apply to the 2009 budget and onwards, and to assess it in light of the experience of other countries. Although track records are mixed, the experiences with MTBFs elsewhere have been favorable. However, the exact designs differ across countries and the effects on fiscal policy outcomes are difficult to isolate. A key angle of this paper is to attempt to identify particular characteristics of other countries' frameworks that have been effective and that can be applied to Austria. Equally important will be to highlight aspects that have caused or could cause problems, as well as possible trade-offs that could arise when setting up a framework.

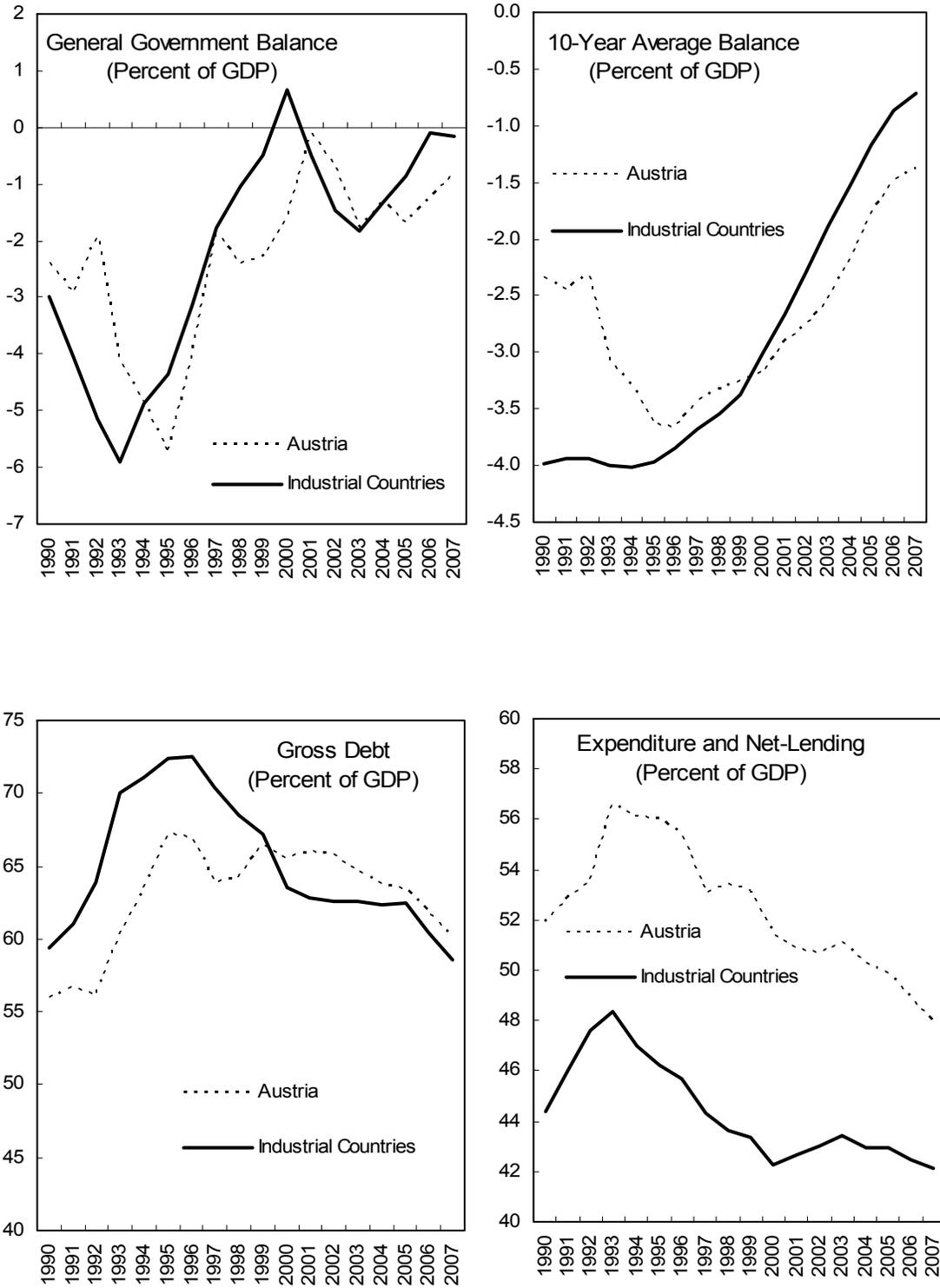
The paper is organized as follows. The next section describes the basic motivations for budgetary reform in Austria and outlines the principal characteristics of its MTBF. Section III turns to the international experience, outlining the main motivations for MTBFs in practice, assessing their general effectiveness, and identifying what has worked, what has caused problems, and what the possible trade-offs are. Section IV draws on the experience of other countries to suggest implications for Austria. The Appendix provides a brief overview of MTBFs in a selection of industrial countries.

## II. THE AUSTRIAN MEDIUM-TERM BUDGETARY FRAMEWORK

There is broad political support for the Austrian framework. There are various reasons for this, including the following:

- An MTBF could promote medium-term-oriented fiscal policies with an emphasis on the expenditure side, and on disciplined execution to avoid persistent fiscal deficits and debt buildup. Public expenditures are high, at almost 50 percent of GDP, and the

Figure 1. Austria: Fiscal Developments, 1990-2007\*

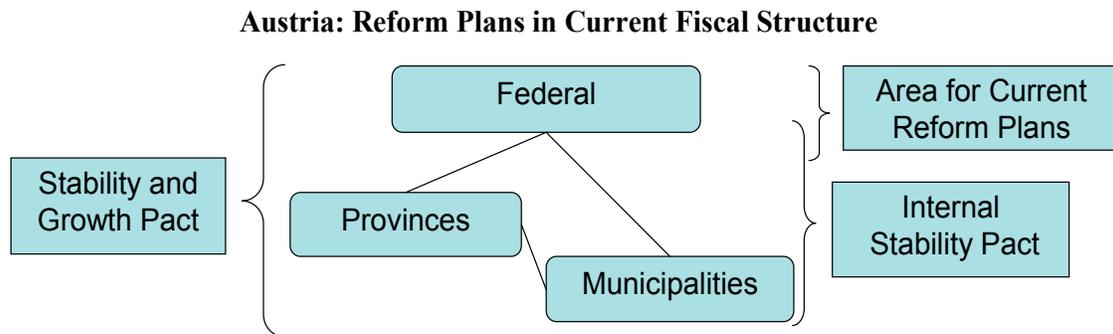


Source: October 2007 World Economic Outlook.

general government budget has only reached balance once since the early 1970s (see Figure 1).<sup>2</sup>

- An MTBF could help achieve the goal of budget balance over the cycle for the general government. This objective was clearly stated in the January 2007 Government Program.
- An MTBF, with a focus on expenditures, would be useful because there is limited room for fiscal consolidation through higher taxes, inter alia due to increased international economic integration.

The current reforms of the Austrian budgeting framework focus on the federal government (see chart below). General government public finances are already restricted by Austria's commitments through the Stability and Growth Pact (SGP) as a euro area country. The finances of lower-level governments and their fiscal relationships with the federal level are regulated by the Internal Stability Pact and the Revenue-Sharing Act (see Box 1).



A law establishing an MTBF has been passed and was published in the federal gazette in January, 2008. The new law will first apply to the 2009 budget. The basic outline is as follows:<sup>3</sup>

- The constitution declares sustainable government finances and macroeconomic equilibrium as general objectives.

<sup>2</sup> The cut-off date for most data included in this paper was end-2007; data are mostly based on the WEO, October, 2007.

<sup>3</sup> Austrian Federal Ministry of Finance (2005 and 2007).

- The MTBF applies to the expenditure side, covers four years, and will be rolled forward by one year every spring. The expenditure ceilings for individual ministries would be binding the first year, while the ceilings for the last three years would be indicative.
- There will be two types of expenditure ceilings: (i) cyclically sensitive expenditures will be set by parameters; and (ii) other expenditures will be fixed in nominal terms.
- To set strategic expenditure priorities, expenditures will be broken down by individual policy areas and subsequently allocated among ministries.

#### **Box 1. The Austrian Internal Stability Pact and the Revenue Sharing Act\***

There are three key levels of government in Austria: federal, provincial, and municipal. Government finances are characterized by intergovernmental coordination and dispute-settling mechanisms. The framework for expenditure responsibilities and taxing powers is laid out in the constitution. As in most federations, the bulk of tax revenues is collected at the federal level, while spending is more decentralized and funds are transferred vertically.

Since 1999, fiscal policies at the three levels of government are coordinated through two medium-term agreements:

The Revenue-sharing agreement (Finanzausgleich) regulates the transfers to subnational governments. Federal revenues are distributed among subnational governments based mainly on the size of their population, with some adjustments made in favor of larger municipalities and provinces with per capita revenue below the national average. The agreement becomes federal law, the Fiscal Equalization Law (Finanzausgleichgesetz).

The Austrian Stability Pact is an internal stability pact established in line with the euro area SGP. It allocates to each province and to the whole of the municipalities annual budget surplus targets measured as a ratio to GDP. Only small annual deviations from the targets are allowed (0.15 percent of GDP for the states; 0.10 percent for the municipalities), and any deviation has to be made up for in the following years. The pact becomes law after ratification by the federal and provincial parliaments. If the targets are breached, penalties apply.

Generally, there is scope to provide better incentives for efficient fiscal management through closer matching of spending and financing responsibilities. Rationalizing intergovernmental fiscal relations would require steps that realign spending and financing responsibility, strengthen accountability, streamline the functions of various levels of government, and generate savings.

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\* See also Diebalek, Köhler-Töglhofer, and Prammer (2005), Schratzenstaller (2005), and Fuentes, Wurzel, and Wörgötter (2006)

The budgetary reforms do not include rules governing lower-level government budgets and their relationship with the federal government. The Austrian Internal Stability Pact that sets budgetary balance targets for the states and the municipalities for the medium-term is already in place and could be a good basis to build upon for a closer linkage between the MTBF for the federal government and the medium-term budgets for states and municipalities. This will

be very important as expenditures at the subnational level account for about one third of all public spending.

There is no explicit provision in the proposal for a balanced budget over the cycle. The SGP, which Austria is subject to as a euro area country, does stipulate limits and reference values for overall budget balances and public debt levels.<sup>4</sup> The MTBF does not include a requirement to conduct and incorporate a long-term fiscal sustainability analysis in order to ensure consistency between medium-term policies and long-term outlooks. Finally, there is no explicit error-correction mechanism that would apply in case actual budget outcomes are significantly different from the budgets. However, deviations are to be corrected in the annual updates of the framework.

Further budgeting reform is set to be implemented together with the MTBF. This will be more time-consuming, taking at least four–five years to fully implement. Four major “principles” of budgeting are planned to be implemented:

- (i) *Performance budgeting*, implying a shift away from the prevailing input-orientated budgeting to the more direct linking of expenditures to objectives.
- (ii) *Transparency*, encompassing the current principles of budget transparency, the exhaustiveness of the budget, unequivocal assignments of responsibility in the budgetary process, and the provision of timely information on the execution of the budget.
- (iii) *Efficiency*, applying to all forms of government activity with a focus on the spending of budgetary resources.
- (iv) *Accuracy in representing the financial situation of the federal government*, implying sophisticated systems of budgeting, accounting, and reporting.

### III. MEDIUM-TERM BUDGETARY FRAMEWORKS IN OTHER COUNTRIES

MTBFs regulate policymakers’ formulation and implementation of multiyear fiscal policies to support fiscal discipline, address fiscal vulnerabilities, and promote efficient use of public resources. The design differs substantially among countries, but generally MTBFs address these objectives in two ways: through (i) fiscal responsibility principles guiding policy formulation, objectives, reporting, and analysis; and (ii) numerical fiscal policy rules for key variables, such as total expenditures and the overall medium-term budget balance. Most, if not all, MTBFs include elements of both, and numerical fiscal policy rules are often a key reflection of the principles of fiscal responsibility.

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<sup>4</sup> See, e.g., Annett, Decressin, and Deppler (2005) and Morris, Ongena, and Schuknecht (2006).

### A. Why Have Countries Introduced MTBFs?

MTBFs and fiscal policy rules have generally been introduced when the need to discipline fiscal policy was strong. The most common trigger has been a period of persistent fiscal deficits and debt buildup. Often, the deficits were caused by an underlying trend of expenditure growth, and an important motivation for introducing an MTBF has been to better control public expenditures (e.g., in New Zealand and the Netherlands). Political economy factors and weak fiscal management often result in procyclical policies and a deficit bias.<sup>5</sup> An economic or financial crisis can also be a trigger, making it politically easier to adopt a framework as the potential benefits of conducting strong fiscal policies become apparent. Long-term fiscal sustainability considerations and a desire to make room for tax cuts through disciplined expenditures are other reasons for introducing MTBFs.

Fiscal sustainability concerns, including those generated by emerging demographic pressures, have also been important as motivation in some countries. When Switzerland introduced its “debt-brake” framework in 2003, the main objective was to control the level of debt. It was not very high at the time but had been on an increasing trend in the 1990s and rising pressure from an aging population made it necessary to arrest the growth in debt.<sup>6</sup> Sweden was also expecting fiscal sustainability pressures from aging and adopted an explicit fiscal surplus target of 2 percent of GDP over the business cycle for this reason. The Australian *Charter of Budget Honesty Act 1998* requires long-term analyses and considerations, and New Zealand amended its framework in 2004 to explicitly include long-term sustainability concerns.

Creating room for tax cuts can also be an important reason for adopting a framework to control spending. Countries that aim at lowering their tax rates (or prevent increases) generally need to curb growth in public expenditures; a medium-term budgetary framework can therefore be an important ingredient in a tax reform strategy.

### B. The General Experience with MTBFs

The experience with these types of frameworks is still limited, as most of them have been introduced only quite recently. In particular, relatively few frameworks have been tested across business cycles. Five industrial countries with some formal MTBF in place before 2000 have been studied more closely for this section: Australia, New Zealand, the Netherlands, Sweden, and the United Kingdom. In addition, two more countries in which formal frameworks are not in place, but where governments have been setting and formulating fiscal policies along the lines of an MTBF have been analyzed as well: Canada and Denmark.

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<sup>5</sup> See, e.g., Jaeger (2001).

<sup>6</sup> See Danninger (2002).

Fiscal developments in Australia and New Zealand suggest that their frameworks, with an emphasis on transparency and public clarity, have been effective (Figure 2). In 1994, New Zealand adopted its the Fiscal Responsibility Act, which legislated budgetary principles of transparency and mandatory short-, medium-, and long-term plans. The act has a clear emphasis on budgetary principles rather than specific numerical targets. In 1998, Australia adopted the *Charter of Budget Honesty Act 1998*, which has a similar emphasis on legislated budgetary principles.<sup>7</sup> Since these frameworks were introduced, both countries have been running fiscal surpluses, and debt levels have been reduced. New Zealand's public gross debt has decreased quite dramatically since the mid-1980s and is now well below the average for industrial countries. Australia, while already in a better position, has still seen further debt reductions, and net public debt turned negative in 2006.

The relatively strong fiscal performance of the Netherlands and Sweden, in particular in the second half of the 1990s, explains why these two rules-based MTBFs have received much attention (Figure 3). The Netherlands has had its medium-term expenditure framework in place since 1994, and Sweden adopted its medium-term expenditure framework in 1997. Both frameworks were initially seen as successful, with narrowing budget deficits, eventually turning into surpluses. In the early 2000s, both countries ran into problems. The Netherlands' fiscal position deteriorated and recorded substantial deficits for a few years, which prompted a reform of its fiscal framework to treat revenue windfalls more restrictively. Sweden managed to perform relatively well, recording only small deficits in 2002 and 2003; however it is still lagging in terms of reaching the target of a 2 percent surplus on average.<sup>8</sup>

The framework in the United Kingdom is generally regarded as having been successful in containing discretion and allowing automatic stabilizers to work (Figure 4).<sup>9</sup> In 1998, the United Kingdom introduced the “golden rule” and the “sustainable investment rule” as the cornerstones of its fiscal policies. The government is allowed to borrow only for investments, and the average current position should be balanced or in surplus over the cycle. The formulation of the golden rule “over the cycle” gives rise to two potential complications: the uncertainty surrounding the dating of the cycle and risk of procyclicality in the event of asymmetric cycles. Nevertheless, the framework is considered to have worked well overall.

Canada and Denmark both have strong fiscal policy track records that have been guided by clearly explained medium-term oriented policies (Figure 5). Neither Canada nor Denmark has formal frameworks regulating how medium-term fiscal policies should be formulated or

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<sup>7</sup> See Australian Treasury (1998) and Simes (2003) for Australia; and for New Zealand, see New Zealand Treasury (1996), Janssen (2001), and IMF (2005).

<sup>8</sup> For the Netherlands, see Blöndal and Kromann-Kristensen (2002), Tijsseling and van Uden (2004), and Hofman (2005). For Sweden, see Annett (2003) and Balassone (2005).

<sup>9</sup> See, e.g., Koeva (2005), Honjo (2007), and IMF (2007b).

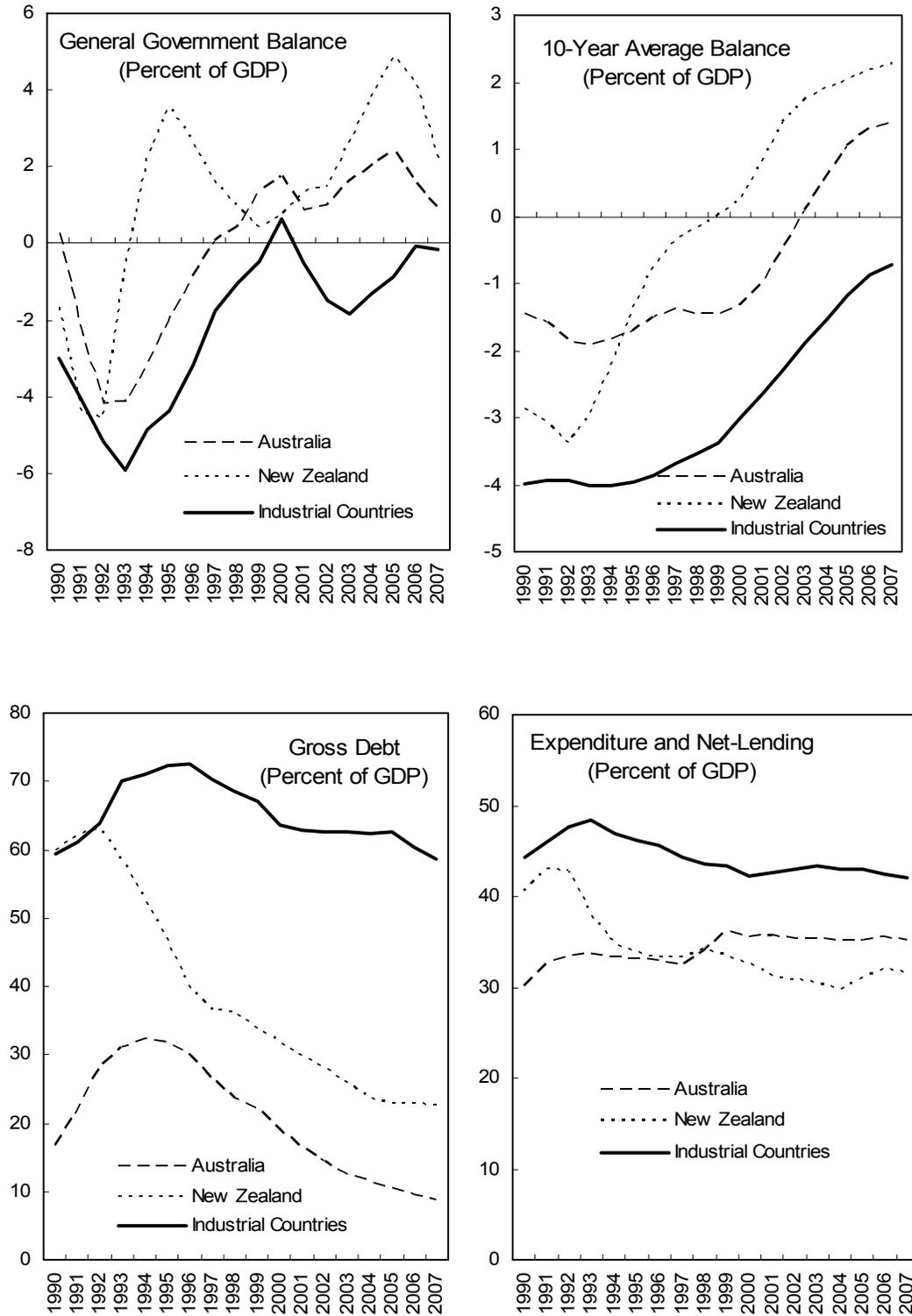
reported. However, in practice both countries have implemented important elements of fiscal responsibility principles, and medium-term-oriented fiscal policies and objectives have been in place since the 1990s.<sup>10</sup> Both countries now stand out as having had prolonged periods of strong fiscal performance, characterized by fiscal surpluses and falling debt. Canada has also been able to reduce its expenditure level faster than many other industrial countries. Public expenditure is now below 40 percent of GDP, down from over 50 percent of GDP in the early 1990s.

Overall, the fiscal performance of countries with MTBFs has been relatively strong (Figure 6). Moreover, among countries with similarly strong track records, four countries (Belgium, Finland, Spain, and Switzerland) now have MTBFs in place. High economic growth could potentially explain the better fiscal balances recorded for these countries. However, comparing the average fiscal balances against the average growth rates during the period 1998-2007 suggests that most countries with MTBFs have had stronger fiscal balances than could have been expected given GDP growth (Figure 7). However, the many other factors that affect fiscal outcome make it difficult to isolate the effects of institutional arrangements. The conclusion is therefore confined to noting that simply studying the fiscal track records of countries with MTBFs in place suggests that such frameworks can contribute to prudent fiscal policies.

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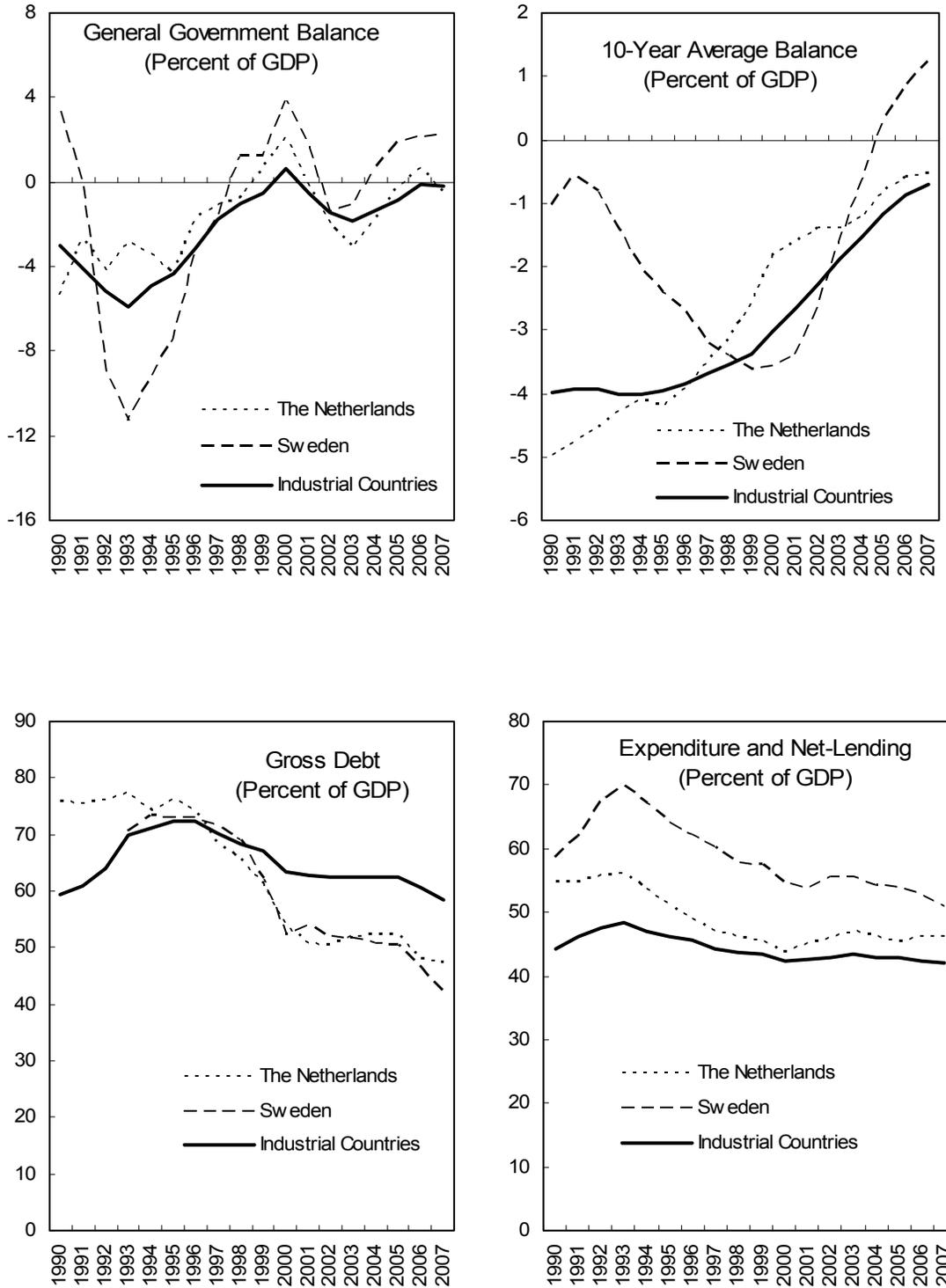
<sup>10</sup> See OECD (2004 and 2006) for a description and analysis of the framework in Canada; for Denmark, see Eskesen (2002).

Figure 2. Australia and New Zealand: Fiscal Developments, 1990-2007



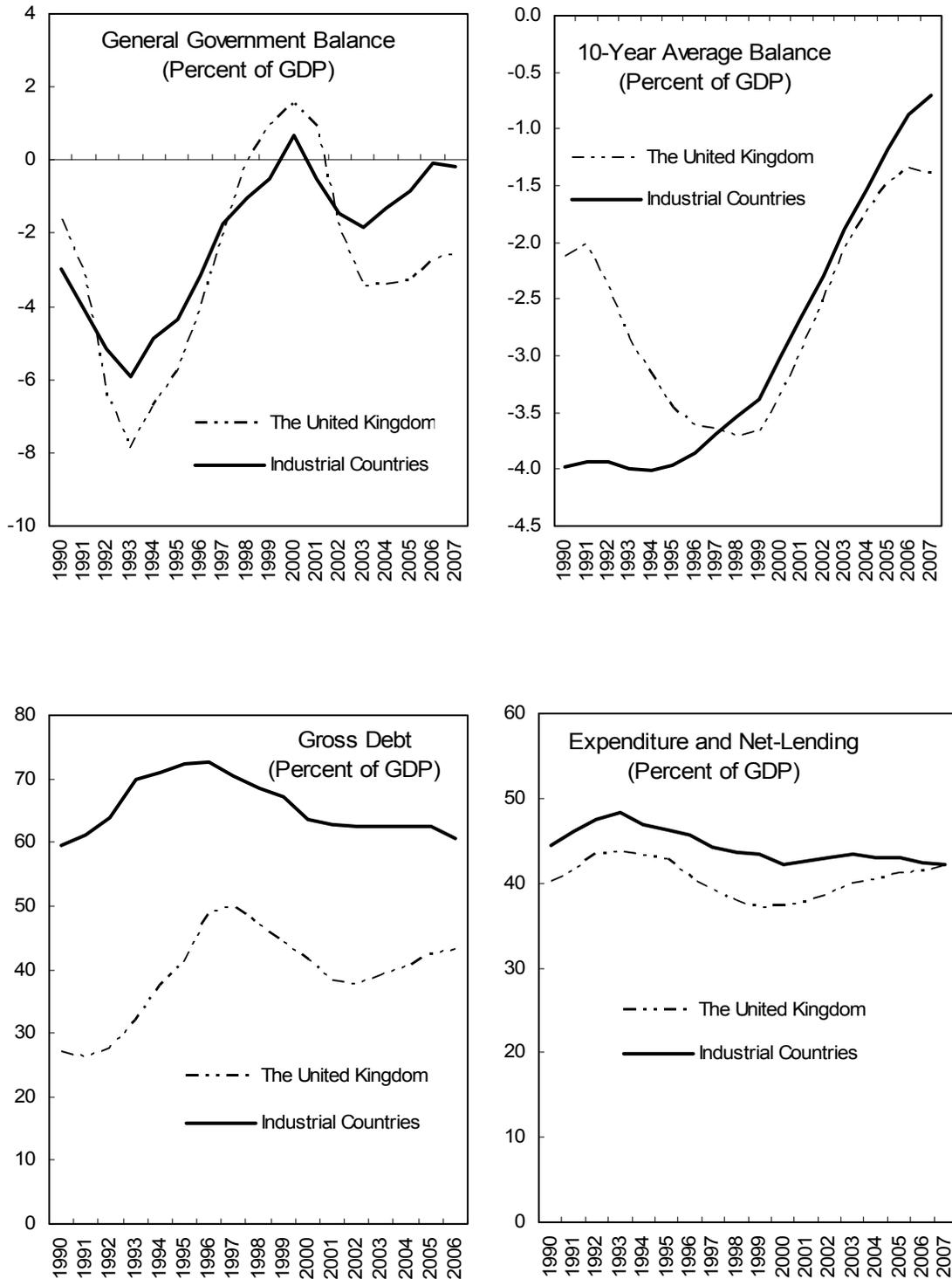
Source: October 2007 World Economic Outlook.

Figure 3. The Netherlands and Sweden: Fiscal Developments, 1990-2007



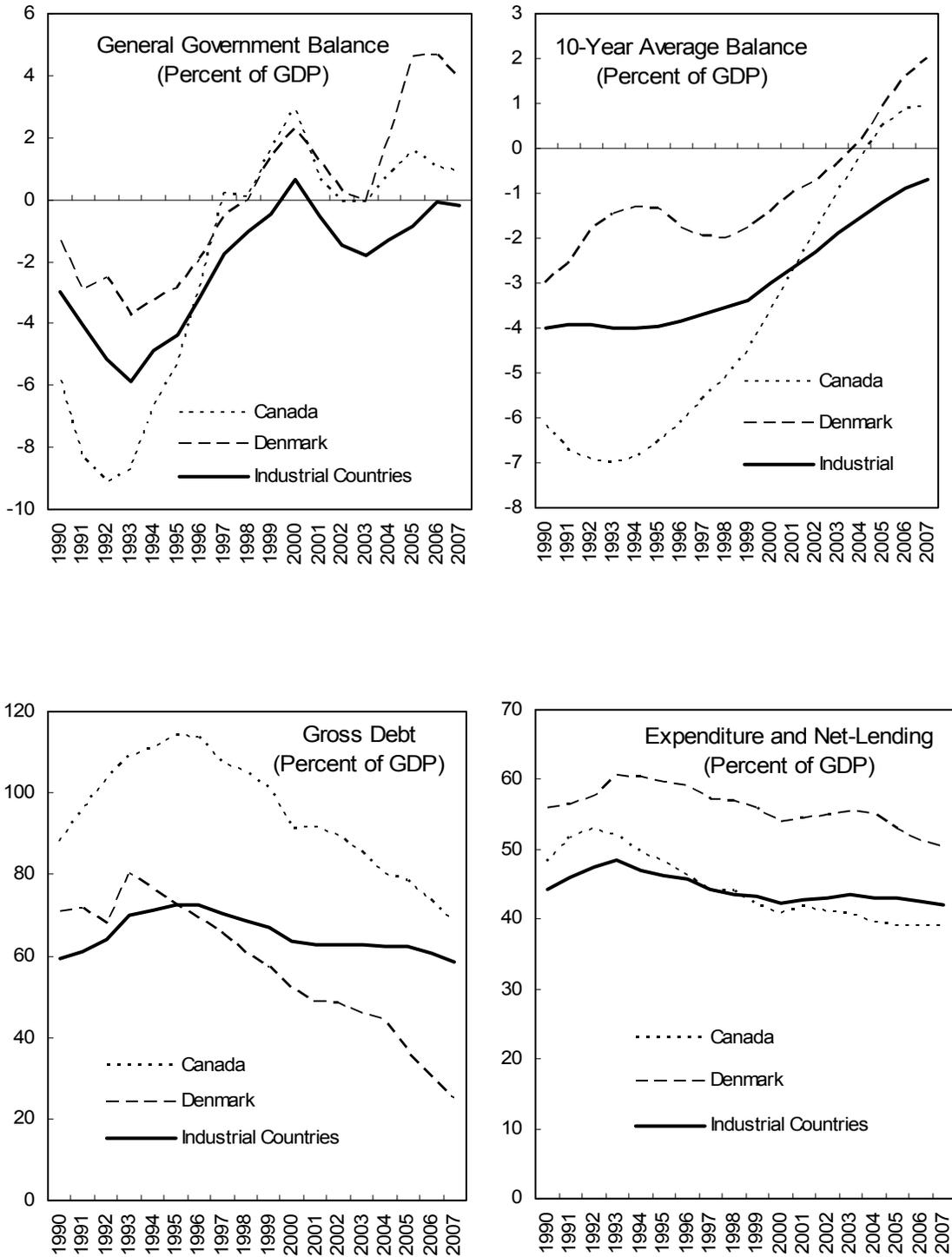
Source: October 2007 World Economic Outlook.

Figure 4. The United Kingdom: Fiscal Developments, 1990-2007



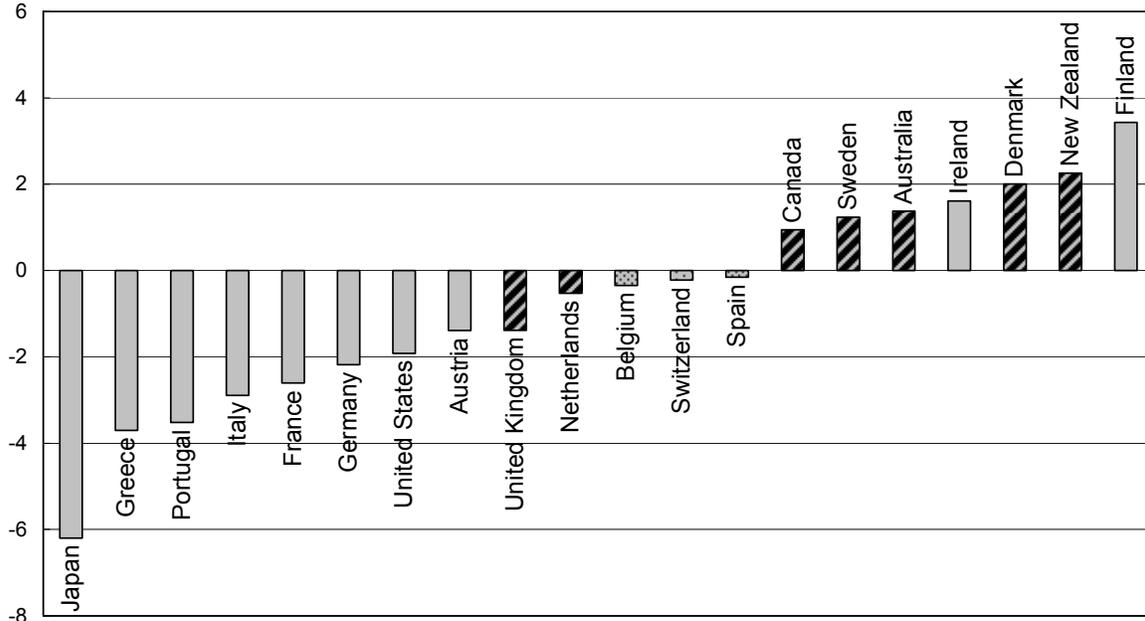
Source: October 2007 World Economic Outlook.

Figure 5. Canada and Denmark: Fiscal Developments, 1990-2007



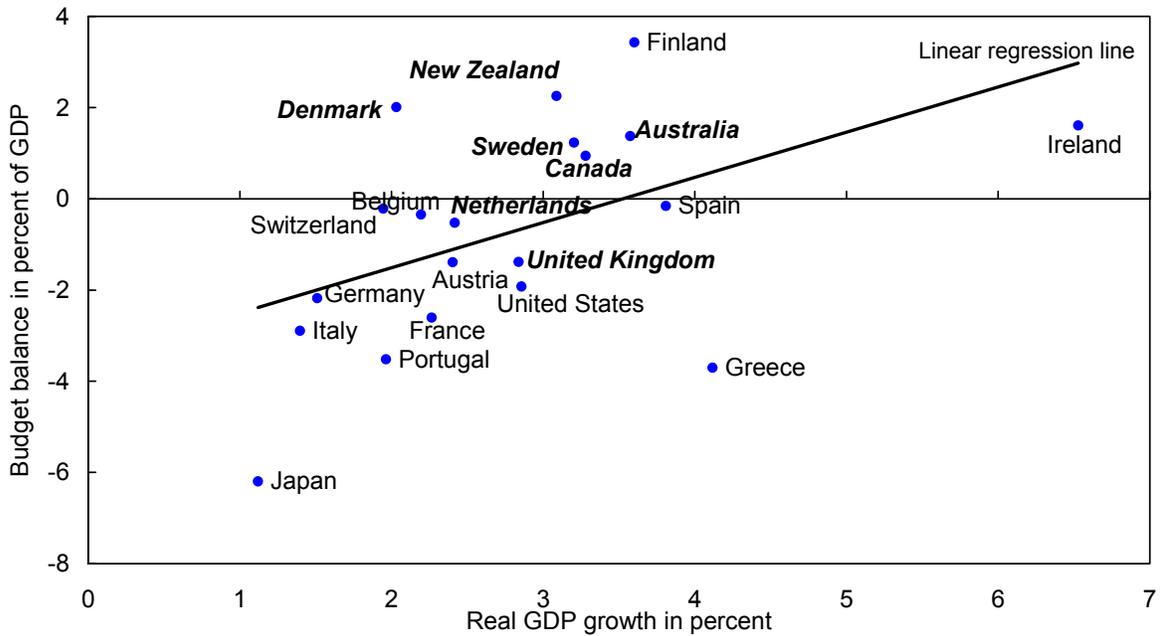
Source: October 2007 World Economic Outlook.

Figure 6. Selected Industrialized Countries' General Government Balance 1/  
(Percent of GDP, 10-year Average, 1998-2007)



Source: IMF, October 2007 World Economic Outlook.  
1/ Striped bars indicate countries with an MTBF before 2000, as discussed in this chapter. Dotted bars indicate countries which adopted an MTBF more recently.

Figure 7. General Government Balances and GDP Growth Rates 1/  
(10-year Averages, 1998-2007)



Source: IMF, World Economic Outlook.  
1/ Bold italics indicate countries with an MTBF before 2000, as discussed in this chapter.

## **C. Key Aspects of the Experience of Other Countries**

### **Transparency, public clarity, and accountability**

Transparency and public clarity are key. Australia's and New Zealand's MTBFs have helped promote spending control and sound fiscal policies in general. In both these frameworks, the emphasis is on transparency, public clarity, and legislated principles of fiscal management, as opposed to specific numerical targets. Policy objectives have to be clearly defined and motivated, and put in the context of strategies for the short, medium, and long term, prompting the government to thoroughly address a broad range of crucial and sometimes difficult fiscal policy issues. In such a setting, where fiscal policy objectives and strategies are clearly defined, significant deviations will be apparent and have high reputation costs, which is likely to be an important incentive for policymakers to adhere to the framework.

Accountability will be strengthened by clearly stating fiscal policy objectives and formulating them within government terms.<sup>11</sup> Some fiscal policy objectives and commitments have to cross term limits, but, clearly, a new government will feel less obliged to follow fiscal policy plans adopted by a previous government unless these enjoyed broad political support. A focus on government terms is also consistent with an MTBF used as a basis for concrete policy negotiations and coalition agreements, as for example in the Netherlands and Finland.<sup>12</sup>

### **Building credibility**

Establishing a strong track record early on builds credibility. It shows commitment, demonstrates that the MTBF works, and increases the political cost for deviations in the future. The political damage for a government from letting fiscal policy deviate significantly from a framework is arguably heavier in countries with good track records than in countries with a pattern of frequent and persistent deviations. An example is the Netherlands, where the initial success appears to have helped establish the MTBF as a given in the minds of Dutch voters and economic policymakers.<sup>13</sup>

### **Broad based fiscal reform**

For MTBFs to be successful, they need to be supported by reform of budget management and budgetary institutions in general. The experience of the Netherlands shows the importance of broad-based budgetary reform, where the government now is in the process of gradually

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<sup>11</sup> This is the case in, e.g., Australia, Finland, the Netherlands, and New Zealand.

<sup>12</sup> For Finland, see Finland Ministry of Finance (2005).

<sup>13</sup> See, e.g., Hofman (2005).

implementing performance based budgeting. Sweden has also reformed its fiscal management principles, which arguably have been instrumental in the relative success of its expenditure rules-based fiscal framework.<sup>14</sup> In New Zealand, the Fiscal Responsibility Act was introduced to formalize a successful reform of fiscal management that had already improved the fiscal situation.

### **Long-term perspective**

Long-term analyses as an integral part of short- and medium-term fiscal policy can strengthen an MTBF. Placing fiscal policy goals and rules in a long-term perspective to ensure fiscal sustainability may shore up public support and, thereby, credibility. In addition, if fiscal plans and rules are not firmly based on long-term analyses, there is a risk that long-term pressures will lead to fiscal difficulties, even if plans and rules are adhered to. In both Sweden and Finland, medium-term fiscal policies are based on long-term analyses, which heighten public understanding of fiscal policies framed by fiscal policy rules. Another example is New Zealand's Fiscal Responsibility Act under which continually updated 10 year plans are mandatory and, since 2004, long-term fiscal analyses are required every fourth year.

### **Lower-level governments**

Regional and local governments present a challenge. The degree and type of challenge differ among countries, and it is difficult to generalize, but clearly, when local and regional governments are relatively large, politically powerful, and/or independent, they will play an important role. This presents a number of potential interdependent problems in implementing an MTBF. First, local and regional governments typically want a certain degree of autonomy and may, therefore, be reluctant to participate in, and agree on, an MTBF. Second, when implementing the MTBF, there may be difficulties in reaching agreements between different levels of government. Third, transfers to and from local and regional governments may distort the incentive structure. More generally, the central government may not have sufficient fiscal control of local governments, which may result in some loss of fiscal discipline and of adherence to MTBFs and fiscal policy rules.

### **Fiscal rules**

Experiences with fiscal policy rules, which set numerical multiyear restrictions on key fiscal policy targets, have been mixed, but multiyear expenditure rules appear to have helped discipline expenditures in some cases. Of particular interest to Austria are the Netherlands and Sweden, where multiyear expenditure frameworks were introduced relatively early. Although both countries have had difficulties in meeting some of their fiscal balance targets,

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<sup>14</sup> See Annett (2003) for a brief discussion of this point in the context of the Swedish MTBF.

the rigor of the expenditure rules in place has appeared to effectively restrain fiscal expenditures.<sup>15</sup> <sup>16</sup> Moreover, Sweden has been running fiscal surpluses in recent years, which separates it from its past record, and from many other EU countries. It also appears that the Netherlands' expenditure framework has been important for its significant fiscal consolidation in recent years, as well as in periods when the underlying economy was weaker. Still, it must be emphasized that rules alone do not create sound fiscal policies; they must be part of a broad-based effort to conduct clearly explained, medium-term-oriented, efficiently managed fiscal policies. Numerical fiscal rules are also relatively easy to motivate and communicate to the public, and are therefore well suited to be part of and strengthen an MTBF framework characterized by transparency and public clarity.

Fiscal policy rules may have procyclical tendencies. In particular, policies may be allowed to be too accommodative during economic upturns that result in revenue windfalls and lower than expected expenditure.<sup>17</sup> One example is Sweden, where strong revenues in 2000 and 2001, boosted by unusually large corporate profits and capital gains, enabled expenditures to grow rapidly within the limits of the fiscal policy rules.<sup>18</sup> Subsequently, as revenue growth abated and expenditure levels remained high, the goal of a fiscal balance over the cycle of 2 percent for GDP was hard to reach. Another example is the Netherlands where expenditures caps in the early 2000s generally appeared to be based on cautious macroeconomic assumptions. However, the economic situation turned out to be significantly weaker, and the fiscal situation deteriorated (also in structural terms) without any significant breach of the spending ceilings. Also, the assumptions regarding the structural revenue position had not been cautious, and windfall gains during years of strong growth had, in keeping with the fiscal policy rules, partly been used for tax cuts. The treatment of windfalls within the framework has subsequently been reformed.<sup>19</sup>

#### IV. IMPLICATIONS FOR AUSTRIA

MTBFs have proved to be effective in other countries, and the introduction of such a framework in Austria is welcome. It promises to be a national framework complementing

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<sup>15</sup> See Balassone (2005) for Sweden, and Hofman (2005) for the Netherlands.

<sup>16</sup> A detail worth noting, however, is that there are indications that countries with stricter expenditure rules have at times experienced increases in tax expenditure in order to circumvent the expenditure rules, see Wierts (2008).

<sup>17</sup> Wierts (2008) suggests that expenditure responses to revenue shortfalls tend to be procyclical in countries with weaker rules.

<sup>18</sup> See Annett (2003).

<sup>19</sup> See Zhou (2004) and Hofman (2005).

and deepening the commitments under the SGP. While an MTBF cannot by itself provide solutions, it can become a useful vehicle for addressing the fiscal challenges facing Austria, thus contributing to macroeconomic stability and predictability, and to fiscal sustainability.<sup>20</sup> The framework can potentially facilitate the formulation, implementation, and communication of fiscal policies, drawing immediate attention to basic policy choices in the medium to long term. As in other countries, an MTBF could become a useful basis for policy discussions and agreements in Austria, which has a tradition of coalition governments.<sup>21</sup>

The basic outline of the framework, including multiyear expenditure ceilings, seems appropriate. There appears to be broad agreement that controlling expenditure must be the focus. There is limited room for tax hikes, as taxes are not low, and past periods of significant deficits and debt buildup have been associated with high levels of public spending. Formal multiyear expenditure ceilings therefore appear to be attractive instruments of budgetary control for Austria. In this context, a special emphasis could be placed on the reporting and analysis of policies during a government term.

Austria should make transparency and public clarity key features when implementing its MTBF. Based on experience elsewhere, legislated principles of transparency and public clarity seem to have been overall quite effective. Clearly, legislation and regulations should be comprehensive in this regard; however, this is also an area where policymakers could and should be proactive and ambitious, as this has proved to be effective in fostering responsible fiscal policies in other countries. The annual Stability Program and other work done in the context of Austria's participation in the SGP provide a good basis to build upon.

The introduction of an MTBF as part of a broader reform agenda to improve fiscal management will increase the likelihood of success. Based on the experience of other countries, such an approach will help the successful implementation of an MTBF. Therefore, Austria should make a strong effort to ensure implementation of the various aspects of the broad fiscal management reform agenda in parallel.

Long-term considerations should be an integral part of the framework. Austria, like most other advanced countries, faces significant demographic challenges in the medium to long term. Therefore, long-term goals and restrictions should be mapped to concrete medium-term targets that in the end define the envelope for current fiscal policies and anchor the expenditure ceilings. This long-term perspective would help maintain satisfactory and sustainable fiscal policies, and avoid future fiscal tensions.

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<sup>20</sup> See e.g. IMF (2007a).

<sup>21</sup> Hallerberg, Strauch, and von Hagen (2004) find that explicit rules are most effective where governments typically are multiparty coalitions.

It will be essential to analyze thoroughly and deal with the implications for subnational governments when implementing the MTBF. Austria is faced with an element of procyclicality at the lower levels of government, as the targets for the annual balances within the Internal Stability Pact do not vary with the cyclical position of the economy.<sup>22</sup> More generally, fiscal policy set in a medium-term perspective would typically focus on the fiscal budget balance over a business cycle, while the internal stability pact sets specific targets for each year. Also, the pact does not specify in detail how the subnational governments should reach their budget targets.

The inclusion of mandatory buffers in the budgetary projections is welcome and could be complemented by a mechanism for dealing with unexpected windfalls. Some of these elements are in place in other countries and have been useful. However, it should be noted that buffers can be used up quickly and push problems forward. It would also be advisable to have a system in place to prevent unexpected, possibly temporary, savings or revenues from being used for additional spending or tax cuts, as this could cause a structural fiscal loosening.

Political will is essential for the MTBF's credibility and successful implementation. Reputation and accountability will ultimately be the main enforcement mechanism of the framework. Consequently, the broad-based political support bodes well, and Austria should make every effort to quickly establish a good track record for its new framework.

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<sup>22</sup> The potential problem of pro-cyclicality has also been pointed out by Schratzenstaller (2005), and in particular by Diebalek, Köhler-Töglhofer, and Prammer (2005).

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## APPENDIX: BRIEF OVERVIEW OF MEDIUM-TERM BUDGETARY FRAMEWORKS IN OTHER COUNTRIES

### Australia<sup>23</sup>

In 1998, Australia adopted the *Charter of Budget Honesty Act 1998*, in order to establish a fiscal framework that provides for greater fiscal discipline, transparency and accountability in fiscal policy. The Charter requires the Government to set out its medium-term fiscal strategy in each budget and to release economic and fiscal outlook reports at budget, mid-year and before elections to enable an assessment of actual fiscal performance against its fiscal strategy. The time horizon is four years rolling (the budget year and the following three years), with an intergenerational report at least every five years.

The primary objective of the previous Australian Government's medium-term fiscal strategy, as set out in successive budgets, was to maintain budget balance, on average, over the course of the economic cycle.<sup>24</sup> The medium-term fiscal strategy had a number of sub-objectives, including: maintaining budget surpluses over the forward estimates period while growth prospects were sound; not increasing the overall tax burden from 1996-97 levels; and improving the Australian Government's net worth position over the medium to longer term. The supplementary objective of no increase in the overall tax burden was intended to ensure that the Government achieved budget balance over the cycle through a disciplined approach to spending and not by recourse to increased taxation.

Under the *Charter of Budget Honesty Act 1998*, the recently elected Australian Government will formally release and table its first fiscal strategy statement in the Australian Parliament before its first budget in May 2008. The new Australian Government committed during the 2007 election campaign to adhering to a medium-term fiscal strategy that keeps the budget in surplus on average over the economic cycle without increasing the overall tax burden.<sup>25</sup> In light of inflationary pressures, the Australian Government has since announced that it will aim to deliver a budget surplus of at least 1.5 percent of GDP in 2008-09, provided growth prospects remain as currently anticipated.<sup>26</sup>

As in the case of New Zealand, this framework has been successful, despite the absence of an adjustment rule, and one important advantage seems to have been predictability. Net debt has been declining since 1996, expenditure as share of GDP has been declining, and the fiscal

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<sup>23</sup> See e.g. Australian Treasury (1998), and Simes (2003).

<sup>24</sup> The previous Australian Government was in office from March 1996 to November 2007.

<sup>25</sup> *ALP National Platform and Constitution 2007*.

<sup>26</sup> Speech by the Prime Minister of Australia, the Hon Kevin Rudd MP, titled *Building Australia's Economic Future*, 21 January 2008.

balances have been solid. In both of the successful cases of New Zealand and Australia, the elected governments assume responsibility for establishing and meeting fiscal targets, rather than these being specifically mandated within the relevant legislation.

### **Belgium<sup>27</sup>**

#### **Belgium's fiscal framework consists of three components:**

- (i) A political commitment to a medium-term path for the nominal general government deficit. This is enshrined in the coalition agreement, typically negotiated every four years following elections.
- (ii) A formal midterm budget adjustment procedure for the federal budget. Every year in June an assessment is made of whether the budget execution is on track, and adjustments are adopted to stay within the original target. In addition, quarterly budgetary controls, including one in September, are performed to ensure that budgetary objectives are met at year's end. These controls often result in one-off adjustments.
- (iii) An internal stability pact between the federal government and the regional governments. This is a political agreement in which the regions commit to a medium-term path for their nominal budget balance, consistent with targets agreed for the general government in the context of Belgium's Stability Program.

The framework has been successful, with budgetary targets achieved since its inception in 2000. The internal stability pact has also promoted consensus for consolidation across levels of government and the general public. However, the framework has some drawbacks. The focus on nominal targets maintains a procyclical bias and has led to an over reliance on one-off measures, often involving trade-offs of current benefits for future outlays, instead of producing durable measures. Also, reform of the fiscal federalism arrangements appears needed in order to achieve the expected medium-term buildup of fiscal surpluses.

### **Canada<sup>28</sup>**

There are no fiscal rules at the federal level in Canada, and no legal requirements for the government to provide medium- and long-term fiscal strategies and objectives. However, the annual Economic and Fiscal Update voluntarily prepared by the Minister of Finance includes five-year fiscal projections and intentions. The Minister of Finance also voluntarily provides an ex post report on budget implementation every year.

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<sup>27</sup> See e.g. IMF (2006a).

<sup>28</sup> See e.g. OECD (2004 and 2006).

Large fiscal deficits and increasing public debt led the parliament to pass the Spending Control Act in 1992. It set nominal spending targets for five years (1991/92-1995/96), with a view to controlling debt buildup. The act was successfully implemented but was not renewed. However, reforms to the budgeting process were made in 1994/95, which included two-year rolling fiscal targets, the introduction of contingency reserves, and a commitment to economic prudence in the budget. These reforms were introduced directly by the government without passing any legislation. Since the reforms started in the early 1990s, Canada's fiscal performance has been strong, with balanced or better budget outcomes since 1997 and falling debt ratios.

### **Denmark<sup>29</sup>**

Besides the SGP, Denmark does not have a legal framework that regulates how medium-term fiscal policies should be formulated or reported. Denmark has, nevertheless, moved toward a more medium- and long-term oriented fiscal policy and explicit medium-term fiscal targets during the last decade. In 1997, the government presented its first medium-term fiscal plan with an ambitious consolidation plan extending through 2005. The objective was to reduce public debt to 40 percent to GDP by targeting real public consumption growth and introducing structural reforms. A budget surplus target was later added. In 2001 the plan was updated, extending the time horizon to 2010. The target variables were the same, but the budget surplus target was modified to be set as a target range over the business cycle, reflecting the uncertainty surrounding estimates of the surplus targets needed for fiscal sustainability.

Medium-term policies are set to be consistent with long-term fiscal sustainability. For this reason, the update and extension of the plan through 2015 planned for 2006 was postponed because a welfare reform agreement between major political parties was reached in 2006. The agreement has important fiscal implications, including for pensions. The long-term fiscal sustainability calculations are made in cooperation with academic economists so that the most advanced techniques can be used.

The fiscal framework has overall been successfully implemented, led to a high degree of transparency, and appears to have become widely accepted by the public. Denmark's fiscal situation has improved since the first plan was introduced and is now one of the strongest in Europe. The main weakness of the framework has in practice turned out to be the difficulty in restraining spending at the local level. Local government spending exceeding initially set ceilings has been the main reason for the repeated breach of the real public consumption growth targets.

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<sup>29</sup> See e.g. Eskesen (2002).

**Finland<sup>30</sup>**

Finland's current MTBF was introduced in 2003. The reform of Finland's fiscal budgetary framework had begun in 1991 in response to the fiscal difficulties caused by the recession in the early 1990s. The current framework is based on the multi-year expenditure framework that was adopted in 1995. The framework appears to have contributed to fiscal stability and prudence. Finland stands out as a country that has compiled one of the strongest fiscal track records since the mid-1990s.

When a new government takes office, it formulates a four-year framework that covers its entire term. The expenditure caps are expressed at constant prices and are broken down into 14 broad administrative areas, which are essentially different ministries. The framework is subsequently adjusted every year to reflect actual price changes, and additional years are included in the framework such that a new four-year framework is adopted. The focus is on the years within a government's term, and the part of the framework that extends beyond the current government's term cannot be regarded as binding. The development vis-à-vis the targets initially set up for the government term is explicitly discussed and accounted for. Some expenditures are not covered by the framework, mainly those dependent on the business cycle and interest on the public debt. The framework does not include any target regarding the fiscal balance or public debt, but the Stability Program submitted to the European Commission every year sets such targets. Local governments are to be balanced by law.

**The Netherlands<sup>31</sup>**

The Netherlands has had a MTBF in place since 1994. The basic motivation for the Dutch framework was that deficit/surplus targets had proven not to be enough, as they do not discipline spending and tend to lead to ad hoc measures. The Netherlands also wanted to restrain spending to make room for tax cuts. The initial phase of the budgeting process takes place when a new government enters into office and formulates an overall budgetary policy for its entire four-year term and is part of a coalition agreement (normally no political party enjoys a majority in parliament). It is not only a statement of intent, but consists of concrete budget objectives, which subsequently are operationalized for different government activities on an annual basis.

The budget policy anchor is the level of expenditure. Fixed maximum caps in real terms are established for each sector, letting automatic stabilizers work through the revenue side. The degree of fiscal adjustment during the term is determined by the incoming government and is not regulated by the framework. The idea, which generally has been the case, is that the caps

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<sup>30</sup> See e.g. Finland Ministry of Finance (2003 and 2005).

<sup>31</sup> See Blöndal and Kromann Kristensen (2002), Tijsseling and van Uden (2004), and Hofman (2005).

should be based on cautious macroeconomic assumptions. However, in hindsight it has been realized that the assumptions in the late 1990s were not conservative.

The Netherlands' experience illustrates the problem of pro-cyclicality. There were basically no rules regarding how lower than expected expenditures should be handled, which led to some structural expenditure increase. With weaker economic growth in 2002-03, the fiscal situation became somewhat problematic, leading to the formulation of stricter rules on how lower than expected expenditures can be used. A related issue is how revenue windfalls should be treated, and the Netherlands have changed to a rule that all windfalls should go to debt reduction. Previously, part of the windfalls were dedicated to tax cuts.

### **New Zealand<sup>32</sup>**

In 1994, New Zealand adopted the Fiscal Responsibility Act, which legislated budgetary principles of transparency and mandatory short-, medium-, and long-term plans. The act also stipulates that New Zealand has to run an operating surplus over the cycle,<sup>33</sup> that public debt should be lowered to prudent levels, and that the level of public net worth provides a buffer against adverse future events. An important distinction is that net worth includes non-debt liabilities such as pensions. One interesting aspect of the New Zealand experience is that the Fiscal Responsibility Act was introduced when the country had already entered a path of fiscal consolidation through more effective spending prioritization and fiscal management. The act was to some extent a way of codifying what had been working well in recent years.

The introduction of more specific numerical targets was considered, but four main arguments against the idea were put forward: (i) there is no clear optimal fiscal target; (ii) rigid adherence to targets can distort decision making, while minor deviations from the targets can be overly costly in terms of loss in credibility; (iii) specific targets are inflexible, of course, and may prevent an appropriate policy response to changing economic circumstances; and (iv) fiscal targets can always be circumvented: unless the political will is there, the goals of the targets will not be met. The time horizon is three years rolling, with an updated long-term outlook (ten years minimum) every year. The New Zealand framework has been successful, even though, besides reputation, there is no adjustment rule. One important advantage seems to have been predictability. Debt has been on a steady declining trend since the early 1990s, expenditures as share of GDP have been declining, and the fiscal balances have been solid.

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<sup>32</sup> See New Zealand Treasury (1996), and Janssen (2001).

<sup>33</sup> Operating surplus is the balance of general government expenditures and revenues plus net-profits of state owned entities.

### **Spain<sup>34</sup>**

Spain adopted a Budgetary Stability Law (BSL) in 2001, and it took full effect in 2003. The main motivations for adopting a BSL in 2001 were to (i) lock in gained achievements; (ii) enhance fiscal discipline and transparency; and (iii) complement a regional financing agreement. The law is also seen as a part of a strategy to address future demographic challenges. A new BSL took effect in 2007, which introduced greater cyclical flexibility and aimed to increase ownership and observance by the regions.

The backbone of the framework is to target fiscal balance over the cycle for the general government, excluding the social security system. To avoid the complexities of defining the cyclical position, it establishes targets for three states of the economy: a fiscal balance for normal growth; a small public deficit for low growth; and a surplus for high growth. For the social security system, it envisages a separate target, set to ensure its financial sustainability. The low-growth deficit is allocated predominantly at the regional government level, while no indication is provided about the level and allocation of the high-growth surplus. Individual targets for each region will be determined by bilateral negotiations. If these are inconsistent with the overall target, the Ministry of Economy can set individual targets. The new law excludes some capital and other expenditures aimed at improving productivity and competitiveness. Three-year corrective plans are envisaged for any level of government that fails to reach the over-the-cycle target. Enforcement relies on expected increased transparency and timeliness of subnational data, and on an explicit barring of regional government bailouts.

### **Sweden<sup>35</sup>**

Sweden decided, in 1997, to set up an MTBF based on three pillars: (i) three-year nominal expenditure targets; (ii) 2 percent surplus on average, due to demographic considerations; and (iii) balanced local government budgets. The MTBF has worked fairly well, but has had procyclical problems, and the fiscal situation is under structural pressure, illustrating the need for a comprehensive approach. Nominal expenditure targets have been good for transparency, but have also led to creative accounting. The background to the decision to set up an MTBF was a severe financial and fiscal crisis in the early 1990s.

### **Switzerland<sup>36</sup>**

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<sup>34</sup> See e.g. IMF (2006b).

<sup>35</sup> See e.g. Annett (2003), and Balassone (2005).

<sup>36</sup> See e.g. Danninger (2002), and Bodmer (2006).

Since the 2003 budget, Switzerland has had its “debt brake” in place. It sets out to have a balanced budget over a business cycle and anticyclical fiscal policies through a mechanism that caps the accumulation of public debt. So far the framework has been quite successful, and political parties as well as the public are basically supportive of the approach. Part of the success has been due to the pedagogic element of the framework, including the emphasis on the debt brake. The balanced budget rule was included in the constitution, and the framework concerns only the federal government. The cantons’ fiscal policies are not integrated or coordinated with the federal government, and generally the cantons have balanced budget rules in place already.

The annual expenditure limit is set to structurally balance the budget in every period. The annual expenditure ceiling is set to equal the expected structural revenues, derived by applying a statistical filter to calculate the output gap. After each year, the deviation of the actual balance outcome from the plan is calculated and kept in a fictional account. The law stipulates that the government must eliminate any negative balance in that account. There is no time limit on when that has to be done unless the negative balance exceeds 6 percent of annual expenditures. Then it has to be brought down below 6 percent within three years. This error-correction mechanism is the debt brake.

### **The UK<sup>37</sup>**

In 1998, the UK introduced the “golden rule” and “sustainable investment rule” as the cornerstones of its fiscal policies. The underlying idea is that the government is allowed to borrow only for investments, not for current expenditures. Technically, the golden rule is that, over the cycle, the average current balance should be balanced or better. The formulation of the golden rule over the cycle gives rise to two potential drawbacks: the uncertainty surrounding the dating of the cycle and the risk of procyclicality in the event of asymmetric cycles. The sustainable investment rule states that net debt should be kept at a prudent level, which currently is defined as 40 percent of GDP at all times. The rules are accompanied by a three-year spending framework in which the government sets a ceiling on spending that is not affected by cyclical conditions.

Two important features of the U.K. golden rule framework are a margin of uncertainty, built into fiscal projections, and transparency. The margin of uncertainty is created by (i) cautious assumptions; (ii) a buffer in the annually managed expenditures; (iii) the setting of fiscal policies such that the current budget shows a surplus; and (iv) calculation of an alternative scenario with growth 1 percentage point lower. Transparency is achieved by having clear rules and by officially publishing cyclically adjusted fiscal indicators.

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<sup>37</sup> See e.g. Koeva (2005), Honjo (2007), and IMF (2007b).