How Does the Fiscal Rule Work? First the public financial management system shall be adapted to fiscal rule

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The law draft on Fiscal Rule was sent to the Grand National Assembly of Turkey (TBMM). The first policy notes on fiscal rule were published by TEPAV in 2007. So, let us first remind the context. Back then, we told that in the post-IMF period, one option for Turkey was to tie fiscal discipline to a fiscal rule. This was also when we published the first note on the Brazilian Fiscal Responsibility Law. Then the global crisis hit and the world changed. Meanwhile, Turkey declared that a fiscal rule regulation will be pursued instead of signing a deal with the IMF. Fiscal rule implementation is of great importance in terms of offsetting the damage that the crisis caused on the budget. The draft of the law on fiscal rule was finally sent to the TBMM, Turkish parliament, this week.

Now there are exactly two things to do. First, it is necessary to underline the steps taken in the field of public finance since 2001 and the relevant achievements and missing elements. This way it can be possible to have an opinion on the specific fiscal rule implementation that the public financial management system allows. The second thing to do shall evidently be addressing to what degree the prepared law draft targets what can be achieved. As a result of this effort, we can come up with a series that allows us to make an evaluation complementary to the note in Fiscal Rule Notes series written by Ümit Özlale concentrating on the general framework and institutional fundamentals of the fiscal rule implementation.

This note aims to outline the progress made so far with respect to public financial management in Turkey. It is evident that impressive progress has been made; nonetheless, the restructuring achieved in public financial management is currently insufficient for healthy fiscal rule implementation. Taking these exact insufficiencies into account, the Draft Law on Fiscal Rule proposes positive new steps to be taken on certain issues that will be mentioned below. This sure is a good development. The soundness of the fiscal rule implementation is closely related with the steps proposed to be taken in the law draft. So, let us first enumerate the things to be done in relation with the institutional infrastructure and then frame the issues the government sought to address in the draft sent to the TBMM.

Do you remember what we used to do when we did not have a Medium Term Program?

Turkey did not know of the concept ‘medium term program’ 7-8 years ago. Back then, the expenditure estimates and revenue forecasts of public institutions were used to be prepared, negotiated, and budgeted in annual basis. The goal in general was to keep the deficit at minimum in comparison with the year before taking the macroeconomic forecasts for the coming year. So, for public finance, the world was reestablished and the balances were reset every year. In normal times[1] there was no tradition to set a predetermined prospective target for a financial parameter committed and declared to the public.

Without a doubt, this was not the only problem pertaining to the public financial management, either. Public fiscal discipline was ignored to a high extent over the 1980’s and 1990’s. Though enhancements were made in the second half of 90’s, the importance of fiscal discipline was learned the hard way with the 2001 crisis after which the public financial management was – almost

[1] Of course, the programs implemented with the IMF were multi-year and included various targets and restrictions. Nonetheless, when the program terminated, the old practices were restored.

completely – restored. At this date, medium term budgeting system was adopted, public debt management was set out, and debt stock was brought under control along with the contributions of a long-term IMF program. Thus, Turkey covered a lot of ground considering public financial management and budget control. It is useful to take a look back and see how far we have come

How does the fiscal rule work?

In order to eliminate the deteriorations in the fiscal balances that gained ground in 2007 along with the impact of the global crisis, the government this time seeks to implement a fiscal rule tailored to secure fiscal discipline in the medium term. This was the declared as the main target of the recently proposed law draft. The rule stipulates that budget deficit shall be kept constant at 1% in average over a certain period of time while also accounting the level of economic activity. To begin with, it is necessary to stress that this attempt is of critical importance as it puts an emphasis on fiscal discipline and reflects the will of the government to impose a rule on itself. Therefore, this attempt shall be analyzed more deeply and in more detail.

As it was underlined in the first note of the series, fiscal rule shall not be considered as a magical tool. Studies on fiscal rule reveal that there are some preconditions for efficient implementation of fiscal rules.[2] The first prerequisite is an adequate public financial management infrastructure: an accounting system that provides detailed and reliable information and data, the capacity to realistically forecast the fundamental budget aggregates, a comprehensive and timely budget reporting system and annual reports, and a comprehensive internal and external audit system.

The second element is about timing: In many countries, fiscal rules are introduced as the last pillar of a comprehensive reformation process as emphasized also in the general rationale of the draft law on fiscal rule sent to the TBMM. These reforms constitute the building blocks of the financial management. If some of these building blocks are missing, the fiscal rule implementation most likely proves problematic. On the other hand, researchers highlight the political will to institutionalize the mentioned comprehensive reform and fiscal discipline rather than the fiscal rules. “If there is a political will determined to introduce comprehensive reforms and ensure fiscal discipline; rules are optional, if such a political will does not exist, rules will not work.”[3]

The third element is the quality of the regulations pertaining to the structure, monitoring, evaluation, and sanctions for fiscal rule. If the fiscal rule is expected to serve as an ‘anchor’, it is also important on which variable the rule is imposed, what types of restrictions are introduced and how the monitoring and sanctioning is made.

Now let us address these elements separately to see where Turkey stands.

Good came out of bad: 2001 crisis redesigned the public financial management system of Turkey.

As also mentioned above, Turkey’s public fiscal management system was reconstructed after the 2001 crisis. With the Law No 5018 on Public Financial Management and Control introduced in December 2003, budget processes were redefined, the scope of the budget was expanded, the financial control system was renewed and an external auditing model was envisaged, the connection

[2] IMF, Fiscal Rules-Anchoring Expectations for Sustainable Public Finances, December 16,2009. Pg.11-12
[3] Allen Schick, The Role of Fiscal Rules in Budgeting, OECD Journal of Budgeting, Vol:3 No:3, 2003. Pg.9

between strategic management and performance was established, a medium-term perspective was introduced, and the institutional infrastructure of fiscal discipline was enhanced with the redefinition of responsibilities. With the No 4749 Law on Public Finance and Debt Management enacted in March 2002, public debt management was disciplined and the recently-abolished first fiscal rule in the history of public finance in Turkey was introduced. As per Law No 4734 on Public Procurements, dated April 2002, public procurement system was designed from the top in harmony with EU standard. Apart from these, inclusive reforms targeting at transparency in public financial system were launched in different sectors including energy, agriculture, heath, and social security.

All these reforms were designed and implemented in a short period of time. These are attempts that shall not be overlooked and that can set an example at global level. At this point, it is possible to say that the public financial management reform was implemented successfully considering the budget processes in particular. Therefore, on the basis of the implementation results, it can be concluded that a considerable level of fiscal discipline was attained between 2002 and 2007.

Low-quality fiscal adjustment is a problem for fiscal rule.

Nonetheless, it should be added that the quality and thus the sustainability of the fiscal discipline is also discussed[4]. Criticism about the quality of fiscal adjustment mainly stress that fiscal adjustment is predominantly ensured by increasing indirect taxes; that expenditures are not cut; that primary expenditures are tried to be controlled via reducing expenditures on education and public investments against the compulsory expenditures that tend to rise (such as personnel, social security or health expenditures) as well underlining that this is not sustainable in the long term. Failing to control the expenditure side of the budget and thus adjusting the revenues to sum of expenditures is not what securing fiscal discipline refers to. Fiscal discipline is related directly with disciplining expenditures. In this context, we should admit that criticisms about the quality are valid to some point.

Then, what does this imply for fiscal rule? This situation creates the risk of pursuing measures that will deteriorate further the resource allocation in order to comply with the fiscal rule. For instance, increasing taxes due to the death of a space to cut expenditures represent such risks. A closer analysis of the 2010 program reveals that in the central government budget, the level of primary expenditures was not changed and in fact raised slightly while the ratio of tax revenues to national income was increased by 1.5%. In the 2010 program, indirect taxes are pushed up by 24% whereas direct taxes were increased by 8%, both in comparison with the year before[5]. It appears that taxes, indirect taxes in particular, will be the most important tool of fiscal adjustment unless serious structural measures are introduced in the expenditure side. Given the existing structure of the budget, it becomes quite apparent that fiscal rule shall be put on primary expenditures instead of budget deficit[6].

[4] Hakkı Hakan Yılmaz, **İstikrar Programlarında Mali Uyumda Kalite Sorunu:2000 Sonrası Dönem Türkiye Deneyimi**, TEPAV | Governance Studies, April 2007

[5] SPO, 2010 Annual Program, pp. 52-60

[6] IMF Country Report, No. 07/364, 2007; Selected issues, pg. 17, Davide Lombardo, Should Turkey Adopt a Fiscal Rule?

Deficiencies of the accounting system will make harder the prioritization between programs required by the fiscal rule

The second major 'infrastructure' problem stems from the medium term program. The issue is directly related with fiscal reporting and transparency. The stability program implemented after the 2001 crisis increased considerably the responsibilities of the public sector about fiscal transparency. Nonetheless, there still exist problems in this area which can be called structural and behavioral.

Let us start with the structural problems: Although provide macro information at institutional, economic, and sector levels, the accounting system, and analytical budget coding structure lack information at the 'program' level. Expenditures can be made in conformity with strategic priorities only if the priorities are accounted, monitored, and evaluated at program level. However, the system does not yet operate at program level but run mainly on the basis of individual expenditure items.

The problems this situation will lead to concerning the fiscal rule are also related with resource allocation and efficiency. Preference of evaluation, negotiation, and economizing on the basis of individual expenditure items over program-based budgeting system will damage the efficiency of expenditures. Moreover, if a mistake is made at the first evaluation, it will also be hard to correct it.

Another problem in this respect is the inability to calculate the exact cost of programs and policy changes. If all cost elements pertaining to a new program and the activities involved in the program cannot be calculated at the stage of budgeting, the medium-term forecasting capacity that will back the fiscal rule implementation will be inadequate. This issue is also addressed below in the context of the problems pertaining to medium term program.

The behavioral problem results from the public accounting practice of deferred liabilities. Deferred liability can be defined as not recording a legally accrued expenditure at the year-end in order to understate the budget deficit. For detailed information on this issue, TEPAV Fiscal Monitoring Reports can be referred to.[7] On the other hand, the Draft Law on Fiscal Rule stipulates some steps in the right direction in this regard.

Fiscal rule cannot be implemented unless the transparency of public accounts is secured

Some problematic practices with respect to transparency and fiscal discipline also pose a threat for efficient resource allocation in fiscal rule implementation. A short list for the mentioned practices is given below:

A- Expenditure side

- Mass Housing Administration (TOKİ) was left out of the scope of No 5018 Public Financial Management Law first and of Auction Law second. There are still several institutions out of the scope of Auctions Law in particular. This practice about TOKİ proves problematic not only for public financial management system and the balance sheet of the state, but also for competition law practice.
- There exist problems about accessing to timely and comprehensive information on Municipalities and Economic Enterprises of Municipalities.

[7] For instance, December 2007Fiscal Monitoring Report indicates that health expenditures are predominantly deferred upon this method.

- A large proportion of expenditure making institutions does not or cannot produce year-end activity and financial reports.
- The budget documents submitted to the TBMM are rich in number and data but insufficient with respect to information and analysis.
- From time to time expenditures are made without associating to the budget. Payments for Enforced Savings Account and Housing Supports were made this way (June-July-August 2008 Fiscal Monitoring Report).
- Budget deficit of the current year is understated through transfers from personnel and interest allowances to auxiliary allowance and then receiving a complementary allowance from the Court of Accounts (December 2009 Fiscal Monitoring Report)

B- Revenue Side

- Funds transferred from Saving Deposit Insurance Fund (TMSF) to the Treasury are recorded as revenues instead of deducing the amount from payables (December 2009 Fiscal Monitoring Report)
- A part of the unemployment fund revenues were transferred to budget in order to finance investment expenditures. Therefore, funds which were already recorded among public revenues were counted twice as revenue.
- Tax expenditures are not presented separately to ensure transparency.

C- Concerning the transactions about Debt Management

- With 25 June 2009 dated No 5917 Law, the borrowing limit stipulated as per the No 4749 Law on Public Finance and Debt Management was raised. As already known, the mentioned borrowing limit prescribed that borrowing can be made only to finance budget deficit. However what needed to be done was to define a supplementary budget (April 2009 Fiscal Monitoring Report)
- Receivables of the Treasury pertaining to the foreign debt loans made to some public institutions were deleted or deducted without associating to the budget. (March 2006 Fiscal Monitoring Report)
- Some amendments which enable the avoidance of budgeting of foreign debt use by some institutions, which can be undesirable concerning transparency, were made in No 4749 Law. (November 2006 Fiscal Monitoring Report)

The Draft Law on Fiscal Rule prohibits debt and receivable deduction and deletion of debts without associating the transaction with the budget. This doubtlessly is a positive development.

Fiscal rule cannot be executed without implementing a medium-term expenditure program

Another important problem area concerning fiscal rule is that the medium term expenditure program is not yet implemented properly. As known, medium term expenditure program is based on the following principles: forecasting of macro variables for coming years; top to bottom allocation of financial aggregates in relation with variables; determination of sector and thematic priorities by the expenditure-making institutions; and distribution of the allowances in line with sector and thematic priorities following the negotiations between the relevant institution and the Ministry of Finance. Expenditure-making institutions turn their strategic priorities into programs provided that they stay within the expenditure ceilings defined for them and then prepare three-year budget proposals and forecasts. Then, budget proposals are negotiated with the State Planning Organization (SPO) for investments and with the Ministry of Finance for other expenditure items, when finalized, are discussed at Higher Planning Council; and submitted to the TBMM.

The first problem area in this process is related with the projections and determination of fiscal aggregates consistent with projections. There exists almost no analytical information on the assumptions on which the macroeconomic projections are based, the differences between estimates for previous years and realizations, and the reasons for deviations. In Brazil, for instance, in the context of the fiscal rule implementation medium term programs include information on deviations and analysis on the implementation performance for the previous years. In Turkey deviations from medium term program is considerably high. However, there exists no analysis or evaluation on the reasons for this (Please see Annex 1). Article 6 of Draft Law on Fiscal Rule stipulates to eliminate this problem.

If cost determination is not made on the basis of sector programs, prioritization and thus medium term expenditure program cannot be made.

Another problem about medium term expenditure program is the failure to turn policies for sectors into programs[8] to prioritize and set the cost of them. As a result of this failure, to what extent sector policies are or will be involved in budget estimates cannot be foreseen and the fiscal impact of sector policies cannot be estimated. Ideally, it is necessary to calculate first the 3-year budget estimate in the case where no policy change takes place as the base-line in the context of the medium term program, and then to identify the impact of the new policies and programs or the changes in existing policies on the base-line. Similarly, expenditure-making institutions also fail to turn their sector strategies into medium term expenditure programs, which does not only contribute to ambiguities about fiscal rule, but also leads to a serious efficiency problem in resource allocation. Draft Law on Fiscal Rule stipulates that medium term program and fiscal plan will be combined and prepared “taking into account the policies which are in effect or which are declared to take effect as well as other important developments which can have an impact on the fiscal and economic outlook.” It will be useful to monitor closely what this statement accounts for in practice.

The power of the fiscal rule is inasmuch as the credibility of the authority monitoring it.

The last point to address is how the fiscal rule will be monitored and what type of sanctions the rule will be subject to. It is evident that the efficiency of any fiscal rule is closely connected with the monitoring and sanctioning process it will be subjected to. Compliance with the fiscal rule shall be taken into account in the budget planning, implementation, and auditing stages. We have discussed above that there are problems about the budget planning process. It should be added there are also some problems in the budget implementation process[9]. Monitoring and sanctioning of complex transactions by a set of bodies composed of central government, local administrations, social security

[8] Programs are sums of expenditures that cover multiple years, that can involve more than one institution, and that constitute integrity of content. Fight against smoking, family physician practice, generalization of pre-school education are typical examples of programs.

[9] The existing capacity in central government institutions and particularly in local administrations is currently inadequate for the introduction of internal auditing system. It should be noted that this constitutes an important fiscal risk.

institutions, and SEE's with a focus on fiscal rule is problematic under the existing legislation. Such monitoring and sanctioning activities are regulated by 'Fiscal Responsibility' laws, which give significant auditing and sanctioning authorities for reaching fiscal targets to finance ministries. Fiscal responsibility laws are in force in one third of countries implementing a fiscal rule[10]. For instance, in Brazil fiscal responsibility law is in force since 2000. Nonetheless, a significant part of the disciplining provisions are lacking in Turkey's law draft.[11]

Brazilian Fiscal Responsibility Law (FRL) regulates all rules, which have the characteristics of fiscal rule and which are regulated by at least a dozen of laws and regulations, for public bodies at any degree without discriminating amongst them. In this sense, a more holistic approach that involves sanctions and reporting requirements is represented.

Brazilian FRL requires restructuring for institutions that exceed a certain limit and back this provision with criminal sanctions. The sanctions in Turkey's legislation cannot achieve these qualifications; sanctions are indefinite and tailored solely to facilitate collections. The importance of the sanctions is already proved by the dramatic conditions facing the Stability and Growth Agreement of the European Union.

Fiscal responsibility rules generally necessitate a medium term program framework. Targets and limits are set as a part of the medium term and macroeconomic parameters; annual budgets and other decisions and arrangements act as an 'anchor' for these medium term targets; and the adherence to these targets are audited on the basis of the fiscal responsibility law. Therefore, the fact that the medium term program in Turkey does not work in practice as well as the lack of the fiscal responsibility law give way to a severe problem of credibility about the fiscal rule.

Taking into account the mentioned implementation problems, perhaps some improvements are proposed in the draft law on fiscal rule. It is a good thing that the problem is realized. For instance, the draft stipulates that the 'budgeting directory' of local administrations shall be prepared upon the opinion of the Ministry of Finance and that the approval of the Treasury shall be taken for borrowings that exceed 10% of the municipalities' revenues. Furthermore, SEE's are stipulated not to set a total borrowing requirement and prepare strategic plans. However, none of these provisions involve sanctions at the degree of certainty that is expected from a Fiscal Responsibility Law devised to ensure compliance to the fiscal rule. So, the only thing to do is to closely monitor the implementation process.

The audits by Court of Accounts do not serve the purpose

Problems also appear with respect to post-implementation audits. As per the draft law, fiscal rule implementation results will be audited by the Court of Accounts. However, the auditing by the Court of Accounts is quite incompetent for fiscal rule implementation in terms of scope and content. This incompetence can be examined in three categories:

1-Independence: The most fundamental element of a successful fiscal rule implementation is that the compliance with the rule is ensured by an independent and credible institution. The credibility of the fiscal rule can be defended to the extent that this criterion is fulfilled. In this sense, some

[10] IMF, a.g.e.,
[11] For more information please see Annex 2

researchers argue that the monitoring shall be fulfilled by independent financial commissions[12]. The Court of Accounts carry out auditing on behalf of the TBMM and the head and members of the Court is assigned by the TBMM. However, because of the political system in Turkey, the government that holds the majority in the legislative process will be determinant in the selection of the head and members of the Court. This implies that the independence will no longer be the most fundamental element.

2-Scope: Though Court of Accounts has the lawful authority to audit the municipalities, this does not take place in practice. A few of municipalities can be audited with a certain delay. On the other hand SEE's are audited by the State Auditing Board; not by the Court of Account. Economic Enterprises of Municipalities are already out of the scope of the audits.

3- Court of Accounts predominantly inspects legality, which is concerned with whether or not expenditures are made duly in accordance with the relevant law. The Court of Accounts can evidently carry out an inspection for the compliance with limits. In fact the Court audited the Treasury for GDS (government debt securities) issuing limits in the past. Nevertheless, in fiscal rules, the limit is put on total budget deficit. Therefore, it is not possible to inspect institutions individually with respect to compliance with the fiscal rule. Thus, the content of the audits is also uncertain.

CONCLUSION:

The declaration of political will for implementing fiscal rule and the emphasis put on fiscal discipline are good developments being the sign of the realization at political level that budget deficit which reached 6.5% of GDP during the crisis period shall be controlled. The timing of this attempt is also meaningful given the tension raised by the Greek crisis.

However, it is sensed that the will to implement a fiscal rule was a snap decision based on the conjuncture, as the anti-transparent budget practices, the failure to implement the medium term expenditure program completely; and the budget constraints in both revenue and expenditure sides are considered. What is more, the infrastructural deficiencies in the independent monitoring-auditing and sanctioning raise question marks about the process.

The implementation of a fiscal rule, under the current circumstances and despite the deficiencies, will be a favorable development considering fiscal discipline in the long term. The draft law intends to eliminate a part of the existing deficiencies, which should also be considered as a positive development. The government's will to control itself is a favorable development. Nonetheless, we believe that the debt stock in TL terms, the average maturity of which is 8 months and the 81% of which will be rolled over in one year, requires a more comprehensive and rapid fiscal credibility construction in a milieu where the expectations for the deepening of the crisis in Europe intensifies.

[12] Debrun, X., D. Hauner, and M. S. Kumar (2009), "Independent Fiscal Agencies," *Journal of Economic Surveys,* Vol. 23, No. 1, pp. 44–81.

Table 1. 1-year Targets Envisaged in Medium Term Plans (MTP) and Realizations, 2006-2009

	1 Year Targets**				Realizations				Deviation			
	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
GDP growth (%) *	5	7	5.5	5	6.89	4.67	0.66	-4.74	38%	-33%	-88%	-195%
Exports (FOB) ($ billions)	84.1	93.1	112.4	149.2	85.5	107.3	132.03	102.1	2%	15%	17%	-32%
Imports (CIF) ($ billions)	122.6	150.3	168.4	234.6	139.6	170.1	201.96	140.9	14%	13%	20%	-40%
Current Account Balance / GDP (%)	-4	-7.9	-6.4	-6.8	-6.1	-5.9	-5.7	-2.3	53%	-25%	-11%	-66%
Unemployment Rate (%)	10	10.5	9.6	9.8	10.2	10.3	11	14	2%	-2%	15%	43%
Central Government Budget Expenditures (TL billions)	160.143	189.877	225.859	259.14	178.1	204.067	227.03	267.275	11%	7%	1%	3%
Central Government Budget Revenues (Net, TL billions)	141.822	181.111	206.951	243.592	173.484	190.36	209.598	215.06	22%	5%	1%	-12%
Central Government Budget Tax Revenues (Gross, TL billions)	130.335	155.248	174.141	198.601	137.48	152.835	168.109	172.417	5%	-2%	-3%	-13%
Central Government Budget Balance	-18.322	-8.766	-18.909	-15.548	-4.643	-13.708	-17.432	-52.215	-75%	56%	-8%	236%

*Shows the percentage change with real prices.

**Figures for 2006 were taken from 2006-2008 MTP, for 2007 from 2007-2009 MTP, for 2008 from 2008-2010 MTP, and for 2009 from 2009-2011 MTP.

Source: SPO, TURKSTAT, CBRT, Ministry of Finance

Table 2. 2-year Targets Envisaged in Medium Term Plans and Realizations, 2007-2009

	2 Year Targets**			Realizations			Deviation		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
GDP growth (%) *	5	7	5.7	4.67	0.66	-4.74	-7%	-91%	-183%
Exports (FOB) ($ billions)	93.7	105.5	124.2	107.3	132.03	102.1	15%	25%	-18%
Imports (CIF) ($ billions)	133.7	164.7	184.1	170.1	201.96	140.9	27%	23%	-23%
Current Account Balance / GDP (%)	-3.5	-7.3	-6.3	-5.9	-5.7	-2.3	69%	-22%	-63%
Unemployment Rate (%)	9.8	10.6	9.5	10.3	11	14	5%	4%	47%
Central Government Budget Expenditures (TL billions)	162.28	199.027	228.07	204.067	227.03	267.275	26%	14%	17%
Central Government Budget Revenues (Net, TL billions)	150.318	196.263	220.755	190.36	209.598	215.06	27%	7%	-3%
Central Government Budget Tax Revenues (Gross, TL billions)	139.821	169.264	186.866	152.835	168.109	172.417	9%	-1%	-8%
Central Government Budget Balance	-11.962	-2.764	-7.315	-13.708	-17.432	-52.215	15%	531%	614%

* Shows the percentage change with real prices.
**Figures for 2007 from 2006-2008 MTP, for 2008 from 2007-2009 MTP, and for 2009 from 2008-2010 MTP.

Source: SPO, TURKSTAT, CBRT, Ministry of Finance

Table 3. 3-year Targets Envisaged in Medium Term Plans and Realizations, 2008-2009

	3 Year Targets**		Realizations		Deviation	
	2008	2009	2008	2009	2008	2009
GDP growth (%) *	5	7.1	0.66	-4.74	-87%	-167%
Exports (FOB) ($ billions)	105.8	120.4	132.03	102.1	25%	-15%
Imports (CIF) ($ billions)	146.8	181.8	201.96	140.9	38%	-22%
Current Account Balance / GDP (%)	-3.1	-6.6	-5.7	-2.3	84%	-65%
Unemployment Rate (%)	9.6	10.4	11	14	15%	35%
Central Government Budget Expenditures (TL billions)	165.958	205.732	227.03	267.275	37%	30%
Central Government Budget Revenues (Net, TL billions)	161.638	210.143	209.598	215.06	30%	2%
Central Government Budget Tax Revenues (Gross, TL billions)	151.627	182.212	168.109	172.417	11%	-5%
Central Government Budget Balance	-4.32	4.411	-17.432	-52.215	304%	-1284%

*Shows the percentage change with real prices.
**Figures for 2008 from 2006-2008 MTP, and for 2009 from 2007-2009 MTP

Source: SPO, TURKSTAT, CBRT, Ministry of Finance

ANNEX 2:

Brazilian Fiscal Responsibility Law (FRL):

Brazil responded the global crisis which began with the 97 Asian Crisis, and deepened with the 98 Russian Debt Crisis, with reforms in two critical areas. First, floating exchange rate regime was adopted in 1999 and a couple months later inflation targeting policy was launched. In the year after, Fiscal Responsibility Law was put in force.

Fiscal responsibility law (FRL) constitutes of provisions that discipline public fiscal management at each of the three administration levels: federal, state, and municipal level.[13]

The law involves three main elements of discipline: 1-Limits 2- Sanctions[14] 3-Transparency and Reporting. All of the three elements are drawn complementarily to back one another. The law cross-cuts the disciplinary elements and the following factors on the basis of the type of fiscal transactions:

- expenditures,
- tax expenditures[15],
- conditional liabilities,
- personnel expenditures,
- public borrowing and lending policy,
- central bank policies in partial, and
- public equity policy.

Furthermore, the Law makes references to the legislation, execution, and judiciary subjecting these organs to similar rules.

The FRL stipulates the publication of medium term 'Fiscal Targets' as an annex to a separate law (Budget Procedure Law). These should include target of revenues, expenditures and public debt for the coming two years; evaluations on the realization of targets in the previous year; national economic targets and the consistency of the fiscal targets with the national economic targets; remarks on the public 'net equities' for the previous three years and information on the sale of equities, assessments on financial and actuarial positions, and remarks on tax expenditures, compensating measures, and obligatory expenditures. As another annex, the FRL stipulates that the report on the forecasts and measures on fiscal risks (conditional liabilities) shall be revised. The budget proposal made by the Federal Government shall also include information on monetary policy targets.

As per the FRL, Annual Budget Laws shall involve a statement on the consistency of budget aggregates with the fiscal targets mentioned above. Budget Law shall also have an auxiliary

[13] Here it will be more meaningful to classify the provisions not going into detail. For detailed information on the provisions of the Law, please see www.planejamento.gov.br/arquivos_down/lrf/integra_lei/lei_101_ingles.PDF

[14] In addition to the Fiscal Responsibility Law, the Law on Financial Crimes was introduced in October 2000 with which new financial crimes were defined (for instance, unauthorized issuing of bills) and sanctions were aggravated.

[15] Tax expenditures involve the changes introduced in the tax rate or base such as tax remission, tax rebate, tax incentive, or tax exemption.

allowance to cover fiscal risks and unforeseen expenditures. Personnel expenditures and other current and investment expenditures of the Central Bank are also a part of the Federal Budget. The Law associates the profit and loss recorded by the Central Bank with the Treasury and ensures that regular information will be generated on the operational cost of the Bank.

The most important distinctive feature of the FRL is the measures tailored to secure the consistence between the budget implementation process and the medium term targets enumerated above. Detailed analysis of these measures is out of the scope of this note; but to summarize, the Government has to publish the expenditure program and the financing plan within 30 days following the issuance of the Budget. If, at the end of the second month, it is understood that the revenues are below the level set in the context of Fiscal Targets, the institutions are asked to cut their expenditures on the basis of commitment and as per the provisions of the Budget Procedure Law. The government is authorized to take measures ex officio in case the legislative and judiciary bodies fail to do so.

The government shall give a briefing on the adherence to Fiscal Targets in a parliament meeting open to public three times a year (local administrations will do the briefing in their own assemblies). This obligation also applies for the Central Bank, which has to give a briefing two times a year.

As per the FRL, revenue forecast shall involve the evolution in revenues over the previous three years and the forecast for the coming two years, the assumptions used and the methodology employed as well as take into account the legislation and the changes in the general price levels, in compliance with technical and legal standards. Revenue forecasts can only be made if changes are technically proved. Moreover, along with the budget expenditure schedule, the government declares the monthly revenue collection targets and the measures against tax evasion etc.

Also, new tax expenditures shall be enacted with a fiscal burden (for the current year and the coming two years) estimate that includes the impact of new tax expenditures on the absolute budget. Moreover, the relevant regulation shall involve a) the declaration of the institution proposing the tax expenditure that the mentioned expenditure is foreseen in the budget or b) the measures to compensate for the tax expenditure. The regulation cannot be put into force if these provisions are missing.

Along with **any action**[16] that increases the public expenditures of the executive body;

a) Forecasts about the fiscal impact of the decision for the current and the coming two years shall be provided (methodology and assumptions shall be stated) and

b) The relevant institution shall declare that the decision is in concordance with the medium term fiscal targets and fiscal and financial provisions in the legislation. Furthermore, the decision shall not lead to an exceeding of the allowance. These provisions have the characteristics of classical fiscal control measures.

Another important feature of the FRL is the sensitivity about the increases in compulsory and permanent expenditures. The Law defines compulsory expenditures as “the current (personnel and

[16] Though the concept “action” is not defined here, it is believed that it refers to legal arrangements and policy changes in general.

other current) expenditures that stem from a law or an administrative decision and that shall be made over two years or a longer period." Any decision that puts an upwards pressure to compulsory expenditures shall make the technical calculations similar to those mentioned above and prove that the relevant increase in expenditures is in concordance with the fiscal targets or will be compensated for with specific **permanent measures**[17]**.** Otherwise, the decision that stipulates the increase in the expenditures cannot be put into force.

FRL also imposes a numerical limit on personnel expenditures. According to this, personnel expenditures cannot exceed 50% of net revenue of the current year for federal government, and 60% for states and for municipalities.[18]

Apart from these, the FRL involves detailed sanctions in relation with the numerical limit. Though details will be avoided, here it is necessary to say that as per the Article 23 of the Law, in the case that personnel expenditures made by any organ (legislative, executive or judiciary) exceed the limit, the amounts beyond the limit shall be eliminated proportional over two four-month periods (also through the implementation of measures stipulated in the Law). Furthermore, one third of the reduction shall be fulfilled over the first four-month period. Otherwise, the relevant federation member is punished via cuts in fiscal transfers.[19]

In addition to regulations that require an increase in expenditures, any regulation that intensifies the obligations pertaining to social security system shall also make the fiscal burden estimates and introduce compensatory measures.

Another important area regulated by the FRL is borrowing and lending policies. Within 90 days following the issuance of the FRL, the President of Brazil submits the consolidated debt limit at each administrative level (federal-state-municipality) to the Senate and the limit on Government Debt Securities to the National Congress, as per the relevant constitutional provision. Proposals on these limits shall include information and remarks on the:

1. Consistency with the fiscal policy targets and FRL rules,
2. Impact of the limits on the administrations at each level (federal-state-municipality),
3. Rationale for the differentiated limits for each level, and
4. Calculation method.

The limits are set as a ratio to the net current revenue of each administrative level and debt accounts are evaluated once in every four months on the basis of the compliance with limits. If, upon the examination, it is understood that the debt of any member of any Federation is above the predetermined limit, the debt is reduced under the limit over the following two periods (in eight months). A compliance of at least 25% shall be ensured in the first four-month period ahead. In case of the identification of incompliance with the debt limit, domestic and foreign borrowing is banned and the relevant administration is made to make the necessary revenue and expenditure savings.

[17] Permanent revenue measure is defined as an increase in tax rate or base, a new tax, or contribution.
[18] FRL also introduces a limit within each administration level. For instance, at federal level the personnel expenditures of the executive body, legislation, legislation (including the Court of Accounts) and Federal prosecution office cannot exceed 40.9%; 6%, 2.5%, and 0.6%, respectively. The Law also defines the net revenue of the current year.
[19]It is known that these measures are introduced for some states in particular.

The administration that does not comply with the limit at the end of the legal term cannot receive fiscal transfers from federal or state budgets.

The Ministry of Finance can inspect the credit operations (lending) of any member of the Federation[20] or the firms controlled directly or indirectly by any member with respect to the compliance with the borrowing limits given above. The financial institution that engages in credit (lending) relation with any Federation member shall ask proof from the member on the compliance with the mentioned debt limits. Credit operations that do not comply with these provisions are neglected and the principal of the debt is returned while accrued interests and costs are not returned.

FRL launches detailed regulations on the credit operations and provision of guarantees and counter-guarantees[21]. These regulations involve disciplinary provisions similar to the measures explained above. Here it will be enough to give the last paragraph of Article 40 in order to reflect the similarities with the Turkey case. According to this, "...any federation member the debt of who is undertaken by the federal government in the context of a provided guarantee cannot benefit from any other credit or finance unless he/she pays the debt f-completely."

FRL also involves provisions that prevent direct or indirect financing of the Treasury by the Central bank. As can be remembered, such limitations were also imposed in Turkey along with the amendments made in the Central Bank Law in the aftermaths of the 2001 crisis. FRL moreover prohibits accumulation of liquid assets of public institutions in a private account; purchasing of securities issued by any state or municipality using the mentioned liquid assets; or lending to third parties or to the government. Using the revenues from the sale of public assets to finance the current expenditures is also prohibited.

Finally, FRL has detailed provisions on accounting system, accounting standards, financial control, external auditing, and reporting. It will be enough to talk about the Financial Management Report. As per the FRL, at the end of each four-month period, the head of the executive body at each administrative level shall submit a comprehensive report on the limits put on personnel, credit operations, guarantees, and borrowing as per the Law as well as on the realizations of Fiscal Targets annexed to the Budget Procedure Law and the measures to be implemented in case of exceeding of the limits.

Medium Term Program	Brazil	Turkey
3-year macro-fiscal targets	X	X
Evaluation of the previous year	X	
Methodology, rationale, remarks	X	
Assessment of the financial and actuarial status	X	
Assessment of the net worth	X	
Forecasts for tax expenditures and	X	

[20] Federation member refers to the federal government, all states, and all municipalities.

[21] The reason for the introduction of regulations in this detail is that some large states entered in a debt payment crisis in mid 1990's. The debt of the mentioned states was undertaken by the Federal Government. As of the end of 1996, the amount of debt undertaken by the Federal Government reached $123 Billion in cumulative. For detailed information on this issue, please see: www1.worldbank.org/publicsector/decentralization/cd/**Brazil**.pdf

compensatory measures		
Evaluations on the upwards trend in permanent and compulsory[22] expenditures	X	
Tables on fiscal risks	X	
Annual Budget Law		
Commitments for the consistence with Medium Term Targets	X	
Auxiliary allowances for conditional liabilities	X	X
Investments of more than one year, which are not considered in the MTP, cannot be included.	X	
Budget Implementation	X	
Measures that compensates for tax expenditures and permanent and compulsory current expenditures		
Monthly release and budget payments table	X	X
Automatic measures to step in when revenue targets cannot be fulfilled	X	
Submitting information on fiscal realizations to the Parliament three times a year	X	
Any action of the government (execution and other) that will lead to an increase in expenditures are put into force along with the declaration on the fiscal impact over the current year and the coming two years (calculation methodology is also declared), and the declaration on the consistence of the action with the annual budget law and the Medium Term Program.	X	
Any increase in permanent and compulsory expenditures shall be compensated with permanent cuts in expenditures.	X	
Limits on personnel expenditures and debt stock (as a ratio to current revenue)	X	*Only in Municipalities*
Procedures and sanctions that apply in case of the exceeding of limits are defined.	X	
The head of an executive body at any level, whose term in office will end in less than 8 months, cannot make any commitment for an increase in expenditures if the repayment or financing is due at a date after the termination of his/her term in the office.		
Reporting		
Budget implementation results	Bimonthly	Monthly
Financial Management Report (prepared by all public institutions) including fiscal and financial results, compliance with limits, and measures	Once in four months	Activity report (annual)

[22] Current expenditures that put the government under obligation for two years or a longer period.