# Design Choices for Debt Sustainability

## From a rules-based approach to a constrained discretion regime

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**Design Choices for Debt Sustainability: From a rules-based approach to a constrained discretion regime**

June 2025

Written by Yanne Horas, Fernando Morra, and Anahí Wiedenbrüg

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Tower of the Central Bank of West African States in Ouagadougou, Burkina Faso

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# Executive Summary

Emerging markets and developing economies (EMDEs) face mounting fiscal challenges due to rising debt costs, constrained fiscal space, and growing financing needs. Current rules-based fiscal approaches have proved insufficient, often leading to excessive complexity, unenforceability, and ineffective debt management. This report proposes a shift from rigid rules-based approaches to a flexible, regime-based framework that prioritizes transparency, accountability, and long-term debt sustainability.

## Key Challenges Identified

- Excessive rigidity and enforcement challenges undermine the effectiveness of rules-based approaches and prevent adaptability.
- Layering multiple fiscal rules in an incremental way has created redundancies, contradictions, and inefficiencies.
- These frameworks exacerbate negative feedback loops, lack credibility due to fiscal fatigue, and are intrinsically unstable, particularly in EMDEs.

## Policy Recommendations

- Replace rigid debt rules with flexible debt anchors designed to ensure long-term sustainability while allowing for temporary deviations to address shocks.
- Embed anchors in a broader fiscal policy regime, incorporating goals, fiscal strategies, and independent evaluations to build a cohesive framework that balances fiscal discipline with adaptability.
- Enhance transparency and accountability, requiring governments to outline clear policy strategies, communicate future fiscal intentions, and disclose relevant data to strengthen market and public confidence.
- Leverage independent institutions, establish fiscal councils or similar bodies to assess fiscal risks, advise policy-makers, and ensure fiscal strategies align with debt sustainability objectives.

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# 1.0 Introduction: From a rules-based approach to a constrained discretion regime

Debt sustainability is a crucial goal for providing the macroeconomic environment conducive to investment and growth. It is, hence, a key objective for sound fiscal policy. In recent years, debt rules have emerged as an instrument for achieving this goal. This International Institute for Sustainable Development policy report explores how such rules aimed at ensuring debt sustainability in emerging markets and developing economies (EMDEs) have developed and examines the relevant factors for their sound implementation in country-specific contexts.

Given the increasingly tight fiscal situation that EMDEs face, establishing credibility in debt sustainability is essential. Debt costs are rising due to multiple global shocks that have made climate and macroeconomic conditions more difficult. In this context, even non-debt-distressed countries facing high borrowing costs and limited fiscal space, are unable to make the investments needed to achieve their socioeconomic development goals.[1] At the same time, EMDEs face growing financing needs.[2] The reliance on "buffers" to strengthen the credibility of debt rules may hinder investment and restrict the flexibility needed to adapt fiscal policies to evolving circumstances, ultimately affecting long-term growth.

We believe that legal frameworks, including debt rules, can play a vital role in navigating these challenges, provided they are well-designed and integrated into a broader fiscal policy regime. In Section 2, we establish a taxonomy of debt rules based on their widespread adoption across 85 countries, and discuss different designs for debt rules on a spectrum of how much flexibility they allow policy-makers.

In Section 3, we discuss the risks and limitations that arise from a rules-based approach, in relation to EMDEs. We show that the adoption of debt rules has coincided with the implementation of additional fiscal rules governing spending, revenues, and budget balances. This parallel process has led to an "incremental approach" (Eyraud et al., 2018), both in introducing new rules and incorporating complex conditions, such as cyclical adjustments and escape clauses. However, this has not necessarily contributed to debt sustainability[3] and has introduced excessive complexity. Moreover, the adoption of rules without a solid economic foundation has led to an "impossibility principle," making the enforcement of these rules unattainable. To address this challenge, we propose shifting the focus from rigid rules to a broader "regime" approach, where fiscal policy is viewed as a dynamic process that requires a clear ordering, such as distinguishing between objectives and policy instruments.

[1] Over 3 billion people live in countries where debt servicing exceeds education or health care spending (United Nations Trade and Development, 2024).

[2] The gap to achieve the United Nations 2030 Sustainable Development Goals stands at USD 4 trillion a year (United Nations Department of Economic and Social Affairs, 2024).

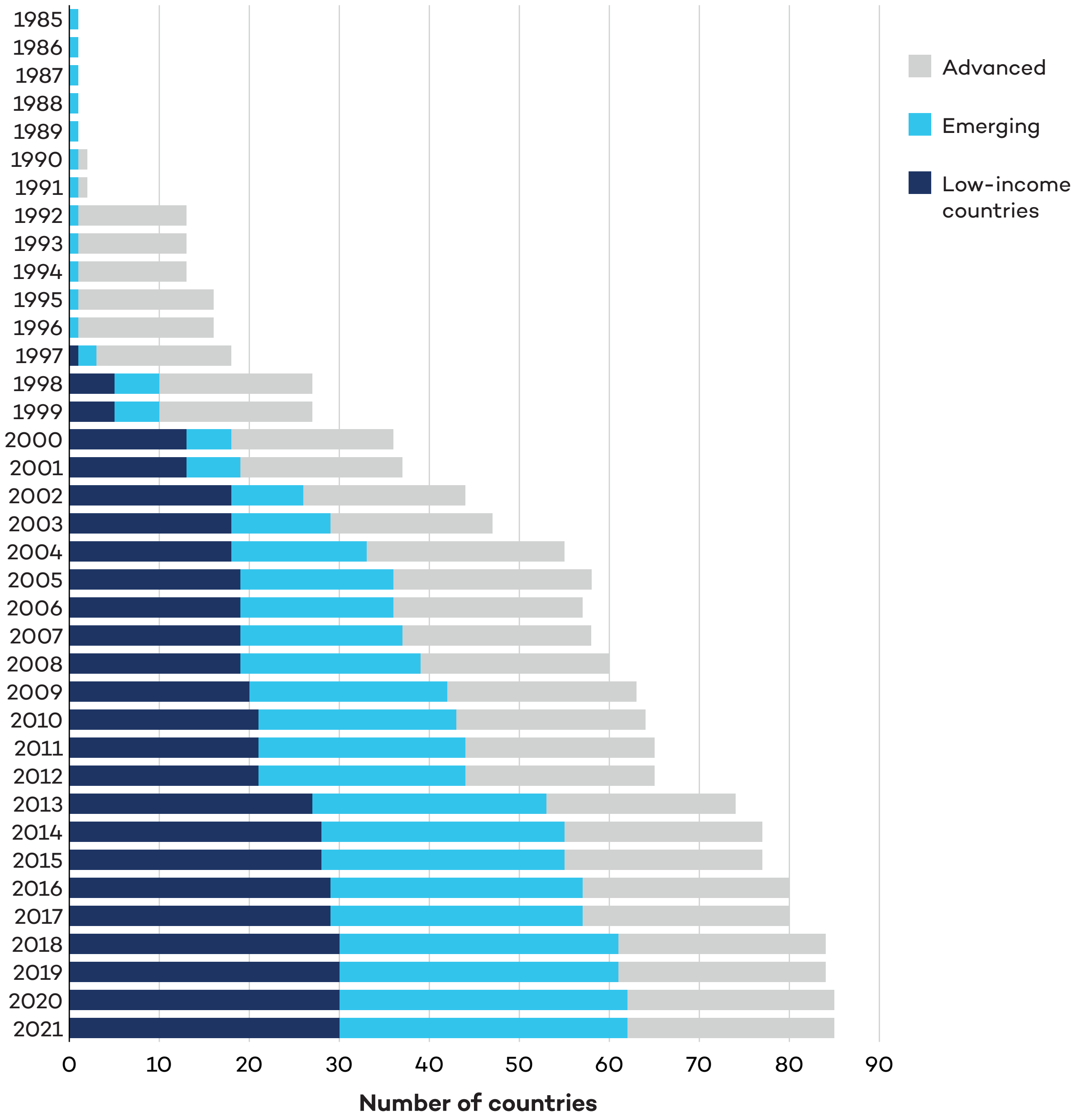
[3] See, for example, Ardanaz et al., 2023.

In Section 4, we propose that countries shift from a rules-based approach to a fiscal policy regime. We outline the structure of such a framework, exploring potential configurations to avoid the "impossibility principle," and propose a constrained discretion regime as a solution. We suggest using debt rules as an anchor to guide the system, while introducing a set of additional rules focused on the necessary disclosure of information, with the budget balance as the primary instrument. We also outline the key elements within this framework that guide policy actions, enabling policy-makers in EMDEs to exercise bounded discretion.

# 2.0 The Emergence of Debt Rules as a Tool to Address Debt Sustainability

Over the past 40 years, debt rules have emerged as a central instrument intended to strengthen countries' ability to maintain debt sustainability. Debt rules, often codified in legal frameworks, were primarily designed to constrain fiscal policy to avoid excessive debt-financed spending. Today, debt rules have become a common tool used by governments in EMDEs seeking to avoid the deficit bias[4] usually associated with discretionary policies.

**Figure 1.** Number of countries with debt rules by income




Source: Authors' own calculations, based on dataset by Davoodi et al., 2022.

[4] Deficit bias, according to public choice theory, contends that governments have a tendency to overspend and run deficits (Alesina & Tabellini, 1990).

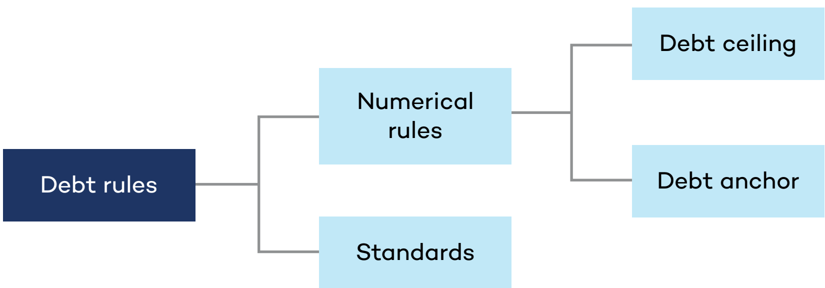
With the increasing professionalization of debt management practices, debt rules aiming to enhance fiscal responsibility have become a common feature (Abbas et al., 2019). While advanced economies spearheaded debt rules, 62 EMDEs now use them. Today, over 70% of countries that have debt rules are EMDEs—of which almost half are low-income countries. This widespread adoption reflects the growing recognition of debt sustainability as a key policy goal.

## 2.1 Types of Debt Rules: A taxonomy based on flexibility

Debt rules aim to constrain deficits by setting numerical targets or standards for debt management. While they all share the underlying goal of limiting policy-makers' discretion to maintain credibility regarding debt sustainability, not all debt rules are designed equally. In order to derive a catalogue for policy-makers, we have analyzed a comprehensive dataset by Davoodi et al., (2022), expanding it with granular country-level data.

There are three design options for debt rules that sit on a spectrum of maximum rigidity to maximum flexibility. Debt ceilings set predefined, mechanical limits for fiscal policies, focusing on numerical debt limits. In turn, debt anchors establish medium- to long-term debt paths, or debt trajectories. While debt ceilings and debt anchors are generally based on a fixed numerical rule, debt standards are qualitative prescriptions that leave a high degree of discretion or "room for judgment" for policy-makers. Note that the different types of rules can be adopted in parallel and are not mutually exclusive.

**Figure 2.** Types of debt rules based on flexibility and debt dimension




Source: Authors, based on dataset by Davoodi et al., 2022.

### Box 1. Examples of countries using a debt ceiling

In **Botswana**, Article 20 of the Stocks, Bonds, and Treasury Bills Act (2005) caps both domestic and foreign debt at 20% of GDP, each. It establishes a total debt ceiling of 40% of GDP.

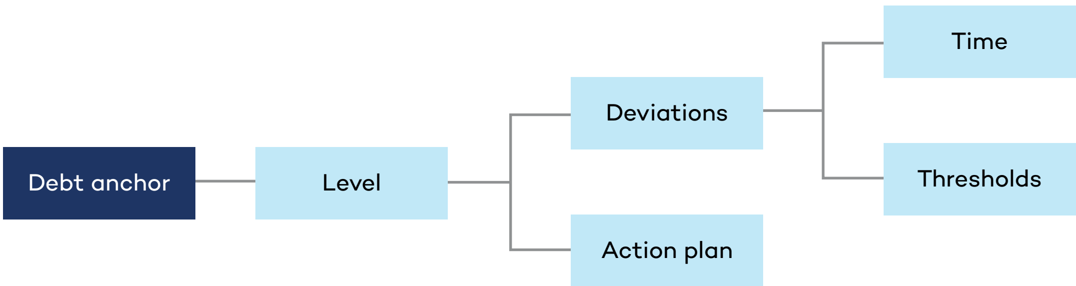
**Kenya and Malaysia** have opted to express ceilings in terms of a currency cap, which is set at 9 trillion Kenyan shillings and 35 billion Malaysian ringgit on external debt, and 10 billion Malaysian ringgit for treasury bills, respectively.

Apart from debt ceilings, a second way of designing numerical debt rules are debt anchors. Debt anchors are meant to establish medium- to long-term debt paths, or debt trajectories that fiscal policy should strive for. A review of our dataset reveals that 17 of the 85 countries identified with a debt rule have adopted some type of debt anchor or "debt target" rule.[5]

While a debt anchor may resemble a debt ceiling's mechanical rules by using the same numerical references, the key difference is that these values are not intended to set rigid directives that prohibit any deviation. Instead, a debt anchor is explicitly designed to function as a guide that offers operational freedom to debt managers, while still limiting discretion by using numerical values as benchmarks to hold them accountable.

A debt anchor can be designed with several key components. It generally features a debt level to serve as a reference, typically in the form of a numerical restriction combined with a clear definition of acceptable deviations, which may include time flexibility or threshold limits. Such a rule can also be bound by the requirement to outline a detailed action plan, which can complement anchors to ensure the trajectory aligns with the established goals.[6] The implementation of debt anchors has often placed emphasis on one specific dimension, such as being time-based (e.g., ensuring debt reaches a certain GDP threshold by a specific date) or level-based (e.g., setting broad reduction targets with commitments to gradually reduce or eliminate debt).

**Figure 3.** Options for debt anchors




Source: Authors.

Finally, the third type of debt rule is standards, which stipulate qualitative prescriptions rather than precise or detailed numerical targets. Generally, debt standards are more concerned with establishing clear criteria regarding the responsibilities of authorities to report on different debt related indicators,[7] including how the information should be presented, its content, and how it aligns with the underlying standards. In our dataset, debt standards have not been adopted in EMDEs yet and only exist in New Zealand—and to some extent—in the United Kingdom.

[5] These countries are Antigua and Barbuda, the Bahamas, Canada, Dominica, Ecuador, Finland, Grenada, India, Jamaica, Mauritius, Pakistan, Panama, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and the United Kingdom (Davoodi et al., 2022).

[6] Generally structured as a sequence of budget balances, outlining the steps needed to achieve fiscal consolidation.

[7] These include overall financial position, exchange rate, interest rate, and the value of financial assets and liabilities, etc.

### Box 2. Examples of countries using debt anchors and debt standards

#### Debt anchors

- In Jamaica, debt rules require a reduction of total government debt to 60% of GDP or below by FY 2027/28 (date-based), and to generally maintain and improve debt targets beyond that (level-based).
- An example of a specific action plan is included in the first schedule of The Bahamas' Fiscal Responsibility Bill (2018). It indicates that, in order to achieve the goal of reducing the debt level to no more than 50% of GDP, a significant increase in the fiscal budget balance was required during the FY 2018/19 to 2020/21, implemented through a gradual approach that allowed time for the public sector and economy to meet debt targets in an orderly manner.
- The United Kingdom has transitioned from a time-based focus with precise time windows to reduce debt targets, to a level-based rules approach that provides general references to the decline in public sector debt. The United Kingdom's debt rule is a hybrid that features elements of both models—debt anchor and debt standard (Keep, 2025).

#### Debt standard

- New Zealand's Public Finance Act (1989) requires the government to reduce debt to prudent levels and to maintain those levels on average over a reasonable period. The government is also mandated to prudently manage the fiscal risks that it faces.[8]

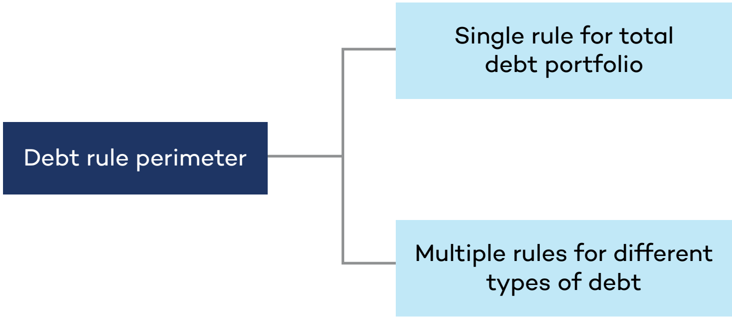
## 2.2 Alternative Approaches to Flexibility in Design

Just as it is often challenging to distinguish between different types of rules, the design within these rules also involves nuances that can introduce varying degrees of flexibility and enforcement. This section explores four dimensions: the definition of the scope of debt covered by the rule, the way numerical constraints are included, the earmarking, and the potential escape clauses.

When defining the debt perimeter, a debt rule must decide between a single, uniform debt limit that applies to all public debt, or a multi-perimeter approach, which sets tailored limits based on risk exposure and repayment capacity. A country's debt could be classified into external and domestic debt obligations, which can be distinguished in terms of currency, nationality of the holder, or legal jurisdiction under which debt is issued (World Bank, 2024). The single rule is simpler to monitor and enforce, but it may lack flexibility. On the other hand, while establishing multiple rules makes it possible to adopt differentiated policy responses and flexibility based on issuer and type of debt, it may result in convoluted structures that are difficult to monitor.

[8] New Zealand was not included in Davoodi et al.'s (2022) total number of countries that have adopted debt rules. Its Public Finance Act specifies "principles for responsible fiscal management in the conduct of fiscal policy and requires regular reporting on the extent to which the Government's fiscal policy is consistent with those principles" (The Treasury, 2023, p. 2).

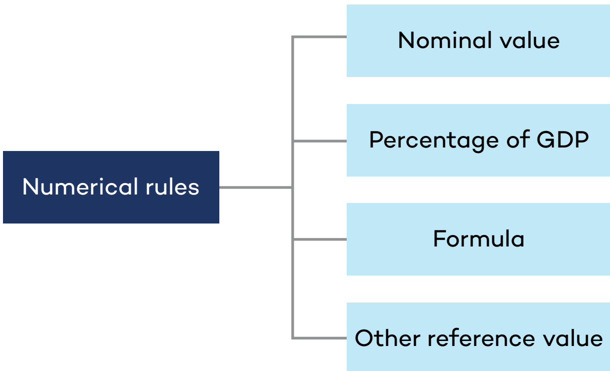
**Figure 4.** Options for debt perimeters




Source: Authors.

Similarly, the definition of numerical restrictions in the rule presents various options. A numerical debt rule can set nominal values that establish an upper debt limit (e.g., the U.S. debt ceiling). Alternatively, it may be expressed as a percentage of GDP, providing more flexibility to accommodate economic fluctuations and growth. A formula-based approach might incorporate dynamic calculations, factoring in elements such as fiscal deficits, growth rates, or debt servicing costs. Lastly, it could rely on other reference points, using alternative benchmarks like government revenue or foreign exchange reserves. While a more complex approach offers greater flexibility and adaptability to different circumstances, it comes at the cost of increased difficulty in enforcement and anchoring expectations.

**Figure 5.** Options for numerical debt rules




Source: Authors, based on dataset by Davoodi et al., 2022.

Another dimension that potentially increases the rigidity of debt rules is the earmarking of debt for specific investment purposes. Specifying how borrowed funds must be used can be a useful technique to limiting flexibility and ensuring they meet specific national priorities or project needs. Earmarking rules are generally defined to reflect the specific needs and goals of a country, yet it eliminates flexibility and judgment in the allocation of borrowed funds.

### Box 3. Country cases with earmarking

In the dataset, examples of these rules include requirements that debt should be used only to finance infrastructure projects, as is the case with the debt rules applicable in Luxembourg,

Debt rules are earmarked toward the productive sectors in Timor-Leste (Government of Timor-Leste, n.d.), or capital spending in Liberia.

*Source: Davoodi et al., 2022.*

On the other hand, debt rules can be made more flexible by allowing for deviations. For example, in the event of a disaster, an exemption clause could be triggered, providing the government with the fiscal capacity to respond with countercyclical measures. Once the economy recovers, the focus should shift back to a path toward the long-term debt target.

To account for specific situations that may warrant deviation from existing debt rules, the majority of countries in the sample have included escape clauses with varying conditions. These clauses may be designed in several ways, as they may allow for temporary breaches of debt rules if certain conditions are met, such as a declining real GDP. They may also be triggered by specific events, such as a state of emergency (as defined by the constitution) or natural disasters. Another option is that they may be conditional on approval from the parliament or a fiscal council before a breach can occur.

### Box 4. Country cases for suspensions of debt rules

In **Peru**, the debt rule allows for temporary breaches of the debt ceiling of up to 4% of GDP during periods of financial volatility, provided the remaining fiscal rules are being met.

In **Hungary**, the debt rule can be temporarily suspended in cases of a state or national crisis, state of emergency, state of preventive defence, state of terrorist threat, unexpected attack, and state of danger.

*Source: Davoodi et al., 2022.*

## 2.3 Additional Rigidities: Legal sources of the rule

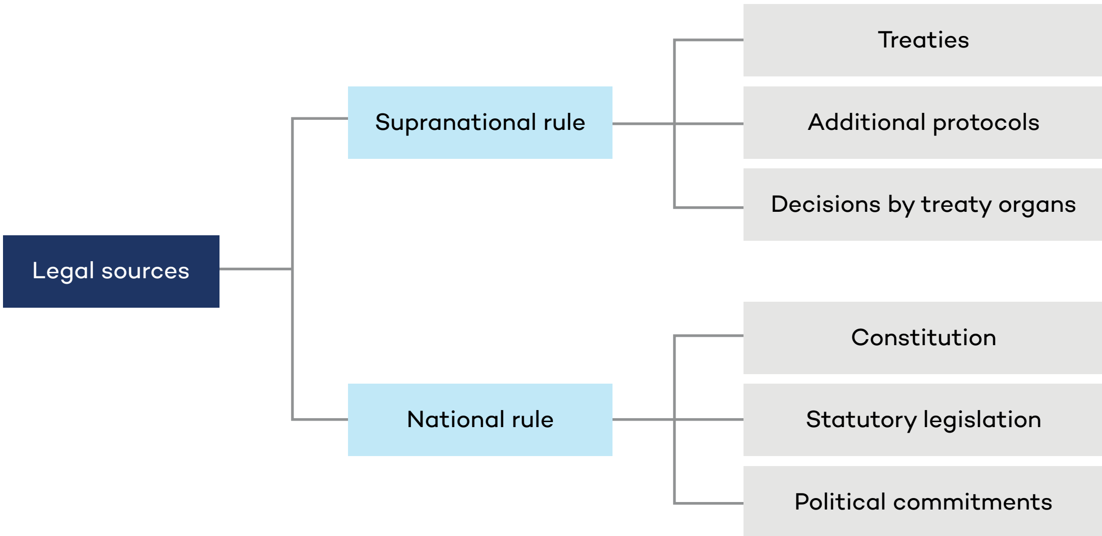
Finally, it is important to consider that debt rules are generally established at different levels of government. The source or institutional basis of debt rules can significantly influence both the flexibility of the provisions and the ability of debt managers to exercise judgment in the execution of debt policy. This applies not only to the binding nature of debt rules but also to the capacity to modify the rules across time in response to changing circumstances.

The national debt rule and the institutional ecosystem need to accommodate supranational rules and make sure they are synchronized. If calibrated correctly, this can provide an additional degree of credibility, while maintaining enough flexibility and room to manoeuver for sound fiscal policy.

A basic distinction exists between supranational and national levels that may be useful to consider. Debt rules at the supranational level tend to be based either on international treaties and protocols—such as the Maastricht criteria—or on decisions adopted by supranational fiscal or monetary bodies created by these treaties, such as the debt target established by the Eastern Caribbean Central Bank for the Eastern Caribbean Economic and Currency Union.[9]

International treaties that contain debt rules are binding on state parties and often contain provisions that make these rules hard to amend or suspend.[10] In contrast, rules issued by supranational treaty bodies may, in principle, be better suited to account for differing economic realities over time, as they can be more easily modified and updated to adapt to financial crises or other changes in economic trends.

**Figure 6.** Options for debt rules based on the legal source of the rule




Source: Authors, based on a review of debt rules outlined in dataset by Davoodi et al., 2022.

[9] The majority of supranational debt rules fall into the first category.

[10] For example, changes to the protocols to the Treaty of the European Union [12008M/PRO/12] (including Protocol No. 12 on the excessive deficit procedure) are treated as integral parts of the treaty and are therefore subject to the rules for amending the treaty, outlined in Article 48.

# 3.0 Challenges of the Rules-Based Approach

Despite their widespread adoption, fiscal rules have failed to converge toward an effective and coherent design. The first issue came from the trilemma of balancing flexibility, simplicity, and enforceability in order to maintain credibility in capital markets and in domestic political constituencies (Debrun & Jonung, 2019). Each of the different types of debt rules discussed in Section 2 puts a different emphasis on those three aspects. A numerical rule may have advantages due to its simplicity, making it easier to defend in political discourse and understandable for investors; however, it may not leave sufficient room for adjustment when economic circumstances change. On the other hand, debt standards offer greater flexibility, leaving additional space for judgment by policy-makers; however, they may be hard to enforce or operationalize.

This challenge was compounded by another, more closely related to the approach taken to address fiscal issues and the time-dependent nature of the process. The deficit bias was framed in such a way that the rules served to constrain actions rather than to facilitate the optimal use of policies. As a result, the proliferation of various rules through an incremental approach—without a clear articulation of the underlying policies—led to redundancies, contradictions, and inefficiencies (Eyraud et al., 2018). The following sections outline this process and explore the challenges and potential solutions to both issues.

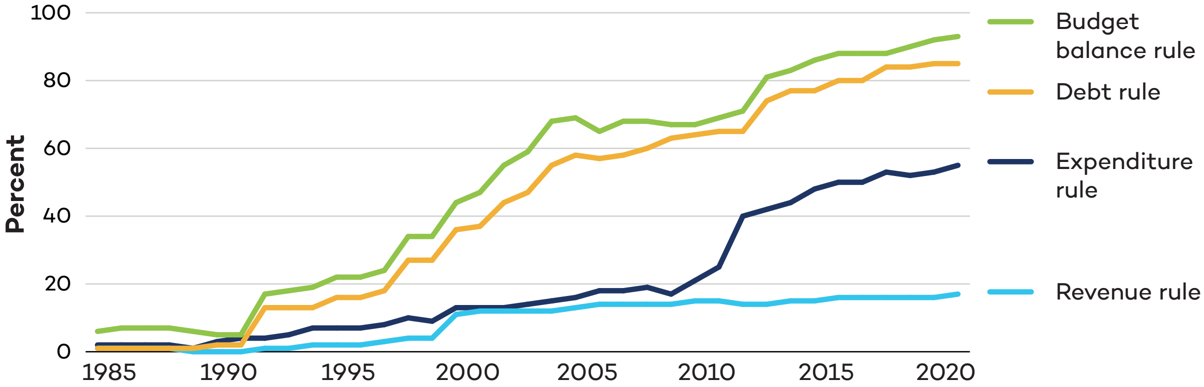
## 3.1 Debt Rules With Other Fiscal Rules: The incremental approach

The adoption of debt rules has occurred simultaneously with the implementation of other fiscal rules. There are three further types of fiscal rules targeting budget balance, revenues, or expenditure.[11] All these rules were generally imposed to signal fiscal discipline as a prerequisite for accessing credit or participating in economic unions.[12] Over time, this led to an accumulation of rules, each attempting to address different aspects of fiscal management. While fewer than 10 countries had fiscal rules 40 years ago, there are over 90 countries with budget balance rules and over 50 countries with expenditure rules today.

[11] Budget balance rules target fiscal balance to address deficit bias; and often include corrective mechanisms. Revenue rules set floors or ceilings on revenue to control deficits or limit tax burdens. Expenditure rules limit total, primary, or current spending, using growth rates, GDP proportions, etc.

[12] The emergence of fiscal rules can be traced back half a century to the international credit arrangements in the 1970s in response to economic and budgetary crises.

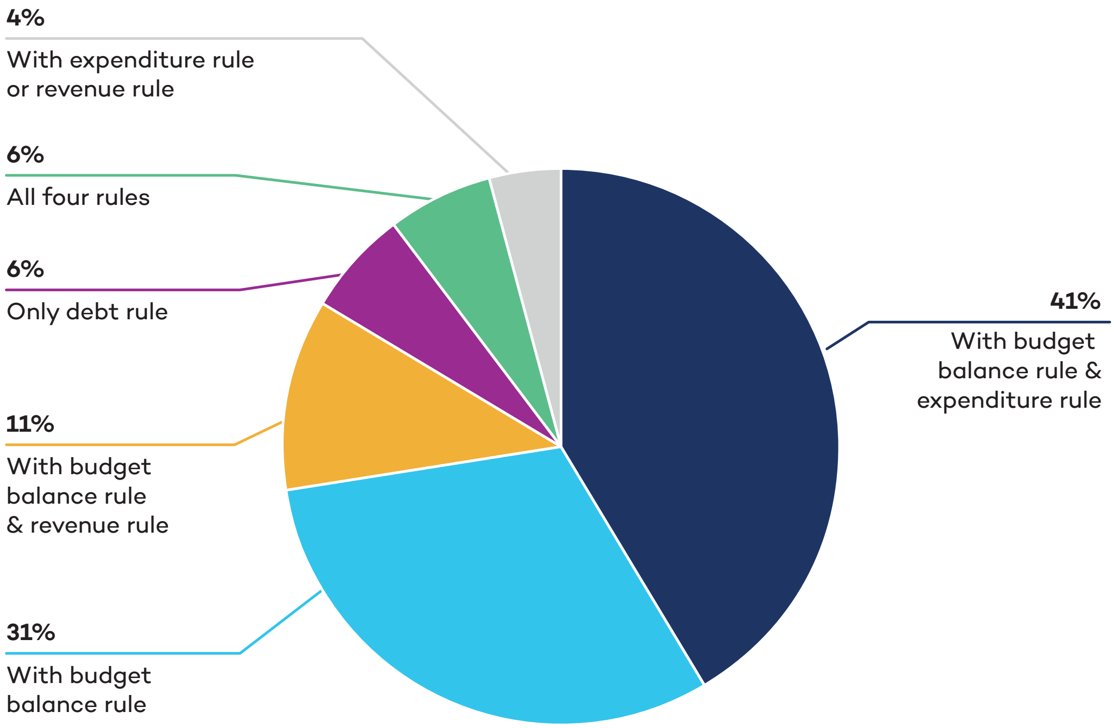
**Figure 7.** Growth in debt rules and other fiscal rules




Source: Authors' calculations, based on Davoodi et al., 2022.

Only 6% of countries with a debt rule do not have any other fiscal rules. Another 6% of countries have all four types of fiscal rules in place. The vast majority—over four out of five countries in our dataset—uses a debt rule in combination with a budget balance rule. Of these, about half have also implemented an expenditure rule, and a quarter of countries with debt and budget balance rules add a revenue rule to the mix. Less common—found in about 4% of countries—is a combination of a debt rule with an expenditure rule, revenue rule, or both, but without a budget balance rule.

**Figure 8.** Debt rules combined with other fiscal rules




Source: Authors' own calculations, based on Davoodi et al., 2022.

## 3.2 The Unintended Consequences: Complexity and unenforceability

As observed, the process of adopting rules has increasingly moved toward adding complexity by incorporating additional conditions, which has undermined both simplicity and enforceability. Overall, these rules were seen more as a way to constrain the budgeting process rather than as a means to achieve the best possible policy outcome.

Even worse, the lack of a comprehensive and coherent framework has led to significant inconsistencies. Attempting to comply with or calibrate both budget balance and debt rules simultaneously is unlikely to succeed, given the uncertainty of future growth rates and interest rates. Enforcing a fiscal surplus in this context may lead to a debt level that does not align with the target, requiring an adjustment to the budget balance to achieve the desired debt level. With this uncertainty, it becomes evident that enforcing both rules at the same time is not feasible. Strict adherence to these rules may fail to achieve the desired outcomes.

### Box 5. The impossibility of simultaneously enforcing budget balance and debt rules

**Debt-stabilizing primary surplus is a useful way to understand the relationship between debt levels and primary surplus:**

- The debt-stabilizing primary surplus (s) is the level of fiscal surplus required to keep a country's debt-to-GDP ratio constant over time. It depends on the difference between the real interest rate (r) and the real growth rate (g), as well as the current debt level (d).
- The formula to calculate it is: $s = \frac{r-g}{1+g}d$

**Small changes in growth rates or interest rates can significantly affect the primary surplus needed to stabilize debt:**

- For a real interest rate of 4% and a growth rate of 2%, stabilizing the debt at 60% of GDP requires a primary surplus of 1.2% of GDP.
- In the same context, a real interest rate of 6% requires doubling the primary surplus to 2.4% of GDP.

This highlights the challenge of applying both budget balance and debt rules in an environment of economic uncertainty.

One potential solution to this indeterminacy is to include contingencies that adjust both rules based on economic conditions. However, adding more clauses for every possible scenario can quickly become overly complex, undermining the simplicity needed to anchor expectations. Another approach is to use conservatism in fiscal rules, known as "buffers," which make the rules more resilient to higher refinancing costs or slower economic growth. While designing rules with buffers—such as stricter budget balance and debt limits—aims to ensure long-term fiscal stability, it can also result in overly restrictive fiscal policies that reduce public goods and worsen inequality. The main issue with this conservative approach is not just the "second-best" outcomes it leads to, but also that, even when well-calibrated, it can cause an unstable debt dynamic.

### Box 6. Important feedback loops in fiscal policies

**Debt rules have to navigate the complex relationship between economic growth and fiscal adjustments:**

- Fiscal adjustments often have short-term, negative output effects, which means that they reduce economic growth. This "contracting" effect on the economy may in turn cause negative feedback loops, in which debt repayment conditions worsen as borrowing costs rise further.
- The mere expectation in financial markets of significant fiscal adjustments aimed at stabilizing debt may inadvertently complicate, rather than improve, debt repayment prospects.

**This situation can give rise to multiple potential outcomes, leading to economic instability:**

- When debt levels become too high, the cost of servicing the debt increases, adding further strain on the system.
- If the government cannot generate sufficient surpluses to control the debt, the system risks losing stability, increasing vulnerability to fiscal crises.

**Fiscal fatigue:**

- As governments face growing demands to raise budget surpluses to pay for debt service, they may reach a point where maintaining them is no longer socially or politically acceptable—a phenomenon termed "fiscal fatigue" (Ostry et al., 2010).

Accurately determining sustainable debt levels and calibrating a debt rule means being responsive to multiple potential outcomes—or "multiple equilibria" in the language of economics. With bonded financing from private creditors replacing bilateral and multilateral lending as the dominant source of financing in EMDEs, the creditor landscape today is evermore complex. As debt obligations owed to private creditors are often issued under the legal regimes of the global financial centers and not under domestic law, this increases the dependency on international capital and can make it harder for EMDEs to adhere to debt rules.[13] Once credibility in capital markets is lost, it is very hard to regain.

In a negative feedback loop, a policy decision perceived as "irresponsible" in international markets can worsen a country's credit rating and, consequently, its refinancing conditions. Those power dynamics regarding sovereign states vis-a vis their private creditors can also negatively affect the internal political dimensions in borrower countries (Guzman et al., 2024).

[13] It can make renegotiation of repayment terms more difficult as there are vested interests among different groups of creditors.

These limitations are especially important for EMDEs, which operate with a different set of constraints compared to advanced economies. For EMDEs, maintaining debt sustainability is harder, as they are often faced with higher interest rates, harsher fiscal trade-offs, and vulnerability to global liquidity. In particular, refinancing conditions can be a challenge as private investors have been able to demand consistently higher interest rates from EMDEs.[14]

Rules not only have to address endogenous factors, which are feedback loops within economic cycles, but also have to be amenable to external economic shocks and instability, such as changing macroeconomic conditions and climate shocks. Furthermore, debt rules should be responsive to democratic decisions, for example, a government mandate to invest in infrastructure or education reflecting shifting societal priorities. They also must be understandable to the public in order to gain political acceptance for “fiscal adjustments,”[15] which are often necessary to comply with a debt rule.

In this context, both flexibility and simplicity are key to maximizing the effectiveness of fiscal policy and enhancing debt sustainability. However, it is essential to design frameworks that focus on anchoring expectations rather than relying on strict enforcement. We believe the solution lies in two key elements: first, structuring fiscal policy to clearly distinguish between long-term objectives (debt) and short-term instruments (budget balance). Second, since policy actions critical for debt sustainability have a medium-term horizon, it is important to create an institutional framework that fosters transparency and the disclosure of these policy intentions. We call this approach a constrained discretion regime. Striking an optimal balance between structured rules and necessary flexibility, is something we believe can only be achieved if we move from a narrow focus on rules, to a broader focus of an institutional ecosystem, in other words a debt sustainability regime. This shift away from a mere rules-based approach to a more comprehensive system of different institutions of governments revolving around a debt rule will be introduced in the next section.

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[14] Research analyzing bonded debt data over the last 200 years has revealed that private creditors as an interest group also have been able to extract significant rents from borrowing to sovereigns (Meyer et al., 2022).

[15] This generally means a reduction in spending and, hence, less availability of public services and benefits.

# 4.0 Embedding Debt Rules in a Fiscal Policy Regime

In the previous section, we discussed two key issues. First, the challenges of balancing flexibility, credibility, and enforceability. Second, the absence of a well-grounded economic theory, which has led to an incremental approach with significant inconsistencies. We argue that a rules-based approach cannot resolve this issue and that a shift toward a process-oriented perspective and a regime-based approach is necessary. In this section, we propose a framework for designing such a regime.

## 4.1 Ordering Goals and Instruments: A time-based approach

While budget balance rules focus on the fiscal year and hence operate on a short-run time horizon, debt rules generally allow for more flexibility, as they aim to maintain sustainable debt levels in the long run. This does not imply that expectations surrounding debt sustainability do not need to be well anchored. What it does suggest is that the operational independence required to react swiftly does not necessarily need to be present all the time in the fiscal space. This provides room for a more gradual approach to managing fiscal tools, while ensuring that decisions are aligned with long-term objectives and communicated transparently.

It is important in such an approach, to balance adherence to a firm debt anchor without seeking to rigidly constrain decision making. Rather, it should be the aim of an adequate debt rule embedded in a fiscal policy regime to work in sync with an institutional design that safeguards the credibility of fiscal policy in the long term and across different political cycles. We think that this framework can be built around three key components:

- **Goals**: The primary objective of any such framework should be to ensure long-term debt sustainability. This goal should be clearly stated in the legal framework, serving as the foundational principle that guides the entire system. It is generally advisable that this framework be enshrined in a specific law, with the most comprehensive design possible, at least covering the three key building blocks outlined here.
- **Fiscal strategy and principles**: Governments must be required to define their short and long-term fiscal intentions, including forecasts for budget balances and financing strategies alongside the budgetary process.[16] Additionally, governments should be required to assess whether their fiscal policies are consistent with the achievement of key debt-related principles, and to communicate both clearly through official reports.
- **Independent assessment and evaluation**: An independent authority, separate from both the executive and legislative branches, could be tasked with evaluating the government's fiscal policy decisions. This institution would assess the associated risks, monitor any potential deviations from established principles, and provide recommendations to both the government and the legislature.

[16] Such as a medium-term debt strategy and an annual borrowing plan.

**Table 1.** Overview of an adequate policy regime which embeds debt rules

| Focus | Implementation |
|---|---|
| Objective | Debt sustainability |
| Judgment | Required to adapt to unknown conditions and to respond to market expectations |
| Transparency and communication | Forward guidance. Regular communication to guide public and market expectations |
| Institutional environment | Clear transmission mechanisms, strong public confidence, stable environments, clear authority lines, and effective management |
| Independence | Possible governance independence. No operational independence (political nature of fiscal policy formulation and implementation) |
| Policy response time horizon | Longer-term outlook |

Source: Authors.

Depending on the country context, different levels of rigidity or flexibility may be favourable. There is no blueprint for the optimal debt rule that applies to all countries. However, some general guidelines can be helpful to follow. In practice, we believe that the most suitable design for most EMDE contexts—striking an appropriate balance between flexibility and credibility—is the debt anchor. This involves establishing long-term numerical constraints, such as debt-to-GDP ratios, to limit discretion, while still allowing room for adjustment in the face of shocks. However, setting clear debt targets and permitting deviations is only part of the solution. It must be paired with an institutional framework that transparently outlines action plans—particularly the sequence of budget balance—to anchor expectations, effectively replacing the need for strict enforcement. This approach will be detailed in the next section.

## 4.2 Replacing Enforcement With Accountability

We have argued that a more effective approach is to implement flexible debt rules from the outset—debt anchors with provisions for deviations. However, because this approach prioritizes flexibility, it requires additional safeguards to manage discretion. These safeguards must be backed by a clear action plan. Fiscal policy-makers must manage expectations about future debt sustainability to maintain investor confidence and ensure the credibility of their strategies. This includes announcing future policy intentions related to economic factors, such as budget balances, refinancing conditions, growth projections, and external influences, while being transparent about the economic reasoning behind these decisions. We believe that governments should be required to clearly articulate their policy strategies as part of the budgetary process.

Given that the budgetary process involves various stakeholders—including parliament, central banks, ministries, debt management offices, and audit institutions—effective oversight mechanisms are essential to the success of this design. Regular oversight and audits are crucial to ensure compliance and transparency in the disclosure of relevant information, strengthening the overall system.

At its core, the focus should be on transparency and the disclosure of information, rather than rigid adherence to fixed limits. The assumption is that this will create the right incentives for governments to pursue responsible fiscal policies while retaining the flexibility to make decisions as circumstances evolve. The role of an independent authority should primarily be to monitor, advise, and communicate the adequacy of fiscal strategies, not to directly manage policy instruments.

The role of the independent authority in assessing fiscal risks can be designed to ensure transparency and clarity in fiscal decision making. In some cases, this role may be unnecessary, as such assessments are an inherent part of the executive branch's responsibilities. In other cases, it could be taken on by the congressional budget office or an external body, such as a fiscal council (Davoodi et al., 2022). Regardless of the structure, the most important factor is clear communication regarding policy objectives and how fiscal actions align with the goal of ensuring debt sustainability. For most EMDEs, we believe that an independent institution, such as a fiscal council, combined with clear disclosure rules for fiscal authorities, would be the optimal approach.

# 5.0 Concluding Remarks

In this report, we have explored the limitations of a rigid rules-based approach to fiscal policy in achieving debt sustainability. We have argued that moving to a regime that promotes flexibility and simplicity—paired with clear accountability and transparent communication—offers a more effective way forward. By embedding rules within a fiscal policy regime that allows for deviations, countries can strike a balance between fiscal discipline and the flexibility needed to respond to economic shocks.

Our proposed framework emphasizes the importance of long-term debt sustainability, the need for clear fiscal strategies, and the role of independent institutions to assess risks and maintain transparency. While the specific design of such a framework will vary depending on the country's context, the underlying principle remains the same: fiscal policy should be flexible yet anchored in transparent, credible, and accountable processes.

In practice, we believe that for most EMDEs a debt anchor, combined with an institutional framework that includes independent assessment and clear disclosure rules for fiscal authorities, will be the most effective solution. This approach will not only enhance fiscal responsibility but also provide the necessary room for governments to adjust to evolving economic conditions without compromising long-term debt sustainability. By fostering transparency, accountability, and credibility, such a regime can ensure that fiscal policy remains resilient across political cycles and economic uncertainties.

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