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| from:    | The General Secretariat of the Council   |
| to:      | Delegations  |
| Subject: | Domestic Fiscal Frameworks<br>- How National Fiscal Governance Can Contribute To<br>Budgetary Consolidation Over The Medium Term |

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Delegations will find attached a document on domestic fiscal frameworks from the Services of the Commission.

Encl.:



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## **DOMESTIC FISCAL FRAMEWORKS**

### **HOW NATIONAL FISCAL GOVERNANCE CAN CONTRIBUTE TO BUDGETARY CONSOLIDATION OVER THE MEDIUM-TERM**

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(Note for the attention of the Economic Policy Committee)

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## **Summary and Conclusions**

**1. The current crisis has seen GDP fall on an unprecedented scale since the 1930's. The huge fiscal effort put in place within the EERP by EU countries seems to have helped avoid a deflationary spiral in the short-term.** However, the other side of the coin of this impulse is the large structural deficits and growing debt ratios that will have to be addressed in the next future.

**1. The important role played so far by fiscal policy in coping with the adverse economic developments will continue to be a key element for the overall policy strategy in the aftermath of the crisis.** While discretionary budgetary measures have been one of the main building blocks of the policy response at the "crisis control and mitigation" stage, the design of fiscal policy will also be crucial during the "crisis resolution" and "crisis prevention" phases (see Table 1). Specifically, there is an urgent need for a timely exit strategy and well-designed budgetary consolidation plans over the medium-term in the period of "crisis resolution". Subsequently, an urgent necessity to improve the conduct of fiscal policy arises at the "prevention" stage to overcome the policy mistakes observed over the recent past.

**2. This places fiscal-related issues at the core of current and future policy initiatives to restore stability and promote a growth-oriented macroeconomic outlook.** In this respect, the current crisis offers a wide and rich set of policy lessons that should shape the conduct of fiscal policy in the years ahead. A significant number of EU countries put into practice a relatively loose budgetary policy during the boom period preceding the downturn. This subsequently amplified the effects of the crisis and rendered EU economies less resilient and more fragile than they would otherwise have been.

**3. Not only is this pre-crisis fiscal stance likely to have entailed a strong pro-cyclical and deficit bias in normal times and to have had negative consequences in terms of growth and macroeconomic stability in the short-term, but it may also undermine the long-term sustainability of public finances in a context of emerging age-related costs.** This clearly calls for improved fiscal policy making at national level within the EU fiscal framework. This new approach in the conduct of fiscal policy should be primarily supported by appropriate national fiscal governance.

**4. Adequate domestic fiscal frameworks can be conducive to establishing the right institutional setting with suitable incentives and constraints for policy makers to commit to a lasting fiscal consolidation and sustainable budgetary policies.** The appropriate features of fiscal frameworks are, however, country-specific and there are no one-size-fits-all solutions.

**5. Despite the importance of country-specific circumstances, the economic literature and policy experiences provide a number of insights on how the main elements of domestic frameworks should be designed and implemented.** The reform of these elements, namely numerical rules, independent institutions, medium-term frameworks and budgetary procedures, should be regarded as one process. All these fiscal arrangements are closely interconnected and the appropriate functioning of one of them may positively influence the working of the remaining elements. Partial or fragmented reforms usually fall short of the needed improvements. For instance, the strengthening of fiscal rules and the upgrading of budgetary procedures are complementary rather than substitutive measures. Policy-makers should pay attention to these interplays.

***Table 1: Role and features of fiscal policy in tackling current economic developments***

| <b><i>Crisis stages</i></b>          | <b>Crisis control</b>  | <b>Crisis resolution</b>   | <b>Crisis prevention</b>   | <b>EU instruments</b>   |
|--------------------------------------|--|--|--|---|
| <b><i>Fiscal policy response</i></b> | <ul style="list-style-type: none"> <li>• Automatic stabilisers plus discretionary measures subject to fiscal space considerations.</li> <li>• EU coordination based on the EERP</li> <li>• Discretionary measures following the TTT criterion</li> <li>• BoP Facilities</li> </ul> | <ul style="list-style-type: none"> <li>• State-contingent exit from fiscal expansion subject to both: <ul style="list-style-type: none"> <li>- Recovery</li> <li>- Long-term sustainability</li> </ul> </li> <li>• Design of time consistent fiscal consolidations plans. Greater focus on debt developments.</li> <li>• Plan the strengthening domestic fiscal frameworks to sustain credibility of fiscal retrenchment.</li> <li>• Possibility of one-off measures to deal with the emergence of deflationary risks</li> </ul> | <ul style="list-style-type: none"> <li>• Fiscal policy based on automatic stabilisers (no fine tuning) and long-lasting consolidation.</li> <li>• State-contingent one-off fiscal stimulus in case economic developments deteriorate dramatically.</li> <li>• Better accounting of contingent liabilities.</li> <li>• Fiscal policy more sensitive to: <ul style="list-style-type: none"> <li>- counter cyclical stance (particularly in good times)</li> <li>- asset price developments and credit growth</li> <li>- fiscal space considerations.(e.g. external imbalances)</li> </ul> </li> <li>• Introduce domestic fiscal frameworks reforms to favour the above features</li> </ul> | <ul style="list-style-type: none"> <li>• SGP</li> <li>• European Investment Bank</li> <li>• EERP</li> </ul> |

**6. On this basis, the strengthening of domestic fiscal frameworks should focus on four key elements.** Specifically, these reforms may be described as follows:

**7. Firstly, national fiscal governance should primarily rely on a rules-based framework.**

There is large empirical evidence that numerical fiscal rules have an influence on budgetary outcomes and may considerably reinforce fiscal discipline. While their final effectiveness depends on a number of characteristics (primarily monitoring and enforcement mechanisms), potential shortcomings relating to the stabilisation function of fiscal policy may be addressed by adequate design and target definition (e.g. rules defined on a cyclically-adjusted basis or over the cycle). Numerical fiscal rules include budget balance rules, debt rules, expenditure rules and revenue rules and several of these may be combined together in a set of fiscal rules.

**8. Expenditure rules exhibit a number of properties that could adequately tackle some of the observed pitfalls in the domestic fiscal policy making: recurrent spending overruns and frequent pro-cyclical policies.** These rules target the part of the budget that is more immediately under the discretionary control of fiscal authorities, thereby ensuring a high degree of accountability, while hardly preventing the functioning of automatic stabilisers. The extensive use of this type of rules during past episodes of budgetary consolidation reflects their instrumental character in sustaining fiscal discipline.

**9. Overall, spending rules have generally been adopted as a cornerstone of ambitious consolidation plans and are currently one of the main building blocks of the most successful and resilient domestic fiscal frameworks across EU countries.** Thus, the Netherlands, Denmark, Sweden and Finland, which can be considered the most outstanding Member States in terms of fiscal discipline, have rules-based systems in place which hinge upon an expenditure rule combined with revenue or cyclically-adjusted budget balance rules. In this respect, some of these country-experiences also show the countercyclical role that well-designed revenue rules may play.

**10. The appropriate set of numerical fiscal rules should reflect domestic circumstances, including political, legal and cultural factors. However, some common principles stemming from successful country experiences and reflecting the overarching objective to restore fiscal sustainability may be identified with a view to strengthening rules-based frameworks in the years ahead. In particular, the following elements appear relevant:**

- Regardless of whether a debt rule is in place or not, a central objective of fiscal policy over the next year across the EU should be the halting and reversing of the debt ratio.
- The path for the evolution of the debt ratio should be underpinned by operational (primary) budget balance targets sustained by a budget balance rule applied to the whole of the general government sector.
- The budget balance rule should be operationalised through binding expenditure ceilings based on a multi-annual spending rule for the general government. Expenditure thresholds should reflect the envisaged debt reduction path and cautious macroeconomic and revenue projections for the relevant period. The expenditure rule should be supplemented by a revenue rule to ensure that higher-than-expected receipts are allocated to debt reduction.
- Finally, a budget balance and/or debt rule consistent with the envisaged overall expenditure ceilings should be applied to sub-central governments.

**11. A rule-based system, consisting of an expenditure rule supplemented by a revenue rule and/or a budget-balance rule, seems to have yielded positive budgetary outcomes in terms of both discipline and stabilisation.** For instance, the Dutch fiscal framework relies on strong multiannual expenditure ceilings complemented by a revenue rule. In the case of Sweden, the existing expenditure ceilings are consistent with a budget balance rule. In both countries, a balanced-budget requirement applies to sub-central governments. As to Finland, the multiannual spending limits are consistent with a balanced-budget rule for the central government and accompanied by a revenue rule for the social security that operates following a 'Rainy Day Fund' scheme. In this case, territorial governments are also covered by a balanced-budget rule.

**12. Countries with a high fiscal decentralisation should pay due attention to the interactions between their rules-based system and how fiscal policy is implemented across government levels.** In particular, most fiscal rules applied to territorial governments

are balanced-budget or debt rules, which may imply a pro-cyclical bias in the conduct of fiscal policy. A feasible solution to address this shortcoming should be based on a close coordination of all government layers and the adoption of a multiannual perspective to take into account the effects of the cycle. This coordination should take place at an early stage of the budget process, and preferably when fiscal targets for all government tiers are set.

**13. Secondly, a complementary policy option to reinforce fiscal governance is the establishment of non-partisan public bodies acting in the field of budgetary policy.** It is worth stressing that the type of institutions considered in this note does not entail any fiscal policy delegation to an independent institution as suggested by some other proposals. Thus, these institutions should be seen as independent advisory bodies supplementing fiscal authorities and entrusted with some technical tasks related to budgetary policy making.

**14. In some Member States such institutions have been playing an important role in promoting sound and sustainable fiscal policies.** The main fields in which these bodies carry out their activities are the provision of macroeconomic forecasts for the budget preparation, the analysis of budgetary developments vis-à-vis the respect of fiscal targets, and the estimation of the budgetary impact of specific policy measures.

**15. The involvement of the institution in the budget process emerges as the most crucial element determining its influence on the conduct of fiscal policy.** The existing arrangements currently in place in some EU countries have proved to be effective in conveying the policy messages issued by these independent bodies. The most widespread options consist of regular hearings by the Parliament during the budget preparation, consultation by the Government in the course of the budgetary process, or the obligation of the fiscal authorities to justify departures from the forecasts or recommendations released by the institution.

**16. Independent institutions can also play a role in more recent policy proposals relating to the latest economic developments.** In the aftermath of the current crisis, a number of institutional reforms and policy instruments have been suggested in order to implement fast decision-making mechanisms to determine policy actions for crisis prevention. In all these proposals, national independent fiscal bodies could be involved in assessing the suitability of these policy measures and in counteracting credibility risks stemming from political interferences in their implementation. Thus, these independent bodies could evaluate the suitability of a temporary suspension of fiscal rules on the basis of well-defined escape clauses and might also assess the appropriateness of implementing a state-contingent one off-fiscal stimulus in case economic developments worsen dramatically.

**17. The role of an independent institution or fiscal council can be undertaken by either a new body, or by enlarging the scope of existing institutions (such as audit authorities) if this has the capability or reputation to play this role effectively.** Either way, its mandate should be clear and unambiguous, containing the tasks assigned to the institution and their scope and backed by strong legal provisions. Moreover, a high degree of autonomy and functional independence vis-à-vis fiscal authorities are important preconditions to ensure that the functioning of the institution is not hampered by political interference.

**18. A third policy option to reinforce national fiscal governance and supplement rules and institutions is the strengthening of national medium-term budgetary frameworks (MTBFs) for multiannual fiscal planning.** MTBFs are defined as those fiscal arrangements that allow the government to extend the horizon for fiscal policy making beyond the annual budgetary calendar. Most fiscal measures have budgetary implications that go well beyond the usual yearly budgetary cycle, thus justifying the introduction of such a

policy instrument. On top of that, current fiscal imbalances clearly call for sizeable consolidation measures with a non-negligible budgetary impact over the medium term, which further substantiates the importance of an effective multiannual budgetary planning.

**19. Most EU Member States currently have in place a MTBF. However, a large majority of them also show significant shortcomings that hamper the use of this fiscal arrangement as an effective policy instrument for a time-consistent fiscal planning.** These weaknesses mainly consist of the non-constraining character of fiscal targets (i.e. budgetary figures considered in the MTBFs are merely projections and are not binding), regular revisions of the main fiscal aggregates and a lack of political commitment. Likewise, budgetary projections are frequently based on unrealistic macroeconomic assumptions raising credibility problems. Finally, the absence of independent monitoring and regular reporting, together with the absence of corrective mechanisms in case of deviation from the envisaged fiscal path, further weaken the use of this fiscal arrangement.

**20. The strengthening of domestic MTBFs should follow some specific prescriptions based on a number of successful country experiences.** Firstly, on the expenditure side MTBFs should rely on binding multi-annual expenditure ceilings. These spending projections should be complemented by revenue projections stemming from cautious macroeconomic forecasts. An appropriate breakdown of both expenditure and revenue projections should be included to allow reflection of the envisaged strategy over the medium-term. Specifically, domestic frameworks should incorporate total expenditure limits for the government sub-sectors and a breakdown of these limits according to the main expenditure areas covered by the budget. This is the approach followed by some EU Member States reporting good result in terms of multiannual fiscal planning (i.e. respect of fiscal targets over time and limited episodes of pro-cyclical policies). Generally, these are the same countries that have implemented strong multiannual expenditure rules and have independent advisory bodies as those described above.

**21. Moreover, the baseline macro projections should include alternative scenarios to allow the identification of budgetary priorities in case an unforeseen increase or decrease in revenues materialises.** Ex post, actual out-turn figures should be compared to the MTBF projections and difference should be explained and justified.

**22. Monitoring mechanisms and enforcement procedures pre-defining actions in case of non-compliance are important too.** These mechanisms, which should specify the frequency and body in charge, should be closely linked to those established for the expenditure rule on which the MTFB should be based. The same institution should monitor and enforce both elements of the fiscal framework in case these tasks are assigned to an independent body.

**23. Last but not least, projections and objectives included in the medium term framework should form the basis on which the budget law and the SCP are prepared.** In this respect, the role played by national Parliaments vis-à-vis the MTBF should be strengthened: the projected fiscal path, particularly the expenditure targets, should formally be presented, discussed and approved in the Parliament before the submission of the budget law.

**24. Finally, available information suggests there is still margin to further improve the existing budgetary procedures at national level.** These procedural rules cover the three stages of the budget process, namely planning, approval and execution, and a significant number of Member States show weaknesses mainly relating to transparency, centralisation of the budgetary process, scant use of top-down budgeting and realistic economic assumptions.



**25. The lack of centralisation at the budgetary planning stage in a number of countries emerges as one of the main problems in the domestic budget process, particularly in some new Member States.** This potentially enhances the deficit bias through the common pool problem and may hamper fiscal discipline. This shortcoming should be addressed by the reinforcement of the Ministry of Finance with a veto power over line ministries' requests, the implementation of expenditure rules providing binding spending limits, and imposing limitations to the Parliament to modify the overall size of the budget

**26. A final change to procedure that should be considered is the introduction of top down budgeting.** This should significantly reinforce the centralisation of the budget process and sustain fiscal consolidation. The resort to this type of budgeting must be considered an essential element of the reformed fiscal framework. However, it must be clear that its successful implementation goes hand in hand with the establishment of effective binding ceilings on expenditure developments and the existence of a strong Ministry of Finance.

## **1. – Introduction:**

**1. The current crisis has seen GDP fall on an unprecedented scale since the 1930's. The huge fiscal effort put in place within the EERP by EU countries seems to have helped avoid a deflationary spiral in the short-term.** However, the other side of the coin of this impulse is the large structural deficits and growing debt ratios that will have to be addressed in the next future.

**2. Once the recovery is firmly underway, the need for a lasting fiscal consolidation calls for a well-designed fiscal policy exit strategy in the short-term supplemented by an adequate policy framework to ensure budgetary discipline in the medium and long-term.** The current fiscal expansion risks jeopardising fiscal sustainability while entailing higher real interest rates unless an appropriate consolidation strategy is planned in advanced, especially once the future costs of ageing are factored in.

**3. In this context, it is important to underscore that the prevailing agreement among policy-makers to avoid discretionary policies to smooth cyclical fluctuations still applies.** Discretionary fiscal policy is only justified in the current scenario by the magnitude of the crisis and the impairment of the monetary transmission channel (i.e. this was not a "standard" cyclical downturn).

**4. On top of that, the main shortcomings of discretionary fiscal policy in terms of lags and reversibility remain in place, and automatic stabilisers appear superior to discretionary actions in this respect.** Finally, the heritage of discretion is generally an enhanced deficit bias in the conduct of fiscal policy with significant structural deficits and an accelerating path of debt accumulation. Unfortunately, the current stimulus packages are not an exception in this respect and pose a risk for the future.

**5. The reversal of the current unsustainable deficit and debt trends requires stronger and stability-oriented domestic fiscal frameworks, which should not only support the attainment of this objective but also supplement the EU fiscal framework and the respect of the SGP provisions.** Fiscal frameworks should therefore be strengthened and adapted to take into account the lessons of the current crisis, facilitate fiscal policy exit, and sustain fiscal consolidation.

**6. This is in line with the importance attached to domestic institutional issues by the Council in its report on the 2005 SGP reform.** The Council explicitly underscored the active role that domestic budgetary rules and national institutions should play in sustaining member States' commitments under the SGP. Moreover, this political orientation has been reiterated in further Council conclusions in October 2007, May 2009 and in the October 2009 conclusions of the fiscal exit strategy. The 2009/10 SCPs will also recognise the important role of domestic fiscal frameworks, as measures related to their strengthening will be given new special emphasis.

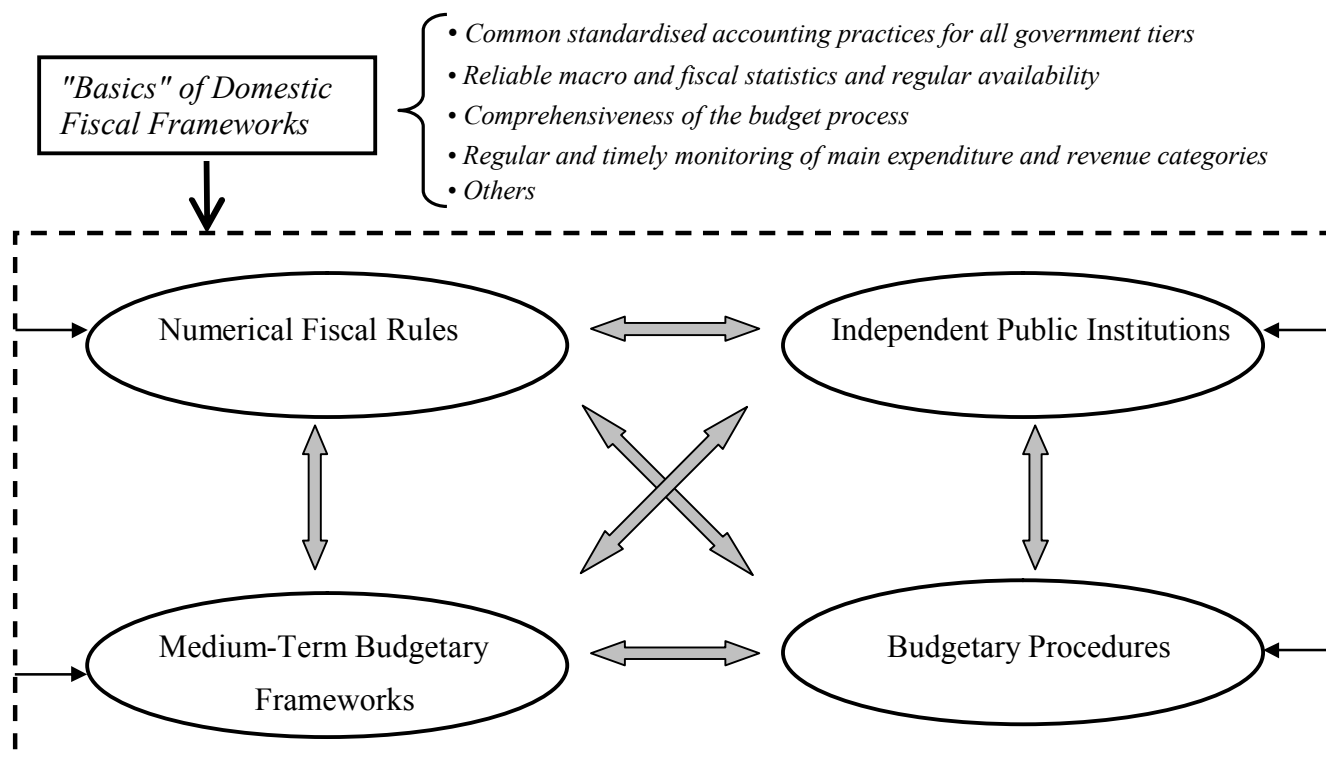
**7. This note analyses what elements should be taken into account more carefully in designing resilient fiscal frameworks so as to pave the way for the needed fiscal retrenchment and promote the respect of the SGP provisions.** The note is organised as follows. Section II provides the definition of domestic fiscal frameworks and describes its main elements. Section III reviews the role played domestic fiscal frameworks in previous episodes of fiscal consolidation while Section IV includes some general considerations on the reform of national fiscal governance. Finally, the reform of the main elements of domestic fiscal frameworks, namely rules, institutions, multiannual planning and budgetary procedures, is addressed in Section V.

## 2. – Domestic fiscal frameworks: definition and main elements

8. A domestic fiscal framework can be defined as the set of elements that form the basis of national fiscal governance, i.e. the country-specific institutional policy setting shaping fiscal policy making at national level. Thus, domestic fiscal frameworks concern the overall system of arrangements, procedures and institutions that underlies the planning and implementation of budgetary policies. These arrangements create the environment, the incentives and constraints under which policymakers take policy decisions.

9. The main elements of domestic fiscal frameworks are numerical fiscal rules, independent public institutions acting in the field of budgetary policy, medium-term budgetary frameworks for multiannual planning and budgetary procedures governing the preparation, approval and implementation of budget plans.<sup>1</sup> All these elements interplay with each other influencing the working of the whole system of fiscal governance. Figure 1 below represents graphically the composition of domestic fiscal frameworks.<sup>2</sup>

*Figure 1: Main elements of domestic fiscal frameworks.*



10. It is important to stress the interaction of these elements and their complementary rather than substitutive character. For instance, strong fiscal rules and well-designed budgetary procedures are typically mutually reinforcing. While the fulfilment of fiscal rules can be facilitated by an adequate budget process through a higher budgetary centralisation, the implementation of binding fiscal targets stemming from fiscal rules may promote the use of top-down budgeting to support the achievement of these budgetary objectives.

<sup>1</sup> Strictly speaking, medium-term budgetary frameworks are one element entering into the definition of budgetary procedures. However, given their importance so as to ensure a medium term perspective in the fiscal policy making, they are generally treated separately from the remaining elements. This approach has also been adopted in this working document.

<sup>2</sup> The appropriate definition for each one these elements will be provided in the following sections dealing with each component of domestic framework separately.

### **3. – Did domestic fiscal frameworks play a role in previous consolidation episodes?**

**11. Over the last twenty years, a fruitful strand of economic literature has analysed the main determinants of successful fiscal consolidations.** According to this research, the list of elements determining the success or failure of fiscal consolidation policies has changed over time. In particular, since the inception of EMU new elements have come into play to explain why some attempts of fiscal retrenchment were successfully crowned.

**12. The first wave of these empirical analyses, carried out between the late 1980s and the mid 1990s, primarily focused on the composition of the fiscal adjustment and the role played by the political and institutional setting (e.g. coalition versus single-party governments).** The main finding pointed out that successful budgetary consolidations over the 1970s and 1980s were mainly expenditure-based, with a particular emphasis on primary current expenditure (mainly public wages and transfers). Fiscal adjustments following this strategy, which directly tackled those expenditure items driving unsustainable public spending trends, were generally longer-lasting than consolidations based on tax hikes and investment cuts (Alesina and Perotti (1995), (1996), and Alesina and Ardagna (1998)).

**13. More recent research has qualified these earlier results suggesting a broader range of factors behind successful fiscal consolidations.** While long-lasting consolidations remain more expenditure-based, the experience of the 1990s suggests that revenue increases can be part of the successful mix (European Commission (2007)).<sup>3</sup> This is particularly relevant in the current scenario, in which the huge fiscal efforts required to restore budgetary discipline seem only attainable through a combination of both spending and tax measures.

**14. However, possibly the most interesting finding of this recent research is the prominent role that some elements of domestic fiscal frameworks seem to have played in the fiscal consolidation episodes since the early 1990s.** Some of these analyses show that fiscal rules have sustained fiscal discipline in a number of EU countries (see Larch and Turrini (2008)), while other emphasize the importance of well-designed budgetary procedures to ensure the centralisation of the budget formulation (Von Hagen et al. (2002)). In other cases, some features of fiscal frameworks, such as the existence of binding expenditure ceilings, were key elements behind the observed fiscal adjustments (Guichard et al. (2007)).

**15. The relevance of this finding is further underpinned by other analyses providing evidence that stronger fiscal frameworks tend to yield higher surpluses or lower deficits.** For instance, countries implementing stronger rules over a larger share of general government finances are likely to register better budgetary outcomes (Debrun et al. (2008)), whilst effective medium-term budgetary planning are instrumental in sticking to budgetary plans (European Commission (2007)). In turn, the quality of domestic budgetary procedures determines the achievement of better budgetary performance (Fabrizio and Mody (2006)).

**16. At the present juncture, this evidence warrants a close analysis of domestic fiscal frameworks.** This may allow to identify those features of the institutional fiscal setting that should be strengthened with a view to sustaining fiscal policy exit and budgetary consolidation in the years ahead.

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<sup>3</sup> This is likely to reflect a number of factors behind the run-up to EMU. Over the last decades policy-makers tended to favour the shrinkage of government size (e.g. privatization programmes), reducing gradually the margin to implement "easy" expenditure cuts on less sensitive spending items. Additionally, the required sizeable adjustments to qualify for EMU triggered the resort to higher revenues to supplement the expenditure containment efforts. In this context, the success of consolidation was less determined by the composition than by the policy-makers' ability to maintain over time expenditure cuts and revenue increases.

#### **4. – The strengthening of domestic fiscal frameworks: some general considerations**

**17. The findings summarised in the previous section have given rise to a commonly accepted view among economists and policy-analysts that fiscal discipline needs to be backed by an adequate domestic fiscal governance.** The reform of national fiscal frameworks should provide the right incentives for government arms and institutions involved in fiscal-policy making to interact in way that favours sound and sustainable fiscal policies.

**18. However, policy experiences show that the successful implementation of such reforms is subject to a number of preconditions.** For instance, the scope of the reform must be sufficiently wide to tackle the main institutional pitfalls and ensure an appropriate sequencing of reforms.

**19. In turn, especially in the context of EMU, the reform of domestic fiscal governance must be consistent with Member States commitments' under the EU fiscal framework and adapted to the domestic institutional set-up, in particular the degree of fiscal decentralisation.** Due attention must be given to both the EU and the domestic perspective when designing the reform of the main elements of the fiscal framework. The following sub-sections focus on these issues.

##### **4.1 – Preconditions for a successful reform of domestic fiscal frameworks**

**20. In general, the suitable reform of the fiscal framework is country-specific and its appropriate design depends on the nature of the fiscal problems and the existing institutional and political setting.** Therefore, one-size fit all solutions for fiscal framework reform does not exist. A careful planning taking into account these domestic features is of utmost importance to ensure the main sources of fiscal unbalances are tackled.

**21. Despite the country-specific nature of fiscal framework reform, policy experiences also show that some common elements exist and are particularly relevant.** These elements heavily influence the success or the failure of any policy strategy to review the whole fiscal governance.

**22. Firstly, the reform of fiscal governance must be comprehensive by addressing all the main institutional pitfalls.** Partial or fragmented reforms usually fall short of the needed improvements. For instance, the establishment of an independent monitoring body and the introduction of fiscal rules are complementary rather than substitutive measures and may have strong feedback effects between them. Policy-makers should pay attention to these interplays.

**23. A second common element to all reforms refers to the functioning of the most primary elements of the fiscal framework.** Specifically, prior to introducing more meaningful reforms, such as more constraining fiscal rules or a medium-term fiscal planning, some basics elements mainly related to statistical, accounting and monitoring issues should function up to minimum international standards. For instance, the use of a common standardised accounting methodology in the whole public administration and the need for regular availability of budgetary statistics are key pre-conditions. Likewise, the existence of regular monitoring and timely reporting for the main expenditure and revenue categories are crucial to ensuring a proper functioning of the fiscal framework (e.g. fiscal rules). Some EU countries currently suffer from these shortcomings. See Box I for details on the appropriate sequencing of reforms.

**24. Last but not least, the overhaul of the fiscal framework by introducing "sophisticated" policy tools such as rules or medium-term frameworks is not a substitute for political commitment to fiscal discipline.** A strong political willingness to restore fiscal stability and a broad social consensus on the need to conduct sound fiscal policies must necessarily support the establishment of such reforms in order to ensure their successful implementation.

### **Box I: Appropriate sequencing of fiscal framework reforms**

According to the policy experiences of those countries in the forefront of institutional budgetary reforms, three stages can be distinguished in the appropriate pace:

**1.** - Prior to implementing and developing some "sophisticated" institutional arrangements, such as fiscal rules or outcome-oriented budgeting, the "basics" of the fiscal framework must be in place and work appropriately.<sup>4</sup> The list of these primary elements should include the following:

- *Common standardised accounting practices applied to all general government sub-sectors.*
- *Regularly available reliable fiscal and macroeconomic statistics and regular availability.*
- *Realistic macroeconomic forecasts.*
- *Comprehensiveness of the budget law (i.e. limited off-budget operations and special funds outside the standard budgetary process).*
- *Pay-go principle (i.e. any proposal entailing revenue losses or increased expenditures must contain an appropriate measure to offset the budgetary cost).*
- *Effective programme-based budgeting.*
- *Procedural budgetary rules ensuring the centralisation of the budget process, which should entail:*
  - i) Strong competences and veto power assigned to the minister of finance during the budget preparation.*
  - ii) Limited power of the parliament to modify the overall size of the budget at the approval stage of the budgetary process.*
  - iii) Barring exceptional circumstances (e.g. natural catastrophes), the legislative body cannot amend the budget at the execution stage of the budgetary process.*
- *Reliable monitoring of the main expenditure categories and regular reporting.*
- *Tax system functioning up to minimum international standards.*
- *Appropriate cash treasury management.*
- *Adequate debt management including a well-designed debt rescheduling if necessary.*

**2.** - Once the "basics" work properly, other elements of the fiscal framework can be introduced to further strengthen fiscal governance. These elements would comprise:

- *Numerical fiscal rules.*
- *Top-down budgeting.*
- *Multiannual fiscal planning (i.e. medium-term budgetary frameworks).*
- *Strengthening of checks and balances in the budget process. For instance, independent bodies involved in the budget process (e.g. an independent institution could monitor budgetary execution and the respect of the existing fiscal rules). In the same vein, a more active role of the parliament as regards medium-term fiscal targets and the SCP preparation.*
- *Introduction of long-term considerations in the fiscal policy making (e.g. age-related expenditure and contingent liabilities).*

**3.** – Finally, this sequencing would focus on performance budgeting issues. This could include:

- *Output-oriented budgeting.*
- *The use of performance indicators to regularly assess public spending programmes.*
- *Introduction of performance contracts between ministries and governmental agencies.*

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<sup>4</sup> Some of these basics are related to the transparency of the budget process (e.g. reliable monitoring and regular reporting), and are in some countries regulated in the so-called Fiscal Responsibilities Laws.

#### **4.2 – Reforming domestic fiscal governance: national and EU perspectives**

**25. In the last decade, the management of public finances in EU countries has simultaneously been affected by two major changes in the economic and institutional setting.** Firstly, a deeper European integration that has notably entailed the formation of an economic and monetary union. Secondly, a progressive decentralisation process in a majority of EU Member States, implying greater fiscal powers for regional and local governments.

**26. This reshaping of national budgetary competencies has not only affected the conduct of fiscal policy domestically but it has also had significant implications for the fulfilment of the fiscal requirements at EU level.** Specifically, the Treaty and the SGP obligations concern the general government as whole, that is, central, regional and local governments plus the social security sub sector. Against the background of growing decentralisation, the role of territorial governments in ensuring the respect of the SGP provisions has considerably increased.

**27. In the context of EMU, it is important to analyse which features of domestic fiscal frameworks are most conducive to making decentralisation consistent with sound public finances and the respect of the SGP.** The Council has repeatedly stressed the closely links between national fiscal governance and the fulfilment of Member States' commitments at EU level: fiscal performance is primarily influenced by domestic institutional elements, which in turn interact with the EU fiscal frameworks.<sup>5</sup>

**28. The reform of national fiscal governance should take into account this growing budgetary decentralisation and its implications for a sustained fiscal consolidation within the EU framework.** In particular, fiscal relations across levels of government should be designed to promote and support stability-oriented policies. The following elements appear relevant.

**29. First of all, transparency should be one of the main features of the distribution of fiscal responsibilities across government tiers.** This should apply to all stages of intergovernmental relationships, and particularly with respect to the following three elements:

- **First, there should be a clear-cut sharing of policy responsibilities across layers of government.** This would allow determining which spending functions are assigned to which tier avoiding responsibility-shifting.
- **Second, the distribution of expenditure powers should be accompanied by a stable financing system for territorial governments.** These funding mechanisms should be based on transparent rules governing the transfers to sub-national authorities and the working of tax-sharing schemes. Additionally, a reasonable amount of tax autonomy in accordance to the spending powers assigned to lower levels of government should also be considered, to avoid vertical fiscal imbalances.

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<sup>5</sup> For instance, the Protocol on the excessive deficit procedure annexed to the EU Treaty underlies that Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty. Likewise, the report on the SGP reform endorsed by the European Council in March 2005 states that national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact and that national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level.

- **Finally, transparency should also be present in the monitoring and enforcement mechanisms put in place to ensure the correct functioning of the spending and revenue schemes implementing the distribution of fiscal powers and responsibilities government across tiers.** The possible role that the State Audit Office might play in ensuring an independent monitoring should be explored. Crucial elements in this context are the availability of budgetary data for the lower tiers of public administration and their timeliness and reliability.

**30. A second feature that should support fiscal decentralisation consistent with sound public finances refers to fiscal rules and independent fiscal institutions.** While playing an important role in supporting accountability, well designed fiscal rules are needed to establish the limits that policy makers at all levels of government have to respect to ensure budgetary discipline. Additionally, the role played by some independent public bodies in promoting a strong and efficient coordination across general government layers to ensure sustainable public finances deserves due attention (e.g. the High Council of Finance in Belgium).

**31. According to some views, financial markets' discipline would be a better instrument than fiscal rules to ensure sound budgetary positions at all levels of government.** The main argument is that, as sub-national governments gain greater autonomy over larger shares of public budgets, they should also have more access to domestic and international credit markets, which could in turn impose fiscal discipline through higher risk premia, thereby rendering fiscal rules useless.

**32. However, policy experience does not always support a market-based approach to ensuring fiscal discipline.** First, credit markets are poorly suited to disciplining the borrowing of sub national governments. This is basically due to the limited tax autonomy assigned to territorial authorities. In this context, creditors often view transfers from the central government as implicit guarantees of sub-national debt, which hampers its supposed efficiency to discipline territorial finances. Secondly, it should be kept in mind that controls imposed by financial markets tend to be sudden and abrupt, imposing additional costs that would be better to avoid. Therefore, appropriate fiscal rules are best-suited to maintaining fiscal discipline at territorial level.

**33. Finally, a fluent political dialogue supported by an adequate institutional setting is a key element to ensure sound fiscal relations across government layers.** The commitment of authorities and political representatives at all levels of government to pursue appropriate fiscal policy coordination is crucial.

**34. The so-called "domestic or internal stability pacts" currently in place in several EU countries are an example of a disciplinary framework supporting fiscal decentralisation.** In spite of some observed shortcomings (e.g. weak monitoring and enforcement mechanisms), the overall functioning of national stability pacts can be considered broadly satisfactory in terms of budgetary outcomes for a majority of those Member States that have implemented these arrangements, notably Belgium, Italy, Spain and Austria. In all these countries, national stability pacts, including the fiscal rules or working agreements that assist their implementation, have played an important role in coordinating government tiers' efforts to meet the agreed fiscal objectives and, thereby, to support the respect of the SGP.



## **5. – Reviewing the main elements of fiscal frameworks: some guidelines**

**35. This Section addresses more in detail the reform of the main building blocks of national fiscal governance, following the taxonomy considered in Section 2.** Notwithstanding the separate analysis of these elements (i.e. numerical fiscal rules, independent public institutions, medium term budgetary frameworks and budgetary procedures), their complementarities and an overall perspective on the reform of the whole fiscal framework should be kept in mind as stressed in the previous section.

### **5.1 – Numerical fiscal rules**

**36. According to the most commonly agreed definition, numerical fiscal rules provide a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major component thereof.<sup>6</sup>** Therefore, this definition excludes those fiscal targets that may be revised frequently without any restriction (e.g. fiscal targets included in most medium-term budgetary frameworks currently in place in a large number of EU countries). The main objective of fiscal rules is to establish incentives and constraints on the use of policy discretion so as to favour a sound budgetary policy-making and promote sustainable policies.

**37. The number of domestic rules in force across EU countries has been growing steadily since the early 1990s: from 16 rules in place in 1990 to 67 in 2008.<sup>7</sup>** By type of rule, 40% are budget-balance rules, debt and expenditure rules represent one third each and revenue rules account for less than 10% (see Box II for further details on the existing rules in the EU).

#### **Box II: Main features of domestic fiscal rules in the EU**

Since the early 1990s the number of domestic fiscal rules in the EU has steadily been increasing and at present only three Member States have no rules in place (CY, EL and MT). A growing number of fiscal rules applied to the general and central governments have been introduced over the most recent years, which contrasts with the prevailing situation in 1990 with a majority of rules covering regional and local government sub sectors. In relative terms, rules applied to the general and central government accounted for 25% in 1990 compared to nearly 50% in 2008.

Most of budget balance and debt rules are applied to regional and local governments while central government and social security sub sectors resort more often to expenditure rules. Most of fiscal rules do not include an independent monitoring and enforcement mechanisms in case of non compliance are generally weak. In turn, escape clauses are generally not included in the definition of the rule.

There is a large diversity in terms of target definition. More than one third of budget balance rules target a balanced budget and only a few of them are defined on a structural basis. Nearly fifty percent of debt rules, mostly applied to territorial governments, establish debt limits according to the repayment capacity (i.e., the ratio between debt service and revenues). Expenditure rules are evenly distributed between those setting up spending ceilings and those targeting expenditure growth rates. While ceilings are generally defined on a nominal basis, targets for growth rates are formulated in nominal or real terms in almost equal proportion. Finally, two thirds of revenue rules oblige fiscal authorities to pre-define the allocation of windfalls revenues.

<sup>6</sup> See "Fiscal Policy Rules" by Kopits, G. and S. Symansky (1998); IMF Occasional Paper 162). For a thorough analysis of fiscal rules in the EU see the 2006 and 2009 Public Finances in EMU (European Commission).

<sup>7</sup> A major element behind the increasing resort to these budgetary arrangements seems to be the establishment of the EU fiscal framework based on the Treaty and SGP provisions in 1992 and 1997 respectively (see Ayuso-i-Casals et al. (2009)).

**38. Recent research provides ample evidence on the influence of numerical fiscal rules on budgetary outcomes (Debrun et al. (2008) and European Commission (2009)). The extent of this influence highly depends on a number of features, which have been extensively analysed in the literature (e.g. Bohn and Inman (1996)).** Thus, elements such as the statutory basis of the rule (i.e. whether the rule is enshrined in a legal text or simply stems from a political agreement), the monitoring of budgetary developments vis-à-vis fiscal targets (i.e. whether it is carried out by an independent body and its frequency), and the existence of corrective mechanisms in case of non-compliance should be carefully taken into account in the design of fiscal rules to ensure their effective influence on the fiscal policy making.

**39. According to available evidence, features related to the enforcement and corrective mechanisms are particularly relevant for the effectiveness of fiscal rules (Ayuso-i-Casals et al. (2007)).** Box III summarises the key elements in the design of effective fiscal rules.

**40. The influence of fiscal rules on fiscal outcomes can be seen in relation to different, albeit interrelated, aspects: budgetary discipline and macroeconomic stabilization.** On the one hand, the main objective of fiscal rules is to tackle the deficit bias, arguably the main factor behind the trend increase in public debt in the industrialised countries. The role of fiscal rules in improving fiscal discipline is not only confirmed by the literature but has also been well-documented in a number of country-specific consolidation episodes.<sup>8</sup> On the other hand, a potential drawback of rule-based framework for the conduct of fiscal policy is a weak contribution of fiscal policy to macroeconomic stabilisation.<sup>9</sup>

**41. However, depending on the type and the specific design of fiscal rules, an appropriate balance between the two aspects of budgetary policy can be achieved.** Achieving the right balance between fiscal discipline and stabilisation is an important policy issue: while current budgetary unbalances call for a sustained consolidation, one of the main lessons of the current crisis is the need to reinforce counter-cyclical fiscal policies.<sup>10</sup>

**42. Consequently, a joint examination of the properties of different types of fiscal rules exhibit in relation to the fiscal discipline and stabilisation objectives appears warranted.** Accordingly the following four sub-sections focus on the features of budget balance, debt, expenditure and revenue rules and their policy implications for the two objectives.

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<sup>8</sup> For instance, this is the case of Sweden, Finland, the Netherlands and Belgium in the 1990s. This is also confirmed by other policy experiences outside the EU. A study underway by the IMF shows that large fiscal adjustments around the world were sustained by the establishment of fiscal rules at the outset or at an early stage of the consolidation process.

<sup>9</sup> Actually, this argument is often used to sustain that discretionary policy is always needed to ensure that the stance of fiscal policy is the adequate. As a consequence, the resort to fiscal rules is likely to impose excessive constraints in the use of discretion and may hamper stabilization. Of course, this reasoning assumes that discretionary policies are not themselves pro-cyclical. If this is not the case, as policy experience shows (European Commission (2007)), the adoption of fiscal rules could in reality provide benefits in terms of less volatile output. Therefore, what really matters in the design of numerical rules is the no interference of these policy instruments with the free working of automatic stabilisers.

<sup>10</sup> See European Commission (2006) for a complete overview of fiscal policy pro-cyclicality in the EU since the early 1980s.

### Box III: Key elements in the design of fiscal rules

- **Statutory base:** Ideally, the rule should be backed by strong legal provisions signalling the importance attached by the government to fiscal consolidation (e.g. a law of fiscal responsibility or similar). Likewise, the legal statutory base should clearly establish the requirements to amend the rule, which may reinforce the credibility at the moment of its introduction. The existing monitoring mechanisms and the pre-established enforcement procedures in case of non compliance with the rule should also be supported by legal basis.

- **Multiannual character:** Overall, rules embedded into a medium term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances. This may facilitate to internalise the budgetary effects of current policies over the medium term, which is particularly relevant in the current macroeconomic juncture. Finally, a multi-annual time frame may limit the potential circumvention of the rule by postponing the record of expenditures or the implementation of structural adjustments.

- **Accounting system:** The use of the ESA95 methodology appears at first sight advisable so as to be consistent with the EU fiscal surveillance framework. However, the higher availability of cash data and the need for timely monitoring to allow prompt action in case of deviation from the adjustment path suggests that a dual approach could be envisaged (e.g. the rule could be defined in cash terms with a parallel mechanism of translation in ESA95 on a quarterly basis).

- **Monitoring:** The effectiveness of monitoring heavily relies on two elements. Firstly, the frequency of monitoring determines to what extent the overseeing of expenditure developments can be effective in (almost) real-time or only ex-post with a long delay. Obviously, a well-timed reporting allowing for timely corrective measures is conditional on the availability of updated and reliable data (see previous point in this respect). Secondly, the probability that budgetary trends are adjusted to ensure the observance of the rule is higher when monitoring is carried out by an independent public body sending early warnings to the government in case risks of non-compliance are identified.

- **Enforcement mechanisms:** The design of corrective and enforcement mechanisms emerges as an important feature to ensure a proper functioning of fiscal rules (Ayuso-i-Casals et al. (2007)). Actions in case of non-compliance should always be defined ex-ante so as to make the rule credible and enforceable (e.g. the amendment of the budget law, the obligation to take corrective measures promptly, automatic budgetary sequesters or withholding of additional expenditure etc). In the absence of these predefined actions, the only cost for non-compliance is reputational, which can suffice for stable and solid fiscal frameworks but appears inadequate in those cases in which an acute fiscal distress is accompanied by weak budgetary institutions. Finally, the enforcement of corrective measures ought to be preferably ensured by a non-partisan institution. This independent body should be provided with an appropriate legal framework and competencies. The same independent body could be carrying out simultaneously the tasks of monitoring and enforcement.

- **Sanctions:** In case of non compliance with the rule, pre-established sanctions may supplement the existing enforcement mechanisms. These sanctions may adopt two different forms. Firstly, personal sanctions applied to the elected representatives, policy-makers or officials responsible for the respect of the rule. They can entail a dismissal procedure or the obligation to resign, fines or lower wages. These types of sanctions are more commonly applied in developing countries. Secondly, institutional sanctions applied to those general government tiers that do not comply with the rule. These penalties can materialise in the form of fines, automatic withholdings of transfers, restrictions on debt issuance etc. This typology of sanctions is more frequently applied in developed nations.<sup>11</sup>

- **Escape clauses:** Well-defined escape clauses specifying under which circumstances departures from the rule are permitted constitute a key element. Such clauses normally refer to natural disasters or acute economic slowdowns or recessions. Clear and detailed escape clauses may reinforce credibility by limiting the list of events allowing for non-compliance. However, vague and non-concrete clauses facilitate circumvention and may entail the ineffectiveness of the rule. Overall, their definition requires particularly attention, and their final design should ensure that they are only applied in a limited number of circumstances.

<sup>11</sup> e.g. in Spain the existing law establishes that in case the 3% deficit threshold of the EU fiscal framework is breached, all government layers have to contribute to the payment of a possible fine in proportion to their share over the overall deficit.

### 5.1.1 – Budget-balance rules

**43. In 2008, twenty-six out of the sixty-seven rules implemented across EU Member States were budget-balance rules.** Although there is considerable variation in their target definition, balanced budget and nominal balance target rules are by large and far the most widespread option.

**44. According to recent empirical research, budget-balance rules have on average a strong impact on the budget balance and can address satisfactorily the deficit bias (Debrun et al. (2008)).** They may therefore be considered appropriate policy instruments from the point of view of discipline. Needless to say that their overall effectiveness will depend on the ambition of the target and on the design of the rule (e.g. the time horizon, coverage and monitoring and enforcement procedures). Likewise, the functioning of other elements of the overall fiscal frameworks including complementarities vis-à-vis other fiscal rules are also important (e.g. budget balance rules supplemented by expenditure ceilings appear to be more efficient; see Guichard et al. (2007))

**45. However, this budget-balance rules are often considered to entail risks for the quality of public expenditure.** In case no item is excluded from the coverage of the rule, fiscal adjustment may excessively rely on growth-enhancing expenditure categories that are less politically-sensitive, such as spending on R&D and infrastructure. Policy experience shows that this expenditure restraint strategy cannot only hamper growth prospects but may also give rise to short-lived consolidation episodes. This has prompted the resort to budget-balance rules excluding investment expenditure (i.e., golden rules). Attempts at redefining the coverage of the rules to preserve incentives to future-oriented expenditure can easily run into incentive problems of their own, as the concept is difficult to operationalise and conventional definitions offer scope for opportunistic behaviour (European Commission (2003)).<sup>12</sup>

**46. A major criticism of budget balance rules refers to their potential adverse effect on macroeconomic stabilisation.** Specifically, budget balance rules defined in nominal terms (either in level or as a percentage of GDP) may introduce a pro-cyclical bias in the conduct of budgetary policy in both "good" and "bad" times: in "bad" times the respect of fiscal targets can imply a pro-cyclical tightening, whereas in "good" times buoyant revenues may facilitate the achievement of the targeted balance allowing for a pro-cyclical fiscal loosening.<sup>13</sup>

**47. The extent to which deficit rules interfere with the stabilization function of fiscal policy actually depends on their design.** For instance, multiannual deficit rules defined over

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<sup>12</sup> While on theoretical grounds this option may appear sensible, its practical implementation may imply an inefficient allocation of public resources and a reclassification of expenditure items to circumvent the rule, which in turn may also complicate monitoring (European Commission (2003)). An alternative way to weaken golden rules consists of adopting a broad definition of public investment (i.e. a definition departing from the standard concept on a national accounts basis). This allows excluding a large number of expenditure items from the coverage of the rule and may considerably hamper its effectiveness in terms of fiscal discipline. This was the case of the former golden rule applied to the Federal Government and the L  nders in Germany, which has recently been replaced by a budget balance rule defined on a cyclically adjusted basis.

<sup>13</sup> As for the budget balance and debt rules of the SGP, the 2005 reform of the Pact aimed at strengthening the incentives to run an appropriate fiscal stance in good times and reduce the risk of induced pro-cyclical behaviour in bad times. Under the preventive arm, the revised Pact has introduced cyclically-adjusted medium-term objectives (MTO) and requires higher consolidation efforts in good times. Under the corrective arm, it is now possible to avoid stepping up the excessive deficit procedure (EDP) if failure to respect the adjustment programme can be attributed to unexpected adverse economic developments with a significant negative budgetary impact.

the cycle are likely to be more stabilisation-friendly than budget-balance rules operating on a single year basis. The most frequent problem of budget-balance rules is the correct assessment of the cyclical position of the economy (specifically, identifying the starting and/or ending point of the business cycle). Difficulties in defining the cycle can be significant enough to impair the effectiveness and credibility of the rule.<sup>14</sup> Alternatively, cyclically-adjusted budget balance rules may provide enough flexibility to ensure discipline while accounting for the cycle. However, these rules are also vulnerable to uncertainties on the measurement of the output gap entailing significant revisions over time, which clearly complicates the conduct of fiscal policy and renders real-time monitoring difficult. Despite these shortcomings, the current EU fiscal framework relies on cyclically adjusted medium-term objectives and new policy initiatives in some Member States follows the same approach (see Box IV below summarising the new cyclically-adjusted budget-balance rule in Germany).<sup>15</sup>

#### **Box IV: The new budget-balance balance rule in Germany**

The new rule follows the structure of the SGP and sets a ceiling for the federal structural deficit in normal times at 0.35% of GDP from 2016 onwards with a transition period starting in 2011. Budgets of the Länder must be structurally balanced as of 2020.

The rule includes a (virtual) adjustment account (Kontrollkonto) which would record deviations from the defined level of authorized new borrowing. Overruns will be booked as debit, and underruns recorded as credit. Debit will be limited to 1.5% of nominal GDP. The methodology underlying the calculation of the structural balances will follow the commonly agreed methodology at EU level.

The exceptions from the rule are cases of natural disasters and extraordinary emergency situations which are outside the control of the government. The current crisis is considered to meet these preconditions.

Main concerns of the new rule relate to the uncertainty surrounding the calculations of cyclically-adjusted figures, which could hamper its practical implementation, and the long transition periods that could give rise to credibility problems. A different criticism is that the rule may prove too rigid, resulting in an unnecessary tight fiscal policy stance, particularly during sharp and protracted slowdowns.

**48. The distribution of budget-balance rules across levels of government may also complicate the stabilization function of fiscal policy.** In the EU Member States, both budget balance and debt rules are mostly applied to territorial governments and are generally defined in nominal terms with annual time-horizons, which implies a risk of pro-cyclicality. At the same time, rules defined in cyclically-adjusted terms similar to those applied to general and central governments are hardly feasible at territorial level. A possible and realistic policy option to tackle this risk of pro-cyclicality should be based on well-defined coordination mechanisms between the various levels of government. Coordination should be implemented during the preparatory phase of the budget process based on a medium-term perspective

<sup>14</sup> The UK's fiscal rules defined over the cycle are a telling example of these difficulties.

<sup>15</sup> For a comprehensive overview of the main methodological problems of the cyclically-adjusted balance (CAB) and its increasing use in the context of the EU fiscal surveillance framework see Larch and Turrini (2009). As the authors underlie, with the reform of the SGP, the CAB has moved to a centre stage of the EU fiscal framework. This has been possible thanks to the intense and gradual work to improve the CAB measurement carried out at the EU level over the latest years. In turn, rising awareness of the limitations of the CAB coupled with these improvements may allow the domestically resort to this indicator to improve national budget balance rules.

explicitly taking into account the implications for fiscal stabilisation of budget balance rules applied to sub-central governments.

**49. An additional option to endow budget balance rules with an appropriate flexibility to cater for cyclical fluctuations is the incorporation of escape clauses allowing for temporary suspension of the rule conditional on exceptional events such as natural catastrophes or a sharp output contraction.** According to the literature, escape provisions are an important element in the formulation of all type of fiscal rules to cope with uncertainty while maintaining credibility; they may be appropriate for providing flexibility in the case of budget balance rules. However, as Box III underscores, the definition of these clauses must be clear and confined to strictly circumscribed circumstances in order to preserve credibility. The sizeable GDP contraction experienced in 2008 and 2009 should presumably fall in any conceivable definition of exceptional circumstances.

**50. Finally, other type of fiscal arrangements, such as "Rainy Day Funds", may supplement budget balance rules while encouraging a more countercyclical fiscal stance.** Such arrangements require depositing contingency reserves generated from fiscal surpluses in economic booms in a stabilization fund. These reserves may subsequently be withdrawn during slowdowns to finance deficits. This scheme should help counteract political pressures to spend higher-than-expected revenues in good times. Additionally, there is some evidence that in the USA, where the resort to these funds is much more widespread than in the EU, expenditure volatility is significantly reduced and the countercyclical fiscal capacity is increased (see Hou and Moynihan (2008) and Wagner and Elder (2005)). Although these fiscal arrangements are not a panacea (as presented in some papers), its wider use in EU countries could facilitate a more adequate fiscal stance over the cycle. However, at EU level the introduction of 'Rainy Day Funds' is discouraged by the definition of budget deficit adopted for assessing compliance with the ban on excessive deficits. In turn, clear rules regulating the use of these funds would also be needed (see Balasone et al. (2009)).

### **5.1.2 – Debt rules**

**51. In 2008 eighteen domestic debt rules were implemented across EU Member States and a large majority applied to sub-central governments.** Most of these rules establish a debt ceiling in nominal terms or limit debt according to repayment capacity. The latter is the approach adopted in a significant number of EU countries to impose debt limits on regional and local governments. Specifically, these limits are based on the debt service-to-revenue ratio, which is the most appropriate simple indicator of the repayment capacity (Bernoth et al. (2004)). As for debt rules applied to higher levels of government, the target definition usually follows the EU debt threshold formulation, i.e. a debt ceiling as a percentage of GDP.

**52. Similarly to balance budget rules, debt rules are found to have a strong influence on budgetary developments in terms of fiscal discipline (Debrun et al. (2008)).** Their final effectiveness also depends on the ambition of the target and on a number of design features, in particular monitoring and enforcement (see paragraph 34 and Box III).

**53. Given the overarching objective of debt reduction in the years ahead, debt rules may increase in relevance as a policy instrument to achieve this goal.** However, no debt rule currently in place in the EU Member States focuses on the debt dynamics in their target

definition (i.e. no debt rule links explicitly targeted debt developments with operational and intermediate budget balance objectives).<sup>16</sup>

**54. Besides possible adverse effect on the quality of public expenditure, the same potential shortcomings identified for budget balance rules with respect the stabilization function of fiscal policy apply to debt rules.** In general, debt rules embedded into a medium-term framework may take into account stabilisation concerns and limit their potential pro-cyclical bias. In the same vein, strong policy coordination across government tiers when setting fiscal targets for general government sub-sectors is the most appropriate and feasible way to offset possible pro-cyclical effects stemming from debt rules applied to local and regional authorities. Finally, well-defined escape clauses and 'Rainy Day Funds' may also be instrumental in increasing the counter-cyclical stance of debt rules.

### **5.1.3 – Expenditure rules**

**55. In 2008, seventeen domestic expenditure rules were in place in the EU (i.e. one third over the total number of rules into operation approximately) and were mainly applied to central government and social-security sub-sector.** The main objective of these rules is to promote fiscal discipline through an improved expenditure control. A significant number of these rules are embedded into a medium-term budgetary framework and their features are meant to tackle some of the observed pitfalls in domestic fiscal policy making: recurrent primary spending overruns and frequent pro-cyclical budgetary policies.

**56. Notably, expenditure rules tend to target the part of the budget that government controls most directly, thereby ensuring a higher degree of accountability.** Accountability is enhanced if specific items not fully under the control of government are excluded from the coverage of the rule (e.g. primary expenditure rules excluding interest payments). Strong accountability may in turn promote not only the respect of the target but also transparency in the course of the budget process (Derosse et al. (2006)).<sup>17</sup>

**57. The extensive use of expenditure rules during the largest episodes of budgetary consolidation reflects their instrumental character in sustaining fiscal discipline.** Overall, spending rules have generally been adopted as a cornerstone of ambitious consolidation plans and are currently one of the main building blocks of the most successful and resilient domestic fiscal frameworks across EU countries.<sup>18</sup>

**58. Additionally, expenditure rules defined in level or growth rate hardly prevent automatic stabilisers from operating and may therefore contribute significantly to macroeconomic stabilisation.** Specifically, spending rules may help curbing a frequently observed pro-cyclical bias in good times stemming from strong pressures for additional spending in the presence of revenue windfalls. In case the rule is defined in nominal terms and cyclically-sensitive expenditure items are excluded from the coverage, the counter

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<sup>16</sup> For instance, the UK debt rule aims at keeping the debt ratio at a prudent level of 40% of GDP over the cycle. By the same token, a debt limit in line with the Treaty provisions (i.e. 60% of GDP) is currently in place in Poland, and is accompanied by a number of corrective measures as the actual debt ratio approaches the ceiling.

<sup>17</sup> The effects of spending rules on the quality of public expenditure and the possible shortcomings associated with the exclusions of certain items from the coverage do not depart significantly from those related to budget balance rules considered in paragraph 35.

<sup>18</sup> Fiscal frameworks of the Netherlands, Denmark, Sweden and Finland, which can be considered the most outstanding in terms of fiscal discipline, hinge upon an expenditure rule combined with revenue or cyclically-adjusted budget balance rules. The role played by expenditure rules was also prominent in other successful experiences of consolidation in the past, such as BE throughout the 1990s.

cyclical stabilisation is further enhanced (i.e. larger than expected fiscal adjustment in a context of a demand-pull inflation). A pro-cyclical bias could conceivably result if the target definition was based on an expenditure-to-GDP ratio. However, this is rarely observed in practice.

**59. Ideally, the institutional coverage of expenditure rules should include the whole of the general government sector.** Maximum coverage would require a proper fiscal coordination across level of governments (see Section 4.2). In particular for highly decentralised countries, a strong institutional cooperation among government tiers may raise ownership of fiscal targets and hence increase the probability of their respect.

**60. Finally, according to the most successful EU country experiences resorting to expenditure rules (see footnote 15), binding spending ceilings play a crucial role in the functioning of the whole fiscal framework in interplay with other elements of fiscal governance (Kopits (2007)).** For instance, multiannual spending rules form the basis of well-designed medium-term budgetary frameworks for budgetary planning. The same rules may prompt the adoption or the strengthening of sound budgeting procedures, such as top-down budgeting implementing a more centralised budgetary process. Last but not least, the existence of well-designed expenditure rules is a key element to ensure the effectiveness of budget balance rules (Guichard et al. (2007)).

#### **5.1.4 – Revenue rules**

**61. Only six revenue rules were in place across the EU Member States in 2008.** Revenue rules can pursue a wide range of policy objectives related to the revenue side of the budget, such as establishing a ceiling on the tax burden or impose some constraints on specific tax revenue developments.

**62. However, the most widespread option in the design of revenue rules aims at avoiding the conduct of pro-cyclical policies.** In particular, this can be achieved by obliging fiscal authorities to specify ex-ante in the budget law the allocation of higher-than-expected revenues (e.g. allocation to debt reduction). Rules on the allocation of extra revenues are meant to restrain expenditure pressures in good times.

**63. An important lesson drawn from the current crisis refers to the role played by property and asset prices and the corresponding windfall tax proceeds in the boom period.** This is not only crucial for explaining the ongoing bust and macroeconomic unbalances, but also for singling out some of the appropriate reforms to the prevailing domestic fiscal frameworks to help avoid these disruptive episodes (Joumard and André (2008)).

**64. Specifically, higher-than-anticipated proceeds were often allocated to finance additional public expenditure in the belief they were permanent and not temporary (i.e. they were improving the underlying budgetary position).** This resulted in pro-cyclical in good times, widening both internal and external imbalances, and putting at risk fiscal sustainability over the medium-term. Although the underlying fiscal position may be deteriorating rapidly if proper account is taken of the asset boom, fiscal sustainability is rarely perceived as a risk if government budgets are registering small surpluses or low deficits. See Box V describing the case of Spain for an illustration.



### **Box V: Windfall revenues and fiscal policy in Spain over the recent past**

From the second half of the 1990s Spain recorded its longest period of growth in excess of the euro area since the late sixties, growing by nearly 3¾% for more than 10 years in a row. This period featured a combination of persistently low real interest rates and a dynamic demography sustained by high immigration flows, which fed into unprecedented growth in asset markets. In parallel, total-tax receipts grew by about 4¼ percentage points of GDP, implying an elasticity with respect to GDP of 1.2, in excess of the normal values typically close to one. The increase in tax receipts was largely associated to changes in the composition of GDP, in particular the long consumption and construction boom. Econometric analyses provide evidence that 50 to 75 percent of the increase in tax revenues, observed in Spain between 1995 and 2006, was likely of transitory. However, conventional measurement of cyclically-adjusted balances, using standard tax elasticities would produce an overestimation of structural revenues and an incorrect assessment of the fiscal stance. The size of transitory composition effects associated to the asset boom in Spain highlights the interest for the policymakers to carefully assess the implementation of unfunded tax cuts and/or expenditure increases, especially those more difficult to revert in bad times (see Martinez-Mongay et al. (2007) for a comprehensive analysis of the Spanish case).

**65. Reforms to domestic fiscal frameworks should therefore favour the achievement of higher surpluses in 'good times' so as to limit pro-cyclicality and create fiscal space to conduct countercyclical policies in 'bad times'.**<sup>19</sup> Consequently fiscal policy making ought to guard against misreading revenue windfalls during asset price boom periods as durable improvements in the underlying fiscal position (European Commission (2009)).

**66. Revenue rules pre-defining the allocation of windfall receipts to debt reduction can be instrumental in creating fiscal space and reducing the deficit bias in 'good times'.** At present, only France, the Netherlands and Lithuania currently in place a revenue rule that oblige fiscal authorities to specify in advance the allocation of higher-than-expected. However, only in the case of the Netherlands windfalls revenues are systematically assigned to deficit reduction through a constraining revenue rule, which together with a multiannual expenditure rule forms the basis of the Dutch fiscal framework.

**67. Additionally, fiscal arrangements other than numerical rules may also be instrumental in implementing countercyclical fiscal policies during economic booms.** Thus, the existence of 'Rainy Day Funds' described previously in paragraph 40 can help resist political and social pressure to spend windfall revenues in good times. Although limited to the unemployment social security contributions, Finland set up in 1999 a buffer fund to save higher-than-expected social contributions collection.

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<sup>19</sup> Obviously, these fiscal governance reforms should be accompanied by some changes in the budgetary policy making that go beyond the pure fiscal institutional setting. For instance, in addition to the usual debt and deficit figures, the formulation of fiscal policy should be based on a close follow-up of a wider set of indicators related to fiscal space, such as external deficit, competitiveness problems, inflationary pressures etc. In the same vein, given the uncertainty related to the structural underlying fiscal position and the technical difficulties to differentiate permanent from temporary revenues, the importance of releasing cautious revenue projections for the budget preparation is clearly heightened. Likewise, prudent nominal expenditure growth considered in the budgetary plans should take into account long-term GDP growth prospects, and an inflation target in line with the ECB price stability objective rather than overoptimistic macroeconomic scenarios supported by a transitory boom period with buoyant tax revenues.

### *5.1.5 – Is there an ideal mix of fiscal rules?*

**68. Similarly to other elements of the institutional fiscal framework, the specific set of numerical fiscal rules should reflect domestic circumstances, including political, legal and cultural factors.** However, some common principles stemming from successful country experiences and the reflecting overarching objective to restore fiscal sustainability should be identical with a view to strengthening rules-based frameworks in the years ahead. In particular, the following elements appear relevant:

- Regardless of whether a debt rule is in place or not, a central objective of fiscal policy over the next year across the EU should be halting and reversing the increase in debt. This demands the formulation of a path for the evolution consistent with a prudently defined sustainability objective and macroeconomic scenario.
- The path for the evolution of the debt ratio should be underpinned by operational (primary) budget balance targets. In turn, primary balance targets should be translated into a budget-balance rule applying to the whole of the general government sector. This should be consistent with the achievement of the medium-term objectives of the SGP.
- The budget-balance rules should be operationalised through binding expenditure ceilings based on a multi-annual spending rule for the general government. Expenditure thresholds would reflect the envisaged debt reduction path and cautious macroeconomic and revenue projections for the relevant period. The expenditure rule should be supplemented by a revenue rule to ensure that higher-than-expected receipts are allocated to debt reduction.
- Finally, a budget balance and/or debt rule consistent with the envisaged overall expenditure ceilings should be applied to sub-central governments.

**69. A rule-based system consisting of an expenditure rule supplemented by a revenue rule and/or a budget-balance rule seems to have yielded positive budgetary outcomes in terms of both discipline and stabilisation.** For instance, the Dutch fiscal framework relies on strong multiannual expenditure ceilings complemented by a revenue rule. In the case of Sweden, the existing expenditure ceilings are accompanied by a budget balance rule. In both countries, a balanced-budget requirement applies to sub-central governments. As to Finland, the multiannual spending limits are consistent with a budget-balance rule for the central government and accompanied by a revenue rule for the social security that operates following a 'Rainy Day Fund' scheme. In this case, territorial governments are also covered by a balanced budget rule.

## 5.2 – Independent public institutions

**70. A complementary policy option to reinforce fiscal governance is the establishment of non-partisan public bodies acting in the field of budgetary policy.** It is worth stressing that the type of institutions considered in this section does not entail any delegation of the conduct of fiscal policy to an independent body as suggested by some proposals in the literature (see Calmfors (2003) and Wyplosz (2005)). According to the literature on policy delegation, fiscal policy does not fulfil the conditions for delegating its formulation to an independent body as it is the case for monetary policy approach (Alesina and Tabellini (2003) and European Commission (2006)).<sup>20</sup>

**71. The next section focuses only on those independent bodies that are entrusted with some concrete technical tasks related to budgetary policy.**<sup>21</sup> In some Member States such institutions have been playing an important role in promoting sound and sustainable fiscal policies. For instance, successful EU domestic rule-based frameworks often resort to independent bodies to assist and lend credibility to their operation. The main fields in which these bodies carry out their activities are summarised in Box VI.

### **Box VI: Independent fiscal institutions in the EU Member States**

In 2008, twenty seven independent institutions were present in seventeen EU countries. These public bodies contribute positively to the fiscal policy making through different three channels:

- (i) Providing unbiased inputs for the annual budget preparation (e.g. macroeconomic forecasts on which budgetary projections are based).
- (ii) Preparing independent analyses on fiscal policy issues (e.g. monitoring budgetary developments, assessing compliance with the existing fiscal rules and/or estimates of the budgetary cost of specific policy measures).
- (iii) Issuing regular assessments and recommendations related to different aspects of fiscal policy (e.g. recommendations addressing long-term sustainability issues or proposals containing fiscal targets for the different general government tiers).

In a number of cases, these institutions have succeeded in conveying their policy advice and effectively influencing the conduct of fiscal policy. Among others, the Netherlands Bureau of Economic Policy Analysis (CPB), the National Account Institute (NAI) and the High Council of Finance (HCF) in Belgium, the Institute of Economic Research (WIFO) in Austria, the Institute of Macroeconomic Analysis and Development (IMAD) in Slovenia and the recently established Swedish Fiscal Policy Council represent examples of the role that this kind of institutions can play. Overall, these public bodies enjoy a high reputation, which generally has been acquired through a long period of time and are highly respected by the political establishment.

<sup>20</sup> Actually, fiscal policy delegation is not only probably unfeasible (at present no independent fiscal institution in charge of budgetary policy making exists in any EU country), but is likely to be undesirable in terms of an efficient policy-decision making. Specifically, fiscal policy entails significant redistributive effects, on which only political representatives are legitimized to decide.

<sup>21</sup> For more detailed information, see the 2006 Public Finances in EMU (European Commission). In this note, the definition of independent fiscal institution focuses on those domestic bodies, coming on top or besides the usual budgetary process, which provide independent analyses and/or recommendations in the area of fiscal policy on a regular basis. Thus, bodies like parliamentary commissions or ad hoc expert working groups that could carry out these tasks on a one-off or occasional basis are excluded. These independent bodies should be primarily financed by public funds and be functionally independent vis-à-vis the government. In particular, the institution should be given a large discretion in relation to the tasks included in its mandate and there must be appropriate mechanisms against any ex-ante political interference (e.g. specific appointment procedures ensuring political independence). Thus, private think tanks and research departments of private companies are not considered.

**72. A relevant policy implication stemming from the examples in Box VII refers to the embedding of independent institutions in domestic fiscal frameworks, which turns to be an important element for their successful implementation.** There is a broad agreement in the literature that national ownership vis-à-vis institutions taking part in the fiscal policy making is a key element to ensure they can effectively influence budgetary developments. National ownership is more feasible through a national "watchdog" than through an international institution (Stéclebout and M. Hallerberg (2007)).

**73. Unlike fiscal rules, which can be operational immediately after their introduction, independent fiscal bodies usually need more time to be fully functional.** While they require specific resources in terms of technical and methodological skills related to fiscal policy-making, policy experiences show that their performance improve following a "learning by doing" process. Actually, a significant number of these institutions in the EU were set up long time ago and are mainly established in the former EU15.<sup>22</sup>

**74. Taking into account the time needed for reputation-building, some proposals advocate widening the mandates of the existing institutions in order to enlarge the scope of their tasks rather than setting up new fiscal bodies.** This is the case of the Court of Auditors in several Member States, which carry out some tasks beyond their traditional ex-post accounting control (e.g. the National Audit Office in the UK). Whether an existing institution has the capabilities and reputation to play effectively the role of a fiscal council should be assessed against the possibility of establishing a new body, which ought to build up its own credibility from the beginning.

**75. Overall, the design of a new independent fiscal institution and the content of its mandate are country-specific issues and there is no ideal arrangement that could be transposed to all Member States.** Practical aspects related to the implementation of national fiscal bodies largely depend on domestic preferences and institutional features, including technical capabilities and the nature of the fiscal problems.

**76. Despite the country-specific nature of these institutions, experiences across EU Member States may provide some useful insights into the most relevant elements.** They are reviewed in succession in the paragraph below.

**77. First, the mandate should be clear and unambiguous, specifying the tasks assigned to the institution and the scope of its activities, and backed by strong legal provisions.** In this respect the following remarks are pertinent:

- The mandate should ensure that the tasks assigned to the institution will be carried out on a regular basis and not only occasionally.
- Forecasts, monitoring tasks and assessments should be comprehensive and not limited to partial aspects of fiscal policy.<sup>23</sup>

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<sup>22</sup> Against this backdrop, the implementation of an independent institution in some EU countries might be problematic due to a lack of technical capabilities and scarce human resources. Some new Member States, in particular, seem to have gathered their limited human resources for conducting and monitoring fiscal policy in the ministries of finance, central banks and academia. In this context, taking stock of the available technical expertise to decide what tasks can be assigned to the new institution appears an appropriate approach.

<sup>23</sup>For instance, in some EU countries government revenue projections are provided by an independent body. However, these forecasts are based on the macroeconomic assumptions prepared by the government. This is likely to hamper the quality of the revenue forecasts as a possible optimistic bias in the macro projections would reverberate into tax revenue forecasts.

- Should the mandate include the provision of forecasts and/or monitoring tasks, the institution should be given access to internal information in the national statistical office, ministries and other governmental bodies.
- Finally, in case the institution is entrusted with the enforcement procedures of fiscal targets and rules, the scope of the measures this independent body can take and the possible connections with the judiciary branch should be unequivocally specified in its mandate and supported by legal provisions.

**78. Second, a high degree of autonomy and functional independence vis-à-vis fiscal authorities are important preconditions to ensure the functioning of the institution is not hampered by political interferences.** This can be ensured by:

- An appropriate public financing clearly stipulated in a legal text.
- Specific appointment procedures, particularly in the governing board, ensuring its functional independence.

**79. Third, the involvement of the institution in the budget process emerges as the most crucial element determining its influence on the conduct of fiscal policy.** The existing arrangements currently in place in some EU countries have proved to be effective in conveying the policy messages issued by independent public bodies. The most widespread options consist of regular hearings by the Parliament during the budget preparation, consultation by the Government in the course of the budgetary process, or the obligation of the fiscal authorities to justify departures from the forecasts or recommendations released by the institution. Delegation of macroeconomic forecasts for the budget preparation can be considered a particular and successful case of involvement in the budgetary process. EU country experiences show that independent forecasts not only avoid possible optimistic bias on growth assumptions but may also provide more realistic macroeconomic scenarios to adopt policy decisions (Jonung and Larch (2006)). Box VII provides concrete country examples.

**80. Last but not least, in the aftermath of the current crisis a number of institutional reforms and policy instruments have been put forward in order to implement fast-decision mechanisms to trigger policy actions for crisis prevention.**<sup>24</sup> For instance, both the prevailing and new fiscal rules should be accompanied by clear escape clauses allowing their temporary suspension in case economic conditions deteriorate markedly and new policy measures are called for. In the same vein, consolidation plans could be paired with state-contingent one-off fiscal stimulus measures (e.g. deferrals of tax payments) should risks to short-term growth emerge again. In this connexion, some proposals pursue to automate the discretionary policy reaction to sharp cyclical fluctuations by predefining the content of stabilisation measures (Solow (2005) and Feldstein (2007)).

**81. In all these proposals, national independent fiscal bodies could be involved to assess the suitability of these policy measures and counteract credibility risks stemming from political interferences in their implementation.** Thus, these independent bodies could evaluate the appropriateness and timeliness of a temporary suspension of fiscal rules and/or the implementation of a one-off fiscal stimulus. Similarly, they could pass judgement on the adoption of pre-established stabilisation measures based on the recent developments of a set of economics indicators.

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<sup>24</sup> Some of these mechanisms would aim at removing the lags that usually constrain the effectiveness of discretionary fiscal policy and would be equivalent to an increase in the scope of automatic stabilisers without increasing the size of the public sector.

**82. Finally, credibility problems related to budget balance rules defined in cyclically-adjusted basis or over the cycle can also be partly addressed by independent fiscal bodies.** The shortcomings of this type of rules, which were already mentioned in paragraph 37, are mainly related to the technical problems for dating the start and end point of the economic cycle and for estimating the output gap to compute cyclically-adjusted figures. An implication is that ex-ante decisions based on a real-time estimate of the current cyclical position turn to be inappropriate ex-post in the light of received data and updated forecasts. This situation may give rise to the perception that policy-makers may seek to circumvent the rules by invoking the need to take into account new information. A feasible policy option to cope with this lack of credibility would be based on the establishment of an independent body in charge of the estimates of the cyclically-adjusted figures and the assessment of the fiscal room for manoeuvre.

### **Box VII: Independent institutions providing macroeconomic forecasts in the EU**

In a number of EU Member States, the government has entrusted an independent institution with the provision of macroeconomic forecasts against which the official projections can be assessed. However, in most of cases, fiscal authorities are free to base budgetary plans on their own forecasts, without having to provide any justification in case both set of projections diverge. There are four exceptions to this rule:

- I. In Belgium, **the National Account Institute (NAI)** provides the macroeconomic forecasts to be used by the federal government in the budgetary process. Actually, the NAI is made up of other public institutions, and has no staff and resources of its own. Its functioning follows a committee approach, in which officials from the Ministry of Economic Affairs, the Federal Plan Bureau, the Central Bank and the National Statistical Office work together. Finally, the macroeconomic forecasts released by NAI have to be used for the budget on a compulsory basis.<sup>25</sup>
- II. The second exception concerns the **Institute of Economic Research (WIFO)** in Austria. This research institute analyses national and international economic trends and supplies short- to medium-term economic forecasts. It is generally consulted (no obligation) by the government in the course of the budgetary process. Although the government is formally free to prepare the budget and/or the Stability or Convergence Programme using its own macroeconomic assumptions, deviations from the WIFO forecasts have in practice been rare and are publicly justified. The members of the governing board include academics, civil servants and representatives of some social partners. The total staff amounts to 100 people approximately.
- III. The third exception is the **Central Plan Bureau (CPB)** of the Netherlands. Like for Austria, there is no formal obligation for the government to use the projections of the CPB. However, the CPB forecasts are in practice (almost) always used for the preparation of the Budget. The CPB also releases budgetary forecasts and analysis of budgetary developments and assess compliance with fiscal targets and rules. The director is appointed by the government and his mandate has to be extended every two years. More than 150 employees work for the CPB.
- IV. Finally, the **Institute of Macroeconomic Analysis and Development (IMAD)** in Slovenia also provides macroeconomic forecasts for the budget preparation. On top of that, the IMAD also carries out analysis of structural and institutional changes and economic reforms, and contributes to prepare the budget memorandum and the SCP. The governing board is appointed by the government and its members cannot hold political responsibilities simultaneously. The IMAD employs nearly 60 people.

<sup>25</sup> According to some analysts, the binding character of this rule is debatable from a legal point of view. In any case, the government continues to base its budget law on the NAI's projections.

### **5.3 – Medium-term budgetary frameworks (MTBFs)**

**83. Medium-term budgetary frameworks (MTBFs) are defined as those fiscal arrangements that allow the government to extend the horizon for fiscal policy-making beyond the annual budgetary calendar.<sup>26</sup>** Although the approval of the annual budget law remains the key step, in which important decisions on budgetary policy are adopted, most fiscal measures have budgetary implications that go well beyond the usual yearly budgetary cycle. As a result, a single year perspective provides a poor basis for sound fiscal planning.

**84. This explains why a majority of EU member States have supplemented their annual budget law with a MTBF.** At present, 22 EU countries declare to have a MTBF in place to plan fiscal developments over the medium-term.

**85. In the present juncture, the need for protracted sizeable underscores the importance of an effective multiannual budgetary planning.** Thus, a well-designed MTBF should reflect the impact of past budgetary commitments as well as the future cost of new policy measures. Additionally, strengthening of the MTBF can efficiently complement the introduction of other institutional reforms such as the introduction of an expenditure rule or top-down budgeting.

**86. Experience suggests that complementarities between a multi-annual expenditure rule and medium-term budgetary framework should be exploited to secure medium-term budgetary objectives.** In particular, expenditure rules cannot exclude risks related to the revenue side of public budgets. For instance, spending limits cannot prevent non-financed tax cuts or systematic upbeat revenue forecasts from leading to growing deficits. Therefore, a binding expenditure rule should be supplemented with a medium term objective for the budget balance based on cautious growth assumptions and plausible revenue projections.

**87. Medium-term budgetary objectives represent a weaker form of commitment than a pure rule incorporating binding targets.** However, they may help ensure fiscal discipline by making more apparent the impact of current policies on the government balance in the coming years. Likewise, the existence of a MTBF may facilitate monitoring by providing benchmarks against which budgetary developments can be assessed over time.

**88. MTBFs implemented across EU Member States tend to show some common shortcomings (European Commission (2009)).** These weaknesses mainly refer to the non constraining character of fiscal targets (i.e. budgetary figures considered in the MTBFs are merely projections and are not binding), recurring revisions of the main fiscal aggregates and lack of political commitment.<sup>27</sup> Additionally, budgetary projections have frequently been based on unrealistic macroeconomic assumptions, which make them unsuitable for an effective multi-annual fiscal planning. Finally, the lack of an independent monitoring and regular reporting and the absence of corrective mechanisms in case of deviation from the envisaged fiscal path further weaken the use of MTBFs as a policy instrument.

**89. Against the increasing need to establish time-consistent consolidation plans for the long run, the identified shortcomings call for a reform of the current MTBFs.** Similarly to the other elements of domestic fiscal frameworks, there is no one size fits all solution and

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<sup>26</sup> See 2007 Public Finances in EMU (European Commission) for a detailed analysis of this policy instrument.

<sup>27</sup> For instance, in a significant number of countries, national Parliaments only discusses the projected medium-term path together with the annual budget law and focuses exclusively on the next year's budgetary figures.

the final design of an appropriate MTBF is a country-specific issue.<sup>28</sup> However, a number of principles for reform can be distilled from successful EU country-experiences. Specifically:

- ***MTBFs should cover the general government sector over the next. A breakdown of the general government budgetary projections into sub-sectors should also be provided (i.e. central and territorial governments and social security), particularly for those highly decentralised countries.***<sup>29</sup>
- ***MTBFs should preferably adopt the form of a fixed framework relying on binding spending ceilings.***<sup>30</sup> *This ought to strengthen the use of the MTBFs as an operational policy instrument for a multiannual budgetary formulation.*<sup>31</sup>
- ***On the expenditure side, medium-term frameworks should preferably be based on multiannual binding expenditure ceilings. Two specific elements deserve particular attention:***
  - (1) The MTBF should incorporate total expenditure limits for the government sub-sectors and a breakdown of these limits according to the main expenditure areas covered by the budget. A further breakdown of each expenditure area into spending programmes should also be included in the projected outlays over a 3-year period.<sup>32</sup>
  - (2) The binding character of the disaggregated expenditure projections could vary depending on the level of detail and the time horizon.<sup>33</sup>
- ***The expenditure projections within the multiannual spending ceilings should be complemented by revenue projections based on cautious macroeconomic assumptions. Similarly to the expenditure side, an adequate breakdown by main type***

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<sup>28</sup> For instance, the degree of fiscal centralisation varies significantly across countries and heavily influences the appropriate level of detail of budgetary projections according to government tiers.

<sup>29</sup> The effective inclusion of territorial governments in the MTBF could imply the improvement of the statistical quality and availability for this sub-sector.

<sup>30</sup> A fixed framework implies that budgetary objectives, for instance spending targets, are set once for all and are not adjusted over time unless unexpected exceptional events arise during the period covered by the framework. These escape clauses should be clearly specified in the legal text establishing the medium-term framework. Telling examples of this approach are the frameworks implemented in the Netherlands, Sweden and Finland. Most of these MTBF are based on a multi annual spending rule that provides binding expenditure limits. It is important to stress that fixed frameworks represent a constraint on discretionary fiscal policy and contrast sharply with flexible frameworks, which allow for revisions of the overall objectives on a yearly basis according to policy changes. The latter is actually the approach adopted so far in Romania.

<sup>31</sup> Recent research has found evidence that those EU Member States with MTBF based on these characteristics tend, on average, to register better budgetary outcomes and show a better adherence to their expenditure plans (see 2007 Public Finances in EMU).

<sup>32</sup> This is a key element of an effective and efficient MTBF. Specifically, this level of detail of expenditure projections would signal to line ministries what amount of resources they can expect to manage over the medium-term. This makes spending ministries responsible for deciding how their expenditure policy may adjust to these spending limits.

<sup>33</sup> For instance, in year t both the total spending ceilings and their breakdown by expenditure areas and programmes would be binding for the first year of the MTBF (t+1). For the second year (t+2), only the total ceilings for the institutional sub-sectors covered by the MTBF and for the expenditure areas would be binding, whereas the figures related to individual spending programmes would only be indicative and could be revised in t+1 when discussing the medium-term objectives for the period (t+2)-(t+4). Finally, in year t, only the total spending limits for t+3 would be binding, while spending ceilings for both expenditure areas and programmes would be indicative.



of revenues (i.e. mainly tax revenues) should also be provided in order to show the budgetary impact of tax policy measures.

- **Previous year's actual budgetary outcomes should be compared to the projections initially considered in the MTBF.** Differences and deviations should be explained and justified. Likewise, measures implemented to off-set deviations from the medium-term path of fiscal projections should also be spelled out. All this information should be included in the MTBF documentation.
- **The baseline projections and the corresponding macroeconomic assumptions should be supplemented by the inclusion of alternative scenarios.** This would allow identifying budgetary priorities in case an unforeseen increase or decrease in revenues materialises, which in turn could also be instrumental in avoiding the recurring resort to ad-hoc supplementary budgets.<sup>34</sup>
- **The correspondence between fiscal projections on a cash basis and their values based on ESA 95 concepts should be clearly specified.** While the cash figures should allow a timely monitoring, the corresponding ESA95 data increase transparency and allow to check the consistency of the current medium term budgetary planning vis-à-vis the fiscal targets relevant for compliance with the SGP.
- **The projections and objectives included in the medium-term framework should form the basis on which the budget law is prepared.** In this respect, the role played by the Parliament in the MTBF preparation should be strengthened: the projected fiscal path, particularly the expenditure targets, should formally be presented, discussed and approved in the Parliament before the submission of the annual budget law.<sup>35</sup>
- **Last but not least, monitoring mechanisms should be specified (i.e. frequency and body in charge), and enforcement procedures pre-defining actions in case of non-compliance should be clearly stipulated.** Obviously, these mechanisms would have to be closely linked to those for the monitoring of the expenditure rule on which the MTBF should be based. The same institution should monitor and enforce both elements of the fiscal framework in case these tasks are assigned to an independent body.

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<sup>34</sup> This specific aspect is closely linked to the introduction of a revenue rule pre-establishing the allocation of higher-than-anticipated revenues (see Section 5.1.2).

<sup>35</sup> A significant shortcoming of most MTBFs in place is their weak influence on the annual budget law. Ideally, fiscal targets included in the budget law should be based on the targets considered in the first year of the MTBF. In the same vein, the fiscal strategy adopted in the MTBF should form the basis for the main fiscal measures contained in the budget. In a number of Member States, this link is established in the opposite direction (i.e. targets considered in the first year of the MTBF are revised annually according to the figures of the annual budget law). This approach places fiscal policy making in a very short-term perspective and renders difficult the implementation of a time consistent budgetary strategy.

#### 5.4 – Budgetary Procedures

**90. The definition of domestic budgetary procedures encompasses all the procedural rules laid down in law covering the three stages of the budget process, namely planning, approval and execution.** According to the literature, a number of desirable features of this budget process may have a positive impact on budgetary outcomes (Hagen et al. (1999).

**91. Specifically, seven budgetary dimensions are commonly accepted to be quality-enhancing vis-à-vis the three stages of the budget process.** Box VIII below lists and briefly describes these dimensions.

##### **Box VIII: The seven dimensions of the budget process**

**1. - Transparency:** This is a crucial element to ensure that fiscal authorities are held accountable. Transparency mainly requires reliable and timely budgetary data, standard accounting practices and a comprehensive coverage of the budget law (i.e. limited off-budget operations).

**2. - Multiannual budgetary planning:** A medium-term budgetary framework provides the basis for designing and implementing a fiscal strategy beyond the yearly budgetary cycle. This allows fiscal authorities to commit to a pre-defined path for the main budgetary aggregates and to take into account the multiannual budgetary impact of current policies.<sup>36</sup>

**3. - Budgetary centralisation at the planning and approval stages:** This is one of the most important dimensions of the budget process and heavily influences fiscal outcomes. In general, a fragmented budget preparation involving a large number of deciding actors leads to deficit bias due to the common pool problem.

**4. - Budgetary centralisation at the implementation stage:** In contrast to the planning and approval phase, certain decentralisation during the execution of the budget may be needed in order to better reallocate resources. While the overall spending ceiling should always be respected, some flexibility to change the distribution of resources among spending programmes can be appropriate if efficiency gains are within reach.

**5. - Top-down budgeting:** This budgeting approach starts the budgetary planning with a binding ceiling limiting the total amount of resources. Subsequently, this amount is distributed among expenditure areas and programmes. This is more conducive to fiscal discipline than the traditional bottom-up approach, in which the total spending is obtained by the sum of the individual expenditure requests of all line ministries and agencies.

**6. - Realistic economic assumptions and reserves:** Prudent and plausible macroeconomic assumptions should avoid systematic and overly optimistic budgetary projections, which in turn should facilitate a more credible and effective fiscal planning. As for reserves funds, they provide flexibility to deal with unexpected budgetary developments.

**7. - Performance budgeting:** This budgeting practice is based on the evaluation of spending programmes vis-à-vis the achievement of their policy objectives. A link between the resource allocation and the efficiency of these programmes should promote a more adequate resource allocation in the budget preparation.

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<sup>36</sup> See footnote 1.

**92. At present, the main source of information on domestic budgetary procedures is the OECD database, which was updated in 2007 and contains data for 20 EU Member States.<sup>37 38</sup>** For the main purpose of this note (i.e. elements of domestic fiscal frameworks that can contribute more to fiscal consolidation), the following analysis focus on only three of the seven budgetary dimension considered in Box VIII: transparency, budgetary centralisation at the planning and approval stages, top-down budgeting and realistic economics assumption for the budgetary preparation.

**93. Some interesting stylised facts emerge from the information collected by the OECD and confirm the existence of some weaknesses in the existing domestic budget processes.** Some relevant examples in relation to the budgetary dimensions mentioned in the previous paragraph are provided below:

○ **Prudent economic assumptions and transparency:**

- i. Half of the EU Member States included in the survey do not have any independent review of the economic assumptions used in the budgetary preparation. In turn, based on information collected in other sources different than this OECD database, the seven EU Member States not covered by this survey do not appear have any independent review of their macroeconomic assumptions either.
- ii. One third of the twenty EU countries covered by the OECD survey declare that the methodology used for establishing the economic assumptions underlying the budget preparation is not publicly available. Similarly to the previous paragraph, none of the seven EU Member States excluded from this database seem to release this methodology either.
- iii. Economic scenarios used in the budget are fully developed by the Ministry of Finance and/or other governmental bodies. Only in three Member States these scenarios are prepared by an independent body.

○ **Centralisation of the budget process:**

- i. In two thirds of the EU countries considered in the survey, neither the Minister of Finance nor the Prime Minister has the final say to resolve disputes between spending ministries and the central budget authority. This seems also to be the case for most of the EU Member States not covered by the OECD survey.
- ii. In twelve Member States out of the twenty EU countries comprised in the survey, the legislature has an unrestricted power to amend the budget proposed by the executive, including its overall size.

○ **Top-down budgeting:**

- i. Only a limited number of Member States seem to impose a binding expenditure ceiling at an early stage of the budgetary planning.
- ii. In a large majority of EU countries overspending can occur before a supplementary budget law has been approved by the legislature.

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<sup>37</sup> The information was collected through a survey conducted by the OECD across its Member States. The seven EU Member States not included are Bulgaria, Cyprus, Estonia, Latvia, Lithuania, Malta and Romania.

<sup>38</sup> This departs from the previous sections, which were based on data collected by the Commission through three comprehensive surveys on rules, institutions and MTBFs. The results of these surveys were published in the 2006 and 2007 Public Finance Report in EMU.

**94. Possible improvements in the three critical budgetary dimensions of prudent assumptions, centralisation and top-down budgeting are:**

- **In order to ensure the use of unbiased macroeconomic projections for the budget preparation resorting to an independent body entrusted with this task has proved to be a useful arrangement in some Member States.** In particular, the case of the National Accounts Institute in Belgium provides a good example on how these independent bodies can be implemented relying on existing institutions and technical capabilities (see Box IV).
- **A higher centralisation of the budget preparation should be considered a top priority objective in countries exhibiting insufficient central control of the budgetary process.** Stronger centralisation can be implemented through different channels, including in particular: strengthening of fiscal rules and the medium term budgetary framework, especially the use of binding spending ceilings, the reinforcement of the role played by the Minister of Finance, e.g. by delegating strong prerogatives and veto power on spending decisions to this member of the cabinet.
- **Finally, the introduction of top-down budgeting should significantly reinforce the centralisation of the budget process.** The resort to this type of budgeting must be considered an essential element of the reformed fiscal framework. However, it must be clear that its successful implementation goes hand in hand with the establishment of effective binding ceilings on expenditure developments and the existence of a strong Ministry of Finance.

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