

## ARTICLES

# THE IMPORTANCE AND EFFECTIVENESS OF NATIONAL FISCAL FRAMEWORKS IN THE EU



*The sovereign debt crisis has exposed fundamental weaknesses in the economic governance framework of the European Union, and in the euro area in particular. Important aspects that have been highlighted in the debate on fiscal governance are the limited enforcement of EU fiscal rules by the European Commission and the Council of the European Union, and insufficient national ownership to implement EU fiscal rules. Recent governance reforms have sought to remedy these problems, in particular by strengthening the enforcement mechanism of rules and increasing minimum requirements for national budgetary frameworks so as to ensure consistency and alignment with the reinforced EU governance framework, and, ultimately, to ensure the sustainability of public finances.*

*Against this background, this article takes stock of the existing national fiscal frameworks in the EU Member States and identifies the reforms needed to bring them into line with the newly defined requirements. The article discusses the six most important elements of national fiscal frameworks, namely (i) fiscal rules, (ii) medium-term budgetary planning, (iii) budget coordination, (iv) fiscal councils, (v) budget monitoring and (vi) macroeconomic and budgetary projections. In addition, it sets out more far-reaching reform steps, which may be needed to ensure the effectiveness of national fiscal frameworks, as is necessary for the smooth functioning of EMU.*

*Progress towards effective fiscal frameworks has so far been uneven across EU Member States and across the various elements of such frameworks. In nearly all cases, further institutional reforms – going beyond the existing requirements – are necessary, especially for euro area countries, in order to secure sound fiscal policies going forward.*

### I INTRODUCTION

The current sovereign debt crisis has exposed fundamental weaknesses in the EU's economic governance framework. The fiscal framework, and the Stability and Growth Pact (SGP) in particular, as implemented in the early years of EMU, did not prevent the build-up of large fiscal imbalances in several euro area countries. Sanctions were not applied at the EU level for non-compliance with the rules. There was also a widespread lack of national ownership, as EU Member States did not feel obliged to strictly implement the EU fiscal rules in order to achieve and maintain fiscal sustainability. Moreover, the pre-crisis governance framework did not set any minimum requirements for national fiscal frameworks, the design of which remained at the full discretion of the Member States. This might have been one important reason why national parliaments, governments and monitoring institutions failed to fully internalise the requirements of being a member of EMU.

National fiscal frameworks reflect the full set of rules, procedures and institutions that shape fiscal policy-making at the national level. They are also expected to transpose the European governance framework to the national level. Their main purpose is to anchor fiscal discipline and market expectations, as well as to support sustainable public finances in every EU Member State. The most important requirements for national fiscal frameworks to be fully effective are credible and enforceable numerical fiscal rules, clear medium-term budgetary planning, strong budget coordination arrangements between the different levels of government, independent fiscal councils, reliable fiscal statistics and effective budget monitoring, as well as unbiased macroeconomic and budget projections.

The recent strengthening of the EU fiscal governance framework has not been restricted to the European level<sup>1</sup> but has, for the first time, set out requirements for national budgetary frameworks in order to ensure that fiscal frameworks at the national level are consistent with the requirements at the EU level. This strengthening has taken place via the introduction of important legislation over the past two years, with the legislative package known as the “six-pack” and the fiscal compact of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, while the “two-pack” proposal by the Commission, also aimed at strengthening economic governance, is still under negotiation (see Box 1 for further details). Of particular significance is Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (hereinafter referred to as the “budgetary frameworks directive”), which is part of the “six-pack” and which has to be transposed into national law by 31 December 2013. In this context, the Commission published an interim report on the implementation of this Directive in December 2012, which found “substantial but uneven progress in transposing the Directive” across Member States.

This article analyses the importance and effectiveness of the national fiscal frameworks in the EU Member States and, in particular, the euro area, with respect to ensuring sound fiscal policies. Section 2 defines some benchmarks for effective national fiscal frameworks. Section 3 outlines recent changes in the EU legislation related to national budgetary frameworks. On the basis of this, Section 4 identifies reforms needed at the national level in order to comply with the requirements of the new EU fiscal governance framework. Section 5 sets out some proposals on how to further improve national fiscal frameworks in order to help foster budgetary discipline by going beyond the EU requirements, also reflecting the normative benchmarks outlined in Section 2. Section 6 concludes.

## 2 HOW SHOULD EFFECTIVE NATIONAL FISCAL FRAMEWORKS BE DESIGNED?

The empirical and theoretical literature underlines the importance of effective national fiscal frameworks, and in particular fiscal rules, in guiding fiscal policy towards stronger budget discipline.<sup>2</sup> Fiscal rules can target the budget balance, public debt, government revenue or government expenditure.<sup>3</sup> The effectiveness of fiscal rules largely depends on their specific design. Past experience shows that the design of numerical fiscal rules needs to satisfy three main principles<sup>4</sup>: the rules need to be (i) well defined – encompassing all levels of government – (ii) strictly binding, and (iii) fully enforceable.

1 See for example the article entitled “The reform of economic governance in the euro area – essential elements”, *Monthly Bulletin*, ECB, March 2011, the box entitled “Stronger EU economic governance framework comes into force”, *Monthly Bulletin*, ECB, December 2011, and the article entitled “A fiscal compact for a stronger economic and monetary union”, *Monthly Bulletin*, ECB, May 2012.

2 See Ayuso-i-Casals et al., “Beyond the SGP – features and effects of EU national-level fiscal rules”, in European Commission (ed.), “The role of fiscal rules and institutions in shaping budgetary outcomes”, *European Economy – Economic Papers*, No 275, April 2007; Debrun, X. and Kumar, M.S., “The discipline-enhancing role of fiscal institutions: theory and empirical evidence”, *IMF Working Papers*, No 07/171, July 2007; and Schaechter et al., “Fiscal rules in response to the crisis – toward the ‘Next-generation’ rules. A new dataset”, *IMF Working Papers*, No 12/187, July 2012.

3 The empirical literature is inconclusive as regards which type of rule is most desirable. Several papers support expenditure rules, e.g. Werts, P., “How do expenditure rules affect fiscal behaviour?”, *DNB Working Paper Series*, No 166, 2008; Turrini, A., “Fiscal policy and the cycle in the euro area: the role of government revenue and expenditure”, *European Economy – Economic Papers*, No 323, 2008; Holm-Hadulla, F., Hauptmeier, S. and Rother, P., “The impact of expenditure rules on budgetary discipline over the cycle”, *Applied Economics*, No 25, 2012. Others regard balanced budget and debt rules or even a combination of several different rules to be more effective, e.g. Debrun et al., “Tied to the mast? National fiscal rules in the European Union”, *Economic Policy*, No 23, 2008.

4 In their seminal contribution to this debate, Kopits and Symansky single out a larger number of optimal features of fiscal rules, namely: fiscal rules need to be well-defined, transparent, adequate, consistent with other rules, simple, flexible to accommodate large exogenous shocks, and enforceable, and they need to be supported by efficient policy actions (see Kopits, G. and Symansky, S.A., “Fiscal policy rules”, *IMF Occasional Papers*, No 162, 1998). This *Monthly Bulletin* article only refers to three features, which seem to be most important for the effectiveness of fiscal rules.

First, well-defined fiscal targets are important for guiding the preparation and execution of the budget. This includes the clear definition of numerical benchmarks for fiscal variables, which ensure sustainable fiscal policies over the short as well as the long term. The effectiveness of fiscal rules is found to be stronger when they have broader coverage, i.e. when they target all levels of government rather than just specific parts. Moreover, strong and credible budgetary cooperation arrangements among the different levels of government can further reinforce the disciplinary effect of fiscal rules.<sup>5</sup> Such cooperation is of obvious importance for EU Member States, in particular the ones which are strongly decentralised: while the fiscal targets of the EU fiscal framework refer to the general government sector, it is generally the central or federal government that is held liable for the implementation of the EU fiscal rules. Moreover, it is important that compliance with the rules can be easily monitored and that any slippages in meeting the annual fiscal targets are detected early on in the budget year, before large imbalances can accumulate. This requires reliable and timely data, as well as the establishment of frequent and effective fiscal surveillance exercises (for example, by making it mandatory for budgetary reviews to be carried out on an “intra-year” basis, i.e. more frequently than once a year).

Second, fiscal rules need to be strictly binding in order to foster compliance. This requires them to be laid down in national law or, better still, in a country’s constitution. Moreover, in order to ensure fiscal discipline over a longer horizon and to limit ad-hoc decisions by governments, it is important to see fiscal rules as multi-annual targets, ideally in the context of a multi-annual budgetary framework which should be of a binding nature. If escape clauses which allow for a certain deviation from the numerical benchmark are considered, they should be narrowly defined and be restricted to large exogenous shocks beyond the control of the authorities. Preferably, fiscal slippages – including those accumulated under escape clauses – should ex post not be consigned to the past, but be cumulated and corrected to avoid numerical fiscal benchmarks becoming moving targets.

Third, to be fully credible, fiscal rules need to be enforceable. Thus, in the event of non-compliance with the rules, a clearly defined correction mechanism should be activated – preferably automatically. A clear time horizon for correcting deviations from the fiscal target needs to be defined. Furthermore, effective enforcement requires a gradual, well-defined and credible sanctions mechanism, which leaves only very limited room for political discretion and is preferably fully automatic. To further strengthen the enforcement of fiscal rules and counteract governments’ inherent deficit bias, compliance with fiscal rules should be monitored by an independent body, such as a fiscal council.

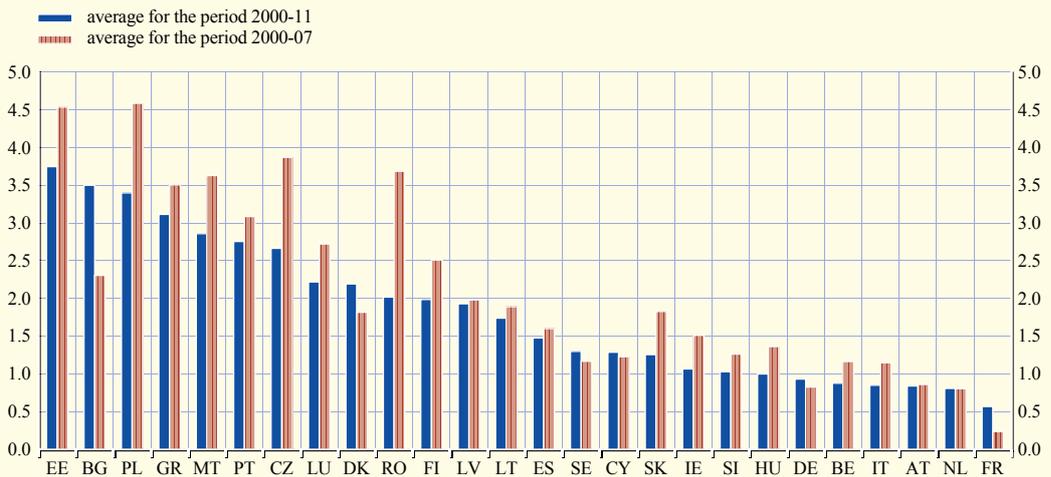
Fiscal councils can play an important role in enforcing fiscal rules and fostering budgetary discipline. For example, they can help to achieve unbiased and realistic macroeconomic and budgetary projections, either by producing them themselves or at least scrutinising government projections. Sound and realistic projections are essential for sound fiscal planning and budget preparation, as overly optimistic projections may trigger too positive an assessment of the underlying fiscal stance, masking any emerging fiscal imbalances.<sup>6</sup> In fact, projections of economic growth and government

5 Budget coordination arrangements and their effects are discussed in the following: Escolano, J., Eyraud, L., Moreno Badia, M., Sarnes, J. and Tuladhar, A., “Fiscal performance, institutional design and decentralization in European Union countries”, *IMF Working Papers*, No 12/45, February 2012; Eskeland, G.S., Litvack, J. and Rodden, J.A. (eds.), *Fiscal decentralization and the challenge of hard budget constraints*, MIT press, 2003; Joumard, I. and Kongsrud, P. M., “Fiscal relations across government levels”, *OECD Economics Department Working Papers*, No 375, 2003; Ter-Minassian, T. (ed.), *Fiscal federalism in theory and practice*, IMF, 1997; Asatryan, Z., Feld, L.P. and Geys, B., “Partial fiscal decentralization and sub-national government fiscal discipline: empirical evidence from OECD countries”, workshop paper/mimeo, 2012; Baskaran, T. and Hessami, Z., “Fiscal decentralisation and budgetary stability: transitory effects and long-run equilibria”, workshop paper/mimeo, 2012; and Foremny, D. and von Hagen, J., “Sub-national budgetary discipline during times of crisis: the impact of fiscal rules and tax autonomy”, workshop paper/mimeo, 2012.

6 Realistic macroeconomic projections are particularly important for accurate government revenue projections, given that revenue strongly depends on macroeconomic developments, while government spending is more influenced by political decision-making.

## Government revenue projection errors

(as a percentage of GDP)



Sources: European Commission and national sources.

Notes: The projection errors are proxied by the average of the annual difference between government revenue projections one year ahead (as stated in the respective stability and convergence programmes) and actual government revenue for the corresponding year (expressed as a percentage of GDP). The averages are shown for two time periods, thus including and excluding the crisis years. The series are adjusted for the years for which no projections are available. No annual projections are available for the United Kingdom.

revenue have been “too optimistic” in a number of EU Member States over the past decade, with the proxy for the projection errors ranging on average from 0.5% of GDP to around 4.5% of GDP in the period from 2000 to 2011 (see Chart).<sup>7</sup> Yet, the projection errors appear to be smaller in countries where projections are either produced or scrutinised by independent bodies, such as in the Netherlands, Austria and Belgium.

How do fiscal councils need to be designed if they are to support the enforcement of fiscal rules and foster budgetary discipline? The general conclusion that can be drawn from the literature is that three conditions need to be met if fiscal councils are to be effective<sup>8</sup>: first, fiscal councils need to be strictly independent from the government; second, their mandate should be comprehensive; and third, they should possess forceful instruments to trigger peer pressure.

First, strict independence is fundamentally important for facilitating unbiased fiscal analyses and/or projections while at the same time achieving institutional credibility. Credibility in turn is a precondition for effectively increasing the political cost of deviations from the government’s commitments. In order to ensure political independence, it is necessary to establish appointment procedures based on professional qualifications and not political preferences, as well as long terms of service, and to prohibit the government from interfering with the analyses of the fiscal council or its mandate, or influencing its executives.<sup>9</sup> These elements can be reinforced by reputation-building over time and international monitoring of adherence to the principle of independence.

<sup>7</sup> See also Beetsma, R., Giuiodori, M. and Wierds, P., “Fiscal plans and outcomes”, *Economic Policy*, No 24, 2009.

<sup>8</sup> See Wyplosz, C., “Fiscal rules: theoretical issues and historical experiences”, *NBER Working Papers*, No 17884, 2012; von Hagen, J., “Sticking to fiscal plans: the role of institutions”, *Public Choice*, No 144, 2010; Debrun, X., Hauner, D. and Kumar, M.S., “Independent fiscal agencies”, *Journal of Economic Surveys*, No 23, 2009; Hagemann, R., “How can fiscal councils strengthen fiscal performance?”, *OECD Journal: Economic Studies*, Vol. 2011/1, 2011; Frankel, J., “Over-optimism in forecasts by official budget agencies and its implications”, *NBER Working Papers*, No 17239, 2011.

<sup>9</sup> For details see for example Wyplosz, C., op. cit., or Calmfors, L. and Wren-Lewis, S., “What should fiscal councils do?”, *Economic Policy*, Vol. 26, No 68, October 2011, pp. 649-695.

Second, the mandate of fiscal councils should be comprehensive, stressing the importance of long-term fiscal sustainability. It should include the ex post analysis of whether fiscal policy has complied with the rules, as well as the evaluation of fiscal plans with respect to the targets derived from the fiscal rules and the underlying projections. In order for fiscal councils to fulfil their mandate, they should be given far-reaching access to the required data, and government transparency should be mandatory, for example with respect to fiscal projections or the forecasting of the effects of discretionary policy measures on the budget. Furthermore, the calibre and quantity of the technical staff needs to be sufficient in order to ensure that analyses are reliable and of a high quality.

Third, it is crucial for the success of fiscal councils as effective “watchdogs” that they have a prominent public voice. This implies that the analyses of fiscal councils should be highly visible. An instrument to ensure this visibility could be the requirement for governments to “comply or explain”, i.e. either to follow, or to publicly explain deviations from, the fiscal council’s advice. An alternative avenue could be to oblige governments to publish the results of ex post projection reviews or to empower the independent body to ask for a revision of the forecasts that the government carries out to base the preparation of the budget on sound assumptions.

### 3 RECENT EU GOVERNANCE REFORMS TO STRENGTHEN NATIONAL FISCAL FRAMEWORKS

This section describes recent EU governance reforms aimed at strengthening national fiscal frameworks (see Box 1 for a detailed overview of the EU’s tools for fostering reforms in national fiscal frameworks). Reforms relating to the six most important areas of national fiscal frameworks are presented, namely those covering (i) numerical fiscal rules, (ii) medium-term budgetary planning, (iii) budget coordination between levels of government, (iv) fiscal councils, (v) budget monitoring, and (vi) macroeconomic and budget forecasting.

#### Box 1

#### THE EU TOOLS FOR FOSTERING REFORMS IN NATIONAL FISCAL FRAMEWORKS

This box provides an overview of the EU tools for fostering reforms in national fiscal frameworks.

#### Directive on requirements for budgetary frameworks (as part of the “six-pack”)

Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States was adopted in November 2011, as part of a major reform of the EU economic governance framework known as the “six-pack”. A directive allows Member States to gradually adapt their laws to meet the goals set out in the directive by the indicated deadline, and gives them the freedom to decide how to do so. A full transposition of the budgetary frameworks directive is expected by the end of 2013, although the Heads of State or Government of the euro area sought to introduce its content by the end of 2012.<sup>1</sup> In the event of a Member State not complying by the 2013 deadline,

<sup>1</sup> Statement by the Heads of State or Government of the euro area and EU institutions, 21 July 2011.

whether in the form of inaction or omissions in transposition, the European Commission can launch an infringement procedure or even refer the case to the Court of Justice of the European Union.

### **Fiscal compact (as part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)**

The requirements for national fiscal frameworks have subsequently been further reinforced through the fiscal compact as part of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The Treaty entered into force on 1 January 2013 after ratification by 12 euro area countries. The correct transposition of the fiscal compact into national law by the deadline of the end of 2013 will be verified by the Court of Justice of the European Union, following a report by the European Commission.

The Treaty confers on the European Commission the responsibility for proposing binding common principles “concerning in particular the nature, the size and the time-frame of the corrective action to be undertaken (...) and the role and independence of the institutions responsible at national level for monitoring the observance of the rules”. In consultation with the Member States, the European Commission outlined the design features of the correction mechanism in a communication which was endorsed by the Council of the European Union (EU Council) in June 2012.<sup>2</sup>

### **The “two-pack”**

The proposed regulation for “monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of the Member States in the euro area” forms one of the additional two draft EU legal acts aimed at further strengthening the budgetary and economic surveillance of euro area countries and restoring confidence in financial markets. The “two-pack” proposals were presented by the European Commission in November 2011 and are still under negotiation at the time of writing.

### **Policy recommendations and peer review**

To complement the binding rules on national fiscal frameworks, the European Commission and the EU’s Economic Policy Committee were charged with performing a regular assessment and peer review of the Member States’ fiscal frameworks in order to share best practices. In May and November 2011, the Economic Policy Committee reviewed the national fiscal frameworks of all 27 EU Member States and adopted country-specific policy recommendations taking into account differences in institutional and cultural traditions.<sup>3</sup> However, these recommendations are not binding and there are no tools at the disposal of the EU authorities to enforce them. The means of pressure available include regular follow-up peer reviews of the implementation of the recommendations. An interim review was carried out in 2012 for several countries which were considered to be facing particularly important challenges (Cyprus, Greece, Ireland, Latvia and Portugal).<sup>4</sup> In addition, for 12 countries the policy advice on strengthening fiscal frameworks issued by the

2 European Commission Communication entitled “Common principles on national fiscal correction mechanisms”, 20 June 2012 (COM (2012) 0342).

3 European Commission, “Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review”, *European Economy Occasional Papers*, No 91, February 2012.

4 European Commission, “Fiscal Frameworks in the European Union: May 2012 update on priority countries”, *European Economy Occasional Papers*, No 113, July 2012.

EU Council in July 2012 in the context of the “European semester” fed into their country-specific recommendations. The implementation of these recommendations will be subject to an annual review by the European Commission and the EU Council.

### Macroeconomic adjustment programmes

In countries subject to an EU-IMF macroeconomic adjustment programme, the national fiscal frameworks have been shaped by the conditionality attached to financial assistance. The broad policy conditions are defined by the EU Council and further developed in a Memorandum of Understanding concluded between the European Commission, the IMF, the ECB and the country concerned.

To sum up, the tools used to foster reforms in national fiscal frameworks are ideally mutually reinforcing. EU Member States are expected to conduct comprehensive reforms of their national fiscal frameworks, based on the latest EU economic governance requirements and lessons learnt from peer reviews. While it is too early to fully assess the effectiveness of the various governance tools used so far, binding rules definitely provide more legal certainty and the means for their enforcement. This is one of the reasons why in its legal opinion on the “two-pack” the ECB expressed its preference for setting out the key elements of the fiscal compact – including the specification of the automatically triggered correction mechanism of the balanced budget rule – in secondary legislation, i.e. in the “two-pack”, rather than using “softer” channels (such as communications).<sup>5</sup>

5 Opinion of the European Central Bank of 7 March 2012 on strengthened economic governance of the euro area (CON/2012/18).

### NUMERICAL FISCAL RULES

Numerical rules tend to foster budget discipline. The budgetary frameworks directive does not, however, prescribe any specific rules at the national level. Indeed, it merely stipulates that Member States should have numerical fiscal rules in place based on the following general principles: (i) fiscal rules need to be clearly defined and promote compliance with the SGP effectively; (ii) they should be monitored effectively; (iii) non-compliance with fiscal rules should only be permitted temporarily under clearly defined escape clauses; (iv) there should be some enforcement of the rules in the case of non-compliance; and (v) the fiscal rules need be reflected in the country’s annual budget laws.

Binding requirements to that effect are included in the fiscal compact. The euro area countries are required to introduce a balanced budget rule at the national – preferably constitutional – level, combined with an automatically triggered correction mechanism. National budgets are defined as balanced if the annual structural budget balance<sup>10</sup> is in line with the country-specific medium-term objective as defined in the preventive arm of the SGP. The fiscal compact specifies an upper limit to the structural deficit of 0.5% of GDP, and 1% of GDP at most for Member States with debt-to-GDP ratios significantly below 60% of GDP and low risks to long-term fiscal sustainability. The balanced budget rule must include a correction mechanism which is triggered automatically in the event of significant deviations from the medium-term objective or the adjustment path towards it. Significant deviations are defined according to the preventive arm of the SGP. Concrete principles

10 The structural budget balance is defined in terms of the annual cyclically adjusted balance, net of one-off and temporary measures.

for specifying the correction mechanisms at the national level were outlined by the European Commission and endorsed by the EU Council in June 2012.<sup>11</sup>

The fiscal compact also requires Member States to respect the expenditure rule of the preventive arm of the enhanced SGP when approaching their medium-term objectives. According to this rule, total real expenditure growth under the control of the government<sup>12</sup> must not exceed potential medium-term GDP growth. Furthermore, the numerical benchmark for debt reduction is also enshrined in the fiscal compact. This rule stipulates that Member States with debt-to-GDP ratios above 60% must reduce the excess of their debt ratios at an average rate of one-twentieth per year as a benchmark. Under the SGP, Member States have to comply with the debt rule after a three-year transition period following the termination of their current excessive deficit procedures.

### **MEDIUM-TERM BUDGETARY PLANNING**

In order to be able to better predict multi-annual fiscal plans, the budgetary frameworks directive asks Member States to establish credible and effective medium-term budget frameworks with a planning horizon of at least three years. The main elements of the medium-term framework proposed in the directive are: (i) transparent multi-annual budgetary objectives for the general government deficit and debt, as well as public expenditure; (ii) projections of the main revenue and expenditure items for the budget year and beyond, which shall also constitute the basis for budget preparations; (iii) a description of the medium-term policies envisaged; and (iv) a prediction of the impact of these medium-term policies on long-term fiscal sustainability. Moreover, the directive prescribes that annual budget laws should be consistent with the provisions of the medium-term budgetary framework (in line with the stability and convergence programmes). In addition, the “two-pack” proposal requires the medium-term fiscal plans to be published annually together with the underlying documents.

### **BUDGET COORDINATION BETWEEN LEVELS OF GOVERNMENT**

Strong budgetary coordination between the different levels of government is important for ensuring full compliance with fiscal rules, including at the European level (given that fiscal rules usually relate to general government, which includes levels of government that are not under the direct control of central government). The budgetary frameworks directive stipulates that Member States should have appropriate coordination mechanisms in place across the different sub-sectors of general government. These mechanisms should ensure comprehensive and consistent coverage of all government entities with respect to annual and multi-annual fiscal planning and compliance with the numerical fiscal rules.

### **INDEPENDENT FISCAL COUNCIL**

Independent bodies, for example fiscal councils, can markedly increase the transparency and quality of fiscal policies and the effectiveness of fiscal rules. The budgetary frameworks directive states that

11 The common principles relating to national fiscal correction mechanisms, as published by the Commission, are: (i) national fiscal correction mechanisms should be enshrined in national law, preferably at constitutional level; (ii) they should be consistent with the EU framework; (iii) they should be activated in well-defined circumstances; (iv) the size and the timeline of the correction should be framed by pre-defined rules; (v) the mechanisms may give a prominent operational role to rules on public expenditure and discretionary tax measures; (vi) escape clauses are foreseen in exceptional circumstances; and (vii) their activation should be monitored/assessed by an independent body. See the European Commission Communication entitled “Common principles on national fiscal correction mechanisms”, 20 June 2012 (COM (2012) 0342).

12 Expenditure is defined as total expenditure minus interest payments, non-discretionary changes in unemployment benefits and spending increases mandated by law.

independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States should monitor the Member States' compliance with their respective numerical fiscal rules.

## BUDGET MONITORING

An adequate monitoring framework is crucial to effective fiscal surveillance, to ensure that fiscal slippages are detected at an early stage. Such a framework needs timely and accurate budgetary data, covering all sub-sectors of general government.<sup>13</sup> The budgetary frameworks directive includes additional requirements with respect to statistical reporting – especially concerning the derivation of quarterly national accounts data (which are decisive in assessing compliance with EU fiscal rules) from quarterly national cash data (see Box 2). It requires that contingent liabilities which could have a large impact on public budgets are published. In addition, the reinforced SGP introduces the possibility of financial sanctions for Member States that misrepresent government deficit and debt data, while Eurostat's audit powers have already been widened. The “two-pack” proposal requires that Member States subject to an excessive deficit procedure monitor their in-year budgetary implementation and that the respective reports be made public.

## MACROECONOMIC AND BUDGET FORECASTING

Unbiased and realistic macroeconomic and budgetary projections are another cornerstone of effective fiscal surveillance. The budgetary frameworks directive requires Member States to base their fiscal planning on the most up-to-date information and the most likely macroeconomic and budgetary assumptions. Furthermore, Member States are asked to publish their macroeconomic and budgetary projections – including the methodology used and the underlying assumptions – and to regularly engage in a technical dialogue with the European Commission on the assumptions. Moreover, to allow for sufficient peer pressure, the directive also requires that the projections are regularly evaluated ex post, including against other available projections. Member States should specify which institutions are responsible for the macroeconomic and budgetary forecasts.

To complement the budgetary frameworks directive, the “two-pack” proposal for euro area countries requires macroeconomic projections, on which draft budgets are based, to be prepared or at least endorsed by independent bodies. The “two-pack” provisions specify the coverage of the draft budget plans (the main revenue and expenditure components) for general government, which should be published together with the underlying assumptions.

13 European government finance statistics are based on a series of legal instruments, which can be divided into those relating to methodology (see, in particular, Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community), to data transmission (among others, Regulation (EC) No 1267/2003 of the European Parliament and of the Council of 16 June 2003 amending Council Regulation (EC) No 2223/96 with respect to the time limit for transmission of the main aggregates of national accounts, to the derogations concerning the transmission of the main aggregates of national accounts and to the transmission of employment data in hours worked) and to statistical aspects of the excessive deficit procedure (Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community).

**THE NEW ACCOUNTING STANDARDS/STATISTICAL REQUIREMENTS**

This box summarises the new accounting standards/statistical requirements of the reinforced EU economic governance framework. The budgetary frameworks directive stipulates that the public accounting systems of EU Member States should comprehensively and consistently cover all sub-sectors of general government and contain the information needed to generate accrual data to enable the preparation of data based on the ESA 95 statistical standard. Thus, Member States must ensure the timely and regular publication of fiscal data for all sub-sectors of general government, including:

- (i) cash-based fiscal data (or the equivalent figures from public accounting if cash-based data are not available);
- (ii) a detailed reconciliation table showing the methodology for the transition from quarterly cash-based data (or the equivalent figures from public accounting if cash-based data are not available) to data based on the ESA 95 standard.

The transition from cash-based data to data based on the ESA 95 standard is crucial, as it allows for better transparency, comparability and accountability of quarterly fiscal data, qualities which were previously only required for annual data. The ESA 95 prescribes the use of accrual accounting principles, which require transactions to be recorded when goods have been received or services have been provided, regardless of when the payment is made. Accrual accounting is the only way to obtain a complete and reliable picture of the economic and financial position of the public sector both for the period to which the accounts relate and the time when obligations are met.

To increase the transparency of general government finances, the budgetary frameworks directive also requires Member States to publish relevant information on contingent liabilities with a potentially large impact on public budgets, including government guarantees, non-performing loans and liabilities stemming from the operation of public corporations. Member States are also required to publish information on the participation of general government in the capital of private and public corporations in respect of significant amounts.

The first scheduled publication dates for these national data are February 2014 for the monthly data and June 2014 for the quarterly data (with January 2014 and the first quarter of 2014 being the respective starting points).

From an ECB perspective, the directive is an important step in improving the enforcement of high-quality government finance statistics provision in the EU. The directive supports the implementation of accrual-based public accounting systems, which are interconnected with ESA 95-based data and subject to internal control and independent audits. In addition, the directive should further enhance the quality of statistics.<sup>1</sup> These factors should help to detect

<sup>1</sup> See the box entitled “The Reform of Economic Governance in the Euro Area – Essential Elements”, *Monthly Bulletin*, ECB, March 2011.

fiscal slippages at an early stage and facilitate their timely correction. Moreover, ESA 95-based data may currently differ significantly from public accounting data, since the latter have not been harmonised nationally or internationally.<sup>2</sup> The adoption of harmonised public sector EU accounting standards that include all sub-sectors of general government may be considered further on a step-by-step basis in the medium term.

<sup>2</sup> Eurostat carried out an assessment of the suitability of using International Public Sector Accounting Standards (IPSASs) for the EU Member States. The conclusions of the study were delivered at the end of 2012. They show that there is major potential for the budgetary integration of harmonised public sector EU accounting standards.

#### 4 OVERVIEW OF EXISTING NATIONAL FISCAL FRAMEWORKS AND THE REFORMS NEEDED

This section analyses the extent to which EU Member States are already complying with the new requirements for national fiscal frameworks and identifies reforms that may be needed.<sup>14</sup> The main insights are summarised in the Table below.

##### NUMERICAL FISCAL RULES

In the EU, the most stringent fiscal rules currently in place are those in Sweden and in Germany. Sweden has, *inter alia*, a balanced budget rule included in public finance legislation, which is defined in cyclically adjusted terms, i.e. general government should have a surplus of 1% of GDP over the business cycle. Germany incorporated a “debt brake” rule into its constitution, which has been coming into effect gradually since 2011. The rule restricts the cyclically adjusted deficit to 0.35% of GDP for central government from 2016 onwards, while state governments will be obliged to balance their budgets over the business cycle from 2020 onwards. Fiscal slippages will be recorded in a specific correction account, with the objective of effectively ensuring compliance with the balanced budget rule over time and preventing upward debt trajectories.

Inspired by these rules and following ratification of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, several Member States (such as Denmark, Italy, Ireland, France and Spain) have recently passed, or are in the process of passing, legislation concerning balanced budget rules for general government. In most countries, however, these rules have not yet come into force. Moreover, there seem to be some differences across countries with respect to the automaticity of the underlying correction mechanism, the correction of cumulated deviations from fiscal targets and the definition and applicability of escape clauses. Furthermore, the numerical fiscal rules are not set at the constitutional level in all countries (attempts to anchor the fiscal rules at the constitutional level have not always been met with the necessary majorities, for example in Austria).

In addition to the balanced budget rule, some countries also have well-functioning public debt and expenditure rules in place. In Poland and Slovakia, for example, the public debt limits foresee a gradual correction mechanism, with sanctions if certain thresholds are exceeded. Portugal has recently established expenditure ceilings for central government.

<sup>14</sup> EU Member States will need to formally comply with the requirements of the directive from 2014 onwards, and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union only entered into force on 1 January 2013.

## MEDIUM-TERM BUDGETARY PLANNING

In the context of the “European semester”, all Member States are supposed to prepare stability or convergence programmes which include their medium-term budgetary objective for general government and projections for the main revenue and expenditure items. In most countries, annual budget laws are in line with the multi-annual fiscal planning outlined in their stability and convergence programmes. In Belgium and Hungary, however, the methodological approaches taken in preparing the annual budgets seem to differ from those in the stability and convergence programmes.

To foster medium-term budgetary planning, some countries have multi-annual planning frameworks in place, for example in the form of binding expenditure ceilings. This is the case in the Netherlands, Austria, Sweden and Finland, among others. In 2012 Ireland introduced a binding medium-term expenditure framework for its central government. In addition, Portugal and Hungary improved their multi-annual budgetary frameworks for their central governments in the context of the revised budgetary framework legislation while, in Spain, recent developments in multi-annual budgetary targets affected all levels of government. Other countries, such as Latvia and Cyprus, are currently in the process of strengthening their medium-term planning frameworks. Currently, however, Belgium and Luxembourg still do not envisage introducing a comprehensive national medium-term planning framework.

## BUDGET COORDINATION BETWEEN LEVELS OF GOVERNMENT

Coordination mechanisms between different sub-sectors of general government are not yet established in all EU Member States. However, there have recently been some advances at the national level, reflecting the fact that the fiscal compact refers to general government, which indirectly requires at least some degree of coordination between central government and the sub-sectors. In Germany, the “Stabilitätsrat” (stability council) is required to help coordinate budget planning for the Federal Government and the federal states in order to ensure sound fiscal policies and compliance with the requirements of the German “debt brake”.<sup>15</sup> In Spain and Italy, among others, the newly established numerical fiscal rules at the constitutional level are also to cover regional and local authorities. In addition, sub-national budgetary plans in Spain need to be validated ex ante by the central government; if budgetary targets are exceeded at sub-national level, the central government can impose sanctions and corrective measures (such as examining their accounts and cutting sub-national spending). Moreover, in Denmark a recently adopted budget regulation foresees that, from 2014 onwards, regions and municipalities will be faced with a cut in grants from the central government if they exceed certain defined expenditure ceilings.

## INDEPENDENT FISCAL COUNCILS

In more than half of the EU Member States, independent fiscal councils or bodies with functional autonomy either already exist or are about to be established. In Belgium, Austria and Sweden, for example, fiscal councils are long established. While the fiscal councils’ mandates differ across countries, they typically focus on providing fiscal assessments (including of long-run sustainability and compliance with rules) and estimates of the budgetary impact of proposed measures, as well as verifying government projections.

<sup>15</sup> For details see: Deutsche Bundesbank, *Monthly Report*, October 2011, pp. 20-24.

Overview of national fiscal frameworks in the EU								
	Numerical fiscal rules <sup>1)</sup>			Medium-term planning <sup>2)</sup>	Budget coordination <sup>3)</sup>	Fiscal council <sup>4)</sup>	Budgetary monitoring <sup>5)</sup>	Projections <sup>6)</sup>
	Budget balance	Debt	Expenditure					
Belgium					+/-	x	x	x
Bulgaria	+/-	+/-	+/-	x	x		+/-	
Czech Republic		*	*	x		*	x	
Denmark	x		x	x	x	x	x	
Germany	x			x	x	+/-	x	x
Estonia				x	x			
Ireland	x	x	x	x	+/-	x	x	
Greece				x	*		+/-	
Spain	x	x	x	x	x		x	
France	x			x	+/-	x		
Italy	x			x	x	x	+/-	
Cyprus	+/-	+/-	+/-	x	+/-	+/-	+/-	+/-
Latvia	*	*	*	x	x			
Lithuania	*			x	x			
Luxembourg					+/-			+/-
Hungary		x		x		+/-		
Malta	*			x			x	
Netherlands			x	x	x	x	x	x
Austria	+/-		x	x	x	x	x	x
Poland		x		x	x			
Portugal	+/-		+/-	x	x	x	+/-	
Romania			+/-	x	x	x	x	+/-
Slovenia	*			x	+/-	+/-	x	x
Slovakia		x		x		x	x	+/-
Finland			x	x				
Sweden	x	x	x	x	x	x	x	
United Kingdom				x		x		x

Notes: Based on information publicly available up to December 2012. "x" indicates that requirements have been fully met and "+/-" that they have only been partly met. "\*" indicates improvements to national fiscal frameworks that have not yet been adopted/passed, but which are already at an advanced stage in the legislative process (i.e. they have at least passed the first reading in parliament).

1) Effective and binding numerical fiscal rules targeting the budget balance, public debt or government expenditure (including expenditure ceilings), preferably contained in the constitution.

2) Fiscal planning procedure in place covering at least three years.

3) Implicit or explicit budget coordination between different levels of government.

4) Independent fiscal council that provides regular assessments of, and operational recommendations for, budgetary policy.

5) Official budget review and comprehensive and timely data on budget implementation.

6) Unbiased and realistic macro or revenue projections, ideally prepared or scrutinised by an independent agency.

## BUDGET MONITORING

While all EU Member States monitor budget implementation during the year, monitoring procedures differ substantially across countries. There is still no official intra-year budget review in place in nearly half of the EU Member States. Only a few countries, such as Belgium, the Netherlands, Romania, Slovakia and Slovenia, have fully-fledged official intra-year budget reviews, which are even made publicly available.

As regards budget statistics, the availability and quality of budgetary data is rather mixed in the EU Member States and has remained broadly unchanged in recent years. However, Spain has recently taken measures to improve the availability of sub-national government budgetary data. Moreover, in the context of the financial assistance programmes, measures have been adopted to improve the quality of budgetary data (such as in Greece).

## MACROECONOMIC AND BUDGET FORECASTING

In line with the budgetary frameworks directive, macroeconomic and economic projections are published in more than half of the Member States, while the underlying methodologies are only publicly available in a few countries, namely Denmark, Finland and Slovakia. Moreover, no country seems to have a legislative process in place to evaluate the projections ex post on a regular basis. However, in some countries (e.g. Romania) the government is obliged to publicly explain any significant differences between its projections and those of the European Commission.

In most Member States, macroeconomic and budgetary projections are still prepared by the respective finance/budget ministry and not by independent agencies.<sup>16</sup> In only a few countries are the government projections at least scrutinised by an independent agency or committee (Germany and Slovakia, for example). The Member States with long-established independent bodies for macroeconomic projections are Belgium, the Netherlands, Austria and Slovenia. The United Kingdom recently set up an independent office in charge of producing macroeconomic and revenue projections and scrutinising the government's input into the public finance projections (although the government formally retained its right to produce its own forecasts). However, in some countries in which macroeconomic and revenue projections are prepared by an independent body (such as Luxembourg and Romania), the government is not obliged to use these projections when preparing the budget.

## 5 THE EFFECTIVENESS OF NATIONAL FISCAL FRAMEWORKS – POSSIBLE AREAS FOR IMPROVEMENT

This section discusses how the normative benchmarks outlined in Section 2 compare with the existing requirements for national fiscal frameworks and identifies possible areas for improvement in euro area countries in order to make national fiscal frameworks fully commensurate with the requirements of the single currency.

### NEED FOR BETTER ENFORCEMENT AND STRONGER AUTOMATICITY

The existing requirements for national fiscal frameworks, in particular those included in the fiscal compact, foresee clearly defined numerical fiscal rules which are enforceable and ideally anchored at the constitutional level. These requirements seem to be broadly in line with the normative benchmarks needed for credible fiscal targets. However, as has been spelt out on previous occasions,<sup>17</sup> the fiscal compact, though expected to help strengthen fiscal credibility, contains some loopholes, for example with respect to the rather generous escape clauses and the correction mechanism not being fully automatic.

Moreover, more effective fiscal surveillance frameworks are needed in order for slippages in annual fiscal targets to be detected early in the budget year. This surveillance could take the form of mandatory intra-year budgetary reviews. Although the budgetary frameworks directive falls short of requiring the establishment of adequate monitoring frameworks for budget implementation, the “two-pack” proposal foresees the regular monitoring of in-year budgetary execution for those euro area Member States subject to an excessive deficit procedure. Going forward, it would be preferable for this to become a standard feature for all Member States.

<sup>16</sup> In the EU Member States there are even fewer independent agencies in charge of preparing revenue projections.

<sup>17</sup> See for example the article entitled “A fiscal compact for a stronger economic and monetary union”, *Monthly Bulletin*, ECB, May 2012.

Furthermore, with respect to the need to ensure that multi-annual fiscal plans can be better predicted and to limit ad-hoc decisions by governments, the current requirements can only be seen as minimum requirements. Indeed, the EU fiscal surveillance framework needs to be better integrated with national fiscal planning so that budget preparation is fully consistent with the budgetary plans outlined in the stability and convergence programmes. Another weakness in current medium-term planning is that the commitments under the medium-term fiscal frameworks are not binding and cannot be enforced. Experience has actually shown that binding medium-term planning frameworks tend to be more effective in avoiding fiscal slippages. EU Member States should therefore go beyond the current requirements and strengthen the multi-annual character of budget planning. This calls for a stronger enforcement of medium-term fiscal plans.

Furthermore, budget coordination between different levels of government is key for budgetary discipline and meeting the fiscal targets covering general government. However, the current legislation falls short of specifying requirements for effective budget coordination that would successfully prevent non-compliance with fiscal targets at the sub-national level. Going beyond the current requirements, effective budget coordination at the national level should be explicit and take the form of regularly updated and sufficiently binding internal stability programmes, for example. Further possible means of strengthening budget coordination across different levels of government are the introduction of an internal sanctions mechanism in the case of non-compliance with targets set for the different levels and a request for the correction of cumulated ex post fiscal slippages, such as through the implementation of a correction account.

#### **MORE EFFECTIVE MONITORING OF BUDGETARY COMMITMENTS NEEDED**

The EU requirements for national fiscal frameworks already include some important elements that apply to fiscal councils to ensure their effectiveness. The budgetary frameworks directive defines the need for fiscal councils to monitor compliance with numerical fiscal rules at the national level. Moreover, the common principles for independent bodies as spelt out in a European Commission communication in June 2012<sup>18</sup> seem adequate, if fully implemented, to ensure that fiscal councils are sufficiently independent. However, the legislation may prove to be lacking as regards the comprehensiveness of the related tasks. In particular, fiscal councils are not required to be solely responsible for the preparation of macroeconomic and budgetary forecasts. Moreover, EU legislation does not include provisions to ensure that fiscal councils are highly visible. In particular, it remains very vague on the consequences if a fiscal council finds non-compliance with fiscal rules or if government projections are found to be too optimistic. Thus there is a need to further strengthen the voice of fiscal councils at the national level in order for them to gain greater leverage in relation to governments, as well as national parliaments, for example by obliging governments to either comply with, or publicly explain deviations from, the councils' advice.

## **6 CONCLUSIONS**

Effective national fiscal frameworks are crucial for ensuring that fiscal policies are sound and that EMU functions smoothly. Recent reforms of the EU economic governance framework also rightly targeted fiscal frameworks at the national level. However, reform progress has so far been uneven across countries. As a first step, it is imperative that countries foster their reform efforts and fully comply with the minimum benchmarks for national fiscal frameworks and the provisions

<sup>18</sup> See footnote 11.

of the fiscal compact by the deadline for its transposition. While Member States are currently in the process of establishing balanced budget rules, government expenditure and debt rules are still not a common feature. Moreover, further progress is required in the area of budget coordination between levels of government; the availability and quality of sub-national government budgetary data should be strengthened; and several countries still do not have an independent council, so they need to ensure that their fiscal planning is based on unbiased projections.

The new governance requirements, however, while constituting a step in the right direction, may not be sufficient to ensure sound fiscal policies in the EU going forward, especially in the case of euro area countries, given the larger interdependencies created by EMU. In particular, in several ways the new fiscal governance reform steps, even if fully implemented, fall short of what is required to ensure effective national fiscal frameworks and foster budget discipline. Euro area countries should therefore go beyond the minimum requirements, as spelt out in the budgetary frameworks directive.

There are a number of ways to achieve this. For example, the effectiveness of fiscal councils could be increased by obliging governments to either comply with, or publicly explain deviations from, the councils' advice. Similarly, in order to strengthen budget coordination across different levels of government, an internal sanctions mechanism could be established in the event of non-compliance. Moreover, the commitments under medium-term fiscal frameworks ought to be made binding and a mandatory review of intra-year budget implementation be introduced for all EU countries. Such steps would make a significant contribution to establishing truly effective national fiscal frameworks, to fostering fiscal discipline, and to ensuring the smooth functioning of EMU.