

Part III

How to stick to medium-term
budgetary plans

Summary

A number of EU countries faced in the past chronic difficulties in respecting the medium-term budgetary targets set in their stability and convergence programmes (SCPs). The ‘close to balance or in surplus’ objective of the original Stability and Growth Pact became, in these countries, a moving target. Against this background, the finance ministers of the EU Member States decided, in the context of the 2005 SGP reform, to take concrete actions to strengthen the preventive arm of the Pact. To ensure a better functioning of the SGP, the Council notably emphasised the importance of improving national fiscal governance and formulated concrete proposals to strengthen the national ownership of the medium-term budgetary targets set in the SCPs. The aim of this chapter is to assess which factors explain that some countries were able to stick to their medium-term budgetary plans while this was not the case for others. It is notably analysed to what extent reliance on a proper medium-term budgetary framework helps respect multiannual budgetary targets.

The analysis proceeds in three steps. Firstly, it presents the main arguments in favour of medium-term budgetary frameworks. Based on concrete examples in the EU countries and existing literature, it reviews the various types of frameworks and identifies a number of desirable characteristics. Secondly, the analysis reviews the medium-term budgetary plans formulated by Member States in their SCPs and compares them with outcomes. The aim is to identify possible origins for the difficulties of some Member States to achieve the planned improvements in the government balance. Thirdly, it assesses which factors explain that some countries were able to stick to budgetary plans while this was not the case for others. It is notably examined whether reliance on a proper medium-term budgetary framework (MTBF) favours better adherence to medium-term fiscal plans.

Functions of medium-term budgetary frameworks

In most EU countries, the preparation of the annual budget is the budgetary step in which crucial fiscal policy decisions are taken. At the same time, most fiscal policy deci-

sions have economic and budgetary implications which go well beyond the year in which they are taken. A majority of EU countries have therefore decided to supplement their budgetary institutions with MTBFs. The literature has underlined the benefits of such instruments, which contribute to improved transparency in the conduct of fiscal policy and provide the fiscal authorities with a better planning tool supporting effective expenditure management and the implementation of structural reforms.

Design of medium-term budgetary frameworks

There is a wide range of possibilities concerning the design and status of MTBFs, depending on country preferences. A number of characteristics appear however desirable to ensure that such frameworks play a meaningful role in the conduct of fiscal policy. MTBFs should preferably cover the whole of the general government sector, to fully take into account the medium-term budgetary impact of policy decisions. Medium-term budgetary targets should be vested with a sufficient degree of political commitment, by the executive and the legislative branches. They should also preferably be set following a proper coordination between various levels of government involved in the conduct of fiscal policy. Moreover, there should be a strong connection between the MTBF and the annual budget procedure, in the sense that the multiannual targets set in the previous years should form the basis upon which the budget is prepared. Finally, the preparation of macroeconomic assumptions underpinning budgetary projections should be devoted a careful attention, as these assumptions largely determine the amount of public resources available in the medium term to finance policies.

Situation in the EU Member States

The situation of the EU Member States varies considerably concerning the degree to which their fiscal policy is placed in a medium-term perspective. While in some countries developed national MTBFs have been introduced a long time ago and play a key role in fiscal policy-making, in some other Member States the only instrument

putting annual fiscal policy decisions in a multiannual context is the SCP. In some countries, the medium-term budgetary targets are prepared by the government with no or little coordination with other levels of governments and virtually no involvement of the national parliament. In other countries, the medium-term budgetary targets are set following coordination between all levels of governments and the approval of the national parliament. The situation also varies substantially concerning the link between the MTBF and the annual budgetary procedure. In a number of EU countries, this link can be assessed as relatively strong while in other cases the medium-term budgetary projections seem to be only indicative and hardly taken into account in the preparation of the annual budget laws. Overall, the analysis on the existence and properties of MTBFs currently in force in the EU countries points, on average, to a relatively large gap between what would be desirable and current practice.

Medium-term fiscal plans and outcomes

A critical question is whether reliance on proper MTBFs favours the respect of multiannual budgetary targets. A detailed examination of the reasons for the difficulties to respect these targets in the past provides necessary background material for this analysis. The analysis of multiannual budgetary plans formulated by Member States in the SCPs shows that the EU countries have typically planned expenditure-based fiscal adjustments: the expenditure-to-GDP ratio has on average been projected to decline by about 1½ percentage points over the three-year horizon typically covered by a SCP.

When comparing budget plans to outcomes, it appears that there were on average sizeable deviations from the planned adjustment paths. In about two thirds of cases the improvement in the government balance was less pronounced than targeted. Difficulties in the implementation of medium-term expenditure plans can be considered the main cause for the underperformance in attaining budget balance targets. The increase in nominal government expenditure over the three-year period covered by SCPs was higher than planned in more than three quarters of cases. Such a result contrasts with the expected benefits of MTBFs: negative and positive risks should tend to offset each other over time so that in the medium-term deviations from medium-term expenditure plans should be limited in frequency and size. It should however be stressed that there was a considerable heterogeneity of performance across Member States. While some countries were

almost consistently successful in sticking to expenditure targets, others were almost always unsuccessful.

The analysis suggests that deviations from the planned improvements in the government balance also partly result from negative GDP growth surprises compared to the projections in the SCPs. While the frequencies of positive and negative surprises in real GDP growth are similar, the average size of negative surprises has been significantly higher than that of positive surprises. Interestingly, the picture is different when looking at developments in nominal GDP. When considering this variable, the frequency and size of positive and negative GDP growth surprises are very similar. This explains that developments in government revenue were on average in line with medium-term plans, or even slightly more favourable.

Which factors help respecting medium-term expenditure plans?

The analysis brings a number of answers on the determinants of government expenditure overruns in the EU. It shows notably that there is a statistically significant relation between the 'degree of ambition' of medium-term expenditure plans, in terms of the planned reduction in the expenditure-to-GDP ratio, and the size of the discrepancy between the planned and observed increase in government expenditure. Member States projecting large cuts in their expenditure-to-GDP ratio tend, *ceteris paribus*, to show a lower degree of adherence to plans. The analysis also confirms that it is relatively easier for countries with a relatively large public sector to achieve ambitious expenditure-based fiscal consolidations. Another interesting result is that expenditure overruns seem to be independent from macroeconomic developments. The frequency and size of expenditure overruns were similar in periods of positive and negative growth surprises. Finally, and this can be considered the main result of the analysis, there is a statistically significant relation between the quality of institutions for medium-term budgetary planning and the capacity to achieve multiannual expenditure targets. Overall, the implementation in the EU countries of adequate MTBFs seems to be a promising way forward to ensure better compliance with medium-term expenditure targets. Controlling for other variables, reliance on developed medium-term budgetary frameworks can significantly contribute to limit the size of the discrepancy between planned and observed increase in real primary expenditure. This suggests that the implementation in the EU countries of adequate MTBFs is a promising way forward to ensure better compliance with medium-term expenditure targets.

1. Introduction

Several EU countries faced in the past difficulties in respecting the medium-term budgetary targets set in their stability and convergence programmes (SCPs) and the ‘close to balance or in surplus’ objective of the original Stability and Growth Pact became, in these countries, a moving target. The finance ministers of the EU countries decided, in the context of the 2005 SGP reform, to take concrete actions to strengthen the preventive arm of the Pact. Country-specific medium-term budgetary objectives (MTOs) were set for all Member States and a number of simple provisions relating to the appropriate speed of adjustment towards the MTOs were introduced in the SGP ⁽¹⁾. To ensure a better functioning of the SGP, the Council also emphasised the importance of improving national fiscal governance and formulated concrete proposals to strengthen the national ownership of the medium-term budgetary targets set in the stability and convergence programmes (SCPs)⁽²⁾. The Council notably encouraged newly elected governments to present a ‘stability or convergence programme for the legislature’, providing information on the means and instruments they intend to employ to reach the medium-term targets. It also invited governments to strengthen the status of their SCP by presenting it, as well as the Council opinion thereon, to their national parliament.

The aim of this chapter is to assess which factors explain that some countries were able to stick to their medium-term budgetary plans while this was not the case for others. It is notably analysed to what extent reliance on developed medium-term budgetary framework (MTBF) helps respect multiannual budgetary targets. According to a survey launched by the European Commission in 2006, the situation of the EU Member States varies considerably concerning the degree to which their fiscal policy is placed in a medium-term perspective. While in some

countries developed national MTBFs have been introduced a long time ago and play a key role in fiscal policy-making, in some other Member States the only instrument putting annual fiscal policy decisions in a multiannual context is the SCP. Moreover, the status and role of SCPs vary considerably from one country to another. In some Member States, they are prepared by the government with no or little coordination with other levels of governments and virtually no involvement of the national parliament. In other countries, the medium-term budgetary targets are set following coordination between all levels of governments and the approval of the national parliament. Several studies have already demonstrated the potential benefits of MTBFs, notably on fiscal discipline. Compared to existing literature, this part of the report takes an original perspective and seeks to assess whether reliance on such institutional devices can effectively help a country to attain its medium-term budgetary targets.

The analysis proceeds in three steps. Firstly, it presents the main arguments in favour of MTBFs. Based on concrete examples in the EU countries and existing literature, it reviews the various types of frameworks and identifies a number of desirable characteristics. The analysis exploits newly-collected survey data on MTBFs in force in the EU Member States and on the preparation and status of SCPs. Secondly, this part of the report reviews the medium-term budgetary plans formulated by Member States in their SCPs and compares them with outcomes. The aim is to identify possible origins for the difficulties of some Member States to achieve the planned improvements in the government balance. The analysis is based on a comprehensive database comparing multiannual budgetary projections and observed developments. Thirdly, it assesses which factors explain that some countries were able to stick to budgetary plans while this was not the case for others. It is notably examined whether reliance on a proper MTBF favours better adherence to medium-term fiscal plans. The respective influences of the initial budgetary position and of macro-economic developments are also examined.

⁽¹⁾ For a detailed description of the changes introduced by the 2005 SGP reform, see European Commission (2005a).

⁽²⁾ For a review and assessment of the influence of national fiscal rules and institutions, see European Commission (2006a).

2. The functions of medium-term budgetary frameworks

2.1. Introduction

The preparation of the annual budget law is, in all European countries, the budgetary step in which crucial fiscal policy decisions are taken. At the same time, most fiscal policy decisions have economic and budgetary implications which go well beyond the year in which they are taken. In some cases, the budgetary consequences of policy measures even only show up in the medium or long run. Moreover, there is widespread recognition that a single-year budget perspective gives fiscal policymakers a poor basis for strategic budgetary planning and the implementation of structural reforms, the positive effects of which generally materialise in the medium term. These considerations have led a majority of EU countries to supplement their budgetary institutions with MTBFs. Such frameworks today exist in most of the EU Member States. This section presents the functions and benefits of MTBFs and reviews the various types of frameworks. It also provides an overview of the MTBFs in force in the EU countries and discusses the properties of SCPs as a MTBF.

2.2. Functions of medium-term budgetary frameworks

A MTBF can be defined as an institutional device allowing fiscal authorities to extend the horizon for fiscal policymaking beyond the annual budgetary calendar. MTBFs are typically based on a macroeconomic scenario, which determines the availability of government resources in the medium term to finance policies. On this basis, the fiscal authorities provide medium-term projections for the main aggregates of government finances (government balance and debt; government expenditure and revenue and their composition), for part or the whole of the general government sector.

2.2.1. Expected benefits from medium-term budgetary frameworks

MTBFs have several benefits. They contribute to an increased transparency on the medium-term budgetary objectives of the country, which allows economic agents to be better informed on the ongoing trends in government finances. MTBFs also allow to better take into account future budgetary implications of policy measures in the decision-making process. Taken together, these elements contribute to sound fiscal policies and help address the main causes for the deficit bias in fiscal policymaking.

MTBFs notably contribute to better time consistency in the conduct of fiscal policy. The literature has highlighted that governments may have a short-term focus when taking fiscal policy decisions ⁽¹⁾. Reliance on MTBFs helps address the time inconsistency issue in two ways. Firstly, the existence of a developed MTBF will make it more difficult for governments to hide or understate the multiannual budgetary effects of new policy measures. Secondly, well-defined MTBFs force the fiscal authorities to commit to a predefined path for the main aggregates of government finances in the medium term. This makes it more difficult to postpone the implementation of difficult fiscal consolidation measures.

MTBFs also help address the common pool problem of public resources, which is according to literature the other main reason for overspending and accumulation of deficits and debt over time. This problem arises when

⁽¹⁾ See Persson and Svensson (1989) and Tabellini and Alesina (1990). The main argument is that governments not sure of being re-elected may have a tendency to implement generous fiscal policy measures to increase their re-election chances and to overlook the medium to long-term consequences of budgetary decisions. This is possible because individuals (voters) tend to see the short-term benefits they can get from lower taxes and increased government spending but are not always fully aware of the possible long-term costs of such policies.

groups that benefit from a particular type of government spending or tax exemption do not fully internalise the costs of such measures, since the financing is generally spread among a wide set of contributors ⁽¹⁾. By allowing to better take into account future consequences of budgetary decisions, in the context of a centralised framework, reliance on a well-defined MTBF will contribute to reduce the common pool problem and shift the focus from the size of total government spending to the possibilities for reallocations within programmes over a pre-defined period.

Another argument in favour of MTBFs is that such frameworks provide the fiscal authorities with a better planning tool for the conduct of their policies. In the absence of a proper MTBF, the risk exists that resource allocation is made on an ad hoc or piecemeal basis, with the implications of past and present decisions being overlooked. MTBFs are a way to bridge this gap and to improve the quality and stability of the decision-making process. A number of authors have highlighted that MTBFs favour the implementation of structural reforms targeting, for instance, significant re-allocations across general government subsectors or government programmes, or major changes in the level and structure of taxation. Such reforms are generally implemented over several years, and reliance on a MTBF permits to give visibility to economic agents on the benefits of such reforms in the medium term. This contributes to increased acceptability and feasibility of reforms.

2.2.2. Key conditions for the effectiveness of medium-term budgetary frameworks

Cautious macroeconomic assumptions

The literature has pointed out a number of key conditions for the effectiveness of MTBFs. To the preparation of macroeconomic assumptions underpinning budgetary projections particular careful attention should be devoted as these assumptions determine the amount of public resources available in the medium term. A delicate issue is related to the uncertainty associated with multi-year macroeconomic projections. The basic idea is that overestimation of GDP growth over the medium term may create *ex ante* an upward pressure on multiannual public expenditure plans. Moreover, line ministries and departments may see the resource allocation defined in the context of the MTBF as an entitlement, making *ex*

post downward revisions of expenditure difficult in the event of a shortfall in GDP growth developments (OECD, 2003). The difficulty is that projecting macroeconomic developments in the medium term is a genuinely difficult exercise. A way to address this question is to deliberately base medium-term budgetary projections on conservative assumptions. A number of EU countries have to this end introduced so-called ‘prudence factors’ in their MTBF. This is done either through a systematic downward adjustment of economic assumptions compared to the central scenario, or by incorporating contingent reserves which can only be activated in case of a negative surprise on macroeconomic or government revenue developments (e.g. in Sweden). To avoid possible use of macroeconomic forecasts to artificially increase the amount of resources available in the medium term, a number of Member States (e.g. Belgium, the Netherlands and Austria) have decided to delegate the preparation of the medium-term macroeconomic scenario used in the MTBF to independent bodies.

Budgetary objectives need to be credible

The literature also mentions the risk of opportunistic use of MTBFs. The temptation may exist for opportunistic governments to avoid or postpone the implementation of difficult (politically costly) fiscal consolidation measures by presenting an overly favourable picture of medium-term prospects for government finances, projecting for instance large reductions in the government deficit and debt. To avoid such a risk, a number of conditions should be fulfilled for budgetary targets to be credible.

Firstly, medium-term budgetary targets should be vested with a sufficient degree of political commitment by all actors playing a role in the conduct of fiscal policy. In this respect, the involvement of the national parliament in the preparation of the budgetary targets is a relevant indicator. The medium-term targets should also preferably be set following a proper coordination between the various levels of government involved in the conduct of fiscal policy. Secondly, for the MTBF to have a meaningful role and influence in the conduct of fiscal policy there should be a clear link with the annual budget law, in the sense that the preparation of the annual budget should start by considering the projections elaborated in the preceding year(s) in the context of the MTBF. Deviations from previous plans should be explained and justified. Thirdly, there should be a high degree of transparency concerning the nature of the budgetary projections

⁽¹⁾ See Weingast et al. (1981).

formulated in the context of the MTBF. There should notably be a clear indication of whether the medium-term budgetary projections are forecasts or targets; in other words whether the projected path for the main budgetary aggregates is attainable under unchanged policies or whether policy action will be needed in the future to achieve the fiscal targets. In case policy actions will be needed to reach the targets the framework should request the specification of the financial gap between the objectives and developments in government finances under unchanged policies.

2.2.3. Main types of medium-term budgetary frameworks

Experience shows that the nature and properties of national MTBFs vary considerably from one country to another. This section reviews the main options in the design of MTBFs and identifies a number of desirable characteristics.

Share of government finances covered and time horizon of MTBFs

MTBFs can cover part or the whole of the general government sector. A wide coverage is preferable (IMF, 2001) as partial coverage may not allow considering the total implications of new policy measures, which is one of the main objectives of MTBFs. In the case of MTBFs covering several general government subsectors, a sufficient degree of coordination between various general government tiers should be ensured when setting the multiannual budgetary targets. This is crucial to ensure a sufficient degree of political commitment of all actors taking part in the conduct of fiscal policy to implement the necessary policies to respect these targets. As regards the time horizon, MTBFs generally cover three or four years, including the budget year. This can be considered

a good compromise between the need to stay within foreseeable time horizons for the macroeconomic aggregates and the objective of providing fiscal authorities with a proper medium-term planning tool.

Flexible versus fixed frameworks; rolling versus periodical frameworks

A distinction should be made between ‘flexible’ and ‘fixed’ MTBFs. Flexible frameworks allow for revisions of the overall objectives from year to year to adjust for economic developments or changes in the fiscal policy agenda. In a fixed framework, a number of key budgetary objectives are set once for all and are not adjusted over time. Fixed frameworks are generally articulated around a medium-term path for government expenditure (in real or nominal terms) which cannot be revised from year to year, unless exceptional events occur (e.g. sharp economic slowdown, change of government). These frameworks have the big advantage to provide strong guarantees against temptations to revise expenditure targets in good times. By construction, they also ensure a strong connection between the MTBF and the annual budget process.

A distinction is also made between ‘rolling’ and ‘periodical’ MTBFs. A periodical framework covers a definite period of time, in the sense that a new framework is not drawn up before this period ends, unless exceptional events occur (e.g. change of government, major slippages compared to initial targets, etc.). The period covered by a periodical framework is generally aligned with the term of a legislature. In a rolling framework, on the contrary, a new year is added at the end of the period covered by the previous projections at the occasion of every annual update. It should be stressed that

Table III.2.1

Medium-term budgetary frameworks — A typology

	Fixed frameworks	Flexible frameworks
Rolling frameworks	Rolling fixed frameworks A new year is added every year, but the targets already set in the previous years for the intermediate years are not updated.	Rolling flexible frameworks A new year is added to the framework every year, and at the same time the targets for the intermediate years are revised.
Periodical frameworks	Periodical fixed frameworks The medium-term targets are set once and for all for a definite time period. There is no updating of the targets during the period.	Periodical flexible frameworks The medium-term targets are set for a definite time period (e.g. 2005–10), but the targets are revised during the period.

Source: Commission services.

rolling frameworks can incorporate fixed elements (see Table III.2.1 and the description of the Swedish MTBF in Box III.2.3). However, practice shows that most of the rolling frameworks turn out to be flexible as in the annual process of adding a new year to the framework the opportunity also to revise targets for the intermediate years is typically exploited.

Level of detail and nature of the projections

Another important feature concerns the level of detail of the medium-term budgetary projections. The provision of sufficient detail on the evolution of the composition of taxes and government spending is an element favouring the stability and credibility of the medium-term budgetary objectives. Detailed indications on the medium-term appropriations (by programmes of min-

istries) will allow line ministers and agency managers to have a clearer view of the resources available in the medium term to finance policies, and will possibly favour savings in programmes with less priority. The preparation of detailed projections should, on the expenditure side, be based at least in part on ‘bottom-up’ information from the line ministries (for central government) and from other authorities responsible for part of government spending (local and regional governments, authorities in charge of social security), which are the economic agents with the best knowledge of the underlying spending trends. The incorporation in the MTBF of efficiency targets will also improve the accurate costing of expenditure programmes.

Box III.2.1: The medium-term budgetary framework in the Netherlands

Description

The Dutch MTBF has a four-year-ahead horizon (t to t+4). The medium-term budgetary targets are set when a new government arrives in office. These targets are not enshrined in law, but are based on a coalition agreement between the parties in government. During the design of the coalition agreement, the Central Planning Bureau (CPB), an independent governmental forecasting institution, plays an important role. It is responsible for the medium-term forecasts assuming unchanged policy, which is the baseline scenario in the medium-term. During the negotiations between the government parties, the CPB also estimates the effects of the main proposals for new policy measures.

A key element of the Dutch MTBF is the expenditure ceiling. This ceiling is divided into three subceilings: the ‘core’ central government sector, the social security sector and the healthcare sector. While the two last sectors usually are the responsibilities of a single minister respectively, the responsibilities for the ‘core’ are divided between many ministers and the MTBF also contains projections of expenditure on these different policy areas. The expenditure ceiling is set in real terms. As opposed to the flexible medium-term frameworks in many other EU countries, the overall expenditure ceiling in the Netherlands is fixed, i.e. it is usually not revised as long as the coalition stays in office. The allocation between different sectors and programmes are, however, frequently revised. The automatic stabilisers are, in principle, allowed to work on the revenue side.

Monitoring and enforcement

The Ministry of Finance is responsible for reporting about compliance of the medium-term fiscal targets, and all budgetary memorandums sent to parliament are supposed to include such a report. In practice the ceiling is well respected. The success is linked to the fixed nature of the framework, which turns the attention away from the total expenditure and gives incentives for line-ministers to look for expenditure reallocations to finance new policy measures. It also reflects the fact that economic forecasts used to calculate the ceilings in the medium-term budgetary framework are based on a cautious scenario, prepared by an independent institution. The framework also contains a signal value for the government deficit: when the deficit approaches 2.5 % of GDP, measures to increase revenues or cut expenditure should be taken.

Functioning

The Dutch MTBF has regularly been assessed as one of the most developed example of such frameworks. It is based on a sound economic rationale (reliance on fixed expenditure ceilings) and benefits from the involvement of a credible independent institution. Nevertheless, like for other MTBFs which are highly dependent on expenditure ceilings, the question of circumvention through tax expenditures has been raised.

2.2.4. Conclusions

As seen above, MTBFs can be designed in several different ways. To some extent, the choice depends on the institutional characteristics of each country. A number of key characteristics appear however desirable in most of cases. Firstly, careful attention should be devoted to the preparation of the macroeconomic assumption. Secondly, MTBFs should cover a large part of the general government sector, to fully take into account the medium-term budgetary impact of policy decisions. Where several government subsectors are covered, there should be a proper coordination between various government tiers when setting the multiannual budgetary targets. This is crucial to ensure a sufficient degree of ownership of these targets by all actors taking part in the conduct of fiscal policy. Thirdly, there should be a strong connection between the MTBF and the annual budget procedure in the sense that multiannual targets set in the previous years should form the basis upon which the budget is prepared. Finally, the medium-term targets should be vested with a sufficient degree of political commitment, by the executive and the legislative branches. The reliance on 'fixed' MTBFs, articulated around a fixed path for government spending, generally ensures a strong degree of political commitment to the medium-term targets and connectedness with the annual budget procedure.

2.3. What types of medium-term budgetary frameworks in the EU?

This section provides an overview of the MTBFs currently in force in the EU countries. The first subsection concerns the properties of the national MTBFs. The second subsection is about the preparation and status of the SCPs in the Member States. While the primary aim of SCPs is to ensure a proper coordination of fiscal policies in the EU, these programmes can also be used domestically as a MTBF, as Member States are requested to present in these programmes detailed information on their medium-term macroeconomic and budgetary targets for the whole of the general government sector ⁽¹⁾. The analysis is based on original survey data collected by the European Commission by the end of 2006 ⁽²⁾.

⁽¹⁾ In five EU-25 countries, the SCP is the only public instrument placing fiscal policy in a multiannual perspective. In countries where a national MTBF exists, the SCPs projections are largely based on those formulated in the context of the national MTBF.

⁽²⁾ Note by the Commission services for the attention of the Economic and Financial Committee on stability and convergence programmes and budgetary procedures in the Member States: a questionnaire.

2.3.1. National MTBFs

Of the EU-25, 20 Member States have complemented their fiscal institutions with a national MTBF ⁽³⁾. The only exceptions are Greece, Cyprus, Luxembourg, Hungary and Portugal. The properties of these MTBFs vary significantly across countries.

Time horizon and share of public finances covered

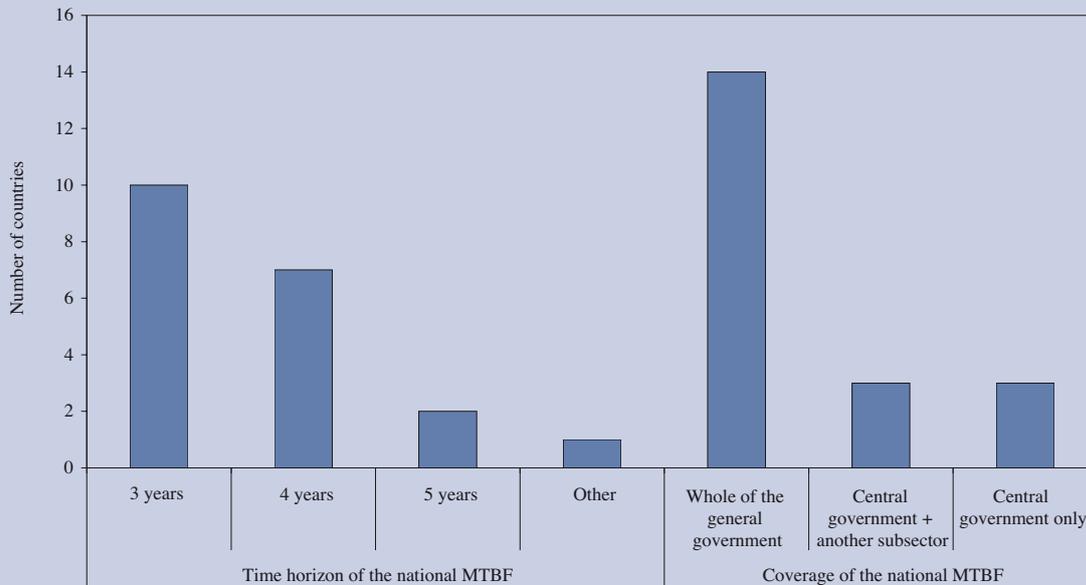
In almost all EU countries the MTBF covers a period of three to four years including the budget year. There are however exceptions. In Latvia, for instance, medium-term budgetary projections cover a period of five years, including the budget year. The diversity is larger for what concerns the part of government finances covered by national MTBFs. In 14 countries, the national MTBF covers the whole of the general government. In the Netherlands and Sweden the MTBF covers the central government and the social security sectors; in Ireland, it covers the central and local governments. In the remaining three countries, the MTBF only covers the central government. Among the 17 countries in which the MTBF covers all or several general government subsectors, in only nine cases there is a proper *ex ante* coordination exercise involving all government subsectors covered by the MTBF (see Graph III.2.2). In the remaining cases the fiscal targets seem, at least to some extent, imposed by the central government. In these countries the ownership of the medium-term budgetary targets by sub-central governments may not be sufficient to ensure a strict adherence to plans.

Rolling versus periodical and flexible versus fixed MTBFs

Most of national MTBFs are flexible rolling frameworks. This means that, every year, a new year is added at the end of the period covered by the previous projection. It also means that revisions to budgetary objectives (and notably expenditure targets) generally occur within the period covered by a multiannual plan. In only a limited number of cases, the MTBF is articulated around a fixed path for government expenditure. This is notably the case in the UK, the Netherlands, Finland and Sweden. In the first two countries the framework is fixed and periodical. In the Netherlands, for instance, new multi-year expenditure ceilings are announced for a period of four years when a new government arrives in office. The expenditure ceil-

⁽³⁾ The analysis in this part of the report focuses on the EU-25 Member States. The case of Romania and Bulgaria are not treated as these Member States have submitted their first convergence programme only by end-2006.

Graph III.2.1: Features of national medium-term budgetary frameworks



Source: Commission services.

ings are neither revised nor extended on a rolling basis but only after expiration of the period (see Box III.2.1 for a detailed description of the Dutch MTBF).

Level of detail and nature of the projections

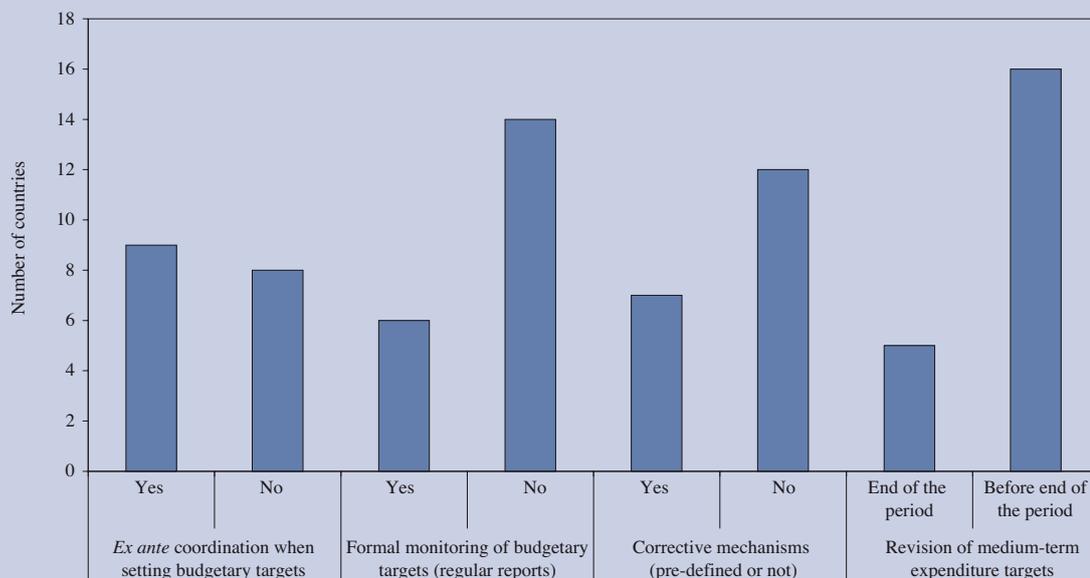
The situation varies considerably across Member States concerning the level of detail of the projections provided in the context of the national MTBF. An example of country with very detailed medium-term budgetary projections is Slovenia. In this country, the government prepares every year a fully detailed budget for the two following years. Another example is Sweden, where the MTBF revolves, to a large extent, around the expenditure ceiling and where the government makes projections for 27 expenditure areas for all the years covered by the MTBF. In the UK, the budget preceding a multiannual spending review sets an overall envelope for public spending that is divided between government departments, giving them fixed three-year budgets. In most other countries, medium-term budgetary projections cover the main government finances aggregates (i.e. budget balance and debt; government expenditure and revenues) but there is only little quantified indication on the composition of government spending and taxation in the medium term. In most cases, little information is also provided on the ways to attain the objectives.

Degree of political commitment and connectedness to the annual budget

The degree of political commitment attached to the multi-annual budgetary targets varies considerably from one country to another. In several cases, the budgetary targets are considered by policymakers as purely indicative targets, resulting from a technical exercise. Some countries set, on the contrary, constraining budgetary targets for the general government and/or its subsectors. In a few countries the fiscal targets themselves are approved by the parliament and written into law (e.g. Slovenia, Sweden). In other countries (e.g. the Netherlands, Austria) the medium-term budgetary targets are part of the coalition agreement between parties in government. In Finland the medium-term budgetary targets are set when a new government arrives in office ⁽¹⁾. In a number of countries (e.g. France, Poland) a medium-term path for the main general government finances aggregates is set in documents annexed to the budget law.

⁽¹⁾ Each year in the spending limits decision a revision is made taking into account price changes and changes in the structure of the budget. In addition the government is free to change the allocation of expenditure between administrative branches.

Graph III.2.2: Features of national medium-term budgetary frameworks



Source: Commission services.

Another key criterion to assess the importance of the MTBF in the fiscal policy setting of a country concerns the degree of connectedness between the MTBF and the annual budget. In about half of the cases, this link was assessed, on the basis of the questionnaires submitted by the Member States, as strong or relatively strong, in the sense that expenditures plans in the budget have to remain within the multiannual real expenditure ceilings set previously (e.g. the Netherlands) or that the multiannual targets form the basis on which the budget proposal is prepared (e.g. Finland). In a number of other cases the link between the MTBF and the preparation of annual budgets is either not very clear or appears relatively weak. In a number of countries budgets for the following years are in practice rarely consistent with the previously announced budgetary or expenditure targets.

Monitoring and enforcement mechanisms

In most cases, there is no predefined action in case of deviation from the targets set in the multiannual projection and the objectives are simply adjusted in the context of the following medium-term planning exercise. Only in a few countries, the compliance with the multiannual targets is formally monitored, and the government regularly publishes reports assessing compliance with the previous multiannual targets. The examples of Spain and

Slovakia are interesting. In Spain, when a risk of deviation is detected, the government sends a warning to the administration concerned and informs the relevant authorities. If the deviation is confirmed, a three-year plan to restore the budgetary situation has to be prepared. In Slovakia, the Ministry of Finance publishes regular reports on fiscal developments and assesses whether the medium-term budgetary targets will be achieved or not. If a risk of slippage is identified in the report, measures should be proposed to correct the situation.

2.3.2. The role of stability and convergence programmes

In the EU context, the EU Member States prepare every year stability and convergence programmes (SCPs) in which they provide medium-term budgetary objectives for the general government sector and its subsectors ⁽¹⁾. These programmes are then assessed by the Commission and the Ecofin Council. The preparation of SCPs has been, since 2001, guided by a code of conduct on the format and content of SCPs. This document, which was updated in the context of the SGP reform in 2005, stipulates that SCPs should provide macroeconomic and

⁽¹⁾ Euro area countries prepare stability programmes and non-euro area countries prepare convergence programmes.

Box III.2.2: Empirical studies on the effectiveness of medium-term budgetary frameworks

The empirical research on the effectiveness of MTBFs covers two broad families of studies. (I) horizontal quantitative studies covering a large number of countries; these studies are generally based on the construction of numerical indexes measuring the quality of budget procedures (including the existence of a MTBF), and test the significance of such indexes in explaining budgetary developments; (II) detailed country studies assessing the procedures of one or a group of countries.

Horizontal studies

Von Hagen (1992) investigates, for a sample of 12 EU countries, whether the degree of fiscal discipline increases when budgetary procedures force policymakers to consider the medium and long-term trends and consequences of their policy. The main result of the analysis is that the influence of MTBFs is in most cases positive, but that a MTBF alone is not sufficient to overcome the problems of fiscal discipline for a country where budgeting procedures have structural weaknesses. Yläoutinen (2004) highlighted that most of the new Member States have introduced MTBFs. The medium-term fiscal targets are however generally relatively weak (not binding) and in many cases there is no clear link between the MTBF and the annual budget. He concludes that strengthening the MTBFs in these countries is a promising avenue for promoting fiscal discipline. Other relevant studies were made on a sample of South American countries, which provide evidence of the positive role of MTBFs. Notably, Filc and Scartascini (2004) find that the existence of a MTBF is significant to explain differences in budget outcomes.

A frequent argument in this body of the literature is that a medium-term orientation in the budget process is particularly suited for countries with ideologically dispersed coalitions, and in which agreement on multiannual budget plans between various government parties is conducive to fiscal discipline. These countries are generally denominated in the literature as ‘contract countries’. Some authors have argued that MTBFs may be less efficient in ‘delegation countries’, i.e. countries with one-party governments or coalition governments of closely aligned parties. The main arguments for the introduction of MTBFs are, however, valid for both categories of countries and most authors are viewing MTBFs as a useful tool for all countries.

Case studies

Based on the experience with MTBFs in Germany, the United Kingdom and Australia, the IMF (2001) draws a number of conclusions on the desirable features of MTBFs: (i) fiscal policy objectives and quantitative fiscal targets need to be articulated and defended at the highest level of government; (ii) robust revenue forecasts are critical; (iii) budget estimates are better set in nominal terms; (iv) the framework should be based on clearly defined and fully costed policy proposals; (v) the MTBFs should be accompanied by strengthened measures to review individual expenditure policies. It is notably emphasised that MTBFs will only be effective if there is a real stable, transparent fiscal control.

In a study on Finland, Blöndal, Kristensen and Ruffner (2002) stress the importance of developing a better rolling multi-year expenditure framework to support the targets set in the coalition agreements between government parties. They consider the link between the medium-term targets and the annual budget process too weak. The Finnish budget system was revised in 2004, introducing a firmer framework with annual expenditure limits. In a recent study, Kraan and Wehner (2005) analyse the Slovenian budgetary framework, which is a unique system of annual formulation of detailed budgets for two consecutive years. They conclude that such a framework provides an interesting compromise between the needs to give medium-term visibility to the budget process and to maintain flexibility in the face of macroeconomic circumstances. Blöndal and Kristiansen (2002) evaluate the periodical MTBF set in coalition agreements in the Netherlands. They find that the system is an excellent instrument for control of public finances and an example for other countries to follow. Kraan (2005) finds that one particular advantage with the Dutch framework is that the framework is fixed. Boije and Fischer (2007) assess positively the Swedish MTBF noting among other things that the expenditure ceilings have been met in all years since their introduction. They suggest that one reason to its success is the critical surveillance of several national institutions and the relatively extensive media coverage.

budgetary projections for the current year and at least the three following years ⁽¹⁾. It leaves the possibility for Member States to cover a longer period if they so wish. Projections have to be provided for all the main budgetary aggregates. Moreover, the code of conduct specifies that SCPs should be based on realistic and cautious macroeconomic forecasts and describe the budgetary and other economic policy measures being taken or proposed to achieve the medium-term budgetary targets. In many respects, SCPs can therefore be considered a type of MTBF. In countries where a national MTBF exists, the SCP is typically largely based on the budgetary plans formulated in the context of the national framework. The SCPs are rolling frameworks in the sense that they are adding a new year in every update. In most of the cases they are also flexible frameworks, except in countries relying domestically on a fixed MTBF. According to the results of the survey, the preparation and status of the SCPs vary considerably from one country to another ⁽²⁾.

⁽¹⁾ See opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes, endorsed by the Ecofin Council on 10 July 2001; and specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes, endorsed by the Ecofin Council in September 2005.

⁽²⁾ Complementary information on the relation between SCPs and the annual budget process can be found in Section II.1.2.

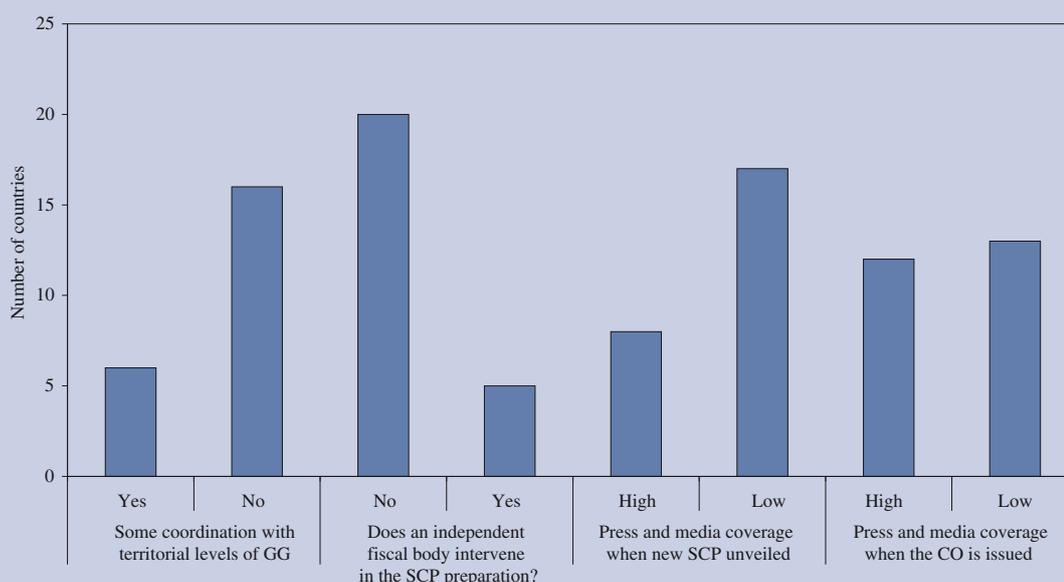
Coordination across levels of government

SCPs have to present budgetary projections for the whole of the general government sector. However, according to available information, these programmes are typically prepared with only little, in several cases without, coordination between the various levels of government (see Section II.1.2). In some cases, the targets set for local governments are based on the expected adherence to existing numerical budget balance or debt rules, but then it is not clear how projections for developments in expenditure are made (e.g. France). In a number of cases the budgetary targets for the social security and territorial levels of governments are based on agreements reached in the context of a national MTBF.

Involvement of national parliaments in the preparation of SCPs

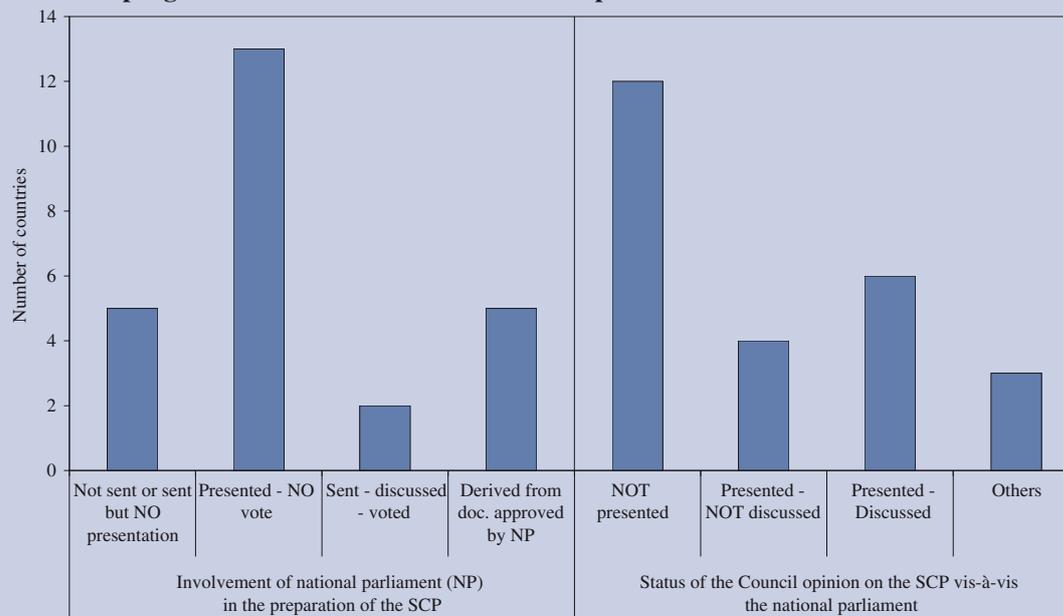
In the context of the 2005 SGP reform, the Council formulated concrete proposals to strengthen the national ownership of the medium-term budgetary targets set in the SCPs and the degree of political commitment to reach them. The Council notably encouraged newly elected governments to present a 'stability or convergence programme for the legislature', providing information on the means and instruments they intend to employ to reach the medium-

Graph III.2.3: Preparation of the stability and convergence programmes



Source: Commission services.

Graph III.2.4: Involvement of national parliament in the preparation of the stability and convergence programmes and status of the Council opinion



Source: Commission services.

term targets. It also invited governments to strengthen the status of their SCP by presenting it, as well as the Council opinion thereon, to their national parliaments. According to the survey in only two countries the SCP is the object of a vote in the national parliament (see Graph III.2.4). In five other cases, the SCP is derived from a document which was previously adopted by the national parliament (generally in the context of the national MTBF). In about half of the cases, the SCP is presented to the national parliament, but there is no vote on it. In five cases, the programme is not even presented to the national parliament.

The survey also provides interesting information on the follow-up in the Member States to the adoption of the Council opinion on the SCP. It appears that in about half of cases, the Council opinion is formally discussed by the government of the country concerned. This opinion is systematically presented and discussed in the national parliament in only six countries. These results suggest that, in a significant number of EU countries, the opinion of the Council on the SCP does not lead to a formal discussion in the domestic context. This of course does not mean that the Council opinions do not have influence on the conduct of national fiscal policies. An interesting element in this respect is that, according to answers to the

questionnaires, the release of the Council opinion seems to draw more attention from the media and public opinion than the release of the SCP itself.

2.4. Conclusions

The preparation of the annual budget is typically the budgetary step in which crucial fiscal policy decisions are taken. At the same time, most fiscal policy decisions have economic and budgetary implications which go well beyond the year in which they are taken. A majority of EU countries have therefore decided to supplement their budgetary institutions with MTBFs. Such instruments contribute to improved transparency in the conduct of fiscal policy and provide fiscal authorities with a better planning tool supporting effective expenditure management and the implementation of structural reforms. In the context of a MTBF the fiscal authorities set their medium-term budgetary targets and a path towards these targets. Budgetary projections are based on a multiannual macroeconomic scenario which determines the amount of resources available in the medium term to finance policies. The preparation of these assumptions therefore deserves particular attention.

Box III.2.3: The medium-term budgetary framework in Sweden

Description

The Swedish MTBF has a three-year-ahead horizon (t to t+3). In both the spring fiscal policy bill and the budget bill the budgetary information is presented in a three-year perspective. The budgetary framework revolves, to a large extent, around the expenditure ceiling, which covers the central government and the pension system. Interest payments are excluded. The ceiling sets a restriction for nominal expenditure in budget accounted terms (cash-based). A new third additional year (t+3) is added each year in the context of the preparation of the budget, and is approved by parliament. For example, the ceiling for 2010 is proposed to parliament in the budget bill for 2008. In principle, the parliament can also make changes to the previously approved expenditure ceilings of year t+1 and t+2, but this is rarely the case. The Swedish MTBF can therefore be characterised as a fixed framework.

In a formal sense, parliament only approves the detailed budget for the upcoming fiscal year and the overall expenditure ceiling for year t+3. However, parliament is also asked to vote on a preliminary allocation of expenditure to 27 expenditure areas. In this way, the government seeks to anchor its medium-term fiscal policy at an early stage. The budget also contains the estimated levels of appropriations for the second and third additional years, which makes it possible to compare the government's projected fiscal development to the expenditure ceiling. This level of detail is, however, only presented as information. There is also a government agency, the National Financial Management Authority, that makes in-year and medium-term forecasts, which are publicly disclosed. These forecasts also help the public assess the performance of the government in relation to the expenditure ceiling.

Monitoring and enforcement

There are no *ex ante* specified sanctions if the ceiling is exceeded. But so far the expenditure ceiling has been observed for every year since its introduction in 1997. The success in this case is probably connected with the strong 'top-down'-approach, which makes the ceiling binding also throughout the execution of the budget with a great amount of freedom for the line minister to make reallocations within their policy area. Also the parliamentary approval process follows the 'top-down' approach starting with the approval of ceilings and subceilings, followed by the approval of appropriations within the ceiling. There is also an informal budget margin built in the system against forecasting errors as the total sum of the indicative subceilings normally is less than the overall expenditure ceiling. This can be considered a relevant prudence factor. As from 2000 the MTBF has contained a surplus target for the general government sector requiring that average net lending should average 2.0 % of GDP over the business cycle.

Functioning

According to several authors, the first 10 years with the framework can be defined as a success story. Some criticisms were however recently put forward, notably concerning the link between the surplus target and the expenditure ceilings. Some authors have also raised the question of circumvention of the ceiling through tax expenditures and creative accounting.

Beyond these common basic features, the nature and design of MTBFs may vary significantly, reflecting notably country-specific preferences. A number of characteristics appear however desirable. Firstly, MTBFs should preferably cover the whole of the general government sector, to fully take into account the medium-term budgetary impact of policy decisions. Secondly, there should be a proper coordination between various government tiers when setting the multiannual budgetary targets. This is crucial to ensure a sufficient degree of ownership of these targets by all actors taking part in the conduct of fiscal policy. Thirdly, there should be a strong connection between the MTBF and the annual budget procedure. The multiannual targets set in the previous

years should form the basis upon which the budget is prepared. Finally, the medium-term targets should be vested with a sufficient degree of political commitment, by the executive and the legislative branches. The reliance on 'fixed' MTBFs, which are articulated around a fixed path for government spending, generally ensures a strong degree of political commitment to respect the medium-term targets and strong connectedness with the annual budget procedure.

Of the EU-25, 20 Member States have a national MTBF. Most of these frameworks cover the whole of the general government sector or several subsectors of general government. However, there is a proper *ex ante* coordination

exercise involving various government tiers in only about one third of cases. Most national MTBFs are flexible frameworks, in the sense that revisions to the budgetary objectives generally occur within the period covered by a multiannual plan. The situation also varies substantially across Member States concerning the link between the MTBF and the annual budgetary procedure. In about half of cases, this link can be assessed as relatively strong. In other cases the medium-term budgetary projections seem to be largely indicative and hardly taken into account in the preparation of the annual budget laws.

In the context of the preventive arm of the SGP all Member States are requested to present annually SCPs in which they provide medium-term macroeconomic and budgetary forecasts for the whole of the general government sector. While the main aim of such programmes is to ensure a proper coordination of fiscal policies in the EU, they can also be used domestically as a MTBF. Even if such programmes have to present budgetary projec-

tions for all general government subsectors, it appears that the degree of coordination with other levels of government in the preparation of SCPs is generally relatively low. Moreover, budgetary targets in the SCPs are on average vested by a relatively low degree of political commitment. In only a few EU countries the SCP is the object of a vote or derived from a document which was previously adopted by the national parliament.

Overall, the analysis in this part of the report on the existence and properties of MTBFs currently in force in the EU countries points to a relatively large gap between what would be desirable according to theory and the actual practice. Considerable progress can be made by most of the EU Member States to establish MTBFs or to strengthen the existing ones. A number of good examples can however be identified in the EU. According to the information provided by Member States in the 2006/07 updates of SCPs, there seems to be ongoing progress in a number of countries towards the introduction of national MTBFs, or reforms of existing ones.

3. Experience with stability and convergence programmes under the preventive arm of the Stability and Growth Pact

3.1. Introduction

This section analyses the medium-term budgetary plans formulated by Member States and compares them with outcomes. The analysis exploits an updated and extended version of a database summarising the medium-term budgetary plans laid down in the SCPs ⁽¹⁾. Every year before December, the EU Member States prepare such programmes in which they provide medium-term economic and budgetary projections. The EU-15 Member States submitted their original SCP in 1998. The ‘new’ EU-10 Member States submitted their first SCP in June 2004. These programmes have since then been updated annually, so that a total of nine vintages of SCPs have so far been submitted by the EU-15 Member States (four for the EU-10 countries).

The content of SCPs has become more and more standardised over time with the adoption by the Council of a code of conduct on the content and format of SCPs in July 2001. This document was revised and enriched in the context of the 2005 reform of the SGP. The objectives have also evolved over time. The original Stability and Growth Pact stated that Member States should target in their SCP the attainment of a budgetary position close to balance or in surplus. The 2005 SGP reform changed this requirement and the revised SGP requests Member States to target the attainment of country-specific medium-term budgetary objectives (MTOs) ⁽²⁾. The

2005 SGP reform has also introduced a number of simple principles guiding the adjustment towards the MTO ⁽³⁾. The EU Member States have provided a considerable amount of information in their SCPs. In practice, these programmes contain medium-term projections for the general government balance and debt, but also on the expected developments in government expenditure, interest payments and revenue. Information is also provided on the macroeconomic assumptions underpinning the budgetary projections and on the policy measures being envisaged to achieve the objectives of the programme. SCPs have a medium-term perspective and programmes submitted before December of year t contain projections for the years $t+1$, $t+2$ and $t+3$ ⁽⁴⁾.

This section first reviews the medium-term fiscal consolidation strategies followed by the Member States in their SCP in terms of the size and composition of the planned fiscal adjustments. In a second step, it assesses to what extent Member States achieved their multiannual budgetary targets and the reasons for possible deviations.

3.2. Stylised facts about a typical stability/convergence programme

3.2.1. Member States have on average planned significant improvement in public finances

Table III.3.1 summarises the plans formulated by Member States in the SCPs submitted over the period

⁽¹⁾ A description of this database, which was first built-up and used by Moulin and Wierds (2005), is provided in Box III.3.1.

⁽²⁾ MTOs are defined taking into account the current debt ratio and potential growth prospects. Considerations on implicit liabilities, i.e. the budgetary impact of ageing population, will be taken into account as soon as modalities for doing so are appropriately established and agreed by the Council (see Section II.1.6).

⁽³⁾ Notably, the countries of the euro area or participating in ERM II which have not yet reached their MTO have to pursue an annual adjustment of their structural balance by 0.5 % as a benchmark. Larger efforts have to be made in good times.

⁽⁴⁾ A number of programmes cover a longer time horizon (up to $t+5$ in some cases). However, for comparability reasons, it was decided to base the analysis on the years t to $t+3$.

1998–2006. It shows that, over the three-year horizon of their SCP, the EU-15 countries have on average planned a cumulated improvement in the government balance by 0.7 percentage point of GDP. Interestingly, the projected improvement in the first year covered by the SCP (0.1 % of GDP on average) has on average been lower than in the following two years (0.3 % of GDP). Such a result is surprising. It could on the contrary have been expected that countries which have not yet reached a sound fiscal position plan significant efforts in the early years covered by the SCP to reach

such a position and plan to stabilise the government balance thereafter.

The tendency to project larger adjustments in the outer years of the periods covered by SCPs has regularly been highlighted by the Commission in its assessments. A possible interpretation is that some EU countries have sought to avoid the implementation of difficult measures by delaying the consolidation efforts to the end of the period covered by their SCP. The announced budgetary targets for these years are indeed vested by a much

Table III.3.1

Medium-term budgetary plans formulated by Member States in their stability and convergence programmes over the period 1998–2006

% of GDP	Initial gen. gov. balance (1)	Initial debt ratio (2)	Planned change in the balance ratio	Planned change in the exp. ratio	Planned change in the prim. exp. ratio	Planned change in the revenue ratio	Planned change in the debt ratio
EU-15 Member States — Simple averages							
t – t+1	– 0.6	65.8	0.1	– 0.4	– 0.2	– 0.3	– 1.6
t – t+2 (cumulated)			0.4	– 1.0	– 0.7	– 0.6	– 3.3
t – t+3 (cumulated)			0.7	– 1.6	– 1.1	– 0.9	– 5.2
Before SGP reform — EU-15 Member States — Simple averages							
t – t+1	– 0.5	66.4	0.1	– 0.5	– 0.2	– 0.3	– 1.6
t – t+2 (cumulated)			0.3	– 1.1	– 0.7	– 0.7	– 3.4
t – t+3 (cumulated)			0.6	– 1.6	– 1.2	– 1.0	– 5.2
After SGP reform — EU-15 Member States — Simple averages							
t – t+1	– 1.0	63.7	0.2	– 0.3	– 0.3	– 0.2	– 1.4
t – t+2 (cumulated)			0.4	– 0.8	– 0.6	– 0.4	– 3.0
t – t+3 (cumulated)			0.8	– 1.2	– 1.0	– 0.5	– 4.9
EU-10 Member States — Simple averages							
t – t+1	– 2.8	38.7	0.4	– 0.4	– 0.4	0.1	– 0.6
t – t+2 (cumulated)			0.9	– 1.5	– 1.4	– 0.5	– 1.4
t – t+3 (cumulated)			1.5	– 2.6	– 2.5	– 1.1	– 2.5
EU-15 Member States with a large initial deficit (above 2% of GDP) — Simple averages							
t – t+1	0.0	71.6	0.6	– 0.4	– 0.3	0.1	– 0.3
t – t+2 (cumulated)			1.1	– 1.1	– 1.0	0.0	– 1.4
t – t+3 (cumulated)			1.7	– 1.8	– 1.6	– 0.1	– 2.8

NB: (1) and (2) show the budget balance and the debt ratios in year t, which is the year of submission of the programme.

Source: Commission services.

weaker degree of political commitment, potentially for two reasons. Firstly, the outer years of the programme may fall after the term of the current legislature. Secondly, the status of budgetary projections for the outer years of SCPs is by nature different from those for the year following its submission, which is generally the year covered by the budget and for which budgetary objectives and measures to achieve them were approved, or are about to be approved, by the national parliament.

Unsurprisingly, there is a strong link between the level of the initial government balance and the magnitude of the planned fiscal adjustment. Countries with a relatively large government deficit (larger than 2 % of GDP) in the year of submission of the SCP have on average planned an annual improvement more than twice as high as the average. The fiscal adjustments planned by these countries were also spread more evenly across the time horizon of the SCP: the planned improvement in the deficit in the first year of the programme was broadly the same as that planned in the following two years. A possible reason for these differences with the average pattern is that a significant proportion of these SCPs was submitted by countries subject to an excessive deficit procedure and therefore to obligations to bring their government deficit below 3 % of GDP within specified time limits. Graph III.3.1 points to a linear relation between the average starting point for the general government balance (as

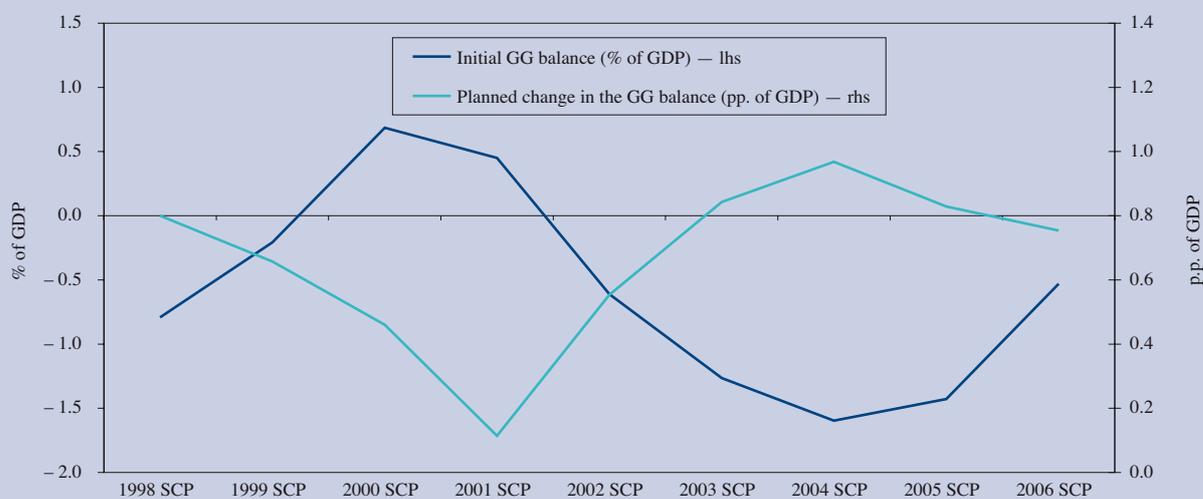
a percentage of GDP) and the planned change in this variable over the following three years. On average, a worse starting position for the general government balance by one percentage point of GDP implied a larger planned adjustment cumulated over a three-year period by about ½ % of GDP (see Table III.3.2 for detailed data).

Data in Table III.3.1 also show that the EU-10 Member States have on average planned large fiscal adjustments in their SCPs. These countries have planned a cumulated improvement of their government balance by 1½ percentage points of GDP over three years, as against about ¾ percentage point for the EU-15 countries. To a large extent this reflects the fact that the initial fiscal position was significantly worse in these countries (by about two percentage points of GDP on average).

3.2.2. Composition of the planned adjustment

As already pointed out by the European Commission (2005a) and Moulin and Wierts (2006), the EU countries have typically planned expenditure-based fiscal adjustments. Member States have on average projected a decline in the expenditure-to-GDP ratio by about ½ percentage point per year (1½ percentage points over a three-year horizon). About half of the savings expected from such a decline were planned to be allocated to an improvement in the government balance; the other half

Graph III.3.1: Initial fiscal position and planned consolidation over a three-year horizon (simple average of EU-15 Member States)



Source: Commission services.

to finance a reduction in the government revenue-to-GDP ratio ⁽¹⁾. Interestingly, Member States with high initial deficits (more than 2 % of GDP) have on average planned reductions in the expenditure-to-GDP ratio of a similar size compared to those with small initial deficits. However, these Member States planned to allocate virtually all the budgetary margins created on the expenditure side to the improvement in the government balance. About one third of the envisaged fall in the ratio of government expenditure to GDP was expected to stem from a decline in the debt interest burden. Such a reduction was supposed to be triggered by (i) a planned reduction in the debt interest rate (reflecting past and, in some cases, projected declines in interest rates) and (ii) a planned decline in the debt ratio, by a total of five percentage points of GDP on average over a three-year period.

Graph III.3.2 complements the information in Table III.3.1 by providing a synthetic representation of the composition of the planned change in the government balance ratio in the SCPs considered in the analysis. It shows that almost 90 % of SCPs have planned a

decline in the government expenditure-to-GDP ratio over a three-year period. About 80 % of SCPs have planned a decline in both the expenditure and the revenue ratio. As already pointed out by Moulin and Wierds (2005), in only 15 % of cases the fiscal adjustment planned in the programme was also based on an increase in the revenue ratio.

An interesting result is that the planned decline in the ratio of government expenditure to GDP was significantly larger in the programmes submitted in the early years of the period considered (1998–99) than in the latest years (2005–06), despite the comparatively better starting fiscal position in the early years (see Table III.3.2). The more favourable medium-term growth assumptions in the SCPs submitted in the early years of the period considered explain only part of the difference between the two periods (denominator effect), suggesting that expenditure targets have become less ambitious over time. A possible explanation is that the expenditure-to-GDP ratio has declined significantly in a number of countries over the period considered: countries may then have felt a less pressing need for expenditure restraint in the recent period. Another possible reason is that recurrent difficulties in attaining ambitious expenditure targets (see Section 3.3.4 below) have led Member States to project more realistic and attainable expenditure targets.

⁽¹⁾ The information available in the database does not allow drawing a firm conclusion on whether the projected decline in the ratio of government revenue to GDP in the SCPs reflected expected unfavourable tax-to-GDP elasticities developments or planned tax cuts. However, given the relatively long time period considered and the evidence in the programmes, the second assumption is to be privileged.

Table III.3.2

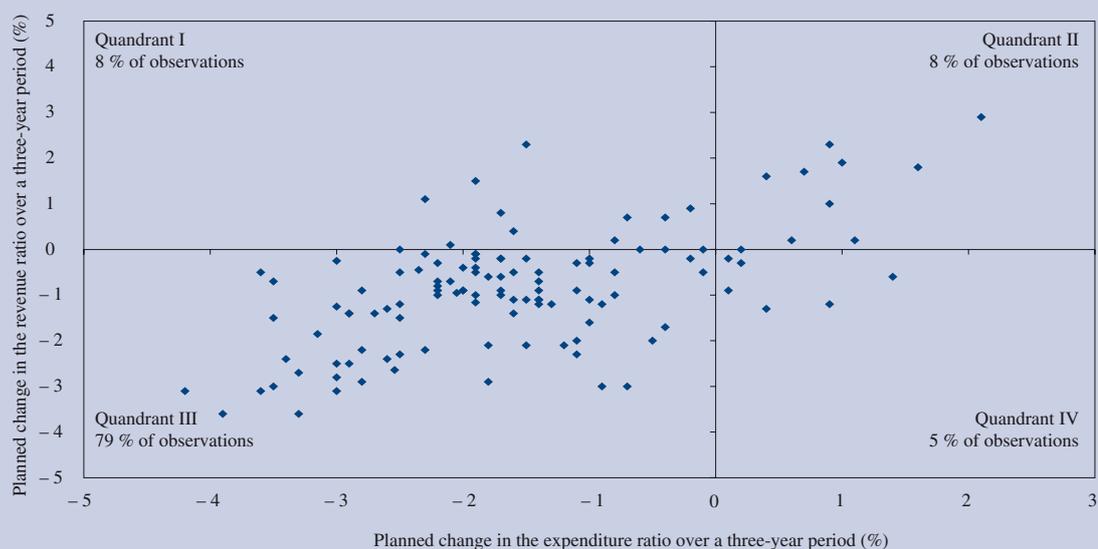
Medium-term budgetary plans formulated by Member States in the successive stability and convergence programme updates over the period 1998–2006 (change over three years, simple averages)

% of GDP	Initial gen. gov. balance (1)	Initial GG expenditure ratio (2)	Initial GG revenue ratio (3)	Planned change in the gen. gov. balance (over three years)	Planned change in the GG exp. ratio (over three years)	Planned change in the GG rev. ratio (over three years)	Planned increase in real GDP (over three years), % change
EU-15 Member States — Simple averages							
1998 SCP	- 0.8	49.1	48.2	0.8	- 2.1	- 1.2	8.9
1999 SCP	- 0.2	48.4	48.3	0.7	- 2.0	- 1.3	9.3
2000 SCP	0.7	47.0	47.7	0.5	- 1.9	- 1.4	9.9
2001 SCP	0.5	46.9	47.3	0.1	- 1.1	- 1.0	8.2
2002 SCP	- 0.6	47.4	46.8	0.6	- 1.4	- 0.8	8.1
2003 SCP	- 1.3	47.8	46.5	0.8	- 1.6	- 0.7	8.0
2004 SCP	- 1.6	47.9	46.3	1.0	- 1.5	- 0.5	8.3
2005 SCP	- 1.4	47.3	45.9	0.8	- 1.3	- 0.5	7.8
2006 SCP	- 0.5	46.4	45.9	0.8	- 1.2	- 0.4	8.0

NB: (1), (2) and (3) show the ratios as a % of GDP in the year of submission of the programme.

Source: Commission services.

Graph III.3.2: Composition of the consolidation planned in the programme (EU-15 Member States)



Source: Commission services.

3.2.3. Macroeconomic assumptions

The EU-15 Member States have on average planned an annual increase in real GDP by 2¾ % over the period covered by the SCPs (unweighted average) ⁽¹⁾. This is slightly higher than the average rate observed in the last two decades for the same sample of countries ⁽²⁾. The

planned rate of real GDP growth has on average been the same for the first, second and third year of the period covered by the programme. EU-10 Member States have on average planned an increase in GDP by 4.8 % per year in real terms and 8 % in nominal terms. This is clearly above the average observed in the period preceding the submission of the first programme by these Member States.

⁽¹⁾ In the case of SCPs containing several macroeconomic scenarios only the cautious scenario was considered.

⁽²⁾ The simple average of real GDP growth rates of the EU-15 countries over the period 1980–2000 is 2.5 %.

Interestingly, there were over time significant fluctuations in the medium-term real GDP growth forecasts (see

Table III.3.3

Medium-term macroeconomic projections in the stability and convergence programmes

	Planned increase in nominal GDP (%)	Planned increase in real GDP (%)	Planned increase in the GDP deflator (%)
EU-15 Member States — Simple averages			
t – t+1	4.9	2.7	2.1
t – t+2 (cumul.)	10.1	5.6	4.2
t – t+3 (cumul.)	15.4	8.5	6.3
EU-10 Member States — Simple averages			
t – t+1	8.1	4.8	3.1
t – t+2 (cumul.)	16.3	9.8	5.9
t – t+3 (cumul.)	25.2	15.3	8.5

Source: Commission services.

Table III.3.3). A close look at the data suggests that contemporaneous macroeconomic developments have had a significant influence on the medium-term macroeconomic forecasts included in the SCPs. Graph III.3.3 exhibits a link between real GDP growth in the year of submission of a SCP and the average annual real GDP growth rate projected in the three following years covered by the SCP. The macroeconomic assumptions underlying the SCPs submitted in the midst of the high-growth period at the turn of the decade were particularly high. Real GDP growth was projected to average 3¼ % over the period 2001–03 in the EU-15 Member States (simple average).

The fact that SCPs elaboration in high-growth periods were based on more optimistic macroeconomic assumptions suggests that forecasters and policymakers tend to extrapolate contemporaneous developments to the medium term. The indicators commonly used in the analysis of cyclical developments may also have played a role, as real-time estimates of potential growth, which generally constitute one of the elements used in the preparation of medium-term macroeconomic forecasts, are to some extent influenced by ongoing macroeconomic developments. It should be noted that the tendency to revise growth forecasts upwards in favourable growth periods seems to have come to an end in the recent period and notably since the 2005 SGP reform. The positive macroeconomic developments in 2006 has not led

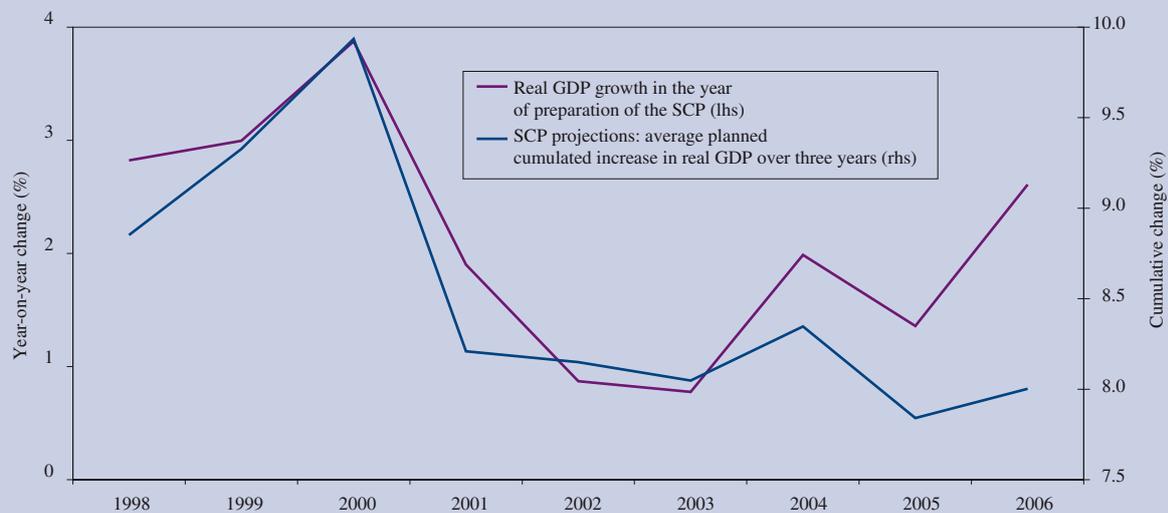
to upward revisions in medium-term growth forecasts for the period 2007–09.

3.3. Comparing plans to outcomes

This section compares the multiannual budgetary plans submitted by Member States in their SCPs to outcomes. A number of papers have provided analysis on the capacity of Member States to respect their medium-term budgetary targets. Strauch et al. (2004) evaluated the performance of budget and growth forecasts in the convergence reports and SCPs over the period 1991–2002. Their analysis notably concluded that national forecasts of budget balances and economic growth are marked by a cautionary bias in some countries, while in others they seem to be affected by an optimistic bias. These authors also found that governments do not seem to use available information efficiently to minimise the forecast error of their budgetary projections, as forecasts of budget balances and economic growth produced by the Commission services generally show better results than those included in the multiannual programmes submitted by Member States ⁽¹⁾.

⁽¹⁾ These authors argue that political and institutional variables can explain these patterns. Notably, they find that the forms of fiscal governance are important determinants of biases in budgetary and GDP growth forecasts. Those governments where budgetary targets are based on pre-negotiated contracts seem to have a cautionary bias.

Graph III.3.3: Contemporaneous growth conditions and macroeconomic forecasts (simple average of EU-15 countries)



Source: Commission services.

Box III.3.1: The database comparing multiannual budgetary plans and outcomes

The analysis of the medium-term budgetary plans of Member States is based on an updated and extended version of a database summarising the macroeconomic and fiscal projections included in the SCPs submitted by Member States from 1998 to 2006. This database contains data on the macroeconomic assumptions underlying budgetary projections (real GDP, nominal GDP, GDP deflator) and on the projected developments in the main aggregates of government finances (budget balance, government expenditure, interest payments, government revenue and debt). The database contains information on these aggregates (projected and observed) expressed as a percentage of GDP, but also in level.

The database covers all EU Member States, except Bulgaria and Romania. As the EU-15 Member States submitted their initial SCP in 1998, a total of nine vintages of SCPs are included in the database. The new EU-10 Member States submitted their first SCPs in July 2004. Due to their different submission date (July vs November) and to the need to base comparisons on a homogeneous basis, these programmes were not included in the database. The three updates of these SCPs, submitted in November 2004, 2005 and 2006 were included in the database. The database therefore consists of a total of 165 SCPs (15 countries times 9 SCPs, plus 10 countries times 3 SCPs). Each SCP has three observations ($t - t+1$; $t - t+2$; $t - t+3$), so that the database has a total of 495 observations.

A number of SCPs do not contain all the information. Notably, SCPs for EL (1998), BE (2000), NL (1999, 2000, 2001) and LU (1998) did not provide information on projected developments in government expenditure and revenue. In some cases (e.g. FR 1998, FR 1999, FR 2000) linear extrapolations were made as data were only provided for the initial and end-year covered by the SCP. In a number of other cases, there were no data on primary expenditure and interest payments.

Moulin and Wierts (2006) showed that problems to achieve the projected improvements in the general government balance reflect primarily difficulties to adhere to expenditure plans (in nominal or real terms). The analysis in this section updates and complements the previous findings by these authors. The analysis of the reasons for the deviation from budgetary targets is extended, notably by not only looking at average developments but also at the distribution of SCPs depending on the reasons for the difficulties to reach multiannual budgetary targets. The analysis is extended to the EU-10 Member States⁽¹⁾. The analysis of the respective influence of developments in government revenue and expenditure, as a share to GDP but also in level (in nominal and real terms), is also deepened. The aim of the analysis in this section is to identify broad trends in the reasons for the difficulties to respect the budgetary targets, rather than to provide a detailed country-by-country analysis. Box III.3.2 provides indications on the relative positions of the various Member States.

3.3.1. Planned improvements in the general government balance were not achieved

The previous section has shown that Member States have on average planned significant improvements in

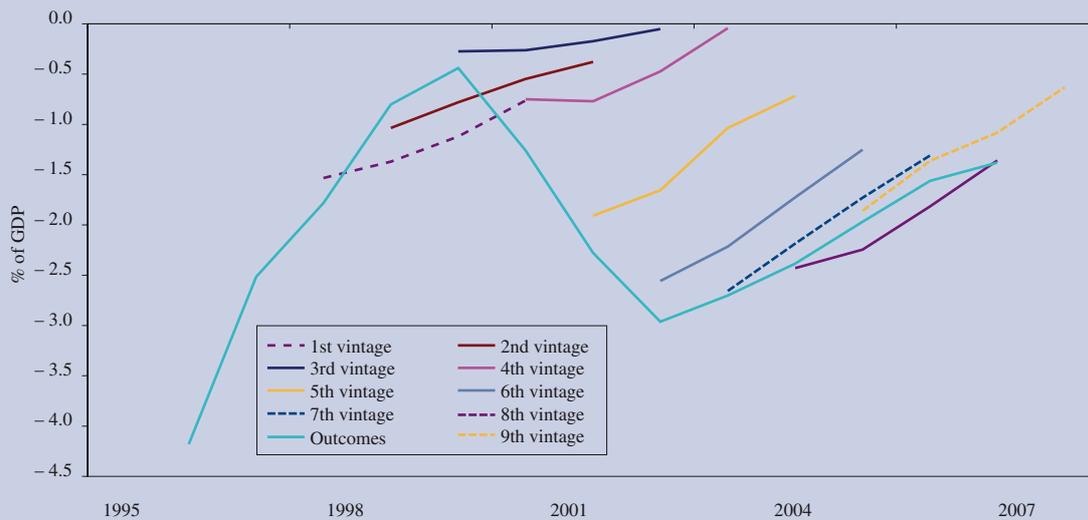
their government balance over the three-year horizon of their SCP. Graph III.3.4 shows that there were on average sizeable deviations from the planned adjustment paths. It also indicates a better performance in the recent years, which correspond to those following the 2005 reform of the Stability and Growth Pact and to a context of improving macroeconomic conditions.

Graph III.3.5 provides complementary information. It plots the planned changes in the government balance ratio on the horizontal axis and the observed changes on the vertical axis, for the EU-15 Member States and for various time horizons ($t-t+1$; cumulated over $t-t+2$; cumulated over $t-t+3$). The focus on changes in government finances aggregates is justified by the need to neutralise possible base effects resulting from statistical revisions in the initial years⁽²⁾. The main message is that in about two thirds of cases the improvement in the general government balance was less pronounced than planned (or there was a worsening). Interestingly, the frequency of negative surprises increases when lengthening the time horizon considered. When considering the gap between plans and outcomes for the first year covered by the SCPs, i.e. the year

⁽¹⁾ The analysis for these countries is less detailed than for the EU-15 Member States, for data availability reasons.

⁽²⁾ The influence of base effects cannot however be fully neutralised. In some Member States, better-than-expected or worse-than-expected budgetary outcomes in the year of submission of the SCP may indeed have had an influence on the fiscal policy decisions in the following years and implied deviations from plans.

Graph III.3.4: Budget balance ratio — Successive plans in the stability and convergence programmes and outcomes (% of GDP) — Simple average of EU-15 countries



Source: Commission services.

generally covered by the budget law, the performance is almost balanced: changes in the government balance were disappointing in only 55 % of cases. Cumulated changes in the government balance over three years were worse-than-planned in more than 70 % of cases.

The same message emerges when looking at the average difference between the projected and observed change in the government balance-to-GDP ratio (simple averages of the EU-15 Member States). Table III.3.4 shows that the gap between the planned and observed improvement in the general government balance tends to increase when lengthening the time horizon considered. Such a result, which is surprising as negative and positive risks (e.g. growth and tax elasticity surprises) should offset each other over time provided that GDP growth evolves around a stable trend, calls for further investigation on the reasons for the negative surprises in budgetary developments.

Data for the EU-10 Member States show a different pattern. There were on average fewer surprises in government finances developments in these countries compared to the projections of the SCPs. The conclusions for the EU-10 countries should however be taken with care as the analysis for these countries relies on a much smaller sample. It is

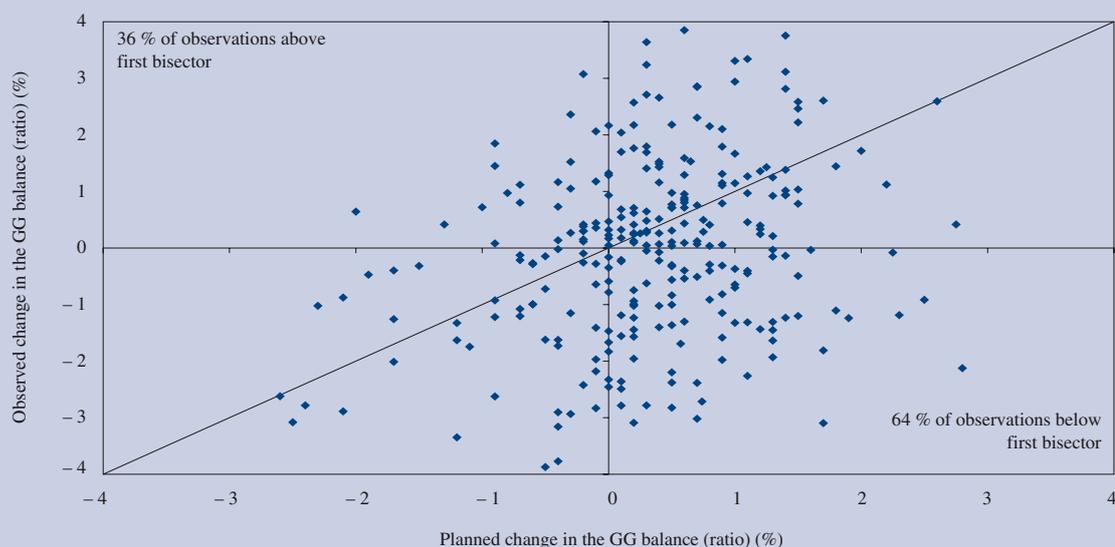
based on the comparison of plans submitted in the 2004 and 2005 SCPs with budgetary outcomes in 2005 and 2006.

3.3.2. Developments in GDP growth

A possible explanation for the worse-than-planned developments in the government balance is that macro-economic developments turned out to be less favourable than expected. Graph III.3.6 compares the cumulated increase in real GDP over various time horizons ($t-t+1$; $t-t+2$; $t-t+3$) projected in the SCPs to the observed increases over the corresponding period. It appears that the frequency of positive surprises in real GDP developments is roughly equivalent to the frequency of negative surprises. This could suggest that real GDP growth has, on average, been in line with projections. However, a closer look at the data shows that the size of negative surprises has on average been twice as high as the size of positive surprises, implying that there were on average substantial negative surprises in real GDP growth developments compared to plans (see Table III.3.5).

An interesting exercise is to assess what may have been the consequences of negative growth surprises on budgetary developments. A proxy can be estimated by applying the standard budgetary sensitivity to the cycle to the

Graph III.3.5: Plans versus outcomes — General government balance (ratio) — EU-15 Member States



Source: Commission services.

Table III.3.4

Planned and observed changes in the government balance ratio

% of GDP	Surprise in the change in the budget balance (1)	Contributions of developments in		
		Primary expenditure ratio	Interest payments ratio	Government revenue ratio
EU-15 Member States — Simple averages				
t-t+1	-0.1	-0.4	0.1	0.2
t-t+2 (cumul.)	-0.5	-1.1	0.2	0.5
t-t+3 (cumul.)	-1.1	-1.8	0.2	0.6
E-10 Member States — Simple averages				
t-t+1	-0.4	-0.7	0.0	0.2
t-t+2 (cumul.)	-0.2	-1.3	0.1	1.1

NB: (1) Difference between the planned and observed change in the budget balance (% GDP) for different time horizons.

Source: Commission services.

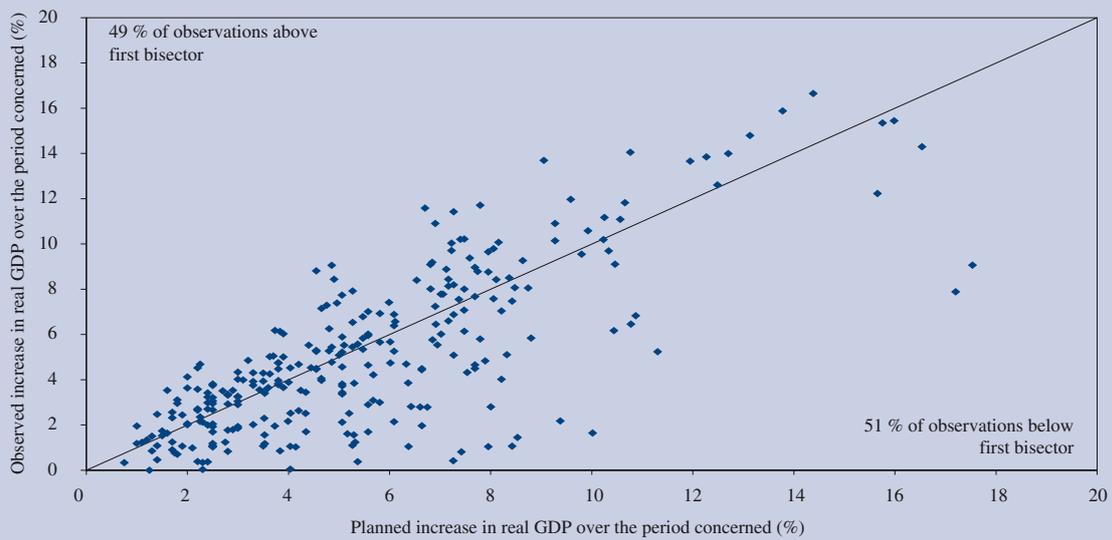
surprise in real GDP growth. The calculation shows that a significant part (from one third to half) of the difference between the planned change in the government balance and the observed change can be attributed to negative GDP growth surprises.

The assessment of real GDP growth developments compared to plans does however not tell the full story, and the picture is significantly different when considering developments in nominal GDP. As shown in Graph III.3.7 and

Table III.3.5, nominal GDP growth developments were in fact on average very much in line with plans (frequency and size of negative and positive surprises are similar).

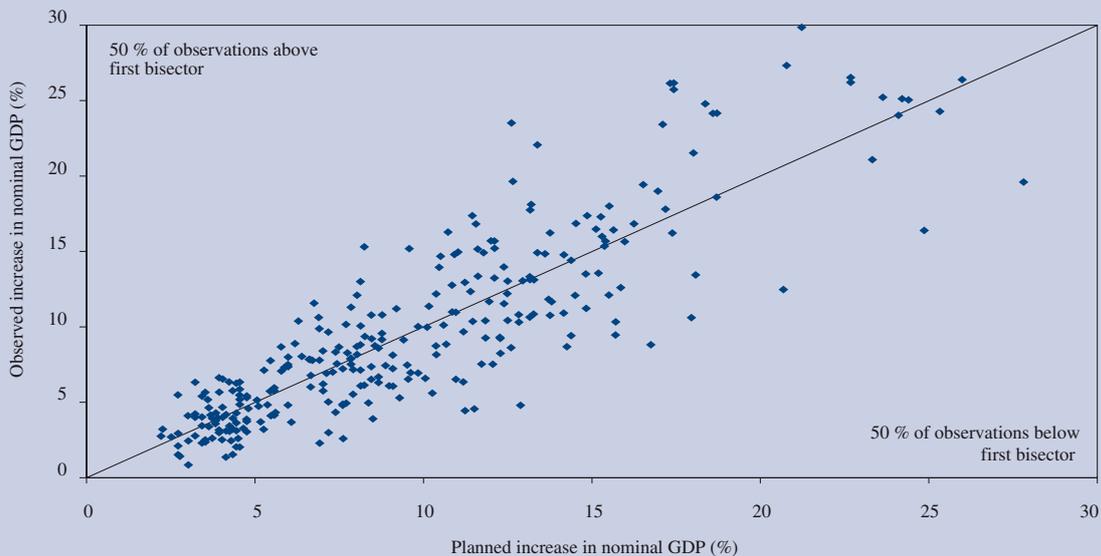
The analysis for the EU-10 countries shows a significantly different picture than for the EU-15 Member States. On average there were, over the short period of time considered, large positive GDP growth surprises compared to the macroeconomic assumptions included in the SCPs (in both real and nominal terms).

Graph III.3.6: Plans versus outcomes — Real GDP growth — EU-15 Member States



Source: Commission services.

Graph III.3.7: Plans versus outcomes — Nominal GDP growth — EU-15 Member States



Source: Commission services.

3.3.3. Developments in government revenue

The previous section has shown that nominal GDP has increased roughly in line with plans in the EU-15 Member States. Graph III.3.8 compares the cumulated

increase in government revenue over various time horizons ($t-t+1$; $t-t+2$; $t-t+3$) to the observed increases over the corresponding period. It appears that developments in government revenue were more favourable than expected in more than half of cases. This is confirmed by

Table III.3.5

Planned and observed changes in GDP growth

	Surprise in the variation of the budget balance (1) (%)	Surprise in nominal GDP growth (2) (%)	Surprise in real GDP growth (3) (%)
EU-15 Member States — Simple averages			
t-t+1	- 0.1	0.3	0.1
t-t+2 (cumul.)	- 0.5	0.2	- 0.4
t-t+3 (cumul.)	- 1.1	0.1	- 1.1
EU-10 Member States — Simple averages			
t-t+1	- 0.4	2.0	1.4
t-t+2 (cumul.)	- 0.2	1.3	1.3

NB: (1) Difference between the planned and observed change in the government balance ratio (% GDP).

(2) Difference between the planned and observed change in nominal GDP.

(3) Difference between the planned and observed change in real GDP.

Source: Commission services.

the data in Table III.3.6 which show that, over the three-year horizon of a SCP, nominal government revenue increased significantly faster than expected in the SCP.

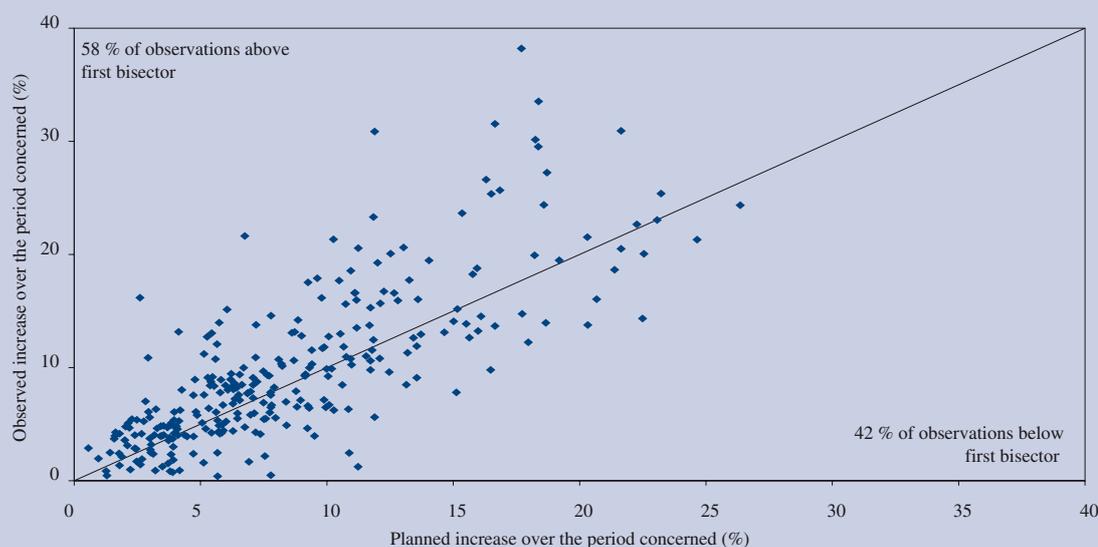
The fact that government revenue increased faster than expected, while nominal GDP increased in line with plans, calls for an explanation. A first possibility is that there were recurrent positive surprises on the developments in the 'spontaneous' (i.e. before the impact of policy measures) tax elasticities. Given the period consid-

ered (eight years), systematic positive tax elasticity surprises appear however unlikely. An alternative explanation is that part of the tax reductions initially planned in the SCPs were not implemented or at least partly offset by other measures affecting revenue developments.

3.3.4. Developments in government expenditure

The analysis of compliance with expenditure plans is crucial for several reasons: (i) as seen in Section III.3.2

Graph III.3.8: Plans versus outcomes — Nominal revenue — EU-15 Member States



Source: Commission services.

the EU countries have typically planned expenditure-based fiscal adjustments; (ii) government expenditure is the part of government finances that is the most directly under the control of the government; (iii) the previous section showed that there were on average positive surprises on the revenue side, implying that the main source for the difficulties in respecting medium-term budgetary targets are to be found on the expenditure side.

Graph III.3.9 compares the planned cumulated increase in nominal government expenditure over various time horizons (t-t+1; t-t+2; t-t+3) for the EU-15 Member States to the observed increases over the corresponding period. It appears that the increase in nominal government expenditure growth was larger than planned in 75 % of cases. This percentage falls to less than 70 % when considering the discrepancy between the planned and observed increase in government expenditure plans for the year t+1, i.e. the year covered by the budget law, and exceeds 80 % when considering the gap between the planned and observed cumulated increase in government expenditure over a three-year horizon.

Table III.3.7 shows that the larger-than-planned increase in government expenditure is largely responsible for the difficulties to achieve budget balance targets. It also shows that the negative gap between the observed and planned increases in government expenditure has had a tendency to widen with the time horizon considered. On average (simple average of EU-15 Member States), the negative surprise in the increase in nominal government expenditure reached 0.4 % of GDP after one year, 1.1 %

of GDP after two years and a cumulated 1.9 % over the three-year horizon of a SCP. Such developments show that the fiscal authorities have, on average, not compensated expenditure overruns in a given year by restraint in the following years of the period considered.

The analysis of the reasons for the negative surprises on the expenditure side should take into account that nominal government expenditure can also be affected by macroeconomic developments. In particular, inflation developments and fluctuations in interest rates may have an influence on government expenditure (depending on indexation rules, the level of interest rates and the size of government debt). A way to address this issue is to focus the analysis on developments in government expenditure net of interest payments and corrected for inflation developments. Graph III.3.10 compares developments in real primary expenditure to initial plans. It shows that the frequency of observations showing a larger-than-planned increase in expenditure is even higher when considering this variable. This is because developments in interest expenditure have contributed to limit the increase in government expenditure compared to plans, due to the unexpected fall in interest rates over the period.

Another element possibly explaining the larger-than-planned increase in government expenditure is the direct effect of negative growth surprises on government expenditure, e.g. through higher unemployment benefits and other social transfers. This effect is neglected here due to the very low level of the sensitivity of government expenditure to cyclical developments (less than 0.1 on

Table III.3.6

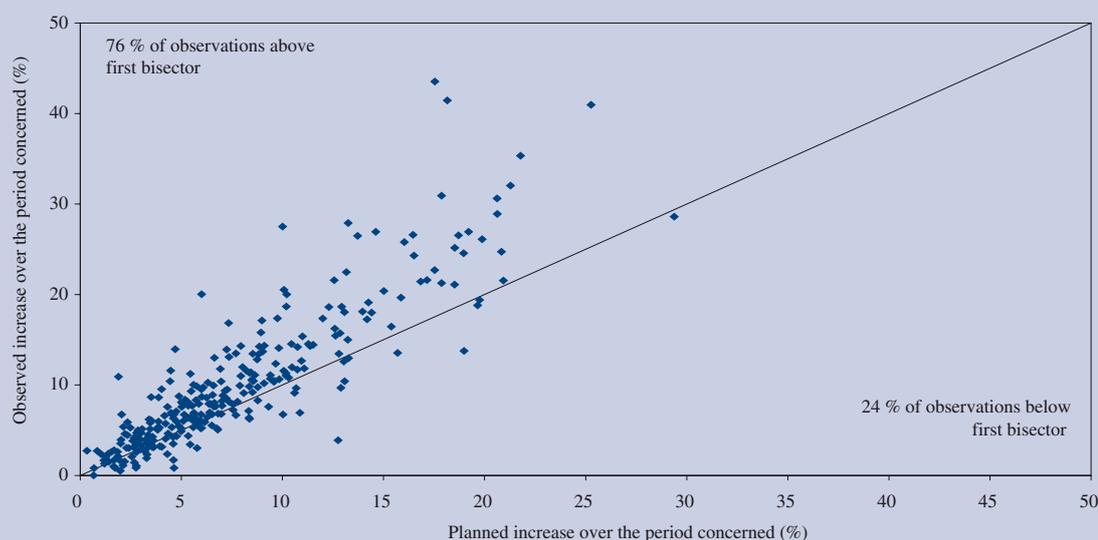
Planned and observed changes in the government revenue ratio

	Surprise in the revenue ratio (1) (%)	Numerator effect (2) (%)	Denominator effect (3) (%)
EU-15 Member States — Simple averages			
t-t+1	0.2	0.3	- 0.1
t-t+2 (cumul.)	0.5	0.6	- 0.1
t-t+3 (cumul.)	0.6	0.7	0.0
EU-10 Member States — Simple averages			
t-t+1	0.2	1.0	- 0.7
t-t+2 (cumul.)	1.1	1.6	- 0.5

NB: (1) Difference between the planned and observed change in the revenue ratio (% GDP).
(2) Contribution of the larger-than-planned increase in nominal government revenues.
(3) Contribution of developments in nominal GDP compared with plans.

Source: Commission services.

Graph III.3.9: Plans versus outcomes — Nominal expenditure — EU-15 Member States



Source: Commission services.

Table III.3.7

Planned and observed changes in the government expenditure ratio

	Surprise in the GG balance ratio (1) (%)	Surprise in the expenditure ratio (2) (%)	Numerator effect (3) (%)	Denominator effect (4) (%)
EU-15 Member States — Simple averages				
t-t+1	- 0.1	- 0.3	- 0.4	0.1
t-t+2 (cumul.)	- 0.5	- 0.9	- 1.1	0.1
t-t+3 (cumul.)	- 1.1	- 1.7	- 1.9	0.0
EU-10 Member States — Simple averages				
t-t+1	- 0.4	- 0.7	- 1.5	0.7
t-t+2 (cumul.)	- 0.2	- 1.2	- 1.8	0.5

NB: (1) Difference between the planned and observed change in the government balance ratio (% GDP).

(2) Difference between the planned and observed change in the expenditure ratio (% GDP).

(3) Contribution of the larger-than-planned increase in the nominal expenditure to the surprise in the expenditure ratio.

(4) Contribution of developments in nominal GDP to the surprise in the expenditure ratio.

Source: Commission services.

average in the EU). However, it is not excluded that for some Member States having faced large negative growth surprises, this may have explained a non-negligible part of the expenditure overrun compared to plans ⁽¹⁾.

Another interesting exercise is to assess whether expenditure overruns in a given year reflect successive upward revisions in expenditure plans or whether they reflect a default in the implementation of plans which were consistent over time. Given that SCPs are rolling and flexible medium-term frameworks, growth in government expenditure in a given year t is typically projected three times: in the SCPs submitted in November of year t-3, t-2 and t-1.

⁽¹⁾ See Moulin and Wierds (2006).

Box III.3.2: Situation in groups of Member States

As indicated in the introduction, this chapter does not aim at identifying country-specific patterns. A number of interesting messages can however be drawn when looking at developments in the various countries. A first relevant message emerging from the data is that there was a large heterogeneity of performance across Member States, in the sense that some of them were consistently successful in sticking to budgetary targets, notably expenditure targets, while others were almost always unsuccessful. The analysis in the previous paragraphs has shown that two variables have played a crucial role in explaining deviations from budgetary plans: (i) negative surprises in real GDP growth; and (ii) expenditure overruns. The table below shows the distribution of the EU countries depending on whether the size of surprises in real GDP growth and government expenditure developments compared to plans of the SCPs were larger or lower than the median. On this basis, four groups of countries can be identified.

- A first group is made up of countries which experienced negative growth surprises, in some cases of a significant size (e.g. Germany), and showed at the same time a relatively high degree of adherence to government expenditure targets. This allowed them to limit the negative budgetary consequences of unfavourable economic developments for government finances. This group consists of Belgium, Denmark, Germany and Austria. Within this group, the behaviour of Belgium is very close to the average, while Denmark, Germany and Austria have shown a remarkably high degree of compliance with expenditure plans compared to the average.
- The second group consists of countries which combined negative growth surprises and larger-than-average spending overruns. This group is made of France, Italy and Portugal. In the three cases the size of spending overruns was relatively close to those observed on average in the EU-15 countries, but negative real GDP growth surprises were significantly larger in the case of Portugal. This country experienced a significant deterioration in its budgetary position over the period considered.
- A third group consists of countries which experienced positive real GDP growth surprises and managed to keep expenditure in line with plans. This group is made of Finland and Sweden. The size of positive growth surprises was relatively larger in the case of Sweden compared to Finland. The two countries in this group experienced over the period considered a large improvement in their government finances. In both countries, the general government balance improved from a deficit of about 1 % of GDP in 1997 to a large surplus (more than 3 % of GDP) in 2006.
- Finally, a fourth group is made up of countries which experienced at the same time larger-than-planned increases in real growth and larger-than-average expenditure overruns. Ireland, Greece, Spain and the United Kingdom are in this group. The magnitudes of growth and expenditure surprises differ considerably from one country to another. Positive real GDP growth surprises were particularly large in Ireland and Spain. The larger expenditure overruns were also observed in these two countries. A key issue is of course to what extent real GDP growth surprises reflect temporary or permanent factors, which could justify an upward revision in expenditure targets.

Situation of the EU-15 Member States compared with the median

	Small or positive surprises in nominal expenditure growth	Large negative surprises in nominal expenditure growth
Negative surprises in real GDP growth	BE, DK, DE, AT	FR, IT, PT
Small or positive surprises in real GDP growth	FI, SE	IE, EL, ES, UK

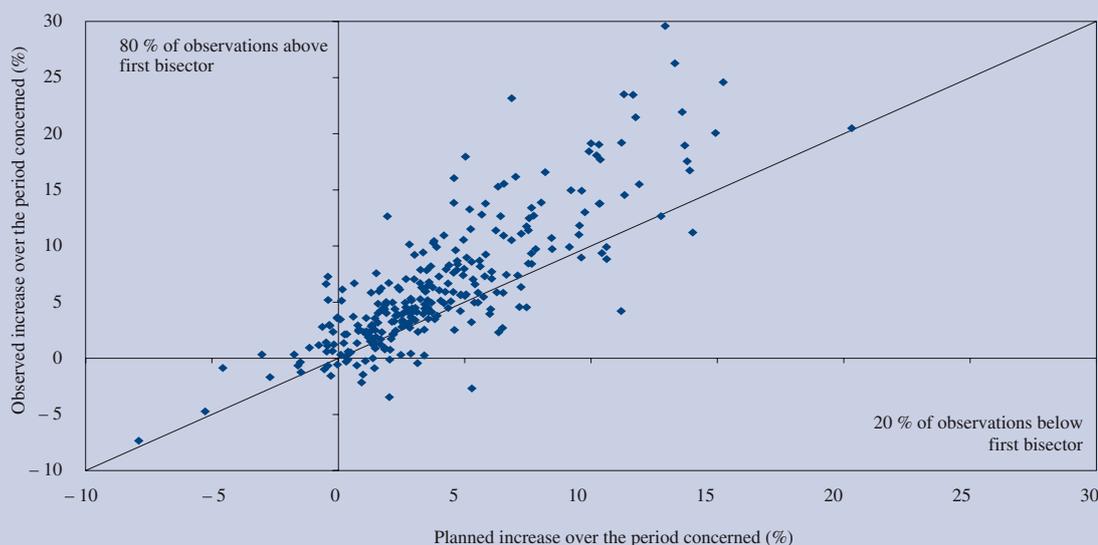
Note: The Netherlands and Luxembourg were not inserted in the table due to a lack of data for these two countries.

Source: Commission services.

Table III.3.8 analyses how growth in nominal and real government expenditure in a given year has on average been revised in the successive SCP updates. It shows that, on average over the period considered, about half of the discrepancy between the first forecast for the increase in government expenditure in year *t* (made in year *t*-3) and the observed increase reflects revisions in

plans (from the SCP submitted in year *t*-3 to the SCP submitted in year *t*-1); the other half reflects expenditure overruns compared to budget plans. This points to a relatively high degree of inconsistency of expenditure targets over time and, at the same time, to significant defaults in the implementation of plans formulated in the context of annual budgets.

Graph III.3.10: Plans versus outcomes — Real primary expenditure — EU-15 Member States



Source: Commission services.

Table III.3.8

Consistency of general government expenditure plans over time (EU-15 Member States), 2000–06

Observed and planned growth rates	Nominal GG expenditure (%)	Real GG expenditure (%)
Observed increase in year t	5.4	2.8
Planned increase in the SCP submitted in t-1	4.2	1.9
Planned increase in the SCP submitted in t-2	3.7	1.7
Planned increase in the SCP submitted in t-3	3.1	1.5

Source: Commission services.

3.4. Conclusions

This section reviews the medium-term budgetary plans formulated by Member States in their stability and convergence programmes (SCPs) and compares them with outcomes. The analysis shows that the EU-15 Member States have on average planned significant improvements of their government balance in their SCPs. Countries have typically planned expenditure-based fiscal adjustments. The expenditure-to-GDP ratio has on average been projected to decline by about 1½ percentage

points over the three-year horizon typically covered by a SCP. In about 80 % of cases, SCPs have planned, over a three-year period, a decline in both the expenditure and the revenue ratios. When comparing plans and outcomes, it appears that there were on average sizeable deviations from the planned adjustment paths. In about two thirds of cases the improvement in the general government balance was less marked than planned. Moreover, the negative gap between the planned and observed improvements in government finances is smaller when considering the first year of the SCP, i.e. the year generally covered by the budget law, than when considering the gap for a cumulated period of two or three years following the submission of the SCP.

While government revenue evolved broadly in line with plans, there were considerable difficulties in the implementation of medium-term expenditure plans. This can be considered the main cause for the underperformance in attaining budget balance targets. The increase in nominal government expenditure over the three-year period covered by SCPs was higher than planned in more than three quarters of cases. The frequency of spending overruns is similar when comparing developments in real primary expenditure to plans in the SCPs. The data show that expenditure overruns in a given year were in general not compensated in the other years of the multiannual

period considered. It should however be stressed that there was a considerable heterogeneity of performance across Member States. Some of them were almost consistently successful in sticking to expenditure targets, while others were almost always unsuccessful.

The EU-15 Member States have on average planned annual increases in real GDP by 2³/₄ % over the period covered by their SCPs. This is above the average of the last two decades. Interestingly, contemporaneous macroeconomic developments seem to have had a significant influence on the medium-term macroeconomic forecasts included in the SCPs. The ambitious macroeconomic assumptions of the SCPs submitted in the midst of the high-growth period at the turn of the decade turned out to be clearly optimistic. This inclination

to revise medium-term growth forecasts upwards in favourable growth periods seems however to be less pronounced since the 2005 SGP reform. The analysis confirms that part of the worse-than-planned developments in the government finances is related to negative growth surprises. While the frequencies of positive and negative surprises in real GDP developments are equivalent, the average size of negative surprises has been twice as high as that of positive surprises. Interestingly, the picture is different when considering developments in nominal GDP, for which the frequency and size of positive and negative growth surprises were very similar. This explains that developments in government revenue were on average broadly in line with multiannual plans.

4. Which factors help stick to budgetary plans?

4.1. Introduction

The previous section has shown that difficulties in the implementation of medium-term expenditure plans can be considered the main cause for the underperformance in attaining budget balance targets. It also pointed to a possible role played by negative growth surprises. In a first step, this section assesses which factors explain that some countries were able to stick to expenditure plans while this was not the case for others. It is notably analysed whether and how the initial fiscal position of a country, the degree of ambition of a SCP in terms of the planned reduction in the expenditure-to-GDP ratio, or differences in national fiscal governance arrangements have influenced the capacity of Member States to achieve their medium-term expenditure targets. The analysis is based on newly collected survey data on the existence and properties of national medium-term budgetary frameworks (MTBFs) in the Member States and on the preparation and status of SCPs. In a second step, this section discusses possible explanations for the negative surprises in real GDP growth developments compared to plans in some of the EU countries.

4.2. Which factors explain the difficulties in respecting expenditure plans?

Government expenditure is the part of government finances that is most directly under the control of the fiscal authorities. The capacity to achieve expenditure targets therefore reveals, at least in part, the ability of policy-makers to implement the chosen policies in the medium term. In this context, the chronic difficulties faced by a number of European countries to respect their own multi-annual expenditure targets are a source of concern.

This section examines which factors may have played a role in the capacity of a country to stick to its own

medium-term expenditure plans. The reference variable in this assessment is the difference between the planned and observed increase in real primary government expenditure, for different time horizons. The choice to focus the analysis on real primary expenditure, instead for instance of nominal government expenditure, was driven by the consideration that it is preferable to neutralise the influence of fluctuations in interest payments and in inflation, which are outside the control of governments (interpretation of results is easier) ⁽¹⁾. The analysis of the reasons for the negative surprises in government expenditure is by nature complex, as the magnitude of expenditure overruns can potentially depend on a number of interrelated factors.

- Firstly, there may be a relation between the size of the planned reduction in the expenditure-to-GDP ratio, and the size of spending overruns. Large cuts in the expenditure ratio may be more difficult to implement. This relation may also depend on the initial size of the government sector, in the sense that large cuts in the expenditure-to-GDP ratio may be relatively easier to implement in countries with initially large public sectors.
- Secondly, expenditure overruns can result from voluntary, discretionary action in reaction to particular macroeconomic developments, favourable or unfavourable, or simply reflect an insufficient control by the fiscal authorities on the dynamics of expenditure.
- Thirdly, the institutional characteristics of a country may play a role. A number of economists have

⁽¹⁾ The results and conclusions of this part of the report would be similar if the analysis focused on developments in total nominal government expenditure compared to plans.

argued that a rules-based, medium-term orientation in the budget is particularly suited in countries with governments typically formed by ideologically dispersed coalitions, than in countries with one-party governments or coalition governments of closely aligned parties ⁽¹⁾.

- Finally, the performance in achieving expenditure targets may depend on the quality of the institutions which constitute the environment in which medium-term budgetary plans are formulated and in which adherence to plans is monitored and enforced. Reliance on well-defined medium-term budgetary frameworks can be expected to favour a better adherence to plans.

The next section assesses the influence of these elements in a descriptive way. The following one studies the interactions between various dimensions.

4.2.1. Descriptive evidence on the influence of the various factors

Ambition of multiannual expenditure targets and size of governments

Difficulties to adhere to medium-term expenditure targets may partly reflect the fact that initial plans, in terms of the envisaged cut in the government expenditure-to-GDP ratio over the medium-term, were very ambitious. Large cuts in the expenditure ratio may genuinely be more difficult to implement. It also cannot be excluded that in a number of cases — concerning notably Member States with large government deficits the fiscal authorities made the choice to plan very large reductions in the government deficit, to be achieved through equally large cuts in the expenditure-to-GDP ratio, knowing that only a share of them could actually be implemented. Such a strategy could have been used to signal to private economic agents the strong willingness of fiscal authorities to cut government expenditure, with the aim of making fiscal consolidation less costly in terms of growth. Another possible explanation could be linked to a strategy of the finance ministers to set in advance strong negotiation basis for the preparation of budgets in the following years ⁽²⁾. Such strategies would however have

been at the price of a loss of credibility for the national medium-term budgetary projections.

Graph III.4.1 puts in relation, for various time horizons ($t-t+1$; $t-t+2$; $t-t+3$), the degree of ambition of expenditure targets — in terms of the planned change in the expenditure-to-GDP ratio over a given period and the size of the discrepancy between the planned and observed increase in government expenditure over the same period. The graph exhibits a negative but relatively weak relationship between the two variables. This conclusion holds when considering separately the various time horizons considered in the analysis ($t-t+1$; $t-t+2$; $t-t+3$). This suggests that while the initial degree of ambition may play a role in explaining the difficulties to stick to expenditure targets, a number of other elements may be relevant to determine and explain differences in the degree of adherence to expenditure plans across the EU Member States.

One of these elements is the initial size of the ratio of primary expenditure to GDP. The basic idea is that it may be relatively easier to achieve a given reduction in the expenditure-to-GDP ratio in countries with a relatively large public sector than in those with a relatively small public sector. Graph III.4.2, which shows a negative relationship between the initial level of the ratio of primary expenditure to GDP and the size of expenditure slippages, tends to confirm this view.

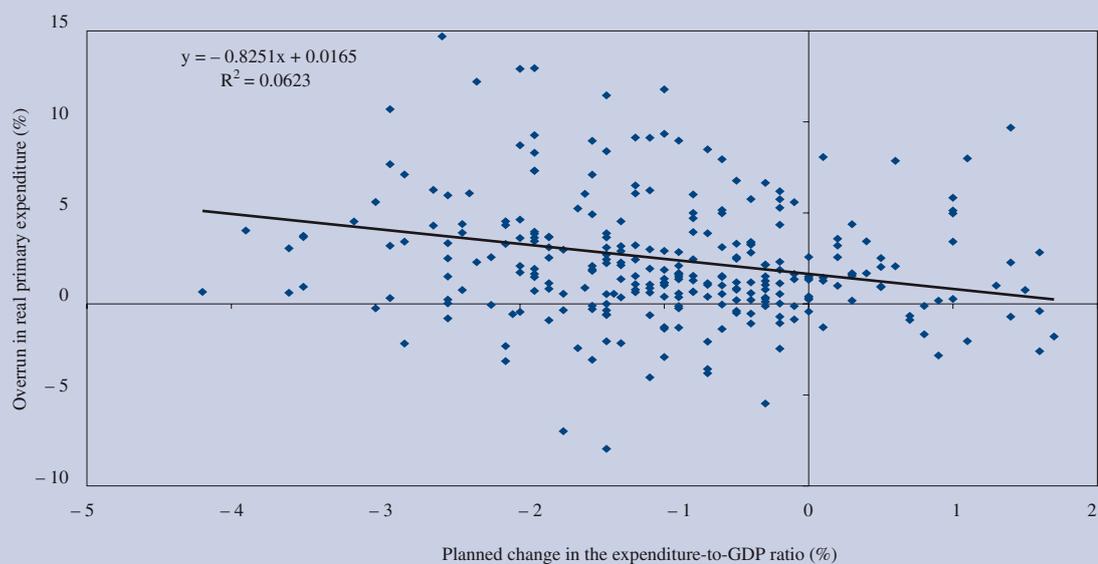
Policy action versus insufficient control of government expenditure

Expenditure overruns can result from voluntary, discretionary action in reaction to particular macroeconomic developments or simply reflect an insufficient control of fiscal authorities on the dynamics of expenditure. For instance, governments facing a severe economic downturn may deliberately decide to stabilise the economy via a discretionary increase in expenditure compared to plans. Another possibility, not exclusive with the previous one, is that governments facing positive growth and tax revenue surprises deliberately choose to use part of the revenue windfalls to finance additional government expenditure compared to plans. In both cases, the larger-than-planned increase in expenditure results from a deliberate policy choice.

⁽¹⁾ The basic idea is that the deficit bias stemming from the common pool problem may be more severe in countries with ideologically dispersed coalitions. These countries however generally rely on multiannual budgetary contracts agreed *ex ante* in the context of a coalition agreement. They are generally denominated in literature as ‘contract’ countries. For a precise definition see European Commission (2006a).

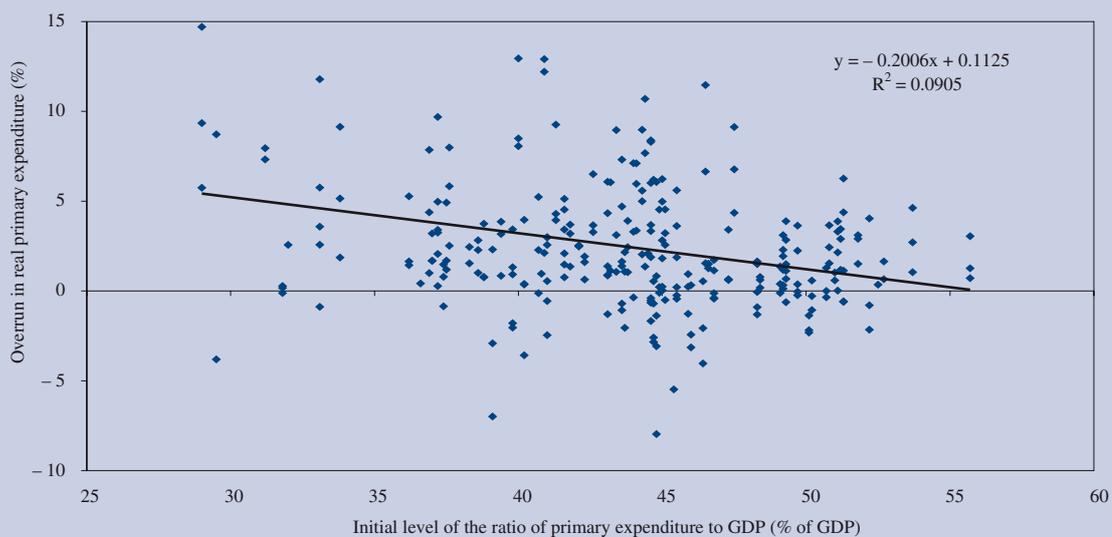
⁽²⁾ Some countries could have used such a strategy to delay the possible imposition of sanctions in the context of the excessive deficit procedure.

Graph III.4.1: Plans versus outcomes — Expenditure overruns and planned changes in the expenditure ratio — EU-15



Source: Commission services.

Graph III.4.2: Plans versus outcomes — Expenditure overruns and size of general government — EU-15



Source: Commission services.

The alternative possibility is that the larger-than-planned increase in expenditure reflected an insufficient control by fiscal authorities on the dynamics of government

spending. This would be the case, for instance, if the central government, which is *ex ante* in charge of the preparation of the SCP and therefore of setting expenditure

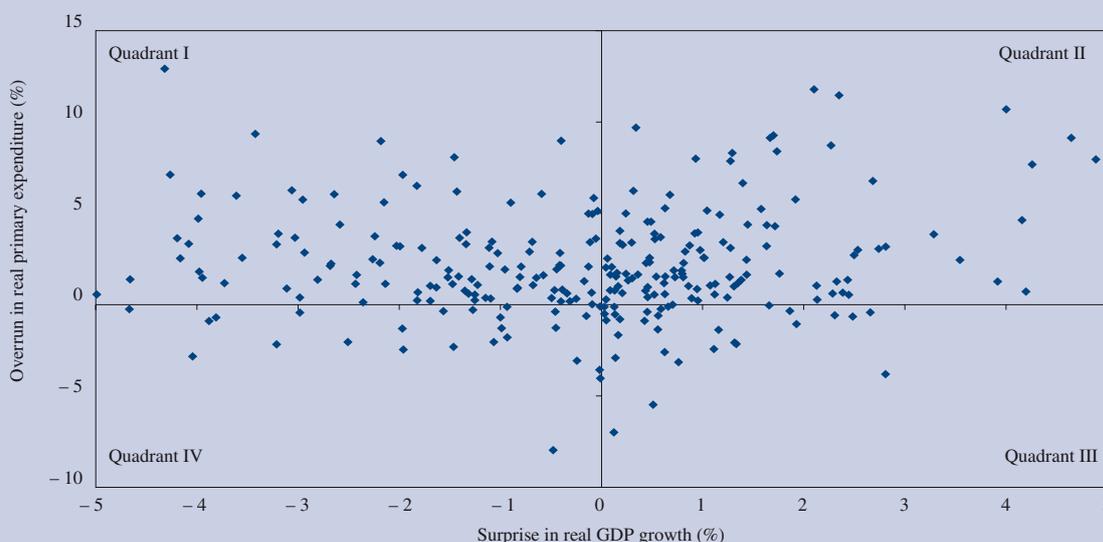
targets for the whole of the general government, does not succeed in imposing *ex post* fiscal discipline (on the expenditure side) to the other levels of government. Such a situation may occur in case of insufficient coordination prior to the setting of the multiannual expenditure targets for the whole of the general government. It may also arise in case the multiannual budgetary targets are not vested by a sufficient degree of political commitment (e.g. adoption by the national parliament).

To shed light on this question, Graph III.4.3 shows the relation between surprises in real GDP growth and surprises in real primary government expenditure. Both variables are measured as the difference between the observed and planned increase over various time horizons. A relatively larger frequency of observations in quadrant I, which corresponds to episodes of higher-than-planned increase in government expenditure in periods of negative growth surprises, would tend to support the assumption according to which expenditure plans were deliberately revised upwards to counter unfavourable macroeconomic developments. A larger frequency of observations in quadrant II (positive surprises on growth and larger-than-planned increase in government expenditure) would on the contrary support the assumption according to which the larger-than-planned

increase in government expenditure reflected the decision to finance extra expenditure via tax windfalls in periods of positive growth surprises.

The graph shows that the frequency and size of government expenditure overruns observed in periods of positive real GDP growth surprises are remarkably similar to those observed in periods of negative growth surprises. This result can be interpreted in two ways. Firstly, it can be argued that there is a significant spending bias in the EU countries, which leads to overspending both in good and bad economic times. According to this view, the fiscal authorities would deliberately choose to spend more than planned in both periods of positive and negative growth surprises. An alternative explanation of the high degree of dispersion (or randomness) in the distribution of surprises in expenditure developments is that there is, in some EU countries, a lack of control in the dynamics of government spending. According to this view, the distribution of expenditure overruns would be independent from cyclical developments as it does not result from the implementation of policy choices, but rather from the lack of the adequate instruments (expenditure rules, medium-term expenditure frameworks, internal stability pacts, etc.) to keep expenditure in line with initial plans.

Graph III.4.3: Plans versus outcomes — Expenditure overruns and real GDP growth surprises — EU-15



Source: Commission services.

Type of fiscal governance (contract versus delegation countries)

Another element possibly explaining the discrepancy between the planned and observed increase in government expenditure concerns the type of governance in place in a country. As stressed in Section III.2, a number of authors have in the past argued that a medium-term orientation in the budget process is particularly suited to countries with ideologically dispersed coalitions. The presumption is that in such countries the deficit bias stemming from the common pool problem may be more severe as various parties in coalitions will try to satisfy their own electoral base. Experience however shows that such countries have in the past introduced ‘contracts’, under the form of multiannual fiscal rules, with a view to taking into account spending claims in a centralised way. It is also argued that checks and balances may be stronger in these countries, which is conducive to fiscal discipline and better adherence to budgetary targets. The effect of the type of fiscal governance in a country on its capacity to respect expenditure objectives is therefore a priori undetermined.

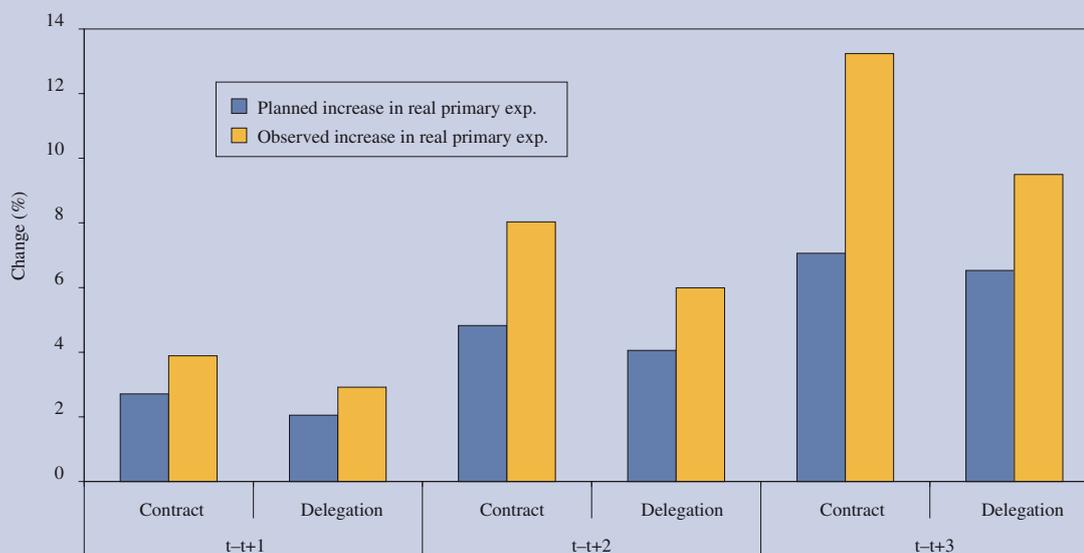
When looking at the data, it appears that the track record in the respect of plans in real government primary expenditure was on average better in so-called

‘delegation countries’ than in ‘contract countries’ (see Graph III.4.4). This conclusion applies to all the time horizons considered in the study ($t-t+1$; $t-t+2$; $t-t+3$). This result reflects the fact that a number of delegation States managed to keep expenditure remarkably in line with plans (Germany, Austria), while a number of contract countries experienced important overruns in government expenditure (Ireland, Luxembourg). It indeed confirms that sound fiscal institutions to place fiscal policy in a medium-term perspective are even more important in countries with ideologically dispersed coalitions than in countries with single or closely aligned parties in government.

Quality of medium-term budgetary frameworks

A last relevant aspect in examining the reasons for departures from medium-term expenditure targets is related to the quality of the institutions which constitute the environment in which such plans are formulated and adherence to them is monitored. The basic idea is that countries in which medium-term budgetary targets are vested with a strong degree of political commitment are less likely to show important deviations from their expenditure plans. In the EU context, two types of institutions may play a role in this respect: the national

Graph III.4.4: Planned and observed increases in real primary expenditure in groups of countries — EU-15 — Simple averages



Source: Commission services.

MTBFs and the SCPs. According to the survey presented in Section III.2, 20 of the EU-25 Member States have a national MTBF. However, there are big differences in the design of these frameworks, concerning notably the share of government finances they cover, the existence of coordination mechanisms between levels of governments when setting the medium-term budgetary targets, the link with the annual budgetary procedure, etc. Similarly, while all Member States submit SCPs, there are large differences in the preparation of the multiannual budgetary targets in these programmes.

A way commonly used in economic literature to analyse the link between the quality of institutions and budgetary developments is to put in relation country-level fiscal variables with synthetic indicators measuring the extent to which the fiscal institutions of a country correspond to the desirable features according to theory. To this end, an index was built to capture the existence and properties of national MTBFs and the preparation and status of the SCPs. This index takes into account the following dimensions (Box III.4.1 provides details on how scores were attributed in constructing the index).

- *Existence of a national MTBF:* it was considered that the existence of a national MTBF, on which the SCP is generally based, constitutes per se a positive element for the reliability of medium-term budgetary targets. The basic idea is that medium-term fiscal plans formulated domestically and supported by sound domestic institutions are likely to benefit from a higher degree of national ownership and therefore to be respected.
- *Connectedness between the multiannual budgetary framework and the annual budget:* in developed MTBFs, the multiannual targets set in the previous years typically form the basis upon which the budget is prepared. Countries relying domestically on a ‘fixed’ medium-term budgetary framework, which are typically articulated around a fixed path for government spending, can be expected to show a better respect of medium-term expenditure plans than countries relying on flexible medium-term budgetary frameworks.
- *Involvement of the national parliament when setting the medium-term budgetary objectives:* countries where the multiannual budgetary targets are formally adopted by the national parliament, and therefore vested with a stronger degree of political

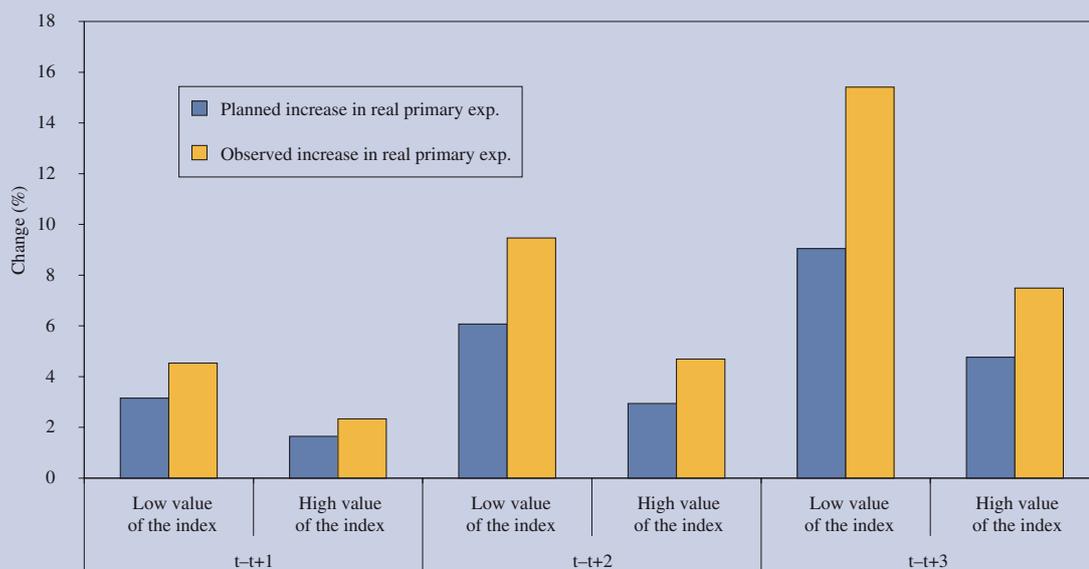
commitment, can be expected to show a better adherence to medium-term expenditure plans.

- *Coordination between levels of government:* countries where multiannual budgetary targets for the general government are set following a proper coordination between the levels of government playing a role in fiscal policy can also be expected to show a better adherence to plans. Coordination is crucial to ensure a sufficient political commitment of all actors taking part in fiscal policy to respect the medium-term budgetary targets of the country.
- *Monitoring and enforcement procedures:* countries where the achievement of medium-term targets is the object of a regular monitoring and predefined action is foreseen in case of deviation from the objectives in the multiannual projection, are expected to show a better track record in terms of adherence to their multiannual budgetary plans.

Graph III.4.5 exhibits a positive relation between the level of the synthetic index measuring the quality of institutions for medium-term budgetary planning and the capacity of the country concerned to achieve its medium-term expenditure targets. The average gap between the planned and observed increases in real primary expenditure is, for all the time horizons considered in the study ($t-t+1$; $t-t+2$; $t-t+3$), lower in countries with values of the index higher than the median. The gap between the two groups of countries seems to widen when lengthening the time horizon considered and becomes very significant when considering the three-year horizon of a SCP. More generally, countries with a high value of the index measuring the quality of institutions for medium-term budgetary planning seem to perform better with respect to all the fiscal variables considered in the study (see Graph III.4.6). The track record in terms of adherence to planned changes in the budget balance, debt, and expenditure ratios is better for all the time horizons considered in the study.

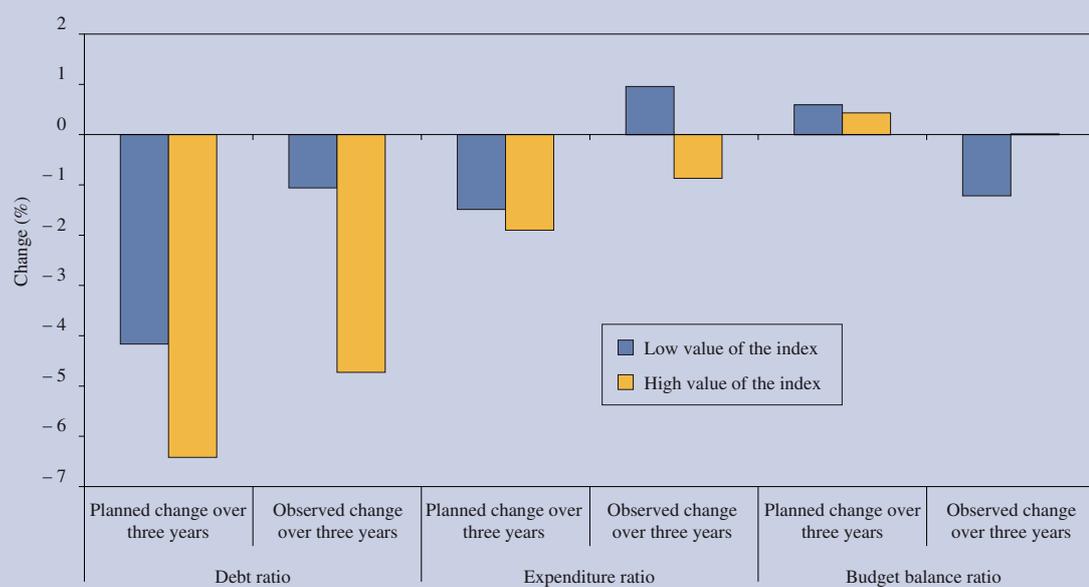
This section has shown that a number of factors may explain the differences of country performances in respecting medium-term government expenditure targets. The analysis has been based on simple, descriptive analysis. However, in a number of cases, interactions between the various factors may be relevant. For instance, countries with a high value of the index on the quality of institutions for medium-term budgetary planning had on average better starting fiscal positions, in

Graph III.4.5: Planned and observed increase in real primary expenditure in groups of countries EU-15 — Simple averages



Source: Commission services.

Graph III.4.6: Planned and observed budgetary developments in different groups of countries EU-15 — Simple averages



Source: Commission services.

terms of the size of their government deficit. They therefore have on average projected less ambitious cuts in the expenditure-to-GDP ratio, which could in turn explain the better-than-average performances in respecting

medium-term expenditure targets. Assessing the interactions between all the dimensions considered requires relying on more sophisticated empirical techniques. This is made in the following section.

Box III.4.1: Construction of an index on the quality of institutions for medium-term budgetary planning

This box provides details on the construction of the index measuring the quality of institutions for medium-term budgetary planning. The index was calculated taking into account both the existence and properties of national MTBFs and the preparation and status of SCPs. A difficulty when constructing the index was to assess how national MTBF, when they exist, interact with SCPs. In some cases, for instance, the SCP is entirely based on a pre-existing national MTBF: there is no formal approval of the budgetary targets set in the SCPs in the national parliament, but the SCP is entirely based on a document which was previously approved by the national parliament. This was taken into account when attributing scores for the various dimensions considered. Another case concerns the situation where the national MTBF regards only the central government sector. In such a situation, scores concerning the coordination between levels of government prior to setting the multiannual targets were assigned taking into account the information on the preparation of the SCP. This box provides details on the how scores were attributed and how the EU-25 countries rank with respect to this index.

Construction of the index

The synthetic index measuring the quality of institutions for medium-term budgetary planning is made of five components (justifications for taking into account these dimensions are in the main text). For each criterion, the scores were attributed as follows:

- (1) Existence of a national MTBF (on which the SCP is based):
 - 2 for a MTBF covering the whole of government sector or a large part of it (e.g. central government and social security)
 - 1 for a MTBF covering central government
 - 0 no national MTBF
- (2) Connectedness between the multiannual budgetary targets and the preparation of the annual budget (domestic MTBF or SCP):
 - 2 fixed framework (articulated around a pre-defined path for government expenditure, generally not revised over time)
 - 1 the medium-term budgetary targets form the basis upon which the budget is prepared but there can be deviations
 - 0 flexible framework in which medium-term targets are only indicative (no clear link with the annual budget)
- (3) Involvement of the national parliament in the preparation of the medium-term budgetary plans (domestic MTBF or SCP):
 - 2 vote of the parliament on the main medium-term objectives (in the context of a national MTBF or of the SCP)
 - 1 no vote but formal presentation of the objectives to the national parliament
 - 0 no formal presentation of the objectives to the national parliament
- (4) Existence of coordination mechanisms prior to setting the medium-term budgetary targets (domestic MTBF or SCP):
 - 2 in case there is a proper *ex ante* coordination mechanism between all levels of general government
 - 1 coordination mechanisms only for some general government sub-sectors
 - 0 no coordination mechanism
- (5) Monitoring and enforcement of multiannual budgetary targets:
 - 2 if there are well-defined actions in case of deviations from plans and a regular monitoring of targets (reports, etc.)
 - 1 some monitoring and enforcement procedures
 - 0 no clearly defined monitoring and enforcement procedures

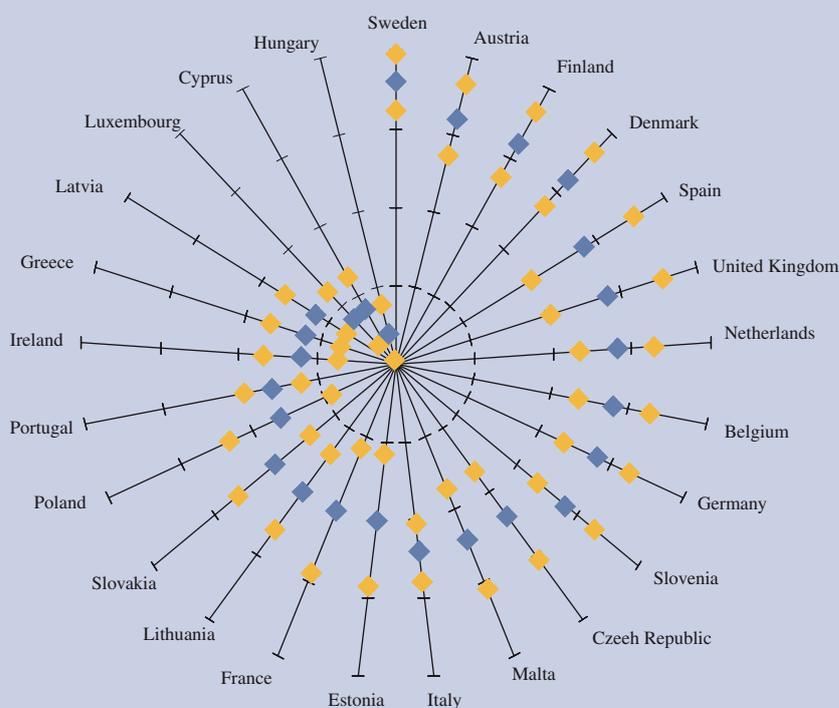
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Box III.4.1 (continued)

Scores concerning the existence and properties of national MTBFs

The graph below shows how the EU countries rank with respect to the index. The dark points show the value of the total index. In absence of strong a priori on which of the five dimensions considered above is the most important, the same weight was given to all the five components. The clear points show the limit within which 90 % of the values of the synthetic index would fall if the synthetic index was calculated with 10 000 different sets of random weights applied to the five dimensions. As expected, countries with well-developed MTBFs (Denmark, Spain, the Netherlands, Austria, Finland, Sweden, etc.) have relatively high scores.

Graph 1: Index measuring the quality of medium-term budgeting institutions



Source: Commission services.

4.2.2. Empirical analysis

The main purpose of this section is to assess whether there is a link between the adherence to medium-term expenditure targets and the institutional settings of a country, controlling for other variables. The approach followed is to analyse econometrically the impact of various variables on the capacity to achieve expenditure targets for various time horizons (one, two and three years ahead).

The dependent variable is the difference between the observed and planned increase in real primary expendi-

ture. The explanatory variables are (i) the degree of ambition of expenditure targets, measured as the planned change in the primary expenditure-to-GDP ratio; (ii) the initial size of the government, as measured by the level of the ratio of primary expenditure to GDP in the year of submission of the SCP; (iii) a dummy variable capturing the type of fiscal governance in a country and the ideological distance of parties in government coalitions (contract vs delegation); (iv) the gap between the planned and observed real GDP growth over the period considered; and (v) our synthetic index measuring the quality of insti-

tutions for medium-term budgetary planning, calculated as detailed in Box III.4.1. The econometric relations were estimated for the sample of EU-15 countries. Four regressions were run: three to assess the determinants of the gap between plans and outcomes for a given time horizon (first year, first two years or first three years covered by a SCP), and one combining all time horizons. In the latter case two dummies were inserted in the specification to capture the fact that the average deviation between the planned and observed increases in real primary expenditure has had a tendency to increase with the time horizon considered. The results of the econometric estimates (see Table III.4.1) can be summarised as follows.

- There is a statistically significant relation between the size of the planned reduction in the expenditure-to-GDP ratio and the size of the discrepancy between the planned and observed change in real primary expenditure. The relation is significant for all the time horizons considered. This suggests that Member States projecting large cuts in their expenditure-to-GDP ratio tend, *ceteris paribus*, to show a lower degree of adherence to plans ⁽¹⁾. A possible explanation is that SCPs planning ambitious cuts in government expenditure were not always backed with equally ambitious policy measures.
- The variable capturing the level of the ratio of primary expenditure to GDP at the moment of the elaboration of the medium-term budgetary plans (year of submission of the SCP) is also significant with a negative sign. This confirms the presumption according to which ambitious cuts in the expenditure-to-GDP ratio are relatively easier to implement in countries with a large initial ratio of primary expenditure to GDP.
- The variable capturing the economic growth surprises (difference between forecasts and outcomes in real GDP growth) is not statistically significant in explaining the deviations from expenditure plans. The achievement of expenditure targets does not seem to depend crucially on the sign and magnitude of surprises in real GDP growth developments ⁽²⁾. This result holds when taking into account surprises in nominal GDP growth. Given the possible reverse causation effects between surprises in government

expenditure and surprises in GDP growth developments, further empirical investigation would however be necessary to confirm this result.

- The dummy capturing the size of ideological distance between parties in government and the type of fiscal governance (contract vs delegation countries) is significant in the equations, with a negative sign. This suggests that, on average and controlling for all the other variables, delegation States tend to show a better adherence to their budgetary plans than contract countries.
- Finally, and this can be considered the main result of the analysis, the coefficient of the index measuring the quality of the medium-term budgetary planning institutions is negative and significant (at the 5 % level) for all the time horizons considered in the study ($t-t+1$; $t-t+2$; $t-t+3$). This means that, controlling for other variables, reliance on developed medium-term budgetary frameworks can significantly contribute to limit the size of the discrepancy between planned and observed increase in real primary expenditure.

4.3. Real GDP growth forecasts: the role of institutions

As seen in Section III.2, relying on unbiased or even cautious macroeconomic projections is crucial for the effectiveness of medium-term budgetary frameworks. Macroeconomic forecasts are one of the main inputs for the preparation of multiannual budgetary plans, as they determine the global amount of resources available in the medium term to finance envisaged policies. Optimistically biased forecasts may create an upward pressure on public expenditure in the medium term, which will be difficult to correct *ex post*. In this context, the fact that there were on average significant negative surprises in real GDP growth developments in the EU-15 countries is a cause for concern.

4.3.1. Possible explanations for the negative real GDP growth surprises

A key question concerns the reasons for the negative real GDP growth surprises. A first possibility is that there were genuine, unpredictable negative growth surprises. It is relevant in this respect to compare real GDP growth in the period considered in the study with the average developments in the previous decades. Graph III.4.7 shows that in the period considered in the study (1999–2006) the simple average of annual real GDP growth rates in the EU-15 countries reached 2.8 %. This is rela-

⁽¹⁾ These are not necessarily Member States with high initial government deficits. See Section III.2 for more details.

⁽²⁾ This result holds when taking into account surprises in nominal GDP growth.

Table III.4.1

Dependent variable: difference between the observed and planned increase in real primary expenditure

Time-horizon considered	t-t+1		t-t+2		t-t+3		Whole sample	
	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat
EU-15 Member States								
Constant	0.1 (***)	4.4	0.1 (***)	4.8	0.2 (***)	5.4	0.1 (***)	4.6
Planned change prim exp. ratio	-0.6 (**)	-2.2	-0.9 (**)	-2.8	-1.3 (**)	-2.2	-1.0 (**)	-2.3
Initial level prim exp. ratio	-0.1 (***)	-3.4	-0.2 (***)	-3.7	-0.3 (***)	-4.1	-0.2 (***)	-3.8
Dummy contract (0) delegation (1)	-0.0 (***)	-3.0	-0.1 (***)	-3.7	-0.3 (***)	-3.7	-0.2 (***)	-3.4
Real GDP growth surprises	0.1	1.1	0.0	0.2	-0.2	-1.4	-0.1	-0.9
Total index MTBF/SCP	-0.2 (**)	-2.2	-0.6 (**)	-2.3	-1.3 (**)	-2.6	-0.6 (**)	-2.5
Dummy t+2	—	—	—	—	—	—	0.1 (***)	3.8
Dummy t+3	—	—	—	—	—	—	0.2 (***)	3.5
N. Obs.	109		94		79		282	
R. Sq	0.18		0.28		0.53		0.48	

NB: Estimation method: fixed-effect OLS with robust standard errors. (**) and (***) denote, respectively, significance at the 5 % and 1 % levels.

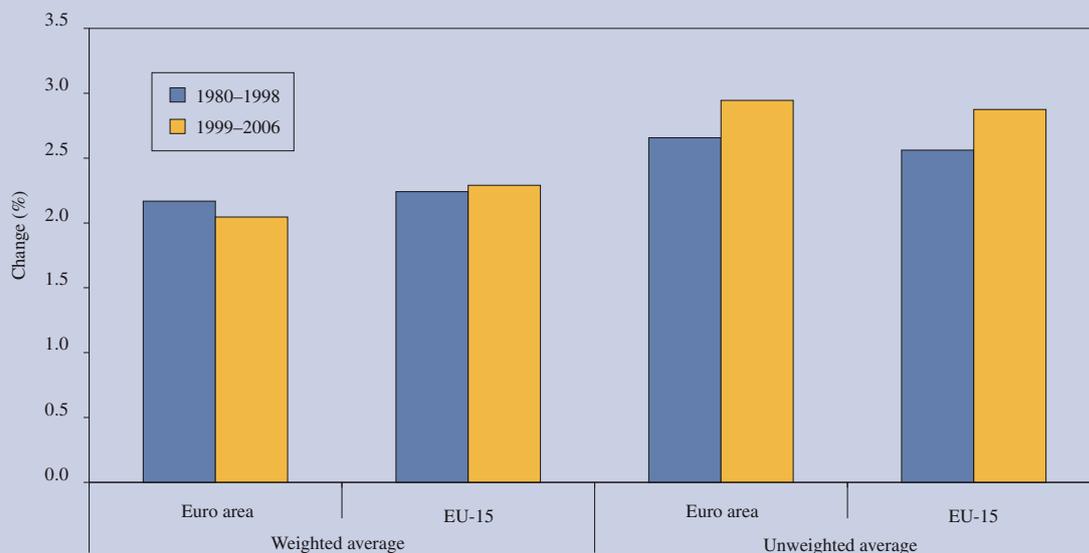
Source: Commission services.

tively close to the average rate observed for the same sample of countries over the period 1980–98 (2.6 %). This result supports the view that the negative growth surprises compared to plans experienced since 1999 cannot be attributed to a genuinely unpredictable economic slowdown over the period considered. This conclusion however does not apply to individual countries. Real GDP growth in the period considered in the study was significantly lower than in the preceding 20 years in a number of countries (notably Germany and Portugal). It was significantly higher for a number of other countries, e.g. Ireland, Greece, and Spain.

Another possibility is that medium-term macroeconomic projections were, in a number of countries, deliberately optimistic. Milesi-Feretti and Moriyama (2004) provided an explanation for the possible optimistic bias in macroeconomic forecasts. These authors argued that opportunistic governments may try to avoid the political cost associated with the implementation of difficult consolidation measures by using overly favourable growth assumptions. Corrective measures can then be avoided *ex ante*, while *ex post* the deficit will turn out to be higher than expected as growth is lower than projected. The resulting higher deficit can then be blamed on bad luck, even if it results from a deliberate forecast bias in growth projections.

Recent empirical analysis on the role of growth forecasts provides evidence of a forecast bias in a number of EU countries. Larch and Salto (2005) found evidence of a significant negative impact of such a bias on budgetary outcomes in three of four large EU Member States. Moulin and Wierts (2006) studied whether growth forecast in the SCPs have been deliberately optimistic since 1998. Taking the European Commission service's autumn 2005 forecast as a benchmark, they show that only in two cases growth was lower than projected in the SCP and domestic growth projections were significantly more optimistic than those released by the Commission services. According to Larch and Jonung (2006), a way to remedy possible politically motivated biased macroeconomic forecasts is the establishment of institutions in charge of providing independent macroeconomic forecasts. This may have a direct beneficial impact if the government is obliged to use the forecasts of the independent institution in the preparation of the budgetary plans. A positive effect can also be expected when there is no formal obligation for the government to take into account these forecasts. In such cases, the independent forecasts provide benchmarks against which the plausibility of the macroeconomic forecasts of the government can be assessed, which may limit the temptation to deliberately overes-

Graph III.4.7: Real GDP growth developments in the period considered by the study and in the two decades preceding it



Source: Commission services.

timinate growth. These arguments were further developed in European Commission (2006a).

4.3.2. The role of institutions

According to a survey launched by the European Commission in 2005, 10 EU countries already have at least one institution that regularly produces independent macroeconomic forecasts against which the official projections can be assessed ⁽¹⁾. However, in the large majority of cases, the government is free to base its budgetary plans on its own forecasts, without having to provide any justification in case there are deviations compared to the forecasts of the independent institution. There are three exceptions to this rule: in Belgium, the National Account Institute provides the macroeconomic forecasts to be used by the federal government in the budgetary process. The second exception concerns the Institute of Economic Research in Austria. The macroeconomic forecasts prepared by this independent body almost always constitute the basis for the preparation of fiscal plans. The third exception is the Netherlands Bureau for Economic Policy Analysis. Against this background, it is interesting to assess whether negative real GDP growth surprises were less pronounced

in countries where the task of preparing macroeconomic forecasts is delegated to independent institutions. Another interesting question is to see whether these countries project real GDP growth in the medium term more in line with the currently estimated trend or potential growth.

When looking closely at the data comparing real GDP growth projections in the SCPs and outcomes, it is striking to observe that two of the three countries in which the task of preparing macroeconomic forecasts used for annual and medium-term budget planning are prepared by an independent institutions experienced larger than average negative surprises in real GDP growth developments (see Graph III.4.8) ⁽²⁾. Similarly, when dividing the sample in three groups of countries: (i) those delegating the macroeconomic forecast activity to independent institutions; (ii) those in which an independent forecasting institution exists, but there is no delegation of task; (iii) those in which there is no such institution, it appears that the relation between forecast errors and the existence of an independent institution is not clear cut. This result is largely influenced by the large positive surprises in real GDP

⁽¹⁾ See European Commission (2006a) for an overview of the results of this survey.

⁽²⁾ According to Moulin and Wierds (2006), these countries experienced genuine negative growth surprises, in the sense that other, independent forecasters did not predict better the economic downturn experienced by these countries.

growth developments in Ireland and Luxembourg, two countries in which no independent institution in charge of preparing macroeconomic forecasts exist. For that reason, and because the analysis is based on a short period of time, during which most EU countries were affected by unexpectedly steep and protracted economic slowdown, the conclusions should be taken with care.

4.4. Conclusions

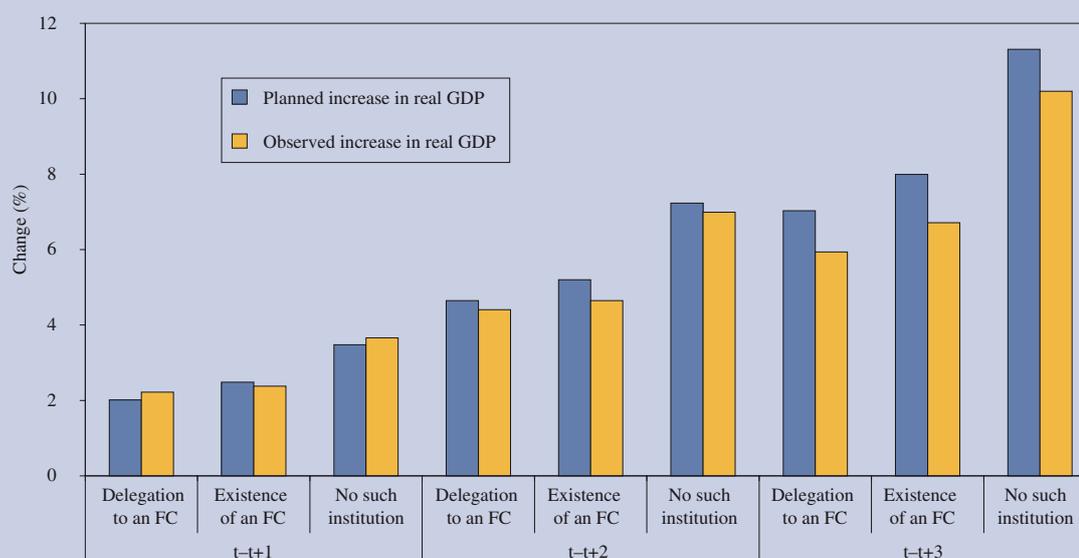
This section assesses which factors explain that some countries were able to stick to their medium-term budgetary plans while this was not the case for others. The analysis first examines the reasons for the difficulties to adhere to multiannual expenditure targets. This is crucial as medium-term fiscal consolidation efforts planned by Member States typically foresaw significant efforts on the expenditure side and as government expenditure is the part of government finances that is most controlled by the fiscal authorities.

The analysis brings a number of answers on the determinants of expenditure overruns in the EU. It shows notably that there is a statistically significant relation between the 'degree of ambition' of medium-term expenditure plans, in terms of the planned reduction in the expenditure-to-GDP ratio, and the size of the discrepancy

between the planned and observed increase in government expenditure. Member States projecting large cuts in their expenditure-to-GDP ratio tend, *ceteris paribus*, to show a lower degree of adherence to plans. *Ceteris paribus*, it is relatively easier to achieve ambitious expenditure targets for countries with a relatively large public sector. Another interesting result is that expenditure overruns seem to be independent from macroeconomic developments. Both the frequency and size of expenditure overruns were similar in periods of positive and negative growth surprises. Finally, and this can be considered the main result of the analysis, there is a statistically significant relation between the quality of institutions for medium-term budgetary planning and the capacity to achieve expenditure targets. Reliance on developed MTBFs can significantly contribute to limit the size of the discrepancy between planned and observed increase in real primary expenditure.

In a second step, the analysis focuses on the causes for the negative GDP growth surprises. The analysis in this case is less conclusive. The data suggest that real GDP growth surprises were on average not due to a genuinely unpredictable economic slowdown, as real GDP growth was in the period considered in line with the trend of the previous two decades.

Graph III.4.8: Real GDP growth projections in different groups of countries



Source: Commission services.