4. FISCAL RULES, INDEPENDENT INSTITUTIONS AND MEDIUM-TERM BUDGETARY FRAMEWORKS

4.1. INTRODUCTION

The elements that form domestic fiscal frameworks have been drawing growing attention from economists and policy-makers over the last years. Fiscal arrangements such as national fiscal rules, independent public institutions involved in the budget process and medium-term budgetary frameworks for fiscal planning have been the main subject of a relatively recent research stream, which has been triggered by the increasing resort to these elements in the fiscal policy making.

For instance, the report on the SGP reform endorsed by the European Council in March 2005 states that *"national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact"* and that *"national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level"*.

Against this background, the Commission launched at the end of 2005 two comprehensive surveys on national fiscal rules and independent public institutions in the EU member States over the period 1990-2005. The results and the analysis of these surveys were published in the Public *finances in EMU – 2006* report. ([1]) Subsequently, a third survey on the existing domestic medium-term budgetary frameworks in the EU was also conducted by the Commission in 2006. Similarly, the main analytical results were published in the *Public finances in EMU – 2007* report. ([2])

This section provides the main results of the updates of these three surveys carried out in 2008 in the context of the Working Group on the Quality of Public Finances (WGQPF) attached to the Economic and Policy Committee (EPC). These updates follow the mandate by the May 2008 ECOFIN council and attempt to complement the heterogeneous reporting on these issues included in the SCPs. The content and the structure of the questionnaires remained broadly unchanged in order to have comparable data and information.

([1]) http://ec.europa.eu/economy_finance/publications/publication423_en.pdf
([2]) http://ec.europa.eu/economy_finance/publications/publication338_en.pdf

4.2. NUMERICAL FISCAL RULES IN EU COUNTRIES

Like in the previous survey, the 2008 questionnaire followed the definition proposed by Kopits and Symansky (1998), which states that a fiscal rule is "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance". ([3]) In turn, the indices encapsulating the strength and coverage of domestic fiscal rules over the period 1990-2008, which were firstly computed on the basis of the former survey, were now recalculated using the new data set. While Box II.4.1 describes the findings of the 2005 survey, the next two sub-sections provide the main descriptive results of the new sample as well as the changes in the index values based on this updating.

4.2.1. Main descriptive results based on the 2008 questionnaire

The 2008 update confirms the previously observed tendency for a growing use of fiscal rules in the EU countries. Whilst fiscal rules in place grew from 16 in 1990 to 61 in 2005, this figure further increased to 67 in 2008. ([4]) ([5]) Since the previous survey, five countries, three of which from the new Member States, have implemented seven new fiscal rules (BG, FR, LT, HU and PT). In the same period, one country reported to have abolished one rule (FI) whereas three Member

([3]) Kopits, G. and S. Symansky (1998).
([4]) The total number of rules in 2005 departs slightly from the figure published in the 2006 *Public Finances Report*. This is due to the inclusion of Bulgaria and Romania in the survey, which were not previously considered, and some adjustments in the sample stemming from more accurate information provided by some countries (e.g., rules reported in the 2005 survey which were not yet in force).
([5]) Rules applied to more than one government tier they are accounted according to the number of sub-sectors concerned (e.g., a balanced budget rule for regional and local governments would represent two rules), the sum of fiscal rules in 2008 would amount to 76 (70 in 2005).

Box II.4.1: **Key findings in the 2005 survey on national fiscal rules**

The 2005 survey found that fiscal rules had become a wide-spread policy tool across Member States. In 2005, 61 national fiscal rules were in force, up from less than 20 in 1990. At the central government level, which represented nearly 25% over the total sample, rules targeted mostly public expenditure. In contrast, at regional and local levels, fiscal rules typically capped the budget balance or the debt level (close to 50% over the total number of rules). Fiscal rules at the local level also generally exhibited some strong design features compared to other government layers. In particular, many were enshrined in law or the constitution and included an automatic correction mechanism if violated. However, in terms of coverage local fiscal rules naturally accounted only for a small share of the general government sector. By contrast, a significant number of rules applied to the general and central government are based on political agreements and the only cost for non-compliance is reputational.

A number of weaknesses in the design of the rules were also identified. In particular, only few rules included independent monitoring and pre-defined enforcement mechanisms (generally rules for sub-national governments). On top of that, media visibility, which could serve as an informal enforcement device, was rather limited in most cases. The scant resort to revenue rules, which can pre-define how excess revenues should be allocated, was another weakness since they are the most direct tool to keep the spending of windfall revenues in good times into check. A more extensive use of these rules could have helped address pro-cyclicality and the deficit bias.

On average, fiscal rules were stronger in the old than the recently-acceded Member States but variations across countries were large. Among the old Member States, the United Kingdom, Spain, the Netherlands and the Scandinavian countries stood out with a particularly strong set of rules. Estonia, Poland, Slovakia, Slovenia and the Czech Republic had, among the new Member States, the strongest rules in place. Three countries, Cyprus, Greece and Malta, did not rely at all on fiscal rules.

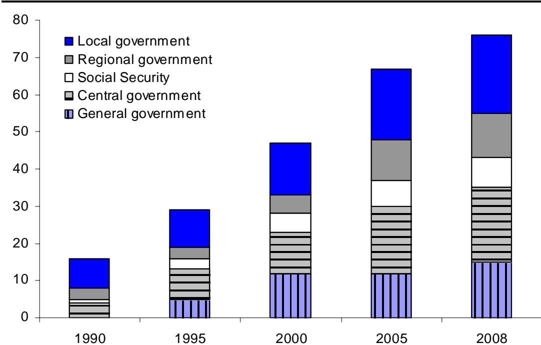
Empirical analysis showed a positive link between the quality of national numerical fiscal rules and fiscal discipline in the EU countries. In particular, it suggested that an increase in the share of government finances covered by numerical fiscal rules leads, ceteris paribus, to an improvement in the budget balance. The analysis also found that the influence of fiscal rules on budgetary outcomes depends on the rules' characteristics. Strong rules, enshrined in law or constitution and supported by pre-defined enforcement mechanisms, seem, on average, to have had more influence on fiscal discipline than weak rules.

States remained in 2008 without fiscal rules (CY, EL and MT). Box II.4.2 gives further details on the new fiscal rules.

Similarly to the 2005 survey, a growing number of fiscal rules applied to the general and central governments have been introduced over the most recent years, which contrasts with the prevailing situation in 1990 with a majority of rules covering regional and local government sub-sectors. In relative terms, rules applied to the general and central government accounted for 25% in 1990 compared to nearly 50% in 2008 (see Graph II.4.1).

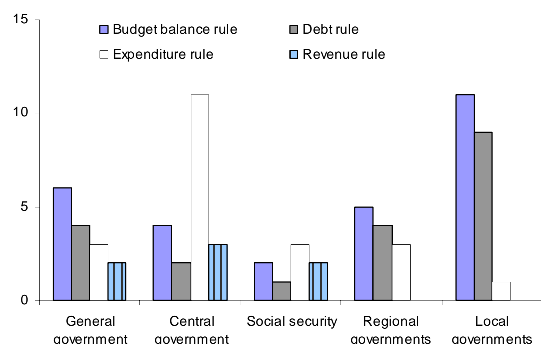
More than one third of the existing fiscal rules in the EU countries are budget balance rules (including golden rules) while expenditure and debt rules represent about one quarter in both cases. By contrast, revenue rules account for less than 10 percent. In line with the 2005 results, most of budget balance and debt rules are applied to regional and local governments. This departs from the central government and social security sub-sectors, which resort more often to expenditure rules (see Graph II.4.2).

Graph II.4.1: **Fiscal rules in the EU Member States by sub-sector**



Note: See footnote (65).
Source: Commission services.

Graph II.4.2: **Fiscal rules in the EU Member States by type of rule**



Note: See footnote (65).
Source: *Commission services.*

Fiscal rules currently in place show a large diversity in terms of target definition (see Table II.4.1). More than one third of budget balance rules target a balanced budget and only a few of them are defined on a structural basis. Nearly fifty percent of debt rules, mostly applied to territorial governments, establish debt limits according to the repayment capacity (i.e., the ratio between debt service and revenues). Expenditure rules are evenly distributed between those setting up spending ceilings and those targeting expenditure growth rates. While ceilings are generally defined on a nominal basis, the number of targeted growth rates in nominal and real terms is similar in both cases. Finally, two thirds of revenue rules oblige fiscal authorities to pre-define the allocation of windfalls revenues.

Other characteristics of the existing fiscal rules have hardly changed between 2005 and 2008. For instance, most of fiscal rules continue to lack an independent monitoring and the poor enforcement mechanisms in case of non-compliance remain in place. Overall, the main results of the 2005 survey described in Box II.4.1. still apply.

4.2.2. Changes in the index of strength of fiscal rules in the EU Member States

The indices that capture the strength and the coverage of fiscal rules, which were firstly computed on the basis of the 2005 survey, have now been recalculated using the information of the updated questionnaire. This has been done following the methodology outlined in the *Public finances in EMU – 2006* report, which is briefly summarised in Box II.4.3.

While the number of fiscal rules has increased (see previous section), not many reforms to strengthen the existing rules were implemented. Thus, the fiscal rules index shows an improvement mostly in those countries that adopted new rules. This holds particularly for some recently acceded Member States (BG, LT and to a lesser extent HU). France's new rules also raised its fiscal rule index while the new Portuguese rule left the country below the EU average since the new rule only applies at the regional level. Finland's index fell because a debt rule applied to the central government was abolished. In all other Member States, the reforms were generally very minor or related to aspects not covered under the fiscal rules index. ([6]) As a result, the overall index for the EU-27 only improved slightly between 2005 and 2008 (see Graph II.4.4).

Overall, the positive relationship between the fiscal rule index and budgetary outcomes found in the previous survey still apply on the basis of the updating. Thus, those EU Member States with the highest index values show on average better budgetary outcomes. This is reflected in Graph II.4.3, in which the country groups scoring higher in the fiscal rule index also tend to register higher primary cyclically-adjusted balance figures over the most recent years.

([6]) Sweden's slight decline in its fiscal rules index between 2005 and 2008 is due to some changes in authorities' reporting on their existing rules, including on the legal basis and media visibility.

Box II.4.2: Main features of the new fiscal rules over the period 2005-2008

Two new budget balance rules were in place in 2008 (HU and PT). In Hungary, the rule requires since 2007 that the general government primary budget balance be in surplus. As for Portugal, the state budget law defines annual net indebtedness limits for regional governments. In Poland, a political agreement entered into force in 2006 to cap the nominal central budget deficit at PLN 30 bln aiming at its gradual reduction as a percentage of GDP. However, this rule was abolished in 2008 and the government announced recently the tightening of the current debt rule.

An indication that countries are becoming increasingly aware of the problem of pro-cyclical fiscal policy is reflected in the adoption of two new revenue rules. In France, the government has to define ex ante how possible revenue surpluses (compared to plans) will be allocated. This rule had already been approved at the time of the 2005 survey but only entered into force in 2006, so that it is presented only now in terms of the fiscal rules index. In Lithuania, the deficit of the approved state budget shall be reduced by excess revenue of the current year. Nevertheless, even with these additions, revenue rules are so far only in place in six countries (DK, FI, FR, LT, LV, NL), and not all of them pre-established the allocation of higher-than-anticipated revenues to deficit and debt reduction.

New expenditure rules entered into force in Bulgaria and Lithuania. The limit for the general government in Bulgaria is to maintain an expenditure-to-GDP ratio of less than 40%. With a ratio of 37.8% in 2007, the limit was not yet binding. Lithuania links the expenditure ceiling to revenues. Specifically, it requires that if the arithmetic average of the general government operating balance, i.e. the general government balance, for the previous five years was negative, then the annual growth rate of the planned state budget appropriations may not exceed ½ of the average growth rate of the state budget revenue of the past five years.

France's new debt rule, adopted in 2005 and in force since 2008, applies to the social security. The rule pursues to keep unchanged the terms of "social debt" repayment. Therefore, any debt increase in the social security sub-sector should be matched by a revenue increase in order to avoid any term repayment extension.

Table II.4.1: **Target definitions by type of rule**

Budget Balance Rules	Golden rules	Balanced budget rules	Nominal ceiling	Ceiling as a % GDP	Rules in structural terms	Total
	5	10	7	1	3	26
Debt Rules	Debt ceiling in nominal terms	Debt ceiling as a % of GDP	Debt ceiling related to repaiment capacity	Other		Total
	5	3	8	2		18
Expenditure Rules	Nominal expenditure ceiling	Real expenditure Ceiling	Expenditure growth rate (nominal)	Expenditure growth rate (reall)	Other	Total
	5	2	4	3	3	17
Revenue rules	Tax burden as a % GDP	Rule related to tax rates	Allocation of extra revenues	Other		Total
	0	1	4	1		6

Source: Commission services.

Box II.4.3: Criteria used to calculate the index of strength of fiscal rules

A fiscal rule is considered strong if it is likely to be respected and may significantly influence the conduct of fiscal policy. Following the methodology applied in the *Public finances in EMU – 2006* report, the measurement of the strength of fiscal rules is based on five criteria:

(i) The statutory base of the rule: A rule enshrined in the constitution or in law is considered stronger than a rule based on a simple political agreement or commitment.

(ii) The nature of the body in charge of monitoring the respect of the rule: When the monitoring is carried out by an independent body that may send an early warning in case a risk of non-compliance is identified, the probability that rule is respected can be expected to be higher.

(iii) The nature of the body in charge of enforcement of the rule: Like in the previous criterion, the resort to a non-partisan institution to ensure that appropriate measures will be adopted in case of non-compliance is considered to promote the respect of the rule.

(iv) Enforcement mechanisms of the rule: The existence of automatic correction mechanisms and the possibility to impose them in case of deviation from the rule can be expected to foster compliance.

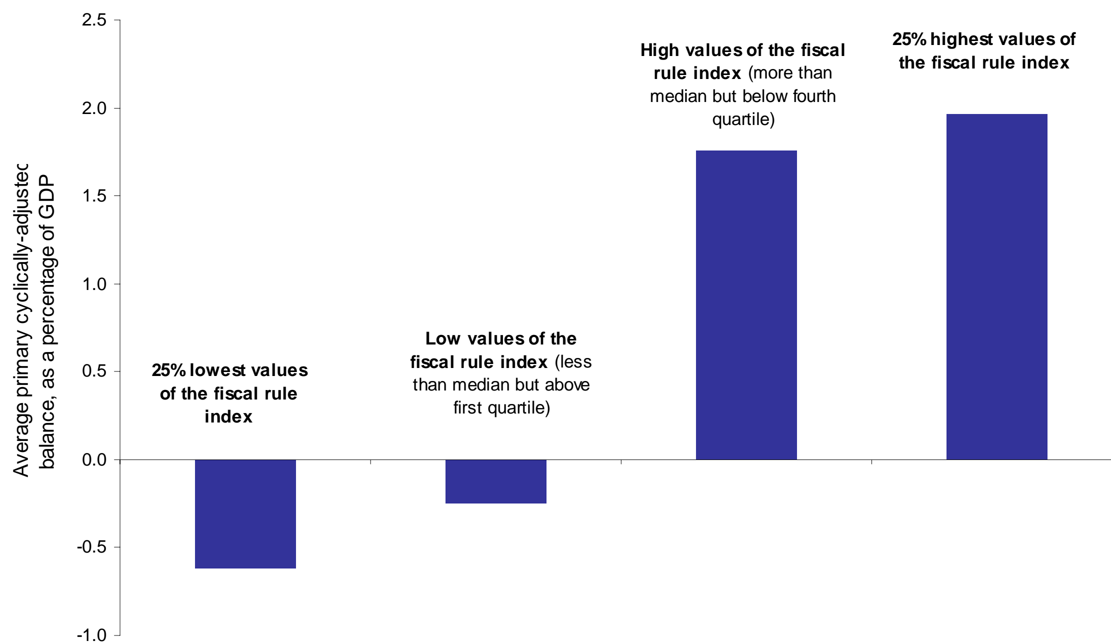
(v) Media visibility of the rule: The effectiveness of fiscal rules is considered to be higher when they may benefit from a large media visibility and non-compliance is likely to cause a public debate.

Since there is no theoretical prior on how to weigh the criteria, they were aggregated using 10,000 random weights with the median of the index reported here. This measurement of 'strength' of fiscal rules was combined with a measurement of the 'coverage' by weighting the rule with the percentage share of the general government finances covered by the rule. The index was standardised so that the average over the sample (1990-2008) is zero and the standard deviation is one (see the 2006 Public Finances in EMU for further details).

While the EU on average saw some improvements, the reported reforms appear to be more important in some of the new Member States allowing them to slightly overtake the euro area as group in terms of the fiscal rule index (see Graph II.4.4). The calculated index, however, also has some caveats that need to be recalled in light of such comparisons. It is based on self-reporting and may not yet reflect the actual experience with a fiscal rule when it has just entered into force. Moreover, the index cannot always capture how binding a rule is. For example, Bulgaria's debt rule foresees a ceiling of 60% of GDP which is far away from the current debt stock of about 18% of GDP in 2007. This is also the case for other new Member States' fiscal rules such as Latvia and Poland. (7) All in all, direct comparisons of the index between individual Member States or between groups of EU countries must be interpreted cautiously.

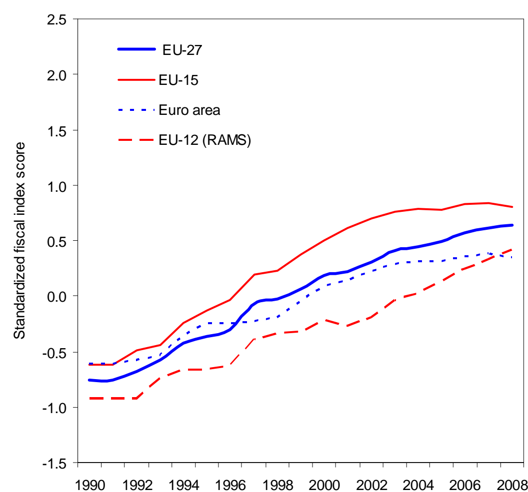
(7) On top of that, some of these fiscal rules implemented in some of the new Member States are very often applied to the whole of the general government sector or to the central government plus the social security sub-sector (i.e., a very large coverage), which further increases the score of the fiscal rule index. Finally, the gradual incorporation of some Member States with no fiscal rules in the euro area pulls down the average index value for this group of countries .

Graph II.4.3: **Fiscal rule index and average primary cyclically-adjusted balance in the EU-27 in the period 2000-2008**



Source: Commission services.

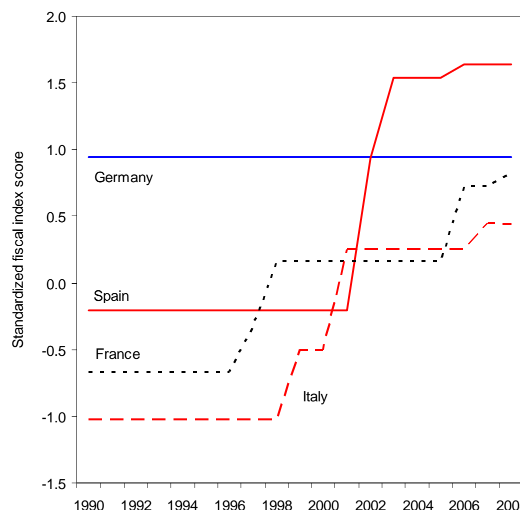
Graph II.4.4: **Development of the fiscal rule index in the EU**



Source: Commission services.

The evolution of the index reflects in some cases the reform efforts implemented at the end of the 1990s with a view to joining the first bunch of countries adopting the single currency. In particular, this was the case of France and Italy. By contrast, Spain embarked upon a major fiscal framework reform after joining the euro and Germany did not introduce any significant change over the last twenty years (see Graph II.4.5).

Graph II.4.5: **Development of the fiscal rule index in selected EU Member States**



Source: Commission services.

Finally, in line with the results based on the 2005 dataset, statistical and econometric exercises suggest the existence of a link between numerical fiscal rules and budgetary outcomes. (8) Table II.4.2 reports the results of the econometric

(8) See Public Finances in EMU 2006.

analysis linking the fiscal rule index and budgetary outcomes measured by the cyclically-adjusted primary balance (CAPB) in the EU27 Member States. The coefficient reflecting the influence of the fiscal rule index on the CAPB is positive and significant, which indicates that an increase in the value of the index (i.e. a larger coverage and/or stronger features of fiscal rules) leads, ceteris paribus, to lower deficits or higher surpluses.

Table II.4.2: **Influence of fiscal rules on the primary CAB (EU-27, 1990-2008)**

Explanatory variables:	Dependent variable: Cyclically-adjusted primary balance (CAPB)
Lagged output gap	-0.058 (-1.1)
Lagged CAPB	0.54 (9.6)***
Lagged debt ratio	0.04 (3.6)***
Fiscal rules index	0.48 (-2.7)**

(1)Estimation method: OLS with time and country-fixed effects. Heteroscedasticity robust and adjusted for 27 clusters standard errors. The "t" values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for fixed-effects are not reported.
Source: Commission services.

4.3. INDEPENDENT FISCAL INSTITUTIONS

The 2008 update keeps the definition of independent public bodies in the field of fiscal policy unchanged with respect the previous survey. Thus, national fiscal agencies are defined as independent public bodies, other than the central bank, government or parliament that prepare macroeconomic forecasts for the budget, monitor fiscal performance and/or advise the government on fiscal policy matters. These institutions are primarily financed by public funds and are functionally independent vis-à-vis fiscal authorities. Courts of Auditors are included in the survey if their activities go beyond the accounting control and cover any of the tasks mentioned above. Similarly to fiscal rules, the 2008 questionnaire to update the previous survey was kept largely unchanged in order to have comparable and homogenous information.

4.3.1. Main results of the 2008 survey

As expected, the main results of the 2008 update provided no major changes compared to the previous survey (see Box II.4.4 for a brief overview of the prevailing situation in 2005).

In 2008, 27 independent bodies were implemented in 17 EU Member States. Only two countries set up two new bodies (SE and PT) while only minor changes to the existing institutions were introduced in DK and DE.

In most new Member States however, independent fiscal institutions are still the exception. An attempt to explain why fiscal institutions have so far been less popular in new Member States, despite their rapid catching up in other aspects of fiscal frameworks, has not yet been elaborated. A plausible hypothesis can be raised in this respect. The long history of fiscal institutions in most of old Member States and the few recent reforms and additions suggest that the introduction of these independent bodies usually takes more time than the implementation of other institutional arrangements such as fiscal rules or medium-term budgetary frameworks. Actually, establishing fiscal institutions requires sufficient financial and human resources and capabilities, in contrast to mostly legal changes needed for building up other aspects of the fiscal frameworks. Particularly, some of the small new Member States may have preferred to concentrate their human resources for monitoring fiscal policy making in the central bank, ministries of finance and academia leaving them thin-spread to add fiscal councils.

Whether in the future Member States will increase their reliance on these independent bodies will likely be impacted by the experiences in the old Member States and outside the EU as well as by country-specific circumstances, including resource constraints.

4.3.2. Main recent initiatives related to independent institutions in the EU Member States.

Sweden established a new fiscal institution with the aim to provide an independent evaluation of Swedish fiscal policy. The newly created Fiscal Policy Council, which took office on 1st August 2007, supplements the already existing fiscal institution (the National Institute of Economic Research) that prepares non-binding macroeconomic forecasts for the budget.

Box II.4.4: Key findings in the 2005 survey on independent fiscal institutions

In 2005, 25 independent public bodies were implemented across 17 EU Member States, of which 13 belonged to the former EU-15. Those countries having more than one independent institution were DE (4), AT (3) and ES and FR (2). The new Member States reporting the implementation of such an institution were EE, LT, HU and SI.

Overall, 19 institutions released analyses of budgetary developments while 15 issued normative recommendations related to the conduct of fiscal policy. Institutions providing macroeconomic and fiscal forecasts amounted to fifteen. However, among the latter only four Member States (BE, NL, AT and SI) relied on independent fiscal institutions to provide the macro forecasts for the budget preparation and medium-term fiscal planning. Finally, nine institutions carried out these three tasks simultaneously.

According to the survey, these institutions often look back on a long history which may partly explain that they are far more common among old Member States. In new Member States the role of fiscal institutions is often played by central banks, which are not covered under the definition used here. In general, these institutions enjoyed a high reputation and functional independence. Finally, the quality of their work is perceived to be above standards.

The creation of the Fiscal Policy Council, consisting of eight academics and policy experts, was mostly motivated by the desire to increase the transparency of fiscal policy making, thereby ensuring confidence in the fiscal policy framework. This is to be achieved by assessing whether the fiscal policy objectives, including long-run sustainability, the budget target, the expenditure ceiling and the consistency of fiscal policy with the cycle, are met. Additional tasks are to examine the clarity of government proposals and to review the economic forecasts and models used to generate them. To achieve these objectives, the Council prepares an annual report to the government and participates in the public policy debate.

Portugal created a special unit to support the parliament's budget committee, assess public finances and make them more transparent. The Unidade Técnica de Apoio Orçamental (UTA) started operations in November 2006 with responsibilities of assessing the macroeconomic scenarios underlying the budget as well as the budget itself. Moreover, it monitors the implementation of the budget (on a quarterly basis) and the SCP and analyses the budgetary impacts of legislative initiatives under discussions. It produces various reports for the respective tasks.

Finally, two countries (Denmark and Germany) brought minor reforms of their fiscal institutions over the period 2005-2008, however, without implications for the institutions' functions. Denmark merged the Danish Economic Council and the Environmental Assessment Institute DK into the Danish Economic Councils. Germany's Council of Economic Advisers (SVR) has been charged to annually produce an additional report on selected topics to be decided jointly by the government and the council, which could include fiscal issues.

4.4. MEDIUM–TERM BUDGETARY FRAMEWORKS

In line with the surveys on fiscal rules and institutions, the 2008 questionnaire on medium-term budgetary frameworks (MTBFs) hardly changed compared to the 2006 version, and the definition of MTBFs adopted in 2008 was the same as the previous survey. Finally, the approach used to compute an index measuring the quality of domestic budgetary frameworks remained also unchanged.

While the next two sub-sections describe the main changes identified in the 2008 update and the recalculation of the quality index, Box II.4.5

provides the most important findings based on the 2006 data. ([9])

4.4.1. Main descriptive results of the 2008 survey

Overall, medium-term budgetary frameworks (MTBFs) are those policy instruments that allow extending the horizon for fiscal policy making beyond the annual budgetary calendar. Although in all Member States the adoption of the annual budget is the key step in which crucial decisions on fiscal policy are taken, most fiscal policy measures have budgetary implications that go well beyond the yearly budgetary cycle. As a result, a single-year budgetary perspective provides a poor basis for a sound fiscal policy management. This is the main reason justifying that a majority of EU countries have currently adopted an MTBF for fiscal planning.

Barring five Member States (EL, CY, HU, LU and PT), all EU countries declared to have an MTBF in place in 2008. ([10]) This figure did not change compared to the 2006 survey, and no major revisions of the existing frameworks have been implemented either over the last three years. In general, changes have been small and limited to a few countries. Actually, only France has adopted some significant reforms. The main change in the last survey is the larger coverage of the sample, which now includes Bulgaria and Romania.

As a result, the time horizon and the institutional coverage of domestic MTBFs have remained largely unchanged. Most of medium-term frameworks continue to cover a three or four-year period while the whole of the general government is still by far the most common institutional sector targeted.

Likewise, the 2008 survey also showed limited progress in the area of institutional coordination, monitoring, corrective mechanisms and target revisions (see Graph II.4.6). Only France seems to have made some progress related to the required coordination among government layers when setting budgetary targets. However, since both Bulgaria and Romania operate with some coordination mechanisms, the overall picture on this particular aspect appears more favourable than in the 2006 survey results.

Regarding the implementation of a regular monitoring, France and Latvia reported to have implemented new procedures to better oversee budgetary developments. In contrast, no additional corrective mechanisms in case of non-compliance have been put in place since 2006.

Finally, most domestic MTBFs remain rolling and flexible frameworks (i.e., every year the time horizon is extended one additional year while targets for the remaining years can be revised). This includes also the MTBFs of Bulgaria and Romania. In this respect, the reform of the existing framework in France might be an exception. Although fiscal targets are not legally binding, according to the information provided by French authorities the reformed MTBF implies to set a fixed path for fiscal targets, which should not be revised during the time horizon of the framework unless major changes in the underlying macroeconomic assumptions materialise. ([11])

Overall, reform efforts as regards MTBFs have been slow. The revisions implemented since 2006 were, in most cases, relatively minor and contrast with the intentions of implementing new MTBFs or reforming the existing ones as expressed by a number of countries in their recent SCPs. As a result weaknesses in MTBFs are still broad based.

([9]) See the 2007 *Public finances in EMU* report or a comprehensive analysis of the 2006 survey.

([10]) Cyprus reported not to have a domestic MTBF in place. However, the 2007 Stability Programme of Cyprus announced the introduction of a MTBF from 2007 onwards with the objective to better controlling public sector employment growth and containing other current expenditures.

([11]) Specifically, with the expenditure targets being defined in real terms, significant deviations from the projected inflation developments would entail revisions of the nominal spending figures. However, since these targets are not legally binding, only the magnitude and frequency of the target revisions over the next years will allow assessing their constraining character.

Box II.4.5: **Key findings in the 2006 survey**

According to the 2006 survey, a majority of MTBFs covered the whole of the general government sector or a large part of it (e.g. central government plus social security) and had a three or four-year horizon. In most of them, every year the time horizon was extended one additional year with the option to revise budgetary plans for the remaining years (i.e., rolling and flexible MTBFs). Setting a fixed path for budgetary aggregates (e.g., public expenditure) was the exception practiced only in FI, SE and NL, and to a lesser extent in DK and the UK. In general, the level of detail provided by the budgetary projections was rather poor. In a large majority of cases, medium term budgetary projections only covered the main budgetary aggregates (i.e., budget balance and debt figures and total revenue and expenditure developments), while there was hardly any indication on the composition of government spending and receipts. A few countries can, however, be considered outstanding exceptions in this respect (e.g., SI, SE and the UK).

Most of domestic MTBFs exhibited a large number of weaknesses. In particular, scant monitoring and a lack of pre-defined correction mechanisms in case of non-compliance emerged as the main shortcomings. Specifically, MTBFs were not formally monitored in nearly 50% of EU countries whereas corrective measures that take force when targets are missed hardly existed. In the same vein, in only about half of EU Member States the medium-term frameworks and the annual budget preparation appeared relatively well linked while in the remaining countries this link was not clear or seemed weak. In general, the media had only shown a meagre interest in covering governments' compliance with their multiannual fiscal plans, which entail modest reputational costs. Finally, in a number of countries a lack of coordination among government tiers to ensure the respect of fiscal targets included in the MTBFs came out as a major drawback

4.4.2. Main changes in the quality index of domestic MTBFs

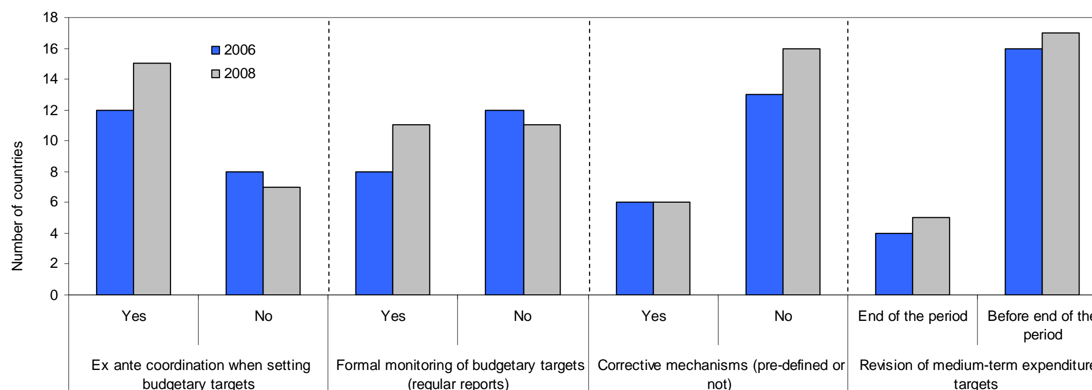
The index that encapsulates the main features of the existing medium-term frameworks in the EU countries was firstly calculated on the basis of the 2006 survey. This section shows the new values of this index according to the new survey conducted in 2008. This updating was done following the methodology outlined in the 2007 *Public finances in EMU* report, which is briefly summarised in Box II.4.6. ([12])

As the previous section stressed, no new MTBFs were implemented since 2006 and the reforms to the existing ones were generally rather minor except for the case of France. Consequently the country-specific values of the quality index of medium-term frameworks remained unchanged for almost all Member States. Only the index of France and to a lesser extent the one of Latvia reflected the improvements introduced since 2006. This is shown in Graph II.4.7. ([13])

([12]) In particular, when one country did not operate a domestic MTBF, the strength of its SCP in terms of multi-annual budgeting was taken into account to compute the index. However, while SCPs can be considered a specific type of an MTBF, they are not viewed to be totally on an equal footing with domestic MTBFs. Thus, for the calculation of the MTBF index, which measures the strength of Member States MTBFs, those countries that only use SCPs were given a lower rating in one of the dimensions considered for the index.

([13]) An unchanged index, however, does not necessarily imply that no changes occurred at all. For instance, Italy has recently improved its MTBF by including a detailed breakdown of revenues and expenditure components that allows identifying the fiscal strategy adopted to achieve fiscal targets. This may potentially improve the conduct and the monitoring of fiscal policy over the medium term. However, the breakdown of budgetary aggregates is not considered into the five dimensions of our MTBF index and, therefore, this change has no impact in its calculation. In cases where reforms have not entered into force, such as for Austria or Poland, they have also not yet been included in the index.

Graph II.4.6: **Coordination, monitoring, corrective mechanisms and target revisions in domestic MTBFs**



Source: Commission services.

Box II.4.6: Criteria used to calculate the quality index of domestic MTBFs

Similarly to fiscal rules, the information provided by the surveys were summarised into a composite index to assess the quality of MTBFs. The index originally developed in 2006 has now been reviewed and updated in the light of the 2008 questionnaire. Like the fiscal rules index, it is based on information reported by Member States, which only enter the index calculation when the specific aspects of the MTBF were already in force in July 2008. The index captures the quality of MTBFs through five criteria: ([1])

(i) Existence of a domestic MTFB.

(ii) Connectedness between the multi-annual budgetary targets and the preparation of the annual budget.

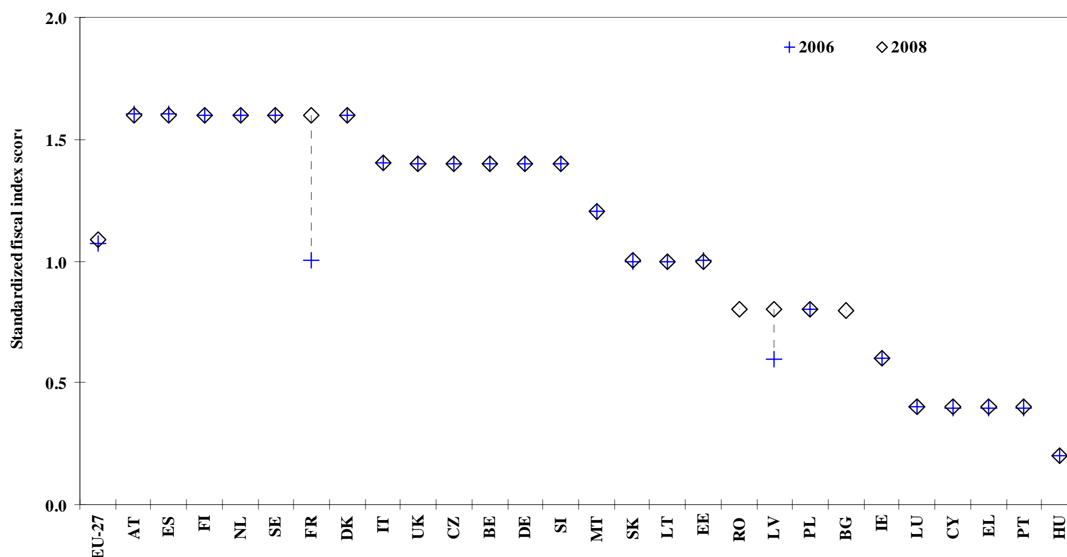
(iii) Involvement of national parliaments in the preparation of the medium-term budgetary plans.

(iv) Existence of coordination mechanisms between general government layers prior to setting the medium-term budgetary targets.

(v) Monitoring and enforcement mechanisms of multi-annual budgetary targets.

([1]) See the 2007 *Public finances in EMU* report for further details.

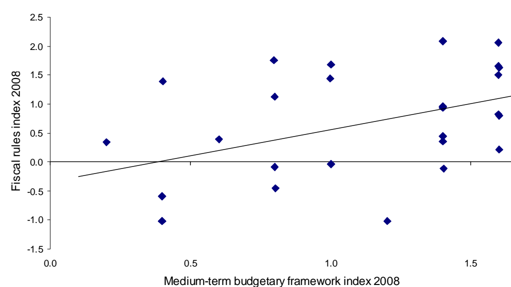
Graph II.4.7: **MTBF index scores and ranking in the EU27**



Source: Commission services.

Finally, although those countries with stronger MTBFs not necessarily also have strong fiscal rules, on average there is a positive relation between the quality of both fiscal arrangements as Graph II.4.8 shows.

Graph II.4.8: **Quality of medium-term budgetary frameworks and fiscal rules, 2008**



Source: Commission services.

4.5. CONCLUSIONS

Since the first surveys on fiscal frameworks conducted in 2005 and 2006, the number of EU Member States resorting to fiscal rules, independent institutions and MTBF has continuously increased.

The main changes experienced between 2005 and 2008 refer to fiscal rules. While few countries reformed existing rules, five countries, three of which are new Member States, introduced seven new fiscal rules. The use of revenue rules, which are particularly suited to deal with cyclicality of fiscal policy, remains scarce but the entering into force of revenue rules in France and Lithuania is a promising development. Another remarkable trend is the rising importance of fiscal rules that cover central and general governments. At the same time, budget balance rules continue to be by far the most popular type of rules in the EU. On the downside, scant independent monitoring and weak enforcement mechanisms remain the main shortcomings of current fiscal rules.

Fiscal institutions continue to be wide-spread in the EU-15 but are less common in new Member States. The creation of two new independent fiscal institutions in Sweden and Portugal was motivated by the need and desire to raise the transparency on fiscal policy making and thereby ensure the trust in medium-term policy decisions. While these institutions are responsible for assessing the underlying macroeconomic assumptions for the budget as well as monitor its execution and the adherence to medium-term budgetary plans, they do not provide binding macroeconomic forecasts for the budget. Actually, the use of fiscal council's

macroeconomic forecasts for the budget preparation is only effective in Austria, Belgium, the Netherlands and Slovenia. No new fiscal institutions have been formed in the new Member States, which largely rely on their independent central banks to also monitor fiscal policy and the Court of Auditors for a proper use of public funds.

Progress on MTBFs has been much slower than expected when judging the intentions for reforms expressed in recent SCPs. While several countries had foreseen framework reforms, only France adopted some significant changes. This explains why the quality index of domestic MTBF has remained unchanged in almost all EU Member States. As a result, the broad-based weaknesses in Member States' MTBFs identified in the 2006 survey still apply in 2008. These include poor monitoring mechanisms and lack of predefined measures in case budgetary developments depart from medium-term budgetary objectives.