3. NATIONAL FISCAL FRAMEWORKS

3.1. INTRODUCTION

The current economic crisis has called for huge fiscal efforts to avoid a deflationary spiral. This resulted in large structural deficits and growing debt ratios EU-wide, putting at risk fiscal sustainability. The resulting need for fiscal consolidation means that a well-designed fiscal policy exit strategy once the recovery is firmly underway is necessary. At the same time, to facilitate the exit and sustain budgetary consolidation, domestic fiscal frameworks need to be strengthened and adapted in the light of the lessons of the crisis. The importance of strong and resilient fiscal frameworks has been emphasised by the October 2009 Council conclusions on the fiscal exit strategy. Specifically, the Council stated that "*...important flanking policies to the fiscal exit will include strengthened national budgetary frameworks for underpinning consolidation strategies and support long-term sustainability*."

Domestic fiscal frameworks can be defined as the set of elements of the institutional policy setting that shape fiscal policy making at the national level. They comprise the arrangements, procedures and institutions governing the planning and implementation of budgetary policies. The main components of domestic fiscal frameworks are (1) numerical fiscal rules, (2) independent fiscal institutions (i.e., specific public bodies acting in the field of budgetary policy), and (3) budgetary procedures governing the preparation, approval, and implementation of budget plans. As part of the latter category, (4) medium-term budgetary frameworks (MTBFs) for multi-annual budgetary planning are specifically considered apart because of their importance in fostering medium term horizons for fiscal policies.

This chapter analyses what elements and considerations should be taken into account more carefully in designing resilient fiscal frameworks so as to support optimal policy-making during the needed fiscal retrenchment, to avoid repeating past policy mistakes in the period of expansion, and to promote the respect of the Stability and Growth Pact provisions. It is organised as follows. First, the stylised facts on the contribution of fiscal frameworks to budgetary consolidation are reviewed (section II.3.2). In the next section, a comprehensive overview of the main elements of domestic fiscal frameworks as well as different policy options for their strengthening are provided (section II.3.3). Next follows a discussion on how best to ensure the successful implementation of domestic fiscal framework reforms and the implications of recent institutional developments at both national and EU levels on the appropriate design of country-specific fiscal governance (section II.3.4). Thereafter, policy lessons are drawn from successful country experiences to outline an ideal fiscal framework (section II.3.5). Finally, a summary of the main arguments is provided (section II.3.6).

3.2. DID DOMESTIC FISCAL FRAMEWORKS PLAY A ROLE IN PREVIOUS CONSOLIDATION EPISODES?

In the past twenty years, a sizeable body of literature has elaborated on the determinants of successful fiscal consolidation. The first wave of these analyses – between the late 1980s and the mid-1990s –focused primarily on the composition of the adjustment and the role played by the political and institutional setting (such as coalition versus single-party governments and the prevailing electoral system). According to this research, successful fiscal consolidations were preponderantly expenditure-based, particularly through primary current expenditure cuts based mainly on public wages and transfers. Fiscal adjustments following this strategy were generally longer-lasting than those based on tax increases and investment cuts (Alesina and Perotti (1995), ibid. (1996), Alesina and Ardagna (1998)). More recent studies, based on the experience of EMU, have qualified these findings, highlighting the role of revenue increases as part of a successful mix of consolidation measures (European Commission (2007)). These findings are likely to reflect the specific situation in the run-up to EMU that prompted efforts to reduce the size of government and therefore reduced the margin to implement "easy" expenditure cuts on less sensitive spending programmes. At the same time, many countries faced sizeable fiscal adjustments to qualify for EMU, leading them to resort to tax hikes to supplement the expenditure containment efforts. Under those circumstances, the success of consolidation plans was particularly dependent on policy-makers' ability to maintain both expenditure cuts and revenue increases over time. These results are particularly relevant in the current scenario, in which the huge fiscal efforts required to restore budgetary discipline seem only attainable through a combination of measures.

Importantly, this recent research has also highlighted the prominent role that some elements of domestic fiscal frameworks seem to have played in the fiscal consolidation episodes since the early 1990s. While some research shows that fiscal rules have sustained fiscal discipline in a significant number of countries (Larch and Turrini (2008), Guichard et al. (2007)), other papers emphasise the importance of well-designed budgetary procedures in ensuring the centralisation of the budget formulation (von Hagen et al. (2002)). Other contributions have analysed the effect of specific characteristics of fiscal frameworks on budgetary performance. For example, countries implementing stronger rules over a larger share of general government finances are found to register better budgetary outcomes (Debrun et al. (2008)), whilst effective medium-term budgetary planning appears instrumental in sticking to budgetary plans (European Commission (2007)). The quality of domestic budgetary procedures is also shown to contribute to better budgetary performance (Fabrizio and Mody (2006)).

3.3. REVIEWING THE MAIN ELEMENTS OF FISCAL FRAMEWORKS: SOME GUIDELINES

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

3.3.1. Numerical fiscal rules

According to the most commonly agreed definition, numerical fiscal rules provide a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major component thereof (Kopits and Symansky (1998)). This definition thus excludes fiscal targets which may be revised frequently without any restriction, such as those included in most medium-term budgetary frameworks in many EU countries. The main objective of fiscal rules is to establish constraints on the use of policy discretion in order to promote sound budgetary policy-making. In 2008, there were 67 rules in place in EU Member States, of which more than one third were budget balance rules; debt and expenditure rules represented about one quarter each, and revenue rules accounted for less than 10%.

Recent research provides ample evidence on the influence of numerical fiscal rules on budgetary outcomes (Debrun at al. (2008); European Commission (2009)). The extent of this influence depends strongly on a number of features which have been extensively analysed (e.g. Bohn and Inman (1996)). The findings of this research suggest that elements such as the statutory basis of the rule, the monitoring of budgetary developments against the fiscal targets, and the existence of corrective mechanisms in case of non-compliance should be carefully taken into account in the design of fiscal rules to ensure their effective influence on the conduct of fiscal policy. According to available evidence, features related to the enforcement and corrective mechanisms are particularly relevant for the effectiveness of fiscal rules (Ayuso-i-Casals et al. (2009)). Box I summarises the key elements in the design of effective fiscal rules.

The influence of fiscal rules on fiscal outcomes can be seen under two angles: budgetary discipline and macroeconomic stabilisation. The contribution of fiscal rules to the first objective, improving fiscal discipline, is well-documented by a large number of country-specific consolidation episodes and confirmed by the literature (IMF (2009)). A potential drawback of their use, however, is their possible adverse effects in terms of weak macroeconomic stabilisation. In the design of rule-based fiscal frameworks, an appropriate balance between these two objectives needs to be sought. The following sub-sections sketch out the features of budget balance, debt, expenditure, and revenue rules and discuss their implications with regard to both fiscal discipline and stabilisation.

Budget balance rules

Budget balance rules are by far the most widespread fiscal rules in force across the EU Member States, accounting for twenty-six out of the sixty-seven fiscal rules in force in 2008. Recent empirical research suggests that budget balance rules are effective policy tools as, on average, they are linked to better budgetary outcomes – that is higher surpluses or lower deficits. They therefore seem to address satisfactorily the deficit bias and are generally appropriate in terms of budgetary discipline (Debrun at al. (2008)). However, they might entail risks for the quality of public expenditure. If no item is excluded from their coverage, fiscal adjustment may rely excessively on cuts to growth-enhancing, but politically less sensitive, expenditure categories (e.g., R&D spending). This has prompted some countries to introduce budget balance rules that exclude investment expenditure, so-called golden rules. In practice, though, this concept is difficult to operationalise, and conventional definitions offer scope for opportunistic behaviour to circumvent the rule (European Commission (2003)).

A major criticism of budget balance rules concerns their potential adverse effect on macroeconomic stabilisation. Specifically, budget balance rules defined in nominal terms (either in level or as a percentage of GDP but not cyclically-adjusted) may introduce a pro-cyclical bias in the conduct of budgetary policy.

The extent to which deficit rules interfere with the stabilisation function of fiscal policy depends on their design. For example, multi-annual deficit rules defined over the cycle are likely to be more stabilisation-friendly than budget balance rules operating on a single year basis. The most frequent problem of rules defined over the cycle is the correct assessment of the cyclical position of the economy. Alternatively, cyclically-adjusted budget balance rules may provide flexibility to account for the cycle while ensuring discipline. However, these rules are also vulnerable to uncertainties on the measurement of the output gap, which renders real-time monitoring difficult. Still, the current EU fiscal framework relies on cyclically adjusted medium-term objectives, not least against the background of recent improvements in the measurement of the cyclically-adjusted balance (see Larch and Turrini, 2009). In addition, some Member States such as Germany have recently implemented new budget balance rules following the same approach as at EU level.

Further complications of the stabilisation function of fiscal policy by budget balance rules arise from their distribution across levels of government. In the EU Member States, most of these rules apply to territorial governments; they are defined in nominal terms with annual time horizons, implying risks of pro-cyclicality. However, rules defined in cyclically-adjusted terms similar to those applied to general and central governments are hardly feasible at territorial level. Therefore, against the risk of pro-cyclicality, well-defined coordination mechanisms between the various levels of government are required. Coordination should be implemented during the preparatory phase of the budget process, and it should be based on a medium-term perspective that explicitly takes the implications of the sub-national rules for fiscal stabilisation into account.

An additional option to endow budget balance rules with flexibility to cater for cyclical fluctuations is the incorporation of escape clauses allowing the temporary suspension of the rule. This provisional suspension should be conditional on exceptional events such as natural catastrophes or a sharp output contraction. However, the definition of these escape clauses must be clear and confined to strictly specified circumstances in order to preserve credibility (see Box II.3.1). The GDP contraction experienced in 2008 and 2009 would presumably fall in any conceivable definition of exceptional circumstances.

A further possibility to counter the risk of pro-cyclicality is to supplement budget balance rules with the so-called "rainy day funds". Such stabilisation funds require that fiscal surpluses resulting from economic booms be set aside as contingency reserves that may be withdrawn during slowdowns to finance deficits. For the USA, where they are much more widespread than in the EU, such funds have been found to considerably reduce expenditure volatility and enhance the counter-cyclicality of fiscal policy (Hou and Moynihan (2008), Wagner and Elder (2005)). In the EU, however, the introduction of "rainy day funds" is discouraged by the definition of budget deficits adopted for assessing compliance with the rules forbidding excessive

Box II.3.1: Key elements in the design of fiscal rules

Statutory base: Ideally, any rule should be backed by strong legal provisions signalling the importance attached by the government to fiscal consolidation (e.g., a law of fiscal responsibility). The legal statutory base should clearly establish the requirements for amending the rule, in order to enhance credibility. It should also specify the monitoring mechanisms and the pre-established enforcement procedures in case of non- compliance.

Multi-annual character: Rules embedded into a medium term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances, and may facilitate the internalisation of the budgetary effects of current policies over the medium term. A multi-annual timeframe may limit the potential circumvention of the rule by postponing the recording of expenditures or the implementation of structural adjustments.

Accounting system: The use of the ESA95 methodology is consistent with the EU fiscal surveillance framework. However, data are more readily available on a cash basis. The need for timely monitoring therefore suggests a dual approach: a rule could be defined in cash terms with translation into ESA95 done on a quarterly basis.

Monitoring: The effectiveness of monitoring relies on two elements. First, in order to monitor compliance with the rule in an effective manner, updated and reliable data must be available. Where they are not, compliance can only be assessed with considerable delays. Second, an independent monitoring body is more likely to result in necessary adjustments of budgetary trends being implemented once they have been identified.

Enforcement mechanisms: The design of corrective and enforcement mechanisms is an important feature to ensure the proper functioning of fiscal rules. The actions to be taken in case of non-compliance should always be defined ex-ante so as to make the rule credible and enforceable. Otherwise, the cost of non-compliance would be only reputational, which is insufficient in the presence of acute fiscal distress and weak budgetary institutions. The enforcement of corrective measures ought to be ensured by a non-partisan institution, legally endowed with the requisite competencies. Monitoring and enforcement could be carried out by the same independent body.

Sanctions: In the case of non-compliance with the rule, pre-established sanctions may supplement the enforcement mechanisms. They may adopt two different forms. In developed nations, non-compliance sanctions typically apply to institutions, comprising fines, automatic withholdings of transfers, restrictions on debt insurance, etc. ([1]) In developing countries, personal sanctions prevail, including dismissal procedures, obligations to resign, fines, or lower wages.

Escape clauses: Well-defined escape clauses constitute a key feature of good fiscal rules. They specify the circumstances under which departures from the rule are admissible: usually these include natural disasters or acute economic slowdowns or recessions. Precise escape clauses may reinforce credibility, while vague and non-concrete clauses may render the rule ineffective. Overall, the definition of escape clauses requires particularly attention: they should only allow for a limited number of circumstances.

([1]) For example, in Spain the existing law establishes that in case the 3% deficit threshold of the EU fiscal framework is breached, all government layers have to contribute to the payment of a possible fine in proportion to their share over the overall deficit.

deficits. The introduction of such funds would therefore first require a review of the current ESA95 rules applied both at EU and national level. Then clear rules regulating the use of these funds would also be needed (see Balassone et al. (2009)).

Debt rules

In 2008, eighteen domestic debt rules were in operation across EU Member States; the large majority applied to sub-national governments.

They typically limit debt according to the debt repayment capacity measured by the debt service-to-current revenue ratio (Bernoth et al. (2004)). For higher levels of government, the target definition usually follows the EU debt threshold formulation, with a ceiling being set as a percentage of GDP. Given the challenge of debt reduction in the years ahead, debt rules may gain importance across the EU Member States.

Similarly to balance budget rules, debt rules are found to have a strong influence on fiscal discipline (Debrun et al. (2008)). Their effectiveness depends on the ambition of the target and on a number of design features, in particular monitoring and enforcement (see Box I). Besides possible adverse effects on the quality of public expenditure, the same potential shortcomings identified for budget balance rules with respect the stabilisation function of fiscal policy apply to debt rules. Debt rules which are embedded in a medium-term framework may be better able to take into account stabilisation concerns, thus limiting their potential pro-cyclical bias. In addition, strong policy coordination across government tiers when setting fiscal targets is the most appropriate way to offset possible pro-cyclical effects stemming from debt rules applied to sub-national authorities. The counter-cyclical stance of debt rules may be further enhanced by escape clauses and "rainy day funds".

Expenditure rules

In 2008, seventeen domestic expenditure rules were in place in the EU. They represent around one third of all fiscal rules and predominantly concern central governments and social security spending. Most of these rules are embedded into a medium-term budgetary framework.

Expenditure rules serve to address two frequent pitfalls in fiscal policy making: recurrent primary spending overruns and pro-cyclical budgetary policies. They foster accountability by targeting the part of the budget that is under more direct government control, particularly if specific items not fully under the influence of government, such as interest payments are excluded from their coverage. This strong accountability may promote not only the respect of the target but also transparency in the course of the budget process (Deroose et al. (2006)). Spending rules and limitations of their coverage bear similar problems with regard to the quality of public expenditure as do budget balance rules (see above).

However, expenditure rules are effective in sustaining fiscal discipline, as proven by their extensive use during large budgetary consolidations. Moreover, they are consistent with the stabilisation objective as well as they hardly prevent the automatic stabilisers from operating and they may curb pro-cyclical spending stemming from pressures in the presence of revenue windfalls in good times.

Admittedly, the functioning of this type of rules may also be associated with some pitfalls. For instance, a pro-cyclical bias could result if the expenditure target is defined as a share of GDP. In practise, this is however rarely observed. Another possible shortcoming of expenditure ceilings is the incentive to use tax expenditures for various policy objectives to which direct spending might be better suited. At worst, the result can be that large tax expenditures do away with a significant part of the benefits of spending restraint due to lower tax receipts, while at the same time these tax exemptions may be inappropriate policy instruments i.e. less targeted instruments for the ultimate purpose. Once significant tax expenditures have been introduced, it is politically very difficult to withdrawn them, which may eventually lead to an erosion of the tax base and a complicated tax system. This makes advisable to supplement spending ceilings with budget balance rules and/or clear regulations constraining the resort to tax expenditures.

Despites this potential disadvantages, expenditure rules represent the cornerstones of the most resilient domestic fiscal frameworks in some EU Member States, namely those of the Netherlands, Denmark, Sweden, and Finland.

Experience in these EU countries shows that binding spending ceilings can play a crucial role in the functioning of the whole fiscal framework (Kopits (2007)). Expenditure rules may also prompt the adoption or strengthening of sound budgetary procedures, such as top-down budgeting and more centralised budgeting processes. Well-designed expenditure rules appear decisive to ensure the effectiveness of budget balance rules

(Guichard et al. (2007)). Ideally, such rules should cover the whole of the general government sector, which requires proper coordination across levels of governments (see sub-section II.3.4.2). Such co-ordination could enhance ownership of fiscal targets and increase their respect, particularly in highly decentralised countries.

Revenue rules

Revenue rules are not common across national fiscal frameworks in the EU: in 2008, only six EU Member States had such rules.

Revenue rules can aim at a wide range of objectives relating to the revenue side of the budget, such as establishing a ceiling on the tax burden or constraining specific tax revenue developments. The most widespread objective is the avoidance of pro-cyclical policies. In the pursuit of this objective, an important issue is how to deal with budgetary revenues that exceed budgeted figures and forecasts. One possibility is to oblige fiscal authorities to specify the allocation of higher-than-expected revenues *ex ante* in the budget law. One obvious example is to allocate such revenues to the purpose of debt reduction, thereby mitigating expenditure pressures in good times. At present, France, Lithuania, and the Netherlands operate such revenue rules. However, only the latter systematically assigns unexpected revenues to deficit reduction. Other fiscal arrangements can, of course, supplement revenue rules to implement countercyclical fiscal policies during economic booms. For example, the previously mentioned "rainy day funds" can help resist political and social pressure to spend windfalls in good times. Finland is an example of a country operating such a fund for unemployment insurance contributions since 1999.

A crucial issue in the functioning of the above rules is how to distinguish transitory from permanent revenue increases. Here, the current economic crisis offers important lessons to be drawn in particular in connection with asset price increases (Joumard and André (2008)). Owing to the technical difficulties inherent in differentiating permanent from temporary revenues, higher than anticipated tax proceeds from booming property and asset prices were considered permanent in many cases. This allowed for additional public expenditure, leading to risk of pro-cyclicality and unsustainable fiscal policies. Spain is a telling example in this respect. Ex post analysis has shown that since the mid-1990s about half to three quarters of tax revenue increases it experienced were transitory and caused by the exceptional economic growth at the time. However, conventional techniques of cyclical adjustment overestimated structural revenues and provided an incorrect assessment of the fiscal stance at the time (Martinez-Mongay et al. (2007)).([55])

3.3.2. Independent fiscal institutions

- A complementary policy option to reinforce fiscal governance is the establishment of independent fiscal institutions (also called fiscal councils). These are non-partisan public bodies acting in the field of budgetary policy that are financed by public funds and are functionally independent vis-à-vis fiscal authorities. The definition excludes the central bank, government or parliament. These independent bodies are entrusted with some technical tasks relating to fiscal policy, such as the preparation of macroeconomic forecasts or the assessment of budgetary measures, while the final decision on budgetary targets and the fiscal stance remains under the sole authority of the elected government.([56])

In 2008, twenty seven independent institutions were established in seventeen EU countries. These public bodies have been contributing positively to

([55]) This experience once more highlights the importance of caution in the adoption of revenue projections for the budget preparation. It further underlines that the implementation of unfunded tax cuts or expenditure increases must be carefully considered, especially those that are difficult to revert. To guard against misreading revenue windfalls as durable improvements in the underlying fiscal position, changes are required in budgetary policy making that go beyond the institutional setting. In particular, in addition to debt and deficit data, the formulation of fiscal policy should be based on a follow-up of a wider set of indicators relating to fiscal space, such as the external deficit, competitiveness indicators, inflationary pressures, and so on. Moreover, expenditure projections should take into account long-term GDP growth prospects and an inflation target in line with the ECB price stability objective rather than over-optimistic scenarios extrapolating from transitory boom periods with buoyant revenues.

([56]) As a result, the type of independent public institutions considered in this section does not entail any delegation of the conduct of fiscal policy as suggested by some proposals in the literature (Wyplosz (2005)).

fiscal policy making through one or several of the following three channels.

- The provision of unbiased inputs for the annual budget preparation, such as macroeconomic forecasts on which budgetary projections are based.

- The provision of independent analysis on fiscal policy issues. This may include monitoring budgetary developments, assessing compliance with the existing fiscal rules and/or estimating the budgetary cost of specific policy measures.

- The issuing of regular assessments and recommendations relating to different aspects of fiscal policy, such as recommendations addressing long-term sustainability issues or proposals containing fiscal targets for the different tiers of general government.

In a number of cases, these institutions have been successful in disseminating their policy advice and effectively influencing the conduct of fiscal policy. Such successful institutions include the Netherlands Bureau of Economic Policy Analysis (CPB), the National Account Institute (NAI) and the High Council of Finance (HCF) in Belgium, the Institute of Economic Research (WIFO) in Austria, the Institute of Macroeconomic Analysis and Development (IMAD) in Slovenia and the recently established Swedish Fiscal Policy Council. In four of these cases (i.e. the CPB, the NAI, the WIFO and the IMAD), the government has entrusted the independent institutions with the provision of macroeconomic forecasts for the budget preparation. Overall, these public bodies enjoy a good reputation, which generally has been acquired through a long period of time and are highly respected by the political establishment.

In addition to the tasks mentioned above, new proposals to enhance the scope of the activities entrusted to independent fiscal institutions have recently emerged. In the aftermath of the economic crisis, the introduction of fast decision-making mechanisms to trigger measures for crisis prevention has been suggested, including mechanisms which aim to reduce the lags that usually constrain the effectiveness of discretionary policy. Examples of such mechanisms are clear escape clauses allowing the temporary suspension of fiscal rules in the presence of a marked deterioration of economic conditions, the specification of state-contingent one-off fiscal stimulus measures in consolidation plans to safeguard short-term growth, or predefined stabilisation measures automating the discretionary policy reaction to sharp cyclical fluctuations (Solow (2005)), Feldstein (2007)). National independent fiscal bodies could be involved in the implementation of such mechanisms by assessing the suitability and the timing of the measures foreseen – for example, whether and when to temporarily suspend fiscal rules, implement a one-off fiscal stimulus, or adopt any pre-established stabilisation measures – thereby counteracting the credibility risks that arise from political interference in their operation. In the European context any measures introduced by or due to independent fiscal institutions still have to comply with the Stability and Growth Pact. In addition, if independent fiscal institutions are given a role in implementing one-off stimulus measures, this raises the risk of asymmetric fiscal expansions. Such mechanisms should therefore be accompanied by appropriate measures for good times, to counter-act the risk of creeping debt accumulation. These could include "rainy day funds" to allocate revenue windfalls (see section II.3.3.1).

National independent fiscal institutions can also be instrumental in addressing credibility problems relating to budget balance rules defined in cyclically-adjusted terms or over the cycle. Technical difficulties in identifying the cyclical position of the economy and estimating the output gap as well as the shortcomings of preliminary data at the time when budgetary decisions are taken may harm the credibility of fiscal policy. One remedy might involve fiscal councils providing cyclically adjusted indicators and assessments of the fiscal room for manoeuvre.

Unlike fiscal rules, which can be operational immediately, the setting up of new fiscal institutions is less straightforward and more time is required until they are fully functional. First, the tasks assigned to these bodies generally require specific technical and methodological skills, which may be scarce in some countries, particularly in some small new EU Member States. In such cases, the assignment of tasks to the new institution should be preceded by an assessment of the available technical expertise to decide what technical tasks can be effectively delegated. Second, independent fiscal bodies usually need time before their mandate is completely developed: their performance has been found to improve from a long "learning by doing" process and, more importantly, time is also needed for the build-up of a reputation which is an essential asset of such institutions. For this latter reason, some proposals suggest to widen the mandates of existing institutions – provided that they have the capabilities and reputation to effectively play the role of a fiscal council – instead of setting up new fiscal bodies. This has been done with the courts of auditors in some EU Members such as the United Kingdom.

The actual establishment of national fiscal bodies depends on domestic institutional characteristics and preferences. Still, existing experience provides some useful guidance for the design of such institutions that focuses on the following elements. These are summarized in Box II.3.2.

Box II.3.2: Important elements in the design of independent fiscal institutions

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

- The mandate should ensure that the tasks assigned to the institution will be carried out on a regular basis and not only occasionally. Forecasts, monitoring tasks and assessments should be comprehensive and not limited to partial aspects.([1])

- Should the mandate include the provision of forecasts and/or monitoring tasks, the institution should be given access to internal information in the national statistical office, ministries and other governmental bodies.

- Finally, where the institution is entrusted with the enforcement procedures of fiscal targets and rules, the scope of the measures this independent body can take and the possible connections with the judiciary branch should be unequivocally specified in its mandate and supported by legal provisions.

Functional independence: A high degree of autonomy and functional independence vis-à-vis fiscal authorities are important preconditions to ensuring the institution is not hampered by political interference. This can be ensured by:

- Public financing, preferably stipulated in a legal text.

- Specific appointment procedures, particularly for the governing board, ensuring its functional independence.

Involvement in the budget process: The involvement of the institution in the budget process emerges as the most crucial element determining its influence on the conduct of fiscal policy. The arrangements in some EU countries have proved to be effective in conveying the policy messages issued by independent bodies. These include, for example, regular hearings in the parliament during the budget preparation, consultation by the government in the course of the budgetary process, or the obligation of fiscal authorities to justify departures from the forecasts or recommendations released by the institution. Delegation of macro forecasts for the budget preparation is an example of strong of involvement in the budget process. Country experiences show that independent forecasts result in more realistic macroeconomic scenarios being used to adopt policy decisions, with biases in the growth assumptions due to government optimism being reduced (Jonung and Larch (2006)).

([1]) For example, in some EU countries government revenue projections are provided by an independent body. However, these forecasts are based on the macroeconomic assumptions prepared by the government. This is likely to hamper the quality of the revenue forecasts as optimistic bias in the macro projections would reverberate into tax revenue forecasts.

3.3.3. Medium-term budgetary frameworks

Medium-term budgetary frameworks are fiscal arrangements whereby the horizon of fiscal planning is extended beyond the annual budgetary calendar. Their importance stems from the fact that most fiscal measures have budgetary implications going well beyond the yearly budgetary cycle. A well-designed MTBF reflects the impact of past budgetary commitments as well as the future cost of new policy measures. In 2008, twenty-two EU countries had a MTBF.

Medium-term budgetary objectives incorporated into a MTBF represent a weaker form of commitment than a rule including binding targets. Still, by shedding light on the future costs of ongoing policies, they may enhance fiscal discipline. They also facilitate monitoring by providing benchmarks against which budgetary developments can be assessed over time. Despite the country-specific character of these fiscal arrangements, the existing literature on MTBFs provides some guidance on the appropiate design of such frameworks. Box II.3.3 sumarises these desirable design features.

In addition to the elements contained in Box II.3.3 some succesful country policy experiences provide a number of valuable insights into how best to design MTBFs. Specifically, the two following elements are relevant.

First, complementarities between multi-annual expenditure rules and MTBFs should be exploited in order to adhere to medium-term budgetary objectives. In particular, expenditure rules cannot exclude risks related to the revenue side of public budgets, such as non-financed tax cuts or systematically upbeat revenue forecasts. Therefore it is advisable to supplement expenditure rules with medium term objetcives for the budget balance based on cautious growth assumptions and plausible revenue projections.

Second, MTBFs should preferably adopt the form of a fixed framework relying on binding spending ceilings. Fixed frameworks imply that budgetary objectives, for example spending targets, are set once for all and are not adjusted over time unless unexpected exceptional events arise during the period covered by the framework. Telling examples of this approach are the frameworks implemented in the Netherlands, Sweden, and Finland. Most of these MTBFs are based on a multi-annual spending rule providing binding expenditure limits. Fixed frameworks represent a constraint on discretionary fiscal policy and contrast sharply with flexible frameworks, which allow for (annual) target revisions according to policy changes.

Apart from the country examples mentioned in the previous paragraph, most MTBFs implemented in the remaining EU Member States tend to show some common shortcomings (European Commission (2009)). These include the non-binding character of the fiscal targets and their frequent revision, the lack of political commitment,([57]) unrealistic macroeconomic assumptions on which the budgetary projections are based, and the absence of independent monitoring and corrective mechanisms in case of deviation from the projected fiscal path. These weaknesses call for a reform of the MTBFs, especially given the need for time-consistent long-run consolidation plans under the present budgetary imbalances. While there is no one-size-fits-all design of an appropriate MTBF, experience suggests that the principles presented in Box III can be a useful starting point to strengthen the current MTBFs and ensure an effective medium-term fiscal planning.

([57]) In several EU countries, national parliaments only discuss the projected medium-term path together with the annual budget law and focus exclusively on the budgetary figures of the year ahead.

Box II.3.3: Key elements in the design of MTBFs

***Coverage*:** MTBFs should ideally cover the general government sector, or at least the central government plus the social-security sub-sectors, over a period of three or four years. A breakdown of the general government budgetary projections into sub-sectors should also be provided, particularly for highly decentralised countries.

Expenditure projections: As explained in the main text, effective MTBFs are usually based on binding expenditure limits. An appropriate breakdown of these projected spending ceilings according to the main expenditure areas is required in order to incorporate spending policy priorities and the envisaged expenditure adjustments in the medium-term fiscal planning.

***Revenue projections*:** Expenditure projections should be complemented by plausible revenue projections based on cautious macroeconomic assumptions. Similarly to the expenditure side, an adequate breakdown by main type of revenues should also be provided in order to show the budgetary impact of tax policy measures.

Analysis of departures from the envisaged fiscal path: The previous year's actual budgetary outcomes should be compared to the projections initially set out in the MTBF. Differences and deviations should be explained and justified. Likewise, measures implemented to offset deviations from the medium term path of fiscal projections should also be spelled out. All this information should be included in the MTBF documentation.

Macroeconomic assumptions: The baseline projections and the corresponding macroeconomic assumptions should be supplemented by the inclusion of alternative scenarios. This should allow the identification of budgetary priorities in case an unforeseen increase or decrease in revenues materialises, which in turn could also be instrumental in reducing the need to resort to ad-hoc supplementary budgets ([1]).

Accounting system: The correspondence between fiscal projections on a cash basis and their values based on ESA 95 concepts should be clearly specified. While the cash figures allow more timely monitoring, the corresponding ESA95 data increase transparency and the consistency of the current medium term budgetary planning in relation to the fiscal targets relevant for compliance with the SGP to be checked.

Input into the annual budget law: The projections and objectives included in the medium term framework should form the basis on which the budget law is prepared. In this respect, the role played by the Parliament in the MTBF preparation should be strengthened: the projected fiscal path, particularly the expenditure targets, should formally be presented, discussed and approved in the Parliament before the submission of the annual budget law. ([2])

Monitoring and corrective mechanisms: Monitoring mechanisms should be specified with respect to the frequency of assessments and the body responsible for undertaking these and corrective procedures pre-defining actions in case of deviations from the envisaged fiscal path should be clearly stipulated. Where a MTBF relies on a multiannual spending rule, these mechanisms should be closely linked to those for the monitoring the expenditure ceilings. The same institution should monitor and enforce both elements of the fiscal framework where these tasks are assigned to an independent body.

([1]) This specific aspect is closely linked to the introduction of a revenue rule pre-establishing the allocation of higher-than-anticipated revenues.

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

3.3.4. Budgetary procedures

Domestic budgetary procedures encompass all the procedural rules laid down in law covering the planning, approval and execution of the budget process. According to the literature, seven budgetary dimensions are conducive to the quality of the budget process (von Hagen and J. M. Poterba (1999) and A. Alesina and R. Perotti (1999)); these dimensions are set out in Box II.3.4.

Given the focus of the present review on the contribution of elements of fiscal frameworks to budgetary consolidation, below we focus on the three dimensions that are most relevant in this respect. These are transparency and realistic economic assumptions, budgetary centralisation, and top-down budgeting. Comprehensive information on the budgetary procedures in the EU Member States is available from the OECD dataset on the subject that includes 20 EU Members (the Baltic countries, Cyprus, Malta, Bulgaria and Romania are excluded); this dataset has been most recently updated in 2007. In terms of the dimensions of budgetary procedures discussed above, it shows the following.

First, concerning prudent economic assumptions and transparency, half of the EU countries surveyed do not have any independent review of the economic assumptions used in the budget preparation. Additional sources to the OECD database show that the EU Members not covered by the survey do not have any independent review of the macroeconomic assumptions for budgetary forecasts either. Importantly, one third of the EU countries surveyed by the OECD do not release the methodology used for establishing the economic assumptions to the public; this appears to be the case for the other seven EU countries as well. Also, only in three EU Members are the economic scenarios for budget preparation provided by independent bodies; in all other cases, they are descided upon by the respective ministry of finance or other governmental bodies.

Second, in terms of the degree of centralisation of the budget process, in two thirds of the EU countries considered in the survey and apparently in the countries left out as well, neither the minister of finance nor the prime minister have the final say to resolve disputes between spending ministries and the central budget authority. In twelve Member States out of the twenty, the legislature has unrestricted power to amend the budget proposed by the executive, including its overall size.

Third, as concerns the implementation of top-down budgeting, only a limited number of Member States impose a binding expenditure ceiling at an early stage of the budgetary planning. In the large majority of EU countries, overspending may occur before a supplementary budget law has been approved by the legislature.

Thus, in most EU Member States there is considerable scope for improvement of their budgetary processes along these three important dimensions. For the sake of unbiasedness, the elaboration of macroeconomic projections for budget preparation should be assigned to an independent body, as practiced by Belgium among others, where the National Accounts Institute provides a good example of an independent body being based on existing institutions and technical capabilities. Next, a higher degree of centralisation of the budget preparation should be considered a priority in countries exhibiting insufficient central control over the budgetary process. Stronger centralisation can be implemented by strengthening the fiscal rules and the medium term budgetary framework (including the implementation of binding spending ceilings in particular), or by reinforcing the role played by the minister of finance. This can include granting him or her a veto on spending decisions. Finally, the introduction of top-down budgeting should be considered an essential element of fiscal framework reforms. This can be expected to foster the centralisation of the budget process as well. In any case, the successful implementation of top-down budgeting goes hand in hand with the establishment of effective binding spending ceilings and the existence of a strong minister of finance.

Box II.3.4: **The seven dimensions of the budget process**

(1) Transparency: Transparency requires reliable and timely budgetary data, standard accounting practices, and a comprehensive coverage of the budget law. Transparency is crucial for the accountability of fiscal authorities.

(2) Multiannual budgetary planning: A medium-term budgetary framework provides the basis for fiscal strategies beyond the yearly budgetary cycle. It allows fiscal authorities to commit to a pre-defined path for the main budgetary aggregates and to take into account the multiannual budgetary impact of policies.

***(3) Budgetary centralisation at the planning and approval stages*:** As one of the most important dimensions of the budget process, budgetary centralisation heavily influences fiscal outcomes. Fragmented budget preparation by a large number of actors results in deficit bias because of the common pool problem.

(4) Budgetary centralisation at the implementation stage: During the execution of the budget, some decentralisation may be needed in order to better allocate resources. While the overall spending ceiling should always be respected, some flexibility in the distribution of resources among spending programmes might be appropriate.

(5) Top-down budgeting: This approach starts the budgetary planning with a binding ceiling on the total amount of resources to be distributed among expenditure areas and programmes. This is more conducive to fiscal discipline than the traditional bottom-up approach, where total spending is obtained as the sum of the individual expenditure requests of all ministries and agencies.

(6) Realistic economic assumptions and reserves: Prudent and plausible macroeconomic assumptions should avoid systematic overly optimistic budgetary projections. Reserve funds provide flexibility to deal with unexpected budgetary developments.

(7) Performance budgeting: This practice is based on the evaluation of spending programmes against the achievement of their policy objectives: resource allocation in the budget preparation is then based on the efficiency of past spending.

3.4. THE STRENGTHENING OF DOMESTIC FISCAL FRAMEWORKS: GENERAL CONSIDERATIONS

The findings summarised in the previous sections have given rise to a commonly accepted view that fiscal discipline needs to be backed by adequate domestic fiscal governance. National fiscal frameworks should therefore be reformed where necessary to provide the right incentives for fiscal policy making to favour sound and sustainable fiscal policies. Policy experiences show that the success of such reforms is subject to a number of preconditions. In addition, in the context of EMU, the reform of domestic fiscal governance must be consistent with Member States' commitments under the EU fiscal framework, while any reform also has to be adapted to the domestic institutional set-up and the degree of fiscal decentralisation in the country in question. The following sub-sections elaborate on these issues in more detail.

3.4.1. Preconditions for a successful reform of domestic fiscal frameworks

Reforms of fiscal frameworks have to address country specific fiscal problems within the specific national institutional and political setting. Therefore, there is no one-size-fits-all solution for their reform. When planning such a reform, the specific domestic circumstances to be taken into careful consideration. Nevertheless, experience provides important lessons about common elements, as discussed in the following paragraphs.

First and most importantly, the reform of fiscal governance must comprehensively address all the main institutional pitfalls. Partial or fragmented reforms usually fall short of delivering the expected improvements. For example, the establishment of an independent monitoring body and the introduction of fiscal rules are complementary rather than substitutive measures, displaying strong feedback effects. Policy-makers should pay attention to these interplays.

A second common element to all reforms is the need to secure the functioning of the most basic fundamentals of the fiscal framework. In particular, statistical reporting, accounting and monitoring issues must function up to minimum standards. A common standardised accounting methodology in the whole public administration and the regular availability of reliable budgetary statistics are key pre-conditions for well-functioning fiscal frameworks, as are regular monitoring and timely reporting of the main expenditure and revenue categories. Some EU countries currently suffer from these fundamentals being insufficiently developed. In this context, the appropriate sequencing of the reforms is also relevant: the strengthening of these fundamentals has to take place prior to the introduction of more elaborated elements such as constraining fiscal rules or medium-term fiscal planning. Failure to do so would render the latter ineffective.

Finally, explicit tools such as rules or medium-term budgetary frameworks do not substitute for political commitment to fiscal discipline. A strong political willingness to restore fiscal stability and a broad social consensus on the need to conduct sound fiscal policies must necessarily support the establishment of any reform to ensure its success.

3.4.2. Reforming domestic fiscal governance: national and EU perspectives

In the last decade, the management of the public finances in EU countries has been affected by two major changes in the economic and institutional setting. These are deeper European integration notably including the establishment of EMU, and progressive fiscal decentralisation in a significant number of EU Member States, which implies the assignment of greater fiscal powers to sub-national governments. The reshaping of national budgetary competencies has not only affected the conduct of fiscal policy domestically, but it has significant implications for the fulfilment of fiscal requirements at EU level as well. The Treaty and the SGP obligations apply to the general government as whole, i.e. to central, regional, and local governments, and the social security sub-sector. Against the background of growing decentralisation, the role of territorial governments in ensuring the respect of the SGP provisions has considerably increased. The close link between national fiscal governance and the fulfilment of Member States' commitments at EU level has been repeatedly stressed by the Council. The reform of national fiscal governance should thus take into account the growing budgetary decentralisation and its implications for sustained fiscal consolidation within the EU framework; fiscal relations across levels of government should be designed to promote stability-oriented policies. In this context, the following elements appear relevant.

First, the distribution of fiscal responsibilities across government tiers should be transparent. Transparency should apply to all stages of intergovernmental relationships. This implies that policy responsibilities across layers of government should be clearly established, to allow for the clear assignment of spending functions to government tiers and to avoid responsibility shifting. The distribution of expenditure powers should be accompanied by a stable financing system for territorial governments. The funding mechanisms should be based on transparent rules governing the transfers to sub-national authorities and the working of tax-sharing schemes. In addition, in accordance with their spending powers, a reasonable extent of tax autonomy should also be provided to lower levels of government, to avoid vertical fiscal imbalances. Transparency should also be present in the monitoring and enforcement mechanisms in force. Particular tasks might be assigned to state audit offices or other specific independent bodies. In this context, the timely availability of reliable budgetary data for the lower tiers of public administration is crucial.

A second feature to support a fiscal decentralisation process compatible with sound public finances concerns fiscal rules and independent fiscal institutions. All levels of government must respect spending limits to ensure budgetary discipline; fiscal rules serve to foster the respect of the prevailing institutional fiscal framework and to support policy makers' accountability. In turn, independent fiscal institutions can play a role in enhancing fiscal sustainability by promoting strong and efficient coordination across different layers of general government.

There is also a view that the disciplining effect exerted by financial markets could be more supportive to sound fiscal policies at all levels of government than fiscal rules. It is argued that as sub-national governments gain greater budgetary autonomy, they should also have access to domestic and international credit markets, which in turn could impose fiscal discipline through differentiated risk premia. This could reduce the need for fiscal rules. However, so far, experience shows that credit markets fail to exert disciplining pressure on sub-national governments; since these have only limited tax autonomy, they are receive to transfers from the central government. Just the possibility of these transfers may be considered by the markets an implicit guarantee of debt. Further, controls imposed by financial markets tend to be sudden and abrupt, imposing additional costs that would be best avoided. For these reasons, the market mechanism does not appear to be a suitable replacement for fiscal rules in terms of maintaining fiscal discipline at a territorial level.

One final element to ensure sound fiscal relations across levels of government is a fluent political dialogue supported by appropriate institutions. In this context, the commitment of all general government tiers to co-operate in such coordination is crucial. A disciplinary framework proven to foster co-ordination across levels of government is provided by the so-called "domestic" or "internal stability pacts" currently in place in several EU countries, notably Belgium, Italy, Spain, and Austria. In these countries, in spite of some obvious shortcomings (e.g., weak monitoring and enforcement mechanisms), domestic stability pacts and the rules or working agreements that assist their implementation have played an important role in coordinating government tiers' efforts to support the respect of the SGP.

3.5. IS THERE AN IDEAL MODEL OF FISCAL FRAMEWORKS?

When planning a reform of the national fiscal framework, it is important to consider the fact that policy setting will adapt to the particular specifications of the new framework and that how this will occur will depend on political, legal, and cultural factors. Therefore, no particular fiscal framework can be ideal for all countries. However, with a view to strengthening existing domestic frameworks, some common principles stemming from successful country experiences and reflecting the overarching objective to restore fiscal sustainability may be identified.

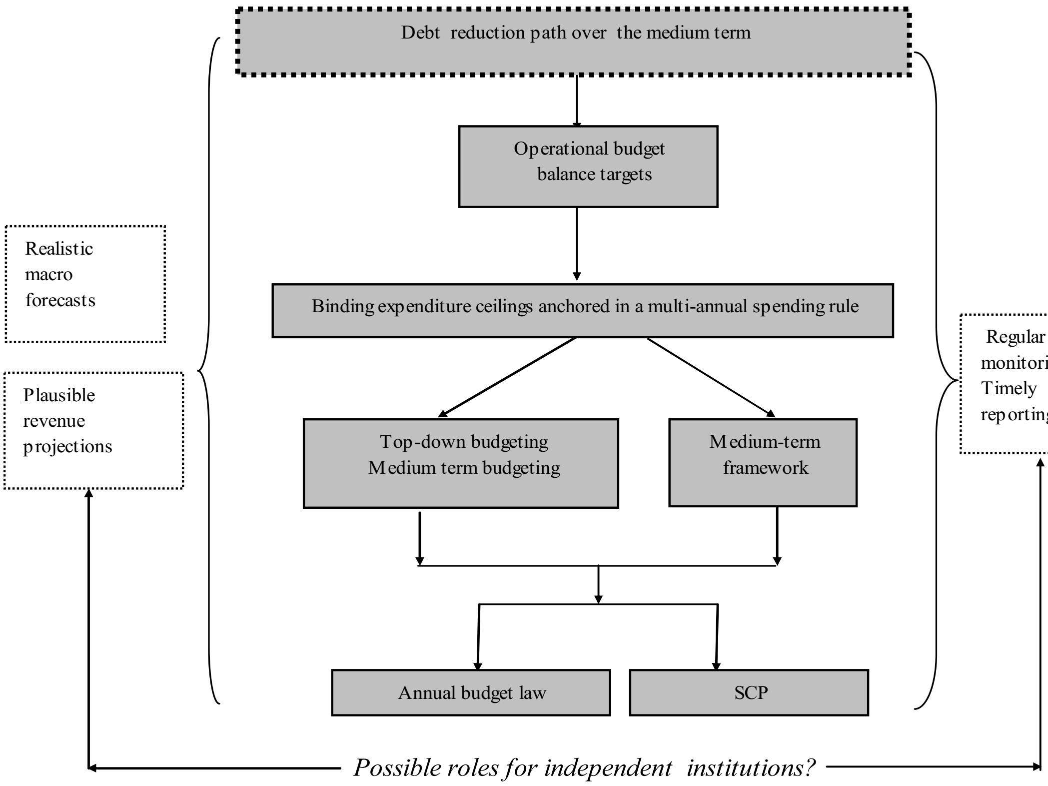
Specifically, multi-annual spending rules embedded into a MTBF have generally been adopted as a cornerstone of ambitious consolidation plans and are currently one of the main building blocks of the most successful and resilient domestic fiscal frameworks across EU countries. The Netherlands, Denmark, Sweden and Finland, which can be considered the most successful Member States in terms of fiscal discipline, have rule-based systems in place which are based upon an expenditure rule combined with revenue or cyclically adjusted budget balance rules. While in all of them the centralisation of the budget process is supported by these expenditure ceilings and top-down budgeting, the role played by independent fiscal bodies (e.g. the CPB in the Netherlands and the Swedish Fiscal Policy Council) is also crucial to enhancing transparency and promoting sound fiscal policies.

Following these countries' experiences, the following lessons concerning the interplay among the different targets and rules can be drawn to aid the reversal of unsustainable debt trends:

- Regardless of whether a debt rule is in place or not, the central objective of fiscal policy over the next years across the EU should consist in halting and reversing the growing debt ratio. This demands the formulation of a path for debt developments consistent with a prudently defined sustainability objective and macroeconomic scenario.

- The path for the evolution of the debt ratio should be underpinned by operational

Graph II.3.1: **Domestic fiscal frameworks based on the expenditure side**



Source: Commission services.

(primary) budget balance targets, which might be translated into a budget balance rule, ideally applying to the whole of the general government sector (or at least the central government and the social security sector). This should be consistent alongside the achievement of the medium-term objectives of the SGP.

- These budget balance targets should in turn be operationalised through binding expenditure ceilings based on a multi-annual spending rule for the general government. Expenditure thresholds would reflect the envisaged debt reduction path be based on cautious macroeconomic and revenue projections for the relevant period. The expenditure rule could be supplemented by a revenue rule to ensure that higher-than-expected receipts are allocated to debt reduction.

- Finally, a budget balance and/or debt rule consistent with the envisaged overall expenditure ceilings should be applied to sub-central governments.

The following illustration encapsulates the main relationships among fiscal rules and other elements of domestic fiscal frameworks according to this ideal model.

3.6. MAIN CONCLUSIONS

In the context of the current crisis, the huge fiscal effort put in place by EU countries seems to have helped avoid a deflationary spiral in the short term. However, the other side of the coin is that large structural deficits and growing debt ratios will have to be addressed in the next future. This places fiscal issues at the core of current and future policy initiatives to restore stability and promote a growth-oriented macroeconomic framework. In this context, well-designed domestic fiscal frameworks can enhance policymakers' commitment to a lasting fiscal consolidation and sustainable budgetary policies. The appropriate features of fiscal frameworks are, however, country specific and there are no one-size-fits-all solutions.

Despite the importance of these country-specific circumstances, economic analysis and policy experience provide a number of insights on how the main elements of domestic frameworks should be designed and implemented. The reform of these elements, namely numerical rules, independent fiscal institutions, medium term budgetary frameworks and budgetary procedures, should be regarded as a single process. All these fiscal arrangements are closely interconnected, and the functioning of one of them affects the working of the remaining elements. Partial or fragmented reforms usually fall short of providing the needed improvements. For example, the strengthening of fiscal rules and the upgrading of budgetary procedures are complementary rather than substitutive measures. Policy makers should be mindful of these interplays. With this in mind, the strengthening of domestic fiscal frameworks should focus on their four key elements.

First, national fiscal governance should primarily rely on a rule-based framework. There is a large body of empirical evidence suggesting that numerical fiscal rules can considerably strengthen fiscal discipline. While, in the end, their effectiveness depends on a number of characteristics and on the monitoring and enforcement mechanisms in particular, potential shortcomings relating to the stabilisation function of fiscal policy may be addressed by adequate design and target definition. This could involve rules defined on a cyclically adjusted basis or over the cycle. Expenditure rules exhibit a number of properties that could adequately tackle some of the observed pitfalls in the domestic fiscal policy making: recurrent spending overruns and the pro cyclical policies. Rule-based systems, consisting of an expenditure rule supplemented by a revenue rule and/or a budget balance rule, appear to have yielded positive budgetary outcomes in terms of both discipline and stabilisation in a number of EU countries (e.g. the Netherlands, Sweden, Denmark, and Finland).

Countries with a high degree of fiscal decentralisation should pay due attention to the interactions between their rules and how fiscal policy is implemented across government levels. In particular, most fiscal rules applied to territorial governments are budget balance or debt rules, which may imply a pro cyclical bias of fiscal policy. A feasible solution to address this shortcoming should be based on a close coordination of all government layers and on the adoption of a multi-annual perspective to take into account the effects of the cycle. This coordination should take place at an early stage of the budget process, and preferably when fiscal targets for all government tiers are set.

A complementary policy option to reinforce fiscal governance is the establishment of non-partisan public bodies acting in the field of budgetary policy. In some Member States, such as Belgium and the Netherlands, these institutions play an important role in promoting sound and sustainable fiscal policies. The main fields in which these bodies carry out their activities are the preparation of macroeconomic forecasts for the budget preparation, the analysis of budgetary developments vis-à-vis the respect of fiscal targets, and the estimation of the budgetary impact of specific policy measures.

A third policy option to reinforce national fiscal governance and supplement rules and institutions is the strengthening of national medium term budgetary frameworks for multi-annual fiscal planning. Most EU Member States currently have a MTBF in place. However, a large majority of them also display significant shortcomings that hamper the use of this fiscal arrangement as an effective policy instrument for time-consistent fiscal planning. These weaknesses mainly consist of the non-constraining character of fiscal targets (i.e. budgetary figures considered in the MTBFs are merely projections and are not binding), and a lack of political commitment. Likewise, budgetary projections are frequently based on unrealistic macroeconomic assumptions resulting in credibility problems. Finally, the absence of independent monitoring and regular reporting, together with the absence of corrective mechanisms further weaken the use of this fiscal arrangement. All these shortcomings should be addressed in order to render domestic MTBF an effective fiscal planning tool in the current context of fiscal consolidation measures over the medium-term.

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

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