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EDITORIAL

Four years on from the onset of the crisis, we still find ourselves in very challenging economic times. The economic recovery has not lived up to the expectations that existed at the time of the publication of last year's report. The EU is entering recession again and concerns over debt sustainability in some Member States, signalled by persistently high spreads in their sovereign bond yields continue to dominate the policy agenda. The vicious circle between sovereign debt and a still fragile banking sector added to the vulnerability.

Member States remain committed to the consolidation of their public budgets, both in this and coming years, as is evident from their medium-term plans. These show that despite the worsened macroeconomic outlook, Member States are sticking with their consolidation plans and will continue closing their deficits this year and next. The composition of consolidation in terms of the expenditure/revenue split and types of measures that are being implemented is broadly consistent with a credible consolidation supportive to medium-term growth. This is discussed in Part I of the Report. It shows that the significant increase in debt ratios seen since the start of the crisis alongside the still sizeable deficits mean that there is little scope for many Member States to ease off the fiscal tightening, despite the extra pressure that this might put on already faltering growth. Amid the debate about how best to continue to respond to the crisis, concerns have been raised that further fiscal consolidation amid weak growth prospects may have self-defeating effects on debt ratios. Part III presents a detailed analysis that highlights how such effects may arise but concludes that such cases are rather theoretical and anyhow short-lived under reasonable economic assumptions. The analysis shows that for a large negative response of growth to consolidation – as captured by a high value of the fiscal multipliers – such undesired effects would be quickly reversed unless these multipliers have a high persistence. This happens in cases where the fiscal adjustments are repeatedly non-credible or if effects on interest rates are large and negative, contrary to what is normally expected in consolidations. So, in order for the consolidation driven increase in debt to persist, a high degree of financial market myopia alongside an implausible negative reaction of interest rates to consolidation are required. Such a situation would happen if factors that cannot be modelled influence heavily the reaction of financial markets, for example if financial markets come to believe that consolidation will be reversed based on the consideration that the short-term negative impact on growth will make consolidation too unpopular. Simulations based on projections for the EU Member States confirm the expectation that any negative response of debt to consolidation will be quickly reversed, even for high debt countries.

As part of the response to the crisis, the EU has introduced a major overhaul of the EU system of economic governance. Economic and budgetary surveillance in the EU – and especially in euro area – has been largely reformed with the adoption of the legislative package known as the "Six Pack", which entered into force at the end of 2011. The new provisions that now apply put conditions on the debt level at the heart of the Stability and Growth Pact and will ensure that reducing the high public indebtedness that the crisis will have left behind is a key priority in Member States' fiscal policy setting. In addition, the introduction of an expenditure benchmark and the possibility of financial sanctions in the preventive arm of the Stability and Growth Pact will provide a framework that supports better fiscal policy-making when better economic times return, to ensure that the Member States public finances return to a position of underlying health. Despite these changes, increasing evidence of the scale of the spillovers between euro area countries has given impetus to the drive to further strengthen euro area economic governance. In November 2011, the Commission took a first step in this direction, proposing enhanced monitoring of budgetary policies of all euro area Member States as well as specific surveillance procedures for those experiencing financial stability risks. The Commission's proposals were followed by the signature of an intergovernmental Treaty by 25 Member States in March this year, committing the contracting parties to ambitious fiscal discipline including an appropriate mirroring of the core EU budgetary rule – namely, the requirement that each country's structural balance should be at its Medium-Term Budgetary Objective – in national legislation. The new architecture is not that of a perpetual fiscal austerity: after an initial effort to put their fiscal house in order, Member States have to ensure that their expenditure is financed. This should be normal practice to ensure sustainability of public finances but poses no constraints on the size or type of expenditure that governments undertake. All that is required is that there are sufficient revenues

to fund the spending programmes. The Report describes developments in budgetary surveillance in Part II.

In a phase of consolidation, there are concerns that the increasing devolution of tasks from central to subnational tiers of government may jeopardise aggregate fiscal discipline. Part IV of the Report characterises fiscal decentralisation arrangements in the EU from both the expenditure and revenue side, based on Eurostat data and country-specific descriptions. It shows through econometric analysis that fiscal decentralisation is not in itself harmful for fiscal discipline, as long as subnational governments predominantly finance their expenditures with their own taxes and fees rather than with transfers from the central government. Policy concerns should therefore not focus on decentralisation as such but on decentralisations that are not accompanied by subnational responsibility on the revenue side. It is not who undertakes the spending that is important, but whether those spending are also those who are accountable to taxpayers.

The reforms of fiscal governance adopted and proposed make the necessary budgetary consolidation at Member States' level more credible and equip the EU with much better tools to appropriately respond to future crises. Moreover financial backstops have been put in place since 2010 and progressively strengthened to guarantee the stability of the euro area, culminating in the adoption of a permanent crisis resolution mechanism, the European Stability Mechanism, in February of this year. While far-reaching, these measures still cannot solve all the current difficulties of the EU economies. While sound public finances are and will remain a cornerstone of the European Union's policy response to the crisis, complementary action on the fragile financial system is necessary. In this regard, the Euro Area Summit of 29 June affirmed that it is imperative to break the vicious circle between banks and sovereigns.. These are all steps towards the achievement of a genuine economic and monetary union, for which a specific and time-bound road map is being prepared.

Marco Buti

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SUMMARY

Recent economic developments have been worse than expected…

Following the deep contraction the EU economy went through in 2009 modest growth had returned in the third quarter of 2009 and with it came an expectation that albeit-slow return to normality had begun. While this seemed to be the case in 2010, by the end of 2011, the outlook had taken a downward turn. The expectation now is that real GDP will stagnate or go into slightly negative territory this year before picking up again in 2013 based on an appeasement of uncertainties linked to the situation in Greece and Spain. While there are some encouraging signs on the global stage in terms of the outlook for the world economy, the continued need for profound macro-economic adjustment as a consequence of the imbalances that have built up during the last decade in the public and private sector weigh heavily on the growth outlook.

…and the differences across countries are particularly marked

The macroeconomic environment is thus characterized by considerable variation within the European Union..In 2011, economic growth exceeded 3% in several Member States, but was negative in others like Greece, Portugal and Slovenia.

Despite disappointing growth developments, deficits have been reduced thanks to decisive expenditure-based fiscal consolidation plans….

Despite weaker growth in 2011 than forecast a year ago, overall public deficits were reduced thanks to strong consolidation efforts. In the euro area, the average general government deficit fell from 6.2% of GDP in 2010 to 4.1% of GDP in 2011, and a similar improvement also occurred in the EU27. Around half of this improvement was structural, indicating that consolidation measures and economic growth played a roughly equal role in reducing the deficit. The better budgetary positions in the euro area were primarily expenditure-based.

In the euro area, budget balances vary widely. While the highest deficit amounted to 13% of GDP (Ireland), two countries were able to bring their deficit below the 3%-of-GDP Treaty limit in a sustainable manner (Bulgaria and Germany). Yet, twenty one Member States remain subject to the Excessive Deficit Procedure.

…and are expected to shrink further in 2012 and 2013

Overall, the reduction in deficits is forecast to continue in 2012 and 2013. According to the Commission services' Spring 2012 forecast, public deficit is set to shrink to 3.8% of GDP in 2012 and then to fall further to 3.4% in 2013 for the EU as a whole. The combination of continued falling deficits alongside a widening output gap for 2012 means that overall the fiscal stance is expected to turn pro-cyclical this year, before turning counter-cyclical again in 2013 with the anticipated return of stronger growth, although in an environment of large and negative output gap.

The budgetary plans submitted by Member States show continued structural tightening over 2012 and 2013…

In view of the substantial debt increase induced by the crisis, the Member States plan for pursuing ambitious fiscal consolidation plans. Their Stability and Convergence Programmes (SCPs), which were submitted to the Commission and Council in Spring as part of the European Semester, show that they have broadly the same expectations on growth than the Commission. They broadly maintain their nominal fiscal targets in spite of the foreseen protraction of the cyclical slowdown currently underway. On aggregate, both the EU27 and the euro area are projecting that they will significantly improve their fiscal positions every year between 2011 and 2015, with the time profile of the consolidation being relatively front-loaded.

This overall pattern conceals considerable variation across Member States, with Ireland, Spain, Italy, Slovenia, Bulgaria, Latvia, Lithuania, Poland, Romania, and the United Kingdom showing the largest deficit reductions in their 2012 budgets.

The consolidation plans set out in the SCPs rely on large structural tightening. The average structural balance in both the EU27 and euro area should fall by over 3 percentage points of GDP over the four years from 2011 to 2015. For a number of Member States, the pace of consolidation tends to be more moderate as they move out of excessive deficits and embark on the adjustment path towards their medium-term objective (MTO). The marked structural improvement of around 1½ percentage points of GDP expected for 2012, as opposed to the planned structural tightening close to 1 percentage point in last year's SCPs, indicates that the Member States have generally undertaken additional structural adjustments, while macroeconomic conditions are less favourable.

…with the composition of the consolidations being broadly supportive of medium-term growth. This is in line with the overall long-term European growth strategy.

It is evident, that economic growth is a key concern: this is the reason why the EU, in line with its Europe 2020 growth strategy, proposed in the context of the European Semester, country-specific recommendations for the reforms that need to be undertaken to deliver stability, growth and jobs. However, the weak growth environment poses a challenge to fiscal consolidation. One element that plays a role in the relationship between growth and consolidation is the composition of the consolidation. Consolidations based on expenditure rather than revenues tend in general to be more lasting and more growth-supporting in the medium-term, but more recessive in the short-term. Indeed, the improvements in the budgetary positions in the euro area between 2010 and 2011 have been primarily engineered via expenditure restraint. However, this has been also achieved through phasing out the stimulus programmes of 2009, including reductions in public investment. According to plans set out in the SCPs, Member States project to base further fiscal consolidation on expenditure cuts, thus aiming at making it as durable as possible.

Growth affects deficits – but consolidations also affect growth – these two countervailing effects need to be balanced through an adequate design for consolidation.

The need to restore the credibility in the public finances and the danger posed by large deficits and debts are obvious and even more so now that growth prospects are looking weak again. However, while weak growth causes larger deficits, the effect of consolidation on growth must also be taken into account. As a country consolidates, in the short-term aggregate demand falls and this has a negative impact on growth before the positive impacts from reduced interest payments and reduced taxation kicks in.

The crisis years have driven debt up in the EU…

However, consolidation remains a must in view of the effect of several years of the worst economic and financial crisis since World War II on overall government debt figures. Deficits may be falling on average, but they remain significant, and public support to the financial system continues to drive up public debt. In 2011, the average debt-to-GDP ratio in the euro area reached 88% of GDP – some 20 percentage points higher than at the start of the crisis in 2007. Portugal, Spain, Greece and Ireland saw the highest increases in 2011. Further expected increases in debt in 2012 and 2013 point to a euro

area debt to GDP ratio of 92.6% of GDP by 2013, with a possibility of higher levels resulting from any further public interventions in the financial sector.

…to a point where some countries have faced market censure over their perceived ability to repay their debt.

A number of countries have faced strong pressure from financial markets, as doubts about their ability to finance their increased debt have led to unprecedented spreads on the interest rates on their sovereign debt. Within the euro area, Greece, Ireland and Portugal have been granted financial assistance, enabling them to access funds from outside the markets, subject to strict conditionality requirements. The case for strong and sustainable public finances no longer needs to be made – the events of recent times make the case for it evident.

The difficulty some countries have faced in accessing liquidity has led to the creation of financial backstops…

The aggravation of market tensions for some euro area countries led to the creation of financial backstops of last resort in order to safeguard stability of the euro area. The temporary firewalls that were gradually developed in the course of 2010 are currently providing financial support to Greece, Ireland and Portugal. At the end of 2010, the European Council decided to establish a permanent crisis resolution mechanism. Following technical and political decisions to enhance the mechanism's flexibility, euro area Member States signed a Treaty establishing the European Stability Mechanism (ESM) in February 2012. The strict conditionality attached to the financial support provided by all these mechanisms implied a significant strengthening of economic and fiscal surveillance on the Member States concerned.

…together with regulation for financial markets and more is in the pipeline

The supervisory and regulatory framework of the banking system also underwent significant reforms. A new EU financial supervisory framework became operational in January 2011. In response to G20 commitments, the EU continues its financial regulation programme notably by strengthening the capital requirements for banks and by presenting a European framework for bank recovery and resolution. The proposed framework sets out the necessary steps and powers to ensure that bank failures across the EU are managed in a way which avoids financial instability and minimises costs for taxpayers. Moving towards a genuine banking union based on a single banking supervision mechanism, the June 29 Euro Area Summit confirmed that the Commission would present proposals to that effect.

The crisis led to major overhaul of EU economic and budgetary governance

A major overhaul of the EU economic governance framework was proposed by the Commission in September 2010 and adopted by European Parliament and Council in the second half of 2011 (the so-called 'Six Pack'). With its entry into force in December 2011, the EU is now equipped with much stronger rules than before the start of the economic and financial crisis.

The "Six Pack" sets up a new macroeconomic imbalances procedure…

The Six Pack legislation has strengthened a wide range of existing aspects of economic governance and introduced new ones. A new Macroeconomic Imbalances Procedure has been set up to prevent or correct macroeconomic imbalances to reduce the risks of their unwinding resulting in sudden rises of government deficits and debt. In addition, the Six Pack introduced wide reforms to the Stability and Growth Pact (SGP) which sets out the provisions according to which the Treaty requirements to ensure fiscal discipline are implements. The SGP contains two arms – the preventive and the corrective – with the former setting the requirements for policy-making under normal circumstances and the latter dealing with the consequences of gross errors in fiscal policy making.

... reforms both the preventive and corrective arms of the Stability and Growth Pact...

As a result of the Six Pack legislation, the adjustment towards the medium-term budgetary objective, which is the core concept of the preventive arm of the SGP, has a new dimension, easier to monitor. While compliance was previously assessed by looking at a country's structural balance, a new expenditure benchmark has been added, which will allow an early detection and correction of unsustainable expenditure developments. In the years prior to the onset of the crisis, increases in expenditure were a key reason for a persistence of weak underlying public finances, which then left Member States with insufficient fiscal space to support their economies when the crisis hit. As for the corrective arm, in line with the Treaty envisaging both a deficit and a debt criterion to examine compliance with budgetary discipline, a debt-reduction benchmark has been established to allow the opening of an excessive deficit procedure (EDP) on the basis of an insufficiently diminishing debt-to-GDP ratio. Preceded by an assessment of the relevant factors, an EDP can now be launched for Member States whose debt exceeds 60% of GDP and does not comply with the numerical debt benchmark, even if they show a deficit below 3% of GDP.

....including a new toolbox of early and gradual enforcement mechanism...

The Six Pack also changed the provisions for enforcement of the SGP. For the euro area, enforcement is now ensured by an early and gradual system of financial sanctions, which can already be invoked in the preventive arm, in the case of inadequate measures to correct a significant deviation from the appropriate adjustment towards the MTO. Previously, the possibility of financial sanctions was limited to a very late stage of the corrective arm.

...and introduced minimum requirements for national budgetary frameworks.

The Six Pack also includes a new Directive on national budgetary frameworks aiming at promoting compliance with the SGP by introducing minimum standards for Member States' fiscal frameworks. Different frameworks can be compatible with EU budgetary framework, as long as their quality and the consistency of their rules is conducive to the achievement of the EU obligations. For this reason, the Directive requires only minimum standards, in particular with regard to accounting and statistics, forecasting, numerical fiscal rules, medium-term budgetary frameworks and transparency. But further initiatives have also been taken: in order to help countries that wish to go beyond the minimum requirements set out in the Directive, Member States also participate in an exchange of information in order to help identify best practices and provide examples of how to build stronger frameworks and institutions. The first meetings took place in November 2011.

Since the euro area shares enhanced spillovers new proposals for additional surveillance requirements for euro area countries and a new procedure for countries experiencing severe difficulties, are underway.

With the sovereign debt crisis intensifying over the course of 2011, the consensus in favour of deeper reforms, both at national and EU level, to support the euro area gained in strength and momentum. On 23 November 2011, the Commission proposed two regulations further strengthening the budgetary and economic policy surveillance requirements and processes for the euro area. The first proposal aims at enhancing monitoring of budgetary policies of euro area Member States, including provisions specific to euro area Member States subject to Excessive Deficit Procedure, to which stricter monitoring requirements apply. The second proposal concerns euro area Member States experiencing severe difficulties with regard to their financial stability or receiving a financial assistance on a precautionary basis.

The consensus for mirroring EU rules at national level is also behind the

signature of the Treaty on Stability Coordination and Governance (TSCG) that was signed by 25 Member States (all EU countries except the United Kingdom and Czech Republic) on 2 March 2012 and that is currently undergoing the process of ratification. The TSCG commits participating euro area countries to the Fiscal Compact which reinforces the obligation to reach the MTO already envisaged by the preventive arm of the SGP through national rules and automatic corrective mechanisms.

The adoption of these initiatives, has not, of course, solved the debt crisis. Whatever the extent of the improvement, a reform of the economic governance framework cannot suddenly solve a crisis which is fundamentally a (private and government) balance sheet problem. Overcoming the current crisis requires deleveraging in both the public and private sectors. The reforms adopted and proposed enhance the credibility of the planned fiscal adjustment and thus reduce its negative short term impact on real GDP growth and set up the framework for better policy-making in the years when growth has returned.

In the current juncture consolidation is inescapable in many EU Member States.

It has been however claimed in some corners that there are circumstances in which consolidation can lead to dynamics where consolidating may lead to increase rather than reduce debt-to-GDP ratios, at least in the short-term. In particular, such counter-intuitive dynamics would play out when the effect of a consolidation has such a negative impact on the economy, that government debt as a share of GDP increases significantly due to the shrinking of its denominator (other things being equal, as GDP falls, debt as a share of GDP increases). This then has the effect of increasing the interest payments in GDP and requires further consolidation which further increases the debt burden. Part III shows that this would be the case only under very restrictive assumptions.

The success or failure of a consolidation depends on the reaction of the economy and on the nature of the consolidation pursued.

The main factors driving the success of a consolidation in reducing the debt ratio are the value of the fiscal multiplier (which measures the reaction of the economic output to a budgetary expansion or consolidation by the government) and the reaction of sovereign yields to consolidation. The size of first-year multipliers is larger if the fiscal consolidation is based on government expenditures – and government investment in particular – if the measures taken are not credible and temporary, if agents are not financially constrained and if the monetary policy stance is such as to reduce real interest rates along with the fiscal shock. The negative output effects of consolidations are larger if consolidations are implemented at the same time worldwide. The composition of consolidation has an impact on long-term output with tax-based consolidations less supportive of long-term growth.

Estimating the parameters for the EU economies shows that counterintuitive effects of consolidation on debt dynamics are unlikely….

However, there is a growing understanding that fiscal multipliers are non-linear and become larger in crisis periods due to uncertainty about aggregate demand and credit conditions, the presence of slack in the economy, the larger share of consumers that are liquidity constrained, and to the more accommodative stance of monetary policy. Given these findings, it is reasonable to suspect that in the present juncture the multipliers for composition-balanced permanent consolidations are higher than normal. The simulations conducted show that it cannot be excluded that counter-intuitive effects on the debt ratio may arise under certain, very specific, strong

assumptions. Such short-term effects are countered if the immediate reaction of interest rates to consolidation is very large.

…and even so, they would be short-lived

These effects, however, can only arise, if several factors play out at the same time: the effects of consolidation on GDP would last various years, the deficit reduction would induce a large increase on average effective interest rates (contrary to what is normally expected and estimated in consolidations) the increase in risk premia induced by a higher observed debt ratio are ten times the average estimates and, finally, financial markets would suffer from a high degree of myopia. Simulations based on projections for the EU Member States yield the result that given these extreme assumptions, such debt-increasing effect of consolidations would in general be short-lived.

Consolidation efforts concern all the different levels of the general government…

Consolidation needs within the European fiscal framework is based on general government balance, which is the appropriate level as overall debt sustainability is the key element of the Stability and Growth Pact. This is the reason why budgetary targets set within the EU fiscal surveillance framework apply to the whole of general government. However, the responsibility for their achievement rests on central government only.In recent years, EU policymakers have increasingly raised the concern that the behaviour of subnational governments may be one of the factors hindering the achievement of budgetary targets at general government level. The necessity of consolidation and the implementation of minimum requirements for national budgetary framework have given prominence to the necessity of designing carefully fiscal rules for subnational authorities within EU Member States, especially against the trend towards increasing fiscal decentralisation across most of the EU from both the expenditure and revenue sides.

…and the recent increases in the decentralisation of government functions can make this more difficult, depending on the exact set-up of the relationship between central and subnational government.

Part IV documents that, albeit with some cross-country heterogeneity, this trend concerns also traditionally centralised countries, with common patterns emerging with respects to the functions that are more frequently devolved to subnational tiers. In many cases, functions that used to be centralized along with expenditures that have a markedly local dimension have been devolved – fully or in part – to subnational tiers of government. However fiscal responsibility has not always followed, as transfers from the central government tend to predominate over taxes as the main revenue source of subnational governments across the EU and truly autonomous subnational taxes are quantitatively important mainly in the more decentralised Member States. However subnational governments are often subject to fiscal rules, but, generally, default of subnational entities in fiscal distress is *de facto* ruled out, although central government 'bailout' often comes at the price of much tighter central control on subnational policies.

Fiscal decentralisation can adversely affect fiscal balances if financed predominantly through transfers from the central government and if not matched by subnational responsibility on the revenue side.

Part IV also investigates the relationship between fiscal decentralisation and fiscal outcomes of general government in the EU through econometric analysis. It appears that fiscal decentralisation is not harmful for budgetary discipline at the general government level per se, although it is likely to have an adverse effect if predominantly financed by transfers from the central government and if not matched by subnational governments having the responsibility for financing the expenditures through their own taxes and fees. This is in line with theoretical predictions underlining the risk of a 'soft-budget constraint' associated with a high reliance on transfers. Therefore, the policy concerns over possible adverse implications on budget balances should not focus on decentralisation as such but on a 'bad' design of decentralisation, i.e. one which is not accompanied by subnational financial responsibility. With respect to fiscal rules applying to subnational governments, borrowing rules appear to partly counteract the adverse effect of transfers on fiscal balances.

Part I

Current developments and prospects

SUMMARY

The recovery which had followed the worst economic crisis since World War II is now stalling with the euro area and the whole EU economy being estimated to have been in a mild recession over the last few months. After the deep recession in 2009 and the temporary rebound in 2010 followed by a still favourable beginning of 2011, GDP growth started to slow again in the course of 2011. In particular, the final weeks of the year brought about sluggish growth, tensions in many sovereign debt markets and banking sector fragility, which spread over the first months of 2012. GDP is expected to slightly decrease in 2012 in the euro area and to remain flat in the EU, with higher growth of the rest of the world leading to a slow recovery as of the second half of the year, assuming the resolution of present uncertainties in the sovereign and banking markets. Against this background, the Euro Area Summit of June 29 stressed the necessity to break the vicious circle between banks and sovereigns and supported a proposal for an effective single supervisory mechanism for banks in the euro area allowing the European Stability Mechanism (see box I.1.1) the possibility to recapitalize banks directly relying on appropriate conditionality. The introduction of such a novelty and the financial support to Spain will help the return to financial stability.

However, growth developments in the EU are now diverging more strongly across Member States than in previous years. In 2011, GDP growth ranged from high positive rates of over 3% in several Member States to negative growth in others. GDP growth is expected to be widely differentiated also in 2012, with a certain number of countries going back to negative growth.

The public finances continue to be heavily affected by adverse GDP and labour market developments and the majority of EU countries posted a 2011 government deficit above 3% of GDP, although Member States reduced deficits substantially in 2011. The euro area headline deficit decreased by two points to 4.1% of GDP, with a similar improvement registered in the EU as a whole. Within the euro area, all Member States posted improvements, with the exception of Cyprus and Slovenia but with highly differentiated budgetary positions. The stronger budgetary positions in the euro area were primarily due to a lower expenditure-to-GDP ratio.

According to the Commission services' Spring 2012 forecasts, the improvements in the budgetary positions are expected to continue, although downside risks remain and country-specific developments differ widely. The aggregate general government deficit for the euro area and the EU is expected to shrink by 0.9 percentage points to reach 3.1% of GDP (3.6% of GDP for the EU) in 2012 with a further improvement in 2013, despite the fact that the additional effect of high interest expenditures kicks in. As a consequence of continued structural fiscal tightening coupled with widening negative output gaps, in several EU Member States the fiscal stance is forecast to be pro-cyclical in 2012, albeit to a very different degree.

High budget deficits and overall modest real GDP growth with public interventions in the financial system continued to drive up public debt. In 2011 the debt-to-GDP for the euro area amounted to 88% (83.0% for the EU) 2.4 (2.8 for the EU) percentage points up on 2010. A further increase in debt in 2012 to 92.6% of GDP in the euro area (87.3% in the EU) by 2013 is projected in Commission services' Spring 2012 forecast. Moreover a high risk remains of further public intervention in the financial sector in certain countries. Public finance developments and outlook in the euro area and in the EU are analysed in Chapter I.1. Consolidation can have a negative short-term impact on aggregate demand, as discussed in more detail in Part III. However, consolidation is necessary in many EU Member States, especially those under a macroeconomic-adjustment programme or those under heavy pressure from the financial markets in order to avoid dangerously spiralling interest rates. It is therefore important that consolidation is done in a way that preserves growth prospects in the medium-term and accompanied by appropriate structural reforms.

Chapter I.2 focusses on the excessive deficit procedure (EDP) and describes the developments in the application of the Stability and Growth Pact (SGP) in the first year following the major reform strengthening EU fiscal governance which was approved by the legislator, in late 2011. Developments in this area reflect the fact that in 2011 the government deficit exceeded the 3% of GDP reference value in seventeen Member States.

The Council abrogated the Finnish EDP in 2011 and the Bulgarian and the German EDPs in 2012.

It is worth stressing that in the case of Hungary the Council took recourse in 2012, for the first time, to the possibility of suspending cohesion fund commitments following Hungary's non-compliance with its EDP recommendation. Such a decision was lifted by the Council upon the conclusion that Hungary had made adequate progress towards a timely correction of the excessive deficit.

Chapter I.3 provides an overview of the 2012 updates of the Stability and Convergence Programmes (SCPs) submitted by Member States in the context of the European Semester. As this round of SCPs and the related assessment is the first one based on the new provisions of the SGP, the Chapter provides, besides the examination of macroeconomic assumptions and budgetary objectives, an analysis of the SCPs also relative to the expenditure benchmark and the debt reduction benchmark.

In view of the persistent pressure on the euro area sovereign debt markets but also the less favourable growth assumptions, the February 2012 ECOFIN Council had reaffirmed the principle of differentiated fiscal exit strategies taking into account country-specific macro-financial situations. Together with the EDP recommendations, these principles represent the basis for the assessments of the programmes. In the context of the European Semester, the Council recommendations are expected to feed into the national budgets for 2013.

The overall picture emerging from the SCPs is one of stagnation of GDP growth in 2012, followed by some recovery in 2013, in line with the 2012 Commission Spring forecast. Relatively large differences are found only for Bulgaria and Sweden.

Member States plan to continue consolidating in spite of the foreseen protraction of the cyclical slowdown. On aggregate, both the euro area and the EU27 plan to improve significantly their fiscal positions every year between 2011 and 2015, with the time profile of the consolidation being relatively front-loaded. According to the SCP plans, the average structural balance in both the euro area and the EU27 should fall by over 3pps of GDP over the four years from 2011 to 2015.

For a number of Member States, the pace of consolidation tends to be more moderate as they move out of excessive deficits and embark on the adjustment path towards their medium-term objective (MTO). The marked average structural improvement of around 1½ pp of GDP expected for 2012, as opposed to the planned structural tightening close to 1 pp in last year's SCPs, indicates that the Member States have generally reacted to less favourable macroeconomic conditions with additional structural contractions. Further structural improvements of similar size are projected for the remainder of the programme period.

This overall pattern conceals however considerable variation across Member States, with Ireland, Spain, Italy, Slovenia, Bulgaria, Latvia, Lithuania, Poland, Romania, and the United Kingdom showing the largest deficit reductions already in their 2012 budgets. On average, the consolidations set out in the SCPs for both the euro area and the EU27 are primarily expenditure-based. Also the composition in terms of revenues is tilted towards indirect taxes, thus favouring medium-term growth.

The main risks are related to policy implementation as overall the national budgetary projections appear to rely on especially favourable assumptions on growth, revenue or expenditure in the cases of Belgium, Spain, France, Poland, Slovenia, Bulgaria, Lithuania, Sweden and the Netherlands, although, in the case of the last two Member States, favourable macroeconomic assumptions and optimistic expenditure projections are partially compensated by prudent estimates on the revenue side.

The SCPs project that in the euro area debt will reach 85% of GDP (80% in the EU) at the end of the programme period after having peaked in 2012. Hence, as long as the consolidation measures are not reversed after 2014, debt should be on a declining path for the years beyond the programmes' horizon. In all Member States except Denmark and Luxembourg, debt is projected to peak before 2015. However, in Spain and the United Kingdom, the projected reduction in 2015

is small and reaching back the pre-crisis debt levels is likely to take many further years.

According to the new rules accompanying the evolution towards the debt reduction benchmark established by the reform of the Pact (and detailed in Part II), the structural government balance in Member States whose current debt-to-GDP ratio is above the 60% threshold and that are currently in EDP, has to evolve so that it is guaranteed that the respect of the debt benchmark will be respected three years after the end of the EDP. According to the plans set out in the SCPs all Member State concerned by this transition period would implement structural adjustments large enough to ensure sufficient progress towards the debt reduction benchmark by the end of their transition period.

1. CURRENT DEVELOPMENTS AND PROSPECTS

1.1. A STALLING AND DIFFERENTIATED RECOVERY

The recovery which has followed the worst economic crisis since World War II is now stalling, with the euro area and the EU economy being estimated to have been in a mild recession over the last few months. In early 2012, thanks to determined policy responses and a strengthening of the institutional framework underpinning economic policy in the EU, tensions in financial markets receded and private sector confidence returned. These developments are now subject to the effects of the persisting concerns about the situation in the sovereign market and in the banking sector. Following an assumption that confidence will strengthen over time, as the challenges raised by the crisis are successfully addressed, including through the strong implementation of the agreed determined policy actions, an expected higher growth of the world economy is set to lead to a slow recovery taking off in the second half of the current year, and further accelerating in 2013. In other words, the recovery might be stalling only temporarily and would resume, under the condition that funding costs in vulnerable Member States and risks related to the overall policy environment can be kept in check. Forthcoming proposals towards a banking union should mitigate financial instability.

Graph I.1.1 shows the GDP growth projections according to the Commission services' Spring 2012 forecast. ([1]) For the euro area the graph shows a deep recession in 2009 with GDP shrinking by 4.3% followed by a recovery in 2010 (1.9%) and 2011 (1.5%) expected to stall in 2012 (0.3%). For the EU27, the pattern of GDP developments looks similar, output shrunk by 4.3% in 2009, grew by 2.0% in 2010 and by 1.5% in 2011 and is expected to stagnate in 2012. For both the euro area and the EU27, the outlook for 2013 is for a rebound of growth of 1.3% and 1.0% respectively, driven by external demand. However, in spite of encouraging signs pertaining to the overall situation of the world economy, concerns about fiscal sustainability in several EU Member States weigh heavily on the growth outlook, by adding uncertainty and presenting downside risks.

([1]) See Europen Commission (2012a).

Correspondingly, output gaps in the euro area and the EU are expected to widen again to reach the negative levels of –2.6 and –2.7 respectively; in both cases this is slightly worse than in 2010 when the corresponding gaps were –2.4 and –2.5. More details are given in Section I.1.3 below.

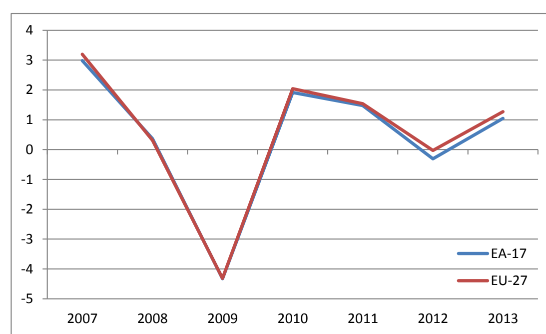
Growth developments in the EU are now diverging more strongly across Member States than in previous years. These wide disparities depend, *inter alia*, on different structural challenges and further domestic and external imbalances, with developments in competitiveness being particularly important. While some Member States are growing, others still remain in –or are re-entering – recession. In 2011, GDP growth ranged from high positive rates of over 3% of GDP in several Member States (Estonia, Lithuania, Latvia, Poland, Sweden, Slovakia, Austria and Germany) to negative growth in Greece, Portugal and Slovenia. Within each of these two categories there was again considerable variation, with the extremes being growth of 7.6% in Estonia and – 6.9% in Greece. In the large Member States, real GDP is expected to grow by between 2.7% in Poland and -1.8% in Spain this year. In Greece, Portugal, Spain, Italy, Slovenia, the Netherlands, Cyprus, Hungary, Belgium and the Czech Republic the output change is forecast to stagnate or to be in the negative territory, sometimes markedly.

The economic crisis has also had visible effects on the labour market. From the low of 7.6% in the euro area (7.1% in 2008), the euro area unemployment rate has risen rapidly, although reacting with a lag to real GDP developments. In the euro area it stood at 10.1% in 2010, to increase marginally to 10.2% in 2011 (EU27 at 9.7% in both years). Unemployment is expected to remain at the higher level of 11% in the euro area (10.3% in EU27) in both 2012 and 2013.

However, labour market developments differ markedly across countries, with weaker Member States hit by rapid deterioration of labour market and Member States with better growth observing an increase in employment levels. A very considerable deterioration in the labour market is expected in countries undergoing large-scale economic adjustments, while some others are set to experience some improvements, albeit of a mostly

limited order. Adverse labour market developments affect the sustainability of the public finances directly via the usual revenue and expenditure channels. Moreover, the current malfunctioning of credit markets in some Member States such as Spain further compounds the major policy challenge for the euro area and the EU economy to reduce unemployment.

Graph I.1.1: **Real GDP growth developments**



Source: Commission services.

1.2. SHORT-TERM DEVELOPMENTS AND PROSPECTS FOR THE BUDGET BALANCE

In 2011, the budgetary positions in the euro area and the EU improved significantly in comparison to 2010, when they had broadly stalled, and to the two preceding years where they had dramatically deteriorated. Table I.1.1 shows the budget balances for all EU27 countries from 2009 to 2013 on the basis of the Commission services' Spring 2012 forecast, while Table I.1.2 breaks down the general government balance for the euro area into its constituent parts over the years 2008 to 2013. As Table I.1.1 shows, the euro area average headline deficit came in at 4.1% of GDP in 2011, down from the 6.2% in 2010. This is still far above the historical low of 0.7% posted in 2007 before the outbreak of the crisis. As shown in Table I.1.2, the average general government deficit in the EU decreased by 2 percentage points reaching 4.5% of GDP in 2011. In both the euro area and the EU, the decrease in the headline deficit was matched by a decrease about half this size in the structural deficit – headline deficit net of cyclical factors and one-off and other temporary measures; by 1.0% and 1.1% respectively. This strengthening of the structural balance suggests that the improvement in the headline deficit was of both a structural and a cyclical nature, in roughly equal proportions.

Within the euro area, all Member States posted improvements in 2011, with the exception of Cyprus and Slovenia. The deficit was highest at 13.0% of GDP in Ireland, which had however experienced an unprecedented deterioration in the budget balance the year before. Several other Member States also posted significant improvements. Among these are Germany, Portugal and Slovakia. Improvements of between 1 and 2 percentage points of GDP were recorded in Greece, France, Malta and Austria. In all euro area countries except Germany, Luxembourg, Austria, Malta, Finland and Estonia, the deficit in 2011 exceeded the 3% of GDP reference value of the Treaty. Estonia is the only euro area Member State to have posted a surplus, of 1.0% of GDP.

According to the Commission services' Spring 2012 forecast, further improvements in the budgetary positions are expected in 2012 and 2013, although downside risks remain and country-specific developments differ widely. Against the current growth outlook, the aggregate general government deficit of the euro area Member States is expected to reach 3.2% of GDP in 2012, 0.9 percentage points lower than the year before. A further improvement to 2.9% of GDP is projected for 2013. Broadly the same profile is expected for the EU as a whole. The aggregate deficit is forecast to decline to 3.8% of GDP in 2012, from 4.5% in 2011, and to continue to decrease to 3.4% of GDP in 2013.

Table I.1.1: **Budget balances in EU Member States (% of GDP)**

	Budget balance					Structural balance					Structural primary balance				
	2009	**2010**	**2011**	**2012***	**2013***	**2009**	**2010**	**2011**	**2012***	**2013***	**2009**	**2010**	**2011**	**2012***	**2013***
BE	-5.6	-3.9	-3.9	-3.1	-3.3	-3.7	-3.2	-3.4	-2.7	-2.6	-0.1	0.2	-0.1	0.7	0.7
DE	-3.2	-4.3	-1.0	-0.9	-0.7	-1.3	-2.3	-0.8	-0.4	-0.3	1.4	0.2	1.8	2.1	2.0
EE	-2.0	0.3	1.0	-2.4	-1.3	-0.9	-0.5	-0.2	-0.8	-0.5	-0.7	-0.4	-0.1	-0.6	-0.3
IE	-14.0	-31.2	-13.0	-8.3	-7.5	-9.7	-9.6	-8.4	-8.1	-7.9	-7.6	-6.5	-4.9	-4.1	-2.4
EL	-15.6	-10.5	-9.2	-7.3	-8.4	-14.7	-9.0	-5.7	-2.9	-4.5	-9.6	-3.4	1.2	3.4	1.9
ES	-11.2	-9.3	-8.5	-6.4	-6.3	-8.7	-7.4	-7.3	-4.8	-4.8	-6.9	-5.4	-4.9	-1.6	-1.5
FR	-7.6	-7.1	-5.2	-4.5	-4.2	-6.2	-5.7	-4.1	-3.2	-2.9	-3.7	-3.3	-1.5	-0.6	-0.2
IT	-5.4	-4.5	-3.8	-1.9	-1.0	-4.0	-3.6	-3.6	-0.7	-0.1	0.7	1.0	1.3	4.7	5.5
LU	-0.8	-0.9	-0.6	-1.8	-2.2	1.3	0.5	0.4	-0.6	-1.4	1.6	0.9	0.9	0.0	-0.8
NL	-5.6	-5.0	-4.6	-4.4	-4.6	-4.1	-3.8	-3.5	-2.4	-2.5	-1.9	-1.8	-1.4	-0.3	-0.3
AT	-4.1	-4.5	-2.6	-3.0	-1.9	-2.7	-3.3	-2.4	-2.2	-1.8	0.0	-0.6	0.2	0.5	0.9
PT	-10.2	-9.8	-4.2	-4.7	-3.1	-8.6	-8.4	-6.2	-3.0	-1.3	-5.8	-5.6	-2.3	1.8	3.7
SI	-6.1	-6.0	-6.4	-4.3	-3.8	-4.4	-4.5	-3.9	-2.2	-1.9	-3.0	-2.9	-2.0	0.3	0.7
FI	-2.7	-2.8	-0.9	-1.0	-0.6	0.8	-0.5	0.6	0.3	0.3	1.9	0.5	1.7	1.5	1.6
MT	-3.8	-3.7	-2.7	-2.6	-2.9	-3.5	-4.4	-3.3	-3.5	-3.3	-0.4	-1.3	-0.2	-0.2	0.1
CY	-6.1	-5.3	-6.3	-3.4	-2.5	-5.9	-5.0	-5.5	-2.7	-1.7	-3.3	-2.7	-3.1	0.5	1.6
SK	-8.0	-7.7	-4.8	-4.8	-5.1	-7.7	-7.3	-5.1	-4.4	-4.6	-6.3	-5.9	-3.5	-2.5	-2.5
EA-17	**-6.4**	**-6.2**	**-4.1**	**-3.2**	**-2.9**	**-4.6**	**-4.4**	**-3.4**	**-2.1**	**-1.9**	**-1.7**	**-1.6**	**-0.4**	**1.1**	**1.4**
BG	-4.3	-3.1	-2.1	-1.9	-1.7	-3.1	-1.5	-1.0	-0.7	-0.8	-2.3	-0.9	-0.3	0.1	0.2
CZ	-5.8	-4.8	-3.1	-2.9	-2.6	-5.6	-4.6	-2.6	-1.8	-1.8	-4.3	-3.2	-1.2	-0.4	-0.3
DK	-2.7	-2.7	-1.9	-4.2	-2.1	0.6	0.1	0.2	-1.7	-1.0	2.4	1.8	1.9	-0.1	0.4
LV	-9.7	-8.1	-3.5	-2.1	-2.1	-6.6	-5.0	-3.2	-2.2	-1.7	-5.1	-3.5	-1.7	-0.6	0.1
LT	-9.4	-7.3	-5.5	-3.2	-2.8	-7.2	-5.1	-4.6	-2.9	-2.1	-5.9	-3.3	-2.8	-0.8	0.0
HU	-4.5	-4.3	4.2	-2.6	-3.0	-2.2	-3.6	-4.3	-2.1	-2.0	2.5	0.4	-0.2	2.0	2.1
PL	-7.4	-7.9	-5.1	-3.0	-2.5	-7.4	-7.5	-5.0	-2.8	-1.9	-4.8	-4.8	-2.3	-0.1	0.9
RO	-9.0	-6.8	-5.2	-2.8	-2.2	-9.6	-6.1	-3.3	-1.8	-1.2	-8.1	-4.6	-1.7	0.0	0.6
SE	-1.0	-0.1	0.1	-0.5	-0.1	2.5	1.1	0.1	0.3	0.4	3.5	1.9	1.1	1.4	1.5
UK	-11.4	-10.2	-8.3	-8.0	-6.9	-9.4	-8.8	-6.9	-6.9	-5.1	-7.4	-5.9	-3.7	-3.5	-1.6
EU-27	**-6.9**	**-6.5**	**-4.5**	**-3.8**	**-3.4**	**-5.1**	**-4.9**	**-3.8**	**-2.7**	**-2.2**	**-2.4**	**-2.2**	**-0.8**	**0.4**	**0.9**

Note: The structural budget balance is calculated on the basis of the commonly agreed production function method (see European Commission (2004)).
*Figure from Commission services' Spring 2012 forecast.
Source: Commission services.

Outside the euro area, the general picture conveyed by the Commission services' Spring 2012 forecast is one of continued deficit reduction. The Czech Republic, Denmark, Poland, Lithuania, Latvia and Romania are expected to bring down the general government net borrowing to 3% of GDP or below in either 2012 or 2013. Bulgaria is expected to continue running deficits below the 3% threshold over the forecast horizon, while in Sweden close-to-balance headline budgetary positions are projected for both 2012 and 2013. While a further substantial budgetary improvement of 1.6 pps. is forecast for the United Kingdom in 2012, the deficit is expected to fall only by 0.2 pp. in 2013. Due in part to the one-off accounting impact of pension reforms, the deficit in Hungary is forecast to revert to 2.6% of GDP in 2012, following a surplus in 2011.

The structural balance is estimated to improve in 2012 by 1.3 pps. of GDP in the euro area and 1.1 pps in the EU as a whole. For 2013, further limited improvements of the order of 0.2 pp. of GDP in the euro area and of 0.5 pp. in the EU as a whole are projected. The more limited reduction expected for 2013 is linked to the no- policy-change scenario underlying Commission services' forecasts, which implies that only measures that have been specified in sufficient details have been taken into account. In several EU Member States, namely Bulgaria, Belgium, the Czech Republic, Greece, Spain, Italy, Cyprus, Poland, Portugal, Romania, Slovenia, Slovakia, Sweden and the United Kingdom, fiscal policy is forecast to be pro-cyclically tightening in 2012, albeit to a very variable degree.

None of the euro area countries that had attained their medium-term budgetary objective (MTO) in 2008 managed to meet their MTO in 2010. In 2011 Finland was the only euro area Member State which had achieved its objective. Section I.1.3 considers the MTOs, which are set to be updated in 2012, in more detail. Structural fiscal positions are forecast to remain weak over the forecast horizon, and despite some improvements, very few EU countries will be near to attaining their MTOs in either 2012 or 2013.

Table I.1.2: **Euro area - The General government budget balance (% of GDP)**

	2008	2009	2010	2011	2012*	2013*
Total revenue (1)	45.0	44.8	44.7	45.3	46.2	46.1
Total expenditure (2)	47.1	51.2	51.0	49.4	49.4	49.0
Actual balance (3) = (1) - (2)	-2.1	-6.4	-6.2	-4.1	-3.2	-2.9
Interest (4)	3.0	2.9	2.8	3.1	3.2	3.2
Primary balance (5) = (3) + (4)	0.9	-3.5	-3.4	-1.1	0.0	0.3
One-offs (6)	-0.1	0.0	-0.7	0.1	0.1	0.0
Cyclically adjusted balance (7)	-2.9	-4.6	-5.1	-3.3	-2.0	-1.8
Cyclically adj. prim. balance = (7) + (4)	0.2	-1.8	-2.3	-0.2	1.2	1.4
Structural budget balance = (7) -(6)	-2.8	-4.6	-4.4	-3.4	-2.1	-1.9
Change in actual balance:	-1.4	-4.3	0.2	2.1	0.9	0.3
- Cycle	-0.6	-2.4	-0.1	1.1	-0.4	0.1
- Interest	0.1	-0.2	-0.1	0.2	0.2	0.0
- Cycl.adj.prim.balance	-0.9	-2.0	-0.5	2.0	1.5	0.2
- One-offs	-0.1	0.0	-0.6	0.8	0.0	-0.1
- Structural budget balance	-0.8	-1.8	0.2	1.0	1.3	0.2

Note: Differences between totals and sum of individual items are due to rounding.
*Figure from Commission services' Spring 2012 forecast.
Source: Commission services.

1.3. CONSOLIDATION CONTINUES IN THE EU

The previous figures are completed by the observation that the euro area primary balance is expected to be balanced in 2012 with the structural primary balance showing on average an improvement of roughly two and half points of GDP in only two years – the corresponding figure for the EU is of the same order of magnitude. While in some Member States fiscal exit had already started in 2010, in 2011 all EU Member States begun to withdraw the fiscal stimulus measures which they had put into operation in 2009–2010 to support their economies. As a result, the structural balance improved and is set to continue to do so in 2012, despite the inertia linked to the level of non-cyclical expenditure. Similarly, in 2011 the average headline deficit has decreased along with the shrinking of the negative output gap, and is also set to continue to do so in 2012.

These achievements are remarkable, since while the output gap was narrowing by more than one percentage point between 2010 and 2011, it is expected to widen in 2012 to reach again 2010 levels – as noted in Section I.1.1. Therefore the fiscal stance is expected to be pro-cyclical in 2012. However, according to the Commission services Spring 2012 forecast, the expected growth rebound in 2013 would narrow output gaps, thereby entailing a countercyclical fiscal stance.

Notwithstanding large differences across Member States, a restrictive fiscal stance stems from the fact that consolidation has become a necessity given the peak levels reached by debt from an historical perspective after the beginning of the financial crisis. Indeed the budgetary legacy of the economic and financial crisis of 2009–2010 has compounded already existing high debt levels in the EU. In some countries this has seriously put at risk fiscal sustainability. Thus overall, despite the short-term adverse effect on growth, consolidating in line with SGP requirements is the only option for many EU countries. ([2])

In particular, , as stipulated in conclusions of the ECOFIN Council from February 2012,([3]) Member States benefiting from a financial assistance programme should stick to the targets as agreed in the programme and should fully and timely implement the policy measures, including in particular structural reforms, agreed in the respective Memorandum of Understanding. Similarly, Member States facing close market scrutiny should continue to meet the agreed budgetary targets and stand ready to pursue further consolidation measures if needed.

The strain that the crisis left on government finances ([4]) is explained by three factors: the role of the automatic stabilisers in reaction to the crisis, the introduction of discretionary measures including the large-scale support to the financial

([2]) Successfully tackling the debt crisis as set out in the five-point plan of the Council of October 2011 requires further bold consolidation efforts along these lines.

([3]) The conclusions of the ECOFIN Council are available at http://www.consilium.europa.eu/press/press-releases/economic-and-financial-affairs?BID=93&lang=en

([4]) During the first phase of the crisis, between 2007 and 2009, the budget balance deteriorated from a deficit of 0.7% of GDP to 6.4% in the euro area and from 0.9% of GDP to 6.9% in the EU.

sector, and, in some Member States, the fall in revenues due to the bursting of housing and/or credit bubbles. This latter effect is significant in countries where, before the crisis, real estate bubbles temporarily masked an underlying fiscal weakness because the buoyancy of tax receipts depended heavily on real estate transactions. As these revenues plummeted the underlying weaknesses of fiscal positions showed up.

Automatic stabilisers ([5]) represented around half of the deterioration in 2009, and various types of support measures explain the other half. Many of these support measures then remained in place in 2010, when average headline deficits persisted at levels above 6% of GDP in the euro area and EU. The increases in deficits led to corresponding increases in debt. In addition, the debt ratios have risen substantially on the back of below-the-line operations in the context of the support to the financial sector. While this extra effect on debt measured as capital injections to banks accounted for less than 2% of GDP in 2009 in both the euro area and the EU, it has been rising continuously and reached around 3% of GDP at the end of 2011 in both the euro area and the EU([6]) with a very differentiated impact by country.

1.4. SHORT-TERM DEVELOPMENTS AND PROSPECTS FOR PUBLIC DEBT

Graph I.1.2 displays the increases in debt projected between 2007 and 2013. It shows that debt in the euro area is projected to rise from 66.3% of GDP in 2007 to 92.7% in 2013 and from 59.0% to 87.3% in the EU. Within these totals, there is considerable variation in both the starting levels of debt, which ranged from 3.7% of GDP in Estonia to 107.4% in Greece, and in the overall increases. By contrast, a decrease in public debt is forecast for Sweden. At the EU level, debt will not start to decrease before 2014.

Table I.1.3 shows that despite the impressive performance of the euro area and the EU in reducing government deficits, the contribution of the deficit to the increase in the debt ratio is still the largest, larger than the snowball effect. ([7])

At a country level, Member States with higher starting levels of debt are more likely to face both a snowball effect of debt and an increase in the interest rate as markets may doubt countries' ability to service their debt over the medium term. In the most difficult cases the country concerned might even be precluded from refinancing itself in the markets. For this reason, high levels of debt can increase the urgency to consolidate, even in spite of an unfavourable economic environment, if there is a realistic fear of a sovereign debt crisis. In these cases, there is no overall benefit from providing more support for the economy in the short-term, given the price that will be paid in terms of servicing the resulting debt. .

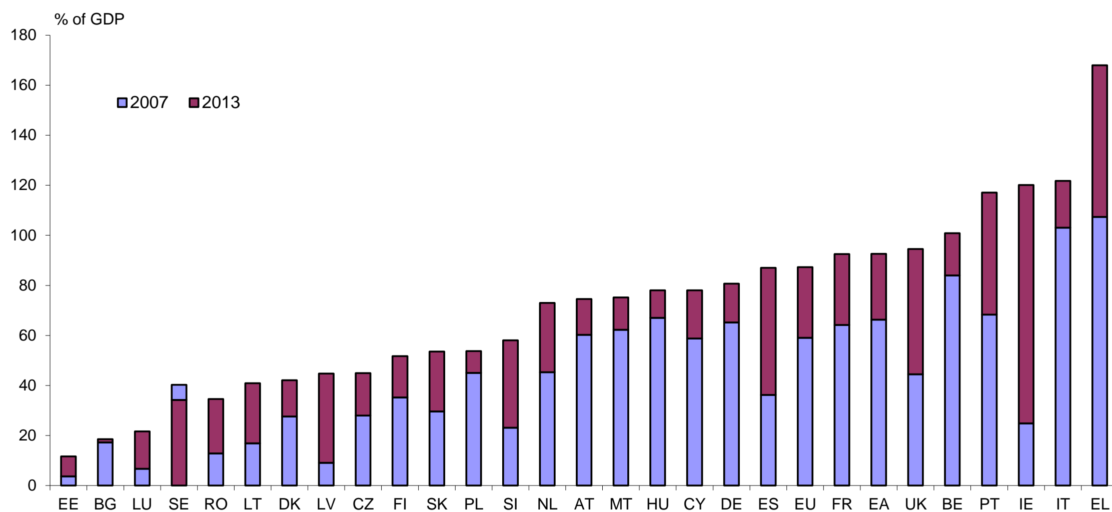
But high debt is not the only reason why markets may doubt a country's likelihood of repaying its debt. Other factors such as the outlook for growth in the medium term, the presence of macro-financial imbalance risks related to the overall policy environment are also key determinants of the reaction of financial markets.

([5]) The automatic stabilisers vary across countries in their size and composition. Overall, in bad times, governments receive less revenue from taxes while spending levels tend to rise due to an increased burden on the social security system. However, automatic stabilisation mainly works through the inertia of expenditure with respect to cyclical swings in output: their share in GDP increases 'automatically' in downturns and declines in upturns.

([6]) These are Commission services (DG ECFIN) elaborations based on a survey made by Member States within the context of the Economic and Financial Committee.

([7]) The snowball effect of debt stems from the interaction between the interest-growth rate differential and the debt level: if the difference between the interest paid on debt and the growth rate is positive – and it will in general increase with debt – the dynamics of debt are explosive and an increase in primary balances is required to escape from the resulting cycle.

Graph I.1.2: **Short-term fiscal impact of the crisis - general government debt**



Notes: 2012 and 2013 are forecast data. Differences between the sum and the total of individual items are due to rounding.
Source: Commission services.

The continually rising debt-to-GDP ratios reflect the still high budget deficits in certain countries, but also public interventions in the financial system. In 2011 the average debt rose by 2.4 percentage points relative to 2010 to 88% of GDP in the euro area, and by 2.8 percentage points to 83.0% in the EU27. Debt increases in Portugal, Spain, Greece and Ireland were particularly notable, with Greek debt increasing to an unprecedented 165.3% of GDP, resulting in private sector involvement in its containment. A further increase in debt to 92.7% of GDP by 2013 is projected in the euro area and to 87.3% in the EU, as primary deficits are coupled with a weak contribution from economic growth in 2012 and the additional effect of high interest expenditure, in some Member States in particular. There also remains the risk of further debt increases from further public intervention in the financial sector.

Part of the heterogeneity in the rise in debt is also due to sizeable differences across countries in public interventions in the financial sector. In the case of Ireland, government debt was among the lowest in the EU before the crisis, but is projected to reach 120.2% of GDP in 2013. Countries with large public interventions in the financial sector typically have large debt-increasing stock-flow adjustments in Table I.1.3.

On the whole, as new regulatory requirements strengthening the resilience of financial sector institutions are bearing fruit, the total current effective support level in the EU - measured as total aid to banks comprising also guarantees - has been declining from a peak of 13% of GDP in the Autumn of 2009 to 8% of GDP in early 2012. ([8]) That could signal certain financial sector recovery and reduced exposure of Member States to potential losses on the support provided. Nonetheless significant downside risks to public finances emanating from the financial sector do persist in some Member States.

([8]) See footnote (5).

Table I.1.3: **Composition of changes in the government debt ratio in EU Member States (% of GDP)**

	Gross debt ratio						Change in debt ratio	Change in the debt ratio in 2008-13 due to:		
	2008	2009	2010	2011	2012*	2013*	2008-3*	Primary balance	Interest &growth contribution	Stock-flow adjustment
BE	89.3	95.8	96.0	98.0	100.5	100.8	11.5	2.4	5.5	6.8
DE	66.7	74.4	83.0	81.2	82.2	80.7	14.0	-2.6	4.8	14.4
EE	4.5	7.2	6.7	6.0	10.4	11.7	7.1	3.7	-0.4	-3.8
IE	44.2	65.1	92.5	108.2	116.1	120.2	75.9	56.0	19.7	14.5
EL	113.0	129.4	145.0	165.3	160.6	168.0	55.0	20.2	51.9	4.7
ES	40.2	53.9	61.2	68.5	80.9	87.0	46.9	29.3	13.0	1.7
FR	68.2	79.2	82.3	85.8	90.5	92.5	24.3	15.9	5.2	2.0
IT	105.7	116.0	118.6	120.1	123.5	121.8	16.1	-8.0	20.6	3.2
LU	13.7	14.8	19.1	18.2	20.3	21.6	7.9	3.8	-0.5	13.9
NL	58.5	60.8	62.9	65.2	70.1	73.0	14.5	13.9	7.6	8.4
AT	63.8	69.5	71.9	72.4	74.4	74.5	10.7	2.7	4.7	6.3
PT	71.6	83.1	93.3	107.8	113.9	117.1	45.5	12.6	20.9	5.9
SI	21.9	35.3	38.8	47.6	54.7	58.1	36.1	16.5	10.4	2.7
FI	33.9	43.5	48.4	48.6	50.5	51.7	17.7	1.0	0.1	20.3
MT	62.3	68.1	69.4	72.0	74.8	75.2	12.9	-0.4	4.6	2.4
CY	48.9	58.5	61.5	71.6	76.5	78.1	29.2	9.9	8.7	-3.5
SK	27.9	35.6	41.1	43.3	49.7	53.5	25.6	21.8	2.5	-3.3
EA-17	**70.1**	**79.9**	**85.6**	**88.0**	**91.8**	**92.7**	**22.5**	**7.7**	**9.7**	**7.0**
BG	13.7	14.6	16.3	16.3	17.6	18.5	4.8	9.3	1.1	-4.7
CZ	28.7	34.4	38.1	41.2	43.9	44.9	16.2	12.2	5.3	-4.0
DK	33.4	40.6	42.9	46.5	40.9	42.1	8.7	4.9	4.5	14.2
LV	19.8	36.7	44.7	42.6	43.5	44.7	25.0	17.7	5.0	10.5
LT	15.5	29.4	38.0	38.5	40.4	40.9	25.4	19.4	3.2	1.8
HU	73.0	79.8	81.4	80.6	78.5	78.0	5.1	-11.1	9.5	5.1
PL	47.1	50.9	54.8	56.3	55.0	53.7	6.6	12.4	-1.2	-2.4
RO	13.4	23.6	30.5	33.3	34.6	34.6	21.2	18.0	0.8	0.2
SE	38.8	42.6	39.4	38.4	35.6	34.2	-4.6	-4.6	-0.2	3.0
UK	54.8	69.6	79.6	85.7	91.2	94.6	39.8	28.1	4.7	9.5
EU-27	**62.5**	**74.8**	**80.2**	**83.0**	**86.2**	**87.3**	**24.8**	**10.3**	**8.2**	**5.6**

Notes: Differences between the sum and the total of individual items are due to rounding.
*Figure from Commission services' Spring 2012 forecast.
Source: Commission services.

Aggregate figures tend to mask diverging developments at the country level. There are several Member States with low or very low pre-crisis debt levels, which however have been rising sharply until 2012. This group of countries includes Ireland, Spain and the United Kingdom, and, starting from lower levels, Latvia, Lithuania and Slovenia. Moreover, five euro area countries are expected to have debt above 100% of GDP by 2012. Italy already had a public debt-to-GDP ratio above 100% of GDP before the crisis. In Greece the extremely high debt ratio of 165.3% of GDP is also expected to remain at such high levels over the forecast horizon, reaching 168.0% of GDP in 2013 (under the usual no-policy-change assumption). In Ireland and Portugal the debt-to-GDP ratio exceeded 100% of GDP in 2011 and is set to continue growing, while in Belgium it is forecast to stand again at triple-digit levels from 2012 onwards (again under the no-policy-change assumption). Germany, France, Cyprus, Hungary, Malta, the Netherlands and Austria also had debt ratios above the 60% threshold in 2011 and further increases of these ratios are projected in all these countries except Germany and Hungary. Moreover, the debt ratio is projected to start declining in Italy, Poland and Sweden in 2013.

1.5. GOVERNMENT REVENUE AND EXPENDITURE: A WELL BALANCED CONSOLIDATION

The consolidation between 2009 and 2012 was reached via a relatively balanced composition of expenditure and revenue measures, with expenditures diminishing by broadly 1.8 percentage points of GDP and revenues increasing by 1.5 percentage points. In 2010 and 2011, the improvement in budgetary positions in the euro area was the result of a lower expenditure-to-GDP ratio rather than tax increases; the reduction in spending was also due to lower public investment. Table I.1.4 shows the main components of government revenue and spending for the euro area from 2008 to 2013. It shows that that the revenue ratio remained stable overall between 2009 and 2010, while expenditure fell. Despite the expectation of lower growth in 2012, a marked

Table I.1.4: **Euro area - Government revenue and expenditures (% of GDP)**

	2008	2009	2010	2011	2012*	2013*
Total revenue	**45.0**	**44.8**	**44.7**	**45.3**	**46.2**	**46.1**
Taxes on imports and production (indirect)	12.5	12.5	12.7	12.8	13.1	13.3
Current taxes on income and wealth	12.5	11.6	11.6	11.8	12.4	12.4
Social contributions	15.3	15.8	15.6	15.7	15.7	15.5
of which actual social contributions	14.2	14.6	14.4	14.5	14.5	14.3
Other revenue	4.7	4.9	4.8	5.0	4.9	4.9
Total expenditure	**47.1**	**51.2**	**51.0**	**49.4**	**49.4**	**49.0**
Collective consumption	8.0	8.6	8.4	8.2	8.1	7.9
Social benefits in kind	12.6	13.6	13.6	13.3	13.3	13.2
Social transfers other than in kind	16.0	17.6	17.6	17.4	17.5	17.5
Interest	3.0	2.9	2.8	3.1	3.2	3.2
Subsidies	1.2	1.2	1.4	1.4	1.3	1.3
Gross fixed capital formation	2.6	2.8	2.5	2.3	2.2	2.1
Other expenditures	3.7	4.4	4.7	3.7	3.7	3.8

Note: Differences between the sum and the total of individual items are due to rounding.
Expenditure figures are corrected for the difference between the definition of expenditures according to ESA95 and according to EDP rules. This mainly reflects the interest expenditures related to swap transactions.
*Figure from Commission services' Spring 2012 forecast.
Source: Commission services.

increase in revenues with stable expenditure ratios is being forecast

Moreover,the composition of revenue increases is not likely to weigh on labour and production – social contributions and current taxes on income and wealth are broadly stable over the period, while indirect taxes increase, a change in the revenue mix which is found to be growth-supportive in the medium term.

Table I.1.5 shows the expenditure and revenue ratios for all EU countries and shows, that, according to the Commission services' Spring 2012 forecast, the expenditure ratio in the euro area is expected to continue to decrease over the forecast horizon, while the revenue ratio is set to remain stable.

Table I.1.5: **Government revenue and expenditure (% of GDP)**

	Revenue					Expenditure				
	2009	**2010**	**2011**	**2012***	**2013***	**2009**	**2010**	**2011**	**2012***	**2013***
DK	55.2	55.1	56.0	54.5	54.7	57.8	57.6	57.8	58.6	56.6
EE	43.2	40.9	39.2	38.9	38.1	45.2	40.6	38.2	41.2	39.3
IE	34.8	35.6	35.7	35.8	35.5	48.8	66.8	48.8	44.1	43.1
EL	38.2	39.7	40.9	42.4	42.2	53.8	50.0	50.0	49.7	50.6
ES	35.1	36.3	35.1	36.0	35.7	46.3	45.6	43.6	42.4	42.0
FR	49.2	49.5	50.7	51.8	52.0	56.8	56.5	55.9	56.3	56.2
LT	34.3	33.7	32.0	33.5	33.1	43.8	40.9	37.5	36.8	36.1
MT	39.7	39.5	40.2	41.9	40.8	43.5	43.3	43.0	44.4	43.8
NL	46.0	46.2	45.5	46.3	46.1	51.6	51.3	50.2	50.8	50.8
PL	37.2	37.5	38.5	40.1	39.8	44.5	45.4	43.6	43.1	42.4
RO	32.1	33.4	32.5	33.4	33.2	41.1	40.2	37.7	36.2	35.4
SK	33.5	32.4	32.6	33.0	32.5	41.5	40.0	37.4	37.7	37.3
HU	46.9	45.2	52.9	46.1	44.6	51.5	49.4	48.6	48.6	47.6
IT	46.5	46.0	46.1	48.4	48.4	52.0	50.6	50.0	50.4	49.5
SI	43.2	44.2	44.5	44.4	44.0	49.3	50.3	50.9	48.7	47.9
UK	40.1	40.2	40.8	40.8	40.8	46.3	47.3	48.3	49.3	50.3
BE	48.1	48.9	49.4	50.9	50.4	53.7	52.7	53.2	53.9	53.7
BG	36.3	34.3	33.1	33.3	33.6	40.7	37.4	35.2	35.2	35.3
CZ	39.1	39.3	40.3	40.4	40.5	44.9	44.2	43.4	43.3	43.1
DE	44.9	43.6	44.7	44.7	44.4	48.1	47.9	45.7	45.6	45.2
CY	40.1	41.1	41.0	42.6	42.8	46.2	46.4	47.3	46.0	45.3
LV	34.7	35.7	35.6	36.0	34.9	44.5	43.9	39.1	38.1	37.0
LU	42.2	41.6	41.4	41.9	41.8	43.0	42.4	42.0	43.6	44.0
AT	48.7	48.1	47.9	48.4	48.6	52.9	52.6	50.5	51.4	50.6
PT	39.6	41.4	44.7	43.0	43.1	49.7	51.2	48.9	47.7	46.1
FI	53.4	52.7	53.2	53.6	54.3	55.9	55.2	53.7	54.3	54.7
SE	54.0	52.4	51.4	51.8	51.8	54.7	52.2	51.1	52.1	51.8
EA-17	44.8	44.7	45.3	46.2	46.1	51.2	51.0	49.4	49.4	49.0
EU-27	44.2	44.1	44.6	45.2	45.2	51.1	50.6	49.1	48.9	48.4

*Figure from Commission services' Spring 2012 forecast.
Source: Commission services.

2. IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

2.1. INTRODUCTION

The EU fiscal framework, as laid down by the Stability and Growth Pact (SGP), aims at ensuring budgetary discipline through two main requirements. Firstly, Member States are required by the Treaty to avoid excessive government deficit and debt positions, measured against reference values of respectively 3% and 60% of GDP(9). Secondly, they are required by the preventive part of the SGP(10) to achieve and maintain medium-term budgetary objectives (MTO), which are given as cyclically adjusted targets for the budget balance, net of one-off and temporary measures. Compliance with the MTO is meant to secure the sustainability of public finances and to allow the automatic stabilizers to work without breaching the 3% of GDP deficit threshold set by the Treaty.

The EU legislator, in late 2011, adopted a major reform strengthening the framework of EU economic governance, including EU fiscal surveillance, as presented in Part II. Steps in EU budgetary surveillance launched after this date are subject to the new rules including transition provisions.

This section reviews the implementation of budgetary surveillance since January 2011, focussing, in particular, on the excessive deficit procedure (EDP).

Following the marked deterioration of public finances in EU Member States in the wake of the severe economic recession of 2009, many Member States have undertaken fiscal consolidation efforts in 2010, including in particular efforts to correct excessive government deficits under the Stability and Growth Pact. The efforts were intensified in 2011 and led to a significant improvement of public finances in both the euro area and in the EU as a whole. Based on data notified by Member States and validated by Eurostat, in 2011 the government deficit exceeded the 3% of GDP reference value in seventeen EU Member States. This is somewhat better than previously expected: in Commission services' Autumn 2011 forecast still nineteen countries were projected to exceed this 3% of GDP reference value. However, not for all Member States that reduced the deficit-to-GDP ratio below the 3% threshold in 2011 the budgetary correction can be considered durable at this stage; in fact, based on Commission services' Spring 2012 forecast (11), in some of these countries the deficit-to-GDP ratio is expected to increase again above the 3% of GDP reference value in 2012 or 2013. As a result, the EDP abrogation cannot yet be considered for these countries.

As shown in Chapter I.1, according to the 2012 Spring forecast,(12) the process of fiscal consolidation is expected to continue in 2012 at a measurable pace with an estimated improvement of the structural budget balance in 2012 expected to be above 1% of GDP both in the EU and the euro area. The projected improvement of the budgetary situation in the EU is broad based across Member States. Only a limited number of countries would register an increasing headline deficit in 2012 and 2013, limit of the horizon covered by the Commission services' 2012 Spring forecast.

At the beginning of 2011, a number of Member States were assessed to have taken effective action in response to the recommendations to correct their excessive deficit recently addressed to them the Council. In the case of Greece, which is the only

(9) Article 126 of the Treaty lays down an excessive deficit procedure (EDP) which is further specified in Council Regulation (EC) No. 1467/97 'on speeding up and clarifying the implementation of the excessive deficit procedure', amended in 2005 and 2011, which represents the corrective arm of the SGP. The Code of Conduct provides specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes, and has been updated on 24 January 2012. Relevant legal texts and guidelines can be found at: http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm

(10) The preventive arm of the SGP is contained in Council Regulation (EC) No. 1466/97 'on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies', which was amended in 2005 and 2011. This Regulation specifies the obligation for the Member States to achieve and maintain their MTO. Together with Regulation (EC) No.1467/97 and the new Directive on requirements for budgetary frameworks of the Member States (Directive (EC) No. 2011/85) and Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, it forms the SGP.

(11) See European Commission (2012a).

(12) See footnote 9.

Member State currently subject to a notice under Article 126(9) to take (specific) measures to remedy the situation of excessive deficit, the review of the notices and the assessment of compliance with them occurred regularly, in parallel to the review of the macroeconomic adjustment program.

In the summer, on recommendation by the Commission, the Council abrogated the Finnish EDP. However, in autumn 2011, the comprehensive assessment of budgetary developments in all EU countries undertaken in the context of the Commission services' Autumn 2011 forecast revealed that a timely and sustainable correction was clearly at risk in some Member States, specifically in Belgium, Cyprus, Hungary, Malta and Poland, where the deadline for correcting the excessive deficit was imminent or close, that is 2011 or 2012. These five Member States were called to treat as a matter of urgency the adoption of a budget for 2012 and/or additional measures that ensure timely and sustainable correction of the excessive deficit.

As stated in the Communication issued on 11 January 2012, the Commission considered that the four Member States concerned (Belgium, Cyprus, Malta and Poland) had taken effective action towards a timely and sustainable correction of the excessive deficit.

At the same time, on recommendation by the Commission, the Council stepped up the EDP for Hungary in March 2012 and set a new deadline – 2012 – for bringing the general government balance below the 3% of GDP reference value of the Treaty.

As a follow-up of this new Council recommendation under Article 126(7), on 30 May 2012, the Commission adopted a Communication on the assessment action taken. .

In June 2012, on the basis of a Commission recommendation, the Council abrogated the decision on the existence of an excessive deficit for Germany and Bulgaria (see below).

Finally, also following a recommendation by the Commission, the Council addressed to Spain a revised recommendation under Article 126(7) on 10 July 2012. Spain is recommended to correct its excessive deficit by 2014. The Council established the deadline of 3 months for the Spanish government to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Currently, all EU Member States are subject to the EDP, except for Bulgaria, Estonia, Finland, Germany, Luxembourg and Sweden. For all countries under the EDP, except Spain, the procedure is now in abeyance. ([13])

Among Member States subject to the EDP, Greece, Portugal, Ireland and Romania are benefiting from financial assistance, while Spain, Cyprus and Hungary have recently requested financial assistance. Meanwhile, the Balance of Payment (BoP) programme for Latvia ended in January 2012.

2.2. THE EXCESSIVE DEFICIT PROCEDURE (EDP)

This section focuses on the implementation of the EDP since January 2011. The historical country-specific developments are summarised in Tables I.2.1.-I.2.3. ([14])

2.2.1. EDP in euro-area member states

Table I.2.1. shows the EDP steps taken for all euro-area countries except Greece, which is shown in Table I.2.2.

Proceeding in a chronological order, on 6 January 2011, the Commission assessed the action taken by Malta in compliance with the February 2010 Council recommendation to end bring the excessive deficit situation to an end and concluded that effective action had been taken. While acknowledging that the Maltese authorities had taken fiscal consolidation measures to correct the excessive deficit by 2011, the Council noted that in spite of a better macroeconomic environment than expected in the Council recommendations, there

([13]) Greece is subject to a notice by the Council under Article 126(9). See subsequent paragraphs.

([14]) All the country-specific developments regarding the excessive deficit procedure (EDP) can be followed at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

had been no acceleration in the reduction of the deficit in 2010, and that considerable downside risks existed to the achievement of the 2011 deficit target.

Malta notified a deficit of 2.7% of GDP for 2011. The Commission services' Spring 2012 forecast projected the government deficit at 2.6% of GDP in 2012 and 2.9% of GDP in 2013. The deficit was thus projected to remain below the 3% of GDP threshold over the forecast horizon, but very small margin. The Commission has not yet recommended to the Council to abrogate the decision on the existence of an excessive deficit, but the situation will be re-evaluated later in the year, subject to complementary information, including the results of the EDP dialogue visit to Malta conducted by Eurostat in May 2012. ([15])

In late January 2011, the Commission concluded that effective action had been taken by Cyprus and Finland in compliance with the July 2010 Council recommendations to correct the excessive deficit. On this basis, in mid-February 2011, the Council concluded positively on action taken by the two countries.

Following Finland's first notification of government deficit and debt data, which notably reported that the general government deficit had remained below 3% of GDP in 2010, and given the durability of the correction, showed in the Commission forecast of a deficit ratio below 3% in the two subsequent years, the Commission recommended to the Council to abrogate the existence of an excessive deficit. The Council closed the Finnish EDP procedure on 12 July 2011.

On 24 August 2011, the Commission concluded that Ireland had made adequate progress towards a timely correction of the excessive deficit, in response to the December 2010 Council recommendation to correct the excessive deficit situation, and that no further EDP steps were needed. Based on the Summer 2011 review of the financial assistance programme for Ireland, the government deficit in 2011 is expected to remain below the target outlined for that year in the EDP decision, and to reach the respective target for 2012. ([16])

In the case of Greece, the excessive deficit procedure runs in parallel to the macroeconomic adjustment program agreed between Greece and the Commission on behalf of the lenders, in liaison with the ECB and the IMF. ([17]) In the EDP context, the Commission has further assessed action taken in compliance with the February 2010 Council decision to give notice to Greece in February 2011. ([18]) Based on Commission recommendations, the Council adopted further amendments to its February 2010 decision to give notice (recast in July 2011) to the Greek authorities under Article 126(9) TFEU, in March, July and November 2011. Further amendments of this decision in March 2012 included a revision of the fiscal adjustment path, in particular in light of worse than previously expected economic performance and newly announced government measures for the reduction of the primary deficit, while leaving the deadline for the correction of the excessive deficit in 2014.

On 30 May 2012, following Germany's first notification of government deficit and debt data for 2011 which reported that the deficit-to-GDP ratio returned well below the 3% of GDP reference value, and given that, according to the Commission services' 2012 Spring forecast([19]), further improvements are expected over the forecast horizon, the Commission adopted a

([15]) In accordance with Council Regulation (EC) No 479/2009 on the application of the Protocol on the EDP annexed to the Treaty establishing the European Community.([16]) The excessive deficit procedure for Ireland runs in parallel to the macroeconomic adjustment program agreed between Ireland and the Commission on behalf of the lenders, in liaison with the ECB and the IMF. See the 'Memorandum of Understanding on Specific Economic Policy Conditionality' between the Commission and the Irish authorities that was signed on 16 December 2010.

([16]) The excessive deficit procedure for Ireland runs in parallel to the macroeconomic adjustment program agreed between Ireland and the Commission on behalf of the lenders, in liaison with the ECB and the IMF. See the 'Memorandum of Understanding on Specific Economic Policy Conditionality' between the Commission and the Irish authorities that was signed on 16 December 2010.

([17]) See Memorandum on Economic and Financial Policies and Memorandum of Understanding on Specific Economic Policy Conditionality (both 3 May 2010). All the documents related to the implementation of the EDP in the case of Greece can be found at: http://ec.europa.eu/economy_finance/sgp/deficit/countries/greece_en.htm

([18]) The noticed was revised in July, October 2011 and again in March 2012.

([19]) See footnote 9.

recommendation for a Council decision abrogating the decision on the existence of excessive deficit for Germany. On 19 June 2012, the Council decided to abrogate the excessive deficit procedure for Germany.

In the case of Spain, the Commission recommended on 6 July 2012 to the Council to adopt a new recommendation for correction of the excessive deficit adopted by the Council in 2009. In particular, it was recommended to extend Spain's deadline for correction of the excessive deficit by one year, to 2014. To this end, the Spanish authorities shall deliver an improvement of the structural balance of 2.7pp. of GDP in 2012, 2.5pp. of GDP in 2013 and 1.9pp. of GDP in 2014. The headline deficit targets should be 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP in 2014. This recommendation was made in view of the fiscal effort undertaken by the Spanish authorities and, in line with Article 3(5) of Regulation (EC) 1467/97, in response to a substantial deterioration of the country's economic situation and outlook, compounded by a less tax-rich growth composition, compared with the projection underpinning the earlier Council recommendation. The Council adopted this recommendation on 10 July 2012.

2.2.2. EDP in non-euro area Member States

Table I.2.1. shows the EDP steps taken for the non euro-area countries. Proceeding in a chronological order, in February 2011 the Council concluded that Bulgaria and Denmark had taken effective action in compliance with its July 2010 recommendation to end the excessive deficit, and that no further EDP steps were needed at that time. In its January 2011 assessment, the Commission had concluded, based on the Commission services' 2010 autumn forecast, that both countries had taken the necessary measures to correct the excessive deficit by the deadlines set by the Council. On 30 May 2012, on the basis of the Bulgaria's first notification of government deficit and debt data for 2011 stating that the deficit-to-GDP ratio returned below the 3% threshold and of the Commission services' 2012 spring forecast showing a further improvement of the budgetary situation over the forecast horizon, the Commission adopted recommendation for a Council decision to abrogate the decision on the existence of an excessive deficit. On 19 June 2012, the Council abrogated the excessive deficit procedure for Bulgaria.

In the case of Hungary, in its assessment of action taken of 11 January 2012, the Commission concluded that Hungary had not taken effective action in response to the July 2009 Council recommendation. While the general government balance was expected by the Hungarian authorities, based on the 2011 autumn EDP notification, and by the Commission services' 2011 autumn forecast, to turn into surplus in 2011 (which actually amounted to 4.2% of GDP), this was exclusively due to one-off revenues of almost 10% of GDP, linked to the transfer of pension assets from the private pension schemes to the state pillar. Moreover, according to the Commission services' 2011 autumn forecast, in 2012 the 3 % of GDP reference value of the Treaty would have again been respected thanks to one-off measures of close to 1 % of GDP, while in 2013 the deficit was expected to exceed the 3 % of GDP reference value. On the basis of the Commission's recommendation, the Council decided on 24 January 2012 that the country had not taken effective action in response to its recommendation to correct the excessive deficit situation of 7 July 2009.

On 13 March 2012, on a recommendation from the Commission, the Council adopted a new recommendation addressed to Hungary to end the excessive deficit situation by 2012, by requiring an additional fiscal effort, i.e. additional measures of a structural nature, of at least 0.5% in 2012, on top of the 1.9% of GDP already expected.

On the same date, the Council also adopted a decision suspending almost a third of scheduled commitments for Hungary from the EU Cohesion Fund in 2013, taking recourse, for the first time, to the possibility of suspending Cohesion Fund commitments in case of non-compliance with its EDP recommendation under Article 126(7) of the Treaty, according to Article 4(1) of Regulation (EC) No 1084/2006.

On 30 May 2012, the Commission concluded that Hungary had made adequate progress towards a timely correction of the excessive deficit, in response to the March 2012 Council recommendation to bringing an end to the excessive deficit situation, and that no further EDP

steps were needed. On the same date, the Commission also adopted a proposal for a Council decision to lift the suspension of the commitments from the Cohesion Fund, in accordance with Article 4(2) of Regulation (EC) No 1084/2006 establishing the conditions for lifting the suspension for the Cohesion Fund commitments, which the Council adopted on 19 June 2012.

Table I.2.1: **Overview EDP steps - Euro area Member States**

Table I.2.1: Overview EDP steps - Euro area Member States

Steps in EDP procedure	Treaty Art.	Country													
		IE	FR	ES	MT	BE	DE	IT	NL	AT	PT	SI	SK	CY	FI
Starting phase															
Commission adopts EDP-report = start of the procedure	126(3)	18.02.2009	18.02.2009	18.02.2009	13.05.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	12.5.2010	12.5.2010
Economic and Financial Committee adopts opinion	126(4)	27.02.2009	27.02.2009	27.02.2009	29.05.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.5.2010	27.5.2010
Commission adopts:															
opinion on existence of excessive deficit	126(5)	24.03.2009	24.03.2009	24.03.2009	24.06.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	15.6.2010	15.6.2010
recommendation for Council decision on existence of excessive deficit	126(6)	24.03.2009	24.03.2009	24.03.2009	24.06.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	15.6.2010	15.6.2010
recommendation for Council recommendation to end this situation	126(7)	24.03.2009	24.03.2009	24.03.2009	24.06.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	15.6.2010	15.6.2010
Council adopts:															
decision on existence of excessive deficit	126(6)	27.04.2009	27.04.2009	27.04.2009	07.07.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	13.7.2010	13.7.2010
recommendation to end this situation	126(7)	27.04.2009	27.04.2009	27.04.2009	07.07.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	13.7.2010	13.7.2010
deadline for taking effective action		27.10.2009	27.10.2009	27.10.2009	07.01.2010	02.06.2010	02.06.2010	02.06.2010	02.06.2010	02.06.2010	02.06.2010	02.06.2010	02.06.2010	13.01.2011	13.01.2011
fiscal effort recommended by the Council*		at least 1.5% of GDP in 2010-2013	at least 1% of GDP in 2010-2012	at least 1¼% of GDP in 2010-2012	-	¾% of GDP in 2010-2012	at least 0.5% of GDP in 2010-2013	at least 0.5% of GDP in 2010-2012	¾% of GDP in 2011-2013	¾% of GDP in 2011-2013	1¼% of GDP in 2010-2013	¾% of GDP in 2010-2013	1% of GDP in 2010-2013	at least 1½% of GDP in 2011-2012	at least 0.5% of GDP on 2011
deadline for correction of excessive deficit		**2013**	**2012**	**2012**	**2010**	**2012**	**2013**	**2012**	**2013**	**2013**	**2013**	**2013**	**2013**	**2012**	**2011**
Follow-up of the Council recommendation under Art. 126(7)															
Commission adopts communication on action taken		-	-	-	-	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	27.01.2011	27.01.2011
Council adopts conclusions thereon		-	-	-	-	13.07.2010	13.07.2010	13.07.2010	13.07.2010	13.07.2010	13.07.2010	13.07.2010	13.07.2010	15.02.2011	15.02.2011
Commission adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	11.11.2009	11.11.2009	11.11.2009	27.01.2010										
Council adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	02.12.2009	02.12.2009	02.12.2009	16.02.2010										
deadline for taking effective action		02.06.2010	02.06.2010	02.06.2010	16.08.2010										
fiscal effort recommended by the Council*		2% of GDP in 2010-2014	above 1% of GDP in 2010-2013	above 1.5% of GDP in 2010-2013	¾% of GDP in 2011										
revised deadline for correction of excessive deficit		**2014**	**2013**	**2013**	**2011**										
Follow-up of the NEW Council recommendation under Art. 126(7)															
Commission adopts communication on action taken		15.06.2010	15.06.2010	15.06.2010	06.01.2011										
Council adopts conclusions thereon		13.07.2010	13.07.2010	13.07.2010	18.01.2011										
Commission adopts recommendation for Council decision establishing inadequate action	126(8)	-													
Council adopts decision establishing inadequate action	126(8)	-													
Commission adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	03.12.2010		06.07.2012											
Council adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	07.12.2010		10.07.2012											
deadline for taking effective action		07.06.2011		10.10.2012											
fiscal effort recommended by the Council*		9½% of GDP over 2011-2015		**											
new deadline for correction of excessive deficit		**2015**		**2014**											
Follow-up of the NEW Council recommendation under Art. 126(7)															
Commission adopts communication on action taken		24.08.2011													
Council adopts conclusions thereon		02.09.2011													
Abrogation															
Commission adopts recommendation for Council decision abrogating existence of excessive deficit	126(12)						30.05.2012								29.06.2011
Council adopts decision abrogating existence of excessive deficit	126(12)						19.06.2012								12.07.2011

Notes: * Average annual fiscal effort, unless indicated otherwise.

Source: Commission sources.

Table I.2.2: **Overview EDP steps - Non-euro area Member States**

Steps in EDP procedure	Treaty Art.	Country								
		HU	UK	LV	PL	LT	RO	CZ	BG	DK
Starting phase										
Commission adopts EDP-report = start of the procedure	126(3)	12.05.2004	11.6.2008	18.02.2009	13.05.2009	13.05.2009	13.05.2009	07.10.2009	12.05.2010	12.05.2010
Economic and Financial Committee adopts opinion	126(4)	24.05.2004	25.6.2008	27.02.2009	29.05.2009	29.05.2009	29.05.2009	27.10.2009	27.05.2010	27.05.2010
Commission adopts:										
opinion on existence of excessive deficit	126(5)	24.06.2004	02.07.2008	02.07.2009	24.06.2009	24.06.2009	24.06.2009	11.11.2009	06.07.2010	15.06.2010
recommendation for Council decision on existence of excessive deficit	126(6)	24.06.2004	02.07.2008	02.07.2009	24.06.2009	24.06.2009	24.06.2009	11.11.2009	06.07.2010	15.06.2010
recommendation for Council recommendation to end this situation	126(7)	24.06.2004	02.07.2008	02.07.2009	24.06.2009	24.06.2009	24.06.2009	11.11.2009	06.07.2010	15.06.2010
Council adopts:										
decision on existence of excessive deficit	126(6)	05.07.2004	08.07.2008	07.07.2009	07.07.2009	07.07.2009	07.07.2009	02.12.2009	13.07.2010	13.07.2010
recommendation to end this situation	126(7)	05.07.2004	08.07.2008	07.07.2009	07.07.2009	07.07.2009	07.07.2009	02.12.2009	13.07.2010	13.07.2010
deadline for taking effective action		05.11.2004	08.01.2009	07.01.2010	07.01.2010	07.01.2010	07.01.2010	02.06.2010	13.01.2011	13.01.2011
fiscal effort recommended by the Council*		-	at least 0.5% of GDP in 2009/10	at least 2¾% of GDP in 2010-2012	at least 1¼% of GDP in 2010-2012	at least 1½% of GDP in 2009-2011	at least 1½% of GDP in 2010-2011	1% of GDP in 2010-2013	at least ¾% of GDP in 2011	at least 0.5% of GDP in 2011-2013
deadline for correction of excessive deficit		**2008**	**fin. year 2009/10**	**2012**	**2012**	**2011**	**2011**	**2013**	**2011**	**2013**
Follow-up of the Council recommendation under Art. 126(7)										
Commission adopts communication on action taken		-	-	27.01.2010	03.02.2010	-	-	15.06.2010	27.01.2011	27.01.2011
Council adopts conclusions thereon		-	-	16.02.2010	16.02.2010	-	-	13.07.2010	15.02.2011	15.02.2011
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	22.12.2004	24.03.2009			-	-			
Council adopts decision establishing inadequate action	126(8)	18.01.2005	27.04.2009			-	-			
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	16.02.2005	24.03.2009			27.01.2010	08.02.2010			
Council adopts NEW recommendation to end excessive deficit situation	126(7)	08.03.2005	27.04.2009			16.02.2010	16.02.2010			
deadline for taking effective action		08.07.2005	27.10.2009			16.08.2010	16.08.2010			
fiscal effort recommended by the Council*		-	beyond 1% of GDP in 2010/11-2013/14			at least 2¼% of GDP in 2010-2012	1¾% of GDP in 2010-2012			
new deadline for correction of excessive deficit		**2008**	**fin. year 2013/14**			**2012**	**2012**			
Follow-up of the NEW Council recommendation under Art. 126(7)										
Commission adopts communication on action taken		13.07.2005	-			21.09.2010	21.09.2010			
Council adopts conclusions thereon		-	-			19.10.2010	19.10.2010			
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	20.10.2005	-							
Council adopts decision establishing inadequate action	126(8)	08.11.2005	-							
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	26.09.2006	11.11.2009							
Council adopts NEW recommendation to end excessive deficit situation	126(7)	10.10.2006	02.12.2009							
deadline for taking effective action		10.04.2007	02.06.2010							
fiscal effort recommended by the Council*		-	1¾% of GDP in 2010/11-2014/15							
new deadline for correction of excessive deficit		**2009**	**fin. year 2014/15**							
Follow-up of the NEW Council recommendation under Art. 126(7)										
Commission adopts communication on action taken		13.06.2007	06.07.2010							
Council adopts conclusions thereon		10.07.2007	13.07.2010							
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	-								
Council adopts decision establishing inadequate action	126(8)	-								
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	24.06.2009								
Council adopts NEW recommendation to end excessive deficit situation	126(7)	07.07.2009								
deadline for taking effective action		07.01.2010								
fiscal effort recommended by the Council*		0.5% of GDP in cumulative terms in 2010-2011								
new deadline for correction of excessive deficit		**2011**								
Follow-up of the NEW Council recommendation under Art. 126(7)										
Commission adopts communication on action taken		27.01.2010								
Council adopts conclusions thereon		16.02.2010								
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	11.01.2012								
Council adopts decision establishing inadequate action	126(8)	24.01.2012								
Commission adopts recommendation for NEW Council recommendation to	126(7)	06.03.2012								
Council adopts NEW recommendation to end excessive deficit situation	126(7)	13.03.2012								
deadline for taking effective action		13.09.2012								
fiscal effort recommended by the Council		at least 0.5% of GDP on top of the 1.9% of GDP foreseen								
new deadline for correction of excessive deficit		**2012**								
Follow-up of the NEW Council recommendation under Art. 126(7)										
Commission adopts communication on action taken		30.05.2012								
Council adopts conclusions thereon		19.06.2012								
Abrogation										
Commission adopts recommendation for Council decision abrogating existence of excessive deficit	126(12)								30.05.2012	
Council adopts decision abrogating existence of excessive deficit	126(12)								19.06.2012	

Notes: * Average annual fiscal effort, unless indicated otherwise.
Source: Commission sources.

Table I.2.3: **Overview EDP steps - Greece**

Steps in EDP procedure	Treaty Art.	EL
Starting phase		
Commission adopts EDP-report = start of the procedure	126(3)	18.02.2009
Economic and Financial Committee adopts opinion	126(4)	27.02.2009
Commission adopts:		
opinion on existence of excessive deficit	126(5)	24.03.2009
recommendation for Council decision on existence of excessive deficit	126(6)	24.03.2009
recommendation for Council recommendation to end this situation	126(7)	24.03.2009
Council adopts:		
decision on existence of excessive deficit	126(6)	27.04.2009
recommendation to end this situation	126(7)	27.04.2009
deadline for taking effective action		27.10.2009
fiscal effort recommended by the Council		-
deadline for correction of excessive deficit		**2010**
Follow-up of the Council recommendation under Art. 126(7)		
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	11.11.2009
Council adopts decision establishing inadequate action	126(8)	02.12.2009
Commission adopts recommendation for Council decision to give notice	126(9)	03.02.2010
Council decision to give notice	126(9)	16.02.2010
deadline for taking effective action		15.05.2010
fiscal effort recommended by the Council		at least 3½% of GDP annualy in 2010 and
new deadline for correction of the excessive deficit		**2012**
Follow-up of the Council decision		
Commission adopts communication on action taken		09.03.2010
Council adopts conclusions thereon		16.03.2010
Commission adopts recommendation for NEW Council decision to give notice	126(9)	04.05.2010
Council decision to give notice	126(9)	10.05.2010
fiscal effort recommended by the Council		at least 10% in cumulative terms over 2009-
new deadline for correction of the excessive deficit		**2014**
Follow-up - 1st review		
Commission adopts communication on action taken		19.08.2010
Council adopts conclusions thereon		07.09.2010
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	19.08.2010
Council decision amending the Council decision to give notice	126(9)	07.09.2010
new deadline for correction of the excessive deficit		**2014**
Follow-up - 2nd review		
Commission adopts communication on action taken		09.12.2010
Council adopts conclusions thereon		20.12.2010
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	09.12.2010
Council decision amending the Council decision to give notice	126(9)	20.12.2010
deadline for correction of the excessive deficit		**2014**
Follow-up - 3rd review		
Commission adopts communication on action taken		24.02.2011
Council adopts conclusions thereon		07.03.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	24.02.2011
Council decision amending the Council decision to give notice	126(9)	07.03.2011
deadline for correction of the excessive deficit		**2014**
Follow-up - 4th review		
Commission adopts communication on action taken		01.07.2011
Council adopts conclusions thereon		12.07.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	05.07.2011
Council decision amending the Council decision to give notice	126(9)	12.07.2011
deadline for correction of the excessive deficit		**2014**
Follow-up - 5th review		
Commission adopts communication on action taken		26.10.2011
Council adopts conclusions thereon		08.11.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	26.10.2011
Council decision amending the Council decision to give notice	126(9)	08.11.2011
deadline for correction of the excessive deficit		**2014**
Follow-up - Second Adjustment Programme		

Source: Commission services.

3. STABILITY AND CONVERGENCE PROGRAMMES

This Chapter provides an overview of the Stability and Convergence Programmes (SCPs) that Member States submitted in April-May 2012. This round of SCPs and the related assessment is the first one based on the new provisions of the Stability and Growth Pact which entered into force in December 2011. Therefore, the present Chapter provides, besides the examination of macroeconomic assumptions and budgetary objectives, an analysis of the SCPs against the expenditure benchmark and the debt reduction benchmark (see Part II on Evolving budgetary surveillance). Recommendations based on the SCPs were adopted by the Council in July 2012 on the basis of a Commission recommendation. Prior to this, in view of the persistent pressure on the euro area sovereign debt markets but also of the less favourable growth assumptions, the February 2012 ECOFIN Council had reaffirmed the principle of differentiated fiscal exit strategies taking into account country-specific macro-financial situations. Together with the EDP recommendations, these principles represent the basis for the assessments of the programmes. In the context of the European Semester, the Council recommendations are expected to feed into the national budgets for 2013. For this reason, this Chapter gives special attention to 2013, examining the deficit targets set out in the SCPs against the background of the Commission services' Spring 2012 forecasts. It then presents the adjustment paths, the time profile and the composition of the consolidation over the whole horizon of the programmes. The Chapter finally outlines the implications of the fiscal plans for the debt path.

The Chapter consists of four sections. Section 1 examines the macroeconomic scenarios with particular attention given to their sectoral implications. A decomposition of the gap between SCP projections and the Commission forecasts is presented. Section 2 highlights the fiscal consolidation strategy (pace, time profile and composition of the fiscal adjustment) and also assesses expenditure plans for 2013 and for 2014–2015. In addition, it presents the convergence path towards Member States' medium-term budgetary objectives (MTOs), including an assessment of the respect of expenditure benchmark. Section 3 assesses the short term implications of the macroeconomic scenarios and the consolidation plans on debt. This part also considers – where appropriate – whether sufficient progress towards compliance with the debt reduction benchmark is ensured according to the SCPs plans. Section 4 assesses the longer term implications of the plans for fiscal sustainability, notably taking into account the projected changes in age-related expenditure. SCP data are taken from the SCP tables submitted by Member States. SCP data for Greece are not reported as Greece did not submit the relevant tables. ([20])

3.1. MACROECONOMIC SCENARIOS

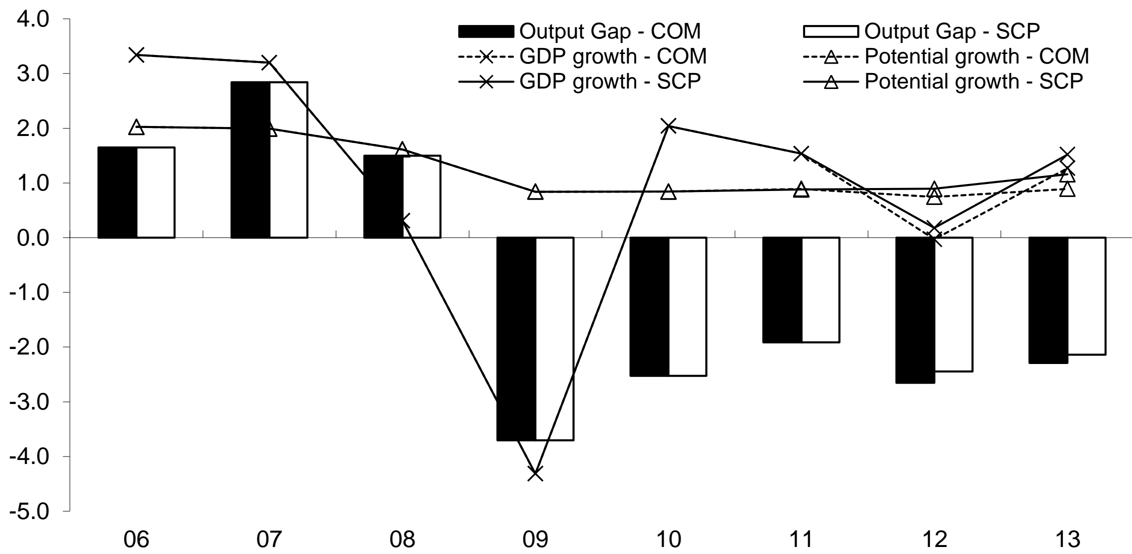
On average, macroeconomic scenarios for 2012-2013 are similar between SCPs and Commission forecasts, albeit slightly less favourable for the latter. The overall picture is one of stagnation in 2012, followed by some recovery in 2013. According to SCPs, EU27 growth would average 0.2pp in 2012 (Commission: 0.0pp) and 1.5pp in 2013 (Commission: 1.3pp). Forecasts are slightly lower for the euro area (Graphs I.3.1-I.3.2).

According to SCPs, except in a few countries, the slowdown implies a widening output gap in 2012, contrasting with projections made last year of a gradual pick-up in growth and a narrowing output gap already in 2012. With nominal budgetary projections for 2012 often remaining close to those of a year ago, this implies a tightening of the average fiscal stance. For 2013, some moderate reduction in the output gap is generally expected. At the EU 27 or euro area level, the output gap would remain large and negative over 2012-2013 (above 2% in 2013), with some further closing expected by 2015 (up to about ¾ %). Output gaps are deemed to be largest (and remain so) in countries currently experiencing recessions (such as Portugal, Spain and Slovenia), with moderately large output gaps also in a number of other countries.

In some countries there are notable differences between SCPs and Commission's growth forecasts. Some SCPs pencil in markedly more favourable assumptions (for either 2012 or 2013, or both),

([20]) Since Greece did not present a Stability Programme in 2012, it is not taken into account in SCPs weighted averages for the euro area and/or the EU27 presented in this note, as opposed to Commission services' Forecasts which cover all EU27 Member States.

Graph I.3.1: **Growth assumptions (EU)**



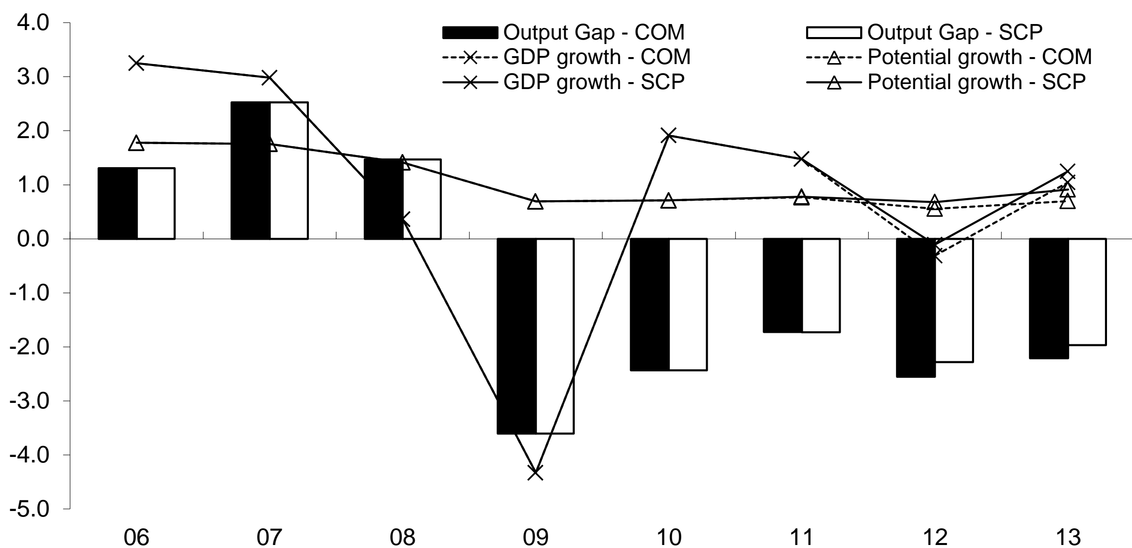
Source: SCPs, Commission services.

especially so for Bulgaria and Sweden, and to some extent for Slovenia, Hungary, the Netherlands, France and Spain. A few countries project weaker growth than the Commission forecast over 2012-2013 (Estonia and Slovakia).

The counterpart of improvement in government balances foreseen in the SCPs is, for nearly all Member States, an expected dissaving by the domestic private sector, which is particularly sizeable in Ireland, Lithuania, the United Kindom, the Netherlands, Romania, France, Poland and Belgium (Graph I.3.3).

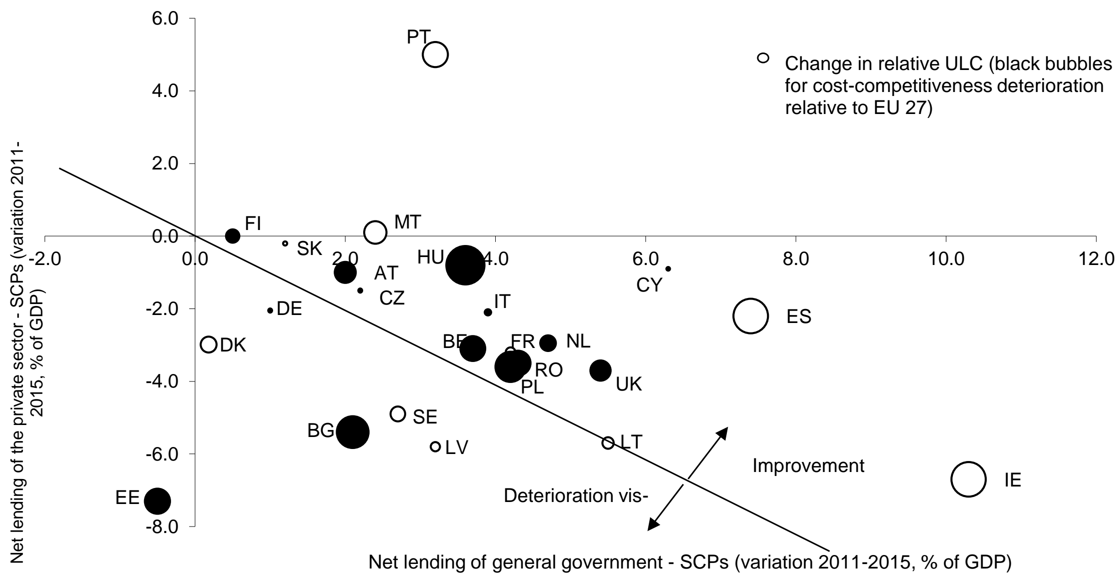
External balances also are expected to improve in the majority of cases. The bisector in Graph I.3.3. delineates the boundary between those countries where an improvement is expected vis-à-vis the

Graph I.3.2: **Growth assumptions (euro area)**



Note: "Potential growth - COM" refers to Commission's 2012 spring forecasts. "Potential growth - SCP" refers to potential growth based on the harmonised methodology and the growth assumptions of SCPs. The same conventions hold for "Output Gap – COM" and "Output Gap – SCP"
Source: SCPs, Commission services.

Graph I.3.3: **Sectoral net lending and relative ULC changes in the SCPs (2011–2015)**

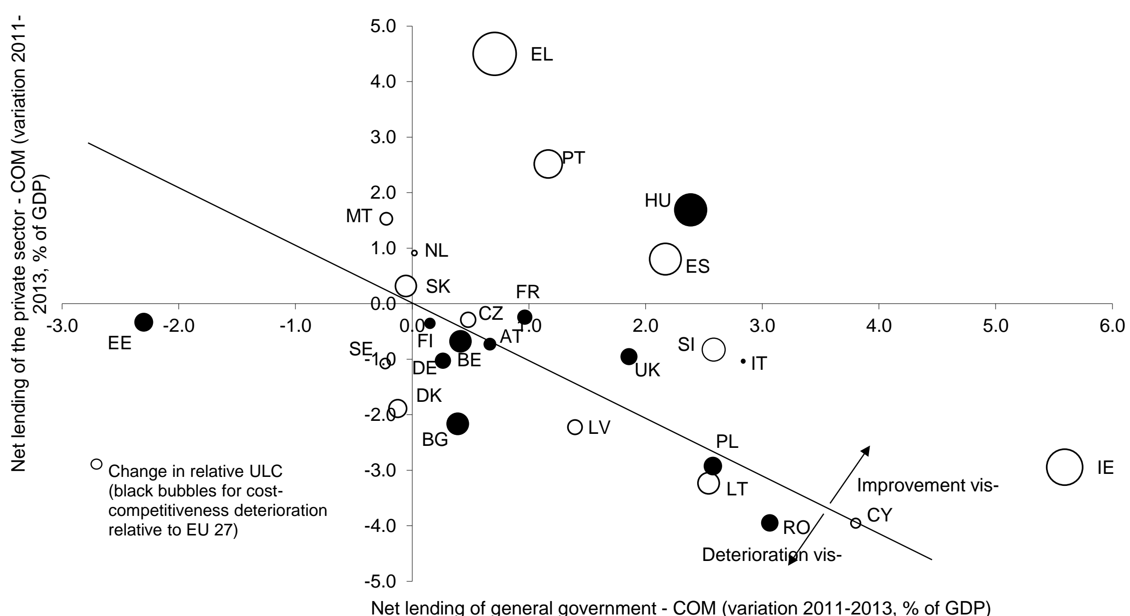


Source: SCPs, Commission services.

rest of the world – countries that lie above the line are expected to show an improvement in their external balances while those below are expected to show a deterioration.

An improvement in the external balance takes place when the sum of the changes in private net lending and public net lending is positive. This is the case in particular for Portugal, Cyprus, Spain and Ireland, with also significant changes in

Graph I.3.4: Sectoral net lending and relative ULC changes in the COM forecast (2011-2013)



Source: SCPs, Commission services.

Hungary ([21]), Malta, Italy, the Netherlands and the United Kingdom. In some Member States however, the planned improvement in government balances is more than offset by private sector dissaving, resulting in a deteriorating external position. This includes Estonia, Denmark, Bulgaria, Sweden, Latvia, and to a lesser extent Germany. Portugal is the only Member State where both the public and the private sector are projected to deleverage. Member States expecting a very large improvement of their external balance also foresee large improvements in cost competitiveness as measured by relative unit labour costs (ULC). ([22]) However, there is no systematic correlation between the evolutions of relative ULC and external balances.

Although not directly comparable in terms of time period, the Commission services' forecast over 2011-2013 (Graph I.3.4) broadly confirms these projected trends. On average however, Commission services' forecasts tend to show less marked improvements in domestic private sector balances and a more balanced distribution between Member States improving and those deteriorating in terms of external balance.

3.2. FISCAL CONSOLIDATION

The conclusions of the 21 February 2012 ECOFIN Council stressed that all Member States should continue to respect their commitments in line with the rules of the Stability and Growth Pact (SGP). While these rules allow the automatic stabilisers to work around the agreed path of structural fiscal adjustment, these conclusions highlight that the room for fiscal manoeuvre differs sharply across Member States, with those benefiting from a financial assistance programme or those facing close market scrutiny being called to exercise particular vigilance. Therefore countries benefiting from a financial assistance programme should stick to the targets as agreed in the programme and should fully and timely implement the policy measures, including in particular structural reforms, agreed in the respective Memorandum of Understanding. Similarly, Member States facing close market scrutiny should continue to meet the agreed budgetary targets and stand ready to pursue further consolidation measures if needed. Finally, the conclusions express a preference for expenditure-based consolidations – calling for the growth of expenditure (net of discretionary revenue measures) to remain below the medium-term rate of potential GDP growth until they have reached their MTO – while advocating expenditure prioritisation in favour of growth-friendly items.

Against this background, this section reviews the size and time profile of the planned consolidation, in terms of both headline targets and structural balances. It contains also an assessment of the rate of progress towards the MTO against the expenditure benchmark introduced by the reform of the Pact alongside the traditional approach, based on the improvement in the structural balance. The main risks to the achievement of the targets – both macroeconomic and policy-related – are highlighted on the basis of a comparison with the Commission forecasts based on a no-policy-change scenario. This is followed by a more detailed analysis of the composition of the planned consolidation, including a disaggregation for broad categories of expenditure.

3.2.1. Size and time profile of planned consolidation

After the sizeable reduction in government deficits achieved in 2011([23]) in both the euro area (from 6.2% of GDP in 2010 to 4.1%) and the EU as a whole (from 6.5% to 4.5%), Member States plan overall to continue with ambitious consolidation against a background of the foreseen protraction of the cyclical slowdown, evident since the second half of last year.

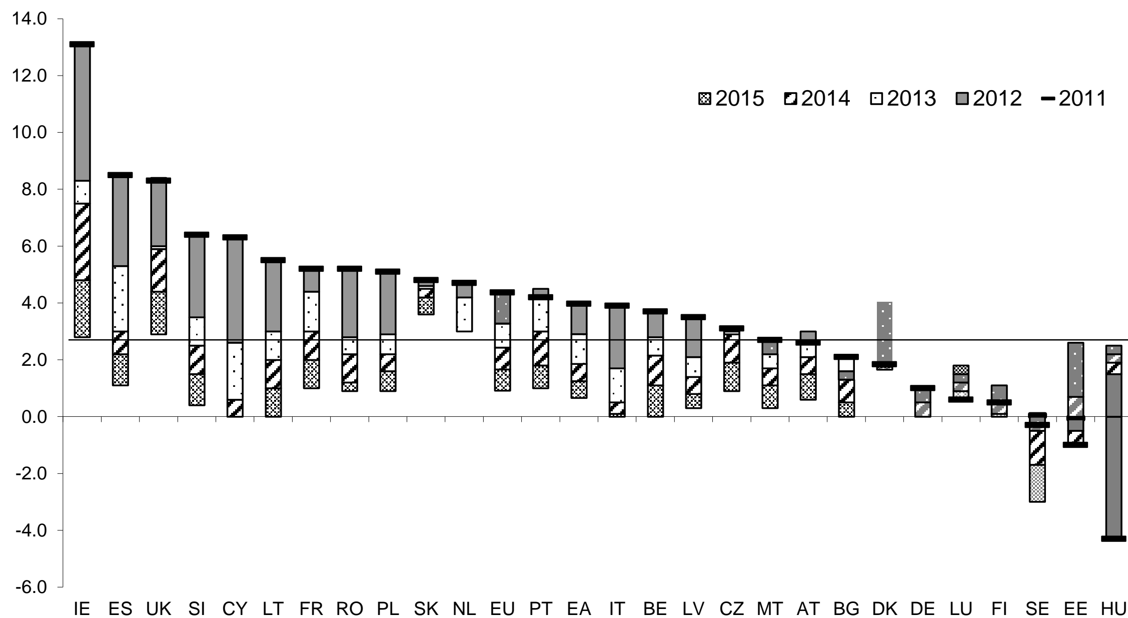
Graph I.3.5 shows the planned changes in government deficits over the 2011–2015 horizon, as set out in the SCPs. It shows that, on aggregate, both the EU27 and the euro area are projected to improve significantly their fiscal positions every

([21]) In Hungary net public lending is adjusted for one-off and temporary measures in 2011.

([22]) The size of the a country's circle reflects the percentage change of the real effective exchange rate over the 2011–2015 horizon relative to the EU27, with white circles indicating improvements in competiveness and black circles deteriorations. Formally, the indicator represents the percentage change in the nominal unit cost of labour over 2011–2015 relative to the EU27 according to methodology in the Commission services' quarterly report on Price and Cost Competitiveness.

([23]) This deficit reduction exceeded the plans in the 2011 SCPs by 0.4pps of GDP in both the euro area and the EU27.

Graph I.3.5: **Planned changes in government deficits over 2011–2015 in the SCPs**



Source: SCPs, Commission services.

year between 2011 and 2015. Overall, the time profile of the consolidation is relatively front-loaded, as the largest reduction in the deficit, by about 1pp of GDP, is planned for 2012, while somewhat lower reductions are pencilled in from 2013 on, in particular for the euro area.

While the extent of the planned deficit reductions broadly reflects starting positions, considerable cross-country variations are observed, including in the profile of adjustment. In Belgium, Malta, Austria, Portugal, Slovakia, Finland, Bulgaria, the Czech Republic, Slovakia and Denmark, the comparison between the first years (2012–2013) and the outer years (2014–2015) of the programmes suggests a relatively back-loaded adjustment. For Austria, Portugal, Finland and Denmark, the deficit is even projected to increase before resuming a downward path from 2013 onwards.

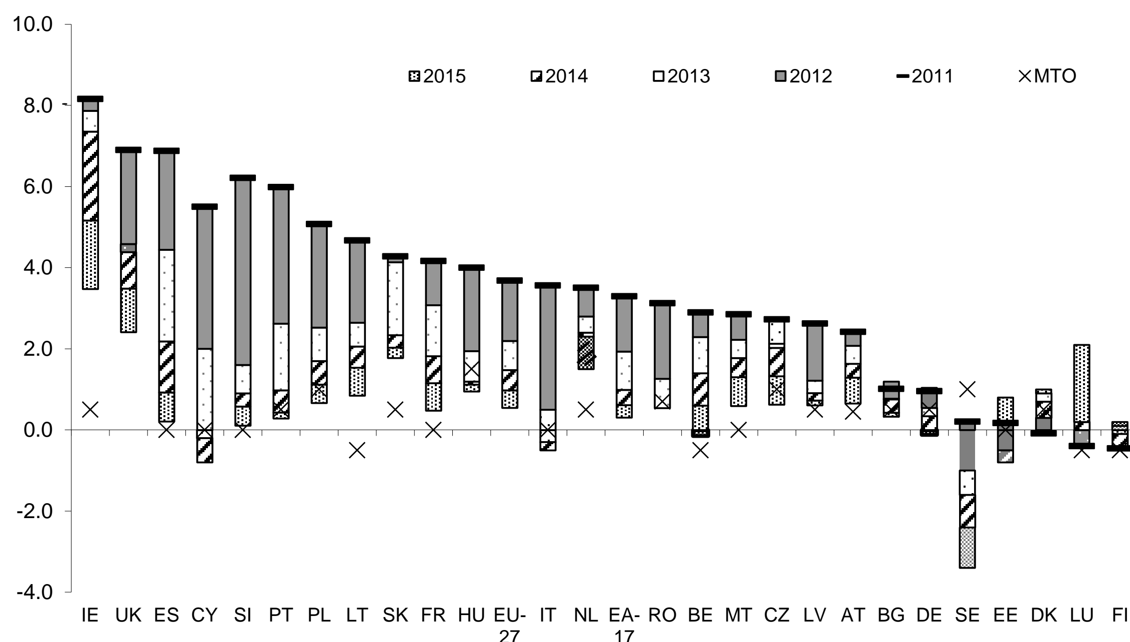
The same comparison suggests a frontloaded consolidation in Ireland, Spain, Italy, Slovenia, Bulgaria, Latvia, Lithuania, Poland, Romania and the UK, which show the largest deficit reductions already in their 2012 budgets. The largest reductions planned for 2013 are in Spain, Cyprus, France, Portugal and Denmark.

Estonia and Sweden stand out for having achieved a budget surplus already in 2011, which according to plans would turn into a deficit (albeit of very small proportion for Sweden) in 2012, before moving again into surplus territory (already in 2013 for Sweden, a year later for Estonia). The surplus recorded in 2011 in Hungary reflects large one-off operations and is planned to be followed by declining deficits. Finally, no apparent pattern of deficit reduction can be detected in the plans of Luxembourg, where the small deficit recorded in 2011 is planned to be followed by deficits oscillating between 1 and 2% of GDP.

3.2.2. Evolution of structural balances

The Member States generally foresee substantial structural consolidations over the period. This can be seen in Graph I.3.6 which shows the level of the structural balance for the years from 2011 to 2015, alongside the respective medium-term objectives. According to the SCP plans, the average structural balance in both the EU27 and euro area should fall by over 3pp of GDP over the four years from 2011 to 2015. This effort is somewhat frontloaded, with a more sizeable adjustment in the early years as compared to the later years covered by the SCPs. For a number of Member States, the pace of consolidation tends to be more moderate as they

Graph I.3.6: **Planned changes in the structural government deficits over 2011–2015 in the SCPs and the MTOs**



Source: SCPs, Commission services.

move out of excessive deficits and embark on the adjustment path towards their medium-term objective (MTO).

For 2012 a marked structural improvement of around 1½pp of GDP is expected on average by SCPs. This compares with a structural tightening close to 1pp planned for 2012 in last year's SCPs. This indicates that the Member States have generally undertaken additional structural adjustments, while macroeconomic conditions are less favourable. The combination of a wider output gap and a significant structural adjustment leads to a pro-cyclical stance in 2012.

According to the SCPs, a substantial policy tightening should still occur in 2013, with a structural improvement of about ¾pp for the EU27 and close to 1pp at the level of the euro area. Structural adjustments should continue thereafter at a slower pace of close to ½pp for the EU27 average, with slightly lower tightening for the euro area.

Graph I.3.6 also shows that the Member States are moving towards their MTOs and some of them are set to have achieved it by 2015 or before. These countries are Portugal, Bulgaria, Czech Republic, Poland and Romania, while Cyprus, Hungary, Italy, Germany, Sweden and Estonia expect tol overachieve it. Spain, Slovenia, Belgium, Latvia, and Austria are projecting that they will come close to their MTO by 2015.

While almost all countries plan some consolidation over the 2011–2015 period, there are notable differences in terms of pace and timeline. The cumulated size of the structural adjustment tends to be related to the starting position of the countries (with a generally larger adjustment when the structural deficit is initially higher). Moreover and while there are exceptions, a correlation can be found between large cumulated consolidation and frontloaded adjustment (in the sense of taking place in 2012-2013 rather than in later years).

Thus, over 2011-2015, substantial and rather frontloaded structural improvements are foreseen in Spain, Cyprus, Slovenia, Portugal, France, Italy, Lithuania, Hungary, Poland, Romania and the United Kingdom. Significant structural improvements are also planned in most other countries but in a more spread out manner. A loosening of the structural balance is expected in Finland, Denmark and Luxembourg.

Box I.3.1: The expenditure benchmark

Since the entry into force of the reform of the Stability and Growth Pact (SGP) – the so-called Six-Pack – in December 2011, the appropriateness of the adjustment path of Member States towards their medium-term budgetary objective (MTO) under the preventive arm, is assessed based on two pillars. ([1])

The first pillar is the analysis of the annual structural adjustment undertaken by the Member States, which should amount to 0.5% of GDP as a benchmark until the MTO is reached. The second pillar compares the evolution of government primary expenditure, net of discretionary revenue measures, to a reference rate, based on the medium-term potential GDP growth (see Section II.2.1). Countries that are at their MTO will have a reference rate equal to their medium-term potential GDP growth rate, while those not yet at their MTO will have a reference rate that is lower. The second pillar will be used for the first time to assess adjustment towards the MTO based on the 2012 budgetary plans. ([2])

Table 1 presents the real growth rate of government expenditure net of discretionary revenue measures, as planned by Member States in their SCPs for 2012 and 2013, in light of the benchmark they should respect according to the requirements of the preventive arm of the SGP (such periods are flagged with grey shading). Bold figures warn that the enforcement of such plans would not comply with the current benchmark: out of 15 Member States subject to the preventive arm in 2012 and/or 2013, 4 could be concerned (Germany in 2012, Romania in 2013, Estonia and Luxembourg in both years). If this materialises with an observed impact on government balance of at least 0.5% of GDP over one year (or cumulatively over two consecutive years), the deviation from the adjustment path towards the MTO might be considered to be significant (as defined in Art. 6 of Reg. 1466/97).

Overall, EU Member States' policy choices, in terms of expenditure growth and discretionary revenue measures ([3]), as presented in the SCPs, would, in the great majority of cases, be consistent with medium-term potential growth. The outliers are Luxembourg, which stands clearly over its benchmark rate in 2012, while Estonia, Denmark, Germany and Belgium also markedly exceed it; as far as the 2013 plans are concerned, Member States are expected to comply, at the exception of a clear deviation for the UK and Estonia, while Luxembourg stands again above its benchmark rate.

However, a majority of Member States actually plan a larger adjustment than what is required by the preventive arm (by maintaining real net expenditure growth well below the benchmark); this reflects the undergoing correction of current excessive deficits and a large consolidation of public finances which is underway in the EU, and more specifically in the euro area.

([1]) All results of this first exercise of the assessment of policy plans against the expenditure benchmark, presented in this note, are only based on plans as reported by Member States in their programmes, at the exception of corrections undertaken after bilateral contacts with the authorities.
([2]) Member States subject to the EDP are not formally concerned by this benchmark.
([3]) In accordance with Art.5 of Reg. 1466/97, the change in expenditure is recalculated in order to avoid taking into account non-discretionary changes in government expenditure due either to unemployment benefits or to EU programmes matched by EU funds revenue. To avoid penalizing peaks in investment, corresponding expenditure is also smoothed over four years. Finally, the effect of measures taken by the Member States on the revenue side is deducted, to obtain a net change in government expenditure. As for the benchmark, the reference rate used as a ceiling over expenditure growth corresponds to the 10-year average growth rate of potential GDP (2007-2016). Moreover, as long as the Member State is not at its MTO, this expenditure growth should remain below the reference rate, in order to support the required structural adjustment by 0.5% of GDP towards the MTO; this yields a lower benchmark (the "lower rate"). Member States which have overachieved their MTO could temporarily exceed the benchmark as long as, taking into account the possibility of significant revenue windfalls, the MTO is respected throughout the programme period.

(Continued on the next page)

Box (continued)

Table 1: **Growth of government expenditure net of discretionary revenue measures and applicable benchmark**

	Applicable benchmark for 2012 and 2013[a] (%)	Real growth rate of government expenditure net of discretionary revenue measures presented in SCPs			
		2012	2013	2014	2015
BE	0.4	**1.5**	-0.2	-0.5	-0.7
BG	1.1 in 2012, 2.6 in 2013	-11	-2	-0.4	**5.2**
CZ	1.2	-3.3	-1.7	-2.4	0.2
DK	0.9 in 2012, 0 in 2013	**2**	-2.4	**0.4**	0.5
DE	0.0 in 2012, 1.2 in 2013	**0.9**	0.6	0.2	**1.4**
EE	1	**2.2**	**4.6**	**2.5**	-0.2
IE	-0.8	-13.4	-5.3	-6.1	-4.6
EL	-1.4	n.a.	n.a.	n.a.	n.a.
ES	-0.2	-12	-7.4	-2.9	-2.1
FR	0.3	-1.4	-1.2	-0.3	-0.3
IT	-0.8	-6.7	-3.5	-1.2	0.1
CY	0.3	-9.1	-5.2	-3.3	**2.6**
LV	-0.1	-3	-0.5	-0.7	-1.1
LT	0.8	-6.3	-0.6	0.4	**3**
LU	1.8 in 2012, 0.6 in 2013	**4.9**	**2**	**2.2**	**2.6**
HU	-0.6	-9.5	-2.5	**1.7**	**2.2**
MT	0.2	-4.4	-1	-0.5	-0.7
NL	0.4	-3.6	-0.1	-0.6	-1.1
AT	0.5	**0.8**	-0.3	0.5	0.1
PL	2.6	1	1.2	0.6	0.5
PT	-1.1	-2.3	-3.3	-2.4	-0.6
RO	1.4	-4.3	**1.5**	**1.4**	2
SI	0.6	-9.2	-6.5	-2.6	-3.1
SK	1.8	0.4	0.1	0.6	1.3
FI	1.4 in 2012, 0.5 in 2013	0.9	-1	0.5	**1.5**
SE	1.8	2	1.5	0.3	0.8
UK[d]	0.1	-4.3	**2.8**	-2.5	-1.5
EA17		-3	-1.7	-0.7	0
EU27		-2.9	-0.9	-0.9	-0.1

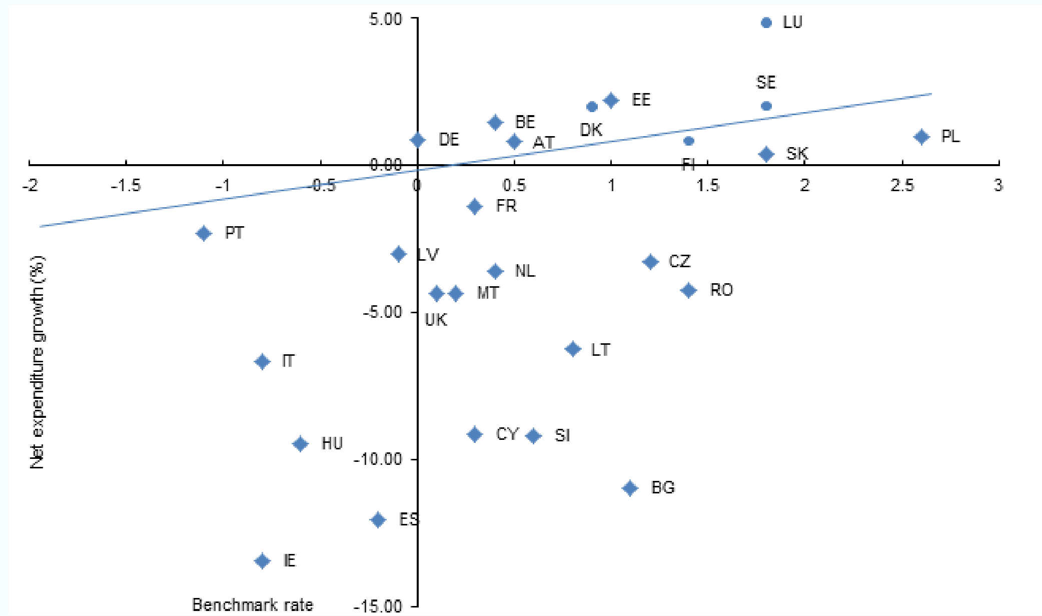
a: for all Member States but SE (as well as DK, FI and LU in 2012 and BG and DE in 2013), the applicable benchmark is a rate below their reference medium-term rate of potential GDP growth to support the adjustment towards the MTO.
b: shaded rows correspond to years to which the requirements of the preventive arm are applicable.
c: bold figures indicate an excess of net expenditure growth over the applicable benchmark (only indicative for 2014 and 2015, also taking into account planned achievement of the MTO). Concerning SE, the overachievement of the MTO over the programme period allows a temporary excess over the benchmark..
d: the deadline for UK to correct its excessive deficit corresponds to the fiscal year 2014/2015.
Source: SCPs, Commission services

Graphs 1 and 2 present expenditure plans for 2012 and 2013 (the net real growth rate is shown on the vertical axis) in comparison to their respective benchmark (to be read on the horizontal axis). To respect the benchmark, net expenditure growth needs to remain below the bisector. According to the requirements of the preventive arm, a few Member States would simply be required to keep the net growth of real expenditure at or below their medium-term potential GDP growth rate (depicted with a circle), in order to remain at their MTO. However, most of the Member States have to maintain it below a lower rate (depicted with a diamond), as they have to progress towards their MTO.

(Continued on the next page)

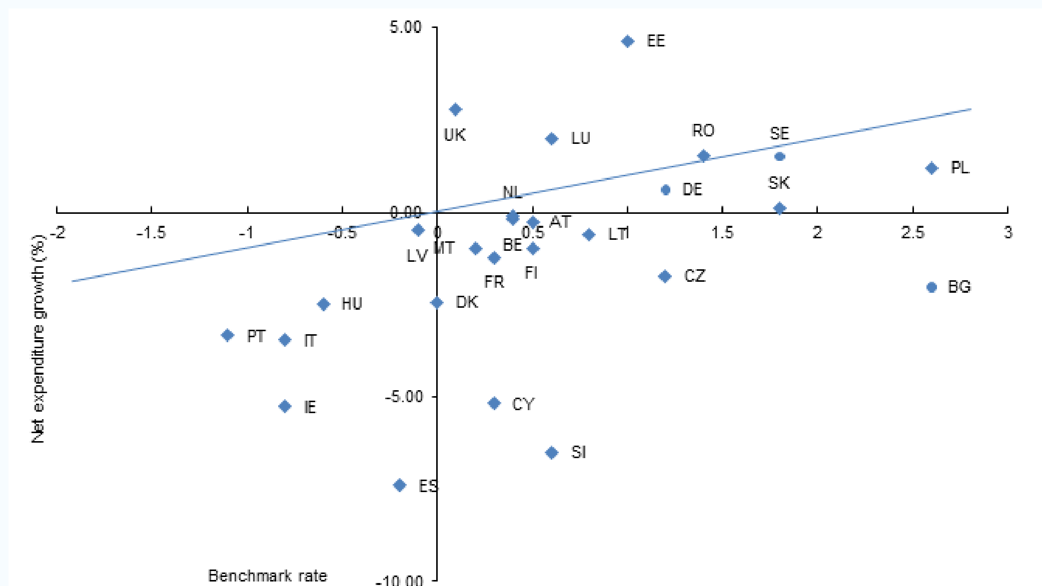
Box (continued)

Graph 1: **Real growth of government expenditure net of discretionary revenue measures and applicable benchmark as presented in SCPs in 2012**



Source: SCPs, Commission services.

Graph 2: **Real growth of government expenditure net of discretionary revenue measures and applicable benchmark as presented in SCPs in 2013**



Source: SCPs, Commission services.

Table I.3.1: **Budgetary developments in the Member States up to 2014 according to the SCPs**

	Real GDP growth				Government balance				Structural balance				Government gross debt			
	2011	2012	2013	2014	2011	2012	2013	2014	2011	2012	2013	2014	2011	2012	2013	2014
BE	1.9	0.1	1.3	1.7	-3.7	-2.8	-2.2	-1.1	-2.9	-2.3	-1.4	-0.6	98.0	99.4	97.8	95.5
DE	3.0	0.7	1.6	1½	-1.0	-1.0	-½	0.0	-1.0	-0.5	-0.3	0.1	81.2	82.0	80.0	78.0
EE	7.6	1.7	3.0	3.4	1.0	-2.6	-0.7	0.1	-0.2	-0.8	0.0	0.5	6.0	8.8	11.0	10.6
IE	0.7	0.7	2.2	3.0	-13.1	-8.3	-7.5	-4.8	-8.2	-7.9	-7.4	-5.2	108.2	117.5	120.3	119.5
EL	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	-	-	-	-	#N/A	#N/A	#N/A	#N/A
ES	0.7	-1.7	0.2	1.4	-8.5	-5.3	-3.0	-2.2	-6.9	-4.4	-2.2	-0.9	68.5	79.8	82.3	81.5
FR	1.7	0.7	1.8	2.0	-5.2	-4.4	-3.0	-2.0	-4.2	-3.1	-1.8	-1.2	85.8	89.0	89.2	88.4
IT	0.4	-1.2	0.5	1.0	-3.9	-1.7	-0.5	-0.1	-3.6	-0.5	0.5	0.5	120.1	123.4	121.5	118.2
CY	0.5	-0.5	0.5	1.0	6.3	-2.6	-0.6	0.0	6.9	-2.0	0.2	0.8	71.6	72.1	70.2	67.8
LU	1.6	1.0	2.1	3.3	-0.6	-1.5	-1.2	-0.9	0.4	-0.2	0.1	-0.2	18.2	20.9	23.6	24.4
MT	2.1	1.5	2.0	2.0	-2.7	-2.2	-1.7	-1.1	-2.9	-2.2	-1.8	-1.3	72.0	70.3	68.7	67.4
NL	1.2	-¾	1¼	1½	-4.7	-4.2	-3.0	n.a.	-3.5	-2.3	-1.5	-2.8	65.2	70.2	70.7	n.a.
AT	3.1	0.4	1.4	2.0	-2.6	-3.0	-2.1	-1.5	-2.4	-2.1	-1.6	-1.3	72.2	74.7	75.3	74.6
PT	-1.6	-3.0	0.6	2.0	-4.2	-4.5	-3.0	-1.8	-6.0	-2.6	-1.0	-0.4	107.8	113.1	115.7	113.4
SI	-0.2	-0.9	1.2	2.2	-6.4	-3.5	-2.5	-1.5	-6.2	-1.6	-0.9	-0.6	47.6	51.9	53.1	52.6
SK	3.3	1.1	2.7	3.6	-4.8	-4.6	-4.5	-4.2	-4.3	-4.1	-2.3	-2.0	43.3	50.2	52.0	53.0
FI	2.9	0.8	1.5	2.1	-0.5	-1.1	-0.5	-0.1	0.5	-0.2	0.2	0.1	48.6	50.7	51.8	51.9
EA-17 (*)	**1.7**	**-0.1**	**1.2**	**1.6**	**-4.0**	**-2.9**	**-1.9**	**-1.2**	**-3.3**	**-1.9**	**-1.0**	**-0.6**	**86.1**	**89.7**	**89.3**	**87.7**
BG	1.7	1.4	2.5	3.5	-2.1	-1.6	-1.3	-0.5	-1.0	-0.6	-0.6	-0.2	16.4	19.8	18.4	18.0
CZ	1.7	0.2	1.3	2.2	-3.1	-3.0	-2.9	-1.9	-2.7	-2.0	-2.1	-1.3	41.2	44.0	45.1	44.8
DK	1.0	1.2	1.5	1.8	-1.8	-4.0	-1.8	-1.9	0.1	-0.9	-0.3	-0.7	46.5	40.5	41.4	41.2
LV	5.5	2.0	3.7	4.0	-3.5	-2.1	-1.4	-0.8	-2.6	-1.2	-0.9	-0.7	42.6	44.5	45.8	46.7
LT	5.9	2.5	3.7	3.4	-5.5	-3.0	-2.0	-1.0	-4.7	-2.6	-2.1	-1.5	38.5	40.2	38.6	36.7
HU	1.7	0.1	1.6	2.5	4.3	-2.5	-2.2	-1.9	-4.0	-1.9	-1.2	-1.1	80.6	78.4	77.0	73.7
PL	4.3	2.5	2.9	3.2	-5.1	-2.9	-2.2	-1.6	-5.1	-2.5	-1.7	-1.1	56.4	53.7	52.5	50.6
RO	2.5	1.7	3.1	3.6	-5.2	-2.8	-2.2	-1.2	-3.1	-1.7	-1.2	-0.5	33.3	34.2	33.7	32.8
SE	3.9	0.4	3.3	3.7	0.3	-0.1	0.5	1.7	-0.2	1.0	1.6	2.4	38.4	37.7	35.4	31.8
UK (1)	0.8	0.8	2.0	2.7	-8.3	-5.9	-6.0	-4.4	-6.9	-4.4	-4.6	-3.5	84.0	89.0	91.9	92.7
EU-27 (*)	**1.7**	**0.2**	**1.5**	**2.0**	**-4.4**	**-3.3**	**-2.4**	**-1.7**	**-3.7**	**-2.2**	**-1.5**	**-1.0**	**81.1**	**84.3**	**84.3**	**83.0**

(1) Convergence programme and autumn forecast: financial years ending in following March.
(*) In case of missing programmes: weighted average of the figures for those countries that have submitted a programme.
Source: SCPs, Commission services.

3.2.3. Risks to the SCPs targets: an assessment

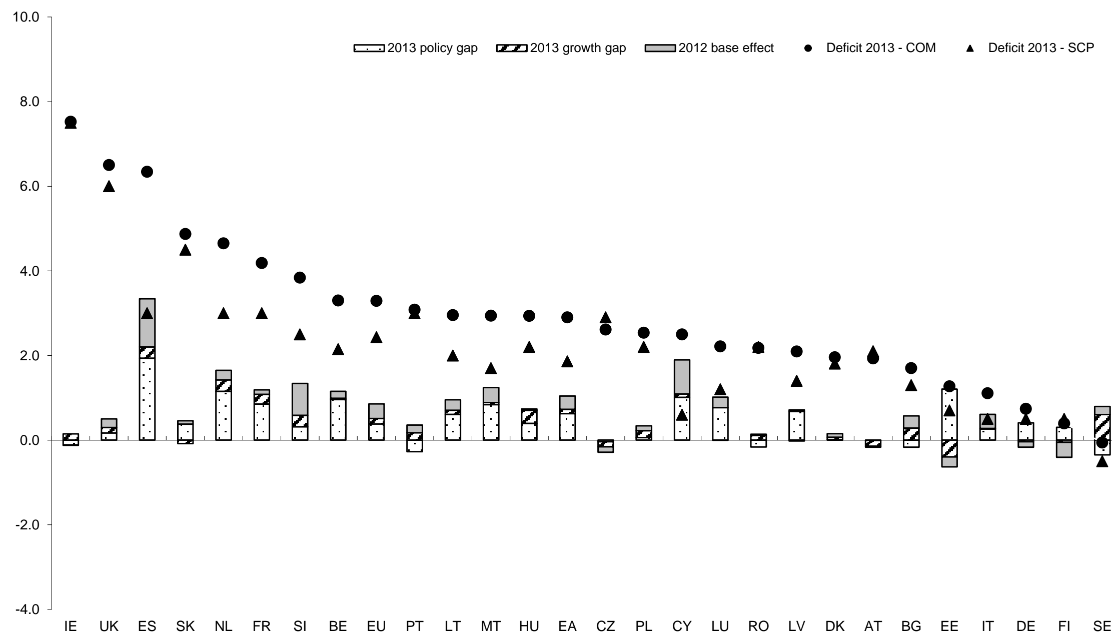
The budgetary targets outlined in SCPs can be seen as vulnerable to three risks: less favourable macroeconomic conditions may negatively affect the achievement of the targets throughout the programme period; the impact of the consolidation measures may have been overestimated; and the targets may not be supported by sufficiently detailed measures, especially for the years not covered by the current budget.

Graph I.3.7 seeks to highlight these different risks by focusing on the gap between Member States' targets and the Commission services' deficit forecasts for 2013, in terms of the following three components: i) the difference in the deficits projected for 2012 (labeled the '2012 base effect'), reflecting differences in the growth projections for 2012 and/or the assessment of the impact of the measures in the 2012 budget; the effect of difference in the growth projections for 2013 (labeled '2013 growth gap'), calculated using the standard semi-elasticities of budgetary balance to growth; iii) the residual difference, (labeled the '2013 policy gap'), presumably mainly stemming from the absence of detailed consolidation measures for 2013 (and hence their non-inclusion in the Commission services' forecasts based on the no-policy change assumption).

The base effect, reflecting a different assessment of the budgetary outcome for the current year, amounts to a relatively modest 0.3pp of GDP for both the euro area and the EU as a whole. There is however considerable variation across countries: the 2012 base effect explains 0.8pp of GDP of the higher deficit projected by Commission services in Cyprus and Slovenia while in Spain it attains 1.1pp. Conversely, in Finland and Estonia and to a lesser extent in Germany and the Czech Republic there are small positive base effects.

The gap stemming from different growth projections for 2013 is even smaller, at 0.1pp of GDP for both the euro area and the EU. While a possible favorable bias emerges for Spain, France, the Netherlands, Hungary, Poland, Bulgaria, Hungary and Sweden, only in the case of Sweden where it amounts to 0.6pp of GDP does this appear to be sizeable. By contrast, the macroeconomic scenario may impart a small prudent bias to the budget plans in Austria, Estonia, the Czech Republic and Slovakia.

Graph I.3.7: **General government deficit for 2013: decomposition of the gap between the SCP projections and the COM forecasts**



Source: Commission services.

For the EU27 as a whole, revenue-to-GDP ratios in the SCPs are 0.5 and 0.3pp of GDP lower in 2012, and 2013, respectively, than those projected by the Commission services, whereas for the euro area revenue ratios are higher than envisaged by the Commission services, by 0.1pp and 0.4pp in 2012 and 2013, respectively. Revenue projections could be considered to be particularly cautious in the Netherlands, Denmark, Poland, Sweden and the UK. In the cases of Latvia and Estonia revenue projections appear somewhat on the high side in 2012, but this possible bias is almost totally offset by apparently very conservative assumptions for 2013. By contrast, revenues appear to be projected on the basis of especially favorable assumptions in Belgium, Spain, Italy, Malta and Bulgaria, where in these cases the revenue ratios in SCPs imply revenue growth rates that exceed those of GDP by more than 3pp in 2012.

Expenditure projections are lower in the SCPs than in the Commission services' 2012 Spring forecasts. The expenditure ratios in the SCPs are on aggregate lower by 1pp in 2012 and by 1.2pp in 2013 for the EU27, whereas for the euro area differences are narrower and amount to 0.2pp in 2012 and of 0.5pp in 2013. This pattern is observed for most Member States, among which Spain, France, Cyprus, Luxembourg, the Netherlands, Slovenia, Lithuania, Poland, Denmark, Sweden and the United Kingdom present in their SCPs the most sizeable differences when compared with Commission services' projections. At least part of the differences is accounted for by policy measures that are not included in the Commission services 2012 Spring Forecast.

For the remaining countries, the size of the difference between the two sets of forecasts may be taken as an estimate of the required measures to meet the targets in the SCPs and hence provide an indication of the magnitude of the underlying implementation risks. By contrast, expenditure projections in Germany, Italy, Malta and especially in Austria and Bulgaria can be considered to lean toward the conservative side.

In conclusion, balancing the different types of risks, overall budgetary projections appear to rely on especially favourable assumptions on growth, as well as on revenue or expenditure in the cases of Belgium, Spain, France, Poland, Slovenia, Bulgaria, Lithuania, Sweden and the Netherlands.

However, in the case of the last two Member States, favourable macroeconomic assumptions and optimistic expenditure projections are partially compensated by prudent estimates on the revenue side.

3.2.4. Composition of consolidation

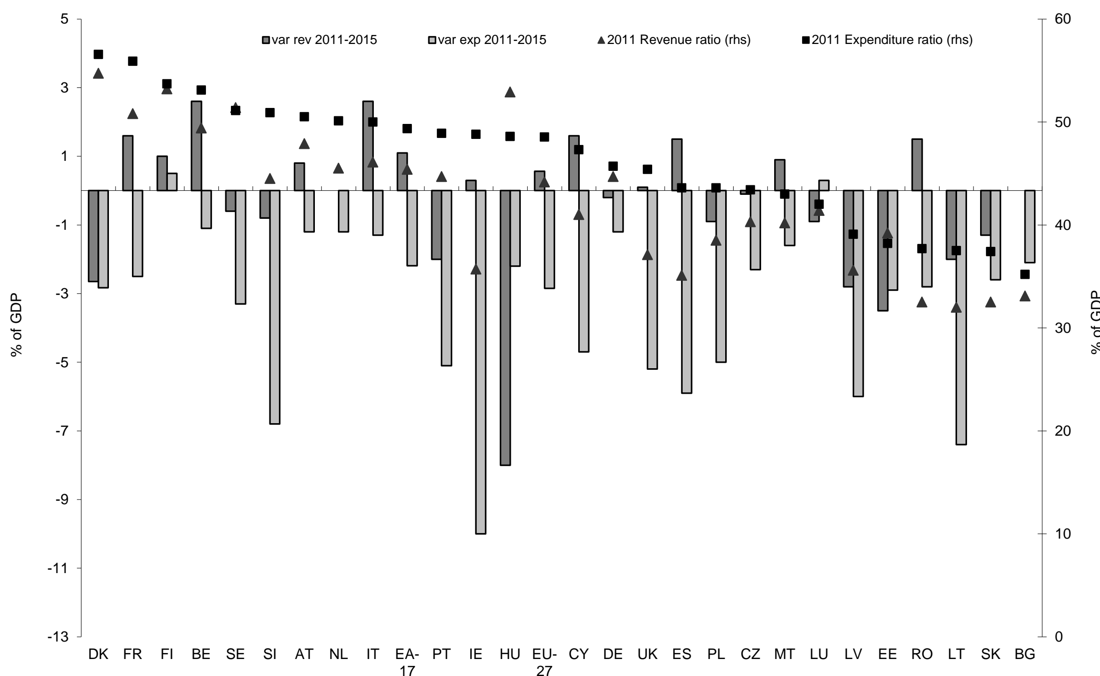
On average, the consolidations plans set out in the SCPs for both the euro area and the EU27 are primarily expenditure-based. Graph I.3.8 indicates the 2011 starting level for revenue and expenditure ratios, as well as the variation expected for both variables by 2015, as set out in the SCPs. It shows that, on average, general government expenditure is forecast to decrease from 49.4% of GDP in 2011 to 47.2% in 2015 in the euro area, and from 48.5% to 45.7% of GDP in the EU27. Meanwhile, revenue is forecast to increase from 45.4 % of GDP in 2011 to 46.5% in 2015 in the euro area and from 44.2% of GDP to 44.7% in the EU27. The change in expenditure corresponds to nearly 2/3 of the overall change in the deficit in the euro area and over 4/5 in the EU27, making the consolidation plans broadly expenditure-based on average.

The expenditure-to-GDP ratio is set to fall between 2011 and 2015 in all Member States except Finland and Luxembourg. Ireland, Lithuania, Slovenia, Spain, Latvia, the United Kingdom, Portugal and Poland are forecasting reductions in expenditure of over 5pp of GDP. ([24])

While almost all countries are reducing expenditure, only 11 Member States plan an increase in the revenue-to-GDP ratio over the 2011-2015 programming period. Belgium and Italy foresee an increase in revenue of over 2½pp of GDP, while France, Cyprus, Spain, Romania and Finland project an increase of over 1pp. In Ireland, an increase in the tax revenue ratio is offset by a reduction in non-tax revenues. In addition, 13 Member States forecast a reduction in their revenue as a share of GDP. The largest reduction is foreseen in Hungary (8pp of GDP, largely reflecting one-off increase in revenues in 2011), while Estonia, Latvia, Denmark, Portugal and Lithuania forecast a decrease of over 2pp.

([24]) For IE and UK, the observed change in expenditure-to-GDP relies in part on one-off measures.

Graph I.3.8: Envisaged variation in expenditure and revenue ratio 2011-2015*



* For IE and UK, the observed change in expenditure-to-GDP relies in part on one-off measures.
***Source**:* SCPs, Commission services.

Overall, fiscal consolidation is entirely expenditure-based in Denmark, Slovakia, Lithuania, Latvia, Poland, Estonia, the Netherlands, Slovenia, Portugal, Germany, Hungary, Bulgaria, the UK and Sweden. In Spain, Austria, Cyprus, France, Malta and Romania, it is relatively evenly balanced between spending cuts and revenue increases, while it is primarily revenue-based in Belgium and Italy. ([25])

Table I.3.2 displays the yearly fiscal adjustment at the aggregate EU27 level and its expenditure and revenue components as foreseen in the SCPs between 2012 and 2015. Those are compared with the corresponding adjustment forecast by the Commission services for the years 2012 and 2013. The envisaged improvement in the primary balance exceeds Commission services forecast marginally for 2012 (by 0.2pp of GDP) and more strongly for 2013 (by 0.5pp of GDP). Therefore, the SCPs appear to be slightly more optimistic than Commission services forecast on the size of the budgetary improvement at aggregate EU level.

The table also shows the composition of the adjustment. For 2012, the SCP adjustment is evenly balanced between revenue and expenditure, while the Commission services forecast consolidation only on the revenue side. For 2013, 2014 and 2015, SCP consolidation is driven by expenditure cuts. Overall, in 2012, the adjustment appears to be front-loaded on the revenue side, and more uniform – if not slightly back-loaded – on the expenditure side.

3.3. DEBT IMPLICATIONS

This section assesses debt implications of the macroeconomic scenario and of the consolidation plans set out in the SCPs, including an analysis of compliance with the new provisions concerning the debt reduction benchmark.

3.3.1. Evolution of the debt-to-GDP ratio

Graph I.3.9 shows the projected changes in general government debt over the period 2011–2015. In the euro area, overall debt is projected to reach a level slightly above 85% of GDP after having peaked at almost 89% of GDP in 2012; in the EU27 the corresponding figures are 80% and 84% of GDP. The implication for the medium term is that as long as the consolidation measures are not reversed beyond 2014, debt should be on a declining path for the years beyond the programmes' horizon. In all Member States except Denmark and Luxembourg, debt is projected to peak before 2015. However, in Spain and the United Kingdom, the projected reduction in 2015 is small and coming back to pre-crisis levels is likely to take many further years.

Graph I.3.9 also shows that consolidations envisaged by the Member States does not ensure that debt-to-GDP ratios in 2015 will be lower than in 2011: Spain, Ireland, Slovakia, Luxembourg, the United Kingdom, Estonia, Slovenia, Finland, Czech Republic and Portugal will see their debt-to-GDP ratio increase between 2011 and 2015.

While consolidation is a necessary prerequisite for the debt to go down in the long-run, debt dynamics also depend crucially on the interest rate-growth differential. ([26]) The larger the differential

([25]) In Finland the small fiscal adjustment envisaged is entirely revenue-driven.

([26]) The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * (r_t - g_t)\right) + \frac{SF_t}{Y_t}$$

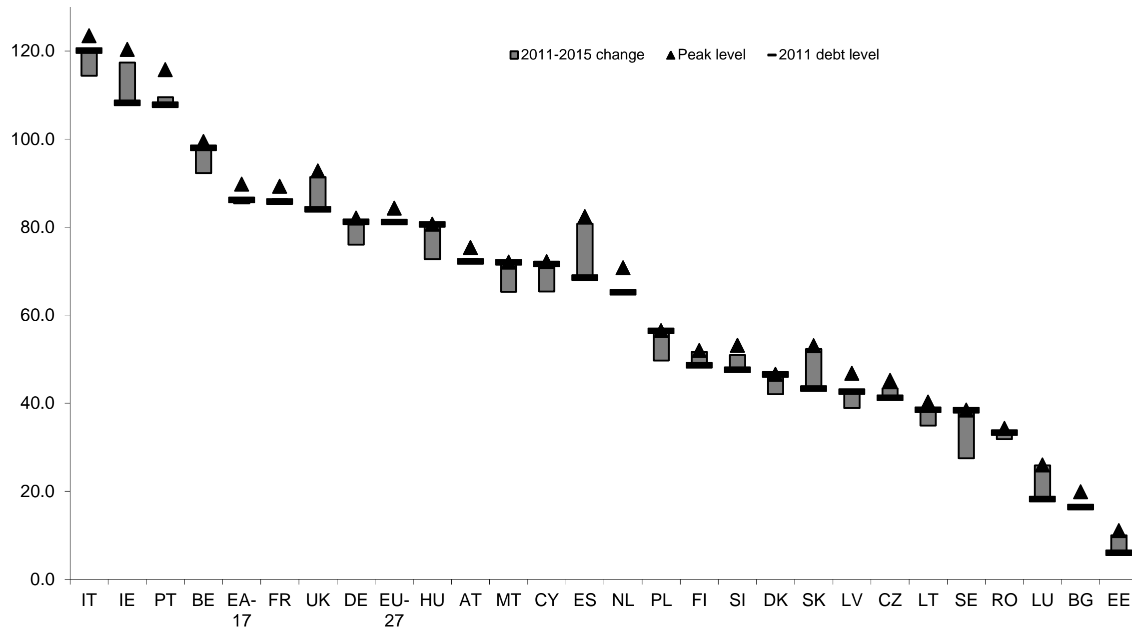
where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and r and g represent

Table I.3.2: **Fiscal adjustment for EU 27: 2012 SCPs vs. Spring 2012 EC Forecasts**

	2012		2013		2014	2015
	SCPs Planned Δ	EC Forecast Δ	SCPs Planned Δ	EC Forecast Δ	SCPs Planned Δ	SCPs Planned Δ
Revenue	0,6	0,8	0,1	-0,2	-0,1	0,0
Expenditure	-0,5	0,0	-0,7	-0,5	-0,9	-0,8
Government Balance	1,1	0,9*	0,8	0,3	0,8	0,7

* Deviations are due to rounding.
Source: SCPs, Commission services.

Graph I.3.9: **2011-2015 planned changes in general government debt**



Source: SCPs, Commission services.

between real interest rate and real GDP growth (r-g), the larger the increase in the primary balance required to stabilize a given debt ratio. Thus, (r-g) plays a key role in determining an appropriate strategy to achieve a given debt target.

Graph I.3.10 show that the interest-growth differential is positively correlated with the level of public debt in normal times (2005 to 2008) and Graph I.3.11 shows that this is also true during the crisis (2009 to 2013): the larger the public debt ratio, the higher the differential tends to be. This might obey to two main elements. Firstly, a high debt ratio may trigger an increase in risk premia ([27]), thereby leading to higher interest rates. Secondly, higher debt levels and interest rates might weigh on economic growth, especially when debt exceeds a certain threshold level as a number of papers suggest. ([28])

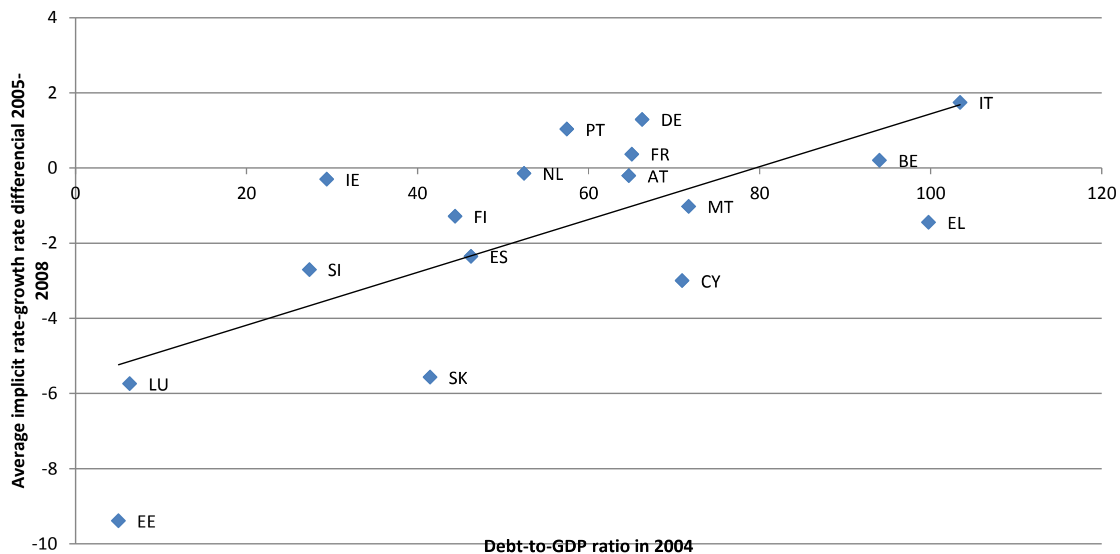
the average real interest rate and real rate of GDP growth. The term in parentheses represents the "snow-ball" effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

([27]) See empirical evidence in Part III.
([28]) See for example Kumar and Woo (2010).

The consolidation strategies envisaged in the SCPs have an impact on long-run debt-to-GDP ratios. The last column of Table I.3.3 shows the debt-stabilizing primary balance, under the assumption that the interest-growth differential remains constant from 2015 onwards (column of the middle). If the 2015 structural primary balance projected in the SCPs (fourth column) is higher than the debt-stabilizing primary balance, this means that the planned consolidation over 2011-2015 will ensure the stabilization of the debt-to-GDP ratio from 2015 onwards. Table I.3.4 shows that it is the case according to all Member States' consolidation plans.

How do the SCP debt projections compare with the Commission Spring forecasts? Graph I.3.12 presents the projections for 2013 using a similar methodology as for Graph I.3.7. The figure shows the level of debt projected by both the SCPs and the Commission services and decomposes it into the '2012 base effect' which represents the difference in projected levels of debt in 2012, the '2013 growth gap' which quantifies the differences due to different growth assumptions for 2013 and the residual '2013 policy gap', which is assumed to reflect the contribution that policy changes included in the SCPs have on the debt projections.

Graph I.3.10: **Comparing average 2005-2008 interest-growth differential and debt ratio in 2004 in Euro Area Member States**

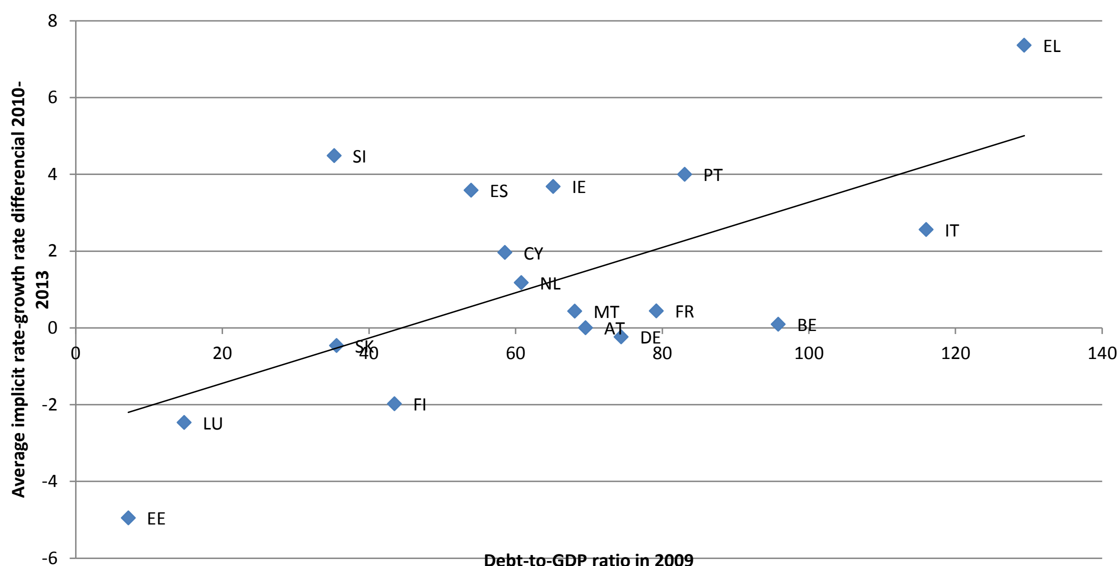


Source: SCPs, Commission services.

The figure shows that for both the euro area and EU27, the Commission services forecast slightly higher debt-to-GDP ratios in 2013. For the euro area, the Commission services expect debt to come in at 92.6% of GDP, while the SCPs project 89.3%. For EU27 the difference between the two is similar; while the Commission services expect the debt of 87.2% of GDP the SCPs forecast 84.3%. The '2013 policy gap' accounts for 0.8pp of the difference in the euro area debt, and 0.5pp in the EU27. A significant contributor to the difference is also the '2012 base effect' which accounts for 2.3pp in the euro area and 2.2pp in the EU27.

This overall '2012 base effect' is driven by a number of Member States that show very significant differences in their SCPs relative to the Commission services' estimates. The largest

Graph I.3.11: Comparing average 2010-2013 interest-growth differential and debt ratio in 2009 in Euro Area Member States



***Source:* SCPs, Commission services.**

Table I.3.3: **Debt-stabilizing primary balance for Member States whose debt-to-GDP ratio is projected to exceed the 60% threshold in 2015**

Member State	2015 Debt-to-GDP	2015 Interest- growth differential (%)	2015 structural primary balance (% GDP)	Debt-stabilizing primary balance (% GDP)
BE	92.3	0.2	3.5	0.2
DE	76	0.8	2.6	0.6
ES	80.8	-0.4	2.9	-0.3
FR	86.4	-0.6	2.2	-0.5
IE	117.4	1.5	2.1	1.7
IT	114.4	1.6	6.1	1.7
CY	65.4	0.4	3.6	0.3
HU	72.7	2.7	2.8	1.9
MT	65.3	1.8	3	1.1
AT	72.8	0.5	2	0.4
PT	109.5	0.2	4.5	0.2
UK	91.4	-0.8	0.9	-0.7

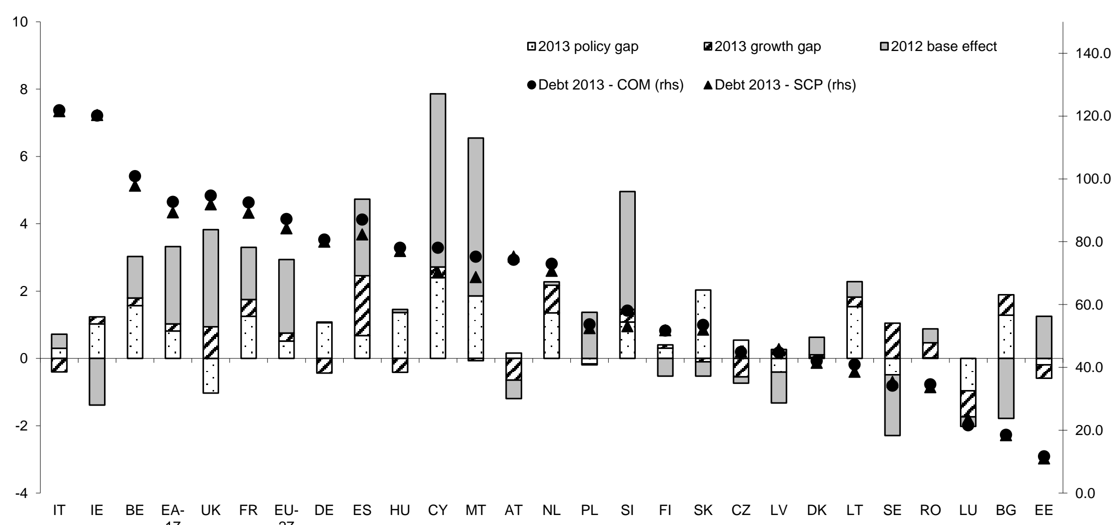
Source: SCPs, Commission services.

differences in 2012 base levels are found for Cyprus (5.1% of GDP), Malta (4.7% of GDP) and Slovenia (3.5% of GDP) but these small Member States account for little in the weighted average. However, France and the United Kingdom also have sizeable differences of, respectively, 1.5% and 2.9% of GDP. As with the differences in the deficit projections, the fact that many Member States have significant policy changes penciled in is both a risk and a challenge, as consolidation measures must be implemented, to ensure that the outcomes are not weaker than the plans.

3.3.2. Debt benchmark

According to the debt reduction benchmark introduced by the reform of the Pact, Member States whose current debt-to-GDP ratio is above the 60% threshold have to reduce the distance to 60% by an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available. The debt reduction benchmark is also considered to be fulfilled if the budgetary forecasts of the Commission services indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which the data is

Graph I.3.12: General government debt for 2013: decomposition of the gap between the SCP projections and the COM forecasts



Source: **SCPs, Commission services.**

Table I.3.4: **Minimum adjustments over the transition period for Member States whose debt-to-GDP ratio exceeds the 60% threshold in 2011**

Member States	Debt Ratio in 2011	Deadline for EDP correction	Minimum cumulative required structural adjustment over the transition period[1]		Cumulative planned adjustment in the SCPs
			SCPs/COM Forecasts[2]	SCP Plans[3]	
IT	120.1	2012	0	0	0.8
PT	107.8	2013	0	0	0.7
BE	98	2012	1	0.9	2.4
FR	85.8	2013	0.2	0.1	2
UK	85.7	2014	1.5	1.2	2.5
DE[4]	81.2	2013/2011	0	0	0.9
HU	80.6	2012	0.7	0	1
AT	72.2	2013	0	0	1.4
MT	72	2011	1.7	0.7	2
CY	71.6	2012	0.1	0.2	2.6
ES	68.5	2013	0.4	0.1	2
NL	65.2	2013	0	0	n.a[5]

[1] In both cases (SCPs/COM forecasts and SCPs plans), fiscal plans are assumed to follow SCPs projections until the EDP deadline. Differences between both scenarios then only stem from growth assumptions.
[2] Growth projections between 2012 and 2020 are the following: in 2012 and 2013, they rely on the 2012 COM Spring forecasts, then from 2014 to 2016, the real GDP growth is assumed to linearly close the output gap by 2016, finally from 2016 onwards, projections are assumed to converge towards the AWG projections.
[3] Growth projections between 2012 and 2020 are the following: they rely on the SCPs as long as data are available and then, assuming constant potential growth, real GDP growth is assumed to close the output gap by 2016 and equal to potential thereafter.
[4] In case of Germany, the calculations are made for a 2011 EDP abrogation and thus the transition period is assumed to start in 2012.
[5] Not available since the Netherlands have not reported structural balance beyond 2013.
Source: SCPs, Commission services.

available, based on unchanged policies. However, Member States subject to an excessive deficit procedure at the time of the entry into force of this new provision are granted a three-year period following the correction of the excessive deficit during which Member States should make progress towards compliance with the debt benchmark. A negative assessment of the progress made towards compliance with the debt benchmark should lead to the preparation of a report under Art. 126(3). "Sufficient progress towards compliance" is defined as a continuous and realistic adjustment needed to ensure meeting the debt benchmark at the end of the transitional period. Specifically, to ensure continuous and realistic progress during the transition period Member States should respect simultaneously two conditions as laid down in the Code of Conduct:

- 1) the annual structural adjustment should not deviate by more than 0.25% of GDP from the minimum linear structural adjustment ensuring that the debt rule is met by the end of the transitional period.

- 2) At any time during the transitional period, the remaining annual structural adjustment should not exceed ¾ % of GDP.

This ensures that the path of deficit reduction is sustained over the three years of the transitional period (first condition) and realistic (second condition), while allowing some room for manoeuvre during the transition period.

For each Member State concerned by the transition period, Table I.3.4 compares the minimum required adjustments to the structural balances set out in the SCPs. ([29]) It shows that, based on plans, all Member States would implement structural adjustments large enough to meet the debt reduction benchmark by the end of their transitional period. All Member States also plan sufficient progress according to the two criteria mentioned above.

([29]) The minimum required adjustment is the minimum structural adjustment that ensures that, if followed, the debt reduction benchmark will be met at the end of the transition period.

Box I.3.2: **Overview of Council recommendations relating to fiscal policy**

1. AT

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is cautious for the years 2012 and 2013. For 2014-2016 the scenario becomes more optimistic, projecting average GDP growth of 2.1%, consistently above the current estimates of potential growth. The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2013 and reach the medium-term budgetary objective (MTO) by 2016. The programme has changed the MTO from the target of a balanced budget over the business cycle to a structural deficit of 0.45% of GDP, adequately reflecting the requirements of the Stability and Growth Pact. The foreseen correction of the excessive deficit is in line with the deadline set by the Council recommendation issued in the context of the Excessive Deficit Procedure in December 2009. However, based on the (recalculated) structural budget balance*, the average annual fiscal effort planned at 0.5% of GDP for the period 2011-2013 is lower than the 0.75% of GDP recommended by the Council. The envisaged structural progress towards the MTO is sufficient in 2015, but lower than 0.5% of GDP per year benchmark of the Stability and Growth Pact in 2014 and 2016. However, in 2014-2015 the projected growth rate of government expenditure, taking into account discretionary revenue measures, respects the expenditure benchmark of the Stability and Growth Pact. Nevertheless, there are risks accompanying the fiscal targets both on the revenue and on the expenditure side. For example, the budgetary effect of some measures is difficult to quantify because of dependence on individual uptake. Since the legislation has not yet been decided the details of the financial transaction tax are not yet known. The envisaged expenditure cuts at the sub-national level are not defined. The programme foresees that the debt-to-GDP ratio, which amounted to 72.2% at the end of 2011, is going to peak at 75.3% in 2013 before gradually falling to 70.6% in 2016. In terms of the debt reduction benchmark of the Stability and Growth Pact, Austria will be in a transition period in the years 2014-2016 and the plans presented in the programme would ensure sufficient progress towards compliance with the debt reduction benchmark. However, there are risks attached to this projection because of the growing debt of state-owned companies classified outside the general government sector and potential further burden due to the banking sector government support.

Recommendation:

- Implement the 2012 budget as envisaged and reinforce and rigorously implement the budgetary strategy for the year 2013 and beyond; sufficiently specify measures (in particular at the sub-national level), to ensure a timely correction of the excessive deficit and the achievement of the average annual structural adjustment effort specified in the Council Recommendations under the Excessive Deficit Procedure . Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term budgetary objective (MTO), including meeting the expenditure benchmark.
- Take further steps to strengthen the national budgetary framework by aligning responsibilities across the federal, regional and local levels of government, in particular by implementing concrete reforms aimed at improving the organisation, financing and efficiency of healthcare and education.

2. BE

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible for the years 2012 and 2013 and optimistic for the years 2014 and 2015 as it foresees GDP growth to be substantially higher than the latest estimates of potential growth emerging from the Commission's 2012 spring forecast. The objective of the budgetary strategy outlined in the programme is to bring the deficit below 3% of GDP in 2012 (to 2.8% of GDP, down from 3.7% of GDP in 2011) and to zero in 2015. The programme confirms the previous medium-term budgetary objective (MTO) of a surplus of 0.5% of GDP in structural terms, which adequately reflects the requirements of the Stability and Growth Pact The planned 2012 headline deficit complies with the deadline set by the Council for the correction of the excessive deficit and the planned fiscal effort complies with the EDP recommendation of a minimal average annual effort of ¾% of GDP in structural terms. The planned growth rate of government expenditure, taking into account discretionary revenue measures, complies with the expenditure benchmark of the Stability and Growth Pact in 2013 to 2015, but not in 2012. Based on the (recalculated) structural budget balance*, the programme projects the structural balance to improve by 1.1 percentage point of GDP in 2012 and by about 0.8% of GDP on average over the period 2013-2015. However, there are risks stemming from the fact that the additional measures to be taken from 2013 onwards are not yet specified and that the macroeconomic scenario from 2014 onwards is too optimistic. The government debt, which at 98.0% of GDP in 2011 is well above the 60% threshold, is planned by the programme to stabilise and then to decline to 92.3% in 2015, which would imply sufficient progress towards meeting the debt reduction benchmark of the Stability and Growth Pact. Moreover, implicit liabilities stemming from the guarantees given to the financial sector are particularly large. The rules-based, multi-annual framework for general government, particularly with regard to expenditure would benefit from enforcement mechanisms and/or commitments from the regions and communities, as well as from the local level, in order to meet their allocated deficit targets.

(Continued on the next page)

Box (continued)

Recommendation:

- Implement the budget for the year 2012 to make sure the excessive deficit is corrected by 2012. Additionally, specify the measures necessary to ensure implementation of the budgetary strategy for the year 2013 and beyond, thereby ensuring that the excessive deficit is corrected in a durable manner and that sufficient progress is made towards the mediumterm budgetary objective (MTO), including meeting the expenditure benchmark, and ensure progress towards compliance with the debt reduction benchmark. Adjust the fiscal framework to ensure that the budgetary targets are binding at federal and sub-federal levels, and increase transparency of burden-sharing and accountability across layers of government.

3. BG

Summary assessment:

The Council is of the opinion that compared with the Commission´s 2012 spring forecast the macroeconomic scenario underpinning the budgetary projections in the programme is optimistic for the 2012-13 period, when annual growth is expected to reach 1.4% in 2012 and 2.5% in 2013. The Commission's 2012 spring forecast foresees a GDP growth of 0.5% in 2012 and 1.9% in 2013. After the correction of the excessive deficit in 2011, the objective of the budgetary strategy outlined in the programme is to achieve a budgetary position which is close to balance, both in terms of the structual and headline budget balances, by the end of the programme period. The medium-term budgetary objective (MTO), defined in structural terms, has been marginally revised from a deficit of 0.6% of GDP to a deficit of 0.5% of GDP. The new MTO adequately reflects the requirements of the Stability and Growth Pact. Based on the (recalculated) structural deficit*, Bulgaria plans to achieve its MTO over the programme period. In 2012-2014, the growth rate of government expenditure, taking into account discretionary revenue measures, would respect the expenditure benchmark of the Stability and Growth Pact, yet breach it in 2015. Planned fiscal consolidation faces a number of risks stemming from (i) lower revenue given the optimistic macroeconomic scenario as well as less tax-rich underlying growth structure of the economy and (ii) inefficiencies in the public sector, particularly with respect to arrears in healthcare, which may lead to considerable expenditure pressures. The debt ratio is below 60% of GDP and, according to the programme, it is expected to peak at close to 20% of GDP in 2012 and then to decrease over the programme period. There is considerable scope for improvement in tax compliance and advancing in this area would allow Bulgaria to support higher growth enhancing expenditures. A requirement to keep the budget deficit below 2 % and limiting government expenditure to 40 % of GDP was adopted as an amendment to the Organic Budget Law, thus strengthening the binding nature of the fiscal framework and improving the predictability of budgetary planning. However, challenges remain with respect to further improving the contents of the medium-term budgetary framework and strengthening the reporting on accrual basis including through improving the quality and timeliness of reporting by State Owned Enterprises and sub-national governments.

Recommendation:

- Continue with sound fiscal policies to achieve the medium-term budgetary objective by 2012. To this end, implement the budgetary strategy as envisaged, ensuring compliance with the expenditure benchmark, and stand ready to take additional measures in case risks to the budgetary scenario materialise. Strengthen efforts to enhance the quality of public spending, particularly in the education and health sectors and implement a comprehensive tax-compliance strategy to further improve tax revenue and address the shadow economy. Further improve the contents of the medium-term budgetary framework and the quality of the reporting system.

4. CY

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme appears optimistic in 2012-2014. Although incorporating a major downward revision of the growth outlook, the macroeconomic scenario underpinning the budgetary projections in the programme remains subject to downside risks, relating in particular to the evolution of domestic demand in 2012-2013. The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2012 and to reach the medium-term budgetary objective (MTO) by 2014, and to stay at MTO in 2015. The programme confirms the previous MTO of a balanced budget in structural terms, which adequately reflects the requirements of the Stability and Growth Pact. The planned correction of the excessive deficit is in line with the deadline set by the Council recommendation issued in the context of the Excessive Deficit Procedure on 13 July 2010. Based on the (recalculated) structural deficit,* the average annual fiscal effort planned at 1.5% of GDP for the period 2011-2012 is equal to the effort recommended by the Council. The envisaged progress towards the MTO in 2013 is sufficient as it is higher than the 0.5% of GDP benchmark of the Stability and Growth Pact both according to the Commission's 2012 spring forecast and the programme. The growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact in 2013-2014, but not in 2015. There are risks accompanying the budgetary targets of the programme linked to the macroeconomic scenario appearing optimistic in 2012-2014 and the planned consolidation effort in 2013, party relying on not fully specified measures. According to the programme, the debt-to-GDP ratio, which amounted to

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Source: **SCPs, Commission services.**

Box (continued)

ensure sufficient progress towards compliance with the debt reduction benchmark. However, there are risks attached to this projection linked to the possible rescue operations of financial corporations.

Recommendation:

- Take additional measures to achieve a durable correction of the excessive deficit in 2012. Rigorously implement the budgetary strategy, supported by sufficiently specified measures, for the year 2013 and beyond to ensure the achievement of the medium-term budgetary objective (MTO) by 2014 and compliance with the expenditure benchmark and ensure sufficient progress with the debt reduction benchmark. Accelerate the phasing-in of an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanism. Take measures to keep tight control over expenditure and implement programme and performance budgeting as soon as possible. Improve tax compliance and fight against tax evasion.

5. CZ

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. According to the convergence programme, GDP growth is expected to reach 0.2% and 1.3% in 2012 and 2013 respectively, compared to 0% and 1.5% in 2012 and 2013 respectively in the Commission's 2012 spring forecast. The objective of the budgetary strategy outlined in the programme is to reach a balanced budget in 2016. The general government deficit target of 2.9% of GDP in 2013 is in line with the deadline for correcting the excessive deficit set out in the Council recommendations of 2 December 2009. The average annual fiscal effort of 0.9% of GDP over the period 2010-2013, based on the (recalculated) structural budget balance*, is slightly below the effort of 1% of GDP recommended by the Council. The programme confirms the previous medium-term budgetary objective (MTO) of a deficit of 1% of GDP, which adequately reflects the requirements of the Stability and Growth Pact, to be reached in 2015. The progress towards the MTO is 0.8% and 0.7% of GDP in 2014 and 2015 respectively, based on the (recalculated) structural balance and the rate of growth of government expenditure complies with the expenditure benchmark of the Stability and Growth Pact. The budgetary projections of the programme are subject to several risks. The law on financial compensation to churches, currently discussed in Parliament, would increase the general government deficit by 1.5% of GDP in the year of entry into force. More generally, the nature and extent of the envisaged consolidation measures on both the revenue and the expenditure side entails a considerable risk for the sustainability of the fiscal adjustment beyond the programme period. Budgetary adjustment has so far relied mostly on across-the-board cuts, which affect also growth-enhancing expenditure. Additional savings in public administration expenditures amounting to almost 1% of GDP are planned for 2013 - 2015, but details are not sufficiently specified in the programme. Finally, most of the planned revenue measures are of a temporary nature and should expire in 2015. According to the programme, the debt-to-GDP ratio is expected to peak at 45.1% of GDP in 2013 and decline thereafter, mainly on account of the projected continuous improvement of the primary balance.

Recommendation:

- Ensure planned progress towards the timely correction of the excessive deficit. To this end, fully implement the 2012 budget and specify measures of a durable nature necessary for the year 2013 so as to achieve the annual average structural adjustment specified in the Council recommendation under the Excessive Deficit Procedure. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term objective, including meeting the expenditure benchmark. In this context, avoid across-the-board cuts, safeguard growth-enhancing expenditure and step up efforts to improve the efficiency of public spending. Exploit the available space for increases in taxes least detrimental to growth. Shift the high level of taxation on labour to housing and environmental taxation. Reduce the discrepancies in the tax treatment of employees and the self-employed. Take measures to improve tax collection, reduce tax evasion and improve tax compliance, including by implementing the Single Collection Point for all taxes.

6. DE

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. The programme's projections for 2012-13 are broadly in line with the Commission's 2012 spring forecast as regards the pace and pattern of economic growth as well as labour market developments. The programme's projections for economic growth in the outer years are broadly in line with the Commission's estimate of Germany's medium-term potential growth rate. The objective of the budgetary strategy outlined in the programme is to meet the medium-term budgetary objective (MTO) already in 2012 and to reach virtually balanced nominal budgets as from 2014, starting from a nominal deficit of 1.0% of GDP in 2011, thus below the 3% of GDP reference value of the Treaty significantly ahead of the 2013 deadline. The programme specifies the previous MTO of a structural deficit of ½% of GDP, (interpreted as a narrow range around 0.5% of GDP), which adequately reflects the requirements of the Stability and Growth Pact, to imply a deficit not exceeding 0.5% of GDP. Risks to the deficit and debt targets may arise notably if additional measures to stabilise the financial sector turned out to be required. Based on the (recalculated) structural deficit*, Germany plans to respect its MTO throughout the programme period, which should also be the case taking into account the risk assessment. According to the information provided in the programme and also

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Box (continued)

increase by 0.8 pp. to 82.0% of GDP in 2012, before falling to 80% of GDP in 2013 and remaining on a downward path thereafter. Following the correction of the excessive deficit, Germany is in a transition period and, according to plans, is making sufficient progress towards compliance with the debt reduction benchmark of the Stability and Growth Pact.

Recommendation:

- Continue with sound fiscal policies to achieve the medium-term budgetary objective by 2012. To this end, implement the budgetary strategy as envisaged, ensuring compliance with the expenditure benchmark as well as sufficient progress towards compliance with the debt reduction benchmark. Continue the growth-friendly consolidation course through additional efforts to enhance the efficiency of public spending on health care and long-term care, and by using untapped potential to improve the efficiency of the tax system; use available scope for increased and more efficient growth-enhancing spending on education and research at all levels of government. Complete the implementation of the debt brake in a consistent manner across all *LÄNDER*, ensuring timely and relevant monitoring procedures and correction mechanisms.

7. DK

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. The scenario projecting GDP growth at 1.2 and 1.5% in 2012 and 2013 is broadly in line with the Commission's 2012 spring forecast of 1.1 and 1.4%. Accordingly, the government deficits are slightly smaller in the convergence programme (4.0 and 1.8% of GDP in 2012 and 2013 respectively, compared with 4.1 and 2.0% of GDP in the Commission's 2012 spring forecast). The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2013 and achieving the medium term budgetary objective (MTO) of a structural deficit of no more than 0.5 percent of GDP. The government's objective is also to reach at least a structurally balanced budget in 2020. The programme thereby confirms the previous MTO, which adequately reflects the requirements of the Stability and Growth Pact. The planned headline deficit in 2013 is consistent with a timely correction of the excessive government deficit and, based on the (recalculated) structural budget balance*, the planned fiscal effort in that year complies with the Council recommendation issued under the Excessive Deficit Procedure in July 2010. Net discretionary measures as presented in the programme are estimated to yield a consolidation broadly in line with the EDP recommendation. The consolidation path has become more back-loaded than previously planned and a sizeable effort is needed in 2013 to ensure the required structural adjustment. Risks of falling short of the 3% of GDP reference value in 2013 are limited; the Commission's 2012 spring forecast sees the government deficit at 2.0% of GDP. Denmark is expected to reach its MTO in 2013. However, based on the (recalculated) structural budget balance, this is not the case from 2013 onwards, and the estimated budgetary improvement in the structural budget balance falls short of the 0.5% of GDP required by the Stability and Growth Pact. At the same time, the growth rate of government expenditure, taking into account discretionary revenue measures, is expected to be in line with the expenditure benchmark of the Stability and Growth Pact. Part of the budget deficits will be financed by reducing the government's account with Denmark's Nationalbank. Denmark's gross public debt is projected to fall from 46.5% of GDP in 2011 to 42.1% in 2015, well below 60% of GDP.

Recommendation:

- Implement the budgetary strategy as envisaged, to ensure a correction of the excessive deficit by 2013 and achieve the annual average structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term budgetary objective (MTO), including meeting the expenditure benchmark.

8. EE

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible in 2012-13, when GDP growth is expected to average around 2.4%. The Commission's 2012 spring forecast foresees GDP growth of 3.8% in 2013. The objective of the budgetary strategy outlined in the programme is to ensure sustainable fiscal policy that supports balanced growth, by achieving a structural surplus while ensuring sufficient fiscal buffers and reducing the tax burden on labour. The strategy also aims at fulfilling the requirements of the Stability and Growth Pact. The programme aims at overachieving the medium-term budgetary objective (MTO) of a structural surplus as of 2013. The MTO adequately reflects the requirements of the Stability and Growth Pact. Based on the (recalculated) structural budget balance,*, the rate of growth of government expenditure, taking into account discretionary revenue measures, will meet the expenditure benchmark of the Stability and Growth Pact by 2015. In parallel, the programme aims at reaching headline surpluses as of 2014. The debt ratio is well below 60% of GDP and, according to the programme, is likely to decrease after 2013 to about 10% in 2015.

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Box (continued)

more binding multi-annual expenditure rules within the medium-term budgetary framework, continue enhancing the efficiency of public spending and implementing measures to improve tax compliance.

9. EL

Recommendation: Detailed recommendations are set out in a Memorandum of Understanding.

10. ES

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underlying the programme is broadly plausible for 2012 and optimistic thereafter. The Commission's 2012 spring forecast projected GDP growth to reach -1.8% in 2012 and -0.3% in 2013, against -1.7% and 0.2%, respectively, in the programme. In compliance with the Excessive Deficit Procedure, the objective of the budgetary strategy outlined in the programme is to bring the general government deficit below 3% of the GDP reference value by 2013, based mainly on expenditure restraint, but also on some revenue-increasing measures. Based on the (recalculated) structural balance*, the annual average improvement of the structural balance planned in the programme is 2.6 % of GDP for 2011-13, above the fiscal effort of over 1.5 % of GDP on average over the period 2010-13 recommended under the Excessive Deficit Procedure. Following the correction of the excessive deficit, the programme confirms the medium-term objective (MTO) of a balanced budgetary position in structural terms, which would be almost reached by 2015 with a structural budget deficit of 0.2 % of GDP. The MTO adequately reflects the requirements of the Stability and Growth Pact. The envisaged pace of adjustment in structural terms in 2012-13, represents sufficient progress towards the MTO and the growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact. The programme projects the government debt ratio to peak in 2013 and to start declining thereafter. In 2014 and 2015 Spain will be in transition period and plans presented in the programme would ensure sufficient progress towards compliance with the debt reduction benchmark of the Stability and Growth Pact. The deficit and debt adjustment paths are subject to important downside risks. Macroeconomic developments could turn out less favourable than expected. Moreover, measures are not sufficiently specified from 2013 onwards. Budgetary compliance by regional governments, given their recent poor track record, a greater sensitivity of revenues to the ongoing structural adjustment, the uncertain revenue impact of the fiscal amnesty and potential further financial rescue operations also pose risks to the budgetary strategy. Any impact of these financial rescue operations on the deficit would be of a one-off nature. Strict enforcement of the Budget Stability Law and the adoption of strong fiscal measures at regional level would mitigate the risks of a slippage at regional level. Given the decentralised nature of Spain's public finances, a strong fiscal and institutional framework is essential. The Council welcomes the intention of the Commission to present a thorough assessment of the implementation of the Council recommendation on correcting the excessive deficit, also taking into consideration the announced multi-annual budget plan for 2013-14 in the coming weeks.

Recommendation:

- Deliver an annual average structural fiscal effort of above 1.5% of GDP over the period 2010-13 as required by the EDP recommendation by implementing the measures adopted in the 2012 budget and adopting the announced multi-annual budget plan for 2013-14 by end July. Adopt and implement measures at regional level in line with the approved rebalancing plans and strictly apply the new provisions of the Budgetary Stability Law regarding transparency and control of budget execution and continue improving the timeliness and accuracy of budgetary reporting at all levels of government. Establish an independent fiscal institution to provide analysis, advice and monitor fiscal policy. Implement reforms in the public sector to improve the efficiency and quality of public expenditure at all government levels.

11. FI

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible for the 2012-13 period, GDP growth expected in the programme is in line with the Commission's 2012 spring forecast. Projections are also realistic for the years 2014 and 2015 as they foresee GDP growth to be substantially lower than encountered before the crises and lower than in the recovery years 2010-11. The main budgetary goal of Finland's 2012 stability programme is to reduce the central government deficit by limiting expenditures and increasing revenues. As the central government budget is the main source of the general government deficit, improving its position will contribute to balancing of the general government budget. The medium-term budgetary objective (MTO) of a surplus of 0.5% of GDP in structural terms reflects adequately the requirements of the Stability and Growth Pact. Based on the (recalculated) structural budget balance*, Finland has met the MTO in 2011 but would marginally deviate from it over 2012-15. The rate of growth of government expenditure, taking into account discretionary revenue measures, complies with the expenditure benchmark of the Stability and Growth Pact in all years except 2015. The programme aims at balancing the general government budget by 2015 and reaching surpluses as from 2016. The debt ratio is well below 60% of GDP and according to the programme, the debt level will peak in 2014 at close to 52% of GDP and then start declining. A notable sustainability gap still exists in Finland's public finances, mainly stemming from a rapidly deteriorating dependency ratio caused by population ageing. The sustainability gap in public finances needs to be continuously

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Box (continued)

monitored and measures adjusted accordingly. Finland's fiscal framework is anchored to multi-annual expenditure ceilings, but these do currently not apply for the municipal sector.

Recommendation:

- Preserve a sound fiscal position in 2012 and beyond by correcting any departure from the medium-term budgetary objective (MTO) that ensures the long-term sustainability of public finances. To this end, reinforce and rigorously implement the budgetary strategy, supported by sufficiently specified measures, for the year 2013 and beyond including meeting the expenditure benchmark. Continue to carry out annual assessments of the size of the ageing-related sustainability gap and adjust public revenue and expenditure in accordance with the long-term objectives and needs. Integrate the local government sector better in the system of multi-annual fiscal framework including through measures to control expenditure.

12. FR

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is optimistic. The Commission's 2012 spring forecast projected GDP growth to reach 0.5% in 2012 and 1.3% in 2013, against 0.7% and 1.75%, respectively, according to the programme. After the deficit came out better than expected at 5.2% of GDP in 2011, the programme plans to bring it down to 3% of GDP in 2013, which is the deadline set by the Council for correcting the excessive deficit, and to continue consolidation thereafter, with a balanced budget to be achieved by 2016. The medium-term budgetary objective (MTO) of a balanced budget in structural terms is expected to be reached within the programme period. The MTO adequately reflects the requirements of the Stability and Growth Pact. Based on the (recalculated) structural balance[*], the planned average annual fiscal effort in 2010-2013 is in line with the Council recommendation of 2 December 2009. Annual progress in structural terms equivalent to a further 0.7% of GDP towards achieving the MTO is projected to be made in 2014–16. According to the programme, the growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact. The adjustment path presented in the programme is subject to risks. The macroeconomic scenario could turn out to be less favourable as indicated by the Commission's 2012 spring forecast. Measures are not sufficiently specified to reach the targets from 2013 onwards and to achieve the recommended average annual fiscal effort. Furthermore, France's track record when it comes to meeting expenditure targets is mixed. Therefore, it cannot be ensured that the excessive deficit will be corrected by 2013 unless the planned measures are sufficiently specified and additional ones implemented as needed. Starting from 85.8% of GDP in 2011, the debt ratio is expected to reach 89.2% in 2013 and to drop to 83.2% in 2016. According to the programme, the debt reduction benchmark will be met at the end of the transition period (2016).

Recommendation:

- Reinforce and implement the budgetary strategy, supported by sufficiently specified measures, notably on the expenditure side, for the year 2012 and beyond to ensure a correction of the excessive deficit by 2013 and the achievement of the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term budgetary objective (MTO), including meeting the expenditure benchmark, and ensure sufficient progress towards compliance with the debt reduction benchmark. Continue to review the sustainability and adequacy of the pension system and take additional measures if needed.

13. HU

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is somewhat optimistic. The Hungarian authorities' growth projections for 2012 and 2013 are higher by around half a percentage point compared to the Commission's 2012 spring forecast on the account of the more optimistic official assumptions regarding domestic demand, particularly in 2013. The objective of the budgetary strategy outlined in the programme is to ensure the sustainable correction of the excessive deficit by the 2012 deadline set by the Council in line with the Council Recommendation of March 2012. The official deficit targets and the planned fiscal efforts comply with the March 2012 Council recommendations based on Article 126(7). The programme confirms the previous medium-term budgetary objective (MTO) of 1.5% of GDP, which it plans to achieve by 2013. The MTO adequately reflects the requirements of the Stability and Growth Pact. Based on the (recalculated) structural budget balance[*], progress towards the MTO does not appear to be adequate in 2013 against the assessment of the Commission's 2012 spring forecast, which takes into account the implementation risks related to selected saving measures and a less optimistic macroeconomic scenario. The growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact in 2013, but not in 2014 and in 2015. According to government plans, the public debt is continuously reduced throughout the programme period to below 73% of GDP in 2015, but will remain above the 60% of GDP reference value. Regarding the debt reduction benchmark, Hungary will be in transition period in 2013-2014 and the programme would ensure sufficient progress towards compliance with the benchmark. According to the programme, the debt reduction benchmark would be met at the end of the transition period, in 2015, and thereby should help to reduce the accumulated external and internal indebtedness.

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Box (continued)

Recommendation:

- Correct the excessive deficit by 2012 in a durable manner, by implementing the 2012 budget and the subsequently approved consolidation measures, while reducing the reliance on one-off measures. Thereafter, specify all structural measures necessary to ensure a durable correction of the excessive deficit and to make sufficient progress towards the medium-term budgetary objective (MTO), including meeting the expenditure benchmark, and ensure sufficient progress towards compliance with the debt reduction benchmark. Also to help mitigate the accumulated macroeconomic imbalances, put the public debt ratio on a firm downward path.
- Revise the cardinal law on economic stability by putting the new numerical rules into a binding medium-term budgetary framework. Continue to broaden the analytical remit of the Fiscal Council, with a view to increasing the transparency of public finances.

14. IE

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections of the programme is plausible. Economic growth projections in the programme are similar to the Commission's spring 2012 forecast. The objective of the budgetary strategy of the programme is to reduce the general government deficit below the 3% of GDP threshold by end 2015, which is in line with the deadline set by the Council for correcting the excessive deficit. The programme currently projects a deficit of 8.3% of GDP (below the programme target of 8.6% of GDP) in 2012, 7.5% of GDP in 2013, 4.8% of GDP in 2014 and 2.8% of GDP by the end of the programme period in 2015. This path is underpinned by consolidation measures of 2.7% of GDP implemented in the budget for 2012, and broad consolidation measures of 3.9 % of GDP in 2013-2014 and a further partly specified consolidation effort of 1.1% of GDP in 2015. The programme restates the medium-term objective (MTO) of a structural general government deficit of 0.5 % of GDP, which is not reached within the programme period. The MTO adequately reflects the requirement of the Stability and Growth Pact. General government debt is above 60% of GDP and is projected to increase from 108% of GDP in 2011 to 120% in 2013 before starting to decline. For the duration of the Excessive Deficit Procedure until 2015 and in the following three years, Ireland will be in transition period and the budgetary plans would ensure sufficient progress towards compliance with the debt reduction benchmark of the Stability and Growth Pact.

Recommendation: Detailed recommendations are set out in a Memorandum of Understanding.

15. IT

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underlying the programme is plausible, under the assumption of no further worsening in financial market conditions. In line with the Commission's spring 2012 forecast, it expects real GDP to contract sharply this year and recover gradually in 2013. In compliance with the Excessive Deficit Procedure (EDP), the objective of the budgetary strategy outlined in the programme is to bring the general government deficit below the 3% of GDP reference value by 2012, based on further expenditure restraint and additional revenues. Following the correction of the excessive deficit, the programme confirms the medium-term budgetary objective (MTO) of a balanced budgetary position in structural terms, which adequately reflects the requirements of the Stability and Growth Pact. It plans to achieve it in 2013, i.e. one year earlier than targeted in the previous stability programme, through the measures already adopeted in 2010 - 2011. Based on the (recalculated) structural deficit*, the planned average annual fiscal effort over the period 2010-2012 is well above the 0.5% of GDP recommended by the Council under EDP. The envisaged pace of adjustment in structural terms in 2013 allows achieving the MTO in that year and the planned rate of growth of government expenditure, taking into account discretionary revenue measures would comply with the expenditure benchmark of the Stability and Growth Pact. The programme projects the government debt ratio to peak in 2012 and to start declining at an increasing pace thereafter, as the primary surplus increases. In 2013-14 Italy will be in transition period and its budgetary plans would ensure sufficient progress towards compliance with the debt reduction benchmark, as also confirmed in the Commission's 2012 spring forecast. According to plans, the debt reduction benchmark will be met at the end of the transition period (2015). Reaching the above deficit and debt outcomes will require strict and full budgetary implementation of the corrective measures adopted in 2010-11.

Recommendation:

- Implement the budgetary strategy as planned, and ensure that the excessive deficit is corrected in 2012. Ensure the planned structural primary surpluses so as to put the debt-to-GDP ratio on a declining path by 2013. Ensure adequate progress towards the medium-term budgetary objective, while meeting the expenditure benchmark and making sufficient progress towards compliance with the debt reduction benchmark.
- Ensure that the specification of the key features of the Constitutional balanced budget rule in the implementing legislation, including appropriate coordination across levels of government, is consistent with the EU framework. Pursue a durable improvement of the efficiency and quality of public expenditure through the planned spending review and the implementation of the 2011 Cohesion Action Plan leading to improving the absorption and management of EU funds, in particular in the South of Italy.

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Box (continued)

16. LT

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. It is broadly in line with the Commission's 2012 spring forecast for 2012 and 2013. The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2012 as recommended by the Council and progressing towards the medium-term budgetary objective (MTO) thereafter. The programme confirms the previous MTO, i.e. a structural general government surplus of 0.5 % of GDP, which adequately reflects the requirements of the Stability and Growth Pact, and outlines a consolidation of at least 1 percentage point per year, planning a balanced budget by 2015. While the budgetary plans are in line with a timely correction of the excessive deficit, the average annual fiscal effort in 2010-2012, based on the (recalculated) structural budget balance*, is expected to be lower than 2.25% of GDP required by the Council in its recommendation of 16 February 2010. The planned annual progress towards the MTO in the years following the correction of the excessive deficit is slightly higher than 0.5% of GDP in structural terms, that is, the benchmark of the Stability and Growth Pact. The planned rate of growth of government expenditure, taking into account discretionary revenue measures, complies with the expenditure benchmark of the Stability and Growth Pact in 2013 and 2014, but not in 2015. General government debt is projected to remain below 60% of GDP over the programme period, increasing to nearly 41% of GDP in 2013, according to the Commission's 2012 spring forecast, while the convergence programme targets the debt to decrease to around 35% by 2015. The reform of budget planning and execution is progressing but the government has still to approve the proposed laws. These laws would improve accountability within the fiscal framework, by establishing an independent body, and to tighten rules on treasury reserves.

Recommendation:

- Ensure planned progress towards the timely correction of the excessive deficit. To this end, fully implement the budget for the year 2012 and achieve the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. Thereafter, specify the measures necessary to ensure implementation of the budgetary strategy for the year 2013 and beyond as envisaged, ensuring an adequate structural adjustment effort to make sufficient progress towards the medium-term budgetary objective, including meeting the expenditure benchmark, while minimising cuts in growth-enhancing expenditure. In that respect, review and consider increasing taxes least detrimental to growth, such as housing and environmental taxation, including introducing car taxation, while reinforcing tax compliance. Strengthen the fiscal framework, in particular by introducing enforceable and binding expenditure ceilings in the medium-term budgetary framework.

17. LU

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. In particular, the programme scenario for 2012 and 2013 is very close to the Commission's 2012 spring forecast. Medium-term deficit projections are made under a slightly optimistic growth scenario, above potential growth although still well below average historic rates. The objective of the budgetary strategy outlined in the programme is to bring the deficit from 1.5% in 2012 to 0.9% in 2014 with a package of consolidation measures of around 1.2% of GDP and provide a wider room for manoeuvre in case of negative shocks. The programme confirms the previous medium term objective (MTO) of a structural surplus of 0.5%. However, this MTO cannot be regarded as appropriate under the provisions of the Stability and Growth Pact because, based on current policies and projections, this MTO does not appear to take sufficiently into account the implicit liabilities related to ageing, despite the debt being below the Treaty reference value. Moreover, based on both the Commission's 2012 spring forecast as well as on the (recalculated) structural budget balance in the programme, Luxembourg would significantly depart from its own MTO starting from 2012. The growth rate of government expenditure, net of discretionary revenue measures, is expected to significantly exceed the expenditure benchmark as defined in the Stability and Growth Pact. At 20 % of GDP, gross government debt is below the reference value of the Treaty.

Recommendation:

- Preserve a sound fiscal position by correcting any departure from a medium-term budgetary objective (MTO) that ensures the long-term sustainability of public finances, in particular taking into account implicit liabilities related to ageing. To this end, reinforce and rigorously implement the budgetary strategy, supported by sufficiently specified measures, for the year 2013 and beyond, including meeting the expenditure benchmark.

18. LV

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections is cautious in 2012, taking into account the latest available information, and plausible in 2013. While macroeconomic projections for 2012 in the programme scenario are very close to those in the Commission's spring 2012 forecast (with GDP growth projections respectively at 2.0% and 2.2%), recent

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Box (continued)

convergence programme has changed the medium-term objective from -1.0% to -0.5% of GDP; the new MTO adequately reflects the requirements of the Stability and Growth Pact. The planned headline deficit in 2012 complies with the deadline for correction of the excessive deficit established in Council Recommendation of 7 July 2009. For 2013, the programme targets a headline deficit of 1.4% of GDP, although the planned expenditure reduction is not yet fully supported by measures. Based on the (recalculated) structural budget balance[*], Latvia will approach its MTO by the end of the programme period in 2015. While the recalculated information suggests that progress towards the MTO is less than 0.5% of GDP in structural terms in outer years of the programme, planned expenditure restraint would ensure that the growth rate of government expenditure, taking into account discretionary revenue measures, would be in line with the expenditure benchmark of the Stability and Growth Pact. At the same time, tax changes from the second half of 2012 as adopted by Parliament on the 24th of May, which are not yet reflected in the programme scenario but acknowledged in the letter accompanying the submission of the 2012 convergence programme represent a risk to the attainment of targets in 2013 and beyond. The general government debt ratio is below 60% of GDP, increasing from 42.6% of GDP in 2011 to 46.7% of GDP in 2014, as the authorities pre-fund large repayments related to the international financial assistance programme that are due in 2014-2015, and falling to 38.9% in 2015 as these repayments are made.

Recommendation:

- Ensure planned progress towards the timely correction of the excessive deficit. To this end, implement the budget for the year 2012 as envisaged and achieve the fiscal effort specified in the Council recommendation under the Excessive Deficit Procedure. Thereafter, implement a budgetary strategy, supported by sufficiently specified structural measures, for the year 2013 and beyond, to make sufficient progress towards the medium-term budgetary objective (MTO), and to respect the expenditure benchmark. Use better than expected cyclical revenue to reduce government debt.
- Implement measures to shift taxation away from labour to consumption, property, and use of natural and other resources while improving the structural balance; ensure adoption of the Fiscal Discipline Law and develop a medium term budgetary framework law to support the long-term sustainability of public finances; restore contributions to the mandatory funded private pension scheme at 6% of gross wages from 2013.

19. MT

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections is optimistic, especially in the outer years of the stability programme period when compared with potential growth as estimated by the Commission. The objective of the budgetary strategy outlined in the programme is to gradually reduce the deficit, to 0.3% of GDP in 2015, after the planned correction of the excessive deficit in 2011. The programme confirms the previous medium-term budgetary objective (MTO) of a balanced position in structural terms, which is to be achieved beyond the programme period. The MTO adequately reflects the requirements of the Stability and Growth Pact. There are risks that the deficit outcomes could be worse than targeted, stemming from (i) lower revenue given the slightly optimistic macroeconomic scenario; (ii) possible overruns in current primary expenditure; and (iii) the ongoing restructuring of the national airline (Air Malta) and financial situation of the energy provider (Enemalta). Based on the (recalculated) structural budget balance[*], annual progress towards the MTO is planned to be in line with the 0.5% of GDP benchmark in the Stability and Growth Pact. Using the Commission's identification of the one-offs included in the budgetary targets, average progress towards the MTO is slightly higher (¾% of GDP) but spread very unevenly, with no progress in 2012 followed by an effort of 1¼% in 2013. According to the information provided in the programme, the growth rate of government expenditure, taking into account discretionary revenue measures, would be in line with the expenditure benchmark of the Stability and Growth Pact throughout the programme period. The risks to the budgetary targets imply, however, that the average adjustment towards the MTO could be slower than appropriate. After peaking at 72% of GDP in 2011, the general government gross debt ratio is planned in the programme to start decreasing and to reach 65.3% of GDP in 2015 (still above the 60% of GDP reference value). According to the plans in the programme, Malta is making sufficient progress towards meeting the debt reduction benchmark of the Stability and Growth Pact at the end of the transition period (2015) but this assessment is subject to risks as the debt ratio could turn out higher than planned given the possibility of higher deficits and stock-flow adjustments. Malta's medium-term budgetary framework remains non-binding, implying a relatively short fiscal planning horizon. The programme announces that the Maltese government is considering reforms to the annual budgetary procedure, including timelines, and introducing a fiscal rule embedded in the Constitution, including monitoring and corrective mechanisms, in line with recent changes to the euro area governance framework.

Recommendation:

- Reinforce the budgetary strategy in 2012 with additional permanent measures so as to ensure adequate progress towards the medium-term budgetary objective (MTO) and keep the deficit below 3% of GDP without recourse to one-offs. Continue fiscal consolidation at an appropriate pace thereafter, so as to make sufficient progress towards the MTO, including meeting the expenditure benchmark, and towards compliance with the debt reduction benchmark, by specifying the concrete measures to back up the deficit targets from 2013, while standing ready to take additional measures in case of slippages. Implement, by end-2012 at the latest, a binding, rule-based

(Continued on the next page)

Box (continued)

multi-annual fiscal framework. Increase tax compliance and fight tax evasion, and reduce incentives towards indebtedness in corporate taxation.

20. NL

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is optimistic. For 2013, the stability programme projects economic growth of 1¼% without taking into account the negative impact of the additional consolidation measures on growth, whilst, on the basis of the same no-policy change scenario, the Commission's forecast a lower growth rate of 0.7%. The stated objective of the programme is to meet the Council recommendations on correcting the excessive deficit and to strive to further improve the budgetary position towards the medium-term budgetary objective (MTO) by targeting a structural effort of at least 0.5% per year. The programme targets a headline general government deficit of 3% of GDP in 2013 and confirms the previous MTO of a structural deficit of 0.5% of GDP, which adequately reflects the requirements of the Stability and Growth Pact. The average annual fiscal effort of 0.75% of GDP over the period 2010-2013, based on the (recalculated) structural budget balance*, is in line with the structural effort of ¾% of GDP recommended by the Council. As the programme does not provide budgetary targets beyond 2013, the sustainability of the budgetary correction in 2013 and progress towards the MTO in the outer years, including compliance with the expenditure benchmark of the Stability and Growth Pact, cannot be assessed. The budgetary projections over the programme period are subject to implementation risks. These are not solely restricted to the newly announced consolidation measures, but also to the implementation of some of the measures agreed upon earlier by the outgoing government. The additional measures proposed by the government in April 2012 for 2013 and their budgetary impact have been further specified and quantified on 25 May after the cut-off date for assessment. Budgetary adjustment has so far relied mostly on expenditure cuts, which also affect growth-enhancing expenditure. According to the 2012 stability programme, the debt-to-GDP ratio is expected to further rise relatively markedly in 2012, to 70.2% of GDP and to increase slightly further to 70.7% of GDP in 2013, taking into account the impact of the additional consolidation measures. The debt ratio is thus projected to remain well above the 60% reference value. For 2014 and 2015, the programme does not specify debt targets and therefore an assessment of compliance with the debt reduction benchmark of the Stability and Growth Pact beyond 2013 cannot be given.

Recommendation:

- Ensure timely and durable correction of the excessive deficit. To this end, fully implement the budgetary strategy for 2012 as envisaged. Specify the measures necessary to ensure implementation of the 2013 budget with a view to ensuring the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term budgetary objective (MTO), including meeting the expenditure benchmark, and ensure sufficient progress towards compliance with the debt reduction benchmark whilst protecting expenditure in areas directly relevant for growth such as research and innovation, education and training. To this end, after the formation of a new government, submit an update of the 2012 stability programme with substantiated targets and measures for the period beyond 2013.

21. PL

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible and is in line with the Commission's 2012 spring forecast. The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2012 and reach medium-term budgetary objective (MTO) by 2015. The programme confirms the MTO of a deficit of 1% of GDP, which adequately reflects the requirements of the Stability and Growth Pact. The planned correction of the deficit is in line with the deadline set by the Council and the planned fiscal effort complies with the recommendation under the Excessive Deficit Procedure. Based on the (recalculated) structural deficit*, the planned annual progress towards the MTO is higher than 0.5% of GDP (in structural terms). The growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the benchmark of the Stability and Growth Pact over entire programme period, but exceeds the expenditure benchmark by a small margin in 2013, according to the Commission's 2012 spring forecast. Sufficient progress towards the MTO may require additional efforts as it predominantly relies on sizeable cuts in public investment expenditure and is not sufficiently supported by detailed measures in the outer years of the programme. General government debt is projected to remain below 60 % of GDP in Poland over the programme period. The national authorities forecast it to decrease gradually from 56.3% of GDP in 2011 to 49.7% of GDP in 2015, whereas the Commission, taking account of possible risks to the consolidation plans, expects the improvement to be slower.

Recommendation:

Ensure planned progress towards the correction of the excessive deficit. To this end, fully implement the budget for the year 2012 and achieve the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Thereafter, specify the measures necessary to ensure implementation of the budgetary strategy for the year 2013 and beyond as envisaged,

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Box (continued)

- Speed up the reform of the fiscal framework by enacting legislation with a view to introducing a permanent expenditure rule by 2013. This rule should be consistent with the European system of accounts. Take measures to strengthen the mechanisms of coordination among the different levels of government in the medium-term and annual budgetary processes.

22. PT

Recommendation: Detailed recommendations are set out in a Memorandum of Understanding.

23. RO

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. The objective of the budgetary strategy outlined in the programme is to reach a budget deficit below 3% of GDP in 2012, in line with the Council recommendations given to Romania under the Excessive Deficit Procedure. Thereafter, it aims at achieving a medium-term budgetary objective (MTO) defined as a deficit of 0.7% of GDP in structural terms. The MTO adequately reflects the requirements of the Stability and Growth Pact. Following the planned correction of the excessive deficit in 2012, the deficit is expected to decrease further to 2.2% of GDP in 2013, to 1.2% of GDP in 2014 and 0.9% of GDP in 2015. Based on the (recalculated) structural budget balance*, this implies an improvement in the deficit by 1.5% in 2012, 0.5% in 2013 and 0.7% in 2014, in line with the 0.5% of GDP benchmark of the Stability and Growth Pact. The growth rate of government expenditure is in line with the expenditure benchmark of the Stability and Growth Pact over the 2012-2015 period. The programme foresees the achievement of the MTO in 2014. The main risks to the budgetary targets are the arrears of state owned enterprises, as well as potential re-accumulation of arrears at local government level and in the health sector, even if some measures have been taken in the health sector. As regards public debt, it was below 34% of GDP by end 2011 thus remaining substantially below 60% of GDP.

Recommendation: Detailed recommendations are set out in a Memorandum of Understanding.

24. SE

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible for 2012 and optimistic in 2013-15, when GDP growth is expected to average around 3.5%. The Commission's 2012 spring forecast foresees GDP growth of 2.1% in 2013. The objective of the budgetary strategy outlined in the programme is to ensure long-term sustainability by respecting the rules of the Swedish fiscal framework, including the target of having a surplus in general government net lending of 1% of GDP over the cycle. The strategy also aims at fulfilling the requirements of the Stability and Growth Pact, notably respecting the 3% of GDP reference value. The programme has changed the medium-term budgetary objective (MTO) from a general government surplus of 1.0% of GDP to a deficit of 1.0% of GDP. The new MTO adequately reflects the requirements of the Stability and Growth Pact. Due to the change, the MTO is, based on the (recalculated) structural budget balance, likely to be met over the programme period, even taking into account the likelihood of further expansionary discretionary measures in 2013 or 2014, . Certain downside risks to budgetary projections from 2013 onwards are linked to the optimistic macroeconomic assumptions. The planned growth rate of government expenditure, taking into account discretionary revenue measures, would comply with the expenditure benchmark of the Stability and Growth Pact. The debt ratio is below 60% of GDP and, according to the programme, is projected to continue to decrease over the programme period.

Recommendation: Detailed recommendations are set out in a Memorandum of Understanding.

25. SI

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is optimistic when compared with the Commission's 2012 spring forecast. The objective of the budgetary strategy outlined in the programme is to bring the general government deficit below 3% of GDP in 2013, the deadline set by the Council, and to pursue further deficit reduction thereafter so as to broadly achieve Slovenia's medium-term budgetary objective (MTO) by 2015. The MTO is defined as a balanced position in structural terms, unchanged from the previous programme, but cannot be regarded as appropriate under the provisions of the Stability and Growth Pact because, based on current policies and projections, it does not ensure sufficiently rapid progress towards long-term sustainability. There are risks that the deficit outcomes could be worse than targeted, due to (i) a lack of specification of the measures foreseen, in particular for the period 2014-15; (ii) a track record of primary current expenditure overruns; (iii) lower revenue given the relatively optimistic macroeconomic scenario and uncertainty about the impact of the recently decided tax measures; and (iv) possible additional capital support operations and calling of guarantees. Based on the (recalculated) structural balance*, the average annual fiscal effort over the period 2010-2013, is planned to be almost 1% of GDP, slighty above the one recommended by the Council. However, the Commission's 2012 spring forecast implies that an additional effort will have to be made in 2013 to respect the recommendation over the

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Box (continued)

growth of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact in both years, so overall the programme plans a broadly appropriate adjustment path towards the MTO. Taking account of the risks mentioned above, the progress towards the MTO could be slower than appropriate in both years. From around 48% of GDP in 2011, general government gross debt is projected in the programme to peak by 2013 at 53% (thus remaining below the 60% of GDP reference value) before falling slightly by the end of the programme period. The debt projections are subject to upward risks from the possibility of higher deficits mentioned above and higher stock-flow adjustments. Slovenia's medium-term budgetary framework and expenditure rule remain insufficiently binding and insufficiently focussed on achieving the MTO and securing long-term sustainability.

Recommendation:

- Implement the 2012 budget, and reinforce the budgetary strategy for 2013 with sufficiently specified structural measures, standing ready to take additional measures so as to ensure a correction of the excessive deficit in a sustainable manner by 2013 and the achievement of the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards an appropriate medium-term objective for the budgetary position, including meeting the expenditure benchmark. Strengthen the medium-term budgetary framework, including the expenditure rule, by making it more binding and transparent.

26. SK

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. It is broadly in line with the Commission's 2012 spring forecast, although the latter assumes somewhat higher real GDP growth in 2012. The stated objective of the budgetary strategy outlined in the programme is to ensure the long-term sustainability of public finances. The intermediary steps defined to reach this are a rigorous implementation of the 2012 budget and a reduction of the headline deficit below 3% of GDP in 2013, the deadline for correction of the excessive deficit set by the Council. The achievement of the headline deficit target in 2013, however, may fall short of plans. The programme has changed the medium-term budgetary objective (MTO) from a close-to-balanced budget to a structural deficit of 0.5% of GDP, which is not foreseen to be achieved within the programme period. The new MTO adequately reflects the requirements of the Stability and Growth Pact. Based on the (recalculated) structural budget balance[*], the average annual fiscal effort in 2010-2013 amounts to 1.3% of GDP, well above the required value recommended by the Council, whereby the residual fiscal effort is somewhat back loaded to 2013. The target for 2013 is subject to risks, as suggested revenue measures may fall short of the objective; simultaneous implementation of all small-scale measures can be difficult to implement, and in light of upwards revisions of the deficit targets that took place in the past. In addition, further across-board expenditure cuts may prove unsustainable in the medium term. In 2014 and 2015, the average fiscal effort stands at 0.3% of GDP annually, which is below the required adjustment of 0.5% of GDP for countries which have not yet reached the MTO. Nevertheless, according to the programme the growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact in the outer years of the programme. Government debt would remain well below 60% of GDP. While Slovakia passed legislation establishing the Fiscal Council, so far it has not been set up and the legislation on expenditure ceilings has not yet been adopted.

Recommendation:

- Take additional measures in 2012 and specify the necessary measures in 2013, to correct the excessive deficit in a sustainable manner and ensure the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure. Implement targeted spending cuts, while safeguarding growth-enhancing expenditure, and step up efforts to improve the efficiency of public spending. Thereafter, ensure an adequate structural adjustment effort to make sufficient progress towards the medium-term objective, including meeting the expenditure benchmark. Accelerate the setting up of the Fiscal Council and adopt rules on expenditure ceilings.
- Increase tax compliance, in particular by improving the efficiency of VAT collection; reduce distortions in taxation of labour across different employment types, also by limiting tax deductions; link real estate taxation to the market value of property; make greater use of environmental taxation

27. UK

Summary assessment:

The Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. The objective of the budgetary strategy outlined in the programme is to implement the necessary fiscal consolidation to achieve the government's fiscal targets on net debt and cyclically-adjusted current balance. The convergence programme does not include a medium-term objective (MTO) as foreseen by the Stability and Growth Pact. According to programme projections, the deadline to correct the excessive deficit set by the Council in its recommendation of 2 December 2009 is expected to be missed by one year. The government

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Box (continued)

deficit in 2014-15, the deadline set by the Council, is estimated at 4.4% of GDP, implying, based on the (recalculated) structural deficit[*], an average fiscal effort of 1.25% of GDP between 2010-11 and 2014-15 which is below the 1¾% effort set out in the Council recommendation under the Excessive Deficit Procedure. Although the government has not deviated from its fiscal consolidation strategy which initially, based on previous macroeconomic projections, appeared sufficient to comply with EDP targets, the fiscal performance and outlook have been affected by a deterioration of economic growth prospects. Revenue measures have been significantly front-loaded in the adjustment path of the fiscal consolidation. Almost 40% of the total annual fiscal consolidation planned for the 2010-11 to 2014-15 period has been achieved by the end of 2011-12, including 30% of the spending cuts and two-thirds of the net tax increases. The potential revenue contribution from an increased efficiency of the tax system, stemming from a review of the VAT rate structure, remains relatively underexploited. According to the convergence programme, the general government deficit is expected to be 8.3% of GDP in 2011-12, 5.9% in 2012-13, 6.0% of GDP in 2013-14, 4.4% of GDP in 2014-15, 2.9% of GDP in 2015-16 and 1.2% of GDP in 2016-17. These estimates are somewhat lower than those by Commission services, who in its 2012 spring forecast expect a deficit of 6.1% of GDP in 2012-13 (which would be 7.9% without an upcoming one-off pension fund transfer) and 6.5% of GDP in 2013-14. The differences stem from a lower growth forecast and amendments made by Eurostat to UK data. Some adjustments were made to the government's fiscal plans in the 2011 Autumn Statement to prioritise growth-enhancing expenditure, but public sector investment is still set to fall sharply by 2014-15. Government debt, forecast at 94.7% in 2013-14, is expected to peak in 2014-15.

Recommendation:

- Fully implement the budgetary strategy for the financial year 2012-13 and beyond, supported by sufficiently specified measures, to ensure a timely correction of the excessive deficit in a sustainable manner and the achievement of the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure and to set the high public debt ratio on a sustained downward path. Subject to reinforcing the budgetary strategy for the financial year 2013-14 and beyond, prioritise growth-enhancing expenditure to avoid the risk that a further weakening of the medium-term outlook for growth will negatively impact on the long-term sustainability of public finances

[*] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the programme, using the commonly agreed methodology.

Part II

Evolving budgetary surveillance

SUMMARY

The deepening of the sovereign debt crisis in 2011 and 2012 marked a turning point in the debate on the EU economy and its governance framework, in particular in relation to the euro area. The move to stricter budgetary and economic surveillance intensified, building on the recently adopted reforms.

Despite the preceding period of sustained economic growth, many Member States entered the recession in 2009 with little or no room for fiscal manoeuvre to reduce its impact on the economy. In some Member States, the apparent fiscal space vanished as macroeconomic imbalances and strains in financial markets unwound. The dramatic social implications of shrinking economic output and rising government deficits and debt in those Member States that were most strongly affected, along with the first signs of spillovers to other euro area countries, triggered a consensus on the need to change the EU governance framework. As a result the economic and fiscal surveillance framework in the EU as a whole was reformed, and a crisis resolution mechanism for the euro area was introduced.

The supervisory and regulatory framework of the banking system also underwent significant reforms. A new EU financial supervisory framework became operational in January 2011. In response to G20 commitments, the EU continues its financial regulation programme. The latest Commission's legislative proposal on credit rating agencies (CRA3) is meant to tackle the overreliance of financial markets on ratings, concentration in the credit rating sector, CRAs civil liability and remuneration models. Other major on-going projects include revisions of the capital requirements for banks (CRD4 directive) and the markets in financial instruments directive (MIFID), both currently being discussed in the European Parliament and the Council. Most recently, on 6 June 2012, the Commission adopted a legislative proposal for bank recovery and resolution. The proposed framework sets out the necessary steps and powers to ensure that bank failures across the EU are managed in a way which avoids financial instability and minimises costs for taxpayers. The May 2012 informal European Council summit resolved that Economic and Monetary Union needed to be deepened and a potential 'banking union' could be established with more integrated banking supervision and resolution, and a common deposit insurance scheme. The June 2012 Euro Area summit confirmed that the Commission would present plans for a European single supervisory mechanism along with a framework for the potential direct recapitalisation of euro area banks through the ESM, paving the way for a banking union.

With a number of euro area members facing insolvency/illiquidity, backstops of last resort were set up as early as May 2010 (see Box I.2) to guarantee the stability of the euro area. The temporary firewalls were developed gradually. In February 2012, Member States signed a Treaty establishing the European Stability Mechanism (ESM). The strict conditionality attached to the financial support provided by all the different backstops implied a significant strengthening of economic and fiscal surveillance on the Member States concerned.

The lack of fiscal space for some countries to support their economies during the early days of the crisis, and the more recent evolution of the crisis from a banking crisis to a sovereign debt one, highlighted the extent of the implications of inadequate national economic and budgetary policy during the boom years. With the risks to spillovers to other Member States also becoming evident, an overall strengthening of EU surveillance has been undertaken. A major overhaul of the EU economic governance framework was proposed by the Commission in September 2010 and adopted by European Parliament and Council in the second half of 2011 (the so-called 'Six Pack'). With its entry into force in December 2011, the EU now thus much stronger rules than before the start of the economic and financial crisis.

The Six Pack legislation has strengthened a wide range of existing aspects of economic governance and introduced new ones. A new Macroeconomic Imbalances Procedure has been set up to prevent or correct macroeconomic imbalances. Early detection of such imbalances will reduce the risks of their unwinding resulting in sudden rises of government deficits and debt in Member States with apparently sound public finances.

A move towards a more integrated framework for assessing economic reforms and public finance

plans had already started in Spring 2011, when, in the context of the Europe 2020 strategy, the European Semester was implemented for the first time. The European Semester coordinates and aligns the submission of the Stability and Convergence Programmes (SCPs), which contain Member States' budgetary plans, with that of National Reform Programmes (NRPs), which contain the elements necessary for monitoring progress towards the Europe 2020 national targets for sustainable and inclusive growth. Both these documents are now submitted by mid-April so that they can be analysed and country-specific recommendations under Article 121(2) – on the Broad Economic Policy Guidelines – and 148(4) – on Employment Guidelines – can be issued before the summer – in time to feed into the preparation of the national policies for the following year.

The Stability and Growth Pact (SGP) sets out the provisions according to which the Treaty requirements to ensure fiscal discipline are implemented. In light of the heated debate on the need to adapt the fiscal policy reaction to a deteriorating economic environment Chapter II.2 explains the SGP provisions that apply to Excessive Deficit Procedures (EDPs) in the case of worsening economic conditions as well as the methods used to assess whether an extension of the timeline for correcting an excessive deficit can be granted.

Chapter II.2 also presents the main new features introduced in the SGP by three of the regulations contained in the Six Pack. The adjustment towards the medium-term budgetary objective (MTO) which is the core of the preventive arm of the SGP will now be assessed on the basis of a new expenditure benchmark, which allows early detection and correction of unsustainable expenditure developments, as well as on the structural balance. As for the corrective arm, in line with the Treaty envisaging both a deficit and a debt criterion to examine compliance with budgetary discipline, a debt-reduction benchmark has been established to allow the opening of an excessive deficit procedure (EDP) on the basis of an insufficiently diminishing debt-to-GDP ratio. For the euro area, enforcement is now ensured by a gradual system of financial sanctions, which can already be invoked in the preventive arm, in the case of inadequate measures to correct a significant deviation from the appropriate adjustment towards the MTO.

Compliance with the SGP will also be promoted by the minimum standards introduced for Member States' fiscal frameworks. Chapter II.3 presents the main elements of the Directive on national budgetary frameworks which was also part of the Six Pack. As is the case for most other national institutions, national budgetary frameworks are far from homogeneous within the EU. Such diversity is documented by a database created as a result of the Ecofin Council's 2006 decision to ask the Commission to conduct a comprehensive analysis of the existing national fiscal rules and institutions in the EU Member States. Based on a recent update of this database, Chapter II.3 outlines the main changes in national fiscal frameworks that took place in 2010.

The variety across national fiscal frameworks reflects different political and economic environments and traditions. Different frameworks can be compatible with EU budgetary framework, as long as their quality and the consistency of their rules is conducive to the achievement of the EU obligations. For this reason, the Directive requires only minimum standards, in particular with regard to accounting and statistics, forecasting, numerical fiscal rules, medium-term budgetary frameworks and transparency. However, best practices going beyond these minimum requirements are also discussed amongst Member States, in peer review exercises, in order to help countries achieve the best outcomes they can. Chapter II.3 briefly outlines the outcome of the November 2011 session of this exercise.

With the sovereign debt crisis intensifying over the course of 2011, it has become widely acknowledged that the postponement of the adoption of even deeper reforms, both at national and EU level, could put the Economic and Monetary Union (EMU) at serious risk, with dramatic implications for all Member States.

The most recent initiatives of reforms to the budgetary surveillance framework have focussed on the euro area, where spillovers are particularly high. Chapter III.4 presents the two regulations proposed by the Commission on 23 November 2011, focussing in particular on the main features of the draft regulation aimed at enhancing

monitoring of budgetary policies on euro area Member States. The same regulation includes provisions specific to euro area Member States subject to Excessive Deficit Procedure, to which stricter monitoring requirements apply. The second regulation concerns only euro area Member States experiencing severe difficulties with regard to their financial stability or receiving financial assistance on a precautionary basis.

National governments have also spurred a further strengthening of the adopted reforms for the national level. Chapter II.5 presents the content of the Treaty on Stability Coordination and Governance (TSCG) that was signed by 25 Member States ([30]) on 2 March 2012 and that is currently undergoing the process of ratification. In particular, the Fiscal Compact which is part of the TSCG reinforces the obligation to reach the MTO already envisaged by the preventive arm of the SGP through national rules and automatic corrective mechanisms.

Finally, a vision for the future of a more deep and integrated EMU has been presented on 26 June 2012 in the Report "Towards a Genuine Economic and Monetary Union" prepared by the President of the European Council, in cooperation with the Presidents of the Commission, of the Eurogroup and of the European Central Bank. [31] The Report sets out four building blocks for the future EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability. In its June 2012 meeting, the European Council invited its President, again in cooperation with the Presidents of the Commission, of the Eurogroup and of the ECB, to develop a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union.

([30]) The United Kingdom and the Czech Republic did not sign the TSCG.
([31]) See (European Council, 2012).

1. INTRODUCTION

Budgetary frameworks are set up to guide policy making over time. In order to be effective, they need to be stable enough to facilitate planning over the years but they must also be flexible enough to adapt as any weaknesses become apparent and as the environment in which they operate changes. The need for stability is a key reason why changes are not usually introduced as a result of small weaknesses being identified. However, lack of timely adaptations of frameworks to the emerging policy challenges is also explained by institutional inertia. Consensus on improvements proves particularly difficult to achieve when they concern introducing more binding rules. Major changes are thus often adopted only as a result of dramatic events, which disclose the unsustainability of the *status quo*.

Although there has been an increase in research into budgetary institutions and rules in recent years, the available empirical work is still limited (see for instance Fabrizio, 2008). The existing work does seem to confirm, though, that one determinant that typically brings about change to budgetary institutions and rules are negative economic shocks. Sufficiently large economic shocks not accommodated by markets help build a constituency for improving budget institutions. The fiscal framework of the European Union has proven to be no exception to these findings.

The overall favourable macroeconomic conditions that characterised the first decade of the Economic and Monetary Union (EMU) had masked the extent of the potential consequences of the pitfalls of the EU governance framework. A first reform to the Stability and Growth Pact (SGP) ([32]) – the framework for budgetary surveillance at EU level – was carried out in 2005. This reform was also linked to the effects of a – more moderate – negative shock. Deficits rising above the 3% of GDP threshold during an economic downturn clearly showed that government balances that had not improved in structural terms in the late 1990s and early 2000s (Buti, 2006). However, the reform was essentially triggered by the difficult debate between EU institutions and Member States that ensued from the November 2003 decision by the Council not to follow the Commission recommendations concerning the excessive deficit procedures for France and Germany.

The reform followed in 2005 was a positive step forward, as it enhanced the economic rationale of the SGP. It introduced provisions on how to deal with special circumstances and country-specific problems, above all linked to macroeconomic downturns. In particular, following the 2005 reform, the adjustment required to correct the excessive deficit was formulated in structural terms to allow the automatic stabilisers to operate freely around the fiscal consolidation path, unless there are specific risks to financial stability. This provision remains particularly relevant in the current economic situation (Chapter II.2 includes an explanation of how effective action to correct an excessive deficit is assessed).

However, several problematic aspects of the SGP that had already been identified at that time were not effectively addressed by that reform, including the definition of the satisfactory pace of debt reduction, the poor enforcement mechanisms and the often too optimistic macroeconomic and budgetary forecasts prepared by national authorities. The experience of the 2005 reform brought forward the importance of seizing the window of opportunity given by the call for reforms in bad economic times to also address imprudent fiscal policies in good times. Changes to budgetary frameworks should not just focus on contingent situations that are likely to be exceptional, but should carefully consider the incentives inherent in the emerging framework for the medium and longer term.

While a number of weaknesses had already been identified before the start of the current economic and financial crisis in 2008 (see European Commission, 2008), the momentum for reforms to the EU governance framework only really gained pace when the possibility of the illiquidity or insolvency of both EU and euro area Member States arose for the first time since the launch of the euro.

([32]) Member States are required by the Treaty on the Functioning of the European Union to avoid excessive deficits (Article 126) and to ensure coordination of their economic policies and sustained convergence of their economic performance (Article 121). The Stability and Growth Pact (SGP) provides the secondary legislation that defines these obligations in greater detail and thus sets out the framework within which fiscal policy making is to be set and monitored at European level.

The impact of financial crises on the public finances is typically very large and long lasting (see the analysis of the fiscal cost of financial crises in European Commission, 2009). The consequences of a crisis are, however, even worse in countries where they come on top of underlying public finances fragilities, which, in some instances, are revealed by the crisis itself. This has been the case for a number of EU Member States.

Lack of room for budgetary manoeuvre with the onset of the crisis and the subsequent risks to financial stability spurred acknowledgement that the SGP had not provided sufficient incentive to pursue prudent fiscal policies in good times. Also, the SGP's effectiveness in correcting government deficits below 3% of GDP was not enough to curb unsustainable developments of government expenditure and debt ratios (European Commission, 2010).

On 12 May ([33]) and 30 June 2010 ([34]), the Commission issued two communications outlining a comprehensive set of measures that were considered urgent to reinforce economic governance in the EU, drawing on the lessons of the first ten years of EMU. ([35]) Since then, a number of initiatives have followed.

A first package of legislative proposals reforming economic governance – the so-called Six Pack – was presented by the Commission on 29 September 2010. This package is addressed to all Member States although certain aspects of it apply only to the euro area. Thanks to changes in legislative procedures introduced by the Lisbon Treaty ([36]), the European Parliament was, for the first time, deeply involved in the design of the EU fiscal framework. Rapid but intense negotiations between the European Parliament and the Council led to the adoption of all six proposed pieces of legislation at the first reading. Parliament gave its position in September 2011 and the Council decided on the legislation in November, confirming the same texts agreed by the Parliament. While the legislative process entailed a number of changes with respect to the proposals presented by the Commission, in particular with regard to the formulation of the principle of prudent fiscal policy making, the thrust of the Commission's proposals was broadly retained. The legislation entered into force on 13 December 2011.

These six pieces of legislations include a major reform of the SGP, but also new legislation, with a wider scope. First, the boundaries of EU surveillance have been extended to include macroeconomic surveillance. Previously, macroeconomic surveillance came under the recommendations stemming from the Broad Economic Policy Guidelines – the Six Pact sharpens the definition of macroeconomic surveillance and adds enforcement mechanisms. Second, the legislation revamps fiscal frameworks not only at EU level, but also at national level.

The new regulation on the prevention and correction of macroeconomic imbalances also has important implications with regard to fiscal surveillance. It addresses cases like those of Ireland and Spain, where government deficit and debt figures were not a source of concern ahead of the crisis. In these Member States, government deficits and debt, however, increased suddenly and dramatically once the crisis hit, as a result of the unravelling of imbalances that were not essentially of a fiscal nature, although they contributed to mask unsustainable expenditure trends. ([37]) The new regulation aims to ensure the timely assessment and correction of risks as they emerge.

The new directive on national budgetary frameworks addresses the need to ensure consistency between national fiscal governance and the EU budgetary discipline provisions. It also promotes stronger frameworks to support national economic policy-making in those Member States

([33]) COM(2010) 250 final http://ec.europa.eu/economy_finance/articles/euro/documents/2010-05-12-com(2010)250_final.pdf
([34]) COM(2010) 367/2 http://ec.europa.eu/economy_finance/articles/euro/documents/com_2010_367_en.pdf
([35]) The Report EMU@10 (European Commission, 2008) taking stock of the experience of the first ten years of EMU had already highlighted some of the challenges ahead.
([36]) According to the Lisbon Treaty, legislation on the coordination of economic policy has to be adopted by both European Parliament and Council, through ordinary legislative procedure. A special legislative procedure envisaging only Council adoption remains for legislation that concerns the Excessive Deficit Procedure (EDP) and the related EDP protocol.
([37]) Regulation (EU) 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

that have still to make progress in this respect. In line with subsidiarity concerns and a history of very different budgetary frameworks across Member States, the directive sets only minimum requirements. However, with a view to exceeding these minimum requirements, best practice is discussed between Member States through a peer review process. The directive and the peer review process are presented in Chapter II.3.

The reformed SGP is presented in Chapter II.2. The reform included two regulations amending the existing legislation on: (i) the preventive arm of the SGP ([38]) – the part of the SGP which aims to ensure that Member States are at their Medium-Term budgetary Objective (MTO) – and (ii) the corrective arm of the SGP – the Excessive Deficit Procedure (EDP) ([39]). The main revisions concerned the introduction of benchmarks for expenditure (net of discretionary revenue measures) and debt developments, in the preventive and corrective arm, respectively. Further provisions have also been added, in particular as regards severe economic downturns for the EU or the euro area as a whole, as well as for the launch of EDPs for Member States with government debt-to-GDP ratios below 60% of GDP.

The pieces of legislation mentioned above apply to all Member States. ([40]) The only specific euro area aspect of the legislation on economic governance that entered into force in December 2011 are the two regulations on enforcement mechanisms (one regulation related to the SGP and one regulation on macroeconomic imbalances) which do not concern Member States outside the euro area. In particular, the regulation on enforcement mechanisms for the SGP envisages a gradual system of financial sanctions for euro area Member States that can already be invoked in the preventive arm – this is well before the sanctions envisaged by the Treaty (Article 126) in the case where a euro area Member State does not comply with recommendations by the Council to correct its excessive deficit repeatedly. Unlike the sanctions foreseen by the Treaty, enforcement mechanisms foreseen by the new regulation are deemed adopted on the basis of a Commission recommendation, unless a majority of euro area Member States in the Council rejects this recommendation (the so-called "reversed qualified majority").

A distinction between provisions for euro area and non-euro area Member States is warranted by the different implications of fiscal misbehaviour by euro area or non-euro area countries on other Member States. As demonstrated by the sovereign debt crisis – and in particular by the need to put in place common financial backstops – spillovers from fiscal policies are high within a currency union. More integrated economic and financial systems mean that other countries bear a higher share of the cost of one country's profligacy than would otherwise be the case. The increased awareness of the cost of not preventing these negative spillovers has led the Commission to present two further legislative proposals, known as the Two Pack, for regulations specific to the euro area on 23 November 2011. On the same day, the Commission also presented a Green Paper on the feasibility of common euro area debt issuance, in particular on Stability Bonds that could over the medium term contribute to completing the institutional setup of EMU (see Box II.4.1). One of the legislative proposal is linked to the aforementioned financial backstops. It seeks to strengthen the economic and budgetary surveillance of Member States experiencing or threatened with severe difficulties with regard to their financial stability or receiving a financial assistance on a precautionary basis. ([41])

The other legislative proposal, on enhanced budgetary monitoring, is more directly linked to the SGP and will become part of it, when adopted. ([42]) It aims to reinforce the coordination, surveillance and discipline of euro area Member

([38]) Council regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.
([39]) Council Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
([40]) Only provisions on national numerical fiscal rules do not apply to the UK, in view of its specific Protocol annexed to the Treaties.
([41]) Proposal for a Regulation of the European Parliament and of the Council on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area (COM/2011/0819 final).
([42]) Proposal for a Regulation of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (COM/2011/0821 final).

States' public finances. It sets common budgetary rules and a timeline for all euro area Member States. Above all, it envisages an assessment of governments' draft budgetary plans each autumn by the Commission, so as to feed into national Parliaments' examination of the draft budget. Stricter provisions should apply to Member States in EDP, for which the proposed regulation envisages a closer monitoring.

On 21 February 2012, the Council reached agreement on a general approach to the proposed Regulation for negotiations with Parliament. The European Parliament's negotiation position was adopted in plenary meeting on 13 June 2012.

At the date of publication of this report, the negotiations between the co-legislators have just started. Accordingly, Chapter II.4 presents the Commission proposals of 23 November 2011.These Commission proposals were followed by another important initiative aimed at enhancing economic governance, including fiscal surveillance and budgetary frameworks. On 9 December 2011, the Heads of State and Government of the euro area as well as almost all non-euro area Member States put forward proposed changes to economic governance of the euro area by way of a 'fiscal compact' based on stricter budgetary rules, completed by closer economic policy coordination, and a strengthening of stabilisation instruments.

On 30 January 2012, the Heads of State and Government of 25 Member States (the only non-signatories were the United Kingdom and the Czech Republic) agreed on the draft of an intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which they signed on 2 March 2012. The content of the TSCG, including provisions going beyond the fiscal compact, is described in Chapter II.5.

Participating Member States essentially undertake intensified commitments through the TSCG, in particular to reflect the SGP rules in their national legislation. The Article on the fiscal compact contains a provision to enshrine a balanced budget rule at national level through binding, permanent and preferably constitutional provisions. The TSCG explicitly refers to the respect of the MTOs of the SGP. The rule should also contain an automatic correction mechanism that shall be triggered in the event of significant deviation from the MTO or the adjustment path towards it, and be monitored at the national level by independent institutions.

The TSCG tasks the Commission to propose: (i) common principles concerning the national automatic correction mechanisms and the role and independence of the institutions responsible at national level for monitoring compliance with the rules; (ii) a time frame for convergence towards the country-specific MTOs.

The TSCG will enter into force following ratification by at least twelve euro area countries ([43]). Along with the transposition into national legislation of the directive on national budgetary frameworks, to be completed by December 2013, the TSCG entail the adoption of important reforms of national fiscal governance in many Member States.

In its Communication of 20 June 2012, the Commission has already put forward seven common principles for designing the national correction mechanisms. The principles cover the legal status of a national correction mechanism, its consistency with the EU framework, activation, nature of the correction in terms of size and timeline, operational instruments, escape clauses, and the role and independence of monitoring institutions. ([44])

([43]) At the cut-off date of this document Greece, Portugal, Slovenia and Latvia have deposited their instrument of ratification of the TSCG.
([44]) COM(2012) 342 final
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF

2. THE 2011 REFORM OF THE STABILITY AND GROWTH PACT

2011 reform of the SGP

As part of the EU response to the crisis, a reform of the European common fiscal framework – the Stability and Growth Pact (SGP) – entered into force on 13 December 2011. The new framework has two main components:

Stronger preventive action and deeper fiscal coordination: A new expenditure benchmark will now be used alongside the change in the structural budget balance ([45]) to assess adjustments towards the country specific medium-term budgetary objective (MTO). Inadequate action to correct significant deviations from the appropriate adjustment path towards the MTO can lead to an interest-bearing deposit (of 0.2% of GDP as a rule) to be lodged by non-compliant euro area countries.

Stronger corrective action through a reinforced SGP: The launch of an Excessive Deficit Procedure (EDP) can now result from government debt developments as well as from government deficit. Member States with debt in excess of 60% of GDP should reduce it in line with a numerical benchmark. Furthermore, regardless of whether an EDP is launched on the basis of deficit or debt developments, progressive financial sanctions on euro area Member States kick in at an earlier stage of the EDP. In cases of particularly serious non-compliance, including those evidenced by the existence of an interest bearing deposit, a non-interest bearing deposit (of 0.2% of GDP as a rule) will be requested from a euro area country when it is placed in EDP. Failure by a euro area country to comply with a Council recommendation under Article 126(7) to correct its excessive deficit will result in a fine (of 0.2% of GDP as a rule). The fine imposed can rise up to 0.5% of GDP per year in the case of non-compliance with a notice to take measures for the deficit reduction in accordance with Article 126(9).

2.1. THE REFORM OF THE PREVENTIVE ARM OF THE SGP

The provisions of the preventive arm of the SGP should provide the main guidelines for budget planning and execution of the Member States when they are not subject to the more stringent requirements of an EDP. Countries currently in this situation are Bulgaria, Estonia, Germany, Finland, Luxembourg and Sweden. The preventive arm is implemented through Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

The expenditure benchmark

Under the preventive arm of the SGP, Member States aim at a specific fiscal target – the so-called medium-term budgetary objective (MTO) – to ensure the sustainability of their public finances. The new rules define an *"expenditure benchmark"* for judging progress towards the MTO, to complement the assessment based on the structural balance. The aim is to improve the planning and the fiscal record of the Member States by guaranteeing the financing of expenditure programmes by permanent revenues of an equivalent level. This should help avoid the repetition of mistakes made ahead of the crisis, when unsustainable expenditure trends were temporarily funded through windfall revenues or additional borrowing. The expenditure benchmark does not constrain governments in terms of their level of government expenditure – it simply requires that all changes to expenditure are financed through additional revenues. The actual size of the spending to GDP ratio is not constrained.

For Member States that have achieved their MTO, the expenditure benchmark is complied with when the annual growth of government expenditure, net of discretionary measures taken on the revenue side, does not exceed a reference medium-term rate of potential GDP growth.

For Member States that have not yet reached their MTO, the expenditure benchmark is complied with when the annual growth of government expenditure, net of discretionary measures taken on the revenue side, does not exceed a rate below reference medium-term rate of potential GDP growth.

([45]) The structural balance is defined as the cyclically adjusted balance net of one-off and temporary measures

The difference between the reference rate and the rate below the reference rate – referred to as "the convergence margin" – is country-specific, depending on the size of government spending in the economy([46]), in order to ensure that complying with this lower rate yields an annual improvement of the government balance. Applying a lower reference rate for Member States not at their MTO means letting revenues grow more rapidly than spending: this should help the Member State to meet the required structural adjustment of 0.5pp of GDP. Table II.2.1 summarises the different requirements and their effects for Member States both at and not yet at their MTOs.

The reference medium-term rate of potential GDP growth is based on regularly updated forward-looking projections and backward-looking estimates, taking into account the relevant calculation method provided by the Economic Policy Committee (EPC). The reference medium-term rate of potential GDP growth will be the average of the estimates of the previous 5 years, the estimate for the current year and the projections for the following 4 years. The aim is to have a measure which is sufficiently stable over time to provide a reference, but is also regularly updated so as to avoid that the reference provided to guide policy is out of touch with the economic situation.

The government expenditure aggregate to be assessed excludes interest expenditure, since it is to a large extent not under the control of the government, and non-discretionary changes in unemployment benefit expenditure, so as to allow for these to vary counter-cyclically. It also excludes expenditure on EU programmes fully matched by EU fund revenue and increases in revenue mandated by law. Due to the potentially very high variability of investment expenditure, especially in the case of small Member States, the government expenditure aggregate is to be adjusted by averaging investment expenditure over 4 years.

([46]) The convergence margin is set so that the lower increase in net expenditure relative to GDP is consistent with a tightening of the budget balance of 0.5pp of GDP, when GDP grows at its potential rate. It is calculated based on the assumption that any decrease in the share of public expenditure in the economy (which would occur if expenditure grows slower than potential GDP) would be translated into an exactly proportional improvement of the structural balance (the coefficient being equal to the base value of the share of public expenditure in GDP times the convergence margin of expenditure growth).

The notion of "significant deviation" and the enforcement provisions

In the preventive arm, the enhanced Stability and Growth Pact allows a stronger action in the event of *"significant deviation"* of a Member State from the MTO or from the appropriate adjustment path towards it.

To enforce this rule, the concept of *"significant deviation"* has been defined in the amended Regulation 1466/97 and has been detailed in the Code of Conduct ([47]). The identification of a significant deviation from the MTO or the appropriate adjustment path towards it is to be based on outcomes (i.e., *ex-post* data) as opposed to plans. In substance, the analysis of the '*significant deviation*' consists of an assessment of both the deviation of the structural balance from the appropriate adjustment path towards the MTO and of the impact of an excess of expenditure growth over the expenditure benchmark.

([47]) Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of Stability and Convergence Programmes:

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Table II.2.1: **Expenditure benchmark in relation to MTO achievement**

Member State at its MTO	Member State not at its MTO
Net expenditure growth in line with the reference rate	Net expenditure growth in line with a rate below the reference rate
% government expenditure in GDP constant	% government expenditure in GDP decreases
Structural balance constant over time	Structural balance strengthens
Remains at MTO	Gap with the MTO closes over time

Source: Commission services.

For a Member State that has not reached the MTO, the deviation will be considered significant if both: (i) the deviation of the structural balance from the appropriate adjustment path corresponds to at least 0.5% of GDP in one single year or at least 0.25% of GDP on average per year in two consecutive years ; and (ii) an excess of expenditure growth has had a negative impact on the government balance of at least or 0.5% of GDP in one single year or cumulatively over two years. In case only one of the two conditions above is verified, the deviation will be considered significant if the overall assessment evidence limited compliance also with respect to the other condition.

In the event of a significant observed deviation a warning under Article 121(4) is issued by the Commission. Within one month from the date of adoption of this warning, the Council will examine the situation and, on the basis of a Commission recommendation, adopt a recommendation under Article 121(4) for the necessary policy measures within the established deadline, normally of five months ([48]). The recommendation under Article 121(4) is adopted by the Council by qualified majority.

The Member State concerned has to report to the Council on action taken in response to the recommendation within the deadline established by the Council. It the Member State fails to take appropriate action in response to the Council recommendation under Article 121(4), the Commission recommends immediately to adopt a decision establishing that no effective action has been taken. Also this decision is adopted by the Council by qualified majority. At the same time, the Commission may recommend to the Council to adopt a revised recommendation under Article 121(4) on necessary policy measures.

However, if the Council does not take the decision that no effective action has been taken and failure to comply with the recommendation under Article 121(4) persists, after one month from its previous recommendation, the Commission adopts a new recommendation to the Council to take a decision that no effective action has been taken. In this case, the decision is adopted by the Council by "*reversed simple majority*"([49]). Also in this case, at the same time the Commission may recommend to the Council to adopt a revised recommendation under Article 121(4) on necessary policy measures.

In the case of euro area Member States, a financial sanction (an interest-bearing deposit of 0.2% of GDP as a rule) may be imposed if the Council decides that no action has been taken to address the Council recommendation under Article 121(4). This sanction is recommended by the Commission and adopted by the Council according to the "*reversed qualified majority*" vote ([50]).

In order to deal with exceptional circumstances, an escape clause has been inserted. This foresees that the deviation may be left out of consideration when it results from an unusual event outside of the control of the Member State concerned which has a major impact on the financial position of the general government or in case of severe economic downturn for the euro area or the EU as a whole, provided that this does not endanger fiscal sustainability in the medium-term.

The operational entry into force

The new provisions of the preventive arm are immediately operational, in particular with regard to the content of the Stability or Convergence Programmes (SCP). If a Member State submits an SCP which presents plans that do not comply *ex-ante* with the provisions of the preventive arm, the Council should invite the Member State to submit a new programme.

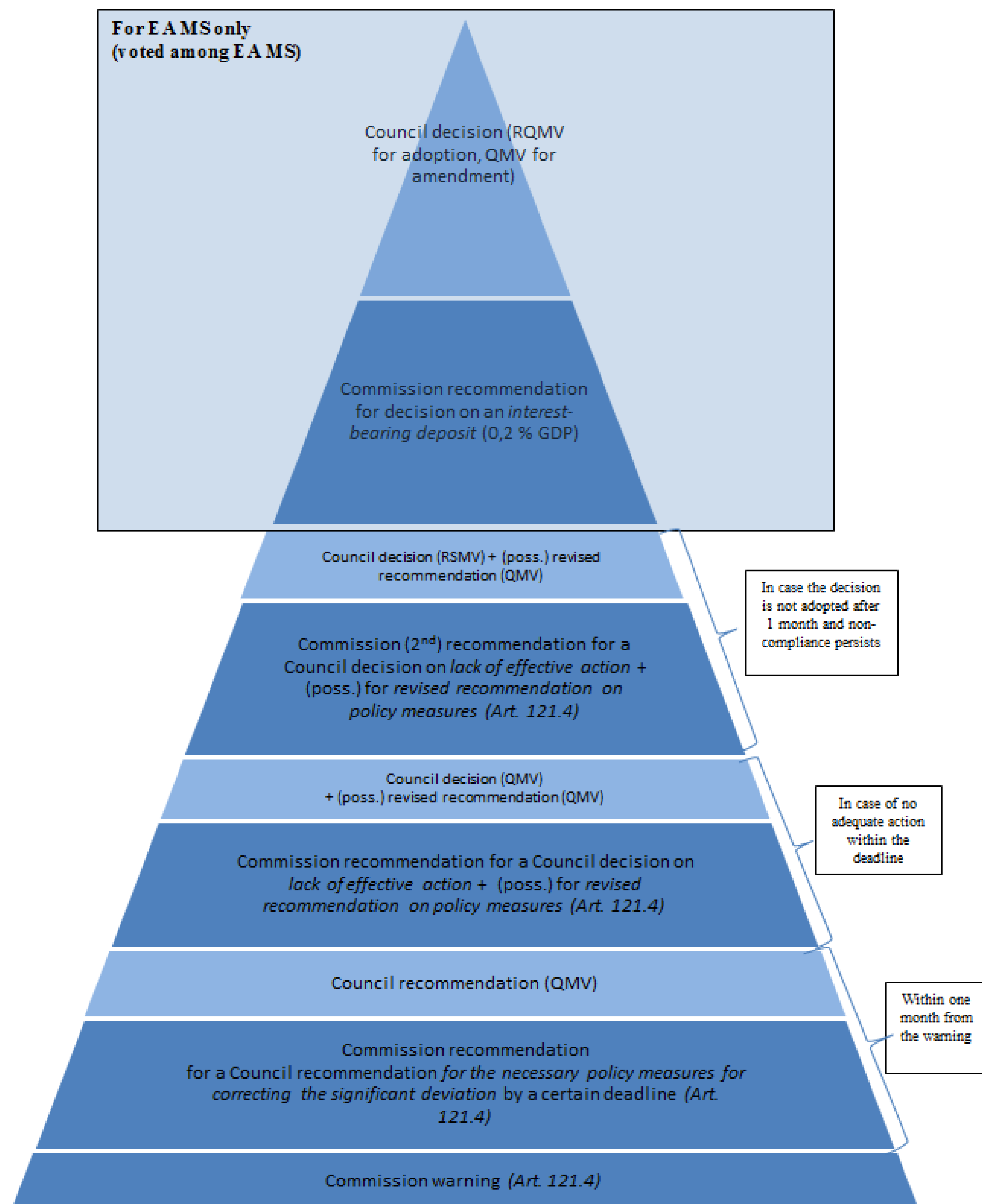
Programmes of Member States which are still subject to an EDP need to demonstrate that they meet the obligations deriving from the preventive arm after correcting their excessive deficit.

([48]) The deadline is reduced to three months if the Commission, in its warning, considered the situation to be particularly serious and warranting urgent action.

([49]) This means that the Commission's recommendation is adopted unless a simple majority within the Council decides to reject it, within ten days or its adoption by the Commission.

([50]) This means that the Commission's recommendation is adopted unless a qualified majority within the Council decides to reject it.

Graph II.2.1: **Legal steps under the preventive arm of the SGP as of 13 December 2011**



Member States concerned: Member States not already bound by the more stringent requirements of the corrective arm.
For all Council decisions: no account of the vote of the MS concerned.
Qualified majority voting (QMV) rules (Lisbon Treaty): 55% of MS participating in the decisions (i.e., in the context of the SGP, 16 countries if EA, 26 otherwise, as the concerned country does not vote), comprising at least 65% of population of these States.
Until the end of the Lisbon Treaty transitional period (as defined by the Protocol 36 to the Treaty): 2/3 of EA MS (excepted concerned country), with weights computed according to that Protocol, are needed to reach a QM.
Reversed voting rules (RQMV/RSMV): the qualified/simple majority rules need to be fulfilled to reject the Council decision.
Source: Commission services.

While the *ex-ante* compliance with the expenditure benchmark in the SCPs has already been examined in Spring 2012 (see Section I.3), the *ex-post* compliance with the expenditure benchmark and possible existence of a significant deviation will be evaluated for the first time in Spring 2013, when the outturn of 2012 budget formulated under the new rules will be assessed.

2.2. THE REFORM OF THE CORRECTIVE ARM OF THE SGP

The corrective arm of the Stability and Growth Pact (SGP) is concerned with the procedure to be followed if a country's public finances fall outside the requirements of the Treaty. It is based on Article 126 of the Treaty which specifies that Member States shall avoid excessive government deficits. It defines the criteria according to which compliance with budgetary discipline should be examined in terms of whether the general government deficit exceeds 3% of GDP or the debt-to-GDP ratio exceeds 60% and is not sufficiently diminishing towards this reference ratio. Hence, an Excessive Deficit Procedure (EDP) can be launched not only on the basis of the deficit criterion but also on the basis of the debt criterion. The corrective arm is implemented through Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the EDP.

The debt reduction benchmark

Following the amendments to the corrective arm that entered into force on 13 December 2011, Member States with debt in excess of 60% of GDP should reduce their debt in line with a numerical benchmark.

In particular, according to Article 2 (1a) of Regulation 1467/97, a government debt ratio above 60% of GDP should be considered in compliance with the debt criterion if its excess over 60% "has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available. The requirement under the debt criterion should also be considered fulfilled if the budgetary forecasts of the Commission indicates that the required reduction in the differential will occur over the three years period encompassing the two years following the final year for which the data is available."

The compliance with the debt criterion will then be checked in three steps and an excessive deficit procedure could be launched when:

- *First step*: the government debt ratio is above the reference value of 60% of GDP

and

- *Second step*:

  $bt > bbt = 60\% + 0.95/3\,(bt\text{-}1 - 60\%) + 0.95^2/3\,(bt\text{-}2 - 60\%) + 0.95^3/3\,(bt\text{-}3 - 60\%)$

  where

  bt stands for the debt-to-GDP ratio in year t;

  bbt stands for the backward-looking benchmark debt ratio in year t;

and

- *Third step*:

- (a) $bt+2 > bbt+2 = 60\% + 0.95/3\,(bt+1 - 60\%) + 0.95^2/3\,(bt - 60\%) + 0.95^3/3\,(bt\text{-}1 - 60\%)$

  where

  bbt+2 stands for the forward-looking benchmark debt ratio;

  bt+1 and bt+2 stand for the debt forecast in year t+1 and t+2 as estimated by the Commission under the 'no-policy-change' assumption on the basis of the fiscal outcome of year t;and, in parallel

- (b) the breach of the benchmark cannot be attributed to the influence of the cycle.

The proposed formula for the benchmark debt level and the long time horizon over which it is computed is meant to avoid the pitfalls of a simple benchmark requiring a 1/20th annual reduction of the excess of the debt ratio over 60% of GDP,

specifically the volatility of the benchmark and its vulnerability to manipulation ([51]).

Graph II.2.2 illustrates the procedure for judging whether a country's debt trajectory is in compliance with the debt benchmark.

Member States subject to excessive deficit procedures opened before the adoption of the debt reduction benchmark have to comply with recommendations and notices focussing on the only requirement to bring their deficit below 3% of GDP in a durable manner.

However, a deficit of 3% of GDP does not, however, ensure that debt-to-GDP ratios diminish sufficiently toward 60% of GDP. In fact, this was the reason why a debt-reduction benchmark had to be introduced. Compliance with the existing recommendation to correct the excessive deficit does not thus ensure that the debt benchmark will be also complied with in the year following the correction. On the contrary, lacking a sizeable additional correction, a breach would be likely. In order to avoid having to launch an excessive deficit procedure on the basis of the debt criterion at the same time of the abrogation of the procedure based on the deficit criterion, a three-year transitional period has been envisaged. In particular, as specified by the same Article 2 (1a) of Regulation 1467/97, "*For a Member State that is subject to an excessive deficit procedure on 8 November 2011 and for a period of three years from the correction of the excessive deficit, the requirement under the debt criterion shall be considered fulfilled if the Member State concerned makes sufficient progress towards compliance as assessed in the opinion adopted by the Council on its stability or convergence programme*."

Extension of the list of the other relevant factors

Before establishing that an excessive deficit exists, the Commission prepares a report under Article 126(3) TFEU if a Member State does not fulfil the requirements specified under either the deficit or debt criteria. The Commission report should take into account the other relevant factors whose list has been enlarged by the amendments to regulation 1467/97 ([52]).

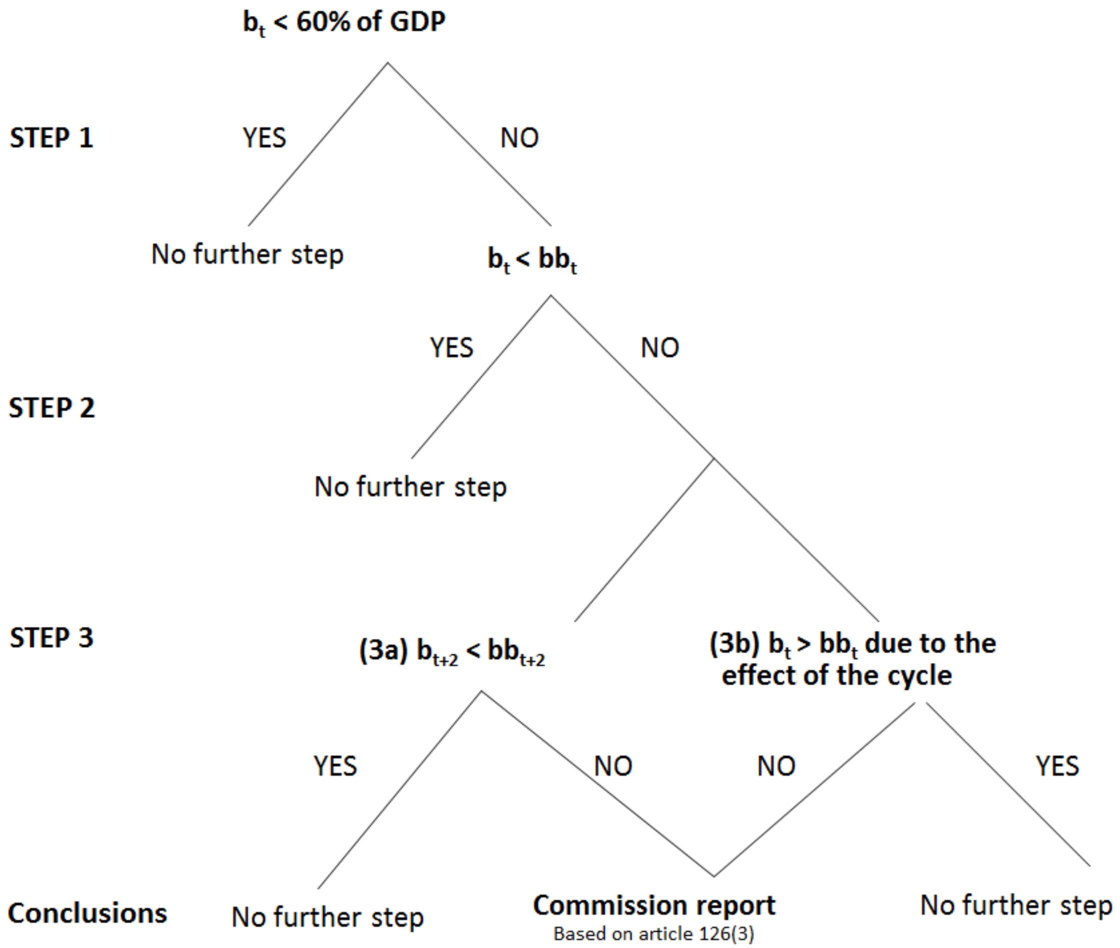
However, as regards relevant factors, the deficit criterion and the debt criterion are not on an equal footing. Before establishing that an excessive deficit exists on the basis of the debt criterion, the whole range of relevant factors covered by the Commission report should be taken into account, which is not always the case for the launch of excessive deficit procedures based on the deficit criterion.

([51]) The properties of the formula were presented in last year edition of the Report (European Commission, 2011).

([52]) According to Article 2(3) of regulation 1467/97, "The report shall reflect, as appropriate:
(a) the developments in the medium-term economic position, in particular potential growth, including the various contributions provided by labour, capital accumulation and total factor productivity, cyclical developments, and the private sector net savings position;
(b) the developments in the medium-term budgetary positions, including, in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks;
(c) the developments in the medium-term government debt position, its dynamics and sustainability, including, in particular, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government.

The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances."

Graph II.2.2: **Steps preceding the preparation of a Report under Article 126(3) assessing a possible breach of the debt criterion**



Source: Commission services.

In particular, with regard to the deficit criterion, the 2011 reform introduced a distinction between Member States with the debt-to-GDP ratio above or below 60% of GDP. The whole range of other relevant factors has to the taken into account when evaluating the existence of an excessive deficit on the basis of the deficit criterion in Member States with debt-to-GDP ratios below 60% of GDP. Moreover, where the excess of the deficit over 3% of GDP reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory fully funded pillar, the Commission and the Council will also consider the net cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures for Member States, as long as the general government deficit does not significantly exceed a level that can be considered close to 3% of GDP and the a debt-to-GDP ratio remains below 60% of GDP, on condition that overall fiscal sustainability is maintained ([53]).

However, if the Member State's debt ratio exceeds 60% of GDP, when evaluating compliance with the deficit criterion, the relevant factors assessed in the Commission report will be taken into account in the steps leading to the decision on the existence of an excessive deficit only if the general government deficit remains close to the reference value and its excess over the reference value is temporary (this is the so-called "double condition of the overarching principle").

([53]) The net cost of the pension reform is measured as its direct impact on the general government deficit (as defined in Article 1 of Regulation 479/2009).

Box II.2.1: **The transition period**

In order to assess the debt path during the transition period, a definition of "sufficient progress towards compliance" is necessary. It is defined as the minimum linear structural adjustment ensuring that – if followed – Member States will comply with the debt rule by the end of the transition period. This minimum linear structural adjustment path will be built taking into account both the influence of the cycle and the forward-looking nature of the debt benchmark. Also, in order to ensure continuous and realistic progress towards compliance during the transition period, Member States should simultaneously respect the following two conditions:

- First, the annual structural adjustment should not deviate by more than ¼% of GDP from the minimum linear structural adjustment ensuring that the debt rule is met by the end of the transitional period;
- Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾ % of GDP.

This should ensure that the path of deficit reduction chosen by the Member State is sustained over the three years of the transitional period (first condition) and realistic (second condition), while allowing some room for manoeuvre during the transition period.

A negative assessment of the progress made towards compliance with the debt benchmark during the transition period should lead to the preparation of a report of the Commission, based on Article 126(3).

Enforcement provisions

Beyond improvement of the corrective arm of the SGP, a new Regulation on the enforcement of budgetary surveillance in the euro area also entered into force on 13 December 2011. This Regulation sets progressive financial sanctions which kick in at an earlier stage of the EDP than was previously the case. A non-interest bearing deposit of 0.2% of GDP may be requested from a euro area country already when it is placed in EDP (either on the basis of its government deficit or debt). Failure of a euro area country to comply with recommendations for corrective action will result in a fine.

Assessment of effective action: which implications?

The 2005 reform of the SGP introduced rules to take into account the fact that, in spite of an adequate response to the recommendations, the deadline for correction might not be achieved because of unexpected unfavourable economic developments. In case an unexpected economic event occurs with major unfavourable consequences for the Member State concerned by the excessive deficit procedure, the possibility extending the deadline for correction without stepping up the procedure is, however, considered only if the Member State has taken "effective action" to comply with the recommendation or notice addressed to it by the Council.

The 2011 reform of the SGP did not change dramatically the provisions on assessment of effective action, but provided some important elements of clarity. First, the recommendations issued after the entry into force of the amendments will include annual nominal targets, which should be consistent with a minimum annual fiscal effort

of at least 0.5pp. of GDP as a benchmark ([54]). This novelty just aims at transparency; it does not imply a repeal of the important changes introduced by the 2005 reform to return to an obligation of delivering a nominal adjustment. Second, Member State under an EDP will have to prepare a report on the action taken in response to the Council's recommendation under Article 126(7) or a notice under Article 126(9) ([55]). The report shall include the targets for government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side consistent with the Council's recommendation, as well as information on the measures taken and the nature of those envisaged to achieve the targets. Reports of Member States subject to a notice under Article 126(9) should also include the information on the actions being taken in response to the specific Council recommendations ([56]).

These provisions did not apply to recommendations that were issued before 13 December 2011, which is the case for almost the totality of recommendations that characterise ongoing EDPs. Their implementation will however not entail major changes to the methodology developed to assess effective action for existing EDPs, which is described below.

The initial assessment of effective action

The Council recommendations under Article 126(7) establish a maximum deadline of six months for effective action to be taken. The 2011 reform has explicitly envisaged that, when warranted by the seriousness of the situation, the deadline may be three months ([57]).

The Code of Conduct of the SGP specifies the modalities of the initial assessment of effective action. Following the expiry of the deadline, the Commission assesses whether the Member State concerned has acted in compliance with the recommendation ([58]). This assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

This is a preliminary assessment in most cases and particularly so in cases of a multi-annual correction framework. In the specific case of recommendations or notices which have set a deadline for the correction of the excessive deficit more than one year after its identification, the assessment should mainly focus on the measures taken for the year following the identification of the excessive deficit.

The assessment of effective action when the procedure is held in abeyance

If the Commission considers that the Member State has acted in compliance with the recommendation or notice, it informs the Council accordingly and the procedure is held in abeyance.

After the first and only systematic assessment of effective action required by the SGP, Member States' compliance with the recommendation is subject to a continuous monitoring which does not embed fixed/defined occasions to take stock of the situation.

According to the Code of Conduct, during the period of abeyance the Commission should assess whether the measures already announced or taken are being adequately implemented and whether additional measures are announced and implemented in order to ensure adequate progress toward the correction of the excessive deficit within the time limits set by the Council.

Lack of effective action: case for stepping up the EDP and imposing sanctions

The Code of Conduct also specifies what should be done in case it appears that the Member States concerned has not acted in compliance with the recommendation or notice. Specifically, it requires the following step of the EDP procedure to be activated.

([54]) Articles 3(4) and 5(1) of Regulation 1467/97.
([55]) Articles 4(2) and 6(1) of Regulations 1467/97.
([56]) The reporting requirements of Member States in EDP will increase with the entry into force of the two-pack, which foresees bi-annual and quarterly reporting for 126(7) recommendations and 126(9) notice respectively (see Section II.4).
([57]) Articles 3(4) of Regulation 1467/97.
([58]) As indicated in the Code of Conduct, in the case of a notice under Article 126(9), the initial assessment of effective action takes place after the four month period following the notice.

This means that the Commission has to recommend to the Council to adopt a decision under Article 126(8) in case the Member State was subject to a recommendation under Article 126(7). For euro area Member States, the decision under Article 126(8) is followed by a notice under Article 126(9). In case the Member State does not even comply with the notice, the Treaty envisages enforcement measures under Article 126(11).

The 2011 reform introduced additional enforcement mechanisms of euro area Member States, all already entered into force ([59]).

The imposition of a non-interest bearing deposit is now possible already when the excessive deficit procedure is launched. In particular, the Commission will recommend to the Council to require a non-interest bearing deposit: (i) in case the Member State was already subject to an interest-bearing deposit for inadequate action to correct a significant deviation from the adjustment path towards the MTO; or (ii) in case of particularly serious non-compliance with the obligations laid down in the SGP.

A Council decision on non-effective action under Article 126(8) addressed to a euro area Member State is now followed by a Commission recommendation to the Council to impose a fine corresponding to 0.2% of GDP as a rule. In the case of Cohesion Fund beneficiaries, the possibility to suspend a part of the commitments under the Cohesion Fund in view of a Council decision 126(8) exists both for euro area and for non-euro area Member States([60]).

A decision under Article 126(11) includes, as a rule, fines up to 0.5% of GDP per year (a fixed component of 0.2% of GDP plus a variable component linked to the size of the deficit).

([59]) Enforcement mechanisms for euro area Member States are included both in Regulation 1173/11 on the effective enforcement of budgetary surveillance in the euro area and in Regulation 1697/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

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([60]) Council Regulation (EC) No 1084/2006 of 11 July 2006, establishing a Cohesion Fund and repealing Regulation (EC) No 1164/94.

The case for postponing the deadline

According to Article 3(5) of Regulation 1467/97 (and analogous Article 5(2) in case of notices): *"If effective action has been taken in compliance with a recommendation under Article 126(7) TFEU and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU. The revised recommendation, taking into account the relevant factors referred to in Article 2(3) of this Regulation may, in particular, extend the deadline for the correction of the excessive deficit by one year as a rule. The Council shall assess the existence of unexpected adverse economic events with major unfavourable consequences for government finances against the economic forecasts in its recommendation. In the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU provided that this does not endanger fiscal sustainability in the medium term."*

Therefore, the Regulation allows for the possibility of postponing the deadline for correction when a Member State has taken effective action but cannot meet the deadline for correction because unexpected events occurred with major unfavourable consequences for government finances. While this provision was already part of the SGP since the 2005 reform, the 2011 introduced the possibility of considering the postponement of the deadline not only on the basis of unexpected adverse economic events for the Member State concerned but also in case of a severe economic downturn in the euro area as a whole or in the Union as a whole, provided that the revision does not endanger fiscal sustainability in the medium term([61]). In this latter event, the postponement is not conditional on action taken.

([61]) Regulation 1467/97 does not provide a specific definition of severe economic downturn for the Union or the euro area as a whole that could lead to a postponement of the deadline for correction. Only indicatively, a reference is provided by the provision specifying whether an excess of the deficit over the reference value resulting from an economic downturn could be considered as exceptional.

Abrogation of the procedure in case of a durable correction

Some important clarifications on conditions for abrogating the excessive deficit procedure have been included in the latest version of the Code of Conduct. In particular, the Code of Conduct foresees that a decision on abrogation should be based on notified (i.e. observed) data and that abrogation should only occur if the Commission services' forecast indicates that the deficit will not exceed the 3% of GDP reference value over the forecast horizon ([62]).

Irrespective of the structural effort implemented, a "durable correction" is deemed achieved if:

- (i) the notified data for the previous year show a deficit below 3% of GDP or a deficit close to 3% of GDP that has declined substantially and continuously and where the excess over the 3% threshold is fully explained by the net cost of the implementation of a multi-pillar system that includes a mandatory, fully funded pillar;

and

- (ii) the Commission services' forecast indicates that the deficit will not exceed the 3% of GDP reference value over the forecast horizon or where the excess over the 3% threshold is fully explained by the net cost of the implementation of a multi-pillar system that includes a mandatory, fully funded pillar.

If the deadline has expired but one or both of the above conditions are not respected, the procedure should be stepped up.

How to assess effective action?

According to the Code of Conduct, a Member State should be considered to have taken effective action if it has acted in compliance with the recommendation or notice, regarding both the implementation of the measures required therein and budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council ([63]) and the underlying improvement in the cyclically adjusted balance net of one off and other temporary measures. In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically adjusted balance net of one off and other temporary measures falls significantly short of the adjustment underlying the target, a careful analysis of the reasons for the shortfall would be made. In particular, the analysis should take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented.

- Based on Regulation 1467/97 and the specifications provided in the Code of Conduct, the Commission assessment of effective action reflects the comparison of three different variables:

- The recommended effort (R);

- The apparent fiscal effort (S) measured by the change in the structural balance computed according to the commonly agreed methodology;

- The "adjusted structural balance" (S*), where the adjustment takes into account:

– the impact of revisions of potential output growth compared to that assumed at the time of the recommendations (α) (See Box II.2.1),

– the impact of the composition of economic growth or of other windfalls/shortfalls on revenue, the whole effect being measured by the impact of the divergence in the apparent elasticity of revenue to GDP (net of

According to article 2(2), this would be the case "if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential".

([62]) Reflecting the operationalization of the debt criterion in the EDP allowed by the 2011 reform, the Code of Conduct also specifies that the abrogation requires the debt ratio to comply with the forward-looking element of the debt benchmark. However, the envisaged transitional period for the debt benchmark implies that this provision does not apply for current EDPs.

([63]) The provision on the annual budgetary targets is fully relevant only for recommendations and notices adopted after the entry into force of the 2011 reform.

discretionary revenue measures) from its long-term norm, or, if different, from the value retained in the macroeconomic scenario underlying the recommendation ([64]) (β),

– the impact of other unexpected events on the general government balance (γ).

The comparison of R with S*, to assess the extent of the effort taken with respect to the recommended one, is compounded by a comparison of S and S*, which provides an approximation of unexpected events with an impact on public finances.

For current EDP recommendations entailing a multi-annual correction defined in terms of average structural effort, the comparison should focus on the period since the start of the correction period until the year for which the budget should normally already have been adopted. Admittedly, the formulation of recommendations in terms of average structural effort suggests that lower effort in initial years compared to that recommended should be taken into account as an aggravating factor in case correcting by the deadline is at risk in the later years even if due to a deteriorated macroeconomic scenario in those years.

How to interpret the results?

- If the implemented effort, as measured both by S and S*, is in line with that recommended, then the conclusion is that effective action has been taken;
- If S* indicates a lower effort than that recommended it can be concluded that no effective action has been taken. With the current recommendation requiring an annual average fiscal effort, consideration should be given to the existence of a margin for manoeuvre for reaching the deadline through a higher effort in the later years. This margin for manoeuvre is subject to some constraints. In particular, it should be such that the effort postponed to later years remains realistic, especially given the possibility of a less favourable macroeconomic scenario. However, no effective action could still be concluded in specific cases such as a strong backloading in the early years of the consolidation period despite a supportive business cycle;
- If S is below the recommended effort but S* indicates an effort in line with that recommended, then there is evidence that some economic events with an impact on public finances have materialised. However, a small difference would mean that the unfavourable consequences for government finances of the unexpected adverse economic events where not major.

How to proceed with the careful analysis?

The Code of Conduct requires a careful analysis of why the fiscal effort fell short of that underlying the recommended targets. In particular, since the 2011 reform of the SGP, the Code of Conduct specifies that the careful analysis should take into account whether:

- the expenditure plans have been achieved,
- the discretionary revenue measures planned have been implemented.

The composition of growth and its effect on the tax base have already been taken into account in the computation of S* and in particular of β. However, a more detailed analysis should be carried out, including highlighting possible reasons for divergences between the fiscal effort measured by the change in the structural balance and the budgetary impact of the measures effectively implemented by the Member State concerned, i.e.

([64]) The idea is to compute a short-term tax elasticity $\left(\frac{\Delta R_t - NT_t}{R_{t-1}}\right) / \left(\frac{\Delta GDP_t}{GDP_{t-1}}\right)$, where R_t is the level of revenues in t, NT_t the new discretionary taxes in t relative to t-1 and GDP_t the level of GDP in t. It is then compared to a reference value. Such comparison allows the computation of a "revenue gap" stemming from the divergence of the short-term tax elasticity from the long-term average. The « revenue gap » is then $R_t - R_{t-1} \times \left[1 + \varepsilon^* \frac{\Delta GDP_t}{GDP_{t-1}}\right] - NT_t$ where ε^* is the reference value for the elasticity. If this expression is negative, it means that revenues have not increased how they should have, given the change in GDP.

divergences between the top-down and the bottom-up approach.

When is extending the deadline permissible?

In the case of effective action and an unexpected adverse economic event with major unfavourable consequences for government finances, the deadline may be extended, by one year as a rule. However, there is no obligation to postpone the deadline. Such a decision should include supplementary considerations on:

- the size of the gap to the 3% of GDP threshold,
- the macro-financial vulnerability,
- the overall fiscal stance,
- and any other relevant country-specific factors.

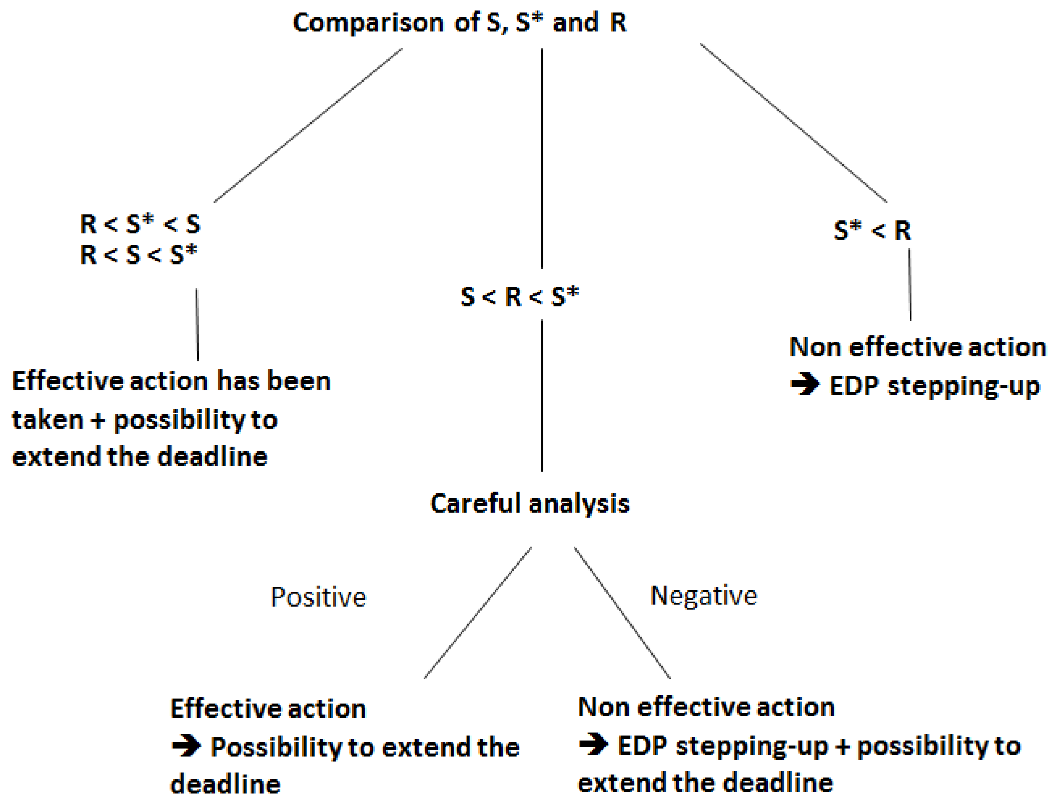
A large amount of uncertainty surrounding the forecast might also require caution in proceeding with an immediate postponement of the deadline. For example, this could be the case if such a decision is to be considered in the early years of a multi-annual correction. In case of non-effective action, which implies a stepping up of the procedure, a decision to extend the deadline in the new recommendation or the notice can also be taken. This decision should essentially rest on an assessment of the plausibility of meeting the old deadline. If the size of the gap to the 3% of GDP is too large, then an extension of the deadline could be considered.

To summarize, following consideration whether the general government deficit be durably below the 3% of GDP reference value by the recommended deadline, the assessment of effective action should address the following sequence which is set out in the decision tree in Graph II.2.3:

- (1) Has the recommended fiscal effort been achieved once all possible unexpected economic events with major consequences for government finances are taken into account?
- and
- (2) What does a careful analysis reveal about the expenditure and revenue developments compared to original plans in case of doubts?

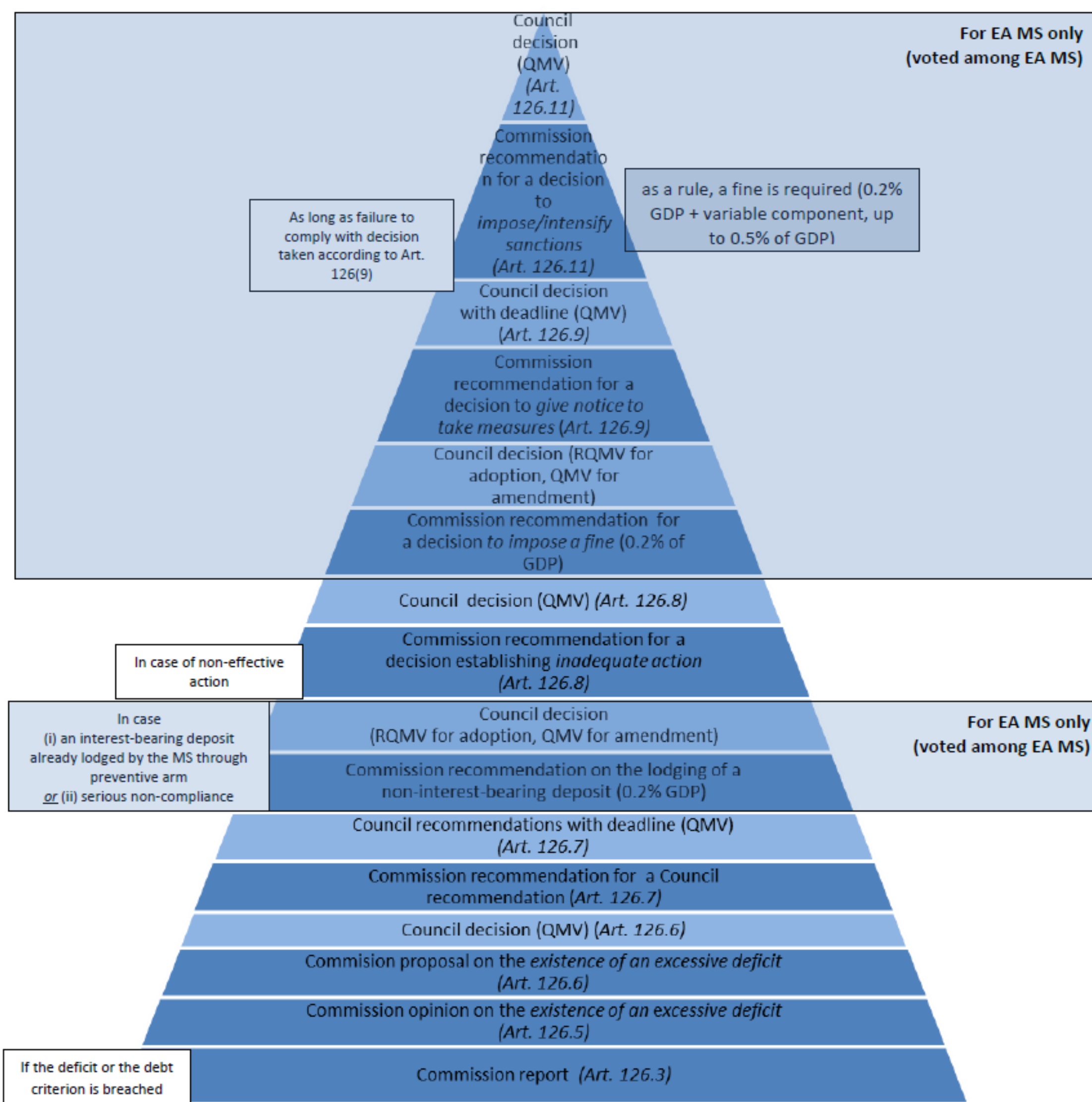
As mentioned above, the application of this framework needs particular caution when effective action is assessed in response to recommendations envisaging an average structural effort to be carried over a multi-annual correction period, given the existence of a margin for manoeuvre for delivering the required effort in future budgets.

Graph II.2.3: **The legal steps of the corrective arm of the SGP as of 13 December 2011**



Definitions
Required fiscal effort = R
Change in the structural budget balance = S
Change in the adjusted structural budget balance = S*
S=S*-(α+ß+γ)
Effect of revision of potential output growth on S = α
Overall tax elasticity effect on S = ß
Other effects on S (e.g. natural disaster) = γ
Careful analysis: analysis of expenditure and revenue developments compared to national plans in line with recommendation, bottom-up approach.
Source: Commission services.

Graph II.2.4: **The legal steps of the corrective arm of the SGP as of 13 December 2011**



Source: Commission services.

3. NATIONAL BUDGETARY FRAMEWORKS: MINIMUM REQUIREMENTS AND PEER REVIEWS

In the context of the recent overhaul of European economic governance undertaken in response to the crisis in 2010-2011, the role of national fiscal frameworks has been given new prominence: most visibly, through the adoption of a binding legal text on minimum requirements; but also through the sharing of best practices between Member States through a peer review process. The monitoring of progress at the EU level is also supported by an extensive, robust dataset maintained by the Commission (Directorate General for Economic and Financial Affairs – DG ECFIN).

3.1. A BINDING INSTRUMENT: THE DIRECTIVE ON NATIONAL BUDGETARY FRAMEWORKS

The **Directive on requirements for budgetary frameworks of the Member States** ([65]) was adopted as part of the Six-Pack economic governance package and will be transposed by end of December 2013. It sets out minimum requirements for Member States' fiscal frameworks in five key areas outlined below, with a view to ensuring consistency between national fiscal governance and budgetary discipline provisions from the EU Treaties and the Stability and Growth Pact (SGP). The legal instrument chosen was a Directive, to ensure the most appropriate association of uniform EU-level requirements with the variety of Member States' budgetary structures. Contrary to voluntary standards, a Directive is binding, but unlike a Regulation – through which most of the SGP rules are established – it leaves Member States the flexibility to choose the means they will use to comply with its requirements. In particular, the Directive on budgetary frameworks allows Member States to adapt their existing frameworks to the new EU rules, and leaves open the possibility of enacting – or maintaining – more stringent provisions than its minimum requirements. This is crucial not only to respect existing institutional settings, but also to anchor national ownership of EU rules.

([65]) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States which entered into force on 13 December 2011.

Key requirements in five areas of budgetary policy-making

– **1) Accounting and statistics:** Sound fiscal statistics are not only necessary to support national budgetary processes from budget preparation to execution, they are also crucial for a proper functioning of the EU fiscal surveillance framework. Building on the proven methodological framework provided by the European System of Accounts, the Directive requires accruals-based data compliant with ESA95 covering all the general government subsectors, and also regular audits, both internal and external, of public accounts. Member States are required to publish cash-based fiscal data, at a monthly frequency for each of the central and regional government and social security subsectors, while local governments are required to report on a quarterly basis. Reconciliation tables explaining how ESA95 data is derived from primary sources should also be made publicly available.

– **2) Forecasting:** Macroeconomic and budgetary forecasts are an essential component of the budget process, as fiscal planning based on biased or unrealistic forecasts may hamper budgetary discipline in a significant manner. The Directive mandates the public availability of official macroeconomic and budgetary forecasts prepared for fiscal planning, and also of the methodologies, assumptions and parameters on which these forecasts are based; alternative scenarios (e.g. lower-than-expected growth) shall also be considered. Furthermore, the reliability of the forecasts can be improved through comparisons with forecasts from other institutions – such as the Commission – and independent economic institutes; other relevant stakeholders should contribute to strengthening the robustness of forecasts.

– **3) Numerical fiscal rules:** Well-designed national rules-based frameworks are known to significantly enhance budgetary discipline; numerical fiscal rules can therefore provide effective domestic leverage for the SGP (itself a rule-based system defined on quantitative fiscal targets) through increased domestic

ownership of fiscal goals. While discretion is left in the definition of the numerical fiscal rules – which may target not just the debt or deficit but also expenditure and/or revenues – basic features are mandated in the Directive. These features include the requirements that the targets and scope of the rules be well defined, that effective and timely independent monitoring be put in place, that strict compliance mechanisms must exist and that well-circumscribed escape clauses should be defined. This can be relevant not only at the general government level, but also at the sub-national level, as shown in Part IV.

- **4) Medium-term budgetary frameworks** (MTBFs)**:** Although the annual budget law is the pivotal element of fiscal policy in all Member States, most fiscal measures have budgetary implications beyond the yearly cycle; a multiannual perspective can greatly improve fiscal planning. While Stability and Convergence Programmes are already presented from a multi-annual perspective, they could have a greater impact on domestic budgetary debates, notably given that annual budgets are supposed to be in line with SCP commitments. The Directive therefore sets out minimum requirements for domestic MTBFs which include a fiscal planning horizon of at least three years, the embedding the MTBF into the EU fiscal framework (including reference to the achievement of the medium-term objective), revenue and expenditure projections on the basis of unchanged policy and an explicit link to annual budgets.

- **5) Transparency:** Increasing fiscal decentralisation in most Member States strengthens the need for coordination between central government (which, according to Protocol 12 of the Treaty, is the level at which compliance with Treaty provisions on fiscal matters is judged), and regional and local governments, which manage an increasing share of public expenditure. The Directive promotes accountability by calling for national fiscal frameworks to appropriately cover all general government tiers and requires that Member States establish coordination mechanisms across subsectors, including numerical fiscal rules. The Directive also requires more clarity on specific items which may have an impact on budgets, namely extra-budgetary funds, tax expenditures and contingent liabilities.

Recent progress on adoption and monitoring

All Member States must fulfil the requirements of the Directive within the given transposition deadline, that is the end of 2013. By then, Member States must have taken all the necessary legal, institutional and procedural measures to ensure full compliance.

Euro Plus Pact partners aim for an early implementation. If they so wish, Member States can choose to exceed the requirements imposed by the Directive. They can also ensure that these are transposed into national legislation in advance of the deadline. This is the case for participants to the Euro Plus Pact (members of the euro area plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania), who pledged in mid-2011 to transpose the Directive by the end of 2012.

Sweeping reforms are underway in most European countries. Spurred on by the impending deadline for the transposition of the Directive, and supported in parallel by the sharing of best practice at European level through the Economic Policy Committee (EPC) Peer Review process which is described below, most Member States have recently committed to a strengthening of their national fiscal framework. In spite of different national traditions in the conduct of fiscal policy, and of different starting positions, significant reforms were undertaken in a majority of Member States in 2011 in the pursuit of better fiscal governance.

Taking stock of this progress, the Commission will prepare an Interim Progress Report for the Directive by the end of 2012. As provided for by the adopted Directive, the Commission will prepare a report on the measures in place across countries implementing the main provisions of the Directive by mid-December, on the basis of information to be provided by the Member States in the second half of 2012.

3.2. THE PEER REVIEW OF NATIONAL FISCAL FRAMEWORKS

The Directive on budgetary frameworks ([66]) constitutes one of two pillars of the Commission's strategy to reinforce fiscal-structural settings in the European Union. The second pillar has been developed as a forum for discussion among Member States which should lead to tangible developments in the area. Together with legislative initiatives, this two-pronged approach was approved in the final report of the Van Rompuy task force on economic governance. It foresaw the organisation of a regular assessment and peer review of domestic fiscal frameworks, alongside the requirements set in the Directive. Its purpose was to seek policy advice and evaluate other desirable but non-binding features of domestic fiscal frameworks which support good policy making. The Van Rompuy Task force concurred with the earlier Council conclusions of 18 May 2010, which invited the Commission and the EPC to promote the exchange of best practices, in particular in view of the elements that have proven to be most successful in underpinning fiscal consolidation efforts and in contributing to building up sustainable public finances.

Consequently, the peer review was carried out in 2011 under the aegis of the Economic Policy Committee (EPC) in two sessions. The first session in May 2011 reviewed the frameworks of 14 Member States (Estonia, Ireland, Greece, Italy, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Portugal, Romania, Slovakia and the United Kingdom). The second session covered the remaining 13 Member States in November 2011 (Belgium, Bulgaria, Czech Republic, Denmark, Germany, Spain, France, Luxembourg, Netherlands, Austria, Slovenia, Finland and Sweden).

The output of the peer review took the form of EPC policy advice to the reviewed Member States. This non-binding guidance consisted of elements that were deemed to improve each country's fiscal framework, while taking account of national specificities and respecting the wide spectrum of institutional and administrative traditions in the EU. The Commission services contributed to the peer review by preparing country factsheets. ([67])

While the country-specific elements usually prevailed over common factors, the 2011 peer review revealed a number of general trends. It confirmed that there was strong momentum for fiscal framework reform in most Member States. This is particularly the case in those with previously weak frameworks, including a lack of any independent fiscal institution supporting the preparation, execution and assessment of annual budgets, as well as limited numerical fiscal rules and poor medium-term planning. The peer review identified important gaps in these areas and provided policy advice to specify the relevant key building blocks that would need to be put in place. Particular attention has also been paid to the need for comprehensive and timely fiscal statistics. Pressing ahead the implementation of the agreed commitments will prove critical for these countries which are often undertaking major macroeconomic reforms in parallel, as structural improvements in fiscal policymaking should support and go hand-in-hand with fiscal consolidation efforts.

Another feature emerging from the peer review is that reforms are not only taking place in Member States with the weakest frameworks. Member States with relatively stronger frameworks are also taking steps to refine existing structures and add new building blocks. While some of the best fiscal performers in the EU have been able to rely on a relatively light fiscal framework, based on a combination of mutual trust, strong political commitment and popular support, those Member States have recently felt the need to cement the informal arrangements they were used to into legislation, further reinforcing the link between political commitment and policy deliverables. Some Member States took further steps to enshrine key fiscal principles into their national constitution, with the intention of providing a stronger legal base to enforce the reforms.

From a thematic point of view, cross-cutting issues identified in the 2011 peer review included: (i) fiscal rules; (ii) fiscal councils; (iii) medium-term budgetary frameworks (MTBFs) and (iv) sub-national governments slippages (on the relevance of it, see Part IV).

([66]) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States which entered into force on 13 December 2011.

([67]) See European Commission (2012b).

As part of the advice delivered in the course of the peer review, the introduction of fiscal rules was suggested for a number of countries, especially on the expenditure side. While these rules share the same general objectives and features (as target and scope definition, enforcement and compliance mechanisms, and escape clauses), different approaches were discussed, including the treatment of cyclical expenditure, tax expenditure and/or expenditure not considered to be directly under the control of public authorities.

The introduction or the strengthening of fiscal councils has also been advocated for several countries, though some differences among EPC Members remained in the assessment of their performance and suitability. In smaller countries, resource constraints are more often considered to be a hindrance to their establishment and development. An alternative could be to facilitate cooperation between resources scattered across existing institutions.

The introduction or strengthening of MTBFs was recommended for some Member States, mostly through the insertion of more binding features. The discussion of specific design features addressed several items, for example the proper mix of fixed and flexible elements or methodologies to account for multi-year price and cost developments.

Another promising topic concerned sub-national governments and their place in budgetary frameworks. While the construction of a fiscal framework usually begins with the resolution of issues at the central government level, it should also encompass sub-national governments as they may be an important source of fiscal slippages, especially if expenditures at sub-national level are not matched with the adequate level of funding responsibilities as indicated in Part IV. A number of Member States received policy advice in this field, especially countries with a federal or a heavily-decentralised administrative structure. The peer review also highlighted the need for further work to better assess how expenditure in sub-national governments could be effectively monitored and controlled. Avenues for further research include stricter internal funding and borrowing arrangements, tasking fiscal councils with the monitoring of sub-national governments (in countries with stronger fiscal decentralisation) or enhancing reputational sanctions through increased transparency.

Overall, the 2011 peer review process provided a unique opportunity for Member States to brief each other and the Commission on progress made. It gave impetus to these reforms by providing examples of 'good/best practices' amongst Member States. Where appropriate, elements of the resulting policy advice were incorporated into the country-specific recommendations in the 2011 European semester exercise. A monitoring process has been agreed upon by the EPC, whereby Member States' progress towards the measures advised would be discussed in 2012 and 2013.

Leaving aside common features, the following section presents country-specific information about the most visible recent reforms introduced in the Member States examined in the November 2011 session of the peer review. ([68])

In **Austria**, the fiscal framework consists of the Fiscal Equalisation Law and the Austrian Stability Pact encompassing all levels of government as well as the medium-term expenditure framework (MTEF), which concerns only the federal government. On 15 November 2011, the Austrian federal government adopted a proposal for a 'debt brake', with the transition to a structural general government deficit of 0.35% of GDP by 2017. The reform package foresees the extension of the MTEF to the Länder level. Subsequently, following negotiations on the debt brake with sub-national authorities, the proposed deficit limit was raised from 0.35% to 0.45% of GDP.

In **Belgium**, the budget process has gradually taken the form of a series of agreements or conventions not only between the political parties of the governing coalition but also between the different government layers. The framework relies on the two existing independent bodies (the Federal Planning Bureau and the High Council of Finance), which continue to positively influence public finance developments. By contrast, numerical fiscal rules and medium-term budgetary frameworks appear to be less developed, which has contributed to frequent slippages in the past. It is expected that the framework will undergo

([68]) For Member States examined in May 2011, see European Commission (2011a), pp.107-108.

significant changes as a result of the new agreement on institutional reforms which was concluded in October 2011. This calls for adequate measures to reinforce the domestic fiscal framework with a view to tackling the rising debt challenge.

In the **Czech Republic**, the government has launched a review of the existing fiscal framework (dating from 2004) with the aim of improving its functioning. As a first step, an internal expert group at the Ministry of Finance is identifying weaknesses in the current framework. In the second phase, the government will propose draft legislation which will also aim at complying with the new requirements on fiscal frameworks stemming from EU legislation. Proposals currently under consideration include: possible ways of improving coordination between different levels of government, a new fiscal rule for local and regional governments, stronger enforcement mechanisms for the existing fiscal rules, better monitoring and ex post evaluation of budgetary performance, and the introduction sustainability considerations in the fiscal targeting. Furthermore, the possibility of establishing an advisory body on fiscal and budgetary matters is also under discussion.

In **Germany** a wide political debate on the sustainability of public finances led to an amendment of the Constitution in 2009, replacing the golden rule by the debt brake stipulating balanced budgets for federal and Länder governments. For the federal budget, the debt brake has been in effect from 2011 and applies to the cyclically adjusted budget. It sets a ceiling for the federal structural deficit in normal times of 0.35 % of GDP which will apply from 2016 with a transition period starting in 2011. The implementation of the debt brake for the federal budget includes a (virtual) control account registering deviations in budget execution from the defined level of authorised new borrowing, with overruns entering as debits, and savings as credits. Debits on the control account need to be reduced once they exceed 1 % of GDP, but only in an economic upswing and by no more than 0.35% of GDP per annum. Länder budgets must be balanced as of 2020. The constitutional amendment also included the establishment of a Stability Council with a view to enhancing the monitoring of budgetary developments at the federal and Länder level and introducing a federation-wide early warning system. In 2010, it replaced the former Financial Planning Council and consists of the federal ministers of finance and economic affairs as well as the state ministers of finance.

In **Denmark**, given the important role of regional and local authorities in administrating public expenditure, the government put forward a proposal for multi-annual expenditure ceilings covering all levels of government to tighten spending control and to prepare for the effects of demographic ageing in spring 2011. The ceilings are to be underpinned by sanctions, including reductions in appropriations and grants, and to be controlled by the Danish Economic Councils (DORS), which are currently monitoring the implementation of the general government's budget plans and quantifying short-term and long-term budgetary effects of envisaged policy measures and reforms.

In **Spain**, in response to perceived weaknesses, the fiscal framework was strengthened in 2010 with the obligation for autonomous regions to publish standardised economic and budgetary execution data on a quarterly basis. In addition, in July 2011, the government introduced an expenditure rule, according to which central government and municipalities cannot set an expenditure growth rate greater than the medium-term nominal GDP growth rate in the setting of their budgetary stability objectives. In September 2011, the parliament approved a constitutional balanced budget amendment, which should prohibit structural deficits in excess of targets set at the EU level and limit the size of the aggregate debt of all levels of administration to the reference value set in the Treaty on European Union; it also enshrines the expenditure rule and prioritises debt repayments over other expenditure. Crucial parameters of the constitutional rule have been defined in an organic act on budgetary stability specifying, in particular, the definition of the structural deficit and the deficit ceilings at the general government level (which is 0 as a general rule but can reach 0.4% of GDP in case it accompanies structural reforms), the distribution of deficit and debt limits between the different levels of administration and the responsibility of each government in case of breach, the exceptional circumstances that can justify exceeding the limits, and the corrective mechanisms for non-compliant

administrations. The act entered into force on 1 May 2012, but the main binding provisions will only take effect from 2020 onwards.

In **France**, in line with the constitutional reform of July 2008, a second multi-annual public finance planning act was passed for the 2011–14 period in December 2010. On the expenditure side, the target now covers the whole general government sector, including local authorities. A maximum increase in expenditure compared to that of 2010 has been set and central government expenditure excluding interest payments and civil servants' pensions is now to remain unchanged in nominal terms. An annual ceiling exists for healthcare spending and for the main mandatory funds of social security. Transfers to local governments have been frozen in nominal terms.

In **the Netherlands**, the September 2010 Coalition Agreement endorsed new rules, following the advice of the Budgeting Framework Commission. These include (i) the adoption of a signalling margin: a downward deviation of one percentage point relative to the path for the general government deficit would trigger additional consolidation measures; (ii) expenditures sensitive to cyclical trends (unemployment benefits, social assistance benefits and movements in the terms of trade) and interest expenditure have been reintroduced within the expenditure ceiling frameworks; (iii) the rule that spending overruns should be compensated in a 'specific' manner was broadened; (iv) a windfall formula for tax relief was introduced, but subject to strict eligibility conditions.

In **Slovenia**, the budget for 2010/11 was prepared using performance-based budgeting, whereby the budgetary lines are translated into 16 policy areas for the first time. A new expenditure rule for the general government (in cash terms) was applied for the 2011–14 period. It lays down expenditure ceilings on a rolling basis by limiting expenditure growth to potential GDP growth (both in nominal terms) and restraining it further as long as the primary deficit and the general government debt (as % of GDP) exceed their target values. Ceilings are fixed for the first two years and indicative ceilings for the following two years.

3.3. EVIDENCE FROM THE FISCAL GOVERNANCE DATABASE

With a view to supporting the EU reflection and decision-making process, the Fiscal Governance database maintained by DG ECFIN collects information on the main elements of national budgetary frameworks that underlie the conduct of budgetary policies of general government at all stages ([69]), such as national fiscal rules, medium-term budgetary frameworks, and independent fiscal institutions.

The fiscal governance database was created as a result of the Ecofin Council's January 2006 decision to ask the Commission to conduct a comprehensive analysis of the existing national fiscal rules and institutions in the EU Member States. In April 2009, the Ecofin Council invited Member States to annually update the Commission's questionnaire on changes to their fiscal governance.

The most recent update of the fiscal governance database focused on changes in fiscal frameworks that took place in 2010.

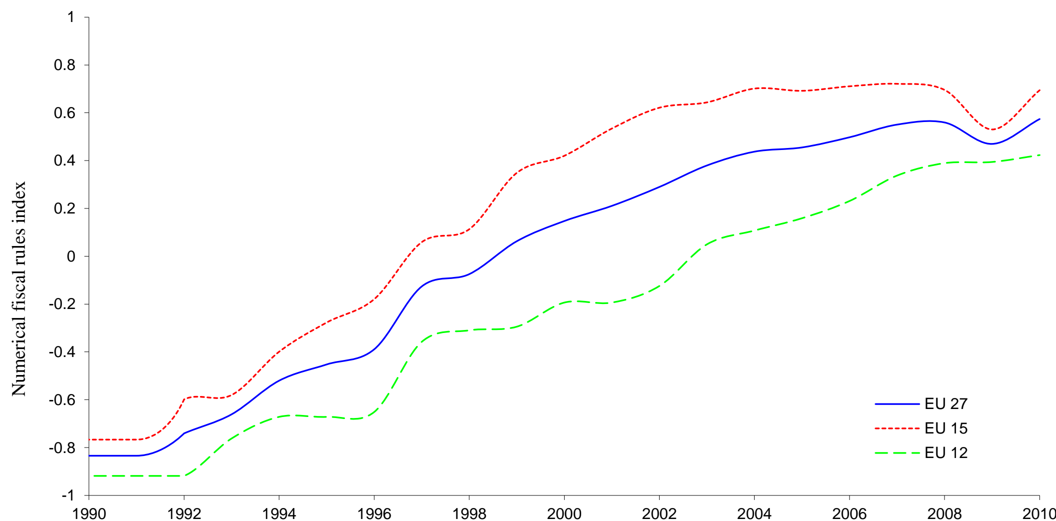
Numerical fiscal rules

The Commission services have defined a composite index measuring the strength of numerical fiscal rules based on five dimensions, on which information has been collected through the annual survey. These are the rules' statutory base, the room for setting or revising objectives, the nature of the bodies monitoring compliance and fostering enforcement of the rule, their enforcement mechanisms, and media visibility. The index also takes into account the coverage of general government finances by the numerical fiscal rules.

In 2010, the number of numerical fiscal rules in force increased by two compared to 2009. Thus 24 Member States were operating a total of 70 numerical rules in 2010 (Cyprus, Malta and Greece did not have any numerical fiscal rules, as in previous years). This increase is a result of new

([69]) The fiscal governance dataset is accessible on DG ECFIN's website at http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

Graph II.3.1: **The fiscal rule index (FRI) in the EU27 and selected groups of Member States, 1990 to 2010**



Source: Commission services.

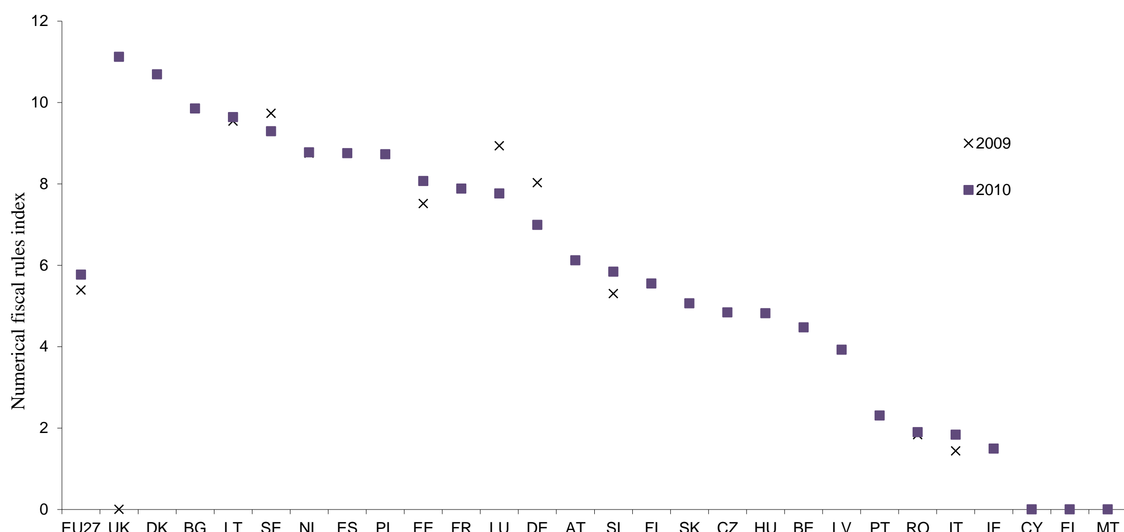
rules introduced in 2010, of which two were implemented in the United Kingdom, one in Slovenia and one in Estonia, while at the same time, Slovenia and Germany abolished one existing rule each.

By type, budget balance rules continued to be the most widely used, making up around 40 per cent of the rules. Debt rules and expenditure rules correspond to 27 and 24 per cent of the rules, respectively. About 25 per cent applied to both central and general government while the majority – over 30 per cent – applied to local governments.

The fiscal rule index (FRI) summarising the average strength of numerical fiscal rules in force in the EU27 countries along five dimensions has recovered from its first ever drop in 2009. ([70]) This

([70]) Note that the fiscal rule index calculated from the 2009 data is obtained from slightly modified calculations as compared with earlier releases of the

Graph II.3.2: **The fiscal rule index (FRI) in the EU-27 by country, 2009 and 2010**



Source: Commission services.

results mainly from the two new rules implemented in the United Kingdom that replaced previously suspended rules. Graph II.3.1 shows the FRI over time, for the EU27 and for the pre-2004 members (EU15) and more recent entrants (EU12). It shows that the average strength of numerical fiscal rules has increased more significantly in the EU15 than it has amongst the EU12. In terms of individual Member States Graph II.3.2 shows the value for the FRI by Member State for 2009 and 2010. It highlights the significant improvement of the United Kingdom and minor changes taking place in other countries.

Medium-term budgetary frameworks

Medium-term budgetary frameworks (MTBFs) are defined as institutional policy instruments that allow the extension of the horizon for fiscal policy making beyond the annual budgetary calendar. ([71]) Similarly to fiscal rule index, the MTBF index captures the quality of these devices based on five dimensions: (1) the existence of a domestic MTBF, (2) the connectedness between the multi-annual budgetary targets and the preparation of the annual budget, (3) the involvement of national parliaments in the preparation of the medium-term budgetary plans, (4) the existence of coordination mechanisms between subsectors of general government prior to setting the medium-term budgetary targets, and (5) the monitoring of enforcement mechanisms of multi-annual budgetary targets.

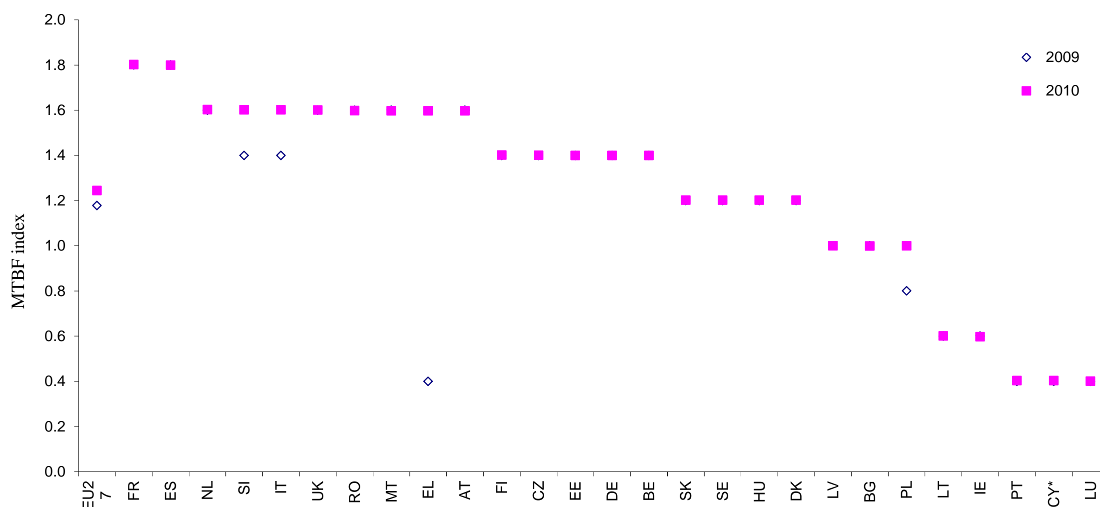
2010 saw several changes to MTBFs in the EU Member States. A major novelty was the new budgetary framework in Greece which aims to include fiscal targets for the general government and its sectors as well as measures to achieve these targets, as a minimum. In Poland, a Multi-Year Financial Plan of the State is prepared as of 2010. It comprises a statement of the government medium-term fiscal policy, medium-term projections of expenditure and revenue and aggregate fiscal projections together with macroeconomic assumptions.

Graph II.3.3 shows the MTBF index for all Member States for 2009 and 2010. It shows that in 2010 the quality of medium-term budgetary frameworks as measured by the MTBF index experienced an improvement compared to 2009. This results from the considerably higher score of Greece that had no MTBF before, as well as minor improvements in several other countries including Poland, Italy and Slovenia.

index. Still, figure 3 is based on a recalculated series of the fiscal rule index for the whole period covered by the dataset, therefore comparability in time is not impaired by the change in methodology.

([71]) See European Commission, Directorate-General for Economic and Financial Affairs (2007) for this definition and details.

Graph II.3.3: **The MTBF index in the EU27, 2009 and 2010**



* The MTBF index for Cyprus is considered the same as in 2009 since no new information was submitted in 2010.
Source: Commission services.

Independent fiscal institutions

Independent fiscal institutions are a further institutional mechanism to improve budgetary performance and help foster a medium-term orientation for budgetary policy. Their role is to provide independent input, analysis, assessment and/or recommendations in the area of fiscal policy. In a number of EU Member States these institutions (also called fiscal councils) have proved to be instrumental in improving fiscal policy making by providing positive and/or normative analysis, assessments, and recommendations.

In 2009, there were 29 independent fiscal institutions located in 17 EU Member States. Such institutions were far more common in the former EU15, often having a long history. In new Member States some tasks of independent fiscal institutions are often assumed by central banks that are not covered under the definition used in the survey.

In 2010 three new independent fiscal institutions were established (Greece, Romania and the United Kingdom), two were reformed (Sweden and the United Kingdom) and one closed (Italy). The new Greek fiscal council, the Parliament (State) Budget Office, is responsible for monitoring the implementation of the state budget, the analysis and evaluation of the state budget's data and forecasts, and of the sustainability of long term fiscal figures. The Romanian Fiscal Council is composed of five members who will support the work of government and parliament in the process of elaboration and development of fiscal and budgetary policies. Finally, the Office for Budget Responsibility, new fiscal institution in the United Kingdom, is responsible for examining and reporting on the sustainability of the public finances and for assessing the extent to which the fiscal mandate has been, or is likely to be achieved.

In Italy, on the other hand, the Italian Institute for Studies and Economic Analyses (ISAE) ceased to exist at the end of 2010. The closure of the Institute was part of a general rationalisation of public bodies. The new Constitutional law on a balanced budget rule envisages the creation of a fiscal council within the Italian Parliament.

Even with the increase in the number of fiscal councils, among the new EU Members only 5 have such institutions (Estonia, Hungary, Lithuania, Slovenia and Romania). This might be due to the fact that independent fiscal institutions require a certain investment in terms of adequate financing and skilled human resources, in contrast to other areas of fiscal governance where changes can be achieved by legal instruments. Some of the new EU members may therefore have preferred to concentrate their human resources for monitoring fiscal policy making in the central bank, ministries of finance, and academia.

4. PROPOSAL INTRODUCING ENHANCED MONITORING AND ENSURING THE CORRECTION OF EXCESSIVE DEFICIT OF THE MEMBER STATES IN THE EURO AREA

A clear need for an enhanced monitoring of budgetary policies in the euro area

Member States experience strong interlinkages between both their economic situations and their budgetary policies. The management of the public finances in each of the euro area Member States becomes a matter of common concern given that it may affect all other participant countries. In good times, this interdependence brings increased prosperity. But it also means that the sharing of risk should be accompanied by a sharing of responsibility and a seamless procedure covering all eventualities, including the use of financial backstops, is needed.

The Stability and Growth Pact (SGP) contained stronger provisions for the euro area Member States since its inception and the Six Pack enhanced and added to these. In this way, the imposition of financial sanctions in case euro area Member States do not comply with the rules of the SGP has been intensified. In addition, it was necessary to adapt the surveillance framework to the exceptional situations of euro area Member States under financial assistance, and for those experiencing financial difficulties.

The increasing awareness of the interlinkages of the euro area economies has led to an acknowledgement of the need to further reinforce the framework for budgetary coordination and governance for euro area Member States. In the light of this**, the Commission put forward two additional proposals for legislation and a Green Paper on Stability Bonds on 23 November 2011** (the Green Paper is described in Box II.4.I).

Both proposals are based on Article 136 of the Treaty on the Functioning of the European Union (TFUE), which allows specific legislation aimed at reinforcing budgetary coordination and surveillance in the euro are to go beyond the legal framework applicable to the Union as a whole (corresponding to Regulations No 1466/97 and 1467/97 in the context of fiscal surveillance). This so-called Two Pack comprises:

1) A proposal for a Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of the Member States in the euro area.

2) A proposal for a Regulation on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area.

This second proposed Regulation sets out explicit rules for enhanced surveillance for those euro area Member States facing severe difficulties with regard to their financial stability; those in receipt of financial assistance on either a precautionary basis or as part of a full-scale assistance programme; and those in the process of exiting such assistance. For the first time, there will be a common and graduated framework that will set out the surveillance requirements made in such cases.

Taken together, these proposals puts in place an enhanced monitoring procedure that builds on and complements the SGP for the euro area Member States, ensuring a seamless continuity of policy monitoring in all budgetary situations.

Following the usual process for the adoption of legislative proposals, both texts have since been discussed in the Council and the European Parliament. The Council reached agreement on a general approach to the proposed Regulations, which was endorsed by the 21 February ECOFIN. The European Parliament's negotiation position was adopted in plenary meeting on 13 June 2012.

At the date of publication, the negotiations between the co-legislators have just started. Accordingly, this Chapter presents the Commission proposals of 23 November 2011.

Box II.4.1: **Stability Bonds**

The recent discussion about possible common euro area debt issuance ignited again in particular after the Report of the President of the European Council of 26 June 2012 (see European Council (2012)) which presents a vision for the consolidation of the Economic and Monetary Union. The report states that "In a medium term perspective, the issuance of common debt could be explored as an element of.a fiscal union". A large number of proposals for Eurobonds have been put forward, including the issuance of mutualised bonds combined with a debt redemption fund as suggested by the German Council of Economic Advisers([1]), different options of Stability Bonds as outlined in the Commission's Green Paper or the common issuance of short-term debt securities (E-Bills). These various Eurobond schemes differ remarkably related to the aims, the structure and the time pattern of the new instrument. To further frame the intensified public debate on common debt issuance in the euro area, the European Commission published a Green Paper on the feasibility of introducing Stability Bonds on 23 November 2011. It identified significant potential benefits of introducing Stability Bonds. Creating a new sovereign bond market segment would accommodate the shortage of stable, deep and liquid assets in the euro area. Although common issuance of government bonds is unlikely to play any decisive role in overcoming the current sovereign debt crisis, Stability Bonds could over the medium term contribute to completing the institutional setup of EMU. Stability Bonds would thereby (i) facilitate the transmission of monetary policy, (ii) deepen the internal market and render capital markets more efficient, (iii) increase the stability and shock resilience of the financial sector, (iv) raise the attractiveness of euro-area financial markets and the euro at global level, and (v) reduce the impact of excessive market fluctuations on sovereign borrowing costs and hereby strengthen the stability and robustness of government financing. The European Commission considers that the main feature of common issuance should be overall enhanced financial stability. To emphasize this aim the term "Stability Bonds" is used instead of "Eurobonds".

The Green Paper outlines three generic options for common issuance, by combining two main features: the guarantee structure (joint and several vs. several) and the degree of substitution of national by joint issuance (partial vs. complete):

- Option 1, based on joint and several guarantees, full substitution of national bonds;
- Option 2, based on joint and several guarantees, partial substitution of national bonds;
- Option 3, based on several guarantees, partial substitution of national bonds.

The three options are characterized by different trade-offs between expected benefits on the one hand and the fulfilment of preconditions as well as the difficulty of implementation on the other hand. Option 1 seems to be the most likely to provide a high credit quality of commonly issued bonds, as well as major positive effects on financial integration, on financial stability and on the global attractiveness of EU financial markets. At the same time, this approach would however imply the greatest risk of moral hazard, as it would completely suppress financial markets and market interest rates as signals and incentives for individual Member States' fiscal policy. The third approach addresses this latter concern, while, at least in the absence of further credit enhancement, it does not provide the best credit quality or not the best rating. Consequently, the expected level of liquidity of the Stability Bonds would be more limited. The impact on financial integration, on financial stability and on the global attractiveness of EU financial markets would overall be rather medium to low. The second option is commonly referred to as the "blue-red approach"[2] and balances the different previous arguments. It implies a relatively high credit quality for common bonds ("blue bonds") and addresses at the same time the risk of moral hazard through the remaining national-guaranteed bonds (or "red bonds"). Member States with higher debt would not be able to refinance them through common bonds, but beyond a threshold rely on financing all additional debt through national bonds. As they would be obliged to serve the common bonds first (seniority principle), the national bonds would be issued at higher costs. The three approaches also differ in terms of required adjustment of the regulatory framework. As

[1] See German Council of Economic Experts (2011).
[2] See Delpa et al.(2010).

(Continued on the next page)

Box (continued)

option 3 would not call for changes of the Treaty on the Functioning of the European Union (TFEU), it could be used as short-term immediate crisis management tool. In contrast to this, options 1 and 2 would need Treaty changes and are therefore more suitable as medium to long-term instruments. Hereby Stability Bonds option 2 could be launched as medium-term tool to repair financial markets after the crisis, while option 1 would rather be an instrument to complete the EMU architecture in the long run by contributing to a more advanced economic and financial architecture.

While Stability Bonds would provide substantial benefits in terms of financial stability and economic efficiency, it is essential to meet important economic, legal and technical preconditions. The positive net effects of common issuance of bonds depend on managing the potential disincentives for financial discipline and the therefrom resulting consequences. Budgetary discipline must be guaranteed in order to limit moral hazard. While the EU's governance framework has been considerably reinforced over recent years, it remains to be seen whether such a framework would provide sufficient safeguards also in a framework of more advanced or ambitious forms of common issuance. In such a case, additional criteria or conditions for the participation in common issuance might be warranted. Second, Stability Bonds would need to have high credit quality to be accepted by investors. The successful implementation of the new economic governance framework already in force and in the process of being put in place may be a significant step towards fulfilling the preconditions for common issuances. Furthermore, consistency with the EU Treaty would be essential to ensure the successful introduction of Stability Bonds. Common bonds must not be in breach with the Treaty prohibition on the "bailing out" of Member States (Art. 125 TFEU). This would be particularly relevant within Bond issuance under joint and several guarantees. While some options would require Treaty changes, others would not. Issuance under several but not joint guarantee would be possible within the existing Treaty provisions. Overall, the technical design of Stability Bonds impacts all above mentioned issues. It is therefore most important to consider various design options and to analyse the resulting consequences. The Commission's Green Paper elaborated on the various parameters and options and provided a first tentative analysis of their advantages and disadvantages.

In winter 2011/2012 the Commission invited all citizens and organisations to contribute to the public consultation on its Green Paper on the Feasibility of introducing Stability Bonds. The results of the public consultation, published in May 2012, showed significant differences in views between supporters of and opponents to Stability Bonds. However, the majority of respondents were in favour of implementing a common debt issuance instrument. Most of the supporters expressed a preference for Stability Bonds option 2. Overall, several issues were raised: Respondents voiced their concerns about moral hazard and emphasised on the fact that sufficient fiscal discipline should be ensured before implementing Stability Bonds. Therefore a stable legal and governance framework should be put in place. Furthermore participants stressed that Stability Bonds under joint and several guarantees should involve a tight control on national budgets possibly including a restriction of sovereignty. Especially market stakeholders called for a stable and definite instrument, rather than a transitory one and emphasized simplicity and transparency. They objected to hybrid or over-collateralised structures, with or without credit enhancement, and favoured a simple issuance structure, ideally via a central debt management office. Fears of an unjustified burden on citizens and an increase of financing costs for sub-national entities have also been put forward. Finally, legal concerns were addressed as well.

Even if the number of replies is relatively low and cannot be interpreted as representative, they offer a useful snapshot of relevant concerns and preconditions of political and technical nature. The public consultation was a useful process for further reflection on Stability Bonds, as it revealed several additional issues not addressed in the Green Paper. The issues raised in the responses are being studied by the Commission services and further reflection is taking place on possible implementation schemes of Stability Bonds.

Due to the existence of trade-offs between the political scope of a new instrument and the legal, political and technical feasibility of introducing such an instrument in the short term, more limited options for common issuance are under discussion. Especially if the main objective was to design common issuance as a crisis management took, an instrument that differs in design and phasing compared to the Green Paper approaches

(Continued on the next page)

Box (continued)

time and/or maturity of such common issuance. Main examples of such more limited approaches include (1) common issuance based on several guarantee only; (2) time-limited common issuance based on joint and several guarantees in the form of a debt redemption fund as proposed by the German Council of Economic Experts, or (3) common issuance only of short-term debt with a maturity of up to 1 to 2 years, so-called"Eurobills" / "E-bills".

The latter proposal has attracted the most significant attention. As all other proposed instruments, E-bills involve specific advantages and disadvantages. However, while aiming for a crisis management tool the benefits of common issuance of short-term debt seem to exceed the negative consequences. E-bills would contribute to financial market completion by providing a larger supply of short-term securities markets of sufficiently high credit quality. Until now markets for T-bills, commercial paper and certificates of deposit are relatively underdeveloped in most Member States. Eurobills could moreover strengthen financial stability insofar as they would assure a ready supply of short-term liquidity for all euro area Member States. Compared to long-term bonds, the potential exposure of Member States to E-bills under joint and several guarantees would be reduced in volume and time. This is mainly due to the smaller size of the government bill markets and the lower average maturity of bills. The common issuance of short-term securities would also seem beneficial for the conduct of monetary policy in the euro area, as the transmission channels would be strengthened and harmonised. Finally, some of the more technical issues to be solved for commonly issuing long-term bonds (i.e. trading venues or maturity profiles), would be smaller for issuing short-term paper only. Nevertheless the limits of Eurobills need to be considered. Unlike for long-term bonds, collective gains in liquidity premia would be extremely limited, as bills are typically not traded, but purely bought and held. Effects on market integration and efficiency would equally be restrained. Furthermore, euro area Member States' current reliance on T-bills in overall issuance differs widely. This would complicate the introduction of Eurobills, including an agreement on aggregate limits. In addition, it should be avoided that, by creating a particularly attractive short-term instrument, a bias towards short-term issuance appears, particularly in vulnerable Member States. This could lead to very serious rollover risks over the medium term. As is the case for the issuance of common bonds, care would also need to be taken to ensure that an introduction of Eurobills does not breach the no bailout condition enshrined in the TFEU under Article 125.

Still, E-bills should be considered as a possible crisis management tool, as they are more flexible and more easily manageable. As they are of short-term nature their issuance can relatively easily been phased out in the event they lead to unwarranted consequences. While, when successful they could become a stepping stone for other forms of common issuance.

MAIN FEATURES OF THE PROPOSED REGULATION ON ENHANCED MONITORING

The proposal for a Regulation on monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of the Member States in the euro area sets out graduated steps and conditions that reinforce the monitoring of national budgetary policies. The main features of the Commission proposal are set out in this Subsection.

A Common Budgetary Timeline for the euro area

All Member States of the euro area will follow a common timeline, as well as common rules, regarding their budgetary procedures. These new requirements aim to complement the European Semester so as to ensure a good integration of the European Union policy guidance in the national budgetary process and to allow taking a view of the euro area as a whole (see Graph II.4.1). Experience has shown that effective planning plays a key role in ensuring sound public finances, in particular when it allows the *ex ante* identification of any risk of gross errors and thus prevents them from occurring.

In addition, euro area Member States need to take into account the fact that their budgetary plans may potentially trigger spillover effects on the other countries sharing the same currency. Therefore, a first step in reinforcing the preventive aspect of

European surveillance is to ensure a better synchronisation of the key steps of the budgetary procedure. Sharing a common budgetary timeline should help Member States exchange relevant information and follow the budgetary procedures of their counterparts in a transparent manner, and so facilitate synergies. This will reinforce the effectiveness of the European Semester, organised for the first time in 2011, and which is premised on the same rationale which is that the EU Member States need to coordinate better their budgetary and economic processes in line with common objectives, building on Commission and Council recommendations.

This common budgetary timeline is organised around three milestones:

By 15April: the fiscal plans in accordance with the national medium-term budgetary frameworks are made public.

Each Member State must prepare a national medium-term budgetary framework and publish it alongside its Stability Programme that is submitted to the Commission and the Council, in accordance with the preventive arm of the SGP.

As a starting point, the information to be presented in the national medium-term budgetary framework should encompass all the data required in the Stability Programme; however, the Member State may decide that this national document might go further either in the horizon or in the coverage of the medium-term budgetary strategy that it sets out.

By 15 October: The draft budget is made public, together with the macroeconomic forecasts on which it is based;

The draft budgetary plans for the general governments are made public and submitted to the Commission and the Eurogroup.

The submission of draft budgetary plans is intended to mirror the procedure of the Stability Programmes, but with focus on the following year. This new milestone will be specific to the euro area, acknowledging the need for an enhanced synchronisation of the budgetary policies of Member States sharing the same currency.

By 31 December: Budget Laws are adopted and made public.

Finalising all countries' budgetary processes in a synchronised manner should eliminate any uncertainty possibly linked to the forthcoming budgetary plans of the euro are Member States and enhance the transparency both across countries and towards external observers.

Common Budgetary Rules for euro area Member States

Building on the same rationale as the Directive on national budgetary frameworks adopted in 2011 presented in Section II.3, the proposal for a Regulation on enhanced budgetary monitoring sets out more precise requirements for euro area Member States. The new rules are therefore additional to the provisions of the Directive on national budgetary frameworks which should be transposed in all Member States by end-2013.

There is strong evidence showing the effectiveness of rules-based fiscal frameworks in supporting sound and sustainable fiscal policies. The introduction of national fiscal rules which are consistent with the European framework is important to ensure that Member States are equipped to abide by their obligations under the SGP.

While the directive on national budgetary frameworks requires EU Member States to have numerical fiscal rules in place to promote compliance with EU obligations([72]), the proposed regulation proposed more explicitly requires euro-area Member States to enshrine the medium-term budgetary objective (MTO) in their national budgetary process. At least for euro area Member States, the approval of this provision would allow transposing in secondary legislation the core commitment of the Contracting Parties of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed on 2 March 2012 (see Chapter II.5). The binding nature of such national rules would demonstrate the strongest commitment of national authorities to meet their

([72]) The UK is exempted from this provision, in view of its special Protocol annexed to the Treaties.

obligations deriving from the preventive arm of the SGP, too often neglected in the past.

Ensuring that all Member States of the euro area have high-quality budgetary processes is another safeguard to help them meet the strengthened requirements and ensure a sound management of their public finances. The first area concerned by these new common budgetary rules is the reliability of the forecasts on which Member States base their budgetary plans, be they the national medium-term fiscal plan or the draft budget for the forthcoming year. Indeed, in the absence of realistic and unbiased forecasts, the link between budgetary planning and execution is weakened and Member States are likely to miss the targets foreseen in the plans. In particular, as the revenue projections are based on the level and composition of economic growth, overly optimistic GDP forecasts will leave the government unable to respect its budgetary targets for revenues and hence, for the overall budget balance. The directive asks the macroeconomic and budgetary forecasts to be realistic and subject to a regular evaluation. The proposed regulation requires fiscal plans of euro area Member States to be based on independent macroeconomic forecasts.

In addition, according to the Commission proposal euro area Member States should rely on independent fiscal bodies for the monitoring and implementation of national rules, in particular, of rules ensuring compliance with the MTO. The directive does not strictly require national independent bodies to monitor fiscal rules. However, it envisages that monitoring of numerical rules should be based on analysis carried out by independent bodies

New reporting requirements in order to improve the monitoring of Member States' budgetary policies

An enhanced monitoring of budgetary policies in the euro area exerted at the European level and based on a reinforcement of existing processes for budgetary and economic surveillance, has been deemed necessary to take account of the fact that national economic policies of Member States are a matter of common concern – particularly in the case of countries sharing a single currency. This implies greater awareness and interest by national parliaments and stakeholders in the EU-level perspective.

The new Regulation, builds upon the European Semester by introducing a new exercise to be conducted in the autumn, when the budgetary plans of Member States of the euro area will be assessed. This new exercise would involve only the forthcoming budgetary year, as opposed to the European Semester, which considers budgetary plans and policies over the medium run. By taking into account one budgetary year only, just ahead of the adoption of the Budget by the National Parliament, this new milestone should allow a more targeted and more relevant intervention into national budgetary processes, thus reinforcing substantially the preventive function of the SGP.

By requiring the submission by Member States of their draft budgetary plans by 15 October, the Regulation enables the Council and the Commission to examine the national draft budgets of all euro area Member States, both individually and with an overall view on the forthcoming fiscal stance in the euro area.

In addition, the Eurogroup will hold a discussion on the fiscal prospects for the euro area for the forthcoming year, on the basis of the assessment of the draft budgetary plans undertaken by the Commission.

The Regulation lays down the required information which is expected to be provided by Member States in their draft budgetary plan (see Box II.3.2). This information, provided following the common European accounting standards (ESA 95), in order to be fully comparable across Member States, will ensure horizontal consistency in the assessment and to allow the framing of a euro area-wide picture of fiscal positions. Indeed, the information required has been selected in order to provide a comprehensive overview of the fiscal position of each Member State over the forthcoming year. The proposal presented on 23 November envisages that the specific content and the format of the draft budgetary plans is to be established by the Commission.

There are two potential steps that the Commission might decide to undertake on the basis of the draft budgetary plans. First, in exceptional cases of serious non-compliance of the budgetary plan with

the obligations of the Member States deriving from the SGP, the Commission will be able, within two weeks from the date the Member State submitted its programme, to request a revised draft budgetary plan. In particular, this would be the case where the implementation of the initial budgetary plan would put at risk the financial stability of the Member State concerned or would risk jeopardising the good functioning of the EMU, or where the implementation of the initial budgetary plan would entail an obvious significant violation of the recommendations formulated by the Council under the SGP.

In addition, the Commission may adopt an opinion on a Member State's draft budgetary plan, after having properly assessed it. This opinion will be given as soon as possible, with a maximum deadline established in the Commission proposal at 30 November. The objective is to transmit this information to the Member State concerned before the plan is adopted by the National Parliament, inviting the budgetary authorities to take it into account in the process of the budget law adoption. The Commission would then stand ready to present its opinion to the national Parliament at its request.

This new role of the Commission is one of information and monitoring, and there is no transfer of sovereignty away from the Member States, which remain fully competent on deciding on their budgets. The final budget Law is adopted by the National Parliament in full respect of its prerogatives. It is clear that countries will need to respect European requirements on their public finances when setting their budgetary plans if they want to avoid that the Commission requests a new budgetary plan; but these requirements are already set in the Treaty and the SGP and this new exercise is only meant to enhance the dialogue between the Member States and the European institutions and among themselves. The Regulation on enhanced monitoring therefore adds to the national rules and scrutiny of Member States' policy making but does not place additional requirements on the policies themselves that should have anyway been in compliance of the requirements recalled in Chapter II.2.

In addition, any Commission Opinion issued on the draft budgetary plan of a Member State may help inform any subsequent decisions about whether this Member State should be placed in an Excessive Deficit Procedure; the Opinion will be formally taken into account in the steps leading the opening of the procedure. More precisely, the extent to which this opinion has influenced the final budget should be part of the assessment, where no follow-up to the early guidance from the Commission should be considered as an aggravating factor.

Finally, The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) described in Chapter II.5 acknowledges the necessity to enhance coordination on the budgetary side by also increasing the exchange of information concerning debt management. The objective is to ensure that each national debt manager benefits from useful information about broad parameters of debt issuance by other debt managers in the euro area. The Commission proposal for this Regulation could be amended accordingly to foresee a regular reporting by Member States on their *ex ante* debt issuance plans.

Of course, possible gains, deriving from increased transparency and predictability of funding plans to all sovereign debt issuers in the euro area, have to be weighed against the imperative and justified needs of flexibility and confidentiality of issuing policies and procedures.

This reporting could be built on existing mechanisms and frameworks for information sharing across Member States on their debt issuance. For instance, the Economic and Financial Committee's Sub-Committee on EU sovereign debt markets (ESDM), primarily composed of representatives of Member States' debt management offices, could constitute an appropriate forum for such consultation and cooperation. The ESDM has been established for a number of years and has started to implement ad-hoc codes on monthly reporting of national debt issuance. Existing processes could therefore allow Member States to comply with what is now set as a legislative requirement.

Box II.4.2: Extract from Article 5 of the proposed Regulation on enhanced monitoring: Information to be presented by Member States in their draft budgetary plan

The draft budgetary plan shall contain the following information for the forthcoming year:

(a) the targeted budget balance for the general government as a percentage of Gross Domestic Product (GDP), broken down by sub-sector of general government;

(b) the projections at unchanged policies for expenditure and revenue as a percentage of GDP for the general government and their main components;

(c) the targeted expenditure and revenue as a percentage of GDP for the general government and their main components, taking into account the conditions and criteria to establish the growth path of government expenditure net of discretionary revenue measures under Article 5(1) of Regulation (EC) No 1466/97;

(d) a detailed description and a well-documented quantification of the measures to be included in the budget for the year to come in order to bridge the gap between the targets referred to in point (c) and the projections at unchanged policies provided in accordance with point (b). The description may be less detailed for measures with a budgetary impact estimated to be lower than 0.1% of GDP. Particular attention shall be paid to major fiscal policy reform plans with potential spillover effects for other Member States whose currency is the euro;

(e) the main assumptions about expected economic developments and important economic variables which are relevant to the achievement of the budgetary targets. These assumptions shall be based on independent macroeconomic growth forecast;

(f) where applicable, additional indications on how the current recommendations addressed to the Member State concerned in accordance with Article 121 of the Treaty in the budgetary area will be met.

A closer monitoring of progress by euro area Member States under the Excessive Deficit Procedure (EDP)

While the enhancement of the monitoring of national budgetary policies for all Member States of the euro area reinforces the preventive aspect of European surveillance, the new proposed Regulation also includes provisions to increase the effectiveness of its corrective part. The corrective arm only concerns Member States which have already breached the rules governing either the deficit level or the pace for debt reduction, and which, as a consequence, are subject to an Excessive Deficit Procedure (EDP). The fiscal position of such Member States being particularly fragile, it becomes a matter of common concern for the euro area as a whole. It is therefore the responsibility of the EU to put in place tighter requirements to ring-fence the budgetary fragilities and ensure an effective and durable correction of budgetary slippages.

Enhancing the effectiveness of the monitoring exerted at the EU level in the framework of the EDP means ensuring that Member States concerned take sufficient and effective action, so that their excessive deficit is corrected within the specific deadline set by the Council. The SGP already foresees that concerned Member States would submit a progress report to the Commission and the Council. This report presents the action taken by the Member State to correct the excessive deficit (Article 3(4a) of Regulation 1467/97) within the six months (at the latest) following Council recommendations issued in accordance with Article 126(7) TFUE (see Table II.4.1). It is on the basis of the information provided in that report that the Council decides, on a recommendation by the Commission, whether effective action has been taken.

However, experience has shown that a closer monitoring of budgetary developments and of the corrective action undertaken, over and above this existing report, would be instrumental in ensuring

an early correction of any deviations from the Council recommendations on the correction of the excessive deficit. Building on this rationale, this proposed Regulation increases both the requirements placed on euro area Member States in terms of the scope of the information to be shared and the frequency of the reports to be submitted to the Commission and to the Council. This will allow an early identification of risks to the compliance with the Member State's deadline to correct its excessive deficit.

When an EDP is opened, the Member State has to present a comprehensive overview of its budgetary situations and of the actions it plans to take to correct the excessive deficit. In this way the proposed Regulation complements the initial report on action taken with a comprehensive assessment of in-year budgetary execution for the general government and its sub-sectors, including financial risks associated to contingent liabilities with potentially large impacts on public budgets, to the extent that they may contribute to the existence of an excessive deficit.

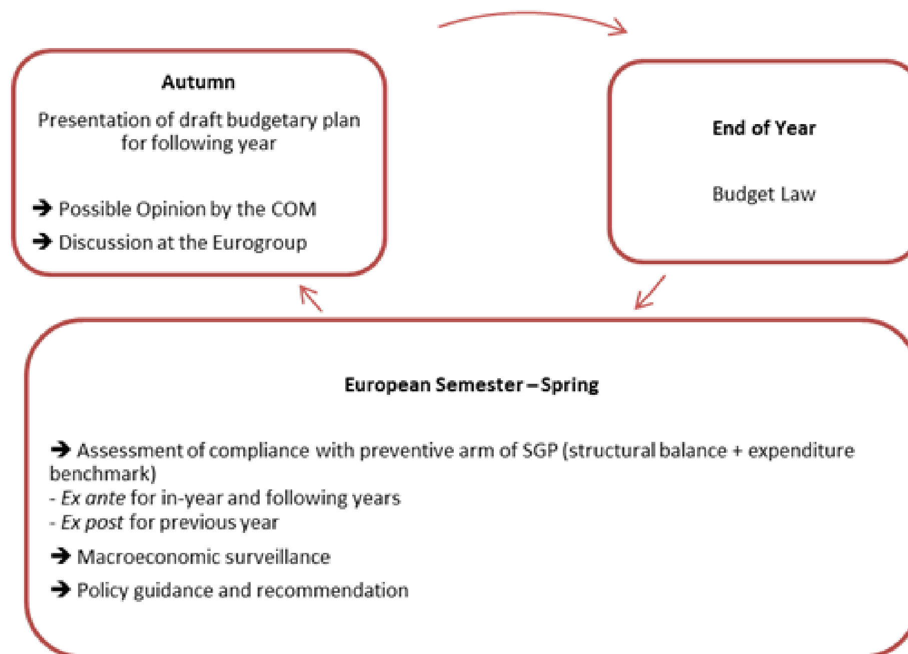
Second, besides this initial overview of situation and the elaboration of the plans drawn up by the Member State after entering the excessive deficit procedure, the proposed Regulation foresees a regular exchange of information, following the initial report, until the excessive deficit is actually corrected. Accordingly, euro area Member States in EDP are required to report regularly to the Commission and to the Economic and Financial Committee, providing these bodies with information on the in-year budgetary execution, the budgetary impact of discretionary measures taken on both the expenditure and the revenue side, targets for the government expenditure and revenues, as well as information on the measures adopted and the nature of those envisaged to achieve the targets for the general government and its sub-sectors. The report shall be made public.

As provided for in Article 126 of the Treaty, the modalities of such closer monitoring have to be graduated depending on the stage of the procedure the Member State is subject to. Therefore, after the initial report on action taken to be submitted in accordance with Regulation 1467/97, the new regular reporting introduced by the proposed Regulation on enhanced monitoring is to be submitted every six months, but the frequency is heightened to every three months if the Member State is subject to a Council notice (in accordance with Article 126(9) TFUE). Indeed, such Council notice is issued after the Council has decided that the Member State has not taken effective action to correct its excessive deficit; this more critical situation deserves a closer and more frequent monitoring of budgetary developments for the Member State concerned.

In this way, more frequent information sharing will be the basis for the identification of the risks that a Member State might not correct its excessive deficit within its deadline. In the event of such risks being identified, the Commission will issue a recommendation to the Member State for measures to be taken within a given timeframe. This recommendation will be presented to the Parliament of the Member State concerned at its request. Compliance with this recommendation should allow for a rapid correction of any developments putting at risk the correction of the excessive deficit within the established deadline.

Assessment of compliance with such a Commission recommendation should be part of the continuous assessment made by the Commission, of the effective action to correct the excessive deficit, in particular when deciding whether effective action to correct the excessive deficit has been taken.

Graph II.4.1: **The new fiscal governance framework in the euro area**



Source: Commission services.

As described in Chapter II.5, the TSCG introduces the concept of 'economic partnership programme' for countries in EDP, i.e., a programme including structural reforms to ensure a durable correction of the excessive deficit. Also progress with the implementation of the economic partnership programme could be included in the closer monitoring envisaged by this proposed regulation.

Attention has been paid to avoid over-burdening national administrations: reports and monitoring already envisaged throughout the excessive deficit procedure, as described in the corresponding Regulation of the SGP, are included and combined with the requirements set out in the new proposed text (see Table II.4.I). In addition, countries which are subject to a macroeconomic adjustment programme are also exempt from the reporting requirements of this proposed Regulation on monitoring and assessment.

Finally, in order to enhance the dialogue between the Union institutions – in particular between the European Parliament, the Council and the Commission –and to ensure greater transparency and accountability, the competent committee of the European Parliament may offer the opportunity to the Member State concerned by a Commission recommendation issued in the context of the closer monitoring to participate in an exchange of views.

Table II.4.1: **Reporting obligations for euro area Member States subject to the excessive deficit procedure**

Content required by Regulation 1467/97 as reformed by the Six-Pack	Content required for closer monitoring foreseen by the proposal for a Regulation on enhanced monitoring (euro area only)
Within deadline set in 126(7) recommendation (max. 6 months), report on action taken to correct the excessive deficit	
(Art. 3.4a) Targets for government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side consistent with the Council's recommendation, as well as information on the measures taken and the nature of those envisaged to achieve the targets.	*(Art. 7.2)* Comprehensive assessment of in-year budgetary execution for the general government and its sub-sectors; financial risks associated to government-owned entities and government contracts shall also be covered by the assessment to the extent that they may contribute to the existence of an excessive deficit.
	6 months later and every 6 months until abrogation/stepping up
	(Art. 7.3) For the general government and its sub-sectors: in-year budgetary execution, budgetary impact of discretionary measures taken on both the expenditure and the revenue side, targets for the government expenditure and revenues, as well as information on the measures adopted and the nature of those envisaged to achieve the targets.
	If subject to an Art. 8.2 Commission recommendation assessing for further measures because compliance with correction by the deadline is at risk: (Art. 8.3) similar information on other measures being taken in response to the Commission recommendation, to be submitted together with Art. 7.3 report.
Following 126(9) notice, report on action taken in response thereto	
(Art. 5.1a) Same as under Art.3.4a plus information on the actions being taken in response to the specific Council recommendations.	Reporting foreseen by Art. 7.2, if not already submitted at the same time as report under Regulation 1467/97 Art. 3.4a.
	3 months later and every 3 months until abrogation
	(Art. 7.5) Same content as biannual report following 126(7) recommendation, plus information on the actions being taken in response to the 126(9) Council notice.
Upon request by the Commission	
(Art. 10a) If Member State subject to 126(8) or 126(11) decisions, all necessary information for the preparation and conduct of on-site monitoring missions.	*(Art. 7.6)* Comprehensive independent audit of the accounts of the general government conducted in coordination with national supreme audit institutions, aiming at assessing the reliability, completeness and accuracy of these public accounts for the purposes of the excessive deficit procedure.
	Additional information for the purposes of monitoring the progress towards the correction of the excessive deficit

Source: Commission services.

Box II.4.3: **The proposed Regulation on enhanced surveillance for Member States experiencing severe difficulties with regard to their financial stability or for those in receipt of financial assistance**

The second proposal for a Regulation of the so-called Two-Pack makes Member States experiencing severe difficulties with regard to their financial stability or receiving a financial assistance on a precautionary basis subject to enhanced surveillance. The proposal dovetails the financial assistance granted outside the framework of the Union with the Treaty, by setting out a clear procedure for preparing and adopting macro-economic adjustment programmes. It also sets out the procedure for post-programme surveillance for countries which have received loans or have drawn a precautionary assistance.

The main components of the proposed regulation are:

(a) enhanced surveillance

The Commission can, in close cooperation with the EFC, decide to make a Member State subject to enhanced surveillance, with such a decision being automatic for countries receiving precautionary financial assistance. This surveillance involves (a) an obligation on the Member State to adopt measures to address the sources of instability, (b) regular review missions, and (c) quarterly reporting by the Commission to the Eurogroup Working Group (EWG). This will give the Commission significant powers: beyond full access to fiscal data, the Commission would have the capacity to force a stress test exercise or to access disaggregated data of financial institutions.

If monitoring shows that further measures are needed and the financial situation of the Member State concerned has a significant impact on the financial stability of the euro area, the Commission can propose to the Council to recommend that this Member State take precautionary measures or prepare a macroeconomic adjustment programme (*de facto*, seek financial assistance).

(b) procedure for deciding and monitoring a macroeconomic adjustment programme

The programme is prepared by the country and the Commission (in liaison with the ECB) and is submitted for approval to the Council via a Commission proposal. The Commission, in liaison with the ECB, will ensure the monitoring of the programme. The two main novelties are (a) an obligation on the MS facing insufficient administrative capacities to seek technical assistance from the Commission and (b) the possibility for the Council to decide that a beneficiary is not complying with the policy requirements contained in the adjustment programme. The latter decision would have very significant effects; it would de facto trigger the interruption of the disbursements of the financial assistance of the European Financial Stability Fund (EFSF)/European Stability Mechanism (ESM) and a suspension of payments or commitments under the structural funds.

(c) simplification of the monitoring of programme countries

Macroeconomic adjustment programmes go beyond fiscal issues and have a wide scope, covering all policy areas that could improve the economic and financial situation. All attention naturally focuses on the monitoring of the programme, if only because it conditions the disbursements. For this reason, it is proposed to avoid duplication and overburdening by suspending the monitoring under the SGP and the implementation of the Excessive Imbalance Procedure (EIP), European Semester and the proposed Regulation on enhanced budgetary monitoring.

(d) post-programme surveillance

Post-programme surveillance inadvertently offers lenders extra protection by ensuring that the beneficiary remains on the right fiscal track, thus protecting its capacity to repay its debt. Under the proposed Regulation, a country would be subject to the post-programme surveillance conditions as long as it has not

(Continued on the next page)

Box (continued)

repaid 75% of its debt. This could lead to a very long surveillance period, which explains why post-programme surveillance is not described in detail. The Commission would have monitoring powers and report twice a year. Where appropriate, it can propose to the Council to recommend to the MS concerned to adopt corrective measures. The wording allows enough flexibility to fine tune the level of surveillance according to specific needs; it can be either intrusive or very light, depending on the economic and financial situation of the Member State concerned.

It should be noted that the Commission will implement post-programme surveillance only if the financial support is financed by the EU (EFSM) or its Member States (ESM, EFSF), but not if it comes from the IMF or third countries.

5. THE STABILITY TREATY AND THE FISCAL COMPACT

The Treaty on Stability, Coordination and Governance (TSCG), an intergovernmental initiative, is the latest stage of the European economic governance reform. As part of the multidimensional response to the economic and financial crisis, it is a reflection of Member States' willingness to further strengthen and fully implement the provisions of the revised Stability and Growth Pact (SGP). Indeed, Contracting Parties have decided to incorporate key concepts of the SGP within their national legislation, and to go beyond in some cases. Even if the preference would have been the adoption of similar provision within the framework of EU law, the TSCG nevertheless runs alongside and complements the new legislation on fiscal and macroeconomic surveillance – the so-called "six-pack" – which entered into force on 13 December 2011.

5.1. THE TREATY ON STABILITY, COORDINATION AND GOVERNANCE : AN INTERGOVERNMENTAL INITIATIVE TO STRENGTHEN BUDGETARY DISCIPLINE AND ECONOMIC POLICY COORDINATION

5.1.1. An intergovernmental initiative

At the European Council of 8-9 December 2011, most EU Member States decided to open the way to an intergovernmental treaty designed to ensure greater fiscal surveillance and economic coordination within the European Union. Following a period of negotiations which involved all 27 Member States, as well as consultations with the European Parliament, the Commission and the European Central Bank, the Treaty was signed on 2 March 2012 by 25 Heads of State or Government(73).

The option of an international treaty allowed those Member States willing to proceed with commitments going beyond what is currently envisaged by the European Treaties, to do so despite other States wishing to remain outside the process. While not being part of EU law as such, the Treaty on Stability, Coordination and Governance is however consistent with EU law and shall be applied in conformity therewith. The Treaty therefore appears as a demonstration of Member States' willingness to go for a closer economic union.

The 25 signatories of the Treaty on Stability, Coordination and Governance (TSCG), concentrated their commitments to achieve greater budgetary and economic coordination on three main dimensions: (i) fiscal discipline, (ii) economic policy convergence and (iii) enhanced governance of the euro area.

5.1.2. Building on the Stability and Growth Pact, a fiscal compact to improve Member States' budgetary discipline

On the budgetary side, the fiscal compact (Articles 3 to 8 of the TSCG), which covers the fiscal rules of the TSCG, gathers elements of a reinforced coordination for all stages of budgetary surveillance, which is governed at the level of the Union by the SGP – with some reinforced provisions specific to the euro area.

The fiscal compact follows the two-fold approach of the SGP, where a preventive arm is designed to maintain or guide Member States towards medium and long-term fiscal sustainability; coming at a later stage, in cases that the preventive arm is supposed to avoid, corrective mechanisms, namely the excessive deficit procedure (EDP), ensure the correction of gross policy errors.

The fiscal compact intends to complement both stages of fiscal surveillance, through:

– at a preventive stage: implementation of a balanced-budget rule into national law; ex-ante reporting on debt issuance plans;

– ensuring the correction of gross policy errors: greater deterrence of the corrective procedure; new focus on structural reform necessary to accompany correction of fiscal imbalances.

– As main commitments consist in enshrining in national law, and with the support of national mechanisms, core principles of the SGP, the fiscal compact demonstrates an increased ownership of European rules. This can only

(73) The TSCG was signed by all euro area Member States, and by Bulgaria, Denmark, Hungary, Latvia, Lithuania, Poland, Romania, and Sweden. The United Kingdom and the Czech Republic did not sign the TSGC.

reinforce adherence and compliance with a common commitment towards sounder fiscal policy-making in Europe.

Accordingly, and building directly on the concepts of the European Stability and Growth Pact, the fiscal compact sets the following rules:

- Contracting Parties commit to translate at the national level the core concept of the 'preventive arm' of the SGP: their budget will have to reach a 'balanced or in surplus' position, deemed respected if the annual structural balance of the general government is at the country-specific medium-term objective (MTO). In most cases, this MTO will have a lower limit amounting to a structural deficit of -0.5% of GDP (see section 5.2.2 below). Following the same rules as in the SGP, a temporary deviation from the medium-term objective or the adjustment path towards it will only be possible in exceptional circumstances. In case of significant observed deviations from the MTO or the adjustment path towards it, also assessed in accordance with SGP concepts, correction mechanisms will be triggered automatically at the national level.

- To ensure compliance, the Contracting Parties will have to enshrine those rules in their national law through provisions of binding force and permanent character. Failure to do so may result in the CJEU imposing a financial sanction of up to 0.1% of the Member State's GDP. In addition, independent bodies will be in charge, at the national level, of monitoring compliance with the balanced-budget rule.

- If deficits need to be contained, the crisis showed that debt also requires to be monitored closely. A major innovation of the six-pack was to give to the government debt as much importance as to the deficit, by allowing the opening of an EDP if any of the two criteria is not respected. Recalling their commitment to comply with what has been translated into a new debt reduction benchmark (see Chapter II.2), the Contracting Parties re-state in the TSCG that, in case their general government debt exceeds 60% of GDP, they will have to reduce the difference between their debt-to-GDP ratio and the 60% threshold at an average rate of one twentieth per year as a benchmark.

- Confirming the greater focus on debt and with a view to better coordinate the planning of their national debt issuance, the Contracting Parties will report ex ante on their issuance plans to the Council of the EU and to the European Commission.

- Enforcement of the rules of the SGP was one of the challenges to be addressed by the reform of the SGP. In that vein, the six-pack reinforced disincentives for non-compliant Member States of the euro area, through the creation of quasi-automatic financial sanctions attached to the different steps under the preventive arm and under the EDP. Indeed, sanctions are triggered under a recommendation of the Commission, unless a qualified majority of Member States opposes them: this is the so-called reversed qualified majority voting. If such voting rules were possible for these new sanctions introduced by secondary law, the steps of the EDP itself are set by the Treaty on the Functioning of the European Union (TFEU), together with the corresponding voting rules in the Council of the EU: they could not be modified by one of the Regulations of the six-pack. As a consequence, to strengthen the deterrence of the procedure by introducing more automaticity in the different steps of the EDP, the only alternative to a Treaty change was an intergovernmental agreement. Hence the "behavioural commitment" of the Contracting Parties of the TSCG to support Commission recommendations in the context of the EDP unless a qualified majority of Member States is against – mimicking the so-called reversed qualified majority voting. Even though this provision is restricted to cases when the procedure is opened on the basis of an excessive deficit, leaving aside debt-based EDPs, this provision, coming on top of the new financial sanctions of the six-pack, will enhance the dissuasive dimension of the EDP for euro area Member States.

- To support the correction of excessive deficits, and ensure its effectiveness and durability, Contracting Parties add a complement to existing requirements under the excessive

deficit procedure. Contracting Parties subject to an EDP will have to present an economic partnership programme detailing the structural reforms that are deemed necessary to support an effective and durable correction of the excessive deficit.

5.1.3. An agreement aimed at reinforcing economic coordination and governance of the euro area.

Economic policies are a matter of common concern for all Member States of the Union, as stated by Article 121 of the TFUE. Commitments are made in that direction in the framework of the TSCG, to deepen economic policy coordination and convergence (Title IV of the TSCG). These include increased recourse to enhanced cooperation on matters essential for the smooth functioning of the euro area, as well as greater *ex-ante* coordination of the major economic policy reforms planned by the signatories. Such coordination will involve the institutions of the European Union.

Provisions were also introduced in order to reinforce the governance of the euro area (title V of the TSCG). The Treaty makes provision for regular informal meetings to take place between the Heads of State or Government of euro area Member States, together with the President of the European Commission. The objective of those Euro Summit meetings, which shall take place at least twice a year, will be to discuss issues concerning the governance of the Economic and Monetary Union, as well as strategic orientations to increase economic convergence among euro-area Member States. A President of the Euro Summit, appointed by the euro-area Heads of State or Government will ensure the preparation and continuity of the meetings in close cooperation with the President of the European Commission. Herman Van Rompuy was designated to embody this function, with the same term of office as for the presidency of the European Council that he holds in parallel until 30 November 2014. The President of the Euro Summit, will keep non-euro area Member States informed of the preparation and outcome of those meetings and will present a report to the European Parliament after each of them.

5.2. OPERATIONALISING THE TREATY - RATIFICATION PROCESS AND ANCHORING INTO EU LAW

5.2.1. The ratification process of the TSCG

Before it becomes operational, the Treaty on Stability, Coordination and Governance will have to go first through a ratification process by the Member States' national parliaments.

The Treaty shall enter into force on 1 January 2013, provided that twelve euro-area signatories have ratified it. The national parliaments of several euro area Member States have already approved it: Greece was the first signatory to notify the ratification the TSCG on 10 May 2012, followed by Slovenia, Portugal and Latvia.

While euro-area Member States are bound by the Treaty from the first day of the month following the deposit of their instrument of ratification, other Contracting Parties whose currency is not the euro may decide to be bound by certain provisions related to the fiscal compact and economic policy coordination, on a voluntary basis.

In parallel, the European institutions are working towards the integration of some provisions of the Treaty into EU law.

5.2.2. Anchoring provisions into EU law: possible Commission initiatives and connection with the Two-Pack

Contracting Parties of the TSCG pledged to incorporate the provisions of the intergovernmental treaty into the EU legal framework within five years of its entry into force. The European Commission has indicated its intention to operationalize relevant parts of the treaty, such as key elements of the fiscal compact, through secondary legislation. The objective of the European Commission is to ensure that novelties, and elements needed for their operationalization, are entrenched into law via the Community method, in full compatibility with the Stability and Growth Pact. Relying on EU law, when appropriate, will ensure a quick and smooth implementation.

5.2.2.1. Calendar for convergence towards the MTO

While Member States commit in the fiscal compact to set up a constraining framework at the national level to ensure that their budgetary position is maintained at the medium-term budgetary objective, most of the Contracting Parties are currently not yet at their MTO. Therefore, a horizon needs to be set for their adjustment towards the objective. Accordingly, the Commission will define a timeframe for the convergence towards Member States' respective MTOs.

This calendar will be presented by the Commission following the imminent revision of the MTOs, which occurs every three years and is due this year. It will be based on common principles, and in full accordance with the spirit and the principles of the SGP.

According to the fiscal compact, MTOs in the euro area, which are country-specific values, could not go below a structural deficit of 0.5% of GDP: this is slightly more stringent than what exists in the current legislation, i.e. -1% for Member States participating in the Economic and Monetary Union or in the European Exchange Rate Mechanism II. The fiscal compact however maintains this limit of -1% of GDP for Member States with a debt-to-GDP ratio significantly below 60% and low risks for the sustainability of public finances.

5.2.2.2. Common principles for the national set-ups ensuring compliance with the balanced-budget rule

In order to ensure compliance with the new rules implementing MTOs at the national level, the fiscal compact foresees that a correction mechanism will be triggered automatically in the event of a significant deviation from the medium-term objective or the adjustment path towards it.

According to the TSCG, this national mechanism is to be put in place on the basis of common principles to be proposed by the Commission on the nature, size and timeframe of the corrective action to be undertaken, as well as on the role and independence of the national institutions responsible for monitoring compliance with the rule. A Communication putting forward common principles underlying the national correction mechanisms was issued by the Commission on 20 June 2012. (see Box II.5.1).

5.2.2.3. Strengthening ex ante economic coordination

The TSCG envisages a reinforced economic coordination, stipulating that the Contracting Parties should ensure that all major economic reforms that they plan to undertake will be discussed ex ante, and where appropriate, coordinated among themselves.

According to these provisions, Contracting Parties will have to present information on those economic reform plans - which could have spill over effects on other Member States - ahead of their adoption, so that they may be discussed at the level of the Eurogroup. Countries that do not participate in the Economic and Monetary Union may also opt in the process and present their own economic reform plans to other Member States. This mechanism will allow identifying best practice and benchmarking future reforms. This will also be an occasion to look systematically at likely cross-border spill over effects as well as implications for the euro area's overall macro-economic policy stance.

Box II.5.1: **Common principles for national fiscal correction**

The common principles for national fiscal correction mechanisms as expressed in the Communication form the Commission COM(2012) 342 of 20 June 2012 are the following.

(1) [Legal status] The correction mechanism shall be enshrined in national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. The mechanism shall fully respect the prerogatives of national Parliaments.

(2) [Consistency with EU framework] National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a 'significant deviation' and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the Stability and Growth Pact.

(3) [Activation] The activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the medium-term objective (MTO) or the adjustment path towards it. The activation triggers may comprise EU-driven or country-specific criteria, to the extent that they meet the above condition. Subject to the same condition, both ex ante mechanisms that set budgetary objectives preventing the materialisation of deviations and ex post mechanisms that trigger corrections in reaction to prior deviations, may fulfil the requirements.

(4) [Nature of the correction] The size and timeline of the correction shall be framed by pre-determined rules. Larger deviations from the medium-term objective or the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline, and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(5) [Operational instruments] The correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general government.

(6) [Escape clauses] The definition of possible escape clauses shall adhere to the notion of 'exceptional circumstances' as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the concerned Member State with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the euro area. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. The correction mechanism shall foresee a minimum pace of structural adjustment once out of the escape clause, with the requirement from the Stability and Growth Pact a lower limit. When exiting the escape clause, Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(7) [Role and independence of monitoring institutions] Independent bodies or bodies with functional autonomy acting as monitoring institutions shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The concerned Member State shall be obliged to comply with, or alternatively

(Continued on the next page)

Box (continued)

explain publicly why they are not following the assessments of these bodies. The design of the above bodies shall take into account the already existing institutional setting and the country-specific administrative structure. National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.

5.2.2.4. Connections with the Two-Pack Regulation on enhanced monitoring

The rationale of the TSCG shares some traits with that of the proposals of the Two-Pack Regulations (see Part II.4). In particular, with the proposed Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

Both initiatives have the same objective to secure sound fiscal policy-making in the euro area, by provisions complementing at the same time the preventive and the corrective arms of the SGP. Both intend to articulate better budgetary practices at Member State level with strengthened provisions for euro area fiscal surveillance.

This is why the current inter-institutional negotiations on the Two-Pack offer an appropriate context to reflect on how to enshrine into EU law some of the provisions of the intergovernmental treaty. The proposed Regulation on enhanced monitoring could provide a suitable legal space to enshrine into EU law some of the key elements operationalising the TSCG, and more specifically the fiscal compact.

Part III

Consolidation and dynamics of the multipliers. Are there counter-intuitive effects?

SUMMARY

One of the main consequences of the economic and financial crisis has been sharp increases in government debt. As a result, the EU Member States started the necessary process of consolidating their government finances in 2010. In the face of growing signs of a weakening economy, a public debate is taking place on the effectiveness of consolidating government finances. The tone of the debate has mounted in the claim that "austerity can be self-defeating". The aim of this Chapter is to provide simulations on the short- and long-term effects of fiscal consolidations under various scenarios.

The main factor driving the impact of a consolidation on the debt-to-GDP ratio is the size of the fiscal multiplier, i.e. the impact of consolidation on growth, and the reaction of sovereign yields to such a consolidation. While there is a large body of research concerning the former (with an equally large variance in the results), less evidence is currently available concerning the latter.

The size of the fiscal multipliers depends on many factors, the most relevant of which are i) the composition of the adjustment and whether it is perceived to be permanent or temporary, ii) the absence or presence of financial constraints for economic agents, iii) the size of automatic stabilizers, iv) the initial level of public debt, v) the stance of monetary policy and vi) the international economic environment. Moreover the size of the fiscal multipliers evolves with time. The size of first-year multipliers is larger if the fiscal consolidation is based on government expenditures – and government investment in particular – if the measures taken are not credible and temporay, if agents are financially constrained and if the monetary policy is unable or unwilling to accommodate the effect on real interest rates along with the fiscal shock. The negative output effects of consolidations in one country are reinforced if consolidations are implemented at the same time by all its trade partners. The composition has an impact on long-term output, as tax-based consolidations have a long-term negative impact on output which is not present in expenditure-based consolidations unless these are based on government investment.

In addition, there is a growing understanding that fiscal multipliers are non-linear and become larger in crisis periods because of the increase in aggregate uncertainty about aggregate demand and credit conditions, which therefore cannot be insured by any economic agent, of the presence of slack in the economy, of the larger share of consumers that are liquidity constrained, and of the more accommodative stance of monetary policy. Recent empirical works on US, Italy Germany and France confirm this finding. It is thus reasonable to assume that in the present juncture, with most of the developed economies undergoing consolidations, and in the presence of tensions in the financial markets and high uncertainty, the multipliers for composition-balanced permanent consolidations are higher than normal.

For the counter-intuitive dynamics to happen multipliers should be large, either due to significant slack in the economy or lack of credibility of the consolidation programme, very persistent and financial markets very short-sighted.

However, even when these factors come together, the analysis also shows that even for high but plausible values of the first-year fiscal multipliers such counterintuitive scenario would be short-lived unless the effects of consolidation on GDP remained large for two-three years or if deficit reduction induces a rapid and large increase on average effective interest rates - contrary to what is normally expected and estimated in consolidations - and the increase in risk premia induced by a higher observed debt ratio are ten times the average estimates. In the latter and improbable case only, somewhat longer-lasting counter-intuitive dynamics could not be excluded. Once again, a high degree of financial market myopia is further required for these effects to happen: if, to the contrary, after consolidation measures have been implemented financial markets do not only look at the debt ratio of the first year (and attach implausibly high risk premia to the observed short-term change in the debt ratio, while ignoring any longer-term debt-reducing effect) but instead consider those three or four years ahead, the debt dynamics would evolve as one would expect: consolidation reduces the debt-to-GDP ratio. Thus, under reasonable assumptions, counter-intuitive debt dynamics become practically impossible.

Finally, some calculations are performed taking as a baseline current economic projections for EU Member States. They first show that the reverse

effect of consolidations would end within three years or less even if the impact of consolidation on GDP growth is long lasting, provided that financial markets do not require substantially higher risk premia when the country consolidates – even though the required interest rates increase with debt levels. High debt countries would experience a scenario in which the debt ratio increased following fiscal tightening only if financial markets were myopic and induced a very high increase of average effective interest rates when the country consolidates. Second, it is also shown – in line with the analysis provided in Chapter I.3 - that in view of the debt dynamics in a number of EU Member States, sizeable fiscal efforts of some points of GDP would be needed to bring debt ratios back to current levels within the next decade. Given the high level of debt reached in many of these countries, consolidation is a necessity. The analysis shows that, in these cases, high multipliers do not play a decisive role in debt dynamics, but may, under adverse scenarios delay the fall in the debt ratio by one year at most.

The simulation-based analysis in this Section assumes that the relation between the risk premia paid on sovereign debt and the fiscal multipliers is relatively small. However, fiscal consolidations in the presence of large multipliers could lead to increases in the debt ratio, thereby entailing rises in the government real interest rates. This would imply that a consolidation would take a long time to bring debt below baseline. The case for interest rates increasing with a consolidation can reflect factors affecting financial markets that cannot be modelled, for example if financial markets come to believe that consolidation will be reversed based on political economy reasons. This could entail an increase in risk premia offsetting the action of monetary policy. This simplifying assumption is a useful first approximation. In any case it is to be noted that, in presence of a myopic reaction of financial markets to consolidations, such an assumption is could more easily generate a scenario displaying the counter-intuitive dynamics. So by making such an assumption the results found here constitute a limit to the possibility of having unexpected debt dynamics.

A final issue that is not included in the scenario analysis is the effect of consecutive consolidations. If consolidations are repeated, especially in periods where multipliers are large and persistent, the effects on the economy tend to cumulate along the line and can, in presence of continued myopic behaviour of financial markets, induce counter-intuitive dynamics. This could be the case, for example, if the target of fiscal policy is exclusively set in terms of headline variables, like headline debt or deficit ratios and not in terms of cyclically adjusted or structural figures. In this situation it is possible that the scenario consolidation-debt increase-consolidation-further debt increase takes place as long as the current multiplier is high enough to induce further short-term debt-to-GDP increases in response to consolidation. The same spiral can happen with deficits, but for sensibly higher values of the multipliers. As a high degree of financial market myopia is necessary for this to happen, this underlines that the credibility of the adjustment is crucial in providing financial markets with a long-term view. It is therefore better if policy recommendations are formulated in terms of a (path of) structural balances so that, once sufficient measures are taken, time is left for the effects of the consolidation measures to deploy fully, in line with current EU legislation.

1. INTRODUCTION

EU countries have seen large debt increases since the onset of the crisis. In most EU countries debt is now at an unprecedented level. In some cases, the increases since 2007 have exceeded 20 percentage points of GDP starting from an already high level. The impact of the crisis has, for a number of countries, compounded the dynamics of a structural deficit. As shown in Part I, the EU Member States have now started consolidating their government finances. The increased levels of debt have led to pressure being placed on a number of countries by the financial markets especially in absence of interventions from central banks. Moreover, the realisation that inadequate attention to debt levels during the "good" economic times that preceded the crisis led to amendment of the Stability and Growth Pact (SGP) to put debt on an equal footing with the deficit. New provisions in the SGP foresee that EU members with a debt to GDP ratio higher than 60% have to act to put it on a downward path such that the excess of the debt ratio over this 60% value decreases by 1/20th per year on average over three years.

A public debate is taking place both in the press and within the economics profession on the effectiveness of consolidation in government finances in the current situation, mounting in the question whether "austerity can be self-defeating". In this context, "self-defeating" would mean that "a reduction in government expenditure leads to such a strong fall in activity that fiscal performance indicators actually get worse" This formulation stems from Gros (2011), who refutes such a claim for the longer term. (For further contributions, see for example the debate taking place on www.voxEU.org: among many Buti and Pench (2012), Cafiso and Cellini (2011), Corsetti (2011), Gros (2011), and Krugman (2012)). The debate is reflected also in more academic literature (see Section III.2 below) where there has been a large increase in the amount of new research on the effects of fiscal consolidations.

Given the renewed relevance of the debt, both in the financial markets and in the context of the fiscal governance in the EU, the public discussion has centred on the debt-to-GDP ratio as the key fiscal policy indicator. The present Chapter aims to discuss the consolidation dynamics and to define precisely the conditions under which counter-intuitive dynamics can happen. The main result in this respect is that such a possibility exists, but it is mainly short-lived and its occurrence depends on the effects on sovereign yields.

The success of a consolidation in reducing the debt ratio depends crucially on the value of the multiplier, which measures the impact of consolidation on growth, and on the reaction of sovereign yields to such a consolidation. Even a cursory literature review shows that estimates or assessments of the value of the multipliers vary enormously depending on the type of model used, the econometric technique, the economic conditions assumed for the estimate, the conduct of monetary policy and other factors influencing the interest rates, the composition of the adjustment and various institutional factors (from the exchange rate to credit and labour market arrangements.)

The present Part finds a general condition that describes the impact of the adoption of consolidation measures – compared to the situation without consolidation considered as the baseline – on the final debt ratio as a function of starting debt ratio, cyclical budgetary semi-elasticities and fiscal multipliers. Quite intuitively the basic condition shows that in presence of a high starting debt ratio and of a high cyclical semi-elasticity, relatively high fiscal multipliers more likely to be observed in crisis times are needed to have undesired effects of consolidations in the short term. The Part then shows how such a conclusion changes when account is taken of the effect on yields, a particularly relevant condition in the current sovereign crisis.

Chapter III.2 discusses the factors that influence multipliers according to theory and presents a vast review of the empirical literature assessing the value of multipliers. The review covers DSGE calibration-based estimates, model-based estimates of different nature, VAR-based estimates and other estimates based on different econometric techniques. It also provides a review of existing estimates of effects of government debt and deficit on government yields.

Chapter III.2 also presents VAR-based estimates of multipliers for some large euro area countries and for the euro area as a whole. The analysis is conducted using quarterly data and using a

traditional structural VAR approach. The main novelty of the analysis is to take the effects of confidence directly into account which should help reduce the downward bias on the fiscal multiplier induced by the fact that the date at which measures are implemented does not correspond with the date at which measures are announced or become known to the economic actors (for the potential relevance of this point see Romer and Romer (2010), Ramey (2011) and Corsetti et al. (2011) The results of the exercise are in line with literature results, with fist-year multipliers between 0.4 and 1.4 depending on the country, an increased second-year multiplier and values for third year multipliers still in line with first-year multipliers, before a relative quick decrease.

If the consolidation measures taken by the government are of a permanent nature, such an effect can only be short term, since the improvement in the government balance is permanent – and cumulates its effects on debt compared to baseline – the effects on growth of such a consolidation vanish in time. Section III.3 analyses the conditions influencing the number of years that, in case of a short-term consolidation-induced debt-increase, are needed for a consolidation to show its effects on the debt ratio. It shows that the typical horizon for a consolidation to improve debt is relatively short – under the situation in which debt increases from the beginning. Intuitively, the main factors influencing the length of the reverse effect are the multipliers at the different years and the initial level of debt and deficit.

Also in Chapter III.3 estimated cyclical elasticities and actual debt figures for EU countries are used to have a back-of-the-envelope representation of the situation of the various EU countries with respect to the values of multipliers estimated in the literature, given the current crisis situation and tight credit markets.

Finally, Chapter III.4 presents a set of conclusions based on the analysis conducted along Part III.

2. REVIEW OF EXISTING ESTIMATES OF FISCAL MULTIPLIERS

This Chapter aims at providing an overview of existing estimates of fiscal multipliers. It is now acknowledged that it is more correct to talk about the multipliers rather than about the multiplier, given that the value of fiscal multipliers, as it will be seen in more detail in the next Section, depends on many factors relative to the fiscal shock itself (its permanent or temporary nature and its composition), to the economic environment (the economic situation, the economic situation of the partner countries, the stress in the financial market) and to economic policy regime (monetary and exchange rate policy). It is therefore very difficult to compare correctly different estimates and every comparison has to be taken with care. For example, empirical estimates made using Vector Auto-Regression techniques (VAR) concern most of the times very specific fiscal shocks in terms of composition, and always consider temporary fiscal shocks – which are not purely temporary in that fiscal variables have an autoregressive component, while model-based evaluations like evaluations based on Dynamic Stochastic General Equilibrium (DSGE) models can vary in this respect from purely temporary measures to fully permanent so that comparisons are not always correct.

Given the relevance of fiscal multipliers in the discussion concerning consolidation it is however useful to provide an overview of existing results, in particular in the two main areas of the literature which study effects of fiscal shocks.

2.1. A REVIEW OF THE LITERATURE ON FISCAL MULTIPLIERS ESTIMATED BY NEW KEYNESIAN DSGE MODELS

The concept of fiscal multiplier is due to traditional Keynesian macroeconomic analysis, where it indicates the reaction of output to a change in government spending. More precisely, the output multiplier is defined as the ratio between the change in the level of output and the exogenous change in the relevant fiscal variable. However, in practice fiscal shocks have some degree of persistence, which affects the response of output to such shocks. Therefore, the literature often refers to the concept of "cumulative multiplier", especially with VARs. ([74])

In this framework, consumption and investment depend on current income. In presence of nominal rigidities and a low rate of resource utilisation an increase in government spending increases aggregate demand and output. In basic Keynesian economics the key parameter in estimating the fiscal multiplier is the "marginal propensity to consume" which measures the fraction of current income that is consumed rather than saved.

Subsequent developments in economic theory, from the Hicksian IS/LM version of the multipliers via its Mundell-Flemig extension to open economies, the re-discovery by Barro of the so-called Ricardian effects and through to the most recent New Keynesian developments have shown that the marginal propensity to consume is only one of the relevant parameters affecting the value of the multipliers.

According to modern theory – mainly modelled via DSGE models – there are different factors that affect the multipliers. These can be grouped as follows: i) factors that force consumers to base consumption choices on current revenues only, such as financial frictions; ii) factors concerning the nature of the fiscal shock, in particular the credibility of the shock and/or its permanent or temporary nature; iii) the composition of the fiscal shock; iv) structural features of the economy, like the presence of nominal or real rigidities; v) the size of automatic stabilizers; vi) the type of monetary policy, and vii) the exchange rate regime and the degree of openness of the economy. In most of these models responses to shocks are symmetric, for which the discussion of the effects of expensionaly fiscal shocks is equivalent to that of fiscal consolidations with the reverse sign. However, it is likely that responses to fiscal shocks are not symmetric depending on the economic situation or the state of public finances. In this connection, the size of fiscal multipliers could also be conditioned by the initial level of public debt. Thus, fiscal expansions with high public debt levels could have more limited effects (or even

([74]) The cumulative multiplier is defined as the cumulative response of output at a given point in time relative to the cumulative fiscal shock at the same point.

negative) on output as agents might discount a fiscal tightening in the future.

The first two factors in the list act on the fiscal multiplier with the same economic mechanism based on the influence that expectations of future income have on current consumption decisions. If economic agents are forward-looking and make their decisions on the basis of permanent income, an increase in the government deficit induces a negative wealth effect on households, as households expect a corresponding future tax increases and thus future surpluses. This reduces consumption and increases labour supply, which tends to reduce real wages and consumption further. This decline in private demand offsets most of the increased public demand, causing output to increase by less than the increase in government consumption (see Hall (2009) and Woodford (2011)). In this framework, the consumption and investment multipliers are negative and the output spending multiplier is lower than one, even if its value depends on the relative increase in the labour supply relative to the fall in consumption.

Baxter and King (1993) show that a model in which a large (permanent) stimulus causes a large wealth effect and a large increase in labour supply can have a spending multiplier near to one as the consequent boom in the marginal product of capital and investment compensates for the effect on consumption. However, in general, Real Business Cycle (RBC) models in which prices are flexible and competition is perfect indicate that the effects of fiscal policy on output pass mainly via supply effects and generate small spending multipliers which very often are below 0.5.

The capacity of households to make consumption choices on the basis of their permanent income is the divider between Keynesian theory and modern theory. This idea, which was introduced in DSGE models in Galì et al. (2007) and dates back to Campbell and Mankiw (1998) and Mankiw (2000), is meant to reintroduce some Keynesian features in consumption behaviour, in line with observed empirical patterns of the relation between current income and current consumption and of (at least some) consumption increase in response to an increase in government spending. Consumers make choices on the basis of current income either because of less-than-perfect rationality or because they are financially constrained in the sense that they cannot get credit for their present consumption which would be reimbursed with future incomes.

The introduction of this type of consumers along with perfectly rational consumers, together with other features which will be discussed below, constitute the basis for the current mainstream theory, a synthesis between RBC and Keynesian models defined as "New Keynesian" models.

According to the meta-analysis of Leeper et al. (2011) the fraction of non-savers is the single most relevant parameter in influencing the size of the impact spending multipliers – except for the monetary policy regime. Such a fraction explains 19% of the size of the multipliers on impact and 13% of the first-year multiplier. To give an order of magnitude, the QUEST model shows increased impacts on multipliers for temporary fiscal shocks done with measures that concern consumers which are of this order of magnitude or larger. For example the multiplier of fiscal transfers and labour tax doubles from 0.2 to 0.4, while the first year multiplier of increases in government wages increases from 1.1 to 1.3 (see European Commission (2010b) and Roeger et al. (2010)).

The second factor that influences the multiplier, concerns the temporary (or credible) nature of the fiscal shock. A permanent fiscal expansion has a much larger size than a temporary shock, and therefore a larger negative wealth effect on consumers that are Ricardian and/or base their consumption decisions on their permanent income. This depresses consumption more and, as a consequence, decreases the fiscal multiplier. The same mechanism holds if fiscal measures are credible: in that case Ricardian agents know that the measures taken by the government have a permanent effect and therefore the multiplier is decreased via the mechanism just explained This factor has a very large impact on the value of multipliers: for example in QUEST the multiplier of a balanced (in terms of composition) permanent fiscal stimulus is 0.3/0.4 but can increase to 0.7/0.8 if the measures taken are non-credible or temporary.

The composition of the fiscal shock (be it consolidation or stimulus) is the major factor concerning the size of the fiscal multiplier, so that

many economists consider there to not be just one, but a many fiscal multipliers. In general, government spending multipliers are found to be different from tax ones. That is the reason why in spite of fiscal packages usually target both sides of the budget, they are assessed separately. Multipliers vary also when one takes into account the future ways of financing an expansion, which becomes less relevant in the case of a permanent consolidation. Coenen et al. (2012) compare results from the DSGE models used in six institutions and show that in general larger impact and first-year multipliers are found with spending measures (except for general transfers); this is particularly the case with government expenditure, which has a first-year multiplier above unity if measures are temporary. Tax and transfer multipliers have a smaller short-term impact, unless targeted at financially constrained households. Thus first-year multipliers for a permanent consolidation estimated from QUEST (European Commission (2010b) and Roeger et al. (2010) are 1 for government wages and government investments, 0.5 for government purchases and below 0.4 for transfers and taxes.

Most analyses propose values for (temporary) government purchases first year or impact multipliers. The multipliers based on government purchases have the highest value. Thus the multiplier of 1.6 proposed by Romer and Bernstein (2009) and the multipliers analysed in the meta-analysis by Leeper et al. quoted in this Subsection, - which consider environments in which monetary policy is accommodative ([75]) – all refer to multipliers for government purchases. This is the case for the values below 0.7 proposed by Cogan et al. (2010) and for the values oscillating between 0.5 for Germany and 1.1 for the US in Barrel et al. (2012). Tax and transfer multipliers for EU countries are all below 0.4. The corresponding multiplier for temporary government expenditure shocks in QUEST is 0.8 which increases to 1.2 if monetary policy is at the zero lower bound. ([76])

It is worth noting, however, that taxes and expenditures imply also very different long-term multipliers, with a negative and increasing impact on output from cuts in government investment, an increase in corporate tax and long-term positive impact on GDP from cuts in government transfers and purchases, and increases in housing taxes (European Commission (2010b)). QUEST results ([77]) show that fiscal consolidations generally involve a fundamental trade-off between short-run pain and long-run gain. The pain arises from the negative multiplier effects of lower spending or higher taxes, while the gain stems from the lower world interest rates and lower distortionary taxes associated with lower debt levels. The results on both pain and gain are subject to important qualifications such as the design of a fiscal package; if the tightening is well designed with favourable long-run incentives for investment and labour supply, then the short-term pain only arises in the presence of an initial lack of credibility and only lasts for the non-credibility period. If, on the other hand, the fiscal tightening is badly designed – for example sharply raising taxes on income or cutting essential government investment – the long run gain could be much lower or even non-existent, as higher distortions and/or productivity losses offset the gains from lower real interest rates.

These effects also depend on monetary policy. However in general it is preferable to use all instruments: Forni, Gerali, Pisani (2010) simulate a monetary union DSGE model of the euro area and analyse the macroeconomic and welfare effects of alternative fiscal consolidation strategies. They show that a significant debt-to-GDP ratio reduction obtained by reducing both expenditure and taxes can be welfare improving.

The presence of real frictions like the presence of investment adjustment costs and constraints to adapt capacity utilisation, which is common to RBC and new Keynesian models and was introduced by Burnside et al. (2004), reduce multipliers because the presence of those frictions slows the reaction of firms to changes in interest rates because of the costs they entail (see also (Monacelli and Perotti (2008)). According to Leeper et al. (2011) the quantitative impact of the presence of frictions is reduced.

([75]) Accommodative monetary policy is a monetary policy that decreases real interest rates.

([76]) This range can be compared to values for government investment multipliers presented in Coenen et al. (2012) which proposes a range of 0.9 and 1.3 or 1.1 to 2.2 depending on the model discussed.

([77]) This is the case for most DSGE models see for example Clinton et al. (2010).

On the contrary the presence of nominal rigidities like price ([78]) or wage rigidities, characteristic of new Keynesian models, allows them to stress – together with the presence of financially constrained consumers – the relevance of aggregate demand. In a model with monopolistic competition, Woodford (2011) shows that the presence of either of these rigidities increases multipliers. Price rigidities increase multipliers because firms respond to increases in aggregate demand not by increasing prices but rather increasing output. Leeper et al. (2011) show that price rigidities increase first-year multipliers by six percentage points. This is not a very large amount, but the effect remains in the long-term multipliers. The presence of wage stickiness, which clearly refers to Keynes' traditional argument, has similar effects because the real wage may remain constant, or even fall, while average labour productivity increases. It is important to notice that if fiscal policy does not raise inflation expectations but lowers them, the sticky prices assumption worsens the impact on output and labour, because it prevents prices from falling and the mark-up from rising, lowering labour demand and output (see Linnenmann and Schabert (2003)).

The role of monetary policy, via the impact on real interest rates is, in the context of the new Keynesian models, the most important factor determining the size of government spending multipliers. In the Hicksian IS/LM version of the Keynesian approach, spending multipliers are smaller the stronger the reaction of interest rates, as a strong increase in interest rates crowds out investments. Therefore situations in which interest rates do not increase with the increase in expected inflation generated by fiscal stimulus, like the liquidity trap characterising depressed economic environments show large spending multipliers. This feature is very relevant in new Keynesian DSGE models such as described in Woodford (2011), as the stance of monetary policy influences the size of the multipliers: the more accommodative monetary policy is, the smaller the real interest rates and as a consequence the larger the multipliers induced by the same fiscally-generated increase in demand and inflation. Leeper et al. (2011) show that the parameter which represents the reaction of interest rates to expected inflation in the Taylor rule is particularly important, accounting for about 10 percent of impact multipliers. This effect is magnified in situations which can be described as near to the Keynesian liquidity trap, in which the nominal interest rate remains at zero (the so-called "zero lower bound" condition). Christiano, et al. (2011) show that in a fairly standard DSGE model, the multipliers are higher the larger the percentage of spending implemented under this condition, with peak multipliers that can be larger than two if fiscal action is taken in periods w the economy is in liquidity trap and such a liquidity trap condition holds for three years, with values much above one – the fairly standard multiplier for temporary increase in government expenditures in normal times. This result is consistent with the meta-analysis in Leeper et al. (2011) which indicates that under the regime with passive monetary policy and active fiscal policy one-year spending multipliers can be high, at 1.5-1.6. ([79]) To give a further idea of the order of magnitude, Table III.6.1 in European Commission (2010a) shows that, depending on the composition of the fiscal stimulus, multipliers increase by 30 to 50% under monetary accommodation. All six DSGE models analyzed in Coenen et al. (2012) show effects of the same size.

The final aspect to be considered concerns the external side of the economy. This has two aspects: first the degree of openness of the economy, and second the exchange rate regime coupled with freedom of capital movements. In the Mundell-Fleming extension to open economies, the fixed exchange rate regime magnifies the fiscal multiplier in presence of capital mobility because of the monetary accommodation necessary to keep the exchange rate at parity. Erceg and Lindé (2012a) study the relative efficiency of spending versus tax instruments in monetary unions and show that multipliers of spending-based consolidations are smaller than multipliers of tax-based consolidations if monetary policy is at the zero lower bound. However, the reverse holds for a small member of a currency union, or if the other

([78]) This assumption goes together with the assumption of the existence of monopolistic power in the product market.

([79]) The values of 0.8 for QUEST given above and 1.6 are not directly comparable because of different assumptions on credibility and on the composition of the consolidation, but represent the relevant range of values that can be supported by existing models. The comparable QUEST multiplier is 1.2.

members of the currency union are consolidating and monetary policy is in a liquidity trap.

Finally, a high degree of openness of the economy reduces the multipliers in that a fiscal expansion's effect on aggregate demand is limited as part of the effects of the fiscal shock leaks abroad via increased imports and reduced exports. Thus an open economy has smaller multipliers. Corsetti and Mueller (2012a) stress the existence of cross-border effects of national fiscal policy on foreign demand via an interest rate channel and show that in presence of large contagion effects on risk premia, multipliers can be sizably reduced.

2.2. VAR-BASED FISCAL MULTIPLIERS IN THE LITERATURE

An increasing number of empirical studies assessing the macroeconomic effects of fiscal shocks was produced in the last decade. The studies are very different in nature, sample and techniques used, so that they cannot be compared. The main differences concern i) the choice to have panel or individual estimates and ii) the type of technique used. The first choice needs an assumption on whether (at least some of) the crucial parameter of interest are equal across countries composing the panel and trades off the disadvantages from this restriction again the advantages coming from the possibility of making more precise estimates thanks to the different experience of the different countries which can reduce the problems raising from the absence of long enough data series. The second choice is based on the evaluation of which methodology is preferable to solve the identification issue which bias the estimate of the multipliers and is raised by the contemporaneous reciprocal effects of fiscal policy on growth and of growth on fiscal policy outcomes. The choice of the technique relies upon the availability of data and of proper instrumental variables. The present Chapter presents separately estimates based on single country VAR techniques.

The effects of government expenditure shocks in the VAR literature on individual countries

The last decade has seen a large increase in the number of studies assessing the macroeconomic effects of fiscal shocks using VAR techniques. While the most prominent papers have focused on the U.S., there has also been a growing body of evidence on other countries, especially European Union ones. The literature typically finds short-term (usually 1-year) multipliers to be somewhat below 1 in the case of the United States, whereas for European countries cumulative multipliers ([80]) over the same horizon are usually found to be above unity. ([81])

From a theoretical point of view, the sign and magnitude of the impact of discretionary fiscal policy on aggregate demand depends on many conflicting factors, as shown above, which can lead to opposite conclusions.

Government spending multipliers are therefore not structural constants as they depend heavily on a number of structural features as well as on cyclical factors. Thus, as fiscal multipliers depend on the responses of endogenous economic variables to fiscal shocks, they are expected to vary over time.

Empirically, estimated multipliers also depend on the methodology used to derive responses of economic activity to fiscal shocks. In general, VAR multipliers are usually found to be higher than RBC or even DSGE models. The response of private consumption is key. While private consumption is usually found to decrease in RBC models as a result of the negative wealth effect, empirical evidence in VAR studies usually shows positive responses of this variable in response to higher public spending.

One criticism often levied at the VAR literature, is that VAR models cannot properly account for the fact that changes in government spending and taxes can be anticipated due to legislative and implementation lags (Leeper, et al. (2008)) because in this case the effects of the fiscal shock would appear in the economy as from the moment agents anticipate the government decisions. If agents are forward looking Structural VAR

([80]) The cumulative multiplier at a given period is obtained as the ratio of the cumulative response of GDP and the cumulative response of government expenditure. They are especially accurate to correct for the persistence of fiscal shocks.

([81]) Other literature reviews come to the opposite conclusion, namely that fiscal multipliers in the US are somewhat more sizeable than in Europe due to automatic stabilizers playing a larger role in Europe. This conclusion is affected by studies used in the comparison.

(SVAR) models may fail to correctly estimate fiscal shocks, thereby leading to biased estimates of their effects and in particular of fiscal multipliers. This is the so-called "fiscal foresight problem". The debate on this issue is open in that if Ramey (2011) finds that fiscal foresight is a relevant issue inducing a bias on estimates of fiscal multipliers contrary to the previous findings of Perotti (2004,) Bouakez et al. (2010) show that Ramey's results are most likely driven by the data points relative to the Korean War episode only and should thus be not considered of a general relevance. ([82])

Four basic approaches to identify fiscal shocks in VARs can be distinguished (Perotti, (2004);) (1) the identification of fiscal policy shocks by using dummy variables that capture specific episodes (event approach) such as the military build-ups (Burnside et al., 2000; Ramey and Shapiro, 1998; Edelberg et al., (1999)); (2) the imposition of sign restrictions on the impulse response functions (Mountford and Uhlig, (2009)); (3) the identification of fiscal shocks based on a Cholesky ordering (Fatás and Mihov, (2001)); (4) and finally, the identification of fiscal policy shocks by exploiting decision lags in policy making and information about the elasticity of fiscal variables to economic activity (Blanchard and Perotti, (2002) and Perotti, (2004)).

Table III.2.1 summarizes some of the available empirical evidence in the literature on fiscal multipliers to government expenditure shocks. Most of the available empirical estimates of fiscal multipliers refer to the United States, with the different estimates being far from conclusive in view of the marked differences across specifications and methodologies. Short-term multipliers, typically one-year, usually rank between 0.4 and 1; for longer horizons the dispersion is even larger. Blanchard and Perotti (2002) find that expansionary fiscal shocks increase GDP. Their results imply a cumulative multiplier to shocks to direct expenditure of around 0.5 at the 4th and 12th quarters.

Building on this methodology Perotti (2004) also includes the GDP and the interest rate as endogenous variables and observes even lower multipliers for the sample between 1980 and 2001.

By contrast the results in Galí et al. (2007) and Fatás and Mihov (2001) imply a significantly larger cumulative multiplier of government spending, which amounts to above one after one year.

Mountford and Uhlig (2009) use a different methodology that consists in imposing sign restrictions to impulse responses. In this case, their 1-year multiplier also stands close to 0.5, although it decreases quickly thereafter and eventually becomes negative.

In turn, Ramey (2011) criticizes standard VAR identification methods for not accounting for the timing of the news and consequently the anticipation effects of economic agents to fiscal news. She uses a narrative method to construct richer government spending news variables from 1939 to 2008 and obtains short-term government spending multipliers ranging from 0.6 to 1.2, within range of previous estimates.

Despite the evidence being scanter than in the case of the US, the last years have witnessed an increasing amount of empirical studies with further evidence of multipliers for different countries. For Germany, Perotti (2004), Heppke-Falk et al. (2006) and Baum and Koester (2011) estimate 1-year cumulative multipliers ranging between and 0.7. These multipliers are observed to increase somewhat during the second year after the shock, although showing somewhat larger discrepancies. However, the Threshold VAR estimates in Baum and Koester (2011) observe higher spending multipliers in low growth regimes, whereas in good times multipliers are lower and seem to behave more linearly.

([82]) Technically, while Ramey (2011) provides evidence that SVAR-based innovations in the US as identified in Blanchard and Perotti (2002) can be anticipated and Granger-caused by Ramey and Shapiro (1998) war episodes. However, Perotti (2004) finds little evidence that SVAR-based innovations are predictable. In turn, Bouakez et al. (2010) show that, the fiscal foresight problem is not severe enough to preclude the use of SVAR innovations as correct measures of unanticipated fiscal shocks as Ramey's results are driven by the Korean War episode.

Table III.2.1: **Expenditure VAR-based multipliers**

Studies	Sample	Short-term multiplier[1]	Medium-term Multiplier [2]	Identification strategy[3]
Blanchard and Perotti (2002)	US (1947:1-1997:4)	-0.69	0.5[4]	Decision lags in policy making and imposition of contemporaneous GDP elasticities
Perotti (2004)	US (1960:1-1979:4) US (1980:1-2001:4)	1.29 0.36	1.4 0.28	Blanchard-Perotti
Galí et al. (2007)	US (1954:1-2003:4)	0.7	1.74	Cholesky decomposition
Ramey (2011)	US (1939:1-2008:4)	0.6 to 1.2	No estimate	Narrative approach
Mountford and Uhlig (2009)	US (1955:1-2000:4)	0.65[5]; 0.46; 0.28[6]	-0.22	Sign restrictions on impulse responses
Fatas and Mihov (2001)	US (1960:1 - 1996:4)	Similar to Galí et al. (2007)	Similar to Galí et al.(2007)	Cholesky decomposition
Perotti (2004)	Germany (1960:1-1974:4) Germany (1975:1-1989:4)	0.36	0.28	Blanchard-Perotti
Heppke - Falk et al. (2006)	Germany (1974:1-2004:4)	0.62	1.27	Blanchard-Perotti
Baum and Koester (2011)	Germany (1976:1-2009:4)	0.7	0.69	Blanchard-Perotti and Threshold VAR
Benassy-Quere and Cimadomo (2006)	Germany (1971:1-2004:4)	0.23	-0.23	FVAR and Blanchard-Perotti
Biau and Girard (2005)	France (1978:1-2003:4)	1.9	1.5	Blanchard-Perotti
Giordano et al. (2007)	Italy (1982:1-2004:4)	1.2	1.7	Blanchard-Perotti
De Castro (2006)	Spain (1980:1-2001:2)	1.14-1.54	0.58-1.04	Cholesky decomposition
De Castro and Hernández de Cos (2008)	Spain (1980:1-2004:4)	1.3	1	Blanchard-Perotti
De Castro and Fernández (2011)	Spain (1981:1-2008:4)	0.94	0.55	Blanchard-Perotti
IMF (2005)	Portugal (1995:3-2004:4)	1.32	1.07	Blanchard-Perotti
Perotti (2004)	UK (1963:1-1979:4) UK (1980:1-2001:2)	0.48 -0.27	0.27 -0.6	Blanchard-Perotti
Benassy-Quere and Cimadomo (2006)	UK (1971:1-2004:4)	0.12	-0.3	FVAR and Blanchard-Perotti
Burriel et al. (2010)	Euro Area (1981:1-2007:4)	0.87	0.85	Blanchard-Perotti

(1) We define "short-term" as a time gap ranging from simultaneous effects to one year distance from the fiscal shock.
(2) By medium-run is broadly intended a period going from 1 to 3 years after the time fiscal shock took place.
(3) Perotti (2004) distinguished four basic approaches in the literature to identify fiscal shocks in VAR: 1. Setting a dummy variable accounting for specific episodes such as wars; 2. Imposing sign restrictions on IRFs (pioneered in an "agnostic" way by Uhlig 2005); 3. Exploiting Choleski ordering; 4. Considering decision lags in policy making and fiscal variables' elasticity to economic activity (narrative).
(4) Cumulative multiplier between the 4th and 8th quarter.
(5) Impact multiplier.
(6) These two numbers are referred to expenditure multiplier respectively at the 4th and 8th quarters.
Source: Commission services.

Much higher multipliers are obtained by Biau and Girard (2005) in the case of France. Relying on the Blanchard-Perotti identifying methodology, they gauge cumulative multipliers of government spending close to 2 at the 4th quarter, dreceasing only gradually thereafter and amounting to around 1.5 three years after the initial shock. ([83]) Significantly higher than one multipliers are also observed by Giordano et al. (2007) for Italy, although they focus only on purchases of goods and services.

In the case of Spain, either with a Cholesky decomposition or with the Blanchard-Perotti identification strategy direct government expenditure short-term multipliers are estimated at around 1 or above after one and two years, while after three years.they diminish and range between 0.6 and 1 (see De Castro (2006), De Castro and Hernández de Cos (2008) or De Castro and Fernández (2011)).

For Portugal the IMF (2005) also relies on the Blanchard-Perotti approach and also obtain, one-year spending multipliers above unity, remaining above this level for almost three years. These estimates are close to those observed for Spain.

The existing evidence for the United Kingdom contrasts however with that for other countries,

([83]) It is to be noted however that French quarterly data for fiscal policy variables only have been computed recently. Older data are thus constructed using interpolation techniques. The replication of the Biau and Girard exercise made by the Commission with data until 2010 (but notice that series used may be different) gives insignificant values of the multipliers.

Table III.2.2: **Tax VAR-based multipliers (To an increase in net taxes)**

Studies	Sample	Short-term multiplier	Medium-term multiplier	Identification strategy
Blanchard and Perotti (2002)	US (1947:1-1997:4)	Within range -0.7 and -1.3	Within range -0.4 and -1.3	Decision lags in policy making and imposition of contemporaneous GDP elasticities
Perotti (2004)	US (1960:1-1979:4) US (1980:1-2001:4)	-1.41 0.7	-23.87 1.55	Blanchard-Perotti
Favero and Giavazzi (2007)	US (1980:1-2006:4)	0.29	0.65	Narrative approach
Mountford and Uhlig (2009)	US (1955:1-2000:4)	-0.16	-2.35	Sign restrictions on impulse responses
Romer and Romer (2010)	US (1945:1-2007:4)		-3	Narrative approach
Perotti (2004)	Germany (1960:1-1974:4) Germany (1975:1-1989:4)	0.29 -0.04	-0.05 0.59	Blanchard-Perotti
Baum and Koester (2011)	Germany (1976:1-2009:4)	-0.66	-0.53	Blanchard-Perotti and TVAR
Benassy-Quere and Cimadomo (2006)	Germany (1971:1-2004:4)	-1.17	-1.08	FVAR and Blanchard-Perotti
Biau and Girard (2005)	France (1978:1-2003:4)	-0.5	-0.8	Blanchard-Perotti
Giordano et al. (2007)	Italy (1982:1-2004:4)	0.16		Blanchard-Perotti
De Castro (2006)	Spain (1980:1-2001:2)	0.05	0.39	Cholesky decomposition
Afonso and Sousa (2009)	Portugal (1979:1-2007:4)	+	+	Blanchard-Perotti
Perotti (2004)	UK (1963:1-1979:4) UK (1980:1-2001:2)	-0.23 0.43	-0.21 0.7	Blanchard-Perotti
Benassy-Quere and Cimadomo (2006)	UK (1971:1-2004:4)	-0.23	-0.07	FVAR and Blanchard-Perotti
Cloyne (2011)	UK (1945-2010)	Between -0.5 and -1.0	-2.5	Narrative approach
Burriel et al. (2010)	Euro Area (1981-2007)	-0.63	-0.49	Blanchard-Perotti

Source: Commission services.

where spending multipliers are usually found to be very low, usually non-significant (see Bénassy-Quéré and Cimadomo, (2006)) and sometimes even negative (Perotti (2004)).

Also with the Blanchard-Perotti identification methodology, Burriel et al. (2010) for the euro area as a whole obtain multipliers below, although close to unity in the short term, while after 3 years it shrinks to some 0.6. These estimates fall within range of previous empirical evidence for other European countries as well as for the available evidence for the US. Burriel et al. (2010) also find that fiscal multipliers are higher for public investment shocks and in times of fiscal stress.

The effects of tax shocks in the VAR literature on individual countries

As in the case of government expenditure shocks, the bulk of the available empirical evidence on tax multipliers refers to the United States. Results are not conclusive as even differences in the sign of multipliers are observed. In any case, most of the empirical estimates reveal that tax shocks usually entail lower effects on GDP than public expenditure. Table III.2.2 summarizes some of the available empirical evidence.

The results in Blanchard and Perotti (2002) imply tax multipliers ranging between -0.7 and -1.3 for the first two years and somewhat lower in absolute value for the third one. It is worth mentioning that these are not cumulative multipliers; they are estimated with respect to the size of the initial shock.

Favero and Giavazzi (2007) allow for impose the fulfillment of the government borrowing constraint in the VAR specification and obtain positive (non-cumulative) multipliers to an increase of taxes for the sample 1980-2006. The increase of output in response to a tax increase is rather counterintuitive, although this result is also observed in other studies and for other countries.

Mountford and Uhlig (2009), with their methodology consisting in imposing sign restrictions, obtain (non-cumulative) multipliers that amount to around 2 or even above after two years after a negative revenue shock.

Romer and Romer (2010) employ a narrative approach for the US post-World War II period and find very high negative tax multipliers, of almost -3% over the next three years following the shock. This contrasts significantly with the lower multipliers calculated on the basis of tax shocks identified within VARs with the Blanchard-Perotti methodology. Favero and Giavazzi (2010) argue that such difference is not explained by a difference in the shocks (VAR versus narrative) but by the different models used to estimate their effects on macro variables. They show that when the effects of shocks identified by the narrative method are analysed in the context of a multivariate VAR (rather than using a limited information, single-equation approach), multipliers with both methodologies turn out to be rather similar and are estimated at about unity.

For Germany, Perotti (2004) estimates cumulative multipliers to net tax cuts of around -0.6. As in other cases, the reduction of output in response to a tax cut after three years is rather counterintuitive. In turn, in Heppke-Falk et al. (2006) output is barely affected by net tax shocks. By contrast, Baum and Koester (2011), with their linear specification, estimate a multiplier of -0.66 after one year. In their TVAR estimates they do not obtain significant evidence of non-linearities.

In the case of France (Biau and Girard (2005) very low, non-significant tax multipliers are found, whereas for Italy (Giordano et al. (2007)), Spain (De Castro (2006)) or Portugal (Afonso and Sousa (2009)([84]) some counterintuitive results are observed, with higher net taxes yielding positive short-term output responses.

Bénassy-Quéré and Cimadomo, (2006) for the United Kingdom also obtain very low one-year multipliers, of some 0.2, whereas Perotti (2004) also estimates negative multipliers in response to tax cuts, as observed in other cases.

By contrast, Cloyne (2011) identifies fiscal shocks with a narrative approach à la Romer and Romer. He argues that the estimated output elasticities of net taxes in the Blanchard-Perotti method, in addition to automatic responses to output changes, would also be capturing any legislated changes in policy which are contemporaneously correlated with output. He finds impact multipliers to negative tax shocks between 0.5 and 1 per cent, depending on the model specification, which rise to around 2.5 per cent after 10-12 quarters.

Regarding the euro area as a whole, Burriel et al. (2010) gauge net-tax multipliers between -0.6 and -0.5 for the first three years.

2.3. VAR ESTIMATES OF OUTPUT MULTIPLIERS TO GOVERNMENT SPENDING SHOCKS

In order to provide further evidence on the effects of government spending shocks and output multipliers thereof, VARs for Germany, Italy and Spain are estimated. The focus on these three euro area cases is motivated by the availability of quarterly fiscal data to carry out the estimations. In fact, quarterly datasets used in previous empirical studies are employed: in the case of Germany the quarterly dataset in Heppke-Falk et al. (2006); ([85]) for Italy the dataset in Giordano et al. (2007); ([86]) in the case of Spain the new dataset recently compiled by De Castro et al. (2012). ([87]) The VAR estimations cover the period from 1985Q1 to 2010Q4 in the cases of Germany and Italy and from 1986Q1 onwards in the case of Spain. ([88])

The euro area as a whole is also dealt with. To estimate the relevant VAR models we made use of

([84]) They argue that increases in taxes can raise private consumption in the case of fiscal consolidations if it moves the economy from an unsustainable fiscal path to a sustainable one (Giavazzi et al., (2000)). In addition, the effect of a tax shock on output depends on whether it is motivated by the government's desire to stabilize the debt, or is unrelated to the stance of fiscal policy (Romer and Romer, (2007)).

([85]) We thank Bernhard Manzke and Joern Tenhofen for proving us with an updated version of this dataset.

([86]) We thank Sandro Momigliano for an updated version thereof

([87]) This quarterly fiscal database for Spain is compiled for the period 1986Q1-2010Q4 and it is solely based on intra-annual information, on the basis of multivariate, state-space mixed-frequencies models. The models are estimated with annual and quarterly national accounts data and government monthly cash accounts data.

([88]) VAR models were also estimated for France and the UK. However, they are not presented as responses were either rather counterintuitive or non-significant. For France, this can be due to the fact that existing quarterly data for fiscal variables in national accounts are derived from interpolation until very recently. Negative fiscal multipliers for the UK are also found in Perotti (2004).

the quarterly fiscal database for the euro area compiled by Paredes et al. (2009) ([89]) and employed in Burriel et al. (2010) and in Kirchner et al. (2010) to assess the macroeconomic effects of fiscal shocks in the EMU. As in previous cases, the VAR estimations cover the period from 1985Q1 to 2010Q4.

The estimated models include a measure of direct government spending (g) as the relevant fiscal variable. In the cases of Germany, Spain ([90]) and the euro area as a whole this variable is the sum of government purchases of goods and services, personnel expenditure and public investment made by the general government; for Italy the government expenditure variable used in the estimations is the sum of the two first components only, which turns out to be close to government consumption in the quarterly national accounts.

The economic sentiment indicator (ESI) estimated by the European Commission is included as endogenous variable too. Its inclusion aims to address, at least in part, the "fiscal foresight problem" of VAR estimates. The remaining endogenous variables are GDP (gdp), the GDP deflator (p) to allow for price changes and a long-term interest rate (r) (10 years). ([91]) Government spending and GDP enter in real terms in logs. The GDP deflator is the price index used to obtain real government expenditure. In the case of Germany a dummy to capture the effect of the unification has been included as an exogenous variable, given that government expenditure data show an upward swift in 1991. This variable turns out to be highly significant. A dummy for the last crisis period, since 2008Q1, has also been included as an exogenous variable when it turned out to be significant, especially in the case of Spain but also in the euro area as a whole. The purpose for its inclusion is to correct for a number of elements linked to the financial crisis that are not properly accounted for by the endogenous variables. These elements include the sharp correction in residential investments after a protracted period of buoyant housing markets in a number of countries, the credit crunch following the financial crisis and sovereign debt crisis as a result of a lack of markets confidence on the ability by some euro area Member States to meet the service of their public debt.

Government spending shocks are identified by using the Cholesky decomposition with the ordering (g, esi, gdp, p, r). This ordering assumes that public expenditure decisions are predetermined within the quarter and affect contemporaneously the remaining variables in the system. Hence, the identified government spending shocks are equivalent to Blanchard-Perotti ones.

Graph III.2.1 shows the impulse responses to a government spending shock of the main variables for the countries under consideration. Government spending shocks display little persistence in the case of Germany and Italy, whereas they turn out to be fairly persistent in Spain and in the whole euro area where it is still significant after 12 quarters. Confidence increases in all cases, possibly in view of the positive reaction of GDP in the short term. However, confidence worsens around three years after the initial shock, when the initial improvement in economic activity has faded away. In turn, interest rates rise some quarters after the initial shock except in Germany, where their response is broadly non-significant.

The responses for the whole euro area largely follow this pattern. However, in this case the increase in confidence in response to the fiscal shock is not significant. On the other hand, although the euro area interest rate also rises, this response is more muted than in the cases of individual countries. Hence, the interest response loses significance and turns out to be significant only for some quarters around the second year after the shock.

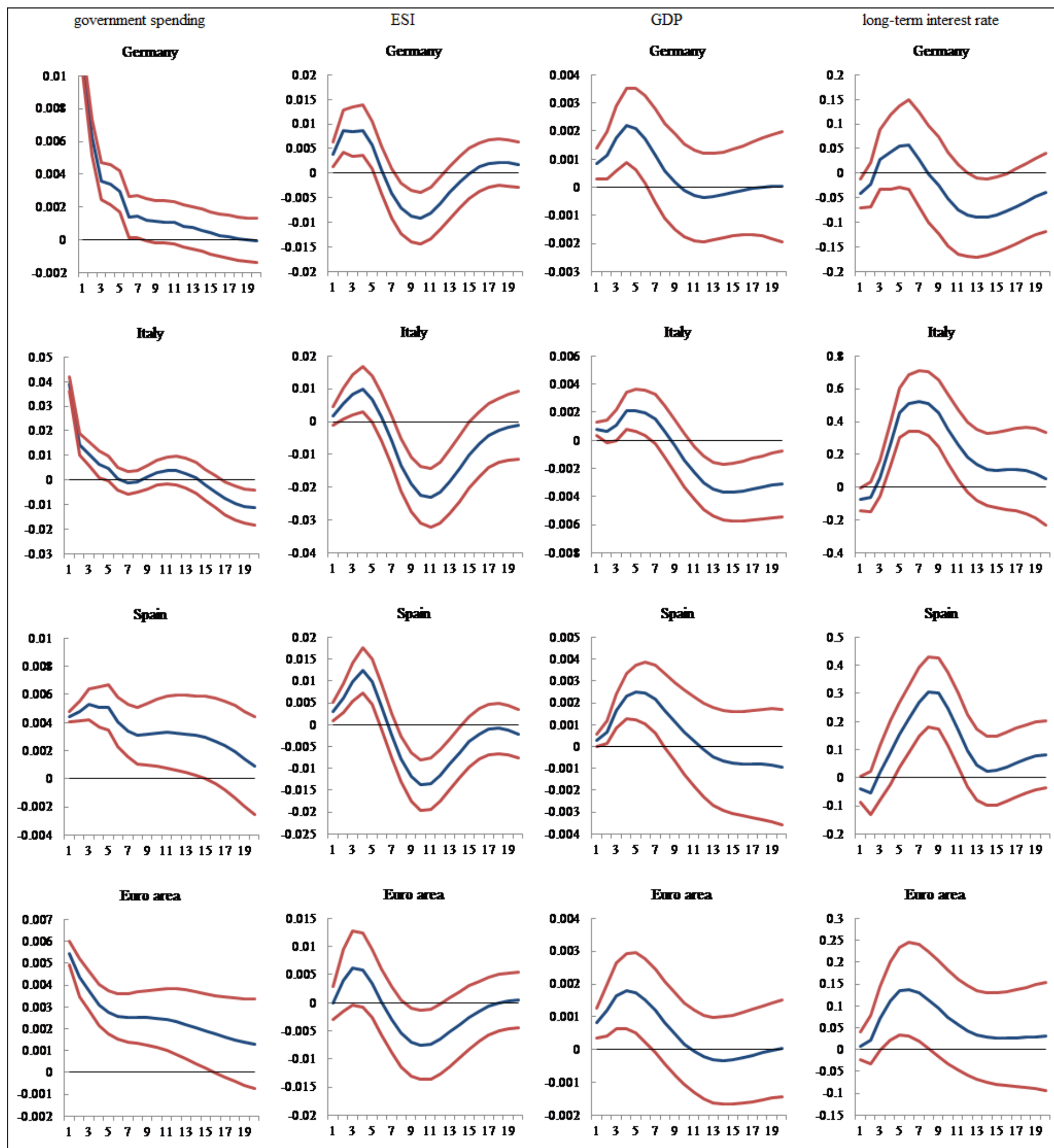
The impulse responses of government spending and GDP are used to estimate the cumulative output multipliers shown in Table III.2.3. The left panel presents the multipliers obtained with the sample covering until 2010, whereas the right panel displays the multipliers for the pre-crisis period. Estimated output multipliers for Germany

([89]) This quarterly fiscal database for the euro area is compiled for the period 1980Q1-2010Q4. As in the case of Spain, it is solely based on intra-annual information, on the basis of multivariate, state-space mixed-frequencies models.

([90]) For the purpose of the analysis in this Section the only variable from the quarterly fiscal database by De Castro et al. (2012) is public investment, as government consumption has been taken from the quarterly national accounts.

([91]) Alternative models including public debt as endogenous variable have been estimated to test the robustness of the results. The results did not differ significantly from those presented here though.

Graph III.2.1: **VAR responses to a government spending shock**



Source: Commission services.

and Spain are very similar and stand around 1.2 after one year for the sample covering until 2010. These values are broadly in line with previous empirical evidence. The estimated impact multiplier for Germany is somewhat below the estimate of 0.62 in Heppke-Falk et al. (2006), whereas the estimated value after one year appears largely comparable with their peak estimate of 1.27 after 6 quarters. By contrast, the multiplier after one year is larger than the short-term linear multiplier of 0.7 reported by Baum and Koester (2011). For Spain these estimates are broadly in line with output multipliers around 1.3 in De Castro and Hernández de Cos (2008). By contrast, medium-term multipliers for both Germany and Spain in Table III.2.3 are higher than those reported by the aforementioned studies.

Estimated cumulative output multipliers in Italy are significantly lower, always below unity. The

Table III.2.3: **Cumulative output multipliers to spending shocks**

	Sample until 2010Q4				Sample until 2007Q4			
	Quarters				Quarters			
	1	4	8	12	1	4	8	12
Germany	0.38	1.19	1.78	1.49	0.71	1.99	3.08	3.4
Italy	0.1	0.34	0.75	0.22	0.11	0.43	0.84	0.5
Spain	0.3	1.15	1.79	1.49	0.58	1.35	1.55	0.98
Euro area	0.63	1.38	1.67	1.27	0.79	1.23	1.57	1.06

Source: Commission services.

peak is observed in the second year after the shock, when the cumulative multiplier amounts to 0.75, to decrease rapidly thereafter. These values are well below cumulative multipliers reported in Giordano et al. (2007). However, they are not directly comparable as multipliers reported by Giordano et all focus only on purchases of goods and services in that expenditure on wages and salaries does not lead to significant responses. On the other hand, it is worth recalling that multipliers for Italy are not fully comparable with those for Germany or Spain, as for these two countries public investment is also embedded in the government expenditure variable in the respective VAR models. Public investment is deemed to entail positive spill-overs on private GDP, for which shocks to this variable would be expected to yield higher multipliers than other spending components.

In the case of the euro area, output multipliers amount to around to 1.4 one year after the shock and remain comfortably well above unity even there years after the initial shock. These contrast significantly with values obtained in Burriel et al. (2010), where cumulative multipliers are lower than those reported in Table III.2.3 regardless of the sample used. The reason for such a different could be that the specification in Burriel et al. (2010) includes net taxes, which rise endogenously to government spending shocks, thereby contributing to assuage the GDP response. By contrast, the specification adopted here does not allow for endogenous net tax responses, which are replaced by the economic sentiment indicator.

The comparison between the estimates with the whole sample and for the pre-crisis period yields interesting results. In the case of Spain medium term multipliers seem to have increased with the crisis. This evidence would, in principle, be consistent with the hypothesis that insofar as the crisis has implied a sizeable increase of financially-constrained agents and a reduction of the used productive capacity it may have contributed to raise fiscal multipliers. However, in the case of Germany the opposite seems true, whereas in Italy however, the crisis does not seem to have had a significant impact on government spending multipliers. In the case of Germany, despite the sizeable fall of GDP in 2009, the unemployment rate has stood at historical lows. Therefore, the share of constrained economic agents, rather than increasing, might even have decreased, thereby contributing to moderate fiscal multipliers. While the results here might appear in some contradiction with those in Baum and Koester (2011), it is worth noticing that the difference between the multipliers in the two panels in Table III.2.3 cannot be taken as an indication of how multipliers in Germany behave in crisis periods; the two panels only reflect the influence of the last three years, where no especial liquidity constraints seem to have been present in Germany.

The multipliers for the euro area as a whole are also higher for the sample covering until 2010 than with the sample ending in 2007. Arguably, this result could be consistent with the hypothesis that multipliers tend to increase in times of subdued economic growth or even when GDP contracts due to the rise in financially-constrained agents and when the economy approached to the lower zero bound. This result is consistent with the findings in Afonso et al. (2011), who find that the size of fiscal multipliers is higher than average in the last crisis. However, this statement must be qualified as for government spending multipliers, given their standard errors, the differences between both sets of estimations are not significant.

Accordingly, the evidence presented in this Section suggests that output multipliers to government expenditure shocks may be sizeable in

the three country cases examined, especially in Germany and Spain, as well as for the euro area as a whole where they stand above 1 in the short and medium term. This evidence appears broadly consistent with previous empirical evidence reported in Section III.2.2.

The range of VAR-based short and medium term output multipliers to fiscal shocks is quite wide, with estimates depending on the sample period, country under scrutiny and the econometric specification employed. Notwithstanding this, some general conclusions can be drawn from both the estimates presented here and from the empirical literature. Despite their wide range, output multipliers to government expenditure shocks are sizeable, in many cases estimated at above one. In turn, net taxes appear to imply lower multipliers than public spending, although their effects in the medium term are deemed to be non-negligible.

While a proper assessment of fiscal multipliers is of high importance when adopting discretionary fiscal measures, this issue gains especial relevance in the coentex of the current crisis where most EU27 Member States are implementing sizeable fiscal consolidation packages simultaneously. According to the evidence on fiscal multipliers presented in this chapter, fiscal contractions are expected to weigh heavily on economic activity in the short term, with some of these effects displaying somewhat high degrees of persistence. These effects must be factored in, especially when designing the consolidation strategies with a view to minimise these negative effects.

2.4. FISCAL MULTIPLIERS IN CRISIS PERIODS

One of the main issues discussed within the context of the "self-defeating consolidations" debate is the non-linearity of the multipliers (see, among many, Parker (2012)), and specifically the fact that multipliers are expected to be larger in crisis periods.

This argument is enshrined in the Keynesian tradition which proposes fiscal policy as an effective instrument to manage aggregate demand in periods in which there are underutilized production factors: high unemployment is expected to avoid wage upward pressure and, in these conditions, the increased demand for output would bring an increase in employment and consumption. The Keynesian tradition is thus inherently non-linear in that the effects of fiscal policy are different depending on the status of the economy.

Modern theory in general does not give this channel a large weight, with the exception of Thomas (1995), which shows that, in situations in which firms have to invest under profits' uncertainty which they cannot hedge risks in the financial markets, employment level is sub-optimal and fiscal policy can be used to increase employment and welfare. The economy in a financial crisis, which is characterized by aggregate non-insurable uncertainty about expected aggregate demand and credit conditions, fits such a model characterized by incomplete markets. ([92])

However DSGE models - also of the new Keynesian type – follow a different line of argument and provide in general linear multipliers, which are functions of the various parameters discussed above. Assessing the value of multipliers in crisis situations, can mostly be done in an heuristic way, by assessing the value that reasonably can be taken by the crucial parameters in crisis times as opposed to the values that those parameters can take under normal circumstances.

Three factors influencing the value of the multipliers in DSGE models can in principle be related to crisis. First channel is the traditional Keynesian presence of slack in the economy. This channel however, in presence of agents that take consumption decisions on the basis of their permanent income – and not only their present income as in the Keynesian tradition – has a very limited effect on the multipliers. More relevant quantitative impact on the multiplier, as shown above, comes from the percentage of agents which are rationed on the financial markets and from the fact that monetary policy is at the so-called zero lower bound i.e. in a situation akin to the Keynesian liquidity trap.

([92]) The relevance of uninsurable uncertainty in depressing investments is corroborated, among many, by the empirical studies of Bloom (2009) and Bloom et al. (2007.)

Even if DSGE models do not make endogenous the share of consumers that are liquidity constrained, it is a reasonable assumption that during crisis, especially crisis originated in the financial sector as the present one, the fraction of consumers that are financially constrained increases. As indicated in the review of the literature above, QUEST,([93]) in line with the literature, indicates an increase of the impact multiplier by 20% on average in presence of financially constrained consumers, with higher value for fiscal measures impacting directly current revenues – like transfers to households - and smaller for other type of measures. ([94])

A second key factor of key relevance is the stance of monetary policy: the more accommodative monetary policy, the larger the multipliers, via the impact on real interest rates. Moreover Christiano, et al. (2011) show that multipliers are higher the larger the percentage of spending implemented under a liquidity trap, with peak multipliers that can be larger than two while Leeper et al. (2011) find one-year spending multipliers at 1.5-1.6. Also Table III.6.1 of European Commission (2010a) shows that the presence of monetary accommodation increases multipliers by 25% to 30%.

The main exceptions to linear models are constituted by Erceg and Lindé (2010) which build a new-Keynesian DSGE model showing that the duration of a liquidity trap is endogenous and is shorter the larger the fiscal stimulus provided by an increase in government spending. Given that multipliers are larger the longer the period in which the economy remains in the liquidity tap, in Erceg and Lindé the size of the multiplier is inversely related to spending levels. The second exception is Canzoneri et al. (2012), which build on the previous reasoning and introduce costly financial intermediation allowing financial frictions to vary counter-cyclically. The model can thus generate impact spending multipliers which are between two and three in recessions and 0.9 in expansions. Yearly cumulative multipliers are almost 1 and roughly two thirds respectively. It should be noticed that these results are obtained with persistence of government shock of 0.97. Interestingly the model mimics two fully Keynesian features: first, the "theorem of multiplier in balance" holds in that multipliers during recessions remain greater than one even if higher spending is financed through taxes; second, debt-financed multipliers are even higher (in recessions).

Recent empirical analysis tends to find that multipliers are larger in crisis periods. Auerbach and Gorodnichenko (2010) using a smooth transition structural VAR (STVAR) methodology find peak values for spending multipliers of 1 and for tax multipliers of -1 in the US. When a distinction is made between expansions and recessions spending multipliers are found respectively around 0.6 and up to 2.5, while tax multipliers become smaller but still differentiated at -0.5 and -0.1 in recessions and expansions, respectively. Values can become very large in recessions depending on the proxies used for fiscal variables' expectations but the difference between expansion and recession remains. Auerbach and Gorodnichenko (2011) use a panel of semiannual yearly observations for OECD data since 1985 to find the same result – but much lower multipliers – with a linear multiplier estimated at around 0.2, a recession multiplier between 0.4 and 0.7 and an expansion multiplier which is never significantly different from 0. IMF (2012) presents similar results using a threshold VAR for the large EU countries.

A similar exercise is made in Caprioli and Momigliano (2011) which use a STVAR technique on a sample of quarterly data for Italy in 1982-2011. They show that in recession the responses of private GDP are much larger than in expansions, with peak responses after six quarters of 0.13 in the linear model, 0.16 in expansions and 0.61 in recessions.

Afonso et al. (2011) use similar techniques on data from a quarterly dataset for the period 1980:4-2009:4 for the U.S., the U.K., Germany and Italy to estimate the differences in multipliers in high financial stress versus low financial stress regimes. They find that the responses of economic growth to a fiscal shock, defined in terms of changes in the debt ratio. are mostly positive (though in some cases very small) in both financial stress regimes,

([93]) See European Commission (2010b), pg. 186.
([94]) The relevance of financial frictions in crisis period is also indirectly confirmed by Kollmann et al. (2012) and in't Veld and Roeger (2012), where it is shown the relevance of state support to banks in reducing risk premia and real interest rates.

but that 3-year multipliers can be twice as large as in high stress regime (0.7 versus 0.3 in Italy, 0.24 versus 0.2 in the US, 0.2 versus 0.15 in the UK and 0.4 versus 0.2 for Germany) so that they conclude that the size of the fiscal multipliers is higher than average in the last crisis.

As mentioned before, Baum and Koester (2011) with a Threshold VAR show that public expenditure multipliers vary depending on the size of the shock, its sign and the level of the output gap. Hence, in low regimes or crisis periods they observe that the higher the size of the shock, the higher the spending multiplier when government expenditure increases. Hence, a government expenditure increase of 5% may lead to a multiplier of around 1.3, whereas when the spending increase only amounts to 2% the multiplier diminishes to around 1. In good times though multipliers are lower and seem to behave more linearly.

Bouthevillain and Dufrenot (2011) estimate a Markov switching model on quarterly data on France for the period 1970:1-2009:4. ([95]) Increasing government expenditures is effective in raising GDP in recessions but not in expansions in expansions, and similarly for a decrease in government revenues.

2.5. EFFECTS OF DEBT AND DEFICIT ON GOVERNMENT YIELD

The other relevant factor that shapes the dynamics of the debt ratio following a consolidation is the response of apparent interest rates on sovereigns. The predictions of economic theory on the effects of fiscal policy variables on interest rates are not univocal. The traditional Keynesian analysis well represented by the IS/LM model stresses the role of deficit: an increase in deficit tends to increase government yields and consequently interest rates via demand pressure: the consequent increased demand for money pushes up interest rates – unless monetary policy reacts by increasing money supply as it is the case if the country wants to keep its exchange rate unchanged following the change in deficit. A similar argument holds for New Keynesian DSGE models, that incorporate a Taylor rule by which interest rates react positively to future inflation generated by the increased demand due to a deficit increase or a devaluation/depreciation of the currency. These models however refer to short-term interest rates, while the relevant rate for the economy is probably the long-term interest rate, which better reflects marginal productivity of capital.

On top of reacting to short term interest rates and inflation expectations, long-term interest rates are influenced by debt levels via different channels. First, as stressed in Engen and Hubbard (2004) and Gale and Orszag (2004) growth theory shows that the debt level rather than the government deficit is the relevant fiscal variable that impact on long-term interest rates. A higher government debt crowds out investments thus resulting in a lower capital stock. This at equilibrium implies higher real interest rates given decreasing marginal productivity of capital. A second channel which relates higher debt to increased long-term interest rates goes via risk premia (see Eaton and Fernandez (1995). Increased debt levels imply a higher probability of default which in turn implies higher risk premia and thus sovereign yields – even though this is necessarily also related to the assumption of lower expected future government deficits as pointed out in Manasse, Roubini and Schimmelpfennig (2003). Thus the main question to be faced by empirical researches is which fiscal variables to use for the analysis, whether deficit or debt.

The existing empirical literature on the effects of fiscal variables on sovereign yields can be categorized in two groups. A first group of papers estimates how fiscal policy variables influence the level of long-term interest rates taking into account the effects of future inflation and monetary policy variables. A second group of articles tries to explain the factors driving the behaviour of spreads, in general vis-a-vis Germany, among which fiscal variables play a role. Many times no choice is made and both variables are tested.

The main technical problem facing the first group of papers is related to endogeneity: the level of interest rates that has to be explained by fiscal variables also influences the very same variables that are used to explain it, both directly via

([95]) True fiscal policy data at quarterly frequency are computed in France only for recent years. Data used in Bouthevillain and Dufrenot, as those used in the present Section are based on yearly time series interpolation by the OECD.

increased expenditures and indirectly, via the impact on the economy. In order to solve this problem, Elmendorf (1993) uses deficit forecasts for the US and finds that an increase in deficit projections of 1% of GNP raises five-year bond yields by almost 50 basis points. The use of projected deficit to solve the endogeneity issue however is not without problems, given that the business cycle affects at the same time the fiscal policy variable and sovereign yields.

Laubach (2009) and Engen and Hubbard (2004), uses therefore five-year-horizon deficit and debt projections by the Congressional Budget Office and finds somewhat lower effects of around 20 basis points for the five-year-ahead ten-year forward rate for each point of GDP increase in deficit and some 3 basis points increase for the five-year-ahead ten-year forward rate for each point of GDP increase in debt. Thomas and Wu (2009) control also for risk indicators but find results in the same range.

As Gale and Orszag (2004) show, this result indicates a roughly similar effect of debt and deficit over a ten year horizon, in that a permanent increase in deficit by one point of GDP would increase the debt to GDP ratio by the same amount and have thus a cumulative effect in interest rates of the same order of magnitude. Always for the US, Gale and Orszag test differences between predictions on real and nominal interest rates and find broadly similar results for deficit, in the range of 30 to 70 basis points increase for each point of deficit increase, and still small but slightly higher for debt up to 6 basis points. None of these papers uses samples containing crisis data.

Similar estimates are found in papers that study the impact of fiscal policy on the yield curve: Dai and Philippon (2005) show that in the US a one percentage point increase in government deficit to GDP ratio lasting for three years increases the 10-year rate by 40-50 basis points and that this increase is due not only to higher expected spot rates – related to monetary policy – but also for one third to higher risk premia.

Another group of paper uses evidence from other advanced economies and applies panel data estimators to assess the impact of fiscal variables on interest rates. Ardagna et al. (2006) finds lower effects of deficits, whereas for the debt no impact is found below the threshold of 63% of GDP and only a small effect is estimated for higher values. Similar effects are obtained in Ardagna (2004), which finds that the ten-years government bond interest rate increases by some 160 basis points in periods of worsening primary government balance and decreases by somewhat lower values in consolidation periods.

For a panel of ten of the early members of the euro area Faini (2006) detects no significant effect from debt levels on ten-year real interest rates but a small effect (a few basis points) from government deficit. The article finds however that there are sizable spillover effects within the euro area: the aggregate euro area deficit and debt have an impact on ten-year real interest rates of some 40 and 3 to 8 basis points, respectively.

The second strand of the literature uses infra annual data at various frequencies to assess the behavior of spreads within the euro area, the main advantage of using high-frequency data being that the endogeneity problem is greatly reduced. The general feature of such analysis is to show that an international risk factor explains the bulk of the spreads behavior, but that fiscal variables have some effect as well. Codogno et al. (2003), using as independent variable differences in debt-to-GDP ratios with respect to Germany, find that fiscal policy variables have effect on relative ten-year government bond swap spreads except for Austria, Italy and Spain when interacting with international risk variables. In turn, Bernoth et al. (2004), with a sample of emissions by thirteen EU countries, finds that each point of difference between the country's debt ratio and Germany's debt ratio entails an effect on the spread around 3 basis points, jointly with some evidence of non-linear effects for large debt levels. Barrios et al. (2009) and Schucknecht et al. (2010) find very alike results in similar contexts but with data from the current crisis considered in the sample. In the latter case, as in Codogno et al. (2003), the effects of government debt on spreads steeply after the bankruptcy of Lehmann Brothers. Values of 12 to 18 basis points are also found in European Commission (2011a) in a study which uses observations of ten founding euro area countries over 1999-2009.

Summing up, despite some dispersion in the estimates, higher fiscal deficits and public debt

Table III.2.4: **Resuming the strand of literature on fiscal consolidation and the cost of debt**

Studies	Sample	Short term int. rates (5 years)	Long term int. rates (10 years)	Approach
Engen and Hubbard (2004)	US (1976-2003)	Debt 0.28	Debt 0.30	Vector auto regression (VAR)
Gale and Orszag (2004)	US (1956-2000)		Deficit 0.3/0.7	LS and ML estimates
Eaton and Fernandez (1995)	Survey of literature		Increased debt levels raise the probability of default. Higher public debt increases risk premia	Literature review
Manasse, Roubini and Schimmelpfenning (2003)	47 economies with market access (1970-2002)		Increased debt levels raise the probability of default. Higher public debt increases risk premia	Logit and binary recursive tree analysis
Laubach (2010)	US (1976:1-2006:2)	Deficit : 0.23 Debt : 0.032 for the 5-year-ahead 5-year forward rate	Deficit : 0.20-0.29; Debt : 0.022-0.044 for the 5-year-ahead 10-year forward rate	LS and IV regression
Thomas and Wu (2009)	US (1983-2005)	Deficit : 0.48-0.60	Deficit : 0.30-0.46	LS regression
Dai and Philippon (2005)	US (1970:1-2003:3)		Deficit : 0.4-0.5	VAR that incorporates a no-arbitrage affine term-structure model with a set of structural restrictions to identify fiscal policy shocks
Ardagna et al. (2004)	16 OECD countries (1960-2002); (1975-2002)		1% of GDP increase in primary deficit: +10 bp (static specification) +150 bp (P-VAR) Non-linear effects of public debt	Panel and Panel VAR
Ardagna (2006)	16 OECD countries (1960-2002) yearly data		Deficit : 0.24-0.42 Debt: 0.04-0.06 interest rate increases by 162 basis points in periods of worsening primary government balance and decreases by 124 basis points on average in consolidation periods	Panel
Faini (2006)	10 EA members (1979-2002)	Debt: 0.53		Panel
Codogno et al. (2003)	9 EMU founding members (1999-2002)		Debt: Lowest in Netherlands 0.05; highest in Portugal 0.08 Debt ratio of 50 points higher than Germany: +47.5 b.p.	Time series inspection and SURE estimates
Bernoth et al. (2004)	13 EMU countries (1999-2002)		Debt ratio of 25 points higher than Germany: +30 b.p.;	Panel
Barrios et al. (2009)	7 Euro area countries (2003-2009)		Government surplus: -0.024 Debt : 0.003	LS and IV regression
Schucknecht et al. (2010)	12 countries (1991-2002)		+marginal debt (benchmark country): 0.09 b.p. before 2008; 1.18 b.p. after.	Panel
European Commission (2010)	10 founding members (1999-2009)		Debt: 12-18 basis points	Panel
Iara and Wolf (2001)	11 EA countries (1999-2009)		Debt: 0.93-1.40	Panel (GMM)

Source: Commission services.

ratios seem to lead to higher interest rates too (see Table III.2.4.). On average, the available evidence suggest that increases in public deficits and debt ratios of around 1% of GDP may entail long-term interest rate rises of around 50 basis points and about 5 basis points, respectively. Both estimates are compatible as a permanent increase in deficits by one point of GDP would increase the debt to GDP ratio by the same amount and have thus a cumulative effect in interest rates of the same order of magnitude. However, these effects may be non-linear. The effects on government yields are expected to rise with the stock of public debt, mainly via the risk premium linked with sustainability concerns. Accordingly, insofar as fiscal consolidations succeeded in reducing public debt, their associated short-term pain would be lower the larger the initial stock of public debt.

2.6. CONCLUSION ON REVIEW OF VALUE OF MULTIPLIERS

The review of the literature presented above allows drawing the following conclusions, despite the large variation in estimates and the difficulty in

comparing them. Assessing the current size of fiscal multipliers is complex, in that the value taken depends on its composition, its permanent nature, and on the economic environment at large.

First, the large majority of estimates of first-year spending multipliers in normal times are located in the range of 0.4 to 1.2. The values are lower – quite often below 0.7 - for tax multipliers. Therefore, if the composition of observed consolidation is taken as a guide, multipliers are expected in general to be lower than the highest estimates: using observed changes in revenues and expenditures to GDP ratios as proxies for the composition of the adjustment shows that in 2012 consolidation is equally shared in revenue and expenditure measures (see Chapter I.3). In the same direction also go the indications that comes from the mostly permanent nature of the consolidation in the EU.

However, it is likely that in the current juncture impact multipliers are higher than normal because the literature stresses that in situations of crisis, and of financial crisis in particular, with many agents constrained in the financial markets, multipliers are larger than average. The specificity of the EU and of the euro area, with high trade integration fixed exchange rates and the necessity of consolidating at the same time and during a period in which the rest of the world is growing well below potential indicate add to the probability that first year fiscal multipliers are relatively high.

The European Commission's QUEST model yields first-year multipliers of around 0.7 and 0.4 for the Euro Area for a balanced consolidation in normal economic times, which is perceived respectively as temporary/not credible or permanent/credible by consumers (European Commission (2010b)). These multipliers can become larger in a crisis period (by a factor of one half) and even larger in a crisis period in which trade partners consolidate when they can be multiplied roughly by a factor of 5/3.

The relevance of the fact that consolidation is pursued at the same time by many partner countries is stressed both in theoretical paper like Erceg and Lindé (2012) relatively to the effects via international interest rates, and in Perotti (2011) where it is shown that the so-called non-Ricardian effects – related to the effect of future government balances on permanent income - where most probably not the source of the short-run success in terms of GDP of the main four episodes of consolidation which were associated with an expansion, rather the main driver of growth was exports rather than internal demand. This is particularly relevant for euro area countries, which, despite being relatively open economies if taken individually and have as main trade partners the other countries of the union (in general). In that case there can be magnifying effect of an area-wide consolidation on the multipliers.

Multipliers in the current juncture as assessed by QUEST are around 0.7 and 1.2 respectively for permanent/credible and temporary/non credible balanced consolidation under an accommodative monetary policy.

Multipliers will be quite different according to the composition of the consolidation, with government consumption multipliers lying between 0.5 and 0.8; larger multipliers correspond to cuts in government wages and government investments (above 1) while smaller multipliers (of around 0 in normal times and 0.7 in times of crisis) correspond to VAT and labour tax increases. The meta-analysis by Leeper, Traum and Walker proposes similar multipliers for partially permanent/credible government consumption based shocks which are in the order of magnitude of 0.6 to 0.9 for normal times but larger multipliers – around 1.6 – for periods in which monetary policy is accommodative and for relatively open economies. ([96])

The estimates of spending multipliers made by the Commission on three large euro area countries and aggregate euro area data ([97]) are in line with literature results, with fist-year multipliers between 0.4 and 1.4, an increased second-year multiplier and values for third year multipliers still in line

([96]) The values of 0.7 and 1.6 are not directly comparable because of different assumptions on credibility and on the composition of the consolidation, but represent the relevant range of values that can be supported by existing models. It is recalled that a comparable QUEST multiplier is slightly above one. See Chapter III.2.

([97]) Estimates for France were made but resulting multipliers were found to be null. This can be related to the fact that the quarterly series which are used are derived interpolating annual data and therefore are not proper quarterly data and do not reflect the reality of fiscal shocks. Non-significant multipliers were found also for the UK, in line with Perotti (2004).

with first-year multipliers, before a relative quick decrease. This is even more the case if composition is taken into account, as spending VAR multipliers are estimated using a composite spending variable which is the sum of government consumption and government investments, which – according to New Keynesian DSGE models – are among the components with the highest multipliers.

It should be noticed that, it is not possible to compare directly VAR-based assessments of fiscal multipliers to model-based ones. The main reason is that fiscal shocks in VAR models are typically temporary, while in models-based assessment the nature of the shock can be different.

3. DEBT DYNAMICS AND EFFECTS FROM CONSOLIDATION

This Chapter looks at the effects that consolidations have on the debt ratio. It looks at the relationship between deficits and debts and estimates the values of key parameters that determine how government debt changes for different levels of deficits. ([98])

In the absence of any stock-flow adjustments, ([99]) the government debt to GDP ratio (b) evolves according to the following formula: ([100])

$$b_t = b_{t-1}(1-g_t) - bal_t = b_{t-1}(1+r_t-g_t) - pbal_t$$

where bal represents the budget balance to GDP ratio, pbal the primary budget balance, r the average effective interest rate on government debt and g nominal GDP growth. The evolution of the debt ratio can therefore be understood as being driven by the primary balance and the snowball effect, which is the difference between the average effective interest rate and the growth rate of the economy. Over the medium-term, the snowball effect is of particular importance as it drives the magnitude of primary balances that are necessary in order to ensure that government debt remains sustainable.

The effects of consolidation on the debt ratio can then be analyzed by looking at the direct effect that the consolidation has on balance and its impact on the snowball effect. The Chapter starts by looking at the short-term impact of consolidations, looking at how the fiscal multipliers translate magnitudes of deficits into changes in economic growth. It considers the impact of the fiscal multipliers and analyses the magnitude of the multipliers – known as critical multipliers – that might generate undesired effects, whereby consolidations lead to increases in the debt due to the impact that they have on the GDP growth. By estimating the value of these critical multipliers for the EU27 Member States and comparing them with the likely range of actual multipliers according to the economic literature, the Chapter considers whether any countries are likely to face short-term debt increases as a result of the current consolidations, due to the effect of consolidations on growth. ([101])

The Chapter then turns to the medium-term, where the impact of consolidations depends on how various parameters – mainly the impact multiplier and the persistence of consolidation on next years' growth but also the starting level of debt, the size of automatic stabilizers and the baseline balance and growth – drive debt dynamics. The effect of these parameters is analyzed by looking at the number of years required for debt to go below a baseline level following a consolidation. Finally, the role played by interest payments on debt dynamics is considered, and how market myopia influences the effect of consolidations.

3.1. SHORT-RUN EFFECTS OF FISCAL CONSOLIDATIONS

This Section analyses the effect of a fiscal consolidation relative to a baseline where no consolidation takes place. The effect of a consolidation ("*a* " in the following) is given by the change induced by it on debt and a positive consolidation effect is found if the debt ratio under consolidation is smaller than the debt ratio in the baseline. ([102]) As Box III.3.1 shows the change induced on debt by consolidation $b_t(da) - b_t(0)$ written in full is:

([98]) This Section Chapter is based on Boussard et al. (2012).

([99]) The stock-flow adjustment is the difference between the change in government debt and the government deficit/surplus for a given period. The main categories of stock-flow adjustments are net acquisitions of financial assets, items that do no directly affect the Maastricht definition of debt and effects of face valuation, comprising also effects of exchange rate variation. See http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/STOCK_FLOW_2011/EN/STOCK_FLOW_2011-EN.PDF

([100]) This formula is derived from the identity $B_t = B_{t-1} - Bal_t$, where *B* represents government debt in cash terms, *Bal* government balance and stock-flow adjustments are assumed to equal zero. The formula in the text is derived by expressing all variables as a ratio to GDP (Y) $\frac{B_t}{Y_t} = \frac{B_{t-1}}{Y_{t-1}}\frac{Y_{t-1}}{Y_t} - \frac{Bal_t}{Y_t}$ and simply rewriting $b_t = \frac{b_{t-1}}{1+g_t} - bal_t$ and approximating $\frac{1}{1+g_t}$ with $(1-g_t)$ gives the formula in the text.

([101]) For a similar analysis restricted to the effects of VAR-based fiscal multipliers see also Eyraud and Weber (2012).

([102]) This is expressed as $b_t(a) - b_t(0) = \frac{db_t}{da}(0) \times da < 0$

$$\frac{db_t}{da} = \frac{db_t}{dpbal_t} \times \frac{dpbal_t}{da} + \frac{db_t}{dg_t} \times \frac{dg_t}{da}$$

In the short-term, a consolidation affects the debt ratio both via its effect on the primary balance and via its effect on the rate of growth of GDP. These two effects are given in the formula above. First, the debt ratio is affected by the change in the primary balance, which, in turn is driven both directly and indirectly by the consolidation measures. The direct effect is given by the fact that consolidation measures reduce the deficit, while the indirect effect is again given via the effect on growth; the primary balance is also affected by the growth rate of the economy via the automatic stabilizers. ([103]) The government balance is therefore increased by the direct effect of consolidation measures but reduced by the impact that these measures have on the economic growth rate (indirect effect). Second, assuming that there is no significant impact of a consolidation on the interest rate, the debt ratio is increased because of the negative effect on economic growth in the short term. ([104])

The effect of consolidation measures on the government balance in the first year ([105]) is composed by three effects: i) the direct of effect of the consolidation measures on balance (which by definition is equal to one, because measures worth one euro reduce government deficit by the same amount for a given growth rate;) ii) the negative effect induced on balance via the automatic stabilizers (i.e. the product of the multiplier times the effect of balance to growth equal to the semi-elasticity of the government balance to the cycle); and iii) the "denominator effect" on the debt ratio caused by the diminution in growth with respect to baseline engendered by consolidation.

Putting these two equations together give the effect of consolidations on the debt level, as a function of existing debt level, the multiplier and the cyclical budget elasticity, ε: ([106])

$$\frac{db_t}{da} = (b_{t-1} + \varepsilon) \times m_1 - 1$$

This equation leads to the conclusions that i) a high starting level of debt tends to dampen the debt-reducing impact of consolidation all else equal. If the initial debt ratio is large enough, consolidations can even bring about increases in the short term. The same holds for the elasticity of the government balance to the cycle; and ii) the larger the short-term multiplier, the smaller the debt-reducing impact of consolidations. This effect is actually independent of the economic growth rate and of the interest rate prior to the fiscal consolidation..

It is therefore possible to compute a critical value for the multiplier which is the largest value the multiplier can take before a consolidation leads to a negative rather than positive impact. This value m_1^c m_1^c is computed as

$$m_1^c = \frac{1}{b_{t-1} + \varepsilon}$$

It diminishes with the level of debt – the higher the debt the larger the growth impact on the debt to GDP dynamic – and with the cyclical semi-elasticity – the effect of consolidation measures on deficit are smaller the more the automatic stabilizers react to diminished growth. For any estimated value of the budget elasticity to growth it is possible to draw the relationship between the

([103]) If the government takes consolidation measures for a total *a,* there will be a reduction in growth compared to baseline, leading to a lower reduction in final deficit - due to the operation of automatic stabilizers - than the one due to the direct effect of the measures taken.

([104]) The higher the growth rate of GDP, the smaller is the debt ratio – for any given deficit. This is usually referred to as the denominator effect: any change in GDP affects the debt ratio via the denominator.

([105]) If m_1 is the one-year multiplier and ε is the elasticity of budget balance to growth the precise formula is

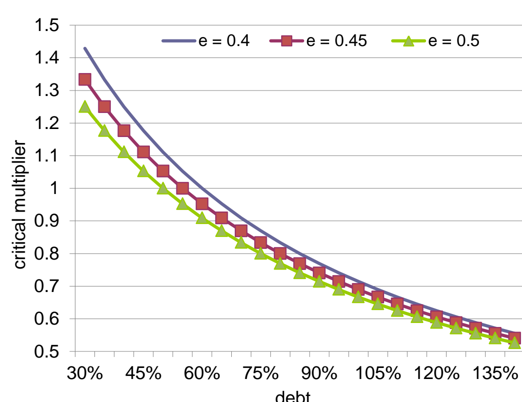
$$\frac{dpbal_t}{da} = \frac{\partial pbal_t}{\partial g_t} \times \frac{\partial g_t}{\partial a} + \frac{\partial pbal_t}{\partial a} = -\varepsilon \times m_1 + 1$$

The non-approximated calculations and formulas are presented in Box III.1.

([106]) All the previous computations are done with respect of a baseline, i.e. they show the comparison between the debt ratio at time t after the consolidation and the debt ratio that would have prevailed at time t in the absence of consolidation. Notice that for one period the result presented here well approximates the result of equation III.5 in Box III.1. As baseline debt does not differ much from the starting level of debt after just one period, this equation also applies approximately to difference between the debt ratios in the first period compared to the period in which consolidation is implemented.

debt level and the critical multiplier. For a debt ratio equal to 100% of GDP, a typical order of magnitude on the value of the critical multipliers can be computed to be 2/3 if it is assumed that the semi-elasticity of budget balance to growth is 1/2.

Graph III.3.1: **Debt ratio and critical multipliers**



Source: Commission services.

Graph III.3.1 shows the relationship between the resulting critical multiplier and the starting level of debt and semi-elasticities. The three curves show the debt ratio and multiplier values such that the effect of consolidation on the debt ratio is zero in the short term, for three different illustrative elasticities. For any given semi-elasticity points above the line – representing higher debt ratios and/or multipliers – are characterised by consolidations leading to a higher debt ratio in the first year.

Country analysis

The theoretical relationship obtained in the previous Subsection can shed light on the effects of the consolidation in the short term in the EU countries. The last column of Table III.3.1 shows the estimated critical multipliers for the EU27, for the 2011 levels of Maastricht debt and using estimated cyclical semi-elasticities of government balance to the output gap to measure the reaction of automatic stabilisers to the change in growth induced by consolidation. [107]

The critical values shown in Table III.3.1 can be compared with the values emerging from the literature review presented in Section III.3.6. As explained in the literature review, the value of the multiplier depends on many factors, with the composition of the adjustment, the existence of a simultaneous adjustment in trade partners and the situation of the economy playing a prominent role.

Table III.3.1: **Critical first year multipliers in EU Member States at constant interest rates in 2011**

	Semi-elasticities	Debt (2011)	Critical Multiplier
BE	0.51	98.0	0.7
BG	0.33	16.3	2.0
CZ	0.36	41.2	1.3
DK	0.65	46.5	0.9
DE	0.54	81.2	0.7
EE	0.30	6.0	2.8
IE	0.44	108.2	0.7
EL	0.42	165.3	0.5
ES	0.43	68.5	0.9
FR	0.53	85.8	0.7
IT	0.49	120.1	0.6
CY	0.43	71.6	0.9
LV	0.30	42.6	1.4
LT	0.29	38.5	1.5
LU	0.44	18.2	1.6
HU	0.44	80.6	0.8
MT	0.38	72.0	0.9
NL	0.62	65.2	0.8
AT	0.47	72.2	0.8
PL	0.38	56.3	1.1
PT	0.45	107.8	0.7
RO	0.32	33.3	1.5
SI	0.45	47.6	1.1
SK	0.33	43.3	1.3
FI	0.58	48.6	0.9
SE	0.61	38.4	1.0
UK	0.46	85.7	0.8

Source: Commission services' calculation

These values can be compared to the values proposed in Section III.3.1 above, i.e. QUEST multipliers of around 0.4 to 0.7 for the euro area for a composition-balanced consolidation in normal economic times, depending on credibility and 0.7 to around 1.2 in crisis situations (up to 1.6 if one considers the spending multipliers from the meta-analysis or cumulative first-year spending multipliers from VAR-based analysis).

([107]) These values are computed by the Commission in the context of the fiscal surveillance on the basis of a methodology developed by the OECD.

Comparing the critical multipliers given in Table III.3.1 with the results of literature indicates that Greece is the only country where short run debt increases could be observed even in normal times and if consolidation is balanced in terms of its composition between expenditures and revenues. However, given the high debt levels now present in the EU and given that large government sectors induce large cyclical semi-elasticities, around one third of the EU countries are likely to see their debt ratio increasing compared to the baseline in the first year when a consolidation process is implemented depending on the composition of consolidation. This is especially true if consolidation is spending-based and is not completely credible so that figures from meta-studies are used and considering the current crisis situation, in which case multipliers can be expected to be larger and a large part of EU countries would be likely to be in the undesired effect area in the short term.

In any case, it is obvious that this analysis does not suggest that remaining at the baseline, i.e. doing nothing, is preferable to consolidation. In particular, the analysis does not suggest that high-debt countries should consolidate less than low-debt countries, only because they have high levels of debt.

3.2. MEDIUM RUN EFFECTS OF CONSOLIDATION

The previous Section looked at the critical multiplier and presented evidence about how the actual multipliers in EU Member States compare with the countries' corresponding critical multipliers showing that it is not impossible that in the current situation consolidation leads to higher debt ratios in the short run. This Subsection looks at how the multipliers affect the debt dynamics following a consolidation, before the next Section introduces possible effects of consolidations on interest rates and moves to look at debt dynamics from a more medium-term point of view.

As will be shown in this Subsection, under most parameter configurations that are in line with the evidence obtained from the economic literature and the simulations presented here, the time period necessary for a consolidation to have a beneficial effect on the debt ratio is two or maximum three years unless multipliers are very high and persistent. The exception to this pattern occurs in the presence of a high degree of myopia concerning determinants of government yields, ([108]) and this will be examined in the next Section which will enrich the analysis by including the impact on government interest rates.

As shown in more detail in Box III.3.1 the evolution of the debt ratio, in the absence of any effect on government yields, it is the sum of same three effects indicated in the previous Subsection: i) the cumulative effect of growth on debt, which is generated by the change that the consolidation has on growth developments. ([109]) This effect is larger if the initial debt stock is larger and if multipliers are larger, while simulations show that the impact of the other parameters of the baseline scenario do not have the same relevance. ii) The cumulative effect of growth on government balance which considers how the growth effect of the consolidation affects the budget balance via the operation of the automatic stabilisers on the budget balance. This component of the effect typically increases debt in a consolidation, because it worsens the government balance for a given consolidation and the effect is greater the larger the size of the multipliers and the size of automatic stabilisers. Finally, iii) the cumulative effect from the adjustment of government balance which represents the cumulative savings effect of the consolidation i.e. the direct debt reduction of the adjustment in the absence of any effects on growth. This effect reduces the debt ratio. It increases with the number of years and with the size of the consolidation implemented.

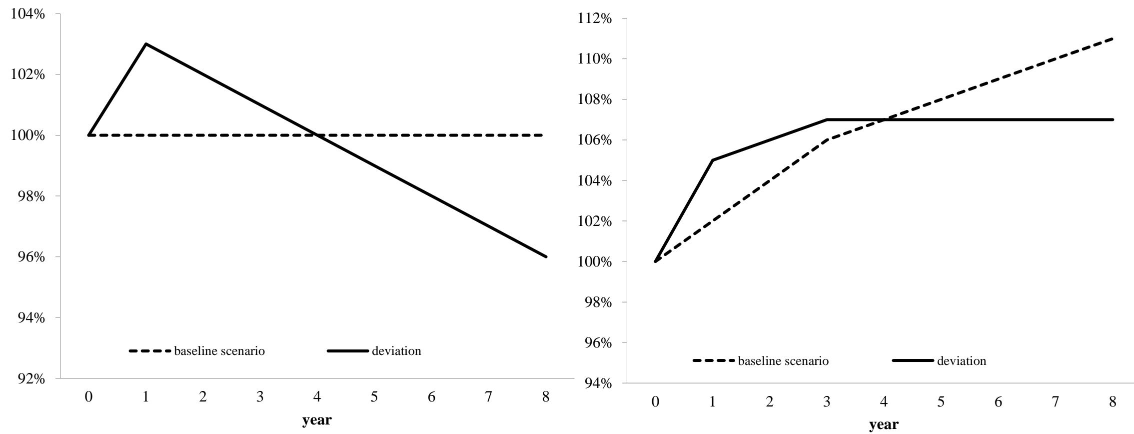
As the first two effects are act to increase the debt ratio, while the third acts to decrease it. One way to look at the medium-term effects of a consolidation, then, is to consider the number of years n^* (hereafter "the critical year") ([110])

([108]) Gros (2011) presents a similar argument in a qualitative and incomplete manner.

([109]) The computation takes into account the fact that the evolution of debt over time is influenced by the path of the government balance, so that a large government balance influences the debt ratio more than a smaller government balance.

([110]) Notice that n*represents the number of years starting from the year of consolidation. If consolidation is implemented in year 1, n* represents the critical year. Therefore n*=1

Graph III.3.2: **Critical year and underlying debt trend**



Source: Commission services.

necessary for the consolidation to lead to a decrease in debt with respect to a baseline scenario. In terms of the equation presented in Box III.1 this is equivalent to the number of years necessary for $\frac{db_n}{da}$ to equal zero (or be negative).

The critical period n* is different from the number of years required for the debt to go below its starting value in year 0 unless the baseline is the steady state of constant debt ratio. Graph III.3.2 shows illustrative paths for the debt under baseline and consolidation scenarios, for a constant baseline in the left-hand panel and an increasing one in the right-hand panel. It shows that, while in the case of a stable baseline scenario n* coincides with the year in which the debt level returns to its level in the consolidation year, this does not happen when the baseline scenario is increasing and the solid line representing the path of debt-to-GDP ratio following a consolidation returns to the starting level only after crossing the dotted line representing the baseline scenario (if ever). When looking at the effects of a consolidation on the debt, the relevant comparison depends on the aim of the exercise. The debt trajectory under a consolidation should be compared to the baseline debt if we are purely interested in the effect of the consolidation per se; however, if there is an overall question of debt sustainability the debt after a consolidation will also need to be compared to the actual starting level of debt.

In order to model debt dynamics and calculate the value of the critical year n* under different consolidation scenarios, to run debt simulations under different consolidation scenarios, a clear picture of the reaction of GDP to consolidation in future years ([111]) is necessary, bearing in mind that is likely to change over time. The higher the multipliers in the first year and the longer the change in GDP induced by the consolidation, the larger the value of n* and the longer it will take for a consolidation to be effective. There are three broad effects emerging from the literature review presented in Chapter III.2 that will be incorporated into the simulations presented later in this Subsection:

i) the values of first year multipliers in normal economic conditions are typically estimated at between 0.3 to around 1 depending on the composition and nature of the policy changes and type of estimate; ii) the values of first year multipliers are larger in crisis years, usually within a range from 0.5 to 1.6; and iii) the impact on GDP in years following consolidation tends to decrease but does so to different degrees depending on the

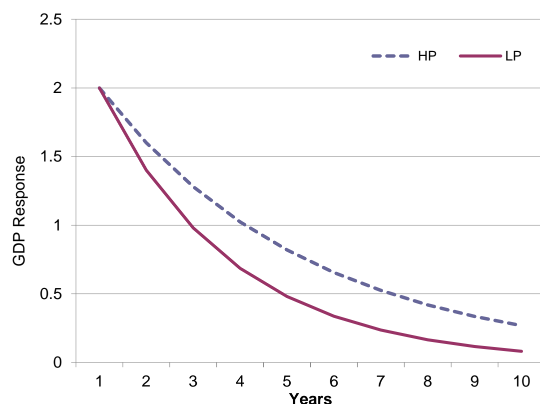
means that there is no self-defeating effect at all, while n*=2 indicates that the perverse effects lasts one year and so on.

([111]) See Box III.1 that defines the adjusted multiplier $\hat{m}$ which corresponds to the difference between GDP and baseline at year t in an impulse-response function.

model used, on the type of estimate and on all the factors affecting multipliers.

The fiscal multipliers can be very persistent or can decay rapidly in the first years, following a convex, autoregressive path. Such an AR1-shaped curve is similar to the shape of GDP responses which can be found in New Keynesian DSGE-based assessments of multipliers for various (but not all) types of consolidation. ([112]) Graph III.3.3 shows two stylised GDP responses following a consolidation of 1% of GDP, under low and high persistence. ([113]) The main difference between the two paths thus concerns the persistence of the effects of the consolidation.

Graph III.3.3: **Stylised paths of GDP impulse responses used in the simulations**

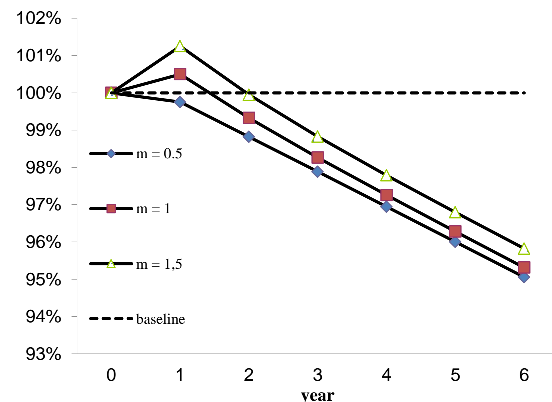


Source: SCPs, Commission services.

Simulations

Graph III.3.4 shows the debt-to-GDP ratio dynamics for the low-persistence multipliers path under different assumptions about the impact multiplier. The baseline scenario is one of a constant debt ratio of 100% of GDP. The Graph shows debt dynamics for a persistence rate of 0.5, ([114]) with first year multipliers of 0.5, 1 and 1.5. All values for the first-year multiplier that lie below the 0.7 level will correspond to an improved debt ratio from the first year – this is so by construction as the 0.7 level corresponds to the critical value for the multiplier. It should be noted that a first year multiplier of 1.5 is on the high side of existing estimates as it is the estimate of a temporary consolidation based on government spending.

Graph III.3.4: **Debt dynamics (baseline steady state, b0 = 100%), no effect on interest rates – with low persistence**

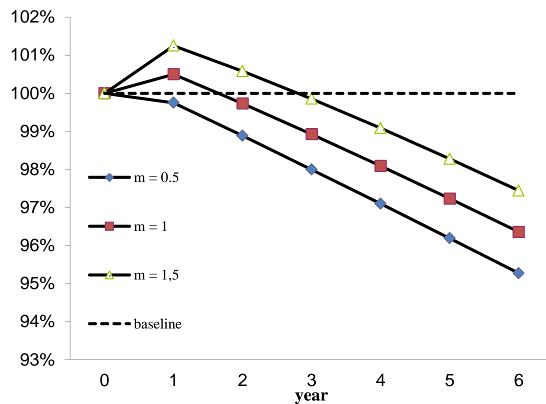


Source: Commission services.

Graph III.3.5 shows the case for a high persistence parameter (0.8) of the GDP response. The higher persistence of the effects of consolidation generates longer-lasting negative effects from fiscal consolidation. If the first-year multiplier is 1.5 the consolidation-based debt increase lasts for one more year so that three years are needed – taking into account the fact that year 1 is the year in which the consolidation is implemented – before debt goes below baseline.

([112]) See for example in Graphs III.6.1 and III.6.2 in European Commission (2010a).
([113]) The precise formula is shown in Box III.1 as equation III.6. It is considered that the multipliers decline according to a persistence parameter to reach a long-term value. The persistence parameter is the ratio between the responses of two consecutive years if the long-run impact of fiscal consolidation is null.
([114]) 0.6/0.7 is the ratio of second to first year GDP responses in the case of composition-balanced permanent consolidation in European Commission (2010a). This is the basis for the choice of 0.5 as low persistence and 0.8 as high persistence parameters. Note that the persistence in the following years is however smaller. Values of the GDP responses broadly constant for the first three years are very commonly found in VAR estimates. This wold make raise an hump-shaped GDP response with the consequence that the debt increases following a consolidation would be reversed only after three years for values of the impact multiplier of 1.5. This being the only difference, the case is not developed here.

Graph III.3.5: **Debt dynamics (baseline steady state, b0 = 100%), no effect on interest rates – with high persistence**



Source: Commission services.

3.3. INTRODUCING CHANGES TO GOVERNMENT YIELDS INTO THE ANALYSIS

Over the medium-term, changes to the average effective interest rate are as important a factor for the debt to GDP dynamics as the growth rate of GDP. This Section incorporates a reaction function of average effective interest rates into the analysis to create a more complete picture of the medium-term dynamics of debt following a fiscal tightening.

The impact of consolidation on average effective interest rates is more visible in the medium-term than in the short-term, with limited first-year impact on the debt level. ([115])

As shown in Box III.1, taking into account the effects of changes in apparent interest rates adds a fourth element to the drivers of debt dynamics. Aside from the impact of growth on the debt and deficit and of the deficit on debt, a new term captures the cumulative effect of average effective interest rates on debt evolution. The interest rate effect (and hence the new term in equation III.11 in Box III.3.1) consists of the increased (or decreased if the interest rate diminishes) future debt burden related to the increased interest payments on the rollover of existing debt stock, and, second, the increased payments on the new debt related to future deficits.

The sign of this effect however is not clear cut as it depends crucially on the way market expectations are generated. ([116]) The normal case, in line with the results of the literature presented in Section III.3.2 and used in the previous Section, is the case in which a consolidation improves the market's confidence in government bonds and reduces yields so that a consolidation leads to a lower average effective interest rate *r*. In this case, the effect of a consolidation on debt is reinforced and debt-to-GDP ratios are likely to decrease at a higher speed (or increase less) than with constant yields. If, on the contrary, the market reacts to consolidation by increasing yields and consequently average effective interest rates, the effect of this term is the opposite. Such an effect would be rather unusual, however. ([117])

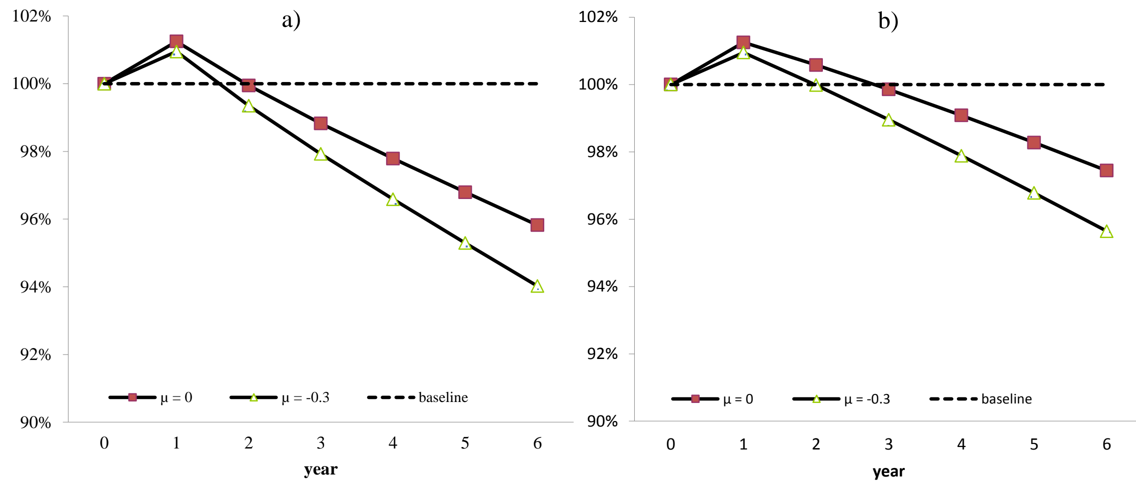
In general real interest rates paid by governments are modelled as being composed of the sum of two elements: central bank real rates – the safe interest rate –and a risk-premium, which depends on a number of very diverse factors. The central bank real rate's reaction to a consolidation depends on the state of the economy, a Taylor rule in normal times and a more accommodative stance in the crisis. This is modelled as an integral part of the New Keynesian DSGE models as seen in Section III.2 above and thus is already integrated in the

([115]) A more immediate impact can be seen on the yield of government debt, which may react more abruptly as borrowing goes up or down. The more muted effect on the interest rate is partly driven by the fact that only a share of overall debt needs to be reissued in any one year and so the effect on the average (or apparent) interest rate is more modest. An increase in interest rate of 50 basis points has a modest impact in the first year if 20% of the debt is rolled over every year: for example with debt ratio at 100% and a 20% rollover, 50 basis points increase means an additional 0.1% increase in deficit/debt. Nevertheless, in difficult times, there have been sizeable increases in the apparent interest rate that can be observed in the data. For example, between 1974 and 1975 the apparent interest rate increased from 15.7 to 22.2 in Denmark, while it increased from 8.3 to 15.2 in Portugal between 1980 and 1981. Conversely to these large sharp increases, decreases are often more gradual even when sustained, as was the case for the countries with higher yields at the entry in the EMU.

([116]) Of course, other variables such as the conduct of monetary policy also affect this term.

([117]) Eyraud and Weber (2012) provides evidence that given markets' concerns about short-term growth, high fiscal multipliers may imply that deficit reductions entail increases in sovereign CDS spreads.

Graph III.3.6: **Confidence effects on debt dynamics - a) low persistence , b) high persistence - first-year m=1,5**



Source: Commission services.

multipliers' values. ([118]) The risk-premium's reaction to consolidation depends on many variables of different nature, from the degree of risk aversion to the long-term sustainability of public finances. These can be proxied by a combination of the cyclically adjusted balance and the debt to GDP ratio expected at a certain horizon h.

In the present simulation it is assumed that the change on average effective interest rates is driven by the risk premium so that the change of the average effective interest rate r_i due to a consolidation a is expressed as

$$\frac{dr_i}{da} = \mu + \gamma \frac{db_{i+h}}{da}_{|dr=0}$$

where μ can be interpreted as combining the yield sensitivity to the structural balance, growth perspectives, and expectation-driven factors in general while γ represents the yield sensitivity to the debt level and h refers to the horizon considered by the financial markets, where h=1 indicates that markets look at the debt in the year of the consolidation. ([119]) Thus the change in government yields from a consolidation is modelled as a function of the shock to interest rates that happens immediately, which can be function of the improvement in deficit and/or of market sentiments, and from the value of expected debt. A high sensitivity of interest rates to the debt ratio could lead to make consolidations self-defeating and act as a driver for a divergent debt ratio. This could happen if a consolidation increases the debt ratio due to the denominator effect, which then leads to increase in interest rates which then further increase the debt ratio and so on. A positive μ means that the decrease in the risk premium due to the decrease in structural deficit does not offset the increase in central bank's real rates due to deflationary pressures.

The way $\frac{dr_i}{da}$ is expressed allows for the impact of quantitative effects of consolidation on interest rates to be easily factored into the analysis. Such effects can be very relevant in crisis situations and are not well modelled in linear models. The formula does, however, have the disadvantage that it does not take into account the spreading of the

([118]) Certain versions of QUEST also integrate risk premium based on debt levels.

([119]) It is to be remarked the assumption that financial markets are assumed not to take into account the consequences of their own behaviour on debt evolution. This is a simplifying assumption which has very reduced practical impact if myopia is interpreted as backward-looking behaviour or if the horizon in question is as short as one or two years. Notice that the formula could apply to new emissions as well, without substantive

changes of government yields on the rest of the economy – or de facto it assumes that such effects are relatively small – because the path of the multiplier is independent from the reaction of interest rates. ([120]) Moreover, the linear form of the interest rate function prevents from taking into account thresholds effects, another characteristic which the literature shows being potentially relevant in crisis periods.

Graphs III.3.6a and III.3.6b show the effects for the two cases of low and high persistence of changes in the interest rate on the critical number of years n* under the condition that the first-year multiplier is 1.5. It can be seen that the critical number of years before the debt is reduced to below its starting level in absence of effects on the interest rates remains the same as shown in Graph III.4.4, for the case without interest rates, for changes in the interest rates which are in line with empirical evidence.

To estimate the importance of confidence effects on interest rates, it is possible to consider the size of the change in interest rates which leads to a reduction in the critical number of years before debt falls below baseline, based on the assumption that $\frac{dr_i}{da}$ is negative as market confidence reacts positively to a consolidation. Under an impact multiplier of two (not shown), the value of $\frac{dr_i}{da}$ that allows debt-to-GDP ratios to fall below baseline one year earlier in a high-persistence model is -0.4; this is equivalent to saying that following a structural adjustment of 1% of GDP, the average effective interest rate must fall by 40 basis points. This is in the high part of the value range estimated in the literature, taking into account that the measured impact on yields of 50-80 basis points refers to new debt, while the 40 basis point figure given here refers to the overall average effective interest rate on debt.

([120]) Notice that if interest rates decrease with consolidation, the formula for the change in r reinforces the possibility of undesired effects. In DSGE models multipliers decrease with interest rates.

Myopic behaviour and debt ratio

So far, the possibility of a dynamically undesired effect on debt ratios from consolidation does not emerge out of the models presented and the likely values of key parameters. However, the presence of financial market myopia can change this. This myopia can be seen in the contradictory requirements sometimes made by rating agencies when they refer to the need to consolidate public finances while also noting the adverse effect of negative short term growth prospects in their notation process, without apparently noticing the short term negative relation between the two variables at least in the short term.

To analyse the case in which short-termism of market sentiment influences the debt dynamics, the second part of the equation for $\frac{dr_i}{da}$ in the previous Subsection ([121]) is brought into the picture. This part looks at how yields are affected by the expected level of debt at a certain horizon h assuming baseline rates. Myopia is measured by the numbers of years ahead that the markets looks at (h): if markets are very myopic the changes in interest rates consequent to a consolidation are solely driven by the debt of the year immediately following consolidation, while if markets are extremely rational the interest rates are solely driven by the expected debt ratio at the steady state. Expectations are adaptive in a sense that agents revise them if the actual level of debt differs from what was expected. ([122])

In line with the literature it is assumed that $\gamma>0$; in the analysis it will be used a value of $\gamma = 0.03$ as found in Laubach (2009) and used in European Commission (2010a), and it is assumed that μ lies between -0.3 and 0.3. Thus negative values reflect the normal reaction of yields to consolidation, while positive values represent the case in which interest rates increase with improvements in government balance for reasons that are not related to the debt level.

If interest rate behaviour is modelled according to equation III.10, the variation of debt at the end of

([121]) It is reported as equation III.10 in Box III.1.
([122]) Such an assumption seems more coherent with myopic behaviour rather than rational expectations.

the period n is determined by the cumulative effect of the change in the deficit, market sentiment and other factors subsumed in the constant part, and a cumulative effect from change in expected debt.

Graphs III.3.7 and III.3.8 show how debt dynamics would evolve under different degrees of myopia and different values for the multiplier, under a high-persistence and low-persistence specification respectively. They show that the presence of highly myopic financial markets can play a role in increasing the number of years after which the debt ratio remains above baseline but that only in very extreme cases would they really lead to a debt increase in the medium run.

The panels of these graphs show various examples of debt ratio dynamics, depending on the impact multiplier, under the case in which i) there is a normal reaction of interest rate to consolidation (first row) in line with estimates with a reduction in sovereign yields following a consolidation and an annual increase in yields related to the increase in debt which can be normal (left) or very large (right column;) ii) there is no immediate reaction to consolidation but an annual impact on sovereign risk premia as a function of the debt ratio expected in the first year which can be small, large (second row) or sufficient to lead to an undesired debt dynamics (third row, left column;) iii) there is an immediate shock on average effective interest rates equal to μ (last rows) which is lasting – μ is a constant – that can be interpreted as a negative confidence shock following consolidation. The impact multiplier is assumed to be large at 1.5.

In low persistence models self-defeating consolidations reinforced by the behaviour of the markets can verify only if consolidation does not bring any benefit in terms of immediate yield reduction and each point of increase in the debt ratio entails an increase in the average effective interest rate of 100 basis points, a value more than 30 times larger than average estimated values.

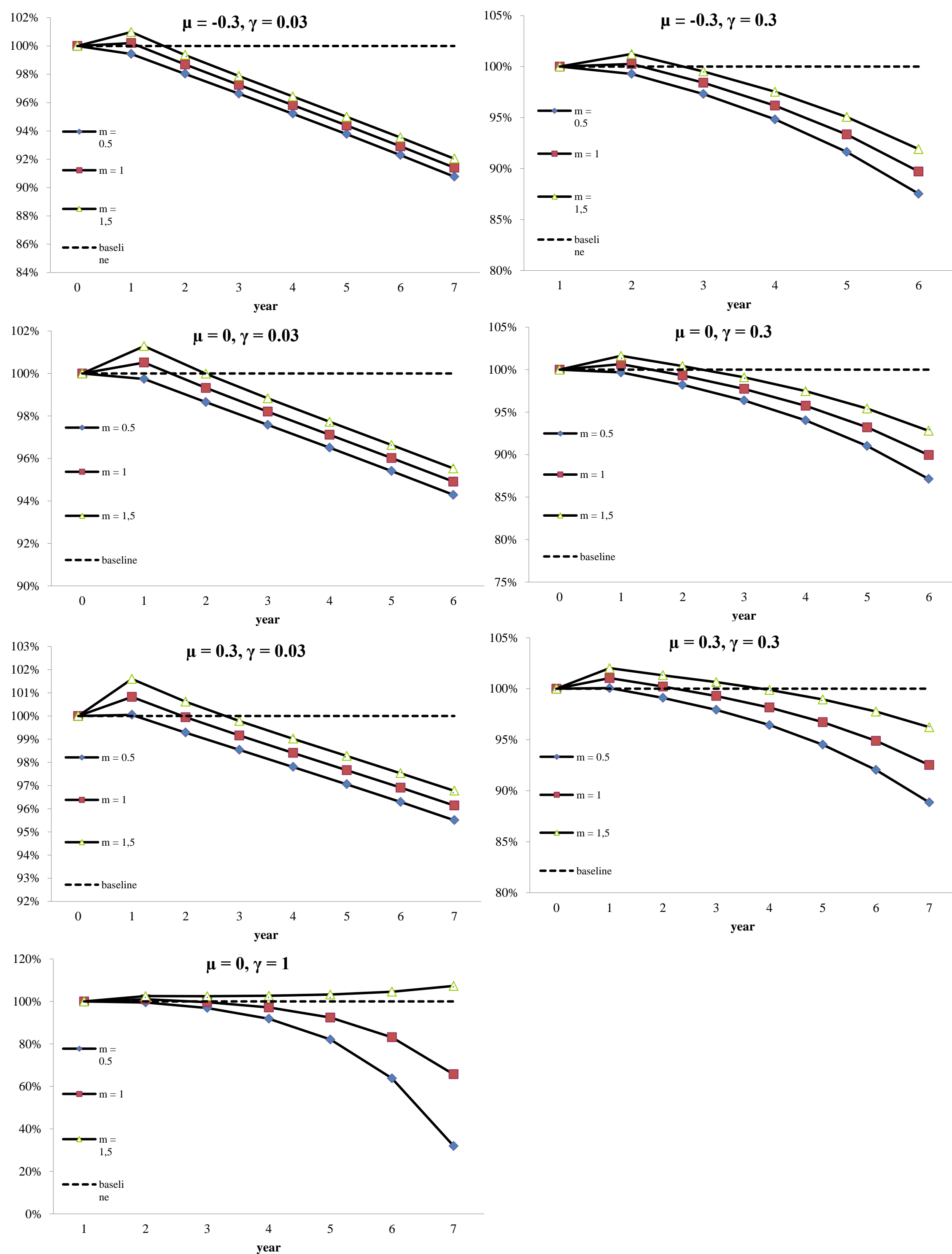
In high-persistence model, n* increases by one or two years if the reaction of the financial markets to consolidation is non-standard. However, consolidations-led debt increases happen only if myopic market reactions are 20 times larger than average estimates, even when the first year multiplier is as high as 1.5.

Under normal average conditions, interpretable as $\mu = -0.3$ and $\gamma = 0.03$, the results of the previous Subsection are confirmed even under extreme market myopia assumed in Graphs III.3.7 and III.3.8.

The existence of undesired effects could in principle be driven by very high impact multipliers (above two) and high persistence in presence of more standard behaviour of the financial markets. Under values for $\frac{dr_i}{da}$ allowing for a consolidation-led debt rise, short-termism in the financial markets can become critical and change the critical number of years before debt-to-GDP falls below baseline through an effect on average effective interest rates. This is shown in Graph III.3.9a and b and in Graph III.3.10. Graph III.3.9 shows that even with large undesired effects in the financial markets a high myopia can have relevant effects. Under a low persistence of the effects of consolidation, when no dynamically undesired effects are generated, n* diminishes from 4 to 2 when the financial markets adopt a medium-term horizon. The horizon of the financial markets becomes more relevant when the persistence is high, because less myopia reduces n* to 3. ([123]) Graph III.3.10 takes an extreme case to show the relevance of financial-markets myopia: a case in which impact multipliers are very high (m=2), persistence is high and financial markets react contrary to expectations. In this case, h=4 is necessary to avoid a fully self-defeating dynamic.

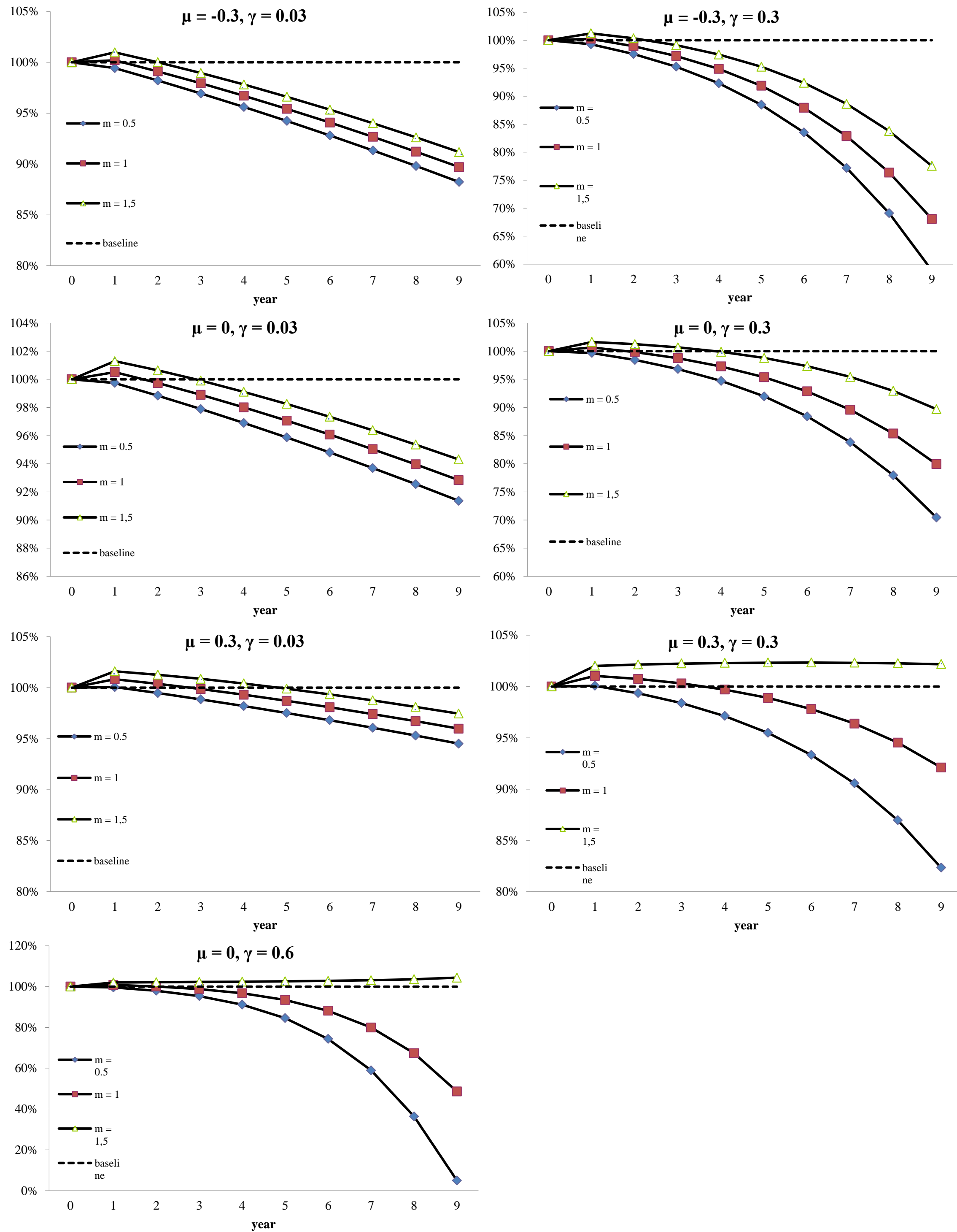
([123]) It should be noted that h=2 already would reduce sensibly n*.

Graph III.3.7: **Debt evolution with myopic financial markets (h=1) – low persistence**



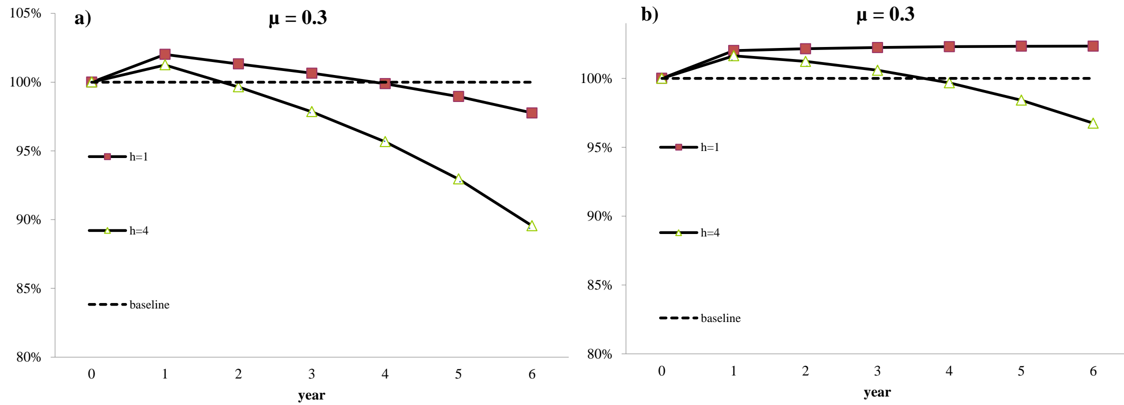
Source: Commission services.

Graph III.3.8: **Debt evolution with myopic financial markets (h=1) – high persistence**



Source: Commission services.

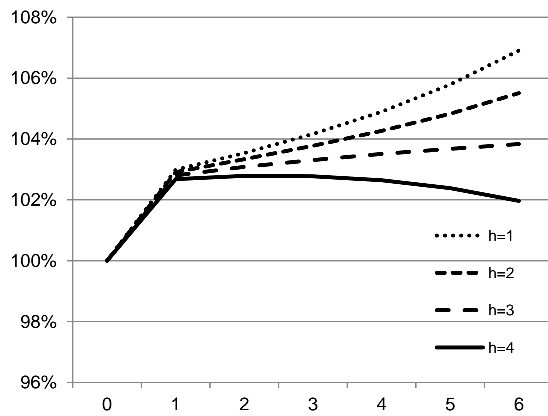
Graph III.3.9: **Debt evolution as a function of market horizon- a) low persistence , b) high persistence - first year m=1,5**



Source: Commission services.

The next Subsection provides a more complete analysis of the effects of myopia on debt dynamics and of the requirements needed to have undesired effects.

Graph III.3.10: **The effect of myopia on debt projections**



Source: Commission services.

Sensitivity to parameters of the year n* in which consolidation is effective

A full assessment of the sensitivity of the critical year n* – the year in which the debt ratio decreases as a consequence of the consolidation – to each individual parameter which affects it cannot be conducted analytically because the effect of each single factor cannot be disentangled easily. A simple, unified view is thus reached by running a least square regression of n* on the value of the parameter within a chosen range. ([124]) The analysis is developed under the same conditions explained in the Box III.3.1 ([125]) The values taken by each parameter – GDP growth, interest rate, primary balance, output gap, initial debt, impact multiplier, multiplier persistence, long-term multiplier, the three parameters driving the reaction of interest rate to consolidation – are set out in Table III.3.2. These values reflect the values found in the literature or the experience of EU countries.

([124]) It is to be noted that n* is an exact function of the parameter An analysis which takes into account the empirical correlation among the parameters – thus giving more weight to more likely combination does not bring very different results.

([125]) The baseline scenario is a steady state. Multipliers are a decreasing function of time and interest rates are a linear function of future debt.

Table III.3.2: **Range of parameters used to assess the sensitivity of the critical year n***

Parameter	Minimum	Maximum
Baseline growth (g)	-2%	2%
Baseline interest rate (r)	-1%	3%
Primary balance (pbal)	-4%	1%
First year multiplier (m)	0.3	1.8
Multiplier persistence (α)	0.5	0.8
Long-term multiplier (β)	-0.1	0.1
Initial debt ratio (b0)	80%	140%
Cyclical elasticity (ε)	0.4	0.5
Impact of future debt on r (γ)	0	0.3
Impact of consolidation on interest rate (μ)	-0.3	0.3
Degree of myopia (h)	0	2

Source: Commission services.

The value of n* associated with each combination of these values is then computed and regressed on the variables that determine the result. Separate estimates are run for different degrees of myopia h.

The result of these regressions ([126]) (not reported) indicate that the parameters that most affect n* are – in decreasing order of magnitude - the impact multiplier, the multiplier persistence, the level of debt, the idiosyncratic shock and the sensitivity of average effective rates to expected solvability. The relevance of the parameter that measures the reaction of interest rates to debt - γ - highly depends on the short-termism of the markets: with short-sighted markets (low h) the higher the sensitivity of rates to solvability, the less effective is consolidation in bringing down the debt ratio under the case in which multipliers are above the critical value. On the contrary with more rational markets the higher is the sensitivity to solvability the more efficient is consolidation. The non-significance of baseline interest rate depends on the fact that changes induced by consolidation are large and affect n* and it should not be interpreted as a claim that sovereign yields are irrelevant.

Table III.3.3 shows the numerical impact on the critical number of years of a change in the variables. The second column, which reports the coefficient of the regression, shows the average impact on n* of the increase of the relevant parameter by 1 unit. The last column is the product of the second and third columns and shows – in the range of the parameter chosen as relevant – the maximum potential impact on the critical year of each parameter in the simulations.

The value of the baseline scenario does not substantially affect the critical year: n^* increases only modestly with baseline growth, average effective rates and output gap, and decreases moderately with the baseline primary balance.

On the other hand, the multipliers are relevant. Impact multipliers have a significant impact on debt dynamics since an increase in multipliers by one point leads to a 6 quarters increase in n*. The

([126]) The regression is
$n^* = a_g g + a_r r + a_{og} og + a_{pbal} pbal + a_m m + a_\alpha \alpha + a_\beta \beta + a_{b0} b0 + a_\epsilon \epsilon + a_\gamma \gamma + a_\mu \mu$
All parameters are very significant, except for the baseline interest rate. This depends on the fact that changes induced by consolidation are large and affect n* and it should not be interpreted as a claim that sovereign yields are irrelevant. Note however that this regression does not represent a true model of the underlying determinants of n*. Given that high number of parameters it is just intended to provide an indication of the average effect of the different parameters.

Table III.3.3: **Potential impact of parameter changes on n***

Parameter	Maximum Range size	Coefficient	Order of magnitude of impact on n*
Baseline growth (g)	5%	0.58 – 0.59	3%
Baseline interest rate (r)	5%	0%	0%
Primary balance (pbal)	6%	0.48 – 0.49	3%
First year multiplier (m)	2	1.4 – 1.6	2.8 – 3.2
Multiplier persistence (α)	0.3	1.5 – 1.9	0.45 – 0.57
Long-term multiplier (β)	0.2	0.5 – 0.6	0.1 – 0.12
Initial debt ratio (b0)	100%	0.9 – 1.2	0.9 – 1.2
Cyclical elasticity (ε)	0.4	2 – 2.3	0.8 – 0.92
Impact of future debt on r (γ)	0.3	-0.2 – 1.3	-0.06 – 0.4
Impact of consolidation on interest rate (μ)	0.6	1.6 – 1.8	1 – 1.1

Source: Commission services.

long-term multiplier and the semi-elasticity of budget balance have a similar impact on n*. ([127])

Finally, a general picture of the previous results shows that:

i) for any given debt-to-GDP ratio, the value of n* increases with the impact multiplier when consolidation has no effect on yields. A three year horizon is reached only with very high debt (140% of GDP) and multiplier at around 1.4.

3.4. COUNTRY ANALYSIS 2011-2020

Sections III.3.2 has considered debt dynamics from a medium-term point of view after Section III.2.1 presented evidence of the value of first-year critical multipliers for the various EU Member States in Table III.3.1. However, in order to extrapolate from the analysis presented and be able to draw conclusions about individual countries, the underlying situation in these countries must be taken into account. Countries with high and/or rapidly increasing debt are likely to be on a non-sustainable path of fiscal policy and need to consolidate government finances – especially when they are under market pressure. Comparing countries on the basis of the critical year only could be very misleading, in that the underlying situation can be extremely different, especially in terms of debt dynamics.

In order to gain a full picture, Tables III.3.4 and III.3.5 present five groups of results for low persistence and high persistence models respectively. Columns two to six show the critical number of years that allow debt ratios to be below baseline following a 1% of GDP consolidation in the 2011 primary structural balance. Second, columns eight to eleven – under the title "n0" – present the number of year that are necessary for the country's debt-to-GDP ratio to return to its 2011 level following an adjustment by 1% of GDP

([127]) Given these result in what follows it is assumed to set real growth, apparent rate, primary balance, output gap and long-term multiplier at zero and the budgetary semi-elasticity at 0.5. Multiplier persistence is fixed at 0.7.

Table III.3.4: Potential impact of a 1% of baseline GDP consolidation on the critical year and return to 2011 debt levels - LP

Low Persistence											
	n*						n0				
Member States	Low m, normal markets	Average m, normal markets	High m, normal markets	High m, only debt effect	High m, myopic markets	Baseline n0	Low m, normal markets	Average m, normal markets	High m, normal markets	High m, only debt effect	High m, myopic markets
BE	1	2	2	2	4	inf	2	2	2	3	5
BG	1	1	1	1	1	inf	3	3	4	4	4
CZ	1	1	2	2	2	inf	4	5	5	5	5
DK	1	1	2	2	3	inf	5	5	6	6	6
DE	1	2	2	2	3	1	1	1	1	1	2
EE	1	1	1	1	1	inf	4	4	4	5	5
IE	1	2	2	2	5	inf	≥10	≥10	≥10	≥10	≥10
EL	1	2	2	2	≥10	inf	≥10	≥10	≥10	≥10	≥10
ES	1	1	2	2	3	inf	≥10	≥10	≥10	≥10	≥10
FR	1	2	2	2	3	inf	4	5	5	6	7
IT	1	2	2	2	6	2	2	2	2	2	3
CY	1	1	2	2	3	inf	3	3	4	4	5
LV	1	1	1	2	2	5	1	1	2	2	2
LT	1	1	1	1	2	inf	2	3	3	3	3
LU	1	1	1	1	2	inf	6	7	≥10	≥10	≥10
HU	1	1	2	2	3	1	1	1	1	2	2
MT	1	1	2	2	3	inf	1	2	2	2	7
NL	1	1	2	2	3	inf	≥10	≥10	≥10	≥10	≥10
AT	1	1	2	2	3	4	2	2	2	3	3
PL	1	1	2	2	2	1	1	1	2	2	2
PT	1	2	2	2	4	8	5	5	5	5	6
RO	1	1	1	1	2	5	2	2	2	3	3
SI	1	1	2	2	2	inf	≥10	≥10	≥10	≥10	≥10
SK	1	1	1	2	2	inf	≥10	≥10	≥10	≥10	≥10
FI	1	1	2	2	2	1	1	1	1	1	1
SE	1	1	2	2	2	1	1	1	2	2	2
UK	1	2	2	2	3	inf	≥10	≥10	≥10	≥10	≥10

Source: **Commission services.**

Table III.3.5: **Potential impact of a 1% of baseline GDP consolidation on the critical year and return to 2011 debt levels - DSGE HP**

High Persistence											
	n*					n0					
Member States	Low m, normal markets	Average m, normal markets	High m, normal markets	High m, only debt effect	High m, myopic markets	Baseline n0	Low m, normal markets	Average m, normal markets	High m, normal markets	High m, only debt effect	High m, myopic markets
BE	1	2	2	3	≥10	inf	2	2	3	4	≥10
BG	1	1	1	1	1	inf	3	4	4	4	5
CZ	1	1	2	2	2	inf	5	5	6	7	7
DK	1	1	3	3	5	inf	5	6	7	8	9
DE	1	2	2	3	6	1	1	1	1	1	2
EE	1	1	1	1	1	inf	4	5	6	6	6
IE	1	2	2	3	≥10	inf	≥10	≥10	≥10	≥10	≥10
EL	1	2	2	3	≥10	inf	≥10	≥10	≥10	≥10	≥10
ES	1	1	2	2	4	inf	≥10	≥10	≥10	≥10	≥10
FR	1	2	2	3	7	inf	5	5	6	9	≥10
IT	1	2	2	3	≥10	2	2	2	2	2	3
CY	1	1	2	2	4	inf	3	4	4	5	6
LV	1	1	1	2	2	5	1	1	2	2	2
LT	1	1	1	1	2	inf	2	3	3	4	4
LU	1	1	1	1	2	inf	6	≥10	≥10	≥10	≥10
HU	1	1	2	3	5	1	1	1	1	2	2
MT	1	1	2	2	4	inf	1	2	2	≥10	≥10
NL	1	1	2	3	5	inf	≥10	≥10	≥10	≥10	≥10
AT	1	1	2	3	5	4	2	2	3	3	4
PL	1	1	2	2	3	1	1	1	2	2	3
PT	1	2	2	3	≥10	8	5	5	5	6	≥10
RO	1	1	1	1	2	5	2	2	3	3	3
SI	1	1	2	2	3	inf	≥10	≥10	≥10	≥10	≥10
SK	1	1	1	2	2	inf	≥10	≥10	≥10	≥10	≥10
FI	1	1	2	2	3	1	1	1	1	1	1
SE	1	1	2	2	3	1	1	1	2	2	2
UK	1	2	2	3	6	inf	≥10	≥10	≥10	≥10	≥10

Source: Commission services.

in the primary structural balance in 2011. Third, column seven gives an indication of the underlying debt dynamic of the EU countries. The projections of the baseline are based on the Commission services' 2012 Spring forecasts (up to 2013), and the macro-economic scenario of the 2012 Ageing Report (see Annex III.1 for details). Column eight indicates the first year in which debt is projected to touch again the debt level of 2011. ([128])

Taking this baseline scenario, five possible parameter configurations are presented. The first three in which average effective interest rates follow a normal market reaction (i.e. they decrease by 30 basis points upon consolidation and increase by 3 basis points with debt), and multipliers are low, average or high (first-year multiplier of 0.5, 1 and 1.5 respectively). The last two consider a high first year multiplier of 1.5 associated with a only debt effect (and no immediate impact from consolidation) and strongly myopic reaction to consolidation by financial markets (both effects induce undesired debt dynamics).

Using high-persistence models as a basis for analysis, it emerges that – if one believes that in this moment first year multipliers are high, for example between 1 and 1.5 – a 1% of GDP consolidation will take maximum three years to show its effects on the debt ratio unless there is an immediate undesired effect of consolidation on interest rates. Countries for which n*=3 are in general high debt countries. This is in line with what was presented in the previous Subsection. However a myopic effect of the financial markets in case of high persistence of the effects of consolidation on GDP not only increase n* in (almost) all cases but can induce a fully reverse dynamic in high debt countries.

These results can then be compared with the corresponding column under "n0", which provides the information relative to the number of years required to return to the 2011 debt ratio, following a 1% of GDP permanent consolidation with respect to the baseline. All countries showing a ≥10 in the optimistic scenario have an underlying diverging debt dynamic: it indicates that even after consolidating the primary structural balance by one percentage point, and correspondingly decreasing

([128]) "Inf" stays for infinity, i.e. the country's debt is diverging. 1 means that the country's debt is converging.

debt, 10 years are not sufficient to bring the debt ratio at the 2011 level. The behaviour of more counter-intuitive cases like Luxemburg, Netherlands, Slovenia and Slovakia are explained by the inner dynamic of ageing costs, which will start having an impact on government balances in the course of the next decade. It is important to note that comparing n0 with the baseline can be misleading: the fact that many countries decrease their n0 from infinity in baseline to two simply by improving their balance by one GDP point does not mean necessarily that these countries will have solved their sustainability (ageing-related) problems with such a small consolidation. In fact n0 is only the first year in which debt decreases back to the level of 2011 after a consolidation. If the dynamic of the ageing costs is increasing in the following years the debt will start increasing again, and this is not captured in the Table.

Comparing Table III.3.4 and Table III.3.5 shows that higher persistence increases n* by one year in many all cases and magnifies the impact of the underlying debt dynamic in case of myopic market behaviour, but that his parameter has a smaller influence than the underlying debt dynamics.

The required total improvement in the structural balance over the period in order for the debt level to return to its 2011 level within nine years (for the countries that present a diverging dynamic) is in general below three points.

Table III.3.6 presents the parameter values assumed for the simulation.

Table III.3.6: **Parameter values assumed for the simulation**

	Low m, normal markets	Avearge m, normal markets	High m, normal markets	High m, no confidence effect	High m, perverse markets
m	0.5	1.0	1.5	1.5	1.5
alpha			0.5 or 0.8		
beta			0.1		
mu		-0.3		0.0	0.3
gamma		0.03		0.03	0.3
h		3		3	1

Source: Commission services.

Box III.3.1: **Debt evolution as a function of consolidation**

The present Box presents the derivation of debt dynamics underlying the formulas presented in the main text. In what follows, higher case letters are in level, lower case letters in ratios to GDP or growth rates. All variables are real and during period i, Y_i is GDP, CAB_i is the cyclically-adjusted general government balance, $CAPB_i$ is the cyclically-adjusted primary balance, CB_i is cyclical component of the balance, B_i is government debt at the end of year i, g_i is GDP growth in i and r_i is the apparent interest rate paid on the stock of government debt in year i.

By definition the general government balance BAL is the sum of a structural component and a cyclical component. Taking ratios to GDP the balance, expressed as the sum of cyclically adjusted balance and cyclical balance is

$bal_i = cab_i + cb_i$

where the cyclical part of the budget varies proportionally to the percentage difference of GDP to baseline, with a coefficient equal to the semi-elasticity of budget balance ϵ. In fiscal policy analysis the tradition is to consider percentage difference from potential GDP.

In what follows the annual structural effort is represented by a diminution in $capb_i$. A permanent consolidation is thus a change in $capb_i$ which is constant in terms of ratio of GDP, i.e. $dcapb_i = dcapb_{i-1} = da$ where the notation means that the change in capb has been put in place at the first period so that the variation of the cyclically-adjusted primary balance remains constant with respect to baseline throughout all years from to onwards.

In the literature, the fiscal multiplier m_i of year i is defined as the variation of GDP over the decrease in structural primary balance i.e. $m_i \equiv -\frac{dY_i}{dCAPB_i}$

For the purpose of notational simplicity it is also useful to define, first, the adjusted fiscal multiplier $\widehat{m}_i$ as the percentage variation of GDP over the decrease in structural primary balance-to-GDP ratio, i.e.

$\frac{dY_i/Y_i}{dcapb_i} = \frac{dY_i/Y_i}{da} = -\frac{m_i}{1+capb_i m_i} \equiv -\widehat{m}_i$

and, second, the fiscal multiplier of the growth rate, λ_i, representing the variation of growth from baseline growth over the decrease in structural primary balance-to-GDP ratio, i.e. $\lambda_i \equiv -\frac{dg_i}{dcapb_i} = (1+g_i)(\widehat{m}_i - \widehat{m}_{i-1})$ with the convention that $\widehat{m}_0 = 0$ so that the fiscal multiplier growth rate in the period in which the consolidation measures are taken depends only on the first year fiscal multiplier. This will allow analysing the behaviour of the evolution of the debt ratio following a permanent adjustment in the structural primary balance. Notice that $\widehat{m}_t$ corresponds to the impulse-response function used to analyse the effects of fiscal (or other) shocks in VAR or DSGE models.

It should be noticed also that if the structural primary balance of the basic scenario is small, and given that the growth rate is usually small enough, this implies that $\widehat{m}_i$ as well as λ_i in the first period are well approximated by the fiscal multiplier

(Continued on the next page)

Box (continued)

as usually defined, and that λ_i in the following periods can be approximated by the change in the multipliers.

If stock-flow adjustments are null, debt-to-GDP ratio evolves with the following dynamics:

$$b_i = \frac{b_{i-1}(1+r_{i-1})}{1+g_i} - pbal_i \cong b_{i-1}(1+r_{i-1}-g_i) - pbal_i$$

To facilitate the readability of the formulas it is supposed that the year of consolidation is year 0. Debt-to-GDP ratio at the end of period n is thus:

$$b_n = b_0 \prod_{i=1}^{n}(1+r_{i-1}-g_i) - \sum_{i=1}^{n} pbal_i \prod_{j=i+1}^{n}(1+r_{j-1}-g_j) \text{(Eq.III.1)}$$

It is thus possible to compute the variation of debt-to-GDP ratio in year n following a permanent consolidation made in year 1, where as a first approximation it has been assumed that interest rates do no not vary with consolidation.

$$db_n = -b_0 \sum_{i=1}^{n} dg_i \prod_{j=1,j\neq i}^{n}(1+r_{j-1}-g_j) - \sum_{i=1}^{n} dpbal_i \prod_{j=i+1}^{n}(1+r_{j-1}-g_j) + \sum_{i=1}^{n} pbal_i \sum_{k=i+1}^{n} dg_k \prod_{j=i+1,j\neq k}^{n}(1+r_{j-1}-g_j)$$

(Eq. III.2)

Notice that since $dcapb_i = da$ is constant and the derivative of the cyclical balance to the structural adjustment can be computed to be $\frac{dcb_i}{da} = -\epsilon\widehat{m}_i$ if the baseline GDP is assumed to be close to potential GDP, the derivative of government primary balance-to-GDP ratio with respect to the annual structural adjustment is

$$\frac{dpbal_i}{da} = 1 - \epsilon\widehat{m}_i$$

The derivative of debt-to-GDP ratio at the end of year n with respect to the annual structural adjustment is thus:

$$\frac{db_n}{da} = b_0 \sum_{i=1}^{n} \lambda_i \prod_{j=1,j\neq i}^{n}(1+r_{j-1}-g_j) - \sum_{i=1}^{n}(1-\epsilon\widehat{m}_i) \prod_{j=i+1}^{n}(1+r_{j-1}-g_j) - \sum_{i=1}^{n} pbal_i \sum_{k=i+1}^{n} \lambda_k \prod_{j=i+1,j\neq k}^{n}(1+r_{j-1}-g_j)$$

Let's assume that the economy was at the steady-state before the adjustment was made, meaning that initial balance is constant, nominal growth is constant and equal to potential growth and the apparent interest rate is constant. The marginal impact of consolidation on the debt-to-GDP ratio at the end of year n becomes:

$$\frac{db_n}{da} = b_0 \sum_{i=1}^{n} \lambda_i (1+r-g)^{n-1} - \sum_{i=1}^{n}(1-\epsilon\widehat{m}_i)(1+r-g)^{n-i} - pbal \sum_{i=1}^{n} \sum_{k=i+1}^{n} \lambda_k (1+r-g)^{n-i-1}$$

(Eq. III.3)

(Continued on the next page)

Box (continued)

With some algebraic manipulation Equation III.3.4 discussed in Section III.4 is obtained:

$$\frac{db_n}{da} \cong \underbrace{\frac{\hat{m}_n(1+g)}{1+r-g}[b_0(1+r-g)^n - n \cdot pbal] + pbal(1+g)\sum_{i=1}^{n}(1+r-g)^{n-i-1}\hat{m}_i}_{cumulative\ effect\ of\ growth\ on\ debt\ evolution} + \underbrace{\epsilon\sum_{i=1}^{n}(1+r-g)^{n-i}\hat{m}_i}_{cumulative\ effect\ of\ growth\ on\ balance} \underbrace{-n}_{cumulative\ ajustment}$$

The first term is the cumulative effect of the change in growth during n years to the debt ratio evolution. The second term is the cumulative effect of the change in balance on debt-to-GDP ratio. The third term is the cumulative effect of the consolidation.

It is important to notice that this formula calculates the deviation of debt with respect to the baseline scenario – considered here as the steady-state scenario – due to the permanent variation in structural primary balance. It takes into account variations in growth rates, primary balance and GDP level that the permanent consolidation – or stimulus – entails.

he short-term case corresponds to n = 1, in which case the formula becomes Equation III.5):

$$\frac{db_1}{da} = \frac{\hat{m}_1(1+g)}{1+r-g}(b_0(1+r-g) - pbal) + \left(\epsilon + \frac{pbal(1+g)}{1+r-g}\right)\hat{m}_1 - 1 = (b_0(1+g) + \epsilon)\hat{m}_1 - 1$$

We deduct the condition on the impact multiplier for the ratio to decrease on impact:

$$\frac{db_1}{da} < 0 \Rightarrow \hat{m}_1 < \frac{1}{b_0(1+g)+\epsilon}$$

$\hat{m}_1$ for small g becomes the formula in the text.

DSGE-type of models

If one assumes that the shape of the impulse-response function follows the typical DSGE result, the path of the adjusted multiplier $\hat{m}$ can be approximated by the following equation:

$$\hat{m}_i = (m-\beta)\alpha^{i-1} + \beta$$

(Eq. III.6)

With $0 < \alpha < 1$ and no assumption on the sign of β the long-run impulse response of GDP to fiscal consolidation. The formula allows representing the situation in which the effect of present consolidation decreases through time. No assumption is made on the sign of the long-run multiplier: a negative figure then

(Continued on the next page)

Box (continued)

which hysteresis effects (see for example de Long and Summers (2012)) are present. A positive one represents the situation in which consolidation is made via cuts in government consumption or increases in property taxes or a situation in which interest rate are lowered by consolidation.
Substituting the function for $\widehat{m}_i$ into the previous formula gives

$$\frac{db_n}{da} = \frac{(m\alpha^{n-1}+\beta)(1+g)}{1+r-g}[b_0(1+r-g)^n - n \cdot pbal] - n + [pbal(1+g) + \epsilon(1+r-g)]\left[m\alpha \frac{(1+r-g)^{n-1}-\alpha^{n-1}}{1+r-g-\alpha} + \beta \frac{(1+r-g)^{n-1}-1}{r-g}\right]$$

(Eq. III.7)

Interest rates

It is often argued that consolidation or stimulus measures have an impact on yields, influencing the future path of debt. Indeed, if we assume that apparent interest rates paid on the stock of debt vary with the implementation of a variation of the structural primary balance the overall variation of the debt-to-GDP ratio at the end of period n becomes (Equation III.8):

$$\frac{db_n}{da} = \frac{db_n}{da}_{|dr=0} + \underbrace{b_0(1+r-g)\sum_{i=1}^{n}\frac{dr_{i-1}}{da} - pbal\sum_{i=1}^{n}(1+r-g)^{n-i-1}\sum_{k=i+1}^{n}\frac{dr_{k-i}}{da}}_{cumulative\ effect\ of\ apparent\ interest\ rate\ on\ debt\ evolution}$$

Where $\frac{dr_i}{da}$ is the variation of the apparent interest rate at period i and $\frac{db_n}{da}_{|dr=0}$ is the debt-to-GDP variation calculated in the previous section with constant interest rates. A negative $\frac{dr_i}{da}$ indicates that consolidation effort improve market's confidence in government bonds and reduce yields. To describe the variation of yields, as a function of debt, deficit, market expectations and market short-termism is expressed as

$\frac{dr_i}{da}$

yields vary by assuming that they depend on the expected solvability of the government given the level of rates. Yields depend on the expected level of debt at a certain horizon h assuming baseline rates: a small h means that financial markets are short-sighted and high h means that financial long-sighted. Expectations are adaptive in a sense that agents revise them if the actual level of debt differs from what was expected. We thus have:

$$\mu_i = \frac{dr_i}{da} = \gamma_h \frac{db_{i+h}}{da}_{|dr=0}$$

(Eq. III.9)

(Continued on the next page)

Box (continued)

μ is the yield sensitivity to structural primary balance, growth perspective and other external factors that affect confidence and γ_h is the yield sensitivity to the debt level.[1]

The variation of the debt-to-GDP ratio $\frac{db_n}{da}$ at the end of the period n becomes (Equation III.10):

$$\frac{db_n}{da}_{|dr=0} \underbrace{+ b_0(1+r-g)\gamma_h \sum_{i=1}^{n-1} \frac{db_{i-1+h}}{da}_{|dr=0} - pbal\,\gamma_h \sum_{i=1}^{n} (1+r-g)^{n-i-1} \sum_{k=i+1}^{n} \frac{db_{k-1+h}}{da}_{|dr=0}}_{cumulative\ effect\ of\ apparent\ interest\ rate\ on\ debt\ evolution}$$

$$=$$

$$= \frac{db_n}{da}_{|dr=0}$$

$$\underbrace{+ b_0(1+r-g)\mu n - \frac{pbal\mu}{r-g}\left[(1+r-g)^n(n-1) - (1+r-g)\frac{1-(1+r-g)^{n-1}}{g-r}\right]}_{cumulative\ effect\ of\ change\ in\ market\ sentiment}$$

$$\underbrace{+ b_0(1+r-g)\gamma_h \sum_{i=1}^{n-1} \frac{db_{i-1+h}}{da}_{|dr=0} - pbal\,\gamma_h \sum_{i=1}^{n} (1+r-g)^{n-i-1} \sum_{k=i+1}^{n} \frac{db_{k-1+h}}{da}_{|dr=0}}_{cumulative\ effect\ of\ change\ in\ expected\ debt}$$

[1] It is to be remarked the assumption that financial markets are assumed not to take into account the consequences of their own behaviour on debt evolution. This seems coherent with the assumption of myopic behaviour.

4. CONCLUSIONS

The present Part has looked at the possibility of counter-intuitive effects of consolidations, whereby consolidations would lead to an increase rather than a decrease in the debt burden. It has shown that the risks of such effect to arise from consolidation in the present context are overstated under plausible assumptions, although over the short-term increases in the debt-to-GDP ratio may be observed, driven by the denominator effect. Such debt increases are in most cases short-lived and followed by a fall in the debt ratio below the baseline of unchanged policy. In other words, over the medium-term, consolidations are generally successful in reducing the debt-to-GDP-ratio.

More specifically, a simulated simple empirical model was presented which showed that the presence or absence of counter-intuitive effects from consolidations on debt dynamics is primarily driven by the size of the GDP multiplier. Chapter III.2 presented the likely range of the multipliers and Chapter III.3 discussed the implications that these values might have on debt dynamics. The range was based on the existing economic literature; however it is likely that one-year multipliers are larger in the current crisis period than in normal times. This is borne out by both of the empirical evidence based on different econometric techniques and of a reasoned analysis of the factors that increase the value of the multipliers in model-based assessments. Chapter III.3 has shown that, for normal values of estimated cyclical elasticities and at the debt levels currently observed in most of the EU countries, with such large crisis multipliers, debt is likely to increase following consolidation in the short run.

It is however shown that for high but plausible values of the multipliers, such counter-intuitive effects are short-lived unless the multipliers have a high persistence – which can happen only in cases where the fiscal adjustments are repeatedly non-credible– or if effects on interest rates are high and contrary to what is normally expected in consolidations. A fully self-defeating dynamic would only be generated under very unlikely configurations, i.e. situations in which multipliers are very large and interest rates rise significantly (and counter-intuitively) due to the consolidation and debt developments. A high degree of financial market myopia is also required for these effects to exist.

Finally, some calculations are performed taking as baseline current economic projections for EU countries. They first show that the consolidation-induced debt increase would end within three years or less, with the high figures holding mainly for high-debt countries. Second, the Part also shows that a number of EU Member States have underlying diverging debt dynamics. This means that at according to the scenario used here there is no expectation that debt ratios will return to current levels within the next decade unless more consolidation is implemented. However, given the peak levels of debt ratios observed in the EU today and the development in fiscal governance (see Part II), a ten-year horizon for debt to revert to current levels is far too long and cannot be guidance for EU countries.

The simulation-based analysis proposed in Chapter III.3 has a main drawback, in that it assumes that the relation between the risk premia paid on sovereign debt and fiscal multipliers is relatively small. Such an assumption can be problematic as multipliers tend to be large when real interest rates increase with consolidations. In the case in which real interest rates increase with consolidation, the negative impact on growth is larger which implies that a consolidation will take a long time to bring debt below baseline. The prime example for interest rates increasing with a consolidation is provided by the case in which factors affecting financial markets that cannot be modelled - for example if financial markets come to believe that consolidation will be reversed based on political economy reasons. This could entail an increase in risk premia offsetting the action of monetary policy.. This simplifying assumption is justified as a first approximation in the short run. Moreover it is to be noted that, in presence of a normal reaction of financial markets to consolidation. An initial improvement in sovereign yields followed by an increase of yields as a function of debt ratio would rather imply an initial diminution in real rates thus reducing the undesired effect on the debt dynamics. The assumption made in the text therefore is favourable to the self-defeating consolidation argument, because the transmission of lower interest rates would reduce the negative effects of consolidation. The results found here constitute therefore a bound to the possibility of having self-defeating consolidation strategies.

The present Part does not answer to the question of whether there is a case in favour of immediate consolidation. The answer would in substance rely on the belief concerning the reaction of interest rates to consolidation and at the same time on the beliefs concerning the underlying behaviour of interest rates. If there exist threshold levels of debt at which the market reacts with large and sudden increase in risk premia so that baseline interest rates increase quickly, then improvements in the primary structural balance bring down the risk-premium for normal values of the parameters and markets do not display extreme myopic behaviour.

A second argument relies on the behaviour of multipliers with time. Even where it is believed that the impact of consolidation on GDP is relatively persistent, the argument in favour of anticipating consolidation remains. This is because if multipliers are very resilient and the baseline scenario is one in which debt is increasing, the future critical multiplier can be lower as its value crucially depends on the debt level at the beginning of consolidation. Moreover, if there are threshold effects from the debt level, a larger consolidation would be required in the future. Although in the present Part the illustrative consolidation was standardised at 1% of baseline, the size of consolidation matters in influencing the negative impact on growth and debt ratios.

A final issue that was not discussed in the Part is the effect of repeated consecutive consolidations. If consolidations are repeated, especially in periods where multipliers are large and persistent, the effects on the economy tend to cumulate along the line and can, in presence of myopic behaviour of financial markets, bring to debt increases. This could be the case, for example, if the target of fiscal policy was set in terms of headline variables, like headline debt or deficit ratios and not in terms of cyclically adjusted or structural figures. In this situation it is possible that the scenario consolidation-debt increase-consolidation-further debt increase takes place as far as the current multiplier is higher than the critical multiplier. The same spiral can happen with deficits, but for sensibly higher values of the multipliers. It is therefore relevant that policy recommendations are formulated in terms of a (path of) structural balances so that, once measures are taken, sufficient time is left for the effects of the consolidation measures to deploy fully.

ANNEX 1
Assumptions underlying the baseline scenario in section III.5

The projections below are based on the Commission services' spring 2012 forecast (up to 2013), and the macro-economic scenario of the 2012 Ageing Report: Underlying assumptions and projection methodologies. The macroeconomic scenario has been brought into line with recent decisions in ECFIN on producing a unified set of medium-term to long-term projections. This decision entails that, as a general rule, the output gap is assumed to close in t+5, after which the potential growth rates converge linearly to the AWG baseline scenario by t+10. Hence, up to 2021, the spring forecast was linked linearly to the baseline scenario in the 2012 Ageing Report (European Economy 2/2009). Beyond 2021, the scenarios discussed below assume a return of (potential) growth to the long-term projection in the 2012 Ageing Report.

The following additional assumptions are also made:

- the increase in age-related expenditure is taken from the so called 'AWG reference scenario' from the 2012 Ageing Report by the European Commission. Age related expenditure refers here to the "strictly" age-related expenditure i.e. excluding unemployment benefits expenditure. For Germany and France, the change for the long-term care expenditure component has been projected through a specific scenario in which the unit costs are assumed to be constant in real terms.

- the primary balance is adjusted by using the budget sensitivities (OECD estimates) in the period until the output gap is assumed to be closed (by 2016 as a rule);

- the inflation rate (GDP deflator) converges linearly to 2% in 2016 (or 2018), when the output gap is closed and remains constant thereafter, for all countries;

- zero stock-flow adjustment after 2013; this means no further purchases of financial assets or recapitalisations of financial institutions, nor disposal of such assets.

- Data (extracted from Bloomberg and elaborated by DG ECFIN staff) on maturing public debt (debt with residual maturity up to 1 year) are used to have a differential treatment in terms of interest rates applied to different debt "vintages" (debt that is rolled over or newly issued in the current year, versus debt that has been issued in the past and is not maturing in the current year).

- Two different assumptions are made on the long-run value to which the two interest rates (short-term and long-term) converge. Given the AWG agreed assumption of real interest rates linearly converging to 3%, we project representative long-term and short-term interest rates as converging respectively to a value above and a value below 3% (in real terms) by 2016 in a way that the (real) implicit interest rate on maturing debt (new and rolled-over) is 3%.

Part IV

Fiscal decentralisation in the EU - main characteristics and implications for fiscal outcomes

SUMMARY

In recent years, EU policymakers have increasingly raised the concern that the behaviour of subnational governments may be one of the factors hindering the achievement of budgetary targets at general government level. This issue has captured increasing interest, in part because subnational governments' responsibilities with respect to the provision of public goods and services are expanding and they are being assigned additional revenues to finance their spending. Budgetary targets set within the EU fiscal surveillance framework apply to the whole of general government – which consists of central government, subnational governments and social security funds whereas the responsibility for their achievement rests solely on central government. This Part of the report aims at assessing the extent and main features of fiscal decentralisation across EU Member States as well as the relationship between fiscal decentralisation and fiscal outcomes at general government level. It attempts to determine whether and under what conditions decentralisation can worsen overall fiscal balances. The Part is structured along three chapters.

Chapter IV.1 provides a cross-country comparison of fiscal decentralisation according to a set of indicators that are constructed using Eurostat data. It characterises EU decentralisation arrangements according to the following aspects: (i) the size of expenditure decentralisation, (ii) the size of revenue decentralisation, (iii) the composition of expenditure decentralisation by government function (e.g. education, health care etc.) and by type or economic function of expenditures (transfers, investments etc.), (iv) the composition of subnational revenues, essentially distinguishing taxes and transfers from the central government, (v) the degree of subnational financial responsibility (the share of subnational expenditures covered by subnational taxes and fees, as opposed to transfers).

The Chapter shows that there is a trend towards increasing fiscal decentralisation across most of the EU from both the expenditure and revenue sides, albeit with heterogeneity across countries. The statutory classification of countries as federal or unitary only imperfectly reflects the effective degree of decentralisation, as significant decentralisation can also exist in formally unitary countries (for instance, Nordic countries.) Across the EU, transfers slightly predominate over taxes as main revenue source of subnational governments. The rate of coverage of subnational expenditures by tax revenues is relatively low (less than 50% in most Member States) and has not increased on average since 1995 even if the trends are very diversified across Member States. The revenue composition is a key aspect as a greater reliance on own resources compared to transfers should strengthen the incentives of subnational governments to behave in a fiscally responsible way. Subnational deficits are not negligible in several Member States, with Spain having the highest deficits. Conversely, subnational debt levels are mostly low and generally correspond to less than 10% of GDP in most countries, although Belgium, Spain and Germany have higher levels. The actual size of subnational fiscal imbalances is to some extent masked by the tendency of central governments to provide additional transfers to cover the gap between expenditures and revenues of subnational governments.

Chapter IV.2 enriches the assessment by comparing and contrasting key elements of national fiscal decentralisation arrangements across the EU based on country descriptions compiled by ECFIN services. This exercise provides significant added value by covering several aspects which cannot be captured through quantitative data, such as the number and legal status of the different subnational tiers, the effective degree of subnational tax autonomy (as opposed to simple assignment of receipts from national taxes), the different typologies of transfers and the criteria used to determine their amounts and the fiscal rules and budgetary procedures applying to subnational governments (including the monitoring, enforcement and possibilities of bailouts of subnational entities in fiscal distress).

The Chapter highlights that EU Member States have generally increased their decentralisation in recent decades – and this is also true of traditionally centralised countries. Some common patterns emerge with respects to the functions that are more frequently devolved to subnational tiers. These include not only functions with a markedly local dimension (e.g. local networks and infrastructure, local economic development and territorial planning) but, in several cases, also education, social protection, environment protection, housing and health care, albeit often with shared competence with the central

government and/or with responsibilities restricted to the implementation of national regulations. Autonomous subnational taxes are quantitatively important in several EU Member States, mainly those which are more decentralised in general and property tax is the most widespread own revenue source of subnational governments.

The weight of shared taxes (without subnational government having the freedom to change tax parameters) is large in most New Member States (but also in AT, PT, EL and BE) and mainly concern the sharing of the personal income tax. Transfers account for a significant share of subnational revenues in a majority of Member States. General transfers often coexist with those earmarked to specific expenditures such as investment spending. Funds are generally allocated on the basis of spending needs and to correct for differences in revenue-raising capacity across subnational entities (equalising transfers). This may weaken subnational governments' incentives for cost-effective provision of services and fiscal discipline. In terms of their overall budgetary discipline, subnational governments are in most cases subject to rules constraining their fiscal behaviour, such as 'golden' rules restricting deficits to capital expenditures or numerical borrowing limits. Budgetary coordination across government tiers exists in more decentralised countries, although its effectiveness in achieving national fiscal targets depends on its design and implementation. Generally, default of subnational entities in fiscal distress is *de facto* ruled out, although central government 'bailout' often comes at the price of much tighter central control on subnational policies.

Chapter IV.3 analyses the relationship between fiscal decentralisation and fiscal outcomes of general government. This is done by testing the impact of the main indicators of fiscal decentralisation introduced in Chapter IV.1 on the primary balance, expenditures and revenues of the general government in the EU through econometric regressions. Results show that (i) expenditure decentralisation leads to a higher primary balance, through lower expenditures and higher revenues; (ii) the impact of fiscal decentralisation largely depends on the way subnational governments are financed: if their revenues come predominantly from taxes and fees (and, among those, from autonomous taxes) the effect of decentralisation on the budget balance is improved, whereas if they mainly come from transfers decentralisation is more harmful for the fiscal balances; (iii) high coverage of subnational expenditures with taxes and fees (rather than with transfers) is associated with an improved budget balance, reflecting a negative effect on expenditures and a positive one on revenues; (iv) with respect to fiscal rules applying to subnational governments, borrowing rules appear to partly counteract the adverse effect of transfers on fiscal balances, whereas no significant effect is found for balanced budget rules.

Overall, the analysis in this part suggests that fiscal decentralisation is not harmful for budgetary discipline at the general government level *per se*, although it is likely to have an adverse effect if predominantly financed by transfers from the central government and if not matched by subnational governments having the responsibility for financing the expenditures through their own taxes and fees. This is in line with theoretical predictions underlining the risk of a 'soft-budget constraint' associated with a high reliance on transfers, as subnational governments can justify their deficits by the lack of own revenue sources and so credibly threaten the central government to drastically cut their services if the centre does not provide them with additional transfers.

Therefore, the policy concerns over possible adverse implications on budget balances should not focus on decentralisation as such but on a 'bad' design of decentralisation, i.e. one which is not accompanied by subnational financial responsibility. Finally, comparison of existing cross-country data with information in country descriptions underlines the complexity and multi-dimensionality of national fiscal decentralisation arrangements in the EU and highlights the fact that the cross-country data are not sufficiently rich to provide a comprehensive overview of the different aspects of fiscal decentralisation and the implications that it can have for budgetary discipline and economic efficiency.

1. MAIN TRENDS OF FISCAL DECENTRALISATION IN THE EU

1.1. INTRODUCTION

According to a large literature and several economic indicators, there is a widespread trend across advanced economies, including many EU Member States, to increasingly shift the responsibility for key public sector functions from the central government to subnational sectors of government. Although the extent and pace of this process varies across countries, it is no longer confined to federal countries and increasingly involves traditionally centralised ones.

With respect to a specific government function, the transfer of competence can be either partial – where the central government retains the responsibility of the overall regulation while assigning the task of management and implementation to subnational governments – or total. Decentralisation can concern both expenditure and revenues, with subnational governments being increasingly assigned a number of revenue sources, mainly in the form of grants and taxes, in order to match, at least partially, growing expenditure responsibilities with corresponding means of financing. This Chapter aims at describing the extent of fiscal decentralisation across EU Member States based on Eurostat data. ([129]) It covers both the expenditure and revenue sides of decentralisation. For both sides it provides evidence on the aggregate extent of decentralisation (subnational governments' shares in total revenue and expenditure of general government), as well as a more detailed assessment based on available break-downs of aggregate data.

With respect to expenditure, the relative weight of subnational governments across different government functions (health, social protection etc.) and types of expenditures (consumption, wages, capital expenditures etc.) is assessed. However, available data do not allow to assess whether the competence assigned to subnational governments on their share of expenditure is total or partial. With respect to subnational government revenues, the break-down between taxes and transfers from the central government is provided.

([129]) Data cover until 2010 as this was the latest year available at the time of data extraction (February 2012) for the purpose of drafting the report.

Unfortunately, Eurostat does not provide data on the share of "own-source" taxes of subnational governments, i.e. taxes which are set at subnational level, as opposed to tax revenues which are simply transferred from the central government, e.g. within tax sharing agreements. Similarly, no further breakdown of transfers, e.g. general vs. earmarked, is available. ([130])

Moreover expenditure and revenue data are compared to assess whether and to what extent the decentralisation of spending functions has been matched by provision of adequate means of financing to subnational governments. Finally, the developments of debt and deficits at subnational level are also described.

1.2. DECENTRALISATION OF EXPENDITURES

1.2.1. Overall degree of decentralisation

The overall decentralisation of public expenditure can be measured by the share of subnational government spending in total general government expenditure. This is presented in Table IV.1.1, where subnational government expenditure is given in columns 2 to 6 as percentage of total general government expenditure and in columns 7 to 11 as a percentage of GDP. The Table shows the levels of expenditure for the earliest and latest year available (1995 and 2010, respectively) and for 2007, which was the last year before the sovereign debt crisis. It also presents the changes over the 1995-2007 and 2007-10 periods. Graphs IV.3.1 and IV.3.2 show the share of subnational spending in overall general government spending for 2010 and in terms of the change over the 1995-2010 period, respectively, in order to ease cross-country comparisons.

The Table and Graphs present Eurostat data. In order to properly interpret the data presented, a qualification is needed. For most EU Member

([130]) However, information on both of these aspects is to some extent provided by country fiches describing fiscal decentralisation arrangements in individual EU Member States. These have been compiled by ECFIN services based on a common template and questionnaire and are available in Annex 1. Chapter IV.2 below provides a summary of them. Furthermore, the OECD Secretariat produced indicators on effective tax autonomy which are used in the analysis of chapter IV.3 below.

Table IV.1.1: **Share of subnational government expenditure in the EU (in %)**

	Share of subnational governments expenditure in general government expenditure					Subnational governments expenditure in % GDP				
	1995	2007	2010	Change 95-07	Change 07-10	1995	2007	2010	Change 95-07	Change 07-10
AT	31.4	30.6	34.5	-0.8	3.9	17.7	14.9	18.1	-2.8	3.2
BE	33.0	37.1	37.0	4.1	-0.1	17.2	18.0	19.7	0.8	1.7
BG	23.7	16.9	18.2	-6.9	1.3	10.8	6.7	6.9	-4.1	0.2
CY	4.2	4.6	4.8	0.4	0.2	1.4	1.9	2.2	0.5	0.3
CZ	19.2	26.1	27.0	6.9	0.9	10.2	10.7	11.9	0.5	1.2
DE	33.2	37.9	37.5	4.7	-0.4	18.2	16.6	18.0	-1.6	1.4
DK	53.7	63.3	63.4	9.6	0.1	31.8	32.1	36.9	0.3	4.8
EE	26.7	27.8	24.6	1.1	-3.2	11.0	9.5	10.0	-1.5	0.5
EL	4.2	5.5	5.6	1.3	0.1	1.9	2.6	2.8	0.7	0.2
ES	33.1	49.9	47.9	16.8	-1.9	14.7	19.6	22.0	4.9	2.4
FI	30.5	39.6	39.9	9.1	0.3	18.7	18.8	22.1	0.1	3.3
FR	17.6	20.7	20.5	3.1	-0.3	9.6	10.9	11.6	1.3	0.7
HU	23.5	23.2	25.4	-0.3	2.2	13.1	11.8	12.6	-1.3	0.8
IE	31.1	19.6	10.2	-11.4	-9.4	12.7	7.2	6.8	-5.5	-0.4
IT	24.1	31.3	30.7	7.2	-0.6	12.6	14.9	15.4	2.3	0.5
LT	24.1	24.0	27.6	-0.1	3.6	8.3	8.3	11.3	0.0	3.0
LU	13.4	12.2	11.5	-1.2	-0.6	5.3	4.4	4.9	-0.9	0.5
LV	19.2	31.0	26.6	11.8	-4.4	7.4	11.1	11.8	3.7	0.7
MT	1.5	1.4	1.6	-0.1	0.2	0.6	0.6	0.7	0.0	0.1
NL	40.2	34.0	33.3	-6.3	-0.7	22.7	15.4	17.1	-7.3	1.7
PL	18.9	31.4	32.5	12.4	1.2	11.0	13.2	14.8	2.2	1.6
PT	11.6	15.1	13.8	3.5	-1.2	4.8	6.7	7.1	1.9	0.4
RO	12.0	25.5	23.9	13.5	-1.6	4.1	9.8	9.8	5.7	0.0
SE	37.8	46.9	47.5	9.0	0.7	24.6	23.8	25.1	-0.8	1.3
SI	14.5	19.8	20.4	5.3	0.5	7.6	8.4	10.2	0.8	1.8
SK	13.1	17.6	16.0	4.5	-1.6	6.4	6.0	6.4	-0.4	0.4
UK	25.8	28.5	27.4	2.7	-1.1	11.3	12.5	13.8	1.2	1.3
EU27	---	29.2	28.9	---	-0.3	---	13.3	14.6	---	1.3

Source: Commission services.

States, Eurostat only provides a break-down of total public expenditure by three sectors; these are central government, subnational government and social security. This means that throughout this Part the 'subnational government' sector encompasses all subnational tiers of government (i.e. municipalities, provinces, counties, regions etc.) even though in most Member States 2 or even 3 subnational government tiers exist. A further break-down between local and state government is only provided for four countries, three of which are federal by Constitution (DE, AT and BE) and one (ES) which is largely regionalised. In these cases 'state' is distinct from 'national' and captures the intermediate layer between central and local government, such as *Länder* in DE and *Comunidades Autònomas* in ES.

According to this measure Member States differ largely in the extent of expenditure decentralisation. In 2010 DK ranked at the top with about 63% of total expenditure being carried out by subnational governments. ES and SE come next with 47-48%, followed by FI, DE, BE, NL, PL, AT and IT with figures ranging between 30 and 40%. At the opposite end of the spectrum are MT with a share of only 1.6%, CY (4.8%) and EL (5.6%), as the least decentralised MS, and IE, LU, PT, SK and BG with shares ranging from 10 to 20%. Clearly these figures suggest that the extent of expenditure decentralisation is not only affected by the institutional framework but also by the geographical and demographic size of the country. As for the institutional architecture of the country, it is interesting to observe that decentralisation is relatively larger not only in constitutionally federal countries but also in a few unitary ones such as the Nordic countries, NL, PL and IT. ([131])

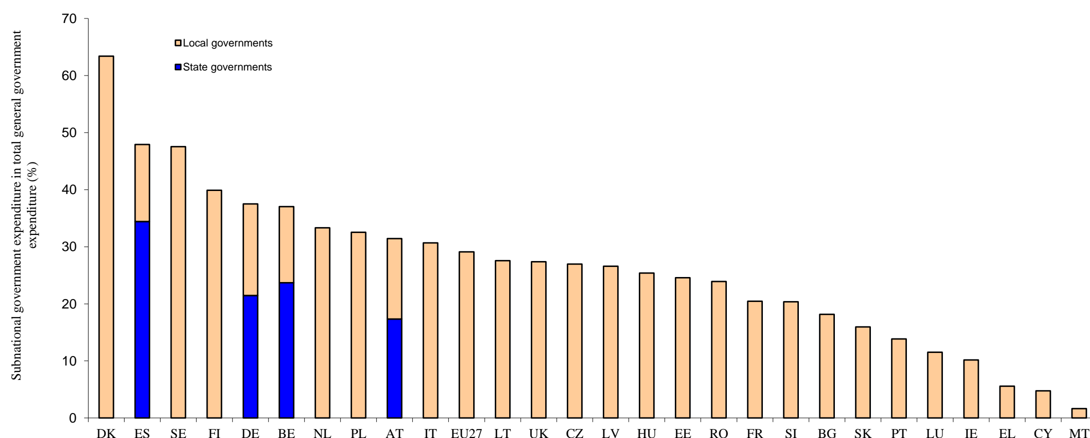
As both Table IV.1.1 and Graph IV.1.2 show, a large majority of EU Member States have increased the share of public expenditure carried out by subnational governments since 1995. Exceptions to this are IE ([132]), NL, BG, EE and LU where decentralisation measured in this way decreased ([133]), and AT, MT and CY where it remained largely stable.

([131]) IT should be considered a highly regionalised country in light of several reforms introduced over the past two decades.

([132]) In Graph IV.1.2 the figure for Ireland relates to 2008 to correct for the exceptional increase of total public expenditure in 2009-10 due to measures aimed at the recapitalisation of the banking sector.

([133]) See below subsection 1.2.2 for a discussion on the change in the share of subnational governments' expenditure by

Graph IV.1.1: **Subnational government expenditure (% of general government expenditure in 2010)**



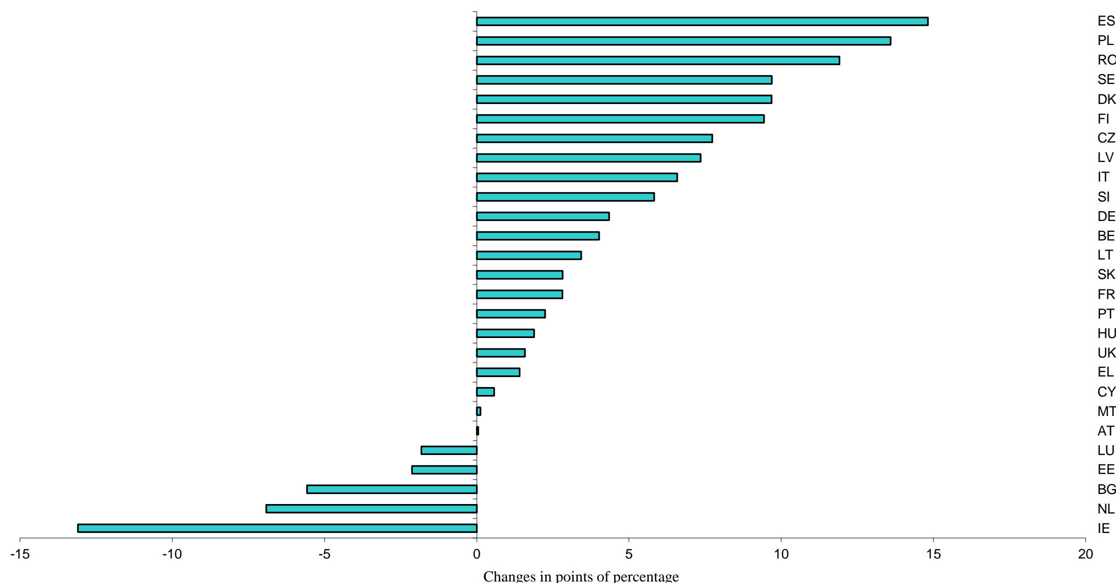
Source: Commission services.

The increase in decentralisation has been particularly pronounced in ES, PL, RO, SE, DK and FI where the percentage of overall general government expenditure undertaken at subnational level rose by about 10 percentage points or more. Graph IV.1.3 plots the aggregate level of government expenditure (as a percentage of GDP) against the percentage of subnational government in total expenditure in 2010. (134) It shows that there is a positive, albeit weak, correlation between these two variables, providing some prima facie

function. In IE the figure in Graph IV.1.2 is mainly driven by a sharp reduction of the subnational government's share in health care expenditure. Moreover, Graph IV.1.5 below shows that the largest reduction in the subnational governments' share in investment expenditure by the general government between 1995 and 2010 occurred in IE and NL.

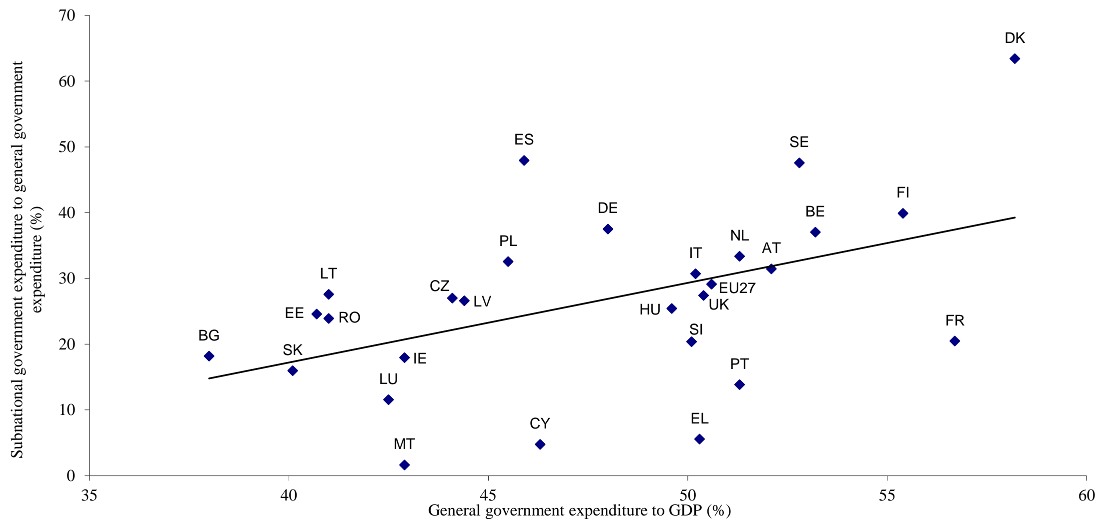
(134) Except for IE (2008), see footnote 132.

Graph IV.1.2: Change in subnational government expenditure between 1995 and 2010 (percentage points of general government expenditure)



Source: Commission services.

Graph IV.1.3: **Subnational government expenditure as a percentage of general government expenditure and government expenditure as a percentage of GDP (2010)**



Source: Commission services.

evidence that decentralisation may be related to a larger overall weight of the public sector in the economy.

1.2.2. Composition of subnational government expenditures

Eurostat figures on public expenditure by sector of government can be further broken down by government function (cofog), although data availability does not go beyond 2009. ([135]) This allows an assessment of whether expenditure decentralisation is predominantly concentrated in specific functions. Graph IV.1.4 plots the percentage of subnational government expenditure over total expenditure *by function* in 2002 and 2009 ([136]) (all government functions considered by Eurostat are shown). ([137]) For each function the average, minimum and maximum figures for EU Member States are shown. ([138]) Table IV.1.2 presents the underlying data by Member State, showing the subnational government percentage of expenditure in each of the 9 functions in 1999 ([139]) and 2009.

As the Graph shows, the most decentralised functions are environment protection and housing, for which between 60 and 80% of total expenditure is undertaken by subnational governments on average, followed by recreation, culture and religion and education, with an average percentage higher than 40%. This pattern is to a certain extent in line with economic rationale, as several expenditure items included in these functions concern services to be organised on a fairly small (i.e. subnational) scale and where heterogeneity of subnational preferences is likely to be more pronounced, i.e. waste management, housing and community developments, water supply, street lightning, recreational and sporting services, nurseries etc. At the other end, the least decentralised functions are general public services ([140]), social protection ([141]) and public order and

([135]) At the time of writing.

([136]) 2002 and 2009 are, respectively, the earliest and most recent year for which a full breakdown in the underlying data is available for all Member States – including an EU average.

([137]) With the exception of defence, for which the share of subnational governments is basically zero.

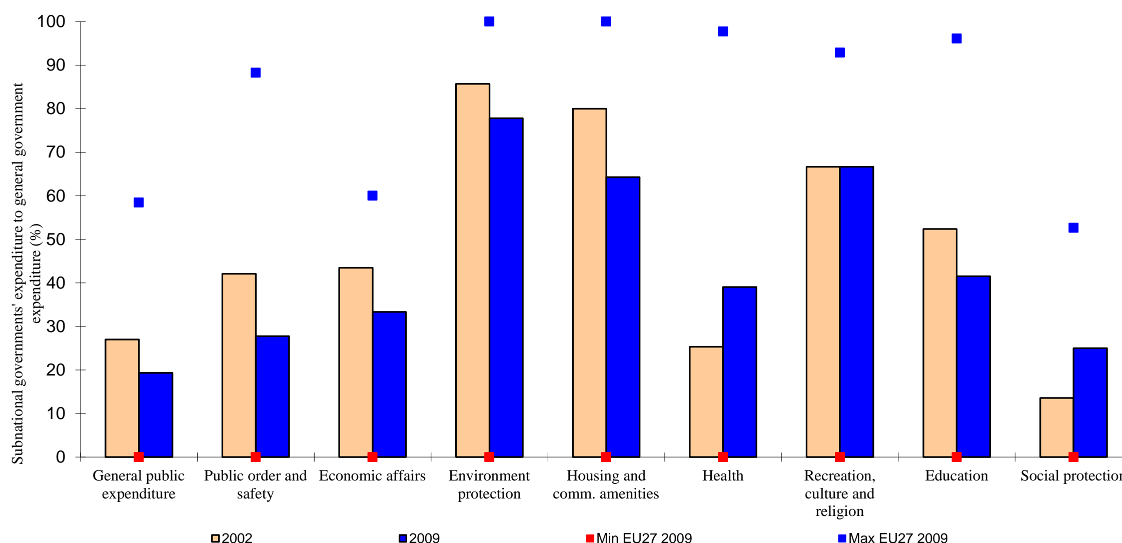
([138]) E.g. in the EU on average about 40% of public expenditure on public order and safety is carried out by subnational governments and, across EU Member States, this share ranges from a minimum of zero to a maximum of more than 90% (see table IV.1.2 for details on country data).

([139]) The earliest year available for all Member States except LT (2000), PL and RO (2002).

([140]) General public services cover administrative expenditure of public bodies, general services, debt service, basic research and foreign aid.

([141]) In principle, at least part of social expenditure falls within the 'social security funds' subsector included in the Eurostat breakdown alongside the subsectors of central and subnational governments. According to the definition in national accounts the subsector of social security funds includes central, state and local institutional units whose

Graph IV.1.4: **Subnational government expenditure by function (% of general government expenditure by cofog) - EU average for 2002 and 2009 and minimum and maximum for 2009**



Source: Commission services.

safety where subnational governments are responsible for below 30% of all spending on average. Comparing the figures from 2009 with those from 2002 ([142]) shows that the relative average weight of subnational governments spending across functions has been reduced for housing, public order and safety, economic affairs, education, environment protection and general public services, whereas it increased for health and social protection and it remained stable for recreation, culture and religion.

Across all functions, the EU average figures mask considerable variation across Member States. As can be seen in Graph IV.1.4, the minimum percentage of subnational governments in overall government spending is zero (across all functions), whereas the maximum one ranges from 50-60% (general public services, economic affairs and social protection) to 90-100% (all remaining functions). In more detail, the figures for 2009 (see Table IV.1.2) show that:

- *General public services*: the percentage of subnational government spending range from 0 in MT to 58.4% in DE. CY, LT, IE, DK and BG all have percentages below 10% of overall spending, whereas AT and FI have percentages over 30%.
- *Public order and safety*: subnational governments have the highest percentages in DE (88%), BE, ES and UK (41-43%), lowest in CY, EE, EL and MT (0).
- *Economic affairs*: largest share in ES, BE, DE and IT (50-60%), lowest in CY, MT and EL.
- *Environment protection*: largest share in BE, CY, CZ (100%), ES, FR, PL, PT and RO (85-90%), lowest in MT, LV, FI and EE.
- *Housing*: highest in BE, EE, ES and PT (100%), lowest in MT, CY and EL.

principal activity is to provide social benefits. Hence figures on subnational government expenditure for social protection may underestimate its actual size. However, the situation may differ by country due to their legal and administrative architecture.

([142]) The earliest year with available data for the EU average for the breakdown by function.

Table IV.1.2: **Percentage of subnational government expenditure by function (% of total general government expenditure by cofog) - 2009**

	General public services			Public order and safety			Economic affairs			Environment protection			Housing and comm.		
	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points
AT	35.2	37.3	2.2	12.5	17.6	5.1	42.9	44.8	2.0	83.3	66.7	-16.7	53.3	75.0	21.7
BE	15.3	16.9	1.6	40.0	42.9	2.9	62.7	55.6	-7.2	100.0	100.0	0.0	100.0	100.0	0.0
BG	7.8	9.2	1.4	4.5	6.5	1.9	14.0	22.5	8.5	90.0	58.3	-31.7	50.0	85.7	35.7
CY	6.1	7.1	1.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	16.0	13.6	-2.4
CZ	32.6	28.8	-3.8	4.3	9.5	5.2	23.2	35.9	12.7	70.0	90.0	20.0	50.0	45.5	-4.5
DE	49.5	58.4	9.0	93.8	88.2	-5.5	51.0	54.0	3.0	100.0	62.5	-37.5	81.8	77.8	-4.0
DK	10.7	8.8	-1.9	10.0	8.3	-1.7	36.1	42.4	6.3	42.9	60.0	17.1	25.0	42.9	17.9
EE	18.0	15.8	-2.2	0.0	0.0	0.0	23.3	37.7	14.5	50.0	36.4	-13.6	100.0	100.0	0.0
EL	8.9	12.1	3.1	0.0	0.0	0.0	2.7	3.5	0.8	80.0	83.3	3.3	50.0	25.0	-25.0
ES	17.4	21.9	4.5	42.1	42.9	0.8	50.0	60.0	10.0	88.9	90.0	1.1	100.0	100.0	0.0
FI	25.8	37.5	11.7	21.4	20.0	-1.4	20.7	27.5	6.8	33.3	33.3	0.0	50.0	60.0	10.0
FR	21.7	25.8	4.1	16.7	23.1	6.4	35.0	30.6	-4.4	85.7	88.9	3.2	75.0	81.8	6.8
HU	15.9	18.0	2.2	5.0	9.1	4.1	11.1	16.7	5.6	75.0	42.9	-32.1	90.9	92.3	1.4
IE	4.0	6.8	2.8	11.8	5.0	-6.8	32.6	23.8	-8.8	66.7	62.5	-4.2	80.0	82.6	2.6
IT	17.2	22.2	5.0	10.0	10.0	0.0	48.8	50.0	1.2	80.0	80.0	0.0	90.0	58.3	-31.7
LT*	8.1	7.5	-0.5	4.8	5.0	0.2	11.5	12.5	1.0	100.0	83.3	-16.7	100.0	80.0	-20.0
LU	14.7	18.5	3.8	11.1	10.0	-1.1	25.6	18.0	-7.6	50.0	58.3	8.3	55.6	45.5	-10.1
LV	30.2	24.1	-6.2	3.8	9.5	5.7	18.6	27.8	9.2	33.3	18.2	-15.2	92.9	66.7	-26.2
MT	9.9	0.0	-9.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NL	20.5	24.1	3.6	40.9	36.7	-4.2	50.0	45.3	-4.7	80.0	80.0	0.0	69.2	76.9	7.7
PL**	18.9	19.7	0.8	12.5	14.3	1.8	48.7	42.1	-6.6	83.3	85.7	2.4	76.5	83.3	6.9
PT	10.1	15.7	5.6	5.9	4.3	-1.5	31.9	34.2	2.3	71.4	85.7	14.3	90.0	100.0	10.0
RO**	18.9	19.7	0.8	12.5	14.3	1.8	48.7	42.1	-6.6	83.3	85.7	2.4	76.5	83.3	6.9
SE	23.1	27.4	4.3	15.4	14.3	-1.1	28.9	32.7	3.8	100.0	50.0	-50.0	53.8	87.5	33.7
SI	15.3	19.0	3.7	5.9	5.9	0.0	15.1	25.0	9.9	42.9	54.5	11.7	50.0	66.7	16.7
SK	7.4	22.8	15.4	3.7	4.2	0.5	6.5	18.2	11.7	18.2	57.1	39.0	36.4	66.7	30.3
UK	12.3	12.7	0.4	50.0	41.2	-8.8	28.6	26.0	-2.6	66.7	54.5	-12.1	62.5	31.0	-31.5
EU27	---	19.4	---	---	27.8	---	---	33.3	---	---	77.8	---	---	64.3	---

Source: Commission services.

(Table IV.1.2 continued)

	Health			Recreation, culture and religion			Education			Social protection		
	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points
AT	43.1	37.4	-5.7	63.6	72.7	9.1	45.7	47.1	1.4	13.5	12.8	-0.7
BE	4.8	4.4	-0.3	90.0	92.9	2.9	86.8	84.7	-2.1	17.2	20.0	2.8
BG	50.0	9.1	-40.9	14.3	37.5	23.2	60.5	55.6	-4.9	5.8	4.4	-1.4
CY	0.0	0.0	0.0	22.2	23.1	0.9	0.0	0.0	0.0	0.0	0.0	0.0
CZ	1.4	3.9	2.5	60.0	64.3	4.3	48.3	49.3	1.0	7.9	9.7	1.8
DE	6.3	6.8	0.5	100.0	88.9	-11.1	97.9	95.8	-2.0	18.7	19.4	0.7
DK	95.7	97.7	2.1	56.2	52.9	-3.3	52.6	48.8	-3.8	47.1	52.6	5.5
EE	18.9	19.8	0.8	40.9	45.8	4.9	42.7	59.7	17.1	7.6	5.6	-1.9
EL	0.0	0.0	0.0	50.0	14.3	-35.7	3.4	2.4	-1.1	0.0	2.2	2.2
ES	60.4	92.8	32.4	71.4	82.4	10.9	79.5	96.1	16.5	7.5	11.0	3.5
FI	63.6	59.8	-3.8	64.3	64.3	0.0	50.6	50.0	-0.6	15.2	18.2	3.0
FR	1.4	1.2	-0.2	72.7	70.6	-2.1	26.2	31.2	5.1	5.5	8.1	2.6
HU	25.3	20.2	-5.1	37.5	37.5	0.0	50.0	47.2	-2.8	10.4	7.1	-3.3
IE	54.2	0.0	-54.2	50.0	50.0	0.0	20.4	17.6	-2.7	12.6	4.1	-8.5
IT	61.1	60.8	-0.3	44.4	55.6	11.1	28.6	26.0	-2.6	3.1	3.1	0.0
LT*	21.5	21.4	-0.2	33.3	46.2	12.8	68.3	63.8	-4.6	9.6	6.0	-3.6
LU	0.0	0.0	0.0	42.1	35.0	-7.1	22.0	22.2	0.2	1.3	0.7	-0.5
LV	22.5	27.8	5.3	50.0	50.0	0.0	50.0	53.3	3.3	5.1	6.3	1.2
MT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NL	5.3	4.3	-0.9	84.6	80.0	-4.6	48.1	50.0	1.9	14.0	10.3	-3.7
PL**	23.2	29.9	6.7	75.0	78.6	3.6	45.8	48.8	2.9	5.2	7.5	2.3
PT	5.0	5.6	0.6	46.2	63.6	17.5	7.8	10.4	2.6	1.7	2.3	0.6
RO**	23.2	29.9	6.7	75.0	78.6	3.6	45.8	48.8	2.9	5.2	7.5	2.3
SE	83.6	82.8	-0.8	78.9	75.0	-3.9	63.7	73.7	9.9	25.0	25.6	0.6
SI	13.1	10.3	-2.9	46.7	42.1	-4.6	38.4	38.7	0.3	2.9	4.1	1.3
SK	1.3	0.0	-1.3	20.0	45.5	25.5	21.4	47.5	26.0	1.9	3.6	1.8
UK	0.0	0.0	0.0	50.0	50.0	0.0	47.1	45.2	-1.9	19.6	20.5	0.9
EU27	---	39.0	---	---	66.7	---	---	41.5	---	---	25.0	---

* 1999 data is replaced by 2000; ** 1999 data is replaced by 2002
Source: Commission services.

- *Health:* highest share in DK, ES (more than 90%), SE (83%), IT and FI (around 60%); zero (or close to) in CY, CZ, EL, IE, MT, SK, UK and FR.

- *Recreation*: highest share in BE, DE, ES, NL, PL and RO (close to 80% or more), lowest in MT, EL, CY, BG, LU and HU (less than 40%).

- *Education:* highest subnational share in ES, DE (96%), BE (85%), SE (74%), LT and EE (60-64%), lowest in CY, MT, EL (0-3%), PT and IE (10-18%).

- *Social protection*: highest share in DK (52%), SE, (25%), BE, DE, FI and UK (18-20%), lowest in CY, MT (0), BG, CZ, EE, EL, FR, HU, IE, IT, LT, LU, LV, PL, PT, RO, SI and SK (less than 10%).

As regards the *change* in shares of subnational expenditures by function between 1999 and 2009, taking as a threshold a 10 percentage point difference, the largest variation are observed for i) housing, with an increase in BG, SE, SK (30+pp), AT (20-30pp), DK, FI, PT and SI and a decrease in IT (32pp), LV, EL, LT (20-30pp) and LU; ii) environment, with an increase in SK (39pp), CZ (20), DK and PT and a reduction in SE (50pp), BG, DE, HU (30-40pp), AT, EE, LT and LV; iii) recreation, with an increase in SK, BG (20-30pp), PT, LT, IT and ES and a reduction in EL (36pp) and DE (11pp); iv) health, with an increase in ES (32pp) and large reductions in IE (54pp) and BG (41pp); and v) economic affairs, with an increase in CZ, EE, ES, SI and SK (never exceeding 15pp).

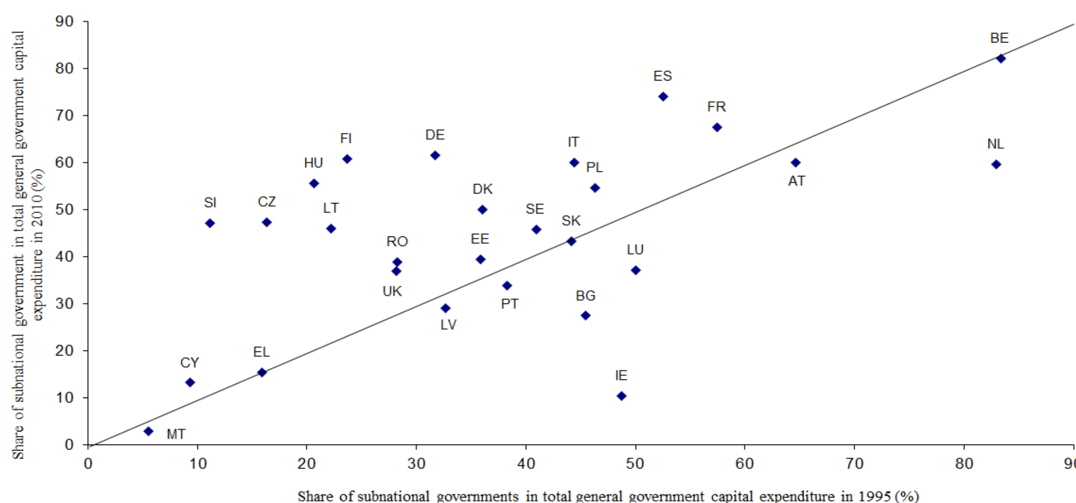
Similarly to Table IV.1.2, Table IV.1.3 below provides figures for the share of subnational government expenditure *by economic function* (i.e. compensation of employees, transfers, capital expenditure etc.) in 2010. Amongst the categories included, the percentage of subnational governments in general government spending is highest for expenditure on intermediate consumption (it represents over 50% of the total in AT, BE, CZ, DE, DK, ES, FI, IT, NL, PL and SE), compensation of employees (over 50% in BE, DE, DK, ES, FI, HU, NL, PL, SE and between 45 and 50% in UK, LV, LT, CZ and AT) and investment

Table IV.1.3: **Percentage of subnational government expenditure by economic function - 2010**

	Intermediate consumption	Compensation of employees	Interest	Subsidies	Social benefits	Other current expenditures	Capital transfers	Investment
AT	51,1	45,4	3,8	52,9	17,4	18,5	50,0	70,0
BE	69,2	77,0	8,3	20,0	12,7	16,0	57,1	88,2
BG	38,7	30,1	0,0	7,7	0,0	1,5	0,0	29,8
CY	8,8	5,0	7,1	0,0	0,0	2,7	0,0	18,4
CZ	51,6	47,4	0,0	63,2	4,1	5,9	14,3	71,9
DE	70,8	78,5	44,0	60,0	15,3	30,7	35,3	85,7
DK	65,7	71,7	10,5	53,8	71,1	3,6	14,3	61,9
EE	38,7	38,7	100,0	27,3	3,4	4,2	16,7	45,8
EL	14,5	10,7	0,0	0,0	0,0	0,9	0,0	20,7
ES	80,4	78,2	19,0	50,0	17,5	19,5	37,5	71,8
FI	64,6	73,6	7,1	13,3	9,6	3,6	0,0	68,0
FR	43,1	26,1	4,2	41,2	4,3	11,4	28,6	74,2
HU	43,0	50,5	2,4	18,2	3,3	2,9	12,5	66,7
IE	24,6	15,4	0,0	0,0	5,0	1,7	0,9	64,9
IT	69,5	42,3	4,5	63,6	13,6	3,4	27,3	71,4
LT	37,5	47,3	0,0	0,0	7,4	1,0	0,0	51,1
LU	32,4	21,3	0,0	11,8	0,5	3,6	0,0	39,0
LV	31,9	45,5	11,1	28,6	6,6	12,8	0,0	74,4
MT	6,6	0,7	0,0	0,0	0,0	0,0	0,0	4,5
NL	59,3	66,3	15,0	26,7	7,8	1,9	17,2	65,7
PL	58,1	57,4	3,8	16,7	7,1	3,9	18,2	58,9
PT	32,0	17,2	3,1	14,3	3,2	7,6	7,1	45,9
RO	33,8	34,7	12,5	16,7	7,3	2,3	33,3	37,9
SE	64,9	76,7	18,2	40,0	21,2	5,0	0,0	50,0
SI	31,9	33,9	0,0	13,6	2,6	3,3	7,1	57,1
SK	40,8	39,0	0,0	23,1	0,5	3,5	0,0	64,0
UK	37,4	46,1	6,5	33,3	11,9	0,0	9,1	50,0
EU27	54,3	52,3	14,3	46,2	12,4	11,1	24,0	65,4

Source: Commission services.

Graph IV.1.5: **Subnational government percentage of investment expenditure by the general government (1995 and 2010)**



Source: Commission services.

spending (at or over 50% in AT, BE, CZ, DE, DK, ES, FI, FR, HU, IE, IT, LT, LV, NL, PL, SE, SI, SK and UK).

On the other hand, the percentage of subnational governments in overall spending is generally low for interest expenditure with most public debt being issued by the central government (exceptions to this include EE and DE where subnational governments undertake 100% and over 40% of this spending, respectively, followed by ES, SE, NL, RO, LV and DK, with a subnational percentage of 10-20%), social benefits (in all cases except DK), other current expenditures (where the subnational government percentage is below 20% for all Member States except DE, where it is over 30%), and capital transfers, (with the exceptions of BE and AT at 50% or more and ES, DE, RO, FR and IT at between 25 and 40%). The subnational percentage in the expenditure for subsidies shows larger variation (it is 50% or more in IT, CZ, DE, AT, DK and ES).

The above evidence on the average composition of subnational expenditures by economic function across the EU is to some extent consistent with recommendations from the "classical" fiscal federalism literature on the optimal assignment of main government functions across sectors of government (Oates, 1999). According to this literature, two out of the three economic functions of government identified by Musgrave's classification (Musgrave, 1959), i.e. income redistribution and stabilisation of macroeconomic shocks, should be assigned to the central government, leaving to subnational governments only the allocation of public goods with a subnational dimension. Such assignment is consistent with the "benefit principle" suggesting that a service should be provided by the level of government that most closely represents the community benefiting from it which implies that, for instance, public goods benefiting only people living in a city should be provided by the municipality, whereas national public goods such as redistribution and macroeconomic stabilisation (where risks of spillovers and free-riding are larger) should be assigned to the central level (McLure and Martinez-Vazquez, 2000). The larger subnational weight in intermediate consumption and investments and the lower one in social benefits are by and large consistent with this recommendation.

Table IV.1.3 shows that subnational government spending accounts for a large share of general government investment. To highlight this issue further, Graph IV.1.5 above provides evidence on the change in the subnational share of government capital expenditure ([143]) by plotting the sum of

([143]) The figures in the graph are computed by summing up expenditures in capital transfers and investments (last two columns in table IV.1.3 above).

subnational government investment spending and capital transfers as a percentage of the sum of general government investment spending and capital transfers for 1995 on the horizontal axis and 2010 on the vertical axis. The figures shown in Graph IV.1.5 thus contain the sum of the last two columns in Table IV.1.3, as this total is a more appropriate way to capture the total contribution of the general government to capital formation ([144]). The Graph should be considered against a backdrop of decreasing overall government investment expenditure in most EU Member States during recent years.

The share of subnational authorities in general government capital expenditure amounts to 50% or more in 11 Member States (BE, ES, FR, FI, DE, IT, AT, NL, HU, PL and DK) including all the most decentralised ones in terms of aggregate expenditure. As the Graph shows, this share increased in a majority of Member States (16 out of 27 lie above the 45 degree line) between 1995 and 2010, with the increase being particularly pronounced in FI, DE, HU, SI, CZ, LT and ES. On the other hand, subnational governments' contribution to public investments decreased significantly in IE, NL, BG and LU.

([144]) This mainly relates to the fact that capital transfers also include capital injections granted by the government to state-owned enterprises which invest in networks and infrastructures (e.g. railways). These enterprises may be classified out of the general government sector if they operate as market operators, hence the investments they undertake would not be accounted if only looking at figures on government expenditure on investments.

1.3. DECENTRALISATION OF REVENUE SOURCES

1.3.1. Overall degree of decentralisation

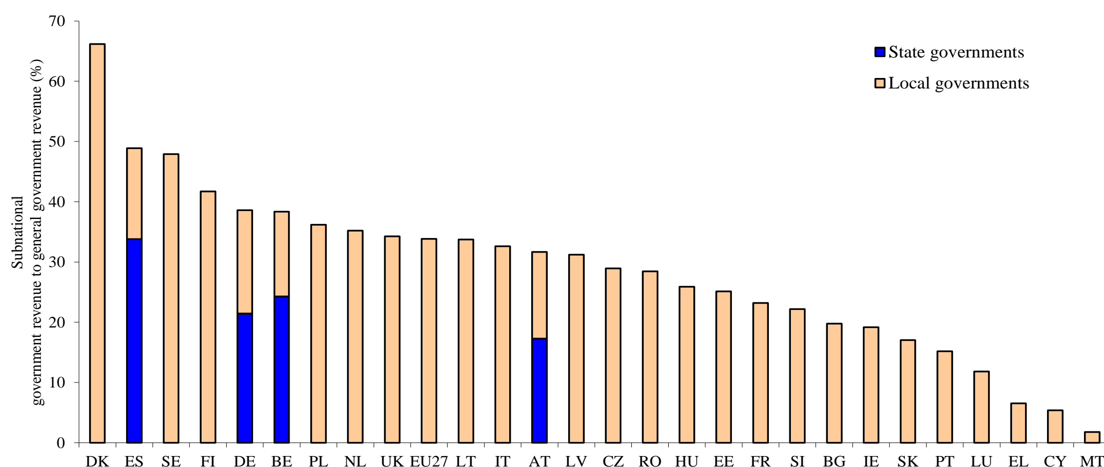
This Section discusses fiscal decentralisation in the EU from the revenue side. First, it considers the overall degree of revenue decentralisation and the extent to which the broadening of subnational governments' competences (and corresponding expenditure responsibilities) are matched with corresponding financial means. Second, it discusses the composition of subnational governments' revenues, by focusing on the relative weight of two main sources, i.e. taxes and transfers.

Table IV.1.4: **Share of subnational government revenues in the EU**

	Share of subnational governments revenue in general government revenue					Subnational governments revenue in % GDP				
	1995	2007	2010	Change 95-07	Change 07-10	1995	2007	2010	Change 95-07	Change 07-10
AT	34.1	31.5	31.6	-2.6	0.1	17.2	15.0	15.2	-2.2	0.2
BE	34.9	37.9	38.5	3.0	0.6	16.6	18.2	18.8	1.6	0.6
BG	22.4	16.1	19.8	-6.3	3.6	8.4	6.6	6.9	-1.8	0.3
CY	3.7	4.2	5.4	0.5	1.1	1.2	1.9	2.2	0.7	0.3
CZ	30.3	27.5	29.0	-2.8	1.5	12.2	11.1	11.4	-1.1	0.3
DE	36.8	39.1	38.8	2.3	-0.4	16.7	17.1	16.9	0.4	-0.2
DK	57.8	57.2	66.3	-0.6	9.1	32.6	31.8	36.8	-0.8	5.0
EE	24.8	24.7	25.2	0.0	0.5	10.5	9.0	10.3	-1.5	1.3
EL	5.2	6.1	6.6	1.0	0.5	1.9	2.5	2.6	0.6	0.1
ES	37.6	46.5	49.0	8.8	2.6	14.0	19.1	17.8	5.1	-1.3
FI	36.1	35.3	41.7	-0.8	6.4	20.0	18.6	21.9	-1.4	3.3
FR	18.8	21.0	23.2	2.2	2.2	9.2	10.5	11.5	1.3	1.0
HU	28.2	25.7	25.9	-2.6	0.2	13.3	11.7	11.7	-1.6	0.0
IE	33.2	19.1	19.2	-14.1	0.1	12.9	7.0	6.8	-5.9	-0.2
IT	28.3	32.2	32.5	3.8	0.4	12.7	14.8	14.9	2.1	0.1
LT	24.3	23.8	33.7	-0.5	9.9	8.0	8.0	11.4	0.0	3.4
LU	13.5	11.8	11.8	-1.8	0.1	5.7	4.7	4.9	-1.0	0.2
LV	19.7	29.2	31.3	9.5	2.1	7.3	10.4	11.3	3.1	0.9
MT	1.7	1.5	1.8	-0.2	0.3	0.6	0.6	0.7	0.0	0.1
NL	48.3	33.5	35.3	-14.8	1.8	22.8	15.2	16.3	-7.6	1.1
PL	23.1	33.0	36.3	9.9	3.3	10.0	13.3	13.6	3.3	0.3
PT	13.4	15.6	15.1	2.1	-0.4	4.9	6.4	6.3	1.5	-0.1
RO	13.1	26.9	28.5	13.8	1.6	4.2	9.5	9.7	5.3	0.2
SE	42.2	43.9	48.0	1.7	4.2	24.3	23.9	25.3	-0.4	1.4
SI	17.7	19.6	22.1	1.8	2.5	7.8	8.3	9.8	0.5	1.5
SK	6.9	18.5	17.0	11.7	-1.5	3.1	6.0	5.5	2.9	-0.5
UK	28.9	30.2	34.2	1.2	4.1	11.0	12.4	13.8	1.4	1.4
EU27	---	32.3	33.9	---	1.6	---	15.5	16.2	---	0.7

Source: Commission services.

Graph IV.1.6: **Subnational government revenues (% of general government revenues - 2010)**



Source: Commission services.

The degree of government revenue decentralisation can be measured by the share of subnational government revenues in revenues of the general government. These are defined as revenues collected by or transferred to subnational governments. ([145]) Table IV.1.4 presents these figures for EU Member States. The format is the same as for Table IV.1.1, which presented the share of subnational government expenditures; in both cases the levels as a percentage of the overall general government total and GDP are given for 1995, 2007 and 2010, alongside the percentage point changes between 1995 and 2007 and between 2007 and 2010 in order to single out the impact of the recent economic crisis. The figures for 2010 are also displayed in Graph IV.1.6 to ease cross-country comparisons.

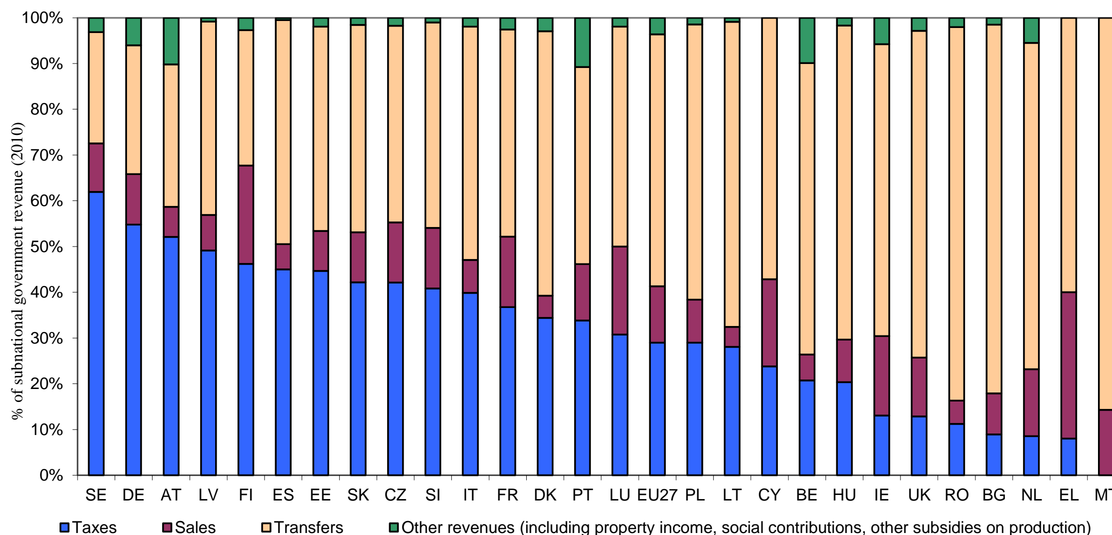
As shown in the Graph, in 2010 DK had the highest revenue decentralisation in the EU with around two thirds of total government revenues being raised by or assigned to subnational governments. ES and SE had subnational percentages close to 50%, whereas FI, BE, DE, PL, NL, UK, LT, IT, AT and LV had percentages in excess of 30%. On the other hand, subnational revenues make up less than 5% of total government revenues in MT, EL and CY and under 20% in LU, PT and SK. Subnational revenues account for 37% of GDP in DK, between 20 and 25% in SE and FI, between 15 and 20% in BE, ES, DE, NL, AT and IT. The share of subnational governments in total public revenues has increased in the 1995-2010 period in the majority of Member States (17 out of 27). The increase has been particularly pronounced exceeding 10 percentage points in RO, PL, LV, ES and SK, whereas DK and LT have seen increases of just below that amount (fully concentrated in the crisis years). Conversely, reductions of over 10 percentage points have occurred in IE and NL, in both cases concentrated in the pre-crisis period.

1.3.2. Break-down of subnational governments' revenues: tax vs. transfers

In terms of composition of revenues, subnational levels of government rely on two main sources – taxes (which can either be set at subnational level or assigned from the central government) and transfers from the central government. Other sources, which are much less important in quantitative terms, include fees paid by service

([145]) The Chapter differs here from a number of papers (e.g. Escolano et al., 2012 and Eyraud and Lusinyan, 2011) where revenue decentralisation is defined as the share of subnational *own revenues (taxes and fees)* in general government revenues, thereby *excluding transfers*. This is done as the current focus is on the whole set of subnational revenues and on their composition across different sources (taxes, transfers and fees), see below. In chapter IV.3 the indicator of *own revenue* decentralisation, distinct from the above indicator (i.e. excluding transfers), is introduced and used in the analysis.

Graph IV.1.7: **Sources of subnational government revenue (2010)**

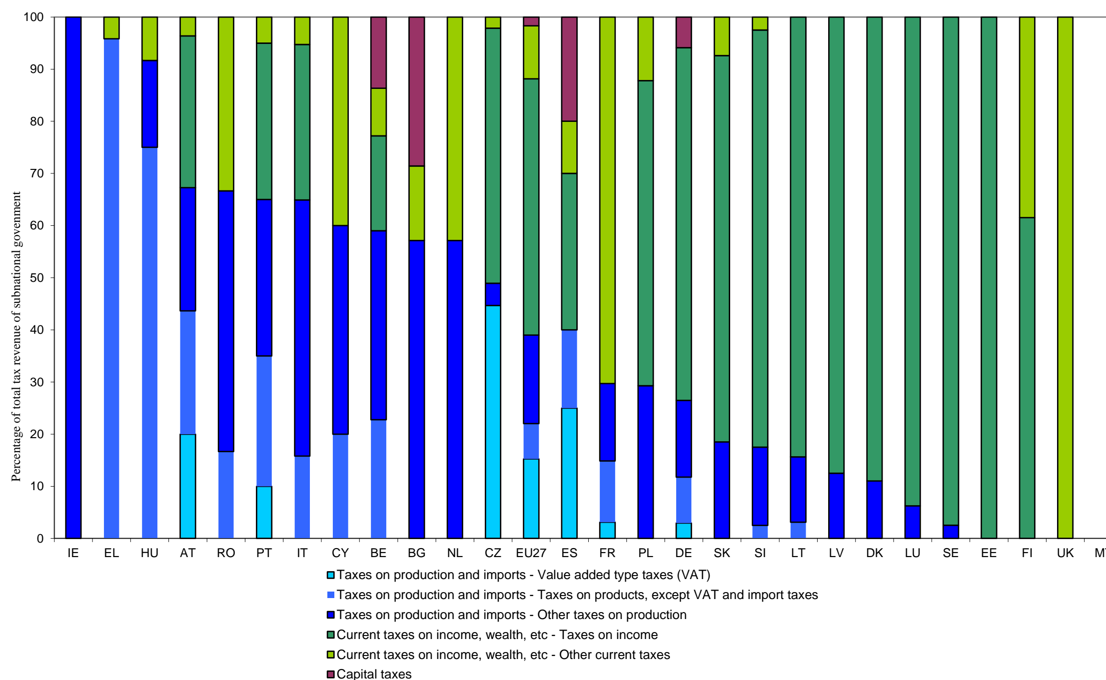


Source: Commission services.

users and property income. The use of borrowing by subnational governments is covered in Section 1.5 below. Graph IV.1.7 above shows the break-down of total revenues of subnational governments by four main sources; taxes, transfers, sales (essentially fees or charges on services provided) and other revenues (including property income, other subsidies etc.) in 2010.

These figures suggest that on average subnational governments across the EU rely slightly more on transfers than on taxes as their main source of

Graph IV.1.8: Decomposition of tax revenues of subnational governments (2010)



Source: Commission services.

financing. Taxes account for 50% or more of total subnational government revenues in SE, DE, AT and LV, and for between 40 and 50% in FI, ES, EE, SK, CZ, SI and IT. At the opposite end of the spectrum, subnational governments receive no income from taxes in MT, whereas they receive less than 10% of their income from taxes in EL, NL and BG and between 10 and 20% in RO, UK, IE, HU and BE. Transfers make up more than half of subnational government revenues in 14 countries (PL, LT, CY, BE, HU, IE, UK, RO, BG, NL, EL, MT, DK and IT). Finally, fees and charges generally account for a much lower share than taxes and transfers, with subnational governments in LU, CY, FI and EL receiving the greatest percentage of their income from these sources amongst EU Member States at or over 20%.

Graph IV.1.8 above shows the break-down of *tax revenues* of subnational governments by type of tax (income tax, property tax, VAT etc.) in 2010 for all EU Member States. It allows to highlight cross-country differences with respect to the predominant type of tax which is assigned to subnational governments. Taxes on income and wealth account for 70% or more of total tax revenues in 13 countries, including some of the more decentralised such as SE, FI, DK and DE, as well as the UK, LU, EE, LV, LT, SK, SI, PL and FR. Within this group of countries, this share is almost entirely accounted by income taxes alone (both personal and corporate) with the exception of UK and FR where wealth taxes (including property taxes) make up all or most tax revenues of subnational governments.

Wealth and property taxes are an important source also in FI, NL, BG, CY and RO. On the other hand, taxes on production and imports are predominant in 11 MS (IE, EL, HU, AT, RO, PT, IT, CY, BE, BG and NL), albeit not including VAT, except in AT and PT. In CZ and ES the weight of production taxes and of income/wealth taxes is quantitatively similar, with a significant role for VAT. Taxes on capital are generally not assigned to subnational governments except in BG, ES and, to a lesser extent, BE and DE.

1.4. EXPENDITURE VS. TAX DECENTRALISATION, VERTICAL FISCAL IMBALANCES

The literature on fiscal decentralisation highlights that own-source revenues, i.e. subnational taxes, are a more efficient financing tool for subnational governments than transfers from the centre. The reason is that if the bulk of subnational expenditure is financed via own-source taxes, subnational public services are paid by the community which benefits from them and so their costs should be fully internalised by subnational policy-makers. Conversely if transfers are their predominant source of revenues, subnational governments are inclined to carry out looser expenditure policies because, firstly, the cost of subnational services is not fully internalised since it is partly borne by other subnational communities via the national budget and, secondly, because they anticipate that any financing gap will eventually be covered by the central government, leading to a 'soft-budget constraint' at subnational level (see Chapter IV.3 below).

However, it should be recalled that there are also a number of economic arguments militating against a full financing of subnational expenditures via taxes assigned to subnational governments, restoring some rationale for transfer schemes, as long as these are well designed. These include i) economies of scale and degree of complexity in tax collection and administration; ii) geographical mobility of tax bases (e.g. capital and investments) and the associated risk of tax competition among subnational governments to attract them; iii) tax exportation, i.e. risk that the subnational tax burden falls on non-residents (i.e. not benefiting from subnational services financed by those taxes); iv) reduced stability of subnational governments' revenues against business cycle fluctuations; v) need to carry out redistributive policies from richer to poorer regions and to ensure similar level of services throughout the country (if all subnational services were financed by subnational taxes poor regions would either be disproportionately taxed or receive worse services).

Clearly, the weight of these arguments, especially as regards ii), varies by the type of tax. The normative literature on fiscal decentralisation is fairly consensual in recommending keeping personal income and corporate income taxation at

central level, while taxes on immovable bases such as property tax and fees on subnational services would be more suitable for subnational governments. VAT is often mentioned to be too complex to administer for subnational governments (Blöchliger and Petzold, 2009 and IMF, 2009).

As mentioned above, existing data on subnational tax revenues do not allow the effective degree of subnational governments' autonomy in setting tax rates and bases to be captured, as they generally also include tax receipts which are transferred (totally or partly) from the central to the subnational government, with no leeway for the latter to adjust the main tax parameters. This means that a part of subnational governments' tax revenues may also be subject to the same adverse incentive effects as grants.

Bearing in mind this data restriction, an indicator of vertical fiscal imbalance, capturing the share of subnational governments' expenditure which is *covered by subnational taxes* has been computed. The assumption is that the lower the gap between subnational taxes and subnational expenditures is, and so the lower the reliance on complementary transfers from the central government to finance these expenditures, the more efficient is the relationship between different levels of government in terms of the incentives for fiscal discipline and prudent expenditure behaviour (Rodden et al., 2003 and Eyraud and Lusinyan, 2011).

This indicator is presented in Table IV.1.5 and Graph IV.1.9 below. Table IV.1.5 presents the percentage of subnational expenditure covered by subnational taxes in 1995 and 2010 and the change between the two years in percentage points.

The Graph plots the figures for 1995 and 2010 for EU Member States to ease cross-country comparisons. The key finding is that in 2010 tax decentralisation fell short of matching expenditure decentralisation across the EU. Subnational tax revenues covered more than half of subnational expenditures in only two countries, SE and DE. In AT, LV, EE, FI and CZ the percentage ranged between 40 and 50%, and in SI, IT, ES, FR, SK, DK, LU and PT, it ranged between 30% and 40%.

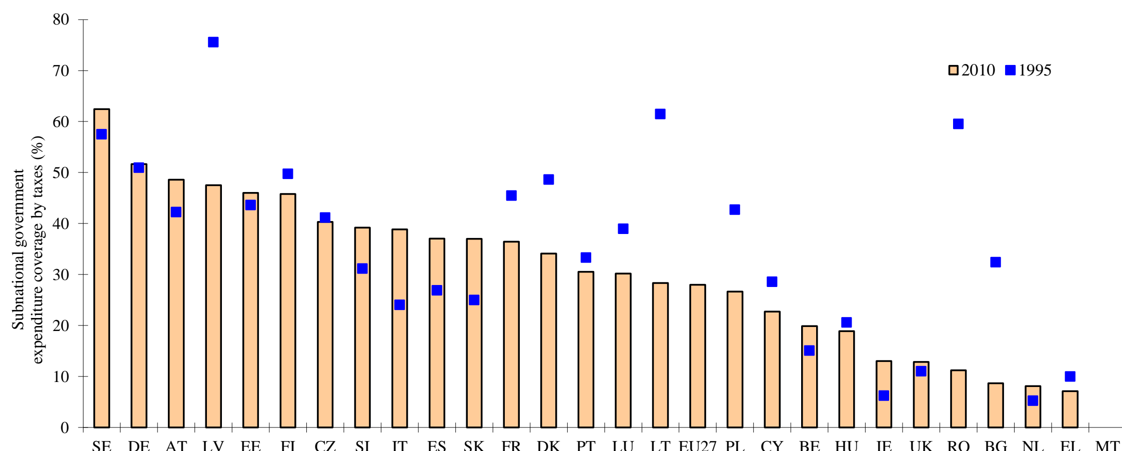
Table IV.1.5: **Coverage of subnational government expenditure by subnational tax revenues**

	1995	2010	Change in the coverage (in points of %)
AT	42.2	48.6	6.4
BE	15.1	19.9	4.8
BG	32.4	8.7	-23.7
CY	28.6	22.7	-5.8
CZ	41.2	40.3	-0.8
DE	50.9	51.7	0.7
DK	48.6	34.1	-14.5
EE	43.6	46.0	2.4
EL	10.0	7.1	-2.9
ES	26.9	37.0	10.2
FI	49.8	45.8	-4.0
FR	45.5	36.4	-9.0
HU	20.6	18.9	-1.7
IE	6.3	13.0	6.8
IT	24.0	38.9	14.8
LT	61.4	28.3	-33.1
LU	39.0	30.2	-8.8
LV	75.6	47.5	-28.1
MT	0.0	0.0	0.0
NL	5.2	8.1	2.9
PL	42.7	26.7	-16.1
PT	33.3	30.6	-2.8
RO	59.5	11.2	-48.3
SE	57.5	62.5	5.0
SI	31.2	39.2	8.0
SK	25.0	37.0	12.0
UK	11.0	12.9	1.8
EU27	---	28.0	---

Source: Commission services.

Overall, there is no systematic pattern across the EU with respect to the change in tax coverage of subnational expenditures between 1995 and 2010, although reductions are slightly more numerous and tend to be larger than increases. Tax coverage decreased sharply in RO, LT, LV, BG (by more than 20pp) and more moderately in PL and DK, and increased in ES, IT, SK (by more than 10pp) and, to a lesser extent, in AT, IE, SI and SE (by 5 to 10pp).

Graph IV.1.9: **Coverage of subnational governments' expenditure by subnational tax revenues (1995 and 2010)**



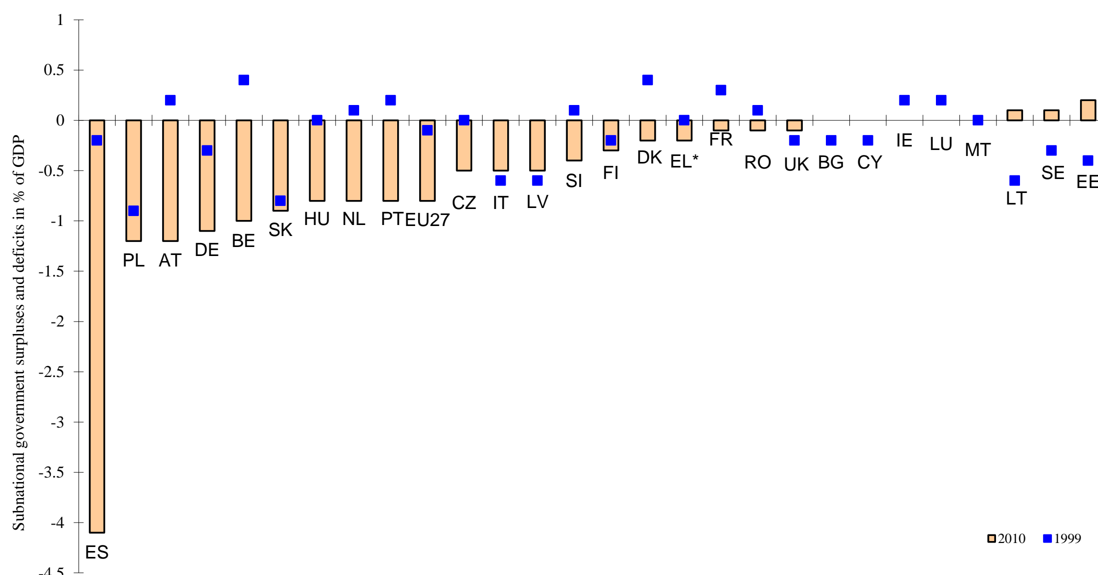
Source: Commission sevices.

Table IV.1.6: Subnational government deficit vs. deficit of general government (% of GDP)

		1999		2010		Change in points of %	
		State or local government deficit in % of GDP**	General government deficit in % of GDP**	State or local government deficit in % of GDP**	General government deficit in % of GDP**	State or local government***	General government***
AT	Local government	0.0	-2.3	-0.4	-4.4	-0.4	-2.1
	State government	0.2		-0.8		-1.0	
BE	Local government	0.0	-0.6	-0.3	-4.1	-0.3	-3.5
	State government	0.4		-0.7		-1.1	
BG		-0.2	0.1	0.0	-3.1	0.2	-3.2
CY		-0.2	-4.3	0.0	-5.3	0.2	-1.0
CZ		0.0	-3.6	-0.5	-4.8	-0.5	-1.2
DE	Local government	0.2	-1.6	-0.2	-4.3	-0.4	-2.7
	State government	-0.5		-0.9		-0.4	
DK		0.4	1.3	-0.2	-2.6	-0.6	-3.9
EE		-0.4	-3.5	0.2	0.2	0.6	3.7
EL*		0.0	-3.7	-0.2	-10.6	-0.2	-6.9
ES	Local government	0.0	-1.2	-0.6	-9.3	-0.6	-8.1
	State government	-0.2		-3.5		-3.3	
FI		-0.2	1.7	-0.3	-2.5	-0.1	-4.2
FR		0.3	-1.8	-0.1	-7.1	-0.4	-5.3
HU		0.0	-5.5	-0.8	-4.2	-0.8	1.3
IE		0.2	2.7	0.0	-31.3	-0.2	-34.0
IT		-0.6	-1.9	-0.5	-4.6	0.1	-2.7
LT		-0.6	-2.8	0.1	-7.0	0.7	-4.2
LU		0.2	3.4	0.0	-1.1	-0.2	-4.5
LV		-0.6	-3.9	-0.5	-8.3	0.1	-4.4
MT		0.0	-7.7	0.0	-3.6	0.0	4.1
NL		0.1	0.4	-0.8	-5.1	-0.9	-5.5
PL		-0.9	-2.3	-1.2	-7.8	-0.3	-5.5
PT		0.2	-2.7	-0.8	-9.8	-1.0	-7.1
RO		0.1	-4.4	-0.1	-6.9	-0.2	-2.5
SE		-0.3	0.9	0.1	0.2	0.4	-0.7
SI		0.1	-3.0	-0.4	-5.8	-0.5	-2.8
SK		-0.8	-7.4	-0.9	-7.7	-0.1	-0.3
UK		-0.2	0.9	-0.1	-10.3	0.1	-11.2
EU27	Local government	0.0	-1.0	-0.3	-6.5	-0.3	-5.5
	State government	-0.1		-0.5		-0.4	

* 1999 value is replaced by 2000
** (-) means a net borrowing
*** (-) means a deterioration
Source: Commission services.

Graph IV.1.10: **Subnational government deficits (% of GDP), 1999 vs. 2010**



* 1999 value is replaced by 2000
Source: Commission services.

1.5. DEFICIT AND DEBT OF SUBNATIONAL GOVERNMENTS IN THE EU

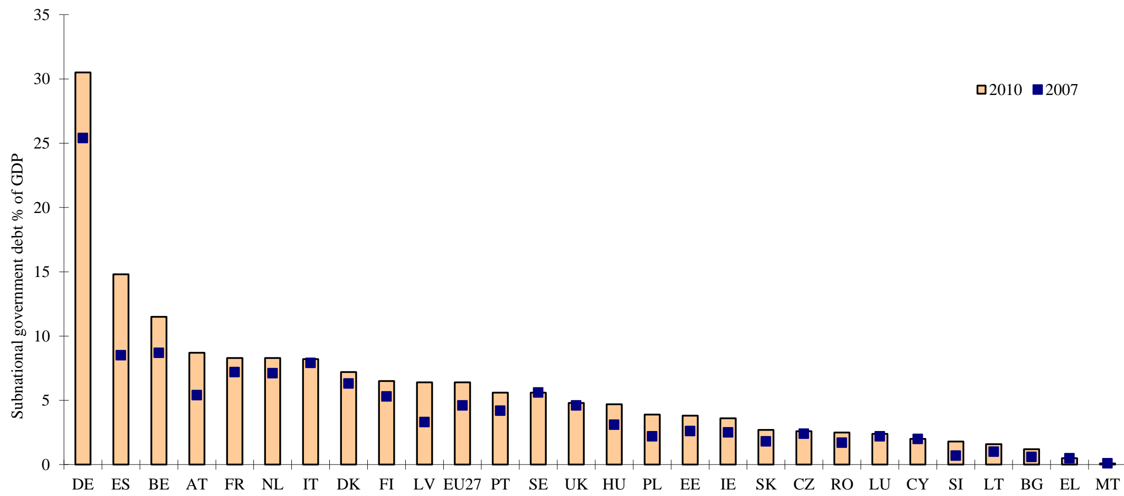
This Section reviews the data on the deficits and debt of subnational governments across the EU in order to assess their contribution to the overall budget balance and borrowing of the general government. The economic rationale for some degree of borrowing by subnational governments may be implied by the need to finance investments in subnational capital endowments, given the generally significant share of public capital expenditure undertaken at subnational level across the EU (see above). Table IV.1.6 provides data on the subnational government deficits as a percentage of GDP. Figures are decomposed for local and state governments for DE, AT, BE and ES. ([146]) The figures are given for 1999 which is the earliest year for which data are available and 2010, and the percentage point change between these two years is also given. In each case the Table also includes the corresponding figures for the deficit of the general government ([147]) to provide a context to the contribution of subnational governments to the general government's budgetary position. The subnational government deficits in 1999 and 2010 for all EU Member States are also shown in Graph IV.1.10 above.

In 2010 the largest subnational deficit, by far, is observed in ES, about 4% of GDP, 3.5 percentage points of which were generated by state governments. PL, AT, DE and BE follow with a subnational deficit of 1% of GDP or slightly more, with, again, a large share of this being run by state governments, i.e. from twice (AT) to more than four times (DE) that of local governments. Figures ranging from 0.5% to 1% of GDP are observed in SK, HU, NL, PT, CZ, IT and LV. On the other hand, a subnational government surplus was observed in SE and LT, whereas subnational budgets were balanced in LU, IE, CY and BG. In ES half of the general government deficit is generated by subnational governments, followed by DE, BE and AT where the share is around one quarter.

Compared to 1999, the budget balance of subnational governments is generally worse in 2010, with the exceptions of LT, SE, BG, CY, UK, IT and LV. The largest deterioration is observed in ES (almost 4 percentage points of GDP), followed

([146]) In this case figures for local and state governments are shown separately for the five countries for which this is possible as it is especially relevant to see which layer of government contributes more to the deficit of general government in federal countries.
([147]) ESA95 figures, Excessive Deficit Procedure.

Graph IV.1.11: **Subnational government debt (% of GDP), 2007 vs. 2010**



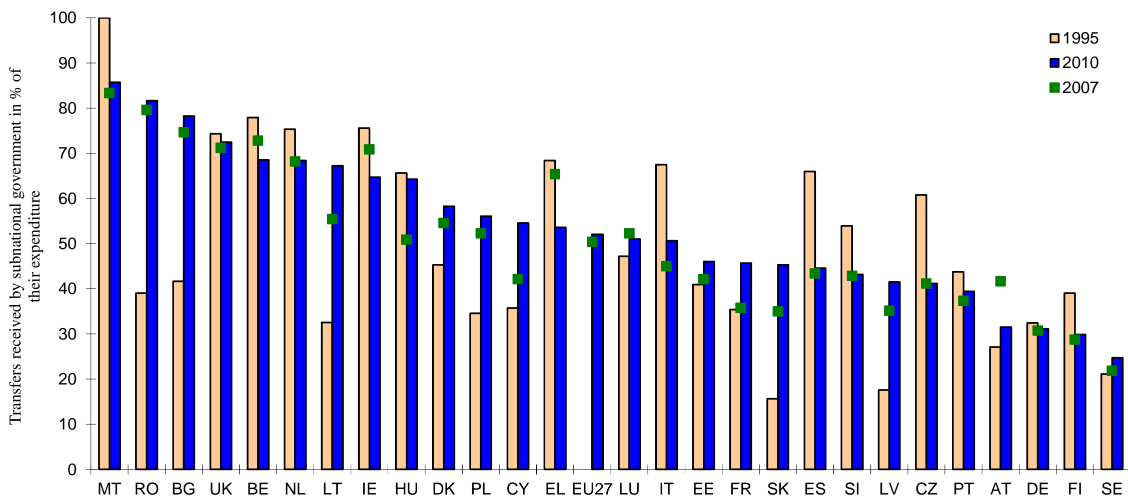
Source: Commission services.

by AT, BE (1.4 percentage points), PT (1 percentage point), NL (0.9 percentage points), HU and DE (0.8 percentage points).

Graph IV.1.11 above presents data on the stock of debt of subnational governments as a percentage of GDP across the EU. ([148]) As the break-down of debt data by sector of government is only available from 2007, the Graph shows the debt levels for 2007 and 2010. This allows an assessment of whether the recent recession has led to significant debt accumulation at subnational level. In 2010, the largest subnational debt is observed in DE, about 30% of GDP, followed by ES with 15%, BE with 12%, and AT, FR, IT and NL with around 8%. At the opposite end, subnational debt corresponds to below 2% of GDP in MT, EL, BG, LT and SI. Some increase compared to 2007 is generally observed, although it is sizeable only in ES, DE, AT and LV. It should be underlined that

([148]) These data should be taken with caution as they refer to gross debt, i.e. unconsolidated, which implies that they do not correct for possible cross-sectoral debt holdings (e.g. state debt held by central government, local debt held by state governments etc.). This especially applies to the four countries (DE, AT, BE and ES) for which debts of the local and state subsectors are summed up.

Graph IV.1.12: Coverage of subnational government expenditures by transfers (1995, 2007 and 2010)



Source: Commission services.

the size of subnational debt is also affected by the economic importance of the subnational sector, which is larger in more decentralised countries such as DE, ES etc.

It is reasonable to expect that data on subnational deficits may underestimate the actual size of fiscal imbalances at subnational government level, since the central government may be moved to, at least partly, cover a rising gap between subnational expenditures and revenues with ex-post balancing transfers. This effect is often mentioned in the literature, and is linked to the fact that a large share of expenditure may be mandated by national legislation so that subnational policy-makers can claim to have limited control over it. This then leads to heightened pressures on the central government to provide additional resources.

On the other hand, the opposite effect may also occur (Darby et al., 2005), i.e. the central government may reduce transfers to subnational governments, especially in times of crisis, in order to force them to cut expenditures and hence contribute to fiscal consolidations. In order to have *prima facie* evidence on which of these two effects prevailed in the EU during recent years, and especially during the economic crisis, Graph IV.1.12 plots figures for the coverage of subnational expenditures by transfers from higher levels of government (i.e. the size of transfers as percentage of subnational expenditures) in 1995, 2007 and 2010.

No general trend towards an increase in subnational governments' reliance on transfers during the sovereign debt crisis (i.e. between 2007 and 2010) is found in the data, although such an increase is observed in CY, HU, FR, LT, SK and, to a lesser extent, LV, IT, EE and DK. This suggests that some pressure on central governments to provide additional resources to the subnational ones may have occurred in these countries. The reverse has occurred in AT, EL, IE and BE. Over the previous period (i.e. 1995 to 2007) transfer dependence decreased in 13 Member States, and particularly so in CZ, ES, IT and HU, and increased in 10, with the increase being most significant in RO, BG, LT, SK, AT and DK.

Overall, the evidence suggests that none of the two above mentioned effects occurred in a systematic way across the EU, although one or the other probably occurred in different groups of Member States, during the recent crisis. The figures are also likely to be influenced by reforms introduced in a number of countries to increase the share of tax revenues assigned to subnational governments.

However, further analysis (which is out of the scope of this Chapter) would be required to disentangle the different effects as figures in Graph IV.1.12 do not control for a number of factors, such as denominator effects (i.e. changes in the transfers' coverage driven by changes in subnational expenditures, rather than transfers), offsetting movements of the two above mentioned effects, or reforms which were not driven by subnational spending pressures or consolidation needs.

1.6. CONCLUSIONS

This Chapter has analysed evidence on the extent and key features of fiscal decentralisation in the EU. It covered expenditures and revenues (both on aggregate and in terms of composition) as well as borrowing of subnational governments. The data show that, on average across the EU, subnational governments have a large share of fiscal responsibilities within general government and that this share has been increasing in most Member States during the 1995-2010 period. This trend concerns both expenditures and revenues and is not confined to countries with a federal structure from the legal point of view.

In terms of revenue composition, subnational governments still rely heavily on transfers from higher levels of government in most Member States, which may lead to adverse incentives in terms of fiscal discipline via 'soft-budget constraints'. On the other hand, the weight of tax revenues assigned to subnational governments has increased in a few countries in recent years. The subnational share of general government deficit has generally increased in recent years, including in some of the most decentralised such as ES, AT, DE and BE although there is no one-to-one link between subnational deficit and decentralisation as shown by the cases of DK and SE.

In Chapter IV.2 below, aspects of decentralisation which cannot be assessed via Eurostat data will

also be to some extent covered based on country-specific analysis providing descriptions of fiscal decentralisation arrangements across the EU. Such aspects mainly include the effective tax autonomy of subnational governments (e.g. distinguishing genuine subnational taxes from assignment of revenues of national ones), the type of transfers and fiscal rules and budgetary frameworks applying to subnational governments. Furthermore, a more precise analysis of the impact of the various aspects of decentralisation considered in this Chapter as well as others (e.g. effective tax autonomy and fiscal rules) on fiscal outcomes of the general government is carried out in Chapter IV.3 below.

2. NATIONAL FISCAL DECENTRALISATION ARRANGEMENTS - A DESCRIPTION BASED ON COUNTRY-SPECIFIC ANALYSIS

2.1. THE CONTENT OF COUNTRY-SPECIFIC ANALYSIS ON FISCAL DECENTRALISATION ARRANGEMENTS

Following the description of the extent and main aspects of fiscal decentralisation in the EU based on available data in Eurostat carried out in Chapter IV.1, this Chapter presents more in-depth description of national fiscal decentralisation arrangements, based on country-specific analysis for all 27 EU Member States. The Chapter highlights main commonalities and differences across the EU, whereas the full country-specific analysis is contained in country fiches which are available in Annex 1.

Compared to information in the previous Chapter, those provided in the fiches are more qualitative and institutional. Fiches have been compiled based on a common template and questionnaire; information provided can be distinguished in four main building blocks:

overall institutional description of the system, i.e. number of government tiers, indications of main laws and reforms which have shaped the current system, constitutional status of subnational government tiers etc.

Areas of competence and size and composition of expenditures of subnational governments. This includes indications of the functions which are devolved to subnational tiers and, as far as possible, the extent of subnational autonomy in setting standards of services within the devolved functions.

Financing of subnational governments. This includes a description of the composition of subnational revenues across own sources (essentially subnational taxes), shared taxes (i.e. national taxes the receipts of which are totally or partly allocated to subnational government tiers) and transfers.

Budgetary frameworks and fiscal rules applying to subnational governments.

Points 3 and 4 are those which enrich information provided in Chapter IV.1 to a larger extent. Point 3 allows, firstly, to distinguish genuine subnational taxes, where subnational authorities are free to change, fully or partly, tax rates and/or bases, exemptions etc., from taxes which are simply shared between the central and subnational government sector. Secondly, it provides information on the allocation formulas of shared tax revenues and transfers from the central government, i.e. whether they are somehow based on costs of services to be provided by subnational governments or compensate for differences in fiscal capacity across them (horizontal equalisation). Thirdly, it distinguishes different types of transfers, e.g. general or earmarked.

Point 4 briefly describes, among other things, the difficulties encountered with ensuring fiscal discipline at subnational level, by highlighting recent changes in the budgetary framework; it also refers to monitoring, sanctions and enforcement of subnational fiscal rules, the role of the ministry of finance or other public bodies in this area and the possibility of bailing-out subnational entities in financial distress.

2.2. A SUMMARY OF MAIN PATTERNS OF FISCAL DECENTRALISATION IN THE EU BASED ON COUNTRY-SPECIFIC ANALYSIS

This Section summarises the main patterns of fiscal decentralisation arrangements across EU Member States based on the description contained in country fiches covering each Member State (see Annex 1). The focus is on the main commonalities and differences across the EU, or across groups or clusters of Member States as regards the four main elements listed above.

The reader should be aware that an exhaustive comparison of country systems in this field would be an immense task, both for the sheer amount of information that need to be collected and analysed and for the novelty of this exercise at EU level, and hence is beyond the scope of this Chapter. The focus here is rather on providing a preliminary overview based on a first attempt to systematically

collect qualitative information for all Member States. A more established tradition for reviewing national systems in this field exists at the OECD Secretariat, which set up a Network on Fiscal Relations across Levels of Government which has been active already for a few years by now.

2.2.1. General considerations on the role and weight of subnational governments across the EU

As it could be easily expected, there is a large variation in the depth and main features of fiscal decentralisation across EU Member States, reflecting the different status recognised to subnational governments in the national Constitutions. A first demarcation can be drawn between federal or highly regionalised states such as DE, AT, ES, BE and IT, on the one hand, and unitary states, on the other. However, it is quite striking to see that the constitutional definition of a country as federal or unitary only imperfectly reflects the actual weight of subnational government tiers in the delivery of public services and their ability to raise revenues.

Actually, all EU Member States, including the smallest ones such as MT, CY and LU, set up some form of subnational government (i.e. municipalities) with autonomous and democratically elected institutions, as opposed to decentralised articulations of central administration. Secondly, several Member States, albeit not being statutorily federal, assign a very large role in terms of public service delivery and revenue raising capacity to subnational governments, in some cases even larger than in constitutionally federal countries, see for instance Nordic Member States such as DK, SE and FI as opposed to AT.

Thirdly, there appears to be a general trend towards increasing rather than decreasing decentralisation of state functions to subnational authorities and this move also concerns countries with a strong centralised tradition, such as FR, which has enacted several legislative reforms between the 1980s (Defferre laws) and the 2000s to create new layers of subnational governments and strengthen the existing ones, or the UK which has created devolved authorities in Scotland, Wales and Northern Ireland and is currently discussing an agenda for 'localism' to increase subnational authorities' leeway in taking decisions over their share of expenditure.

Fourthly, across the EU it is very common to have more than one tier of subnational governments, with the exception of smaller countries such as CY, LU, EE, LV, SI, FI and BG, where municipalities are the only subnational level. Other countries have either two tiers of subnational governments([149]) or three tiers([150]) (DE, IT, ES, AT, PL, FR, BE, SE and UK([151])). In a few cases special entities exist for capital cities([152]) and the division of tiers is not the same across the whole national territory, e.g. in UK and IE. ([153]) In BE the specific ethnic situation motivated the creation of two different types of upper subnational tier, i.e. regions (Brussels, Wallonia and Flanders) and communities, the latter reflecting the three language groups existing in the country (French, Flemish and German-speaking).

An issue mentioned in a few fiches is the excessively small scale (in terms of population) of municipalities which prevents them from maximising efficiency in the provision of their services (e.g. HU, FR and AT). Attempts to overcome this problem are made by gradually increasing the average size of municipalities by cutting their number or encouraging mergers (FI, NL) or by setting-up inter-municipal associations to jointly provide certain services (FR, NL, IE). This suggests that insufficient exploitation of economies of scale in providing public services may constitute a serious challenge for setting up an effective decentralised system.

2.2.2. Expenditures of subnational governments

As far as the government functions that are devolved to subnational tiers are concerned, a number of common patterns can be highlighted. Services that are typically provided on a smaller

([149]) I.e. municipalities and regions or counties
([150]) Including municipalities, provinces/counties and regions/states.
([151]) Including devolved authorities of Scotland, Wales and Northern Ireland.
([152]) E.g. in UK, LT, LV, EE.
([153]) In UK 'unitary authorities' are the only subnational tier in certain areas whereas in others shire counties exist which are further subdivided into districts. Similarly, in IE two tiers exist in rural areas (town and county councils) and only one in urban areas (city councils).

geographical scale and need to be better tailored to subnational preferences, such as subnational infrastructures and utilities, including roads, subnational public transports, water and heating supply, waste management, housing, subnational economic development and territorial planning are generally attributed to municipalities, which is consistent with the normative literature on fiscal federalism. At the same time, in a majority of Member States subnational governments also have at least partial competence over education, social protection/social services and environment protection.

Their involvement over education may concern, according to the country considered, pre-school services (i.e. nurseries) but also primary and secondary education and vocational training (DE, BE, ES, CZ, SK, AT, Baltics), whereas higher level education (i.e. universities) are normally excluded from subnational competence (except in DE and BE). In case a two or three-tier subnational structure exists, responsibilities can be further split between municipalities, often being in charge of nurseries and primary schools, and provinces/counties, managing secondary schools (e.g. SK). As regards social protection, subnational governments are often attributed fairly limited tasks such as providing social assistance services to vulnerable people such as elderly, homeless and disabled([154]) (e.g. IT, LT, LV and EE). However, in a few countries their tasks also include actual payment of welfare benefits to individuals (DK, FI, SE, LT), which are in some other cases managed by autonomous social security agencies (DE, IT).

As regards the management of health care systems, subnational governments have a relatively important role in IT([155]), AT, ES, PL, DK([156]), SE and FI, where they are in charge of the actual provision of medical services within hospitals. In some countries, e.g. LV, LT and EE, responsibilities of subnational governments in this area are more limited as, although the latter may have the ownership of hospitals, these are actually financed and run by specialised agencies (e.g. the Health Insurance Fund in Estonia) or by health insurance companies. Still in these countries municipalities are responsible for organising some 'ancillary' services, such as transport of patients to the health establishments, and may be liable to cover excess expenditures of establishments of their ownership.

When discussing the attribution of specific functions to subnational governments it is important to distinguish cases where they have full competence, i.e. they are free in designing the corresponding policies subject to compliance to national laws, from cases where they are only in charge of implementing national guidelines and regulations. ([157]) Although information in the fiches on this aspect is very limited, the overall impression is that subnational governments tend to enjoy large autonomy in setting policies concerning subnational community services and utilities (e.g. road networks, subnational transports, waste disposal etc.). On the other hand, when they have responsibilities in the areas of health care, education and social protection (e.g. payment of social transfers) they are to a large extent bound by national rules and guidelines([158]), including in highly decentralised countries such as, for instance, ES([159]). In these cases national standards often aim at ensuring homogeneous level and quality of services throughout the country.

In a few Eastern Member States (e.g. PL, BG, SI) an explicit distinction is made between 'own' competences of subnational governments, where the latter retain a larger degree of freedom (i.e. economic affairs, culture and recreation, subnational networks and utilities, nurseries), and competences 'delegated' or 'transferred' from the central government, on which the latter remains responsible for overall regulation (e.g. social protection, education, health care).

A last observation on the expenditure side concerns the existence of shared competences between the central and subnational layers of government. This is especially relevant in DE, a federal country with a large role of *Länder* and

([154]) E.g. organising shelters or structures for care of the elderly.
([155]) In IT health care is almost completely devolved to regions, and account for 80% of their expenditure. In turn regions account for 2/3rds of total subnational expenditure.
([156]) In DK it is the responsibility of regions.
([157]) Including those contained in ministerial decrees, circulars etc.
([158]) E.g. on the eligibility to benefits, teachers' qualifications, number of pupils per class, minimum services in health care etc.
([159]) Exceptions are Nordic countries where subnational autonomy is large even in these three domains.

where most legislation is passed as concurrent legislation of the federation and the *Länder*, except for social security where policies are shaped by the federation and education, which is *Länder* competence, and AT, where the competence on health care is essentially split between the social security system, which regulates the activity of family physicians, and states, which run hospitals with a large margin of autonomy. ([160])

2.2.3. Financing of subnational governments - own taxes, shared taxes and transfers

Moving to subnational governments' revenue sources, an important distinction to be made is the one between Member States that grant to subnational governments the possibility to raise their own taxes, with at least partial freedom to change key tax parameters, and those that do not.

Autonomous taxes are an important revenue source for subnational governments in SE, FI, DE, where there is concurrent legislative competence of *Länder* and federation on most tax matters, ES, BE, IT, FR (albeit more for municipalities than for departments and regions), BG, PL (only for municipalities), CZ (only for municipalities), CY, HU, DK (only for municipalities) and LU. Conversely, own taxes of subnational governments have a low weight in AT, LT, EE, IE, UK, NL, RO, SK and PT and, finally, there is basically no subnational tax autonomy in MT, SI, EL and LV.

The tax which is more often assigned to subnational governments with autonomy in setting its rate and/or base is the property or real estate tax, which is levied on buildings and/or land and on domestic and/or business properties. This is the case in all countries except in MT, EL and LV, although even in the latter two countries receipts of the property tax are at least partly assigned to subnational governments. This tax is commonly assigned to municipalities. In a few Member States, such as DE or BE, upper subnational tiers (*Länder* and regions, respectively) are also entitled to tax properties.

Subnational governments are also generally allowed to levy taxes on vehicles (or vehicle registration), on donations/inheritances, gambling and on subnational economic activities such as public markets, although such sources normally represent a small share of subnational revenues. In a few cases, subnational governments are also entitled to autonomously raise taxes on corporate income or subnational business taxes. This is the case in IT (with the regional tax on productive activities, the IRAP)([161]), ES (for municipalities), DE, PL, CZ, HU, PT and LU. Finally, the tax on personal income largely remains a national tax (albeit quite often its revenues are shared with subnational governments, see below) across the EU with only some exceptions, i.e. DE, ES, SE, FI and DK. The VAT remains everywhere a national tax, except for a regional sur-tax in BE (see below).

In some cases, subnational tax autonomy is granted via the possibility to raise surtaxes on national taxes. Regional and municipal surtaxes on personal income exist in IT and BE (with leeway to change the rate within a band in IT); BE also allows a regional surtax on VAT and municipal and provincial surtaxes on the regional real estate tax. A municipal surtax on corporate income exists in DE and a provincial surtax on car registration in NL.

Therefore, the conclusion can be drawn that despite large historical and institutional differences across the EU, general patterns in the assignment of own tax powers to subnational governments exist and they are by and large consistent with recommendations from normative fiscal federalism literature. This especially concerns the use of real estate tax as a subnational own revenue source almost everywhere in Europe, as real estates and properties constitute an a-cyclical and immobile tax base and hence are not associated with risk of tax competition among subnational governments and of large volatility of tax receipts (see Chapter IV.1). However, as shown by IMF staff estimates, the revenue potential of property taxes is not fully reaped in most advanced economies. ([162])

([160]) In the case of AT, in particular, transferring workload from hospitals to family physicians, which would allow significant savings, has so far been hindered by this division of responsibilities.

([161]) Italian regions have the power to increase or reduce by 1 pp the basic IRAP rate (see fiche of Italy in Annex 1).

([162]) According to IMF staff estimates, taking as a benchmark the average revenues ratios of the best performers among high income countries, the revenue potential from property taxes is about 2.5-3% of GDP, with most advanced

Similarly, the prevalent assignment of personal income tax and of VAT to the central government is in line with economic arguments related to cyclical volatility of revenues from those taxes, redistributive objectives of tax policy, tax spill-overs beyond subnational boundaries and administrative complexity which all contribute to make these revenue sources less suitable for subnational governments.

Additionally, it is important to underline that assignment of own taxes to subnational governments does not imply that the latter are responsible for collecting revenues from those taxes. Tax collection mostly remains a task of the central government, which eventually transfers to subnational governments the amount of tax revenue they are entitled to based on residence of tax-payers or other criteria (see below).

Besides autonomous taxes, EU subnational governments and especially municipalities also collect other types of own revenues, such as user charges/fees on services. ([163]) These account for a normally minor share of subnational revenues, with some exceptions such as FI and IE (see also Chapter IV.1). From the reading of fiches it appears that it is sometimes difficult to draw a line between fees and autonomous taxes. A reasonable criterion should be that fees, unlike taxes, are prices to be paid in return to specific services. Further own revenues sources are those from subnational properties.

The second category of subnational revenues is shared taxes. In order to avoid confusion with autonomous taxes, in this exercise shared taxes only include receipts of national taxes which are fully or partly assigned by the central government to subnational governments, with the latter having no autonomy in setting tax parameters. This implies that cases where central and subnational governments share receipts from a tax but subnational governments also have, at least partly, the power to set its rate or base, falls within the category of autonomous taxes. This is to a large extent the case of DE and ES. ([164])

With this definition in mind, tax sharing is an important revenue source for subnational governments in BE (for the upper tier, i.e. regions and communities), AT, LV, LT, EE, RO, PL, CZ, SK, EL, HU, PT, SI and LU. On the other hand tax sharing without subnational autonomy in setting tax parameters has a relatively small weight in DE, ES([165]) (except for municipalities in both countries)([166]), IT, DK, FI, IE, UK, FR, whereas it is basically absent in MT, CY, SE, NL and BG. In several cases, the sharing of personal income tax receipts plays a significant role, i.e. in BE, LV, LT, EE, RO, PL, SK, EL, HU, PT, SI. Sharing of VAT is important in BE, ES, IT, CZ, EL, PT and LU, whereas corporate income tax is shared in DK, FI, AT, PL and PT. Property taxes (on either buildings or land) are shared in UK (on business properties), EE, LT, LV and EL. Other shared taxes are the vehicle tax (IE, LU), inheritance tax (LT), a gambling tax and natural resource tax (LV) and excise on alcohol-tobacco (ES, LU), electricity tax (ES). In AT the proportions in which tax revenues are shared between central government, states and municipalities are set every six years through negotiations between the three government tiers.

The third and last main category of subnational revenues are transfers from the central government**.** They can be divided in two categories, (i) general transfers, i.e. those which finance subnational expenditures without obligation as regards the specific function/ item for which they have to be used; (ii) transfers earmarked to finance a specific function or item of subnational expenditures.

economies being largely below this level, as average property tax receipts amount to less than 1% of GDP across OECD countries.

([163]) E.g. water supply, sewerage, heating supply, issuance of permits for certain professions/economic activities, construction activities or use of land

([164]) In DE and ES tax sharing and subnational tax autonomy largely go together. In DE tax matters mostly fall within concurrent legislation of the Federation and the *Länder* and at the same time the main taxes (income tax, corporate tax and VAT) are shared between the two tiers in similar proportions. In ES personal income tax rates are composed of two parts, one set by the central government and the other set by autonomous communities. The same applies for allowances and exemptions.

([165]) See footnote 164.

([166]) In ES municipalities that are capitals of provinces or communities get a share of personal income tax, VAT and alcohol-tobacco excise. A small part of personal income tax and VAT is allocated by *Länder* to municipalities in DE, whereas the latter can autonomously raise a local business tax (*Gewerbesteuer*).

General and earmarked transfers, taken together, are the main revenue source for subnational governments (accounting for half of their revenues or more according to the fiches) in MT, UK, IE, NL, BG, IT, DK, BE (for municipalities and provinces), LT, CZ (for regions), PL. They are quantitatively important, albeit to a lower extent, also in CY, SK, RO, AT (for states, less for municipalities), LV, EE, FR, PT, HU, LU and CZ (for municipalities). The incidence of transfers compared to own taxes and shared taxes is instead quite low in ES, DE, BE (for regions and communities), AT (for municipalities), SE, FI, SI and EL.

Normally, general and earmarked transfers coexist. This is the case in BE, SE, DK, FI, EE, IE, UK, NL, MT, CY, BG, FR(167), PL, CZ and HU although the distinction between the two types is not always straightforward based on information in the fiches. In some cases all transfers are by and large earmarked (RO, LU, PT, SK and LV). In several Member States earmarked transfers are devoted to subnational capital/infrastructure expenditure(168) (LU, SI, HU, CY, PL, BG, FR, UK, IE, EE, LV, DE for municipalities), education (LV, IE, UK, PL, CZ, SK, PT, LU for nurseries) or social expenditures (PT, CZ, NL, UK). In a few new Member States, own revenues mainly finance autonomous subnational functions whereas transfers are used to fund state-delegated functions(169) (CZ, BG, LT, SK).

Quite frequently transfers are allocated to subnational governments based on equalisation criteria, i.e. aiming at ensuring uniform levels and quality of services across different subnational entities within the country. This is normally done in two ways: (i) via transfers from central to subnational governments providing the latter with sufficient resources to fulfil their expenditure obligations (vertical equalisation) and (ii) via transfers between subnational governments compensating for differences in revenue-raising capacity and cost of service provision across them (horizontal equalisation).

Equalising transfers exist in DE, ES, SE, LV, FI, LT, EE, IE, UK, NL, RO, BG, PL, SI, PT, FR and HU. The amounts assigned to the different subnational governments are set via specific allocation formulas normally based on demographic variables (mainly population size(170)) and age structure) and economic variables (e.g. unemployment rate), which allow to compute expenditure needs in the various subnational entities, as well as on measures of tax capacity. The formula can be more or less complex depending on the Member State; additional allocation criteria used are number of properties, geographical size of the subnational entity, remoteness of local areas, length of roads network etc. In DE(171) and ES(172) the equalisation system is articulated in different steps.

However, the equalisation formula can be applied not only to the allocation of transfers, but also to that of shared tax revenues (these cases were included in the list of countries in the previous paragraph), making the distinction between these two categories of revenues not always clear cut. This is the case for the allocation of VAT revenues in DE, of the personal income tax in SI and HU, and of a joint pool of taxes, which are put together

(167) Transfers are divided between current and capital expenditures, the former category being admittedly very broad to qualify as earmarked transfer.

(168) The latter mainly including improvement of networks and infrastructures linked to government functions carried out by subnational governments, e.g. roads, school buildings etc.

(169) Albeit with some subnational co-financing with own resources.

(170) E.g. size of transfers being determined as a lump sum per inhabitant.

(171) DE operates a strong system of fiscal equalisation among the *Länder* aimed at ensuring equivalent living standards across them. This is essentially achieved by a complex system of VAT receipts redistribution in three steps, (i) vertical redistribution (from centre to *Länder*) of part of VAT to *Länder* with below-average tax revenues, (ii) horizontal transfers from *Länder* with above average fiscal capacity to those with below-average fiscal capacity, (iii) supplementary federal transfers to *Länder* with lower fiscal capacity. This system allows to largely compress cross-*Länder* differences in per capita revenues. Municipalities also receive vertical (from their Land) and horizontal (from richer municipalities) transfers to minimise differences between their fiscal capacity and their expenditure needs.

(172) ES also has an elaborate system of transfers with multiple steps to ensure uniform access to social services across all *Comunidades*. Firstly, all Autonomous Communities contribute 75% of their tax revenues to a Guarantee Fund which is then redistributed among them based on their funding needs for 'essential public services'. Secondly, supplementary transfers are provided by the central government to those Autonomous Communities with residual financing needs through the Global Sufficiency Fund and through other funds aimed to further reduce differences in financing capacities.

in subnational funds and then redistributed to subnational governments, in ES, PT, EL and LU.

Allocation of transfers based on expenditure needs and independent of the quality and efficiency of service provided tend to discourage the adoption of cost-saving or efficiency enhancing measures by subnational governments. Although this problem is pointed out in several fiches, no Member State, except DK (see 2.2.4 below), appears to have introduced mechanisms to correct this feature. However, this may be partly explained by the fact that performance-based transfers should be conditional on outputs, i.e. on the quantity and quality of public goods and services delivered and on access to them, rather than on outcomes, i.e. the short and long-run consequences of public service provision for consumers and taxpayers([173]), as the latter can be affected by factors beyond the control of subnational authorities. Therefore, performance-based transfers may be difficult to design as the distinction between outputs and outcomes is often not clear cut (Shah, 2007). This being said, it should be pointed out that formulas based on "presumed" costs, measured by demographic or socio-economic indicators, would still be preferable in terms of incentives than systems which simply cover the amount of expenditures claimed by subnational governments. This is illustrated by recent experience in IT([174]), which plans to move from historical to 'standard' costs of services as main criterion for subnational financing, and NL, where reimbursement of subnational claims for social expenditures has been replaced by assignment of fixed (formula-based) amounts of resources.

Another problematic feature of a transfer-based system is the tendency to largely reduce the amount of transfers to subnational governments during 'bad' economic times while keeping subnational obligations to provide services unchanged. This may force the central government to eventually provide 'extraordinary' transfers aimed at covering widening subnational deficits or cope with special economic difficulties, hence further discouraging subnational governments to behave in a fiscally responsible way (by, for instance, raising own taxes to cover the gap created by reduced transfers).

2.2.4. Fiscal rules, budgetary arrangements and bail-out possibilities of subnational governments

The remaining part of this Section summarises main facts with respect to fiscal rules applying to subnational governments across the EU, their monitoring and enforcement, the supervisory role of the central government, the possibility for subnational governments to borrow, the procedures to be followed in case a subnational government falls in financial distress, the budgetary coordination across different tiers of government. A number of conclusions can be drawn after looking at information in country fiches on all these aspects.

Fiscal rules apply to subnational governments in most EU Member States. The most widespread type of rule is the golden rule, whereby subnational governments are entitled to borrow exclusively to finance investments, although it is in some cases extended to cover borrowing linked to temporary revenue shortfalls and repayment obligations of existing debt. Another type which is quite recurrent is a borrowing limit, often formulated as a threshold on the amount of liabilities which can be assumed by a subnational government in a year or as a threshold on annual debt service obligations, both generally expressed as percentage of subnational revenues.

Limits to the total stock of subnational debt are less common, although in some cases borrowing is allowed only if the accumulated debt is below a specified threshold. Surprisingly, statutory limits on subnational expenditures are mostly non-existent across the EU. However lack of control of growth of subnational expenditures is in some cases, e.g. ES, pointed out as adversely affecting the achievement of fiscal targets of general government, calling for the introduction of such ceilings. In DK binding expenditure limits for subnational governments were introduced in 2011

([173]) E.g. in the case of education, literacy rates and supply of skilled professionals.

([174]) In IT a far reaching reform to deepen the system of fiscal decentralisation is currently being implemented (starting from 2009), implying major changes also for the financing of subnational governments: (i) introducing the 'standard cost' principle, rather than the 'historical cost' one to determine subnational expenditure needs, so that subnational entities providing services at higher costs will have to raise additional resources to cover them; and (ii) the introduction of equalisation transfers across subnational governments to compensate for differences in fiscal capacities.

after a long trend of increase in subnational expenditures.

As opposed to statutory thresholds on fiscal aggregates, across the EU it is quite common to have some form of budgetary coordination across different government tiers. This essentially consists in annual negotiations and adoption of targets for the budget balance and, in some cases, expenditures and revenues of both the central and subnational government tiers. These are more common in more fiscally decentralised countries. They are in some cases called Internal Stability Pacts (IT, AT) and in general imply monitoring of compliance to targets by the central government (typically the ministry of finance) and can imply a range of sanctions for non-compliance.

The existence of a system of internal budgetary coordination appears to positively contribute to fiscal discipline at general government level; in some cases (PT, HU) it is precisely the insufficient coordination/exchange of information across levels of government which seems to be one of the causes of fiscal slippages at subnational levels. In the case of PT, this occurred via a systematic overestimation of revenues by subnational governments. However, internal stability pacts are not a panacea, as their effectiveness depends on a number of implementation details, such as the time horizon for fulfilment of fiscal targets (if multi-annual, deficit in one year can be offset by surplus in another year), automaticity of sanctions, variability and degree of ambition of targets and their scope of application (the whole subnational sector vs. individual subnational entities, the latter clearly being stricter).

As for monitoring and sanctions in case of breach of fiscal rules or negotiated targets by subnational governments, across the EU these alternatively include the prohibition to issue new debt, the need to ask authorisation for it, the need to introduce corrective measures within specified timeframes under enhanced supervision of the ministry of finance, cuts in revenue allocation from transfers or shared taxes. The most elaborate example of the latter is provided by DK, which has recently made its block grant to subnational governments partly conditional to fulfilment of expenditure targets and no increase of own taxes by municipalities.

In any case, it is interesting to observe that there is no generalised prohibition to borrow for subnational governments, although this is often restricted to investment financing (see above). In spite of this fact subnational debt levels have remained fairly low across the EU with some exceptions (e.g. PT, NL and DK). However, ability to borrow by subnational governments is in some cases restricted to loans from commercial banks or, in the extreme, only from the state treasury, whereas issuing bonds in capital markets is prohibited. In some cases, subnational governments can issue bonds or obtain loans exclusively through a special public body, e.g. the municipal finance corporation in FI, which is backed by joint guarantee from all municipalities in the country.

If subnational governments experience serious financial problems, in several cases they fall under strengthened surveillance by the central government and they have to negotiate with the latter, sometimes via special joint committees or boards, a stabilisation plan to restore fiscal sustainability. In other cases they are put under forced administration by the central government. Generally there is no formal procedure for insolvency or default of subnational governments. The overall impression is that, despite the frequent lack of formal guarantee by the central government on subnational financial obligations, a subnational default is de facto ruled out across the EU and the central government eventually intervenes to provide 'exceptional' transfers to bail-out the subnational entity in financial distress. The latter can in fact threaten to drastically cut service provision or argue that its spending obligations are mandated by national legislations and hence oblige the central government to cover its debt. In the extreme, this may occur as a result of legal actions in the constitutional court (as was the case for some *Länder* in DE, see also Von Hagen et al., 2000).

In some cases, the application of subnational fiscal rules has been circumvented by the practice of subnational governments to delegate the provision of some services to external enterprises of which they hold the ownership, totally or partially, as such enterprises are often out of the scope of application of those rules implying that their liabilities were not counted within the amount of debt or borrowing of subnational governments.

Another common way to circumvent fiscal rules at subnational level is by running arrears on payments to suppliers, taking advantage of the fact that subnational fiscal accounts are often set in cash terms.

In several cases complex budgetary procedures are foreseen for subnational governments (apart from coordination with the national budget as mentioned above), detailing all the steps for drafting, adoption and monitoring of subnational budgets, typically including an important role of subnational elected assemblies, the obligation to communicate the adopted budget to the ministry of finance, attribution of tasks of monitoring execution and carrying out ex-post checks to external bodies([175]) or auditors. A problem with such bodies may be their lack of full political independence as they are sometimes appointed by subnational policy-makers.

2.3. CONCLUSIONS

This Chapter has summarised main patterns of fiscal decentralisation arrangements across the EU based on individual country fiches compiled for all 27 Member States. It showed that cross-country data available in Eurostat and described in Chapter IV.1, albeit rich, fail to capture all aspects and details of different national systems, and that country descriptions provide a useful set of complementary information.

National systems across the EU show a significant degree of heterogeneity reflecting historical and institutional specificities. However a number of largely common patterns emerge, such as a rising importance of subnational levels of government as providers of services, including the attribution of responsibilities in important functions such as education, social protection and health care, albeit mostly with the task of delivering the services with regulation being largely left with the national level, the varying degree of availability of own resources (i.e. taxes set autonomously) or shared taxes compared to transfers across the EU, the fact that the constitutional status of subnational governments (i.e. federal vs. unitary countries) does not necessarily match the actual fiscal/budgetary weight of subnational tiers, the systematic attribution of certain revenue sources (e.g. property taxes) to subnational entities.

This Section also highlighted that the existence of subnational tiers with at least some expenditure and revenue autonomy does create a number of challenges for overall efficiency of public services and fiscal discipline at the general government level. Divergences of spending and financing responsibilities, allocation of revenues often based on 'presumed' costs of services without rewarding efficiency gains, lack of or badly designed fiscal budgetary coordination across sectors of government, *de facto* impossibility to allow a default of a subnational entity which behaved in a fiscally irresponsible way, insufficient scale of subnational entities to efficiently run services, are all features which may weaken subnational incentives to run services in a cost-effective manner and to positively contribute to achieve national budgetary targets.

Finally, subnational governments are often subject to fiscal rules, especially golden rules (borrowing allowed to finance investments) and borrowing limits, which again underline a general need to constrain subnational fiscal behaviour, and are also generally put under some form of monitoring by the central government (especially the ministry of finance), which is often substantially tightened in case they fall in fiscal distress or deviate from agreed targets negotiated with the central government.

([175]) E.g. the stability council (for *Länder*) and supervisory agencies (for municipalities) in DE. These bodies also formulate budgetary forecasts at the beginning of the budgetary process.

3. FISCAL DECENTRALISATION AND FISCAL OUTCOMES

3.1. INTRODUCTION

In this Chapter the relationship between fiscal decentralisation at national level and fiscal outcomes of the general government, is analysed, based on the different indicators of decentralisation, which were presented and described in Chapter IV.1. The purpose is to assess whether devolving expenditure functions and revenue sources to subnational entities, which has generally occurred across the EU over past years as shown in Chapters IV.1 and IV.2, may have adverse consequences on overall fiscal balances of the general government due to a loss of control of the central government on subnational fiscal behaviour and lower incentives for fiscal discipline at subnational level. This concern is very relevant and increasingly raised by EU policy-makers given that fiscal policy governance at the EU level and, with the recently adopted Fiscal Compact (see Part II), at the national level, is based on general government definitions.

The fiscal outcomes considered are the budget balance and expenditures and revenues, taken separately. The analysis is done in two steps. Firstly, correlations between decentralisation and fiscal outcomes are presented and analysed in order to have *prima face* evidence on the budgetary impact of decentralisation. Secondly, the relationship between indicators of decentralisation and fiscal outcomes is also estimated via regression analysis.

3.2. FISCAL DECENTRALISATION AND FISCAL OUTCOMES: THEORETICAL CONSIDERATIONS

Theoretical priors can be highlighted as regards the sign of the effect of different dimensions of fiscal decentralisation on the main fiscal aggregates of the general government, according to the fiscal federalism literature (see among others Oates, 1999 and 2006; Blöchliger and Petzold, 2009; Blöchliger and King, 2006; Blöchliger and Rabesona, 2009; IMF, 2009; Neyapti, 2010; De Mello, 2007; Darby et al., 2002). However, in most cases the net impact is *a priori* ambiguous as a result of conflicting arguments.

Decentralization of expenditures

The decentralisation of expenditures could have either positive or negative effects on the fiscal balance. The government balance is expected to improve via lower expenditures due to:

(1) A more efficient expenditure allocation as public good provision by subnational governments is better tailored to subnational needs and preferences.

(2) Competition across subnational governments with respect to the technology and methods of production of public goods, which encourages them to select and adopt the more cost-effective ones.

(3) Failure to internalise positive spill-overs of public expenditures to citizens of other subnational communities.

On the other hand, there are arguments pointing to an increase in expenditures due to decentralisation of expenditures with adverse implications for the primary balance, i.e.:

(1) Decentralisation may prevent the exploitation of economies of scale in the production of public goods.

(2) Decentralisation entails unnecessary multiplication/overlapping of administrative procedures, especially due to shared competences across different territorial levels of administration over the same government function and unclear division of responsibilities among them.

(3) Lower productivity of subnational administration compared to the national one, due to greater capability of the latter to attract a more skilled labour force.

(4) Greater proximity of subnational policy-makers to subnational interest groups, which make the former more sensitive than national policy-makers to lobbying for increased expenditures from the latter.

Overall, the prediction of economic theory is that the impact on expenditures and the primary balance is a priori ambiguous. Moreover, a

significant share of subnational governments' expenditures is likely to be mandated by national directives and legislation, leaving only limited room for subnational governments to affect their overall size and evolution. If that is the case, expenditure decentralisation taken at face value would not tell much on the effective devolution of spending powers to subnational governments, and could then have no real impact on the magnitude of expenditures. ([176])

Decentralization of revenues

Decentralisation of revenue sources can also affect fiscal balances. The literature generally underlines that if subnational governments can finance a large part of their expenditures with their own revenue sources (taxes and fees) they have stronger incentives to behave in a fiscally responsible way, with positive effects on the fiscal balance of the general government. The following arguments can explain this effect:

(1) Subnational governments are more accountable to subnational voters on the way they manage their resources as the link between public services provided at subnational level and the taxes raised to finance them is stronger.

(2) The central government can more easily resist pressures of subnational governments to cover an excess in their expenditures as the latter have sufficient revenue autonomy to deal with their expenditure obligations on their own.

(3) Subnational policy-makers have a stronger incentive to provide high quality public services in order to contribute to greater economic growth in their community, as they would get the resulting dividend in the form of higher tax receipts, although the strength of this argument varies according to the type of tax devolved to subnational authorities. ([177])

On the other hand, if subnational governments largely rely on transfers from the central government to finance their expenditures, they can easily justify large unfunded expenditures with the lack of own revenue sources and threaten to scale down public service provision, which is often mandated by national legislation, eventually forcing the central government to intervene to bail them out. This implies that subnational governments face a 'soft-budget constraint', with adverse effects on the general government fiscal balance. ([178])

Moreover, in presence of equalising transfers, i.e. transfers which are allocated in such a way as to fill the gap between expenditure needs and own revenues of subnational entities and hence imply some degree of redistribution from the richer to the poorer of them, subnational governments may fail to internalise the cost of financing additional expenditures, thereby contributing to expenditure and deficit bias.

Finally the composition of subnational expenditure by government function and economic function, normally a neglected aspect in the fiscal federalism literature, may also weigh on the impact of decentralisation on fiscal outcomes. A higher relative weight of subnational governments in expenditure items more affected by demographic and political pressures, such as health care and social protection, may have an adverse effect on fiscal balances, since subnational governments may have lower incentives or ability to counteract such pressures. ([179]) The same reasoning can by and large be extended to cases of strong decentralisation of expenditures on compensation of employees and social benefits. This effect can be tested by using figures on the breakdown of expenditure decentralisation by functions (such as health, education etc.) or economic category, which were also discussed in Chapter IV.1.

([176]) On the other hand, evidence from country fiches suggests that subnational governments are often assigned also increasing decision-making powers on devolved expenditures (see Chapter IV.2.)

([177]) It is likely to be weaker for property taxes than for local income or business taxes.

([178]) However, a counter-argument is proposed in some papers. A larger weight of transfers may give the central government a stronger lever to control the fiscal behaviour of subnational governments and, hence, reduce the risk of subnational fiscal slippages. This effect should be especially relevant if most transfers to subnational governments are earmarked to specific expenditures, leaving little leeway to subnational governments to decide upon their use.

([179]) For instance, subnational administrations may lack the technical expertise to anticipate the future evolution of health expenditure or may have less political will to curb health expenditure because they would assume that the central government would eventually intervene to provide additional funding for such a politically and socially sensitive expenditure item.

Overall, although a number of theoretical predictions can be drawn from the literature about the impact of fiscal decentralisation on fiscal outcomes of the general government, they are often conflicting as regards its sign, implying that this is ultimately an empirical question. Therefore, the remainder of this Chapter turns to the empirical analysis of these issues. In Section 3.3 stylized facts will be presented. Then, in Section 3.4 the main hypotheses derived from theoretical predictions are reformulated and qualified based on the stylised facts (Subsection 3.4.1 below) and then tested through regression analysis.

The effect of fiscal decentralisation can be tested by using the indicators which were introduced in Chapter IV.1 to describe the extent and main characteristics of fiscal decentralisation across the EU. These indicators are:

i) expenditure decentralisation, defined as the percentage of subnational governments' expenditures in total expenditures of the general government;

ii) own revenue decentralisation, defined as the percentage of subnational taxes and fees (i.e. subnational own revenues) in general government revenues;

iii) revenue decentralisation, defined as the percentage of subnational revenues (including transfers) in general government revenues (this indicator will be used exclusively in the Section on stylised facts and not in the one on econometric analysis);

iv) the percentage of tax revenues in subnational revenues;

v) the percentage of transfers from the central government in subnational revenues;

vi) subnational expenditure coverage by own revenues, defined as the percentage of subnational expenditures covered by subnational taxes and fees. ([180])

vii) transfer dependency, defined as the percentage of subnational expenditures covered by transfers.

3.3. STYLISED FACTS ON DECENTRALISATION AND FISCAL OUTCOMES

3.3.1. Pair-wise correlations between fiscal decentralisation and fiscal outcomes

This Subsection presents evidence on pair-wise correlations between fiscal decentralisation and general government fiscal outcomes in order to identify a few stylised facts before moving to econometric analysis of the fiscal impact of decentralisation in Section 3.4 below. The data sample used consists of annual data covering all EU27 Member States in the period 1995-2010. ([181])

The first exercise consists of a comparison of average values of main fiscal outcomes, across high and low decentralisation subsamples of the data. To do this, the data are divided into two subsamples, with values of the different decentralisation indicators lower and higher, respectively, than their overall sample average. ([182]) The exercise is undertaken for four indicators of decentralisation mentioned in Section 3.2 above: expenditure decentralisation, own revenue decentralisation, subnational expenditure coverage by own revenues, share of transfers in subnational revenues. The comparison is carried out for the following fiscal variables: primary balance ([183]), cyclically-adjusted primary balance, primary expenditures and total revenues of the general government, in order to assess the correlation of decentralisation with both the net fiscal balance

([180]) The latter measures the decentralisation of revenues relative to expenditures. The complement to one of this indicator, i.e. the share of subnational expenditure not covered by own subnational revenues is generally called 'vertical fiscal imbalance' (Eyraud and Lusinyan, 2011 and Karpowicz, 2012), as it captures the gap between expenditures and own revenues of subnational governments which must be covered either by transfers or subnational borrowing. It follows from the above considerations that a lower vertical fiscal imbalance should lead to a 'harder budget constraint' for subnational governments, with positive effects on fiscal balances.

([181]) This is the longest time period with available data by sector of government in Eurostat, except for the breakdown by functions (cofog) which is shorter, see below.

([182]) For instance, in the case of the indicator of overall expenditure decentralisation, the sample is divided between observations where the value of this indicator is below or above its sample average.

([183]) ESA95 figures, Excessive Deficit Procedure.

Table IV.3.1: **Fiscal outcomes of general government (% of GDP), averages for observations with low and high values of different indicators of fiscal decentralisation (EU27 Member States, 1995-2010 period)**

		pb	capb	exp	rev
Expenditure decentralisation	Low	-0.8	-0.9	35.6	39.1
	High	1.3	1.2	39.8	44.5
Subnational expenditure coverage by own revenues	Low	-0.2	-0.2	36.0	39.6
	High	0.6	0.4	38.9	43.3
Own revenue decentralisation	Low	0.0	-0.3	35.9	39.8
	High	0.7	0.7	40.2	44.7
Share of transfers in subnational revenues	Low	0.5	0.4	38.8	43.2
	High	-0.1	-0.2	36.0	39.6

Notes: pb = primary balance of general government, capb = cyclically adjusted primary balance of general government, exp = primary expenditure of general government (% of GDP), rev = total revenues of general government (% of GDP).
Source: Commission services.

and the spending and revenue side, separately. Results are shown in Table IV.3.1.

The following patterns emerge:

i) High expenditure decentralisation goes together with a higher primary balance on average, higher (primary) expenditure and higher revenues of general government. ([184]) The same occurs with own revenue decentralisation.

ii) High subnational expenditure coverage by own revenues is associated to higher primary balance, higher (primary) expenditures and revenues although the difference is smaller than between low and high decentralisation of expenditures.

iii) Conversely, a higher share of transfers (or a lower share of own revenues) in subnational revenues is associated to lower primary balance, lower primary expenditure and lower revenues. ([185])

These main messages are by and large confirmed by computing correlations between country averages for the 1995-2010 period of the decentralisation indicators considered and country averages over the same period of the primary balance, expenditures and revenues. ([186])

However, comparisons of fiscal outcomes across low and high levels of a single decentralisation indicator do not control for the fact that different aspects of decentralisation may go together. It is quite likely, for instance, that decentralisation of expenditures goes together with decentralisation of own revenues and larger subnational responsibility to cover their expenditures with their own resources. Therefore, it is possible that the positive effect of expenditure decentralisation on the primary balance is in fact due to the greater subnational financial autonomy and responsibility which may often go with it. Controlling simultaneously for the fiscal impact of different decentralisation variables requires econometric analysis, which is carried out in Section 3.4 below; however two simpler exercises can already shed some light on these issues:

(1) Looking at the relationship between different aspects of decentralisation to test whether expenditure decentralisation tends to be accompanied by greater subnational responsibility on the revenue side and a lower reliance on

([184]) +2.1pp of GDP for the primary balance, +4pp for expenditures and +5½pp of GDP for revenues.

([185]) Looking at the link between decentralisation and the magnitude of subnational government expenditure (not shown), data show that the latter is significantly larger when decentralisation of either expenditures or revenues is higher than average. Less obviously, it is around 2pp higher on average when subnational expenditure coverage by own revenues is *higher* and transfer dependency *lower*.

([186]) The figures are not shown. Specifically, across the EU the average of both expenditure and own revenue decentralisation is positively correlated with the average primary balance, cyclically adjusted primary balance, primary expenditures and revenues in the 1995–2010 period. The correlation coefficients are always in the range of 0.5-0.6. The average rate of coverage of subnational expenditures by subnational own revenues is positively correlated with primary expenditures and revenues, whereas both expenditures and revenues are negatively correlated with subnational dependency on transfers. As for the mix of revenue sources of subnational governments, the average share of taxes in total subnational revenues is positively correlated with expenditures and revenues.

transfers and to assess how the different aspects of revenue decentralisation considered so far (revenue decentralisation, share of taxes, share of transfers and subnational expenditure coverage by own revenues) tend to be combined with each other.

(2) Computing averages of fiscal outcomes for low vs. high expenditure decentralisation controlling for high vs. low levels of the other indicators of decentralisation.

Both exercises are carried out in the remainder of this Section.

The upper part of Table IV.3.2 below compares the average values of the indicators capturing the different aspects of revenue decentralisation for low vs. high decentralisation of expenditures, whereas the bottom part compares the average shares of taxes and transfers in subnational revenues and the average level of subnational financial responsibility (i.e. coverage of their spending with own revenues) for low vs. high revenue decentralisation. ([187])

The Table shows that higher expenditure decentralisation is on average associated with higher revenue decentralisation, both including (first column) and excluding (second column) transfers, higher rate of coverage of subnational expenditure by own revenues, as well as a higher share of taxes and a (marginally) lower share of transfers in subnational revenues. Moreover, revenue decentralisation is accompanied by a higher share of taxes and a lower share of transfers in subnational revenues, as well as by higher subnational expenditure coverage with own revenues.

These findings are by and large confirmed by pair-wise correlations between the mean values of decentralisation indicators by country in the 1995-2010 period. ([188])

Overall, it appears that expenditure decentralisation, own revenue decentralisation and subnational responsibility to cover their expenditures with their tax revenues and fees tend to go hand-in-hand across the EU. Moreover, in countries where total revenue decentralisation is high, taxes tend to be more important than transfers as subnational revenue source. These findings imply that simple relationships between individual aspects of decentralisation and fiscal outcomes should be interpreted with caution, without inferring too easily causal effects and that it is important to look at the effects of different decentralisation aspects simultaneously. A first attempt to do this is done with the exercise mentioned in point (2) and discussed below, whereas an econometric analysis is carried out in Section 3.4.

Table IV.3.3 below compares the average values of primary balance, expenditures and revenues across the two sub-samples with low and high expenditure decentralisation, *conditional on low or high level of own revenue decentralisation, subnational expenditure coverage by own*

([187]) I.e. the share of all revenues of subnational governments, including transfers from the central government, in general government revenues (see above). This indicator differs from own revenue decentralisation by the inclusion of transfers.

([188]) These are not shown. The correlations between decentralisation of expenditures, on the one hand, and decentralisation of own revenues (taxes and fees), share of taxes in subnational revenues and subnational expenditure coverage with own resources are all positive and significant. Also, overall revenue decentralisation (including transfers) is positively correlated with the share of taxes in subnational revenues and negatively correlated with the share of transfers, although it is significant only in the first case.

Table IV.3.2: **Conditional means of selected indicators of fiscal decentralisation for high vs. low expenditure and revenue decentralisation**

Expenditure decentralisation	Revenue decentralisation	Own revenue decentralisation	% of transfers in subnational revenues	Subnational expenditure coverage by own resources	% of taxes in subnational revenues
Low	0.17	0.08	0.53	0.45	0.32
High	0.37	0.18	0.5	0.49	0.39
Revenue decentralisation (transfers included)			**% of transfers in subnational revenues**	**Subnational expenditure coverage by own resources**	**% of taxes in subnational revenues**
Low			0.53	0.46	0.32
High			0.51	0.49	0.38

Source: Commission sources.

Table IV.3.3: **Conditional means of fiscal outcomes of general government (% of GDP) for low vs. high expenditure decentralisation, controlling for low vs. high values of other decentralisation indicators (by column) - EU-27 Member States, 1995-2010**

Expenditure decentralisation	Own Revenue decentralisation		Own Revenue decentralisation		Own Revenue decentralisation	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-0.62	-2.42	35.55	35.63	39.13	38.50
High	1.67	1.20	37.11	40.96	41.73	45.77
	Subnational expenditure coverage by own resources		Subnational expenditure coverage by own resources		Subnational expenditure coverage by own resources	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-1.23	-0.52	34.61	36.30	37.70	40.10
High	0.93	1.65	37.52	41.39	41.74	46.53
	Transfers (% subnational revenues)		Transfers (% subnational revenues)		Transfers (% subnational revenues)	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-0.57	-1.20	36.30	34.54	40.10	37.60
High	1.62	0.97	41.38	37.52	46.50	41.77
	Taxes (% subnational revenues)		Taxes (% subnational revenues)		Taxes (% subnational revenues)	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-1.01	-0.58	35.08	36.26	38.39	40.00
High	1.12	1.48	37.47	41.07	41.77	46.08

Notes: the Table should be read in the following way, taking the example of the first four figures in the top-left corner (primary balance): the sample is broken down between observations with lower and higher than average expenditure decentralisation. Each of these subsamples is then broken down across cases with lower and higher than average own revenue decentralisation, so that the relationship between own revenue decentralisation and the primary balance can be (partly) isolated from the relationship between expenditure decentralisation and the primary balance
Source: Commission services.

resources and shares of taxes and transfers in subnational revenues.

Compared to Table IV.3.1, this exercise allows to better disentangle the relationship between expenditure decentralisation and fiscal outturns from the one between the different aspects of revenue decentralisation and fiscal outturns**.**

As regards the primary balance, the following patterns emerge:

(i) Restricting the analysis to observations with low own-revenue decentralisation, low subnational expenditure coverage by own resources, low share of taxes and low share of transfers in subnational revenues, moving from low to high expenditure decentralisation is associated to an increase in primary balance.

(ii) For high levels of expenditure decentralisation, moving from low to high own revenue decentralisation is associated to a decrease of primary balance, contrary to findings in Table IV.3.1.

(iii) For high levels of expenditure decentralisation, moving from low to high share of transfers in subnational revenues is associated to a decrease in primary balance, whereas moving from low to high subnational expenditure coverage and from low to high share of taxes in subnational revenues goes together with an increase of the primary balance.

As regards expenditures and revenues:

(i) For low levels of own revenue decentralisation, subnational expenditure coverage and share of taxes and transfers in subnational revenues, moving from low to high expenditure decentralisation is associated to both higher expenditures and revenues.

(ii) Once the level of expenditure decentralisation is high moving from low to high own revenue decentralisation, from low to high subnational expenditure coverage by own resources and from low to high share of taxes in subnational revenues is associated with a (quite sizeable) increase in expenditures and revenues.

(iii) Once the level of expenditure decentralisation is high, moving from low to high weight of transfers in subnational revenues is

associated with a decrease in expenditures and revenues.

3.3.2. Conclusions on stylised facts on the link between fiscal decentralisation and fiscal outcomes

Overall, preliminary evidence based on comparing average fiscal outcomes in the EU for low vs. high fiscal decentralisation, looking at both the expenditure and revenue side of the latter, suggests that:

(1) Decentralising expenditures does not appear to increase government deficit. On the contrary, it is associated with improved primary balance. This relationship is strengthened if accompanied by a large rate of coverage of subnational expenditures by own resources (i.e. taxes and fees) and a high weight of taxes in subnational revenues. Conversely this relationship is attenuated if transfers from the central government account for a large share of subnational revenues.

(2) Expenditure decentralisation appears to go together with higher expenditures and revenues and this link is strengthened if accompanied by a large coverage of subnational expenditure with own resources, large share of taxes in subnational revenues, whereas it is weakened in case of a large share of transfers in subnational revenues.

These facts appear to confirm the argument that subnational governments do not fully exploit economies of scale in public goods provision and tend to generate inefficiencies via overlapping and duplications of administrative procedures, leading to higher expenditures in more decentralised countries. However expenditure decentralisation is also associated with higher government revenues and this appears to more than offset the relationship with expenditures, resulting in a net positive link between expenditure decentralisation and the primary balance.

All these relationships seem to be strengthened if expenditure decentralisation is accompanied by larger financial responsibility of subnational governments ([189]) and a larger share of taxes in their revenues whereas they are partly counteracted if transfers account for a large share of subnational revenues. This appears to confirm the prediction that if subnational governments have to finance most of their spending with their own taxes and fees and these make up most of their revenues they tend to raise more revenues to cover their expenditure needs, whereas a large reliance on transfers creates a soft-budget constraint on subnational governments, reducing the positive effect of expenditure decentralisation on the primary balance.

3.3.3. Stylised facts on decentralisation of individual expenditure functions and fiscal outcomes

This Subsection complements the discussion in Subsections 3.3.1 and 3.3.2 above, by presenting the main stylised facts on the link between expenditure decentralisation in individual government functions (i.e. education, public order, health care etc., see Chapter IV.1) and fiscal outcomes based on comparison of conditional means as done in Subsection 3.3.1. Essentially, the goal is to assess whether the main messages on the relationship between decentralisation and fiscal outcomes are enriched by looking also at the break-down of decentralisation by functions. For simplicity, no charts or tables are shown in this Subsection and only the main findings are briefly presented and discussed.

(1) Looking at the relationship between the total expenditure in each function and its degree of decentralisation suggests that there is no systematic relationship between these two variables, except for social expenditure and, to a lesser extent, health care**.** Social and health care expenditures are on average around 4pp of GDP and 1pp of GDP higher, respectively, in countries where such functions are highly decentralised.

(2) Looking at the relationship between decentralisation by function and the primary balance of the general government conditional on a high level of total expenditure decentralisation (in order to control for the effect of overall decentralisation) suggests that decentralising general services and education is associated with a lower primary balance, whereas higher decentralisation of health, economic affairs and

([189]) They cover a large part of their expenditures with their tax revenues and fees.

social protection goes together with a higher primary balance.

(3) Repeating the exercise in (2) for expenditures and revenues (instead of the fiscal balance) suggests that overall expenditure decentralisation is no longer associated to higher total expenditures if education, social protection and health remain centralised, whereas it is associated to substantially higher expenditures if these three functions are decentralised. Similarly, expenditure decentralisation is no longer associated to larger total revenues when social protection and education are relatively centralised.

The same caveat as for evidence presented in Subsection 3.3.1 also applies to stylised facts on the relationship between decentralisation by function and fiscal outcomes, i.e. no conclusions on causal effects should be drawn from them as their robustness should be tested with econometric analysis. In any case the above stylised facts suggest that the fiscal impact of total decentralisation of expenditure and of its composition by function should be tested at the same time. The next Section turns to econometric analysis of the effect of fiscal decentralisation on fiscal outcomes.

3.4. REGRESSION ANALYSIS OF THE IMPACT OF DECENTRALISATION ON FISCAL BALANCE

3.4.1. Model specification and main hypotheses

This Section presents an econometric analysis of the impact of fiscal decentralisation on the primary balance of general government and on primary expenditures and revenues, taken separately. The model used is the fiscal reaction function – an equation which tests the impact of the outstanding government debt ratio on the primary balance after controlling for a number of macroeconomic and institutional variables. The basic underlying assumption is that governments are fiscally responsible and hence react to increasing (decreasing) levels of accumulated debt by increasing (decreasing) the primary balance. This methodology has become quite widespread in the empirical literature on fiscal policy (see Bohn, 1998 and European Commission, 2011a) and has also been used recently to investigate the budgetary impact of fiscal decentralisation (Eyraud and Lusinyan, 2011 and Escolano et al., 2012). ([190])

Therefore, this Section presents and discusses estimates of fiscal reaction functions for the EU enriched with the indicators of fiscal decentralisation previously discussed. The dependent variable of the model is alternatively the primary balance, primary expenditures and total revenues of the general government. As discussed in Section 3.2 above, it is difficult to formulate clear cut predictions on the impact of the different aspects of fiscal decentralisation on fiscal outcomes as theoretical arguments are often conflicting. However, the literature presented in Section 3.2 above and the stylised facts discussed in Section 3.3 suggest a list of main hypotheses to be tested with regression analysis.

(1) Expenditure decentralisation may lead to larger primary expenditures due to a number of reasons such as less exploitation of economies of scale, duplication and overlapping of administrative procedures, lower productivity of subnational administrations as they are less able to attract more skilled civil servants and greater proximity of subnational policy-makers to subnational interest groups.

(2) The net effect of expenditure decentralisation on the primary balance should depend on how the former is combined with revenue decentralisation. Essentially, stylised facts suggest that if decentralised expenditures go together with large financial responsibility of subnational governments to cover them with their own resources (i.e. taxes and fees assigned to subnational governments) and taxes account for a large share of subnational revenues compared to transfers, there should be no adverse effect on the primary balance (or possibly even a positive one) as subnational governments are encouraged to raise more revenues to cover their larger expenditure responsibilities. On the other hand, the combination of high expenditure decentralisation with a strong reliance on transfers from the central government would be more harmful for fiscal balances as subnational governments would face a

([190]) Both these papers use decentralisation indicators similar to those considered here.

soft budget constraint and are likely to be less concerned about balancing their expenditures with their revenues. ([191])

(3) The effect of total expenditure decentralisation on fiscal outcomes may differ according to the specific expenditure item which is decentralised. Decentralisation of health-care, social protection, education or general services may be particularly likely to lead to larger expenditures and/or a worse fiscal balance.

(4) Finally, a greater share of subnational expenditures covered by subnational own taxes and fees (low vertical fiscal imbalance) implies greater financial responsibility at subnational level as the central government can more easily resist pressures to 'bail-out' subnational entities if the latter are endowed with sufficient own resources to finance their expenditures. In these situations there should be a positive effect on the fiscal balance, reflecting a positive effect on revenues and a negative effect on expenditures. However, descriptive evidence discussed in Section 3.3 suggests a positive effect on both expenditures and revenues which needs to be tested through econometric analysis.

(5) As for own revenue decentralisation – the share of subnational own revenues (taxes and fees, as transfers are excluded from own subnational revenues) in general government revenues – theory does not provide clear predictions on its impact on fiscal balances. On the one hand, a high value on this variable means that subnational governments have more own resources to cover a given amount of expenditures, leading to better fiscal balances. On the other hand, this variable tells us nothing on the relative size of subnational own revenues *compared to their expenditures* which is probably a better way to capture subnational incentives to behave in a financially responsible way. Moreover, the impact of own revenue decentralisation may also differ based on whether it goes together with a high or low share of transfers/taxes in subnational revenues, similarly to the case of expenditure decentralisation discussed above.

([191]) As explained in Chapter IV.1, figures on the shares of taxes in subnational revenues do not distinguish autonomous taxes, i.e. on which subnational governments are allowed to change main tax parameters, from the assignment of revenues from national taxes to subnational governments. This may prevent to fully capture the 'true' degree of subnational financial autonomy. Hence, a robustness check for the hypothesis (2) above, is carried out estimating the effect of an indicator of 'true' subnational tax autonomy compiled by the OECD Secretariat. The indicator measures the share of subnational tax revenues on which subnational governments can change the rate and/or base. However, this exercise implies a substantial reduction of available observations as non-OECD EU Member States are not included. Moreover, this indicator has not been computed with annual frequency and is available only for 1995, 2002, 2005 and 2008, implying that the assumption of constant tax autonomy had to be made for missing years in order to compute regressions.

3.4.2. Regression results on the effect of decentralisation on the primary balance

The first set of estimates test the impact of decentralisation on the general government primary balance (as a share of GDP). The number of independent variables (apart from decentralisation) is limited in order to keep the specification of the model parsimonious, and includes (i) the lagged debt-to-GDP ratio, (ii) the lagged output gap to control for the budgetary effect of cyclical fluctuations, (iii) the occurrence of legislative election in the year. ([192]) Further control variables are included in the regressions for expenditures and revenues (see below).

Then, the different decentralisation indicators are included to test the above hypotheses (see Subsection 3.4.1 above): expenditure decentralisation ([193]), own revenue decentralisation ([194]), the share of taxes and transfers in subnational revenues and the share of subnational expenditure that is covered by subnational own revenues. Moreover, as the above hypotheses (points 2 and 5) also concern the impact of combinations of different aspects of decentralisation, the following interactive terms (i.e. the product of two variables) are also included in the regressions:

(i) Expenditure decentralisation and the share of transfers in subnational revenues**;**

(ii) Expenditure decentralisation and the share of taxes in subnational revenues;

([192]) This is systematically found to have good explanatory power of the developments of fiscal balances (see among others Mendoza and Ostry (2008) and Gali and Perotti (2003).

([193]) Percentage of subnational government expenditures in general government expenditures.

([194]) Percentage of subnational government own revenues (taxes and fees) in general government revenues.

(iii) Own revenue decentralisation and the share of transfers in subnational revenues;

(iv) Own revenue decentralisation and the share of taxes in subnational revenues.

As in Section 3.3 above, the sample includes all 27 EU Member States and covers the 1995–2010 period. As the model specification considered includes lagged dependent variable among the explanatory variables ([195]) estimations are carried out with the Least Squares Dummy Variables Bias-Corrected estimator (LSDVC, Bruno, 2005), which corrects for the bias of Fixed Effect estimators in dynamic panel data models, i.e. panels which include the lagged dependent variable.

Results of estimates for the primary balance are shown in Table IV.3.4. The lagged debt has an expected statistically significant positive coefficient in all specifications of the model, suggesting the existence of a debt-sustainability motive in the setting of fiscal policies, whereas the lagged output gap has a negative and mostly significant coefficient suggesting some degree of pro-cyclicality of fiscal policy across the EU. The occurrence of elections has, as expected, a negative impact on the primary balance, albeit not always significant.

As for the indicators of decentralisation, expenditure decentralisation has a positive and statistically significant effect on the primary balance, whereas own revenue decentralisation has a negative and significant effect. Subnational expenditure coverage has a positive and significant effect on the primary balance, which is in line with expectations.

Expenditure decentralisation interacted with the share of transfers in subnational revenues has a negative effect on the primary balance (columns 2, 10, 12 and 13) whereas it has a (further) positive effect if interacted with the share of taxes in subnational revenues (column 3). This confirms the expectation that expenditure decentralisation has a more favourable impact on the primary balance if accompanied by a large share of own taxes and fees in subnational governments and a small share of transfers from the central government.

The interactive term of own revenue decentralisation with the share of taxes in subnational revenues, has a positive and significant coefficient (columns 6 and 8). Such an effect approximately offsets the negative effect on primary balance of own revenue decentralisation *per se*. On the other hand, the interactive term of own revenue decentralisation and the share of transfers in subnational revenues has a negative and significant coefficient (column 9). The shares of taxes and transfers have, respectively, a positive and negative effect on the primary balance also when included individually (columns 4 and 5).

Finally, as explained above (see footnote (190)), a robustness check of the impact of the weight of subnational taxes on the fiscal balance was carried out by estimating the effect of 'true' tax autonomy, i.e. the weight of taxes for which subnational governments can change rate and/or base (see above). This is captured via three interactive terms:

(i) Share of subnational tax revenues on which subnational governments can exert autonomy multiplied by the share of taxes in total subnational revenues; this would capture the share of 'truly' autonomous revenues (column 13);

(ii) Expenditure decentralisation times the term (i), in order to test the joint impact of large decentralisation on the spending side and large 'true' revenue autonomy (column 11);

(iii) Share of subnational expenditures covered by subnational taxes and fees times the share of subnational tax revenues on which subnational governments can exert autonomy; this would capture the coverage of subnational expenditures by effectively autonomous revenues (column 12).

([195]) This is the case, for instance, for the primary balance as it is commonly found to exhibit a high degree of time persistence

Table IV.3.4: **Regressions on the effect of fiscal decentralisation on the primary balance of general government (LSDVC estimator, EU27, 1995-2010)**

	1	2	3	4	5	6	7	8	9	10	11	12	13
VARIABLES							Pb						
L.D	0.03*	0.03***	0.03**	0.03*	0.03**	0.03**	0.02*	0.03**	0.03**	0.03***	0.04**	0.04***	0.04***
L.og	-0.1**	-0.12***	-0.1**	-0.09*	-0.09**	-0.08*	-0.06	-0.05	-0.06	-0.09	-0.08	-0.1**	-0.1**
Expdec	0.12**	1.19***	0.13**	0.22***	0.28***	0.22***	0.4***	0.47***	0.52***	1.22***	0.57***	1.2***	1.2***
Revdec	-0.12*	-1.15***	-0.43***	-0.36***	-0.45***	-0.81***	-0.73***	-1.27***	-0.5***	-1.48***	-1.34***	-1.7***	-1.7***
Expcov							0.19***	0.18***	0.16***	0.17***	0.37***	0.3***	0.3***
Expdec* trsf		-1.12***								-0.89***		-0.76***	-0.74***
Ele	-0.45*	-0.43*	-0.44*	-0.44*	-0.37	-0.42*	-0.29	-0.28	-0.25	-0.3	-0.31	-0.26	-0.26
Expdec* tax			0.34**								-0.02		
% tax				0.08***									
% trsf					-0.11***								
Revdec* tax						0.87***		0.73***					
Revdec *trsf									-1.15***				
Tax *auton													0.06**
Expdec *tax*auton											0.04***		
Expcov* auton												0.05***	
Obs.	405	405	405	405	405	405	405	405	405	405	297	297	297
Number of panel	27	27	27	27	27	27	27	27	27	27	21	21	21

Notes: List of variables: pb = primary balance of general government (% of GDP), L.D = lagged stock of debt of general government (% of GDP), L.og = Lagged output gap (% of potential output), Expdec = expenditure decentralisation, Revdec = own revenue decentralisation, Expcov = coverage of subnational expenditures by own resources, Expdec*trsf = expenditure decentralisation*share of transfers in subnational revenues, Ele = legislative elections (1 if elections occurred in the year, 0 otherwise), Expdec*tax = expenditure decentralisation*share of taxes in subnational revenues, % tax = share of taxes in subnational revenues, % trsf = % of transfers in subnational revenues, revdec*tax = own revenue decentralisation* share of taxes in subnational revenues, revdec*trsf = own revenue decentralisation* share of transfers in subnational revenues, tax*auton = share of taxes in subnational revenues*share of autonomous taxes in subnational tax revenues, expdec*tax*auton = expenditure decentralisation*share of taxes in subnational revenues*share of autonomous taxes in subnational tax revenues, expcov*auton = coverage of subnational expenditures by own resources* share of autonomous taxes in subnational tax revenues.
***, **, *: coefficient estimates statistically significant at the 1, 5 and 10% level, respectively.
Source: Commission services.

Results confirm expectations: greater 'true' tax autonomy improves the primary balance as all the three terms have a positive and significant coefficient. ([196])

Table IV.3.5 presents the results of a model similar to the one used for Table IV.3.4, but enriched with the addition of terms interacting overall expenditure decentralisation with the decentralisation of expenditures in three government functions, i.e. health care, social protection and general services (columns 1 to 3) in order to test the hypothesis in point 3 above. These terms all have negative and significant coefficients, implying that if overall expenditure decentralisation is positive per se for the primary balance, this effect is partly counteracted if accompanied by large decentralisation in general services, social protection and health. ([197]) This was already detected among the stylised facts in Section 3.3 only for general services.

Interactive effects between overall expenditure decentralisation and decentralisation by *economic* function are also tested for public consumption, compensation of employees and social benefits (columns 4 to 6.) The coefficients for the first and the third term are insignificant, whereas the coefficient on employee compensation is positive and significant, suggesting, quite surprisingly, that a large subnational share in the expenditure for compensation of employees improves the positive effect of overall expenditure decentralisation on the primary balance. ([198]) The other indicators of decentralisation retain the usual sign and significance.

([196]) Moreover, when the term (ii) is included the interactive term of expenditure decentralisation and the share of taxes in subnational revenues is no longer significant (column 11), suggesting that it is the true tax autonomy rather than the share of tax revenues assigned to subnational governments as such which improves fiscal balances.

([197]) The same test was carried out also for decentralisation of education expenditures, which turned out to be insignificant.

([198]) Clearly, it is quite difficult to interpret this finding as there are no clear economic reasons on why local governments should be more disciplined than the central government in their wage expenditures.

Table IV.3.5: **Results of regressions with the primary balance of general government as dependent variable and decentralisation by government function and by economic function included among regressors (LSDVC estimator, EU27, 1995-2010)**

	1	2	3	4	5	6
VARIABLES	pb					
L.D	0.0530***	0.0483***	0.0358***	0.0335***	0.0286**	0.0333***
L.og	-0.154***	-0.148***	-0.152***	-0.128***	-0.131***	-0.116***
Expdec	1.414***	1.315***	1.529***	1.215***	1.018***	1.148***
Revdec	-1.297***	-1.288***	-1.340***	-1.151***	-1.151***	-1.144***
Ele	-0.504**	-0.474*	-0.518**	-0.425*	-0.395*	-0.448**
Expdec * trsf	-1.191***	-1.123***	-1.348***	-1.127***	-1.119***	-1.108***
Expdec * decHealth	-0.123***					
Expdec. * decSoc		-0.242**				
Expdec * decGS			-0.528***			
Expdec. * decCons				-0.0788		
Expdec * decWag					0.417**	
Expdec. * decSocBen						0.188
Observations	382	382	383	405	405	405
Number of panel	27	27	27	27	27	27

Notes: List of variables: see Table IV.3.4 above. New variables added: Expdec * decHealth = expenditure decentralisation * subnational share of general government expenditure for health care, Expdec * decSoc = expenditure decentralisation * subnational share of general government expenditure for social protection, Expdec * decGS = expenditure decentralisation * subnational share of general government expenditure for general services, Expdec * decCons = expenditure decentralisation * subnational share of general government expenditure for consumption, Expdec * decWag = expenditure decentralisation * subnational share of general government expenditure for compensation of employees, Expdec * decSocBen = expenditure decentralisation * subnational share of general government expenditure for social benefits.
***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.
Source: Commission services.

3.4.3. Regression results on the effect of decentralisation on expenditures and revenues

Expenditures

Regressions were also estimated with general government primary expenditure (as a share of GDP), instead of the primary balance, as the dependent variable (see Annex 2). The model is adapted relative to the one for primary balance with the addition of inflation and trade openness as further control variables (Eyraud and Lusinyan, 2011.) Focusing on the decentralisation indicators the following findings can be highlighted:

(i) Overall expenditure decentralisation has a negative and significant coefficient, suggesting that expenditure decentralisation per se tends to *decrease* the magnitude of overall expenditures of the general government.

(ii) Subnational own revenue decentralisation has a positive and significant effect on expenditures.

(iii) The interaction between expenditure decentralisation and the share of transfers and of taxes in subnational revenues have a *positive and negative* effect, respectively (both significant).

(iv) The same is found for the interaction between own revenue decentralisation and the share of transfers and taxes in subnational revenues, respectively.

These findings contradict the stylised facts discussed in Section 3.3 above, which suggested a positive correlation between expenditure decentralisation and total expenditures. This confirms the need to interpret stylised facts based on simple correlations with special caution and the importance to check their robustness through econometric analysis. This finding also disconfirms the hypothesis (1) above and confirms opposite arguments proposed in the literature whereby decentralising expenditures should increase public sector efficiency due to better tailoring of public services to subnational preferences and 'healthy' competition and mutual learning across subnational governments on the most efficient ways to provide public services.

Stylised facts in Section 3.3 also suggested that large subnational financial responsibility, a large share of taxes in subnational revenues and a lower

share of transfers were also associated to higher expenditures, whereas the reverse is found in the above regression which properly controls for the impact of several variables. In other words, whereas from the stylised facts it seemed that the positive effect of high subnational financial responsibility and high subnational taxes/low transfers on the primary balance only came from the revenue side, the regression shows that it also comes from restraints on expenditures, which is more consistent with literature predictions.

As regards the functional composition of expenditures, the interactive term of expenditure decentralisation with decentralisation by function has a positive and significant coefficient only for expenditure on general services, meaning that if overall decentralisation leads per se to lower expenditures this is partly undone by large decentralisation of general services. Therefore, stylised facts suggesting a specific role of decentralisation of health, education and social protection in affecting expenditures are not confirmed.

Revenues

Finally, the impact of fiscal decentralisation on revenues was estimated through regressions with, alternatively, general government revenues and the tax burden (both as shares of GDP) as the dependent variable to add a further robustness check (see Annex 2). ([199])

Expenditure decentralisation does not appear to have a significant effect on revenues or on the tax burden. On the other hand, own revenue decentralisation has a negative and significant effect, whereas its interaction with the share of transfers becomes insignificant and its interaction with the share of taxes in subnational governments has a positive and significant effect on the tax burden only. Similarly the interaction between expenditure decentralisation and the share of transfers in subnational revenues is insignificant, whereas the interaction with the share of taxes is positive and significant. The subnational expenditure coverage by own resources has a positive and significant coefficient.

([199]) To check for the possibility that tax revenues may be more affected by the economic incentives created by the governance structure of a country.

Overall it appears that the impact of decentralisation is stronger on the expenditure than on the revenue side, although two dimensions of it also affect revenues in a way which is consistent with their impact on primary balance and expenditures. These are the decentralisation of own revenues, which according to these results increases spending and decreases revenues, thereby adversely affecting fiscal balances from both sides, and the subnational expenditure coverage by own resources, which decreases expenditures and increases revenues, hence positively affecting fiscal balances from both sides. Also, a high relative weight of taxes in subnational revenues appears to (weakly) improve revenues for a given level of expenditure and revenue decentralisation.

3.5. FISCAL RULES, DECENTRALISATION AND FISCAL OUTCOMES

This Section complements the analysis carried out so far by looking at the role of fiscal rules constraining the fiscal behaviour of subnational governments. Data used are the indexes of strictness of such rules computed by DG ECFIN based on information provided by the Member States. ([200]) Essentially, the aim is to assess two aspects:

(1) Whether fiscal rules constraining the behaviour of subnational governments are used more frequently in highly decentralised countries and whether there is a tendency to adopt a specific type of rules (i.e. balanced budget vs. debt rules) at subnational level. ([201]) As regards the first question, it is logical to expect that when subnational governments have more fiscal power on both the expenditure and revenue side central governments attempt to constrain their behaviour via fiscal rules.

(2) Whether the relationship between fiscal decentralisation and fiscal outcomes changes in presence of strict subnational fiscal rules so that

([200]) http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

([201]) As regards the second point, it is expected that balanced budget rules should be more frequently used than debt rules at subnational level as subnational governments are quite constrained in their possibility to issue debt anyway (e.g. due to lower access to capital markets).

rules act as a substitute to subnational financial responsibility/large reliance on taxes as a tool to increase fiscal discipline.

As regards question (1), Table IV.3.6 below, looks at whether different dimensions of fiscal decentralisation go together with stricter fiscal rules at subnational level.

The Table shows that subnational fiscal rules tend to be much stricter when expenditure decentralisation and own revenue decentralisation are high. As for the type of rules used, on average, balanced budget rules applying to subnational governments are much stricter when expenditure and own revenue decentralisation are high, as well as when the tax share in subnational revenues and the subnational financial responsibility([202]) are high, while they are looser when transfer dependency is higher. On the other hand, strictness of debt rules does not change significantly with expenditure decentralisation; however it is correlated with the other decentralisation indicators with opposite sign compared to balanced budget rules, i.e. debt rules are looser with high own revenue decentralisation, high expenditure coverage with own subnational revenues and high share of taxes in subnational revenues, whereas they are stricter when transfer dependency is lower.

Overall, fiscal rules applying to subnational governments are stricter in more fiscally decentralised countries, in line with expectations. With respect to the type of rules applying to subnational governments, balanced budget rules are stricter in countries with higher subnational financial responsibility and greater reliance on taxes compared to transfers, whereas debt rules are stricter in the opposite case.

This appears to disconfirm the substitutability story as far as balanced budget rules are concerned, i.e. they are not used to correct for weak subnational fiscal discipline in case of high transfers and vertical fiscal imbalances. On the other hand, the argument may be valid as far as debt rules are concerned. Moreover, this finding raises the hypothesis that the positive effect of financial responsibility and high taxes/low transfers on the fiscal balance found in Section 3.4 above may in reality be due to the more frequent use of balanced budget rules constraining subnational behaviour.

These hypotheses were tested through regression analysis (see Table IV.3.7). The above model with the primary balance as dependent variable was enriched by including the strictness of rules applying to subnational governments (column 1), its balanced budget rule and debt rule component (column 2 and 3, respectively). Further tests were carried out with interactive terms testing the joint impact of balanced budget rules and, respectively, expenditure decentralisation with high share of taxes in subnational revenues and the subnational expenditure coverage by own resources (columns 4 and 5 respectively, to test whether the effect of the

([202]) High expenditure coverage with own resources.

Table IV.3.6: **Strictness of fiscal rules applying to subnational governments, averages for observations with low and high values of different indicators of fiscal decentralisation (EU27 Member States, 1995-2010 period)**

Expenditure decentralisation	Strictness fiscal rules – subnational gov.	Strictness debt rules – subnational gov.	Strictness balanced budget rules – subnational gov.
Low	1.9	1.2	0.6
High	4.9	1.1	2.4
Own revenues decentralisation			
Low	2.6	1.3	0.7
High	4.4	0.9	2.7
Subnational expenditure coverage by own subnational resources			
Low	3.5	1.6	1.0
High	3.2	0.8	1.9
% of taxes in subnational revenues			
Low	3.3	1.7	0.7
High	3.4	0.6	2.2
Transfer dependency			
Low	3.2	0.7	2.0
High	3.6	1.7	0.9

Source: Commission services.

latter variables is in fact due to the fact that they tend to be accompanied by balanced budget rules), the joint impact of balanced budget rules and, respectively, expenditure decentralisation (column 6) and own revenue decentralisation (column 7) and the joint impact of debt rules and expenditure decentralisation with large share of transfers in subnational revenues (column 8, to test whether decentralisation with large transfers is less harmful for fiscal balance if accompanied by debt rules).

Overall, regression results suggest that strictness of fiscal rules in general and of balanced budget rules in particular applying to subnational governments do not affect the impact of fiscal decentralisation on the primary balance. Specifically, the positive impact of subnational financial responsibility and a large reliance on taxes compared to transfers does not appear to be due to their positive correlation with the presence of balanced budget rules applying to subnational governments, as all the corresponding interactive terms are insignificant. On the other hand, debt rules applying to subnational governments appear to have a positive effect on fiscal balance on their own (column 4) and to slightly counteract the negative budgetary effect of expenditure decentralisation accompanied by large transfers. (203)

Finally, in order to test if the positive effect of debt rules occurs via the expenditure side, two further tests were carried out by enriching the model for primary expenditures discussed in Section 3.4 above with the two terms capturing the impact of debt rules (see above). Results show that debt rules have a negative and significant effect on primary expenditures (column 9) and that they reduce the positive impact on expenditures of expenditure decentralisation accompanied by large transfers (column 10).

Overall, the conclusion is that, while balanced budget rules do not change the relationship

(203) See positive and significant coefficient of the corresponding interactive term in column 8.

Table IV.3.7: Results of regressions on the effect of fiscal decentralisation and fiscal rules on primary balance and expenditures of the general government (EU27, 1995-2010, LSDVC estimator)

	1	2	3	4	5	6	7	8	9	10
VARIABLES	pb								primexp	
L.D	0.03**	0.0289**	0.0346***	0.0289**	0.0294**	0.0283**	0.0287**	0.0337***	-0.0234*	-0.0223*
L.og	-0.0691*	-0.0691*	-0.0750*	-0.0681*	-0.0667	-0.0702*	-0.0681	-0.0947**	0.174***	0.179***
Expdec	0.398***	0.400***	0.403***	0.397***	0.399***	0.402***	0.396***	1.232***	-0.782***	-0.790***
Revdec	-0.995***	-1.004***	-1.012***	-0.995***	-1.000***	-1.001***	-0.988***	-1.494***	0.936***	0.951***
Expdec * tax	0.292**	0.328**	0.311**	0.333**	0.315**	0.337**	0.327**			
Expcov	0.190***	0.187***	0.197***	0.186***	0.190***	0.186***	0.186***	0.176***	-0.0850***	-0.0850***
frilg	-0.0376									
fribbr		-0.137								
fridr			0.183*						-0.240**	
Expcov * fribbr					-0.00164					
Expdec * fribbr						-0.00403				
Expdec * trsf								-0.910***	0.662***	0.682***
Revdec * fribbr							-0.00565			
Expdec * trsf * fridr								0.0100*		-0.0130**
fridr										
Expdec * tax * fribbr				-0.0055						
fribbr										
Ele	-0.282	-0.286	-0.288	-0.299	-0.29	-0.296	-0.297	-0.288	0.0739	0.0553
L.infl	0.0358***								0.0358***	0.0354***
TO									-0.539	-0.625
Observations	405	405	405	405	405	405	405	405	401	401
Number of panel	27	27	27	27	27	27	27	27	27	27

Notes: List of variables: see Table IV.3.4 above, new variables added: Primexp = general government primary expenditures (% of GDP), L.infl = lagged inflation rate, TO = trade openness (% of exports plus imports in GDP), frilg = strictness of fiscal rules applying to Subnational Governments (SNG), fribbr = strictness of balanced budget rules applying to SNG, fridr = strictness of debt rules applying to SNG, Expcov * fribbr = coverage of subnational expenditures by own resources * strictness of balanced budget rules applying to SNG, Expdec * fribbr = expenditure decentralisation * strictness of balanced budget rules applying to SNG, Revdec * fribbr = own revenue decentralisation * strictness of balanced budget rules applying to SNG, Expdec * trsf * fridr = expenditure decentralisation*share of transfers in subnational revenues* strictness of debt rules applying to SNG, Expdec * tax * fribbr = expenditure decentralisation*share of taxes in subnational revenues* strictness of balanced budget rules applying to SNG.
***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.
Source: Commission services.

between decentralisation and fiscal outcomes, debt rules applying to subnational governments reduce the negative effect on the fiscal balance of a large weight of transfers in subnational revenues, and this effect occurs through the expenditure side.

3.6. CONCLUSIONS

Although it is highly challenging to summarise in a few lines all the analysis shown in this Chapter, a number of key points can be highlighted as regards the effect of fiscal decentralisation on general government fiscal outcomes.

(1) Expenditure decentralisation per se appears to be associated with better fiscal balances compared to cases of low decentralisation. This reflects a negative effect on expenditures whereas the effect on revenues is not significant according to regression analysis. This finding lends support to a few economic arguments proposed in the literature which underline that subnational governments should be more able to tailor public goods to subnational preferences and that competition and mutual learning among subnational governments should help them select more cost-effective techniques for the production of public goods. This should in turn lead to more efficient expenditure in more decentralised countries ceteris paribus with positive effects on the primary balance.

(2) The revenue side of decentralisation plays a key role in shaping the net effects of decentralisation on fiscal outcomes. Regression results suggest that expenditure decentralisation accompanied by low subnational financial responsibility to cover their expenditures with their own resources (i.e. taxes and fees) and by a large share of transfers from the central government in subnational revenues is likely to be overall detrimental for the fiscal balance. On the other hand, the budgetary effect of decentralisation is more favourable if it goes together with a large coverage of subnational expenditures by own resources and a large weight of taxes in total subnational revenues. This result reflects effects on both the expenditure and (albeit to a lesser extent) the revenue side.

This result confirms literature predictions which underline that if subnational governments largely depend on transfers from the central government they would be subject to a soft-budget constraint as they would take it for granted that possible excess spending from their part would be eventually covered by a 'bail-out' from the central government. On the other hand, if they can raise sufficient own resources to cover most of their expenditures and the weight of transfers is low the central government can more easily resist bail-out pressures. Moreover, in the latter case subnational policy-makers are more accountable to subnational voters as the link between subnational taxes paid and subnational public goods delivered is stronger which also exerts a disciplining effect on subnational governments fiscal behaviour.

(3) This conclusion is strengthened by the finding on the positive effect on the primary balance of 'effective' tax autonomy, i.e. of a large weight of taxes on which subnational governments can exert autonomy with respect to the rate and/or the base. This suggests that the positive effect of decentralisation on primary balance is improved not only if subnational tax revenues are high and transfers low but also if subnational governments can set those taxes autonomously.

(4) The most puzzling result concerns decentralisation of own revenue sources, i.e. a high share of tax revenues and fees assigned to subnational governments in total general government revenues, which has an adverse effect on the primary balance, reflecting an increasing effect on expenditures and a decreasing one on revenues. On the one hand, this contradicts the idea that devolving relatively large own revenue sources to subnational governments is positive for fiscal discipline which would follow logically from the above mentioned arguments on the benefit of subnational revenue autonomy, responsibility, avoiding soft-budget constraints etc. Upon closer reflection, though, this variable is less suitable than those discussed in point 2 above to capture those aspects as it tells nothing on the size of own revenues relative to subnational expenditures and on the relative weight of transfers vs. taxes and fees in subnational revenues. This does not yet explain the fact that it has an adverse effect on the budget balance, though, rather than being simply

insignificant. ([204]) Further research would be advisable on this issue.

(5) Finally, divergences between stylised facts based on simple or conditional correlations and results of regression analysis, in particular with respect to the impact of expenditure decentralisation, subnational financial responsibility and the relative size of taxes vs. transfers on expenditures, highlight the need to simultaneously control for several features of fiscal decentralisation to disentangle their impact on the fiscal outcomes of the general government.

(6) As for the impact of rules constraining the fiscal behaviour of subnational governments; stricter debt rules appear to affect positively the primary balance via restraints on expenditures. Moreover, they partly alleviate the negative effect of expenditure decentralisation combined with a large share of transfers in subnational revenues, suggesting a partial substitutability between debt rules and subnational fiscal responsibility/large share of own resources as a tool to encourage fiscal discipline. On the other hand, the budgetary impact of fiscal decentralisation does not appear to be affected by stricter balanced budget rules applying to subnational governments.

Overall, it appears that fiscal decentralisation matters for fiscal outcomes and that the interplay between the expenditure and the revenue side of it is crucial to determine its net effect on fiscal balances. Overly pessimistic statements, often heard recently, on a generalised fiscal deterioration caused by increasing fiscal decentralisation across the EU do not seem to find support in the data. This may have occurred in some Member States, but probably not as a result of decentralisation *per se* but of a 'bad' design of decentralisation, i.e. one which does not ensure strong financial responsibility of subnational governments.

In methodological terms, the econometric analysis carried out in this Chapter draws on Escolano et al. (2012). However, several enrichments are introduced compared to this paper, such as testing the impact of subnational expenditure coverage by own resources, of effective subnational tax autonomy (as measured by the OECD Secretariat), of several interactions between different aspects of decentralisation (i.e. between expenditure and own revenue decentralisation, on the one hand, and the share of taxes and transfers, on the other hand; between effective tax autonomy, on the one hand, and expenditure decentralisation and expenditure coverage by own resources, on the other hand) and of the functional composition of expenditure decentralisation. Furthermore, the Chapter extends the analysis of the impact of subnational fiscal rules by looking at the joint impact of expenditure decentralisation, share of transfers and rules, finding statistically significant results for debt rules as opposed to the above mentioned paper, and, finally, runs separate estimates on the impact of decentralisation on expenditures and revenues, in addition to those on the primary balance.

([204]) Although an explanation could be that own revenue decentralisation may capture other effects than the devolvement of revenue sources to subnational governments, such as business cycle effects. An economic downturn would decrease general government revenues and so (if subnational revenues are kept constant) increase own revenue decentralisation via its denominator, even though no policy measure to increase decentralisation is enacted. At the same time this would also lead to a worse primary balance, being consistent with a negative sign of the revenue decentralisation coefficient in the regression.

ANNEX 1
National fiscal decentralisation arrangements in the EU - country fiches

A1.1. BELGIUM

1. General description

Since 1970, five constitutional reforms have gradually transformed the Belgian unitary state into a federal state made up of three tiers of subnational government: six federated entities (three linguistic communities([205]) and three territorial regions([206])), 11 provinces and 589 municipalities. Regions and communities have legislative and administrative competences, while provinces and municipalities have administrative powers and implement upper levels' legislation. Belgium therefore has one of the most far-reaching levels of decentralisation in the EU. Although the decentralisation process has already transferred a considerable number of competences to the subnational levels, federalisation does not seem to have reached its endpoint as the federal government formed in December 2011 plans a sixth constitutional reform and a further transfer of competences.

Since the first constitutional reform of 1970, the Belgian Constitution explicitly stipulates the existence of communities and regions. From that moment on, several waves of reform (1980, 1988-1989, 1993, 2001) have transferred a considerable number of competences and hence spending authority to those federated entities. The distribution of competences among the federal state and the federated entities has been anchored in the Constitution. The federal government has spending power for all competences that do not expressly come under the authority of regions or communities. Regions are competent in areas linked to their territory. Communities are responsible for person-related matters. The distribution of theses competences leads communities and regions to realise almost 24% and provinces and municipalities approximately 13% of total general government expenditure (12.7% and 7.2% of GDP)([207]).

([205]) The German-speaking Community, the French-speaking Community and the Flemish Community
([206]) The Wallonia Region, the Brussels-Capital Region and the Flemish Region
([207]) 2009 data providing from the OECD Fiscal Decentralisation database

The transfer of the corresponding financial means is for the federated entities regulated by the 1989 Special Financing Act, which was amended by the Special Act of 13 July 2001 to take into account the further decentralisation of competences. This has extended the fiscal autonomy of the federated entities but has also led to a complex system of grants, shared and own-source tax revenues. The type of revenue from which subnational governments can benefit differs considerably from one tier to another. Communities benefit from shared tax revenues (mainly personal income tax and VAT) and from some non-tax revenues, whereas regions do also perceive own-source tax revenues, like registration duties, property and vehicle taxes (8.9% of total general government revenues or 4.3% of GDP). Local authorities, i.e. provinces and municipalities, do not share taxes with the federal level but benefit from own-source tax revenues, general and earmarked grants. Their revenue represents 7.5% of total general government revenues or 3.6% of GDP.

2. Government spending

A substantial number of government functions were devolved to subnational entities in Belgium. In 2010, local authorities were in charge of EUR 25 billion of public spending (13.8% of total public expenditure) and federated entities of EUR 53 billion (28.9% of total public expenditure). As often subnational governments are only in charge of part of a government function, the remaining competences that were not expressly attributed to one of the sub-levels stay under the authority of the federal state. As a result, most of the government functions are scattered among the different government tiers.

At local tier, subnational governments are mainly involved in general public services, education, social protection and public order and safety. Provinces have spending power in certain person-related areas, like secondary and higher education, and are responsible for the general affairs of the provinces. Municipalities' spending competence includes local planning, elections and registration, as well as police and some social protection functions, like public social welfare centres.

At the level of the federated entities education is by large the most important spending item, followed by economic affairs, social protection

and general services. Those competences that are person-related were mainly attributed to the communities, whereas territory-linked areas are under the competence of regions. Hence, communities are highly involved in education, as they finance large parts of primary, secondary and higher education. Regions are largely involved in economic affairs like agriculture and transport, as well as in environmental protection and housing.

The federal state remains largely in charge of general public services and it is the only government tier competent for defence matters. The federal state spends almost two thirds of its budget on general services, while approximately 5% is spent on defence. Although health is a person-related service and is therefore expected to be part of the communities' responsibilities, it is the federal state that has the largest spending power with respect to that economic function.

The federated entities and local authorities are autonomous in designing and implementing policies in the areas of competence which were attributed to them([208]). Once a responsibility is transferred to a subnational government, the federal state no longer has power to act or intervene regarding this matter.

An analysis by type of expenditure highlights that more than 85% of expenditures are linked to current expenditures at all government levels. The remaining part of expenditures is related to the reimbursement of capital and the payment of interest costs.

([208]) Areas of competence of communities include cultural matters, education (except for determining the beginning and end of compulsory schooling, minimum conditions governing the granting of diplomas, and the pension plan), services offered to individuals, the use of languages in respect of administrative matters, teaching and contacts between employers and their staff, intra-Community and international cooperation, including the conclusion of treaties, in respect of cultural matters, teaching and services offered to individuals.
Areas of competence of regions include economic policy, including assistance in respect of investment and employment, employment, transportation, public works, financing of sub-ordinate powers, scientific policy pertaining to their fields of jurisdiction, energy, wastewater treatment and the protection and distribution of water, policy governing waste and environmental protection, monuments and sites, foreign trade, agriculture, international relations from the standpoint of the Regions' fields of jurisdiction.

3. Financial arrangements

Throughout the several constitutional reforms, subnational governments have gained a lot of fiscal autonomy, not only from an expenditure but also from a revenue point of view. The Special Financing Act of 1989 sets the pillars for revenue allocation to the federated entities and guarantees that the latter have the means to exercise their competences. At local tier, regions regulate the funding of the local authorities and can introduce limits (regarding type and rate) on taxes set by municipalities. Hence, municipalities and provinces are subject to different financing rules, according to the region in which they are located. Whether at federated or local level, subnational financing is done through tax revenues, as well as through grants from the upper government level. All subnational entities also have the possibility to borrow.

Municipalities and provinces depend for almost half of their financing on grants from the regions. Those grants are allocated to municipal and provincial funds or are earmarked to specific projects. Local authorities are also financed through own-source taxes, which are mainly surtaxes on the federal personal income tax, the regional traffic tax and real estate tax for municipalities and on the regional real estate tax for provinces. Often the upper government level determines the tax base and the local authority sets the rate of the surtax. Local authorities are also free to levy other local taxes, like waste and leisure taxes. Other local revenues include interests received and fee revenues, which account for approximately 18% of total revenues.

The financial autonomy of communities and regions differs considerably. Both communities and regions benefit from shared tax revenues and grants from the federal state. Only regions, however, levy their own-source taxes. The latter amount to approximately 16% of the federated entities' total revenues and include real estate taxes, registration duties, inheritance taxes and vehicle taxes. Regions are entirely free to set the tax base and tax rate of those regional taxes. Although the federated entities have the right to collect the taxes themselves, tax collection is ensured by the federal state. The lion's share of the regions and communities' revenue comes from shared taxes, i.e. a fraction of the proceeds

providing from the personal income tax and the value added tax, collected by the federal state. On top of this fraction, regions can decide to levy surtaxes on those federal state taxes. Additional means, amounting to almost 11% of total federated entity revenue, are transferred from the federal to the federated level in the form of grants. Those include grants for foreign students, for the Brussels-Capital Region, as well as a compensatory grant for abolishing the radio-television licence fee.

The increasing budgetary autonomy of subnational governments also includes the right to run deficits and to borrow accordingly. Although in the past budgetary correcting mechanisms and equalising transfers existed at almost all government levels, now only an automatic compensation mechanism remains regarding health spending by the federal government.

4. Fiscal rules

The project of joining the EU Economic and Monetary Union in 1992 gave Belgium an incentive to reduce its deficit and its debt ratio, which was the highest in the EU at that moment. In order to do so, the country engaged in a thorough reform of its fiscal framework. Two independent fiscal bodies (the National Account Institute (NAI) and a new section of the High Council of Finance (HCF)) were established to give the federal and federated governments advice on public finance issues. Moreover, numerical fiscal rules were introduced from 1990 on to monitor the budget balance, the expenditures and the revenues of the federal government, as well as of some subnational governments.

The institutional part of the renewed fiscal framework has proven crucial, as with the increased fiscal autonomy of the subnational governments it guaranteed a coordination of the fiscal policies of the different government tiers. The annual budget recommendations of the HFC's advisory section were at the basis of budgetary conventions which acted as "internal stability pacts" by setting the medium-term budgetary targets for the different government tiers. Although never used, it allowed the federal level to impose borrowing limits to the regions in case they did not respect their budgetary targets. Regions cannot be liable, however, for providing fiscal surpluses to offset a potential federal deficit.

The rule-based part of the reformed fiscal framework turned to be more problematic, as the improvement of the federal deficit and the debt ratio relaxed the fiscal tension from the end of the 1990s on. Several fiscal rules at federal, regional and local level adopted earlier on, were abolished. As a result, only the federal ceiling for health spending and the regional budget balance rule were kept in place. This fiscal framework, however, may change following the sixth constitutional reform which was agreed upon in autumn 2011.

The Council issued country-specific recommendations to Belgium with respect to subnational governments (see Box I.3.2 above).

A1.2. BULGARIA

1. General description

Bulgaria is a unitary state. Article 136 of the Constitution ratified in 1991 enshrines the principle of local self-government. The Local Self-Government and Local Administration Act was passed the same year, providing the legislative framework for the 264 Bulgarian municipalities.

According to the Constitution, the territory is divided into regions and municipalities. While a region is defined as an administrative unit in charge of conducting the national policy for regional development and ensuring of harmony of national and local interest, the municipality is the only subnational level of the general government with fiscal autonomy. Municipalities have the right to cooperate in a way they can better protect their own interest. They are defined as legal entities in which government citizens participate directly and through elected bodies. Municipalities, in contrast to regions, possess their own budgets and are entitled to permanent revenues by law. According to 2010 figures, total spending by municipalities amounted to only 6% of GDP, around 16% of total public expenditure. In turn, in the same year municipalities' revenues also amounted to 6% of GDP, representing 18% of total revenues of the general government.

The National Association of Municipalities was constituted in 1996 and nowadays represents to all municipalities. Besides its contribution to developing the legislative framework applied to municipalities, the Association also makes proposals on their respective section of the draft budget. Since 1996 there have been ongoing efforts to deepen the decentralization process.

2. Government spending

According to the Local Self-Government and Local Administration Act there are two different types of powers devolved to municipalities. These are the State delegated services and the local services.

State delegated services comprise the management and financing of a number of services, of which the State retains the responsibility to define the main policy principles, such as the type of services, the quality and the eligibility criteria thereof. According to the functional breakdown of public expenditure (COFOG) these delegated services to municipalities include education up to the secondary level, social protection services, such as family and child support and care for the elderly, healthcare and culture. However, the devolution of powers in the area of healthcare have limited to the ownership and maintenance of health care institutions in that since 2001 they have been transformed into *legal entities under the meaning of the Commercial Law with state or municipal ownership* .

By contrast, municipalities have own responsibilities in some areas of general public services, housing and community amenities (public utilities and networks such as urban heat, electricity and water supply), economic affairs (urban public transport, construction and maintenance of roads, building and upkeep of public buildings and territorial development), environmental protection (including also sewerage and waste collection) and recreation culture and religion (public libraries, tourism, some cultural activities and sports facilities).

3. Financial arrangements

Municipalities are financed by three main sources, notably own revenues: including own local taxes (patent tax, property taxes, other taxes) and nontax revenue and assistance (revenue and income from property, local fees, fines, penalties, and forfeits, concessions, other nontax revenues).

The annual State Budget Law grants the provision of financing for current expenses in activities delegated by the state entirely with funds from the general subsidy for state-delegated activities, while the local activities are financed by own revenues, consisting of local taxes and fees, non tax revenues, as well as transfers from the Central Bank for local activities, including common equalising subsidy and transfer for winter maintenance and snow cleanup.

3.1. Own revenues

Tax revenues sum up to 35.8% of total revenues in municipal revenues in municipal budgets on 31 December 2010. According to data from the report on municipal budget cash implementation, tax revenues, donations and aid sum up to 64.2% of own municipal resources on 31 December 2010. Revenues from municipal fees have the largest share of non tax revenues and donations in municipal budgets in 2010 – 69.3%.

Municipalities have full powers on local fees and taxes. The Municipal Council determines the tax levels in line with the conditionalities, order and limits set by the Law on Local Taxes and Fees.

3.2. Expenditures

The expenditures on the activities delegated by the state to the municipalities and on the local activities are being distributed relatively equally, but municipal financing is predominantly with funds from transfers and interactions with the central budget – approximately 57% of total municipal revenues. Subsidies from the central budget for local activities finance 18-25% of expenditures on local activities. Subsidies from the central budget for activities delegated by the state finance approximately 98% of the expenditures on state activities. Municipal own resources finance predominantly local activities (over 90%) and co-finance delegated activities. In the common municipal expenditure structure on 31.12.2010, according to data from the report on municipal budgets, activities delegated by the state total 49%, co-financing with own resources – 2.3%, and the

remaining 48.7% are expenditures on local activities.

The expenditures on the state-delegated activities are financed through state transfer, determined by standards used for shaping the total amount of funds needed and as criteria for their distribution to the municipalities. The budget of each function delegated by the state is determined by established standards and natural indicators determined by the sectoral ministries. The standards are worked out in working groups consisting of representatives of the corresponding sectoral ministry, the Ministry of Finance and the National Association of Municipalities in the Republic of Bulgaria. This ensures comprehensible and transparent distribution of funds to the municipalities and ensures predictability in financing.

3.3. Grants from the central government

The transfers to municipalities are made on the basis of entirely comprehensible criteria.

The targeted transfers amount to 90% compared to the non-targeted ones. The targeted transfers consist of: general subsidy for the activities delegated by the state, funds for winter maintenance, the target subsidy for capital expenditures (including: road maintenance and other expenditures whose purpose is determined by the municipal council), for co-financing municipal projects, funds for compensating travel expenditures (for students, pensionser, military handicaps) and other targeted transfers.

Municipal capital expenditures are financed through a targeted subsidy distributed to projects by the municipal councils. In addition, a target subsidy is assigned to ecological projects and for maintenance and construction of municipal roads at parameters determined by the annual State Law Budget. The target subsidy is distributed on the basis of comprehensible criteria on population – weight 40%; number of cities/towns – weight 40%; municipal territory – 20%.

Additionally the municipalities receive transfers (within the limits of 8-17% of the total transfer size) for financing activities on specific programmes (for example: managing environmental activities, etc.).

Non-targeted transfers consist of an equalizing subsidy assigned to municipalities to provide services to the public, as its size is approximately 7-9% of the total transfer structure. The total amount of the equalizing subsidy is determined according to the rule in Art. 34, p. 5 from the Law on Municipal Budgets (valid since 2005), namely "The size of the general equalizing subsidy cannot be smaller than 10% of the report on own revenues of all municipalities for the previous year". The subsidy is distributed to the municipalities according to a mechanism consisting criteria determined annually by the Minister of Finance and the National Association of Municipalities in the Republic of Bulgaria (Art. 34, p. 4 from the Law on Municipal Budgets). The mechanism for determining the municipal subsidies from the central budget is an annex in the State Budget Law. The municipalities are potential beneficiaries on four of the seven Operational Programmes financed by the Structural and Cohesion Funds in the EU (SCF). In order to be approved for financing, the municipal projects should meet all the criteria set by the European and Bulgarian legislation.

4. Fiscal rules

Municipal departments' monitoring – The Municipal Debt Law limits local government borrowing to financing of infrastructure investment and rollover of previously accumulated debt. There are no limits on the amount of borrowing of local governments; however there are limits on the debt service payments. Current observation of municipal debt amount is in place. Legislative changes were introduced form the beginning of 2011. According to the Municipal Debt Act: "Art 12. (1) (Amended 2010, effective 1.01.2011) The annual amount of payments on the debt during each particular year may not exceed 15 per cent of the sum total of revenues from own sources and the block equalizing grant under the last audited report on the implementation of the budget of the municipality." (Guarantees rule) By the end of 2010 it was 25 per cent. "Article 17a. (New 2010, effective 1.01.2011) (1) The Municipal Council may not adopt decisions to assume long-term municipal debt after the expiry of 39 months of its election." The nominal value of the guarantees may not exceed 5% of the abovementioned sum.

The debt rules have been very efficient in fostering the decrease of the consolidated debt in good economic times and preventing the accumulation of debt at local government level.

Coverage and exclusion: Municipal debt includes the principal, interests and commissions excluding: (i) non-interest loans from the central budget made available to the local governments in order to finance projects and programmes co-financed by the EU funds until their reimbursement; (ii) debt to the Fund for Local Authorities and Governments (FLAG) aimed at providing bridge financing for co-financed with the EU projects; and (iii) debt assumed under the “Loan Agreement for Structural Programme Loan between the Republic of Bulgaria and the European Investment Bank” (pursuant to § 15 of the Transitional and Final Provisions of the 2011 State Budget Law) .

When in previous periods the accumulated municipal debt or guarantees exceed 15% and 5%, respectively, of the sum of total own revenues and the total balancing subsidy under the last audited report for the municipal budget execution, local governments cannot issue new debt or grant new guarantees until the requirements of the rules are complied with. To prevent the accumulation of liabilities that should be serviced beyond the term of the local governments, they could issue long-term debt only in the first 39 months after their election.

The Ministry of Finance is monitoring the application of the rules based on a public registry for municipal debt, securities and guarantees. The content and quality requirements for the information provided in the registry are fixed by the Ministry of Finance.

The rules have been amended and further strengthened in 2010 in order to preserve fiscal sustainability and avoid an accumulation of municipal debt and guarantees in particular by insulating local governments’ liabilities from the impact of political cycles. However, it is important to ensure that the capacity of highly indebted local government to provide the most important public services is not impaired.

5. Other relevant institutional features

Municipalities have total independence in forecasting their own revenues, as they conform to the level of local taxes determined by the municipal council regulations within the limits set by the Law on local taxes and fees. The expenditures forecasts for local activities shall be according to the strategies, forecasts and programmes for municipal development adopted by the municipal council, in line with the trends in the amount and types of public services provided and according to the resources available to the local government.

The preparation of the municipal draft budget is organized by the municipal mayor in cooperation with the town and regional mayors. The revenue administration assists the municipality in determining the size of the annual and monthly revenues.

The municipal budget determines and provides funds for financing local and state-delegated activities.

The municipal mayor submits the draft budget for public debate by the local community. The municipal mayor submits the draft budget to the municipal council within 30 workdays after the State Budget Law for the corresponding year has been made official.

The municipal council adopts the municipal budget within 45 workdays after the State Budget Law has been made official and in accordance with the common budget classification. The municipal draft budget is presented at the local branches of the Court of Auditors and at the Ministry of Finance within one month after it has been approved by the municipal council.

Municipal (local) structures, their structural units and economic subjects applying budgets, budgetary and non-budgetary accounts and funds according to the Municipal Budget Law are included in the scope of budget enterprises defined in paragraph 1 from the Additional provisions in the Accounting Law.

In addition, the Minister of Finance approves annually the Single Budget Classification as an accounting framework for cash basis reporting.

Municipalities and all budget enterprises report on the incoming and outgoing funds on a cash basis according to the Single Budget Classification. This report is the basis for periodic (monthly, quarterly and annual) report on the cash implementation of budget and non-budget accounts and funds.

The annual report on the budget and non-budget accounts and funds cash implementation is a part of the annual financial report.

According to the Municipal Budget Law the municipality prepares a budgetary forecast giving the parameters of municipal revenues and expenditures for the next three years. The municipal mayor presents at the Ministry of Finance a forecast for the amount of own revenues and local expenditures for the budgetary year, as well as the municipal intentions for debt accumulation in the following year.

The process of decentralization, started in 2002, continues in 2012 as the main priorities and goals are set in the long term programme document Decentralization Strategy (2006-2015). It is related to conducting national policy for improving the territorial management and it determines the directions for distributing jurisdiction and financial resources among the central, regional and municipal level of government, aiming at a providing public services more effectively. In 2010 the Council of Ministers adopted updated Decentralization Strategy and a Programme for the period 2010-2013 including measures, responsibilities and deadlines for implementation, such as for example giving more authority to the local government in relation to the transfer of special and professional schools without national importance.

Each year the Council on public government decentralization prepares a report using an adopted system of indicators for monitoring evaluating the implementation and results of the Decentralization Strategy.

The policies in the budget aim at creating opportunities for sustainable and balanced municipal development.

Regarding tax policy and local budget revenues, the trend toward higher municipal financial autonomy is clearly visible in light of the provided full municipal authority in administering local taxes and the authority to determine independently the size of these taxes according to the conditions set in the Law on local taxes and fees.

A1.3. CZECH REPUBLIC

1. General description

Overview

The Czech Republic is a unitary state with two tiers of subnational self-governments: 14 regions (kraj) defined as "higher autonomous local government units" and about 6250 municipalities (obce). Prague has a special statute as both a municipality and a region.

The existence of regions and municipalities is recognized in the constitution articles 99-104 stating that the Czech Republic is divided into municipalities which are the basic units of territorial self-administration. Higher units of territorial self-administration are regions.

Recent institutional reforms

The most recent major reform took place in 2000 and entered into force in stages in 2001 and 2002. In 2001 14 new regions were established from the already existing administrative districts (okres) that existed since 1996. This led to a substantial inequality in terms of size of individual regions that was greater compared to the period 1949-1960 when similar regions existed as well. At the end of 2002 the administrative districts were abolished and their responsibilities were transferred.

2. Government competencies (spending)

There is a distinction between autonomous responsibilities and delegated responsibilities. In terms of the autonomous responsibilities, subnational governments have considerable legal freedom to handle questions of local interest in compliance with the law. Delegated responsibilities are executed in line with central government policy.

Regions

Regions are autonomously responsible mainly for upper secondary education, the regional road network, regional economic development and planning, and healthcare. Similar areas are also the most significant in terms of spending. Education requires around 60% of total spending by regions while almost 20% of total spending is devoted to transport and infrastructure.

Municipalities

Municipal autonomous responsibilities include education (pre-elementary and primary schools), the provision of local social and welfare services (retirement homes, homes for disabled etc.), environment (water and waste management), public housing, local roads, city public transport, territorial planning, urban hygiene and others. In terms of spending, transport and infrastructure together with housing and education are the most significant elements of the overall spending.

Education

A municipality is obliged to create conditions for pre-school education in the last grade prior to commencing compulsory school attendance and conditions for compulsory school attendance of children. For such purposes a municipality can establish or close down a nursery and a primary school. Also, a municipality may establish and close down certain special types of schools such as artistic primary schools etc.

A region is obliged to ensure conditions for secondary and tertiary professional education. For such purposes a region can establish and close down secondary schools and tertiary professional schools.

Infrastructure/Transport

Management, maintenance and repair of highways and category I roads is provided on a central level by the Road and Motorway Directorate of the Czech Republic. Category II and III roads are owned by regions that are responsible for their management, maintenance and repair. Municipalities own local roads. Subnational governments have also number of responsibilities in terms bus and railway public transport.

Healthcare

The conditions for establishment and management of a healthcare facility are prescribed by law in accordance with uniform national guidelines. At the same time, health care facilities can be established not only by the Ministry of Health, but also by regions, municipalities, and private bodies. (209) Subnational governments also provide guidance and coordinate in areas such as medical emergency service and medical and first aid, the quality of health care, the training of health professionals, central purchasing of pharmaceuticals and medical supplies and number of others.

Social services

There is a rather complex system of shared responsibilities in social services. Subnational governments, among other things, identify the needs of providing social services, ensure adequate availability of social facilities and cooperate together in preparing and implementing medium-term development plan for social services. Municipalities were also responsible for accepting applications for certain social benefits and determining the adequacy and level of these benefits. However, as of 2012 Regional branches of the Labour Office of the Czech Republic are responsible for granting and disbursing these benefits.

3. Financial arrangements

Revenues of municipalities and regions can be divided into tax revenues, non-tax revenues and transfers.

Tax revenues include both shared taxes and non-shared taxes. Shared taxes include personal income tax, corporate income tax and value added tax. These taxes are collected centrally and are subsequently redistributed to regions and municipalities. Since 2008, new criteria were

(209) In terms of hospital, there were 166 hospitals in the Czech Republic of which 19 were set up by the Ministry, 24 by regions and 17 by municipalities in 2010. The rest includes either hospitals managed by other entities (such as ecclesiastical) but also hospitals that were turned into private companies. However, these private companies were mostly set up by a region or a municipality which now act as the only shareholder. (Institute of Health Information and Statistics of the Czech Republic - www.uzis.cz)

introduced for redistribution of shared taxes to municipalities. These are based mainly on the size of the population and also on the geographical size of municipality. The 4 biggest cities are excluded since they have special coefficients. In terms of regions, the law directly determines the share of individual regions on the total amount of shared taxes.

Non-tax revenues include items such as interest income, revenues from renting property, own entrepreneurial activity etc.

Finally, transfers represent a complicated system of various earmarked and non-earmarked items. In terms of delegated responsibilities, the central government provides a contribution to both regions and municipalities specifically aimed at these responsibilities. However, the funds provided do not fully cover all the costs and both municipalities and regions need to pay the rest of the costs from other sources. The current system doesn't allow the central government to control the use of the funds or to obtain any feedback about efficiency etc. As a result, the contribution to cover delegated responsibilities can be spent on other purposes.

Revenues of municipalities

Municipalities derive about one half of their revenues from taxes that include both shared and non-shared taxes. In terms of shared taxes the value added tax is the most important one accounting for about 40% of overall tax revenues. Non-shared taxes include real estate tax and a special type of corporate income tax in cases when the municipality itself is a taxpayer. The rate of real estate tax can be partially affected by municipalities through a system of certain coefficients. Apart from these, various fees and charges are included in tax revenues. These include fees and charges related to environment, municipal waste, gaming machines, dogs etc. These own sources represent only about 14% of total tax revenues. ([210]) There is also a tax incentive scheme by which municipalities are motivated to encourage entrepreneurship and employment in their territory in order to raise their tax revenues.

Transfers represented about 36% of total revenues in 2010 of which almost 40% were provided by the Ministry of labour and social affairs and over 10% by the Ministry of Education.

Revenues of regions

The largest part of revenues for regions is represented by transfers that accounted for almost 64% of total revenues in 2010. The vast majority of this, almost 90% of all transfers and loans from the state budget, was provided by the Ministry of Education.

Tax revenues only include shared taxes and accounted for 32% of overall revenues in 2010. The value added tax is again the most important contributor accounting for over one half of overall tax revenues for regions.

Education

Funds from the state budget are provided for activities of schools and school facilities to be used for salaries and other non-investment costs. These funds from the state budget are provided on the basis of the real number of pupils or students and other criteria. The funds are transferred from the centre to individual regions that transfer them directly to individual schools.

A municipality or a region cover the expenses of school facilities established by a municipality or a region with the exception of expenses paid from funds provided from the state budget (i.e. subnational governments provide operating subsidies directly to schools).

Transport

The biggest contributors in terms of providing funds are the State Fund for Transport Infrastructure (90%) and the Ministry of Transport. In terms of railway transportation, regions receive contribution from the state to cover the losses from maintaining public transport. However, this contribution is not sufficient and in recent years the major part of the losses had to be covered from the regions' own budget. Regions also receive contributions to cover loses in the intra-regional bus transport which does not include city public transport that is funded from the budgets of individual municipalities.

([210]) Ministry of Finance, 2010

Healthcare

Healthcare facilities are mainly financed by health insurance companies. For example hospitals, in terms of financing the most demanding element of the system, received over 80% of their overall revenues from health insurance companies in 2010. Operating subsidies are provided by regions or municipalities and, in terms of hospitals, they accounted for 2% of total revenues in 2010. The rest represents other revenues including revenues from sold goods etc. Besides hospitals, subnational governments also provide operating subsidies to emergency medical service facilities, special medical institutes and other facilities.

Social services

Until 2012 the largest part of the funds provided by the state to municipalities was used as benefits (material need, care allowance) transferred to the citizens. However, Regional branches of the Labour Office of the Czech Republic are responsible for disbursing these benefits as of 2012. The state also contributes to the financing of social service facilities in the form of subsidies to finance current expenditures. While regional authorities are involved in financial control and use of grants provided by the government, both regions and municipalities also provide further grants to finance current and other expenditures of social service facilities.

4. Deficit/debt

Budgets of subnational governments do not have to be balanced as long as the deficit is financed either by surpluses from previous years or by loans or bonds.

In 2010 the debt of municipalities was about 2% of GDP. Almost one half of this sum was caused by the 4 biggest cities. Smaller cities have to be much more careful in running deficits. Recently there were certain cases of smaller municipalities having problem with their deficit cause by excessive investments co-financed by EU funds.

In terms of regions, their overall debt was much lower, only about 0.5% of GDP.

In terms of fiscal rules, the Ministry of Finance calculates monitoring indicators, such as total liquidity and the share of non-own resources to total assets, and sends a letter to municipalities that do not comply with certain criteria. The list of municipalities with insufficient criteria values is sent to relevant regional authorities. Municipalities should explain reasons for not achieving the pre-defined values. Ministry of Finance submits information on municipalities' management to the government annually at the end of September.

The government is currently discussing a reform of fiscal framework which would also affect fiscal rules targeted at subnational governments. In addition, a reform of the system of shared taxes is also currently under discussion.

A1.4. DENMARK

1. General description

Denmark is a unitary state where the central government is predominant. However, the Constitution of 5 June 1953 establishes the principle of municipal autonomy under supervision of the state.

The administrative structure in Denmark consists of three tiers including the national government, regions and municipalities. The scope of both local layers is governed by national legislation.

On 1 January 2007, the Local Government Reform came into force. The number of municipalities was reduced from 271 to 98 by mergers, and the 13 counties were abolished and replaced by 5 regions. A reform of the grant and equalisation system was carried out, which takes into account the new distribution of tasks.

Provision of public welfare service is predominantly carried out by the municipalities and partly by the regions. National legislation stipulates which services and to some extent a minimum quality of the services local government is to provide.

Municipalities' activities are financed through the municipal income tax and land value tax and transfers from the state in the form of block grants and reimbursements of specific expenditures. In addition, municipalities have significant revenues from user charges, while interest income and

borrowing also contribute to municipal finance. Municipalities have autonomy to vary certain tax rates (municipal income tax and municipal tax on land value).

Regions rely entirely on a block grant from the central government and activity-based funding from the central government and the municipalities.

Every year, typically in June, the government sign an agreement on the following year's budgets in the municipalities and the regions with the municipalities' national association (Kommunernes Landsforening) and the regions national association (Danske Regioner), respectively. The agreements include boundaries for service and investment costs as well as targets for total local taxes. This practice has been in place since 1979. It should be noted that the agreements are signed for municipalities and regions as a whole, allowing a certain room for manoeuvre for the individual municipality/region. This also creates uncertainty of the overall enforcement of the agreements. Since the local government reform of 2007, the central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services. In recent years the collective agreements have been supplemented by automatic mechanisms to ensure enforcement of the agreed level of local government spending and municipal tax collection.

In 2010, total spending by local government amounted to 38.2% of GDP – around 2/3 of total public spending (including income transfers and capital investments). Total local government revenue excluding borrowing stood at 38.0% of GDP (including transfers from central government).

2. Government spending

The division of tasks between administrative levels and the responsibilities of municipalities and regions are defined in a variety of legislation on different subjects (rather than a law defining local responsibilities).

Municipal responsibilities include: social services (including income replacing transfers); child care; compulsory education; special education for adults; rehabilitation and long-term care for the elderly; preventive health care; nature and environmental planning; local business services; promotion of tourism; participation in regional transport companies; maintenance of the local road network; libraries; local sports and cultural facilities; and a responsibility for employment, shared with the central government.

The new regions took over responsibility for health care from the counties, including hospitals and public health insurance covering general practitioners and specialists, pharmaceuticals, etc. The regions also have a number of tasks involving regional development.

In 2010, total spending by local government amounted to DKK 670 billion or 38.2% of GDP – around 2/3 of total public spending (including capital investments). 96% of local government spending was to cover current expenses. Municipalities account for the vast part of local government spending.

Local government responsibilities mainly concern the practical provision of public goods, whereas the regulation of their (eligibility, quality and other requirements) is to a large extent determined by the central government. Municipalities are responsible for paying all income transfers to citizens and in some cases decide on eligibility according to nationally defined criteria. Municipalities are partly or fully reimbursed by the central government for their expenditures for income transfers. The rate of reimbursement varies among types of income transfers to provide appropriate incentives to municipalities, it is set by the central government, with local governments having no influence on it, and periodically revised.

3. Financial arrangements

In 2010, total local government revenue excluding borrowing stood at DKK 665 billion or 38.0% of GDP (including transfers from central government).

Municipalities' activities are financed through the municipal income tax and land value tax and transfers from the state in the form of block grants and reimbursements of specific expenditures. In addition, municipalities have significant revenues from user charges, while interest income and borrowing also contribute to municipal finance.

The number of taxation levels was reduced from three to two in the 2007 reform, since the regions, unlike the counties, no longer have the authority to impose taxes. Their revenues consist of block grants and activity-based funding from the central government and the municipalities.

DKK 232 billion or 35% of total local revenue was raised by municipal taxes in 2010.

Central government transfers and grants represented 59% of total revenue in 2010. These falls into three categories: block grants, (partial) reimbursement of specific current spending and compensation for transfer of responsibilities.

The remainder stemmed from the sale of goods and services, asset management and extraordinary revenue.

Net borrowing of local governments varies around 0 and amounted to 0.2% of GDP in 2010.

The local taxes are:

- Municipal income tax account for around 85% of local tax revenues. Municipalities are in principle free to set the tax rate as they wish. In 2012, the average municipal income tax rate is 24.923%. The lowest rate is 22.7% and the highest 27.2%. The tax base is defined by the parliament.

- The municipalities levy a tax on the property's land value (on average land value represents about ¼ of the total property values). Municipalities can vary the rate between a minimum of 16‰ and a maximum of 34‰. The average tax rate is 24‰ in 2012. Commercial properties and some public buildings also pay municipal tax on land value.

- Moreover, business properties pay municipal reimbursement duty on the building value and the land value.

- Finally, the municipalities receive 3/25 of the corporate income tax paid by companies in their jurisdiction.

The central government collects the local taxes and reimburses local governments monthly.

The average municipal income tax rate has increased constantly since 1971. In the same period, the tax base has also been broadened. The increase in the average municipal income tax rate partly reflects increased expenditures and taxation agreed in the annual agreement on the economy of the municipalities and partly reflects breaches of the agreed levels of expenditures and taxation.

The total tax revenues of municipalities as a whole is stipulated in the annual agreement between the central government and the municipalities' national association on the following year's budgets. Municipalities can change the balance between the income tax and the property value tax within the agreement.

However, since the agreement is between the central government and the municipalities collectively, there is no guarantee that the sum of the municipalities' actions will fulfil the agreement. Since 2007, the collective agreements have been supplemented by automatic mechanisms to provide incentives to the individual municipality and ensure enforcement of the agreed level of local government spending and municipal tax collection (see Section 4).

The Ministry of Economics and Internal affairs and the Ministry of Finance are responsible for the surveillance of the local entities budgets and accountings and handles block grants and equalisation, municipal taxes and municipal and regional borrowing.

Since the local government reform of 2007, the central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services.

4. Fiscal rules

Three main fiscal rules are in place along with general requirements for the budgeting and accounting at local government level to control the spending of local governments.

Conditional block grants

With effect for the year 2009, a part of the block grant to the municipalities (DKK 1 billion) was made dependent on the total budgeted public expenditure by the municipalities as a whole

keeping within the agreement. ([211]) In 2010, after the accounting of municipal expenditures in 2009 showed a substantial excess spending compared to the budgets, the conditional part of the block grant to the municipalities was increased to DKK 3 billion from the year 2011 and the conditionality was broadened to also cover the accounted expenditures. ([212]) If the municipalities as a whole exceed the budgeted expenditure in 2011 and beyond, the block grant for the following year is reduced with the same amount (up to DKK 3 billion). The conditional block grant is reduced collectively for the municipalities as a whole in case of infringement of the 2011 budgets. For 2012, however, 60% of the possible reduction will be applied to the individual municipality exceeding the budget with the reaming 40% reduction collectively.

Tax mechanism

As part of the strengthening of management of local spending and to keep the municipal tax revenues constant in real terms, a mechanism to reduce the block grant to municipalities in case of increases in municipal taxes was introduced from 2009. ([213]) If the municipalities as a whole increase tax revenues in the budget (through overall increased rates of the municipal income tax, land value tax and reimbursement duty on business properties), the extra municipal revenues will be clawed back through a combination of individual and collective reductions in the block grant. The individual reduction of the block grant will amount to 75% of tax increase in the 1st year in each municipality increasing taxes in the budget (if the municipalities as a whole increase taxes in that year) with the collective reduction representing the remaining 25% in the 1st year. In the 2nd and 3rd year following a tax increase, the individual and collective reduction both amounts to 50% of the tax increase. In the 4th year following a tax increase, the block grant of the individual municipality increasing taxes is 25% of the increase, while the collective reduction is 75%. In subsequent years, an overall municipal tax increase in year 1 lead to collective reduction of the block grant of 100% of the tax increase. ([214]) This mechanism allows individual municipalities autonomy over their tax rates while ensuring better enforcement of the overall municipal spending and taxation level.

Spending ceilings

To further strengthen the control of public expenditures and ensure that fiscal targets are implemented, in March 2012 the government will present a bill introducing a framework and detailed rules for a new fiscal surveillance system. This new fiscal surveillance system will include binding expenditure ceilings for the state, municipalities and regions, respectively. The expenditure ceilings will each year be defined for a rolling four-year period and is to be adopted by the parliament. State, municipalities and regions must stay within the ceilings each year. New economic sanctions will be introduced to support compliance with the expenditure ceilings.

Borrowing

Municipalities have access to borrowing (including issuing bonds) and are allowed to issue guarantees under certain limitations. ([215]) Municipalities and regions can issue bonds in capital markets through their common credit institute (kommunekredit). Municipalities are allowed to take loans corresponding to the sum of expenditures in the fiscal year for specific purposes: 1) capital expenditures, 2) paying off existing loans and 3) the costs of deferred property values taxes granted to pensioners.

Furthermore, the central government establish minor loan pools for specific purposes which the government wish to support in the annual agreement about the following year's budget between local governments' association and the central government. In 2012, these specific loan pools amount to DKK 1.6 billion for the municipalities.

([211]) L 172 (2007-082).
([212]) L 219 (2009-10).
([213]) L 173 (2007-082).
([214]) For 2009 and 2010, the individual reduction amounted to 75%/50%/0% in the 1st, 2nd and 3rd year, respectively, in each municipality following a tax increase. The collective reduction thus represented 25%/50% in years 1 and 2 respectively and 100% in subsequent years. An extra year with 50%/50% individual/collective reduction was added as of 2011.
([215]) BEK nr 1238 af 15/12/2011.

Municipalities can issue loan guarantees. The amount of the loan guaranty is fully subtracted in the municipality's' allowed loan amount. However, this is not the case for loan guaranties for social housing.

Municipalities' entering into rental- and lease agreements is perceived as borrowing when the lease / rental agreement replaces a capital expenditure and causes a deduction from the total borrowing limit.

Regions have more restricted access to borrowing than the municipalities. ([216]) As a general rule, regions can only borrow or issue guarantees following a dispensation by the Ministry of Economics and Internal affairs. Regions may, however, without ministerial approval take up loans and issue guarantees for certain specified capital costs. Regions may only enter into rental- and lease agreements after approval by the Ministry of Economics and Internal affairs.

For both municipalities and regions, the portion of loans of partnerships, cooperatives, limited liability companies, private foundations etc. with participation of municipalities/regions is deducted from the municipality's' allowed loan amount. Sale and lease-back contracts require the approval of the Ministry of Economics and Internal affairs.

A liquidity rule stipulates that the liquidity of municipalities and regions measured over the last 12 months cannot be negative (time deposits and bonds are included in the balance).

Municipalities and regions had a gross debt of DKK 123 billion in 2010.

Local entities in financial difficulties can be put under administration of the Ministry of Economy and Internal affairs.

A1.5. GERMANY

1. Introduction

Germany is a federal state, in which the federal entities – the *Länder* – are the primary units to carry state powers. Five, together with the Eastern part of Berlin, have acceded to the Federation in 1990. These entities display considerable heterogeneity. Berlin, Hamburg, and Bremen are city-states;([217]) among the others, territories range from 2,500 km² (Saarland) to 70,500 km² (Bavaria), populations from 1,000,000 (Saarland) to 17,800,000 (North-Rhine-Westphalia, NRW), and population densities from 71 (Mecklenburg-Vorpommern) to 524 (NRW). The German constitution – *Grundgesetz* or Basic Law, BL hereafter – stipulates that "the exercise of state powers and the discharge of state functions is a matter for the *Länder*" unless otherwise specified by the Basic Law (Art. 30 BL). Its federal organisation is a constituent characteristic of Germany that enjoys special constitutional protection: the Basic Law rules out any constitutional amendment that would affect the division of the Federation into *Länder* and their participation on principle in the legislative process (Art. 79 (3) BL).

This Chapter provides an overview of the decision-making powers, spending responsibilities, and the assignment of revenues of the different sectors of general government – the Federation, the *Länder*, the municipalities, and the institutions of statutory social insurance – in Germany. Section 2 reviews the legislative, executive, and spending responsibilities by sectors of general government (Sections 2.1 to 2.3) respectively. Section 3 provides an account of revue raising competences by sectors of general government (Section 3.1) as well as cross-sector transfers and equalisation transfers specifically (Section 3.2). Section 4 portrays the elements of fiscal governance applying to public deficits and debt (Section 4.1) as well as mechanisms that improve co-ordination and fiscal planning across sectors of general government (Section 4.2). Section 5 concludes with a summary assessment of the German framework of fiscal federalism in view of fiscal stability.

([216]) BEK nr 1299 af 15/12/2011.

([217]) Berlin and Hamburg consist of a single administrative unit. Bremen consists of the municipalities of Bremen and Bremerhaven.

2. Responsibilities for the design, execution, and financing of policies by sectors of general government

2.1 Legislative powers of the Federation and the *Länder*

Legislative powers are assigned to the *Länder* unless conferred on the Federation by the Basic Law (Art. 70 BL); in practice, both the Federation and the *Länder* play an important role in the legislative process. Concerning the legislative power of the Federation, the Basic Law distinguishes matters within the exclusive legislative power of the Federation (Art. 71) from matters which fall under concurrent legislative powers of the Federation and the *Länder* (Art. 72): in matters of the former, the *Länder* may legislate insofar as they are authorised by a federal law; in matters of the latter, the *Länder* may legislate as long as the Federation has not exercised its legislative power (Art. 72 (1)). ([218]) As a general rule, federal law takes precedence over *Länder* law (Art. 31 BL). In the adoption of federal law, *Länder* are represented by a constitutional body called *Bundesrat*, that comprises *Länder* government representatives, as opposed to the *Bundestag*, the genuine legislative body of the Federation. In certain areas including those with financial implications on the *Länder*, the adoption of federal legislation requires the consent of the Bundesrat. In all other areas, the Bundesrat has the right to suspend legislation, which can be overruled by the Bundestag though. Constitutional amendment requires a Bundesrat majority of two thirds.

Most legislation in Germany is passed by the Federation and the *Länder* under concurrent legislation. Art. 73f. of the Basic Law specifies matters of exclusive legislative power of the Federation and of concurrent legislative power of the Federation and the *Länder* respectively. Exclusive Federation legislation extends over foreign affairs and defence, citizenship, migration, currency and measurement, customs and trade, federal railways, and postal and telecommunication services. Concurrent legislation covers a broad area comprising civil and criminal law, court organisation and procedure, public welfare, economic legislation including industry, energy, commerce, banking, and insurance, labour law including employment agencies, as well as social security, including unemployment insurance, educational grants and the promotion of research, agriculture, urban real estate matters, economic aspects of hospitals, shipping, road traffic, and long-distance highways, most issues of environmental protection, regional planning, and state liability. Initially a small fraction, laws passed under concurrent legislation covered more than half of the federal legislation passed in the 1990s. Concurrent legislation has often been difficult because of the frequent mismatch of political majorities in the Bundestag and Bundesrat, though. The fiscal federalism reforms of 2006 and 2009 realigned legislative powers somewhat to revert centralisation. Areas of legislation that have remained under *Länder* competence to date include education policy, municipal law, police law (except the Federal Office of Criminal Investigation), and the construction of roads (except federal motorways). In practice, most policy areas are shaped by joint legislative decision-making of the Federation and the *Länder*, notable exceptions being social security where policy is designed by the Federation, and education, which has remained under *Länder* competence (information from the ECFIN country questionnaire).

Municipalities are granted by power of the Basic Law the right to regulate all local affairs on their own responsibility, within the limits established by law. However, municipalities cannot issue fiscal legislation themselves. Instead the main provisions governing the planning, structure, execution and accounting of local authority budgets are codified in the Local Authority Codes and in the local government constitutions of the *Länder*. ([219]) In order to regulate the individual aspects of local authority budgets, the Interior Ministers of the *Länder* have enacted several ordinances, compounded by special decrees. In particular, the Local Authority Budget Ordinance prescribes, among other things, how the budgets are to be structured. Local authority budgets are executed on the basis of the budget by-law, which must be

([218]) Concurrent legislation established by the Federation still allows for variance enacted by the Länder in certain areas; while in others, the Federation may legislate only to the extent that the establishment of equivalent living conditions or the maintenance of legal or economic unity renders it necessary to do so (Art. 72 (2) BL).

([219]) Bundesministerium der Finanzen, (2008), p. 77.

adopted by the municipality anew each year. That by-law establishes the budget proper, the ceiling for short-term borrowing and the tax rates.

As of 1999 the *Länder* envisaged replacing the traditional cameral system by introducing a system of double-entry budgeting and accounting, compounded by a reformed cash-based governmental budgeting and accounting system, and adopted this from 2003 onwards. ([220]) The underlying idea of this far-reaching reform was to base budgeting system on the actual consumption of resources rather than cash flows. The first states to have implemented the new system are North Rhine-Westphalia, Hesse, Lower Saxony and Saxony-Anhalt. Baden-Württemberg, Brandenburg, Mecklenburg-Western Pomerania, Rhineland-Palatinate, Saarland und Saxony have also committed themselves to introducing double-entry accounting. Schleswig-Holstein and Hesse permit their local authorities to choose between double-entry bookkeeping and an extended cameral accounting system. In deviation, the Free States of Bavaria and Thuringia plan to retain the traditional cameral accounting system, but also to allow their local authorities to introduce double-entry bookkeeping on a voluntary basis.

2.2 Executive powers of sectors of general government

As a general rule, federal laws are executed by the *Länder* in their own right, unless provided for differently by the Basic Law (Art. 8ff. BL). Some federal legislation is also to be executed by the *Länder* on federal commission (Art. 85 BL). The federal government is in charge of oversight of the execution of federal laws by the *Länder*. The Federation is not entitled to assign governmental tasks to the municipal level (Art. 84 (1) BL). The Federation executes laws through its own administrative bodies specifically in the areas of foreign service, federal financial administration, federal waterways and shipping, policing activities related to the protection of the constitution and to dangers towards Germany's external interests, social insurance institutions with jurisdictions extending over several *Länder*, armed forces and federal defence administration, air transport administration, sovereign functions of post and telecommunications, central banking, federal waterways, inland shipping extending over several *Länder*, and maritime shipping, as well as in matters on which it has legislative power and may establish own administrative bodies (Art. 87ff. BL). In some areas – the peaceful production and use of nuclear energy, air transport administration, and rail transport administration – the *Länder* may be assigned the execution of legislation under exclusive federal competence on federal commission or in their own right respectively (Art. 87ff. BL). In addition, there are special rule for the administration of federal waterways and motorways (Art. 90 BL).

The Basic Law allows for some tasks that fall under the joint responsibility of the Federation and the *Länder*, the so-called joint tasks (*Gemeinschaftsaufgaben*) (Art. 91aff. BL). Joint responsibility is assigned for two tasks principally innate to the *Länder*: the improvement of regional economic structures and the improvement of the agrarian structure and of coastal protection (Art. 91a (1)). Joint tasks are such on condition that they are important to society as a whole, and federal participation is necessary for the improvement of living conditions (Art. 91a). Besides, co-operation of the Federation and *Länder* is provided for in matters of scientific research with supra-regional relevance and the promotion of research facilities and projects (other than higher education institutions), projects and research at such institutions, the construction of large scientific installations, and the assessment of the performance of education systems in particular (Art. 91b BL). Voluntary co-operation of the Federation and the *Länder* is further provided for in the area of construction and operation of information technology systems (Art. 91c BL). Besides, concerning basic support for job-seekers, the Federation or the *Länder* or municipalities and their associations responsible according to Land law respectively shall generally co-operate in joint institutions (Art. 91e).

In the area of social security, public tasks are delegated to autonomous institutions under public law. The pillars of the German statutory social security system comprise health insurance, pension funds, accident, long-term as well as unemployment insurance respectively. Since 2005, federal and regional insurance agencies are organised in a common umbrella association at the federal level, *Deutsche Rentenversicherung*.

([220]) Ibid.

Health insurance is provided by statutory carriers, each of which operates a long-term care fund as well. Statutory accident insurance is provided by occupational associations as well as public associations organised on territorial grounds. Unemployment insurance is provided by the Federal Employment Agency. The respective institutions enjoy administrative autonomy including financial and organisational self-government; control of legality is carried out by the Federation (and by the Federal Ministry for Labour and Social Affairs specifically) unless the scope of the activity extends over no more than three *Länder* (Art. 87 (2) BL).

Executive responsibilities of municipalities include notably public utilities such as the supply of water, gas, electricity, heating, refuse collection and wastewater services. They also include various aspects of town planning including land use and permission to build, road construction, green spaces, public transport. Apart from these mandatory tasks there are also voluntary ones such as the operation of cultural entities (theatres, opera houses, museums), sports facilities, or multifunctional municipality halls. Apart from these various tasks pertaining to local self-government there are also tasks having been transferred upon municipalities by the federal or state government, including notably the tasks of the Registrar's Office, but also tasks relating to youth, schools, public health, social policy including the support of long-term jobseekers (in most cases jointly with the Federal Employment Agency, in some even alone).

2.3 Spending responsibilities of the sectors of general government

As a general principle, among the Federation and the *Länder*, spending responsibility for a government tasks is matching administrative responsibility (Art. 104a (1) BL). ([221]) Tasks carried out on federal commission are financed by the Federation (Art. 104a (2) BL). If money grants are to be administered by the *Länder* on the grounds of a federal law, the Federation may pay for part or all of such grants. ([222]) The apportionment of expenditure on joint tasks is governed by special rules (Art. 91a ff. BL). Of the expenditures on the improvement of regional economic structures, 50 per cent have to be borne by the Federation. Of expenditures on improvement of the agrarian structure and of coastal preservation, the Federation has to bear at least one half of the expenditure, in the same proportion in each Land (Art. 91a (3) BL). The apportionment of expenditures related to co-operation in the area of education and research and of information technology systems has to be regulated by agreement (Art. 91b (3) and Art. 91c (2) BL). Concerning expenditure related to basic support for persons seeking employment, if the respective tasks are executed by municipalities or associations of municipalities (at their request), the expenditures have to be borne by the Federation (Art. 91e (2) BL). Further, the Federation may grant financial assistance to the *Länder* for particularly important investment (*Finanzhilfen für Investitionen*, Art. 104b BL). Conditions for such grants are that the investment falls under the legislative remit of the Federation,([223]) it is necessary to avert a disturbance of the overall economic equilibrium, equalise economic capacities within the federation, or promote economic growth (Art. 104b (1)). Such investment grants can only be temporary and have to be provided in descending annual contributions. Special rules also apply to fiscal consequences of international relations and obligations respectively. Specifically, the costs of occupation and internal and external burdens resulting from war are to be borne to the Federation (Art. 120 (1) BL). Costs stemming from a violation of obligations assumed under international or supranational law are assigned in accordance with the internal allocation of competencies and responsibilities between the

([221]) The link between administrative and financial responsibility is bidirectional: if a law provides that the Federation assumes at least 50 per cent of the expenditure, it will be executed by the *Länder* on federal commission (Art. 104a (3)). Federal laws that establish expenditure on money grants or in-kind benefits by the *Länder* – be it on federal commission or in their own right – require Bundesrat consent (Art. 104a (4)).

([222]) Examples of such laws are are the Federal Training Assistance Act (*Bundesausbildungsförderungsgesetz*), the Housing Benefit Act (*Wohngeldgesetz*), and the Federal Parental Benefit and Parental Leave Act (*Bundeselterngeld- und Elternzeitgesetz)*, where the Federation bears 65, 50, and 100 per cent of the funding respectively (Bundesministerium der Finanzen 2010, p. 14).

([223]) Exceptions to the confinement of investment support to the legislative remit of the Federation are allowed in cases of natural disasters or exceptional emergency situations beyond governmental control with substantial harm to state fiscal capacities.

Federation and the *Länder* (Art. 104a (6)). Of the costs arising from the breach of SGP provisions that transcend one specific Land, 15 per cent are assigned to the Federation, 35 per cent to the *Länder* as a whole, and 50 per cent to those *Länder* that have caused the fiscal burden (Art. 104a (6) BL).

As a rule, the Federation and the *Länder* bear the administrative expenditure of their own authorities each (Art. 104a (5) BL). Such expenditures therefore have to be distinguished from purpose-related expenditure. As an exception, if tasks related to basic support for persons seeking employment are executed by municipalities or their associations, all expenditure has to be covered by the Federation, including administrative expenditure (Art. 91e (2) BL).

As in the case of the Federation and the *Länder*, as a general principle, spending and executive responsibilities match. Note that, in contrast to the federal and *Länder* levels, where there is one budget, local authority budgets are divided into an administrative budget and a capital budget. ([224]) The capital budget shows the revenue and expenditure affecting capital formation (including investment expenditure, new loans and loan repayments), while the other payment flows that do not affect capital formation are included in the administrative budget.

Finally, the social insurance carriers bear their spending responsibilities under administrative autonomy.

3. Arrangements determining the revenues of the sectors of general government

3.1 Legislative powers of taxation and apportionment of tax revenue

The assignment of taxing powers and tax revenues in Germany rests upon the principle that sectors of general government must have their means to meet the mandated tasks; powers to legislate on taxes are assigned to the Federation, the *Länder*, or both (Art. 105 BL). Exclusive legislative powers are conferred to the Federation with respect to customs duties and fiscal monopolies. The Federation enjoys concurrent legislative power with respect to all other taxes where it receives part or all of the revenue, or on condition that the establishment of equivalent living conditions or the maintenance of legal or economic unity renders federal regulation necessary (Art. 72 (2) BL). The *Länder* have legislative powers with regard to local taxes on consumption and expenditures, and may besides establish the rate of the tax on acquisition of real estate. ([225]) Bundesrat consent is required for federal legislation on taxes where part or all of the revenue goes to the *Länder* or municipalities. The financial autonomy of the municipalities guaranteed by the Basic Law includes the right to a source of tax revenues upon economic ability and the right to establish the rates of taxation of these sources (Art. 28 (2) BL). However, unlike in the higher levels of government, local authorities are bound by principles relating to the raising of revenue. ([226]) Specifically, under the said principles, the revenues necessary to meet municipal obligations are to be generated firstly by means of special charges (fees, contributions, charges under private law), to the extent that this is reasonable and necessary, for services provided. Thereafter, these services are to be financed by taxes insofar as the other sources of revenue (including transfers from reserves, cost refunds, general financial grants from the *Länder*) do not suffice. Only as a last recourse, funds may be obtained by borrowing.

Tax revenues are distributed among sectors of general government under separate apportionment or shared apportionment. Under separate apportionment, customs duties, taxes on consumption unless not regulated differently, taxes on transactions related to motorised vehicles, taxes on capital transactions and insurance, and the surtax on income tax and corporation taxes among others are federal taxes (Art. 106 (1) BL). Revenue from the property tax, the inheritance tax, the motor vehicle tax, taxes on certain transactions, and taxes on beer and gambling establishments goes to the *Länder* (Art. 106 (2) BL). Municipalities receive revenue from taxes on real property, trades, and from local taxes on consumption and expenditures. By apportionment, the income tax, corporation tax and VAT are joint taxes: their revenues accrue to the Federation, the

([224]) Bundesministerium der Finanzen, (2008), p. 77.

([225]) Municipalities have the right to establish the rates on taxes on real property and trades (Art. 106 (6) BL).

([226]) Ibid.

Länder, and the municipalities in different quantities (Art. 106 (3) BL). The Federation and *Länder* receive income tax and corporation tax revenues in equal shares (Art. 106 (3) BL). Based on federal legislation requiring Bundesrat consent, a share of the income tax revenue has to be distributed to the municipalities according to the taxpaying ability of the inhabitants. ([227]) The apportionment of VAT (turnover tax) revenues to the Federation and the *Länder* is determined by federal law with Bundesrat consent, in line with expenditure needs established by multi-annual planning and the aim to achieve a fair balance and ensure the uniformity of living standards (Art. 106 (3) BL). Of the *Länder* VAT share, at least 75 per cent is distributed among the *Länder* according to their populations (*Umsatzsteuer-Vorwegausgleich*); the remainder is distributed within the framework of horizontal equalisation (*Ergänzungszuweisungen*)(Art. 107 (1) BL, see below). ([228]) Part of VAT revenue also goes from the *Länder* to their municipalities, based on a formula reflecting geographical and economic factors (Art. 106 (5a) BL). Finally, *Länder* legislation has to establish a share of the joint tax revenue to accrue to municipalities; it may also assign part of other *Länder* tax revenues to them (Art. 106 (7) BL). As a result of the above system of joint tax apportionment, the Federation and the *Länder* receive 50 per cent of the corporation tax each. Of the income tax, 42.5 per cent go to the Federation and the *Länder* each, while the municipalities receive 15 per cent as established by the Municipal Finance Reform Act (*Gemeindefinanzreformgesetz*). Of the VAT, a share from the Federation goes to the European Union, that is recalculated annually. In 2011, the planned VAT revenue shares were as follows: 53 per cent to the Federation, 45 per cent to the *Länder*, and 2 per cent to the municipalities (Bundesministerium der Finanzen, 2012). In addition, there are special rules regulating the apportionment of motor vehicle tax and federal grants for local mass transit (Art. 106a and 106b BL).

Municipalities also receive their share in the intergovernmental distribution of tax revenues. As to the shared taxes, they receive shares of income tax and VAT. In particular, they are empowered to draw on the property tax and the local business tax (raised on top of corporate tax and mainly based on company profits albeit corrected for a number of items), of which a minor part are still ultimately paid to the *Länder* and federal governments. To this add local taxes on consumption and expenditure (including taxes on hunting, fishing, drinks, dog ownership, second residences).

Joint taxes provide the largest part of federal revenues. For instance, of the total projected federal gross revenues of 306 billion euro in 2011, about 60 per cent were receipts from joint taxes, while about 30 per cent were federal tax revenues, in addition to other revenues amounting to 10 per cent.

The pillars of social security receive revenues from contributions of contributors – typically by employers and employees in equal shares – that are complemented by grants (see Section 3.2). Social security contribution ceilings (*Beitragsbemessungsgrenzen*) and contribution rates (*Beitragssätze*) are established by concurrent legislation, i.e. in practice by governmental ordinance with the consent of the Bundesrat. The tasks of the statutory accident insurance providers are financed by employers and the Federation, the *Länder* or the municipalities respectively; contributions are being established ex-post to cover outlays based on employment compensation, occupational risk and the number of inhabitants (in the case of municipal bodies) and insured members respectively.

3.2 Fiscal transfers across and within sectors of general government

To equip each Land with the necessary means to cover their necessary expenditures and ensure equivalent living conditions, Germany operates a powerful system of fiscal equalisation involving the Federation and the *Länder*. It consists of three schemes: (1) primary horizontal equalisation between the *Länder* (*gesamtdeutscher Finanzausgleich*) by means of distributing part of the *Länder* share of VAT according to revenue raising capacities (Art. 107 (1) BL), (2) secondary horizontal equalisation – *Länderfinanzausgleich* in

([227]) The same law provide the municipalities with the right to establish supplementary or reduced rates with respect to their share of the tax (Art. 106 (5) BL).

([228]) This apportionment of VAT share among the *Länder* according to their revenue raising capacity constitutes the first in the multi-step process of horizontal fiscal equalisation as described in section 3.2.

the narrow sense – across the *Länder* (Art. 107 (2) BL), and (3) secondary vertical equalisation by supplementary federal grants (*Bundesergänzungszuweisungen*)(Art. 107 (2) BL). In the first step, a maximum of 25 per cent of the *Länder* share of VAT goes to the *Länder* with below-average revenue from income tax, corporation tax and the *Länder* taxes (*Umsatzsteuer-Ergänzungsanteile*) as established by Art. 107 (1) BL. Receipts are established according to the volume of the *Länder* receipts from the joint taxes (without VAT) plus the *Länder* taxes. The second step further equalises tax revenues at the *Länder* level (Art. 107 (2) BL), based on a measure of fiscal capability and a measure of theoretical equal revenues. The former consists of the sum of tax revenues at *Länder* level and 64 per cent of municipal tax revenues in the respective Land. The latter is calculated in the same way, but using average per capita revenues; adjustments then are made to reflect structural characteristics of the city states (with adjustment coefficients of 1.35) and some *Länder* of the former GDR with low population densities (with adjustment coefficients of 1.02 to 1.05). *Länder* with a negative difference between the two indices are entitled to equalisation payments from the *Länder* with above average capabilities, where contributions and receipts decrease towards the mean respectively. In the third step, supplementary non-earmarked grants are provided by the Federation to *Länder* with subpar fiscal capacity, levelling the gap between the revenues against 99.5 per cent of the mean by 77.5 per cent (*Bundesergänzungszuweisungen*). Even further to that, *Länder* with weak revenue raising capability receive transfers to compensate from specific spending needs (Art. 107 (2) BL)(*Sonderbedarfs-Bundesergänzungszuweisungen*). In 2011, such transfers were granted (1) to Berlin and the five eastern *Länder* to cope with investment backlogs resulting from the separation of Germany within the renewed Solidarity Pact (*Solidarpakt II*); these payments will be discontinued as of 2020;([229]) (2) the five eastern *Länder* (without Berlin) to support fiscal needs from structural unemployment and the combination of unemployment benefits and welfare aid, and (3) grants to fiscally weak small *Länder* to compensate for above average expenses on political governance. In sum, these equalisation funds provide considerable and projectable statutory transfers to the *Länder* with below-average fiscal capability.

The variance of per capita revenues across the *Länder* has been considerably compressed by fiscal equalisation. In 2011, the three mechanisms (without transfers for specific needs) reduced the range of *Länder* tax revenues relative to the average from 156 and 128 to 51 per cent (Hamburg and Bavaria versus Thuringia) to 105 to 98 per cent (Hesse versus Saxony)(Bundesministerium der Finanzen, 2011). The volumes involved in the first and the second step amounted to about 7.3 billion euro, i.e. around 3.3 per cent of the total amount of *Länder* revenues without federal grants (but including the VAT *Länder* share), while the federal grants under the third step made up 2.6 billion euro, 1.2 per cent of the *Länder* revenues without these grants. The largest part of revenue – 90 per cent of the vertical distribution of VAT (step one), and 81 per cent respectively involved in horizontal redistribution and the non-earmarked federal transfers (steps two and three) – were received by the ex-GDR eastern *Länder*. The first step reduced the relative fiscal positions of seven countries (Hamburg, Bavaria, Hesse, Baden-Württemberg, North Rhine-Westphalia, Rhineland-Palatinate, and Schleswig-Holstein) while improving positions of the others. In the second and third step were twelve and eleven recipient *Länder* respectively (Lower Saxony, Saxony, Rhineland-Palatinate, Saxony-Anhalt, Schleswig-Holstein, Thuringia, Brandenburg, Mecklenburg-Vorpommern, Saarland, Berlin, and Bremen, and North Rhine-Westphalia (only step 2). The federal grants for special needs (*Sonderbedarfs-Bundesergänzungszuweisungen*) made up for a total of another 12 billion euro. Non-earmarked grants to the *Länder* made up about 10 per cent of the projected budget – 28.8 billion euro – in 2011.

Revenues of the social insurance institutions, including unemployment insurance, are complemented by federal grants as established by the Basic Law (Art. 120 (1) BL). In case of the statutory pension insurance scheme, *Deutsche Rentenversicherung*, the Federation provides co-funding by balancing the difference between revenues and expenditure. In the federal budget

([229]) The first cycle of the Solidarity Pact was established in 1995. As a result of a challenge by Baden-Württemberg, Bavaria, and Hesse, the solidarity pact was renewed in 2005, limiting the transfers and scheduling their discontinuation after 2019.

plan of 2011, grants to the pension scheme amounted to 26 per cent of the federal budget; high subsidies also result from the merger of the social insurance funds of the former GDR with the German statutory insurance carrier. Bodies of the statutory health insurance system (*Gesetzliche Krankenversicherung*) also receive annual grants to compensate for the execution of tasks that are outside their immediate remit (such as co-insurance of non-contributing family members); these were projected to amount to 5 per cent of the federal budget (amounting to 15.3 billion euro) in 2011. ([230])

The own revenues of municipalities are augmented by equalisation revenues. With the exception of the three city states, municipalities receive an additional source of revenue where required to minimise differences in financial power among the municipalities. Indeed on average this is the largest spending item in *Länder* budgets. This system of vertical and sometimes horizontal equalisation (where municipalities become net contributors) within each Land varies and is laid down in individual *Länder* laws. Some of these vertical transfers are disbursed as matching grants, involving co-financing, occasionally also by the federal government or the EU. Those matching grants would typically be for transport and other infrastructure projects. However the largest part of the equalisation transfers is paid out unconditionally, with spending decisions being fully at the discretion of the recipients. The fiscal transfers are calculated on the basis of two criteria: fiscal capacity and fiscal need. Fiscal capacity is computed based on tax revenue at standardised tax rates, while fiscal need is determined on the basis of a politically chosen acceptable amount of spending per resident.

For 2011, the Federation has allocated 11.2 per cent of its planned budget related to basic benefits to jobseekers, that are administered by municipalities or their associations.

([230]) Concerning employment, the federal budget plan 2011 foresees no grant to the Federal Employment Agency (2010, such grants made up 5.2 billion euro or 1.7 per cent of the budget), while loans of comparable magnitude – 5.4 billion euro – are budgeted instead.

4 Fiscal governance

4.1 Provisions on public borrowing, issuance of bonds, insolvency, and bailout

Applying to the Federation and the *Länder*, before 2011, public borrowing was restricted by constitutional provisions in principle but less so in practice. The “golden rule” was introduced into the Basic Law in 1969 to ban financing non-investment expenditure from credit; similar provisions were enshrined in *Länder* constitutions. ([231]) Exceptions made allowed to prevent disturbances to the economic equilibrium. Arbitrary application of this possibility resulted in the rise in public debt at the *Länder* level. Fiscal imbalances have become particularly pressing in three *Länder*: Berlin, Bremen and Saarland.

With entry into force in 2011, Germany introduced a constitutional structural budget balance rule applicable to the Federation and the *Länder*. Specifically, the amendments agreed in 2009([232]) require that the budgets of the Federation and the *Länder* be balanced without revenues from credit (Art. 109 (3) BL). For the Federation, this principle is established to be satisfied when revenue from borrowing does not exceed 0.35 per cent of nominal GDP, while cyclical effects have to be taken into account symmetrically. ([233]) The Basic Law further establishes a notional control account where deviations from the ceiling are recorded; debits on this account exceeding 1.5 per cent of GDP have to be reduced in accordance with the economic cycle (Art. 115 (2) BL). The established credit limits may be exceeded in the case of natural catastrophes or unusual emergency situations beyond governmental control and with substantial harm to the state’s financial capacity. Such deviation requires decision by the majority of Bundestag members as well as the submission of

([231]) Before the 1969 reform, the Basic Law allowed public borrowing only to cover extraordinary needs and only for profitable purposes. The reform in 1969 enabled debt-financed public expenditure for economic stabilisation.

([232]) In the deliberation phase, the *Länder* maintained strong reservations against the introduction of the debt brake, based on their right to fiscal autonomy; positions only moved in the course of the financial crisis 2008. Schleswig-Holstein even – unsuccessfully – challenged the debt brake at the federal Constitutional Court in 2010.

([233]) At the level of the Federation, cyclical adjustment is done using the common OECD/Commission methodology. On the *Länder* level, there is a lack of an agreed methodology for cyclical adjustment: this may result in differences in the effective implementation of the rule.

an amortisation plan including repayment of such excess credit within an appropriate time horizon. The deficit ceiling of the budget balance rule is phased in with a transition period to gradually reduce the excess structural deficit by about 0.3 per cent of GDP p.a. to reach the ceiling as from 2016. For the *Länder*, a transition period is granted to reduce excess structural deficits and comply as of 2020. During the adjustment path, Schleswig-Holstein, Berlin, Bremen, Saarland, and Saxony-Anhalt, *Länder* with particularly difficult fiscal positions will receive assistance payments provided in equal shares by the Federation and the other *Länder* (*Konsolidierungshilfen*). These grants are conditional on compliance with an agreed consolidation path.

Seemingly strong at first sight, the debt brake carries implementation risks at the federal level; substantial scope for variation in the transposition to constitutional and secondary law at *Länder* level adds to the risk of inconsistent and overly permissible application. Specifically, at the federal level, inconsistent accounting provisions, the lack of consideration of financial transactions, and insufficient consideration of fiscal positions of the social security sector and of special funds have been identified as potential obstacles to an effective containment of debt (Sachverständigenrat, 2011). The *Länder* are free to specify the legal basis and relevant implementation provisions. Four *Länder* have already enshrined balanced budget rules in their constitution, while in another such an amendment is being drafted. Another six *Länder* have incorporated budget balance rules in their state budget acts. The latter typically allow for more generous possibilities for non-compliance though, and can besides be modified by ordinary legislative procedures. ([234]) Further scope for differences in implementation is given by the choice with regard to applying the debt brake to nominal or structural budget balances, the methodology for cyclical adjustment, or whether to use a control account. ([235]) The effectiveness of debt brake provisions at the *Länder* level might further be hampered by the insufficient coverage of municipal public finances (Sachverständigenrat, 2011).

The institutional framework to monitor compliance with the debt brake has been strengthened in Germany, while enforcement provisions are less strict. Compliance with the constitutional debt brake at both the federal and the *Länder* level is monitored by the newly established Stability Council that is composed of the federal ministers of finance and economics and the finance ministers of the *Länder*. Assessments are based on a federation wide early warning system to indicate fiscal distress: in their presence, a consolidation will be established in the concerned Land. ([236]) Concerning enforcement provisions, there is the option of filing an action with the Federal constitutional court (covering the *Länder* as well as of 2020) or at the *Länder* constitutional courts in case that respective constitutional amendments have been made at the level of the respective Land. Additional sanctions are available for the recipients of consolidation support (see Section 3) that are suspended in case of non-compliance.

Budget balance rules have also been in place for the local government sector, typically codified in the *Länder* Local Authority Acts**.** Local authority budget law generally obliges the municipalities to balance revenues and expenditure in its administrative and capital accounts, but does permit some borrowing, for investment purposes in particular. The monitoring is carried out by the municipal supervisory agencies of the *Länder*. The local authority supervisory agencies can refuse the authorisation of the municipal budgets in case of non-compliance. They can impose sanctions against the local authority concerned. Municipalities with financial difficulties can be obliged to implement consolidation programmes. In particular cases, the supervisory agencies can

([234]) Schleswig-Holstein, Hessen, Rhineland-Palatinate, and Mecklenburg-Vorpommern have enshrined a debt brake in their constitutions, while such amendment is in the process of adoption in Lower Saxony. Baden-Württemberg, Bavaria, Hamburg, Saxony, Saxony-Anhalt and Thuringia have adopted balanced budget rules in their budget acts (*Landeshaushaltsordnungen*).

([235]) E.g., to date, only Rhineland-Palatinate has set up a control account similar to the one at the federal level. , based on a federation wide early warning system to indicate fiscal distress.[235] The Stability Council

([236]) Potential fiscal distress is monitored using the following indicators: structural budget balance per capita, borrowing-to-expenditure ratio, interest-tax ratio and debt level per capita. When three of these indicators exceed the established thresholds, budgetary distress is identified. Threshold are defined against the *Länder* average. Therefore, a simultaneous worsening of the fiscal situation of the *Länder* is left undetected.

also temporarily take over the administration of the municipality. The rule has been respected in more than 50% of cases and contributes to fiscal discipline. Non-compliance is justified mostly by poor financial endowment of the local authorities.

Default of public authorities has not been a credible scenario in Germany in the past, but expectations could be changing at present. Specifically, according to the bankruptcy code (*Insolvenzordnung*), bankruptcy procedures against public bodies are inadmissible. At the same time, the highly indebted *Länder* recurrently obtained large transfer payments to alleviate their fiscal distress. In 1988, Bremen and Saarland turned to the Constitutional Court to demand transfer payments from the Federation, arguing that their high levels of debts resulted from adverse economic developments outside their control and claiming that they would be unable to fulfil their constitutional mandate otherwise. A ruling of the Constitutional Court of 1992 posited that financial support indeed was to be granted to states in financial hardship. As a result of a Constitutional Court decision of 2005, payments to Bremen and Saarland are to be discontinued until 2019# (Stehn and Fedelino, p. 9).

In the event of municipalities being highly indebted or experiencing payment difficulties, the responsibility rests with the government of the respective Land to restore the financial capability of the municipalities concerned. To that end many *Länder* have implemented or announced programmes for local authority debt reduction and fiscal consolidation. Regional government support generally is linked to consolidation efforts at the local authority level. Municipalities are not directly involved in the debt brake. However, at present there are concerns that its introduction at state level may imply a shift of the financial burden to municipalities.

4.2 Medium-term planning and other budgetary procedures

Although not legally binding, some co-ordination is applied in medium-term budgetary planning of the Federation and the *Länder*. For the Federation, medium-term planning is anchored in the Basic Law (Art. 110 BL). A medium-term financial plan is adopted with the federal budget each year, it extends over three forthcoming years. The plan includes detailed projections for the main expenditure items by spending areas and revenues broken down on different taxes. The budgetary targets can be revised, but medium-term planning is part of the coalition negotiations, so that new drafts are in line with (maintained or revised) budgetary objectives. Owing to their fiscal autonomy, the *Länder* operate separate procedures for medium-term budgetary planning that correspond to that of the federal level. Co-ordination of medium-term planning between the Federation and the *Länder* is provided by the Stability Council. The Stability Council makes recommendations for budgetary discipline and for a common line on expenditure specifically. Furthermore, it biannually discusses budget projections for the federation and the *Länder* used as inputs to the Stability Programme.

Consistency of budgetary planning across sectors of general government is also by the work of independent fiscal institutions traditionally operating in Germany. Specifically, projections for taxes provided by five economic research institutes, the Bundesbank, the German Council of Economic Experts (*Sachverständigenrat*) and the federal Ministry of Finance are co-ordinated by the Working Party on Tax Revenue Forecasting (*Arbeitskreis Steuerschätzung*). This body acts as advisory council to the federal Ministry of Finance and consists of representatives of the federal ministries of finance and economic affairs, the five research institutes, the federal Statistical Office, the Bundesbank, the German Council of Economic Experts, and the Federal Union of Central Associations of Local Authorities (*Bundesvereinigung der kommunalen Spitzenverbände*). The co-ordinated tax revenue estimates are extrapolated to tax revenue for the federal government, the *Länder* governments, the local authorities, and the EU; this provides the grounds for the annual budget and medium-term budgetary planning of the Federation. The consistency of budgetary planning across sectors of general government is further enhanced by the scrutiny of independent fiscal institutions. Notably, the Council of Economic Experts (Sachverständigenrat), a body of independent economic experts, provides fiscal analyses as well as macroeconomic forecasts and long-term projections for all general government, and assesses the medium-term budgetary framework of the Federation. Yet another institution, the Joint

Macroeconomic Forecast initiative of leading research institutes (*Gemeinschaftsprognose*), co-ordinates the data, assumptions and conclusions applied by several leading research institutions in their analyses of general government public finance, and also scrutinises the medium-term planning framework of the Federation. Finally, the Advisory Board to the Federal Ministry of Finance advises the ministry on all issues of fiscal policy, covering all general government and fiscal relations between its sectors as well.

The Council issued country-specific recommendations to Germany with respect to subnational governments (see Box I.3.2 above).

A1.6. ESTONIA

1. General description

Estonia is a unitary country. It has a two-tier government structure introduced in 1993, which includes the central government and 266 local governments. The municipalities have their own councils elected every four years and their own budget. The size of the local governments varies greatly: the biggest municipality is the capital city Tallinn, while around two thirds of the local governments have less than 3000 inhabitants. The local governments can form districts on their territory in accordance with the law.

The local governments are integrated into 15 counties, which are not a separate governance tier, but state administrative units. Their role is to facilitate coordination between the state and the local level in implementing regional development programmes. The counties' governors are appointed by the government in consultation with the local governments to represent interests of the state in the county.

Basic provisions concerning local governments are established in the Constitution and regulated by laws. The main legal act governing municipalities is the Local Government Organisation Act (1993). Estonia ratified the European Charter of Local Self-Government without reservations in 1994. Since then, the local governance framework remained broadly stable.

According to the OECD data ([237]), in 2010, the total expenditure and revenue of the local governments amounted to EUR 1435.4 m and 1467.9 m, respectively, which is around 25% of general government expenditure (slightly below the historical average) or 10% of GDP. Taxes represent around 46% and grants 42% of the total local government revenue, while the respective shares for the central government are 86% and 0%.

2. Government spending

The main areas of responsibilities of the local governments include education, health care, culture and sports, social welfare services, housing and utilities, waste management, maintenance of infrastructure, and spatial planning:

- Education accounts for roughly 40% of all total expenditure of the local governments and 58% of the total education budget. Local governments' responsibility is to organise maintenance of public pre-schooling (e.g. kindergartens), basic and secondary schools, and to cover their operational expenses (teachers' salaries, etc). The local governments are also responsible for organising student transport. The state is responsible for development of education policies and for establishing the overall standards in the education system (such as qualifications and basic salaries of teachers).

- Healthcare accounts for 16% of the total expenditure of the local governments and for about one third of the total healthcare budget. However, this data does not reflect the fact that the healthcare is funded from the budget of the Estonian Health Insurance Fund (HIF), who with the central government is responsible for policy development and implementation. While formally local governments own local hospitals, their operational expenditures are financed from the HIF. Local governments are partly responsible for the provision of the first level health care services (family physician), though the counties (state) have the overall responsibility.

([237]) OECD Fiscal Decentralisation Data includes expenditure of both local governments and dependant units (hospitals).

- Social welfare services account for 8% of the total expenditure of the local governments. Local authorities are responsible for organising maintenance of social welfare institutions owned by them (e.g shelters, care homes, etc.) and for organising social assistance and welfare for elderly, disabled, and other persons in need of assistance (e.g. homeless). The state is responsible for the development of the social welfare policy, the identification of social needs, and for the organisation of victim support and conciliation service.

- Economic activities (provision of transport), recreation (culture and sports), and housing and utilities (water supply, heat supply, waste management, etc.) are under responsibility of the local governments.

3. Financing

According to the Estonian legislation, the state budget and the local governments' budgets are separated. Local governments may use the following means to finance their expenditures: shared (state) and local taxes; grants and allocations from the state budget; locally generated income fees and proceeds from municipal property. There is a mechanism for equalisation of revenue between the municipalities.

Revenues from taxes

- The biggest portion of income for the local budgets comes from the state personal income tax (46% of total revenues in 2010([238]). This is a shared tax, and the local authorities receive 11.4% of resident's total revenue([239]). The tax threshold and tax exemptions are not applied to the local government share, but are settled fully out of the state share. This means that in practice the local share of the tax revenues was as high as 80%.

- Land tax accounted for 4% of the local governments' revenues in 2010. While it is a state tax by law, it is fully paid into the local budgets. The tax base and the limits of the tax rate (0.1–2.5% of the estimated value of land; 0.1–2.0% for agricultural land) are set by law, and the local authorities can determine the tax rate within those limits. In 2013, Estonia abolished the land tax requirement for the most of the residential land provided that the primary residence of a taxpayer is located on that land.

- Local governments can impose and levy local taxes and user charges in accordance with law. The main local taxes include advertisement tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax, and parking charges. However, the local taxes and fines represented only about 1% of the total local revenues in 2010.

State grants and allocations

The second largest source of income for the local governments are grants from the state budget which accounted for 34% of the total revenues in 2010. They are allocated through the equalisation fund and the block grant (together representing some 90% of total grant distribution), and through earmarked grants from ministries and state agencies.

- The purpose of the block grants (ca 3.5% of the 2012 state budget expenditure) is to support service delivery in several areas. The most important area (87% all grants) is education, as the local authorities are obliged to maintain their school houses and to pay salaries to teachers. Other areas include the subsistence benefits, some types of social benefits and services, a support for registration of the changes in population (birth and deaths), and a support to small islands.

- The purpose of the equalisation fund (ca 1.1% of 2012 the state budget expenditure) is to balance the excessive differences among the income bases of different local authorities, and to ensure that all municipalities provide adequate public services to their inhabitants. The amount of the equalisation fund in a draft state budget and its distribution among municipalities are determined in the negotiations between the local governments and the state. The equalisation grants are divided between the local governments based

([238]) Data based on local budget execution reports prepared by the Estonian Statistical Office. It excludes expenditure of the dependent units (hospitals).
([239]) The personal income tax rate is 21%, to be reduced in 2015 to 20%

on the equalisation mechanism that takes into account the average expenditure need based on population size and age structure, and the weighted lagged accounting revenues. Overall, a large majority of the local governments receives the equalisation grants, with a notable exception of Tallinn area and the oil-shale production region in the north-east of Estonia.

- Other earmarked grants cover mainly local governments' activities to maintain and develop infrastructure and are provided from the annual budgets of ministries.

Other sources of revenue

Local governments receive revenue from their economic activity (sale of goods and services, ca 11% of revenues in 2010), property income (2.4%), and a sale of property (1%). The amounts of fees for the use of natural resources and water, as well as the size of the share paid into the local budgets are determined by a government decree.

4. Fiscal rules

The difference between the revenues and expenditures of the local governments is financed by borrowing. In 2009, local governments' debt burden reached 50.8% ([240]). Due to eroding revenue base during the financial crisis, one-off measures were introduced to limit the borrowing by local authorities. Consequently, the debt burden of local governments fell slightly to 50% in 2010, marginally outpassing the 60% threshold only in Harju and Parnu counties (60.7 and 60.5%, respectively).

From 2009 until end-2011, the local government could undertake new financial obligations (i.e. take loans, issue debt securities, sign financial leasing agreements) only under the double condition that the total amount of the outstanding financial obligations by a local government and their servicing would not exceed 60% and 20%, respectively, of the budget revenue planned for a given budget year (excluding the earmarked transfers from the state budget). Moreover, since 2009, the local governments could only borrow to co-finance structural funds and to re-finance their existing liabilities, and only with the consent of the Ministry of Finance.

As of 2012, a new local government financial management act is in force, which makes provisions for medium- to long-term financing frameworks, modernises and increases transparency of financial governance, and reinforces fiscal discipline of the local governments. It establishes a net debt ceiling (debt minus liquid assets) of 60%-100% ([241]) of the operational revenue in the current fiscal year depending on a self-financing capacity of municipalities. The ceiling is allowed to be exceeded by the amount of a 'bridge financing', essentially in order to ensure sufficient co-financing of the EU structural funds. The bridge loan can be taken in the amount of targeted foreign financing and received co-financing to provide payments until the receipt of the targeted financing and co-financing. The new rule is applicable to all borrowing by the local governments and their dependent units, with no escape clauses.

The responsibility for monitoring and enforcement of the rule lies with the Ministry of Finance. In case of deviations, the Ministry of Finance makes proposals to correct the situation. A local government has to submit to the Ministry of Finance an operational plan for t+3 years indicating measures to ensure financial discipline. In case of a risk of a difficult financial situation, the Ministry of Finance forms a committee independent of the local government at risk, which in cooperation with the local government prepares a recovery plan for t+4 years, which includes be a sound financial plan.

To ensure implementation and timely submission of the corrective plans, the Ministry of Finance can suspend the transfers from the equalisation fund and of the income tax share of the local governments. In practice this means that the financial sanctions are only applied if the local governments ignore or disobey the corrective procedure.

([240]) Debt divided by net revenue, based on the local governments budget execution reports. Data provided by the Estonian Statistical Office.

([241]) Exceptionally, in 2012 local governments cannot take new loans if it results in a debt burden of over 60%. Local governments whose debt is already above 60% cannot borrow at all in 2012.

A1.7. IRELAND

1. General description

Ireland is a unitary country. The Irish Constitution recognises the role of local government in providing a forum for the democratic representation of local communities, in exercising and performing at local level powers and functions conferred by law and in promoting by its initiatives the interests of such communities. The Local Government Act 2001 is the principal legal code governing local government in terms of structures, operations and functions. In addition to the 2001 Act, the operation of local authorities is affected by a range of other legislation dealing with specific services such as housing, roads, planning and waste.

Ireland has a three-tier government structure – central government and two-tiers of local government. 26 county councils and 5 city councils are the primary units of local government, which cover the entire territory of the state. In the second tier of the local government are 80 town councils with limited functions in smaller urban areas. ([242])

The most recent wide-ranging reform of the local government sector was in 2001. It simplified the fragmented structure that existed since 1898 and introduced the second tier of the local government. Several lower-level reforms are on-going, including merging of some local authorities; efficiency reforms (shared services, common procurement platform, staff number reductions) and improvements in budget control and reporting framework.

Elected members of the local authority form the principal decision-making body in each authority. They adopt an annual budget, pass or revoke local laws (secondary legislation), approve borrowing and lay down the policy framework under which the county managers must operate. The county or city managers are appointed chief executives with delegated powers to manage local authorities on daily basis.

([242]) Administrative areas of town councils are limited and do not cover the whole country. Town councils do not have all functions of the county councils – both institution levels have distinctive responsibilities in the same territory.

Local government sector in Ireland is one of the smallest in Europe. Total expenditure of the local governments amounted to 6.8% of GDP in 2010 on unconsolidated based. Level of control of the local authorities is even lower as the central government funds about 60% of local government expenditure.

2. Government spending

Local authorities are responsible for an extensive range of services including housing, roads, water services, community development, environmental services and protection, planning, fire services, libraries, arts and culture, parks, open spaces and leisure facilities, higher education grants to students([243]), motor tax collection, maintaining the register of electors, and other services. Local authorities are exclusively responsible for certain services, notably water supply, waste water management and fire-protection services, as well as cover large share of other public services in their area of responsibility. However, they are not autonomous in the decision making process, as services are largely coordinated and funded by the central government. Higher control of local authorities and lower central government funding are in the areas of housing and urban development, cultural services and fire protection. The range of services provided by the local government sector in Ireland is relatively narrow in an international context, with a number of key services such as health and policing being provided through central government systems. However, local government, and government in general, is highly involved in the housing market as compared to other Member States. Local authorities' housing services account for a quarter of their budget and serve almost 16% households in Ireland. They include local authority-owned housing (7% of all households), rent supplement schemes (6%)([244]), housing leased by local authorities (2%) and housing owned by approved voluntary and co-operative housing bodies (1%).

([243]) The Higher Education Grants Scheme is one of four different student grant schemes and it is processed by local authorities, while money comes from the central government (the Department of Education and Skills). Most of the responsibility for education system rests with the central government. Universities in Ireland are classified outside the government sector.

([244]) Provided by central government (Department of Social Protection)

Total expenditure of the local government sector amounted to EUR 10.5 billion in 2010 on unconsolidated bases (about 15% of general government expenditure excluding banking support measures), of which EUR 6.7 billion in current expenditure and EUR 3.8 billion in capital expenditure. Current expenditure covers the service provision costs of local authorities, including staff salaries, housing maintenance, pensions, operational costs of water treatment plants, etc. Current expenditure is funded through a combination of commercial rates, charges for goods and services, specific and general grants from central government. Local authorities employ approximately 30.6 thousand people – about 10% of total public service employees. Capital expenditure is spent on road construction, building or purchase of houses, swimming pools, libraries, etc. Capital expenditure is funded through a combination of central government grants, borrowings and income from other sources such as development levy contributions. While local authorities spend some 70% of the general government investment, central government determines large share of investment priorities as specific capital grants from central government account for around one-third of capital spending. Road construction and maintenance is supervised and coordinated, and funded from the National Roads Authority (part of the central government). Other projects are coordinated between local authorities and respective central government departments. For example, water supply and waste water infrastructure is administered and maintained by the local authorities, but it is largely funded by the Department of Environment, Community and Local Government, also being involved in the decision making process.

3. Financial arrangements

Main source of local government revenue is grants from the central government, which accounted for 60% of total revenue in 2010. There are two types of central government grants to local authorities – general and specific. General grants are not constrained by specific spending parameters and include most of the financing allocated from the Local Government Fund. Specific grants are earmarked for specific purposes and cover the delivery of specific state services or projects through local government such as roads or higher education grants. Local Government Fund is made up of a contribution from the central government and motor tax receipts. Motor tax is collected by the local authorities, but rates are set at the national level, as well as revenue is recorded in the central government accounts. General grants account for 90% of the fund and the rest is specific grants for non-national roads. General grants are structured to bring about equalisation of resources among local authorities over time. For the purposes of allocations, a range of factors is taken into account, including each local authority's expenditure and revenue, as well as the overall amount of funding available for distribution. A computer-based model assists in determining whether spending level and resources are adequate in each local authority.

High share of specific grants in revenue implies limited control of local authorities over this part of their budgets. Excluding expenditure funded by specific grants, local governments have discretion over some 7% of general government expenditure (about 3% of GDP). The share of the grants in the local government has increased as other revenue sources declined during the financial crises. This has required an appropriate adjustment in expenditure of the local authorities, given borrowing restrictions.

Other major revenue source of local government is commercial rates, charges for goods and services and development contributions. The local authorities have some control over this revenue and its use, although some charges (such as planning application fees) are set centrally.

Commercial rates are property taxes (indirect taxation) levied on commercial property. Revenue from commercial rates amounted to 13% of total local government revenue in 2010 (0.9% of GDP). The level of the rate is determined each year by local authorities as part of their annual budgetary process. The rates are applied on the value of the property determined by the Commissioner of Valuation, which periodically revaluates commercial properties in local authorities.

Charges are levied on services provided by local authorities, for example, commercial water charges, housing rents, waste charges, parking charges, planning application fees, refuse and landfill charges, library fees and fire charges. Development contributions are paid to local governments as a condition of planning

permissions and allow recouping some of the public costs for providing public infrastructure and facilities that benefit development in the area. Development contributions and related capital expenditure have substantially declined after the crash in the property market.

In order to place local government on a sound financial footing and reduce reliance on the central government grants, new income streams are being developed. A charge on non-principal private residences of EUR 200 was introduced in 2009 and an additional household charge of EUR 100 in 2012. Both charges yield more than 0.1% of GDP. Further revenue-increasing measures will be introduced in 2013-15, in line with fiscal adjustment plans, yielding additional 0.4% of GDP. In particular, a valuation-based property tax will be introduced replacing the current interim measures.

In the national accounts, different charges and development contributions are recorded as sales, property income and transfers from private sector. Total revenue of this kind amounted to 23% of total local government revenue in 2010 (1.5% of GDP). Social contributions received by local government sector are those paid on wages for own employees.

4. Fiscal rules

A fiscal rule for local government sector was established in 2004 – the sector's fiscal deficit on ESA95 basis should not exceed EUR 200 million in any year. The rule was established as a political agreement and is laid down in administrative circulars. The implementation of the rule is controlled by the Department of the Environment, Community and Local Government. The overall deficit rule is expressed in the operational limits for local government borrowing taking into account existing loan repayments.

The adherence to the rule is monitored by current and capital account controls, and loan sanctions. Control measures have been tightened since 2009 to strengthen adherence to the rule. Accrual-based fiscal target can be measured from both the non-financial transactions and the financial balance sheets. The former are recorded in current and capital accounts of the local authorities, which are required to have balanced revenue–expenditure positions. However, as these accounts include certain financial transactions, a control of financial balance sheets and borrowing limits are necessary. Borrowings by the local authorities are sanctioned by minister, ensuring that the required borrowing limits are respected. The budgets of local authorities are monitored throughout the year and any expenditure overruns should be compensated for by either a reduction in another expenditure area or increased income.

Local government debt was at 3.4% of GDP in 2010, of which 2.8% to central government and 0.6% to private sector. While default by local government is possible, it is most likely to be bail-out the central government. In 2010, the central government repaid some of the loans of local authorities in financial difficulties. Alternatively, these troubled authorities would have cut their services.

A1.8. GREECE

1. General description

The Greek state has been highly centralised since its founding in 1832. This situation has been gradually changed since the adhesion to the European Union in 1981. In 1987, 13 programme-regions were established by a presidential decree. In 1994, the 51 nomoi (prefectures), which have been acting as state territorial administration units for 160 years, became self-governments with directly elected prefects and councils (law 2218/94 on the establishment of democratically elected government at prefecture level). In 1997, the law 2539/97 on the "formation of the first level of local government" was an attempt to empower the municipalities by increasing their size. This programme, called Cappodistrias Plan reduced the number of primary local authorities from 5825 in 1997 to 1034 in 2005. In 2001 a constitutional revision reinforced decentralization and explicitly stated that there are two levels of local government in Greece. From 2003, discussions between the Hellenic Ministry of interior, the Parliament and local authorities were focused on redrawing (under a Cappodistrias 2 plan) the administrative boundaries of the local authorities, in order to better profit from EU funding.

Greece is a unitary state with a two-tier government structure. Its constitution was ratified on June 11, 1975. The articles 101 and 102 recall the principles of decentralisation and local autonomy. The 2001 constitutional revision explicitly states that the administration of local affairs shall be exercised by local governments of first and second level and that they enjoy administrative and financial independence. In particular the article 102, paragraph 5 of the constitution states: "The state takes all the legislative, regulatory and fiscal measures needed for guaranteeing the economic and resources autonomy of the local self-Government Organizations (OTA), together with assuming the responsibility of securing administration transparency of these resources".

Law 3852/2010 on the "New architecture of self-governance and decentralized administration-Programme Kallikratis" is the most recent modification of the decentralised governance in Greece.

In particular, there are two levels of subnational self-governments:

- At the first level, 325 municipalities have been established (substituting the 1034 ones from the previous legislation). Each is comprised by the unification of a number of the pre-existing local departments which have been renamed as local communes (when population is up to 2000) or municipal communes (when population is more than 2000).

  The municipalities (the 1st level of self-governance) are self-governed autonomous public law legal entities. They are governed by the municipal council (the number of its members varies with the corresponding population), the economic committee, the committee of quality of life (for municipalities of more than 10000 inhabitants), the executive committee and the mayor. Each of the municipal communes and local communes are governed by the council and a council president.

- At the 2nd level, 13 regions (peripheries; in the previous legislation they were the decentralised state administration units) are established. Those are governed by the Head of the Region (peripheriarchis), the vice-heads of the region (antiperipheriarchis) the Region Council, the economic committee and the executive committee. The number of these offices is determined by the law according to the population features of each region.

At the national level Greece is divided in **7** integrated decentralised state administration units, called Decentralised Administrations (*apokendrwmenes diikiseis*), for each of which a Secretary General is appointed by the central government.

After Kallikratis Law implementation, subnational governments have undertaken extended competences in functions such as environment, life quality, social protection, education, culture and sports, agriculture, breeding and fishery development, etc (as set by Law 3852/2010).

Subnational governments' share of responsibility has increased after Kallikratis Law implementation as they have also accepted exclusive duties, in all cases served under central government directives.

They do not have autonomy in legislation but according to Constitution (Syntagma) they have administrative and financial autonomy.

2. Revenues of the decentralized self-governments

Law 1828/1989 introduced the model of direct state funding to the local self-governments through institutionalisation of the Central Autonomous Resources (Kendrikoi Autoteleis Poroi, KAP) within the national budget.

After 20 years in service the KAPs have been restructured according to the Law 3852/2010 (Kallikratis) aiming to the long term economic sustainability of the local government finances and their protection towards economic risks. The new sources of these funds are as follows:

- The revenues for the municipal KAPs are

i) The 21,3% of the total annual receipts of the income tax of the physical persons and legal

entities, once revenues earmarked for OGA have been deducted;

ii) The 12% of the V.A.T. total annual revenues; and

iii) The 50% of the total annual receipts on regular property tax.

Two thirds (2/3) of the category (i) revenues and the total of (ii) and (iii), comprise the account covering operational and other general expenditures of the KAP. The rest one third (1/3) of the (i) category covers investment expenditures.

KAP covers 46%-49% of total Revenues of municipalities (and this share is planned to decrease according the Medium Term Fiscal Strategy 2013-2016.

- The revenues of the regional KAPs are:

i) The 2,40% of the total annual receipts of the income tax of the physical persons and legal entities, once revenues earmarked for OGA have been deducted;

ii) The 4% of the V.A.T. total annual revenues.

Those revenues are distributed to the regional accounts specific for operational and other general costs and, to the regional accounts specific for investment expenditure, according to a common decision taken by the ministry of Internal Affairs, the ministry of Decentralization, the ministry of Economics after consultation of the Union of the Regions. Recently, an annual cap of 5.200 mln Euros has been introduced as part of the Medium Term Fiscal Strategy for the sum of the earmarked revenues for municipal and regional local governments. On a Regular Basis, Regions' Revenues come from KAPs and a part of it comes from Public Investment Programs. Additional Revenues include income from taxes of movable and immovable property, insurance contributions, fines and fees.

3. Municipal expenditures and revenues (other than the KAPs)

Expenditures of municipalities include: (i) Operational costs such as remuneration and personnel expenses, remuneration of elected and other staff; costs for serving the public trust (i.e. loans for covering operational and investment costs), costs for consumable goods (i.e. school maintenance and building materials); leasing costs and other general operational costs. (ii) Investments such us purchase of buildings, technical works and procurement of fixed assets; works; fixed assets/holdings in enterprises, and (iii) payments, returns and forecasts incurred in previous years.

Revenues may be distinguished as regular and irregular. Regular revenues are (i) revenues from immovable properties (i.e. rents from the use of public areas such as forest rents or fish-farm rents), (ii) revenues from movable properties (i.e. capital interest etc), (iii) revenues from retaliatory fees (e.g. cleaning, lighting, port, water, and sewer fees), (vi) revenues from royalties and services (e.g. revenues from cemeteries and slaughterhouses, fees on gross tradesmen income), (v) revenues from taxes and duties (electricity tax, beer tax, other municipality specific taxes)([245]). Irregular revenues are mainly: revenues from selling immovable and movable property; subsidies for covering operational costs; investment subsidies (state or community funds); donations and inheritance; surcharges fines and fees (e.g. parking fines); loans. Taxes and their range are set by legislation with the only exception being the retaliatory fees for which municipalities can set their own rate.

4. Fiscal Decentralisation

The article 261 of the Law 3852/2010, explicitly states measures concerning fiscal decentralization of taxation.

1. A percentage of the actual increase of the VAT receipts within the administrative territory of a municipality will be assigned to the municipality concerned and it will exclusively be used for services of social solidarity. This is an attempt of

([245]) The main taxes and fees (imposed as taxes) are 6. Electricity tax, beer tax, immovable property charge, gross income fee, sojourn fee and local tax of Dodecanese. Total taxes and fees imposed by municipalities are about 40. Apart from the main 6 the rest of them account for an important part of total revenues from taxes-fees.

certification, reception and allocation of local public revenues by the local government itself.

2. A percentage of 20 of the property tax revenues may be considered as local municipal revenue depending on the total amount of taxes collected in the administrative area of a municipality and the related ministerial decision. This revenue is allocated to actions concerning urbanization and related services.

3. The municipalities are given the power to ask for information on wealth elements (properties and income) of the physical and legal persons in their administrative territory.

5. Credit Policy

Regions and municipalities may take loans from financial organisations in the country or abroad only in the context of financial investment and debt financing purposes and, under the constraints: (a) that the annual cost of a debt financing does not exceed the 20% of its annual regular revenues; (b) the total debt of the region/municipality proceeding to borrowing does not exceed a threshold percentage of its total revenues. This threshold is determined by a ministerial decision. The total debt of the region/municipality is defined as the sum of its short and long term obligations. Subnational governments can issue bonds but this has not been applied yet. Local Government debt contributed with a minor percentage to General Government fiscal slippages.

Budgetary (5 years' term same as the mandate of the local governments) and financial control of the local governments is made by the Conference of Auditors (Elegktiko Synedrio). There have been cases of bail-outs of local governments in financial difficulties.

A1.9. SPAIN

1. General description

Spain is a highly decentralized country with a significant share of spending powers devolved to the regions denominated Autonomous Communities (CCAA henceforth), mainly on health care, education and social services. Article 2 of the Constitution ratified in 1978([246]) guarantees the right of the CC.AA. and the regions to have their self government and ensures the solidarity amongst them. In turn, Article 137 sets out that CC.AA., provinces and municipalities enjoy autonomy for the management of their respective interests. Article 140 also ensures full autonomy to the municipalities.

As a snapshot, around 35% of total consolidated general government expenditure is made by the CCAA, whereas local governments are responsible for some 13%. Hence, altogether public spending under the responsibility of State (CCAA) and local governments amounts to almost 48% of total general government spending. Likewise, Spain also enjoys a high degree of fiscal autonomy. A sizeable share of tax receipts and fees are transferred to subnational governments, while at the same time they enjoy a high regulatory capacity over both shared and transferred taxes. Thus, shared and transferred taxes to the CCAA and local governments amount to some 29% and 15% of total consolidated government revenues, respectively; the remaining 56% remains in the hands of the Central Government.

The Autonomous Communities are divided into two main groups, namely the Autonomous Communities (CCAA) of Ordinary Regime and the Communities with Foral Regime. The financing systems differ between the two groups. The Autonomous Communities of Ordinary Regime are Andalusia, Galicia, Cantabria, Asturias, Castile-León, Castile-La Mancha, Aragón, La Rioja, Catalonia, Comunidad de Madrid, Comunidad Valenciana, Extremadura, Murcia, Balearic and Canary Islands, and the autonomous enclaves of Ceuta and Melilla. Their financing system of the Autonomous Communities (CCAA) of Ordinary Regime in Spain has been revised very recently (Law 22/2009 of 18 December). In turn, the Communities with Foral Regime are Navarre and the Basque Country, which enjoy full fiscal autonomy excluding customs tariffs, with the limitation that the overall effective tax burden does not fall below that of the rest of Spain.

([246]) http://www.boe.es/aeboe/consultas/enlaces/documentos/ConstitucionCASTELLANO.pdf or also in its English translation http://www.congreso.es/constitucion/ficheros/c78/cons_ingl.pdf

Finally, the principles of the Social Security([247]) are enshrined in Article 41 of the Constitution and its main tasks are assigned to different public agencies within the general government.

2. Government spending

The central government holds full legislative power only in the areas of international relations, nationality, migration, political asylum rights, defence, justice, customs, currency, general finance and Central Government debt, commercial, criminal, labour, civil and intellectual property legislation, general coordination of the public Health Care system and legislation on pharmaceutical products. The central government also has legislative powers on the basic legislation, definition of principles and economic regime of the Social Security including Health Care, although the provision of services is devolved to the CC.AA. and Local Governments. In many areas the central government shares competences with the CC.AA.

By the functional breakdown of public expenditure (COFOG) the assignment of the different competences can be summarized as follows:

- General public services: Definition of policy principles and their implementation lie within the remit of the central government except for debt issuance by CC.AA. and Local Governments.

- Defence: Full responsibility of the central government.

- Public order and safety: The definition of policy principles lie within the remit of the central government except for the areas of police and fire protection services. The effective implementation of public order and safety policies is accomplished by the central government, the CC.AA and the municipalities.

- Economic affairs: The definition of policy principles lies within the remit of the central government, while spending powers concerning areas such as agriculture, forestry, mining, fishing, construction, transport and communication have been devolved to the CC.AA. Local Governments have also powers on public transport within their geographical area.

- Environmental protection: The definition of policy principles and the implementation of these policies lie within the remit of the central government. The CC.AA. enjoy additional legislative power, while municipalities also enjoy spending powers on waste management and pollution abatement.

- Housing and community amenities: These spending competences have been mostly transferred to the municipalities, although the CC.AA can define the basic principles of town and country planning and housing.

- Health: The definition of policy principles and general coordination lie within the remit of the central government, whereas the effective spending powers have been devolved to the CC.AA. However, the legislation on pharmaceuticals lies exclusively on the hands of the central government.

- Recreation culture and religion: The definition of policy principles and general coordination lie within the remit of the central government, whereas the effective spending powers have been devolved to the CC.AA.

- Education: The definition of policy principles and general coordination lie within the remit of the central government; the effective spending powers have been devolved to the CC.AA.

- Social protection: The definition of policy principles and general coordination lie within the remit of the social security, as well as effective spending on areas such as unemployment and old age. Effective spending powers on social services have been devolved

([247]) These agencies are the National Social Security Institute (INSS in its acronym in Spanish), the National Institute of Healthcare Management (INGS), the National Institute of Social Services (IMSERSO), the Social Institute of the Navy (ISM) and the General Treasury of the Social Security (TGSS). However, this national institutional definition of the Social Security does not coincide with the Social Security subsector as defined in ESA95, which comprises the Social Security System (the main function of which is the functioning of the public pension system), the Public National Employment Service (SPEE in its acronym in Spanish) and the Wage Guarantee Fund (FOGASA).

to the CC.AA and, to a lower extent, to municipalities.

3. Financial arrangements

3.1. Autonomous Communities

There are basically two different financing systems for Autonomous Communities in Spain depending on their regime. The two Communities with Foral Regime, notably Navarre and the Basque Country, enjoy full fiscal autonomy excluding customs tariffs, with the limitation that the overall effective tax burden does not fall below that of the rest of Spain. They are responsible for taxes collected in their respective territory and negotiate the amount to be transferred to the central government on account of such taxes for responsibilities remaining centralized, and in proportion to their relative income and population. This transfer is set to evolve in line with the observed growth rate of the Central Government's tax revenues. This agreement is revised every five years. In turn, the Autonomous Communities (CCAA) of Ordinary Regime enjoy a different financing system that has been revised very recently (Law 22/2009 of 18 December). This system is described in greater detail in the next subsection.

The financing system of Autonomous Communities of Ordinary Regime

The current financing system introduced some amendments to the previous one in effect until 2008. In essence, the functioning of the financing system can be summarized as follows:

a. The new system first determines the funding needs (spending needs in the previous system) for all the CCAA in a base year augmented with additional resources contributed by the Central Government.

b. These funding requirements are distributed among the CCAA according to the agreed criteria concerning the so-called "essential public services"([248]) (Guarantee Fund) and confronted with the 75% of the transferred tax revenues in each Autonomous Community. The difference between them takes the form of a grant from (+) or to (-) the Central Government.

c. Levelling transfers are set to ensure that each Autonomous Community receives enough resources in the base year for the competences assumed (Global Sufficiency Fund).

d. Two additional Convergence funds are set, notably the Competitiveness Fund and the Cooperation Fund, whose basic function is to provide certain CCAA. with additional resources.

e. Finally, standards for the evolution of transfers are set. In practice, there are advanced payments on account of budgetary projections in the Central Government Budget for a given year, with its final settlement normally taking place after two years.

a. Overall financing needs in the base year

For each Autonomous Community the resources in the base year were gauged on the basis of the funds that it would have received under the previous system. Thus, the overall funding needs in the base year were assimilated to the finally settled ones by the previous funding system, augmented with additional resources that amounted to some € 7.4 billions (0.7% of GDP). These additional resources were allotted according to some pre-determined criteria.

b. Tax capacity

The tax capacity of CCAA to finance the expenditure related to the spending powers assumed is also estimated for the base year. Such tax capacity includes both the collection of taxes assigned and the specific fees linked to the powers assumed.

TThe new system raised the amount of taxes transferred (personal income tax, VAT and excise duties) and tax powers on the personal income tax and other traditionally transferred taxes such as Property Transfer and Stamp duty, Inheritance and Gift, taxes on gaming, hydrocarbon-oil taxes, taxes on certain means of transport and fees. Specifically, the share of taxes transferred to the CC.AA. are:

([248]) In the previous system funding needs were distributed according to all the powers transferred.

- Personal Income Tax: 50% of total net tax revenues thereof (33% in the previous system), with normative capacity on the regional rate (progressive) without restrictions on brackets, though subject to approval. CC.AA. also have normative capacity on personal and family allowances (± 15% limit for each of the components) and deductions for personal circumstances, business and housing investments. However, the definition of family circumstances covered by such allowances cannot be changed. Restrictions on the number of income brackets and marginal rates were removed on condition that the autonomic rate is progressive. Moreover, regional rates are subject to annual approval.

- VAT: 50% of total receipts thereof (35% in the previous system), although with no normative capacity. These are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE).

- Excise duties on manufactured production of alcohol, tobacco and hydrocarbons: 58% of total net tax revenues thereof (40% in the previous system), with no normative capacity. These revenues are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE), the Ministry of Industry, Energy and Tourism or the Tobacco Market Commissioner.

- Hydrocarbon-oil retail sales: 100%, with some normative capacity on the tax rate.

- Electricity: 100% of total net tax revenues, with no normative capacity. These revenues are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE) and the Ministry of Industry, Energy and Tourism.

- Property Transfer and Stamp Duty: 100%, with normative capacity on the tax rate (except for corporate transactions) and on deductions and allowances.

- Registration of motor vehicles: 100%, with some normative capacity on the tax rate.

- Taxes on gaming: 100%, with normative capacity on exemptions, rate, tax base, fixed fees, allowances and accrual.

- Wealth tax:([249]) 100%, with full normative capacity on the tax rate, allowances and allowances.

- Inheritance and gift tax: 100%, with full normative capacity on the tax rate and some normative capacity regarding reductions in the tax base, deductions, allowances and coefficients of existing wealth.

c. Guarantee fund for essential public services in the base year

The distributing criteria of resources across CCAA only apply to the so-called "essential public services of the welfare state", namely health care, education and social services. ([250]) A Guarantee Fund for Essential Public Services (Guarantee Fund henceforth) aims to ensure uniform access to these basic services to all citizens regardless of their place of residence. All CCAA contribute 75% of the tax revenues and fees assigned to them to this fund,([251]) to which € 8.7 billions contributed by the Central Government were added in the base year. Notwithstanding the way these funds are gauged, most financial resources assigned to the CC.AA. are not earmarked.

This fund was theoretically distributed among the CCAA based on the so-called "adjusted population", which is gauged as a weighted average of seven variables: population (30%), area (1.8%), dispersion (0.6%), insularity (0.6%), equivalent protected population (38%), population aged 65 years or above (8.5%) and population up to 16 years of age (20.5%).

Thus, the net transfer from the Guarantee Fund (NT) was gauged as the difference between the amount of the share of each Autonomous Community in the Guarantee Fund in the base year

([249]) This tax was withdrawn in 2009 and has temporarily been re-introduced to assuage the budgetary impact of the crisis. The tax is envisaged to take effect in 2012 and 2013.

([250]) In the previous system only the first two were considered as such.

([251]) All the calculations are based on "normative taxes", which basically consist on taxes transferred to the CC.AA. before exerting their normative capacity.

(GF) and amount of its contribution (75% of its respective tax revenues in normative terms (TREV). Such net transfer takes the form of a grant between the Central Government and the relevant Autonomous Community according to the following formula:

NTi = GFi - 75% TREVi

d. Global Sufficiency Fund in the base year

In order to ensure enough resources for the competences assumed, a levelling grant called Global Sufficiency Fund (GSFi) for the base year and for each Autonomous Community was set. Such grant covered the difference between the overall financing needs (NFi), on the one hand, and the sum of the tax capacity (TREVi) and the transfer (positive or negative) from the Guarantee Fund, on the other. In practical terms this implies that each Autonomous Community will have the 25% of its tax revenue in normative terms, plus its participation in the Guarantee Fund, plus its share on the Global Sufficiency Fund to cover its financing needs.

NFi = 25% TREVi + GFi + GSFi

This Global Sufficiency Fund consists of a transfer from the central government to respective Autonomous Community if overall spending needs exceed the resources provided jointly by the fiscal capacity and the participation in the Guarantee Fund, or a transfer from the Autonomous Community concerned to the Central Government otherwise.

e. Additional resources

The Central Government provides additional resources to the CCAA to strengthen the Welfare State according to some different criteria under the umbrella of the so-called Competitiveness Fund and the Cooperation Fund. Both funds amount to some € 3.7 billions, around 0.4% of GDP. The former aims to strengthen horizontal equity and reduce differences in per capita funding across CCAA; the latter is intended to promote regional income convergence. These funds are primarily assigned to the CCAA with lower revenues, per capita income and population density.

f. Evolution of the system in subsequent years

After the base year the CCAA obtain their corresponding share of the transferred taxes, jointly with the corresponding (positive or negative) grants from the Guarantee and Global Sufficiency Funds. The variables of distribution of the Guarantee Fund are reviewed annually, although final settlements typically take place with a two-year delay due to data availability limitations. The Central Government contribution to the Guarantee Fund and the Global Sufficiency Fund are set to evolve in line with the observed growth rate the Central Government's tax revenues. Finally, tThe structural variables of the system are revised every five years.

3.2. Local Governments

The Royal Legislative Decree 2/2004, of 5 March 2004,([252]) which approves the revised text of the Local Tax Offices Regulatory Law, forms the basis of the local financing system. According to Article 2 therein, the resources of local governments consist of revenues stemming from its property, own taxes, fees and surcharges accrued on taxes of CC.AA., their agreed shares on central government and CC.AA. taxes, subsidies, regulated prices, fines and sanctions within the remit of their powers and resources stemming from credit operations and debt issuance.

In particular, own taxes are divided in two groups: regular-basis taxes and other taxes. The former comprise taxes on immovable property, the local business tax and the tax on motor vehicles; the latter comprise taxes on construction, settlements and works and the tax on the increase in the value of land of urban nature. Town/city councils can raise or lower tax rates and establish discretionary tax benefits but are not allowed to set new taxes.

Municipalities that are capitals of a province or Autonomous Community, or which have over 75,000 inhabitants , are assigned a part of the Personal Income Tax, VAT and special taxes on alcohol, hydrocarbons and tobacco products (approximately between 1% and 2%, depending on the tax and whether it is a municipal or provincial

([252]) http://www.minhap.gob.es/Documentacion/Publico/NormativaDoctrina/FinanciacionTerritorial/Financiacion%20Local/REAL%20DECRETO%20LEGISLATIVO%202%202004%20_Haciendas%20Locales_.pdf

one). The so-called "tourist municipalities"([253]) enjoy somewhat similar special regime.

4. Fiscal rules

Fiscal rule

The current Budgetary Stability Act entered into force in 2008. ([254]) According to it, the general government as a whole, its subsectors and public-owned entities must attach to the principle of budgetary stability. Budgetary stability implies that the Central Government, the Autonomous Communities and the Local Governments have to be in balance or in surplus in an ESA95 basis along the economic cycle. This implies that their cyclically adjusted balances have to be in balance or in surplus. In their case, an upper and a lower threshold for GDP growth are defined. Hence, if GDP growth falls short the lower threshold, the general government as a whole could register a deficit no higher than 1% of GDP, of which the central government deficit should not exceed 0.2% of GDP, the deficit of the Autonomous Communities should not exceed 0.75% of GDP and the deficit of the Local Governments should not exceed 0.05% of GDP. If GDP growth stands between both thresholds, these subsectors and the general government as a whole should be in balance at least. Finally, if GDP growth exceeds the upper thresholds these subsectors and the general government as a whole should register surpluses. Moreover, the Social Security subsector is set to be in balance or in surplus, regardless of the cyclical position.

Higher deficits, however, are exceptionally allowed if they are devoted to financing productive investment projects, including Research, Development and Innovation. Higher deficit derived from these programmes cannot exceed 0.2% of GDP in the central government, 0.25% of GDP for the Autonomous Communities as a whole and 0.05% of GDP in the Local Governments subsector.

([253]) These are places that, although they do not comply with the requirements for accessing the tax assignment system, do have a population of over 20,000 inhabitants and a greater number of second homes than first homes.
([254]) This Act revised the first Budgetary Stability Act due to 2001 and in force between 2002 and 2007.

In the case of the Central Government, a ceiling on total non-financial expenditure is set in the Budget Law each year. No expenditure ceiling though is set for either the Autonomous Communities or the Local Governments.

Budgetary targets

Budgetary targets have to be formulated within a multiannual scenario. In the first semester of the year the government has to set the budgetary targets (as a percentage of GDP) for the general government as a whole, its subsectors and each of the different entities therein for the next three years. Such targets will be set on the basis of a report on the cyclical position of the economy conducted by the Bank of Spain, and taking into account the economic forecast by the European Commission and the European Central Bank.

Accountability and enforcement

Before the 1st of October each year the Ministry of Finance will submit to the Government a report assessing the degree of compliance with the budgetary targets in the previous year. This report will be made public. In case of deviations from the specified targets, the Autonomous Community or the Local Government concerned has to present a 3-year rebalancing plan. In case of non-compliance with the previous provisions the Government will be entitled to impose constraints to credit or debt issuance to the relevant entity.

Sanction mechanism

In case of non-compliance the concerned administration will have to contribute to any financial sanction raised according to the EU Stability and Growth Pact in proportion to its fiscal slippage.

Debt issuance and bailouts

Autonomous Communities and Local governments can issue debt on condition of compliance with their budgetary targets. In case of non-compliance with the budgetary stability target, but with an approved corrective plan, any new long-term indebtedness is subject to approval by the Central Government. In case of not having any approved corrective plan, all indebtedness operation regardless of the term is subject to approval.

In any case, the central government will not bail any autonomous community or local government out in case of default.

Due to the current economic and financial crisis the budgetary targets have been missed since 2008 on. No default by any entity within the general government has taken place.

5. Other relevant institutional features

In normal years spending by subnational governments, especially on healthcare, has risen at elevated rates. Buoyant revenues, partly linked to the housing sector, allowed offsetting to a large extent such spending increase. However, the collapse of tax revenues due to the economic and financial crisis has unveiled the main weaknesses of the system as expenditure levels at the onset of the crisis were clearly oversized. On the other hand, the normative capacity of Autonomous Communities on a number of taxes has mainly been used to raise allowances and deductions, thereby increasing tax expenditure, while being largely reluctant to use it to increase taxes.

The system lacked credible enough incentives to prevent fiscal profligacy by regional and local administration. No expenditure ceiling rule applied to subnational levels of government prior to the approval of the new Budgetary Stability and Financial Sustainability Act. The new Law though aims to fill this gap, jointly with imposing more stringent deficit criteria. This is a promising step to underpin budgetary discipline.

The new Budgetary Stability and Financial Sustainability Act, amending the previous Budgetary Stability Act, has been passed and entered into force on 28 April 2012. The basic principles of the reformed law are:

- The general government deficit in structural terms cannot exceed 0.4% of GDP in periods of low or negative growth. The structural balance will be gauged according to the methodology employed by the European Commission.

- The general government and its subsectors are subject to the principle of financial sustainability to meet present and future expenditure needs within the deficit and debt limits enshrined in the Spanish and European legislation. In this connection, no bail-out clauses among the different subsectors are established.

- A transition period is envisaged to resume to debt levels below 60% of GDP.

- An expenditure ceiling is set for all entities within the general government. Thus, the relevant government expenditure should not breach the reference rate of medium-term GDP growth. This reference growth rate will be gauged according to the methodology employed by the European Commission.

- The sanction mechanism is reinforced.

The Council issued country-specific recommendations to Spain with respect to subnational governments (see Box I.3.2 above).

A1.10. FRANCE

1. General description

France is a unitary state where the central government is predominant. However, the Constitution adopted on 4 October 1958 recognises the principle of local government autonomy. This principle has been consolidated since the constitutional reform of 28 March 2003.

The country is broken down into three tiers of subnational government the main units of which, defined by the Constitution as *collectivités territoriales*, are the regions, the departments, and the municipalities (and also the overseas territories). There is no subordinated link between the three entities; all three layers are governed by national legislation. There are 22 regions and 96 departments of mainland France, 4 regions and 6 departments overseas, and nearly 37 000 municipalities, which can gather within *établissements publics de coopération intercommunale* (EPCI). A small number of local governments, known as *collectivités territoriales à statut particulier*, have slightly different administrative frameworks; among these are the island of Corsica and the country's largest cities.

The so-called Defferre laws of 1982–83 together with the 2003 constitutional reform are the main institutional reforms that have shaped over time the current system. Prior to these French municipalities and departments enjoyed a limited autonomy, and the chief executive of the department was the government-appointed prefect (*préfet*) who also had strong powers over other local authorities.

The decentralisation process initiated in the early 1980s translated into a number of key changes. The administrative stewardship of the prefect was replaced by a legal check and balance exercised by the administrative courts and the regional courts of auditors. Departmental executive power was transferred from the prefect to the president of the departmental council (*Conseil général*). Regions were given full powers and recognised as *collectivités territoriales*, with directly elected regional councils and the power to elect their executive. The law also devolved to local governments many functions hitherto belonging to the central government, in particular economic development, social welfare, regional planning, secondary schools, cultural matters, etc.

The 2003 constitutional reform introduced the principle of financial autonomy of local governments. The changes also introduced the possibility of holding local referenda and the right to petition. New responsibilities were also transferred to local governments as part of the Decentralisation Act that followed in 2004, particularly to regions and departments (responsibility of non-teaching staff in schools, vocational training, ports, airports, etc.).

In 2010, total spending by local government amounted to 11.8% of GDP([255]). Three quarters were to cover current expenses. Total revenue excluding borrowing stood at 11.7% of GDP. 55% of total revenue was covered by taxes set and raised locally or by shared taxes. The main direct taxes are the property tax on buildings and land, the residence tax and up until 2009 the local business tax. Central government transfers and grants represented 28% of total revenue. These fall into two categories: grants and subsidies for current spending and compensation for transfer of responsibilities, and grants and subsidies for capital expenditure. Borrowing is yet another source of revenue for local governments in France, and represents around 1% of GDP each year. Local authorities do not need to seek central government authorisation in order to borrow money but all resources from borrowing can only be spent on investment (not current spending)([256]).

2. Government spending

Municipalities benefit from a general responsibilities clause: they can intervene over and above their responsibilities in all fields of local interest. Traditional responsibilities include register office functions, electoral functions, social aid, primary education, sports and art facilities, maintenance of municipal roads, land development and planning, local public order, and local public utilities. Departments are mainly in charge of social assistance and medical prevention, construction and maintenance of secondary roads, construction and maintenance of secondary schools and management of some non-teaching staff (*collèges*), culture and heritage, economic development, and environment. Regions are responsible for economic development, territorial development and planning, transport, vocational training programmes, construction and maintenance of secondary schools and management of some non-teaching staff (*lycées*), as well as special education institutions.

In 2010, total spending by local governments amounted to EUR 228.7 billion or 11.8% of GDP. Based on the COFOG classification, local

([255]) To be noted is one of the measures of November 7 (article 108 of LFI 2012) :

'Chaque année, le Gouvernement dépose en annexe au projet de loi de finances un rapport qui comporte une présentation de la structure et de l'évolution des dépenses ainsi que de l'état de la dette des collectivités territoriales. A cette fin, les régions, les départements et les communes ou les établissements publics de coopération intercommunale de plus de 50 000 habitants transmettent au représentant de l'Etat, dans des conditions fixées par décret en Conseil d'Etat pris après avis du comité des finances locales, un rapport présentant notamment :

- *les orientations budgétaires,*
- *les engagements pluriannuels envisagés,*
- *la composition et l'évolution de la dette,*
- *ainsi que la composition et l'évolution des dépenses de personnel, de subvention, de communication et d'immobilier'.*

([256]) Funds obtained through borrowing can no longer be used to service outstanding debt (which has to be financed by a surplus of the operating budget).

governments spent 18% of their budget on general public services, 17% on social protection, 16% on education, 15% on housing and community amenities, 13% on economic affairs, 9% on recreation, culture and religion, 8% on environmental protection, and 4% on other functions. The share of social protection in total expenditure has increased substantially since 2000 (+4 pps.) while that of general public policies has registered a significant decrease (–6 pps.).

Among capital expenditure items, housing and community amenities accounted for one third of total spending, general public policies and education represented approximately 15% each, followed by recreation, culture and religion (12%), economic affairs (10%), and environmental protection (9%).

Local government responsibilities mainly concern the implementation of policies, whereas their regulation is generally entrusted to the central government. In the case of education, for instance, overall standards (i.e. requirements of educational institutions, level of qualification of teachers, etc.) are set by the central government, whereas municipalities are responsible for establishing, reorganising and closing education institutions. The same goes for social allowances such as the *revenu de solidarité active*, the *allocation personnalisée pour l'autonomie* and the *prestation de compensation du handicap*: local governments are responsible for paying such allowances([257]), while the amount and eligibility criteria are determined nationally.

3. Financial arrangements

In 2010, total revenue of local governments excluding borrowing stood at EUR 227 billion, or 11.7% of GDP.

Tax revenue (own-source local taxes and shared taxes) accounted for 55% of total revenue while operating and investment grants represented approximately 28%([258]). The remainder stemmed from the sale of goods and services to end users, asset management and extraordinary revenue. Municipal and departmental revenue was mainly tax-based, while that of regions was broadly balanced between tax revenue and grants.

Own-source tax revenue, which represents 80 to 100% of total tax revenue for each of the three tiers of *collectivités territoriales,* mainly comes from four direct local taxes, which account for nearly two thirds of total tax revenue. These are levied by local governments and by some inter-municipal cooperation structures. French local taxation works on a system of rate stacking: the overall rate of each tax is calculated by summing up rates imposed by different local government tiers, thus varying across land areas. However, the role of regions and departments in setting tax rates has recently decreased, while they are not empowered to set up new taxes. The central government collects the local taxes annually, and reimburses local governments monthly.

The four main local taxes are:

- The CET (*contribution économique territoriale*) which replaces the local business tax (*taxe professionnelle*). The local business tax was paid by companies and was essentially based on the rental value of fixed assets. It was subject to exemptions decided by the central government. This tax was abolished in 2010 and replaced by a new economic contribution for business, the CET, a flat-rate tax on network businesses, and new tax revenue were transferred to local governments. The CET tax comprises a land tax levied on companies (*cotisation foncière des enterprises* or CFE) and a new levy on the value added by a company (*cotisation sur la valeur ajoutée des enterprises* or CVAE). Local government (municipalities) can only set the rate for the CFE.

- The property tax on buildings, paid by property owners (companies and individuals), is based on the property's theoretical rental value according to the local land registry, and is adjusted in line with inflation. As of 2011, the tax rate is set only by departments and municipalities.

([257]) Including associated proximity services (monitoring, activation measures etc.).

([258]) Figures reported here come from Dexia Crédit Local's *Note de conjuncture* available at: http://public-dexia-clf.dexwired.net/collectivites-locales/expertise/Documents/ndc_france_2011.pdf

Box IV.A1.1: **Equalisation mechanisms across subnational entities in France***

The basis for *vertical equalisation* is the "financial potential", applicable to all subnational entities and set each year by the Finance Law. This corresponds first to the income which would be generated if the local government concerned were applying to its tax base, and for the four main local taxes presented above, the average rate observed nation-wide at a similar level of sub-government. Since 2005, was added to this "tax potential" the amount perceived the preceding year from the global operating grant (regions and EPCI are also concerned since 2011 only). The financial potential therefore corresponds to the revenue the subnational entity should be able to rely on if it were applying "average" tax policies.

With the dying out of the "professional tax" in 2011, it was also decided to create for a fund for *horizontal equalisation* at the municipal level (*fonds de péréquation national des recettes intercommunales et communales* (FPIC)), on the model of a fund created specifically in 2010 for the Ile-de-France region (Paris and surroundings). The FPIC will begin operating in 2012.

* For more information, please refer to *Péréquation financière entre les collectivités territoriales : les choix de la commission des finances du Sénat*,.Rapport d'information n° 731 (2010-2011) de MM. Philippe DALLIER, Charles GUENÉ, Pierre JARLIER et Albéric de MONTGOLFIER, fait au nom de la commission des finances, déposé le 6 juillet 2011, http://www.senat.fr/rap/r10-731/r10-731.html .

- The residence tax, paid by the residents of housing buildings, is also based on the property's theoretical rental value and adjusted in line with inflation. There are exemptions for over 60s, low-income households and also if the property is incapable of occupation due to it needing extensive renovation. As of 2011, the tax rate is set only at the municipal level.

- The property tax is also paid by owners of non-built land (companies and individual). As of 2011, the tax rate is set only at the municipal level.

Local governments levy other own-source direct or indirect taxes, including transfer taxes on property transactions (municipalities and departments), a transport contribution (municipalities), a household waste disposal tax (municipalities), a vehicle registration tax and a tax on driving licences (regions), an electricity tax (municipalities and departments), and various town planning taxes levied by local governments as a whole.

The central government has increasingly shared tax revenue with local governments to compensate for transferred responsibilities and reforms such the local business tax abolition. Regions have been receiving a fraction of the domestic tax on petroleum products (*taxe intérieure sur les produits pétroliers* or TIPP) and a surcharge on the apprenticeship tax (*taxe additionnelle à la taxe d'apprentissage*) since 2005. Departments have also been receiving a fraction of the TIPP tax and a fraction of the special tax on insurance contracts (*taxe spéciale sur les conventions d'assurance* or TSCA) since 2005. Except for an earmarked share of the TIPP tax, where regions have the power to set rates (within a limited range), local governments do not fix the rate of any of these indirect taxes. Some new tax revenue has been transferred to local governments since 2011 as part of the local business tax reform, including the remaining fraction of the TSCA tax.

Grants from the central government consist of operating grants and capital expenditure grants (82% and 18% respectively in 2010). In the past the central government set up various mechanisms (*pacte de stabilité, contrat de croissance et de stabilité, contrat de stabilité*) aiming at better controlling increase in grants. Under the second multi-annual public finance planning act, which covers the period 2011–14, transfers to local governments have been frozen in nominal terms([259]).

([259]) And a 200 M€ decrease was voted in the 2012 budget law as part of the fiscal consolidation package.

The main operating grant is the so-called global operating grant (*dotation globale de fonctionnement* or DGF), which amounted to EUR 41.1 billion in 2010 and represented around 85% of all operating grants. It has increased drastically since the 2004 budget, which simplified operating grant structure by integrating various grants and compensations for tax exemptions into the DGF. This reform also introduced a share for regions, and reviewed financial equalisation mechanisms: each local government receives a fixed grant, where the amount allowed may vary according to local needs, and an equalisation fraction with a view to remedying the adverse effects of the unequal distribution of resources and expenditure requirements.

In addition, capital expenditure grants include reimbursement of the VAT that local governments pay on investment spending, a rural area equipments grant, a school equipments grant for regions and departments, and also some ministerial subsidies.

4. Fiscal rules

Principles of sincerity and balance cover both the operating and capital formation sections of the budget of all subnational entities, requiring expenditure and revenue to match in each section. The term budget as used under the rule refers to the voted budget. *Ex-post*, the budget can be unbalanced but deficits([260]) may not exceed 5% of the year's current revenue (10% for small municipalities). There are no pre-existing escape clauses. Average deficits, observed *ex post*, shrank from close to 5% of the annual revenue in 2007 and 2008 to less than 1% in 2010([261]).

The golden rule applicable to the *collectivités territoriales* prohibits current expenditure to be financed by debt; borrowing can thus only be used to finance capital expenditure and is today used to cover about one third of investment spending undertaken by subnational entities([262]). This also means that debt annuities, in turn, have to be financed by own resources([263]). The rule has been into force since 1983 for municipalities and departments, and since 1988 for regions.

Any decision to borrow is subject to *ex-post* legal control on the decision to borrow. It is also subject to a budgetary control by the central government representative – the prefect – together with the regional chamber of auditors to ensure that debt annuity has been included in the budget as a compulsory expenditure and to check compliance with the rule. In case a significant deficit is recorded (see above mentioned thresholds), the regional chamber of auditors shall propose corrective action within one month.

Since 1982 French local governments have been able to borrow freely, without requiring central government's permission. The outstanding amount of subnational government debt, which has substantially decreased since the 1990s, represented 6.3% of GDP in 2011([264]) (mainly driven by regions and municipalities), thus less than one tenth of the outstanding debt of the public sector. Banks have been the biggest source of external funding to local governments, which borrow around EUR 20 billion or 1% of GDP each year in the form of loans, structured loans, revolving loans, and foreign currency loans. Although legally allowed, direct financing via capital markets has been little used to date.

Local governments are obliged to deposit their liquid assets and cash with the French treasury in a non-interest bearing cash account. They are therefore not allowed to invest their daily cash with banks. However, local governments are entitled to use bank lines to cover their day-to-day liquidity shortfalls.

Local governments cannot be declared bankrupt. In the event of default, there is no central government guarantee. For example, when the cities of Angoulême and Briançon defaulted on their debt, in 1991 and 1992 respectively, they had to negotiate a debt rescheduling with their creditors and had to undertake a stringent plan for

(260) Of the operating part of the budget.
(261) For detailed statistics, see Insee "Dépenses et recettes des collectivités locales (S13131)", available at http://www.insee.fr/fr/themes/comptes-nationaux/tableau.asp?sous_theme=3.2&xml=t_3206
(262) Net borrowing is at 5/10% of investment but gross borrowing is at around 16M€ for 45 M€ of capital expenditures.

(263) It is in fact even tighter than this, as resources of the investment part of the budget cannot be used to that purpose.
(264)) Eurostat's Excessive Deficit Procedure press release, April 2012.

the consolidation of their public finances. In case of extreme liquidity tensions, the central government may however provide local governments with exceptional transfers in the form of advances on tax payments; for instance, Angoulême was granted 10.7 million francs (about 1.5 EUR mn) over 7 years, in 1991, to support the stabilization of its financial situation and meet mandatory payments. Furthermore, the representative of the central government can put local governments under supervision (*tutelle de l'État*).

A1.11. ITALY

1. General description

As in many other European countries, fiscal decentralisation in Italy has historically been driven by pressures from regions for more direct participation and control in the political process. Italy is currently composed of 20 regions, including five that have a special status granting them more autonomy[265], 110 provinces and 8092 municipalities. Regions were granted political autonomy by the 1948 Constitution of the Italian Republic, but the actual implementation of regional autonomy was postponed until the first regional elections of 1970. Since then, the Italian public finances have been characterised by a combination of high centralisation of revenue and sizeable decentralisation of expenditure, corresponding to an important devolution of functions to the lower government levels. Subnational powers of taxation increased somewhat in the 1990s, alongside a further decentralisation of administrative functions.

In 2001 a Constitutional reform introduced deep changes in the relationships between State, regions and local authorities, opening the way to fiscal federalism. However, delays in the adoption of the ordinary legislation required to allow the entry into force of the new fiscal configuration has kept alive a system where the funding of subnational government expenditure is highly dependent on transfers from the centre. A crucial step was taken in May 2009, with the approval of a framework law that delegated the government to adopt legislative decrees enacting fiscal federalism, on the basis of identified principles and guidelines.

In 2009, sub-central government expenditure amounted to 31% of general government expenditure (15% of GDP), while local government revenue excluding transfers from the central government is estimated at 17% of general government revenue (8% of GDP). In this context of relatively high subnational government spending but limited revenue de-centralisation, fiscal relations between the central government and the local authorities during the past decade have been regulated by a domestic stability pact (DSP), setting annual constraints on expenditure and/or the budget balance of the subnational units, and a health pact, controlling regional governments' spending on health services. Parliament is now about to adopt a bill introducing a balanced budget rule in the Italian Constitution that applies to all government levels.

2. Government spending

A major Constitutional reform of the distribution of powers across levels of government was approved by the Italian Parliament in 2001. The reform increased the regulatory and spending functions falling under the jurisdiction of sub-central governments.

The Italian central government is exclusively, or near-exclusively, responsible for expenditure on social protection transfers (38% of total general government expenditure), defence (3%), and public order and safety (4%). On the other hand, health care (14% of total general government expenditure) is practically completely devolved to the regions. Sub-central authorities also make a large majority of national spending on housing and community amenities (1.5% of total general government expenditure) and on environmental protection (1.5%), reflecting the limited scope for economies of scale in centralised provision of such services. Municipalities and regions are also directly responsible for town planning.

The new Title V of the Constitution and subsequent legislation also specified functions of shared competence between the central and sub-central governments. These include general public services (18% of total general government

[265] The five regions with special status are Friuli Venezia Giulia, Sardegna, Sicily, Trentino-Alto Adige and Valle D'Aosta.

expenditure, more than half of which is accounted for by debt servicing expenditure by the central government), education (10%), economic affairs (8%), and recreation, culture and religion (1.5%). Following conflicts over the actual division of responsibilities in the areas of shared competence, the Constitutional Court stated that responsibilities should be split up as follows: (a) the central government legislates the fundamental principles for the exercise of the power in question; (b) the region undertakes the financing, administrative, and management functions for this exercise; and (c) the local authorities perform "hands on" delivery of services unless there are strong reasons to do so at a higher level.

Table IV.A1.1 lists the different competencies devolved to the three tiers of sub-central governments in Italy.

Expenditure by regional governments accounts for around two-thirds of total sub-central government expenditure in Italy. Reflecting the fact that 80% of regional expenditure goes to health care provision, the purchase of goods and services and wages account for 50% and 25% of regional spending respectively. Provinces account for only 5% of sub-central government expenditure, or less than 2% of total general government spending. Their very limited role in the current fiscal devolution set-up confirms that there is scope for administrative expenditure savings through the integration of their functions in the other two tiers of sub-central governments, as has been stipulated in the December economic and budgetary package. Capital expenditure is a relatively important part of the combined budget of municipalities and provinces, with investment spending representing around 20-25% of their total expenditure between 2005 and 2010.

3. Financial arrangements

The Constitution (Art.119) establishes that subnational governments have revenue autonomy to perform the new functions attributed to them. Specifically, they can raise revenue from:

- Own taxes;

- Shares in the national tax revenue;

- Equalising transfers for territories having lower per-capita taxable capacity.

A golden rule is, however, envisaged for subnational governments, which are allowed to borrow only for investment financing. Moreover, the central government has the possibility to allocate supplementary resources to subnational governments in order to promote economic development and social cohesion or to perform functions that go beyond their normal remit.

In 2009, the total revenue of sub-central governments in Italy amounted to 33% of (consolidated) general government revenue (15% of GDP). Transfers from the central government accounted for 50% of sub-central revenue (8% of GDP).

Sub-central government revenue from indirect taxation (excluding taxation on property) was in 2009 the most important source of own-revenue for sub-central authorities, accounting for more than 25% of their total revenue (4% of GDP). Almost 60% of the sub-central government indirect tax revenue is collected through a regional tax on productive activity (IRAP - *Imposta regionale sulle attività produttive*). IRAP is a tax on the value added of firms, with some tax deductions for labour costs gradually introduced since the inception of the tax in 1998 (including in the December 2011 budgetary package). The basic rate of IRAP stands at 3.9%, with regions having the power to increase or reduce the rate by around 1%. Sub-central authorities also receive a share of the national revenue from VAT, which in 2010 was equivalent to 10% of sub-central indirect tax revenue. The distribution of national VAT revenue across regions takes into account health-related indicators designed to measure regional differences in health spending pressures. The five special-statute regions are entitled to a higher share of the national taxes due on economic activity carried out in their territories. Other important sources of indirect taxation for sub-central governments include taxation on car insurance and motor vehicle registration (6% of sub-central government indirect tax revenue), taxation on building permits (5%) and a surtax on electricity consumption (3%).

Table IV.A1.1: **Subnational government competencies in Italy following the 2001 constitutional reform**

Municipalities	Provinces	Regions
Social housing	Road network maintenance	Health
Town planning	Transport	Health centres and hospitals
Aid to the disabled and other social services	Secondary schools (construction of buildings)	Vocational training
Local public transport	Environment including protection and improvement of the energy resources	Culture
Road network maintenance	Cultural heritage	Town planning
Local police	Household waste and sewage	Road networks, civil engineering and regional railway transport
Pre-primary (all), primary and vocational schools (building construction and maintenance)	Management of employment services and subsidies	Agriculture
Culture	Vocational teaching	Environment
Sport	Economic development	Country side planning and economic development
Sewage and waste disposal	Management of employment services and subsidies	Social services
Upkeep of pharmacies in rural areas		Education

Source: ISAE.

Sub-central taxes on personal income (IRPEF - *Imposta sul reddito delle persone fisiche*) were equivalent to 10% of sub-central revenue (1.5% of GDP). Regional and municipal income surtaxes are levied on top of the national income tax, using the same tax base. The regional income surtax in 2010 stood at 0.9%, but the regions can increase it to 1.4%. Regions running substantial financial deficits on health care provision have been authorised to increase their surtax to 1.7%. The December 2011 package increased the basic rate of regional income tax from 0.9% to 1.23% as from the 2011 tax year. The maximum municipal income surtax rate is 0.8%, although the rate is automatically increased by 0.3% for municipalities in breach of "stability pact" provisions.

Taxation on property (ICI – *Imposta Comunale sugli Immobili*) accounted for less than 5% of sub-central revenue (0.5% of GDP) in 2009, with the intakes accruing to municipalities. The tax base is based on so-called cadastral values of property, which are official reference values that take into account property specificities but which are well below market values. The importance of property taxation for financing the activities of municipalities is expected to increase substantially starting from the current year, especially with the widening of the property tax base to include homes of first residence.

4. Fiscal rules

Fiscal relations between the central and sub-central governments have been regulated over the past decade through a domestic stability pact (DSP) and, for spending on health services, a health pact. The entry into force of fiscal federalism's permanent provisions will make both pacts unnecessary; however, they will remain in place in the current long transition period.

4.1 Domestic Stability Pact

A Domestic Stability Pact (DSP) was introduced for the first time in the budget law for 1999 to improve the governance of fiscal relations between the central and sub-central governments. The DSP rules, which are established each year by the budget law, set annual constraints on expenditure and/or the budget balance of the sub-central governments. The rules changed substantially over time, in part reflecting successive attempts to correct identified weaknesses in rules set in preceding years. Although enforcement mechanisms have been strengthened, the frequent changes in the DSP targets and coverage have reduced the effectiveness of the DSP as a tool for the central government to ensure budgetary discipline at local level and as a mechanism for expenditure planning by sub-central governments. Initially, regions and local governments respected

the DSP rules, but the high degree of compliance was primarily the result of the relatively unambitious constraints set by the rules. Regional and other local administrations in breach of the DSP must increase regional/local surtax rates. In case of serious and protracted breach, the central government can replace locally elected administrators with centrally appointed commissioners.

As from 2012, sub-central governments have to provide a significant contribution to the national consolidation effort, by around 0.4% of GDP per year. This will be shared among them also according to a system based on "virtuosity", namely the respect of previous years' DSPs, and pending the identification of essential service levels and their standard cost.

4.2 Health Pact

The Health Pact is a separate fiscal mechanism governing regional government's health-related spending. The Pact, which is updated every three years, sets limits to current and capital expenditure for health care by region. Sanctions apply to regions exceeding their limit: local tax shares are increased, citizens' contributions to costs are raised, and/or administrative sanctions (including the dismissal of administrators) are imposed. Still, over the last decade, annual health expenditure exceeded its funding by around 0.3 pp. of GDP per year on average. The health pact also incorporates specific caps on the share of pharmaceutical expenditure in total health expenditure, with the purpose of encouraging savings both through tougher price negotiations with suppliers and the wider use of generic drugs.

5. Design of a new institutional set-up

5.1 The 2009 framework law on fiscal federalism

The implementation of the Constitutional provisions granting greater financial responsibilities to sub-central authorities requires enabling legislation. Postponement of the adoption of such legislation sustained a system where the funding of subnational government expenditure remains highly dependent on transfers from the centre. A crucial step was taken in May 2009, with the adoption of a framework law setting down broad guidelines to support the transition towards a more complete federal fiscal structure by 2017. The law, however, still required the central government to adopt, in agreement with the subnational governments, enacting decrees in order to specify the rules governing fiscal federalism. To date, eight decrees have been adopted by government and approved in Parliament, including on the definition of essential financing needs and standard costs for sub-regional authorities (November 2010), the role of municipalities in tax assessments (March 2011), allocation of additional financial resources to less prosperous areas (May 2011), standard costs and financial needs for health care provision (May 2011), and sanctioning and reward mechanisms (September 2011). This Section describes the fiscal federalism set up that is expected to take place over the next few years as a result of the 2009 framework law and subsequent legislation.

The most innovative and important principle established in the 2009 framework law consists in the introduction of the so called “standard cost” criterion in place of the “historical expenditure” criterion used so far to determine the costs necessary to the pursuit of the functions entrusted to the territorial bodies. Standards of quality and efficiency are to be adopted in establishing proper unit costs and service provision methods and procedures. Subnational governments providing essential services at a higher cost, or offering more services that those identified as standard needs of the population have to raise additional sources of financing. Another key principle is the introduction of equalisation transfers redistributing revenue across subnational governments. These transfers will partially compensate for differences in fiscal capacity, as measured assuming identical tax rates, so as to bridge the financing gap in providing essential services.

The main sources of financing for regions will continue to be the regional tax on productive activity (IRAP), part of the revenue from VAT, and the surcharge on the personal income tax. Regions will be able to increase the latter by up to 0.5 pp. in 2013, 1.1 pp. (cumulative) by 2014 and 2.1 pp. as from 2015. An equalizing fund will transfer resources to regions with lower fiscal capacity.

The decree law on municipal fiscal federalism sets up a temporary experimental re-balancing fund ("*Fondo sperimentale di riequilibrio*") to aggregate all the proceeds that are intended to replace permanent and general transfers from other administrations, namely: 30% of the recurrent taxes raised on real estate property part of the resources coming from a new tax on property leasing (21.6% from 2012 onwards), and a share in VAT revenues. The aim of this fund, which will cease to operate after 2013, is to ensure a gradual and geographically-balanced devolution to municipalities of real estate taxation. In a second and final phase, which was originally planned to get underway in 2014, existing taxes are planned to be replaced by two new forms of municipal taxes: (i) a municipal tax on real property (unified municipal tax IMU) that would combine the current ICI tax and the part of personal income tax (IRPEF) payable on property income; (ii) a secondary municipal tax on the occupancy of state property.

In December 2011, the Italian government brought forward to 2012 the introduction of the unified municipal tax (IMU) and extended it to owner-occupied dwellings (homes of first residence) that had been excluded from taxation in 2008. Part of the receipts from IMU will be initially assigned to the central government. The government also announced plans for a substantial revision to the cadastral property valuation register, which is the tax base of IMU.

Although several enacting decrees specifying the rules governing fiscal federalism have been adopted in 2010 and 2011, crucial details are still to be determined through administrative acts. Chief among them are the revenue sharing mechanism and the definition of essential levels of services and their standard costs. They will have to be defined by 2016, with fiscal federalism expected to enter into full force by the end of 2017.

5.2 Constitutional amendments establishing balanced budgets principle

On 15 December 2011, the Italian parliament approved a bill introducing a balanced budget rule in the Italian Constitution. The amendments approved by parliament as part of this process included changes to Article 119 that establish the financial autonomy of subnational governments. The amending provisions introduce the principle that subnational governments must balance revenue and expenditure in their budgets. The Constitutional amendment also retains the existing possibility for subnational governments to resort to indebtedness to fund investments, but under the condition that the aggregate budget of all sub-central governments within a region must be in balance. The key to the success of this new provision to contribute to the achievement of a balanced budget for the whole general government will hinge on enforcement mechanisms for execution. Effective ordinary legislation will need to be designed, specifying the balance to be considered, modalities of application (e.g. on cyclical conditions) and appropriate correction mechanisms, as required by the fiscal compact.

The Council issued country-specific recommendations to Italy with respect to subnational governments (see Box I.3.2 above).

A1.12. CYPRUS

1. General description

Cyprus became an independent republic on the 16th August 1960. It is a member of the United Nations, the Council of Europe, the Commonwealth and the Non-Aligned Movement. According to the above treaty, Britain retains two Sovereign Bases (158.5 sq. km) on the island, at Dekeleia and Akrotiri-Episkopi.

Administrative districts

Cyprus is divided into six administrative districts (eparcheies). These are: Nicosia, Limassol, Pafos, Larnaka, (in the government-controlled areas) and Famagusta and Keryneia (in the occupied areas). Each District is headed by a District Officer (eparchos) who is essentially the local representative or extended arm of the government. The District Officer acts as the chief-coordinator of the activities of all Ministries in the District. District Officers are answerable to the Ministry of the Interior, which is headed by a Permanent Secretary as chief administrator.

Local authorities

Municipalities and Communes are the two types of local authorities and are governed by separate laws. In principle, Municipalities constitute the form of local government in urban and tourist centres while communities constitute the local structure in rural areas. 33 municipalities (dimarchia) account for about 60 per cent of the population, while 353 communes (koinotita) cover the rest of the population. The functions of Municipalities are determined by the Municipalities' Law of 1985. Their finances derive from municipal taxes, fees and duties as well as state subsidies.

In October 1985, a new comprehensive law on local government, the Municipalities' Law 111 of 1985, was passed by the House of Representatives. This Law has since been amended by 25 amending Laws. In addition to the six principal (Nicosia, Limassol, Famagusta, Larnaca, Paphos and Kyrenia) and nine rural communities, the Law provided for the establishment of new municipalities. According to this Law, any commune may become a municipality by local referendum, subject to the approval of the Council of Ministers, provided it has either a population of more than 5,000 or has the economic resources to function as a municipality. Eleven new municipalities were established in 1986, five in 1994 and one more in 1996, increasing the number to thirty-three.

Mayors are elected directly by the citizens on a separate ballot, for a term of five years and are the executive authority of the municipalities. The Mayor represents the municipality in a court of Law and before any state authority, and presides over all Council meetings, Administrative Committee meetings and any other municipal committee. He executes the Council's decisions and heads all municipal services which he directs and supervises.

Municipal councils, which are the policy-making bodies of the municipalities, are elected directly by the citizens for a term of five years, but separately from the Mayor. The Council appoints the members of the Administrative Committee. The latter's duties include the preparation of the municipality's budgets and annual financial statements, the provision of assistance and advice to the Mayor in the execution of his duties, coordination of the work of other committees appointed by the Council and the carrying out of any other duties entrusted to it by the Council or the Mayor. The Council may also set up ad-hoc or standing committees which have an advisory role.

According to the law, the main responsibilities of municipalities are the construction, maintenance and lighting of streets, the collection, disposal and treatment of waste, the protection and improvement of the environment and the good appearance of the municipal areas, the construction, development and maintenance of municipal gardens and parks and the protection of public health. The Municipal Council has the authority to promote, depending on its finances, a vast range of activities and events including the arts, education, sport and social services. In addition to the Municipalities Law, there are several laws giving municipalities' important powers other than those already mentioned. Such laws are the Streets and Buildings Regulation Law, the Town Planning Law, the Civil Marriages Law and the Sewerage Systems Law.

2. Local government finances

The main sources of revenue of municipalities are municipal taxes, fees and duties (professional tax, immovable property tax, hotel accommodation tax, fees for issuing permits and licences, fees for refuse collection, fines etc.), as well as state subsidies. Taxes, duties and fees represent the major source of revenue while state grants and subsidies amount to only a small percentage of the income. The central government, however, usually finances major infrastructure projects undertaken by the municipalities, but this is dependent very much on each individual project. The yearly budgets of the municipalities are submitted to the Council of Ministers for approval and their accounts are audited annually by the Auditor General of the Republic. Municipal loans also need to be approved by the Council of Ministers. The following figures concerning municipalities finances are rough estimations and may vary among municipalities:

Municipalities' revenues mainly come from (i) government subsidies estimated to approximately 40% of total revenues; taxes, licence fees and rights estimated to approximately 45% of total

revenues and; fines approximately to 5% of total revenues

Municipalities' expenditure is mainly categorised into: (i) salaries and payments to pension schemes estimated to approximately 55%-65% of the total spending; (ii) utility works/maintenance approximately 15% of the total and; (iii) loan repayments to approximately 10%-15% of total spending.

A1.13. LATVIA

1. General description

Latvia is a unitary country. Local self-government is only indirectly recognised in the Constitution via references in certain articles.

A major territorial administrative reform took effect from July 2009, implementing a two-tier government structure, including the central government and local governments, the latter comprising 9 republican cities and 110 local municipalities. Before the reform, the government structure had three tiers and included over 500 local government units, with districts being the intermediate level. As a result of the reform,

- Most municipalities were amalgamated into larger ones, by forcing rural municipalities which did not have the scale and resources to efficiently provide public services under their competence, to merge with others.

- Districts were abolished.

To facilitate planning and resource management, the municipalities are furthermore integrated into five planning regions since 2003. These do not represent a separate governance tier but nevertheless play an important administrative role as an interface between state administration and local governments in preparing, co-ordinating and implementing regional development programmes, including those co-financed from the EU structural funds. Legally these regions have a status of derived public persons. The governing bodies of planning regions are elected by municipalities, while their operational costs are covered from the state budget.

Main legal acts governing municipalities in Latvia are the Law on Self-governments (in force since 1995), the Law on the Equalisation of Self-government Finances (in force since 1998) and the Law on the Stabilisation of Self-government finances and the Monitoring of the Financial Activities of Self-governments (in force since 1999). The territorial administrative reform was implemented on the basis of the Administrative-Territorial Reform Law (in force since 2005).

2. Government spending

The main autonomous functions of local governments are the provision of utilities (water supply and sewerage, supply of heat, management of municipal waste, water management etc.); provision of education services (including pre-school, primary and general secondary education, extracurricular training etc.); ensuring access to health care and promoting healthy lifestyle; maintaining public facilities (buildings, streets, roads, parks etc.); providing social assistance to poor and socially vulnerable persons; determining procedures for utilisation of public-use forests and waters; maintaining of cultural objects and preservation of traditions; performing civil status document registrations; issuing permits and licences for commercial activity and others.

Total expenditure of local governments amounted to LVL 1,534 m in 2010, which formed 27% of general government expenditure (broadly corresponding to historical average) or 12% of GDP.

Education is by far the largest expenditure category in local governments' budgets, representing ca 37% of their total expenditure in 2010; local governments are responsible for delivering ca 70% of the overall education budget. The role of local governments in the provision of pre-school, primary and secondary education is, however, restricted to the implementing the education policy by establishing, reorganising and closing education institutions, while overall standards (i.e. requirements for educational institutions, level of qualification of teachers and their basic salaries etc.) are set by the central government. Following the implementation of the "money follows a pupil" principle from 2009, local governments receive transfers from the central government in accordance with the number of

children enrolled in schools and pre-school establishments on their territory , but they can supplement educational expenditure from own resources.

The provision of healthcare services is organised at the level of the central government and direct involvement of local governments in health services provision is relatively limited. Nevertheless, municipalities can play an important role in ensuring the accessibility of healthcare services (e.g., organising transport for socially vulnerable patients to reach a health establishment), as well as by providing the necessary infrastructure and support services (e.g. rooms for general practitioners). Moreover, as most formal health establishments in Latvia are owned as limited liability companies either by state or by municipalities, the municipalities may be confronted with a need to cover operational losses of municipal hospitals. The healthcare related expenditure accounts for around 9% of municipalities' budgets.

Municipalities have an almost exclusive competence with regard to the provision of housing and community amenities, which accounts for another 10% of their budgets' expenditure side. Moreover, provision of public transport services is another area where the local governments play an important role by organising urban public transport in cities and regional transport at the level of planning regions; this function is partly covered by earmarked transfers form the central government.

With regard to the social sphere, the autonomous role of municipalities relates to the provision of social assistance to socially vulnerable citizens and groups; this function accounts for another 10% of municipal expenditure (while social insurance and categorical social benefits are financed respectively by the Social Insurance Agency and the Ministry of Welfare). While legal minimum requirements governing the provision of social assistance are set in the law, the financing for the social assistance function of local governments is not allocated from the central budget([266]) and its financing remains the responsibility of local governments.

Overall, local governments in Latvia play an important role in ensuring that state's basic functions are delivered to citizens according to appropriate standards, from the provision of basic infrastructure and transport services to social assistance and the provision of preschool, primary and secondary education. However, only part of the financing for implementing these functions is provided from the central government budget.

3. Financial arrangements

Local governments in Latvia do not have own-source taxes. The financing mainly comes from shared taxes (56% of total revenue of local governments in 2010) and grants from the central government (36% of total revenue in 2010). Furthermore, within the local governments' sector there is a mechanism for redistributing revenue between richer and poorer municipalities.

Shared taxes include:

- The Personal Income Tax, which is the most important tax revenue source for municipalities (representing close to 50% of overall revenue and over 85% of tax revenue of local governments). The overall tax rate, base and sharing formula of the PIT are however defined by the central government and these parameters have been frequently changed in the recent past. Thus, until 2009 the personal income tax rate was set at a flat rate of 25 %, while the share of local governments in the overall PIT revenue was gradually increasing from 71.6% in 2005 to 83% in 2009. However, the flat rate was lowered to 23% in 2010, increased to 26% 2011 and lowered again to 25% in 2011, while the share of local governments was first lowered to 80% in 2010, then increased to 82% in 2011 and lowered again to 80% in 2012. These frequent changes create an unstable planning environment for local governments; moreover, the tax revenue itself is rather volatile, making local governments' revenue base highly cycle-sensitive. However, the fact that local governments receive their share based on forecasted rather than actual tax

([266]) Except in 2009-2012 when the provision of Guaranteed Minimum Income (GMI) was 50% co-financed and the provision of housing benefits 20% co-financed from the state budget under the Emergency Social Safety Net Strategy.

collection, adds some predictability for local governments.

- The real estate and land tax (representing 7% of local governments' total revenue and 12% of tax revenue in 2010). Municipalities receive 100% of the receipts from this tax, although currently they have no leeway over the tax rate or base; however, according to current plans local governments will receive considerable flexibility in application of the real estate and land tax rates from 2013.

- Other taxes include ca ¼ of gambling tax and below half of the natural resources tax collected at the level of the general government; these taxes together represented 0.5% of local governments' total revenue and 1% of tax revenue in 2010. In particular the natural resource tax has a potential to become more prominent revenue source in the future.

- Other sources of own non-tax revenue are formed by self-earned revenue (e.g. payments for services), non-tax revenue (e.g. property income) and to a marginal extent donations. These other sources accounted for 9% of total revenue of local governments in 2010.

Grants from the central government formed ca 35% of total revenue of local governments in recent years. All these grants are earmarked; they cover education expenditures (i.e. teachers' salaries and education activities) as the biggest category, road maintenance (via the Road Fund), investment projects and other.

In addition to own revenue and earmarked grants from the central government, there is a mechanism for re-distribution of revenue through the Local Government Finance Equalisation Fund (LGFEF), with the aim to ensure availability of sufficient resources also for regions with lower tax base. The fund is mainly financed by municipalities with more solid revenue base (in particular the city of Riga) and, to a much lesser extent, by the central government. According to the law, its total envelope is decided annually via negotiations between the central government and the Latvian association of local and regional governments. The redistribution formula is based on expenditure need, i.e. the minimal amount required to carry out municipal tasks, calculated based on demographic and other criteria, and on revenue equalisation, so that municipalities with tax revenue from PIT and real estate tax which exceeds by 10% or more their calculated expenditure needs have to contribute to the Fund. Most municipalities are net receivers from the LGFEF.

Overall, while the local governments are free to attribute non-earmarked revenue sources (which form approximately two-thirds of total revenue) across expenditure categories – including to top up earmarked grants – several minimum requirements for the provision of services are set in legislation, thus limiting notably the discretion of local governments and possibly creating disparities in the standard of provision of various services across the municipalities. Most of the revenue sources of local governments have a marked cyclical nature, while the ability to raise own taxes currently does not exist (although a more flexible approach with regard to the real estate and land tax will be adopted from 2013). During years of fiscal consolidation in 2009-2012, local governments shared the burden of the adjustment, as their revenue sources (notably personal income tax) considerably declined both as a result of both cyclical developments and discretionary policy decisions, while expenditure pressures coming from social assistance needs increased.

4. Fiscal rules

The main fiscal rule applicable to local governments is a debt rule, which targets stabilisation of local governments' debt level in nominal terms and thus acts as a de fact budget balance rule. According to the legislation, annual debt servicing by a municipality should not exceed 20% of its local tax revenue. The borrowing and issuing of guarantees by municipalities is constrained by the central government on an annual basis, with aggregate borrowing and guarantees limits being negotiated between municipalities and the central government and these limits included in the annual budget law. During the budgetary year, the municipalities are allowed to take loans and to provide loan guaranties only within these limits. Furthermore, regarding each individual loan within the limit, the municipalities must consult the Board monitoring and supervising municipal loans and loan guaranties, which involves officials of the ministry

of finance. Such permissions are granted only for financing of investment projects – and in more recent years only for investments co-financed from EU structural funds – thus imitating the "golden rule". The rule has been in place since 1994 and generally respected, thus contributing to limiting the expenditure growth and nominal debt levels of local governments. The gross debt of local governments amounted to 6.4% of GDP as of end-2010.

Given the considerable volatility of local governments' revenue and restrictive borrowing regulation, several municipalities use precautionary savings; as of end-2010 accumulated liquid assets of local governments amounted to 2.4% of GDP.

In case of intra-year financial difficulties, short-term borrowing is allowed only to cover a short-term deficit and has to be repaid within a year. The main lender of local governments is the State Treasury, although few bigger municipalities have loans from financial institutions; loans taken from another institution need to be authorised by the minister of finance. The Treasury can impose sanctions to local governments if they do not comply with repayment obligations. Municipalities in financial difficulties, as stipulated by law, are required to prepare and implement a financial stabilisation plan under a supervisor appointed by the minister of finance. Currently only one municipality is under the financial supervision procedure, although the number was considerably higher before the implementation of the territorial reform.

As a result of the debt rule and other financial requirements applicable to municipalities, their fiscal position has been overall sound in recent years and their debt level is modest. Given the involvement of central government in setting borrowing limits and borrowing procedures for municipalities, it is unlikely that local governments can pose a serious threat to meeting fiscal targets at the general government level, although expenditure of local governments financed from previously accumulated reserves falls outside the control of the central government. Before the 2009-2010 crisis local governments (similarly to the central government) contributed to the loosening of the fiscal position of Latvia by spending large part of the windfall revenue, although some municipalities did accumulate precautionary reserves. While at the level of the central government the envisaged Fiscal Discipline Law is expected to substantially improve the counter-cyclical nature of fiscal policy making, no particular changes are foreseen at the level of municipalities.

A1.14. LITHUANIA

1. General description

Lithuania is a unitary country. The government structure has three tiers, with 10 counties being the intermediate level. There are 60 local governments whose self-governing right is secured by the Constitution and other laws.

The development and operation of local governments are legally defined in the Constitution of the Republic of Lithuania and in the Law on Local Self-government. The Constitution grants administrative units the right to free and independent governance within the limits of their competence, implemented through local government councils. Members of local government councils are elected for three-year terms in direct elections. Law establishes that local government councils have the right to form executive bodies for the direct implementation of laws and the decisions of the government and local government council.

The Constitution gives local governments the right to draft and approve their own budgets, to establish local duties and to levy taxes and duties. Local governments also must have a reliable financial basis. According to the Law on Methodology for the Establishment of Local Government Budgetary Revenues, part of the personal income tax income is ascribed to the local government budget.

In the Law on Local Government, local authority functions are strictly defined and according to decision making freedom they are divided into: (i) independent, (ii) ascribed (insufficiently independent), (iii) state (relegated by the state to municipalities for execution), and (iv) conventional. The Laws on Budget Structure and on Local Government define their financial resources that could be split into tax and non-tax income and state budget transfers. Local

authorities may also use bank credits, take and give loans in the order established by law. All financial resources of local authorities are included in local government budgets which according to the Constitution and the Law on Budget Structure are independent. Independent municipal functions are financed at most by tax and non-tax income of local governments. Execution of state and a part of ascribed functions as well as projects of the Parliament and Government are financed by transfers from the state budget of special purpose.

The local government expenditure and revenue are around 25-30% of total general government expenditure and revenue and these make around 10% of GDP.

2. Government spending

Local governments are charged with providing services in the fields of education, social security, health care, culture and leisure and communal economy.

- In the field of education local governments establish, reorganize and abolish primary and secondary schools, as well as appoint and dismiss, with the approval of the Ministry of Education and the county governor, the heads of these institutions. They also approve the regulations of educational institutions, ensure their functioning and maintenance, administer the registration of children under the age of sixteen and organize transport to school for children in remote areas.

- The functions of local governments concerning social security focus on providing social services and benefits. Local governments may also engage in social care if they have adequate material resources. Generally local governments establish, reorganize and abolish local government institutions in charge of social services and regulate the activities of social service providers. Local governments also collect and analyse data on persons who are in need of social support, administer their registration and establish the scope and methods of assistance.

- Concerning health care, local governments manage primary health care centres, clinics and ambulance services, centres of psychological health and a number of other public health institutions. Local governments also organize health control.

- In the field of culture and leisure local governments manage libraries, museums, cinemas, theatres and other cultural establishments. Since such institutions may be subordinate to various central, regional and municipal organs, local governments are responsible only for those that they establish. However, they may not reorganize or abolish such institutions without the permission of the Ministry of Culture.

- Concerning economic issues, local government services provide communal services such as water, gas, electricity and heating supply; waste collection and treatment; and administration of engineering networks. These services may be provided by state and local government enterprises, joint-stock companies, private and non-profit companies. Local governments also address public transport, construction and maintenance of local roads and various construction projects.

There are no specific legal restrictions on the privatisation of local services, but local governments manage a number of companies specifically designated for such service provision that would not be able to function without local government support. Local governments have the right to privatise up to 30% of their shares in such companies.

3. Financial arrangements

The National budget is comprised of the state budget and of independent budgets of local authorities. The latter have to be balanced.

The process of designing budgets of local authorities is regulated mainly by the Law of the Budget Structure and the Law of the Methods for Determining Local Authority Budged Income and Government decision. Designing their budgets, the local authorities must observe the financial indices for local authorities' budgets approved by the Parliament. The local authorities have to approve their budgets no later than in two months after

approval of financial indicators of the state and local authorities' budgets. Thus, rather strict time limits are set for local authorities to adjust and coordinate financial indicators of their budgets with those approved by the Parliament. If a local authority fails to confirm its budget before the end of the budgetary year, then in the following year its activities are limited and it is allowed only to pursue existing obligations (i.e. not allowed to take new obligations) and to serve debt until the budget is approved. Resources allocated to that purpose cannot exceed 1/12 of the last year's budget per month (until the budget is approved). Because a fortnight is likely to be short to adopt the budgets of the local government (following the adoption of the financial indicators by the Parliament, probably there are only two weeks left before the end of the year, see above), execution of the functions of the local authorities might be limited until the budgets are adopted([267]). Following the requirements of the law, a local authority has to submit to the Ministry of finance not only approved budgets, but also the estimate of the privatisation fund.

Lithuanian legal acts set the following kinds of budget receipts for local authorities:

- Tax revenue, comprised of taxes assigned to local authorities and part of common taxes set by law.
- Non-tax revenue received from the property of a local authority, local levies, fines, and other non-tax sources.
- Transfers from the state budget, allotted for equalising the differences of income and expenditure among local authorities and for performing the functions relegated by the state.

Tax revenue includes following different taxes: (i) part of personal income tax, after mandatory health insurance deduction, (ii) land tax, (iii) tax on renting state land and use of state water reservoirs for commercial or amateur fishing, (iv) tax on real estate of enterprises and organizations, (v) stamp duties, (vi) tax on the use of marketplaces, (vii) inheritance and donations tax and (vii) other minor taxes established by law.

Non-tax revenues include (i) revenues received from municipal property, (ii) fines and revenues from the sequestration of property, (iii) local duties, (iv) revenue from the services of local government budgetary institutions, (v) interest on funds in current accounts, (vi) revenue from non-agricultural state land leasing or sales in accordance with established procedures, and (vii) other non-tax revenues established by law.

The local government can set the level of the tax on income from economic activities requiring a business certificate and on related charges, the level of the real estate tax, within the limits set by the Law on Immovable property, and rates of the taxes for the state land lease within the limits set by laws or decisions of the Government. In other cases (i.e. for the remaining taxes) the local government can reduce the rate of the tax or grant an exemption from it and cover the financial losses from its budget. The local government has no freedom of imposing taxes on personal income of residents, on pollution of the environment and on natural resources of the state.

Transfers from the state budget are either general or earmarked. The allocation from the state budget are regulated by the Law of the on the Methodology of Municipal Budget Income Estimation. The general transfers are for creation of reserves for unforeseen expenses during the planned budgetary year, for the equalization of tax-related revenues and for the equalization of structural differences in expenditures caused by objective factors that do not depend on local government activities. The earmarked transfers are allocated to perform state functions prescribed to municipalities and implement programs approved by the Parliament and the Government. Amounts of transfers are approved by the Law on State and Municipality Budget Financial Indices of the corresponding budgetary year, based on rules set by the Government. These transfers are related to very clear functions to be performed by the local government assigned by different ministries and the needs are calculated according to approved methodology. Since 2009, if these funds are not used for purpose of a specific function they have to be returned back to the state budget at the end of the budget year.

([267]) Essentially, this implies that the local authorities may not manage to approve their budgets by the end of the year and hence their functions and budgetary means might be limited for a few weeks or months in the following year until their budgets are approved.

According to the Law on Charges municipal councils have the right to determine eleven types of local charges. Income from local charges comprises only 1% of all the municipal budget revenue. In accordance with the Law of Charges, the local council has a right to set local charges in its territory for giving permissions. The council of a local government makes its own decision on local charges and approves the rules. A local government may index the size of charge once a year, in case the annual price index of commodities is larger than 1.1.

As mentioned above, budgets of local authorities have to be formed without deficit, i.e., expenditure should not exceed revenues. Local authority is under an obligation, set by law, to undertake functions committed to them. Appropriations for local authorities can be used only to carry out the state functions devolved by law to local authorities as well as to pursue the programmes approved of the common councils.

However, local authorities are also permitted to raise short-term and long-term domestic and foreign loans if they fail to balance their budget, according to the decision by the Government.

Concerning borrowing rules for local governments, borrowing can be permitted only for following purposes:

- Take long-term domestic and foreign loans to finance investment projects, to buy movable and immovable properties, to cover debts;

- Take short-term domestic and foreign loans to cover a temporary income shortfall in a fiscal year, if committed budgetary means are insufficient;

- Provide guarantees for loans to companies controlled by the municipality used to finance investment projects.

Borrowing limits are set annually and approved by the Parliament in the Law on State and Local Government Budgets. 2012 budget law sets borrowing limits for local authorities as following:

- The debt of municipalities, with the exception of Vilnius city municipality, cannot exceed 70% of the approved 2012 municipal budget revenues (excluding state grants of special purposes). For Vilnius city municipality debt cannot exceed 120% of the approved 2012 municipal budget revenues (excluding state grants of special purposes), at least 30% of it can only be related with payments for arrears in services provided until 31 December 2011.

- The municipality's annual net borrowing shall not exceed 20% (the Vilnius city municipality – 35%) of approved 2012 municipal budget revenues (excluding state grants of special purposes);

- Loans to be repaid in 2012 and subsequent years and interest to be paid may not exceed 15% of the approved municipal budget revenues (excluding state grants of special purposes);

- Guarantees provided by the municipal may not exceed 10% of the approved 2012 municipal budget revenues (excluding state grants of special purposes).

- According to 2012 budget law, municipalities (except Vilnius) with a debt of more than 45% of the approved 2012 municipal budget revenues (excluding state grants of special purposes) in 2012 can borrow only for implementation of projects co-financed by the EU and other international financial support. Vilnius city municipality can borrow only to cover the payments for services provided until 31 December 2011 and the implementation of projects funded by the EU and other international donors.

Local authorities have to inform the Ministry of Finance about undertaken borrowing and provided guarantees according to the rules defined by the Ministry.

According the Law on Local Self-government, a controller elected by the local council supervises the use of municipal budgetary funds and the legitimacy, suitability and effectiveness of the municipal property use and state property entrusted to the local authority. The main problem seems to be the lack of independence from the local government council as the council may dismiss the

controller by a majority vote on proposal of at least one-third of the councillors.

The State Audit Office, which is subordinated to the Parliament, supervises the legal and effective use of state property, the fulfilment of the state budget and financial discipline of state institutions. While performing its functions concerning local self-governments, the State Audit Office determines if local authorities are using state funds appropriately and efficiently and, if necessary, evaluates municipal budget performance and the economic and financial activities of municipal offices and enterprises.

4. Fiscal rules

Until 2011, the main fiscal rule concerning the local government budget was a balanced budget rule, which requested that the approved local budget has to be balanced as defined by the Law on Budget Structure. However, as the local authorities might receive additional revenue than planned in the budget and also use borrowed funds (for limited purposes as described above), budgetary outturn might result in a deficit. Therefore, the Law was amended in 2010. Currently, the Law states that the approved deficit of the municipal budget must not exceed the planned borrowing (within the approved borrowing limits set by the Law on State and Local Government Budgets) for financing of investment projects. To ensure that local government does not borrow more than set in the limits, the Government representative participates in the council meetings and ensures supervision before the local government makes a decision for additional spending. However, there are no official sanctions set in legislation.

Therefore, the main fiscal rule applicable to local governments is a debt rule, which targets stabilisation of local governments' debt level in nominal terms. Annually the Law on State and Local Government Budgets sets clear limits for additional long-term borrowing, debt servicing (shall not exceed 15% of its budget revenue) and guarantees issued by municipalities. During the budgetary year, the municipalities are allowed to take loans and to provide loan guaranties only within these limits. The gross debt of local governments increased somewhat from 1.3% of GDP in 2008 to 1.8% of GDP in 2011 but remained limited compared to the general government debt of around 40% of GDP. Municipalities can take long-term loans for investment purposes only; short-term loans are only to cover temporary revenue shortfalls.

A1.15. LUXEMBOURG

1. General description

The Grand Duchy of Luxembourg is a unitary state. Luxembourg's 106 municipalities (communes) are the only tier of subnational government. Their autonomy is anchored in the Constitution([268]). Communes have mandatory responsibilities defined by the Constitution or delegated by laws related to spatial planning, enforcement of public order and safety, organization of nursery and primary school education and supply of public utilities and networks (local road network, drinking water distribution, sewerage, waste collection and disposal, cemeteries,…). In addition, communes have optional responsibilities such as providing infrastructure for sports, culture, tourism, health care or public transport. In order to increase efficiency, communes are allowed to form legal associations ('*syndicats de communes*') to fulfil certain services jointly. A territorial reorganisation of the communes is on-going in order to increase quality and efficiency of services.

Municipalities are allowed to impose communal taxes after approval by the central government. Total expenditure of local governments amounted to EUR 2283.9 million in 2011, which represents 12.7 % of general government expenditure and 5.2 % of GDP. In 2011, local government realized a consolidated surplus of EUR 50 mio (0.12% of GDP). Gross debt of local government amounted to around 975 million EUR or 2.3% of GDP.

2. Government spending

The main areas of spending of local government are education, general public services, economic affairs, recreation and culture, and environment

([268]) Art. 107 of the Constitution: Communes form autonomous authorities, on a territorial basis, possessing legal personality and administrating through their institutions, their patrimony and own interests under central government control.

protection. The Minister of the Interior supervises municipal acts and can reject municipal budgets. For this administrative surveillance, the communes are grouped into three administrative districts (Luxembourg, Diekirch and Grevenmacher), each managed by a district commissioner appointed by the government. The City of Luxembourg falls outside these districts and reports directly to the Minister of the Interior.

3. Financial arrangements

Luxembourg communes receive an overall grant from the State via the communal financial endowment fund (*Fonds communal de dotation financière* or FCDF). The FCDF is funded by revenues from taxes on alcohol, 10% of VAT revenues, 20% of the motor vehicle taxes and by a budget line from the Ministry of the Interior. The yearly transfer from the fund to the communes is determined as the sum of 18% of personal income tax receipts, 10% of VAT receipts, and 20% of motor vehicle tax receipts, on top of a subsidy which is established on an annual basis. It amounted to EUR 740 million in 2010, representing one third of overall communal revenues. The amount is divided between communes in accordance with the municipality's surface and population.

Beside this general grant from the FCDF, municipalities receive earmarked grants for specific purposes, such as musical education, nurseries and compensation of employees in the municipal administration.

Local authorities have also limited availability to raise their own revenues via taxes. All municipal taxes, levies and fees must be approved by the municipal council and the central government. Most taxes are collected by the central government, and then transferred to local authorities. Total local government receipts from own taxes amounted to EUR 742 million in 2011, representing about 32% of their total revenue and around 6.7% of total general government tax revenue.

The municipal business tax (*impôt commercial communal* or ICC) accounts for around one fourth of total revenues. This tax on local business profits is levied by the central administration for the benefit of municipalities. Municipalities are allowed to set the rate freely but the rates must be approved by the government. The municipalities are allowed to collect a property tax (*impôt foncier* or IF), which nowadays only represents a small share of their revenues (around 1.5%).

Furthermore, a variety of other taxes exist (property transfer duty, gaming taxes, tourist tax, dog tax, etc) which constitute however only a minor share of overall municipal revenue. Municipalities have also some own revenues from the provisions of services (*autres recettes propres des communes* or ARP) such as drinking water supply, waste water treatment, waste collection, distribution of electricity and gas. Lastly they also get part of their revenue from own property.

In addition, municipalities receive extra-ordinary revenues. The Ministry of the Interior allocates earmarked grants to municipalities and inter-municipal groupings for basic utilities, constituting capital expenditure arising from the municipalities' mandatory missions. These grants are targeted towards the creation or expansion of schools, town halls, infrastructure for water supply, technical services and cemeteries.

4. Fiscal rules

The Interior Ministry is responsible for the budgetary surveillance of local authorities. According to the Communal Law, municipalities are not allowed to run an operating deficit. Investments can be financed by issuing debt if no other financing is possible or viable and only when a regular reimbursement of the annuities is ensured through the operation budget([269]).

A1.16. HUNGARY

1. General description

Fiscal governance in Hungary is characterised by a mixed, hybrid system with a decentralised structure, strong financial dependence on the centre and, until recently, broad local public service obligations.

In 1990, after the change in the political regime, local communities (regardless of their size) were

([269]) Art. 118 of the *Loi communale* of 13 Dec 1988

given the right for self-governance, which was also enshrined in the constitution. The intermediate layer of counties was kept but municipals were not subordinated to counties and thus their influence on local affairs was significantly reduced. This resulted in a very fragmented, decentralised structure with nearly 3200 municipalities and with an average population of around 3100.

Municipalities enjoy a wide range of freedoms (independence, legislative power, right to levy taxes, etc.) but, at the same time, the 1990 Act on Local Governments (ALG) also delegated to the local level the delivery of a sizable part of public services. According to the COFOG classification, in 2010, 66% of government expenditure on education was carried out at the local level; this ratio stood at 37% for health, 44% for spending on recreation and culture, and 73.5% for environmental protection. Overall, local authorities are responsible for ¼ of total government expenditure.

Thus, there are effectively two layers of public administration in Hungary: the central administration and the local governments of the municipalities. The rather small average size of the latter together with an extensive range of mandatory services makes the Hungarian system distinct from other unitary models, such as the Mediterranean-type system (small units, fewer responsibilities) or the Scandinavian-type system (larger units, wide range of competences). Some features, such as the 'multi-purpose micro-regional associations', were introduced to move towards a more balanced mix of size and competence at the local level. Also, the main role of the additional layer of counties has been to bundle together some of the public services (especially in the education sector) of small municipalities or parishes by taking over both their service obligation and the associated central transfers. Nevertheless, the apparent mismatch between the size of local units and their obligation in delivering public services has been a driving factor in the evolution of subnational fiscal governance in Hungary.

Local governments also got a free-hand in managing their financial affairs. They had acquired the ownership of formerly state-owned local properties, received block grants and shared taxes from central government and were free to issue liabilities. However, the wide range of service obligations relative to the average size (and thus revenue raising capacity) of municipalities created a challenge in financing the activities of the local level. At the same time, the lack of fiscal space of the general government led to decreasing allocation of funds to municipalities, together with the increasing use of earmarking or ex post financing through reimbursement formulas.

Local governments compensated shrinking fiscal transfers by a rundown of their wealth; initially through sales of assets and eventually through growing indebtedness. Ineffective regulations and the practice of central government to cover local deficits created the perception of a soft budget constraint and diminished incentives to fill the financing gap through raising local taxes.

The Hungarian subnational fiscal governance system has become almost dysfunctional, with entities inadequate in size to deliver the wide range of obligatory services and lacking both the incentives and the institutions to ensure prudent financial management at the local level. However, the ALG being an organic law, little changes to the regulatory environment were possible until recently. The amended the ALG, which has come into force on 1 January 2012, has significantly reduced the range of obligatory services, especially in the education and health sectors. Moreover, a draft law on the establishment of administrative micro-regions ("járás") has been submitted to Parliament in late March 2012. The new regulation foresees that a number of public tasks will be carried out by these new districts (notably, permission for buildings, issuance of various IDs, etc). These efforts should bring the optimal size of local public service provision better aligned with the actual size of municipalities, reducing their reliance on vertical government transfers. However, the implications of the amended ALG on the functioning of intra-government transfers and on public financial management as whole are not yet known.

2. Government spending

The 1990 ALG assigned numerous service obligations to the local level. The compulsory responsibilities of local entities included education (up to secondary level), health (basic medical care, specialised health services and hospitals), social welfare, provision of local public utilities and

tourism. The overall expenditure of local governments reached to 12.7% of GDP in 2010, which is in line with the EU average of 12.2%.

Spending in education is mainly covered by normative grants, whereas operational grants primarily contribute to healthcare services and public goods provision (e.g. public lightning, infrastructure). These grants from central government are, in effect, formula-based reimbursements of (part of) the expenditure by local authorities. Thus, unlike block grants, they de facto limit the municipalities' room for manoeuvre when it comes to reshuffling funds between the different expenditure items. Besides these funding constraints, the municipalities enjoy a substantial flexibility with respect to the quality of the service they provide. This has led to a significant dispersion in the quality of obligatory public services, especially in the health sector.

Difficulties in funding and the cash-based accounting and budgeting system (in which the costs of the 'wear and tear' are not shown explicitly) led to an under-spending on fixed capital. Indeed, gross fixed capital formation in the first decade of the 2000s was only sufficient to cover amortisation; the former averaged at 1.8% and the latter at 1.7% of GDP. At the same time, in EU27 fixed capital investments of local governments amounted to 1.5% of GDP but it more than covered the consumption of capital which averaged at 1% of GDP.

The recently amended ALG, in parallel to completely evacuating the county level activities, shifted to the central administration the duties related to secondary education and hospital services. This rearrangement of duties is expected to considerably alleviate the burden of local authorities and to improve the efficiency and effectiveness of public services by leaving those tasks at the municipal level in which they are likely to be more competent than the state.

3. Financial arrangements

Revenues of local governments come from own resources, shared taxes, state transfers and other grants. Own-source revenues and grants from the central budget each cover around one third of total revenues. Shared taxes, investment grants (including EU grants) and grant-like revenues from other government entities (such as the Health Insurance Fund and the Labour Market Fund) make up the remaining one third.

Local governments have the authority to levy local taxes, the most important of which is the business tax levied on gross corporate profits, covering more than 80% of all local taxes. Local authorities can decide on the tax rate (within the ceiling of 2%) but revenues are effectively collected by the central tax authority. The vehicle tax (which was initially shared with the central budget) is collected the same way, but it amounts to only 7% of all own-source revenues. A similar amount is raised through the locally collected property tax (levied on buildings and land).

Revenues from the personal income tax (PIT) are shared between the central and local levels through different channels. First, some of the PIT receipts used to be passed on to municipalities in the form of normative grants. However, starting from January 2012, all normative grants have been delinked from PIT, while maintaining their level; thereby reducing the cyclicality of state transfers. Second, 8% of PIT revenue is allocated to the municipalities based on the residence of the tax payer, representing 4% of total revenues of the local government level. Finally, the PIT is the source for the revenue equalising grant which is used to diminish the gap between municipalities stemming from their different fiscal capacity.

Around ¾ of the transfers from the central budget are provided as normative grants. Investment grants, revenue equalising transfers and operational grants make up the remaining part. While only a small part of the normative grants are explicitly earmarked for specific purposes, general normative grants are also allocated to narrowly defined functions, mostly in the fields of education, social protection and culture. These transfers are in general based on expenditure needs rather than on actual output (also with a view to balance the financial disparities among municipalities), a feature that effectively discourages raising the efficiency or the quality of local public services. Moreover, the nearly 100 normative titles and the more than 150 operational grants (prior to the recent reduction in obligatory services) also makes the system administratively very costly, while frequent changes in the formulas

increases uncertainty and hinders medium-term planning.

The equalisation system for local governments includes adjustments to the normative grants, a designated equalising transfer and a mandatory deficit grant. The latter was designed to cover the deficits that the municipalities encounter for no fault of their own. While deficit grants are used extensively (roughly one third of local governments received a mandatory deficit grant and even more received a discretionary deficit grant) the amount so distributed has remained limited (less than 0.1% of GDP).

To summarise, local governments enjoy – by design – a great deal of autonomy; however, the mix of local public services is determined to a large extent by their financial ties with central budget. At the same time, the intra-governmental financial system is overly complicated and without a clear relationship between different instruments and their policy purposes (e.g. the equalisation system). Hence, this government structure is not conducive to raising the efficiency and quality of public goods provision or to improving financial prudency at the subnational level.

4. Fiscal rules

Given the legal independence of local authorities, ensured by the Constitution, little constraints apply to the financing or wealth management of municipalities. In fact, local governments are allowed to borrow from financial institutions or directly from the market (by issuing bonds). Also, until recently, there has been no procedure put in place that would have allowed the central administration to oversee such borrowing. Furthermore, no 'golden rule' exists; hence, even operational deficits were often financed by borrowing or disinvestment (i.e. sale of assets). As a result, assets in the local government sector have been declining while the sector's debt has been increasing in the past decade. This serious problem has been long recognised and the recently amended ALG now forbids operational deficits. However, it is yet unclear how this will be enforced in practice.

In fact, government control (either central or local) over local financial affairs are also hindered by the extensive use of state owned enterprises (SOEs) in the public service provision. Transparency of financial management is further reduced by the possibility for local governments to open an account in commercial banks and by the use of cash-based accounting and reporting systems. Moreover, in case of insolvency of a local authority existing procedures only concern settling liabilities vis-à-vis creditors but no remedial action is triggered to correct structural problems or to prevent the recurrence of such situations.

Finally, there is no 'national stability pact' type agreement between the central and the local levels. On a positive note, fiscal rules governing public finances at subnational level have been strengthened by the 2011 Economic Stability Act. In particular, municipalities engaging in new financial liabilities are in general subject to authorization by the central government (both for new loans and for rolling over existing ones). Loans can be taken out only for investment purposes (operational loans with a longer maturity are forbidden) and only if debt redemption would not exceed 50% of own revenues in any given year during the maturity of the loan contract (a more precise formulation is yet to be established by secondary legislation).

Prior to the new regulation and starting from 1996, the Local Government Act set a ceiling on the debt stock of subnational governments, which was specified at 70% of the "annual own revenue capacity" (calculated as receipts from local taxes and other revenues minus interest payments). However, this provision was not monitored or enforced by any official entity. As a result, from the early 2000s, local governments started to increasingly circumvent the regulation e.g. by accumulating debt in the books of local government-owned public companies instead of their own accounts. Indeed, the consolidated debt of local governments increased from roughly HUF 200 billion in 2000 to more than HUF 1200 billion (4½ % of GDP) in 2011; although this amount has been reduced by HUF 180 billion in 2012, due to the fact that the central government took over both the assets and the liabilities of the counties. In addition, according to the State Audit Office, 80% of the servicing costs of the liabilities (mostly accumulated in 2007-2008) will weigh on local governments' budget starting from 2014.

A1.17. MALTA

1. General description

As one of the most centralised countries in the EU, Malta has a three-tiered unitary government system, based on central government, regional committees and local councils. There are also administrative committees which fall under their respective Local Council. . Local government (local councils) was established in 1993 through the Local Councils Act, which is the regulatory primary legislation, complemented with subsidiary legislation on financial, tendering, audit, human resources and other matters. The Local Councils Act was modelled on the European Charter of Local Self-government of the Council of Europe and has been amended on several occasions.. The system of local government is also entrenched in the Constitution of Malta through an amendment in 2001([270]).

There are currently 5 Regional Committees, 68 Local Councils and 16 Administrative Committees. According to Eurostat's Government Finance Statistics for 2010, local government expenditure represents around 1.5% of total general government expenditure (0.7% of GDP), mainly taking the form of intermediate consumption (64%), followed by investment (21%) and compensation of employees (15%). Local government revenue corresponds to around 1.7% of total general government revenue (0.7% of GDP).

2. Government spending

Local authorities have gradually gained more responsibilities over the years. They have powers in the areas of environment, internal security and infrastructure. In particular, they are responsible for the general upkeep and embellishment of the locality, establishment and maintenance of playgrounds, public gardens, local libraries and sports facilities, local enforcement, refuse collection and carry out general administrative duties for the central government, such as the collection of government rents and funds, and answering government-related public inquiries. Local Councils do not participate directly in national economic planning. Their participation in national spatial planning is limited; they are allowed to make recommendations to any competent authority in relation to any planning or building scheme.

3. Financial arrangements

Local Councils depend mainly on central government for their financing. Their annual financial allocation is determined by a formula in the Local Councils Act. Originally the formula for allocating funds to Councils was based on each locality's population and surface area. However, in 1999, a new funding formula was introduced to better reflect the financial needs of each locality, based on the cost it incurs for the provision of local services and administration. This funding formula was further refined in 2009. The Minister for Finance may approve a supplementary allocation if it is found, after due consultation with the Minister responsible for local government, that the original amount was insufficient, while payments to cover special needs of a locality or localities are possible in exceptional cases. Since 2009

Local Councils have benefitted from a number of financial schemes launched by central government. These schemes have been directed towards all aspects of society and include such diverse areas as: accesibility, cultural activities, alternative energy, sustainable localities and localities with special needs.

Local Councils are empowered to raise funds "by means of any scheme designed to provide additional funds". They enact bye-laws to charge fees for, for instance, advertisements on (Council) street furniture and notice boards, the administration of (Council) property and use of (Council) facilities, etc. Local Councils may also be empowered to act as agents for public bodies or government departments, for instance when the handling of licences is delegated to the local level, in which case they can be granted a percentage of the collected fees.

Local Councils need written authorisation from both the Minister responsible for local government

([270]) "The State shall adopt a system of local government whereby the territory of Malta shall be divided into such number of localities as may by law be from to time determined, each locality to be administered by Local Council elected by the residents of the locality and established and operating in terms of such law as may from time to time be in force"

and the Minister for Finance in order to take a bank loan (there are no statutory criteria for such loan approvals but Councils have to follow a strict procedure in applying for such loan approvals) and the local commercial banks are the main sources of their borrowing. There are no provisions regarding guarantees given by the state or by other bodies.

4. Fiscal rules

There are no fiscal rules guiding the finances of local government. However, a portion of the financial allocation of a local council may be retained if necessary to correct a local deficit or a balance below the benchmark established in its annual budget. A persistent breach of financial responsibilities could constitute a ground for the Prime Minister to advise the President to dissolve the local council concerned.

5. Other relevant institutional features

The local councils' accounts are audited by local government auditors under the responsibility of the Auditor General. The auditors also verify that proper arrangements are in place for securing economy, efficiency and effectiveness.

A1.18. THE NETHERLANDS

1. General description

The Netherlands is a unitary state, defined in its Constitution (last revised in 2002) as decentralised with a three-tier government structure (provinces and municipalities).

Throughout history the Netherlands was first constituted as a federal republic of sovereign provinces in the 16th century, but a unitary and centralised form of government prevailed since the Napoleonic period. In the past 30 years the country has, still being a strong unitary state, moved somewhat towards a more decentralised model which increased the responsibilities of local governments. Municipalities remain by far the most important level of local government, and since the Second World War a steadfast consolidation trend, driven by efficiency considerations, has seen their number cut from over 1100 to 430 currently. Their expenditure amounts to around 10% of GDP (2009 figures), while the 12 provinces spend around 1% of GDP. Joint arrangements among (mainly) municipalities also exist. ([271]) In parallel to this tiered system, an additional feature of Dutch public administration rooted in history and the topographic specificities of the country is the separate, autonomous network of water authorities([272]) which raise their own taxes and run specific elections.

While an overwhelming majority of revenue is raised by the central government, sizeable transfers grant significant spending responsibilities to the provincial and, in particular, municipal levels. The main responsibilities of provinces cover environmental and infrastructure issues at regional levels, whereas municipalities are in charge of delivering some major expenditure items such as social protection, health, primary education, and housing.

The recent trend over the past two decades has been to accompany the greater transfer of these tasks to municipalities with an increased focus on resource efficiency, through e.g. greater accountability and financial controls, aligned incentives for spending, and fewer earmarked transfers.

2. Government spending

By and large, government functions in the Netherlands remain largely centralised, whereby policy is determined centrally and implemented subnationally through the provincial and municipal governments' delegated authority. This is for instance the case for education, social and healthcare policy: the financial responsibility and discipline of municipalities is spurred by financial management incentives but leaves little policy discretion. Only for a few areas directly relevant to local/regional-scale management, responsibilities

([271]) Joint arrangements are partnerships between different government levels, mainly municipalities (in isolated cases, central government, provinces and water boards may be involved). Municipalities work together especially in the field of public transport, employment, health, waste disposal, and environmental management and planning (source: CBS). Joint arrangements represent a combined total annual expenditure of around €7.5 bn.

([272]) Water authorities form a separate network of public administrations mirroring the general government's structure at local, provincial and national level. The nature of their activity dealing mostly with large-scale infrastructure funding also implies much longer term financial commitments.

are more equally shared across government tiers e.g. spatial planning, transport and environmental issues. The main areas where spending is devolved to regional and local authorities reflect the increasing transfer of spending competences to the local level.

For instance, the government's major expenditure item, social protection, is split between government layers, with municipalities assuming charges such as social assistance (incl. minimum income), unemployment benefits, support to families and the elderly, special care… whereas provinces focus their action on child/youth action programmes.

3. Financial arrangements

The power of provinces and municipalities to raise tax revenue is very limited. The provinces' only source of own revenue stems from collecting a share of the national car registration tax (in the form of a surcharge, with a capped rate). Municipalities can collect tax and sales revenue on a broader variety of local bases (e.g. real estate, building permits, parking fees, sewage, rubbish collection, pets, tourism…) but this still only constitutes a limited share of their operational income.

Most of the revenue of subnational governments is therefore based on transfers from central government. In the case of municipalities (the major tier of subnational government) transfers make up almost 2/3 of their revenue.

General transfers

General transfers to municipalities (respectively provinces) are managed through the operation of a dedicated fund and distributed using a formula based on fairly sophisticated criteria. (273) The size of the municipality and provincial funds is indexed on the overall expenditure of central government, which has the drawback of occasionally increasing their allocation with no specific increase in matching responsibilities; however, austerity at central government level also results in a shared effort at subnational scales.

Provinces and municipalities then dispose of a certain leeway in the use of the general funds, while having to fulfil their devolved competences. The recent trend has moved towards more aligned incentive schemes in those areas of responsibility, e.g. social services: "More incentives implied a change in financing Dutch social assistance benefits. In the past, municipalities could claim most of their expenses on social benefits to the central government. However, since 2004, they receive a fixed budget which is insulated from the macro-economic developments through a calculation by the CPB. As a consequence, municipalities now have an incentive to reduce the number of social assistance benefits."

Earmarked transfers

In addition to the general transfers channelled through the municipality / provincial funds, subnational governments still receive a large share of specific transfers allocated by the central government for devolved implementation of specific missions. The breakdown by government ministries illustrates the predominance of social service costs in specific transfers.

4. Fiscal rules

Provincial governments exert a role of financial control over municipalities; however, both tiers of subnational governments may borrow without any prior authorisation and from the establishment of their choice; bond emissions are rarely used (Dexia 2008).

In practice however, since the medium-term budgetary framework imposes a "golden rule" for subnational governments' budgets, borrowing is only used to finance investment, which is defined using self-defined accounting standards(274). No upper limit to borrowing has been set so subnational governments can borrow as long as they can finance the debt service.

(273) Which "[not only takes into] account the number of inhabitants, but corrects also for differences in tax earning capacity (real estate value of dwellings and business property) and external circumstances, like a regional function or the social and physical structure. Indicators used are the number of households receiving social benefits, number of people from ethnic minority groups, number of young or elderly, density of addresses and the surface area of the historical centre. However, differences in other revenues, like interest, dividend or from the sale of land, are not taken into account. Supplementary to the general distribution formulae, the Frisian Islands and the four major cities receive a fixed amount." (Bos, 2010)

(274) This budget balance would therefore technically result in a deficit by ESA standards.

Following decentralisation efforts between the two world wars, the debt of municipalities had increased sharply in the 1920s to over 40% of GDP. It stabilised around 20-30% of GDP in the 1970s where it still constituted the overwhelming majority of Dutch public sector debt. With increased fiscal discipline the trend has been steadily decreasing since then, when at the same time central government debt increased significantly. By 2009, the outstanding debt of the Dutch subnational public sector (mostly municipalities) had been reduced to 8.2% of Dutch GDP (still, the second highest level in the EU) at nearly 47.9 bn€ (2'890€ per inhabitant, the highest amount in the EU).

In the unlikely event of a municipality threatening to declare bankruptcy, the entity in question would lose control over their budget and the national government takes charge. The strictest form is the control under article 12 of the "financiele verhoudingswet". In 2009-2012, 4 municipalities were under this special control scheme of the central government and received in total around 22.4 million euro (2011) in financial support.

A1.19. AUSTRIA

1. General description

Austria is a federation, where government responsibilities are shared among three different territorial levels: federal, regional (9 states) and local (2357 municipalities). As in other similarly organised countries, the reasoning behind the federal structure is that it provides increased efficiency from the decentralisation of allocative functions and that public services should be produced and financed in accordance with the preferences of the residents of the area that enjoys the benefits([275]). Compared with the degree of fiscal decentralisation in other countries, Austria is moderate in terms of the share of sub-national government outlays in total general government spending (34% in 2010) and at the lower-medium end when it comes to the contribution of sub-national governments' own revenue to total public sector revenue (2%)([276]).

The relations between the three layers of government in Austria are defined by the Fiscal Constitutional Law (1948) and governed by the periodically negotiated Fiscal Equalisation Law (Finanzausgleichsgesetz - FAG) and the Austrian Stability Pact (ASP). The three layers of government coordinate their medium-term budgetary plans in the FAG, which allocates the revenues to territorial authorities for the period of six years (previously four years). The law specifies the types of taxes that are to be shared among the three levels of government, as well as the proportion at which they are to be divided among them. Revenues from most of the tax categories are collected by the federal government and then distributed to the three levels according to the key agreed on in the FAG negotiations. A part of the revenue from the shared taxes is withheld before the distribution to the various levels of government and earmarked for special purposes, e.g. financing of family benefits. The FAG also determines the horizontal distribution of revenues at the regional and local level. The rules set out in the FAG are rather complex and lacking in transparency. Not only are revenues from most individual taxes shared among the three territorial levels in fixed proportions, but also decision-making in many areas is divided among various levels of authority. Revenue-raising and spending responsibilities for different activities do not reside within the same level of government. In its present form, the system does not encourage the agents involved to use resources in the most efficient way and keep firm control over spending. Therefore, there is considerable potential for increasing efficiency in the public sector.

2. Government spending

Austria's Fiscal Constitutional Law defines the spending competences of the federal government, the main ones being tertiary education, parts of social policy (family allowances and private sector pensions), unemployment benefits, internal security, justice, foreign policy, defence and national infrastructure. The competences not listed

([275]) Balassone F. and D. Franco (2005), *Fiscal federalism in Fiscal Policy in Economic and Monetary Union*, Edward Elgar, Cheltenham, UK

([276]) Bergvall, D. et al (2006), *Intergovernmental Transfers and Decentralised Public Spending,* OECD, Journal on Budgeting, Volume 5, No. 4

by the Constitution fall in the remit of the states. These include: social assistance, health care (hospitals), parts of primary and secondary education, environment and regional infrastructure. Communes are responsible mainly for local planning, the functioning of local infrastructure (roads, waste and water management) as well as for providing such services as obligatory education, kindergartens, old peoples' homes etc. The problem with the Austrian municipalities lies in the fact that many of them are very small (more than half of them have less than 5000 inhabitants), which makes the provision of local services very costly.

A marked weakness of the set-up of inter-governmental relations in Austria lies in the fact that in many areas the decision-making, funding and spending responsibilities are shared by different levels of government. Streamlining of these competences could potentially result in significant efficiency gains and reduction in public expenditure. The most notable examples here are health care and education systems.

The Austrian health care system is organised is a fairly complex way. The social security system funds practising physicians. In terms of hospitals, the federal government sets out framework conditions, but the real decision-making powers lie with the states, even though they provide less than half of the government outlays for hospitals (the rest comes from social insurance as well as from the federal and local governments). In running hospitals, the states and municipalities do not always pursue an exclusively health services provision agenda. There are also economic and political interests at stake, which make closing down of redundant hospitals literally impossible in many cases. Since different actors are responsible for the in-patient and out-patient services, there is no incentive to move workload from costly hospitals to practising physicians whose services are cheaper. The number of hospital stays in Austria is one of the highest among the OECD countries. According to the federal audit court, hospital services worth more than 1% of GDP should be shifted from the hospital service to practising physicians([277]).

The financing of the education system is also highly controversial. The federal government is responsible for the curriculum and funds teacher salaries to a large extent. The latter, though, are formally employed by the states, which have far-reaching competences in terms of organisation of schooling (among others the determination of pupil numbers per class and teaching periods). Such division of competences does not encourage effective allocation of resources. In fact, cross-country efficiency analyses show that Austria spends roughly the same amount on education as other economies (i.e. Finland), but the performance in PISA is relatively poor.

3. Financial arrangements

The three layers of government coordinate their medium-term budgetary plans in the FAG, which allocates the revenues to territorial authorities, usually for the period of six years. The law specifies the types of taxes that are to be shared among the three levels of government, as well as the proportion according to which they are to be divided among them. Most of the tax categories are collected by the federal government and then distributed to the three levels according to the key agreed on in the FAG negotiations. A part of the revenue from the shared taxes is withheld before the distribution to the various levels of government and earmarked for special purposes, e.g. financing of family benefits. The federal government receives about 73% of the remaining revenue from the shared taxes. The states and municipalities get about 15% and 12%, respectively([278]). A significant part of the shared revenue that flows to the regional and local governments is earmarked for special spending activities. Some of these flows require co-financing by the sub-national authorities. As a last step, the FAG determines a horizontal distribution of the revenue at the regional and local level.

([277]) Vorschläge des Rechnungshofes zur Verwaltungsreform und zum Bürokratieabbau, Positionen Reihe 2007/1, August 2007

([278]) Fuentes, A. et al (2006), *Reforming federal fiscal relations in Austria*, OECD, Economic Department Working Papers no. 474

Own tax resources (generated and collected within a given state or municipality) constitute a significant part of the local government revenue. However, the only significant tax parameter, which municipalities can set autonomously, is the real estate tax rate. Own tax resources are negligible in the case of the states, indicating a very low degree of tax autonomy. In fact, by international standards Austria is one of the countries where the share of own tax in the regional government's revenue is the lowest (about 2% of the total)([279]). On the one hand, economic theory suggests that the central government should collect taxes from tax bases that are more mobile, more sensitive to cyclical factors and less uniformly distributed([280]). On the other hand, though, splitting the funding and spending powers, like in Austria, weakens the cost-benefit relationship associated with public services, thereby reducing the allocative advantages of a federal structure([281]).

The FAG also defines rules governing the inter-governmental transfers which in 2009 constituted 41%, 16% and 27% of the total revenues of the regional authorities, local authorities and social security funds respectively([282]). The system of transfers was established to ensure that each level of government has at its disposal sufficient means to carry out the tasks assigned to it by the legislation. However, these transfers make the fiscal relations between the three layers of government overly complex and in many instances discourage efficient use of funds. The FAG negotiated in 2008 introduced the conversion of some of the transfers from the federal government to the state and local governments into revenue shares which are devoted to certain activities (e.g. housing assistance scheme and road maintenance). This introduced some transparency to the most opaque part of fiscal federal relations, but further steps toward simplification of the system are needed.

Austria's Federal Budgetary Law enables the federal finance minister to enter into credit transactions on behalf of the states through the Austrian Federal Financing Agency (AFFA). The Agency carries out a quarterly survey of the states' financial needs. The amount of debt issued by the federal government for the financing of the states cannot surpass 20% of total general government expenditure in the given year. In the period 2009-2011 about 4.4% of the potential amount was used on average([283]). Austria's Fiscal Constitutional Law gives the states the competence to adopt legislation regulating credit operations of the communes. As a general rule, municipalities are only allowed to take loans in order to cover extraordinary expenditure. However, the conditions which govern granting the approval for drawing debt by communes differ significantly between states in terms of e.g. which types of transactions have to be notified and starting from which amount. Nevertheless, a common feature is that in most states, the credit approval conditions concerning cities are more lenient than those regarding smaller local governments on the assumption that the former are equipped with superior know-how in terms of debt risk management([284]). The AFFA plays only advisory role for the municipalities.

4. Fiscal rules

The Austrian Stability Pact (ASP), which prescribes deficit/surplus targets (so-called "stability contributions") to the federal, regional and local governments, was first set up informally in 1996 in the context of Austria's preparation for entering the euro area, which required significant fiscal consolidation. The ASP was meant to solve the asymmetry created by the high degree of decentralisation of fiscal policy responsibilities at national level on the one hand and the introduction – at the European level - of rules (i.e. Stability and Growth Pact) on the other, assigning responsibility for the general government balance solely to central governments. In 1999, this enforcement mechanism was formalised for the first time. Its successors were then adopted for the 2001-2004, 2005-2008, 2008-2013 and 2011-2014 periods.

([279]) Schratzenstaller, M. (2007), *Undurchschaubares Transfergeflecht* in der Standard, 25 October

([280]) Balassone F., Franco, D. (2005), *Fiscal federalism* in *Fiscal Policy in Economic and Monetary Union*, Edward Elgar, Cheltenham, UK

([281]) Oates, W. (1972), *Fiscal Federalism*, New York: Harcourt Brace Jovanovich

([282]) *Öffentliche Haushalte in Österreich* (2010), editor G. Steger, Verlag Österreich, Vienna

([283]) Refinanzierungsmöglichkeiten der Bundesländer über die OeBFA (2011), presentation by M. Oberndorfer, Vienna, November

([284]) Grossmann, B. and E. Hauth, (2009), *Kommunales Risikomanagement und Aufsichtsbehördliche Kontrolle in Österreich*, Studie im Auftrag des Staatsschuldenausschusses, April 2009

The FAG foresees financial sanctions in case a State does not ratify the ASP. Once ASP is ratified it fixes the amount of the sanction in case of non-compliance, which takes the form of an interest-bearing deposit. If in the following year the respective target is not reached, the deposit is supposed to be transferred to those governments that are in compliance. However, if the target is achieved, the deposit would be reimbursed. The sanction option has never been used under the Pact as it covered all deviations from numerical targets (negative deviations were compensated by positive deviations).

The ASP is a useful tool aimed at involving all levels of government in the consolidation of public finances. In providing for legally-enshrined budgetary commitments across various government levels, Austria can be considered as a benchmark in the EU. Nevertheless, it should be noted that after an initial stage of general compliance with the Pact in the years 1999-2002, slippages occurred in individual years at all levels of government. However, since according to the ASP's rule the targets were met on average within the duration of the subsequent Pacts, the sanctions foreseen by the ASP have never been used. Initially budgetary surpluses were meant to make up only for the slippages in the past and were not supposed to be carried over to future years. Subsequently, the initial approach towards carry-overs was criticised as pro-cyclical and carry-over of surpluses was admitted with the aim of reaching the goals on average within the duration of the Pact. It should be noted that, striving to fulfil their obligation under the ASP, sub-national governments resorted to some methods that went against the spirit of the Pact, such as reclassification of public entities, transfer of real assets to various federal and regional real estate companies, etc. These were, however, not accepted as part of the stability contributions. Following the recent financial and economic crisis, the discrepancy between the ASP goals and the budgetary outcomes became so significant that the goals were revised in March 2011. This revision was accompanied by strengthening of the enforcement mechanism of the Pact, which consisted among others in shifting the focus back to attaining the budgetary goals in individual years, enhancing the role of the Court of Auditors and making the launch of the sanctioning procedure automatic. This should increase the effectiveness of the Pact, but at the same time it should be noted that the revised budgetary goals under the 2011-2014 Pact were significantly less ambitious than those in the past. In the Pact editions between 2001 and 2010, the local and state governments were required to run balanced budget or come up with surpluses, respectively, whereas now deficits (albeit gradually decreasing) are allowed on both levels. Also, the federal government now has the right to close its books with much higher deficits than in the past (average deficit of 2.5% of GDP in the period 2011-14 versus 1.2% of GDP in the years 2001-2010).

Currently, the latest edition of the ASP is being renegotiated yet again in order to align it with the debt brake ("Schuldenbremse") introduced in December 2011, which limits the structural federal government deficit to 0.35% of GDP starting in 2017. The original attempt to anchor the debt brake limiting the structural general government deficit to 0.45% of GDP in the Constitution failed due to insufficient support by the parliamentary opposition parties. In spite of the lack of the constitutional status i.e. not having bearing on sub-national authorities, the states committed to respect it too. This is supposed to be reflected in the updated goals of the ASP, which should be agreed on in May 2012.

5. Need for reform

The need for reform of the set-up of the fiscal relations between the three layers of government in Austria has been discussed for decades. Numerous experts' groups put forward various proposals as to how to simplify these relations and adjust them to the changed economic reality. In spite of the general consensus on the issue, the implementation of the suggested reforms has so far been very limited. The most urgent problem which needs addressing is the fragmentation of the various competences between the three levels of government. It seems that without bringing together the decision-making powers with funding and spending competences in a given area, the system will continue discouraging cost-cutting and efficient use of public means. The streamlining of competences should be accompanied by significant expansion of the tax autonomy of the sub-national authorities in order to strengthen the latter's accountability to voters and tax payers. The complicated system of transfers between the

federal, regional and local authorities, which has grown over time to such an extent that it is almost completely opaque, should be substantially simplified to allow analysis of flows between the three layers of government. The division of responsibility for certain areas as well as the general formulation of goals of the FAG should be reviewed in order to bring it up to date with today's economic reality and in particular with its international context([285]). Last but not least, merging small municipalities and improving the legal environment for cooperation between them (in particular across different states) could significantly contribute to raising the efficiency of provision of local services.

The Council issued country-specific recommendations to Austria with respect to subnational governments (see Box I.3.2 above).

A1.20. POLAND

1. General description

The public administration reform of 1999 aimed at the decentralisation of power and fostering self-determination by the local communities. It established a three-tiered system of local public administration. According to the Constitution, local governments assume the public tasks which are not explicitly assigned to the other organs of public administration. The entities of different tiers, although territorially overlapping, are independent of each other in the sense that entities of a higher level do not exercise authority or control over the entities of a lower level.

2. Tiers of local government and their responsibilities

The basic tier of local government in Poland is a *gmina* (commune/municipality) which is defined as a self-governing community of people inhabiting a defined territory. Currently there are 2479 *gminas*, 1571 of which are classified as rural, 602 as rural-municipal, and 306 as municipal. A *gmina* can be established, dissolved, merged or divided by the national government on the basis of its ability to effectively exercise its public functions. The law guarantees *gminas* autonomy in all matters of local concern which are not regulated by other legislation or assigned to other tiers of local government; grants them legal identities, ownership rights and independent budgets. In broad terms, a *gmina* is responsible for meeting the collective needs of the community. In this context, it assumes two types of tasks: those which are directly assigned to it by laws ('own tasks') and those which are delegated by the central level of government ('delegated tasks'). Own tasks are divided into obligatory, which a *gmina* is obliged to assume due to their elementary character, and facultative which should be assumed to a degree depending on the financial resources and local community's needs. In particular, most important areas of *gmina*'s own responsibilities include: public transportation, water supply and sewage treatment, waste collection and disposal, energy and heating systems, local roads and buildings, land use and spatial planning, municipal cemeteries, libraries and cultural services, non-obligatory pre-school education for children from 3 to 5 years of age, obligatory pre-school education for children of 6 years and primary education.

The second level of local administration are *powiats* (county) which, depending on the character of the municipality, can have two different legal forms. Usually *powiats* are composed of several *gminas* and have separate administrative organs (currently there are 314 of them). However, larger cities (65 of them) are categorised as 'cities with *powiat* status' (city county / *miasto na prawach powiatu*), which are, de facto, *gminas* which assume also the tasks and responsibilities of a *powiat* (they have no separate *gmina*'s and *powiat*'s organs). In several cases, cities have been separated from its rural neighbourhoods to constitute an independent 'city with *powiat* status'. This has administratively separated the population of a significant area from an infrastructure (mainly secondary education) and own financial resources (tax base being concentrated in the cities), contributing to widening economic and social disparities within the same region. A *powiat* as a new entity introduced by 1999 reform has been assigned relatively narrowly defined range of responsibilities, including: managing general healthcare and hospital services (whose financing

([285]) Grundlegende Reform des Finanzausgleichs: Reformoptionen und Reformstrategien (2011), Technische Universität Wien, Vienna, January

remains however within the responsibility of the National Health Fund), secondary education, roads, sanitary and health inspection, public safety and social welfare services (in particular running local employment offices responsible for active labour market policies and the payment of unemployment benefits).

A third, highest level of territorial division is a *voivodship* (*województwo*), where two tiers of government co-exist with separate responsibilities. Since the administrative reform, the representatives of the central government (*voivods*) have seen their competences shrinking considerably at the benefit of independent regional bodies (*sejmik*). While the former have maintained some role in maintaining the police, security and criminal justice functions of the national government and monitoring the use of grants by local governments, the latter have become fully responsible for the primary function of a *voivodship* which is regional development planning (as such they are the main players in the process of planning and management of the EU structural funds), and a number of other tasks, such as higher education, culture, health care and transport infrastructure. Currently Poland is divided into 16 *voivodships*.

3. Local government's finances

The amount of tasks and degree of responsibilities are reflected in the structure of financial resources used by different tiers of local government. Over the past decade local governments have been responsible for providing an increasing amount of public goods and services to their respective populations (a real increase of ca. 70% in total revenues and expenditures). Among them, *gminas*' budgets, given the widest range of tasks, accounted for almost half of total public finances managed by the local governments. Cities with *powiat* status, given the significant size of population covered, but relatively small number, accounted for over 30%, *powiats* for less than 20% and *voivodships*, due to their limited responsibilities, for less than 10%.

Revenues

The law defines three basic categories of revenues of local government entities: own revenues, general subsidy from the state budget and appropriated allocations. In 2010, ca. 48% of revenues of all local government entities came from own revenues, 29% were transferred as subsidies from the state budget, and 23% were earmarked grants.

Own revenues consist of incomes from local taxes (only for *gminas* and large municipalities), user fees, charges and fines, revenues of productive entities owned by the local government, income from the sale or rental of municipal property, and shares of revenues from personal income tax (PIT) and corporate income tax (CIT) paid by individuals and companies who are residents/located on the territory of the entity.

Local taxes levied by *gminas* include: real estate tax (flat per metre charge on land and a percentage of the construction costs of buildings), agricultural and forestry tax (based on the price of per hectare yields of particular types of land), motor vehicle tax, inheritance and donation tax, tax on civil law transactions, and a simplified income tax on small businesses.

The share of income tax revenues transferred to an entity amounts to 39.34% of PIT and 6.71% of CIT revenues collected on the territory of a *gmina*, 10.25% of PIT and 1.40% of CIT revenues collected in a *powiat*, and 1.60% of PIT and 14.75% of CIT revenues collected in a *voivodship*.

Total amount of the general subsidy transferred from the state budget to the local government entities is defined annually in the budget law, separately for *gminas*, *powiats* and *voivodships*. The subsidy has a redistributive function: the size of a major ('equalization') component depends on the sum of tax revenues (local taxes plus share of PIT and CIT) per inhabitant of a *gmina* and, to a minor extent, on its density of population. A minor ('balancing') component is distributed among *gminas* according to the amount of housing subsidies paid by them and overall level of their population's wealth. For *powiats* and *voivodships* a similar mechanism is complemented with slightly different criteria. In case of *powiats*, the size of a subsidy is determined by tax revenues per inhabitant, the level of unemployment, and a combination of factors: total length of local, regional and national roads, size of family transfers, and a trend in a *powiat*'s revenues. For *voivodships*, it depends on the tax revenues per

inhabitant and the overall number of inhabitants (higher subsidy for small *voivodships*), and a number of other factors: the length of regional roads, unemployment rate, subsidies to regional railway operation and GDP per capita. A separate education subsidy is distributed among entities (*gminas*, *powiats* and *voivodships*) by the Minister of Education, taking into account the range of education tasks under their responsibility. The subsidy is the main source of financing for primary and secondary level of education in Poland. The current formula takes into account the number of pupils weighted according to the type of schools they attend and the pupil-per-teacher ratio in the area. Such formula implicitly favours rural areas, where the latter ratio is the lowest.

The third source of local governments' revenue is earmarked grants. They are either paid from the state budget, in the framework of the programmes financed from the EU funds, or from other earmarked funds. The former ones are allocated for the execution of the own functions of the local government and the functions delegated or commissioned to them by the national government. They must be co-financed (at least 50%) from own resources of an entity and are mainly granted for investments in education, culture and sports.

Expenditures

Local government entities spend their resources on current expenditures, including mainly wages and salaries, purchase of goods and services, social benefits, grants for subordinate organisational entities, and debt service, and on investment expenditures.

The structure of expenditure of various levels of local government reflects main tasks and responsibilities legally assigned to them. While classification of public expenditure according to COFOG is not available at a regional and local level, a national budget classification can serve as a proxy. *Gminas'* main items of expenditure are: education (33.3%) and social protection (16.5%), *powiats* and large municipalities finance mostly education (respectively 28.5% and 27.8%) and transport and communication (respectively 21.7% and 20.3%), while *voivodships* are predominantly responsible for financing transport and communication (39.1%).

4. Fiscal framework

Apart from the legal obligation to exercise the functions assigned to them by law, freedom of the local government entities to pursue their autonomous fiscal policy is constrained by the fiscal framework composed of medium-term programming and fiscal rules.

Medium-term programming involves both central government (in a form of Multiannual Financial Plan of the State) and all levels of local government. Multiannual Financial Projections are prepared for the current and at least three subsequent budget years, but the coverage may be extended if investment projects are implemented over a longer time span. The Projection is established together with the annual budget resolution and submitted to a local accounting council for agreement. The document indicates the level of revenues and expenditures for the entire programming period, serves as a numerical guidance for the fiscal policy adopted in the annual budgets and provides a limit for the budget deficit and debt for a given year, although is not binding in more specific details.

Local governments are also subject to a series of fiscal rules. The general rule can be considered as a type of golden rule: it states that current expenditures planned for a given budget year cannot be higher than the sum of current revenues, budget surplus from the previous year and unassigned resources. An additional rule applying to debt and interest paid on it is expected to change soon. The current rule, in force until end 2013, requires that the overall debt level of each entity do not exceed 60% of its revenues at the end of each year and each quarter (although bonds issued and loans incurred in order to co-finance the EU-financed projects are not accounted for). At the same time, the interest paid on the debt cannot exceed 15%([286]) of the planned revenues. From 2014, a new, more flexible rule established by the Public Finance Law of 27 August 2009([287]), will enter into force. It introduces an individual coefficient of debt, which defines the specific maximum expenditure on debt service for each

([286]) If the state budget debt exceeds 55% of GDP, the limit will be lowered automatically to 12%.

([287]) A 4-year *vacatio legis* has been decided in order to allow the local governments to adopt their budgetary policy to the new rules.

local government entity. It is calculated as a three-year average ratio of the sum of current surplus (current revenues minus current expenditure) and sales to total revenues. The new rule, contrary to the existing one, will allow the entities to devise their individual fiscal strategy in a more flexible manner, depending on their ability to raise additional debt in order to finance sustainable investment projects.

The Council issued country-specific recommendations to Poland with respect to subnational governments (see Box I.3.2 above).

A1.21. PORTUGAL

1. General description

Portugal is a relatively centralized country, but subnational governments enjoy a very large degree of autonomy including at the financial level. Subnational governments in Portugal are composed of 308 municipalities and two autonomous regions, each subnational structure being governed by a separate law. ([288]) Portugal has no formal regional level, except for two autonomous regions that cover the islands of Azores and Madeira. The two regions enjoy broader autonomy than municipalities. They have their own regional legislative assembly, their own regional government presidents (Presidente do Governo Regional) and their own regional secretaries (Secretários Regionais). The two regions also include municipalities and parishes governed by regional regulations and inspection bodies.

Municipalities are politically and administratively independent from central government. They have a municipal assembly, a mayor (presidente da Câmara municipal) and an executive council (Câmara municipal) elected for a four-year term. Municipalities are subdivided into parishes (freguesias), which also have an independent status, being in charge of some local administrative tasks (there are currently, 4,259 parishes). The majority of municipalities are small in size (less than 50,000 inhabitants).

([288]) Local Finance Law 2/2007 of 15 January, and subsequent amendments and Regional Finance Law, Organic Law 1/2007 as amended by Organic Laws 1/2010 and 2/2010.

There has been growing devolution of tasks to subnational government levels. According to the Constitution, the allocation of responsibilities among levels of government is based on the subsidiarity principle. The subsidiarity principle also applies to Azores and Madeira, but their own regulations prevail over national ones. The devolution of tasks at local level is revised annually through a Protocol signed between the central government and the Association of Municipalities. The Association of Municipalities and the Association of Parishes take part in the formal consultation procedures established by the constitution or by law. They are also consulted by the government on an ad hoc basis, in some cases informally before the formal consultation procedures, and are informed on developments of central government policy such as the preparation of the state budget and the Stability and Growth Program.

2. Government spending

Spending at subnational government level has been increasing steadily over the last decade, with budget deficits widening over the last five years. The increase in spending is mostly due to an increase in current expenditure, mainly compensation of employees and intermediate consumption, which has markedly contributed to general government current expenditure. Expenditure competences do not seem to be defined clearly and are revised on an annual basis through the signature of annual protocols between the central and subnational governments. Subnational governments are responsible for a significant part of general government investment, which however has fallen sharply in the last years. A review of the adequate levels of investment at local level is needed to help eliminate inefficiencies and redundancies.

The structure of subnational governments' expenditure in Portugal is similar to other EU countries, with a high percentage of total expenditures on general public services. Data indicates important responsibilities in providing housing and community amenities, environmental protection, and recreation, culture and religion and general public services, while responsibilities in health, education and social protection are shared with central government. An increase in the education services attribution can be observed

since 2006. Municipalities play an important role in licensing, as well as in supervising and enforcing national regulations, in areas such as water supply, drainage network, urban waste disposal, parks and gardens, street repairs, social and cultural facilities, primary schools and the municipal road network. The shared competencies between local governments and central government are being revised annually through a Protocol, and are not considered and/or reviewed in a multi-annual framework.

3. Financial arrangements

About 40 per cent of regional governments' revenues and about 50 per cent of local municipalities' revenues derive from transfers. According to the Regional Finance Law, the transfers are updated annually according to the rate of change of the current expenditure([289]) of the State in the year previous to the State budget authorising the transfers. The allocation between regions is determined by their population, their relative periphery distances, the number of islands and a tax ratio. The regions also benefit from a Cohesion Fund for investment projects. Each year funds are transferred from the State budget to this Fund according to the ratio between regional and national GDP per capita.

Own revenues are collected by the central government’s tax administration (Autoridade Tributária) for all local and regional entities besides Madeira, which has its own tax administration. The information on taxes paid is sent monthly to them by the central tax administration as requested by law. Municipalities in the regions benefit from the same revenue and transfers system as all other municipalities on the mainland. Own revenues represent about 30 per cent of local governments' revenues and 56 per cent of regions' revenues. In addition, regions retain all taxes levied on their territory.

Municipalities' own revenues include according to the Local Finance Law: i) a 5 per cent share in state personal income tax collected from residents; ii) own taxes (property taxes, surcharges on state corporate income tax, tax on vehicles, fees and fines), iii) a block grant defined as a share of central government revenues (currently set at 25.3 per cent) from personal and corporate income tax and value added tax as accrued in the year before the last in which the state budget authorising the transfers refers; and iv) an earmarked grant to finance tasks and responsibilities transferred from the central government. The revenue-sharing between central government and local governments is carried out according to detailed formulas set out in the Local Finance Law, through the following funds:

- the Financial Balance Fund (FEF), composed of: i) the General Municipal Fund (FGM), adjusts the resources of each administrative level to its respective attributes and competences; and ii) the Municipal Cohesion Fund (FCM), designed to correct asymmetries among local authorities resulting from different capacities to collect revenue or different expenditure needs. The two sub-funds are equal in size and are financed through the block grant of 23.5 per cent.

- The Municipal Social Fund (FSM), an earmarked grant to finance responsibilities transferred from the central government in education, health and social services. If the municipality does exhaust the allocated amount, the savings are deducted from the amount to be received the following year.

- The Parishes Financing Fund (FFF), financed through a share of 2.5 per cent of central government average tax revenues obtained from personal and corporate income tax and value added tax.

Municipalities can legally exercise tax powers only to the extent defined in the Local Finance Law. They can adjust the tax rate or base for the taxes under their powers according to the law. Although the overall amount of transfers from State's tax revenues is determined in the Local Finance Law, the central government can modify the attribution by a discretionary decision. Moreover, the overall growth in transfers is capped at 5 per cent.

There is no budget calendar for subnational governments. They finalise their draft budgets following the submission of the State budget to Parliament. The State budget conveys the

([289]) It excludes the transfer for social security and contribution to the civil servant pension system.

information on transfers as well as on central government's tax revenue, which serves as a basis for projecting local and regional taxes. Before the State budget submission there is very little exchange of information between the central government and subnational levels. As a consequence, regional and local governments' budgets have consistently overestimated their projected revenue. During the last five years, average collected revenues were equivalent to only 65 per cent of the amounts projected by local governments. Revenue overestimation together with a weak public financial management is the main cause for the weak budgetary execution.

4. Fiscal rules

Portugal imposes debt rules and borrowing constraints to subnational governments. The Local and Regional Finance Laws define: (i) net debt ceilings, and borrowing constraints for local governments, (ii) and a debt service rule for regions. In addition, the 2012 budget law prohibits any increase in the net debt of regions and municipalities in 2012. This target temporarily supersedes other borrowing constraints.

Net indebtedness of municipalities cannot exceed 125 per cent of the sum of own taxes, shared tax, intergovernmental transfers and dividends from municipal enterprises recorded in the previous year. ([290]) Within the this limit: i) medium- and long-term financial liabilities, which are earmarked for investment purposes, cannot exceed 100 p.p.; and ii) short-term financial liabilities, which are to be used for cash management purposes only, cannot exceed 10 p.p. If a municipality exceeds the limit for net indebtedness, and/or for medium- and long-term financial liabilities, it must reduce it by at least 10 per cent per year until it falls back within the limit. In addition, if a municipality exceeds the limit for net indebtedness, the transfers it receives from central government are reduced by a corresponding amount. The money is then allocated to a regularisation fund (Fundo de Regularizaçao Municipal) to deal with situations of structural financial imbalances of municipalities.

A situation of financial imbalance becomes "structural" if at least three of the following conditions occur: a) medium- and long-term financial liabilities exceed the 100 per cent limit; b) net indebtedness is higher than 175 per cent of previous year revenues; c) arrears exceed 50 per cent of revenues of previous year; d) total financial liabilities (including those not included in the computation of the net indebtedness limit) in excess of 300 per cent of last year revenues; e) average length of arrears above 6 months; f) failure to reduce liabilities by at least 10 per cent per year if the limits for net indebtedness and medium- and long-term financial debt are exceeded. The municipality is required to prepare an adjustment plan which, in this case, needs the approval of the Ministry of Finance. Approval of the plan gives access to the regularisation fund. The municipality must report quarterly on the implementation of the plan. Failure to report or to implement the plan results in the retention of 20 per cent of transfers from the central government. ([291])

The institutional framework that sets out indebtedness limits for local governments in relation to past revenues weakens the budgetary constraints in a pro-cyclical pattern. Growing revenues in good times raise the nominal amount of permitted borrowing under the debt ceiling, while servicing the liabilities incurred becomes more difficult during downturns when revenue transfers are declining. As a consequence, regional and local governments have built up significant amounts of debt over the last decade. Financial debt reached 5½ per cent of GDP at end-2010([292]), while debt to suppliers above 90 days stood at EUR 2.7 billion (about 1.6 per cent of GDP) at end-2011 according to the survey on arrears.

([290]) Net indebtedness is defined as the difference between the sum of liabilities (financial and non-financial) and the sum of financial assets, including those pertaining to associations of municipalities and enterprises owned by local governments. Loans for financing urban rehabilitation programs, those related to EU co-financed projects and those for areas affected by public disaster are excluded from the computation of net indebtedness by authorization of the Ministry of Finance.

([291]) On a voluntary basis, a municipality may declare to be in a situation of "temporary imbalance" and trigger a rebalancing procedure which foresees the preparation of a debt restructuring plan and of measures to reduce expenditure and increase revenues. Any of the following triggering criteria can be used: a) breaching the net indebtedness limit; b) arrears in excess of 40 per cent of previous year revenues; c) total financial liabilities (including those not considered to compute the net indebtedness limit) in excess of 200 per cent of revenues; d) average length of arrears above 6 months.

([292]) Municipalities' debt represented 3½ percent of GDP at the end of 2010, and Madeira's amounted to 1.8 percent of GDP.

Box IV.A1.2: **Subnational governments' institutional reform under the Economic Adjustment Programme of Portugal**

1/ The Local and Regional Finance Laws will be revised to adapt subnational budgetary frameworks to the principles and rules of the revised Budgetary Framework Law, namely (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules; and (iii) the interaction with the Fiscal Council.

2/ Public financial management measures for fiscal reporting and monitoring and accounting in line with central administration will be implemented, and an effective commitment control system will be introduced. The number of public employees will be reduced by 2 per cent per year over the duration of the program.

3/ The fiscal rules for subnational governments will be reviewed and early triggers for corrective action will be introduced. At municipality level, fiscal rules will not be defined in structural terms as at the national level, other solutions to correct for possible pro-cyclical bias will be determined. By contrast, at regional level, the fiscal rules at the national level may be replicated conditional on appropriate development of statistical methods for regional GDP figures. These have the advantage of being simple and easy to understand.

4/ A procedure for an orderly debt resolution for regional and local governments will be designed and implemented.

5/ The revenue sharing mechanisms are to be revised and a fully-fledged medium-term fiscal framework in line with the central government will be introduced. The revisions also need to be designed in the light of the new EU fiscal framework.

Moreover, a significant number of local state-owned enterprises and other quasi-fiscal entities have been created by municipalities. Although, municipalities are not allowed by law to guarantee debt of these entities, the creation of such entities allows further accumulation of debt outside the local governments' balance sheet and weakens their current indebtedness ceilings. New legislation enacted end- 2011 establishes mandatory rules on transparency and information on the operation of the local business sector and suspends the creation of new businesses by municipalities, inter-municipalities and metropolitan areas, as well as the acquisition of shares by them.

The government has tried to address growing financial imbalances in subnational governments through a number of measures: i) triggering of corrective actions as stipulated by the Local Finance Law through the adoption by municipalities of "financial rebalancing programmes"; ii) ad hoc measures included in the annual budget law, such as a limit of zero net indebtedness on aggregate local governments; and iii) several measures under the Economic Adjustment Programme for Portugal (See Box IV.A1.2). Currently, there are 50 municipalities who should fall under the structural financial rebalancing programme according to the criteria set by the law.

In addition, a financial assistance programme between the central government and the Autonomous Region of Madeira was concluded in January 2012 to limit the fiscal risks that the region is causing on the Portuguese public finances. The arrangement includes fiscal consolidation measures, but also measure for structural performance such as introducing an effective commitment control system, an integrated financial management information system, accounting, fiscal monitoring and reporting in line with central administration, a restructuring plan for regional publicly-owned enterprises, and cost benefit analysis for investment projects and PPPs.

A1.22. ROMANIA

1. General description

Romania is a unitary national state with a predominant central government and a two-tier structure of local government([293]). The territorial administrative framework([294]) consists of 41 counties (*judete*)([295]) and the capital city of Bucharest, which are defined by limited autonomy, both in terms of decisional power, and financial and fiscal areas. A second-tier local administration is made out of localities (*localitati*). In 2011, there were 3,181 such jurisdictions, consisting of 2,861 communes (*comune*)([296]), 217 towns (*orase*), 103 cities (*municipii*). The city of Bucharest has a dual status of municipality and county.

During the last two decades, Romania has made important steps in adjusting its system for financing the administrative-territorial units, which could be broadly divided into 3 separate reform cycles: (i) covering the period 1991-1994, in which important steps were made with regard to the administrative structure and financing of public local authorities (including the local tax system); (ii) concerning the period 1998-2000, which saw a further increase of the revenues transferred to the local budgets (from 3.6% to 6.5% of GDP between 1998-2001); and (iii) covering the period 2001 onwards, with the adoption of the 215/2001 Local Public Administration Act that set out the general conditions for self-government, autonomy and organisation at public level and the 273/2006 Local Public Finances Act that set out the framework and the rules for revenues and spending at local level. These changes were mainly driven by the need to increase the performance of local public administration, as well as to assure a high level of transparency and stability of the inter-governmental fiscal relationship. Several other acts (e.g. the 195/2006 Framework Law on Decentralisation, the 286/2006 Local Public Administration Act, and the 51/2006 Community Services of Public Interest Act) reinforced the reforming process of local public administration.

In 2010, total spending by local government amounted to 9.6% of GDP (excluding the interest), of which over 70% are used to cover current expenses. Total revenue accounted for 9.7% of GDP. Central government transfers and grants([297]) represented almost 7.6% of GDP, around 19% of total public expenditure. Local authorities also have the possibility of borrowing money within a total annual ceiling approved by the central government.

2. Government spending

The responsibilities of local government mainly concern the implementation of certain public policies, with some autonomy in particular over capital expenditure for the supporting local infrastructure, while their regulation is conducted by the central government. Nevertheless, municipalities exert some management control on specific public utilities (e.g. water supply, sewerage, waste, district heating, and in larger cities public transportation). The majority of sub-national discretionary spending is devoted to community infrastructure, street maintenance, cultural programs, school operating and maintenance, and social assistance programs.

In 2010, total spending by local governments amounted to EUR 11.9 billion or 9.8% of GDP. Based on the functional breakdown of public expenditure (i.e. COFOG classification), the budgets of local governments are dominated by spending on education. Education accounted for more than 20% of local government expenditure, closely followed by economic affairs with 19%. However, with regard to the education, their role is rather limited, mainly acting as paymasters, as well as for operating and maintaining school buildings (financed from discretionary revenues). Similarly,

([293]) This is according to the Constitution of Romania (articles 119-120), adopted in 1991, amended in 2003 and 2011, as well as in the Law on Public Administration (as amended in 1996).
([294]) Historically, the public administration in Romania was subject to multiple reforms (i.e. approximately 30 reforms during the last two centuries). The current structure is the result of this step-by-step approach in institutionalising the local and regional administrative structures.
([295]) The counties are formally grouped into 8 development regions, according to the NUTS-2 criteria. The regions are not territorial-administrative units, but rather created as a group of counties, aiming to facilitate the implementation of the European regional development policy.
([296]) The communes together comprise more than 13,000 villages, with populations of up to 5,000 inhabitants each.
([297]) They fall into two categories: grants and subsidies for current spending and compensation for transfer of responsibilities, and grants and subsidies for capital expenditure.

they act as agents of centrally-financed social assistance programs (e.g. guaranteed minimum income).

An analysis by type of expenditure shows that current expenditure accounted for EUR 8,578.6 million and represented more than 71.4% of sub-national public expenditure, while the remaining part is related to the reimbursement of capital and the payment of interest costs. In the last years, local investment has been on the rise, mainly as a result of the greater decentralisation. In particular, the ratio of capital expenditure in total expenditure for counties stood at 26.5%, due to their increased responsibilities in the management of public services, as well as maintaining the road network and public transportation.

3. Financial arrangements

Local budgets are highly dependent on the transfers received from the central budget. A small number of local communities generate sufficient revenues by their own. The source of revenues for local administration is divided into several categories: (i) current fiscal revenues (e.g. taxes on properties, land and transportation vehicles); (ii) current non-fiscal revenues (e.g. transfers and grants from the state budget); (iii) capital revenues (e.g. through the privatization process); and (iv) revenues from special sources (e.g. taxes and unused expense allocations for year *t*, which are carried forward to year *t+1*).

In 2009, the largest single source of local government revenue (i.e. 28% of the total sub-national revenues) consisted of earmarked grants for decentralized functions, followed by the personal income tax (i.e. 25%) and local taxes and fees (14%). Subventions, which consist of earmarked subsidies from sectoral ministries, comprised another 10% of total revenues.

Following an ever increasing budgetary autonomy of local governments, the equalization plays an important role and implies a greater responsibility with regard to efficiency and rationality of utilizing local resources. That is why budgetary correcting mechanisms and equalising transfers are set in place. Their aim is to correct imbalances that occur locally both vertically (e.g. local taxes do not cover the public expenditures), and horizontally, because not all local communities are financially sound.

4. Fiscal rules

There are two fiscal rules currently applying in Romania (i.e. budget balance rule, and debt rule), both having a statutory basis in the Local Finance Public Law. 'The budget balance rule' is applicable to local governments, being in force since 1990. Loans used to finance investment and debt refinancing are excluded from the scope of this rule. 'Debt rule' is defined as a ceiling (i.e. percentage) of current revenue and is in force since 1999. Local government cannot contract or guarantee loans if their annual public debt service (e.g. principal payment, interest, commissions) including the loan they want to contract, is greater than 30% of their own revenue. From this rule, the loans for co-financing EU projects are excluded. Local lending is subject to authorisation by a central commission organised at the level of the Ministry of Public Finance.

A1.23. SLOVENIA

1. General description

The Constitution of the Republic of Slovenia provides for a decentralised, two-tier([298]) government structure, composed of central government and local governments (municipalities). This structure was shaped in the second half of the 1990s when the number of municipalities gradually increased from 60 to almost 200; it now stands at 211.

Municipalities are responsible for local functions they can provide independently for their inhabitants (*original functions*) and for functions transferred by the central government, with their consent and if sufficient financing is provided (*transferred functions*). More than half of their revenue comes from the redistribution of personal income tax.

([298]) The Constitution foresees the possible formation of regions, which is the autonomous local government level to administer local functions of a broader importance than those of municipalities as well as other functions as defined by law. However, this provision has to date not been implemented.

According to the OECD Fiscal Decentralisation database, the share of municipalities' expenditure in total consolidated general government expenditure was 25.5% in 2010, corresponding to about 10% of GDP. Their share in total consolidated general government revenue was 15.4% (5.9% of GDP). Municipalities usually record a marginal deficit position of around 0.1% of GDP (over the period 2001-2011, the deficit was higher at around ½% of GDP on average in the years 2008-2010)([299]).

There are also two social security funds: the pension and disability insurance fund (PDIF) and the health insurance fund (HIF). Any PDIF deficit is covered by financing from the central budget, while the HIF has been in deficit in recent years, following several years of surpluses.

2. Government spending

According to the COFOG classification of government expenditure, municipalities' main functions are: (i) economic affairs, especially road transport (24% of their total spending in 2010); (ii) education, especially pre-primary and primary education (20%); (iii) general public services (17%); and (iv) recreation, culture and religion (16%). Other non-negligible functions in terms of spending are environmental protection (waste and waste water management) and housing.

Policies for pre-primary and primary education are designed, and standards formulated, at the central level, whereas municipalities ensure their implementation, with some autonomy in particular over capital expenditure for the supporting infrastructure. Municipalities have some more autonomy in policy and decision making for the other main functions highlighted above.

The PDIF administers various old-age and disability pension schemes. The HIF pays for the provision of medical services and related compensations of policyholders.

([299]) The municipalities' revenue and expenditure shares as percentage of GDP do not add up to the deficit ratios because in the database consolidated total general government expenditure is defined as global total expenditure at general government level plus the total inter-governmental property expenditure and consolidated total general government revenue is global total revenue at general government level plus the total inter-governmental property income.

3. Financial arrangements

Municipalities' financial arrangements are based on the concepts of "adequate spending" and "adequate funding" and the principle of proportionality between responsibilities and resources([300]). *Adequate spending* is the amount a municipality is assumed to spend on its responsibilities. It is based on a formula including a lump sum per inhabitant([301]) and the number of inhabitants adjusted for the situation of the municipality on some specific parameters (such as its relative area surface, length of local roads and proportion of inhabitants under 15 and over 65). It is financed through the redistribution of personal income tax (PIT) revenue, which is based on the concept of *adequate funding* and represents around 58% of municipalities' total revenue, and, where needed, additional government transfers([302]).

Municipalities' revenues also consist of other own resources and municipal fees. Examples of the former are taxes on vessels, on inheritance and gifts and on winnings from conventional games of chance as well as real estate turnover tax; municipalities have no autonomy for setting underlying tax rates or bases. They do have this autonomy (to some extent) for municipal fees, including concessions, fines, environmental

([300]) Financial arrangements are presented in detail in the Municipalities' Financing Act and the Public Finance Act.
([301]) Set at €554.50 in 2012 at the state level.
([302]) Adequate funding is based on a similar formula as adequate spending but with the adjustment reflecting each municipality's specific situation assuming a lower weight. In year t, the central government redistributes 54% of PIT revenue paid in year t-2 indexed for inflation in years t-1 and t, in three steps. First, 70% of this amount is redistributed, based on the proportion of total PIT collected in each municipality (and limited to its adequate funding). Second, additional PIT revenue, eventually increased by part of redistributed PIT revenue from the first step which already exceeded adequate funding for individual municipalities, is allocated up to the total adequate funding for all other municipalities (*solidarity compensation*). Third, in case the total available amount of PIT revenue exceeds total adequate funding, the remainder is further redistributed to proportionally cover as much as possible the gap with municipalities' adequate spending (*additional solidarity compensation*). If a municipality's total PIT revenue still falls short of its adequate spending (expected to apply to 150 municipalities in 2012), it receives an additional equalising transfer from the central government (*financial compensation*) to fill the gap. Municipalities with a higher proportion of high-income earners end up with redistributed PIT revenue exceeding the amount they are assumed to spend on their responsibilities (adequate spending).

charges([303]) and payments for local public services. Finally, municipalities receive property income as well as donations and transfers from the EU and central government for specific purposes (e.g. investment).

The PDIF is funded with mandatory contributions for pension and disability insurance as well as with transfers from the central government budget, which must fully cover any gap between PDIF expenditure and revenue. These transfers are on an increasing trend and stood at around 4% of GDP in 2011. The PDIF is not permitted to accumulate debt.

The HIF is funded with mandatory contributions for health insurance. It was in surplus until 2008; its deficits since then have been covered by reserves.

4. Fiscal rules

Municipalities are only allowed to borrow domestically, and for investment purposes, up to a certain ceiling. A municipality can also borrow for liquidity purposes up to 5% of the last adopted budget. Debt assumptions are prohibited and municipalities cannot issue bonds but they can issue debt guarantees for indirect budgetary users([304]) and local public enterprises. The Minister of Finance has to authorise any borrowing when the repayment is not foreseen to occur within the same budgetary year.

The Municipalities' Financing Act specifies a debt rule for municipalities. The annual ceiling for their payment of loans principal and interest, financial leasing, trade credits and contingent liabilities is set at 8% of their revenue in the previous year (excluding donations, investment transfers from the central government, EU funds and revenue from business activities). The rule is based on cash accounting and there are no predefined escape clauses. It was introduced in 1995 and the most recent revisions have made the rule more coherent by abolishing special treatment of certain investments (e.g. in education, housing, water supply). It is monitored and enforced by the Ministry of Finance. Over-indebted municipalities are not authorised to borrow by the Ministry of Finance and first have to reduce their debts. The available information does not suggest that any municipality has ever defaulted or been bailed out, although there are few municipalities with blocked transaction accounts due to over-indebtedness.

The local debt rule generally appears to have ensured that municipalities curb their expenditure rather than break the debt ceiling. Municipalities are estimated to spend on average around 5.4% of their revenue on the annual payment of liabilities, which suggests that they are generally below the 8% threshold by a relatively wide margin. Still, local government debt in ESA95 terms increased from 0.7% to 1.7% of GDP between 2007 and 2010 and the number of municipalities without debt has shrunk. To improve public finance surveillance at the local level, the government intends to launch an online tool for an up-to-date and comprehensive calculation of individual municipalities' indebtedness levels in the near future.

5. Other relevant institutional features

Several legal provisions seek to limit deviations from the fiscal targets adopted by the municipality council. During the budget execution phase, the mayor can, on a proposal from the municipal department responsible for finance, impose a temporary moratorium (of up to 45-days) on new expenditure by (i) blocking new contracts from being signed; (ii) prolonging payment periods; and (iii) ending the redistribution of budgetary funds among users. If such a moratorium is not sufficient, the mayor must propose a supplementary budget and can prolong the moratorium until this supplementary budget is approved. These arrangements are similar those for the central government budget.

A1.24. SLOVAK REPUBLIC

1. Introduction

Slovak Republic is a unitary state with two tiers of sub national entities: 8 regions (VUC) and 2887 municipalities (obce). The existence of

([303]) Environmental charges are earmarked for infrastructure and implementation of environmental measures and standards.

([304]) These are institutes and foundations, i.e. legal entities for the provision of specific public services, such as schools, libraries, medical centres, sports and cultural centres, etc.... There are some 1500 indirect budgetary users in Slovenia.

municipality and region (higher territorial unit) is embodied in the Constitution which states that the basic unit of territorial self-administration is the municipality. The territorial self-administration is then composed of a municipality and a higher territorial unit. Both levels of subnational government are independent territorially and administratively and they are also independent of each other.

Significant changes to the system took place between 2001 and 2003. In 2001 the regional governments were established as units of self-administration and in 2002 the transfer of competences to regions and municipalities began. Between 2002 and 2003 over 90 competencies were transferred to regions and over 60 to municipalities. ([305]) In 2004, administrative districts (okres) were abolished.

2. Government spending

Main responsibilities of municipalities lie in the fields of education, social welfare for elderly, social housing (construction and maintenance), local utilities, health (outpatients departments, hospitals and medical centres of first type), tourism and public order. In terms of spending, over 30% of overall expenditures in 2011 were devoted to education where municipalities are responsible for preschool education (kindergartens, nursery), primary education and activities which are not directly related to primary education such as art schools, school kitchens and canteens etc.

Main responsibilities of regions are in the fields of secondary education, social welfare and social policy, regional roads, transport, railways, health (hospitals and medical centres of second type, non-state health care) and regional development. Education is again the most significant area of spending with almost 40% of overall expenditures devoted to it in 2011.

3. Financial arrangements

Municipalities and regions provide services in two different ways - through autonomous and delegated competences. These two ways differ in degrees of competences and ways of financing.

When exercising autonomous responsibilities the subnational government is bounded by the Constitution and laws but the actual exercise powers are under the discretion of a municipality or a region. Subnational governments decide independently and carry out all autonomous responsibilities as defined by law and the state only monitors whether subnational governments comply with the law. Autonomous competences of subnational governments are funded from own revenues.

For example, in case of education, financing of art schools, kindergartens, language schools, clubs, children's educational centres for leisure activities and other facilities within the scope of autonomous responsibilities of subnational governments is secured in this way (i.e. from own revenues).

In terms of delegated responsibilities, subnational governments have a role of executive bodies that apply state administration under the control of the state. Subnational authority is bound not only by the Constitution and law, but also by lower levels of legislation such as government regulations, decrees, ministerial actions etc. Although subnational governments finance these services from their budget, the funds in fact come from the state budget and individual ministries in the form of transfers. In this case, the state controls extensively the use of the funds provided to subnational governments. For example, current expenditures on education in primary and secondary schools are funded in this way.

Revenues

Revenues of both levels of subnational governments come from shared taxes, own revenues and grants. Shared taxes include personal income tax which is collected by the state and shared among regions (23.5%), municipalities (70.3%) and the central government (6.2%). The sharing key is a function of demographic criteria. From January 2012 a new rule for sharing tax income revenue entered into force setting new shares for government layers - regions (21.9%), municipalities (65.4%) and the central government (12.7%).

For municipalities, tax revenues account for over 50% of overall revenues. These include own-source revenues such as the real estate tax and

([305]) http://www.infostat.sk/vdc/pdf/slavikdoc.pdf

other taxes on goods and services on which municipalities can freely decide the rate (except for a capping). However, the personal income tax revenues is the most important revenue source accounting for almost 70% of all tax revenues in 2010. This can in a way problematic because revenues from the personal income tax are rather cyclical.

Grants represented almost 35% of total revenues and they were all earmarked to cover all delegated responsibilities or to finance specific projects.

For regions, tax revenues represented about 47% of total revenues in 2010 of which over one quarter is own-source revenue from the vehicle tax. The rest comes again from the personal income tax. Grants accounted for over 45% of total revenues in 2010 and were again all earmarked to cover all delegated responsibilities (or to finance specific projects).

4. Fiscal rules

Fiscal rules aimed at local governments include a debt rule, a budget balance rule and recently certain new measures embodied in the constitution.

Debt rule states that subnational governments are allowed to take out credit/loan/issue bonds only if: a) the total sum of the debt of the municipality or self-governing region does not exceed 60 % of final current revenues of the preceding budget year and b) the sum of the annual instalments of the loans does not exceed 25% of final current revenues of the preceding budget year.

Budget balance rule says that the current budget (one part of the overall budgets of local governments) has to be adopted either as balanced or in surplus. The Act on budgetary rules of subnational governments lists possible exceptions, for example in cases when a subsidy from the state budget is envisaged or when EU financing is budgeted for the fiscal year in question. Capital budget may be set up with a deficit if this deficit can be covered from previous years, and reimbursable sources of financing (loans), or if this deficit is covered by the current budget surplus in the budget year.

Generally, it can be said that the budget balance rule has been respected. If a subnational entity breaks rules the Ministry of Finance may impose a fine of up to €16 597. However, this kind of punishment is not automatic and has been used only in exceptional cases when certain municipalities did not provide their financial statements..

Finally, Constitutional law no 493/2011 article 6 paragraph (3) states that if the total debt of the municipality or higher territorial unit reaches 60% of actual current income of previous financial year or more, municipality or higher regional units are obliged to pay a fine imposed by the Ministry of Finance amounting to 5% of the difference between the total debt and 60% of actual current income of the previous financial year. The paragraph will be effective from 1.1.2015.

In terms of bankruptcy, subnational governments cannot declare bankruptcy. Constitutional law no 493/2011 article 6 paragraph (1) states that the Government does not guarantee funding for provision the solvency and is not responsible for the solvency of the village or higher territorial unit. A procedure for dealing with insolvency of a municipality or higher territorial unit is provided in a secondary legislation. In case of serious financial difficulties municipalities are obliged to introduce "recovery regime" (1st mode) which gives municipalities 120 days to demonstrate an improvement in their financial condition. If they fail to meet this deadline the Ministry of Finance is entitled to decide about the introduction of forced administration (2nd mode) in which case the Ministry has the authority to approve all financial transactions and to request adoption of revenue raising measures. The Ministry does not provide additional funds to a municipality. Out of 2900 municipalities, 12 municipalities introduced a recovery regime in 2011. Forced administration was used in 6 municipalities since 2005.

A1.25. FINLAND

1. General description

Finland is unitary country with two-tier government structure. Municipalities are self-governing units where the highest decision-making authority is vested in local councils elected by residents. Autonomy of the local authorities is protected by the constitution. The law on local

self-governance (*Kuntalaki*) states that the local authorities have to perform the functions delegated to them in the laws and can decide to take other functions by virtue of their autonomy. Local authorities may not be allotted new functions or duties, nor shall they be deprived of functions or rights, other than by passing legislation to this effect.

Municipalities have very important role in Finnish public finances. They are responsible for wide variety of public services, they have right to levy taxes on their inhabitants. The budgets of local and joint municipal authorities were approximately 42 billion euros in 2011 or 22% of GDP. Some 430 000 employees, or close to 20% of the Finnish workforce, are working for the municipalities.

The tax ratio, i.e. the ratio of taxes and compulsory social security contributions to gross domestic product was 42.9 per cent in 2011 in Finland. Local governments collected 19.2 billion euros or 10% of the GDP in local taxes. In addition, the local governments receive revenues from state transfers and for the provision of their services. The stock of loans of local municipalities is ca 12.2 bln euros at the end of 2011.

The Ministry of the Finance is monitoring the operations and finances of local authorities in general and ensures that municipal autonomy is taken into account in the preparation of legislation concerning local authorities. Central Government's Regional Administrative Agencies (*Aluehallintovirasto*) supervise the activities of the municipalities, verifying that these are in line with the laws in force. They also investigate any complaints in this regard. However, this does not give rise to three-tier structure.

At the beginning of year 2012, Finland had 336 municipalities. The municipalities are relatively small – there are less than 6000 inhabitants in more than half of the municipalities. Seven urban municipalities have more than 100,000 inhabitants. Municipalities are encouraged to form joint municipal authorities to provide services to their inhabitants. There are ca. 180 joint authorities in Finland. These are set up by two or more local authorities to carry out specific tasks on a permanent basis. The most important joint authorities are hospital districts, districts for care of the disabled and joint authorities for the performance of functions related to public health and education. Three-quarters of all joint authority expenditure is incurred from organising health services.

There is also special joint authority called regional council or "*Maakuntaliito"* which consists of the municipalities in given geographical region corresponding to the NUTS region. There are 19 regions in Finland and it is obligatory for the municipalities of the given region to be associated with a regional council. However, this must also not be confused with three-tier governance system. The councils are responsible for regional development, including the EU structural funds programmes and regional spatial planning. These represent and promote the regions but their economic importance is limited – the total number of staff of all offices is about 650 persons, the budgets about 50 million euros or around 1% of local government sector expenditure.

The number of municipalities has been declining (there were 452 municipalities in the beginning of year 2000) but is generally still considered to be too large in Finland, arising concerns that the municipalities are not efficient in delivering the services. Fusions of municipalities have been encouraged by the government. There is an on-going debate regarding the reorganization of local authorities, dramatically lowering the number of the municipalities, mainly in order to improve the cost-effectiveness of their services. The reform would also concern legislation governing the activities of the municipalities.

Municipal finances are based on annual budgeting. This consists of the budget for the next financial year and budget framework for minimum three years, including the budget year. The law requires that the budget must be in balance over the four-year period. Ministry of Finance supervises the compliance regarding the budget balance rule. The primary responsibility rests within the municipality itself – committee appointed by the council monitors and reviews the execution of the budget, including the achievement of the objectives set in the budget. Activities and accounts of municipalities are subject to annual audits by professional audit companies. Auditors report to the municipal council.

2. Government spending

Local governments' budgetary expenditure in 2011 was 40.4 bln euros while the general government sector spent 103.5 bln euros. Largest share of expenditure goes towards the production of basic services, the most important of which relate to social welfare and health care, education and culture, the environment and local infrastructure. In each area there is an elaborate division of labour between the central and local government, clearly defined in the legislation. Generally, central government agencies are responsible for making the transfer payments to the citizens while local authorities provide the services. Nature and quality of the services (for example, the content of the curricula at schools or the required medical services) is mostly pre-defined in legislation. Often the legislation defines the objective the municipality has to reach but leaves its hands free in choosing the means. Municipal council has to decide on the allocation of resources to achieve targets set by the laws. In most cases the council is free to select the level of resources but can be made responsible when standards are not met. This includes the possibility to levy fines on the municipality.

As an example of the division of labour, central government agency KELA is responsible for the payment of pensions, including disability pensions, and compensation for the medication. Similarly, they pay compensation for income lost due to sickness and compensate some form of treatment received in the private medical services sector. At the same time, the local authorities are responsible for the organization of the provision of medical services in medical centres and hospitals. They organize children's day-care, services for the elderly, including long-term care etc. In principle, the inhabitants are expected to use the services offered by their municipality.

Important challenge in this system is that the services are fragmented and citizens have unequal access to the services depending on the municipality where they live. Fragmentation increases costs per se, but apparent lack of competition in service provision has enabled steady decrease in the productivity in delivering these services.

49% of municipal expenditure was directed towards social welfare and healthcare services in 2011. Education and culture accounted for 22% of expenditure, municipal investments 11%. Debt servicing expenditure was 4% of the total expenditure.

In the provision of education, the municipalities are responsible for all levels of primary and secondary schools. They are also responsible for life-long learning activities and youth activities. Universities are independent institutions, with autonomy granted in the constitution and governance regulated by special legislative acts.

In addition, the municipalities are responsible for spatial planning and supervising the construction activities. Municipalities arrange the provision of water, energy and waste services, take care of the streets and environmental protection. Often these services are provided by companies owned by the municipalities or groups of municipalities.

3. Financial arrangements

Taking the example of year 2010, the tax revenue of the local authorities accounted for 46% of their total revenue. It consists of municipal tax on earned income, real estate tax and part of company tax. Average municipal tax rate is 18.3%. The tax rate of the municipal income tax can be set to any level decided by the council, but according to the law the tax rate is flat and the tax base is earned income, capital income is not taxed by the local authorities.

Land and buildings are subject to real estate tax, except land used for agriculture or forestry. Tax is paid by the owner of the real estate, taxable value is defined in the act on the valuation of assets in taxation. Municipal councils can determine the rates in the limits set by law. These limits are rather low for primary residences and higher for real estate related to business and industry. Interesting aspect is punitive rate towards empty lots allocated for construction.

Corporation tax is tax collected from companies, the rate of which is 26% of the taxable income of a corporation. This tax is paid to the state, municipalities and parishes of the Finnish Evangelical Lutheran and Finnish Orthodox Churches. The share of municipalities is ca 1/5 of

the tax collected. However, this tax is national tax and municipalities do not have right to decide on the level or base of the tax.

Operating revenue accounted for 27% of the revenues, its sources are revenues from companies owned by the municipalities in water, energy, and waste and public transport sectors. Some revenue is also earned by the provision of social and health services. Education is always provided free of charge.

Further 18% of local government revenues stemmed from the central government transfers (7.7 billion). Central government finances certain state functions delegated to the municipalities. These include obligations of the municipalities to provide services in education, day-care for children, healthcare, social security, protection of minors, assistance to disabled, prevention of health hazards, environmental services, consumer protection and culture, including the provision of library services.

The government transfers are also aimed at streamlining the economic differences between the municipalities in order to achieve uniform level of services across the country. Municipalities can also apply for additional discretionary governmental support in case of lasting economic difficulties. However, the discretionary support is used on very limited cases and the amounts granted are small. In 2011, 63 municipalities applied for the exceptional support (for the amount of €70 mln) and it was granted to 31 in the amount of €20 mln. Largest amount granted was €1.2 mln euros. As such, the possibility to receive discretionary support does not lower the fiscal discipline of municipalities. Any request for discretionary support must include a programme to balance the budget. Special conditions could be set by the government and the municipality cannot count that the support would be awarded also in the following years. The complicated formulas for determining the central government transfers take into account the presumed costs of providing the services, population structure and density, existence of island conditions, remoteness from larger centres, unemployment level, number of disabled and elderly needing care etc. If the estimated tax income per capita is lower than 91.86% of national average, government transfer is increased. The transfers are based on the central government estimations of the cost of required services' provision but the funds are not earmarked to specific activities. This means that there is incentive to be economical in service provision – cost-efficiency enables additional expenditure in other areas whereas the municipality does not have possibility to receive additional transfers when actual cost for some service proves to be higher than central government calculation foresees.

4. Fiscal rules

Local governments are obliged by law to keep their budgets balanced over a four-year period and municipalities generally abide by the law. The Ministry of Finance monitors the ability of the municipalities to meet their funding needs and forecasts short-term trends in local government finances, both in individual municipalities and at regional level. The government has specific powers to enforce a review of a municipality's finances and to work toward a recovery plan if the local government has fallen below target financial ratios. In case the ratios are breached in two consecutive years, a special committee is formed. This includes representative from the Ministry of Finance, representative from the municipality under question and an independent chairperson. The committee forms a proposal on the necessary measures to guarantee the continued delivery of services to the citizens. Based on the review, Ministry of Finance can decide to start the procedures to merge the municipality with another. Municipalities are not subject to the bankruptcy law.

So far, on the aggregate level, local government deficits and debt have remained modest (local debt amounts only to about 6% of GDP).

The municipal council has very wide authority: it sets the tax rates, decides on the general principles for the charges to be collected for services and other performances, sets operational and financial targets for a municipal enterprise, decides whether to provide a guarantee or other security for another party's debt, decide on the principles for the financial remunerations of elected officials, chooses the auditor and approves the financial statements.

When approving the budget, the council must also approve a financial plan for three or more years.

The financial plan must be in balance or show a surplus during the planning period of maximum four years.

Municipalities are also subject to strict reporting rules. Financial statements on each financial year have to be drawn up by the end of March of the following year and submitted to the auditors for inspection. The documents include a report on operations, providing an account of how far the operational and financial targets set by the council have been achieved.

Auditors (professional audit organisations) verify that the local authority has been administered in accordance with the law and council decisions, financial statements give correct and adequate information on finances and that the information given on the bases for and use of government grants is correct.

5. Other relevant institutional features

Local government lending is dominated by Municipality Finance Corporation (*Kuntarahoitus OY*). Owned by municipalities and the Finnish state, Municipality Finance is a credit institution in the service of its members. The credit ratings for Municipality Finance's long-term funding are the highest possible: Aaa from Moody's, and AAA from Standard & Poor's and thus the institution has access to low-cost funding.

Municipality Finance offers financial services on market terms for municipalities, municipal federations, municipally controlled organisations and non-profit housing organisations. The company's funding is obtained from both international capital markets and domestic investors.

All the borrowing is guaranteed by the Municipal Guarantee Board. Almost all Finnish municipalities are members of the MGB and are consequently liable for its liabilities. If a municipal member failed to pay on its obligation, other members would be jointly liable for the shortfall according to their share of participation to the MGB.

Municipality Finance has not suffered any loan defaults. It is not obliged to extend a loan and may decline a loan application, although the strengths of the Finnish local government and government-related sectors make a refusal unlikely.

A1.26. SWEDEN

1. General description

Sweden is a decentralised country with a high degree of local self-governance. Local government has a long tradition in Sweden. The country's 290 municipalities and 20 county councils and regions are responsible for providing a significant proportion of all public services. They have a considerable degree of autonomy and have independent powers of taxation. Local self-government and the right to levy taxes are stipulated in the Instrument of Government, one of the four pillars of the Swedish Constitution.

There is no hierarchical relation between municipalities, county councils and regions, since all have their own self-governing local authorities with responsibility for different activities. The only exception is Gotland, an island in the Baltic Sea, where the municipality also has the responsibilities and tasks normally associated with a county council. A region is a county council with extended responsibilities.

About half of all public revenues and expenditures relate to subnational governments, corresponding to about 24% of GDP. Tax revenues, most of which consist of taxes on earned income, make up about two thirds of overall revenues, with general state transfers providing another 15% and targeted state transfers, user fees, rents and other revenues making up the rest.

2. Government spending

The municipalities are legally or contractually responsible for providing the following services: social services, childcare and preschools, elderly care, support for the physically and intellectually disabled, primary and secondary education([306]), planning and building issues, health and environmental protection, refuse collection and waste management, emergency services and emergency preparedness and water and sewerage.

([306]) All compulsory education is the responsibility of municipalities.

Other activities are provided on a voluntary basis, such as leisure activities, cultural activities (apart from libraries, which are a statutory responsibility), housing, energy as well as industrial and commercial services.

The county councils are legally obliged to provide health care (managing and financing hospitals), dental care for people up to the age of 20 and public transport (in some cases, public transport is managed in cooperation with municipalities). Other activities are provided on a voluntary basis, such as cultural activities, education, tourism services and regional development.

Generally, subnational governments enjoy a relatively high degree of freedom to organise their activities, which can be adapted to local circumstances. The Local Government Act governs the responsibilities, obligations and mandate of local governments. There are some restrictions on what local government can do, notably in the commercial sector in cases where they enter into competition with private firms([307]).

The distribution of municipalities' expenditures is as follows: kindergartens and after-school care 14%, education 28%, elderly care 19%, support for handicapped people 11%, economic support 3%, other individual and family support 4%, business activities 5%, and others 16%. For the counties, the largest items are various forms of health care 79%, support for medicine expenditure 8%, transport and infrastructure 6%, dental care 4% and regional development 2%.

3. Financial arrangements

Municipalities, county councils and regions are entitled to levy taxes in order to finance their activities. Taxes are levied as a percentage of the inhabitants' income. Municipalities, county councils and regions decide on their own tax rates. The average, overall local tax rate is 30 per cent. Approximately 20 per cent goes to the municipalities and 10 per cent to the county councils and regions. Tax revenues are the largest source of income for Sweden's municipalities, county councils and regions and account for approximately two-thirds of their total income. Technically, it is collected by the state, but the revenues are redistributed to the various subnational levels according to their tax base and applicable tax rates.

Grants from the State are either general or targeted. General state grants represent 15% and 9% of total revenues for municipalities and counties, respectively. These are paid per inhabitant. Each municipality, county council or region can use this money on the basis of local conditions([308]). Targeted grants, which make up 3-4% of total revenues, must be used to finance specific activities([309]), sometimes over a specific period of time.

There are major variations in the average income of the inhabitants of Sweden's municipalities, county councils and regions. The cost per inhabitant, for providing the services to which they are entitled, also varies. In order to ensure fairness, a system has been introduced with the aim of providing equitable conditions in all municipalities, county councils and regions. This is the local government equalisation system, which entails redistributing the revenues of the municipalities, county councils and regions on the basis of their tax base and level of expenditure([310]). The equalisation system is managed by the State.

Municipalities, county councils and regions may charge users for their services. A non-profit principle applies, however, which means that fees may not be higher than the costs relating to the service concerned. Fees account for about 6% and 3% of revenues for municipalities and counties, respectively. If the municipalities, county councils and regions are obliged to provide a service, they may only charge for the service if specifically permitted to do so by law.

([307]) The Competition Act was modified in this sense in 2010 giving the Competition Authority to take action against local, regional and central government that are deemed to harm competition.

([308]) General grants come with no strings attached, but as local gov't spending to a large degree is made up of the wage bill, increasing central government grants to local gov't is a rather efficient way of counteracting cyclical downturns, as it may prevent local gov't from reducing staff in cyclical downturns (which they otherwise may deem necessary to comply with the local gov't balanced budget requirement).

([309]) Specific grants can be given for any purpose and depends on the priorities of the central gov't at any given moment in time.

([310]) Measured by structural factors, such as age structure etc.

4. Fiscal rules

Municipalities and counties are subject to a balanced-budget requirement, meaning that they cannot plan a budget with a deficit. The law requires them to conduct their financial planning in a prudent way, which has come to mean in practice that they should aim for a surplus of about 2% of total revenues from taxes and general state grants. Since 2005, the average has been 3%. If, ex post, there is a deficit, it has to be compensated within three years, unless special circumstances apply, for which exceptions can be granted([311]). The experience so far is that municipalities and counties take this requirement seriously and the rule has thus contributed to the overall positive performance of Swedish public finances. There are no formal sanctions for breaches of the rules, but the system has so far worked on the basis of self-discipline, relying on voters to punish bad financial management.

A1.27. UNITED KINGDOM

1. General description

The United Kingdom is constitutionally a unitary state: ultimate sovereignty resides with the UK Parliament, and it is up to Parliament to decide what powers and responsibilities (if any) it devolves to local or regional bodies, and how such bodies are organised and financed. This contrasts with federations such as Germany and the United States of America, where the autonomy of subnational authorities (*Länder* in Germany or states of the USA) and the division of powers between federal and subnational governments are constitutionally entrenched. Historically, the UK has been relatively centralised even compared with other unitary states.

Devolved country governments

The United Kingdom consists of four countries: England, Northern Ireland, Scotland and Wales. The territorial organisation of the UK is highly complex and differs widely across the four countries, not least because devolution was designed differently for each of Scotland, Wales and Northern Ireland

There are three devolved national administrations. Each was set up in 1997 or later and they have varying power and are situated in Belfast, Cardiff and Edinburgh; the capitals of Northern Ireland, Wales and Scotland respectively. The 3 nations have their own institutions, legislative (Wales – only secondary ones) and administrative powers, i.e. they can modify all laws in their sphere. Scotland and Northern Ireland particularise the central powers, while Wales specifies the assigned ones.

Unlike the other countries of the UK England (which has over 80% of the UK population) has no devolved assembly or government of its own but is represented solely by the UK parliament and government. English regions (9) have only administrative competences (and the Regional Development agencies (RDAs) have been abolished).

Local government

Systems of subnational authorities differ across the UK:

- In England there are 34 shire counties (divided into 238 districts), 47 shire unitary authorities, 33 London boroughs (overseen by the Greater London Authority - GLA) and 36 metropolitan (urban) unitary authorities([312]). England therefore has a total of 389 territorial governments, 354 at local level and 35 at intermediate level (county councils and the GLA)
- in Wales – 22 unitary authorities
- in Scotland – 32 unitary authorities,

([311]) Exceptions could be related to unrealized capital losses on financial assets (to avoid the ups and downs of the stock market to lead to yearly fluctuations in the operations of local gov't) or other (unspecified) special circumstances.

([312]) See Dexia (2008). Only the shire counties and GLA are 'intermediate' – all the other entities are 'local'. The London boroughs, other urban metropolitan authorities and shire unitary authorities are all basically at the same level and similar size (usually around 100,000 – 300,000 inhabitants) with similar powers except that in London some powers are with the higher level GLA. The shire districts are often a bit smaller and more 'local'. A lot of UK 'local' governments have much larger populations than the lowest tier of government would have in most other countries (a few of the biggest unitary authorities have over 500,000 people).

- Northern Ireland has 26 district councils.

All local authorities of all types have only administrative competences. There are also some smaller-scale community, parish and town councils which deliver some services for local authorities at a very local level([313]).

2. Government spending

The UK government remains responsible for national policy on all matters that have not been devolved, including foreign affairs, defence, social security, macro-economic management and trade.

It is also responsible for government policy in England on all the matters that have been devolved to Scotland, Wales or Northern Ireland. The UK Parliament is still able to pass legislation for any part of the UK, though in practice it only deals with devolved matters with the agreement of the devolved governments.

Local government spending is about a quarter of all public spending in the UK. Local authorities are funded by a combination of grants from central government, Council Tax and business rates. In Northern Ireland, district councils still raise money through a domestic rate and a business rate.

The main responsibilities of Scottish, Wales and Northern Ireland central authorities are local and regional planning, economic development, transport, agriculture, forestry and fishery, environment, housing, health, education([314]), culture and leisure. Scotland and Northern Ireland has additional competences of local government organisation, civil law (only Scotland), and police and public order. Scotland's unitary authorities and Northern Ireland's councils are assigned areas of local planning, registration, primary and secondary education, traffic, public transport, highways, personal social services([315]), housing, consumer protection, culture and recreation, fire and police services, refuse disposal.

The capital city London has a special statute, with the Greater London Authority (GLA) holding some powers allocated to local authorities and counties elsewhere (the GLA covers the 33 local authorities that are part of London). The GLA is responsible for strategic planning, economic development, transport, environment, public health, fire services, police, and culture. Counties have powers in areas of local planning, transport, primary and secondary education, culture and leisure, personal social services, consumer protection, refuse disposal, fire services and police. Districts have competences of local planning (shared with county), registration, housing, environment, culture and recreation([316]).

However, even in many of the policy areas administered by local government, implementation is still largely on the basis of national policy rules and guidelines. This limits the ability of local government to vary the way in which it operates policy much from a nationally set template (for example education, planning)([317]).

([313]) For more details, see http://www.hm-treasury.gov.uk/d/pesa_2011_chapter7.pdf.

([314]) The Scottish and Welsh governments do have some autonomy in running services. On education, local authorities have traditionally run schools (not higher education) although there is now a mix with 'academies' and 'free schools' which are funded centrally and not under local authority control, while other schools remain under local authority control.

([315]) 'personal social services' is usually referred to in the UK as meaning social care for the elderly and disabled (washing, cleaning, providing meals, etc.) and services to provide support to other vulnerable people (e.g. social workers whose job it is to work with problem families and protect children).

([316]) Some local authorities are trying to move to having more shared services where a number of local authorities provide a single service.

([317]) The current UK government has a policy of 'localism' see http://www.communities.gov.uk/localgovernment/decentralisation/) whereby local bodies are meant to be given increasing autonomy.

Table IV.A1.2: **Local government in England - Functions and powers**

Arrangement	Upper tier authority	Lower tier authority
Shire counties	waste management, education, libraries, social services, transport, strategic planning, consumer protection, police, fire	housing, waste collection, council tax collection, local planning, licensing, cemeteries and crematoria
Unitary authorities	housing, waste management, waste collection, council tax collection, education, libraries, social services, transport, planning, consumer protection, licensing, cemeteries and crematoria †, police and fire come under Shire councils	
Metropolitan counties	housing, waste collection, council tax collection, education, libraries, social services, transport, planning, consumer protection, licensing, police, fire, cemeteries and crematoria †	
Greater London	transport, strategic planning, regional development, police, fire	housing, waste collection, council tax collection, education, libraries, social services, local planning, consumer protection, licensing, cemeteries and crematoria †

+ = in practice, some functions take place at a strategic level through joint boards and arrangements.
Source: Commission services.

3. Financial arrangements

Tax

All taxes are set and collected by the British government, aside from Council tax (for local government), and in Scotland the power to vary income tax by 3% (so far unused).

Tax (and social security) policy remains almost entirely the preserve of the UK central government, meaning that, crucially, devolved and local authorities have little control over their overall budgets. By international standards, UK government finances are highly centralised. The UK has 95% of tax revenue going to central government.

About 85% of taxation revenue is collected by national government. Local authorities impose a council tax on property. Scotland, Wales and Northern Ireland set rates for business property taxes, in England they are set by the central authorities. The revenue is allocated to local authorities on a per capita basis. Scotland has control over local government taxation and can vary the rate of income tax, but it has no borrowing powers. The revenue is mainly in form of transfers. Wales and Northern Ireland have no taxation autonomy and receive block grants. The Greater London gets a share of council taxes in addition to intergovernmental grants.

A large proportion of local authority spending is financed from central government grants. However, they are also entitled to levy one tax, i.e. the Council Tax**.** This is a domestic property tax the rate of which subnational governments can change to raise revenue to finance spending, whereas they cannot change the tax base([318]). It provides about a quarter of local funding. Local authorities set the total Council Tax based on their overall budget for the year. Each household pays an amount depending on the value of their home.

The government has powers to ensure that increases in local authority budgets and Council Tax are not excessive. The current Government has decided in April 2012 that any council that budgets for an increase in council tax of 3.5% or more will be capped unless they have their budget passed by a local referendum([319]). Central government has also offered additional grant to councils who budget for increases of less than 2.5%.

([318]) An adjustment is made so that local authorities with low value property and so low council tax revenues get a more generous block grant from central government
([319]) Some councils have predictably responded by budgeting for an increase of 3.49%.

Table IV.A1.2: **Local government in England - Functions and powers**

+ = in practice, some functions take place at a strategic level through joint boards and arrangements
Source: Commission services.

Business rates are a property tax on businesses and other non-domestic properties. Their formal name is national non-domestic rates. The national rates are set by central government. The revenue is collected by local authorities, pooled by central government, and then redistributed to local authorities([320]). As such local authorities don't benefit directly from increased business activity but they are often responsible for providing infrastructure for new commercial development. To remedy the disincentive to development this creates (especially given up-front costs that may not be compensated at the time), the government is introducing a system whereby local authorities will be allowed to retain additional revenue from new commercial developments for a number of years.

Local authorities may also impose charges for services as an additional revenue source and to recoup the cost of service provision where appropriate (for example parking charges and charges for recreational and personal care services). Due to the ongoing squeeze on their budgets as a result of fiscal consolidation, many local authorities are currently increasing both the scope of charges and their level.

Overall the key point to note about the UK system is that although some taxes are collected at local level and a lot of spending is administered at local level, subnational governments have very limited scope to borrow or to affect the overall level of tax and government spending. Fiscal policy in the UK is therefore effectively set and controlled almost exclusively by national government – if the UK misses deficit targets it will not be due to the actions of subnational governments.

Provision of Funds and equalisation

Central government (or the devolved government in Scotland, Wales and Northern Ireland) provides specific and general grants to enable local authorities to deliver all the necessary services. To divide up the funding, the government uses a system that takes into account the number and value of properties in each area, and how much it costs to provide services there. Given this, and that locally raised taxation provides only a minority of local government budgets while central government grants provide the majority, UK local government financing is strongly characterised by equalising transfers.

Local authority spending is the sum of central government support for local authorities within Departmental Expenditure Limits (DEL) and Departmental Annually Managed Expenditure (AME), plus locally financed expenditure in AME (council tax and other local revenue). Central government support for local authorities consists of current and capital grants, and supported capital expenditure (permissions to borrow).

The largest grants are the revenue support grant([321]) and the redistribution of pooled national non-domestic rates (NNDR). These count within the Communities and Local Government (CLG) departmental expenditure limit. Other departments provide grants for specific purposes (for example education) and these also count in the department's DEL, as does supported capital expenditure.

Departmental annually managed expenditure (AME) includes grants that reimburse local authority payments of social benefits - mainly rent rebates and rent allowances([322]) - and capital grants from the lottery distribution funds.

Local authority spending can also be analysed in terms of what the expenditure is for - such as education or social services. Or it can be broken down by economic category such as pay, procurement, subsidies, other grants and capital expenditure. Economic categories are used by the Office for National Statistics in the compilation of national accounts.

Local Authority own expenditure is defined as the contribution of local authorities to Total Managed Expenditure (TME) as measured in national accounts. TME is a consolidated measure in the sense that transactions between parts of the public sector do not add to TME. So, for example, total local authority expenditure defined here excludes

([320]) Redistribution is broadly on a per capita basis but there are some adjustments based on the cost of providing services – for instance Westminster in central London gets extra money for the cost of providing services to the unusually large number of people that pass through the borough and travel around its streets.

([321]) The block grants that central government give to local authorities are funded by a wide range of taxes.

([322]) As most social transfers are paid by central government agencies. Support for rents paid by local authorities (but ultimately funded by central government) is an exception.

capital grants paid to public corporations and interest paid to central government.

Devolved country governments

The devolved bodies are largely unable to use fiscal policy to influence economic performance or to deliver other distributive or redistributive goals. For instance, the current administrations in Scotland and Northern Ireland have both called for the ability to reduce the rate of corporation tax imposed in their territory in order to attract more inward investment. Both have been rebuffed. As noted above the Scottish government does have the power to vary income tax by up to 3p in the pound, but this has not been used to date.

The subnational governments' lack of fiscal powers means they have no direct ability to influence the size of their own budgets. The UK government allocates to each of the three devolved territories a "block grant" out of its general tax revenues, which the devolved bodies then use to fund the public services for which they are responsible. The size of these grants is calculated principally via the Barnett Formula, based on the respective population shares of the four parts of the UK. ([323]) The advantage for the subnational governments is that they have complete autonomy over how to spend the grant.

Weaknesses of Barnett formula: Lack of accountability; there is no clear relationship between taxes paid and services received. A devolved administration has little influence over the size of the block grant and revenues are not related to management or performance of the devolved administration's economy. Overall budget is not needs-based (the Barnett formula is generous to the devolved governments and spending per head in Scotland, Wales and Northern Ireland is significantly higher than it is in England). The UK Government remains responsible for borrowing to meet any shortfall in tax revenues.

Local authorities (applies to England, and in most policy areas to the rest of the UK)

Local governments are mainly funded by grants from central government but they also levy the Council tax.

Local Authorities are also prevented from issuing their own debt, but they are permitted to borrow to finance capital investment. Prudential borrowing regimes for local authorities in England, Scotland and Wales (and for the Northern Ireland Executive in the case of Northern Ireland) were introduced in 2004-05. HM Treasury is responsible for determining the overall affordability of the UK's public sector debt levels against the general economic and fiscal environment, and for advising the UK Government if borrowing within the public sector needs to be constrained.

The UK does not have local income taxes.

4. Fiscal rules

The UK government introduced a new fiscal framework after taking office in May 2010. The three key pillars are the setting of a new "fiscal mandate" targeting the cyclically-adjusted current balance, the setting of a net debt target and the establishment of the Office for Budget Responsibility (OBR), an independent body tasked with producing the official forecast. The fiscal mandate requires that the cyclically-adjusted current budget be on track to be in balance by the end of a rolling 5-year forecast period, currently ending in 2016-17. This is supplemented by a debt sustainability target which requires the public sector net debt as a percentage of GDP to be falling by 2015-16. The OBR must judge whether the chances of the government meeting the fiscal mandate and debt sustainability rule are greater than 50%.

Government spending is set out in the Spending Review which is published every three or four years. This sets out multi-annual limits for predictable spending in every department through "departmental expenditure limits" (DELs). The remainder of spending, mainly social security, debt interest payments, public sector pensions and EU contributions, is classified as "annually managed expenditure" (AME) and is not capped in advance. The devolved administrations are financed through grants from central governments and cannot issue their own debt.

([323]) See http://www.parliament.uk/documents/commons/lib/research/rp98/rp98-008.pdf.

Due to the limited control over their overall budgets that the devolved country governments and local authorities have, and their very limited powers to borrow, the UK's overall fiscal strategy and its performance against fiscal rules are determined almost wholly by the central UK government. In the context of the size of overall UK tax and government spending any fiscal decisions made by subnational authorities have very limited impact.

5. Other relevant institutional features

There are a couple of recent and current reforms to subnational government with implications for subnational policy:

- Abolition of RDAs: Following the 2010 election the UK government decided to abolish the Regional Development Agencies (RDAs) in England. There were nine RDAs which sat above local authorities and below national government. The RDAs did not have any tax raising powers and had limited policy responsibilities and budgets but one of their main roles was in making use of EU funding streams. The RDAs did however have a significant impact on the implementation of the English European Regional Development Fund (ERDF) (2007-2013) programmes both in terms of management - the RDAs were intermediate implementing bodies- and match funding - the RDA budgets were an important source of match funding in the English programmes.

- Localism: The current UK government is pursuing a 'localism' agenda, which seeks to give greater power and flexibility to local communities. This means giving local authorities (and other local groups, inside and outside government) more control over how they allocate their budgets, implement national policy and run services. Historically UK local authorities have been quite constrained by compartmentalised financial allocations from central government and detailed rules on how national policy should be implemented across the country. It is not yet clear how much of a difference the localism agenda will make in practice. However the (national) government's current plans for localism are more about the allocation of spending than its overall level and do not envisage major new borrowing powers for subnational government. Therefore they should not have a significant fiscal impact in aggregate.

ANNEX 2

Results of regressions on the impact of fiscal decentralisation on government expenditures and revenues

Table IV.A2.1: **Results of regressions with primary expenditure of general government as dependent variable (LSDVC estimator, EU27, 1995-2010)**

	1	2	3	4	5	6	7	8	9
VARIABLES	primexp	primexp	primexp	primexp	primexp	primexp	primexp	primexp	primexp
lagdebt	-0.0204*	-0.0173	-0.0144	-0.0192	-0.0125	-0.00912	-0.0118	-0.00653	-0.0168
L. og.	0.190***	0.166***	0.159***	0.166***	0.173***	0.219***	0.220***	0.223***	0.188***
expdec	-0.784***	-0.0405	-0.185***	-0.222***	-0.216***	-0.699***	-0.723***	-0.782***	-0.715***
revdec	0.800***	0.346***	0.437***	0.803***	0.212***	0.863***	0.865***	0.864***	0.957***
Expdec* trsf	0.792***					0.577***	0.607***	0.691***	0.662***
ele	0.123	0.116	0.0258	0.0311	0.0607	0.114	0.118	0.137	0.059
L infl	0.0290**	0.0259*	0.0355***	0.0323***	0.0264**	0.113***	0.112**	0.117***	0.0344***
tradeopen	-0.736*	-0.736	-0.850**	-0.871**	-0.965***	-1.056***	-1.027***	-1.084***	-0.672*
Expdec* tax		-0.298**							
expcov			-0.109***	-0.0953***	-0.0683***	-0.0833***	-0.0805***	-0.0685***	-0.0848***
Expdec* decSoc						0.138			
Expdec* decHealth							0.0405		
Expdec* decGS								0.213**	
Snownrevdec* %tax				-0.524***					
Snownrevdec* trsf					0.744***				
Expdec* decWag									-0.145
Observations	401	401	401	401	401	380	380	381	401
Number of panel	27	27	27	27	27	27	27	27	27

Notes: List of variables: see Table IV.3.4 above. New variables added: Primexp = general government primary expenditures (% of GDP), L.infl = lagged inflation rate, TO = Trade Openness (% of exports plus imports in GDP).
***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.
Source: Commission services.

Table IV.A2.2: **Results of regressions with total revenues and tax burden of general government as dependent variable (LSDVC estimator, EU27, 1995-2010)**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
VARIABLES	totalrev	totalrev	totalrev	totalrev	taxburden	taxburden	totalrev	taxburden
L.D	0.0235***	0.0191**	0.0185**	0,0117	0,0114	0,00967	0.0194**	0.0154*
Rgrowth		-3.697***	-3.612***		-2.333**	-2.235**	-3.643***	-2.350**
Expdec	-0,000552	0,166	0,0297	0,0116	0,142	0,0402	0,0141	0,0292
Revdec	-0,0863	-0.239**	-0.218**	-0.192**	-0.253**	-0.265***	-0.227***	-0.283***
Expdec* trsf		-0,168			-0,131			
Expcov	0.0308**	0.0372***	0.0406***	0.0359***	0.0411***	0.0397***	0.0402***	0.0465***
Ele	-0.201*	-0,0795	-0,0658	-0,0723	-0,107	-0,096	-0,0816	-0,103
L.infl	0,0034	-0,00538	-0,00458		0,00259	0,00312	-0,00428	0,00353
TO	-0,108	-0,327	-0,299	0,111	-0,0995	-0,0683	-0,316	-0,142
L.og	0,00922							
Revdec * tax			0,149	0,115		0.184*		
L.rgrowth				0,536				
Expdec * tax							0.146*	0.128*
Constant								
Observations	405	375	375	348	373	373	375	373
Number of panel	27	27	27	27	27	27	27	27
R-squared								

Notes: List of variables: see Tables IV.3.4 and IV.A2.1 above. New variables added: totalrev = general government total revenues (% of GDP), taxburden = tax revenues of general government (% of GDP), Rgrowth = real growth rate of GDP, L.rgrowth = lagged real growth rate of GDP.
***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.
Source: Commission services.

Part V

Resources

1. ABBREVIATIONS AND SYMBOLS USED

Member States

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EI	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland

SE Sweden

UK United Kingdom

EA Euro area

EU European Union

EU-25 European Union, 25 Member States (excl. BG and RO)

EU-27 European Union, 27 Member States

EU-15 European Union, 15 Member States before 1 May 2004

EU-10 European Union, 10 Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LV, LH, HU, MT, PL, SI, SK)

Non-EU countries

AU Australia

CA Canada

CH Switzerland

JP Japan

KO South Korea

NO Norway

NZ New Zeeland

US(A) United States

Currencies

EUR euro

ECU European currency unit

BGL Bulgarian lev

CZK Czech koruna

DKK Danish krone

EEK Estonian kroon

GBP Pound sterling

LTL Lithuanian litas

LVL Latvian lats

HUF Hungarian forint

RON New Rumanian leu

SEK Swedish krona

SKK Slovak koruna

CAD Canadian dollar

CHF Swiss franc

JPY Japanese yen

SUR Russian rouble

USD US dollar

Other

AMC Asset management company

AMECO Macro-economic database of the European Commission

CAPB Cyclically-adjusted primary balance

CMFB Committee on monetary, financial and balance-of-payment statistics

COFOG Classification of the functions of government

DEA Data envelope approach

DG ECFIN Directorate-General Economic and Financial Affairs

DGS Deposit Guarantee Scheme

DR Debt requirement

DSGE Dynamic stochastic general equilibrium

DWF Discount window facility

EAMS Euro Area Member States

ECB European Central Bank

ECOFIN Economic and Financial Council

EDP Excessive deficit procedure

EERP European Economic Recovery Plan

EFC Economic and Financial Committee

EFSF European Financial Stability Facility

ELA Emergency Liquidity Assistance

EMU Economic and Monetary Union

EPC Economic Policy Committee

ESA(95) European System of National and Regional Accounts

ESM European Stability mechanism

ESSPROS European System of Integrated Social Protection Statistics

EU KLEMS European database on capital, labour, energy, material and services

FDI Foreign direct investment

FIRB Foundation Internal Ratings Based

GDP Gross domestic product

GLS Generalised least squares

IBP Initial budgetary position

ICT Information and communication technologies

IMF International Monetary Fund

INSEE Institut National de la Statistique et des Études Économiques

ISCED International Standard Classification of Education

LGD Loss Given Default

LIME Working group on methodology to assess Lisbon-related Structural Reforms

LTC Long-term budgetary cost of ageing

MTBF Medium-term budgetary framework

MTO Medium-term budgetary objective

NAIRU Non accelerating inflation rate of unemployment

OECD Organisation of Economic Co-operation and Development

OLS Ordinary least squares

PBB Performance-based budgeting

PISA	Programme for International Student Assessment
pp	Percentage points
PPS	Purchasing power standard
R&D	Research and development
RAMS	Recently acceded Member States
RF	Resolution Funds
RoEA	Rest of euro area
ROW	Rest of the world
SCPs	Stability and convergence programmes
SGP	Stability and Growth Pact
SLS	Special liquidity scheme
SSC	Social security contributions
TFP	Total factor productivity
VAT	Value added tax
WGHQPF	Working Group on the quality of public finance
WHO	World Health Organization

2. GLOSSARY

Asset management company Public or private body aiming at restructuring, recovering or disposing of nonperforming assets.

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Basel Committee on Banking Supervision is a forum for regular cooperation on banking supervisory matters aiming at enhancing the understanding of key supervisory issues and improving the quality of banking supervision worldwide. It also develops guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary rules Rules and procedures through which policy-makers decide on the size and the allocation of public expenditure as well as on its financing through taxation and borrowing.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Candidate countries Countries that wish to accede to the EU. Besides the *accession countries*, they include Croatia and Turkey.

Close-to-balance requirement A requirement contained in the 'old' *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus; was replaced by country-specific *medium-term budgetary objectives* in the reformed *Stability and Growth Pact*.

Code of Conduct Policy document endorsed by the ECOFIN Council of 11 October 2005 setting down the specifications on the implementation of the *Stability and Growth Pact* and the format and content of the *stability* and *convergence programmes*.

COFOG (Classification of the Functions of Government) A statistical nomenclature used to break down general government expenditure into its different functions including general public services, defence, public order and safety, economic affairs, environmental protection, housing and community amenities, health, recreation, culture and religion, education and social protection.

Composite indicator: a compilation of several indicators into a single index reflecting the different dimensions of a measured concept.

Convergence programmes Medium-term budgetary and monetary strategies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. Prior to the third phase of EMU, convergence programmes were issued on a voluntary basis and used by the Commission in its assessment of the progress made in preparing for the euro. See also *stability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *budget balance* that follows

automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically-adjusted budget balance See *structural budget balance*.

Defined-benefit pension scheme A traditional pension scheme that defines a benefit, i.e. a pension, for an employee upon that employee's retirement is a defined benefit plan.

Defined-contribution pension scheme A scheme providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account.

Demand and supply shocks Disturbances that affect the economy on the demand side (*e.g.* changes in private consumption or exports) or on the supply side (*e.g.* changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Deposit Guarantee Schemes reimburse a limited amount of deposits to depositors whose bank has failed. From the depositors' point of view, this protects a part of their wealth from bank failures. From a financial stability perspective, this promise prevents depositors from making panic withdrawals from their bank, thereby preventing severe economic consequences.

Dependency ratio A measure of the ratio of people who receive government transfers, especially pensions, relative to those who are available to provide the revenue to pay for those transfers.

Direct fiscal costs (gross, net) of a financial crisis The direct gross costs are the fiscal outlays in support of the financial sector that increase the level of public debt. They encompass, for example, recapitalisation, purchase of troubled bank assets, pay-out to depositors, liquidity support, payment when guarantees are called and subsidies. The direct net costs are the direct gross cost net of recovery payments, such as through the sale of acquired assets or returns on assets. Thus, the net direct fiscal costs reflect the permanent increase in public debt.

Direct taxes Taxes that are levied directly on personal or corporate incomes and property.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*. See also *fiscal stance*.

Early-warning mechanism Part of the preventive elements of the *Stability and Growth Pact*. It is activated when there is significant divergence from the budgetary targets set down in a stability or convergence programme.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 114 of the. Its main task is to prepare and discuss (ECOFIN) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior government officials whose main task is to prepare discussions of the (ECOFIN) Council on structural policies. It plays an important role in the preparation of the *Broad Economic Policy Guidelines*, and it is active on policies related to labour markets, methods to calculate cyclically-adjusted budget balances and ageing populations.

Effective tax rate The ratio of broad categories of tax revenue (labour income, capital income, consumption) to their respective tax bases.

Effectiveness The same concept as efficiency except that it links input to outcomes rather than outputs.

Efficiency Can be defined in several ways, either as the ratio of outputs to inputs or as the distance to a production possibility frontier (see also Free Disposable Hull analysis, Data Envelope analysis, stochastic frontier analysis). *Cost efficiency* measures the link between monetary inputs (funds) and outputs; *technical efficiency* measures the link between technical inputs and outputs. *Output efficiency* indicates by how much the output can be

increased for a given input; *input efficiency* indicates by how much the input can be reduced for a given input.

Emergency Liquidity Assistance (equivalent to lender-of-last- resort), the most traditional tool available to a central bank for dealing with financial instability. It includes both the provision of liquidity to the financial system as a whole through market operations, as well as emergency lending to individual banks. Not all liquidity injections aimed at preventing the spread of a liquidity problem relate to a crisis, as central banks routinely offer liquidity against specified collateral requirements in order to support the orderly functioning of markets.

ESA95 / ESA79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA95 has replaced the earlier ESA79 standard with regard to the comparison and analysis of national public finance data.

European Financial Stability Facility is a company owned by Euro Area Member States created following the decisions taken in May 2010 by the Council. EFSF is able to issue bonds guaranteed by EAMS for up to € 440 billion for on-lending to EAMS in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Eurogroup. EFSF has been assigned the best possible credit rating; AAA by Standard & Poor’s and Fitch Ratings, Aaa by Moody’s.

European semester New governance architecture approved by the Member States in September 2010. It means that the EU and the euro zone will coordinate ex ante their budgetary and economic policies, in line with the Europe 2020 strategy, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. Based on previous discussions on Commission's Annual Growth Survey, each summer, the European Council and the Council of ministers will provide policy advice before Member States finalise their draft budgets.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See also s*tability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Foundation Internal Ratings Based framework used to set minimum regulatory capital for internationally active banks. The Basel II FIRB framework sets minimum regulatory capital requirements using a modified version of an industry model, the so-called Gaussian asymptotic single risk factor model of credit risk developed chiefly by Vasicek.

Fiscal consolidation An improvement in the *budget balance* through measures of *discretionary fiscal policy*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal decentralisation The transfer of authority and responsibility for public functions from the central government to intermediate and local governments or to the market.

Fiscal federalism A subfield of public finance that investigates the fiscal relations across levels of government.

Fiscal governance Comprises all rules, regulations and procedures that impact on how the budget and its components are being prepared. The terms fiscal governance and fiscal frameworks are used interchangeably in the report.

Fiscal impulse The estimated effect of fiscal policy on GDP. It is not a model-free measure and it is usually calculated by simulating an econometric model. The estimates presented in the present report are obtained by using the Commission services’ *QUEST* model.

Fiscal institutions Independent public bodies, other than the central bank, which prepare macroeconomic and budgetary forecasts, monitor the fiscal performance and/or advice the government on fiscal policy issues.

Fiscal rule 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. See also *budgetary rule, expenditure rules*.

Fiscal stance A measure of the effect of *discretionary fiscal policy*. In this report, it is defined as the change in the *primary structural budget balance* relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, government borrowing, or changes in the monetary base. In the context of EMU, the ability of governments to finance spending through money issuance is prohibited. See also *stock-flow adjustment, sustainability*.

Government contingent liabilities Obligations for the government that are subject to the realization of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Growth accounting A technique based on a production function approach where total GDP (or national income) growth is decomposed into the various production factors and a non-explained part which is the total factor productivity change, also often termed the Solow residual.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Integrated guidelines A general policy instrument for coordinating EU-wide and Member States economic structural reforms embedded in the Lisbon strategy and which main aim is to boost economic growth and job creation in the EU.

Interest burden *General government* interest payments on public debt as a share of GDP.

Lisbon Strategy for Growth and Jobs Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up three-year national reform programmes at the end of 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Loss Given Default The loss incurred if an obligor defaults.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt-to-GDP ratio and a 3 % *general government* deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Maturity structure of public debt The profile of total debt in terms of when it is due to be paid

back. Interest rate changes affect the budget balance directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *public debt*.

Medium-term budgetary framework An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annul basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO) According to the reformed *Stability and Growth Pact*, *stability programmes* and *convergence programmes* present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmarks The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the *Maastricht reference value for the deficit* during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the *'medium-term budgetary objectives (MTO)*.

Monetary Conditions Index (MCI) An indicator combining the change in real short-term interest rate and in the real effective exchange rate to gauge the degree of easing or tightening of monetary policy.

Mundell-Fleming model Macroeconomic model of an open economy which embodies the main Keynesian hypotheses (price rigidity, liquidity preference). In spite of its shortcomings, it remains useful in short-term economic policy analysis.

NAIRU Non-Accelerating Inflation Rate of Unemployment.

Non-Keynesian effects Supply-side and expectations effects which reverse the sign of traditional Keynesian multipliers. Hence, if non-Keynesian effects dominate, fiscal consolidation would be expansionary.

Old age dependency ratio Population aged over 65 as a percentage of working age population (usually defined as persons aged between 15 and 64).

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also *structural balance*.

Outcome indicator Measures the ultimate results (outcomes) of policy choices (e.g. education attainment, healthy life years, economic growth).

Output costs from a financial crisis This is the gap between the hypothetical output development without a crisis and the actual output realised against the back of the crisis. Various methods are available to calculate output losses, in particular either using the trend GDP growth or the level of GDP as a benchmark.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Output indicator Measures the technical results (outputs) of policy choices (e.g. number of university graduates, number of patents, life expectancy).

Pay-as-you-go pension system (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees.

Pension fund A legal entity set up to accumulate, manage and administer pension assets. See also *private pension scheme*.

Performance-based budgeting A budgeting technique that links budget appropriations to performance (outcomes, results) rather than focusing on input controls. In practice, performance-informed budgeting is more common which basis decisions on budgetary allocation on

performance information without establishing a formal link.

Policy-mix The overall stance of fiscal and monetary policy. The policy-mix may consist of various combinations of expansionary and restrictive policies, with a given *fiscal stance* being either supported or offset by monetary policy.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method* and *output gap*.

Pre-accession Economic Programmes (PEPs) Annual programmes submitted by candidate countries which set the framework for economic policies The PEPs consist of a review of recent economic developments, a detailed macroeconomic framework, a discussion of public finance issues and an outline of the structural reform agenda.

Pre-accession Fiscal Surveillance Framework (PFSF) Framework for budgetary surveillance of candidate countries in the run up to accession. It closely approximates the policy co-ordination and surveillance mechanisms at EU level.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural budget balance* net of interest payments.

Principal components A statistical technique used to reduce multidimensional data sets to lower dimensions for analysis. This technique provides a compression of a set of high dimensional vectors (or variables) into a set of lower dimensional vectors (or variables) and then reconstructing the original set summarizing the information into a limited number of values.

Private pension schemes The insurance contract specifies a schedule of contribution in exchange of which benefits will be paid when the members reach a specific retirement age. The transactions are between the individual and the insurance provider and they are not recorded as government revenues or government expenditure and, therefore, do not have an impact on government surplus or deficit.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work. See also *tax-smoothing*.

Production function approach A method to estimate the level of potential output of an economy based on available labour inputs, the capital stock and their level of efficiency. Potential output is used to estimate the *output gap,* a key input in the estimation of *cyclical component of the budget*.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public goods Goods and services that are consumed jointly by several economic agents and for which there is no effective pricing mechanism that would allow private provision through the market.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Public-private partnerships (PPP) Agreements that transfer investment projects to the private sector that traditionally have been executed or financed by the public sector. To qualify as a PPP, the project should concern a public function, involve the general government as the principal purchaser, be financed from non-public sources and engage a corporation outside the general government as the principal operator that provides significant inputs in the design and conception of the project and bears a relevant amount of the risk.

Quality of public finances Comprises all arrangements and operations of fiscal policy that support the macroeconomic goals of fiscal policy, in particular economic growth.

Quasi-fiscal activities Activities promoting public policy goals carried out by non-government units.

QUEST The macroeconomic model of the EU Member States plus the US and Japan developed by the Directorate-General for Economic and Financial Affairs of the European Commission.

Recently acceded Member States Countries that became members of the EU in May 2004 and include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Two additional countries, Romania and Bulgaria joined in January 2007.

Resolution Funds Privately financed funds whose function is to support crisis management authorities in their effort to avoid contagion between banks and limiting systemic risk.

Ricardian equivalence Under fairly restrictive theoretical assumptions on the consumer’s behaviour (*inter alia* infinite horizon for decision making), the impact of fiscal policy does not depend on whether it is financed by tax increases or by a widening deficit. The basic reasoning behind this statement dates back to Ricardo and was revisited by Robert Barro in the 1970s.

Securitisation Borrowing (issuing of bonds) with the intention of paying interest and capital out of the proceeds derived from assets (use or sale of) or from future revenue flows.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection, given various changes in the underlying assumptions.

Significant divergence A sizeable excess of the budget balance over the targets laid out in the *stability or convergence programmes*, that triggers the *Early warning* procedure of the *Stability and Growth Pact*.

Size of the public sector Typically measured as the ratio of public expenditure to nominal GDP.

‘Snow-ball’ effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy. See also *government budget constraint*.

Social security contributions (SSC) Mandatory contributions paid by employers and employees to a social insurance scheme to cover for pension, health care and other welfare provisions.

Sovereign bond spread The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also C*onvergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* net of the *cyclical component and one-off and other temporary measures*. The structural balance gives a measure of the underlying trend in the budget balance. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

SYMBOL SYstemic Model of Banking Originated Losses developed by a joint team of Commission services (Joint Research Centre and the Directorate-General for Internal Market and services of the European Commission) together with academic experts on banking regulation aiming at estimating the losses originated in the banking system.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Tax gaps Measure used in the assessment of the *sustainability* of public finances. They measure the difference between the current tax ratio and the constant tax ratio over a given projection period to achieve a predetermined level of debt at the end of that projection period.

Tax smoothing The idea that tax rates should be kept stable in order to minimise the distortionary effects of taxation, while leaving it for the *automatic stabilisers* to smooth the economic cycle. It is also referred to as neutral *discretionary fiscal policy*. See also *cyclical component of fiscal policy*.

Tax wedge The deviation from equilibrium price/quantity as a result of a taxation, which results in consumers paying more, and suppliers receiving less. When referring to labour tax wedge more specifically, the tax wedge is usually regarded as the difference between the difference between the salary costs of an average worker to their employer and the amount of net income that the worker receives in return, the difference being represented by taxes including personal income taxes and compulsory social security contributions.

Total factor productivity Represents the share of total output not explained by the level of inputs (labour, capital or primary product). It is generally considered as a measure of overall productive efficiency.

UMTS Third generation of technical support for mobile phone communications. Sale of UMTS licences gave rise to sizeable one-off receipts in 2001.

Welfare state Range of policies designed to provide insurance against unemployment, sickness and risks associated with old age.

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4. USEFUL INTERNET LINKS

European Union

European Commission	ec.europa.eu
Directorate-General for Economic and Financial Affairs	ec.europa.eu/economy_finance/index_en.htm
Eurostat	epp.eurostat.ec.europa.eu
European Council	consilium.europa.eu
European Parliament	www.europarl.europa.eu

Economics and Finance Ministries

Belgium	www.treasury.fgov.be/interthes	Ministère des Finances - Ministerie van Financen
Bulgaria	www.minfin.bg	Ministry of Finance
Czech Republic	www.mfcr.cz	Ministry of Finance
Denmark	www.fm.dk	Ministry of Finance
Germany	www.bundesfinanzministerium.de	Bundesministerium der Finanzen
Estonia	www.fin.ee	Ministry of Finance
Ireland	www.irlgov.ie/finance	Department of Finance
Greece	www.mnec.gr/en/	Ministry of Economy and Finance
Spain	www.mineco.es/	Ministerio de Economía y Hacienda
France	www.finances.gouv.fr	Ministère Économie, Finances et l'Industrie
Italy	www.tesoro.it	Ministero dell'Economia e delle Finanze
Cyprus	www.mof.gov.cy	Ministry of Finance
Latvia	www.fm.gov.lv	Ministry of Finance
Lithuania	www.finmin.lt	Ministry of Finance
Luxembourg	www.etat.lu/FI	Ministère des Finances

Hungary	www.p-m.hu	Ministry of Finance
Malta	finance.gov.mt	Ministry of Finance and Economic Affairs
Netherlands	www.minfin.nl	Ministerie van Financien
Austria	www.bmf.gv.at	Bundesministerium für Finanzen
Poland	www.mofnet.gov.pl	Ministry of Finance
Portugal	www.min-financas.pt	Ministério das Finanças
Romania	www.mfinante.ro	Ministry of Finance
Slovenia	www.gov.si/mf	Ministry of Finance
Slovak Republic	www.finance.gov.sk	Ministry of Finance
Finland	www.vn.fi/vm	Ministry of Finance
Sweden	finans.regeringen.se	Finansdepartementet
United Kingdom	www.hm-treasury.gov.uk	Her Majesty's Treasury

Central Banks

European Union	www.ecb.int	European Central Bank
Belgium	www.nbb.be	Banque Nationale de Belgique / Nationale Bank van België
Bulgaria	www.bnb.bg	Bulgarian National Bank
Czech Republic	www.cnb.cz	Czech National Bank
Denmark	www.nationalbanken.dk	Danmarks Nationalbank
Germany	www.bundesbank.de	Deutsche Bundesbank
Estonia	www.eestipank.info	Eesti Pank
Ireland	www.centralbank.ie	Central Bank of Ireland
Greece	www.bankofgreece.gr	Bank of Greece
Spain	www.bde.es	Banco de España
France	www.banque-france.fr	Banque de France

Italy	www.bancaditalia.it	Banca d'Italia
Cyprus	www.centralbank.gov.cy	Central Bank of Cyprus
Latvia	www.bank.lv	Bank of Latvia
Lithuania	www.lb.lt	Lietuvos Bankas
Luxembourg	www.bcl.lu	Banque Centrale du Luxembourg
Hungary	www.mnb.hu	National Bank of Hungary
Malta	www.centralbankmalta.com	Central Bank of Malta
Netherlands	www.dnb.nl	De Nederlandsche Bank
Austria	www.oenb.at	Oestereichische Nationalbank
Poland	www.nbp.pl	Narodowy Bank Polski
Portugal	www.bportugal.pt	Banco de Portugal
Romania	www.bnro.ro	National Bank of Romania
Slovenia	www.bsi.si	Bank of Slovenia
Slovak Republic	www.nbs.sk	National Bank of Slovakia
Finland	www.bof.fi	Suomen Pankki
Sweden	www.riksbank.com	Sveriges Riksbank
United Kingdom	www.bankofengland.co.uk	Bank of England

EU fiscal surveillance framework

Stability and Growth Pact:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/index_en.htm?cs_mid=570

Excessive deficit procedure:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy554_en.htm

Early warning mechanism:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy1075_en.htm

Stability and convergence programmes:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy528_en.htm

Sustainability of public finances:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy546_en.htm

Quality of public finances

http://ec.europa.eu/economy_finance/publications/publication_summary12186_en.htm

http://ec.europa.eu/economy_finance/epc/epc_publications_en.htm#Quality%20of%20public%20finances

Lisbon Strategy for Growth and Jobs

http://ec.europa.eu/growthandjobs/index_en.htm

Institute for National Accounts: www.inr-icn.fgov.be

www.deutsche-rentenversicherung.de