Five Countries, Five Models

A Comparison of Fiscal Frameworks

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FIVE COUNTRIES, FIVE MODELS – A COMPARISON OF FISCAL FRAMEWORKS

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Abstract

In recent years, many countries have sought to transform their fiscal frameworks, with the aim of rendering their public finances more sustainable and preventing the emergence of fiscal problems. This report presents the findings of comparative research into the fiscal frameworks of five countries (Denmark, Ireland, the Netherlands, New Zealand and Sweden). All five countries have developed effective fiscal frameworks in the last two decades, and it is evident that they reflect both reactions to past episodes of fiscal laxity and the fostering of a broad consensus on the necessity of a more disciplined and robust framework.

There are noteworthy differences of approach, with the implication that rather than there being an optimal framework, successful ones can take different forms. It is never easy to transplant what works in one national setting to another, but there are several insights from experience in the comparator countries which could provide useful general lessons for building a solid fiscal framework.

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1. INTRODUCTION

In recent years, many countries have sought to transform their fiscal frameworks, with the aim of rendering their public finances more sustainable and preventing the emergence of fiscal problems. In several cases, the development of the fiscal framework was motivated by past problems or deeper crises, and a motivation derived from a sentiment of 'never again,' is prominent.

This article presents the findings of research into the fiscal framework in five countries considered to be comparable with one another, and thus able to offer the prospect of yielding lessons for reforms internationally.[1] Two are Eurozone members, Ireland and the Netherlands; two are Nordic countries, Denmark and Sweden; while the fifth, New Zealand, has a similar economic size to the former and population, while having a unique institutional framework.

The research undertaken consisted of desk research to establish the key features of the respective fiscal frameworks and interviews with experts. The research team has been impressed by the willingness of these interviewees to engage with the project and to provide invaluable insights, and is very grateful to all of them for taking part and drawing attention to relevant documents and developments of the frameworks.[2]

1.1 APPROACH TO INTERVIEWS

To steer the discussion with experts, an 'interview guide' was developed, covering the various aspects of interest in the national fiscal frameworks. This approach was preferred to a more structured questionnaire for two reasons: first it avoided the need to pose simple (even, simplistic) questions on which answers could readily be found by desk research; second it allowed for a degree of customisation to enable the interview to focus on issues the interlocutor was best placed to answer or explain. This guide and a provisional report on the country were sent in advance to the interviewee, in several cases eliciting helpful corrections of the draft report.

In all countries, the list of interviewees included representatives of the ministry of finance, complemented by discussion with independent experts and representatives of other public agencies, notably the national 'fiscal watchdog.' In addition, officials from the IMF and the European Commission were consulted. A list of the interviewees is appended. Interviews were conducted using Teams which allowed an automatic transcript to be taken (subject to obtaining the permission of the interviewees, none of whom refused), greatly simplifying the task of keeping a full account of what was said. Indeed, the project team was agreeably surprised by the quality of the transcripts. To complement the interviews and analyses, a 'validation' workshop was organized at a late stage of the study. Its purpose was to allow the interviewees and the project steering group to discuss the results of the comparison of national fiscal frameworks.

[1] This report was initially used as a background for research for the Finnish government to present the findings of research into the fiscal framework in five countries which were sufficiently comparable to Finland to offer the prospect of yielding lessons for reforms.

[2] None of the interviewees is named in the report, other than in the list provided as annex, and in the small number of instances where there is a direct citation from an interview, it is anonymised. The views expressed by the interviewees do not necessarily represent the views of the entity by which they are employed.

1.2 STRUCTURE OF THIS REPORT

The remainder of this report is structured as follows. The next section presents snapshots of the most salient features of the five frameworks studied, together with a summary table. Subsequent sections, summarise the main findings, focusing on features that contribute to, or detract from, the effectiveness of fiscal frameworks, then at the governance arrangements underpinning them. A concluding section teases out possible general lessons for fiscal framework from the arrangements and experiences of the five countries.

2. SNAPSHOTS OF THE FISCAL FRAMEWORK IN FIVE COMPARATOR COUNTRIES

This section presents concise descriptions of the arrangements in each case studied, highlighting their most distinctive features, and gives a brief assessment of its performance and challenges it faces.[3] Table 1 provides a synopsis of the key features of the respective frameworks. What is striking about the table is the extent to which key attributes are the same or similar in many respects, even though a few of them, as noted above, are divergent.

2.1 DENMARK

Denmark's chequered history with the conduct of fiscal policy manifestly influenced the system now in place, one which has, certainly since reform enacted in the aftermath of the global financial crisis, proved to be broadly successful in dealing with the sources of recurrent spending overruns and setting the public finances on a sustainable path. There are four-year expenditure ceilings based on medium-term projections, and increasing attention is being paid to the longer term in setting fiscal policy.

The most significant move to put an end to recurrent spending overruns was the enactment in 2012 of the Budget Law, which also incorporated the EU fiscal compact into Danish law. This Law introduced a lower limit for the annual structural budget balance and binding multiannual expenditure ceilings for central government, municipalities and regions (starting from 2014), as key measures. Fiscal policy was to be planned such that the annual structural budget balance would not exceed a deficit of 0.5% of GDP at the time of the budget proposal for a given fiscal year, unless there were extraordinary circumstances (The Danish Ministry of Finance, 2021). In calculating the structural budget balance, the Danish authorities use their own method which is more stable and puts more emphasis on directly observable variables than the common EU method.

Over time, the focus of strategy has changed from an explicit target for lowering public debt to an overarching objective of long-term sustainability of public finances, taking into account projections of future pension and other ageing-related expenditure. In preparation for future demographic pressures, gross debt has been reduced to around 30% of GDP and the government has built up a positive net financial asset position. The medium-term structural balance target is set at zero in 2025 and -0,5% of

[3] More detailed descriptions of the fiscal frameworks is appended in: Begg, Iain, Kuusi, Tero & Kylliäinen, Olavi (11.4.2023). "Five Countries, Five Models – A Comparison of Fiscal Frameworks and Lessons for Finland". *ETLA Working Papers No 102*. http://pub.etla.fi/ETLA-Working-Papers-102.pdf

GDP in 2030. The lower limit of the structural deficit was revised in March 2022 and lowered to 1% of GDP, effective from 1st July 2022 (The Danish Ministry of Finance, 2022).

The fiscal watchdog function is provided by the Economic Councils (in the plural because there are two), an institution widely respected across the political parties and by civil society. The economic element of the Councils assesses long-term fiscal sustainability and the medium-term development of the budget balance, as well as whether the expenditure ceilings are complied with and align with the medium-term fiscal objectives.

Assessment of the framework

According to Lobe Suenson et al. (2016) the 2012 budget law 'was adopted in order to break with 35 years of budget overruns which had resulted in comparatively high public spending growth'. One of the main reasons for these overruns was the lack of enforceable sanctions on municipal governments. In 2011, this was addressed by imposing automatic sanctions on budget overruns in the municipalities. The sanctions were afterwards adapted in connection with the Budget Law in 2012. With the Budget Law, Denmark introduced very stringent stipulations regarding how the government, regions and municipalities must respond to breaches of the ceilings. If the central government ceilings are not respected, the Minister responsible must implement corrective measures immediately. If this fails, the Ministry of Finance shall reduce the ceiling of the following year by the appropriate amount.

The expenditure ceilings, in place since 2014, have never been exceeded and this success is attributed by interviewees not just to the sanction rules, but also the consensus on the benefits of fiscal discipline. Recent years have not seen any budget overruns relative to budget plans, in sharp contrast to the preceding decade. Maastricht debt had fallen from 46.1% of GDP in 2011 to 33.7% in 2019, with surpluses in each year from 2014. As elsewhere, Denmark borrowed to fund its pandemic response in 2020, but quickly reverted to its existing expenditure plans after the pandemic, and Maastricht debt has continued to fall, reaching 29.5% in 2022.

The pivotal role of the Economic Councils and the effectiveness of their scrutiny of the government's fiscal proposals was highlighted by interviewees. The Councils also contributed to transparency by being visible in the media. More generally, transparency is enhanced by the relative simplicity of the fiscal framework and the clarity with which it is explained to the public.

Challenges

The Danish framework has undoubtedly worked as intended thus far. As elsewhere, however, the framework will be tested in future in how it accommodates demographic and climate change related problems. As in other similar richer countries, the projected old-age dependency ratio[4] of Denmark is on the rise. The rules-based, yet in exceptional circumstances pragmatic, and forward-looking way of organizing their public finances will still leave the Danes in a sound position to tackle these future challenges. Projections are made decades ahead and fiscal strategy is tailored to ensure long-term sustainability. Overall, the interviewees adjudged the current fiscal framework to be effective and robust.

2.2 IRELAND

Although it was the solvency of the banking system, not fiscal policy per se that triggered the major economic crisis suffered by Ireland as a result of the global financial crisis, it led to a rethink of its

[4] This indicator is the ratio between the projected number of persons aged 65 and over (age when they are generally economically inactive) and the projected number of persons aged between 15 and 64. The value is expressed per 100 persons of working age (15-64). (Eurostat, 2022).

fiscal framework. The system now in place is linked to EU commitments, but has its own features, partly to cope with the unusual structure of the economy in which exceptionally large fluctuations in annual tax revenue from multinational corporations distort the true state of the public finances. For much the same reason, the calculation of the structural balance using the European Commission methodology is badly inaccurate. An expenditure rule, consistent with EU obligations, is at the core of the system and has recently been revised to include a target for the growth, in nominal terms, of government spending.

In Ireland, the preferred measure of the performance of the economy is known as GNI*. As explained by the Irish Central Statistics Office[5], the principal adjustment is to exclude what it calls globalisation effects associated with the activity of so many large multinational companies. GNI* "differs from GDP by the net amount of incomes sent to or received from abroad, so it excludes the net profits of companies that have been sent abroad." It also corrects for volatile movements in depreciation of intellectual property and of leased aircraft – the latter reflecting a sector prominent in the Irish economy. The adjustment to GNI* results in both a lower headline total for the size of the economy and lower growth; these in turn mean fiscal ratios are less favourable than routinely published in comparative tables of EU member states.

An IFI, the Irish Fiscal Advisory Council, was set up informally 2011 and formalised in 2012, ostensibly in response to EU governance reform, but also in response to domestic rethinking of the institutional context. It quickly gained acceptance and has since played a role in enhancing fiscal discipline, despite some disagreements with the government. Its reports are widely used by the media in a parallel channel of accountability.

Assessment of the framework

From difficult beginnings as Ireland implemented the adjustment programme associated with its bailout in 2010, the Irish fiscal framework had proved its worth in the second half of the 2010s. However, according to one interviewee, it remains 'fragile.' As explained above, the prominence of multinational corporations distorts both growth and public finance data, making the performance of the economy harder to judge than in other comparator countries, although the evidence from interviewees is that published EU or OECD data present an overly positive picture. The Commission's assessment of Ireland's draft budget for 2023 was that it 'is in line with the fiscal guidance' issued by the Council. However, a potential concern is that the provisions for annual adjustments in the expenditure ceiling offer too much scope for politically motivated changes.

Interactions between the IFI and the government, though sometimes strained, have contributed to a better quality of scrutiny and the keen sense of 'never again' seems to have been assimilated by political parties and other stakeholders. The response to the pandemic was proportionate and did not call into question the key features of the framework.

Challenges

What to do with the fluctuations in taxes declared by multinationals, sometimes resulting in massive windfall gains, is a complicated issue for fiscal governance, not least because it can give rise to public pressures for increased spending or tax cuts if the inflows are large. A rainy-day fund or some form of sovereign wealth fund are ideas receiving attention, but with no clear proposal yet put forward.

In 2019, the government adopted a new norm of 5% nominal expenditure growth, of which 3 points were real growth and 2 points inflation. For 2023, the rise is to be 6.5% which could be a cut in real terms if the inflation rate remains closer to 10%. The problem may dissipate if inflation abates quickly, but it does highlight the perils of targeting a fixed rate of growth of fiscal aggregates.

[5] https://www.cso.ie/en/interactivezone/statisticsexplained/nationalaccountsexplained/modifiedgni/

2.3 NETHERLANDS

The Dutch framework is considered to be effective and has enabled the government to remain comfortably in line with EU obligations. There is a trend-based expenditure ceiling, covering four main sectors: government, social protection, health and public investment. The ceiling is the outcome of a process culminating in a coalition agreement and is normally expected to last for the duration of the government. Revenue can fluctuate and is the main means by which automatic fiscal stabilisers function (acting, therefore, in a counter-cyclical way). The treatment of discretionary or windfall revenues (or setbacks) has interesting characteristics. The income "ceiling" (some interviewees suggested it should be called a rule) operates in a way that prevents amendments to expenditure plans. This can lead to unplanned tightening or easing of the fiscal stance but is justified on the grounds that whereas government can control spending, it is less able to do so for revenue.

Since the early post-war years, a distinctive and crucial role in the Dutch framework has been played by the independent Centraal Plan Bureau (CPB). It provides independent forecasts and a range of other analyses and, most recently, has been studying the longer-term aspects of sustainability. The CPB also assesses party proposals in advance of elections, in a strictly non-partisan way. A separate body, the Council of State, has a complementary fiscal watchdog role, and is charged with assessing compliance with national and EU rules. The Council of State advises the government and Parliament on legislation and (economic) governance and is one of the High Councils of State. Their independence is guaranteed in the Constitution, and this ensures they are able to carry out their tasks independently of the government. This institutional standing means, as a watchdog, it can not only bark but bite. In addition, a non-partisan advisory group, the Studiegroep Begrotingsruimte (SBR), composed of high-level officials plus the Governor of the Central Bank and the Director of the CPB uses the CPB's medium term projections to provide (non-binding, although they are not easy for the government to ignore) recommendations to the incoming government.

The 2013 Sustainable Public Finances Act (Wet HOF) codified the basic elements of the Dutch trend-based fiscal policy, already established, as well as obligations related to EU commitments, notably the Stability and Growth Pact (SGP). It also enhanced the monitoring of fiscal compliance. In 2010, before the Wet HOF was passed, the Netherlands was put in the corrective arm of the SGP and was required to report under the Excessive Deficit Procedure between 2010–2014.[6] After targets were met, the annual budgetary process in the Netherlands has been more focused on the national expenditure ceilings and the deficit target at the end of the four-year government term, rather than abiding by the EU's MTO. Therefore, meeting it is merely an outcome and not a target in the Netherlands (Vierke and Masselink, 2017, in a paper for the Commission).

Assessment of the framework

All the interviewees praised the fiscal framework and stressed that it has cross-party support, all the more noteworthy because there are so many parties. As in most EU member states, the debt ratio fell between 2014 and 2019, albeit faster in the Netherlands – 67.9% of GDP in 2014 to 48.5% in 2019 – compared with 86.9% in 2014 to 77.5% in 2019 in EU27 countries. After the Wet HOF, the deficits first fell and subsequently turned into surpluses from 2016. In its assessment of the draft budgetary plans for 2023, the Commission rates the Netherlands as being in line with the relevant guidance.

The arrangement for independent contributions to the fiscal framework are both distinctive and effective. As a long-established and powerful agency, the CPB has high standing in the system and the role of the Council of State in monitoring national and specifically compliance with EU rules is

[6] If a country fails to meet the objectives set in the SGP, they are put into the corrective arm of the SGP in which they must take actions to return to following the objectives by implementing the Excessive Deficit Procedure (EDP).

distinctive. Yet the evidence from the interviewees suggests that the EU rules are more in the background than a central element of the fiscal framework. This is corroborated by Vierke and Masselink[7] who note various way in which the national and EU framework is not aligned, even though the Netherlands' fiscal sustainability is not at risk. The proposed new EU approach may well go a long way towards reconciling these discrepancies.

Challenges

The trend-based framework is highly effective in enabling counter-cyclical fiscal policy. During growth periods, the Government accrues buffers to be used in downturns. The challenge comes from defining when it is appropriate to deem a situation extraordinary and to allow for expenditure to be placed outside of the expenditure ceiling.

Long-term fiscal sustainability, especially in terms of financing an aging population's needs, is a challenge, as with most developed nations. There is no clear link between the medium- and long-term in terms of fiscal tools, but the Dutch have built-up large funds to finance such things as pensions, investments, climate action etc. For instance, the state-funded pension fund ABP is among the largest in the world (WTW, 2022). There is also plenty of discussion around long-term fiscal sustainability and it is notable that the CPB calculates generational accounts for 30 years ahead highlighting these issues. How to incorporate these and other public assets into the framework, and not just the liabilities side of the public balance sheet, is a live issue.

There is plenty of information on the system, implying a high degree of transparency. However, the complexity of the framework and the lengthy process leading up to a coalition agreement can make communicating it (especially to the public) harder, a point mentioned by all the interviewees.

2.4 NEW ZEALAND

As is immediately visible from the New Zealand Treasury's own online description, transparency is at the heart of its approach. There is neither an explicit fiscal rule nor an IFI, with the rationale being that public scrutiny is sufficiently great to deter governments from risky fiscal policy. The absence of rules gives each government (the parliamentary term is just three years) the scope to reach its own decisions about the appropriate level of debt, but it is claimed that it also strengthens the commitment to stick to these plans without having to abide by what could be economically inappropriate rules.

At the heart of the framework is the obligation to balance operating spending and revenues – in effect including investment which should be financed by borrowing. This is a golden rule of sorts, yet also relies on independent bodies such as the Infrastructure Commission (established in 2019) which is charged with infrastructure planning and delivery at a strategic level, with the aim of improving economic performance and social wellbeing. Its mandate includes providing leadership but also trying to optimise the mix of public and private funding of projects.

The Treasury (i.e. Finance Ministry) produces long-term fiscal statements at least every four years (spanning up to 40 years ahead) which attempt to anticipate future fiscal trends. However, these do not appear greatly to influence government plans.

There has been discussion about whether an IFI should be established, partly reflecting pressures from the IMF or the OECD, both of which do have a de facto role in this respect. However, there are no immediate proposals on the table in this regard.

[7] Vierke, H, and Masselink, M. (2017) 'The Dutch fiscal framework and the European fiscal rules, *European Economy Economic Brief* 27, https://economy-finance.ec.europa.eu/system/files/2020-12/eb027_en.pdf

Assessment of the framework

There is a political consensus on commitment to the fiscal framework and the empirical evidence suggests that the country's public finances have been comfortably sustainable. They also, more than systems more formally rule-based, afford more room for political choice, on the basis that the overarching principles are respected. Ownership is strong, with each Government being able to define the parameters themselves. Transparency helps, because opposition parties, the media and the public are able to keep track of what governments do and thereby hold them to account. Debt (measured in a different way from the EU's 'Maastricht' methodology) fell substantially after the framework was initiated, but has since started to rise, albeit not to a level that might jeopardise fiscal sustainability.

Challenges

The follow-up to pandemic-related suspension of normal provisions is uncertain and will be influenced by the outcome of imminent elections. There is an open question about whether transparency will continue to suffice or, instead, an IFI should be introduced.

2.5 SWEDEN

Sweden also recast its fiscal framework following the severe economic and budgetary crisis of the early 1990s, and the resulting arrangements are widely supported by political parties and citizens. There is an expenditure rule, in place since 1997, with a wide coverage, albeit unusual in being expressed in nominal terms, rather than being trend-based. Other key features include a one third of a per cent of GDP surplus target for general government net lending and a 35% of GDP general government consolidated gross debt anchor, with the anchor seen as a basis for medium term sustainability, rather than a constraint on the annual budget. These parameters are reviewed every other electoral period.

A notable aspect of the budget process is that the parliament is asked first to approve the aggregate expenditure ceiling, and only in a second vote to agree the allocation of spending. This process has the important implication that the government would be obliged to return to parliament if it decided to increase the expenditure ceiling, something it would be reluctant to do because of the resulting 'loss of face.' Unlike Denmark, the central government does not have instruments for controlling the expenditure of local government, although the latter are obliged to balance their budgets, meaning few obvious risks for the sustainability of general government finances.

The Fiscal Policy Council, established in 2007, just as the global financial crisis started and before becoming something expected of EU member states, has become a key part of the system. Further independent institutions complement the fiscal council, although the Council has the most high-profile role. Its reports and analyses are widely used by the media and the Council's mandate also allows it to examine issues outside fiscal policy. The National Institute of Economic Research and the National Financial Management Authority assess macroeconomic and public sector financial developments, and present recommendations on fiscal policy. All are used by the media to hold the government to account.

Assessment of the framework

The Swedish fiscal framework appears to have worked well: government debt has fallen, markedly since the 1990s and general government has also been posting surpluses most years since. Indeed, one interviewee observed that Sweden now has the best framework in the world. It has more flexibility than most peers through the buffer between agreed spending and the ceiling, but in a period of rapid inflation this could be a problem if public sector wages rise more rapidly. Expenditure ceilings have

not been exceeded, though the ceilings have on occasion been raised, despite the reputational costs for the government of asking for the change.

The independent scrutiny has worked well and has contributed to disciplined public finances, and the Fiscal Policy Council has, using the discretion in its mandate, also contributed to debate on topics outside fiscal policy. Although the surplus target has, latterly, been reduced, Swedish public finances provided plenty of room for manoeuvre for dealing with the pandemic.

Challenges

A nominal expenditure target works well in a low inflation context but could be more awkward if inflation were to become more entrenched. However, the buffer in the expenditure ceiling still offers some protection.

Features of fiscal arrangements	Denmark	Ireland	Netherlands	New Zealand	Sweden
Fiscal responsibility legislation	Yes, since 2012	Yes, since 2012	Yes, since 2013	Yes, since 1994	Yes, since 1997
Independent fiscal watchdog[8]	Yes, since 1962	Yes, since 2012	Yes, since 1945	None	Yes, since 2007
Explicit numerical targets	Medium-term fiscal balance and long-term sustainability targets	5% annual nominal increase limit in spending (6.5% for 2023) and Euro rules	Euro rules: limits of 3% of GDP structural budget deficit and 60% of GDP Maastricht debt	Each government can set their own targets in the beginning of the 3-year term.	35% of GDP Maastricht debt anchor and 1/3% of GDP structural budget surplus target
Expenditure rule	Legally binding multiannual expenditure ceilings for central government, municipalities and regions covering ~75% of public expenditure.	Legally binding multiannual expenditure ceiling applying to almost all public spending.	Multiannual expenditure ceiling covers between 80–90% of general government expenditure.	No expenditure ceiling, but a set target to ensure expenses are consistent with the operating balance before gains and losses (OBEGAL).	Expenditure ceiling that covers nearly all central government spending. It is set in nominal terms for three years at a time.
Explicit provision for longer-term	Structural budget balance target based on long-term calculations of fiscal sustainability	Spending increase limit is based on medium- to long-term provisions	Public investment and pension funds	Plethora of long-term targets such as the debt and OBEGAL targets	Debt anchor to which the surplus target is linked to
Budget balance target[9]	Zero in 2025 and -0,5% of GDP in 2030 with a legislated lower limit: 1% of GDP structural budget deficit limit	None	None	Seeking to maintain steady surpluses to the OBEGAL on average within a band of zero to two percent of GDP.	1/3% of GDP structural budget surplus target
Debt anchor	None	None	None	Maintain net debt at below 30% of GDP	35% of GDP Maastricht debt

[8] A formal requirement for the EU countries was enacted in 2011, but some of the countries have had such institutions long before it was required.

[9] The Budget balance target and the debt anchor do not include the structural budget balance or Maastricht debt requirements set by the SGP.

Simultaneous agreement of aggregate and detailed spending	Yes, to some extent. Much detail agreed annually, however, within the aggregate.	Yes	Yes, but the budget bill must pass two stages: the House of Representatives and then the Senate.	A separate vote for each subject group and appropriations within them first presented together in the Budget Policy Statement.	No. First, a vote on the overall level and then on allocation.
Use of an escape clause during the pandemic	Yes	Yes	Yes	Yes	Not explicitly, but ceilings were raised
↳ Path back to normality	Successful	Successful	Successful	Successful	Successful
Relations with EU obligations	Legislated. Framework is designed to be consistent with EU rules.	Legislated but unclear because of the difficulty of calculating GDP accurately	Legislated but not restrictive. Complex conversion between the EU fiscal rules and national budgetary data.[10]	No relation	Not nationally legislated and not restrictive
Effectiveness	Effective	Effective	Effective	Effective	Effective
Possible weaknesses	Multiple targets (1-year, 4-year, medium-term and long-term) could impede transparency and in some cases flexibility	Difficulty of applying EU rules due to different calculation methods, public pressure to spend windfalls brought in by the MNEs	Reliance on political commitment[11], complexity of the framework	Reliance on political commitment not least due to the lack of an IFI	Reliance on political commitment, local governments
Features to advocate for others	Clear links between long- and medium-term targets	A nominal 5% spending increase rule	Trend-based approach	Focus on transparency	A double-layered budgetary vote

Table 1. Synoptic Overview of Attributes of Comparator Countries

[10] "In the Netherlands, due to different definitions between the SGP fiscal rules and the data from the budget system that Parliament receives, the latter needs to be converted by the MoF and the CBS specialists. Although this conversion is shown on the MoF website, the complexity reduces transparency." (The Fiscal Policy Audit Network, 2022).

[11] Can adversely be seen as a strength of a framework too.

3. OVERVIEW OF KEY FINDINGS

An important general finding is that, despite some notable differences in how they are configured, the five countries studied have effective fiscal frameworks. This finding has two immediate implications. First, it signals that there is no 'ideal' model for the design of a fiscal framework, a corollary of which is that there can be diverse means of achieving the underlying objectives. Second, a framework contains a plethora of 'moving parts' and the manner in which they interact is often more crucial than whether or not a particular feature is absent or present. For EU Member States, however – more so for those participating in the euro – the interaction between legally-binding EU obligations and national provisions can be a further consideration, although for the four European countries, respect of national rules already ensures compliance with EU rules.

History and culture also emerge as significant influences. Episodes of deep economic crisis, often including acute problems in the public finances, have manifestly exerted a powerful influence on how frameworks have evolved: as mentioned above, 'never again' is a potent motivation. At the same time, trust in institutions and political consensus are vital. Crises also offer opportunities for innovations aimed at increasing the robustness of budgetary frameworks, such as the introduction of independent fiscal institutions in countries which did not previously have them.

3.1 LEGAL PROVISIONS

A rigid legal framework encompassing rules and targets is not necessary for a successful fiscal framework and may, in some circumstances, create complications leading to perverse policy choices. However, a broad fiscal responsibility (or similar wording) law is commonly found, including in the five case-study countries. Even, as in New Zealand, where there is an expectation in the Public Finance Act 1989 that the government should aim for a balance between operating revenues and expenditure, it is not a rigid balanced budget rule; instead, it is about a programme for government for the duration of the parliamentary term.

An important finding of the research is that a national consensus on the aims and modalities of the fiscal framework is important. What this means is not easy to define, nor is it obvious if, or in what circumstances, such a consensus might come under threat, but it was a point stressed in most of the interviews. The benefits are, nevertheless, clear: cross-party agreement (and voter expectations) on keeping within the framework reinforces public confidence in the government plan, and even healthy political contestation on tax mixes or spending priorities does not extend into undermining the system. Governments must take ownership and show responsibility. Consensus also helps to deal with economic or other shocks, insofar as it makes it easier to agree on difficult policy choices.

3.2 THE NATURE OF EXPENDITURE RULES AND TREATMENT OF REVENUES

The comparisons reveal two main approaches to the implementation of expenditure rules: a nominal ceiling (as in Sweden) with an unallocated buffer to meet unexpected spending priorities; and trend-based systems (as in the Netherlands) which take account of cyclical fluctuations in the rate of growth. Both have their merits, although the latter tends to be regarded as the better, despite its greater complexity and the risk that it is harder for non-specialists to grasp.

The coverage of expenditure rule varies, with a tendency to exclude obvious cyclical components and interest payments. One of the experts interviewed, in a subsequent written submission, observes that 'there is some trade-off between exclusion from the expenditure ceilings of not policy-related short-

term influences and inclusion of sizeable buffers within the ceilings. At the same time there is also a trade-off between exclusions of various influences from the expenditure ceilings and the overall transparency and potentially ownership of the framework.'

The optimal approach to treatment of revenues, especially if they are windfalls, is also of interest. One relevant contention is that the government has less immediate control of revenues, especially if the tax system is stable, whereas it directly controls expenditure. For this reason, the focus in the four European comparator countries is on controlling expenditure without allowing the ceiling to be altered if revenue changes. One open question is whether to allow at least some change in expenditure in response to revenue changes, especially if they are large, as they might be in periods of inflation when fiscal drag may boost tax receipts.

3.3 SCRUTINY, TRANSPARENCY AND ACCOUNTABILITY

That effective scrutiny enhances the quality of fiscal policy might be considered a statement of the obvious. However, the evidence from the interviews suggests that the mechanisms through which the government is scrutinised can make a difference. As discussed further below, bodies truly independent of government are most desirable and transparency is a valuable tool. Moreover, although it can be uncomfortable for finance ministries, the benefits from effective scrutiny are likely to be reinforced where the media make use of reports from independent fiscal institutions. The IMF now strongly advocates effective IFIs, although New Zealand, where the word 'transparency' is at the forefront of its framework, has so far opted to do without one. Instead, they emphasise the importance of transparent and extensive reporting of public finances.

Consensus within a country on the goals of a fiscal framework complements scrutiny. It undoubtedly helps if voters, perhaps also financial markets, have faith in the importance and effectiveness of arrangements for managing and overseeing fiscal policy. A respected IFI also helps, including by fostering the taking of 'ownership' by the national authorities. Independent scrutiny of fiscal policy and macroeconomic forecasts is important in how it obliges governments, to borrow an expression from one interviewee, to 'up their game,' but accountability is also enhanced if the public and other stakeholders have confidence in how the IFI assesses government actions and choices. The CPB in the Netherlands has had this status for decades, as has the Danish IFI, but the Swedish and Irish IFIs are examples of more recently created entities that have quickly gained credibility.

In addition, as mentioned earlier, rigid frameworks with strict stipulations and sanctions are unlikely to be as effective as the reputational threat to the government of being seen to ignore well-founded analyses or having to change spending plans agreed by the national parliament. An interesting example is in Sweden, where it is open to the government to go back to the Riksdag to seek an increase in the expenditure ceiling. Yet, because of the political cost it would incur, the ceiling has been raised only a couple of times and it has yet to be exceeded in its 25 years of existence.

3.4 THE LONGER TERM

A significant gap in many fiscal frameworks is the limited attention paid to long run fiscal sustainability, although the indications are that it is an aspect of framework attracting increasing attention. There are only few countries (Denmark is an example) that use a calculation method for the budget balance that is in accordance with long-term fiscal sustainability.

There are divergent views on how useful a debt anchor can be, notably in focusing attention on future objectives. An evident difficulty is that a binding target can lead to inappropriate, possibly pro-cyclical policies, as might happen if a downturn in an economy already close to a threshold required fiscal

tightening. Sweden's answer is to conceive of the debt anchor as a device to influence the medium- and longer-term conduct of policy, but not to let it have an undue influence on annual decisions. However, in light of the November 2022 proposal by the EU to emphasise debt sustainability – and its analysis – in a reformed EU system, debt targets (or target ranges) may become more necessary. There is also inherent uncertainty in any sustainability calculations (for example, what is the long-term cost of climate change?).

A related issue is the targeting of the fiscal balance. Countering climate change and ageing are examples of policy objectives expected to require increased public spending in future, implying that efforts should be made in the present to build up budgetary resilience. In relation to ageing, provisions for pensions, especially, but also other age-related spending can be overlooked as a key part of the fiscal framework from two opposed perspective. The first is estimating future liabilities and ensuring that there is a sustainable path towards meeting the 'pay-as-you-go' component of them. At the same time, funded pensions are a source of financing for long-term infrastructure projects, a point emphasised by the Dutch interviewees.

It is vital to link well-defined long-term targets and the medium-term targets. A consensus approach to the linking of long- and medium-term targets is that there should be (1) a broad prescription of the sustainability of public finance, and (2) a (medium-term) path towards the sustainability goal. Sustainability is an elastic concept, and relates not only to public finances, but also to the successful of reforms and broad policy objectives (for example the green transition), as well as welfare and intergenerational fairness.

Among the comparator countries there are different approaches to linking medium-term and the long-term targets, some more prescriptive than others:

- Denmark: the current long-term fiscal strategy is to ensure sustainability of pensions and other current public spending. The aim is to achieve this by setting a medium-term target consistent herewith (while also keeping the annual structural budget balance below a -1% of GDP limit). The argument is that moderate deficits are reasonable to run as real growth and inflation keep the debt stable. This target has been built on long-term forecasts of the demographics and long-term steady state assumptions on public consumption and taxes.
- Ireland: The recent addition of a nominal spending increase cap based on medium- to long-term calculations of fiscal sustainability bolstered medium-term planning, but the framework is still lacking in distinctive long-term targets and tools. The nominal spending increase cap is yet to be legislated. Ireland is also considering diverting windfall tax revenues from multinationals into a rainy-day fund.
- Netherlands: There is no clear link between medium-term budgeting practices and the long-term, but the Dutch have invested heavily into large public funds ranging from investment funds to pension funds.
- New Zealand: has a surplus target for the operating budget balance before gains and losses that is compared to the costs of population aging, not least growing demand for the health sector. There is no explicit procedure to adjust the target mid-term in case of sustainability problems, but each new Government can set its own targets as they wish. New Zealand also protects public investment with an approach that approximates to a golden rule, albeit without being explicitly such a rule.
- Sweden: there is a formal 35% Maastricht debt-to-GDP anchor and a surplus target of one-third of a percentage of GDP on average over a business cycle for the entire general government sector. There is also a clear link between the short- and medium-term, because of how the surplus target connects with the debt anchor. The long-term plans and fiscal tools are revised every other electoral period to reflect the current and future state of fiscal sustainability.

3.5 FLEXIBILITY

Providing sufficient flexibility during crises is widely regarded as an important feature of fiscal frameworks. It is necessary to avoid situations where circumstances beyond the control of the government put unrealistic pressure on the adjustments of fiscal policy. However, a difficulty in balancing fiscal flexibility and sustainability has emerged, as countries have experienced a large and continuous build-up of debt over time (Davoodi et al., 2022; Caselli et al., 2022).

A key development over the last decades has been the introduction of so-called trend-based budgetary ceilings, as discussed above. They exclude factors adding to expenditure but outside the direct scope of fiscal policy from the ceilings and form the basis of the "second generation" of fiscal rules (Eyraud et al., 2018). These influences on expenditure typically include the cost of inflation, unemployment expenditures and interest on public debt. Most prominently, this development is reflected in the EU's expenditure rule, which has been based on monitoring the growth of public expenditure relative to a country's potential output growth (European Commission, 2019). Trend-based models, applied by several of the comparator countries (Ireland, Denmark and the Netherlands), are also recommended by the IMF (Caselli et al., 2022).

The Swedish model, on the other hand, provides an interesting alternative. Only few items are removed from the ceilings, while the purpose of the framework is merely to control for major policy errors. Such a framework is simple, but it also places greater emphasis on (unallocated) expenditure buffers and/or the cooperation between parliaments and governments in the event of major expenditure or revenue surprises. By comparison, a trend-based system is technically more precise and can guide government policy without the need to change the framework in crises. On the other hand, its application is more complex, which makes it more difficult to communicate and monitor the framework.

Based on the interviews, there is no clear ranking between different forms of implementation, but the functioning of the framework largely depends on the political culture of the countries. All the framework models examined (the Netherlands, Sweden, Denmark, Ireland and New Zealand) have recently succeeded in their steering role. This confirms the earlier finding that very different systems can therefore work, which underlines the fact that reactions to shocks are political decisions that are ultimately the responsibility of governments. The success of the rules depends on how the frameworks are combined with the political culture of each country.

3.6 PUBLIC INVESTMENT

A recurring challenge in managing public finances is how to ensure that public investment is protected, especially in periods of fiscal tightening, when it is often easier to cut than public consumption. For the most part, the interviewees were sceptical about resort to some variation on a golden rule, although the manner in which operating (i.e. current) expenditures and revenues are governed in the New Zealand system, with different provisions for investment, has golden-rule features. Obvious objections include the difficulty of defining investment and the risk of lobbying for inclusion of a disproportionate range of public spending commitments. At the same time, climate change and other underlying societal objectives need to be accommodated.

The main alternative, visible in some of the comparator countries, is to develop a coherent medium-term investment strategy, allied to analyses of medium-term fiscal developments. A suggestion from one interviewee is to use 'green budgeting techniques to collect information on and give visibility to the relationship between budgetary policies and environmental objectives.

The interviews and literature also highlighted the importance of external control of investments, which is considered to have a material impact on their quality. It improves decision-making and long-term

planning. Various options for managing both public and publicly supported investments are in place. In the Netherlands, for example, investment funds are used, while in many other countries, investment decisions are guided by expert boards. Due to the public good nature of green investments, arguments have also been put forward for supranational climate funds, although resort to them could lead to clashes between national sovereignty and supranational control.

3.7 ESCAPE CLAUSES

The pandemic led to unprecedented deviations across the world of public deficits and debt-to-GDP ratios from fiscal rules in 2020-2021 (Davoodi et al., 2022). Around 90% of countries with a deficit rule exceeded its limits in 2020, with a median positive deviation of around 4% of GDP. More than half of the countries with the debt rule had debt above the threshold level, with a median deviation of 50% of GDP in advanced economies and 26% of GDP in emerging markets and emerging economies.

Use of escape clauses has been a prominent way to provide additional flexibility during the corona crisis period. While it gave fiscal leeway to respond to the health crisis, the use of escape clauses represents a difficult trade-off between creating room for manoeuvre in economic policy, on the one hand, and risking longer-term sustainability of public finances on the other. Information from the interviews revealed differing approaches to the use of the escape clauses, but in general they are considered to be a good feature of the system (see also, Blanchard et al., 2021; Caselli et al., 2022; Davoodi et al., 2022).

The formulation of the clauses is essential to their success. However, it can be difficult to set precise numerical rules for use, as large shocks are unpredictable, and the associated numerical values are easily politicized. Especially in countries with strong institutions, focusing on the qualitative description of trigger definitions (or even a procedure without a specific clause in the case of Sweden) may be a better option than setting numerical limits. The definition of extraordinary circumstances to justify triggering the general escape clause of the Stability and Growth Pact was cited by several interviewees as possible model. However, it is noteworthy that it could only be used in the event of major disruptions affecting the entire European Union. The optimal compromise between flexibility and limiting debt risk is likely to require greater discretion (Blanchard et al., 2021).

4. GOVERNANCE FEATURES OF FRAMEWORKS

Although the findings of this study do not suggest there is an optimal model for a fiscal framework, there are several features that can contribute to a robust and resilient approach. In one of its many publications on good governance of fiscal policy, the OECD sets out ten principles for success. They are set out in the box below and some of them provide a checklist for identifying characteristics associated with sound fiscal policy.

Box 1. Principles for Sound Fiscal Frameworks, According to the OECD

1. Manage budgets within clear, credible and predictable limits for fiscal policy.
2. Closely align budgets with the medium-term strategic priorities of government.
3. Design the capital budgeting framework in order to meet national development needs in a cost-effective and coherent manner.
4. Ensure that budget documents and data are open, transparent and accessible.
5. Provide for an inclusive, participative and realistic debate on budgetary choices.
6. Present a comprehensive, accurate and reliable account of the public finances.
7. Actively plan, manage and monitor budget execution.
8. Ensure that performance, evaluation and value for money are integral to the budget process.
9. Identify, assess and manage prudently longer-term sustainability and other fiscal risks.
10. Promote the integrity and quality of budgetary forecasts, fiscal plans and budgetary implementation through rigorous quality assurance including independent audit.

Source: OECD (2015) 'Recommendation of the Council on Budgetary Governance', Paris, OECD, Principles of Budgetary Governance–- OECD

Although these kinds of principles can be regarded objectively as desirable, they have to take account of the history, institutional make-up, and culture of a country. Past crises, traditions in fiscal policy (often derived from ideologies), the powers conferred constitutionally on sub-national governments and the relationships with other agencies responsible for macroeconomic management (not least the monetary authority) are all salient. They are bound, also, to influence the scope for reform of the fiscal framework and the overall approach to economic governance.

Nevertheless, the extent of adherence to the OECD principles can be instructive. Thus, in all the comparators, the alignment of budgets with government medium term priorities is evident, being shaped by the manner in which expenditure rules are implemented. Similarly, one of the most compelling findings of the comparative research is the importance of having robust and independent scrutiny of fiscal policy. How this is achieved varies among the countries studied, but the point was made forcefully by interviewees. Parliaments do have an influence, but it tends to be on the biggest decisions and there is some suggestion that from a day-to-day perspective, parliamentary scrutiny is less important.

4.1 GOVERNANCE OF SCRUTINY AND DECISION-MAKING

Well established and supported IFIs are crucial, but even then, there can be variations in the mandates of these bodies. A point made by some interviewees is that the talent pool is a factor to take into account in choosing how ambitious or extensive the role of the IFI should be, especially in smaller countries. The IFI should, nevertheless, be strongly encouraged to have good media engagement. However, it is important to distinguish between the challenges of resourcing an IFI, on the one hand, and conferring tasks and independence on it, on the other. In the three comparator economies with similar sized economies (DK, IE and SE), ensuring the independence of the IFI is paramount and scarcity of experts does not detract from this aim. Ireland's solution is to broaden the talent pool by being prepared to appoint non-nationals as members of its fiscal council. In the Netherlands, the CPB has a much broader remit and has been able to recruit sufficient talent.

The order in which decisions on expenditure are taken can influence the credibility of expenditure ceiling. In this regard, setting the aggregate in a first vote, as in Sweden, and then having a second vote on the allocations among departments, appears to strengthen the expenditure rule. In Ireland, separate Finance and Expenditure Departments is another approach.

Although awareness of the need to pay attention to the quality of public finances (often interpreted to mean how public spending affects growth potential or the realisation of goals such as the green transition, implicit in rule 3 as set out in the box, above) is widespread, some interviewees suggested it was not a prominent consideration. More generally, while more attention is being paid to the longer term, it is an aspect of frameworks that could be improved.

Changing ceilings is a delicate issue. Their strength and, indeed, their underlying rationale are to establish an agreed pathway for public expenditure which should not be modified without a compelling reason, such as a significant economic shock. If an adjustment is, instead, proposed for political reasons, it risks undermining the disciplining effect of an expenditure rule. As one interviewee put it:

> *"It is a major problem when the size of the overall budget is opened for discussion in the middle of the parliamentary term."*

That said, a shock of the magnitude of the Covid-19 pandemic calls for exceptional policy responses, and thus the need for a degree of flexibility in the fiscal framework. In all the comparator countries, emergency programmes were put in place, outside the expenditure rules, although it worth noting that doing so was facilitated by the robust fiscal position achieved previously. The design of COVID measures was largely ad hoc, although most have aged well in terms of the economic recovery, avoidance of scarring in the labour market and lack of lock-in effects.

What is more problematic is the 'return to normal.' It can be difficult to maintain a high quality of public finances when the primary purpose of exceptional funding is stimulation of aggregate demand. Moreover, when a new expenditure rule and cost-of-living measures are introduced after the crisis, there is still pressure to design them quickly (in weeks or even days), possibly leading to poor design and targeting. Striking a balance between fiscal and structural policies can be difficult. In an economy with well-functioning structures, there may be less need for fiscal stimulus during major crises because resilience is already built in.

4.2 THE INFLUENCE OF SUPRANATIONAL OBLIGATIONS

The influence of EU rules and how it may change as a result of the November 2022 proposal from the Commission varies among the comparator countries. For the two participating in the Euro (Ireland and the Netherland), EU fiscal rules have some salience, but they are not at the centre of the fiscal framework, even though for Ireland, in particular, they influenced the reforms introduced after the 2010 bail-out. In the Netherlands, despite a formal duty of the Council of State to monitor compliance with EU rules, the message from interviewees was that as part of the "trend-based" fiscal framework, the expenditure and revenue ceilings are translated to the norms applicable under the SGP. These ceilings could provide stricter or looser application than SGP requirements, but if so, are translated transparently. For Sweden, EU rules are much further in the background and of little consequence. In Denmark, as a member of the ERM II and thus with an exchange-rate target for monetary policy (unlike Sweden), there is an enhanced reason for fiscal discipline. Rules for the annual structural budget balance as well as possibilities for deviating from that limit in exceptional circumstances have been explicitly designed to comply with and incorporate EU rules.

Nearly all the interviewees who commented on them believe key features of the proposed new Commission approach will be improvements. In particular, a shift to country-specific arrangements is welcome. However, the perseverance with the 3% and 60% rules attracted criticism.

5. CONCLUSIONS

After more than a decade of crises, culminating in the suspension of the EU's fiscal rules in March 2020 in response to the exigencies of the pandemic, fiscal frameworks are back in the spotlight. The European Commission's long-awaited proposals on reforming the Stability and Growth Pact and associated fiscal obligations, published in November 2022 (Commission, 2022), triggered a wide-ranging debate on how to rethink the governance of fiscal policy. The findings of this paper, drawing on comparative research into the fiscal frameworks of five countries (Denmark, Ireland, the Netherlands, New Zealand and Sweden), contribute to this debate and point to lessons for others struggling to restore fiscal sustainability.

Although all five countries have developed effective fiscal frameworks in the last two decades, there are noteworthy differences of approach, with the implication that rather than there being an optimal framework, successful ones can take different forms. Variations on a fiscal responsibility act typically provide the legal underpinning for frameworks and setting a pathway for the level of public expenditure (an expenditure rule) is central to the various approaches.

Differences in practice include the proportion of government spending they cover, how to account for inflation, and adjustments to reflect cyclical fluctuations. The sequence of decision-making also varies: in most cases aggregate spending and its allocation among spending ministries are decided simultaneously, but Sweden is distinctive in agreeing the total in a first parliamentary vote, thereby separating from a second vote reflecting the bargaining among departments. A significant flaw in many fiscal frameworks is the limited attention paid to long run fiscal sustainability, but recent developments in the countries examined point to a range of novel approaches aimed at redressing these shortcomings. Allowing for inflation is another challenge for multi-annual spending agreements. Ireland's answer is the recent introduction of an annual nominal increase in the expenditure total, initially set at 5% and based on 3 points of real growth and inflation of two points – it has since been increased to 6.5% nominal growth

The limited role of legislated numerical fiscal rules is striking. Certainly, for Eurozone member, commitments under EU rules are a constraint to be taken into account, but the evidence suggests that it is the national rule and the decision-making processes behind it are what matter most. In times of crisis, difficult decisions need to be made about how and when to suspend fiscal rules. The evidence suggest discretion is to be preferred to explicit escape clauses, but also that more emphasis should be placed on the pathway to restoration of the fiscal rules.

The transformation of fiscal frameworks reflects both reactions to past episodes of fiscal laxity and the fostering of a broad consensus on the necessity of a more disciplined and robust framework. The word 'ownership' is much used, including in the Commission proposals, yet often vaguely defined. Three aspects of it emerge from this paper's findings as salient.

- The first is the expectation that the rule will, in normal circumstances be adhered to, with the corollary that deviations from it are politically costly.
- Second, consensus across political parties reinforces the commitment to the framework, such that even when changes of government alter the composition of public spending and taxation, the macroeconomic commitment to fiscal sustainability is maintained.
- Third effective scrutiny matters. Independent fiscal councils with sufficiently well-thought-out mandates can fulfil this function and the contributions of long-established fiscal institutions (Denmark and the Netherlands) or of more recently established ones (Ireland and Sweden) have manifestly been considerable. But as New Zealand shows, sufficient transparency, enabling media and other forms of scrutiny, can also work well in holding governments to account. Moreover, a solid relationship between the independent bodies and the media can reinforce the impact of both.

It is never easy to transplant what works in one national setting to another, because the framework has to be sensitive to the institutional structure and political context, nor should the transformation of an inadequate framework be expected to happen quickly or without contestation. It could also be argued that the countries examined are relatively small and may not be representative. Equally, their ability to reform their approach comprehensively testifies to a will to ensure 'never again' will they leave themselves exposed to the fiscal crises that befell them in the past.

The lessons to be learned for others are not just technical (design features of the expenditure rule, how to deal with windfall revenues, investment, flexibility mechanisms, etc), but also about resolving governance challenges and fostering a political consensus for change. The underlying lesson is that it can be done.

ANNEX

Denmark

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Lars Heikensten, Chairman of the Swedish Fiscal Policy Council

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