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National Expenditure Rules: Why, How and When

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National Expenditure Rules – Why, How and When

By Joaquim Ayuso-i-Casals[1]

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Summary and Conclusions

1. **Over the past two decades and particularly since the outset of the current financial crisis entailing high deficits and unsustainable growing debt ratios, the role of fiscal governance has been steadily gaining more prominence in the policy debate.** In particular, the current crisis has unveiled the existing institutional shortcomings hampering the conduct of fiscal policy, which were masked in the pre-crisis period by the good economic conditions in a number of Member States. Thus, the need for an appropriate fiscal policy framework has become a key issue.

2. **In the current European context, fiscal governance has a twofold perspective. Firstly, a EU-wide dimension**. This is mainly based on the 2011 reform of the Stability and Growth Pact (SGP) included in the so-called "six-pack", the enhanced monitoring for the euro-area proposed under the "two-pack" currently being negotiated, and the intergovernmental "Treaty on Stability, Coordination and Governance in EMU" (i.e. the Fiscal Compact). All these new institutional arrangements have substantially improved the budgetary policy framework at EU level by addressing the shortcomings identified in the past.

3. **The second dimension of fiscal policy refers to the domestic institutional context in which budgetary policy making is planned, approved and implemented at national level.** This second element has gradually been drawing more attention from analysts and policy-makers. Indeed, the observed failures in attaining sound and sustainable fiscal positions in a large number of EU countries in the pre-crisis period can largely be attributed to the significant weaknesses in the national fiscal governance structures across EU Member States (Ayuso-i-Casals et al. (2007)).[1]

4. **This note focuses on the resort to one specific element of domestic fiscal frameworks, namely national expenditure rules.** The potential benefits of spending norms and their complementarities with other kinds of fiscal rules and other elements of domestic fiscal frameworks are analysed and discussed.

5. **In general, fiscal rules provide a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major component thereof (Kopits, G. and S. Symansky (1998)).** Their main objective is to establish incentives and constraints on the use of policy discretion so as to favour a sound budgetary policy-making and promote sustainable policies.

6. **Economic literature underscores two main reasons justifying the resort to numerical fiscal rules.** Firstly, the growing deficits and public debt ratios registered in the majority of advanced economies over the last decades, i.e. the so-called deficit bias. And secondly, the tendency to implement pro-cyclical fiscal policies leading to significant macroeconomic imbalances and instability in a large number of industrialised countries in the same period. Ideally, fiscal rules should be defined in such a way to promote simultaneously budgetary discipline and macroeconomic stabilization, and their design should include key elements such as timely monitoring mechanisms and appropriate corrective procedures in order to ensure their effectiveness (see Box I in Section 3).

[1] National fiscal governance or domestic fiscal frameworks (in this note the term fiscal frameworks and fiscal governance are used interchangeably) can be defined as the set of elements that form the basis of national fiscal governance, i.e. the country specific institutional policy setting shaping fiscal policy making at national level. The main elements of domestic fiscal frameworks are numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions and budgetary procedures. All these elements interplay with each other influencing the working of the whole system of fiscal governance and, therefore, shaping the final budgetary outcomes (See European Commission (2010)).

7. Each type of fiscal rule has its advantages and disadvantages in relation to these two different policy goals: discipline and stabilization objectives (see Section 3 and the corresponding Table 1). Thus, there is ample evidence that budget balance and debt rules may help tackle the deficit bias but may also be conducive to pro-cyclical policies. This shortcoming may be addressed by the defining budget balance rules on a cyclically-adjusted basis (CAB). However, these rules are surrounded by a significant degree of uncertainty relative to the computation of the output gap and other factors and may involve substantial revisions in the estimated figures for the CAB, which complicates the monitoring of the rules and hampers transparency and accountability. The effectiveness of revenues rules highly depends on their target definition, i.e. revenue rules pre-establishing the allocation of a higher-than-expected tax collection to debt reduction may help avoid the implementation of a pro-cyclical policy in good times while supporting stabilization. However, they cannot in isolation ensure fiscal discipline.

8. Although expenditure rules also have some limitations, they present a number of features that make them particularly appealing relative to other types of rules, and show an appropriate balance between budgetary discipline and macroeconomic stabilization objectives (see Section 3 and Table 1). Thus, spending rules show the following main features:

- They target the part of the budget that the government controls most directly, thereby reducing uncertainty as to the attainment of the established fiscal target and ensuring a higher degree of accountability. In addition, the government publicly commits to an intermediate visible and operational target, i.e. an expenditure objective.

- They also target the main source of the deficit bias, i.e. frequently spending overruns compared to initial targets.

- They are transparent in the sense that the target formulation and monitoring is simpler than for other types of fiscal rules (e.g. CAB or debt rules) and easy to communicate to the public opinion and elected representatives.

- Moreover, expenditure rules hardly prevent automatic stabilisers from operating, particularly on the revenue side, and may also help dampen down spending pressures in good times.

- Finally, they can also be instrumental in improving the composition of government expenditure by breaking down the overall spending ceiling into separate thresholds for each main expenditure area, which in turn provides clear policy guidelines and priorities for policy-makers.

9. Over the recent past, there has been a growing resort to spending rules across EU countries (See Section 2) playing a key role in the most ambitious and successful consolidation plans over the past two decades. A number of reasons may explain the increasing use of these rules and suggest that this will continue in the future (see Section 4):

- **There is ample evidence in the literature that most successful fiscal consolidations have heavily relied on the expenditure side of the budget.** More recent research points also to the importance of the institutional reforms to strengthen fiscal governance for explaining these episodes of effective fiscal retrenchment. These reforms include the

introduction of fiscal rules, and in particular for those more outstanding country-specific cases the implementation of expenditure rules (e.g. NL, SE, DK and FI). More specifically, expenditure rules seem to have not only reinforced spending control but also to have increased the effectiveness of budget balance rules.

- **A second element indicating the importance of spending control and the use of expenditure rules to effectively ensure an adequate monitoring of spending developments is related to the origins of the fiscal imbalances across EU countries.** A close analysis of the reasons behind the failure of a large number of Member States to achieve their targets in the period 1998-2006 (i.e. since the launch of EMU in 1998 up to just before the outset of the crisis) provides interesting policy conclusions.

- **This analysis shows that the failure to stick to the initial expenditure targets included in the SCPs during this period explains to a large extent the weak underlying budgetary positions in a significant number of countries in 2007 when the crisis started (see Box II in Section 4).** In other words, the failure to attain the projected reductions in the general government deficits were primarily caused by the difficulties to adhere to expenditure plans. This was not due to particularly unfavourable macroeconomic conditions but rather to the problems encountered to implement the required reforms which were necessary to respect the spending objectives.

- **This calls for a greater monitoring of expenditure developments compared to initial plans when assessing the fiscal performance of EU countries and for appropriate institutional fiscal reforms to ensure a more effective spending control.** The implementation of binding expenditure ceilings coupled with an effective and consistent system of medium-term expenditure management in those MSs showing more institutional fiscal weaknesses is of outmost importance. Similarly, a more detailed specification (ex-ante) of the measures and reforms envisaged to achieve the spending objectives in line with the current European Semester exercise is crucial.

10. All these arguments also explain to a large extent some of the reforms recently implemented in the EU fiscal surveillance framework (mainly the reformed SGP contained in the "six pack"), and in particular the introduction of an expenditure benchmark. While this expenditure benchmark tries to cater for some of the policy mistakes occurred in the 2000s, it cannot be considered *stricto sensu* a spending rule at EU level but rather a policy instrument providing guidelines to ensure consistency between expenditure developments and GDP growth prospects (see Box III in Section 4). Specifically, Member States will have to monitor and control public spending developments in line with a realistic potential GDP growth over the medium-term in order to ensure the achievement of the MTOs.

11. In this connection, it is important to underline that both the MTOs and the expenditure benchmark approaches included in the reformed SGP are not different but complementary targets and can be considered the two sides of the same issue (see Annex III). Thus, the respect of the expenditure benchmark is conducive to the achievement of the MTOs and they cannot be considered two different requirements. Member States should put in place the adequate institutional reforms (e.g. the introduction of an expenditure rule together with the appropriate monitoring and corrective mechanisms) to ensure that the domestic conduct of fiscal policy is in line with the new policy provisions included in the EU fiscal framework.

12. The appropriate design of expenditure rules shares with other types of rules some desirable features. These refer mainly to the need for timely monitoring, effective corrective mechanisms in case of non-compliance, well-defined escape clauses and strong political support to their respect (see Box I in Section 3). The lack of these elements may significantly hamper the functioning and effectiveness of the rule.

13. By contrast, some specific design features are particularly relevant for spending norms and deserve accurate attention. These range from the target definition to issues related to the implementation of such a rule in a context of fiscal decentralisation. (See Section V). These design issues can be summarised as follows:

- **The target definition should be set in level or as a growth rate.** This is because the alternative definition expressed as a percentage of GDP (rarely observed in practice) may entail pro-cyclical policies (See sub-section 5.1). In practical terms, the target should be typically set with a reference to a growth rate at the planning stage of the budget process. However, a level ceiling may actually be the binding objective at the approval and execution stage. A further complication may arise in a multiannual setting. With a simple growth approach, the "memory" of previous under or over spending may be lost. In this case, a sort of cumulated growth approach over the whole period covered by the rule may be advisable, particularly in relation to possible correction mechanisms.

- **The choice between real and nominal targets is less straightforward (See sub-section 5.2).** A spending target defined in nominal terms has the advantage of transparency and facilitates its monitoring. Additionally, it can also help keep expenditure under control, through a stronger-than-expected real adjustment, if the inflation outcome is higher than previously anticipated. Conversely, if inflation is lower than expected in a context of a slowdown, nominal expenditure targets may also act countercyclical, albeit at the expense of a budgetary deterioration.

  In contrast, if the target is defined in real terms at the planning stage, compliance is not affected by inflation developments, and it may be less straightforward to measure and assess its fulfilment at the execution stage (i.e. price deflators differ across public expenditure categories and they may also differ from the GDP deflator). Additionally, the translation from real ceiling to a nominal spending figure may open the door to revise the deflator to obtain additional spending room hampering transparency and credibility. However, within a medium-term perspective, real spending targets are more sensible if the government intends to keep stable the real volume of goods and services provided by the public sector.

  All in all, the final and more appropriate choice between nominal and real targets should be based on the previous considerations and real policy experiences. On the one hand, a real expenditure target may not be appropriate if it is used as an operational annual target in the short-term (i.e. an annual real expenditure target might be difficult to meet and destabilising as it may imply significant adjustments in line with price developments and sizeable in-year revisions, which may also complicate the annual budgetary execution). On the other hand, real targets make more sense over a medium-term perspective while multiannual nominal ceilings can only be properly set if they stem from a previously established real expenditure path. As a result, it seems

advisable to have nominal targets as the annual policy target (i.e. no change during the budgetary execution even if there are inflation surprises) and real targets in the medium-term, in particular by adjusting (totally or partially depending on the budgetary and macroeconomic objectives) these multiannual ceilings in line with price surprises.

Overall, it appears sensible to follow a real growth approach when setting up the budgetary figures in the annual budget law and medium-term budgetary framework at the planning stage, while adopting a nominal approach at the execution stage in order to avoid pro-cyclicality as well as problematic and inappropriate in-year adjustments.

14. The coverage of the rule with respect to expenditure budgetary items is also important (See sub-section 5.3). The exclusion of some items may be sometimes justified. However, it must be clear that these exclusions weaken the link of the rule to the sustainability objective. The following items deserve particular attention:

- Interest payments are often excluded since it is generally considered that they are not under the direct control of the government (at least in the short-run) and their exclusion may allow to better evaluate fiscal consolidation efforts (i.e. if interest payments had been overestimated during the budget preparation, an expenditure target including them could be met with a relatively modest effort and might imply a pro-cyclical policy). However, their exclusion tends to weaken the comprehensiveness of the spending limits, and therefore the rule cannot fully ensure consistency between expenditure developments and debt and tax burden objectives.

- Another suggested candidate to be excluded from expenditure ceilings is public investment (i.e. a golden expenditure rule). This would avoid that the largest part of an expenditure adjustment falls on such growth-oriented spending items, which are less politically sensitive to cut. Nevertheless, experience shows that this kind of exclusions can favour creative accounting and opportunistic reclassification of spending items so as to circumvent the rule.

- Finally, cyclically sensitive items are typically candidates to be excluded from the coverage. This is generally justified by the fact that some expenditure categories, such as unemployment benefits, are not under the control of government in the short-run. As a result, their inclusion under the ceiling may entail undesirable spending cuts on other items while hampering the countercyclical properties of spending rules. Additionally, the inclusion of this cyclical spending under the ceiling may cause other type of problems: e.g. during an upswing the cyclical expenditure decrease may open up new room for a rise in other expenditure categories, which may be of structural nature and complicate the adjustment in the subsequent business cycle downturn. Finally, if they are included in the target definition of the rule, this could also make more difficult to assess the real fiscal effort of the government in good times.

  However, the exclusion of these cyclically sensitive items weakens the link with the sustainability objective. For instance, the exclusion unemployment benefits should only consider their cyclical component, while keeping their structural part under the ceiling, which is far from being an easy technical task.

15. As for the accounting system, the use of the ESA95 methodology appears advisable so as to be consistent with the EU fiscal surveillance framework (See sub-section 5.4). However, the higher availability of cash data and the need for timely monitoring to allow prompt action in case of deviation from the adjustment path suggests that a dual approach could be envisaged, i.e. the rule could be defined in cash terms with a parallel mechanism of translation in ESA95 on a quarterly basis.

16. In general, a multi annual rule is always superior to a rule that only sets a target for one year since circumvention becomes more difficult in the former case (See sub-section 5.5). An annual spending rule may be easily circumvented by postponing the recording of expenditures to the following budgetary year and is more subject to creative accounting practices. When the target is set for several years, the possibility to postpone expenditures or structural adjustments to the future to circumvent the rule is more unlikely. Besides, expenditure rules incorporated into medium-term budgetary frameworks, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances while making stabilisation and consolidation objectives more compatible. *Stricto sensu,* from a policy applied point of view, an effective fiscal rule can only be considered as such if it incorporates a multiannual dimension with binding objectives over time. In the absence of this time dimension, fiscal rules can easily be circumvented.

17. Mechanisms for providing policy responses to past deviations from the rule are also important (See sub-section 5.6). In case the deviation from the expenditure path stems from temporary and non-systematic causes there should be no need for adjustment measures. By contrast, should these deviations come from structural factors that can imply a more permanent deviation from the spending targets, incentives and mechanisms to correct these past deviations appear an important element in the design of the rule to ensure its credibility. This has been incorporated in the "Treaty on Stability, Coordination and Governance in EMU" (i.e. the Fiscal Compact) by requiring the introduction of correction mechanisms in the domestic fiscal frameworks.

18. The introduction of an expenditure rule covering all general government sub-sectors could be instrumental in ensuring that fiscal decentralisation and budgetary discipline are compatible (See sub-section 5.7). However, it must be underlined that a spending rule establishing binding expenditure ceilings for all government layers cannot guarantee by itself the consistency of spending developments carried out by each level of government with an overall fiscal target for the entire general government sector. Other institutional reforms are needed to ensure this consistency and they have been enshrined in some cases in the so-called Internal Stability Pacts (ISP). The following aspects normally included in these internal pacts deserve particular attention:

- The timely availability of expenditure data for all government layers is an indispensable pre-requisite to establish an efficient monitoring of spending trends allowing to adopt prompt policy measures in case spending slippages are identified. A pre-established calendar for data dissemination should be established in advance so as to promote transparency.

- There must be a clear-cut sharing of policy responsibilities across layers of government. This would allow determining which spending functions are assigned to each tier avoiding responsibility-shifting while facilitating the correct assessment of the needed resources to carry out these tasks (i.e. this could help better estimate expenditure developments and set the appropriate expenditure ceilings accordingly).

- The distribution of expenditure powers should be accompanied by a stable financing system for territorial governments. These funding mechanisms should be based on fair and transparent rules governing transfers to sub-national authorities and the working of tax-sharing schemes. Additionally, a proper degree of tax autonomy in accordance to the spending powers assigned to lower levels of governments should also be considered to avoid vertical fiscal imbalances and promote joint fiscal responsibility. All these rules and procedures governing the funding system for territorial governments must be made public, which should increase transparency and accountability.

- Transparency should also be present in the monitoring and enforcement mechanisms put in place to ensure the correct functioning of the spending and revenue schemes implementing the distribution of fiscal powers and responsibilities across government tiers.

19. Finally, the establishment of an expenditure rule should also cover the social security, which represents an important share over total public expenditure in most EU countries. In this case, the introduction of spending norms should take into account some idiosyncratic features of this particular sub-sector. Firstly, the institutional arrangements shaping the administrative functioning of the social security is country-specific and varies significantly across EU Member States (e.g. in some countries the social security system is highly centralised while in other Member States it is operated by territorial governments). And secondly, some of the goods and services provided by this subsector present a number of peculiarities compared to other goods and services supplied by other public sector entities (e.g. the cost of health care services which are significantly influenced by technological changes and ageing).

20. Admittedly, there is a number of measures that can be adopted in the short-term to contain and control social spending on pensions, health care and other social entitlements. However, the strong inertia of these spending items and the budgetary costs stemming from ageing and technological developments require more fundamental and far-reaching measures of structural nature to ensure that any expenditure rule applied to the social –security is respected over the medium-term (e.g. structural reforms such as parametric reforms applied to the public pension system or cost-effective considerations in the health care sector). In this respect, the last Kopits and Symansky's criterion (See Box I), which well-designed fiscal rules should meet, is crucial in the case of social security spending rules, i.e. rules can only be effective if they are supported by efficiency-oriented policies and underpinned by structural reforms.

21. Policy experiences clearly point to the need to complement the introduction of expenditure rules with some other measures to upgrade the whole fiscal framework (See Section 6). Some of these elements are crucial to ensure that the functioning of expenditure rules will effectively address the deficit bias and contribute to public spending control. To this end, the following elements should be taken into account:

- A first important element refers to the functioning of the most primary elements of the fiscal framework in a transparent and effective manner. For instance, the use of a common standardised accounting methodology in the whole public administration and the need for regular availability of budgetary statistics are key preconditions. Likewise, the existence of regular intra-year monitoring and timely reporting for the main expenditure and revenue categories for all government layers are crucial to ensuring a proper functioning of the fiscal framework (e.g. the respect of fiscal rules). Appropriate public finance management procedures based on the introduction of expenditure commitment controls are critical since they would ensure that any planned expenditure will be checked against the availability of resources (i.e. budget appropriations) before a definitive payment commitment is approved. Finally, the production of unbiased and realistic forecasts on which the budget preparation is based is also critical to ensure a sound fiscal planning.

- Sound budgetary procedures governing all the procedural rules covering the three stages of the budget process, namely planning, approval and execution are also critical for the appropriate functioning of rules. In particular for expenditure rules, those dimensions of the budget process directly linked to the centralisation of the planning and approval of the budget laws are of outmost importance (e.g. strong Minister of Finance with veto power over line ministers and the use of top-down budgeting). Likewise, the gradual introduction of performance budgeting linking budgetary allocation to efficiency criteria and the regular conduct of spending reviews may be instrumental in promoting savings and productivity gains.

- The comprehensiveness of the annual budget laws limiting the use of extra-budgetary funds outside the standard budget process and off-budget operations is crucial to ensure transparency and accountability for a proper functioning of an expenditure rule.

- Country policy experiences show that the extensive use of tax expenditures can significantly undermine the main objective of an expenditure rule, i.e. coping with the deficit bias from the spending side with a view to improving the overall budget balance. The result can be that large tax expenditures do away with a significant part of the benefits of spending restraint due to lower tax receipts (i.e. well-identified spending is substituted by tax expenditures, which are less transparent, less predictable and less controllable). A strict control of this policy instrument together with the introduction of binding floors for discretionary tax measures are critical to ensure the effectiveness of an expenditure rule.

22. All in all, spending rules may be an effective policy instrument to tackle the deficit bias while showing a number of desirable characteristics in terms of transparency, controllability and simplicity. However, they also need to be into operation together with other types of rules to ensure the overall objective of fiscal discipline by also considering the revenue side of the budget. The appropriate combination of fiscal rules is to some extent country specific and should reflect domestic circumstances, including political, legal and cultural factors.

23. However, some common principles stemming from successful country experiences can be identified. Successful multiannual spending rules embedded into a medium-term budgetary framework (MTBF) have generally been adopted as cornerstones of an ambitious plan for institutional reform and fiscal consolidation. For instance, the Netherlands, Denmark, Sweden and Finland put in place during the 90s rule-based systems, in which an expenditure rule is combined with revenue or cyclically adjusted budget balance rules. Overall, it seems advisable to set an appropriate combination of spending ceilings and floors on discretionary tax measures, including limits on tax expenditures, and a clear and transparent link of these elements with the established CAB objectives.

24. Finally, strong political support and commitment to the respect of the rule is essential as well as a certain social consensus on the need to conduct sound and sustainable fiscal policy with a particular emphasis on spending control.

1. – Introduction:

1. **Over the past two decades with the introduction of EMU, and particularly since the outset of the current financial crisis, the quality of fiscal governance has been steadily gaining more prominence in the policy debate.** The crisis has unveiled the existing institutional shortcomings hampering the conduct of fiscal policy, which were masked in the pre-crisis period by the good economic conditions in a number of EU Member States.

2. **In the current European context, fiscal governance has a twofold perspective. Firstly, a EU-wide dimension**. This is mainly based on the 2011 reform of the Stability and Growth Pact (SGP) included in the so-called "six pack", the enhanced monitoring for the euro-area proposed under the "two-pack" currently being negotiated and the intergovernmental Treaty on Stability, Coordination and Governance in EMU" (i.e. the Fiscal Compact). All these new institutional arrangements have substantially improved the budgetary policy framework at EU level by addressing the shortcomings identified in the past.

3. **The second dimension of fiscal policy refers to the domestic institutional context in which budgetary policy making is planned, approved and implemented at national level.** This dimension has gradually been drawing more attention from analysts and policy-makers. Indeed, the observed failures in attaining sound and sustainable fiscal positions in a large number of EU countries in the pre-crisis period can largely be attributed to the significant weaknesses in national fiscal governance EU countries (Ayuso-i-Casals et al. (2007)).[2]

4. **National fiscal governance or domestic fiscal frameworks can be defined as the set of elements that form the basis of national fiscal governance, i.e. the country specific institutional policy setting shaping fiscal policy making at national level.[3]** Domestic fiscal frameworks concern the overall system of arrangements, procedures and institutions that underlies the planning and implementation of domestic budgetary policies. The main elements of domestic fiscal frameworks are numerical fiscal rules setting binding objectives in terms of a budgetary aggregate such as a budget balance target or an expenditure ceiling (Kopits et al. (1998)),[4] medium-term budgetary frameworks (MTBFs) for multiannual fiscal planning (European Commission 2007), independent fiscal institutions supplementing national authorities in a number of technical tasks related to fiscal policy making (e.g. the provision of macroeconomic forecasts for the budget preparation (European Commission 2006)) and domestic budgetary procedures encompassing all the procedural rules covering the planning, approval and execution of the annual budget law. All these elements interplay with each other influencing the working and performance of fiscal frameworks (European Commission 2010).

5. **Among these elements, the role played by numerical fiscal rules in improving the conduct of budgetary policy and attaining better fiscal outcomes has been underscored by both the literature and a number of country-specific policy experiences.** Depending on their design features, these fiscal arrangements have proved to be instrumental in tackling two important potential pitfalls in the conduct of fiscal policy. Firstly, the growing deficits and public debt ratios registered in the majority of advanced economies over the last decades, i.e. the so-called deficit bias (Roubini et al. (1989).[5] Secondly, the tendency to run pro-cyclical

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[2] In this respect, the "six pack" includes a Directive on requirements for national budgetary frameworks, which aims at improving the conduct of fiscal policy domestically.

[3] In the present note the term fiscal frameworks and fiscal governance are used interchangeably.

[4] This definition excludes those targets that may be revised frequently without any constraint (e.g. fiscal targets included in most medium-term budgetary frameworks currently in place in a large number of EU countries).

[5] This bias is mainly caused by political economy factors, particularly the electoral cycle and the common pool problem. The latter arises when several players representing different interest groups or constituencies bargain over the distribution of public resources to maximize their own allocation without internalizing the overall budget constraint. For an overview of these political economy factors see Ayuso-i-Casals et al. (2009).

fiscal policies in good times by overspending when the amount of resources is more abundant, which will need to be offset by a subsequent round of pro-cyclical budgetary measures in the downswing of the business cycle to curb deficit and debt developments (Tornell et al. (1999)).

6. The influence and the assessment of fiscal rules on budgetary outcomes can be seen in relation to these two different, albeit interrelated, undesirable outcomes, i.e. the deficit bias and pro-cyclicality. In other words, ideally fiscal rules should be designed in such a way to promote simultaneously budgetary discipline and macroeconomic stabilization. Recent research provides ample evidence on the beneficial impact of fiscal rules on budgetary discipline.[6] This positive influence on budgetary performance is also confirmed by a number of country-specific experiences such as the Nordic countries, NL and BE in the 1990s. By contrast, the relationship between fiscal rules and macroeconomic stabilization is less clear-cut. There is significant evidence that discretionary fiscal policy tends to be pro-cyclical (Balassone et al. (2007) and European Commission (2006)). However, the contribution of fiscal rules to stabilization highly depends on the type of rule and its design features. Simple balanced budget rules can actually increase pro-cyclicality, while other types of rules such as expenditure rules or cyclically-adjusted budget balance rules (or a combination of both) may be more conducive to an appropriate balance between discipline and stabilization.[7]

7. Against this background, expenditure rules present a number of features showing a proper balance between discipline and stabilization purposes. Spending rules target the part of the budget that government controls most directly, which may reduce uncertainty in relation to the attainment of the established target, enhance accountability and address the main source of the deficit bias, i.e. overspending (particularly in good times). Likewise, spending rules hardly prevent automatic stabilisers from operating, and the target formulation and monitoring are simpler than other types of rules, which promotes more transparency. Additionally, the role of expenditure rules in the domestic fiscal policy making has been enhanced by the inclusion at EU level of the so-called expenditure benchmark within the "six pack". This should promote a more intensive resort to spending rules domestically.

8. This note focuses on the use of expenditure rules so as to improve the conduct of fiscal policy and promote the respect of the SGP provisions. The potential benefits of spending norms, their appropriate design features and their complementarities with other types of rules and other elements of the domestic fiscal frameworks are discussed. The note is organised as follows. Section 2 provides a quick overview of the main features of the current domestic expenditure rules in the EU. Section 3 compares the properties and advantages of spending rules relative to other types of rules. Section 4 focuses on the importance of expenditure control to keep public finances on a sustainable footing and shows how spending rules may be instrumental in this respect. Section 5 deals with the main design issues of expenditure ceilings, while Section 6 looks at other elements of domestic fiscal framework playing a crucial role to ensure a proper functioning of spending norms. General information on national spending rules in 2010 is included in Annex I, while Annex II provides a more detailed description of some country-specific examples. Finally, Annex III discusses the equivalence between the expenditure benchmark and MTOs approaches in the current EU fiscal framework.

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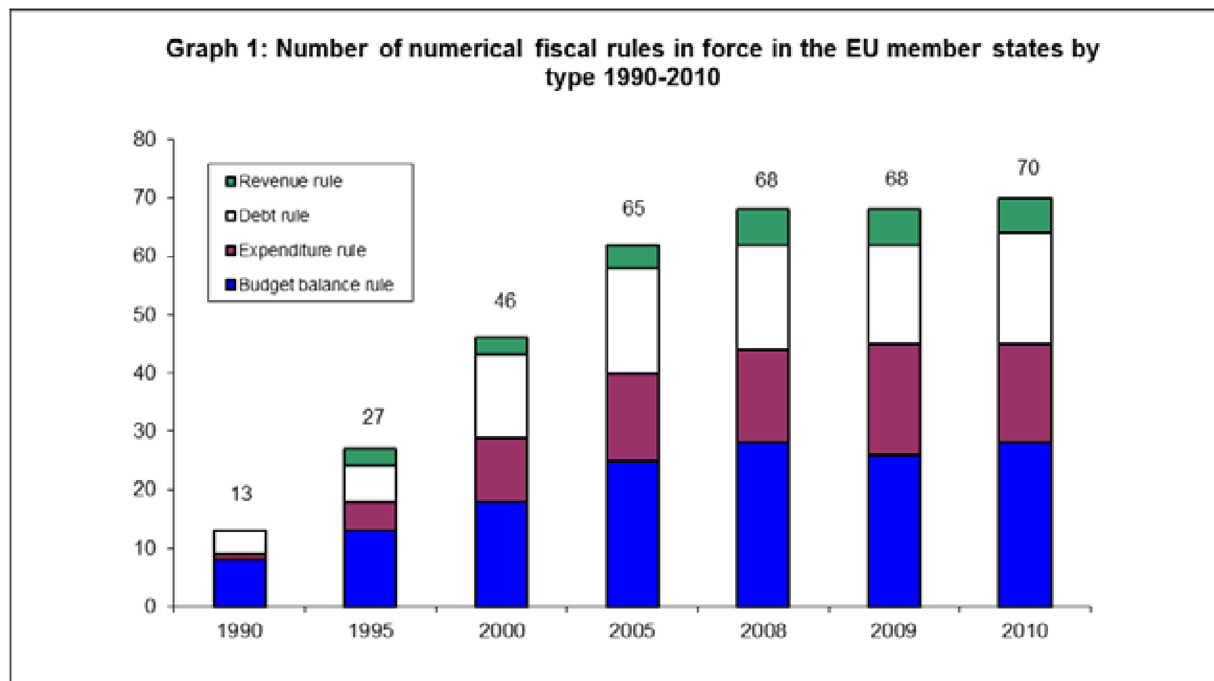
[6] For the positive relationship between fiscal rules and better budgetary results see Debrun et al. (2008), European Commission (2009) and Marneffe et al. (2010). More recently, Iara et al. (2011) show that those countries having in place well-designed fiscal rules keep risk premiums for government bonds at lower levels.

[7] Current trends suggest the gradual emergence of a "next-generation" of fiscal rules, which try to be more flexible in terms of stabilisation purposes and more binding at the same time (IMF (2012)). This is pursued by the introduction of fiscal targets defined in cyclically-adjusted terms, the consideration of escape clauses for exceptional circumstances, and the inclusion of automatic corrective mechanisms. Overall, this "next-generation" of rules seeks to allow the free working of automatic stabilisers.

2. – <u>A quick overview of the existing national expenditure rules in the EU:</u>[8]

9. Over the period 1990-2010 there has been a growing use of fiscal rules in a large number of countries, and in particular in EU Member States. While in 1990 there were thirteen fiscal rules in place across EU countries (i.e. including all types of fiscal rules), in 2010 this figure had increased to seventy.

10. By type of rule, budget balance rules are the most widely used, making up 40% of the total rules into operation. Debt rules and expenditure rules amounted to 28% and 25% respectively, while revenue rules represent 7% over the total (see Graph 1 below).

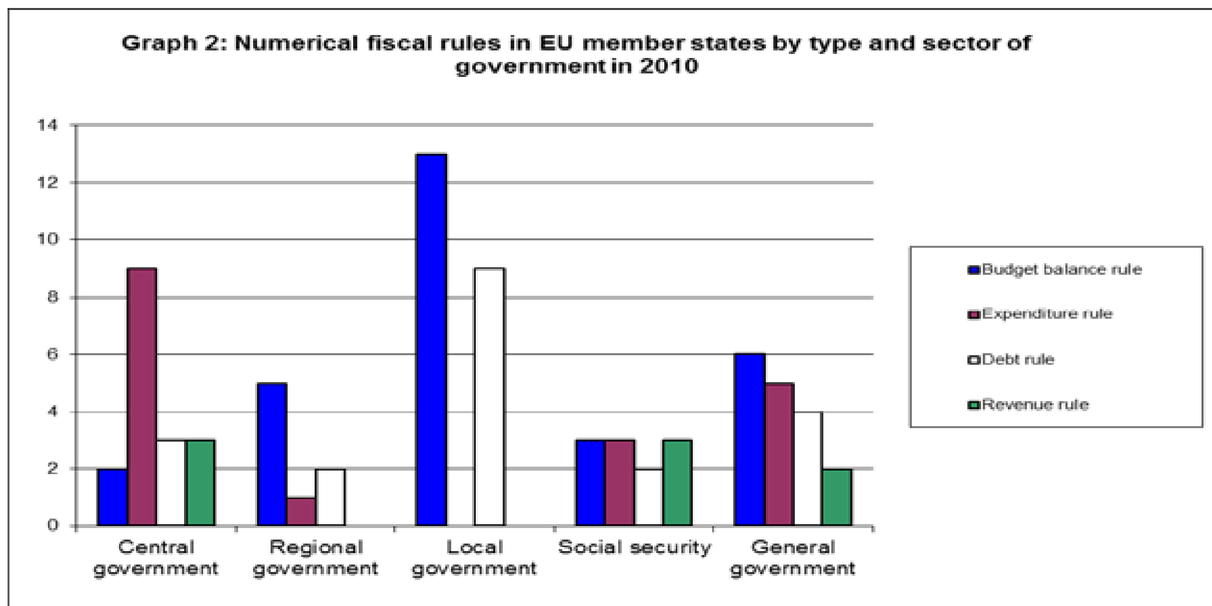


11. The distribution of numerical fiscal rules across sectors of government is featured by a majority of rules being applied to local authorities. About one quarter of the rules in force in 2010 applied to central government, 12% to regional governments, the majority – about 30% – to local governments, and nearly 14% to social security sub-sector. Finally, around one quarter applied to the whole of the general government sector.

12. By type of rule and sub-sectors, expenditure rules prevailed at the level of central government. While revenue rules are almost equally distributed among central and general governments and the social-security sub-sector, budget balance rules were mostly used to constrain budgetary policy making at regional, local and general government levels.[9] Interestingly, half of all the debt rules are applied to local government sub-sector (see Graph 2 below).

[8] This descriptive analysis of the existing expenditure rules across EU countries is based on the Fiscal Governance database of DG Ecfin, which at present covers the period 1990-2010.

[9] The percentage of budget balance rules applied to municipalities is by far the largest.



13. Similarly to the growing use of total fiscal rules between 1990 and 2010, the resort to expenditure rules also shows an upward path in the EU Member States during the same period. Thus, only one spending rule was into operation in 1990 compared to eighteen in 2010.

14. The main features of the eighteen expenditure rules currently in place in the EU Member States can be summarised as follows:

- **Statutory basis:** While 8 expenditure rules were based on a coalition agreement or stem from a simple political commitment, the remaining 10 rules are enshrined in a legal text.[10]

- **Coverage of total general government expenditure:** 6 spending rules cover less than 20% of general government expenditure. In 9 Member States, the coverage of the rule ranges between 20% and 60%. Finally, only 3 rules cover more than 80% of total general government spending.

- **Target definition:** A majority of spending rules targets an expenditure ceiling (8 of them in nominal terms while 4 in real terms). Most of the remaining rules set a target expressed in growth rates almost equally distributed between nominal and real terms.

- **Monitoring body:** The bulk of the existing expenditure rules are monitored by the Ministry of Finance or other governmental structure (i.e. three quarters approximately). The rest of rules are overseen by an independent authority or the National Parliament or both at the same time.

- **Enforcement body:** Similarly to the previous point, the enforcement body of 13 expenditure rules is the Ministry of Finance and/or other governmental structure. For the remaining 5 rules, the role of the enforcement body has been assigned to an independent institution and/or the National parliament.

[10] However, none of them is included in the constitution.

3. – Types of rules and their features: the comparative advantages of an expenditure rule

15. Both the literature and country policy experiences have identified a number of desirable features that any kind of fiscal rules should fulfil. These characteristics range from issues related to the target definition, monitoring, enforcement and transparency to other factors related to other policy areas and macroeconomic considerations in general. Box I concisely summarises these characteristics established by the literature and policy experience.

Box I: Optimal features of fiscal rules according to the literature.

The effective influence of fiscal rules on budgetary results highly depends on a number of features that have been extensively analysed in the literature. In particular, **Kopits and Symansky (1998)** proposed eight criteria to assess the robustness of a rule:

1. A rule must be **well-defined** as to the indicator to be constrained, the budgetary items and the institutional sectors (i.e. general government sub-sectors) covered by the rule and escape clauses to avoid any ambiguity. These elements are critical to ensure the credibility of the rule.
2. Rules should be **transparent**, i.e. data reporting, accounting, forecasting practices and other similar operational arrangements must follow clear norms and standards to avoid opaque off-budget operations and creative accounting.
3. A proper fiscal rule should also be **adequate with respect to its fiscal targets.** Rules should be neither too narrow nor too wide vis-à-vis the budgetary objective, and legal instruments contained in the design of the rule should be conducive to the achievement of the ultimate goal.
4. A fiscal rule or a set of fiscal rules should be **consistent** internally among them and with other macroeconomic policies and objectives pursued by the government.
5. The proper functioning of fiscal norms calls for **simplicity**, i.e. they should be easily applicable and understandable for the public opinion in general and for the elected bodies in particular.
6. Rules need to be **flexible** in order to allow accommodating exogenous shocks beyond the control of the government and factoring their budgetary consequences in the conduct of fiscal policy. This necessarily entails a non-mechanistic application of the rule.
7. A fiscal rule should be **enforceable**, which involves the existence of corrective mechanisms to ensure the respect of the rule and clear stipulated consequences in case of non-compliance. These consequences can range from financial and judicial implications to reputational sanctions.
8. Last but not least, rules cannot last for long unless they are supported by **efficient policy actions and are underpinned by structural reforms**. A balanced budget rule can be met temporary by resorting to one-off measures but its respect can only be ensured over the medium and long-term when more fundamental reforms are implemented.

As the authors of these eight criteria acknowledge, no rule may fulfil simultaneously all of them satisfactorily. This is due to the inevitable trade-offs among some of these principles. For instance, the more flexible a rule, the less likely it is to be simple, as can be illustrated by structural and cyclically-adjusted budget balance rules compared to standard balance targets defined in nominal terms. In the same vein, making the rule very flexible by adding a non-negligible number of (sometimes loosely defined) escape clauses or allowing for discretionary policy decisions may also contradict the simple, clear and transparent definition of the rule while hampering its credibility. Based on the above criteria and policy experiences, a number of practical recommendations can be drawn so as to ensure a proper design of the most basic features of fiscal rules.

Box I: Optimal features of fiscal rules according to the literature (Continuation).

Overall, a rule should establish a numerical target over a sufficiently long time period with a view to guiding budgetary policy, i.e. it targets a summary operational fiscal indicator (e.g. budget balance, expenditure etc.) to which the rule is applicable. This indicator should be as simple as possible so that it can promptly be operationalized, communicated to the public and elected representatives, and monitored (IMF (2009)). **In this context, an operational fiscal rule should provide some guidance for budgetary policies.**[11] All in all, the following elements should be retained:

- The variable to be constrained should establish an unambiguous and **stable link** between the numerical target and the ultimate objective (e.g. debt sustainability). The target must be transparent and simple to monitor providing guidance for the adequate budgetary measures to be adopted.
- Enough **flexibility** to adapt and modify the rule in case of economic shocks or adverse economic circumstances caused by an external factor beyond the control of government (e.g. natural disasters). This can be achieved by the resort to rules defined on structural basis, the consideration of clear and limited **escape clauses** with pre-established rules to trigger them, and to the extent possible, the disentanglement of temporary from permanent shocks.
- The rule should be backed by strong **legal provisions** signalling the importance attached by the government to fiscal consolidation and should include the requirements to amend the rule, which may reinforce credibility. The existing monitoring mechanisms and the pre-established enforcement procedures in case of non-compliance should also be supported by legal basis.
- **Multiannual rules** embedded into a medium-term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances and facilitate to internalise the budgetary effects of current policies over the medium term. A multi-annual time frame may limit the potential circumvention of the rule by postponing the recording of expenditures or the implementation of structural adjustments.
- The use of a standard and comparable **accounting system**, such as the ESA95 methodology, is advisable so as to be consistent with the EU fiscal surveillance framework. However, the higher availability of cash data and the need for timely monitoring to allow prompt action in case of slippages suggests that a dual approach could be envisaged (e.g. the rule could be defined in cash terms with a parallel mechanism of translation in ESA95 on a quarterly basis).
- The effectiveness of **monitoring** relies on two elements. Firstly, the frequency of monitoring determines to what extent the overseeing of budgetary developments can be effective in (almost) real-time or only ex-post with a long delay. A well-timed reporting for timely corrective measures is conditional on the availability of updated and reliable data. Secondly, the adjustment of budgetary trends to ensure the observance of the rule is subject to the sending of early warnings to the government in case risks of non-compliance are identified.
- **Corrective and enforcement mechanisms** emerge as an important feature to ensure a proper functioning of fiscal rules (Debrun et al. (2008)). Actions in case of non-compliance should always be defined ex-ante so as to make the rule credible and enforceable (e.g. the amendment of the budget law, the obligation to take corrective measures, automatic budgetary sequesters or withholding of additional expenditure, pecuniary sanctions etc). If the only cost for non-compliance is reputational, this can suffice for stable and solid fiscal frameworks but appears inadequate in those cases with weak budgetary institutions. Provisions specifying the path back to the rule in case of deviations providing incentives to correct past slippages within a well-defined time frame may also be instrumental in supporting the credibility and effectiveness of the rule (as the Fiscal Compact calls for by requesting corrective mechanisms to be triggered automatically in case of deviations from budgetary objectives). Finally, the enforcement of corrective measures ought to be preferably ensured by a non-partisan institution. This independent body should be provided with an appropriate legal framework, resources and competencies.

[11] In this sense, some expenditure rules, currently in place in some EU countries, establishing an overall ceiling for total spending together with a breakdown setting expenditure limits for the main spending areas would be, for instance, more operational than a simple debt rule.

16. These desirable characteristics for all fiscal rules summarised in Box I interact with the specific properties that each different type of rules features influencing the final budgetary outcomes. These particular properties associated to each type of rules are recapitulated in Table 1. Although some concrete type of rules may perform better than others (see next paragraphs), Table 1 shows that there is no "perfect" rule and all of them present advantages and disadvantages, particularly in relation to their effects on the deficit bias and their macroeconomic stabilisation properties as well as on their simplicity in terms of target setting and monitoring.

17. For instance, according to empirical research, budget balance rules have on average a strong impact on the budget balance and can address satisfactorily the deficit bias (Debrun at al. (2008)). They may therefore be considered appropriate policy instruments from the point of view of discipline. However, there is evidence that BBRs supplemented by expenditure rules appear to be more efficient (see Guichard et al. (2007)). By contrast, these rules are often considered to entail risks for the quality of public expenditure. In case no item is excluded from the coverage of the rule, fiscal adjustment may excessively rely on growth enhancing expenditure categories that are less politically sensitive, such as spending on R&D and infrastructure. This has prompted the resort to budget balance rules excluding investment expenditure (i.e., golden rules). Attempts at redefining the coverage of the rules to preserve growth-oriented expenditure can easily run into incentive problems of their own, as the concept is difficult to operationalise and conventional definitions offer scope for opportunistic behaviour (European Commission (2003)).[12]

18. The main weakness of BBRs is related to the stabilization objective as these rules defined in nominal terms are conducive to the implementation of pro-cyclical policies. Some of the variants of BBRs may, at least partly, address this shortcoming.

19. For instance, multi-annual deficit rules defined over the cycle are likely to be more stabilisation friendly than budget balance rules operating on a single year basis. The most frequent problem of these budget balance rules is the correct assessment of the cyclical position of the economy (specifically, identifying the starting and/or ending point of the business cycle). Difficulties in defining the cycle can be significant enough to impair the effectiveness and credibility of the rule (e.g. the former UK's set of rules in place up to 2010).

20. Alternatively, cyclically adjusted budget balance rules (CAB) and structural rules excluding one-off measures may provide enough flexibility to ensure discipline while accounting for the cycle. In particular, the current EU fiscal framework and recent policy initiatives to strengthen fiscal surveillance (mainly the reformed SGP provisions and the so-called Fiscal Compact) highly rely on the use of a budget balance rule defined on structural terms. This is largely justified by the need to disentangle cyclical elements from discretionary developments to properly assess the conduct of fiscal policy.

21. However, these rules are also vulnerable to uncertainties on the measurement of the output gap and other elements, such as growth composition effects, entailing significant revisions over time (see Larch and Turrini (2009) for an overview of these technical problems). This clearly complicates the conduct of fiscal policy and renders real

[12] While on theoretical grounds this option may appear sensible, its practical implementation may imply an inefficient allocation of public resources and a reclassification of expenditure items to circumvent the rule, which in turn may also complicate monitoring (European Commission (2003)). An alternative way to weaken golden rules consists of adopting a broad definition of public investment (i.e. a definition departing from the standard concept on a national accounts basis). This allows excluding a large number of expenditure items from the coverage of the rule and may considerably hamper its effectiveness in terms of fiscal discipline. This was the case of the former golden rule applied to the Federal Government and the Länders in Germany, which was replaced by a budget balance rule defined on a cyclically adjusted basis (i.e. the debt brake).

time monitoring difficult, which makes advisable to supplement budget balance rules on a structural basis with other type of rules and indicators to assess the effective fiscal policy stance. For example, this is the case of the reformed SGP included in the "six pack", which complements the application of the Medium-term objectives (MTOs) defined in structural terms with the introduction of an expenditure benchmark relating spending developments and medium-term growth prospects (see BOX III for a description of this benchmark).

22. Similarly to budget balance rules, debt rules are found to have a strong influence on budgetary developments in terms of fiscal discipline (Debrun et al. (2008)). Given the overarching objective of debt reduction in the years ahead, debt rules may increase their relevance as a policy instrument to achieve this goal. However, in general, domestic debt rules currently in place in the EU Member States confines themselves to set limits on debt levels but do not focuses on the debt dynamics in their target definition (i.e. no debt rule links explicitly targeted debt developments with operational and intermediate budget balance and expenditure objectives). Additionally, the same potential shortcomings identified for nominal budget balance rules with respect to the stabilization function of fiscal policy apply to debt rules. Debt rules embedded into a medium-term framework may take into account stabilisation concerns and limit their pro-cyclical bias. However, substantial problems may arise when assessing the cyclical position of the economy (see paragraph 19 on budget balance rules).

23. As for revenue rules, their effects on the deficit bias and macroeconomic stabilization depend very much on their target definition. The most interesting option in the design of revenue rules aims at avoiding the conduct of pro-cyclical policies. In particular, this can be achieved by obliging fiscal authorities to specify ex-ante in the budget law the allocation of higher-than-expected revenues (e.g. allocation to debt reduction), which may allow to restrain expenditure pressures in good times. An important lesson drawn from the current crisis refers to the role played by property and asset prices and the corresponding windfall tax proceeds in the boom period.

24. This is not only crucial for explaining the ongoing bust and macroeconomic imbalances, but also for singling out some of the appropriate reforms to the prevailing domestic fiscal frameworks to help avoid these disruptive episodes (Joumard et al. (2008)). Specifically, higher than anticipated proceeds were often allocated to finance additional public expenditure in the belief they were permanent and not temporary (i.e. they were improving the underlying budgetary position). This resulted in pro-cyclicality in good times, widening both internal and external imbalances, and putting at risk fiscal sustainability. Although the underlying fiscal position may be deteriorating rapidly if proper account of the asset boom is taken into account, fiscal sustainability is rarely perceived as a risk if government budgets are registering small surpluses or low deficits (See Box II describing the case of Spain).

25. Compared to other types of rules, particularly budget balance and debt rules, expenditure rules show a number of interesting characteristics that make them appealing from a policy point of view and may play a key policy role in ensuring sound and sustainable fiscal positions. Notably, expenditure rules target the part of the budget that government controls most directly, thereby reducing uncertainty as to the final attainment of the fiscal target.[13] This implies a higher degree of accountability, which may in turn promote not only the respect of the target but also transparency in the course of the budget process. There is empirical evidence of a statistically significant relationship between the strength and

[13] This is an advantage in relative terms vis-à-vis other types of rules such as budget balance rules (including CAB rules), which can miss their objectives even when authorities are acting consistently with the rule.

the appropriate design of expenditure rules and the degree of fulfilment and consistency in the implementation of government spending plans (Deroose et al. (2006)). Overall, spending rules may restrain expenditure and mitigate the effects of shocks on expenditure developments (Wierts (2007)).

26. The main objective of these rules is to promote fiscal discipline through an improved expenditure control. A significant number of these rules are embedded into a medium term budgetary framework and their features are meant to tackle some of the observed pitfalls in domestic fiscal policy making: recurrent primary spending overruns and frequent pro-cyclical budgetary policies.

27. In relation to the optimal features for fiscal rules defined by Kopits and Symansky (see Box I), the following elements and characteristics of spending ceilings deserve to be underlined:

I. **A rule must be well-defined:** The budgetary aggregate to be constrained (i.e. expenditure) is unambiguously defined and simpler to monitor than other target definitions (e.g. cyclically-adjusted figures subject to the estimation of unobserved variables). Coverage in terms of budgetary items and government layers concerned by the rule can also be clearly established (e.g. if the assessment of the real fiscal effort by the government to contain public spending is a main issue, interest payments can be excluded from the coverage without hampering a clear definition of the rule).[14]

II. Rules should be **transparent**: Overall, data reporting, accounting, forecasting practices and other similar operational arrangements related to monitoring are relatively easier in the case of expenditure rules than for other types of norms (e.g. budget balance rules require substantial information from the revenue side, which is not always timely available and is more difficult to forecast).[15] Likewise, debt figures can only be accurately obtained after a certain time-lag and in some cases are more depending on accounting issues while cyclically adjusted figures are often subject to sizeable revisions). For spending rules, transparency highly depends on the existence of an adequate institutional framework incorporating appropriate spending control mechanisms providing timely information and limited off-budget operations.

III. Fiscal rules should also be **adequate** with respect to their fiscal targets: If the main objective is to dampen down the main source of the deficit bias, i.e. overspending slippages, then spending rules may be a proper instrument to tackle this problem while helping achieve a budget balance objective set according to a debt reduction path. However, adequacy would also hinge on a broad coverage of the general government sector by the rule, as opposed to a partial application (e.g. State budget only).

IV. A fiscal rule should be **consistent** internally with other rules into operation and with other macroeconomic policies and objectives: Expenditure limits stemming from spending rules must be coherent with the budget balance and

[14] This of course does not exclude the existence of potential problems of this kind of rules mainly related to the budgetary items covered by the rule which can open the way for "opportunistic" reclassification of expenditure items to accommodate the final coverage of the rule (i.e. the perimeter of the rule) in order to facilitate its fulfilment.

[15] Of course this timely availability of data highly depends on the efficiency of national tax administrations and there is a wide cross-country variation in the EU in this respect.

debt targets the government intends to achieve and the other measures introduced to this end.

V. The proper functioning of fiscal norms calls for **simplicity**: Compared to other kinds of rules, expenditure rules defined in level or growth rates are easier to apply and monitor, and are generally more understandable for the public opinion in general and for the elected bodies in particular (e.g. in general they are easier to communicate than CAB rules).

VI. Rules need to be **flexible** in order to allow accommodating exogenous shocks: Overall, expenditure rules defined in level or growth rate hardly prevent automatic stabilisers from operating, particularly on the revenue side and may therefore contribute to macroeconomic stabilisation (i.e. they are cycle-friendly), while allowing for the traditional tax smoothing argument. This feature compares favourably with other type of rules such as simple BBR or even CAB rules In principle, this flexibility in terms of counter-cyclicality can be enhanced if cyclical sensitive spending items such unemployment benefits are excluded from the coverage of the rule.[16] Spending rules may also help curbing a frequently observed pro-cyclical bias in good times due to strong pressures for additional spending in case of revenue windfalls. In case the rule is defined in nominal terms, the counter cyclical stabilisation is further enhanced (e.g. larger than expected real fiscal adjustment in a context of demand pull inflation).

VII. A fiscal rule must be **enforceable**: As for any other kind of rules, enforceability primarily depends on the existence of corrective mechanisms to ensure the fulfilment of the rule (i.e. pre-established procedures and measures to correct deviations from the initial fiscal target). In turn, consequences in case of non compliance must be clearly stipulated, preferably on a legal basis. These can range from financial and judicial consequences to simple reputational sanctions (e.g. for the latter, the obligation for the government to explain the causes of the expenditure slippages and the envisaged corrective measures in the Parliament). Overall, some policy experiences show that the existence of well-defined correction mechanisms accompanied by a high degree of transparency and accountability in the conduct of fiscal policy (e.g. the reputational costs mentioned previously) are likely to be more important than formal sanctions to promote the respect of the rule.

VIII. Finally, rules must be **supported by efficient policy actions and underpinned by structural reforms** to achieve fiscal targets: Similarly to other rules, an expenditure ceiling may be respected temporarily by resorting to one-off measures whereas a long-lasting expenditure control can only be ensured over the medium and long-term when more fundamental and far-reaching reforms are implemented. In this respect, expenditure rules may be instrumental in providing more clear policy guidelines than other types of rules to achieve the envisaged fiscal targets. Total spending limits may be set up within a more general fiscal plan targeting expenditure control. More specifically, if this overall ceiling is subsequently broken down into spending ceilings for each main expenditure area (i.e. health, education etc), this requires the establishment of policy priorities and the corresponding measures to

[16] However, these exclusions should be balanced against their potential negative implications. For instance, when removing unemployment benefits from the coverage of the rule, possible structural increases in unemployment benefits can also be excluded, which clearly weakens the link with sustainability (see Section 5).

achieve them providing policy guidance. Likewise, spending rules can even enhance the intertemporal consistency of tax reforms by ensuring that tax cuts are sustainable.[17] This policy oriented featured is reinforced if multi-annual spending rules are embedded into a medium-term framework, which allows factoring in the budgetary impact stemming from current policies over the next years.

28. Subject to a number of design features (see Section 5), the assessment of expenditure rules against the criteria announced by Kopits and Symansky is positive and suggest the appropriateness of these rules to improve the conduct of fiscal policy. Likewise, this assessment seems to be more favourable for spending rules than for other types of fiscal norms (see Table 1). This includes the fact that spending norms can be seen to a large extent as a direct reflection of the discretionary action of fiscal authorities, showing in more clear way than other rules the real fiscal effort carried out to attain a fiscal target. All these considerations can explain the extensive use of expenditure rules during the largest episodes of budgetary consolidation, which reflects their instrumental character in sustaining fiscal discipline. Overall, spending rules have generally been adopted as a cornerstone of ambitious consolidation plans and are currently one of the main building blocks of the most successful and resilient domestic fiscal frameworks across EU countries. [18]

29. In this respect, expenditure rules play a crucial role in the functioning of the whole fiscal framework in interplay with other elements of fiscal governance (Kopits (2007)). For instance, multi-annual spending rules form the basis of well designed medium term budgetary frameworks for budgetary planning. The same rules may prompt the adoption or the strengthening of sound budgeting procedures, such as top down budgeting or the implementation of a more centralised budgetary process at the planning and execution stages. Last but not least, the existence of expenditure rules is a key element to ensure the effectiveness of budget balance rules (Guichard et al. (2007)).

[17] Additionally, in case the tax wedge is high, expenditure rules may be instrumental in supporting the policy objective of reducing it by avoiding further spending funded with more distortionary revenue increases.

[18] Fiscal frameworks of the Netherlands, Denmark, Sweden and Finland, which can be considered the most outstanding in terms of fiscal discipline, hinge upon an expenditure rule combined with revenue or cyclically-adjusted budget balance rules. The role played by expenditure rules was also prominent in other successful experiences of consolidation in the past, such as Belgium throughout the 1990s.

Table 1: Types and properties of fiscal rules.

Type of rule	Sustainability and deficit bias	Macroeconomic stabilization	Target monitoring and computational problems	Effects from the exclusion of specific budgetary items	Policy guidelines provided by fiscal rules
Budget balance rules (BBR) defined in nominal terms (both in level and as a % of GDP).	Positive effect since the budget balance is directly link to the debt ratio developments. However, due attention should be given to off-budget operations that may weaken this link.	Likely negative effect. Budget balance rules on a nominal basis usually introduce a pro-cyclical bias in the conduct of fiscal policy (i.e. they allow for expansionary policies in good times while they require restrictive measures in bad times).	Overall, nominal budget balance is a simple, understandable and transparent target, easy to monitor and to communicate to the public and elected representatives. Main operational problems are related to the lack of timely and reliable data and accounting tricks being used to circumvent the rule.	Primary balance rules (i.e. excluding interest payments) might measure better the fiscal effort since interest spending is outside the control of government in the shoert-run. However, they are less linked to sustainability since a rise in interest spending does not require further adjustments. "Golden rules" (i.e. excluding investment items) might help protect the quality of public spending (i.e. growth-enhancing effect). However, policy experiences show that they are subject to reclassification problems of spending items to circumvent the rule while the link to sustainability is weakened.	In principle, budget balance rules do not provide by themselves clear policy and operational guidelines. Measures to reach the target can be achieved via expenditure and revenue measures or by a combination of both. The fact they do not account for the cycle may allow to conduct non-appropriate fiscal policies.
Cyclically-adjusted budget balance (CAB) and structural rules.	Positive effect to contain the deficit bias but their finally effectiveness will highly depend on the ambition of the structural or CAB targets.	In principle they are appropriate to help smooth the business cycle since the cyclical budgetary components have been excluded from the target.	Difficult to monitor due to the uncertainties related to the calculation of the output gap, growth composition and tax base effects and effective tax rate developments. Not easy to differentiate temporary from permanent shocks when setting CAB targets. Need for a clear definition of one-off measures for structural targets.	Idem as for BBR	Idem as for BBR. However, as long as CAB and structural rules exclude the cyclical components of the budget, policy measures should target the structural items of public finances providing more policy guidance.
Budget balance rules over the cycle.	Idem as for BBR.	Adverse effects of BBRs for stabilization purposes are reduced when they adopt a multiannual perspective (room for discretionary fiscal stimulus).	Problems to properly identify the cyclical position of the economy so as to set the fiscal targets consistent with an appropriate fiscal stance. For instance, the implementation problems of the former golden rule defined over the cycle in the UK.	Idem as for BBR.	Idem as for BBR but with the advantage to incorporate a medium term perspective in the fiscal policy making.

Type of rule	Sustainability and deficit bias	Macroeconomic stabilization	Target monitoring and computational problems	Effects from the exclusion of specific budgetary items	Policy guidelines provided by fiscal rules
Debt rules	Direct and positive effect. However, given the lags involved in the impact of budgetary measures on the debt ratio through the budget balance, remedial actions may arrive late to avoid unfavourable debt dynamics (IMF 2009).	Likely negative effects for similar reasons to those of BBRs. Debt rules defined over the business cycle may attenuate this shortcoming (However, problems related to the right assessment of the cyclical position of the economy)	Despite the simplicity of the target (either in nominal terms or as a % of GDP), debt may be highly volatile due to changes in interest rates and the exchange rate, which may involve in some cases unfeasible adjustments. "Below the line operations" and the "stock flow adjustments" may complicate the working of these rules.	In general, these rules do not include exclusions. However, should this be the case, the effects would be similar to those of the BBRs (e.g. exclusion of debt issued to fund public investment or golden rule).	Similarly to BBRs, these rules do not provide guidance for fiscal policy. These rules need to be accompanied by primary balance objectives (Kopits and Symansky (1998)) as well as expenditure limits.
Expenditure rules	Positive effect since it tackles the main source of the deficits bias, i.e. overspending and expenditure slippages. However, their final effectiveness depends also on tax revenues, and they need to be complemented by revenue rules and/or BBRs.	These rules contribute to macro stabilization if the target is defined in level or growth rate since they hardly prevent automatic stabilisers from operating, particularly on the revenue side. Counter-cyclicality is maximal when the target is in nominal terms (e.g. larger correction in presence of a demand-pull inflation). Spending rules defined as a % of GDP (rarely observed) may entail a pro-cyclical bias.	In principle, target monitoring is easy to carry out, in particular if it is defined in nominal terms (more problems can emerge when the target is defined in real terms to accommodate inflation shocks, e.g. the choice of the appropriate variable to deflate nominal figures, which can give rise to transparency problems).	In general, idem to those identified in the case of BBRs. In addition, the exclusion of cyclically sensitive items (such as unemployment benefits and other social benefits) may be justified in order to measure more accurately the government effort to control spending developments and reinforce the countercyclical properties of these rules. However, this weakens the sustainability goal. Some country-specific policy experiences suggest that the effectiveness of these rules is often jeopardised by an extensive use of tax expenditures. This policy instrument may be used to circumvent the rule and weakens the counter-cyclical properties and its effectiveness to tackle the deficit bias (OECD 2010).	They are probably the rules which can be more translated into policy guidelines. Total spending limits are generally set up within a more general fiscal plan, in particular if this overall ceiling is subsequently broken down into spending ceilings for each main expenditure area (i.e. health, education etc), which requires the establishment of policy priorities. This policy oriented featured is reinforced in case multi-annual spending rules are embedded into a medium term framework, which accounts for the budgetary effects of current spending measures over the next years.

Type of rule	Sustainability and deficit bias	Macroeconomic stabilization	Target monitoring and computational problems	Effects from the exclusion of specific budgetary items	Policy guidelines provided by fiscal rules
Revenue rules	Positive or negative effect depending on the definition of the rule. Rules setting up limits on public revenues to stabilise the tax burden may have a negative impact on borrowing costs as markets could consider more likely the emergence of financial problems to attain fiscal targets and control deficit and debt developments due to a more constrained capacity to increase tax collection (European Commission (2006)). By contrast, revenue rules pre-establishing the allocation of higher-than-expected revenues (i.e. windfalls revenues) to debt reduction may tackle the deficit bias and avoid overspending relative to the initial spending plans, particularly in good times.	Positive or negative effect depending on the definition of the rule. Rules based on a revenue-to-GDP ratio objective can be pro-cyclical due to the progressivity of the tax system. Rules allocating windfalls revenues to deficit and debt reduction are conducive to limit the conduct of pro-cyclical policies in good times.	In general, the monitoring of revenue developments critically depends on the functioning of the existing tax administration. If this works properly, the monitoring and the availability of timely data should not present major problems.	The exclusion of certain tax items from the coverage of the rule may entail a loss of credibility and weaker transparency. In the case that only a partial amount of the total higher-than-anticipated revenues is allocated to debt reduction, this would weaken the counter cyclical properties of these rules and would hamper their strength as regards the control of the deficit bias. Of course the magnitude of this weaker link to sustainability will depend on the final share of windfall revenues allocated to debt reduction.	Limits on revenue developments do not necessarily provide policy guidelines unless they are accompanied by pre-established tax policy objectives and may cause pro-cyclical effects. Revenue rules allocating windfalls proceeds to debt and deficit reduction are a clear commitment by the government to fiscal stability and can be interpreted as a clear signal to control sustainability and avoid the implementation of pro-cyclical policies in good times.

4. – Why expenditure control is a key issue for fiscal policy making and why spending rules are needed.

30. In the previous Section it was shown that expenditure rules have some interesting features to promote fiscal discipline while being cycle-friendly. This makes them relatively appealing vis-à-vis other types of rules. Spending control and the introduction of expenditure norms to make it effective are an important element within an overall fiscal policy strategy to ensure sound and sustainable public finances. Nevertheless, there are also other reasons pointing to the relevance of expenditure monitoring and control as a key element in the conduct of fiscal policy at the present juncture.

31. Over the last twenty years, a fruitful strand of economic literature has analysed the main determinants of successful fiscal consolidations. According to this research, the list of elements determining the success or failure of fiscal consolidation policies has changed over time. In particular, since the inception of EMU new elements have come into play to explain why some attempts of fiscal retrenchment were successfully crowned.

32. The first wave of these empirical analyses, carried out between the late 1980s and the mid 1990s, primarily focused on the composition of the fiscal adjustment and the role played by the political and institutional setting (e.g. coalition versus single party governments). *The main finding pointed out that successful budgetary consolidations over the 1970s and 1980s were mainly expenditure based, with a particular emphasis on primary current expenditure (mainly public wages and transfers)*. Fiscal adjustments following this strategy, which directly tackled those expenditure items driving unsustainable public spending trends, were generally longer lasting than consolidations based on tax hikes and investment cuts (Alesina and Perotti (1995), (1996), and Alesina and Ardagna (1998)).

33. More recent research has qualified these earlier results suggesting a broader range of factors behind successful fiscal consolidations. While long lasting consolidations remain more expenditure based, the experience of the 1990s suggests that revenue increases can be part of the successful mix (European Commission (2007)).[19]

34. Probably, the most interesting finding of this recent research is the prominent role that some elements of domestic fiscal frameworks seem to have played in the fiscal consolidation episodes since the early 1990s. Some of them clearly suggest the importance of expenditure control to ensure a successful fiscal consolidation. Thus, some analyses show that fiscal rules have sustained fiscal discipline in a number of EU countries, including expenditure rules (see Larch and Turrini (2008)). Other researchers emphasize the importance of well designed budgetary procedures to ensure the centralisation of the budget formulation in order to avoid budgetary fragmentation and ensure a proper overseeing of spending developments (Von Hagen et al. (2002)). In other cases, some features of fiscal frameworks, such as the existence of binding expenditure ceilings, were key elements behind the observed fiscal adjustments (Guichard et al. (2007)).

35. A second element indicating the importance of spending control and the use of policy instruments such as expenditure rules to effectively ensure an adequate monitoring of spending developments is related to the origins of the current fiscal

[19] This is likely to reflect a number of factors behind the run-up to EMU. Over the last decades policy-makers tended to favour the shrinkage of government size (e.g. privatization programmes), reducing gradually the margin to implement "easy" expenditure cuts on less sensitive spending items. Additionally, the required sizeable adjustments to qualify for EMU triggered the resort to higher revenues to supplement the expenditure containment efforts. In this context, the success of consolidation was less determined by the composition than by the policy-makers' ability to maintain over time expenditure cuts and revenue increases.

imbalances across EU countries. A close analysis of the reasons behind the failure of a large number of Member States to achieve their targets in the period 1998-2006 (i.e. since the launch of EMU in 1998 up to just before the outset of the crisis) provides interesting policy conclusions.

36. This analysis shows that the failure to stick to the initial expenditure targets included in the SCPs during this period explains to a large extent the weak underlying budgetary positions in a significant number of countries in 2007 when the crisis started (European Commission (2007).[20] In other words, the failure to attain the projected reductions in the general government deficits were primarily caused by the difficulties to adhere to expenditure plans. This was not due to particularly unfavourable macroeconomic conditions but rather to the problems encountered to implement the required reforms which were necessary to respect the spending objectives (Moulin et al. (2006)).

37. In addition, in a number of countries expenditure slippages were facilitated by the recurrent appearance of windfall revenues which were used to finance additional spending. While higher-than-anticipated revenues were of temporary nature and not structural, the increased expenditure did not prevent some Member States from formally respecting their initial nominal budget balance targets. In this context, however, the underlying budgetary positions were worsening and gave rise to a rapid deterioration of the headline nominal balances when the crisis started and windfall revenues collapsed (see Box II).

38. This situation clearly calls for a greater attention to expenditure developments compared to initial plans when assessing the fiscal performance of EU countries and the need for the introduction of appropriate institutional fiscal reforms paving the way for a more effective spending control. In particular, the implementation of binding expenditure ceilings coupled with an effective and consistent system of medium-term expenditure management in those Member States showing more institutional fiscal weaknesses is of outmost importance. Similarly, more detailed specification (ex-ante) of the measures and reforms envisaged to achieve the established spending objectives in line with the current European Semester exercise appear as a crucial element.

39. Some recent research focusing on the EU and the Euro Area confirms the important role expenditure rules may play in the European context. Hauptmeier et al. (2010) compare actual expenditure trends with those that would have prevailed in case EU countries had followed "neutral" spending policies based on expenditure rules since the start of EMU up to 2009.[21] The conclusions show that most countries (Germany is an exception) conducted expansionary expenditure policies giving rise to a much higher spending and debt paths compared to a counterfactual neutral spending stance. Overall, neutral spending policies over the period under consideration would have entailed lower primary expenditure ratios by around 2-3½ percentage points of GDP in 2009 in the Euro Area excluding Germany, which at that time implemented a more restrictive expenditure policy. The analysis also shows that

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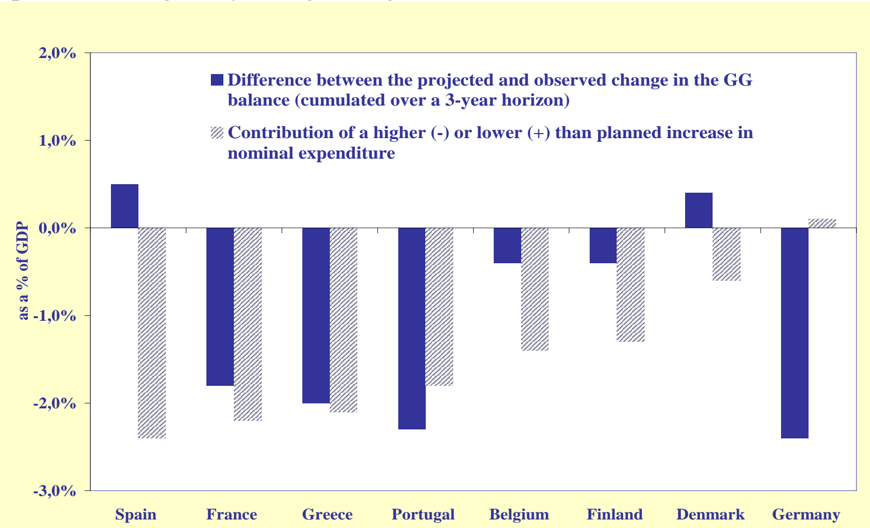
[20] Obviously other elements also help explain this negative outcome compared to the initial targets included in the SCPs, such as back loaded adjustment plans delaying the effective implementation of far-reaching consolidation measures, forecasting errors with overoptimistic projections resulting in negative growth surprises etc. However, the lack of fulfilment of the envisaged expenditure targets remains a key element to explain the non-achievement of sound and safe underlying budgetary positions before the beginning of the crisis.

[21] This neutral stance is measured on the basis of four alternative expenditure growth rules: i) spending growth rate in a given year is set equal to nominal potential GDP growth; ii) expenditure growth is restricted to real potential GDP growth plus the ECB price stability objective of 2%; iii) spending growth is established according to the nominal average growth rate over the period 1999-2009; and iv) spending growth developments follow the nominal 10 years moving average of output growth.

debt figures would have been more benign providing more margin of manoeuvre and a safer underlying budgetary position at the outset of the crisis in 2007. These results are broadly in line with other recent analyses. Holm-Hadulla et al. (2010) argue that EU countries with effective expenditure rules tend to deviate to a significantly lesser extent from their spending plans contained in their SCPs. Likewise, Turrini (2008) shows for a selected group of EU countries that pro-cyclical spending in good times is less pronounced in countries with strong expenditure rules. The conclusion points that simple and prudent-rules-based expenditure policies can be an effective policy tool.

Box II: Expenditure slippages and windfall revenues in the pre-crisis period.

The previous paragraphs describing the fiscal roots of the current budgetary imbalances pointed out the interest in expenditure control as a key element to enhance and make more effective fiscal surveillance, i.e. a significant part of the difficulties to achieve deficit reductions planned in SCPs over the period 1998-2006 stemmed from the fact that Member States missed, sometimes by a large margin, their medium-term expenditure targets (Langedijk and Moulin (2006) and European Commission (2008)). The graph below depicts budgetary performance of some Member States between 1998 and 2005. Specifically, it shows the average gap between the planned and observed change in the deficit cumulated over a 3-year period covered by a SCP, and the average slippage in nominal expenditure growth (cumulated over the same 3 years). The message is that while Germany was blamed for policy errors during this period, it was the best performer of the euro area as regards compliance with expenditure plans. By contrast, Spain, which was often praised for its fiscal policy missed its expenditure targets by a large margin.



As explained in paragraph 37, part of these spending slippages stemmed from the use of windfall revenues to fund additional expenditure. Spain is a telling example in this respect. From the second half of the 1990s, Spain recorded its longest period of growth in excess of the euro area, growing by nearly 3¾% for more than 10 years in a row. A combination of low real interest rates and a dynamic demography sustained by high immigration flows fed into unprecedented growth in asset and housing markets. In parallel, tax receipts grew by about 4¼ percentage points of GDP, implying an elasticity with respect to GDP of 1.2, in excess of the normal values typically close to one. The increase in tax receipts was largely associated to changes in the composition of GDP, in particular the long consumption and construction boom. Econometric analyses provide evidence that 50 to 75 percent of the increase in tax revenues, observed in Spain between 1995 and 2006, was likely of transitory nature. However, conventional measurement of CABs, using standard tax elasticities overestimated structural revenues and gave an incorrect assessment of the fiscal stance. This was partly due to the fact that some transactions entail proceeds for the government but do not form part of the GDP computation (e.g. capital gains, land transactions etc. (see Cuerpo et al. (2011)). The size of transitory composition effects associated to the asset boom in Spain highlights the interest for the policymakers to carefully assess the implementation of unfunded tax cuts and/or expenditure increases, especially those more difficult to revert in bad times (see Martinez-Mongay et al. (2007)).

40. All these arguments explain to a large extent some of the reforms recently implemented in the EU fiscal surveillance framework (mainly the reformed SGP contained in the "six pack"), and in particular the introduction of an expenditure benchmark. This expenditure benchmark tries to cater for some of the policy mistakes occurred in the 2000s described in the previous paragraphs. *However, it must be stressed that it cannot be considered stricto sensu a spending rule at EU level but rather a policy instrument providing guidelines to ensure consistency between expenditure developments and GDP growth prospects in EU countries* (see Box III below for a brief description).

Box III: The expenditure benchmark and the preventive arm of the reformed SGP.

The preventive arm of the reformed SGP is now based on a "two pillar approach" (see European Commission (2011) for further details). *The first pillar* continues relying on the medium-term objectives (MTOs), i.e. budget balance targets defined on a structural basis, and requiring an annual improvement of 0.5% of GDP in the structural balance throughout the adjustment path towards these MTOs. *The second pillar* introduces an expenditure benchmark which EU countries must respect when approaching their MTOs. It is important to underline that both the MTO and the expenditure benchmark are broadly equivalent. Specifically, spending growth needs, to be consistent with the MTOs, not to exceed (and if the MTO has not yet been reached remain clearly below) a reference value of the medium-term growth rate. In two particular situations this general norm for spending developments does not apply. Firstly, in case the excess of expenditure increase over potential growth is offset by discretionary revenue measures. And secondly, if the MTO has been overachieved.

Expenditure is defined as nominal primary spending, i.e. excluding interest payments. From this primary spending, unemployment benefits and expenditure rises compensated by legal mandated revenue increases are also excluded. The key element behind this formulation is that any plan to increase expenditure is properly financed avoiding any deterioration in the underlying budgetary position, while those budgetary items outside the direct control of the government are also kept out. This entails that higher-than-expected revenues which do not stem from discretionary tax policy measures may not be used to fund additional expenditure and can be instead allocated to deficit and debt reduction, thereby addressing one of the policy mistakes observed in the pre-crisis period.

As previously said, the structural balance and the expenditure benchmark are similar approaches since both assess fiscal policy on the basis of a medium-term economic growth rate (i.e. a growth rate net of the business cycle movements). Thus, a positive (negative) change of the structural balance deemed to be expansionary (restrictive) actually implies that expenditure growth exceeds (falls short of) potential GDP growth whereas revenues under unchanged policies are considered to have a unit elasticity in relation to output growth. A similar reasoning applies to the expenditure benchmark approach. Spending growth is assessed with respect to a reference GDP growth rate, while revenues fluctuate according to the economic activity. In case expenditure grows faster than the medium-term economic growth, an expansionary policy is taking place. Conversely, if spending grows less than this growth economic rate then a restrictive policy is being implemented (see Annex III for more details on the equivalence of both approaches). The significant difference between assessing changes of the structural balance and the expenditure benchmark developments is that with the latter the evaluation of the fiscal stance is based on budgetary aggregates that are observable and under the control of government. By contrast, using only the structural balance figures, the assessment is subject to a number of statistical difficulties and data revisions, which render the assessment of the progress towards the MTOs more uncertain and provisional. The resort to the expenditure benchmark overcomes these problems and provides more policy guidelines and more solid basis for assessing the fiscal stance.

A simulation exercise, in which the actual budget balance figures for a selected group of Euro Area countries between 1997 and 2009 are compared with the counterfactual outcomes stemming from the application of the new expenditure benchmark for these countries in the same period, broadly confirms the results of other analyses presented in paragraph 39. Thus, in most countries spending developments consistent with the expenditure benchmark would have provided sounder fiscal positions in the years preceding the current crisis (see European Commission 2011).

41. The importance of expenditure control and the key role that spending rules may play in improving the conduct of fiscal policies have led some researchers to put forward a proposal to implement a genuine expenditure rule at EU level. For instance, Anderson et al. (2006) proposed to implement an expenditure rule at EU level, possibly substituting the current EU fiscal rules (i.e. SGP deficit and debt thressholds). Despite the attractiveness of expenditure rules compared to other types of fiscal norms in terms of accountability, transparency, and countercyclical properties, there are good reasons to not introduce such rules in the EU fiscal framework due to political reasons such as sovereignty issues, country-specific institutional and historical features etc. Instead, the current approach based on the introduction of a simple expenditure benchmark providing policy guidelines for the management of expenditure policy in order to keep consistency with the MTOs seems much more appropriate and feasible (See Box IV below).

Box IV: Why not an expenditure rule at EU level?

While expenditure rules can contribute to sound fiscal policies on the basis of their features discussed in the previous sections, there are good arguments to consider that such rules should not (and cannot) substitute current EU rules based on debt and deficits. At least two reasons can justify this point of view.

First, the use of expenditure rules in a multinational context can be problematic, even if the rules and targets are differentiated across countries. De facto, introducing spending limits in all EU countries would carry the risk to impose homogeneous (or quasi-homogeneous) social preferences to all EU countries. The existence of different social preferences across EU countries is well reflected in the large differences and fluctuations of the expenditure-to-GDP ratio among Member States. Overall, EU countries have different and time-varying preferences as regards the role, the appropriate size of the government and the composition of public spending.

Additionally, implementing expenditure rules at EU level could be inconsistent with the principle of subsidiarity between EU and Member States (i.e. level and composition of public expenditure are issues of national responsibility).

By contrast, the expenditure benchmark introduced in the reformed SGP may provide an anchor to control expenditure developments domestically while avoiding problems related to subsidiarity issues or different social preferences as regards the size and the role of government across EU countries.

The second argument applies to countries taking part in the Economic and Monetary Union. EMU is characterised by a single monetary policy and decentralised national fiscal policies and therefore, there is a need for a fiscal policy framework that ensures excessive budget deficits are avoided over the medium term and national fiscal policies are effectively coordinated. The problem with expenditure norms is that they do not refer to the fiscal variable which can entail negative externalities. While a rising deficit or debt level in one country can create area-wide problems, a rising expenditure level as such does not have negative repercussions on other countries, if it is matched by a corresponding increase in taxes. Expenditure rules cannot prevent deficit and debt increases stemming from tax cuts.

All in all, expenditure rules should be seen as complements at national level of the SGP rules, not as substitutes. There is no doubt that appropriate expenditure rules at national level would contribute to enhancing the effectiveness of the EU budgetary framework. In this respect, the Council has stressed in several occasions that "national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact", and that "the implementation of existing national rules (expenditure rules, etc.) could be discussed in the Stability and Convergence Programmes".

*5. – **Design issues related to the definition of an expenditure rule and its target***

42. In this section different elements related to the appropriate design of expenditure rules are analysed. Thus, issues such as the coverage of the rule and the possible exclusion of some budgetary items from it, the government layers to which the rule applies or the use of nominal versus real variables are addressed in this part of the note.

43. The design options summarised in this section do not entail general firm conclusions on what the best choices are (i.e. there is a number of trade-offs). In some cases, the appropriate design of the rule is country-specific and will highly depend on the nature of the fiscal problem the country is experiencing.

44. However, regardless of the final design of the rule, spending norms and ceilings should fulfil at least two conditions:

- Firstly, expenditure limits should be set before the outset of the budget negotiations, which implies that spending ceilings guide the preparation and execution of the budget, not the other way round.[22] In this way, expenditure targets should become the anchor for a medium-term fiscal framework (Ljungman (2008).
- Secondly, in the current EU context, national expenditure rules, irrespective of their features, must ensure consistency with the expenditure benchmark included in the reformed SGP.

5.1 – Numerical target definition: level, growth rate or percentage of GDP

45. In this case, the election of the target definition is straightforward in favour of level or growth rate. As explained in Table 1, spending rules defined as a percentage of GDP, which are rarely observed, may entail a pro-cyclical bias in the conduct of fiscal policies, which actually leaves the final choice between levels or growth rates. Subject to some qualifications, from a practical point of view both options can be considered equivalent.[23] Actually, very often the distinction between level and growth rate is a bit blurred. For instance, during the annual budget process, a spending growth rate objective has to be translated into a level figure so as to be validated by the Parliament. In the same vein, behind an expenditure target set originally in level terms there is a planned expenditure growth rate, i.e. it seems sensible to plan next year spending level by looking at current year's budgetary appropriations plus some (positive or negative) growth rate.[24]

5.2 – Target definition: real or nominal terms?

46. A spending target defined in nominal terms has the advantage of transparency and facilitates its monitoring. Additionally, it can also help keep expenditure under control, through a stronger-than-expected real adjustment, if the inflation outcome is higher than previously anticipated. In contrast, if the target is defined in real terms, compliance is not

[22] This is closely linked to the use of top-down budgeting for the annual budget preparation.

[23] An expenditure rule defined as the ratio of total spending to potential GDP could theoretically be envisaged to avoid the problem of pro-cyclicality. However, this option would encounter similar difficulties to those observed for CAB and structural balance rules related to the calculation of potential output, which would weaken transparency and simplicity features typically associated to expenditure rules.

[24] In practice, at the planning stage of the budget process, it is the spending growth rate which is used in relation to a medium-term growth of reference for revenues or GDP. However, in a majority of EU Member States, what is legally binding at the approval stage of the budget process is the level figure and not the growth rate. This can give rise to some problems at the execution stage of the budget in case the final expenditure level of the previous year was inaccurately estimated when planning the current budget law.

affected by inflation developments, and it may be less straightforward to measure and assess its fulfilment (i.e. price deflators differ across public expenditure categories and they also differ from the GDP deflator).[25] Additionally, the translation from real ceiling to a nominal spending figure may open the door to revise the deflator in order to obtain additional spending room under the ceiling, which would hamper transparency and credibility.

47. The final choice between nominal and real variables is also influenced by the time horizon (Mills et al. (2002)). In the short-term, nominal spending limits may help fiscal stabilization. In case public spending is set in nominal terms, a positive demand shock or a negative supply shock would lead to a downward shift in real government expenditure, and would help stabilise the economy,[26] which would not be the case if spending limits are targeted in real terms. In case of a negative demand shock or a positive supply shock, automatic stabilisers, at least on the revenue side, may fully work.

48. Against this background, an annual policy objective in the form of an expenditure target defined in real terms, i.e. a commitment to reach a targeted figure of real expenditure growth ex post, may not be appropriate. This is because such a rule could be difficult to meet in practice and potentially destabilising, as it may imply significant adjustments to nominal ceilings in line with revisions of inflation forecasts. These in-year revisions can be quite sudden and abrupt, in particular when facing terms of trade shocks (e.g. the oil price spikes of 2008-2009).[27] As a result, real targets may be inappropriate and destabilising when used as an operational annual target.

49. Over the medium-term, real spending targets are more sensible if the government intends to keep stable the real volume of goods and services provided by the public sector. In this respect, nominal targets over the medium-term can only be sensibly set if they refer to a real path. In this time horizon, however, the relevant issue is how to deal with price surprises or forecast errors. If inflation forecasts do not incorporate a systematic bias (i.e. they are efficient), the distinction between nominal and real figures loses relevance, in particular within a multiannual budgetary planning allowing overspending in one year to be offset in the following years. By contrast, a nominal spending rule may be stabilizing if the inflation is higher-than-expected due to a long-lasting demand shock. Nevertheless, this should be somewhat qualified: if the inflation rate is systematically higher-than-forecast, a nominal spending rule may be difficult to be preserved.[28] In practical terms, however, it is

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[25] From a sustainability point of view the GDP deflator is the straightforward choice, as it ensures that spending evolves in line with tax resources. Unfortunately the GDP deflator may present some shortcomings, e.g. a number of public expenses like entitlements may be indexed to other price indexes such as the CPI deflator (there are yet other possible choices, e.g. domestic demand deflator). In case the CPI is used to deflate problems may arise if there are significant and lasting terms of trade shocks as explained below.

[26] This would however require a high degree of flexibility in real spending, particularly wages and entitlements (Mills et al. (2002)).

[27] As explained in footnote 25, the use of the consumer price index (CPI) to deflate the real figures would be the worst case compared to other alternative deflators (e.g. GDP or domestic demand deflators), since it could entail sizeable revisions of the nominal ceilings in response to terms of trade shocks.

[28] In this context, an important question refers to the timing and modalities of the response to inflation surprises. While adjustments to the current target (i.e. during the current budgetary execution) may pose problems (as explained in paragraph 48), in a multiannual setting a crucial issue emerges to decide when and how the path of nominal ceilings should be revised in response to unexpected inflation developments. A sensible option could consist in adjusting the ceilings the year immediately following the price surprise. For instance, suppose that national authorities have set an expenditure path for years t+1, t+2, t+3 etc., and assume that during the budgetary execution in t+1 the macroeconomic scenario is updated with a higher price level starting in year t+1. Then, the nominal ceiling in year t+1 should be kept unchanged whereas the ceilings for t+2, t+3 etc. would be adjusted (totally or partly depending on the macroeconomic and budgetary objectives) according to the upward

very often the case that price and wage movements over the medium-term are asymmetric throughout the business cycle, i.e. relatively higher inflationary pressures in upswings than the downward adjustments registered in downturns. In this context, nominal expenditure rules may be countercyclical in an economic upturn while being more neutral in a downturn (Ljungman (2008)).

50. Overall, containing the impact of inflationary pressures on the conduct of fiscal policy appears appropriate (IMF (2009)). Real spending targets may accommodate price increases in a situation in which savings are not only needed to sustain fiscal consolidation but also to prevent inflationary shocks from spilling over into the whole economy. This shortcoming stemming from real ceilings may represent a problem for countries showing weak inflationary control and budgetary imbalances. In contrast, nominal thresholds show the opposite feature, i.e. they do not allow any compensatory measure in the budget, which may pose problems to keep nominal ceilings into operation (see previous paragraph). In general, nominal targets may be more appropriate in countries with sizeable governments in which the expenditure inertia related to inflation developments could be more significant.

51. The final and more appropriate choice between nominal and real targets should be based on the considerations elaborated in the previous paragraphs. On the one hand, a real expenditure target may be impractical and destabilising if it is used as an operational annual target. On the other hand, real targets make more sense over a medium-term perspective while multiannual nominal ceilings can only be properly set if they stem from a previously established real expenditure path. Overall, it seems advisable to have nominal targets as the annual policy target (i.e. no change during the budgetary execution even if there are inflation surprises) and real targets in the medium-term, in particular by adjusting (totally or partially) these multiannual ceilings in line with price surprises. All in all, it appears sensible to follow a real growth approach when setting up the budgetary figures in the annual budget law and medium-term budgetary framework at the planning stage, while adopting a nominal approach at the execution stage in order to avoid pro-cyclicality as well as problematic and inappropriate in-year adjustments.

5.3 – Coverage of the rule and exclusions of some budgetary items

52. In general, there seems not to be best practices in relation to the optimal coverage of an expenditure rule, i.e. pros and cons emerge when considering the exclusion of some budgetary items. Transparency calls in principle for a broad coverage of the rule over all budgetary spending items. However, a complete coverage over the whole budget may lead to a pro-cyclical stance in some cases (e.g. the inclusion under the ceiling of unemployment benefits during a downturn). A counter argument arguing against this is that exclusions may significantly weaken the link of the expenditure rule to sustainability.

53. Firstly, it can be considered to exclude *interest payments* from the target and focus instead on primary spending, which is more under the discretionary control of fiscal authorities. This would allow to better evaluate the magnitude of the spending containment. If interest payments had been overestimated during the budget preparation, an expenditure target including them could be met with a relatively modest effort and might imply a pro-cyclical policy. The opposite situation, in which interest charges have been underestimated may entail an undesirable reduction in other spending categories in order to comply with the rule (e.g. expenditure cuts on those less politically sensitive items such as

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revision of the price level in the corresponding years (thereby keeping –totally or partly- unchanged the real volume of expenditure for years t+2, t+3 etc.).

public investment which may affect long-term growth prospects).[29] If the overarching policy objective of the expenditure rule is to ensure that debt targets and tax policy are mutually compatible then interest payments should remain under the ceiling.[30] Moreover, it could be argued that in a medium to long-run perspective, interest payment developments may reflect to some extent those policy actions undertaken or announced by national authorities. In this respect, the distinction between those expenditure categories over which governments have direct control from those that are outside of national authorities' overseeing (at least in the short-run) may be somewhat misleading and could not represent an appropriate basis so as to decide the final coverage of the rule.[31]

54. Secondly, it is sometimes suggested to exclude *public investment* from the expenditure ceilings (i.e. a golden expenditure rule). In principle, this should avoid that the largest part of an expenditure adjustment falls on growth-oriented spending items, which are by nature less politically sensitive to be cut. Nevertheless, experience shows that this kind of exclusions can favour creative accounting and reclassification of spending items so as to circumvent the rule.

55. Additionally, the exclusion of public investment might give rise to some serious difficulties since it is often problematic to draw a clear-cut distinction between current and capital spending, i.e. not all capital expenses are productive (actually expenditure on health and education may be more productive) and the link with sustainability is weaken. This suggests that such exclusions are only advisable in those fiscal settings in which the institutional actors concerned are credible and fully committed to the objective of fiscal consolidation.[32] Overall, it may be more sensible and appropriate to safeguard growth-enhancing expenditure items included within the overall budgetary envelops by setting clear policy priorities. This would ensure that the link with sustainability is not weakened by a narrow coverage.

56. *Cyclically sensitive items* are frequently mentioned as suitable candidates to be excluded from the coverage of expenditure rules. This could be justified by the fact that some expenditure categories, in particular unemployment benefits, are not under the control of government in the short-run and may entail undesirable spending cuts on other items. In addition, their inclusion under the ceiling may hamper the countercyclical properties of spending rules in bad times, while making more difficult to assess the real fiscal effort of the government in good times. In turn, their inclusion may provide room for additional spending during a business cyclical upswing, which may be of structural nature and complicate the adjustment in the subsequent downturn.

[29] These forecast errors in relation to interest payments may be due to the volatility in interest developments, which could cause short-term fluctuations in the effective financial charges and may require unjustified spending reductions in other spending aggregates or create room for permanent increases in other expenditure categories putting at risk sustainability over the medium-term.

[30] This is particularly relevant in the current context, in which for some countries the average public debt cost is significantly higher than the potential growth rate, which may imply an increase in public debt over the cycle (Mills et al. (2002)). For other authors, the inclusion of interest payments will not likely have a significant impact, since the time horizon in budgeting is typically short and it is doubtful that future financial charges will be properly taken into account at the planning stage of the budget process (Ljungman (2008)).

[31] Again this presents some pros and cons. If the expenditure rule also applies to interest payments, this can be conducive to an excessive selling of financial assets to reduce the debt service (IMF 2009). However, fiscal rules in place should not introduce a bias in favour of a lower asset government position since these measures ought to be based on other type of considerations related to the financial position of the general government sector.

[32] See Blanchard et al. (2004) for an interesting discussion on this issue in the context of the EU fiscal framework. See also Dahan et al. (2010) for a more general analysis of the effects of fiscal rules on public expenditure composition.

57. Similarly to other spending items, the counter arguments against this exclusion are mainly based on sustainability issues, i.e. the link to debt developments is weakened. In addition, the inclusion of these sensitive expenditure categories would facilitate to ensure consistency between total spending developments and the actual tax burden to finance them. In the same vein, it is also argued that most cyclical sensitivity is on the revenue side of the budget and the exclusion of this kind of expenditures would have a limited effect in the functioning of automatic stabilisers. Additionally, the removal of the cyclical component of public expenditure is not easy and sometimes may provide unreliable figures. For instance, while unemployment benefits rise during a downturn, spending on sick leave incurred by the Social Security may slow down or even decrease simultaneously (i.e. there are fewer people employed entitled to take sick leaves). Even for the case of unemployment benefits, a rigorous approach implies the exclusion only of the cyclical fluctuation of this spending category while keeping the structural component under the ceiling. Needless to say the challenging technicalities involved in the calculation of these figures and their likely margin of error.

58. In some instances other exclusions related to *non-cyclical entitlements* have been proposed. The main argument to exclude some of these non-cyclical entitlements (e.g. legislated benefits such as pension expenditure or health related entitlements) is that in the short-term they are rigid and to some extent outside the direct control of government, which would make advisable not to include them under a binding ceiling. However, this argument is clearly not valid when a medium-term approach in budgeting is adopted. In the medium-term, the degree of discretion that national authorities have over all expenditure items is significantly enhanced, and therefore the inclusion of these items is necessary so as to take into account sustainability issues and allow the government to take the appropriate corrective measures if needed. In the same vein, these items should be covered by the (multiannual) expenditure rule in order to assess and compare them with other public policies and establish policy priorities in the coming years.[33]

59. Finally, more compelling arguments exist for the exclusion of *spending items financed by non-distortionary earmarked revenues.* If an expenditure item is fully financed by non-distortionary revenues and the government simply acts as an intermediary (e.g. spending funded by donations or foreign grants), this expenditure item could be a suitable candidate to be excluded from the rule. This is not always the case since this type of earmarked revenues does not rule out the risk of underestimating expenditure and/or overestimating revenues, which may have a budgetary impact as long as the government has subsidiarity obligations.[34] In addition, revenues are rarely non-distortionary and contribute to widen the tax wedge of the economy.

60. Some programmes fully funded through the EU budget are a particular case of spending items funded by non-distortionary revenues. They entail an equal expenditure and revenue effect with no impact on the budget balance. In these cases, the exclusion of these items could be advisable.[35]

[33] Even in the short term the 'rigidity' of such items is questionable. For health care, saving measures can be taken with a rapid impact, which makes an annual expenditure target more manageable in practice (e.g. policy measures related to the list of medicines funded by the social security and their administrative prices agreed between the authorities and the pharmaceutical sector). For cash entitlements such as pensions, although the focus would generally be on structural reforms with gradual effects over time, it is also conceivable to deploy more short-term regulating tools (e.g. partial or full non-indexation to prices).

[34] There may be also risks if expenditure is overestimated during the planning stage of the budget process since this could create room for expanding other spending items during the budgetary execution.

[35] If an EU Programme requires public co-financing from Member States then there is an impact on the budget balance and the corresponding amount of domestic funding should be included under the coverage of the rule.

61. Overall, on a theoretical basis expenditure ceilings should ideally include all expenditure categories that are subject to expansionary pressure in the budget process so as to keep a strong link with sustainability. However, this should be assessed against the potential negative effects of a full coverage as explained in the previous paragraphs.

5.4 – Accounting system

62. The use of the ESA95 methodology appears at first sight advisable so as to be consistent with the EU fiscal surveillance framework. However, the higher availability of cash data and the need for timely monitoring to allow prompt action in case of deviation from the adjustment path suggests that a dual approach could be envisaged, i.e. the rule could be defined in cash terms with a parallel mechanism of translation in ESA95 on a quarterly basis (Ayuso-i-Casals (2006)). If such an approach is used, it is important that the conversion of cash data to national accounts figures is carried out in a timely and transparent manner, ideally applying to the whole of the general government sector so as to ensure that expenditure targets are properly monitored.

5.5 – Time horizon

63. In general, expenditure rules incorporated into medium-term budgetary frameworks, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances while making stabilisation and consolidation objectives more compatible. In addition, a medium-term perspective in the management of public expenditure may allow taking into account the future impact of current spending policies over the next years and setting consistent expenditure targets according to the expected macroeconomic prospects, tax revenue developments, sustainability issues and policy priorities.

64. In general, a multi annual rule is always superior to a rule that only sets a target for one year since circumvention becomes more difficult. An annual spending rule may be easily circumvented by postponing the recording of expenditures to the following budgetary years and may be more subject to creative accounting practices.[36] When the target is set for several years, the possibility to postpone expenditures or structural adjustments to the future to circumvent the rule is more unlikely. This multiannual approach is particularly relevant in the case of public investment due to the indivisibility of investment expenditure and the difficulty of accurately projecting the timing of individual payments. In a cash budget and accounting environment, delays in large infrastructure projects can have a substantial effect on aggregate expenditure, which could create room under the ceiling in one year, and put pressure on the ceiling another year (Ljungman (2008)). An alternative way to circumvent an annual rule could consist in simply delaying the attainment of the announced target (e.g. an annual growth expenditure target is systematically breached and postponed until the next period). In this case, the time dimension of the rule including multiannual binding objectives is a key issue.[37]

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[36] These practices would only allow to meet temporarily the target and are generally linked to a lack of transparency in the existing fiscal framework.

[37] Stricto sensu, from a policy applied point of view, an effective fiscal rule can only be considered as such if it incorporates a multiannual dimension with binding objectives over time. In the absence of this time dimension, fiscal rules can be easily circumvented as explained in the text. In this multiannual context with binding objectives set for a certain time period, a crucial element is how to stick to the initial envisaged path and avoid any systematic drift from it. This adherence to the multiannual targets can be promoted through the reinforcement of some of the "ideal" features that fiscal rules should perform in terms of transparency,

65. There are two different approaches to implement this medium-term perspective in the conduct of public spending policies (see European Commission (2007)). Firstly, a fixed-term expenditure framework, in which spending targets are set once and for all and are not adjusted over time unless unexpected exceptional events arise during the period covered by the framework. These escape clauses should be clearly specified in the legal text establishing the medium-term framework. Telling examples of this approach are the frameworks implemented in the Netherlands and Finland. Secondly, rolling frameworks in which each year an additional fiscal year with its corresponding expenditure limits is added to the period covered by the framework. In such approach, the ceilings for the years that have been previously planned are not adjusted unless there are exceptional circumstances. For instance, Sweden annually establishes a ceiling for a third additional fiscal year and includes it into its rolling 3-year expenditure framework.

66. An important element to be incorporated into a medium-term expenditure framework (MTEF), which should form the basis of the annual budget law, is a contingency margin to deal with unexpected spending developments. Taking into account the uncertainties surrounding future spending needs and trends stemming from unforeseen factors (e.g. natural catastrophes, adverse macroeconomic situations etc), planned spending in the MTEF should be set at a lower level than the expenditure ceiling in order to ensure that the final spending outcome respects the threshold. The size of this contingency margin will determine the margin of manoeuvre for the government to deal with unexpected spending as well as the magnitude of forecasting errors the government can make (Lindh et al. (2007)).[38] The example of budgetary margins included in the three-year expenditure ceilings of the Swedish spending rule is a telling example in this respect (See Box V in next page).

5.6 – Policy response to past deviations from the rule

67. An important element related to functioning of a multiannual expenditure rule is that the failure to comply with the spending target in a given year does not necessarily jeopardise adherence to the rule over the medium-term. In case the deviation from the expenditure path stems from temporary and non-systematic causes there is no need for adjustment measures (IMF (2009)). By contrast, should these deviations come from structural factors that can imply a more permanent deviation from the spending targets, incentives and mechanisms to correct these past deviations appear an important element in the design of the rule to ensure its credibility.[39] In this respect, renewed emphasis has been put on the need to introduce correction mechanisms in the context of the "Treaty on Stability, Coordination and Governance" (TSCG). A set of common principles for these correction procedures has recently been put forward by the Commission.[40]

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accountability, timely and reliable monitoring, the existence of pre-established corrective mechanisms in case of budgetary slippages etc. (see the 2nd part of BoxI).

[38] Obviously, these contingency margins, which are generally included in the most outstanding MTEF across EU countries, are closely related to the annual budget process and the monitoring of in-year budgetary execution.

[39] In this case, within a multiannual setting in which spending targets are set with a reference to a medium-term growth, the "memory" of previous under or over spending should not be lost. A sort of 'cumulated growth approach' over the whole period covered by the rule may be advisable so as to set appropriate and credible corrective mechanisms.

[40] *Common principles on national fiscal correction mechanisms*; Communication from the Commission COM(2012) 342.

Box V: Budgetary margins in the 3-year expenditure ceilings of the Swedish rule

The Swedish authorities introduced in 1997 a three-year nominal expenditure ceiling covering the central government plus the pension system (see Annex II for further details). These ceilings are not revised and every year an additional year accompanied by its corresponding ceiling is added. The target setting of these thresholds is consistent with the respect of the existing budget balance rule objective of a surplus of 1% over the cycle. In order to provide a buffer to prevent expenditure developments from exceeding the ceiling, planned expenditure is always set below this threshold. The budgetary margin is precisely the difference between the ceiling and total planned expenditure. This margin is not included in the budget, i.e. it is not appropriated, and its use implies a deterioration of the general government balance.

The primary function of this budgetary margin is to allow automatic stabilisers to work on the expenditure side while ensuring the respect of the ceiling and avoiding the need for spending cuts. This margin is made up of two different parts: 1) The security margin to allow the free working of automatic stabilisers; and 2) Room in addition to the security margin for new policy initiatives.

With a view to fulfilling the main purpose of the budgetary margin (i.e. free functioning of automatic stabilisers), this should have at least the size of the security margin. National authorities resort to an official policy guiding principle which establishes that the security margin (i.e. the minimum size of the budgetary margin) must amount to 1.5% of total expenditures covered by the ceiling for the budget year t+1, and then 2% and 3% for the following two years, i.e. t+2 and t+3. These figures can be considered as the government's estimates of how much expenditures will increase in the presence of a sizeable negative economic shock to the economy.[41]

For instance, in the 2013 budget law (t+1) prepared in 2012, the budget margin for 2015 (t+3) must at least amount to 3% of planned expenditure. In the budget of the following year, i.e. the 2014 budget, the budgetary margin of 2015, which now has become t+2, must at least represent 2% of total spending covered by the ceiling. Finally, in the budget of 2015 submitted in 2014 (i.e. 2015 is now t+1), the budget margin must at least be set at 1.5% of total budgeted expenditure under the ceiling. In this example, in which the total budgetary margin equals the security margin, the government has strictly observed the security margin for 2015 in the three consecutive budgets between 2013 and 2015. If the budgetary margin were larger than the security margin, this additional spending room might be used for new policy measures as long as the 1% surplus target over the cycle is fulfilled and the security margin is respected.

In case the macroeconomic scenario is better-than-expected and inflation is higher-than-anticipated, public spending is likely to increase via inflation indexation. This higher expenditure would be partially or totally off-set by lower unemployment benefits. In case the final impact leads to an increase in total spending, this higher expenditure will have to be accommodated within the security margin. Conversely, if economic developments are worse-than-forecast, the increased spending (e.g. higher expenditure on unemployment benefits) will also be dealt with by the security margin. This security margin could also accommodate an increase in the rights based transfer system (e.g. pensions, maternity leave, sick leave etc.).

Although there are no formal rules preventing the government from using the budgetary margin in a pro-cyclical way, some practical restrictions make difficult this option. Specifically, two constraints may operate to avoid such a situation: 1) New policy measures implying more spending must be consistent with the 1% surplus target over the cycle regardless of how much room is still available under the ceiling; and 2) In every budget law a new ceiling for the third year is proposed and this must be in line with the surplus target. The corresponding margin for the third year may be smaller than the one for the first or/and second year, limiting the room for new policy initiatives.

[41] This official guiding principle is described in an appendix to the spring budget bill 2011, and represents a voluntary commitment by the government. It has a strong foundation in procedural norm and it is mentioned in the official publication "The Swedish fiscal policy frame work" by the government that has been endorsed by the parliament. The budget margin is not explicitly mentioned in the law, but the existence of a margin is discussed in the written material that is motivating the budget law. In this sense the margin has a mild form of mild legal status. However, the size of the margin is not mentioned in the legal documents.

5.7 – Expenditure rules in a decentralised fiscal framework

68. Apart from cultural and historical country specific elements, fiscal decentralization processes may be partly justified on economic grounds. In particular, lower general government tiers may better tailor the provision of public goods and services to local needs and preferences, and establish a closer link between their provision and their financing, thereby increasing accountability at regional and local level (See European Commission (2012a) for a comprehensive overview of the current developments of fiscal decentralisation in the EU countries and their policy implications).

69. However, greater fiscal decentralization may render fiscal discipline, and particularly public spending control, more challenging. This is partly due to the larger number of institutional actors involved in the overall budget process of the country. However, the relationship between fiscal decentralisation and budgetary discipline is an open issue and no firm conclusions can be drawn from the current literature. Some researchers such as Afonso et al. (2009) find some evidence suggesting that a rise in the ratio of territorial public spending over central government expenditure contributes to an increase in the total primary spending as a percentage of GDP. By contrast other recent researches (European Commission (2012a)) find some evidence according to which fiscal decentralisation *per se* is not necessarily associated with worse budgetary outcomes and stress the importance of the design of this decentralisation to explain fiscal performance in a decentralised context. In particular, the funding system of territorial governments is found to be a key issue in order to promote fiscal joint responsibility (i.e. those territorial governments relying more on own revenues (both taxes and fees) to carry out their spending competences tend to show better budgetary outcomes than those regional and local authorities that are more dependent on transfers from central government to finance their expenditures).

70. Overall, a main element underlying a potential fiscal profligacy by lower layers of governments includes growing spending powers coupled with limited revenue autonomy. This may give rise to vertical fiscal imbalances, a too high dependence on transfers from central government creating moral hazard problems and hampering joint fiscal responsibility,[42] as well as possible spillover effects from higher spending jurisdictions to other territories. In this context, it appears essential to establish an adequate fiscal framework to ensure that budgetary developments at all levels of government, and in particular public spending trends, are compatible with sound and sustainable public finances for the whole of the general government sector.

71. Against this background, the introduction of an expenditure rule covering all general government sub-sectors could be instrumental in ensuring that fiscal decentralisation and budgetary discipline are compatible. However, the suitability of this full coverage needs to be qualified from a policy applied point of view. Institutional and historical country-specific backgrounds and legal constraints may render a full coverage by a single rule unfeasible and inappropriate. Additionally, it must be underlined that a spending rule establishing binding expenditure ceilings for all government layers cannot guarantee by itself the consistency of spending developments carried out by each level of government with an overall fiscal target for the entire general government sector. Other institutional reforms

[42] These transfers and grants may create the perception that local public spending is funded by non-residents, weakening spending discipline and public policy-cost awareness. This situation could push demand for regional and local public expenditure above optimal levels. The pressure for increased transfers from central to sub-central authorities can eventually translate into higher deficits and debt of the whole general government sector that might in turn jeopardise the respect of the SGP provisions.

are needed to ensure this consistency (e.g. an appropriate funding system for territorial governments as highlighted previously). These institutional reforms and arrangements have been enshrined in some cases in the so-called Internal Stability Pacts (ISP). The following aspects normally included in these internal pacts deserve particular attention.

72. Firstly, an effective information system, i.e. the timely availability of expenditure data for all government layers, is an indispensable pre-requisite to establish an efficient monitoring of spending trends allowing to adopt prompt policy measures in case spending slippages are identified.[43] A calendar and frequency for data dissemination to make it publicly available should be established in advance so as to promote transparency.

73. Secondly, there must be a clear-cut sharing of policy responsibilities across layers of government in order to avoid any duplication of competences. This would allow determining which spending functions are assigned to each tier avoiding responsibility-shifting while facilitating the correct assessment of the needed resources to carry out these tasks (i.e. this could help better estimate expenditure developments and set the appropriate expenditure ceilings accordingly).[44]

74. Thirdly, the distribution of expenditure powers should be accompanied by a stable financing system for territorial governments. These funding mechanisms should be based on transparent rules governing the transfers to sub-national authorities and the working of tax-sharing schemes. Additionally, an appropriate degree of tax autonomy in accordance to the spending powers assigned to lower levels of governments should also be considered to avoid vertical fiscal imbalances and promote joint fiscal responsibility. All these rules and procedures governing the funding system for territorial governments must be made public, which should increase transparency and accountability. This in turn would provide more incentives for all public authorities to give more attention to medium and long-term consequences of their spending decisions.[45]

75. Fourthly, transparency should also be present in the monitoring and enforcement mechanisms put in place to ensure the correct functioning of the spending and revenue schemes implementing the distribution of fiscal powers and responsibilities across government tiers. So far, these monitoring and enforcement mechanisms have been one of the weaker features of the existing ISPs, and their improvement is an essential precondition to pave the way for a successful implementation of an expenditure rule.

76. Next, the establishment of an expenditure rule applied to all general government sub-sectors does not preclude the existence of other types of fiscal rules applied to territorial governments, which are currently covered by balanced budget rules and/or debt rules in a majority of EU Member States.[46] As explained in Table 1,

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[43] The provision of timely budgetary data for all sub-sectors is one of the requirements contained in the Directive on requirements for national budgetary frameworks included in the six pack.

[44] This is even more relevant at the present juncture. In some EU Member States, territorial governments have assumed important expenditure powers in sensitive areas such as health and education in which spending pressures emerge frequently.

[45] This higher autonomy on the revenue side should be accompanied by coordination mechanisms between territorial and central governments to avoid or minimise possible harmful side effects such as an excessive tax competition across jurisdictions.

[46] Recent research in this field has found that debt rules applied to territorial governments seem to have a positive impact on the primary balance via restraints on spending developments (See European Commission (2012)). At present, most of the existing debt rules in the EU countries apply to territorial governments, and in a large number of cases they constraint the issue of new debt to the debt repayment capacity, which is defined as

spending rules need to be complemented with budget balance and/or revenue rule to ensure the sustainability objective and tackle efficiently the deficit bias. This is the lesson that can be drawn from some successful country-specific policy experiences in the EU (see footnote 18).

77. Last but not least, the role that an independent fiscal institution may play in supporting fiscal coordination and expenditure control across government layers deserves further attention. Obviously, the appropriateness of an independent body to carry out these tasks is a country-specific issue and depends very much on the domestic institutional setting and historical background (i.e. one size does not fit all solutions). In some cases, however, these institutions have proved their instrumental character in providing this institutional coordination (See Box VI on the High Council of Finance in Belgium).

78. Overall, all these elements should be correctly designed and included in the ISPs. This has so far been pursued through two different approaches in those Member States which have put in place these internal pacts.

79. These two different options are based on a cooperative institutional setting and the resort to numerical fiscal rules, respectively. Thus, some countries such as Austria, Belgium and Germany have adopted a cooperative approach that seeks to reach an agreement on the fiscal targets assigned to each level of government in order to ensure the respect of the SGP. In other cases, for instance Spain and Italy, the strategy implemented relies more on the existence of fiscal rules imposing binding constraints on budgetary developments with a view to ensuring consistency with EMU requirements. The two approaches are not however mutually exclusive but rather complementary and, in fact, all ISPs currently in place in EU Member States combine features of both.

Box VI: The High Council of Finance (HCF) in Belgium

In Belgium, the *High Council of Finance* (section 'Public sector borrowing requirements') is a coordination body that determines since 1992 the contribution of federated entities to the stabilisation function of fiscal policy and to the respect of the EU fiscal rules (see European Commission (2006)).Every year, around March, the HCF assesses the realisation of the objectives of the Belgian internal Stability Programme of the previous year. In early summer, it analyses the budgetary situation and perspectives related to the borrowing requirements of each government layer and makes recommendations about the fiscal targets for the short, medium and (since 2002) long-term for the whole of the public sector, the federal and regional levels.

The analyses of the HCF are limited to recommendations on the budget balances, and do not concern issues related to the redistributive function of fiscal policy. These recommendations form the basis of cooperation agreements between the federal and regional governments that set the budgetary targets and act as internal stability programmes. Until 1999, they were integrated in the Belgian convergence programmes and, since then, they have been incorporated in the stability programmes. Since 2001 a Study Committee on Ageing within the High Council of Finance is in charge of approving and releasing projections of age-related budgetary expenditures, which are previously prepared by the Federal Plan Bureau (FPB). Subsequently, the section 'Public sector borrowing requirements' of the High Council of Finance takes these projections into account for its fiscal policy recommendations.

The High Council of Finance (HCF) is composed of 12 high-level experts: academics, members of the National Bank and representatives of the federal and regional administrations with a 5-year term of office. Their mandate is incompatible with any political office, so as to ensure the independence of the Council. The secretariat is held by the research department of the Ministry of Finance (see Lebrun (2007) and fiscal governance database of DG Ecfin available on line).[47]

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the debt service-to-revenue ratio of local and regional governments. There is some evidence suggesting that since the start of EMU, financial markets have shifted their focus from the debt-to-GDP ratio to the debt service-to-revenue ratio since the latter seems to be a better indicator for assessing credit risks (See Bernoth et al. (2004)). However, this positive influence of debt rules in relation to fiscal discipline should be assessed against some undesirable effects in terms of pro-cyclicality stemming from debt rules.

[47] http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm

80. Finally, the establishment of an expenditure rule should also cover the social security, which represents an important share over total public expenditure in most EU countries. In this case, the introduction of spending norms should take into account some idiosyncratic features of this particular sub-sector:

- Firstly, the institutional arrangements shaping the administrative functioning of the social security is country-specific and varies significantly across EU Member States (e.g. the social security budget is sometimes integrated in the central government budget like in the Netherlands and falls almost entirely under the existing expenditure ceiling, while in other countries, such as Spain, health services are decentralised and under the responsibility of regional governments. Alternatively, in France an important part of the social security sub-sector is essentially controlled by national authorities, while another significant part is administered by social partners with a high degree of autonomy in relation to some specific elements such as unemployment insurance and mandatory complementary pension schemes).
- And secondly, some of the goods and services provided by this subsector present a number of peculiarities compared to other goods and services supplied by other public sector entities (e.g. the cost of health care services which are significantly influenced by technological changes or pension expenditure affected by ageing).

81. There is a number of measures that can be adopted in the short-term to contain and control social spending on pensions, health care and other social entitlements. However, the strong inertia of these spending items and the budgetary costs stemming from ageing and technological developments require more fundamental measures of structural nature to ensure that any expenditure rule applied to the social –security is respected over the medium-term. In this respect, the last Kopits and Symansky's criterion (See Box I), which well-designed fiscal rules should meet, is crucial in the case of social security spending rules, i.e. rules can only be effective if they are supported by efficiency-oriented policies and underpinned by structural reforms.[48]

82. This structural feature of spending developments in the social security sub-sector has led to the establishment at EU level of the so-called three-pronged strategy, namely reducing debt at fast pace, raising employment rates and productivity and undertaking structural reforms in the pensions and health care system. This strategy should establish the basis to put social security expenditure on a sustainable footing and therefore contribute to the respect of expenditure ceilings for this institutional sub-sector.[49]

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[48] The structural nature of the necessary measures to contain expenditure pressures and respect spending targets can be easily shown in the case of pension expenditure. Thus total expenditure on pensions as a percentage of GDP can be decomposed as follows:

$$\frac{\text{Pension expenditure}}{\text{GDP}} = \frac{\text{Number of pensions}}{\text{Employment}} * \frac{\text{Average pension}}{\text{Apparent labour productivity}} =$$

$$\frac{\text{Number of pensions}}{\text{Working age population}} * \frac{\text{Working age population}}{\text{Employment}} * \frac{\text{Average pension}}{\text{Apparent labour productivity}} =$$

$$\frac{\text{Number of pensions}}{\text{Working age population}} * \frac{1}{\text{Employment rate}} * \frac{\text{Average pension}}{\text{Apparent labour productivity}}$$

Which shows that total spending on pensions depends on the total number of pensions in relation to working age population, the employment rate (the employed population relative to working age population) and the average pension relative to labour productivity.

[49] This sub-section mentions only on two important spending categories carried out by the social security, namely health and pension expenditure, and briefly analyses what elements of these spending items are more

83. **As for public health-care expenditure, there are some instrumental saving measures that can be quickly adopted with an immediate impact on health spending.** For instance, these short-term measures may include a more intensive use of generic drugs, the exclusion of medicines from the list of drugs publicly funded, a review of drug pricing policies, reimbursement policy of doctors' fees, and cost-sharing policies (i.e. the end user of medical services assumes part of their cost, which should entail not only additional revenues but also a more moderate demand of some of these services).

84. Despite the effectiveness of these measures in the short-run, pressures stemming from ageing and technological developments in the health care treatments, which may improve the final results in terms of better health for the population but at higher costs, may entail an upward trend of health care expenditure over the medium and long-term in the absence of more far-reaching reforms. As consequence, only structural measures reforming the current public health care systems may help revert this increasing spending trend in the future and promote the respect of expenditure ceilings within a multiannual perspective. These possible measures may comprise, among others, adequate cost-effective considerations when alternative treatments are available (see Box VII in this respect), promoting the use of primary health care services to reduce unnecessary use of specialist and hospital care, the introduction of more autonomy and competition in the public hospitals network and assess the number of public hospitals in place against the real health care needs of the population, the implementation of market-friendly mechanisms and more competition for the public and private providers of health care goods and services etc.[50]

85. Similarly to health care spending, public pension expenditure developments can only be consistent with budgetary stability and multiannual spending targets if some key structural reforms are undertaken. In this respect, the existing simulations and analyses of this issue suggest that some specific structural measures may particularly be effective to help slow down the expected unsustainable spending trends stemming from ageing under unchanged policies, and ensure that spending limits on this expenditure category will be respected in the medium and long-term. These measures would generally consist in postponing the effective retirement age (by both adjusting the statutory retirement age and restricting access to early retirement schemes), strengthening the link between benefits and the contributory efforts (namely by calculating the amount of final pensions according to the contributions paid in the whole working life), and adjusting benefits according to changes in life expectancy following the so-called notional accounts model. Other measures more short-term oriented to help respect the establishment of expenditure targets are, for instance, related with the no indexation (or only partially) of pensions to price or wage developments, the introduction of thresholds for the highest pensions and limit the number and/or the amount of pensions one individual can receive from different public pension schemes.[51]

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critical to ensure the respect of an expenditure rule over the medium-term. However, other expenditure functions of this institutional sub-sector are also relevant and should be taken into account in the design of an expenditure rule for the social security tier (e.g. unemployment and sick leave benefits, non-contributory pension benefits etc.).

[50] See Council Conclusions on the EPC-Commission Join Report on health systems in the EU (7th December 2010).

[51] Of course other policy actions such as the move from a single PAYG public pension system to a multi-tiered pension scheme with prefunded private pensions systems playing a more important role may also be relevant. However, a complete description of the appropriate measures to ensure the sustainability of the public pension systems and promote the respect of expenditure targets in this area goes beyond the scope of this note (See European Commission (2010b) for a comprehensive overview of these measures).

6. –Other elements of fiscal frameworks ensuring a proper working of an expenditure rule

86. This Section 6 focuses on the need to complement the introduction of an expenditure rule with some other measures to upgrade the whole fiscal framework. Some of these elements are crucial to ensure that the functioning of expenditure rules will effectively address the deficit bias and contribute to public spending control.

6.1 – The most primary elements of domestic fiscal frameworks

87. A first important element refers to the functioning of the most primary elements of the fiscal framework. Specifically, prior to introducing any kind of fiscal rules, and specifically expenditure rules, some basic elements mainly related to statistical, accounting and monitoring issues should function up to minimum international standards. For instance, the use of a common standardised accounting methodology in the whole public administration and the need for regular availability of budgetary statistics are key pre-conditions. Likewise, the existence of intra-year regular monitoring and timely reporting for the main expenditure and revenue categories for all government layers are crucial to ensuring a proper functioning of the fiscal framework (e.g. the respect of fiscal rules). Finally, the production of unbiased and realistic forecasts on which the budget preparation is based is also critical. Some EU countries currently suffer from shortcomings related to these issues and the Directive on minimum requirements for domestic budgetary frameworks, included in the "six-pack", should be instrumental in addressing these pitfalls. Needless to say that the appropriate functioning of these basic elements are crucial in order to ensure transparency in the whole fiscal framework.

88. In the same vein, the existence of appropriate mechanisms to ensure timely expenditure control by the Treasury is essential to ensure the respect of a spending rule. Specifically, public financial management procedures based on the introduction of expenditure commitment controls would ensure that any planned expenditure will be checked against the availability of resources (i.e. budget appropriations) before a definitive payment commitment is approved (see Box VII below).

Box VII: Expenditure commitments control

The commitment stage of the budget execution process represents a critical stage for maintaining fiscal discipline, i.e., preventing overspending and the accumulation of arrears. A commitment represents a reservation against budget appropriations that would allow spending agencies entering into contractual arrangements. A liability is then incurred when a contract is signed, a purchase order is made, or any other similar arrangement is executed. Expenditure commitment mechanisms verify ex-ante the availability of budgetary resources for any planned expenditure before a firm external contract implying an expenditure commitment is signed.

Commitments may relate to the provision of goods and services, including capital expenditures, subsidy and transfer payments, or obligations to pay interest or repay debt. They may require a single payment, or a series of payments, to be made during a single budget year, or a longer period. In accounting terms, a liability is recorded when goods and services are delivered and delivery is verified as in line with the contract/purchase order. The verification stage will be followed by a payment stage.

Ideally, all line ministries and institutions, as well as territorial governments, should report on a regular basis to the Treasury on their outstanding level of commitments. This should enable the regular monitoring of commitments by the Ministry of Finance. In particular, the assessment of the outstanding stock of existing commitments is a critical step in controlling spending developments and preparing a realistic supplementary budget if needed.

6.2 – Sound budgetary procedures for the annual budget preparation

89. Sound budgetary procedures governing all the procedural rules laid down in law and covering the three stages of the budget process, namely planning, approval and execution are also critical for the appropriate functioning of rules. According to the literature, a number of desirable features of this budget process may have a positive impact on budgetary outcomes (Hagen et al. (1999)).[52]

90. Three of these features are particularly important to ensure the proper functioning of an expenditure rule and the respect of its binding spending ceilings: the centralisation of the budget process at the planning and approval stages, the resort to top-down budgeting during the budget preparation and the gradual introduction of performance budgeting and regular spending reviews. These three dimensions of the budget process are conducive to avoiding the common pool problem, enhance spending control and promote budgetary savings by increasing public expenditure efficiency, thereby supporting the effective functioning of an expenditure rule.

91. Budgetary centralisation at the planning and approval stages heavily influences fiscal outcomes. In general, a fragmented budget preparation involving a large number of deciding actors leads to deficit bias due to the common pool problem. This centralisation of the budget process should entail strong competences and veto power assigned to the Minister of Finance during the budget preparation, and limited power of the parliament to modify the overall size of the budget at the approval stage and to amend the budget at the execution stage (barring exceptional circumstances such as natural catastrophes).[53]

92. Top-down budgeting approach starts the budgetary planning with a binding ceiling limiting the total amount of resources. Subsequently, this amount is distributed among expenditure areas and programmes. While this type of budgeting facilitates the introduction of binding spending ceilings, it is also more conducive to fiscal discipline than the traditional bottom-up approach, in which the total spending is obtained by the sum of the individual expenditure requests of all line ministries and agencies.

93. The gradual introduction of output-oriented budgeting, i.e. performance budgeting assessing the results of public expenditure programmes against their initial objectives and the amount of resources effectively spent, may contribute to increasing the efficiency of public policies while promoting savings (see Joumard et al. (2004) and OECD (2008)). The ultimate objective of performance budgeting is to establish a link between the resource allocation and the efficiency of these programmes in order to promote a more adequate resource allocation in the budget preparation (see Box VIII).

94. Closely linked to performance budgeting, a number of countries have implemented the so-called spending reviews. This can be defined as special forms of policy evaluation in the context of the budget process (OECD (2010a)), in which the review not only look at the effectiveness and efficiency of spending programmes under current funding level but also at the consequences for output and outcomes of alternative funding amounts. In addition, an effective programme may be asked to cut spending if it is considered less priority than other public expenditure policies.

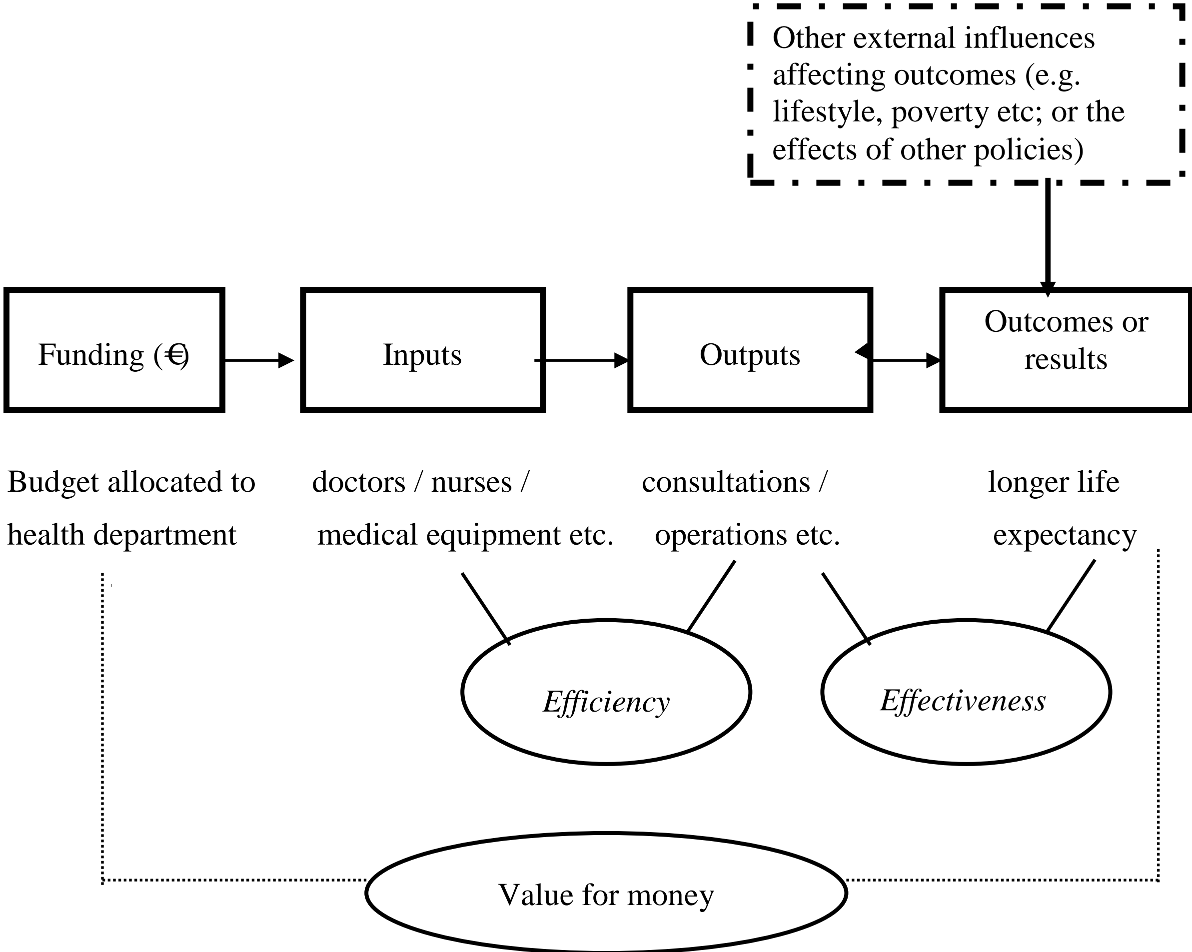
[52] Seven budgetary dimensions are commonly accepted to be quality enhancing vis-à-vis the three stages of the budget process: Transparency, multiannual budgetary planning, budgetary centralisation at the planning and approval stages, budgetary decentralisation at the implementation stage (i.e. reallocation of resources subject to the respect of the overall spending limits), top-down budgeting, realistic economic assumptions and budgetary reserves (i.e. contingency margins) and performance budgeting (see European Commission (2007)).

[53] This refers to amendments introduced at its own initiative by the parliament and not to the budget rectifications typically approved by the parliament in the fiscal year based on proposals from the government.

BOX VIII: Performance in public services' delivery

The internal structure of public policy programmes can be very complex. A conceptual framework for analysing the inter-relationship between inputs, outputs and outcomes in delivering public services can prove to be very useful. The figure below shows how these elements are connected taking as example public health activities. Inputs are those resources that make possible the production and delivery of public services. They commonly include different categories of labour and physical assets (e.g. doctors, nurses, scanning equipments etc.). Outputs are the final products or services for delivery to the final user (e.g. the number of effective medical treatments or operations carried out). Finally, outcomes or results are the final impact for the community as a whole or for the individual that government programmes have brought about. Outcomes usually represent what the public department concerned is trying to achieve (e.g. longer life expectancy or better health measured by a particular indicator). Targets of public programmes are normally expressed in the same unit as outcomes.

As a result, outcomes should be measurable for having an appropriate target setting. Therefore, this target setting is crucial and should be based on SMART criteria: (S) specific, avoiding vague targets leading to uncertainty; (M) measurable, underpinned by sensible and reliable data; (A) achievable, i.e. feasible; (R) relevant, in relation to what the public body is trying to achieve; and (T) timed, with both a clear deadline and timely data. These criteria should help targets to represent a real measure of success (i.e. a noticeable difference in the quality of delivered services and/or significant savings if the target is achieved). A greater awareness that not all public policies are appropriate for the use of performance indicators (e.g. where outcomes and outputs are difficult to measure) and the consciousness that performance budgeting still have important methodological problems should be kept in mind. However, its gradual introduction coupled with the regular implementation of spending reviews may allow governments to save resources to finance new policy objectives or sustain fiscal consolidation in a much more effective manner than other traditional budgeting tools such as across the board cuts, which generally do not discriminate between spending areas and policy priorities.



6.3 –Comprehensiveness of the annual budget law

95. The annual budget law should cover as much as possible all public sector economic transactions and operations with an impact on public spending and the budget balance. Thus, this necessarily entails the need for appropriate budgetary procedural rules to limit the number and ensure the monitoring of extra-budgetary funds outside the standard budgetary process (e.g. social security funds existing in some EU countries which are not included in the regular budget process for the preparation of the annual budget law) and to strictly restrict off-budget operations. Otherwise, the implementation of an expenditure rule could easily be circumvented by the use of these mechanisms. Again, the obligations stemming from the Directive on requirements for domestic budgetary frameworks included in the "six-pack" may be instrumental in addressing these potential shortcomings.

6.4 –Strict control and limitation of tax expenditures

96. According to the OECD, tax expenditures are defined as "those provisions of tax law, regulation or practices that reduce or postpone government tax revenues for a comparatively narrow population of taxpayers relative to a benchmark tax (OECD (2010b)), i.e. they are provisions the implementation of which leads to a loss of revenues for tax authorities and a reduction of the tax burden for a particular group of tax payers compared to what would stem from the application of the general tax norms. They can adopt different forms, e.g. allowances (i.e. amounts deducted from the benchmark to arrive at the tax base), exemptions (i.e. amounts directly excluded from the tax base), rate relief (i.e. a reduced tax rate applied to a particular class of taxpayer or taxable income or transactions), tax deferral (i.e. a delay for the effective tax payment), and tax credits (i.e. amounts deducted from a tax liability).

97. Although the use of tax expenditures may be justified in some cases, country policy experiences show that their extensive use can significantly hamper the main objective of an expenditure rule, i.e. coping with the deficit bias from the spending side with a view to improving the overall budget balance. The result can be that large tax expenditures do away with a significant part of the benefits of spending restraint due to lower tax receipts (i.e. well-identified spending is substituted by tax expenditures, which are less transparent, less predictable and less controllable). In turn, these tax exemptions may be inappropriate policy instruments, i.e. in some cases direct spending might be better suited for the ultimate targeted purpose (European Commission (2010)).

98. Once significant tax expenditures have been introduced, it is politically very difficult to withdraw them, which may eventually lead to an erosion of the tax base and a complicated tax system. This makes advisable to supplement spending ceilings with budget balance rules and/or clear regulations constraining the resort to tax expenditures via the establishment of binding floors for discretionary tax measures.[54]

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[54] The excessive resort to tax expenditures can also increase significantly the complexity of the tax regulations, reduce their transparency, increase tax collection costs and make the tax system regressive, which can give rise to equity problems. Specifically, the increased complexity of tax regulations may place small firms and less well-off households in a relatively less favourable position when attempting to benefit from tax expenditures, since this generally requires some expertise involving costs that only larger firms and wealthier households can afford.

99. A number of countries putting in place an expenditure rule have simultaneously experienced a sharp increase in the number of tax expenditures (OECD 2010b). Additionally, their budgetary cost is often underestimated by national authorities and their effectiveness measured against their objectives is not assessed on a regular basis with reliable criteria.

100. The number of tax expenditures and their budgetary costs may vary widely across EU Member States. However, these figures, as estimated by the OECD (2010b), are in some cases sizeable and likely to hamper the correct functioning of an expenditure rule (See tables 2 and 3 below).[55]

Table 2: Estimated number of tax expenditures

Country	Year	Number of tax expenditures
Germany	2008	85
Netherlands	2008	97
Spain	2008	138
United Kingdom	2007-2008	383

Table 3: Estimated budgetary impact of tax expenditure as percentage of GDP

Country	Year	Percentage of GDP
Germany	2008 (projection)	0.64
Netherlands	2009	1.83
Spain	2008	4.95
United Kingdom	2007-2008	12.54

[55] The analysis carried out by the OECD only includes estimates for four EU Member States. However, for some of the remaining EU countries, available information suggests that both the number and the budgetary impact of tax expenditure may also be significant. This is the case of France, for which according to some estimates provided by the French Court of Auditors, the number of tax expenditures in 2009 amounted to nearly 700 while their budgetary impact in the same year is estimated at around 11% of GDP (this figure does not include tax expenditures introduced by territorial governments). However, measures implemented over the last years seem to have improved the situation mainly thanks to the introduction of binding floors for the evolution of tax expenditures. Similarly to France, the loss of revenues stemming from tax expenditures in Italy amounted to approximately 10.7% of GDP according to a recent report released by the Minsiterio dell'Economia e delle Finanze in 2011, which identified 720 measures of this kind.

6.5 –Expenditure rules must be supplemented by other types of fiscal rules

101. As explained in Section 2, expenditure rules may be an effective policy instrument to tackle the deficit bias while showing a number of desirable characteristics in terms of transparency, controllability and simplicity. However, it was also shown that they need to be into operation together with other types of rules to ensure the objective of fiscal discipline.

102. The appropriate combination of fiscal rules is to some extent country-specific and should reflect domestic circumstances, including political, legal and cultural factors. However, some common principles stemming from successful country experiences and reflecting the overarching objective to restore fiscal sustainability may be identified with a view to strengthening the prevailing frameworks.

103. As mentioned in paragraph 28 and footnote 18, successful multiannual spending rules embedded into a MTBF have generally been adopted as key elements of an ambitious plan for institutional reform and fiscal consolidation. For instance, the Netherlands, Denmark, Sweden and Finland put in place during the 90s rule-based systems in place, in which an expenditure rule is combined with revenue or cyclically-adjusted budget balance rules. While in all of them the centralisation of the budget process is supported by these expenditure ceilings and top-down budgeting, the role played by independent fiscal bodies is also crucial to enhance transparency and promote sound fiscal policies (e.g. the CPB in the Netherlands and the Swedish Fiscal Policy Council).

104. Following this ideal model, the specific interplay among expenditure rules and other different budgetary norms in order to put public finances on a sustainable path can be summarised as follows:

- Regardless of whether a debt rule is in place or not, the central objective of fiscal policy over the next years across the EU Member States should consist in halting and reversing the growing debt ratio. This demands the formulation of a projected debt path consistent with a prudently defined sustainability objective and macroeconomic scenario.
- This path for debt reduction should be underpinned by operational (primary) budget balance targets, which might be translated into a budget-balance rule applied ideally to the whole of the general government sector (or at least to central government plus social security sub-sectors). This should typically be formulated in cyclically-adjusted terms and consistent with the achievement of the medium-term objectives of the SGP.
- These budget-balance targets should in turn be operationalised through binding expenditure ceilings based on a multi-annual spending rule for the general government. Expenditure thresholds would reflect the envisaged debt reduction path and realistic macroeconomic and revenue projections for the relevant period. The expenditure rule would be supplemented by a revenue rule (e.g. ensuring that higher-than-expected receipts are allocated to debt reduction) and/or a set of binding floors for discretionary tax measures.[56]
- Finally, a budget balance and/or debt rule consistent with the envisaged overall expenditure ceilings should be applied to sub-central governments.

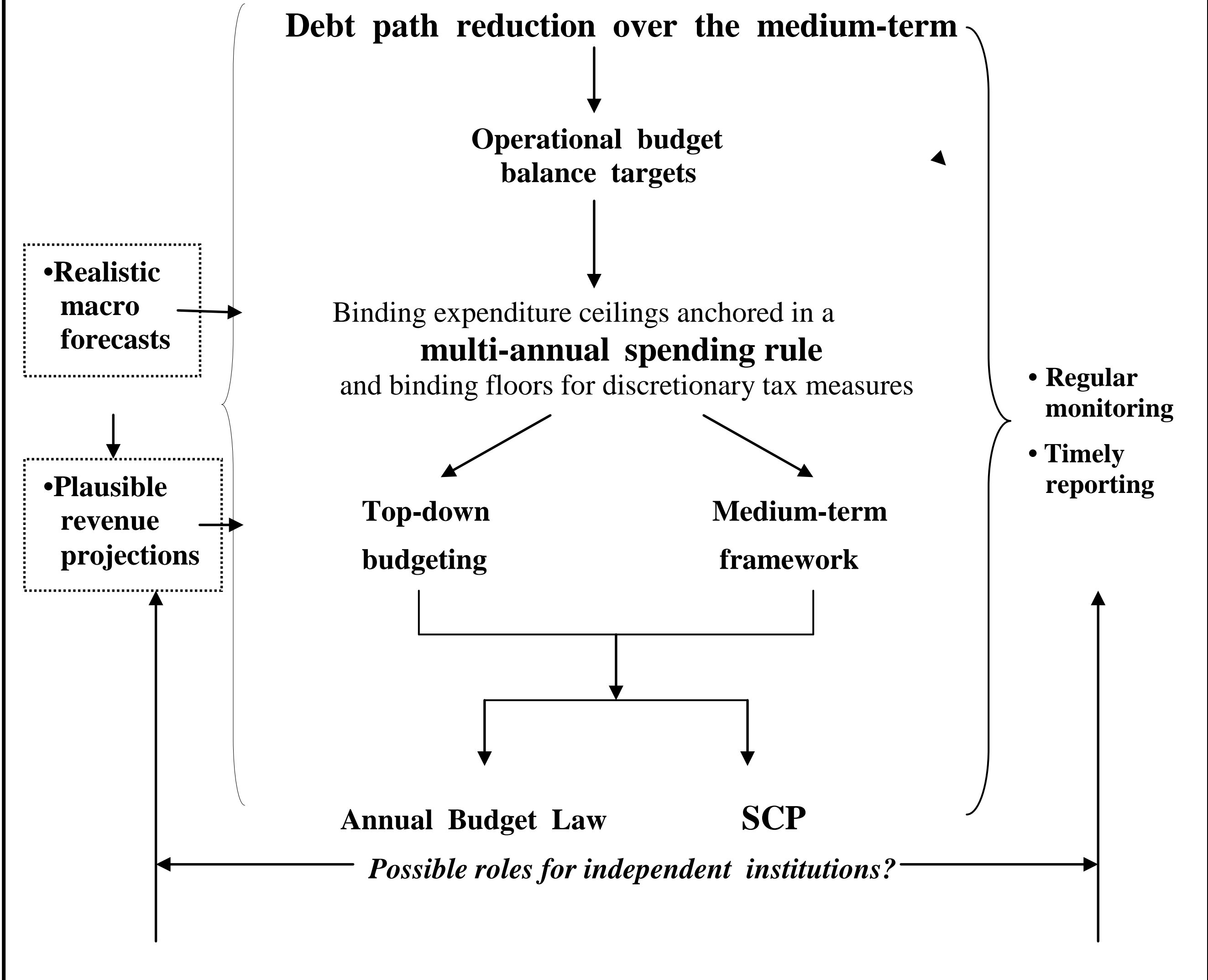
[56] The latter allows for a wider range of policy options, i.e. either a declining or rising overall tax pressure to the extent that in conjunction with the expenditure ceilings the overall consolidation objective is kept.

105. The graph included in Box IX depicts the main relationships among fiscal rules and other elements of domestic fiscal frameworks according to this ideal model.

Box IX: Domestic fiscal frameworks based on the expenditure side

As mentioned in the main text, the most successful and resilient domestic fiscal frameworks across EU countries in terms of fiscal discipline largely rely on the expenditure side, which is the part of the budget that government controls more directly, thereby increasing accountability.

In particular, rule-based frameworks consisting of an expenditure rule supplemented by a revenue rule and/or a budget balance rule seems to have yielded positive budgetary outcomes in terms of both discipline and stabilisation. For instance, the Dutch fiscal framework relies on strong multiannual expenditure ceilings complemented by a revenue rule. In the case of Sweden, the existing expenditure ceilings are accompanied by a budget balance rule defined over the cycle. In both countries, a balanced budget requirement applies to sub-central governments. As to Finland, the multiannual spending limits are consistent with a budget balance rule for the central government and are accompanied by a revenue rule for the social security that operates following a 'Rainy Day Fund' scheme. In this case, territorial governments are also covered by a balanced budget rule. This typology of fiscal framework is encapsulated in the graph below.



***ANNEX I*: Expenditure rules in place in EU Member States in 2010**[57]

[57] This annex relies on the information contained in the Fiscal Governance database of DG Ecfin, which is annually updated and available on line at:

http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

Expenditure rules in force in the Member States as of 2010

Country	Statutory base	Sector	Target/ constraint	Description	Time frame	Monitoring body	Enforcement body	In force since	In force until	Coverage of GG finances
AT	L	GG	Nominal expenditure ceiling	Nominal expenditure ceilings for five main areas (headings) of the budget, legally binding for 4 years.	M	MF	MF	2009	2015	42,2%
BE	CA	SS	Real expenditure growth rate	Real growth of health care expenditure for federal government ought to be equal or lower than a 1.5%.	M	IND, NP	GOV, possibly social partners	1995	2010+	12,2%
BG	PC	GG	Nominal expenditure ceiling as % of GDP	Ceiling on the size of the general government sector: 40% of GDP.	M	MF	MF	2006	2013	97,5%
CZ	L	CG	Nominal expenditure ceiling	Inserted in a medium term expenditure framework (MTEF), covers 2 years beyond the budget year. Expenditure limits are set to achieve a pre-defined deficit target.	M	MF	NP	2005	2010	41,7%
DK	CA	GG	Public consumption growth rate in real terms.	Real public consumption on a national account basis must not increase by more than certain amounts per year. Besides, total ceiling of 26.5% of cyclically adjusted GDP in 2015.	M	MF	MF	2007	2015	52,5%
FI	CA	CG	Real expenditure ceiling	Central government finances must never show a deficit of more than 2 per cent of GDP even in a weak economy. If prognoses show that the deficit is at risk of exceeding this limit, the Government will immediately propose action necessary to cut costs and other measures to avoid the deficit exceeding the limit.	M	MF	MF	2007	2010	38,1%
FR1	L[58]	CG	Real and nominal expenditure growth rate	Double constraint: no increase in the general budget expenditure (in volume), no increase in the general budget expenditure apart from interest charges and pensions (in value)	M	NP, GS, CoA.	MF	2010	2014+	25,2%
FR2	L	SS	Ceiling in volume for expenditure growth rate	Annual vote of the NP on the national ceiling for health expenditure.	M	IND	IND, GOV	2006	2014+	12,2%
IE1	L	CG	Allocation of expenditure	1% of GNP is set aside from GOV expenditure and automatically paid into the National Pension Reserve Fund each year for investment on behalf of the State.	A	MF	MF	2000	2010	2,1%
IE2	L	CG	Nominal expenditure ceiling	Rolling 5-year capital envelopes set out capital investment (Exchequer and PPP funded) by Ministerial Group for each year. They investment priorities over the medium term and include a provision to allow the carry-over of 10% of Exchequer capital savings from one year to the next.	M	GS	GS	2004	2010	6,2%

[58] The rule is not enshrined in law per se but has been included in the "Loi de programmation des finances publiques."

Country	Type	Sector	Target/ constraint	Description		Monitoring body	Enforcement body	In force since	In force until	Coverage of GG finances
IT1	L	RG	Nominal expenditure ceiling	Expenditure ceilings for pharmaceutical products (including patient co-payments, so-called "tickets") expressed as a percentage of the financing level for the national health service contributed by the State. Ceilings: 16,4% (2008); 16% (2009); 15.7% (2010).	M	MF, GS	GS	2008	2010	0,6%
IT2	L	RG	Nominal expenditure growth rate (RG)	According to Decree Law 112/2008, in the years 2009-2010-2011 total final expenditure of the Regions, programmed in 2008, must not exceed final expenditure less 0.6% in year 2009, final expenditure plus 1.0% in 2010 (only if compliant with the Pact in the previous year) and final expenditure less 0.9% in 2011.	M	MF, CoA	GS, CoA	2009	2011	5,6%
LT	L	CG	Nominal expenditure growth rate	If the GG budgets showed a deficit on average over the past 5 calendar years, then the annual growth rate of the planned State budget appropriations may not exceed 0,5% of the average growth rate of the State budget revenue of those 5 years.	M	MF	MF	2008	2010	42,2%
LU	CA	CG	Nominal expenditure growth rate	Realignment of public expenditure growth with medium term growth prospects once the countercyclical budgetary policy in response to the crisis comes to an end.	M	No body	No body	2010	2014	56,1%
NL	CA	GG	Real expenditure ceiling	Any setbacks against the expenditure ceilings must be compensated within the sector; windfalls can only be used to compensate for setbacks within that sector. Windfalls cannot be used to finance new expenditures.	M	MF	MF	1994	2015	92,5%
SE	L	CG, SS	Nominal expenditure ceiling	Nominal expenditure ceiling for CG and pension system.	M	IND, MF	GS, NP	2010	2010+	53,6%
SI	CA	GG	Nominal expenditure ceiling	The establishing legal act of the rule sets nominal expenditure ceilings for year t to t+5	M	MF	MF	2010	2015	97,5%
SK	L	CG	Nominal expenditure ceiling	Expenditure not considered in the State budget law can only be executed if its total amount does not exceed 1% of total expenditure approved in the budget law and the deficit is not increased. Allows increasing expenditure in good times. Initially, the rule set a limit of 15%.	A	IND, GOV, NP	IND, NP	2002	2010+	48,6%

Abbreviations

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
EL	Greece
ES	Spain
FI	Finland
FR	France
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom

A	Annual
M	Multi annual
BBR	Budget balance rule
CA	Coalition agreement
CC	Coordination committee
CG	Central government
CoA	Court of auditors
DR	Debt rule
ER	Expenditure rule
GG	General Government (includes CG, RG, LG, SS)
GOV	Government
GS	Governmental structure
IND	Independent body
L	Legal act
LG	Local government
MF	Ministry of finance
MIN	Ministry/ministries
MTBF	Medium-term budgetary framework
NP	National parliament
PC	Political commitment
RG	Regional government
RR	Revenue rule
SS	Social security

***ANNEX II*: *Detailed information on country-specific expenditure rules in some EU Member States in 2010*[59]**

[59] This annex mainly relies on the information contained in the fiscal governance database of DG Ecfin previously mentioned and on the Annual Peer Review of Fiscal Frameworks, which is a policy exercise carried out every year in the context of the Economic Policy Committee (EPC) (See European Commission (2012)), and on the fiscal governance database of DG Ecfin. Sometimes, other sources of information have been used to update the text or provide additional information.

<u>The Netherlands</u>: Real expenditure ceilings

General description of the rule and target definition: The level of spending, related to the budgetary targets of the coalition agreement is captured in an overall expenditure ceiling divided into three sectors, the 'core' central government sector, the social security sector and the healthcare sector. Any setbacks against the expenditure ceilings must be compensated within the sector; windfalls have first to be used to compensate for setbacks within that sector. Windfalls can be used for new expenditure as long as total expenditure is below the ceiling.

General government sub-sector(s) to which the rules applies: The ceiling applies to the central government and social security and health care sectors, which amounts to roughly 90% of total general government expenditure.

Implementation date: The rule is in force since 1994.

Coverage and exclusions: The coverage of the expenditure ceiling is wide, but not exhaustive. The main excluded items are expenditures from the Fund for Economic Structure enhancement (FES), spending of local governments, tax expenditures and part of the government interventions to stabilise the financial markets. Interest payments and unemployment benefits (which had previously been excluded from the ceiling) are currently under the coverage of the rule.

Accounting system: ESA95

Escape clauses: Expenditure ceilings can be tightened in case the general government deficit exceeds the signalling margin in order to reduce the deficit. The signalling margin is specified as a downward deviation of 1 percentage point relative to the path for the general government deficit adopted at the beginning of the term of office. If the signalling margin is exceeded, additional consolidation measures have to be taken.

Time frame: Four-year coverage.

Details: The ceiling is defined in net terms, i.e. gross expenditures minus certain non-tax revenues. Savings in one sector may only be used to finance additional spending in the same sector, transfers to other sectors can only happen in exceptional circumstances. The expenditure ceilings are first set in nominal terms, at the start of the government period, for each year of the government's four-year tenure. In a second step, they are converted into real ceilings by using four-year inflation projections. As actual expenditure is by definition presented in nominal terms, the ceilings must be translated every year into nominal ceilings using the latest forecast for the domestic demand deflator.

Statutory basis: Coalition agreement.

Monitoring: The adherence to the real expenditure ceiling is monitored by the Ministry of Finance. As the framework is directly connected to the annual budget law, all expenditures and revenues are ultimately under the scrutiny of the Court of Auditors.

Enforcement mechanisms: In case of non-compliance, the Ministry of Finance proposes corrective measures to be taken.

Comments on the functioning of the rule: In practice, the expenditure ceiling is well respected. The success is linked to the fixed nature of the framework, which turns the attention away from total expenditure and gives incentives to line ministries to look for expenditure reallocations to finance new policy measures. It also reflects the fact that economic forecasts used to calculate the ceilings are based on projections from an independent institution. Overall, these positive results have been possible thanks to a strong political support and commitment since the rule is only based on a coalition agreement (Ayuso-i-Casals (2006)).

Sweden: Nominal expenditure ceilings

General description of the rule and target definition: Three-year nominal expenditure ceiling.

General government sub-sector(s) to which the rules applies: Central government and the pension system

Implementation date: The rule started to be applied in 1997. Until recently, there was no legal obligation to establish expenditure ceilings in the Budget Bill. As from January 2010, however, the government is obliged by law to lay down expenditure ceilings for the three following years in the spring bill of the year preceding the three-year period.

Coverage and exclusions: The rule covers all expenditure by the central government and the pension system, except interest expenditure.

Accounting system: The target is defined in terms of budgetary accounting.

Escape clauses: There are no predefined escape clauses.

Time frame: Three-year rolling framework with no sun-set clause.

Details: The introduction of the rule was related to improving expenditure control.

Statutory basis: Legal basis (as from January 2010)

Monitoring: Respect of the rule assessed by the National Parliament and two independent authorities (The Swedish National Audit Office and the Fiscal Policy Council).

Enforcement mechanisms: No formal enforcement mechanisms.

Comments on the functioning of the rule: Compliance with the rule has generally been good and played a major role in controlling expenditure by forcing line ministries to prioritise. On some occasions the government has resorted to "budget netting", i.e. booking only net expenditures and not gross expenditure and revenues in some areas. This practise, which prevents the ceiling from being exceeded in a formal sense, undermines the purpose of the rule. The government has previously announced that it would discontinue this practise. The extensive use of tax expenditures is also an issue that could be addressed.

<u>Denmark</u>: Real expenditure ceiling on public consumption

General description of the rule and target definition: The rule stipulates the target of public consumption as a percentage of cyclically adjusted GDP and real growth in public consumption.

***Implementation date*:** The medium term fiscal plans have included a target for public consumption as a percentage of GDP. Such a target was also part of the Convergence Programme for 2011. The rule for real growth in public consumption was added by the May 2010 Fiscal Consolidation Agreement between the government and the Danish People's Party and also included in the 2020 plan and the 2011 Convergence Programme.

Coverage and exclusions: The rule covers general government, i.e. local and regional governments, central government and social security.

Accounting system: The target is defined in terms of ESA 95 accounting.

Escape clauses: There are no pre-defined escape-clauses.

Time frame: The target in Denmark's 2009 Convergence Programme was that public consumption as a share of cyclically adjusted GDP should be reduced to 26.5% in 2015. There were no targets for the intermediate years. In the May 2010 Consolidation Agreement, the rule that real public consumption growth should be kept at bay was specified for the years 2011-2013.

Details: The introduction of the rule was part of the May 2010 Fiscal Consolidation Agreement which, among other things, also included higher income taxes than previously planned and a reduction in the unemployment benefit period in order to correct the excessive deficit by 2013 as recommended by the ECOFIN Council.

Statutory basis: Medium-term agreement between coalition partners.

Monitoring: The Ministry of Finance is in charge of monitoring the rule.

Enforcement mechanisms: The Fiscal Consolidation Agreement contains enhanced mechanisms to ensure that actual spending does not exceed budgeted spending in local governments. The block grant can be cut by up to 3bn DKK annually if actual spending exceeds agreed spending. In 2011, the municipalities which spend more than budgeted are charged 60% of the deduction while the rest is charged collectively.

Comments on the functioning of the rule: The record of compliance with the rule is mixed. Non-respect has sometimes been due to local governments that breached the agreed targets (Ayuso-i-Casals (2006)). Despite these shortcomings, the rule seems to have contributed to fiscal discipline and the overall assessment is positive. This was the case in 2011, in which sanction mechanisms were introduced along with the rule.

France: Double spending norm at the central government level

General description of the rule and target definition: Central government expenditure is frozen in volume terms. Furthermore, spending excluding interest payments on debt and pensions of civil servants is frozen in nominal terms. The stricter rule applies.

General government sub-sector(s) to which the rule applies: Central government excluding other central government bodies (ODAC). This sub-sector represents roughly one third of total general government expenditure.

Implementation date: The rule was implemented in 1998 (see Moulin (2004)), while the rule on spending freeze in volume terms has been in force since 2004 (i.e. the zero volume increase rule). The rule on spending freeze excluding interest payments and pensions of civil servants in nominal terms is effective from 2011.

Coverage and exclusions: The scope of the norm in volume terms has been extended over time, and today it covers substantially all central government spending. However, certain supplementary budgets are excluded from the norm. Spending relative to the recovery plan, the "investissements d'avenir" programme and the local business tax reform is also excluded.

Accounting system: Budgetary accounting (cash based).

Escape clauses: There are no pre-defined escape clauses.

Time frame: Since the first multi-annual public finance act, the norm covers a 3-year period.

Details: The spending freeze excluding interest payments and pensions in nominal terms constitutes an additional constraint in theory. Nevertheless, the expected increase in interest payments in the coming years implies *de facto* that the other expenditures will have to remain almost unchanged.

Statutory basis: The rule is not enshrined in law per se but has been included in the "Loi de programmation des finances publiques."

Monitoring: In addition to the monthly monitoring of expenditure by the authorities, the Court of Auditors (CoA) assesses *ex-post* the increase of expenditure compared to the norm. In particular, the CoA may consider that certain items of spending have been wrongly ruled out from the calculation of the norm even when using the government's calculation method and that such exclusions are likely to distort compliance with the norm. Moreover, the CoA regularly issues recommendations in order to extend even more the scope of the norm so it includes certain supplementary budgets, which shall not differ from the general budget, according to this institution.

Enforcement mechanisms: There is no pre-defined enforcement mechanism.

Comments on the functioning of the rule: Assessing compliance with the norm is not easy due to repeated scope changes. Despite this difficulty, it can be seen that in the first five years of its implementation in 1998, the rule did not lead to the expected results. Initial targets were missed by a large margin and the objective of consolidating public finances through a structural decline in the expenditure-to-GDP ratio was not achieved (Moulin (2004)). In the period 2004-2010, and based on the perimeter effects (i.e. effective coverage of the rule) such as estimated by the authorities, expenditure growth in recent years roughly equalled inflation, and the objective of zero growth in volume terms was met. Nevertheless, such result shall be seen in a relative light as tax expenditures grew substantially over the same period and some fast growing spending items were ruled out from the perimeter. As a result, over this period, the rule did not prevent from missing the fiscal targets contained in the SCP due notably to expenditure slippages (Ayuso-iCasals (2010)). From 2010 onwards, however, the situation seems to have improved mainly by the introduction of specific tax expenditure floors.

***ANNEX III*: The equivalence between the MTOs and the expenditure benchmark approach in the reformed SGP**[60]

[60] This annex is based on the Public Finance Report in EMU (European Commission 2011).

This annex shows the analytical basis of the CAB and its link with the expenditure benchmark approach (see European Commission (2011)). Starting with the CAB, the budget can be described as the sum of two components, i.e. structural and cyclical. Expressing all budgetary variables in percent of GDP we have:

$$(1) \qquad b_t = r_t - g_t = r^s - g^s + (\varepsilon_r - \varepsilon_g)\left(\frac{y_t}{y_t^P} - 1\right)$$

where r, g, y and y^P are total revenues, total expenditures, actual GDP and potential GDP respectively. The cyclical component of the budget balance is typically modelled as a function of the output gap $\left(\frac{y_t}{y_t^P} - 1\right)$ scaled by the difference between cyclical sensitivity of revenues and expenditures ε_r and ε_g (note that ε_g is negative). The structural components of the budget balance are indicated by the superscript *s*.

The total differential of equation (1) gives the change of the budget balance:

$$(2) \qquad db_t = \left(\frac{\partial r_t^s}{\partial y_t^P} y_t^P - \frac{\partial g_t^s}{\partial y_t^P} y_t^P\right)\frac{dy_t^P}{y_t^P} + (\varepsilon_r - \varepsilon_g)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P}$$

Subtracting the cyclical component from the change in the headline balance yields the change in the CAB

$$(3) \qquad dcab_t = db_t - (\varepsilon_r - \varepsilon_g)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P} = \left(\frac{\partial r_t^s}{\partial y_t^P} y_t^P - \frac{\partial g_t^s}{\partial y_t^P} y_t^P\right)\frac{dy_t^P}{y_t^P}$$

Turning to the expenditure benchmark-based approach we know that

$$(4)^{61} \qquad dcab_t = dr_t^s - dg_t^s = d\left(\frac{R_t^s}{Y_t^p}\right) - d\left(\frac{G_t^s}{Y_t^p}\right) = \left(\frac{\dot{R}^s}{R^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{R^s}{Y^p} - \left(\frac{\dot{G}^s}{G^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{G^s}{Y^p}$$

where capital letters indicate levels of the respective variable and a dot a change with respect to time. This expression tells us how the underlying budget, i.e. the CAB, evolves depending on how fast revenues and expenditures grow relative to potential GDP.

Keeping in mind that in the EU government revenues *R* have an elasticity with respect to GDP equal or close to 1, the first term on the right hand side of equation (4) is equal to zero. In that case, the change of the CAB can only be zero if expenditure *G* grows in line with potential GDP. In terms of equation (3) it means that the increase in expenditure equals the increase in revenues implied by an increase in potential GDP.

Similarly, assuming a government size (G/Y) of around 0.5 an improvement of the CAB in the order of 0.5% of GDP requires that expenditure growth is one percentage point lower than potential GDP growth, unless higher expenditure growth is compensated by discretionary revenue measures, which would go on top of the 'natural' increase of *R*.

[61] Recall that in general: $\frac{d\left(\frac{A}{B}\right)}{dt} = \left(\frac{\dot{A}}{A} - \frac{\dot{B}}{B}\right)\frac{A}{B}$

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