ISSN 1725-3209

EUROPEAN ECONOMY

Occasional Papers 113 | July 2012

Fiscal Frameworks in the European Union: May 2012 update on priority countries

(Addendum to Occasional Papers No.91)

Economic and Financial Affairs

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KC-AH-12-113-EN-N
ISBN 978-92-79-22908-4
doi: 10.2765/23784

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European Commission
Directorate-General for Economic and Financial Affairs

Fiscal Frameworks in the European Union: May 2012 update on priority countries

(Addendum to Occasional Papers No.91: Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review)

EUROPEAN ECONOMY Occasional Papers 113

ACKNOWLEDGEMENTS

This occasional paper is composed of fiches prepared by Commission services (Directorate-General for Economic and Financial Affairs) with a view to the interim peer review of national fiscal frameworks for five priority countries (Cyprus, Greece, Ireland, Latvia, Portugal), conducted under the auspices of the Economic Policy Committee in May 2012. These fiches are meant as an update and complement to the fiches released for these five countries as part of the main publication which accompanied the 2011 peer review.

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Secretarial support was provided by Anne-Marie Ardiff.

The cut-off date for the information contained in the country fiches was June 2012. Comments and suggestions on the contents of the Commission services' fiches by members of the Economic Policy Committee (EPC), as well as by representatives of the International Monetary Fund (IMF) and Organisation for Economic Cooperation and Development (OECD), are gratefully acknowledged.

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GLOSSARY

Acronym	Country	
CP		Convergence Programme
CRE	IE	Comprehensive Review of Expenditure
EC		European Commission
ECB		European Central Bank
EDP		Excessive Deficit Procedure
ELSTAT	EL	Hellenic Statistical Authority
EMU		Economic and Monetary Union
EPC		Economic Policy Committee
ESA 95		European System of Accounts 1995
ESM		European Stability Mechanism
FC		Fiscal Council
FDL	LV	Fiscal Discipline Law
GDP		Gross Domestic Product
IFAC	IE	Irish Fiscal Advisory Council
IMF		International Monetary Fund
MoF		Ministry of Finance
MoU		Memorandum of Understanding
MTBF		Medium-Term Budgetary Framework
MTFS	EL	Medium-Term Fiscal Strategy
MTO		Medium-Term Objective
OECD		Organisation for Economic Co-operation and Development
PPB	CY	Programme and Performance Budgeting
PPP		Public-Private Partnership
SGP		Stability and Growth Pact
SOE		State-Owned Enterprise
SP		Stability Programme
TSCG		Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

INTRODUCTION AND BACKGROUND

A major policy lesson stemming from the current crisis is the need to strengthen Member States' ownership of the EU budgetary framework and ensure that national and EU fiscal governance are consistent. This requires improvements in domestic budgetary frameworks with a view to reinforcing their instrumental character by promoting respect of the fiscal provisions agreed at European level. 'Budgetary (or fiscal) framework' means the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government.

The approach currently followed at European level stems from successive policy initiatives over the past two years in the wake of the crisis. In particular, the May 2010 Ecofin Council conclusions stressed the importance of national fiscal governance to support fiscal exit strategies, the implementation of the Stability and Growth Pact and the credibility of fiscal commitments, and called for a regular assessment and peer review of Member States' fiscal frameworks[(1)]. In its conclusions, the Council also invited the Commission and the Economic Policy Committee (EPC) to promote the exchange of best practices, in particular in view of the elements that have proven to be most successful in underpinning fiscal consolidation efforts and in contributing to building up sustainable public finances. Later in 2010, the final report of the Van Rompuy task force on economic governance supported the Ecofin Council conclusions and laid down the bases of the current two-pronged approach:

- Firstly, a set of minimum requirements that should be met by national fiscal frameworks to be consistent with the EU budgetary rules. This ultimately led to the preparation and adoption at the end of 2011, as part of the 'six-pack' economic governance package, of a Directive[(2)] defining the most fundamental elements of fiscal frameworks, namely accounting, statistical and forecasting issues, numerical rules, medium-term budgetary frameworks and comprehensive coverage of public finances.

- Secondly, supplementing the above pillar, the organisation of a regular assessment and peer review of domestic fiscal frameworks. Its purpose is to share best practices, seek policy advice and evaluate other desirable but non-binding features of domestic fiscal frameworks which could also support an adequate conduct of fiscal policy.

Building on these principles, the inaugural cycle of the peer review was carried out in 2011 under the aegis of the Economic Policy Committee over two sessions, in May and November. It reviewed the framework of each Member State and issued detailed policy advice tailored to the perceived state of each country's framework. The background material prepared by Commission services for these sessions (in the form of country factsheets or 'fiches'), along with the policy advice which was issued by the EPC to each Member State during the meetings, were collated and published in early 2012 in the form of a European Economy Occasional Paper[(3)].

While a full-fledged assessment of the fulfilment of Member States' policy commitments is envisaged for 2013 to allow for the typical implementation lags of fiscal-structural measures, the EPC decided to conduct an interim review in 2012 for the countries in need of urgent improvement of their respective frameworks. This interim review was held in May 2012 and provided an opportunity to present the steps taken thus far in the five Member States concerned: Cyprus, Greece, Ireland, Latvia and Portugal. This was also an opportunity to assess progress made on the policy advice provided in 2011 and, if appropriate, adjust or update this policy advice.

For this exercise also, the Commission prepared for each of the five countries reviewed a concise fiche with an update and assessment of the fiscal framework's situation. The present publication – an addendum to the previous Occasional Paper – presents these fiches, as well as the policy advice (revised if appropriate) issued by the EPC to each of the five countries examined during the interim review. Fiches are structured in a similar way for each country: (i) an assessment of progress against the policy advice provided to each Member State in the 2011 exercise; (ii) a brief update on other elements of the fiscal framework; (iii) if appropriate, an update on the 2011 fiche for technical elements of national frameworks (fiscal rules, fiscal institutions, medium-term budgetary frameworks).

Please note that fiches are presented in the order of review scheduled for the May 2012 EPC meeting.

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(1) According to these conclusions, this exercise should rely on: (i) desirable features of domestic fiscal frameworks according to best practices and successful fiscal governance reforms across the Member States; (ii) ongoing and envisaged fiscal framework reforms in the EU countries, particularly in light of the budgetary impact of the crisis.

(2) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, pp. 41–47.

(3) Occasional paper no. 91 "Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review".

SUMMARY AND KEY INSIGHTS

The current financial and budgetary crisis has focussed the attention of most Member States on the importance of adequate fiscal frameworks to foster fiscal discipline in the long run. Recent reforms of economic governance introduced at European level, in particular with the reinforced Stability and Growth Pact and the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), have spurred individual Member States to consider far-reaching reforms of their domestic budgetary frameworks, both by implementing basic requirements and by promoting best practice.

In this context, the first comprehensive review of the national fiscal frameworks of all Member States was carried out under the auspices of the Economic Policy Committee (EPC) during the course of 2011, and called for an interim review to be carried out in 2012 for a few priority countries (Cyprus, Greece, Ireland, Latvia, and Portugal). This interim Peer Review was a first opportunity to assess developments occurring over a relatively short period of time – one year or less – in those countries deemed to be in most urgent need of reforming their fiscal frameworks.

Although the situations in these five countries vary greatly, with different starting points, challenges and budgetary traditions, the observation of recent evolutions brought by the interim review yields key insights into the process of reform currently underway in these Member States:

- Appetite for reform is strong in the countries reviewed. Whether it accompanies an endogenous move towards fiscal discipline or stems from an external impetus (e.g. in the case of countries under a financial assistance programme), the importance of robust fiscal frameworks now appears to have gained momentum.

- Reforms tend to happen in leaps and bounds. Most countries (e.g. Ireland, Latvia, Portugal) choose to implement sweeping reforms encompassing several components of fiscal frameworks (e.g. fiscal rules, MTBFs, fiscal council) in one key piece of legislation rather than adopt more piecemeal changes to their existing framework.

- Consistent with the above trends, countries tend to aim for a rapid upgrade of their fiscal framework in order to satisfy "all-at-once" recent requirements deriving from the revised SGP ("six-pack", future "two-pack") or the TSCG ("Fiscal Compact").

The rapid rate of progress achieved over the past year in the reviewed Member States is to be commended, although several important outstanding issues still remain in all these countries and it would therefore be too early to draw conclusions on the functioning and effectiveness of the new building blocks that have been put in place.

Commission services country fiches for the interim EPC Peer Review of Fiscal Frameworks (May 2012)

Fiscal governance in Greece

This fiche describes the latest developments in Greece's fiscal framework and assesses progress towards the policy advice adopted by the EPC in 2011. In the context of the Economic Adjustment Programme 2011-2014 for Greece, fiscal governance has substantially improved since last year and further progress is expected until the completion of the Programme.

1. Assessment of progress towards the 2011 policy advice [4]

Greece faces a difficult but critical task in the strengthening of its fiscal framework, which until recently was lagging behind the EU average by a considerable margin. In the context of the implementation of the EC-ECB-IMF adjustment programme, these are the results of the implementation of EPC policy advice on national fiscal framework:

a) *Implementing a medium-term budgetary framework. The new MTBF should cover at least the central government and the social security sector for the next three years. It should be based on the intermediate targets and the Greek Medium-Term Objective referred to in the EC-ECB-IMF adjustment programme and the EU fiscal framework. The MTBF should incorporate expenditure ceilings for the sub-institutional sector concerned and a breakdown of these ceilings according to the main expenditure areas. Revenue projections reflecting the envisaged fiscal strategy and the MTBF underlying macroeconomic assumptions should complement expenditure projections. The MTBF projections should form the basis on which the budget law is prepared and should be presented, discussed and approved in the Parliament.*

Satisfactory progress has been observed on the implementation of the MTBF. The quarterly Memorandum of Understanding (MoU) of 2011 required the preparation of a medium-term fiscal strategy (MTFS). On 1st July 2011, the MTFS 2012-2015 was adopted. It covered the State budget, transfers from the State budget to general government bodies, the Social budget[5], local governments and reclassified public entities. It was consistent with the adjustment programme's objectives. It was also the basis for the preparation of 2012 budget.

The MTFS included, in particular:

- No–policy-change baseline revenue and expenditure projections for the State and for the other government entities;
- a description of permanent fiscal measures, their timing and quantification;
- annual binding spending ceilings for each ministry and fiscal targets for other government entities through 2015. They are updated after each quarter review according to change in targets and new developments in public finance;
- post-measures fiscal projections for general government in line with the deficit and debt targets;
- longer-term debt projections based on prudent macroeconomic projections prepared by the General Accounting Office, and stable primary surpluses from 2014 on;
- privatisation plans.

[4] In the assessment below, the policy advice agreed in 2011 is presented in *italics.*

[5] The Social budget shows revenue and expenditure of Social Security Funds and hospitals. Hence it includes private sector worker pensions (as public sector pensions are recorded in the State budget), unemployment and health benefits.

b) *In order to reinforce the binding character of the targets considered in the new MTBF, introduce a multiannual expenditure rule providing spending ceilings at least for the central government and social security.*

Partial progress has been observed on the implementation of expenditure ceilings. The MTFS 2012-2015 introduced annual spending ceilings for each ministry (including grants from the State Budget to the Social Security Funds) and fiscal targets for other central and general government entities through 2015. It will be revised in 2012. However, expenditure ceilings for Local Governments, Social Security Funds and other central government entities are partially provided.

To identify well-targeted expenditure reductions, necessary to help match the expected levels of expenditure with the targets contained in the MTFS, the government has initiated spending reviews on pensions and social transfers, healthcare, defence spending and central and local administration restructuring.

c) *Introduce a revenue rule for the general government, according to which the allocation of higher-than-expected revenues should be specified ex ante in the budget.*

Insofar as the spending ceilings are binding, any higher than expected State revenue will have a deficit reduction impact. However, there is no such rule for subsectors other than the State.

d) *Enhance the operation of the independent fiscal council entrusted with technical tasks related to fiscal policy-making (e.g. provision of forecast for the budget preparation, monitoring fiscal developments against budgetary targets and fiscal rules, etc…).*

No progress has been observed on the setup of the fiscal council. The Parliament Budget Office initiated its activities in summer 2011, but its board collectively resigned in the meantime, immediately after the publication of its first quarterly report, following criticism by the Ministry of Finance. So far, the board has not been replaced, and all operational activities of the council have ceased.

e) *Introduce stronger expenditure monitoring mechanisms.*

Partial progress has been observed on the implementation of expenditure monitoring. Weaknesses in monitoring spending commitments in certain general government sub-sectors strongly affected last year's budget execution, increasing the end of 2011 overall stock of general government arrears by 7.4% (EUR 394 million) compared to end 2010, though the stock of arrears of the State Budget decreased by EUR 301 million. During last year, public management reforms have progressed towards the creation of the commitment registries and as of April 2012 67% of all general government spending units report via commitment registries, although these reforms have still to gain momentum in order to reduce the overall stock of arrears steadily[(6)].

Following the setup of commitment registries and the increasing number of units reporting data, there has been further progress in the timely provision of fiscal data and on their quality. Nonetheless, the discrepancy is still significant between arrears reported from the commitment registries and those reported through monthly surveys. The Ministry of Finance is working closely with the General Government sub-sector entities to resolve the reporting issues with a view to reducing the overall discrepancy to 1% by end-2012, in line with the targets of the MoU.

Progress is also observable in reducing the discrepancies between Bank of Greece data and other sources (General Accounting Office and ELSTAT). The reporting of budget execution for sectors other than the central government has been significantly improved and the delay in the availability of data has been reduced to two months.

More comprehensive, timely, and accurate reports are expected from the monitoring of budgetary execution that

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[(6)] The stock of general government arrears is still high at about EUR 6.3 billion by end March 2012 while it stood at 5.8 billion (2.7% of GDP) at the end of 2011.

would help spot problems early. To this end, in 2012 the government is committed to:

(i) expanding the arrears database to cover tax refunds, and establishing standards for their processing and payment (by end-June 2012);

(ii) expanding the recently trialled information systems to collect more detailed revenue and spending data from general government entities (the new system will cover more than 90 per cent of spending by end-June 2012).

The final aim is to improve the control over expenditures in order to reduce the outstanding amount of arrears, and avoid the accumulation of new ones.

f) Review the current budgetary procedures to reinforce centralisation of budget planning and implementation. This should include the strengthening of the Ministry of Finance vis-à-vis line ministries and the introduction of effective top-down budgeting.

Progress has been observed in the implementation of top-down budgeting. The preparation of the MTFS and the adjustment programme has effectively asserted the role of the Ministry of Finance vis-à-vis other Ministries. In line with the MoU requirements, an administrative calendar for the update of the medium-term fiscal strategy has been prepared by the Ministry of Finance. The MoU also requires the adoption of legislation streamlining the procedure for submission and approval of supplementary budgets (expected by October 2012).

The Ministry of Finance should improve the monitoring and assessment of any new draft law tabled into the Parliament having an impact on the budget in order to avoid any undesired worsening of the deficit.

2. ADDITIONAL INFORMATION ON PROGRESS MADE UNRELATED TO THE POLICY ADVICE

The main challenge for revenue predictability and fiscal governance remains the effectiveness, increased autonomy and accountability of the tax administration which can be achieved through a sound delegation of powers from the political level to (a reformed) tax administration.

Updated EPC policy advice

***Greece** faces a difficult but critical task in the strengthening of its fiscal framework which, before recent reforms, was lagging behind the EU average by a considerable margin. In the context of the implementation of the EC-ECB-IMF adjustment programme, national authorities should introduce the following measures:*

a) In order to reinforce the binding character of the targets considered in the new MTBF, introduce mechanisms to enforce ceilings for the central government and social security funds building on those set up for the general government;

b) Resume and enhance the operation of the independent fiscal council entrusted with technical tasks related to fiscal policy-making (e.g. provision of forecast for the budget preparation, monitoring fiscal developments against budgetary targets and fiscal rules, etc…);

c) Strengthen expenditure monitoring mechanisms for local governments and social security funds;

d) Review the current budgetary procedures to further strengthen the Ministry of Finance vis-à-vis line ministries;

e) Introduce a revenue rule for the general government, according to which the allocation of higher-than-expected revenues should be specified ex ante in the budget.

Fiscal Governance in Ireland

This fiche describes the latest developments in Ireland's fiscal framework and assesses progress towards the policy advice adopted by the EPC in 2011. In the context of the Economic Adjustment Programme 2011-2013 for Ireland, fiscal governance has substantially improved since last year and further progress is expected in the coming years.

1. Assessment of progress towards the 2011 policy advice [7]

a) Establish a fiscal council to provide an independent assessment of the government's budgetary position and forecasts.

A fiscal council, called the "Irish Fiscal Advisory Council" (IFAC), was established on an administrative basis in mid-2011[8]. It consists of five council members assisted by a small secretariat. The primary functions of the council are assessing: (i) the government's economic and budgetary projections, (ii) the appropriateness of the fiscal stance and (iii) compliance with fiscal rules. The council has quickly acquired prominence and visibility in the domestic debate on fiscal policy, having for example called for a larger and more front-loaded adjustment over 2012-15 than called for under the Excessive Deficit Procedure, in the context of their assessment of the 2012 budget. The council has produced three reports so far – before and after the 2012 budget, and one providing its input in the discussion on the design of the national budgetary framework and fiscal rules. In addition to these publications, the members of the council have gained prominence by engaging in public debate on important fiscal policy decisions and appearing before the parliamentary committee for Finance, Public Expenditure and Reform. The authorities plan to give a statutory basis and to underpin the Council's financial and functional independence through the legislation that would ratify the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), called the Fiscal Responsibility Bill.[9] This draft legislation which is part of the referendum information material envisages that the IFAC be formally tasked with assessing the government's compliance with the budgetary rule – budgetary position in balance or in surplus, or the adjustment path towards the medium-term budgetary objective (MTO). The Bill proposes an adequate funding of EUR 800,000[10] for the Council, and appropriately limits the power of the Minister for Finance to remove Council members without parliamentary process.

b) Adopt a fiscal responsibility law introducing a medium-term expenditure framework with binding multi-annual ceilings on expenditure for every major sub-component (including both current and capital spending), ensuring that the coverage is sufficiently broadly based to allow for the effective management of overall fiscal targets.

The authorities presented their proposal for the national budgetary framework and the country-specific budgetary rules in March 2011. Developments in the EU economic governance framework since then have introduced changes to the initial plans. In particular, the Irish government is committed to the ratification of the TSCG. A referendum was deemed to be required to allow the government to ratify and was called on 31 May 2012[11]. The government published a consultation document which set out the draft legislation that would enable it to ratify the Treaty, as well as national legislation to allow the entry into force of the European stability mechanism (ESM). As compared to the initial drafts, the budgetary rules are now set in line with the revised Stability and Growth Pact definitions. Also, instead of a single Fiscal Responsibility Bill covering all elements of the budgetary framework, the draft legislation covers only the TSCG requirements, leaving other items provided for in the "six-pack" to be introduced in separate national legislation. This further legislation will establish on a statutory basis the binding multi-annual expenditure ceilings for the departments of the central government. The binding expenditure ceilings over 2012-14 for each government department (some demand-led items, such as

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[7] In the assessment below, the policy advice agreed in 2011 is presented in *italics.*

[8] http://www.fiscalcouncil.ie

[9] http://www.finance.gov.ie/documents/publications/other/fisresbillscheme.pdf

[10] For the following years, the funding will be adjusted by inflation.

[11] Update note: with a positive outcome, allowing the legislative process to go ahead.

payments for unemployment benefits, are excluded from the coverage) were already announced on an administrative basis in the context of the 2012 budget.

c) *Ensure that fiscal rules are designed to deliver an appropriate fiscal stance at each stage of the economic cycle, and are effective in ensuring compliance with the economic governance framework at EU level.*

The draft legislation presented in the context of the Treaty sets two new fiscal rules in line with the Stability and Growth Pact's requirements and definitions. The "budgetary rule" requires the budget position of the general government to be either in balance or in surplus, or that an adequate progress towards the MTO is achieved[(12)]. The draft legislation also includes a debt-brake rule whereby at least 1/20th of the difference between the current level of the debt ratio and the SGP reference of 60% is closed every year and allows for automatic correction mechanisms in case of deviations. The modalities for the procedures for the correction from a deviation from fiscal targets are not yet specified, and will be defined according to the common principles proposed by the European Commission under the TSCG[(13)]. The draft legislation suggests that these will be set out by way of a regulation from the Minister for Finance which would need parliamentary approval.

2. ADDITIONAL INFORMATION ON PROGRESS MADE UNRELATED TO THE POLICY ADVICE

A joint European Commission/ECB/IMF mission completed at staff level the sixth review of the financial assistance programme for Ireland at the end of April. Ireland's programme implementation continues to be strong. Fiscal targets for 2011 were met by a healthy margin and the consolidation remained on track in the first quarter of 2012[(14)].

Following the completion of first-generation institutional fiscal reforms (establishment of a fiscal council, fiscal rules and medium-term expenditure framework), further reforms could now be considered, especially in the area of budgetary reporting and fiscal transparency. In particular, there is scope for more analytical reporting of high-frequency public finance cash returns; better explanation of general government outcomes relative to projections; and the introduction of a state balance sheet (given the government's large asset and liability positions following banking sector interventions), including with a view to identifying sources of fiscal risk.

3. UPDATE OF THE SUMMARY INFORMATION OF THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

Fiscal Institution in Ireland: Irish Fiscal Advisory Council

Date of establishment and description of the main tasks related to fiscal policy: June 2011 (on a non-statutory basis). The Fiscal Responsibility Bill when adopted would institutionalise the Council after June 2012.

Its main tasks are: to monitor compliance by the Government with the "budgetary rule" (budget-balance rule); to provide an assessment of official macroeconomic and budgetary forecasts; and to assess whether the fiscal stance (including the MTO) is "*conducive to prudent economic and budgetary management*", including by reference to SGP provisions.

Main outputs released by the institution: At least three reports per year including the annual report. Three reports have been published so far.

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(12) Currently the MTO for Ireland is a structural deficit of 0.5% of GDP in line with the minimum MTO established in 2009. The MTO will be updated this year, in line with Article 2a of Council Regulation (EC) No1466/97 requiring that the MTO should be revised every three years.

(13) Now available in the Communication from the Commission COM(2012) 342 "Common principles on national fiscal correction mechanisms".

(14) More generally, the authorities have also pressed ahead with comprehensive reforms to restore the health of the Irish financial sector. Market confidence in Ireland's policies has improved, contributing to some stabilization in Irish bond spreads, although they remain elevated. Technical work on further financial sector reforms to support prospects for recovery in domestic demand and Ireland regaining market access continues.

Role of the institution in the budgetary process: Provide an independent assessment of the official projections, fiscal stance and compliance with the budgetary rule.

Obligation for the government to use the output of the institution: No formal obligation, but the advice is considered in the official budgetary publications.

Status of the institution: The Fiscal Responsibility Bill would establish the Council as an independent statutory institution funded from the Central Fund (the central government fund over which the government has limited discretion).

Composition and appointment of the governing board: Five members are appointed by the Minister for Finance. The Minister designates one of the members to be chairperson. Members would serve staggered 4-year terms (with up to 2 consecutive terms), and could not be otherwise removed without parliamentary approval.

***Decisions of the governing board*:** The council organises its work and decision making process in line with its reporting requirements included in the mandate of the institution.

Staff: Secretariat currently includes three permanent staff (two economists and one assistant) and has approval for the recruitment of a further economist.

Comments on the functioning of this institution: The council members devoted significant resources to establishing the council and preparing the first reports. Sufficient financing has been negotiated to ensure functioning of the council and adequate compensation / time-buyout for the members.

Domestic budgetary procedures in Ireland (*new section of the fiscal framework fiche*):

The authorities have advanced the public service reform plans that support the fiscal adjustment needs and ensure that adequate level of public services is maintained. A Comprehensive Review of Expenditure (CRE) was completed in advance of the 2012 budget identifying a list of savings across the government departments sufficient to deliver the bulk of the planned adjustment in expenditure in 2012-14. The CRE will be repeated every three years with the next review planned at the end of 2013 or early in 2014. In addition, a new Value for Money Code will evaluate public service programmes on an on-going basis. Principles of performance-based budgeting were piloted on a limited basis in early 2011 and expanded to the majority of departments in the expenditure plans published in February 2012, presenting the plans on the strategic programme basis enabling evaluation of the departments on outputs and outcomes. The government objective is to carefully manage reductions in public service numbers to maintain public service delivery with a smaller workforce while ensuring that fiscal savings are achieved. Other public service reforms include the centralisation of public procurement, the rationalisation of state agencies, and the expanding use of online, shared and external services.

Updated EPC policy advice

Ireland*'s fiscal framework did not restrain high expenditure growth in the year prior to the crisis, which contributed to the significant deterioration of the fiscal position in the downturn. Comprehensive reforms of the medium-term budgetary framework addressing former weaknesses have been implemented and establishing these on a statutory basis is well advanced. These reforms will support the ongoing fiscal consolidation process over the coming years. In the context of the implementation of the EC-ECB-IMF adjustment programme, national authorities should pursue the introduction of the following measures:*

a) Establish the fiscal council on a statutory basis to provide an independent assessment of the government's budgetary position and forecasts and to monitor compliance with fiscal rules.

b) Establish a statutory basis for the already introduced medium-term expenditure framework with binding multi-annual ceilings on expenditure for every major subcomponent (including both current and capital spending), ensuring that the coverage is sufficiently broad-based to allow for effective management of overall fiscal targets.

c) Ensure that the fiscal rules deliver an appropriate fiscal stance at each stage of the economic cycle, and are effective in ensuring compliance with the economic governance framework at EU level.

d) Continue to improve budgetary reporting.

Fiscal Governance in Portugal

This fiche describes the latest developments in Portugal's fiscal framework and assesses progress towards the policy advice adopted by the EPC in 2011. In the context of the Economic Adjustment Programme 2011-2013 for Portugal, fiscal governance has substantially improved since last year and further progress is expected until the completion of the Programme.

1. ASSESSMENT OF PROGRESS TOWARDS THE 2011 POLICY ADVICE (15)

a) *Ensure full implementation of the Budgetary Framework Law, including the prompt establishment of a Fiscal Council, by the 2012 budget.*

The Budgetary Framework Law, approved by the Parliament in 2011, addresses several weaknesses of the budgetary process. In particular, it establishes a multi-annual framework with expenditure and budget balance rules, which applies to all entities part of the general government as defined in national accounts(16); it also requires programme budgeting and accrual accounting for all entities, and creates an independent Fiscal Council.

Given the potentially wide scope of the law, Portugal opted for a gradual implementation in agreement with the European Commission, the International Monetary Fund and the European Central Bank. Some elements were already implemented in 2011, such as the creation of the Fiscal Council, the introduction of programme budgeting and the enlargement of the scope of application. However, challenges remain to be solved in 2012. The Fiscal Council governing board has been nominated but adequate staff still needs to be recruited so that the Council can become fully operational. The Council has already started recruiting candidates and the process should move faster following the approval of the 2012 supplementary budget at the end of March, which allocated financial resources for the Council. Moreover, the multi-annual framework needs further refinements in terms of baseline expenditure projections, setting and modifying expenditure ceilings, defining appropriate contingency reserves and related access rules, and limiting carry-overs within the medium term.

b) *The local and regional financing framework should be made consistent with the principles and rules adopted in the Budgetary Framework Law.*

The local and regional financing framework is currently under revision so as to ensure coherence with the Budgetary Framework Law and to strengthen fiscal accountability. The new EU fiscal policy framework will also be taken into account in the revision of the regional and local financing framework. To this end, a working group with representatives from different ministries and external experts took up work early this year, as well as a monitoring committee that also includes representatives of regional and local governments. A technical assistance mission from the European Commission and the International Monetary Fund took place in mid-March. The amended regional and local financing laws will be submitted to Parliament at the end of 2012 after discussions with the EC/IMF/ECB.

c) *Strict conditions for the correction of deviations from the budget balance rule should be clearly specified.*

The Budgetary Framework Law requires that all subsectors of the general government must attain budgetary stability defined as budget equilibrium or surplus (with a reference to the MTO in line with the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)(17). Deviations from the rule must be corrected in subsequent years. The law establishes similar rules and some exceptions for

(15) In the assessment below, the policy advice agreed in 2011 is presented in *italics.*

(16) As stated in article 5.2 of the Budgetary Framework Law.

(17) The Budgetary Framework Law has the status of an ordinary law (passed with simple majority). Discussions are ongoing as to the possibility of enshrining its main provisions in a constitutional amendment.

integrated services, Services and Autonomous Funds and social security. However, the government has not yet defined how the rule will be applied in practice, i.e. which institution will be in charge of overseeing the application of the rule; more clarity regarding the definition of exemptions to the application of the rule and the establishment of corrective measures would be welcomed.

d) *The budgetary process should be more transparent. Relevant information supporting the preparation of the budget should be public, including a complete assessment of fiscal risks, whether of an intra-budgetary or extra-budgetary nature. At execution stage, monitoring tools should be improved.*

The authorities have implemented reforms aimed at improving fiscal reporting and strengthening the budgetary process. A fiscal risk report will be published each year as part of the budget. The report will outline general fiscal risks and specific contingent liabilities to which the general government may be exposed, including those arising from PPPs, SOEs and explicit guarantees to the banks. A fiscal risk report was submitted in spring 2012, as requested by the Economic Adjustment Programme, which has been discussed in the IMF/EC/ECB review mission organised during the second half of May 2012. In addition, a tax expenditure report was submitted, enhancing the previous survey on tax expenditures. Since January 2012, local governments started reporting fiscal data monthly to the central government (rather than quarterly).

Progress has also been made at the stage of budget execution. The law on commitment control has entered into force to gradually cover all sub-sectors of government and hospital SOEs. The authorities should ensure that a strong and swift implementation takes place as planned, as a pre-condition to stopping the accumulation of arrears. Indeed, the execution of the Economic Adjustment Programme revealed a significant stock of domestic arrears that threatened fiscal stability. With a view to reducing the stock of arrears, the authorities are currently implementing a strategic plan that lays out the prioritization criteria for paying creditors, as well as governance arrangements to ensure a fair and transparent settlement process across all sectors. Tighter reporting standards have been applied, increasing the frequency and the scope of reporting.

To strengthen the public financial management framework, the authorities started to publish quarterly balance targets on a cash basis for the general government as defined in national accounts and, in case slippages occur, corrective measures are to be taken and published.

e) *The Ministry of Finance should have a reinforced control at all stages of the budgetary process.*

In addition to creating budget coordinators in every Ministry, there is a need to strengthen further the position of the Ministry of Finance in the overall budget implementation. To this end, a proposal to reduce budget fragmentation will be submitted by the end of June 2012, with a view to reinforcing the role of the Ministry of Finance earlier on in budgetary planning.

The role of the Ministry of Finance in supervising the creation and functioning of PPPs and SOEs is also being reinforced, with the aim of decreasing fiscal risks. In particular, a new PPP regime has been approved by the Council of Ministers, including the establishment of a PPP unit at the Ministry of Finance. A draft law enhancing local SOEs governance has been sent to Parliament, and further steps at regional and central level are to be taken.

In addition, the government concluded in January a financial arrangement with the Autonomous Region of Madeira[18] to restore the region's fiscal situation and contain the fiscal risks. The arrangement is similar to and consistent with the financial programme between the Republic of Portugal and the EC/IMF/ECB. The Ministry of Finance plays an important role in reviewing progress every quarter.

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[18] Madeira's financial management system reflects weaknesses detected both at national and regional level. Further details can be obtained in the Economic Adjustment Programme documents (see e.g. 3rd programme review, Box 4, p. 28): http://ec.europa.eu/economy_finance/eu_borrower/portugal/index_en.htm

2. ADDITIONAL INFORMATION ON PROGRESS MADE UNRELATED TO THE POLICY ADVICE

Progress towards meeting the policy advice identified in the 2011 peer review exercise must be considered within the broader scope of reforms that are currently taking place in Portugal. The reform of the budgetary framework is still ongoing. The application of the new framework comes in hand with the modernisation of the public sector, a rationalisation of resources at all levels of government (central, regional and local), expanding the use of IT tools and promoting international best practices at every stage of the budgetary process.

In parallel, Portugal was among the first countries to ratify the TSCG.

3. UPDATE OF THE SUMMARY INFORMATION OF THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

The three fiscal rules described in the 2011 fiche are currently being reviewed.

A new institution has been created, the Fiscal Council.

Fiscal Institution in Portugal: Fiscal Council

Date of establishment and description of the main tasks related to fiscal policy: Created in 2011[19], not yet fully operational. It will assess the consistency and sustainability of the Portuguese budgetary policy as well as compliance with fiscal rules and budgetary targets stemming from SGP obligations.

Main outputs released by the institution: The Fiscal Council will produce several reports to be discussed in Parliament. Those will cover the Stability Programme, the multi-annual budgetary framework and the budget proposal. In addition, the Council will produce regular assessment on the sustainability of public finances. These attributions may be redefined in late 2012.

Role of the institution in the budgetary process: As defined in article 6 of its Statutes, the Fiscal Council will, inter alia, check the validity of the macroeconomic scenarios and the respect of the fiscal rules in place, analyse debt dynamics, evaluate the financial situation of regional and local entities, evaluate the financial state of SOEs, analyse fiscal expenditure and monitor budget execution.

Obligation for the government to use the output of the institution: The Fiscal Council has a consultative role. The output produced by the institution will be transmitted to the President, the Parliament, the Government, the Court of Auditors and the Banco de Portugal (central bank). The budgetary calendar as defined in the Budgetary Framework Law should not be modified by the presentation of the report by the Fiscal Council.

Status of the institution: The Statutes of the Fiscal Council were published in the Official Journal in October 2011. Members of the governing board have been designated, including the two non-Portuguese members.

Composition and appointment of the governing board: The governing board has five members[20], of which at least two must be citizens from other EU Member States. They are nominated jointly by the Banco de Portugal (central bank) and the Court of Auditors.

***Decisions of the governing board*:** According to current information, the governing board will meet at least twice a year; first, to examine budgetary execution from the previous year and the multi-annual framework, before they are discussed in Parliament, and second, to evaluate the budget proposal from the government, before it is discussed and voted in Parliament. The reports produced by the Fiscal Council must be discussed and approved by the governing board before publication.

Staff: Supporting staff is not yet defined; the Fiscal Council should be endowed with sufficient resources to adequately fulfil its mandate.

Comments on the functioning of this institution: The Fiscal Council should improve the quality of the budgetary process in Portugal.

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[19] Fiscal Council Statutes, Lei no.54/2011 of 19 October, Diário da República, 1 série, No. 201

[20] One Board member will be a representative from the Parliamentary budget office. The office, which monitors budget execution and outcomes, will remain active alongside the Fiscal Council, which has a much broader remit in particular regarding medium-term budgetary projections and assessments of the cyclical position of the economy.

Domestic budgetary procedures in Portugal

Macroeconomic assumptions underpinning the budget preparation

The Ministry of Finance is responsible for preparing the macroeconomic assumptions for the annual budget. Two forecasts are produced, the first one in October to prepare the budget and an intermediate one in April (released in the Budgetary Policy Steering Report – ROPO). The Fiscal Council will assess the reliability of these forecasts once fully operational.

Centralisation of the budget process at the planning stage

The budgetary process is centralised in the Ministry of Finance at the planning stage. A report is currently under preparation to reduce budgetary fragmentation and increase the oversight powers of the Ministry of Finance. With the 2012 budget, each line ministry has appointed a budget coordinator at the level of the ministry to centralise the budgetary process of all public entities under the responsibility of that respective ministry. The Ministry of Finance prepared and discussed the budgetary allotments based on the centralised information provided by the ministerial budget coordinators. This has greatly facilitated the work of the Ministry of Finance, however, further steps to reduce budgetary fragmentation are needed.

The use of top down budgeting

Under the medium-term budget framework laid out in the Budgetary Framework Law, the budget process is to be anchored by a nominal aggregate expenditure ceiling, within which 12 programme ceilings are set at varying degrees of specificity over a 4-year window. While initially operating as indicative ceilings, they are envisaged to set a hard, top down ceiling on government expenditures that will constrain budget decisions in the following years.

Updated EPC policy advice

***Portugal** has made clear progress towards strengthening its budgetary framework, starting from a low base. Overall, the recent Budgetary Framework Law addresses relevant weaknesses of the budgetary process, however there are still elements that can be further improved. In the context of the EC-ECB-IMF adjustment programme, national authorities should introduce the following measures:*

a) The local and regional financing framework should be made consistent with the principles and rules adopted in the Budgetary Framework Law.

b) Strict conditions for the correction of deviations from the budget balance rule should be clearly specified, including the rules for the application of these mechanisms which should at least fulfil the requirements of the reinforced EU fiscal framework and the fiscal compact.

c) The budgetary process should be reinforced building on improvements already made regarding transparency. Relevant information should be made public, including inter alia forecasts and a complete assessment of fiscal risks, whether of an intra-budgetary or extra-budgetary nature. The methodology used should be clearly specified together with the results and alternative scenarios.

d) The Ministry of Finance should continue to reinforce controls at all stages of the budgetary process.

Fiscal Governance in Cyprus

This fiche provides updated information on the latest developments in Cyprus' fiscal framework and assesses progress with regard to the policy advice adopted by the EPC in 2011.

1. Assessment of progress towards the 2011 policy advice [21]

a) Accelerate the phasing-in of a binding medium-term budgetary framework, as well as Programme and Performance Budgeting (PPB).

Supporting the EPC policy advice of May 2011, Cyprus received a country-specific recommendation in the context of the European Semester 2011, which calls for the accelerated phasing-in of an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanisms, to be in place for the preparation of the 2012 Budget.

The adoption of the Budget Law for 2012 on 16 December 2011 marked the first budget that is based on a MTBF, which provides ceilings on expenditure per line ministries and government agencies provided for the years 2012-2014. For government agencies, a Medium-Term Budgetary Framework (MTBF) was already adopted in 2006, requiring their budgets to be drafted on a rolling-over base for three years.

With regard to the institutionalization of the MTBF into primary law, the government has prepared a draft Bill entitled 'Law on the Medium-Term Budgetary Framework and Fiscal Rules' which, following the legal vetting by the Law Office of the Republic on 4 May 2012, was submitted to the Parliament for adoption. It is intended to be enforceable as of the date of adoption and to apply to the compilation of the 2013 Budget Law. The new MTBF approach will become the only budgetary method for the budget planning as of 2013.

The draft MTBF provides for the achievement of the Medium-Term Budgetary Objective (MTO) through the introduction of an expenditure and debt brake rule. To that end, it provides for the introduction of a MTBF which puts in place monitoring and control of expenditure by line ministries, while promoting the reallocation of expenditure in favour of growth-enhancing activities, consistent with the priorities set in the National Reform Programme. If there is a departure from the MTO (or as long asif the MTO has not been reached), the annual growth rate of expenditure may not exceed a rate below the medium-term potential growth rate of GDP, unless such excess is covered by the generation of new revenues. If the deviation from the specified path towards attaining the MTO exceeds 0.5pp of GDP, corrective measures, mainly of a structural nature on the expenditure side, are to be taken to correct the deviation, taking into account the time frame specified in the recommendation by the EU Council. The Minister of Finance would then have to prepare and submit within one month to the Council of Ministers a supplementary budget, amended budget, or any other bill setting out in detail the necessary steps to correct the deviation.

The draft MTBF Bill states as a matter of principle that the nominal fiscal position of the general government should be balanced or in surplus. The provision is deemed to be met if the annual structural balance of the general government corresponds to the fixed medium-term objective, as defined in the revised Stability and Growth Pact, setting the lower limit for the structural deficit at 0.5% of the GDP.

Though initially the Cypriot authorities committed to accelerating the legal vetting of the MTBF into primary law by the end of March 2012, the draft "MTBF and fiscal rules" Bill had not been adopted by the end of June 2012. Timely adoption and implementation of the new framework is important for a successful and lasting consolidation of the public finances.

The Programme and Performance Budgeting (PPB), initiated in 2007, is still in a nascent state with the implementation of pilot projects covering a number of ministries and spending agencies. The PPB, which is to replace the current line-by-line expenditure analysis, would provide for budgeting per programme, covering the

[21] In the assessment below, the policy advice agreed in 2011 is presented in *italics.*

whole spectrum of associated costs such as operational, personnel, etc. Each programme would be accompanied by quantitative, qualitative and performance indicators that will be used to assess it against specific benchmarks. It is expected that all ministries and agencies will provide their financing year 2013 budgets according to both the traditional (input-based) budget method and the new PPB format. The new budgeting approach is expected to contribute to efficiency gains in terms of improving the quality of public finances by channelling expenditure to activities of higher value-added.

b) Implement an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanisms in case of non-compliance.

As noted above, the 2012 Budget Law, which was adopted by the Parliament on 16 December 2011, reflects the principles of the MTBF. It introduces a multiannual expenditure rule providing spending ceilings for line ministries of the central government for the period 2012-2014[(22)]. As part of the current fiscal consolidation effort undertaken by the government to bring the general government deficit below 3% of GDP in compliance with the relevant Council Specific Recommendation of June 2011, the 2012 budget follows a restrictive course, implying an overall reduction in central government expenditure of approximately 5%. Cypriot authorities pledge to systematically monitor the execution of 2012 budgetary plans, especially on expenditure, but the 2012 budget law does not foresee a corrective mechanism in case of non-compliance.

c) Establish an independent fiscal institution, or widen the mandate and strengthen the scope and competences of existing institutions, such as the office of the Auditor General.

The Ministry of Finance is expected to submit a proposal to the Ministerial Council for the establishment of an independent fiscal institution[(23)] that would engage in several supporting tasks conducive to sound budgetary practices, including the preparation of macroeconomic and budgetary forecasts using the most up-to-date information.

2. ADDITIONAL INFORMATION ON PROGRESS MADE UNRELATED TO THE POLICY ADVICE

On 20 April 2012, the Ministerial Council endorsed the inter-governmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which made Cyprus one of the first countries to do this.

EPC Policy advice (unchanged)

***Cyprus** currently has neither a set of fiscal rules nor a Medium-Term Budgetary Framework. Cyprus also does not have an independent fiscal institution. In this context, national authorities should introduce the following measures:*

a) Accelerate the phasing-in of a binding medium-term budgetary framework, as well as Programme and Performance Budgeting (PPB);

b) Implement an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanisms in case of non-compliance;

c) Establish an independent fiscal institution, or widen the mandate and strengthen the scope and competences of existing institutions, such as the office of the Auditor General.

(22) Conditions for revising the objectives are not in place for the 2012 Budget, but will be as of the 2013 Budget once the MTBF legislation is adopted (by the end of the 1st semester 2012).

(23) As of June 2012, no such proposal had been formally issued.

Fiscal governance in Latvia

This fiche provides updated information on the latest developments in relation to Latvia's fiscal framework and assesses progress towards the policy advice adopted by the EPC in 2011. In the context of the BoP Support Programme for Latvia which expired in January 2012, fiscal governance has substantially improved.

1. ASSESSMENT OF PROGRESS TOWARDS THE 2011 POLICY ADVICE [24]

a) *Adopt a new Fiscal Responsibility Law – possibly supported by amendments to the Constitution – to provide a credible and enforceable framework for limiting expenditure growth in good economic times. The law should take into account the EU Directive on minimum requirements for national budgetary frameworks and include targeting a balanced or surplus position over the cycle.*

The draft Fiscal Discipline (or Fiscal Responsibility) Law (FDL, *Fiskālās disciplīnas likums*) and draft amendments to the Constitution (*Grozījums Latvijas Republikas Satversmē*) were adopted by the Government of the Republic of Latvia on 29 November 2011 and submitted to Parliament on 6 December 2011. The first reading of the draft FDL took place on 12 January 2012 and it is envisaged that the law will be adopted by mid-2012. Draft constitutional amendments, which contain general provisions to enhance the legal standing of the FDL, have not yet been considered by the legislator, given that their adoption would require a higher degree of support; political consultations related to these amendments continue. Therefore, information provided in this fiche is to be considered preliminary.

As a result of the first reading of the draft FDL and reflecting the latest developments in the area of EU economic governance, notably the adoption of the inter-governmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), as well as the entry into force of legal acts strengthening the Stability and Growth Pact ("six-pack"), it was decided to bring the draft law into full compliance with these legal acts. As a result, the following changes have been proposed by the Ministry of Finance:

- replacing the balance rule based on the long-term average growth rate by a structural balance rule; introducing concepts of medium term objective, one-off measures and the adjustment path towards the medium-term objective;
- bringing the expenditure rule in closer compliance with the provisions of Regulation (EU) No 1175/2011 (revised preventive arm of the SGP) and the TSCG;
- introducing automatic correction mechanisms;
- introducing the main principles of fiscal risk management;
- introducing provisions related to the establishment of the Fiscal Council.

The principle of targeting a balanced budget over the cycle was introduced in the initial draft of the law but underwent some changes after the first reading: while the overall principle remains in place, the amended draft law allows targeting structural deficit with a lower limit of 0.5% of GDP, but only in case the deviation from the balanced budget is caused by productive investments. Nevertheless, this implies that Latvia's MTO will be set at the level of structural deficit of 0.5% of GDP; this MTO would be more ambitious than the minimum MTO of a structural deficit of 1.0% of GDP currently applicable for Latvia. Deviations from the budget balance rule are also possible in the case of severe economic downturn (defined as negative real GDP growth), but only to the extent necessary for overcoming the crisis: one of the tasks of the Fiscal Council will be to provide an opinion on the acceptable degree of deviation (as well as on certain exceptional expenditure categories described in more detail below).

Transitional provisions related to the period when the medium-term objective is not yet reached establish that the structural balance should be improved by 0.5% of GDP annually until the achievement of the MTO, unless international agreements signed by Latvia require more stringent adjustment. Any *ex post* deviations from the adjustment path to MTO or, once it is achieved, from the MTO itself, are accumulated on a notional account. In case of deviations with an absolute value lower than 0.5% of GDP, there is no immediate corrective action, but once the accumulated deviations are negative and exceed the threshold of 0.5% of GDP, targets for an outer year

[24] In the assessment below, the policy advice agreed in 2011 is presented in *italics*

covered by the medium-term budgetary framework (t+3) are adjusted accordingly. However, if accumulated deviations in year t-3, which were negative and exceeded 0.5% of GDP, were further aggravated by a worsening of the structural balance in years t-2 and t-1 by more than 0.5% annually, pointing to a presence of a systemic problem, the corrective mechanism is triggered immediately, lowering expenditure targets in the MTBF law by one third of accumulated deviation annually, until the deviation from the target is reduced to a level below 0.5% of GDP.

Once common principles regarding the implementation of national fiscal correction mechanisms are issued[(25)], it may turn out that some aspects of Latvian national implementation rules diverge from this future commonly agreed approach. In such case national rules would have to be adjusted.

b) *Complement the budget balance rule envisaged in the draft Fiscal Responsibility Law with additional rule(s) to ensure that any revenue in excess of what was previously projected is used to reduce the government's debt and that expenditure remains within set limits.*

The initial draft FDL specified that the surplus occurring in the central government basic budget had to be used for reducing the government debt or accumulating long-term stabilisation reserves.

Further elaborations are envisaged in amendments to the draft law. In particular, the amendments seek to incorporate the principle of annual expenditure growth not exceeding the reference medium-term rate of potential GDP, unless the excess is matched by discretionary revenue measures. The expenditure aggregate falling under this rule will exclude interest expenditure, expenditure on EU policy instruments and other foreign assistance programmes (regardless of whether it is co-financed from EU or other external sources or falls under own financing), non-discretionary changes in unemployment benefit expenditure and expenditure falling under the category of exceptions[(26)]. In addition, the rule is directly applicable only to the central government, whereas at the level of local governments there are no directly applicable expenditure rules (while debt limits for local governments set annually in the budget law act as an indirect balance rule).

In its current form, this implementation of the expenditure rule – limited only to central government and covering a broader range of exceptions – does not fully comply with the revised preventive arm of the SGP.

c) *Reinforce the current medium-term budgetary framework by switching to binding multi-year targets and setting up a mechanism for monitoring compliance with the set targets, including elements to ensure public accountability. The timing of the annual medium-term budgetary framework cycle should be aligned with the EU surveillance cycle.*

One of the fundamental principles of the draft FDL is the introduction of the 3-year expenditure planning horizon by means of the medium-term budget framework (MTBF) law. This law is prepared annually no later than 30 April[(27)] (thus being aligned with the EU surveillance cycle), whereas expenditure ceilings for years t+1 and t+2 are inherited from the previous update of the MTBF law and the expenditure ceiling for year t+3 is set such as to conform with the budget balance rule. The expenditure ceiling is applicable only to the central government, although it is calculated on the basis of general government targets and forecasted budgetary position of local governments and public companies that form part of the general government but are not covered by the state budget law. The expenditure ceiling excludes volatile components like interest expenditure, expenditure related to the implementation of EU policy instruments (both financed from EU and national sources), non-discretionary changes in unemployment benefits and expenditure falling under the exceptions category; the upward revision of inheritable expenditure ceilings is possible in exceptional cases[(28)].

[(25)] See the Communication from the Commission COM(2012) 342 "Common principles on national fiscal correction mechanisms"

[(26)] Exceptional cases cover expenditure related to material losses caused by natural disasters, accidents and other factors related to natural and social processes, if the magnitude exceeds 0.1% of GDP; and expenditure related to responses to unexpected threats to national security.

[(27)] Except for the first year of implementation, 2012, when the medium-term budget framework law will be prepared together with the 2013 annual budget law.

[(28)] See footnote 26

Proposals under consideration also foresee the possibility of a revision of the inherited expenditure ceiling for years t+1 and t+2 (in both directions) in cases when economic developments turn out considerably different from previous projections, resulting in differences between inheritable and calculated expenditure ceilings that exceed 0.5% of GDP. However, with regard to the upward revision of the expenditure ceiling, there is another constraint from the EU rules – replicated in the FDL – concerning the annual expenditure growth not exceeding the reference medium-term rate of potential GDP.

There are still some deviations from the EU fiscal governance framework, notably excluding all of the expenditure related to the implementation of EU programmes, as opposed to excluding only those fully financed from the EU budget.

d) Reinforce the annual budgetary process by implementing a top-down approach in the formulation of expenditure targets (based on the MTBF). Develop performance-based budgeting and greater centralisation of budgetary processes to increase the role of the Ministry of Finance in the planning, approval and implementation stages to improve the consistency, effectiveness and flexibility of budgetary processes.

As noted above, the draft FDL introduces the principles of multi-annual budgeting, including those related to the formulation of expenditure ceilings. These ceilings are set on a rolling basis for t+1, t+2 and t+3, whereas ceilings for t+1 and t+2 are as a rule inherited from the previous MTBF law. The ceilings are derived on the basis of general government budgetary targets, thus implementing a top-down approach.

Starting from the 2012 Budget Law, budgetary requests from line ministries have to contain information on goals and performance indicators for every budget programme (including performance over past 3 years, current year and expected trend for medium term), as well as compliance with state policy planning documents. This information on performance indicators and compatibility with government priorities is included in explanatory notes to the State Budget law. In the process of preparing an annual budget law, the Minister of Finance shall evaluate the budgetary requests on the basis of their conformity with the provided objectives, intended results, conformity with the budget objectives and taking into account previous developments, as well as principles of economy and efficiency. When performing *ex post* analysis of budget execution, the analysis of achieved performance indicators shall take place as well.

The introduction of multi-annual budgeting based on expenditure ceilings, which are in turn set on the basis of the application of the budget balance rule and taking other principles into account, represents a considerable step forward in introducing top-down budgeting. Performance-based budgeting is likewise evolving, with respective requirements having been strengthened starting from the 2012 Budget Law.

2. ADDITIONAL INFORMATION ON PROGRESS MADE UNRELATED TO THE POLICY ADVICE

The adoption of a comprehensive fiscal framework, to avoid recurrence of unsustainable expenditure growth in good times, was one of the cornerstone recommendations under the EC/IMF Balance-of-Payments support programme. The draft FDL was discussed, prior to its adoption, with EC and IMF experts in the framework of the 5th Programme review in November 2011. The fifth addendum to the Memorandum of Understanding signed between the government of Latvia and the European Commission on 21 December 2011 acknowledged the progress related to the strengthening of the fiscal framework[(29)]. In January 2012 the three-year Balance-of-Payments support programme expired.

In the 2012 Convergence Programme adopted by the government on 27 April 2012, the MTO has been revised from a structural deficit of 1.0% of GDP to a more ambitious target of a structural deficit of 0.5% of GDP, in line with the draft FDL.

[(29)] See http://ec.europa.eu/economy_finance/eu_borrower/mou/20111221_latvia_mou_en.pdf

3. UPDATE OF THE SUMMARY INFORMATION OF THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORK

The introduction of the Fiscal Council through the draft FDL is an additional mechanism to strengthen the prudent conduct of fiscal policy making and introduce a mechanism for monitoring the set targets. This is a new development compared to the first draft of the law and it aims at bringing the fiscal framework in compliance with the evolving EU legislation, as well as recognising the complexity of monitoring fiscal targets that are based on a structural budget. The currently planned set-up of the Fiscal Council, as described below, is still evolving and it is not unlikely that there may be some changes.

Fiscal Institution in Latvia: Fiscal Council

Date of establishment and description of the main tasks related to fiscal policy: To be established upon adoption of the FDL. The main task of the Council will be monitoring of the implementation of fiscal rules established in the FDL. Additional tasks of the Fiscal Council in relation to the implementation of fiscal rules relate to implementation of escape clauses and providing opinions on macroeconomic projections underpinning budgetary projections.

Main outputs released by the institution: analytical annual observance reports and, in case of deviation from the fiscal targets, *ad hoc* irregularities reports; these reports will be made public.

Role of the institution in the budgetary process: *ex ante* (in form of an annex to the medium-term budgetary framework) and *ex post* (in form of annual compliance reports) monitoring of compliance with the budget balance rule; providing *ex ante* opinions on certain aspects of the implementation of the balance rule (notably those related to concepts of severe economic downturn, productive investment to justify deviation from the balance rule, as well as the structural position of the economy).

Obligation for the government to use the output of the institution: based on the "comply or explain" principle.

Status of the institution: Under consideration.

Composition and appointment of the governing board: According to current plans, the Fiscal Council will not have a governing board and will be a collegial body consisting of 6 representatives, of whom 3 are appointed jointly by the Ministry of Finance and the Bank of Latvia, and 3 are appointed by Parliament.

***Decisions of the governing board*:** Not applicable.

Staff: Under consideration.

Comments on the functioning of this institution: Not yet functioning.

Updated EPC policy advice

While the national fiscal governance framework provides some basis for an effective mechanism to implement counter-cyclical fiscal policy, both past and recent developments suggest that the current framework cannot prevent pro-cyclical policies, thus there is a need to strengthen the existing framework. Numerical fiscal rules and the medium-term framework remain underdeveloped, which explains the frequent mid-year budgetary revisions registered in the past and recurring again in 2012. In this context, national authorities should introduce the following measures, in a way that is consistent with agreements achieved during the EC/IMF Balance-of-Payments support program:

a) Adopt a new Fiscal Responsibility Law –possibly supported by amendments to the Constitution– to provide a credible and enforceable framework for limiting expenditure growth in good economic times and ensure its effective implementation from 2013. The law should take into account the EU Directive on minimum requirements for national budgetary frameworks and include targeting a balanced or surplus position over the cycle;

b) Complement the budget balance rule envisaged in the draft Fiscal Responsibility Law with additional rule(s) to ensure that any revenue in excess of what was previously projected is used to reduce the government's debt and that expenditure remains within set limits;

c) Ensure the effective implementation of the envisaged switch to binding multi-year expenditure targets from the 2013 budgetary cycle and set up a mechanism for monitoring compliance with the set targets, including elements to ensure public accountability. The timing of the annual medium-term budgetary framework cycle should be aligned with the EU surveillance cycle;

d) Reinforce the annual budgetary process by implementing a top-down approach in the formulation of expenditure targets (based on the medium-term budgetary framework).

KC-AH-12-113-EN-N