Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review
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Commission services’ country fiches from the 2011 EPC peer review
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<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>CP</td>
<td>Convergence Programme</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>EDP</td>
<td>Excessive Deficit Procedure</td>
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<td>EMU</td>
<td>Economic and Monetary Union</td>
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<td>ESA 95</td>
<td>European System of Accounts 1995</td>
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<td>ESSPROS</td>
<td>European System of Integrated Social Protection Statistics</td>
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<td>FC</td>
<td>Fiscal Council</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>MoF</td>
<td>Ministry of Finance</td>
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<td>MoU</td>
<td>Memorandum of Understanding</td>
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<td>MTBF</td>
<td>Medium-Term Budgetary Framework</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PIT</td>
<td>Personal Income Tax</td>
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<td>PPP</td>
<td>Public-Private Partnership</td>
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<td>SCP</td>
<td>Stability and Convergence Programme</td>
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<td>SGP</td>
<td>Stability and Growth Pact</td>
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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 both national and EU fiscal governance are consistent. This requires improvement in domestic budgetary frameworks with a view to reinforcing their instrumental character by promoting respect of the Treaty’s fiscal provisions. ‘Budgetary (or fiscal) framework’ means the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government.

The 18 May 2010 Ecofin Council conclusions reiterated the importance of national fiscal governance to support fiscal exit strategies, the implementation of the Stability and Growth Pact and the credibility of the corresponding fiscal commitments, and called for a regular assessment and peer review of Member States’ fiscal frameworks. 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. In these 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.

The final report of the Van Rompuy task force on economic governance supported the Ecofin Council conclusions and laid down a two-pronged approach. Firstly, a set of minimum requirements should be met by national fiscal frameworks to be consistent with the EU budgetary rules. A directive, prepared by the Commission as part of the ‘six-pack’ economic governance package, was released in September 2010 and adopted the following year. This directive basically refers to the most primary elements of fiscal frameworks, namely accounting, statistical and forecasting issues, numerical rules, medium-term budgetary frameworks and comprehensive coverage of public finances (1). Secondly, supplementing this first pillar, the organisation of a regular assessment and peer review of domestic fiscal frameworks was envisaged. The purpose of this was to 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.

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

Commission services contributed to the peer review by preparing country factsheets or ‘fiches’. The present publication collates these Commission fiches for both sessions and all 27 Member States.

For each Member State, the fiche describes the situation of its fiscal framework at the time of the review along with an assessment of the framework’s performance. The policy advice adopted by the EPC is included in the fiches. Finally, annexes at the end of each country fiche provide detailed information on each individual fiscal rule, independent fiscal institution and medium-term budgetary framework currently in force.

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SUMMARY AND KEY INSIGHTS

The current financial and budgetary crisis has given renewed impetus to the Member States to put in place adequate frameworks which enhance compliance with the requirements of the Stability and Growth Pact, including more robust fiscal frameworks. Building on a common desire expressed by the Council of the European Union to not only enforce basic requirements but also disseminate best practice, a 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.

The peer review, which took place in two sessions (May and November 2011), provided an opportunity not only for an in-depth assessment of the existing national frameworks and the sharing of knowledge between countries, but also tailored, country-specific policy advice.

Against this background, common patterns emerged which outline key general features of fiscal frameworks across Member States, as well as overarching themes for current reform and further areas of interest.

Global trends and context

- The outcome of the peer review confirms that there is strong momentum for the reform of fiscal frameworks in most Member States. Some Member States have taken steps to enshrine key fiscal principles into their national constitution, with the intention of providing a stronger legal base to enforce the reforms.

- Reforms are not only taking place in Member States with the weakest frameworks. While most Member States with relatively weaker frameworks are introducing the essential building blocks of fiscal frameworks in their legislation, many Member States with relatively stronger frameworks are taking further steps aimed at refining existing features and adding missing elements.

- The 2011 peer review has decisively given impetus to these reforms by providing examples of ‘good/best practices’ amongst Member States and defining well-targeted policy advice to each individual Member State. Where appropriate, such policy advice has already been, or will be, fed into country-specific recommendations in the context of the European semester.

Overview of cross-cutting issues

- **Fiscal rules**: The introduction of fiscal rules has been suggested for many countries, especially on the expenditure side. While these rules share the same general objectives and mostly follow the essential features laid down in Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (i.e. target and scope definition, enforcement and compliance mechanisms, and escape clauses), different approaches have been tested, including the treatment of cyclical expenditure, tax expenditure and/or expenditure not considered to be directly under the control of public authorities.

- **Fiscal councils**: The introduction or the strengthening of fiscal councils has also been advocated for several countries, though some differences remain in the assessment of their performance and suitability. In smaller countries, resource constraints are considered an obstacle to their establishment. An alternative could be to facilitate cooperation between available resources scattered in existing institutions.

- **Medium-term budgetary frameworks (MTBFs)**: Introducing or strengthening MTBFs has been recommended for some Member States, mostly through the introduction of more binding elements. The discussion of specific design features addressed several items, for example the proper mix of fixed and flexible elements or methodologies to account for multi-year price and cost developments.

Key specific issues:

- **Catching-up frameworks**: Some countries suffered until recently from weak frameworks, including a lack of any independent fiscal institution supporting the preparation, execution and assessment of annual budgets, as well as scarce numerical fiscal rules (often limited in scope) and poor medium-term planning. The peer review identified important gaps in these areas and provided extensive policy advice to specify the relevant key building blocks that would need to be put in place. Particular attention has also been paid to the need for comprehensive and timely fiscal statistics. Pressing ahead with implementing the agreed commitments will prove critical for these countries, often undertaking major
macroeconomic reforms in parallel, as structural improvements in fiscal policymaking should go hand-in-hand with fiscal consolidation needs.

- **Informal frameworks**: Some of the best fiscal performers in the EU have been able to rely on a relatively light fiscal framework. In some cases, these frameworks are based on a combination of mutual trust, strong political commitment and popular support. These prerequisites make it difficult to consider transferring this sort of arrangement to other Member States; meanwhile, even those Member States relying on more informal arrangements have recently felt the need to engrave their informal arrangements into legislation, further reinforcing the link between strong political commitment and strong fiscal frameworks.

- **Sub-national governments**: While the construction of a fiscal framework usually begins with resolving issues at the central government level, it should also encompass sub-national governments as they might be a distinct source of fiscal slippages. A number of Member States have received policy advice in this field, especially countries with a federal or a heavily decentralised administrative structure. The review also highlighted the need for further work to better assess how expenditure in sub-national governments could be effectively monitored and controlled. Avenues for further research may include stricter internal funding and borrowing arrangements, tasking fiscal councils with the monitoring of sub-government (in countries with stronger fiscal decentralisation) or enhancing reputational sanctions through increased transparency.
First session of the 2011 peer review (3 and 4 May 2011)
Fiscal governance in Cyprus

1. Description of the Fiscal Framework

Public Finances in EMU\(^{(2)}\) reported that Cyprus was among a handful of Member States that have neither fiscal rules nor a binding medium-term budgetary framework (MTBF). Cyprus also lacked a fiscal council. Since the report’s publication, no major advances have been made in this respect. The adoption of a three-year MTBF — enacted in 2006, with spending agencies now required to prepare rolling three-year budgets — is gradually being phased in. In 2008, the number of ministries and spending agencies adopting this approach increased, with most agencies preparing their fiscal year 2011 budgets according to both the traditional budget method (input-based) and the new format. According to the Ministry of Finance (MoF), the implementation of the MTBF will institutionalise expenditure rules, give more leeway to spending ministries to reallocate resources within their portfolio while respecting their designated expenditure targets. By the same token, this should increase their accountability.

Similarly, the programme and performance budgeting (PPB), introduced in 2007, is still in a nascent state. The PPB, which is to substitute the current line-by-line expenditure analysis, would provide for budgeting per programme, covering the 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. This new budgeting approach is expected to contribute to efficiency gains in terms of improving both the quality of public finances and also diverting expenditure to more value-adding activities.

Overall, the phased introduction of a genuine MTBF is still in the early stages. It is foreseen that it will only become the official (and only) budgeting method from the fiscal year 2014 onwards, rather than 2012 as was expected until recently. Therefore, its impact could become effective only in the medium-term. In the meantime, where already introduced, the MTBF is in place parallel to the traditional (input-based) budget method, with still non-binding features. Therefore, the new framework’s timely implementation would be critical for a successful and lasting consolidation of public finances.

2. Assessment of the Current Framework

Although, overall, the existing fiscal framework does not provide a stage for sound fiscal policies, it includes a few substantive provisions. In particular, the current framework does not allow the parliament to adopt legislative measures that increase budgeted expenditure. The parliament can only vote for expenditure-increasing legislative proposals submitted by the government.

By contrast, the current budgeting system does not allow the shift of the budgeted expenditure from one line item to another. In addition, the current system has significant deficiencies. Firstly, the existing framework provides for one-year budgets, thus neglecting the medium-term perspective. Secondly, its rigid character has induced governments to resort to presenting supplementary budgets during the course of the year. This, per se, is not bad. However, quite often, the supplementary budgets submitted to the parliament for adoption go beyond the intended reallocation of funds. They have also implied an increase in current primary expenditure. Especially during electoral cycles, the submission of supplementary budgets during the course of the year has very often gone beyond the intended reallocation of funds across various expenditure categories, into increasing discretionary current primary expenditure items. This has been particularly more pronounced in pre-election periods.

Thirdly, as a standard practice, there are recurrent mismatches between headline amounts and effective disbursements for budgeted investment expenditures, thus creating overall instability and opacity in budgetary implementation. This practice induces an inherent risk in the annual budget law. The risk of expenditure overruns may materialise if, in a particular year (especially pre-electoral years), fiscal authorities push effective disbursement rates of investment projects upwards and beyond what might be expected from historical averages.

\(^{(2)}\) Public Finances in EMU – European Economy 5/2009
EPC policy advice

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.

- Accelerate the phasing-in of a binding medium-term budgetary framework, as well as Programme and Performance Budgeting (PPB).
- Implement an enforceable multi-annual budgetary framework with a binding statutory basis and corrective mechanisms in case of non-compliance.
- 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.

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

In Cyprus, the main building blocks of a fiscal framework are missing.

Prudent economic assumption for the budget preparation

Despite the lack of independent fiscal institutions providing for the macroeconomic assumptions used for the budget preparation, economic assumptions have been rather prudent. In fact, during the boom years 2006–08, they had a downward bias. This was also the case for the budgetary projections. The problem with the latter, though, is their lack of a medium-term perspective, in the absence of a binding medium-term budgetary framework.

Centralisation of the budget process at the planning stage

Budget preparation in Cyprus is centralised with a strong role for the MoF. In particular, Article 167 of the Constitution places the responsibility for the preparation of the comprehensive budget on the Minister of Finance. The MoF defines the parameters for budgetary preparation, coordinates the line ministries, and then formulates, monitors, and manages the budget’s implementation.
Fiscal governance in Estonia

1. Description of the fiscal framework

Since the early 1990s, fiscal governance in Estonia has been centred on the budget balance rule; the rule has been seen as a cornerstone of the currency board arrangement that Estonia had maintained until the adoption of the euro. Although the rule has never been legally formalised, all governments had adhered to it until the recent economic crisis, when the scale of the economic downturn made the strict implementation of the rule impossible. The rule is usually set in the coalition agreements signed between coalition partners at the beginning of a new government’s term. In earlier years, the rule had been interpreted as a requirement to adopt a balanced budget for the state while, later, the focus shifted to the general government budget. The rule recently evolved to take into account the cyclical component: in 2007 and 2008, the authorities switched to targeting nominal surpluses, as it became increasingly apparent that the requirement for a nominal budget balance was not sufficient to rein in the overheating tendencies of the economy. As of early 2011, in view of the still negative output gap, the government targets small deficits.

Nevertheless, the rule did not prevent the fiscal loosening that occurred during the years of high growth, even though the extent of the procyclicality only became fully apparent ex post. In particular, mid-year supplementary budgets to increase expenditure targets were adopted annually between 2002 and 2007. While fully switching to targeting a cyclically-adjusted balance has been considered in the past, the plans have been discarded until now given the considerable uncertainties related to real-time estimates of the cyclical position in an economy undergoing rapid structural transformation. According to the coalition agreement for 2011–15 signed on 24 March 2011, the authorities intend to formalise the balanced budget rule in the framework budget law. The details of the new legislation, however, remain unknown at this stage.

Until the end of 2011, the budget balance rule is complemented by a debt rule applicable at local government level, which limits the total amount of outstanding financial obligations by a local government and of their servicing to 60% and 20%, respectively, of the budget revenue planned for a given budget year (excluding transfers from the state budget). Implementation of this rule has been strengthened for the period of 2009–11 by adding, in early 2009, a temporary requirement of ex ante approval of local governments’ borrowing plans.

The medium-term budgetary framework, taking the form of the state budgetary strategy, has been in place since 2003. The document is adopted annually in May and sets fiscal policy targets for the next three years on a rolling basis. Expenditure targets established in the document are, however, not binding and can be revised (and usually are revised in practice) in the following updates of the strategy. There are no established rules or procedures for monitoring and analysing the adherence to previously set targets or to deal with deviations, although the necessary information is readily available to the public. No formal discussion with stakeholders takes place before the adoption of the document, while informal consultations precede the adoption of the document and it is presented to parliament after the adoption.

Apart from, perhaps, the State Audit Office, there is no genuine fiscal council in Estonia which would contribute to the budgetary process at the budget formulation and implementation stages. Macroeconomic and revenue forecasts are prepared by the Ministry of Finance (MoF), in consultation with the Bank of Estonia and with the involvement of some other institutions which provide an independent view on the macroeconomic and fiscal outlook. The National Audit Office (NAO) performs an ex post analysis of the implementation of the budget and scrutinises various aspects of the conduct of fiscal policy, delivering normative statements and recommendations. The reports by the NAO enjoy a high degree of visibility but, while fiscal institutions run a reputational risk in case of failure to respond to these recommendations, there are no formal obligations to implement the recommendations made by the NAO.

The implementation of the state budget is characterised by frequent occurrences of an end-of-the-year spending rush, even though the carry-over regulation is fairly tolerant allowing the transfer of up to 3% of current expenditure appropriations and all unused capital expenditure appropriations to the next budget year.

(1) Formulation of the fiscal rule is one of the Euro Plus Pact commitments by the Estonian government
(4) Notably the Ministry of Economics and the Ministry of Social Affairs.
2. ASSESSMENT OF THE CURRENT FRAMEWORK

The strength of the current fiscal governance framework lies in the long-standing commitment to the budget balance rule, although the rule itself has never been formalised in legislation. While providing a solid anchor for the fiscal policy, the rule, nevertheless, fell short of preventing procyclical fiscal loosening in the years of high growth. The rule has been based on nominal targets — albeit that it has more recently evolved to take into account cyclical elements — and there are no additional requirements in place that would limit expenditure growth when the economic growth is above potential. The authorities intend to formalise the rule in the budget framework law, but the details remain unknown at this stage. In addition, a debt rule applicable to local governments limits borrowing by local authorities.

The medium-term budgetary framework is in place and provides a basis for budgetary planning beyond the next year’s budget. However, expenditure limits set in the framework are of an indicative nature and can be revised (there are no specific procedures or rules for handling deviations), in the next year’s update. Given the uncertainties in real-time estimates of the business cycle, which limit the usefulness of cyclically-adjusted targets in Estonia in avoiding the recurrence of imbalances, the framework would need additional elements — either in the form of strengthening the binding nature of expenditure ceilings or in the form of expenditure or revenue rules — that would prevent procyclical fiscal loosening in years of high economic growth. Moreover, the system of monitoring the strategic targets and reporting on them, including elements of public accountability, could be strengthened. In addition, the annual cycle of the strategy’s update should be aligned with the EU fiscal surveillance cycle.

There are no genuine fiscal institutions that could contribute to the annual or multi-annual budgetary process at the budget formulation and implementation stages, which could be justified given the limited human and financial resources. At the same time, close cooperation between the existing institutions within the country, in particular with the Bank of Estonia, as well as the synergy of peer review at EU level, provide an opportunity for an independent view on the conduct of fiscal policy. The National Audit Office (NAO) performs an ex post analysis of the implementation of the budget and scrutinises various aspects of the conduct of fiscal policy, delivering normative statements and recommendations, although there are no formal obligations to implement the recommendations made by the NAO.

EPC policy advice

While the strength of the fiscal governance framework lies in the long-standing commitment to the budget balance rule, the rule itself is not formalised in legislation and has proved to be insufficient in preventing the procyclical fiscal loosening in years of high growth. The medium-term framework is in place but would need strengthening or augmenting by additional rule(s) to ensure sustainable fiscal policy over the cycle. In this context, national authorities should introduce the following measures.

- Formalise the current budget balance rule in legislation, as currently envisaged by the authorities. The new law should take into account Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States and include targeting a balanced or surplus position over the cycle.
- In order to prevent excessive expenditure growth in good economic times, the binding nature of expenditure ceilings in the medium-term budgetary framework should be strengthened and augmented by multi-annual expenditure rules; the framework would benefit from a strengthening of the monitoring system of the strategic targets, including elements of public accountability.

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

Fiscal rule in Estonia: Budget balance rule (general government)

General description of the rule and target definition: The rule has been applied since 1993 and has been a cornerstone of the economic and fiscal policy in Estonia. In earlier years, the rule was interpreted as a requirement for the state to adopt a balanced budget, while in more recent years the focus has shifted to the general government budget. The rule recently evolved to take into account the cyclical component: in 2007 and 2008, the authorities switched to targeting nominal surpluses, as it became increasingly apparent that the requirement for a nominal budget balance was not sufficient to rein in the overheating tendencies of the economy. Currently, in view of the still negative output gap, the government targets small deficits.

General government sub-sector to which the rules applies: The rule is applicable to the general government.
Implementation date: The rule has been in place since 1993.

Coverage and exclusions: The rule applies to the whole of the general government sector.

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

Escape clauses: There are no predefined escape clauses.

Time frame: Annual/multi-annual

Statutory basis: Coalition agreements

Monitoring and enforcement mechanisms: The MoF monitors the implementation of the annual budget and publishes monthly reports on the implementation of the state (cash) budget in the month following the reporting month. In recent years, estimates for the general government fiscal outcome according to ESA 95 methodology have been added to the monthly report (published with a delay of one month) compared to the cash state budget outcome. In case of substantial deviations from previously set targets, the Minister of Finance has the right to limit expenditure set in the budget law during the budget year. Supplementary budgets can be adopted (and have been adopted in practice) to change the previously set fiscal targets, if deemed necessary.

Comments on the functioning of the rule: The rule has been in place since 1993 and, despite the lack of a legal basis, adhered to by all governments. According to the latest coalition agreements signed on 24 March 2011, there are plans to formalise the balanced budget rule in the framework budget law. The details of the new legislation, however, remain unknown at this stage.

Fiscal rule in Estonia: Debt rule (local governments)

General description of the rule and target definition: Until the end of 2011, local governments can undertake new financial obligations (take out loans, issue debt securities, sign financial leasing agreements, etc.) only under the double condition that the total amount of outstanding financial obligation by the local government and its servicing does not exceed 60% and 20%, respectively, of the budget revenue planned for a given budget year (excluding transfers from the state budget). Since 2009 local governments were allowed to borrow only for the purpose of co-financing of EU funds conditioned upon approval from the Ministry of Finance (5).

General government sub-sector to which the rules applies: The rule is applicable to local governments.

Implementation date: The rule has been in force from 1997 to 2011.

Coverage and exclusions: The rule applies to all borrowing by local governments. The share of local governments’ expenditure of the general government expenditure is 25–30%. The rule does not apply to bridging loans taken to finance projects in the context of EU Structural Funds or foreign aid before the foreign aid is received.

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

Escape clauses: There are no predefined escape clauses.

Statutory basis: Legal basis

Monitoring and enforcement mechanisms: The responsibility for monitoring compliance with the rule and enforcement lies with the MoF. In case of deviations, the MoF makes proposals to correct the situation. If the local government fails to take appropriate measures, the MoF can prepare proposals to reduce transfers from the Equalisation Fund for local governments or apply other measures.

Comments on the functioning of the rule: The rule was introduced following the previous economic downturn in 1997 with the aim to ensure local governments’ fiscal discipline and has been generally respected. Implementation of this rule has been strengthened for the period of 2009–11: in early 2009, a temporary requirement of ex ante approval of local governments’ borrowing plans was added. Due to the basis expressed as a share of revenue, the rule has some procyclical bias, allowing higher borrowing in good economic times.

(5) Editor's note: the following complement was inserted following the completion of the peer review in December 2011

As of 2012, a new local government financing law will be in force, which modifies local governments’ debt rule. The law provides a basis for medium- to long term financing frameworks, modernises and increases transparency of financial governance, and makes provisions for the enforcement of fiscal discipline. It establishes a net debt ceiling (debt minus liquid assets) of 60%-100% of primary revenue in the current fiscal year depending on self-financing capacity of municipalities, which is allowed to be exceeded by the amount of ‘bridge loan’. The new rule is applicable to borrowing by local governments and dependent units, with no escape clauses. The responsibility for monitoring and enforcement of the rule lies with the Ministry of Finance.
Fiscal institution in Estonia: National Audit Office of Estonia

Date of establishment and description of the main tasks related to fiscal policy: The National Audit Office (NAO) of Estonia is an independent constitutional body and was re-established in 1990 after Estonia regained its independence. The NAO is not involved in the budgetary process at the budget formulation and execution stages, but performs ex post annual evaluation of state’s annual reports, makes normative statements on the conduct of fiscal policy and issues recommendations.

General government tiers at which the institution carries out its tasks: The whole of the general government sector and public corporations which are not part of the general government.

Main outputs released by the institution: The main output of the NAO includes evaluation of the consolidated annual report of the state (financial audit), as well as specific performance audit reports regarding various aspects of the use of public funds. The NAO makes its findings public and presents them to parliament.

Role of the institution in the budgetary process: There is no involvement of the NAO at the budget adoption and execution stages. The NAO performs ex post audits of the budget’s execution and issues reports and recommendations on the conduct of fiscal policy in Estonia.

Obligation for the government to use the output of the institution: There is no formal obligation for the government to use output from the NAO although, due to the high public visibility of these reports, the government runs reputational risks if it fails to follow the recommendations. In practice, recommendations made by the NAO are usually taken into account.

Status of the institution: The National Audit Office is a constitutional institution.

Composition and appointment of the governing structure: The National Audit Office comprises the Auditor-General, audit departments and support structural units. The Auditor-General is elected by parliament following a proposal by the President of the Republic of Estonia. The term of office of the Auditor-General is five years.

Comments on the functioning of the institution: The NAO reports enjoy high public visibility and interest. While there is no formal obligation for the government to make changes or amendments to the conduct of fiscal policy as a result of the findings and recommendations of the NAO, these recommendations are usually followed, given that failure to do so entails reputational risks.

Medium-term budgetary framework in Estonia

Description of the national medium-term budgetary framework: The medium-term budgetary framework (MTBF) takes the form of the state budgetary strategy. This document is adopted by the government annually in May and sets fiscal policy targets for the next three years on a rolling basis. For the purposes of the next year’s budget preparations, expenditure targets agreed in the MTBF act as ceilings, while next year’s targets are more of an indicative nature.

Time frame: Three years (t+1, t+2 and t+3): the framework works on a three-year rolling basis.

Institutional coverage: General government

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

Monitoring mechanisms: There is no specific body charged with the task of monitoring adherence to the medium-term budgetary objectives. For the current year, monitoring takes place through the annual budget monitoring.

Connectedness with the annual budget law: Expenditure ceilings included in the MTBF form the basis for budget requests by line ministries and other central government institutions.

Domestic budgetary procedures in Estonia

The annual budgetary cycle

The annual cycle is split into two distinct parts: the preparation of the medium-term budgetary strategy (the state budgetary strategy) in the first half of the year and the adoption of the annual budget law in the second half of the year. The latter starts with the line ministries submitting budget bids based on the MTBF first-year ceilings.
It is followed by the compilation of a draft budget proposal by the Ministry of Finance, taking into account an updated macroeconomic and revenue forecast. The Cabinet of Ministers discusses the draft budget in September and adopts the draft budget by 1 October. Parliament then discusses the draft budget in the remaining three months and usually adopts the budget law in December.

**Economic assumption for the budget preparation**

The Ministry of Finance prepares macroeconomic and revenue projections that form the basis of the annual budget, using some alternative scenarios and sensitivity analysis. There is no independent institution charged with the task of preparing economic forecasts; however, the Bank of Estonia and, to a lesser extent, the Ministry of Economics and the Ministry of Social Affairs, informally provide their views on the forecast.
Fiscal governance in Greece

1. Description of the Fiscal Framework

Against the background of a challenging economic and financial situation, Greece’s fiscal framework remains underdeveloped. The weak fiscal framework is partly behind the recurrent high general government deficits and heavy debt ratio. The systematic deviation from the medium-term path considered in the successive updates of the stability and convergence programmes (SCPs) is explained to a great extent by the persistent expenditure overruns due to the discretionary decisions of fiscal authorities and chronic revenue shortfalls caused by a defective tax system.

Unlike most of its EU partners, no fiscal rules are currently implemented in Greece. Likewise, although budgetary documentation contains macroeconomic and fiscal projections for the next three years, the budget process at the planning and approval stage largely focuses on the year the budget is prepared. This lack of medium-term planning does not facilitate the design of a genuine fiscal strategy giving clear signals as to the prioritisation of certain policy actions over others. However, the 2010 organic law provides for the introduction of a medium-term budgetary framework for the next three years. The Greek authorities are already preparing their first medium-term budgetary strategy for the period 2012–15 in cooperation with the EC, the ECB and the IMF in the framework of the economic adjustment programme for Greece.

Regarding independent fiscal institutions, the Greek authorities reported the existence of a research institute and a newly created Budget Office attached to the parliament. The Centre of Planning and Economic Research (KEPE) focuses on applied research projects concerning the Greek economy and provides technical advice on economic and social policy issues to the Minister of the Economy and Finance. However, fiscal policy tasks do not appear to take centre stage in the institute’s task portfolio. The government does not use KEPE inputs in the budgetary process and does not have to justify departures from KEPE’s forecasts and assessments. However, the 2010 organic budget law provides for the establishment of a Parliamentary Budget Office, which is supposed to provide independent advice and expert scrutiny on fiscal issues, and publicly report on the budgetary plans and execution of the spending entities of the general government, and on macroeconomic assumptions used in the budget.

Until recently, budgetary procedures in Greece have been hindered by shortcomings at all stages of budgetary preparation — planning, approval and execution. The revenue side has been prepared separately by the tax authorities with no coordination vis-à-vis expenditure needs. The existence of many extra-budgetary funds and accounts, the fragmentation of the budget into multiple lines and chapters, and the separation between an ordinary budget and an investment budget are not conducive to transparency. In general, these budgets have been prepared separately and with little consideration of the overall impact on government expenditure. Aware of these weaknesses, the Greek authorities introduced a programme-based budget in 2008 and 2009. Finally, there has been inadequate reporting on budget execution for sectors other than the central government and, until very recently, no regular report on spending commitments made by line ministries against appropriations.

2. Assessment of the Current Framework

Until recently, the absence of binding expenditure limits and a medium-term fiscal planning coupled with the lack of adequate budgetary procedures to monitor fiscal developments largely accounted for the recurrent expenditure overruns. Against this backdrop, the implementation of an expenditure rule could be instrumental in limiting both the existing deficit bias and the conduct of procyclical budgetary policy. This should by no means be an isolated response: policy experiences in some Member States show that an effective implementation of such a rule should be accompanied by other institutional reforms conducive to transparency and a better monitoring of enforcement mechanism.

For example, the expenditure rule should be complemented by a rule on the revenue side. This rule should predefine the allocation of greater-than-expected revenues to debt reduction. The introduction of this rule is likely to pay dividends, especially if the announced reforms to improve tax collection make a difference.
A rule applicable to sub-central governments may also be adequate in the case of Greece. The financial autonomy of local governments is rather limited: nearly 60% of their revenues come from earmarked transfers and tax-sharing agreements with the central government. This large dependence on central government funding might induce supplementary budget requests by municipalities through the budgetary year and increase bailout expectations in case of fiscal distress. A debt rule applicable to this tier of government could prevent municipalities from running increasing deficits and reinforce budgetary discipline within the entire framework. Effective implementation of a fiscal council acting in the field of fiscal policy should be envisaged in a follow-up package once the most urgent remedies to the existing framework have been put in place.

In May 2010, the euro area Member States and the IMF provided financial support to Greece in the context of a sharp deterioration of its financing conditions. The quarterly disbursements of bilateral financial assistance are subject to quarterly reviews of conditionality for the duration of the arrangement. Under the heading ‘Structural fiscal measures’ in the Memorandum of Understanding (MoU), several measures have been earmarked and implemented: (i) a medium-term fiscal framework based on rolling three-year expenditure ceilings for central government, social security and local government; (ii) the strengthening of the position of the Finance Minister vis-à-vis line ministries in both budget preparation and execution phases (granting the Finance Minister the power to veto spending decisions and execution and control over a budget contingency reserve).

In addition, in line with the MoU requirements, the 2010 organic law provides for the creation of a budget office attached to parliament to provide independent advice and expert scrutiny on fiscal issues, to publicly report on the budgetary plans and execution of the spending entities of the general government and on the macroeconomic assumptions used in the budget.

In line with the provisions of the organic budget law of July 2010, the government has set expenditure ceilings for 2011 for the state and deficit target for the various government sectors. There has been progress in the timely provision of fiscal data, although there are still some quality issues: monthly data availability for the government entities other than the state remains clearly below par and prevents an adequate monitoring of intra-year budgetary developments for the government as a whole. While the situation has somewhat improved in the social security sector and state-owned enterprises, fiscal information on local governments remains very limited. The accumulation of arrears in other than the state sector is reflecting long-lasting shortcomings in expenditure monitoring and control.

**EPC policy advice**

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 economic adjustment programme for Greece, national authorities should introduce the following measures.

- Implement a medium-term budgetary framework. The new medium-term budgetary framework (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 objectives referred to in the EC-ECB-IMF economic adjustment programme for Greece 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 parliament.

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

- 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.

- Enhance the operation of the independent fiscal council entrusted with technical tasks related to fiscal policymaking (e.g. provision of forecasts for the budget preparation, monitoring fiscal developments against budgetary targets and fiscal rules).

- Introduce stronger expenditure monitoring mechanisms.

- 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 an effective top-down budgeting.
3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

There are no fiscal rules in Greece.

Fiscal institution in Greece: Centre of Planning and Economic Research (KEPE)

Date of establishment and description of the main tasks related to fiscal policy: The Centre of Planning and Economic Research (KEPE) was established in 1959. The primary aims of KEPE at its establishment were the scientific study of the problems of the Greek economy, the encouragement of economic research and the cooperation with other scientific institutions. Its objectives eventually widened to include the preparation of short, medium and long-term development plans, the analysis of Greece’s short and medium-term economic developments, the formulation of economic policy proposals and the education of young economists.

Main outputs released by the institution: KEPE issues macroeconomic forecasts and public expenditure and revenue projections and also conducts analyses on fiscal policy developments.

Role of the institution in the budgetary process: KEPE has no formal role in the budgetary process.

Obligation for the government to use the output of the institution: The government does not use outputs produced by KEPE and does not have to justify departures from KEPE’s forecasts and assessments.

Status of the institution: KEPE is a public research institute attached to the Ministry of Economy and Finance. It is grounded by a legal act.

Composition and appointment of the governing board: KEPE is managed by a five-member board of directors appointed by the Minister of Regional Development, and Competitiveness. Board members come from the academia and are appointed for a three-year term, starting and ending simultaneously.

Staff: KEPE employs around 35 employees in total at its office in Athens.

Comments on the functioning of the institution: Due to the wide range of subjects dealt with by this institution and its research-oriented approach, the body does not appear, for the time being, able to carry out sustained monitoring of fiscal policy unless additional resources are allocated to it.

Domestic budgetary procedures in Greece

Transparency: Economic and budgetary statistics had not been reliable in the past, while a common accounting framework was lacking for all public sector entities. In particular, social security funds and hospitals, territorial governments, public enterprises and other public entities were not part of the standard budget process. Reporting on budgetary execution has been poor. Stronger expenditure monitoring mechanisms are necessary, particularly the implementation of appropriate control of spending commitments, through which spending entities (line ministries, local authorities, social security funds, hospitals and other legal entities) report on a monthly basis to the Treasury on their outstanding expenditure commitments against their authorised appropriations in the budget law. To this end, the General Secretariat for Information Systems has started developing a special information system, to be complete by June 2011, interconnecting all public entities with the General Accounting Office, to provide real-time data.

Macroeconomic assumptions: Underlying budget preparations have shown an optimistic bias, particularly tax revenues. The Minister of Finance produces forecasts and projections.

Centralisation of the budgetary process at the early stage: The preparation of the budget is fragmented (ordinary budget, investment budget, large number of extra-budgetary funds and off-budget public entities). Individual budgets are usually prepared without consideration of total expenditure at the general government level.

Centralisation of the budgetary process at the implementation stage: Overall, there is a lack of internal controls in line ministries. The existing rules to prevent overspending during the budgetary execution are not linked to the overall fiscal targets and may be circumvented by a number of exceptions. There are no specific rules about the use of windfall revenues, which can be used to finance new measures on the expenditure side. The Minister of Finance has been granted the power to veto spending decisions and execution. In addition, a compulsory contingency reserve under the control of the MoF, covering 5% of the total appropriations of government departments other than wages, pensions and interest, has been introduced.
The use of top-down budgeting: The Ministry of Finance frequently adjusts appropriations during the year and is only required to present a supplementary budget when expenditure and revenue in the budget depart considerably from the actual figures. The 2010 organic law provides for a top-down budgeting approach and imposes expenditure ceilings for line ministries.
Fiscal governance in Hungary

1. Description of the Fiscal Framework

Until late 2008, the Hungarian budgetary framework was characterised by a number of important weaknesses, which recurrently exposed the country to a full-blown electoral cycle in public finances — government deficits had reached their highest levels in election years (1994, 1998, 2002 and 2006). This was corroborated in various empirical studies that found that Hungary had one of the weakest budgetary frameworks in the EU. Following the adoption of the Public Finance Act in 1992, no major changes had essentially been made to the way in which the annual Hungarian budget was planned, formulated and implemented until the recent crisis. The only numerical rule at the time (a cap on local government indebtedness) could not prevent a rapid accumulation of debt by municipalities. As the only fiscal institution existing during this period, the State Audit Office’s work primarily focused on the ex post financial audit of public accounts and legal compliance with the existing provisions.

In order to strengthen budgetary discipline and transparency, a new fiscal framework was adopted by the parliament in November 2008 in the context of the government’s reform programme (endorsed by the EU-IMF medium-term loan of EUR 20 billion granted in reaction to the financial crisis). The reform encompassed the enactment of the new Fiscal Responsibility Law (FRL) in conjunction with a number of amendments of the existing organic law (Public Finance Act). As regards medium-term budgetary planning, the FRL stipulates that the increase in the central government’s gross debt may not increase the inflation rate and the primary balance targets must be consistent with the former objective (real debt rule). These rules were backed, in particular, by stringent procedural rules and institution building: stricter regulation for supplementary budgets and a review of accounting practices, the introduction of the mandatory offsetting principle (pay-go rule) as well as the establishment of an independent three-person fiscal council (FC) equipped with its own 30-strong analytical staff to provide independent macro-fiscal forecasts and fiscal impact assessments. Following an initial three-year phase-in period (for which a couple of additional temporary rules were also enacted), the new set-up was expected to be fully effective by the time of the 2012 budget preparation.

The first two years of the new rule-based framework proved to be relatively successful. This was, for example, exemplified by the fact that the 2010 budget had been prepared and adopted broadly in line with the relevant regulations. In addition, step by step, the FC assumed most of its functions and it closely monitored the entire budgetary process. However, the new government that came into office in May 2010 took a number of steps that weakened the new framework. In June 2010, it significantly loosened the numerical benchmark governing the adoption of a supplementary budget and abolished the newly introduced accounting requirement for the profits/losses of majority state-owned public corporations. Moreover, some of the changes in tax codes and social transfers were not in accordance with the pay-go rule. Finally, in December 2010, the FRL was modified again in order to abolish the separate office of the FC and to replace the members of the Council (appointed by parliament unanimously in February 2009). The revamped FC can send the draft budget proposal back to the government for reconsideration (previously, the FC’s opinion on the draft was published after the submission of the document to parliament), but the government can then submit the draft document to parliament without being required to change anything. In addition, while the adopted 2011 budget is in compliance with the discretionary balance requirement for 2011 set in the previous budget, the medium-term targets were considered to violate the real debt rule by the FC in its December 2010 report on compliance with the fiscal rules: both the discretionary


(*) It is worth recalling that this step was preceded by years of public debates and various reform plans in this area. An important interim move had been when the government presented a comprehensive reform package of draft bills in November 2007, including the introduction of medium-term fiscal rules and the establishment of an independent fiscal institution. As important elements of the proposed set-up could only be approved by a qualified majority in parliament (hence, with the support of the opposition), there was deadlock for a year in the legislative process due to a number of disagreements between the political parties.

(*) The FRL stipulated that, starting from 1 January 2010, ‘... the accounting profit/loss of business associations in majority state-ownership shall be recorded as budget items in the year when the balance sheet is drawn up. Losses shall be recorded as expenditures, profits as revenues.’ This almost complete incorporation of quasi-fiscal activities affected only the national accounting provisions and had no direct impact on ESA figures.

(*) The new members are: Zs. Járai, Head (previously Finance Minister in the Fidesz Government and served as governor of the central bank 2001–07); ex officio members: President of the State Audit Office L. Domokos (served as a Fidesz MEP until mid-2010) and MNB Governor A. Simor (held various managerial posts in the financial sector before his appointment to the central bank).
balance target for 2012 and the primary balance target for 2013 are some HUF 200–300 billion (approximately 1 % of GDP) looser than would have been required.

In mid-March 2011, the authorities unveiled their plan for a new constitution, which, for the first time, contains a separate public finance chapter. The government is aiming to renew the entire rules-based set-up by establishing a constitutional debt brake at 50 % of GDP. Linked to this, a separate provision specifies that until this debt ceiling is achieved the ‘public debt stock must be reduced’. Nonetheless, these rules could be disregarded in case of ‘… the continued and significant decline of economic activity, to the extent required to reinstate the balance of the national economy.’ The FC is also expected to gain constitutional basis and some sort of power to veto the budget. A further regulation establishes that the parliament can be dissolved if the budget is not adopted by 31 March in the actual budget year (there has been no precedent for this over the last two decades). Finally, the Constitution is set to open the possibility that future borrowing transactions of local governments would be subject to ex ante authorisation by a representative of the central government. It is foreseen that after the adoption of the Constitution (the final vote is scheduled for 18 April), successive laws and amendments will follow and make the above mentioned key elements of the proposed reform operational.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

Hungary is at a critical juncture as regards its system of fiscal governance. The country had started to gradually implement a new comprehensive set-up over the last two years, focusing notably on the phasing-in of the real debt rule. There were some palpable weaknesses with this system at the beginning of this process, but most of these could have been corrected provided that broad political support could have been gathered. For example, the weak statutory base of the framework could have been remedied by placing the key elements of the regulation in the Constitution and the missing coverage of sub-national finances could have been solved by introducing a binding deficit/debt rule to local government acts by qualified majority. The complexity of the numerical fiscal rules and of the corresponding processes — sophistication was needed to provide for anti-cyclical fiscal policy — could have been handled by stepping up communication efforts and close professional cooperation between the Finance Ministry and the FC. In summary, as a result of its dominantly high-quality characteristics, including the new procedural and accounting rules, the multi-annual nature of the numerical rules as well as the first contributions of the independent FC, the new system was widely perceived to have the potential to become an effective anchor for fiscal policy.

After a number of steps were taken in the second half of 2010 that effectively watered down this framework, the government is in the process of introducing guarantees into the new constitution safeguarding public finances, chiefly through the specification of a numerical limit on gross public debt at 50 % of GDP and enshrining the FC in the new base law. Providing a constitutional basis for rule-based fiscal policymaking is a very promising step, as evidenced by both the analytical and empirical literature. However, important details of these key initiatives will only be specified in subsequent separate laws (e.g. what exactly will the temporary numerical rules be until the debt ratio declines to 50 % from the current figure of close to 80 %; delineating what will constitute an increase or a decrease in public debt; will there be, apart from the multilateral surveillance framework provided by the Stability and Growth Pact and specifically the requirement to reduce the excess over the 60 % threshold by 5 % per year, ex ante specified and enforceable national correction mechanisms that need to be implemented if the debt threshold is expected to be surpassed; the precise interpretation of the planned escape clause etc.). Therefore, it is not yet possible to make a thorough assessment of the revised fiscal framework. This also concerns the question how the government would like to take its reform plans forward as regards other aspects of fiscal governance, such as a sufficiently restrictive regulation governing the adoption of supplementary budgets or the review of accounting practices (10). The new debt cap would not, per se, promote the medium-term orientation in fiscal policy, so that there is a risk that, yet again, too much focus would be placed on the actual budget year. Finally, there is ample room to continue to increase the transparency of fiscal policy: for example through the publication of fiscal impact assessments for major budgetary steps, the methods and assumptions used for macroeconomic and budgetary forecasting, or through a regular update of the official fiscal projections.

In this context, design issues will also need to be carefully considered, for example the imposition of a nominal debt cap could easily lead to a procyclical fiscal stance if used as an all-purpose device. Given that the real debt

(10) It should be recalled that a Government Accounting Standards Advisory Board was jointly established by the Fiscal Council and the President of the State Audit Office in January 2010 to present recommendations concerning the content of the fiscal accounting rules. To this end, the five-person expert body published its interim report in October 2010 but so far the government has not followed up on the proposals in the document.
rule is still in force, it is important that the government presents a clear economic case for changing the rule. From a credibility point of view, there is a risk that the markets suspect that the government changed the rules at the moment when the real debt rule would eventually have become binding for fiscal policy (this perception might be further accentuated by the looser than required medium-term targets contained in the 2011 budget as described above). Although the ruling coalition possesses the required quorum for the adoption of the new system, building a broad political consensus could be instrumental in ensuring a stability of the new framework, possibly through incorporating most of the improvements achieved in fiscal governance over the last two years.

EPC policy advice

Almost all aspects of Hungary’s fiscal framework have improved significantly since 2008. The adoption of the new Constitution in April 2011, which includes a separate chapter on public finances, will need to be followed by further legislation. In this context, national authorities should introduce the following measures.

- Based on the strong commitment to a sound fiscal framework, determine as soon as possible the operational aspects of the key elements. These should include the exact workings of temporary numerical rules (both at the central and local level) in effect as long as the debt ratio is above the 50 % threshold and the broadened governing arrangements of the Fiscal Council.

- Building on the progress achieved since 2008, embed the constitutional debt brake into a comprehensive fiscal governance framework covering, in particular, multi-annual fiscal planning, real-time budgetary monitoring, the transparency of public finances and stringent procedural and accounting rules.

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

Fiscal rule in Hungary: Real debt rule

General description of the rule and target definition: The rule prescribes that — based on prudent baseline projections in a medium-term framework — the real value of the central government debt stock must not increase from year t+1 to year t+2 (t denotes the year for which the budget is prepared) and, at the same time, it must not be larger than the real debt had been in year t-2. This goal is to be achieved through a three-step algorithm: firstly, in t-3, the minimum primary surplus (expressed in nominal terms) is determined for year t, which is consistent with the real debt rule. Then, in t-2, based on an updated estimate for mandatory items, the discretionary balance requirement for year t is set in accordance with the previously set primary surplus target. Finally, in year t-1, the appropriations for discretionary items adopted with the year t budget, within the preset limit. An error correction mechanism completes the set-up, which provides for three years to compensate for any excess above the stipulated numerical rules.

General government sub-sector(s) to which the rules applies: Central government subsystem, including the central budget, the two social security funds and the six extra-budgetary funds.

Implementation date: The rule was approved in late 2008 and phased in in successive steps starting from the adoption of the 2010 budget (this already included a discretionary balance target for 2011, but it was not yet derived from the real debt rule, but rather from the deficit target as set in the Convergence Programme).

Coverage and exclusions: The rule does not cover the local government sector.

Accounting system: All numerical requirements are defined in terms of cash flow budgetary accounting.

Escape clauses: There are no predefined escape clauses.

Time frame: Multi-annual framework

Details: This set of numerical rules ensures that budgetary planning is embedded in a medium-term framework (three-year cycle). During the budgetary execution, the government is only bound by the preset ceiling on the discretionary deficit, which is under its full control. Thus, compliance with the rule would lead to a continuous decline in the debt-to-GDP ratio — barring negative growth episodes (11) — while it fully allows for the operation of automatic stabilisers; thereby it avoids the procyclicality of fiscal rules.

Statutory basis: Act of Parliament (simple majority law)

Monitoring: Monitoring is primarily ensured by the FC. Its assessment is made public in the opinion assessing the draft budget. The State Audit Office’s parallel report on the draft budget also assesses compliance with the

(11) The rule is designed so that the debt-to-GDP ratio may increase only if the GDP shrinks.
rules from a legal point of view (i.e. it does not present its calculation as regards what the targets should be in numerical terms.)

Enforcement mechanisms: There are no predefined enforcement mechanisms. The ruling government’s reputation would suffer if budgetary legislation/implementation deviated from the target.

Comments on the functioning of the rule: In general, compliance with the rule so far has been mixed. The first set of operational targets specified in the 2010 budget (discretionary balance requirement for 2011 and primary balance requirement for 2012) were in line with the real debt rule — though they were expressed as a percentage of GDP, instead of HUF billion. While the appropriations adopted in the 2011 budget are in compliance with the discretionary balance requirement for that year, the medium-term targets as laid down in the budget bill had been considered by the FC to violate the real debt rule: both the discretionary balance target for 2012 and the primary balance target for 2013 are some HUF 200–300 billion looser than would have been required.

Local government debt rule in Hungary

General description of the rule and target definition: The annual ceiling of the debt-creating commitments (borrowing and related charges, bond issues, etc.) of each local government is set at 70 % of the ‘annual own revenue capacity’ (calculated as receipts from local taxes and other revenues minus interest payments).

General government sub-sector(s) to which the rules applies: Local government: this sector accounts for approximately 20 % of annual public expenditure, and owns roughly 5 % of gross public debt (which is 4 % of GDP) (all data refer to 2009).

Implementation date: The rule was approved in 1995 and entered into force in 1996.

Coverage and exclusions: Short-term liquidity loans are not covered by this regulation. In practice, the regulation can be circumvented by municipalities by accumulating debt in the books of local government-owned public companies instead of their own accounts (this type of debt is currently estimated at close to 1 % of GDP).

Accounting system: The ceiling is defined in terms of cash flow budgetary accounting.

Escape clauses: There are no predefined escape clauses.

Time frame: The rule focuses on the actual budget year.

Details: The idea of linking the debt accumulation of municipalities to the capacity to repay the debt emerged in the context of a major fiscal consolidation programme in the mid-1990s (the so-called Bokros package). At the time of the introduction of the rule, the sector’s debt was around 1 % of GDP, and that remained the case until 2001. Afterwards, however, the local government’s debt-to-GDP ratio started to increase continuously, which was further accentuated by the string of Swiss franc denominated bond issues culminating in 2007. Starting from 2008, the ratio has fluctuated around 4 % of GDP.

Statutory basis: Act of Parliament (qualified majority law)

Monitoring: There is no formal monitoring.

Enforcement mechanisms: There are no predefined enforcement mechanisms.

Comments on the functioning of the rule: This rule struggled to limit the increase in sub-national indebtedness for two main reasons. Even after quadrupling over a decade, local government debt is still far below the maximum level set forth in the legislation. A recent study (13) estimates that local governments could borrow an additional HUF 2 000–4 000 billion (approximately 7 to 14 % of GDP) before they reach the statutory maximum. Secondly, there is nobody monitoring the rule and no sanction mechanisms have been defined, so its effectiveness is likely to be close to nil even once debt accumulation has been reached when it could, in practice, become binding.

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Fiscal institution in Hungary: State Audit Office

**Date of establishment and description of the main tasks related to fiscal policy:** The State Audit Office (SAO) was established in 1989 and provides independent forecasts and projections that are used for the budget preparation.

**General government tiers at which the institution carries out its tasks:** The entire general government sector (very broad mandate in financial audit: around 450 central budgetary units and the approximate 3,200 local governments).

**Main outputs released by the institution:** The main budget-related outputs of the SAO are the *Annual report on the draft budget proposal* (published around mid-October in a typical year, when the draft budget is submitted to parliament by the end of September), and the *Annual report on the final accounts* (published around the end of August each year).

**Role of the institution in the budgetary process:** The SAO assesses the draft budget in qualitative terms before the start of the parliamentary debate and it highlights the risks (low/medium/high) in relation to optimistic projections for revenue and expenditure items. The report also assesses the compliance of the budget document with the relevant legislation. The SAO also carries out *ex post* monitoring of the implementation of the budget law.

**Obligation for the government to use the output of the institution:** The government/parliament is not obliged to take the SAO’s recommendations on board and is free to use its own macroeconomic assumptions and fiscal projections in preparing the budget.

**Status of the institution:** The status and independence of the SAO in enshrined in the Constitution and in a separate law (Law on the State Audit Office of 1989).

**Composition and appointment of the governing board:** The SAO’s president and vice-president(s) are elected by a two thirds majority in the parliament for terms of 12 years. They can be re-elected.

**Decisions of the governing board:** Decisions are adopted by the President (in practice, the SAO functioned for a couple of years without any vice-presidents).

**Staff:** The SAO employs a staff of around 540 people, of which about 70 % are involved in the actual audit work.

**Comments on the functioning of the institution:** Partly due to the fact that the government is not obliged to take the SAO’s recommendations on board as well as that the institution has been better equipped to undertake traditional *ex post* auditing, the body’s support for fiscal responsibility over the last two decades has proved to be rather limited. It is widely considered that the SAO was practically unable to foster effective public scrutiny of the budgetary planning and implementation process.

Fiscal institution in Hungary: Fiscal Council

**Date of establishment and description of the main tasks related to fiscal policy:** The Fiscal Council (FC) was established in 2009. Until the end of 2010, its work was supported by a technical staff of around 30 analysts (Office of the Fiscal Council).

**General government tiers at which the institution carries out its tasks:** The entire general government sector.

**Main outputs released by the institution:** The main (more precisely, sole) output of the FC is its opinion on the draft budget. Its previous incarnation (2009–10) published as main outputs: (i) semi-annual medium-term macro-fiscal baseline projections; (ii) fiscal impact assessments on draft legislation; (iii) opinions on the draft budget after submission to parliament, and an update before the final vote took place; (iv) opinions on motions for amendments submitted to the draft budget or to other important substantive laws with significant budgetary consequences.

**Role of the institution in the budgetary process:** It forms an opinion on the draft budget proposal before it is presented to parliament. It can send the document back to the government for reconsideration, but the government can then submit the draft document to parliament without being required to change anything.

**Obligation for the government to use the output of the institution:** The government/parliament is not obliged to take the FC’s opinion on board and is free to use its own macroeconomic assumptions and fiscal projections in preparing the budget.

**Status of the institution:** The provisions on the status of the FC are enshrined in a law (Fiscal Responsibility Law of 2008).
Composition and appointment of the governing board: The FC consists of *ex officio* the president of the State Audit Office and the governor of the central bank, while its head is appointed by the President of the Republic for a six-year term.

Decisions of the governing board: Since the reorganisation of this body from the beginning of 2011, there has been no publicly available information on its working arrangements and decision-making procedures.

Staff: The FC has no budget and no dedicated support staff. The two *ex officio* members (the president of State Audit Office and the governor of the central bank) use their own staff as technical assistance in carrying out their tasks.

Comments on the functioning of the institution: In its previous form, the FC, equipped with autonomous analytical capacities, was considered an independent counterbalance to the government and a useful point of reference in budgetary matters throughout the entire fiscal year. Currently, there are question marks regarding the effectiveness of the new consultative body, stripped of any staff. Although the official argument for abolition of the Office was to rationalise the public sector as there had been expensive parallel activities, it is discernible that no other body has performed the previous functions of the FC since the beginning of this year (e.g. issuance of updated ‘no-legislation-change’ medium-term baseline, publicly available impact assessments).

Medium-term budgetary framework in Hungary

**Time frame:** Three years (i.e. t+1, t+2 and t+3) as a minimum. This framework works on a rolling basis, in line with the successive steps of the operationalisation of the real debt rule.

**Institutional coverage:** Central government subsystem (the entire general government sector is covered only by the convergence programme updates, which break down medium-term projections according to national accounts classifications).

**Accounting system:** All figures are expressed in terms of cash flow budgetary accounting.

**Target revisions and binding objectives:** The medium-term budgetary targets derived from the real debt rule should not be revised in principle. The discretionary balance target defined for the actual year is binding for execution.

**Level of detail of expenditure and revenue projections:** Both expenditure and revenue projections should be presented in a semi-disaggregated level, differentiating between mandatory and discretionary items — this requirement was only partially fulfilled in the most recent budgets.

**Connectedness with the annual budget law:** The appropriations for discretionary items contained in the actual budget bill should be consistent with the discretionary balance target derived from the real debt rule and specified in the previous year’s budget.

**Monitoring mechanisms:** The FC is primarily in charge of monitoring the compliance with the medium-term targets.

**Enforcement mechanisms:** There are no predefined corrective or enforcement mechanisms for cases of deviation from the envisaged medium-term targets. Emerging differences in different expenditure categories are not considered to be problematic.

**Targets for sub-central governments:** There is no fiscal coordination mechanism (e.g. consultation committees, internal stability pact) between the central government and the various interest associations of the local government sector.

**Comments on the functioning of the framework:** Before the introduction of the real debt rule in 2009, multi-annual fiscal planning in Hungary was the least developed among the EU-27 according to the Commission’s MBTF index. In the annexes of the budget bill, there were three-year nominal expenditure ceilings specified for each budgetary chapter, but it was, at best, indicative planning (even their role in providing direction to budgetary institutions as to their budgetary room for manoeuvre appeared to be rather limited). Starting from the preparation of the 2010 budget, multi-year planning gained much more importance as the need arose to put into practice the real debt rule. However, the preparation of the 2011 budget represented a clear setback in this regard: there was only one overview table depicting the medium-term outlook based on highly aggregated budgetary categories in an annex, without explanation or justification for the projections (e.g. only the anticipated balances of two social security funds were shown, so there was neither information on the projected social security contributions, nor on the expected healthcare or pension expenditures in the budget document beyond 2011).
Domestic budgetary procedures in Hungary

**Transparency**: Budgetary forecasts for the main expenditure and revenue categories for the actual year used to be revised monthly but, from summer 2009, the frequency was reduced to a quarterly update. Since May 2010, the new government has not published any projections for the main revenue and expenditure items (not even in the context of the 2011 budget), and there were contradicting announcements as regards the expected deficit outcome without corrective action. With the preparation of the 2011 budget, the publication of the budget circular was also discontinued. Transparency could also be improved through the public disclosure of the methodology and the main economic assumptions used in the official macro-fiscal projections.

**Prudent economic assumption for the budget preparation**: There is no mechanism to prevent official macroeconomic and fiscal forecasts showing an upbeat bias. The Hungarian track record since accession can be assessed to be better in terms of macroeconomic outcomes, while there were episodes of significant overestimation of revenues and underestimation of expenditures.

**Centralisation of the budget process at the planning stage**: According to the OECD database, the Prime Minister has the final say on major outstanding issues between line ministries and the central budget authority in the course of the budgetary negotiation. The MoF (currently called the Ministry for National Economy) is supposed to resolve all the related technical issues and smaller disagreements. On the other hand, the centralisation of the budget preparation is enhanced by the fact that the parliament traditionally has limited power to amend the budget proposed by the executive.

**The use of top-down budgeting**: The OECD database describes a strong role for top-down budgeting. The central budget authority sends the actual expenditure envelopes well in advance in the preparation process. Furthermore, during the planning process, it imposes detailed set limits for the line ministries’ initial spending requests. It should be noted that the spending envelopes are not included in the budget circular, they are communicated confidentially to the line ministries.

**The regulation on supplementary budgets**: The Public Finance Act stipulates that the government has to prepare a supplementary budget if it is anticipated that the budget balance within the year will deviate from the original plan by more than 5% of the total expenditure (i.e. around 2.5% of GDP). If the deviation is between 2.5% and 5%, the government has to submit an amendment to the budget (this amendment is treated in the House Rules as a normal legislative procedure, while the adoption of a supplementary budget is much more complicated and lengthy). Due to this recently re-established very lax regulation, major expenditure overruns/revenue shortfalls could materialise before a supplementary budget is approved. Despite past episodes of fiscal recklessness, the latest supplementary budget was approved back in 1994.

**Pay-go rule**: It is prescribed that as of 2010, no law or amendments decided by the authorities may worsen the balance of mandatory items with respect to the actual and following year. In other words, whenever any measure is proposed that would result in an increase in mandatory expenditures or a reduction in mandatory revenues, a commensurate offsetting measure must be taken as well (this procedural rule applies to both the legislative and executive branches). It should be emphasised that some decisions of the parliament taken in the second half of 2010 by the parliament did not comply with this rule.
Fiscal governance in Ireland

1. DESCRIPTION OF THE FISCAL FRAMEWORK

Current situation

Ireland operates a traditional, annual cash-based system of government accounting which is founded on the 1866 Exchequer and Audit Departments Act (primary legislation) and reflected in various provisions of the constitution. The annual budgetary process starts with an assessment of the opening position from which the budgetary proposals are made. In July–November, government departments prepare estimates of expenditure for the following year and discuss those with the Department of Finance, and decisions on the annual estimates of expenditure are made collectively by the government. Since 2006, a pre-budget outlook has been published, giving an indication of the status of the public finances in advance of the policy decisions to be announced in the budget. The Minister for Finance presents the annual budget to the parliament in early December, announcing detailed policy measures. On Budget Day, financial resolutions give immediate power for all tax measures, but must be followed by a more detailed finance bill within 120 days. Revised estimates of expenditure are produced in February, examined and voted on by the parliament. Demands for additional spending by departments are met by supplementary estimates voted on by the parliament. By the time overall expenditure is formally approved by the parliament through the annual appropriation bill at the end of December, the out-turn for expenditure may have moved from the original budget day allocation. The final financial statement is audited by the Comptroller and Auditor-General.

Several elements of the multi-annual budgetary planning have been introduced over time. The stability programme update used to be part of the December budget outlining medium-term projections and plans for fiscal policy at the general government level. With the introduction of the European semester, there was no formal requirement to submit the stability programme at the end of 2010; nevertheless, the budget for 2011 contained the main elements of the stability programme with the medium-term projection until 2014. While medium-term budgetary targets are set, they tend to be revised in the following budgets, especially for current expenditure. Capital expenditure has been managed on the basis of five-year rolling envelopes since 2004, with provision for carry-over of up to 10% of unused capital allocation from one year to the next. Multi-year employment and wage bill ceilings were introduced in 2009 to manage the progressive reduction in staff numbers across all areas of the public service.

The Department of Finance has a central role in the management of the budgetary process and control of the budget performance. The department controls financial transactions through the Central Fund, also called the Exchequer Account, which covers a large part of the central government. The monthly Exchequer Reports allow regular monitoring of the budgetary situation during the year.

Currently, Ireland has three numerical fiscal rules in operation. Two expenditure rules for the central government: (i) 1% annual contribution to the National Pensions Reserve Fund (13); and (ii) five-year rolling capital investment envelopes to keep capital investment around 5% of GNP. Both hardly represent any constraint in terms of spending containment and should rather be considered as policy instruments for attaining specific resource allocations. A budget balance rule for the local governments prohibits a net total deficit (according to the definition laid down in the Excessive Deficit Procedure) of no more than a fixed nominal amount (EUR 200 million after 2006). This target has been missed since 2007 and lacks of a multi-annual perspective providing a path for the deficit reduction. In addition, this rule is not backed by a legal statutory basis.

Recent reform proposals

Ireland has already taken several steps to strengthen its medium-term budgetary framework, but a more comprehensive reform is currently being prepared, which should see the introduction of a new fiscal responsibility law and the establishment of a budgetary advisory council. These two elements are also part of conditionality of the financial assistance programme for Ireland. According to the draft discussion document provided by the Department of Finance, a rules-based fiscal governance framework is proposed. The core elements of the expenditure framework would be included in the Fiscal Responsibility Bill (primary legislation),

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(13) According to the budget for 2011, there is no provision for a payment into the NPRF for the years 2012 to 2014.
while detailed elements would be specified at administrative level (a Department of Finance circular to be applied by all departments).

Three numerical fiscal rules are proposed: (i) the public finances correction rule, which gradually relaxes the consolidation effort depending on the excess above the Maastricht reference values; (ii) the prudent budget rule, setting a minimum annual improvement in the primary budget balance of 0.5% of GDP until the medium-term objective has been reached; and (iii) the sustainable expenditure growth rule, preventing any faster growth of gross current government expenditure than the underlying medium-term nominal rate of growth in the economy, unless funded by additional sources of revenue. These fiscal rules should provide the framework within which official targets are set and assessed by the authorities and the general public. However, the government would maintain the flexibility to deviate from the plans in exceptional circumstances, based on the ‘comply or explain’ approach.

A reformed annual budget process provides for a draft medium-term framework to be presented in the annual budget in December. After a consultation process, the final version will be included in the stability programme update and submitted to the European Commission in April. The medium-term budgetary framework will include additional elements to those already existing at national level and set by the Stability and Growth Pact (SGP). In particular, current expenditure ceilings at the aggregate and departmental level are suggested, as well as expenditure reviews every two to three years to reflect new priorities while remaining within aggregate budgetary limits. Further progress in performance budgeting and its integration with budget planning procedures should enhance the general effectiveness of public spending and, possibly, streamline overlapping budgetary lines belonging to different departments.

2. **Assessment of the current framework**

The current budgetary framework has strengths in terms of the management and control of cash allocations from year to year. Ireland adhered quite closely to annual expenditure targets, but multi-annual plans were subject to sizable revisions. Due to the non-binding character of fiscal targets, fiscal projections included in the framework were mainly informative and did not constrain the use of discretion in the conduct of budgetary policy. Furthermore, medium-term projections have frequently been based on unrealistic macroeconomic assumptions. The lack of independent monitoring and corrective mechanisms in case of deviation from the projected path undermined the use of the framework as a policy tool for a proper multi-annual budgetary planning. This placed fiscal policymaking in a very short-term perspective and rendered difficult the implementation of a time-consistent budgetary strategy. For the first time, broad measures underpinning the revenue and expenditure targets for four-year period were spelled out in the National recovery plan in 2010.

Nominal expenditure growth averaged almost 11% in 2000–07 exceeding nominal GDP growth rates, which were already high during the economic boom period. Neither GDP nor expenditure growth rates were sustainable. It proved to be politically difficult to make sufficiently fast adjustments on the expenditure side matching the substantial tax revenue shortfall during the sharp downturn in 2008 and 2009. This weakness should be addressed in the future by the new sustainable expenditure growth rule, which would prevent expenditure from running ahead of the underlying ability of the economy to generate resources. The Budget Advisory Council would be tasked with establishing the medium-term rate of economic growth and assessing the government’s fiscal plans.

The proposed budgetary framework reform is welcome and is also part of the conditions of the financial assistance programme for Ireland. The proposed budgetary framework is adapted to Ireland’s specific circumstances and addresses the weaknesses of the existing budgeting system, learning from bitter experience. However, the reform package can be further perfected by eliminating potential weaknesses and ensuring good linkages between the national rules internally and the SGP.

The use of the ESA 95 methodology and the general government coverage are advisable so as to be consistent with the EU fiscal surveillance framework. However, the greater availability of cash data at the central government level and the need for timely monitoring to allow prompt action in case of deviation from the adjustment path suggests that a dual approach can be envisaged (e.g. the rule could be defined in cash terms with a parallel mechanism of translation to ESA 95 on a quarterly basis). In addition, an exclusion of capital expenditure from the sustainable expenditure growth rule is not advisable as that may give rise to creative accounting or a reclassification of spending items to circumvent the rule. Moreover, enforcement and correction mechanisms in case of non-compliance with the fiscal rules could be more detailed. Targets set for the general
government need to be coordinated across all sectors of the government. The definition of the escape clause could be limited to number of specific circumstances under which non-compliance may be admissible.

**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 its fiscal position in the downturn. A comprehensive reform of the medium-term budgetary framework is being prepared to address the existing weaknesses and to support the ongoing fiscal consolidation process over the coming years. In the context of the implementation of the EC-ECB-IMF economic adjustment programme for Ireland, national authorities should introduce the following measures.

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

### 3. Summary Information on the Main Elements of National Fiscal Frameworks

#### Contribution to the National Pensions Reserve Fund in Ireland

**General description of the rule and target definition:** 1% of GNP is set aside from government expenditure and automatically paid into the National Pensions Reserve Fund (NPRF) for investment on behalf of the state.

**General government sub-sector(s) to which the rules applies:** Central government

**Implementation date:** The rule was established in 2000 and came into operation in 2001.

**Coverage and exclusions:** The 2010 contribution was pre-funded in 2009. In 2009 and 2010, the assets of the pension funds of third-level universities and certain non-commercial semi-state bodies were transferred into the NPRF. There is no provision for a payment into the NPRF for the years 2012 to 2014.

**Accounting system:** The contribution is defined in terms of budgetary accounting and has no effect on the general government balance.

**Escape clauses:** There are no predefined escape clauses.

**Statutory basis:** Legal basis

**Comments on the functioning of the rule:** Good compliance with the rule, but contributions have been suspended during the fiscal crisis.

#### Capital expenditure ceilings in Ireland

**General description of the rule and target definition:** Rolling five-year multi-annual capital envelopes set out capital investment by the Ministerial Group for each year in the five-year period. The envelopes are based on a commitment to maintain capital investment around 5% of GNP.

**General government sub-sector(s) to which the rules applies:** Central government

**Implementation date:** The rule was established in 2004.

**Coverage and exclusions:** Multi-annual capital investment framework covers exchequer capital expenditure, public-private partnerships and investments financed by user charges.

**Accounting system:** The rule is defined in terms of budgetary accounting, but is consistent with ESA 95 methodology.

**Escape clauses:** There are no predefined escape clauses.

**Statutory basis:** Legal basis

**Comments on the functioning of the rule:** Good adherence to the rule
Budget balance rule for local governments in Ireland

General description of the rule and target definition: Local governments must have a net total deficit (according to the definition laid down in the Excessive Deficit Procedure) of no more than a fixed nominal amount (EUR 160 million in 2004 and 2005, EUR 200 million in 2006 and thereafter).

General government sub-sector(s) to which the rules applies: Local governments

Implementation date: The rule was established in 2004.

Coverage and exclusions: In 2004, the Health Boards (part of the local government sector) could have a net total deficit of no more than EUR 40 million in 2004. In 2005, the Health Boards were replaced by the Health Service Executive, which is part of the central government and is prohibited from borrowing or running a deficit.

Accounting system: ESA 95 methodology

Escape clauses: There are no predefined escape clauses.

Statutory basis: Political agreement

Enforcement mechanisms: In case of non-compliance, limits on borrowing of local authorities are imposed.

Comments on the functioning of the rule: The target has been missed since 2007.

Budgetary procedures in Ireland:

See section ‘Current situation’ for detailed explanations.
Fiscal governance in Italy

1. Description of the Fiscal Framework

The legislative basis of Italy’s fiscal framework lies in the constitution (14) as well as in ordinary legislation. A reform adopted in 2009 and entered into force in January 2010 overhauled public accounting rules and the budgetary process, also in view of the new institutional set-up between central and sub-national governments that is being introduced with fiscal federalism. Indeed, Italy’s fiscal framework is still very much in the making.

The enabling law on fiscal federalism, also approved in 2009 (15), requires the central government to adopt, in agreement with the sub-national governments, enacting decrees by mid-2011 in order to specify the rules governing fiscal federalism, which is, in any case, not expected to enter fully into force before 2015–16.

The 2009 reform strengthened the medium-term framework for budgetary planning. Continuing the previous framework, budgetary targets for the general government are set at the beginning of the planning cycle over a three-year period, but are now broken down by general government sub-sector (central government, regional/local administrations and the social security bodies). This is the result of formal consultation with the sub-national government so as to foster shared ownership of the fiscal strategy and its targets across all government layers. The broad measures needed to achieve the budgetary targets over the full three-year period are then incorporated in the three-year budgetary package.

Although the reform anchors the medium-term budgetary targets and the broad measures to achieve them in legislation, Italy’s new medium-term budgetary framework is still not genuinely binding: both the targets for the outer years and the strategy to achieve them can be revised every year. Furthermore, no comprehensive numerical rules are in place to support the new framework. However, in a context where sub-national governments are responsible for about a third of total general government spending while the revenue powers assigned to them are still very limited, fiscal relations between the central government and local governments have been regulated over the past decade through a domestic stability pact (DSP), setting annual constraints on expenditure and/or the budget balance of the sub-national units, and a health pact, controlling regional governments’ spending on health services.

In the early years after its introduction in 1999, most regions and local governments respected the DSP. However, in recent years, expenditure growth at local level has generally been above target. The key weakness of the DSP has been the high frequency of the changes made in its targets and coverage. The resulting lack of a well-established, consolidated set of constraints reduced the effectiveness of the DSP as a control tool in the hands of the central government but also as a planning instrument at the lower levels. Furthermore, the high degree of compliance to the pact, at least in its early years, can best be interpreted as the consequence of the mildness of its rules and the fact that some sensitive spending items, notably health and, often, investment, were not covered (16).

Regional governments’ spending for health services (17) is controlled centrally by a separate health pact. The pact, which is updated every three years, sets limits to current and capital expenditure for healthcare by region. Sanctions apply to regions exceeding their limit: local tax shares are increased, citizens’ contributions to costs are raised, and/or administrative sanctions (including the dismissal of administrators) are imposed. Still, over the last decade, annual health expenditure exceeded its funding by around 0.3 percentage point of GDP per year on average. The health pact also incorporates specific caps on the share of pharmaceutical expenditure in total health expenditure, with the purpose of encouraging savings both through tougher price negotiations with suppliers and the wider use of generic drugs.

(14) Article 81 of the Italian Constitution establishes the principle that all new legislation entailing higher expenditure should indicate the means for its financing. A traditionally loose interpretation of this provision has allowed for large deficits and the accumulation of a debt well above 100% of GDP.

(15) The law lays down the path for the gradual devolution of tax-raising powers from the central to the sub-national governments, after responsibility for spending in a number of policy areas was delegated to the latter with a constitutional reform in 2001.


(17) Health expenditure, which represents over 7% of GDP and 15% of primary expenditure, is borne by the regional authorities and funded through dedicated taxes (e.g. the regional tax on productive activities — IRAP) and the participation in centrally collected tax revenues (share of Personal Income Taxes).
The transparency of the budgetary process in Italy has considerably improved over the years, and the 2009 reform enhanced it further. Budgetary data are published timely, with the appropriate detail and using standard accounting formats. Mechanisms to monitor budget execution are being reinforced in a way that is consistent with the forthcoming implementation of fiscal federalism. In particular, the reform envisages the harmonisation of accounting methods across all government entities and the creation of a single database to collect relevant information for the purposes of budgetary planning and monitoring from all administrations. The reform also streamlined the state budget by adopting a more functional classification structure for revenue and expenditure, more closely related to their policy objectives and consistent with the UN Classification of the Functions of Government (COFOG). To increase accountability, the execution of each budget sub-item (programme) is entrusted to a single administrative unit.

Finally, Italy’s budgetary plans have been underpinned by rather favourable macroeconomic projections, although, in more recent years, the optimistic bias has affected mainly the outer years (18). Budgetary projections and the underlying macroeconomic assumptions are the responsibility of the Ministry of Finance (MoF). There is no independent institution in charge of monitoring them and budgetary execution. The Bank of Italy, however, is responsible for computing government debt statistics, directly collecting some government account data, and monitoring public finance developments in its role as the national central bank and as part of the European System of Central Banks (ESCB).

2. ASSESSMENT OF THE CURRENT FRAMEWORK

Italy’s fiscal framework had undergone several improvements over the last few years, even before the adoption of the 2009 reform. In 2008, a three-year consolidation package underpinned the medium-term fiscal plan with concrete measures; the structure of the state budget has been gradually streamlined as from 2007, while pilot exercises aimed at reviewing the efficiency and effectiveness of public spending at the central level were carried out. The 2009 reform gave a legal basis to those improvements, while encompassing them in a more consistent framework. The reform strengthened, and made more credible, the medium-term budgetary framework through the introduction of a three-year budget. It also enhanced mechanisms to ensure transparency and monitoring of public finances as well as accountability, and laid the basis for assessing the efficiency and effectiveness of public expenditure.

However, the reform’s success in terms of enhanced budgetary planning, monitoring and control will depend on the appropriate specification and consistent implementation of all its elements. The law is an enabling law that requires the adoption of secondary legislation specifying some of its provisions. Enacting decrees still need to be finally adopted to harmonise government budgets, strengthen the systems of expenditure control, analysis and evaluation, and complete the reform of the central government budget.

Furthermore, some of the weaknesses in Italy’s fiscal framework that have contributed to the underachievement of fiscal targets throughout the decade since adopting the euro (19) have yet to be addressed. These are related to: (i) the optimistic bias in the macroeconomic assumptions underlying fiscal plans; (ii) the lack of effective enforcement mechanisms to control primary expenditure dynamics; and (iii) the need to improve coordination across government layers within the domestic budgetary process.

To strengthen the binding nature of the medium-term budgetary framework, Italy could consider introducing a broad numerical rule to control the primary expenditure of general government on a multi-annual basis. The rule should be operated consistently with top-down budgeting principles, ensuring that every public administration contributes to the general government fiscal targets. Predefined, strict corrective mechanisms should be put in place in case of emerging slippages.

The ongoing strong decentralisation of public finances clearly requires an equally strong coordination across government layers in the budgetary process. In the short term, reinforcing controls on local expenditure through the strict enforcement of a steady DSP (and health pact) remains a priority. Considering the longer perspective, the detailed rules governing the implementation of fiscal federalism should be designed in such a way so as to foster fiscal discipline.

(18) Namely, between 1992 and 2009, the average annual real GDP growth in Italy was 0.5 percentage point lower than projected by the government each spring for that year.
(19) As a result, current primary expenditure rose by around 2% per year in real terms over the 1998–2007 period, against an average annual real GDP growth of 1.5%.
**EPC policy advice**

While Italy’s fiscal framework has significantly improved in the last few years, notably as a result of the reform of the budgetary process that introduced a three-year horizon for budgetary planning, the introduction of comprehensive numerical rules and better coordination across government layers would help to rein in expenditure growth and achieve the needed fiscal consolidation. In this context, national authorities should introduce the following measures.

- **Adopt a more binding budgetary framework by introducing enforceable multi-annual expenditure ceilings for all government layers.** Expenditure growth over time should be kept below prudent projections of nominal GDP growth.

- **In view of the ongoing implementation of fiscal federalism, quickly specify and implement the mechanisms foreseen in the 2009 reform to ensure timely monitoring of budgetary developments against targets across all institutional sub-sectors, and the contribution of each of them to the achievement of the general government targets.**

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**3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS**

**Medium-term budgetary framework in Italy**

*Time frame:* Three years (i.e. $t+1$, $t+2$ and $t+3$) on a rolling basis (i.e. a new year is annually added at the end of the period covered by the previous projection).

*Institutional coverage:* The whole of the general government sector.

*Accounting system:* ESA 95

*Target revisions and binding objectives:* The main target is the general government balance as a share of GDP. Medium-term budgetary targets can be revised every year.

*Level of detail of expenditure and revenue projections:* Expenditure projections are broken down according to national accounts classification (i.e. public consumption, public investment, etc.). Revenue projections are broken down into direct and indirect taxes, social contributions, and capital revenues. With the 2009 reform, projections for both revenue and expenditure have to be formulated both in terms of an unchanged legislation scenario (which assumes that future outlays and revenues reflect only the legislation already approved by parliament) and a no-policy-change scenario (as in the Commission forecasts).

*Connectedness with the annual budget law:* The multi-annual fiscal targets that are decided at the planning phase of the budgetary cycle (starting in spring) are incorporated in the multi-annual budget due to be presented to parliament by mid-October. If significant changes are deemed to have occurred in the macro scenario and/or public finance data, updated targets can be presented to parliament (same formal approval as for the initial targets) in September.

*Monitoring mechanisms:* The Finance Ministry’s General Accounts Office is in charge of monitoring. The Court of Auditors performs an annual review of legal conformity of budget execution.

*Enforcement mechanisms:* There are no predefined corrective or enforcement mechanisms in case of deviation from the envisaged medium-term targets.

*Targets for sub-central governments:* The budgetary targets are broken down by general government sub-sector, (i.e. central government, regional/local administrations and the social security bodies). This is the result of a formal consultation among all layers of government before parliamentary approval.

*Comments on the functioning of the framework:* The MTBF was strengthened with the 2009 reform, but its effectiveness is still hindered by its relatively unbinding nature, as medium-term projections and targets can be revised every year. Furthermore, the early adoption of an emergency consolidation package in May 2010 pre-empted the full application of the reformed MTBF, namely in securing the agreement of sub-national governments before submitting the fiscal targets to parliament.

**Fiscal rule in Italy: Expenditure rule No 1 — Domestic stability pact (DSP)**

*General description of the rule and target definition:* The DSP’s targets and coverage have been subject to annual revisions. In the early years, the DSP only covered current expenditure; in more recent years, it was formulated in terms of budget balance although, from 2007, a freeze was imposed on regional and local powers
to increase tax rates or raise new taxes. The current DSP for 2011–13, approved at the end of 2010 within the budget, stipulates that local administrations contribute to the midterm fiscal consolidation by reducing their current expenditure by around 11% in 2011 and 14% in 2012 and 2013 from the reference level recorded in 2006–08. It has to be noted that regional budgets are almost entirely devoted to financing health expenditure, which is subject to a separate health pact (see below).

**General government sub-sector(s) to which the rules applies:** Regional and local governments: the definition of the sub-national units to which the rule applies and the specific implementing procedures have been frequently modified.

**Implementation date:** The DSP was first introduced in 1999 and has been modified almost every year. From 2010, it will be updated annually for the forthcoming three years.

**Coverage and exclusions:** The latest DSP for 2011–13 applies to regional and provincial administrations and to municipalities with more than 5,000 residents. Health expenditure is subject to a separate pact between central and regional governments (see next the section).

**Accounting system:** The target of the latest DSP is defined in cash and accrual terms (ESA 95) for the aggregate institutional level (i.e. regions and local administrations combined). The breakdown among individual administrations is defined in cash terms.

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Three years

**Statutory basis:** Legal basis (included in the budget’s accompanying law — *legge di stabilità*).

**Monitoring:** The DSP is jointly monitored by the Ministry of Finance, the Ministry of Home Affairs and the Council of State, Regions and Local Authorities (Conferenza unificata Stato, Regioni e autonomie locali).

**Enforcement mechanisms:** Regional and local administrations in breach of the DSP must increase regional/local surtax rates. In cases of serious and protracted breaches, the central government can replace locally elected administrators with centrally appointed commissioners.

**Comments on the functioning of the rule:** In the early years, most sub-national governments respected the DSP, but in recent years, expenditure growth at local level has generally been above target. The key weakness of the DSP has been the high frequency of changes made to its targets and coverage.

**Fiscal rule in Italy: Expenditure rule No 2 — Health pact**

**General description of the rule and target definition:** Healthcare expenditure is capped at EUR 107 billion for 2011 (i.e. 2% nominal growth) and can increase by 2.8% (nominal) in 2012.

**General government sub-sector(s) to which the rules applies:** Regional governments

**Implementation date:** The health pact was introduced in 2000 and has been modified frequently. It is updated every three years. The current pact covers the period 2010–12.

**Coverage and exclusions:** The pact covers healthcare expenditure financed by the National Health Service, which accounts for over 15% of general government primary expenditure. Exceptions to the rule can be introduced on an ad hoc basis, (i.e. for specific items of expenditure such as building a new hospital ward) and/or for individual administrations.

**Accounting system:** Nominal expenditure in accrual (ESA 95) terms

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Three years

**Statutory basis:** Legal basis (included in the budget’s accompanying law — *legge di stabilità*).

**Monitoring:** The health pact is monitored by the MoF, in collaboration with the State-Regions Council (Conferenza Stato-Regioni).

**Enforcement mechanisms:** Regional administrations in serious and protracted breach of the rule can negotiate a restructuring plan to redress the situation over several years; these plans usually imply tighter expenditure ceilings and additional sanctions (e.g. higher regional tax rates or the replacement of administrators with commissioners appointed by the central government).
Comments on the functioning of the rule: In the first years of its application, several regional administrations did not comply with the health pact. They, therefore, recorded health expenditure overruns and built up relevant deficits eventually financed by the central government. However, in the second half of the 2000s, monitoring improved and sanctions began to be applied more consistently. Six regions were still subject to restructuring plans in 2009. In the context of the forthcoming fiscal federalism, incentives are being proposed to complement existing sanctions.

Domestic budgetary procedures in Italy

Transparency

Revenue data and the cash-based monthly borrowing requirement are disclosed in a timely manner. Reconciliation tables between cash-based and ESA 95-based data are included in the budget and midterm fiscal planning document. In addition, the 2009 budgetary reform reinforced the transparency of the process by providing for more detailed information on budget planning and execution, including: (i) an explanatory note accompanying the budget to clarify the link between the central government budget and the general government accounts (in ESA 95 terms, by institutional sub-sector); (ii) harmonised accounting systems and formats for general government consistent with the UN Classification of the Functions of Government (COFOG); (iii) consolidated accounts for general government bodies, including sub-national government publicly owned or controlled firms; and (iv) the creation of a ‘unified database’, building upon existing databases that collect data on general government bodies’ budgetary projections, out-turns and operations, plus any other information deemed relevant for the purposes of budgetary planning and monitoring.

Centralisation of the budget process at the planning stage

With the implementation of the 2009 budgetary reform and the gradual transition to fiscal federalism, the central government fixes fiscal targets for the general government but sub-national governments are set to increase their say in determining the targets, notably in breaking them down by institutional sub-sector (i.e. sharing the consolidation effort between layers of government).

Centralisation of the budget process at the execution stage

The ongoing implementation of fiscal federalism is extending tax-raising powers to regional and local administrations, which is bound to increase their fiscal autonomy. However, until fiscal federalism fully enters into force (around 2015–16), budget execution remains rather centralised and its enforcement depends on recently improved monitoring mechanisms, and on various sanctions imposed from the centre.

The use of top-down budgeting

In the recent past, the Italian government has used top-down budgeting as a way to ensure adherence to the fiscal consolidation strategy by the whole public administration. It can be expected to continue doing so, although the provisions of the 2009 enabling law on fiscal federalism — currently being enacted — call for a broader sharing of fiscal planning among all institutional actors.

The 2009 reform allows for some flexibility in allocating resources across and within budget missions, provided that: (i) current and capital spending are kept separate; and (ii) resources set aside for ‘non-modifiable expenditure’ (i.e. deriving from personal entitlements — wages and pensions — as well as EU and international obligations as well as interest expenditure) are not reduced.
Fiscal governance in Lithuania

1. DESCRIPTION OF THE FISCAL FRAMEWORK

Currently, the Lithuanian fiscal framework includes four fiscal rules that are enshrined in legal acts. These include limits set on central government net borrowing, balanced budget rules for local governments, and, since the 2009 budget, revenue and expenditure rules for the state budget. Moreover, the medium-term budgetary framework (MTBF) is adopted by the parliament together with the budget, specifying total national budget revenues and expenditures for the next three years. The statement of medium-term macroeconomic development and fiscal policy (attached to the budget law) includes fiscal policy prospects and forecasts (several budgetary aggregates), EU financing and medium-term state budget expenditure trends.

Despite the rules, Lithuania’s medium-term budgetary framework failed to prevent the implementation of a procyclical fiscal policy in the years of high growth preceding the downturn. Buoyant revenue growth facilitated repeated upward revisions of expenditure targets. With a view to strengthening the framework, a law on fiscal discipline was adopted for central government in November 2007. The law is based on the provisions of the Stability and Growth Pact (SGP) and sets as objectives a balanced budget in the medium term and long-term sustainability. The law focuses on the preparation and execution of the annual budget and does not introduce more forward-looking elements.

The above-mentioned fiscal discipline law contains two new rules for central government. Firstly, the revenue rule calls for the deficit of the approved state budget to be reduced by the estimated ‘excess’ revenue of the current year. Secondly, the expenditure rule links the expenditure ceiling to revenues. It requires that if the average general government operating balance for the past five years is negative, the annual growth rate of the planned state budget appropriations may not exceed half of the average growth rate of the state budget revenue during those five years. However, the enforcement mechanism is very weak: in case of non-compliance, the authority responsible is not obliged to take corrective measures and there is no automatic correction mechanism. Moreover, no sanctions are foreseen in the case of non-compliance.

The 2010 convergence programme proposes a few new elements as regards the fiscal framework. In particular, the programme lists a number of measures to increase the transparency and monitoring of the budgetary process by presenting and publishing government budget indicators based on the ESA 95 classifications. Fiscal stance and fiscal impulse indicators are to be introduced in the budgetary preparation process. So as to improve enforcement, an automatic obligation to implement an anti-inflationary fiscal policy, based on the output gap indicators, is proposed. Moreover, the programme aims to establish ways to determine responsibility for non-compliance with the deficit targets, giving the Ministry of Finance (MoF) greater responsibilities in the surveillance process. The programme provides scope to enhance planning and to reinforce the binding character of the medium-term expenditure ceilings, which would contribute to restraining expenditure. The following would enhance the medium-term spending framework and are expected to be achieved through an improved strategic planning process: better targeting, quantified evaluation criteria and improved cost-benefit analysis as well as better integration of strategic expenditure planning and budgeting. If implemented, these proposals should substantially improve the institutional features of public finances.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

There is a need to enhance Lithuania’s current fiscal framework in order to prevent expenditure overruns and reduce fiscal policy procyclicality. The debt rule aimed at limiting central government net borrowing is insufficiently constraining. There are significant shortcomings relating to the implementation: despite the balanced budget rules for local governments, deficits are recorded in most years. The Social Security Fund borrowing rules have not always been respected either. The current fiscal framework suffers from significant weaknesses relating to the lack of transparency of the budgetary process, including appropriate reporting of revenue and expenditure executions, monitoring of fiscal target execution, and the comparability of budgetary indicators on cash and accrual bases.

The fiscal discipline law, which represents a step forward, has been criticised (by the IMF and others) as being lax and unclear. The law focuses on the preparation and execution of the annual budget and does not as such
introduce more forward-looking medium-term elements. The enforcement mechanism is weak and lacks sanctions. Finally, the law lacks a binding medium-term expenditure framework. Strategic expenditure planning for the state (including line ministries) and municipalities should include performance indicators and be based on programmes rather than on previous years’ expenditures. Moreover, the law does not ensure greater budget transparency and scrutiny of the budgetary process. In order to increase the efficiency and effectiveness of spending, it is necessary to improve annual process of expenditure evaluation.

A new concept law on the reform of the budget planning and execution framework has been prepared and is currently under discussion. The proposed measures include:

(i) creating a fund for state treasury reserves for ‘hardship’ times — the account would be opened at the Bank of Lithuania, hence preventing misuse of this stabilisation fund along political cycles;
(ii) improving transparency and monitoring of the budgetary process by presenting and publishing government budget indicators based on the ESA 95 classifications;
(iii) avoiding procyclicality — fiscal stance and impulse indicators are to be introduced in the budgetary preparation process;
(iv) improving enforcement — an automatic obligation to implement an anti-inflationary fiscal policy, based on output gap indicators;
(v) strengthening of the MoF’s position vis-à-vis line ministries during the budget preparation, and the reinforcement of monitoring mechanisms of budgetary developments as well as enforcement procedures to ensure the achievement of fiscal targets, including a greater role for the parliament and external scrutiny by non-governmental institutions.

If implemented, these proposals would substantially improve the institutional features of Lithuania’s public finances framework.

### EPC policy advice

While Lithuania’s fiscal framework benefits from the existence of annual numerical fiscal rules, the existing medium-term framework is less developed and may help explain the frequent expenditure slippages registered in the past. In this context, national authorities should enhance the medium-term budgetary framework, by introducing more stringent forward-looking elements and mechanisms to avoid procyclicality by introducing the following measures.

- Strengthen transparency (e.g. timely reporting of central government and social security expenditure and ensuring comparability of budgetary indicators on cash and accrual basis).
- Reinforce expenditure discipline through enforceable ceilings in the medium-term budgetary framework.
- Improve the monitoring of the budget execution throughout the year.

### 3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

**Expenditure rule in Lithuania**

**General description of the rule and target definition:** As a rule, general government finances are managed so as to have a surplus or be close to balance. If the average general government balance for the last five calendar years is a deficit (net borrowing), then the annual growth percentage of the state budget appropriations may not exceed half of the average growth percentage of the state budget revenue (EU financial assistance excluded) of the last five expired budget years.

**General government sub-sector(s) to which the rules applies:** All state budget expenditure items, except EU assistance.

**Implementation date:** The rule was approved in 2007 and implemented from 2008 onwards (with the 2009 budget).

**Coverage and exclusions:** The rule covered state budget expenditure, which accounts for more than 50% of general government expenditure. There are several exceptions when the second rule is not be applied: (i) if the nominal GDP growth is less than the average EU nominal growth plus 2 percentage points over the last five years; (ii) if there is an expected improvement of at least 1 percentage point of GDP, at current prices, in the general government balance stemming from the planned state budget appropriations and revenue; (iii) if the
The arithmetic average of the general government balances of the last four calendar years and the current calendar year projected by the MoF is a surplus (net lending), of at least 0.1% of nominal GDP.

**Accounting system:** The target is defined in terms of budgetary accounting, maintaining consistency with ESA 95 methodology.

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Annual budget

**Statutory basis:** Legal basis

**Monitoring:** There is no formal monitoring of the rule as such. However, the law obliges parliament to discuss the Council of the European Union’s opinion on the Lithuanian convergence programme every year before adopting a budget for the next year. The National Audit Office of Lithuania (NAOL) supervises the lawfulness and effectiveness of the management and use of the state property and the execution of the state budget.

**Enforcement mechanisms:** There is no automatic correction mechanism and no penalties for non-compliance are foreseen.

**Comments on the functioning of the rule:** In general, the law does not take into account the stage of the economic cycle. As a five-year average, not necessarily coinciding with the economic cycle, is used to define fiscal discipline rules, this could lead to a mechanical application of the law in the budgetary procedure. Consequently, this could result in an undesirable discretionary tightening or expansionary policy. In more technical terms, the law defines ‘good times’ as Lithuania’s nominal GDP growth comparing to the EU average GDP growth. On the other hand, the SGP (Code of conduct) defines ‘good times’ in the first instance as periods when GDP exceeds its potential level. As the Lithuanian and the EU business cycles do not inevitably coincide, the option contained in the SGP Code of conduct might constitute a better choice when selecting fiscal years of reference. As a general comment, the clauses defining the exceptions to the rules may prevent the budgetary policy from contributing to the necessary adjustment the Lithuanian economy needs. Compliance with the rule has not been met: the law stipulates that, except for 2008, the general government deficit shall not exceed 0.5% of GDP. The deficit in 2008 reached 3.3% of GDP despite positive GDP growth (3.2% year on year).

**Fiscal institution in Lithuania: National Audit Office of Lithuania (NAOL)**

**Date of establishment and description of the main tasks related to fiscal policy:** The NAOL was established in 1919 and restored in 1990. Its main task is to supervise the lawfulness and effectiveness of the management and use of state property and the execution of the state budget.

**General government tiers at which the institution carries out its tasks:** The state government sector

**Main outputs released by the institution:** The NAOL submits opinions on the draft state budget to the parliament and opinions on the account of the execution of the state budget. It also carries out audits of the implementation of the state budget, the budget of the State Social Insurance Fund, and the budget of the Compulsory Health Insurance Fund as well as audits of the use of state budget funds allocated to municipal budgets.

**Role of the institution in the budgetary process:** The NAOL intervenes at the later stage of the budgetary process: it delivers recommendations on the draft state budget submitted to the parliament.

**Obligation for the government to use the output of the institution:** There is no formal obligation for the government to follow the recommendations and opinions of the NAOL. However, in practice, it generally does so.

**Status of the institution:** The provisions relating to the existence of the NAOL are enshrined in the Constitution (Chapter XII on state control), which specifies that the system and powers of the State Control shall be established by law (Law on the National Audit Office No I-907). The NAOL is the supreme public audit institution, accountable to the parliament. It is completely autonomous.

**Composition and appointment of the governing board:** The head of the NAOL is the Auditor-General, who is appointed for a five-year term by the parliament on the recommendation of the President of the Republic of Lithuania. The Auditor-General defines the number of members as well as composition of the Board of the NAOL (Council of the State Control).

**Decisions of the governing board:** The Council of the State Control is an advisory body to the Auditor-General.
Staff: The NAOL employs around 330 employees in total at its central office in Vilnius and regional offices in Kaunas, Klaipėda and Panevėžys.

Comments on the functioning of the institution: The NAOL contributes to improvements in the conduct of fiscal policy. However, its overall impact on the budgetary process could be significantly strengthened, for example, through the preparation of independent macroeconomic forecasts for the annual budget law and the reinforcement of its status under which the government would be legally obliged to take into account NAOL’s recommendations to correct aspects of the fiscal policy that are deemed inappropriate.

Medium-term budgetary framework in Lithuania

Time frame: Three years (i.e. t, t+1 and t+2): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projections).

Institutional coverage: Central and local government, but not social security funds

Accounting system: Cash basis

Target revisions and binding objectives: The main target is the general government balance as a percentage of GDP. Medium-term budgetary targets are revised every year, usually in the context of the budget preparation. Therefore, fiscal targets incorporated into the MTBF are not binding.

Level of detail of projections: Only the headline figures are provided for revenues and expenditures including EU Structural Funds.

Connectedness with the annual budget law: Fiscal targets included in the MTBF are not binding and, therefore, they do not constrain the preparation of the annual budget law (i.e. the multi-annual targets form the basis upon which the budget is prepared but there can be deviations).

Monitoring mechanisms: Fiscal impact assessment carried out by the Ministry of Finance

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the envisaged medium-term targets.

Comments on the functioning of the framework: Multi-annual fiscal planning appears to be relatively weakly developed. Specifically, the absence of real, binding medium-term objectives has hampered the effectiveness of the current MTBF for multi-annual fiscal planning, and partly explains the expenditure slippages observed in recent years. The adoption of a more stringent medium-term framework, encompassing enforceable multi-annual expenditure ceilings, seems an essential precondition to ensure the envisaged fiscal consolidation over the medium-term. This enforceable medium-term fiscal planning should be extended to all general government tiers.

Domestic budgetary procedures in Lithuania

Economic assumption for the budget preparation

Lithuania’s macroeconomic forecasts have tended to be biased in the past years. This rendered proper budgetary planning more difficult and complicated the conduct of time-consistent fiscal policy. The latest forecasts were criticised by the State Audit Office for presenting overly optimistic revenue projections. Lithuania does not have an independent fiscal institute in charge of the provision of forecasts for the preparation of the budget.

Centralisation of the budget process at the planning stage

Given its institutional political setting, Lithuania mainly relies on the agreement of fiscal targets negotiated among the different ruling parties forming the executive, to centralise the budget preparation. This leads to a fairly strong Ministry of Finance (MoF) with respect the implementation stage so as to ensure respect of the agreed target, but with relatively limited power to impose new measures on the basis of strong agenda-setting powers.

The MoF in Lithuania does have the last say when discrepancies between line ministries and the central budget authority emerge in the course of the budgetary negotiation. This is an element that significantly strengthens the centralisation of the budget preparation. The parliament seems to enjoy extensive powers to amend the government’s draft budget.
The use of top-down budgeting

On the one hand, the use of expenditure ceilings seems to be established. However, the fact that expenditure overruns can materialise before a supplementary budget is approved suggests that these expenditure ceilings are not really binding and, therefore, they do not always effectively constrain spending developments.
Fiscal governance in Latvia

1. Description of the Fiscal Framework

The fiscal framework in Latvia can be characterised by its ineffective role as a stabilising anchor, its exposure to procyclical policies, and relatively weak multi-annual perspective, as evidenced by frequent mid-year budgetary procyclical revisions throughout the cycle, and by the absence of firm fiscal rules at the central government level. In recent years, the balance-of-payments assistance programme has acted as a de facto anchor for the fiscal policy in the country.

Nevertheless, the elements that could contribute to a stable and sound fiscal policy are present, albeit underdeveloped. A multi-annual budgetary framework was first introduced in 2007 during the preparation on the 2008 budget and has been used annually since then. However, adverse economic developments affected its implementation, and the multi-annual framework remains untested in a more stable economic environment. The annual programming document is usually adopted in late spring, based on updated macroeconomic and revenue forecasts, and brings together updated goals and priorities for a period of three years. The weakness in the current set-up lies in its bias towards the bottom-up approach in formulating the fiscal targets, as goals and priorities are largely based on input from spending entities. Moreover, while the framework — once agreed and approved by the Cabinet of Ministers — constitutes a basis for the budgetary process that follows in the second half of the year, medium-term targets are not binding and can be revised, without any specific procedure or predefined corrective mechanism, in the next update of the programme or even in the same year in the process of formulating the draft budget. No formal discussion with stakeholders takes place before the adoption of the document, while it is presented to the parliament after adoption. There are no established rules or procedures for monitoring and analysing the adherence to previously set targets or for the handling of deviations.

At central government level, there are no fiscal rules that could impose a binding constraint on the annual budgetary process; the revenue rule applied to the special (social) budget merely aims to ensure that social expenditure is matched by adequate financing. There is, however, a rule that restricts borrowing and the issuance of guarantees by local governments: limits for such borrowing are set in the annual budget law and any decision by a local government to borrow or issue a guarantee has to receive prior approval from a special body. Due to the established practice of limits being set for the following year for local government, the rule acts as a de facto balanced budget rule.

In line with commitments undertaken by the Latvian government in the framework of the balance-of-payments assistance programme, a new fiscal responsibility law is being prepared that aims to impose a binding multiannual constraint on the conduct of fiscal policy. According to the latest available information, the package will consist of amendments to the Constitution to ensure a higher legal status of the rule, together with a new fiscal responsibility law and amendments to other relevant laws. The envisaged amendments aim to balance the budget when growth equals potential. They automatically require surpluses/allow deficits (within the limits of the Stability and Growth Pact) when growth is above/below potential. The authorities expect to present the draft laws to the parliament by the end of 2011. The proposed changes will also envisage the strengthening of the medium-term budgetary framework, to be first applied in the 2013 budgetary process. However, technical aspects of the implementation of the general government’s budget balance rule and the medium-term budgetary framework remain unknown at this stage and further consultation with the Commission and the IMF is expected in the coming months.

There is no independent fiscal institution in Latvia which could contribute to the budgetary process at the budget formulation and implementation stages. Macroeconomic and revenue forecasts are prepared by the MoF, although the Bank of Latvia — and, to a lesser extent, some other institutions — provide their view on the macroeconomic and fiscal outlook. In recent years, coordination with the European Commission and the IMF in the framework of the balance-of-payments assistance programme provided effective support in the strengthening of the robustness of forecasts.

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The State Audit Office (SAO) performs an ex post analysis of the implementation of the budget and scrutinises various aspects of the conduct of fiscal policy in Latvia, delivering an annual audit of state reports and issuing
recommendations. The reports by the SAO enjoy a high degree of visibility but, while fiscal institutions run a reputational risk in case of failure to respond to these recommendations, there are no formal obligations to implement the recommendations made by the SAO.

2. **Assessment of the Current Framework**

The current fiscal governance framework in Latvia exhibits several weaknesses and lacks an effective mechanism to limit expenditure growth in good economic times. This calls for a radical strengthening of the budgetary framework to ensure that sustainable trends can be maintained when the balance-of-payments assistance programme, which currently acts as an anchor for the fiscal policy, expires in early 2012.

The government is currently preparing a package of laws, including amendments to the Constitution and the new fiscal responsibility law. The draft proposal aims to implement the budget balance rule over the cycle and envisages several other elements that would contribute to the sound conduct of budgetary policy. It is important to ensure that the law takes into account relevant legislative developments at the EU level and implements the budget balance rule in such way that targets balanced or surplus position over the cycle. The balance rule could be usefully augmented by expenditure or revenue rule(s), and a control mechanism, to ensure that any revenue in excess of previous projections is used to reduce the government’s debt.

Similarly, the medium-term budgetary framework needs to be strengthened. A good opportunity is provided by the need to align domestic procedures with the EU surveillance cycle. The authorities are currently redesigning the medium-term budgetary framework. When devising the new mechanism, it is important to ensure that budgetary targets are based on credible macroeconomic assumptions and a sustainable medium and long-term strategy; underlying expenditure targets are formulated on the basis of top-down approach; compliance with previously set targets is monitored; slippages are analysed and corrected; and information on the implementation of the strategy and the targets is made available to the public. While setting up an independent fiscal council may be constrained by the limited human and financial resources, the synergy of peer review at the EU level, and effective cooperation within the country, in particular with the Bank of Latvia, should be used to the maximum extent.

**EPC policy advice**

While the national fiscal government framework provides some basis for an effective mechanism to implement countercyclical fiscal policy, there is a need to strengthen the existing framework. Numerical fiscal rules and the medium-term budgetary framework (MTBF) remain underdeveloped, which explains the frequent mid-year budgetary revisions registered in the past. In this context, national authorities should introduce the following measures, in a way that is consistent with the EC-IMF balance-of-payments assistance programme.

- **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 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States and include targeting a balanced or surplus position over the cycle.

- **Complement the budget balance rule envisaged in the draft fiscal responsibility law with additional rule(s) to ensure that any revenue in excess of the previous projection is used to reduce the government’s debt and that expenditure remains within set limits.**

- **Reinforce the current MTBF by switching to binding multi-year targets and setting up a mechanism to monitor 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.**

- **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 improve the role of the Ministry of Finance at the planning, approval and implementation stages to improve the consistency, effectiveness and flexibility of budgetary processes.**
3. **SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS**

**Fiscal rules in Latvia: Debt rule (local governments)**

**General description of the rule and target definition:** The rule targets the stabilisation of debt in nominal terms. Borrowing and issuance of guarantees by local governments is only possible within limits set annually in the budget law, and following an *ex ante* approval by the board which monitors and supervises borrowing by local authorities.

**General government sub-sector to which the rules applies:** The rule is applicable to local governments.

**Implementation date:** The rule has been in force since 1994.

**Coverage and exclusions:** The rule applies to all borrowing and issuance of guarantees by local governments. The share of local governments’ expenditure in the general government expenditure is 20–30%.

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

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Annually set limits

**Statutory basis:** Legal basis (annual budget law)

**Monitoring and enforcement mechanisms:** A special body (the Local Municipalities’ Borrowing and Guarantees Control and Surveillance Council) has been established by the Minister of Finance, with the participation of representatives of the Ministry of Finance, the State Treasury, the Latvian Association of Local and Regional Governments, the Ministry of Environment Protection and Regional Development, the Ministry of Economics and the Bank of Latvia, to supervise developments with regard to borrowing and issuance of guarantees by local governments. On taking out a new loan or issuing a guarantee, a local government is obliged to consult the Council *ex ante*. Given the *ex ante* involvement of the Council and individual decisions passed for each application, there has been no need for predefined escape clauses or actions in case of non-compliance.

**Comments on the functioning of the rule:** The rule has been in place since 1994 and generally respected, thus contributing to limiting the expenditure growth and nominal debt levels of local governments. Given that the limits for local governments are set in the framework of the annual budget law, these are based on the same set of macroeconomic projections and budgetary strategy as the state budget.

**Fiscal rules in Latvia: Revenue rule (special budget)**

**General description of the rule and target definition:** In Latvia, the state budget is divided into the basic budget and the special budget with the latter covering the payment of social benefits. The rule aims to ensure that necessary financing, within limits set in the annual budget law, is always available in the special budget. If social security contributions, which are the main source of revenue for the special budget, are insufficient to cover the expenditure, the basic budget provides a budgetary loan to the special budget.

**General government sub-sector to which the rules applies:** The rule is applicable to the social security sub-sector of the central government.

**Implementation date:** The rule has been in force since 1994.

**Coverage and exclusions:** The state budget is divided into the basic budget and the special budget. The rule applies to the latter, which accounts for around 30% of the state budget. Social security contributions are the main source of revenue for the special budget.

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

**Escape clauses:** There are no predefined escape clauses.

**Statutory basis:** Legal basis (the Law on Budget and Financial Management)

**Monitoring and enforcement mechanisms:** The responsibility for monitoring compliance with the rule and enforcement lies with the State Treasury and is performed within the overall framework of monitoring the budget execution.

**Comments on the functioning of the rule:** Social security contributions, which form the main part of revenue for the special budget, have until recently more than covered the expenditure of the special budget, with the
excess being deposited within the basic budget and used by the latter to finance deficits in other areas. The situation, however, changed when the reversal of the domestic cycle and impact of the global financial crisis led to adverse developments on the labour market. Currently, the special budget is able to draw on previously accumulated deposits within the basic budget; if those are exhausted, the special budget can switch to borrowing from the basic budget. The distinction between the two parts of the state budget is, however, more of an accounting nature and the availability of resources for the special budget is thus conditional on the ability of the basic budget to provide the necessary financing.

Fiscal institution in Latvia: State Audit Office

**Date of establishment and description of the main tasks related to fiscal policy:** The State Audit Office (SAO) of Latvia is an independent constitutional body and was re-established in 1992 after Latvia regained its independence. The SAO is not involved in the budgetary process at the budget adoption and execution stages, but performs *ex post* annual evaluations of the state’s annual reports and analyses, according to a pre-announced calendar, various aspects of the budgetary process and use of taxpayers’ money.

**General government tiers at which the institution carries out its tasks:** The whole of the general government sector and public corporations that are not part of the general government sector.

**Main outputs released by the institution:** The main outputs of the SAO include annual audits of the state’s reports on budgetary execution, as well as specific reports on budgetary performance by ministries within the central government, state-owned enterprises and local governments. The SAO makes its findings public and presents them to the parliament.

**Role of the institution in the budgetary process:** There is no involvement of the SAO at the budget adoption and execution stages. The SAO performs *ex post* audits of the budget execution and issues reports and recommendations on the conduct of fiscal policy in Latvia.

**Obligation for the government to use the output of this institution:** There is no formal obligation for the government to use output from the SAO although, due to the high public visibility of these reports, the government runs reputational risks if it fails to follow the recommendations.

**Status of the institution:** The State Audit Office is one of six constitutional government bodies in Latvia.

**Composition and appointment of the governing structure:** The State Audit Office comprises the Auditor-General, the Council, audit departments and support structural units. The Auditor-General is elected by the parliament and administers the work of the State Audit Office. The term of office of the Auditor-General is four years and re-election is only possible once.

**Comments on the functioning of the institution:** The SAO reports enjoy high public visibility and interest: over the years, the institution has highlighted several shortcomings in the conduct of fiscal policy. There is no formal obligation for the government to make changes or amendments to the conduct of fiscal policy as a result of the findings of, and recommendations made by, the SAO: nevertheless, failure to follow the recommendations entails reputational risks.

Medium-term budgetary framework in Latvia

**Description of the national medium-term budgetary framework:** The MoF annually prepares (usually in late spring) medium-term macroeconomic development and fiscal policy frameworks (MTBF), which include the latest macroeconomic and tax revenue projections. On the basis of these projections, the Cabinet of Ministers agrees on the maximum expenditure levels for next three years. Expenditure ceilings for the year t+1 form the basis of budget requests by line ministries and other central government institutions (submitted in summer). The framework can, however, be revised on the basis of updated projections in the second half of the year, when an updated MTBF is presented to the Cabinet of Ministers together with the draft budget law. Targets for the following years are not binding and can be revised (and are often revised in practice) when preparing the next year’s MTBF. The system has been in use since 2007 and was applied for the first time during the preparation of the 2008 draft budget.

**Time frame:** Three years (t+1, t+2 and t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

**Institutional coverage:** Central government — some information on general government aggregates is included for informative purposes.

**Accounting system:** The framework is defined in terms of budgetary accounting.
**Level of detail of expenditure projections:** By spending entity (line ministries and other central government institutions)

**Level of detail of revenue projections:** Tax revenue projections (disaggregated by main tax categories) and non-tax revenue projections (disaggregated by main categories).

**Monitoring mechanisms:** There is no specific body charged with the task of monitoring respect of the medium-term budgetary objectives. During the budget year, the Cabinet of Ministers submits a report on the financial situation of the state, together with an updated macroeconomic and revenue forecast, to parliament by 1 June.

**Connectedness with the annual budget law:** Expenditure ceilings included in the spring MTBF form the basis for budget requests by line ministries and other central government institutions, but can be revised during the process of finalisation of the draft budget by the Cabinet of Ministers.

**Domestic budgetary procedures in Latvia**

**Economic assumptions for the budget preparation**

Macroeconomic and revenue projections that form the basis for the annual budget are prepared by the Ministry of Finance of Latvia. The use of alternative scenarios and sensitivity analysis remains limited to date. There is no independent institution charged with the task of preparing economic forecasts: however, the Bank of Latvia (and, to a lesser extent, the Ministry of Economics and large commercial banks) provide an independent view on the Ministry’s macroeconomic projections. In recent years, macroeconomic and revenue forecasts have been closely coordinated in the context of the EC-IMF balance-of-payments assistance programme.

**Multi-annual planning**

A budgetary framework with a multi-annual perspective was first used in 2007 during the preparation of the 2008 draft budget with the aim of bringing more strategic elements into the budgetary process (refer to the previous description of the system). However, the introduction of the new approach was overtaken by adverse economic developments, which lead to ad hoc and significant budgetary revisions, leaving little room for strategic and long-term planning.

**The annual budgetary process**

The budgetary process starts at the beginning of the year with the Cabinet of Ministers agreeing on updated and new priorities, based on proposals by line ministries and other central government institutions. Following the analysis of budgetary implications, and after the finalisation of macroeconomic and revenue projections, the Cabinet of Ministers discusses and adopts, in late spring, the medium-term budgetary framework. Based on this document, the line ministries and other central government institutions prepare detailed budget requests, which feed into the draft budget. The Cabinet of Ministers has to submit the draft budget law to parliament by 1 October and parliament usually adopts the budget law in December.
Fiscal governance in Malta

1. DESCRIPTION OF THE FISCAL FRAMEWORK

Malta has experienced government deficits in excess of 3% of GDP almost every year since 1995, which led to the public debt ratio reaching a peak of 72% of GDP in 2004 from 35% of GDP in 1995: at the end of 2009, it stood at 69% of GDP. Against this background, the fiscal framework has remained broadly stable since Malta joined the EU, with improvements in some specific areas. Most notably, reforms have aimed to: (i) increase the accountability of the budgetary process via the introduction of the pre-budget document in 2005; (ii) improve the management of public finances through the adoption of the Public Administration Act in 2009, which should, inter alia, strengthen the value-for-money principle; and (iii) strengthen the surveillance and transparency of the framework with a new accounting system introduced during the course of 2010. Further reforms are reportedly under consideration.

The budget process starts in April/May with consultations among the main stakeholders leading to the pre-budget document, which outlines the main policy challenges that the government faces and the measures under consideration. The document is subject to discussion with the social partners within the Malta Council for Economic and Social Development (MCESD) and the general public, with the outcome of the discussions feeding into the final budget.

The budget is presented by the Finance Minister in the budget speech. In addition to the main policy objectives, budgetary measures and targets for the year t+1, the budget presents key budgetary aggregates for the following two years by way of the national medium-term budgetary framework (MTBF). The MTBF thus covers three years on a rolling basis. Any information on the budgetary strategy for years beyond t+1 is included in the stability programme (20), which may also revise the medium-term projections. As has been pointed out by the Council, the macroeconomic forecasts underlying the budgetary projections have been on the optimistic side, particularly for the outer years (21).

Parliament adopts the expenditure allocations for year t+1 of each spending unit in the Appropriation Bill. Any accompanying legislation changes underlying the revenue projections are adopted in the Budget Measures Act. Revising the spending allocations through the year, which requires approval by the Ministry of Finance (MoF) and subsequently adoption by parliament in supplementary Appropriation Bills, is a common practice, reflecting unexpected or unbudgeted expenditure needs. If the MoF identifies risks for budgetary execution, it can recommend corrective measures, which are implemented through administrative procedures either on ministerial or government-wide level.

The legislative base of the fiscal framework lies in the Constitution and is further expanded into ordinary legislation (22). The budgetary process is centralised with the budgetary projections for the entire general government sector and the underlying macroeconomic framework being prepared by the MoF. Spending allocations are the result of negotiations between spending units and the MoF.

The authorities are committed to improving Malta’s budgetary, institutional and legislative framework and, to this end, are willing to cooperate with international institutions, benefiting from their expertise (23). The government appears to be receptive to the idea of a legally binding fiscal rule (24), but rather reluctant to consider the involvement of independent fiscal institutions (25). The authorities may also consider stricter rules over public expenditure.

(20) The pre-budget document repeats and summarises the multi-annual projections and strategy as laid down in the stability programme and is, therefore, not a document that actively shapes medium-term fiscal policy. It stands to reason that this might change with the move to the European semester.

(21) The latest four Council opinions on Malta’s stability and convergence programmes have pointed out that the underlying macroeconomic scenario for the outer years was on the favourable side. In addition, the year t+1 projections in the 2006–09 and 2008–11 programmes were also assessed as favourable.

(22) The Constitution sets restrictions on the utilisation of public funds and outlines the responsibilities of the finance minister as the main body overseeing the entire framework. It includes provisions for the approval of the spending allocations and their revision and the auditing responsibilities of the auditor-general. A parliamentary standing committee, chaired by a member of the opposition, oversees the transparency of the budget process. The Financial Administration and Audit Act includes more detailed provisions on the budget process, while management of public finances is fixed in the Public Administration Act.

(23) See, for example, the end of 2010 update of the stability programme.

(24) IMF Article IV report, January 2011.

(25) See the 2007 update of the stability programme.
increasing the expenditure allocations originally adopted by parliament (26). To date, however, no details on specific measures have been given.

2. **Assessment of the Fiscal Framework**

Malta’s fiscal framework seems to be, on the whole, flexible. For the year covered by the annual budget, there is room to amend the original set spending allocations: for subsequent years, the amount of flexibility is much greater as the multi-annual targets are not binding. In the context of a very small, very open economy with high exposure to external developments, such as the Maltese economy, this feature may be, to some extent, desirable. On the downside, the non-binding nature of the framework creates risks for expenditure overruns and the achievement of a sound fiscal position in view of the increase in age-related spending. In a similar vein, the government has noted that the practice of presenting supplementary expenditure estimates may be responsible for moral hazard among spending units (27).

Expenditure slippages, particularly from the health sector and the wage bill, are a persistent problem in Malta. On the one hand, this calls for more careful fiscal planning by the authorities and, on the other hand, for stricter monitoring over adherence to the adopted budgetary allocations, including through predefined, strict corrective mechanisms. Furthermore, the tendency for current spending to overrun the target often results in scaling down investment plans, thereby creating risks for growth potential.

The relatively short horizon of fiscal planning has implied delay in the achievement of a sound fiscal position to prepare for ageing, even as Malta is considered to be at high risk for long-term sustainability. The national MTBF included in the annual budget is underdeveloped (28) and non-binding, while the multi-annual targets in the stability programme are subject to annual revisions and built upon macroeconomic forecasts with a favourable bias, especially in the outer years, which may further hamper effective medium-term fiscal planning. Furthermore, frequent revisions to the budgetary estimates through the year point to a fiscal horizon that is even shorter than one year.

Strengthening the legislative basis of the MTBF to make it binding would be an important step in improving Malta’s fiscal framework. The introduction of legally anchored numerical expenditure rules could also promote fiscal discipline by helping to contain expenditure growth (29), especially of items with traditionally high dynamics and/or a tendency to overrun.

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**EPC policy advice**

*In the context of a non-binding medium-term budgetary framework (MTBF), a lack of numerical fiscal rules, persistent expenditure overruns and a tendency to use favourable medium-term macroeconomic assumptions, national authorities should introduce the following measures.*

- Strengthen the MTBF and its legislative base to make it binding and more detailed, thereby enforcing a longer fiscal planning horizon, including the introduction of legally anchored numerical rules to restrain expenditure dynamics.

- Strengthen the budgetary process through: (i) more cautious fiscal planning, based on prudent macroeconomic assumptions; (ii) stricter monitoring of the individual components of the budget; and (iii) the introduction of predefined, strict corrective mechanisms in case of emerging slippages.

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(26) ‘Government is placing further emphasis on the distinct need for departments and other public sector entities to operate within their allocated budget. In particular, government may consider a critical assessment of the current practice allowing the presentation of supplementary estimates to parliament towards the end of each financial year. Whilst such practice provides a degree of flexibility and latitude for action, it may be responsible for increased moral hazard resulting in different behaviour than if the department or public sector entity were fully exposed to the reality of fixed budget allocations’, pre-budget document 2011.

(27) See footnote 23.

(28) The level of detail of the medium-term budgetary projections in the national MTBF is rather poor. It includes only tax and non-tax revenues on the revenue side and current primary, capital and interest expenditure on the spending side: it lacks any further disaggregation.

(29) Average annual growth of current primary expenditure has outpaced that of GDP by over 1 percentage point in nominal terms over 2001–10. Nevertheless, recent years have shown signs of improvement as current primary expenditure growth has been more moderate than GDP growth in nominal terms since 2007.
3. Summary of the Main Elements of the Domestic Fiscal Framework

Medium-term budgetary framework in Malta

**Time frame:** Three years (t+1, t+2, t+3). Only year t+1 is approved in parliament. The framework works on a rolling basis with an additional year being added each year at the end of the period covered by the previous framework. The projections are subject to revision every year.

**Institutional coverage:** The entire general government sector.

**Accounting system:** Mainly cash-based: budget balance, as well as main revenue and expenditure components, are presented in cash terms for the central government sector; corresponding general government balance and government debt ratio presented in ESA 95 terms.

**Target revisions and binding objectives:** Medium-term targets are revised every year and are, therefore, not binding.

**Level of detail of expenditure projections:** Projections broken down into cash-based current, capital and interest expenditures for the central government.

**Level of detail of revenue projections:** Projections are broken down into cash-based tax and non-tax revenues for the central government.

**Connectedness with the annual budget law:** Incorporated into the annual budget, but only year t+1 is adopted by parliament; years t+2 and t+3 are subject to revision.

**Monitoring mechanisms:** The Budget Affairs Division within the MoF is in charge of monitoring the execution of the budgetary targets.

**Enforcement mechanisms:** There are no predefined enforcement mechanisms in case of deviation from the envisaged targets. Corrective action can be taken if deemed necessary by the MoF and takes the form of administrative procedures (adjustments in the relevant ministry or by the government on a more general level).

**Targets for sub-central governments:** The targets for local governments and extra-budgetary units are not made explicitly available. It should be borne in mind that the sub-central governments in Malta are relatively insignificant in fiscal terms.

**Comments on the functioning of the framework:** The effectiveness of the MTBF is hindered by its relatively unbinding nature. Medium-term projections are revised every year, thereby pointing to a relatively short fiscal planning horizon. In addition, the accountability of the framework is rather weak as only the first year is subject to adoption in parliament. Thus, strengthening the binding nature of the MTBF, complementing it with numerical expenditure rules and predefined enforcement and corrective measures would contribute to fiscal discipline.

Domestic budgetary procedures in Malta

**Transparency:** Cash-based data on a monthly basis are disclosed in a timely manner. Reconciliation tables detailing basic elements of transition between cash-based and ESA 95-based data are published as well. In addition, there are institutions in place which carry out internal controls and audits of the public accounting systems. These features provide a reliable overview over the execution of the annual budget.

**Budgetary centralisation:** The budgetary process at the planning and approval stages is, to a large extent, decided by the Finance Minister. This feature should facilitate the fiscal planning process and help avoid an excessive spending and deficit bias that often results when a large number of participants are involved in the budget process.
Fiscal governance in Poland

1. DESCRIPTION OF THE FISCAL FRAMEWORK

The Polish fiscal framework is a set of legal rules which allow the establishment of a medium-term perspective for fiscal policy planning and prevent excessive deficit and debt issuance. Most fundamental elements of the framework are defined by the Public Finance Law and its consecutive amendments. While the latter, especially the two latest amendments of 27 August 2009 and 16 December 2010, have contributed significantly to the strengthening of the framework, the frequency and relative easiness of their enactment raise concerns about its stability and robustness.

Performance budget system

The Public Finance Act of 27 August 2009 established the ‘performance budget system’ which is supposed to improve the efficiency of the management of public resources and the transparency of the budget process. The new system requires that each item of the general government expenditure is presented in the annual budget law according to a double (at least for the time being) classification: according to the responsible entity and according to the function of the state to the implementation of which it is contributing. The classification includes three levels of disaggregation: functions of state, tasks and sub-tasks, the latter being accompanied by specific objectives and measures. The same classification is then used for budgetary execution reporting. Although formally introduced on 1 January 2010, the system is still at the implementation stage, as a result of delays in the introduction of an adequate ICT system.

Medium-term programming

The same Public Finance Act of 27 August 2009 introduced a new instrument for medium-term budgetary planning — the multi-annual financial plan of the state. The document, prepared and updated every year by the government and endorsed by parliament, covers four consecutive years and indicates the goals of the medium-term strategy of economic development and associated socioeconomic policy directions. The aim of the document is to link the medium-term strategic planning with annual decisions on the allocation of public resources to the various functions of the state in the context of the budget law. The document indicates the level of central government revenues and expenditures for the entire programming period. It then serves as numerical guidance for the fiscal policy adopted in the annual budget laws and provides a limit for the budget deficit for a given year (a higher deficit is allowed exceptionally, if supported by detailed explanation from the government), although it is not binding in more specific details.

A similar, although formally independent, instrument exists at local government level. Multi-annual financial projections are prepared at all levels of local government for the current and at least three subsequent budget years. The minimum period may be subject to mandatory extension up to the time of the implementation of the current multi-annual investment projects.

A separate medium-term programming covers the public debt. A strategy for public debt management is established every year by the Minister of Finance, adopted by the government and submitted to parliament together with the assumptions underlying the annual budget law. It covers a period of four years. The document presents a projected level of debt and its structure and describes the objectives and specific tasks linked to the medium-term debt management. As in the case of the multi-annual financial plan, the strategy provides the government with a broad indication of policy to pursue, especially in the first year of the programme, but no formal obligation exists to adhere to the projected level of debt or policies presented.

Fiscal rules

In recent years, a number of numerical fiscal rules applying to both state and local governments have been introduced into Polish law.

The debt rule constrains the ratio of general government debt to GDP and is set out in the Constitution and in the Public Finance Law. The Constitution states that the general government entities are not allowed to take loans or...
allow guarantees as a result of which the state budget debt will exceed 60 % of GDP (30). The Public Finance Act complements this rule by establishing two precautionary debt thresholds of 50 % and 55 % of GDP and specifying the consequences of breaching them (as well as the 60 % limit) in terms of obligatory budgetary procedures. The procedures have been strengthened by the recent (16 December 2010) amendment to the Public Finance Law.

The 2011 Budget Law includes a new expenditure rule applying to the central government sector. It limits the annual nominal growth of all newly enacted expenditure items, as well as existing discretionary items to 1 % over consumer price index (CPI) inflation. While the law does not specify what items are included in the ‘discretionary expenditure’ category, it presents a catalogue of expenditure items excluded from the rule. The rule applies to the whole of the general government discretionary expenditure and not to each category separately. In this way, excessive spending in one expenditure item can be offset by additional savings in another. This expenditure rule is considered a temporary solution and will remain in force until the Council adopts a decision abrogating the Excessive Deficit Procedure for Poland. Subsequently, it is expected to be replaced by a permanent rule, currently being discussed. Although no details have been disclosed yet, it is expected to ‘aim at stabilising the structural deficit at medium-term objective (MTO) level. It would provide a stable link with debt aggregates in order to anchor sustainability and ensure flexibility in the face of macroeconomic shocks to allow for countercyclical fiscal policy responses’ (31).

A separate set of fiscal rules applies to local government entities. The general rule can be described as a type of golden rule: it states that current expenditures planned for a given budget year cannot be greater than the sum of current revenues, budget surplus from the previous year and unassigned resources. An additional rule applying to debt and interest paid on it is expected to change soon. The current rule, in force until the end of 2013, requires that the overall debt level of each entity does not exceed 60 % of its revenues at the end of each year and each quarter, while the interest paid on the debt does not exceed 15 % of the planned revenues. From 2014, a new, more flexible rule established by the Public Finance Law of 27 August 2009 (32), will enter into force. It introduces an individual coefficient of debt, which defines the specific maximum expenditure on debt service for each local government. It is calculated as a three-year average ratio of the sum of current surplus (current revenues minus current expenditure) and sales to total revenues. The new rule, contrary to the existing one, will allow entities to devise their individual fiscal strategy in a more flexible manner, depending on their ability to raise additional debt in order to finance sustainable investment projects.

Apart from the existing debt rule, a new deficit rule for local governments is being prepared. It is expected to enter into force soon.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

While recent efforts to strengthen Poland’s fiscal framework are a step in the right direction, there is still considerable scope to improve its design and functioning.

The existing framework provides for a wide range of instruments but lacks a binding character in many aspects, especially when it comes to the medium-term budgetary programming. Multi-annual plans, either at central or local government level, do not have to be legally taken into account while establishing annual budget laws. Deficit projections remain focused on nominal values and do not account for cyclical fluctuations, which — mainly in good times — results in a procyclical bias in fiscal policy. Since the programmes are updated yearly, they can be easily adjusted to the current needs of fiscal policy, limiting the originally intended medium-term orientation.

Despite fiscal rules covering both central and local government finances, there is still a high level of discretion in establishing the annual budgets. At the central government level, debt rules are legally binding and the possible consequences of breaching them may be considered as severe, but their implementation is contingent on the stability of public debt definition. Recent experience shows that a change in debt definition (through the exclusion of indebted entities from the legal definition of the central government) may serve the purpose of ‘limiting’ the stock of debt. This practice is facilitated by the unsettled issue of considerable, although not clearly

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(30) The perimeter of the State sector differs slightly from the official ESA95 definition of the general government (the National Road Fund has been excluded from the State sector).
(31) Letter from Finance Minister Jacek Rostowski to Commissioner Olli Rehn, 2 March 2011.
(32) A four-year vacatio legis has been decided in order to allow the local governments to adopt their budgetary policy to the new rules.
delimited, differences between the Polish and ESA 95 definition of the general government sector and its sub-components \(^{(33)}\). As a consequence, Polish public finances are, in practice, subject to two separate fiscal frameworks: an internal framework reflecting national legislation and a European framework resulting mainly from the provisions of the Stability and Growth Pact. Each of them refers to different measures of even basic budgetary aggregates.

The newly introduced expenditure rule, although undoubtedly helpful in limiting discretionary expenditure, includes several elements weakening its binding character and allowing for additional spending on an ad hoc basis. The lack of clear delimitation of discretionary and statutory expenditure allows for wide differences in interpretation of the rule’s coverage and estimates of its budgetary effects. Moreover, the possibility of offsetting excessive spending by savings in other areas, while potentially useful, is not documented. This hampers somewhat the analysis of the implementation of the rule by external observers.

The legal framework does not provide for an efficient control of budget implementation throughout the year. While the Ministry of Finance (MoF) is obliged to report on the monthly developments of the main budgetary aggregates, no rules preventing possible slippages exist in the system. Consequently, in recent years, recurrent slippages have been observed, mainly on the expenditure side (0.5 % of GDP on average in 1999–2007).

Finally, a weakness in Poland’s fiscal framework is the lack of an independent institution responsible for enforcing fiscal discipline (fiscal council).

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<th>EPC policy advice</th>
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<tr>
<td>Poland has substantially strengthened its fiscal framework over the past years, with reforms in the field of fiscal rules, medium-term programming and performance budgeting. In this context, Polish authorities should keep up the momentum and further improve the fiscal framework design and functioning by introducing the following measures.</td>
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<tr>
<td>● Enhance the enforceability and transparency of the fiscal rules by adjusting the definitions used in national accounting to ESA 95 standards and ensuring sufficiently broad coverage.</td>
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<td>● Strengthen medium-term planning by enhancing its connection with annual budget preparation and by fostering the mechanisms of coordination between government tiers.</td>
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<tr>
<td>● Complete the design of the new permanent expenditure rule to make it sufficiently comprehensive, transparent, binding and to support more countercyclical fiscal policy responses.</td>
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<tr>
<td>● Improve intra-annual monitoring of budget execution.</td>
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3. **SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS**

**Fiscal rule in Poland: Expenditure rule**

**General description of the rule and target definition**: Overall increase in existing discretionary expenditure and all newly enacted expenditure items cannot exceed 1 % over the CPI inflation.

**General government sub-sector(s) to which the rule applies**: central government budget

**Implementation date**: 1 January 2011. The expenditure rule is considered a temporary solution and will remain in force until the Council adopts a decision abrogating the Excessive Deficit Procedure for Poland. Subsequently, it is expected to be replaced by a permanent rule, currently under discussion.

**Coverage and exclusions**: The rule covers all newly enacted expenditure items and existing discretionary expenditure. While the law does not define the term ‘discretionary expenditure’, it provides for an explicit catalogue of items which are not covered by the rule. These are: public debt servicing; contributions to the budget of the EU and other international institutions; co-financing of the projects financed from the EU funds; old-age and disability pensions, survivors’ and similar benefits, subventions to the Social Insurance Fund.

**Accounting system**: National budgetary accounting, not fully consistent with ESA 95 methodology

\(^{(33)}\) In particular, State figures are derived from cash data, while ESA methodology demands figures in accrual terms.
Escape clause: There are no predefined escape clauses.

Time frame: Annual budget

Statutory basis: Public Finance Law

Monitoring: No formal monitoring procedure

Enforcement mechanisms: No formal enforcement mechanism in place

Fiscal rule in Poland: Debt rule

General description of the rule and target definition: The state sector is not allowed to take loans or grant guarantees, resulting in the state budget debt exceeding 60% of GDP. In case the public debt exceeds 50%, 55% and 60% of GDP respectively, increasingly stringent prudential procedures aimed at halting the increase in debt are to be implemented.

General government sub-sector(s) to which the rule applies: State budget, not fully consistent with ESA 95 methodology

Implementation date: First implemented 1 January 1999, most recent amendments entered into force 1 January 2011

Coverage and exclusions: State budget

Accounting system: National budgetary accounting, not fully consistent with ESA 95 methodology

Escape clause: There are no predefined escape clauses.

Time frame: Annual budget, procedures to be implemented from the beginning of the year following the year when the breach of the threshold has been stated

Statutory basis: Constitution, Public Finance Law

Monitoring: Not explicitly defined in the law

Enforcement mechanisms:

- If public debt exceeds 50% of GDP, the government shall prepare the budget law in which the ratio between deficit and revenues is not greater than the previous year.
- If public debt exceeds 55% of GDP, in addition to the above condition, the government shall prepare the budget law in which: (i) the projected difference between revenue and expenditure is such that debt-to-GDP ratio is lower than the previous year; (ii) the salaries of public sector employees do not increase; (iii) the indexation rate applied to pensions does not exceed CPI inflation; (iv) no new credits and loans from the state budget are allowed. In addition, the government prepares and submits a plan to parliament to reduce the debt-to-GDP ratio, and expenditures of local government entities cannot exceed the sum of their revenues, previous year’s surplus and unassigned resources.
- If public debt exceeds 60% of GDP, in addition to the above conditions, the government prepares and submits a plan to parliament to reduce the debt-to-GDP ratio to below 60%. In the following year’s budget, expenditures of local government entities cannot exceed their revenues and public finance entities are not allowed to grant new guarantees.

Medium-term budgetary framework in Poland: multi-annual financial plan of the state

Time frame: Current year plus three following years, on a rolling basis (a new year is annually added at the end of the period covered by the previous projection).

Institutional coverage: State budget

Accounting system: National budgetary accounting, not fully consistent with ESA 95 methodology
**Target revisions and binding objectives:** The plan includes projections of state budget deficit, debt, revenues and expenditures, as well as estimates of spending on each function of the state.

**Level of detail of expenditure projections:** Expenditures are broken down according to the performance budget system classification (i.e. functions of the state, tasks and sub-tasks).

**Level of detail of revenue projections:** Revenues are broken down into broad categories of tax (direct: CIT, PIT, indirect: VAT, excise, other) and non-tax revenues.

**Connectedness with the annual budget law:** The level of deficit announced in the annual budget law for a given year cannot be higher than the deficit projected in the Plan (a higher deficit is allowed exceptionally, if supported by detailed explanation from the government). However, the Plan is not binding in more specific details.

**Monitoring mechanisms:** The government is obliged to submit information to parliament annually on the implementation of the plan together with a report on the implementation of the annual budget for the previous year.

**Enforcement mechanism:** There are no predefined corrective or enforcement mechanisms in case of deviation from the announced medium-term targets.

**Targets for sub-central governments:** Although not formally linked with the multi-annual financial plan of the state, local government entities are obliged to establish multi-annual financial projections, including target values of revenues, expenditures, budget balance and debt. The document covers a period of minimum four years, but the coverage may be extended if investment projects are implemented over a longer time span. Projections are established together with the annual budget resolution and submitted to a local accounting council for agreement.

**Domestic budgetary procedures in Poland**

**Economic assumption for the budget preparation**

Fiscal planning tends to be realistic and based on the most up-to-date information. While the Commission forecasts are usually taken into account, differences to own forecasts are insufficiently explained. Usually, macroeconomic forecasts prepared for fiscal planning are made public, but there is little information on methodologies, assumptions and parameters.

**Centralisation of the budget process at the planning stage**

The annual budget law in Poland covers the state budget which has a different boundary in comparison with the general government sector as understood according to ESA 95 classification. Plans of the other central government and social security units are attached to the explanatory statement of the budget law. Local governments independently prepare their own budgets, taking into account expected levels of grants from and payments due to the state budget and revenues from shared proceeds of personal income tax, as provided by the MoF.

The MoF plays a pivotal role in the preparation and execution of the state budget by drafting the budget assumptions to be approved by the Council of Ministers. Then the ministry prepares a preliminary allocation of expenditure to each section of the budget which is then submitted to line ministries, which in turn provide detailed budgetary planning within the scope of their competence. The Draft Budget Act, together with an explanatory statement is then prepared by the MoF, approved by the Council of Ministers and submitted to parliament, where the three-stage procedure of budget debate and enactment follows.

The MoF also assumes a supervisory role in the context of the implementation of the budget. It sets up the monthly timetables of budget implementation and exercises general control over the execution of revenues and expenditures over the year. While each line ministry is responsible for controlling — quantitatively and qualitatively — the budgetary execution of its subordinate entities, the MoF is entitled to assess the quality of the management of public funds by the line ministries (excluding the other central state entities and local governments). The MoF may withhold transfers if serious irregularities are ascertained.
Fiscal governance in Portugal

1. DESCRIPTION OF THE FISCAL FRAMEWORK IN PORTUGAL

The Portuguese budget system is mostly defined by the Budget Framework Law of 2001, as amended in 2004 and 2006 and currently under revision, and the 2007 local and regional finance laws. The Budget Framework Law is an organic law, which prevails over ordinary laws. Traditionally, the budget system was based on a hierarchical administrative culture which concentrated mostly on the legality and regularity of public expenditure, leading to an inflexible and incremental budget system (34). The reforms initiated in 2005 and especially the ongoing budgetary reform are expected to strengthen the framework by seeking medium-term budgetary goals and introducing a number of rules and supervision measures in line with international best practices.

Portugal has three fiscal rules in effect, introduced over the period 2002–10: (i) budgets of services with financial and administrative autonomy must be in balance or positive (these services account for around 22% of general government spending according to 2011 budget figures) (35); (ii) net indebtedness for local governments should be capped at 125% of the previous year’s revenues in nominal terms — the Budgetary Framework Law allows the annual budget law to establish different limits to that debt to ensure that this sub-sector’s fiscal developments are aligned with those of the state and that the objectives of the stability programme are attained; for example, the 2011 Budget Law capped local government net debt growth at 0% (this sub-sector accounts for around 9% of general government spending); and (iii) net indebtedness ceilings for autonomous regions (Madeira, Azores) are defined annually in the state budget — the 2011 Budget Law capped regional government net debt growth at 0% (this sub-sector accounts for around 3% of general government spending).

The budget is formulated from broad policy objectives to detailed budgetary items. The Ministry of Finance (MoF) leads the process, although a high number of governmental units are also involved to different degrees in the preparation of the budget. The Minister of Finance does not have full control of the spending allocation as that is decided by mutual agreement between line ministers and the Minister of Finance, with the latter not having any special leverage over the former.

The statistical capability in the fiscal domain was improved with the agreement between INE (the national statistics institute), Banco de Portugal and the Ministry of Finance signed in 2006, which translated into more complete and timely data and fewer data revisions. In view of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, there is still a need to extend the data coverage — particularly on budget execution — to a monthly basis for local and regional authorities and the information disclosed on government-owned enterprises, namely those that are part of the government sector for the computation of the government deficit and debt for the purpose of the Excessive Deficit Procedure (i.e. based on the national accounts rules).

On 2 December 2010, the Council of Ministers approved a draft law revising the Budgetary Framework Law. The draft law was presented to parliament: it is now under discussion and a vote on it is due to be held in the coming weeks. The draft law aims at establishing:

- a multi-annual framework with expenditure and budget balance rules;
- an enlarged scope of application of the law;
- programme budgeting;
- an independent fiscal council.

Within the new framework, the elected government will present a multi-annual budgetary plan to the parliament — to be updated annually with the presentation of the annual budget law — which will include the definition and commitment to expenditure ceilings for the years to follow. The requirement of the draft law is to have budgetary plans for four years, with the level of detail required decreasing for the outer years.

To fully address the sustainability of public finances, the rule for the budget balance of the general government is defined by reference to the close-to-balance value of the MTO assumed by Portugal in the context of the

(35) These autonomous bodies belong to the general government.
Stability and Growth Pact (SGP). Moreover, this draft law establishes the requirement for a subsequent correction whenever deviations from the budget balance rule occur.

The revised budgetary framework is extended to include all entities that are part of general government, based on national accounts rules applied by INE. In addition to their explicit inclusion in the annual budget reports and multi-annual plans, full compliance with intra-annual information requirements is applied to all entities, thus further reinforcing the control of budget execution.

The Fiscal Council (FC) or Council for Fiscal Policy — which will be created as an independent body — will assess the consistency between macroeconomic and budgetary scenarios and objectives, as well as the consistency with the multi-annual expenditure and budget balance rules.

In addition, the government is about to approve the setting up of a system to monitor and control projects involving public investment. This will include public-private partnerships (PPPs) and concessions, paving the way for an approach that is geared to rolling out projects that are technically and financially sustainable.

2. **Assessment of the current framework**

According to the OECD Budget Practices and Procedures Survey and EPC’s database on fiscal frameworks, the current budgetary framework is, on the whole, relatively simple, considering only annual budgets and with relatively few rules with a limited coverage in terms of the government sector. Therefore, the Portuguese fiscal framework has, thus far, fallen behind the other Member States.

In April 2010, the Finance Minister created a task force with the aim of strengthening the Budget Framework Law. The task force presented a report identifying the weaknesses of the Portuguese budgetary process and suggesting areas of reform. Most of these proposals are included in the revision of the Budget Framework Law that is currently under discussion in the parliament. Therefore, the Portuguese budgetary framework must be assessed in light of the ongoing reforms.

The report presented by the task force in July identifies the following weaknesses in the budgetary process: the fragmentation of the budgetary process; insufficient medium-term planning; control system biased towards resources instead of results; and an incomplete accounting system.

A medium-term budgetary framework as it is foreseen by the ongoing revision of the Budget Framework Law is a necessary condition for fiscal discipline. Experience has shown that fiscal consolidation processes in Portugal tend to be very short-lived. Therefore, a multi-annual fiscal framework will limit the short-sightedness and short-termism hurting fiscal policymaking. A multi-annual fiscal framework should also help to better frame fiscal policy within the context of the overall medium-term economic backdrop. That should help public finances to move continuously to an essentially balanced position over the economic cycle (i.e. the medium-term objective). Later, once that balanced position is reached, fiscal policy within a medium-term perspective will also be important for the short-term stabilisation of the economy within the limits imposed by fiscal sustainability requirements. The draft law, currently under consideration by the parliament, defines a rule for the budget balance over the medium-term, obliging corrective measures to be applied when deviations from the budget balance occur. However, the path and timing for such a correction is not detailed in the draft law, which just states that it is subject to the opinion of the FC. In any case, this will only apply from 2015, with the stability programme updates in the meanwhile outlining the trajectory to reach that balance target.

Regarding the fragmentation of the budgetary process, there is a need to further strengthen the position of the MoF in the elaboration of the budget. The technical capabilities of the budgetary unit in the MoF have been improved and there are an increasing number of budgetary experts in other ministries. There are a growing number of joint task forces between the MoF and other ministries thus increasing the ownership of the budget and facilitating its implementation. However, the MoF should focus more on the tasks concerning overall budget design and implementation. Additionally, spending ministries could be more engaged in the various stages of the

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(37) This seems particularly relevant to the case of Portugal as updates of the stability programme tended to be built on visibly optimistic assumptions for economic activity in the medium term.

(38) The scope of the foreseen rule is not known at this stage.
budgetary process, notably in monitoring budgetary execution results in their areas of action and enforcing respect of the budgetary plans.

There are a number of control-related problems with the existing budgetary arrangements. Firstly, fiscal rules visibly fail to cover the whole general government sector. Expenditure-based rules should be strengthened. On 23 March, the MoF published quarterly consolidated targets for 2011 — on a cash basis — for total revenue, tax revenue, total expenditure, total primary expenditure and budgetary balance of the Central Administration (state and services and autonomous funds). While this is certainly a step forward, additional targets for regional and local administration and social security are desirable. However, the corrective measures to be applied in case of slippages were not published. The reform of the fiscal framework combined with a tight implementation of the budget should improve fiscal consolidation over time.

In addition, the budgetary process has too much of an incremental character (i.e. the new budget is prepared on the basis of the budget from the previous year), which means, inter alia, lower incentives for savings or even the non-correction of slippages in the years after their occurrence. At the same time, analyses of deviations in execution do not seem to be scrutinised, at least not in a systematic way.

On the basis of the draft budget framework law, it is not fully clear how the new fiscal council will carry its duties. The composition, the competencies, and the organisation of the fiscal council will be determined by a decree-law (i.e. a legal document from the Cabinet). It would have been desirable to have the parliament involved in the definition of the mandate of the FC, also in order to reinforce the support of the FC. Additionally, it is not clear how the mandate of this new institution will relate to that of the parliament’s Budgetary Technical Support Unit (with the Portuguese acronym UTAO), which was created in 2006 to support the members of parliament in the analysis of fiscal policy documents, even if the existence of the two institutions seems possible without apparent overlap in competences.

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**EPC policy advice**

Portugal has made a clear move towards strengthening its budgetary framework, starting from a low base. Overall, the Budgetary Framework Law, recently approved by the parliament, addresses relevant weaknesses in the budgetary process; however, there are still elements that can be further improved. In the context of the EC-ECB-IMF economic adjustment programme for Portugal, national authorities should introduce the following measures.

- Ensure full implementation of the Budgetary Framework Law, including the prompt establishment of a fiscal council, by the 2012 budget.
- The local and regional financing framework should be made consistent with the principles and rules adopted in the Budgetary Framework Law.
- Strict conditions for the correction of deviations from the budget balance rule should be clearly specified.
- The budgetary process should be more transparent. Relevant information supporting the preparation of the budget should be made public, including a complete assessment of fiscal risks, whether of an intra-budgetary or extra-budgetary nature. At the execution stage, monitoring tools should be improved.
- The Ministry of Finance should have a reinforced control at all stages of the budgetary process.

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**3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS**

**Fiscal rule in Portugal: Budget balance in nominal terms**

**General description of the rule and target definition:** Budgets of services with financial and administrative autonomy must be in balance or positive.

**General government sub-sector(s) to which the rules applies:** General government

**Implementation date:** The rule has been in force since 2002.

**Coverage and exclusions:** The rule covers about 13 % of the general government finances.

**Accounting system:** It is defined in terms of budgetary accounting.

**Escape clauses:** There are no escape clauses.
Time frame: Annual
Statutory basis: Legal basis
Monitoring: The MoF is responsible for the monitoring.
Enforcement mechanisms: Unknown
Comments on the functioning of the rule: The majority of the revenues of these services come from transfers from the state.

Fiscal rule in Portugal: Budget balance in nominal terms for local government

General description of the rule and target definition: The target is a nominal budget balance. Net indebtedness for each local government is capped at 125% of previous year’s revenues, a ceiling for medium and long-term loans (100%) and short-term loans (10%). The Budgetary Framework Law allows the annual budget law to establish different limits to that debt to ensure that this sub-sector’s fiscal developments are aligned with those of the state and that the objectives of the stability programme are attained. The 2011 Budget Law capped the net debt growth for local governments at 0%.

General government sub-sector(s) to which the rules applies: Local government

Implementation date: The rule has been in force since 2007.

Coverage and exclusions: The rule covers about 9% of the general government finances. The Local Finance Act and the annual state budget define which expenditure categories may be excluded from the determination of local government net indebtedness. The main exclusion has concerned public investment which is both co-financed by the European Union and fulfils some additional conditions; occasionally, there have been other typical exclusions as well (e.g. expenditure related to housing policy, renovation of degenerated urban areas, rehabilitation of social facilities affected by forest fires), generally subject to prior ministerial approval. These exclusions represent less than 5% of general government expenditure.

Accounting system: It is defined in ESA 95 terms.

Escape clauses: There are no escape clauses.

Time frame: Annual
Statutory basis: Legal basis

Monitoring: The Ministry of Finance, Directorate-General for Local Government, is responsible for monitoring.

Enforcement mechanisms: For those municipalities that exceed their debt ceiling in a given year, the transfers to it from the state should be reduced in the subsequent year by the amount of debt in excess of the ceiling. Municipalities with excessive debt are expected to diminish the excessive debt by at least 10% per year.

Comments on the functioning of the rule: Overall, local authorities have not been a major source of expenditure overruns in the past, although adverse spillovers from consolidation pressure at the central level could not be ruled out in the future.

Fiscal rule in Portugal: Debt ceiling for regional government

General description of the rule and target definition: Net indebtedness ceilings for autonomous regional government are defined annually in the state budget. However, it must be fixed in such a way so that debt service and principal repayments do not exceed 25% of the revenues of the regional government (excluding transfers from the state). The 2011 Budget Law capped regional government net debt growth at 0%. It targets the stabilisation of a nominal budget balance. The rule is described as a budget balance rule and not a debt rule because it refers to ceilings to the net and not gross debt.

General government sub-sector(s) to which the rules applies: Regional government (Madeira and Azores)

Implementation date: The rule has been in force since 2007.

Coverage and exclusions: The rule covers about 3% of the general government finances.

Accounting system: It is defined in ESA 95 terms.
**Escape clauses:** There are no escape clauses.

**Time frame:** Annual

**Statutory basis:** Legal basis

**Monitoring:** The Ministry of Finance is responsible for monitoring and enforcement.

**Enforcement mechanisms:** Sanctions are foreseen for non-compliance. For those regional governments that exceed their debt ceiling in a given year, transfers from the state should be reduced in the subsequent year by the amount of debt in excess of the ceiling.

**Comments on the functioning of the rule:** The ceiling of 25% of revenues for debt service and principal repayment may hardly be effective in the case that the maturity of debt is long. Whereas the annual budget law may overcome this weakness by fixing tighter limits, establishing tougher debt (or deficit) rules in the Law of Regional Governments’ Finances could be an option.

**Fiscal institution in Portugal: Unidade Técnica de Apoio Orçamental (UTAO)**

**Date of establishment and description of the main tasks related to fiscal policy:** Formed in November 2006, UTAO supports parliamentary budget deliberation by providing the specialist parliamentary committee with analytical reports on the executive’s budget proposal.

**Main outputs released by the institution:** UTAO is responsible for drawing up studies and technical working documents on public budgetary and financial management. Around 20 analytical reports (technical notes and information notes) are prepared per year.

**Role of the institution in the budgetary process:** UTAO prepares technical analyses of government bills on the state budget and amendments thereto, assesses general state accounts, monitors budgetary execution, and analyses revisions to the stability and growth programme.

**Obligation for the government to use the output of the institution:** UTAO delivers its output to parliamentary bodies only.

**Status of the institution:** UTAO was created by the Resolution of the Portuguese Assembly of the Republic No 53/2006 (7 August 2006). It was created within the Directorate of Technical Support and Secretarial Services (DSATS) of the Portuguese Parliament.

**Composition and appointment of the governing board:** There is no director; UTAO functions in accordance with its own internal regulations, which are subject to approval by the President of the Assembly upon a proposal from the Budget Committee.

**Decisions of the governing board:** UTAO’s working plan is subject to approval by the Budget Committee. It functions under the Budget committee’s direct guidance.

**Staff:** Three to five specialists seconded or engaged in accordance with the recruitment rules applicable to parliamentary staff; secondments/fixed contracts are short term.

**Comments on the functioning of the institution:** The OECD suggested that parliament increased the UTAO staff numbers and appointed an independent head to further increase the unit’s credibility. The UTAO does not produce its own economic forecasts and may not request on its own initiative information from the public administration of the government.

**Domestic budgetary procedures in Portugal**

**Macroeconomic assumptions underpinning the budget preparation**

The MoF is responsible for preparing the macroeconomic assumptions for the annual budget. Two forecasts are prepared, the first in October for the preparation of the budget and an intermediate forecast in April (released in the Budgetary Policy Steering Report, ROPO). The reliability of forecasts could be improved by taking into account different macroeconomic projections (e.g. the European Commission’s) and by considering alternative scenarios. So far, the macro-fiscal scenario has been based on overly optimistic assumptions. An independent panel of experts reviewing the government’s assumptions would improve the robustness of forecasts.
Centralisation of the budget process at the planning stage

The budgetary process is centralised in the MoF at the planning stage. The Minister of Finance does not have full control of the spending allocation as that is decided by mutual agreement between line ministers and the Minister of Finance, with the latter not having any special leverage over the former. In recent years, the collaboration with spending ministries (e.g. the Health Ministry) has been strengthened, particularly during the execution phase.

The use of top-down budgeting

According to the OECD database, the Portuguese budget formulation process follows a top-down approach from broad policy guidelines, based on a preliminary budget, to a detailed budget. In contrast, assessment by the parliament follows the opposite approach: the Budget Committee looks into all budget-related matters rather than considering only budget aggregates.
1. **Description of the Fiscal Framework in Romania**

In Romania, years of strong economic growth accompanied by a procyclical fiscal policy led to substantial fiscal imbalances which left no margin of manoeuvre to use fiscal policy as a countercyclical tool once the financial crisis started. The implementation of inappropriate budgetary policies in the past was in part due to weaknesses in the fiscal institutional framework: the lack of independent monitoring of budgetary developments, absence of enforcement mechanisms to ensure respect of fiscal targets, poor multi-annual planning and weak numerical and procedural fiscal rules. Therefore, one of the main features of the financial assistance programme between Romania and the EU, the IMF and other international organisations, was the adoption and implementation of a series of far-reaching fiscal governance reforms, including the adoption of a Fiscal Responsibility Law (FRL). The aim of these reforms was to address the weaknesses in Romania’s fiscal institutional framework to strengthen fiscal discipline and avoid the budgetary slippages of the past.

One of the main objectives of the FRL was to set up the Fiscal Council (FC) which is an independent body required to issue opinions and recommendations on official macroeconomic and budgetary forecasts, the annual budget laws, and to assess the compliance of the medium-term fiscal strategy with the principles and rules specified in the FRL. The FC also assesses the budgetary performance of the government against fiscal targets and policies and prepares cost estimates and opinions on the amendments made to the annual budget law during parliamentary debates. Moreover, 60 days before general elections, the presidents of the political parties may ask the FC (or alternatively, the government) to calculate the financial impact of any of the policies announced by the parties. The members of the FC have been designated and the Council is in the process of filling the positions in its Technical Secretariat. It has provided opinions on the 2011–13 fiscal strategy and the two budget rectifications in the 2010 and 2011 budget laws. It has also started to make its own analysis of the main fiscal issues in Romania.

A second objective of the FRL was to introduce a framework of principles and rules to ensure fiscal discipline. It introduced eight new fiscal rules applicable to the general government sector and covering the budget deficit, the primary deficit, total expenditure excluding financial assistance from the EU, and other donors and personnel expenditure. Two of the eight fiscal rules are pure numerical rules. These rules complement the budget balance and debt rules which were applied to the local government level in the past. The latter rules are reinforced by a new law on local government finances according to which local governments can make new spending commitments only after they have paid back all arrears. Furthermore, if in the last two years, realised revenue at the local level is lower than 97% of the programmed revenue, local governments have to programme revenue in the following budget year that is at most equal to the preceding year’s realised revenue. The rules at general government level are monitored through quarterly targets. If the budget execution shows deviations from these targets, the government has to present compensation measures which have to be evaluated by the FC. Non-respect of these rules leads to a mixture of personal and institutional sanctions. The multi-annual character of these rules was strengthened by embedding them in the medium-term budgetary framework.

The strengthening of the already existing medium-term budgetary framework (MTBF) was the third feature of the FRL. The MTBF sets binding ceilings for the following two years for the budget balance and personnel expenditure. In addition, it sets binding ceilings for the following year for a series of other budgetary indicators such as the primary balance and the level under which the government and the local authorities can issue guarantees. In addition, the government has to use the targets set in the MTBF as inputs when elaborating its budget for the following year and it is only allowed two budgetary rectifications per year, and never in the first six months.

Finally, the domestic budget process is close to the so-called contracting approach as Romania is headed by coalition governments based on multi-party agreements. The budget process uses a mixture of top-down and bottom-up budgeting. The Ministry of Public Finance draws up a framework letter in which it specifies the aggregate expenditure ceilings on which line ministries have to base their budget proposals (and which correspond to the expenditure ceilings in the MTBF). The line ministries take into account their different projects when making their proposals and a negotiation then takes place between the Ministry of Finance (MoF) and the other ministries such that the aggregate expenditure ceilings are met. In case of a persisting disagreement, the final decision is taken collectively by the government such that the overall expenditure targets are respected.
addition, as part of the new follow-up precautionary programme with Romania, particular attention will be given to improvement in the capital budgeting process. A working group under the Prime Minister will establish a list of priority investments for which financing will be available over the next three to five years within the envelope defined in the MTBF for 2011–14. Moreover, the monitoring and evaluation of investment projects at the central government level will be improved by strengthening the public investment monitoring unit of the MoF and by improving the database on investment managed by the Ministry. The macroeconomic forecasts underpinning the budget are made by the National Prognosis Commission which is subordinated to the Ministry of Public Finance. Currently, these forecasts are discussed and agreed with the Commission and the IMF as part of the financial assistance programme. Going forward, the FRL requires that the authorities compare their macroeconomic forecasts with those of the Commission and justify any deviations. Some elements of performance budgeting are used in the process as in the case of co-financing of EU funds and for certain programmes implemented by line ministries, funds are reallocated based on the results of output indicators.

Overall, as all of these new reforms were mostly adopted only in 2010, Romania is only just starting to build up its track record in this respect. Fiscal consolidation was somewhat better than expected last year and the Commission and the IMF are closely monitoring the fiscal consolidation process that is being implemented by the authorities. Both institutions will continue to work to improve the budgetary process in Romania as part of the follow-up precautionary financial assistance programme. However, the true test as to whether the new fiscal institutional framework will improve fiscal discipline and prevent the implementation of inappropriate budgetary policies will come when the new programme with the international organisations expires in 2013.

2. **Assessment of the Current Framework**

The fiscal governance reforms introduced by Romania as part of the multilateral financial assistance programme represent major steps in improving the budget process and in creating an institutional fiscal framework geared towards maintaining fiscal discipline and preventing the budgetary slippages that have occurred in the past. Romania is continuing to receive assistance from the EU, the IMF and the World Bank in order to adequately implement its new framework. The focus now is shifting from the introduction of new reforms towards fine-tuning existing ones and ensuring that they are implemented correctly. Therefore, efforts will be concentrated on further strengthening the functioning of the FC and improving the content of the MTBF and the budget planning process.

Despite not yet being fully operational, the FC has already shown promise in becoming an important player in influencing public finance developments. Its opinions on the MTBF and budget laws were well balanced, providing constructive criticism and useful advice for further improving the budget process. The resources given to the FC in 2010 were a cause for concern as they were insufficient to cover its functioning costs. The situation improved in 2011. Nevertheless, a potential weakness of the FC is that its technical secretariat is limited by the FRL to 10 persons which may not be enough to allow it to provide in-depth analysis on many fiscal issues. Furthermore, as the Council is a new institution, it will take some time for it to become fully functional and it is subject to a ‘learning by doing’ process. It will need to gradually develop its analytical tools and technical capabilities. The Commission and the IMF will continue to help the FC in this process and will work with it to gradually build its track record. The objective over the medium to long term is that the Council is recognised as a strong independent institution and its opinions and analysis become a reference point in fiscal policymaking.

The new fiscal rules have been extended to the general government sector while the rules at local government level have been reinforced, thereby strengthening fiscal discipline. Some of these rules are defined on a nominal basis which provides greater transparency and facilitates timely monitoring. They are based on a multi-annual time frame which should limit the potential for circumventing the rules by postponing the recording of expenditures or the implementation of structural adjustments. This should also help to internalise the possible budgetary effects of current policies over the medium term. The FRL also specifies ex ante the allocation of a better-than-expected budget surplus, thereby contributing to the prevention of budgetary slippages in the future. The fact that the rules are accompanied by actions in case of non-compliance which are defined ex ante as well as by pre-established sanctions should make them credible and enforceable.

The MTBF, introduced in 2003, had a number of weaknesses which hampered effective and efficient medium-term fiscal planning: fiscal targets were non-binding; there were frequent revisions to the main budgetary aggregates and a lack of political commitment. These weaknesses were addressed by introducing binding targets, limiting the number of budget revisions that can be operated in one year and making it compulsory for the budget law to respect the targets set in the MTBF. Further improvements were made by introducing the fiscal
rules together with corrective mechanisms in case of deviation from the fiscal path as well as the monitoring of the targets by the FC. The implementation of the new MTBF should be improved further in the future. One area where more work is needed is in synchronising the adoption of the MTBF with that of the budget law. While, according to the FRL, the MTBF should be adopted by parliament before the submission of the budget for the following year, in 2010 both were adopted simultaneously at the end of December. This problem should be remedied in the course of this year when the budget process should follow the original calendar in the FRL. Another area for improvement concerns the transparency of the actual content of the MTBF. More details should be provided regarding the calculations behind the fiscal consolidation path as well as those underpinning the impact of the fiscal consolidation measures. The MTBF should also provide more information on off-budget items that represent an important contingent liability for the budget such as the losses and arrears of state-owned enterprises (particularly of those that have been, or are, in the process of being reclassified into the general government sector). It should further improve the analysis of the risks to meeting the fiscal targets and on the improvement in the efficiency of public spending. Finally, as the current fiscal targets are based on the cash definition, the MTBF should also gradually move to targets based on the ESA 95 definition once the IT systems have been improved to allow for accrual reporting (39).

The fiscal governance reforms that were recently implemented also addressed a series of weaknesses in Romania’s budgetary process such as a lack of regular and timely reporting, particularly during the budget execution stage, scant centralisation of the budgetary process at the planning stage and the absence of effective top-down budgeting, as well as an optimistic bias on macroeconomic assumptions. The FRL should significantly improve the effectiveness of the top-down budgeting and the centralisation of the budget process at the planning stage through the introduction of the fiscal rules and the binding nature of some of the fiscal targets for the first two years. As regards the budget centralisation process at the implementation stage, the FRL addressed one of the main weaknesses that had led to slippages in the past, namely that investment spending was frequently reallocated to current spending: this is now forbidden. Finally, while budget documents contain information on some essential elements such as deficit financing or the use of proceeds from privatisation, the information about long-term issues, contingent liabilities and financial transactions should also be incorporated into these documents. Also, while the regularity and timeliness of data reporting has improved, efforts are being made within the financial assistance programme to move to accrual reporting on a timely basis and to improve the quality and timeliness of reporting by state-owned enterprises.

EPC policy advice

Romania has taken major steps to improve its institutional fiscal framework through the fiscal governance reforms implemented recently. The focus should now shift from adopting new initiatives to fine-tuning the functioning of the new institutional fiscal framework with special focus on the Fiscal Council, the content of the medium-term budgetary framework (MTBF) and further improving the budget process in a way that is consistent with the EC-IMF balance-of-payments assistance programme. In this context, national authorities should introduce the following measures.

- Ensure adequate resources for the functioning of the Fiscal Council.
- Further improve the content of the MTBF by including information on the off-budget items that represent a potential contingent liability for the budget such as the losses and arrears of state-owned enterprises. Introduce the use of ESA 95 accounting in the MTBF as swiftly as possible.
- Further strengthen the budget planning and management process by improving the capital budgeting process.

3. Summary information on the main elements of national fiscal frameworks

Expenditure rules in Romania

A general description of the fiscal rules and target definitions follow.

- General consolidated budget balance and personnel expenditure as a percentage of GDP cannot be greater than the ceilings defined in the MTBF for the first two years covered by it.
- The balance and the primary balance of the consolidated budget cannot be greater than the ceiling defined in the MTBF for the following year.

(39) Technical assistance is currently being given by the IMF to the Ministry of Finance as part of the multilateral financial assistance programme aimed at improving the Treasury IT system to allow for accrual reporting on a timely basis.
• The total expenditure of the general consolidated budget, excluding financial assistance from the European Union and other donors as well as personnel expenditure cannot be greater than the ceilings defined in the MTBF for the following year.

• In each of the three years covered by the MTBF, the annual growth rate of total expenditure should be below the forecasted annual growth rate of nominal GDP until the budget balance is in surplus in the year preceding the year for which the budget is being elaborated.

• In each of the three years covered by the MTBF, the annual growth rate of total expenditure cannot be greater than the forecasted annual growth rate of nominal GDP if the budget is balanced or in surplus in the year preceding the year for which the budget is being elaborated.

• If there is an increase in tax rates, the nominal increase in total expenditure cannot be greater than the nominal increase in budgetary revenues and the increase in expenditure cannot lead to a breach of the budget balance target set out in the MTBF. Furthermore, expenditure can only be increased in the year following the tax rate increase and only after the FC endorsed the projections for nominal revenue growth.

• During the budget year, funds approved for public investment cannot be transferred to current expenditure.

• If the budget balance is positive and greater than originally forecast for the current year and the following two years, the difference will be used to decrease the public debt accumulated in previous years.

General government sub-sector(s) to which the rules apply: The whole general government sector

Implementation: The rules were approved by the FRL at the beginning of 2010 and they have been implemented from 2010.

Coverage and exclusions: There are no exclusions from the rules coverage.

Accounting system: The targets are defined in cash terms. Improvements in the reporting system are necessary before a move to ESA 95 accounting can take place.

Escape clauses: The fiscal framework of the MTBF can be revised under the following conditions: (i) there is a change in the coverage of the general consolidated budget; (ii) there is a significant worsening of the macroeconomic indicators used in preparing the fiscal strategy; (iii) there is a change in government. In the latter case, the new government will make public whether its programme is consistent with the MTBF and, if not, the Ministry of Public Finance will prepare a new draft MTBF. The revision of the MTBF has to be approved by parliament and is subject to the review and opinion of the FC.

Time frame: Multi-annual framework: the rules apply to the years covered by the MTBF

Details: The rules were introduced as part of the fiscal governance reforms adopted following the conditions of the multilateral financial assistance programme provided by the EU, the IMF, the World Bank and other international financial organisations. The rules aim to strengthen fiscal discipline and improve the budget planning process by introducing a multi-annual framework.

Statutory basis: Legal basis

Monitoring: The government is required by the FRL to present a public evaluation of the quarterly budget execution and performance against the quarterly fiscal targets at the end of April, July and October of each year. In case of deviations from the targets, it also has to present measures for correcting the deviations either through spending cuts or revenue increases. In addition, it also has to present a half-yearly report on the economic and budgetary situation and if the forecasts in the report deteriorate by more than 0.5% of GDP compared to the forecast on which the annual budget was built, the FRL requires the government to implement compensation measures.

Enforcement mechanisms: Breaching the provisions of the FRL leads to joint or political responsibility for the members of the government as well as to the imposition of fines for individual decision-makers. For sub-sectors of the general government, such as local governments and state-owned enterprises, the presentation of budgets that do not follow the rules in the FRL leads to a series of sanctions including a ban on the issuance of guarantees and on the possibility to contract and draw loans, prohibitions to increase budgetary expenditures and ceilings for loans in the following year, the obligation to offset deficits of previous years with surpluses in the
following budget year and the obligation to submit an adjustment programme for spending cuts or the restructuring or merger of the institution in question.

Comments on the functioning of the rules: So far, the authorities have complied with these rules, but more time is necessary to establish a track record in this regard.

Fiscal rule in Romania: Budget balance rule

**General description of the fiscal rule and target definition:** Budget balance rule applicable to local governments, in force since 1990

**General government sub-sector(s) to which the rules apply:** Local governments

**Coverage and exclusions:** Loans used to finance investment and debt refinancing are excluded

**Accounting system:** National budgetary accounting system

**Escape clauses:** There are no escape clauses.

**Time frame:** Annual

**Statutory basis:** Local Finance Public Law

**Monitoring:** The MoF monitors the implementation of the rule.

**Enforcement mechanisms:** There are no predefined actions — the authority responsible is obliged to take corrective measures.

Fiscal rule in Romania: Debt rule

**General description of the fiscal rule and target definition:** Debt ceiling as % of current revenue

**General government sub-sector(s) to which the rules apply:** Local government

**Implementation:** Local government cannot contract or guarantee loans if their annual public debt service (principal payment, interest, commissions) including the loan they want to contract, is greater than 30 % of their own revenue.

**Coverage and exclusions:** Loans for co-financing EU projects are excluded from the rule.

**Accounting system:** National budgetary accounting system

**Escape clauses:** There are no escape clauses.

**Time frame:** Annual

**Statutory basis:** Local Finance Public Law

**Monitoring:** Carried out by the MoF

**Enforcement mechanisms:** No predefined actions — the authority responsible is obliged to take corrective measures

**Comments:** This rule has been in force since 1999.
Fiscal Institution in Romania: Fiscal Council

Date of establishment and description of the main tasks related to fiscal policy: The Fiscal Council (FC) was established in mid-2010. It provides analysis and issues opinions on the official macroeconomic and budgetary forecasts, the annual budget laws, the MTBF (it also assesses its compliance with the rules and principles of the FRL), assesses the performance of the government against fiscal targets and policies, prepares cost estimates and issues opinions on the amendments made to the annual budget law during parliamentary debates. It also provides information and advice to the government and parliament on legislative recommendations for maintaining and strengthening fiscal discipline and transparency of fiscal policies.

General government tiers at which the institution carries out its tasks: The whole general government sector

Main outputs released by the institution: The main output of the FC is an annual report which contains an analysis of the implementation of fiscal policy in the previous year compared to the MTBF and the annual budget, the assessment of macroeconomic and fiscal trends and projections from the MTBF and the annual budget, the assessment of progress against fiscal policy objectives, targets and objectives set out in the MTBF and the annual budget, the assessment of the government’s compliance with the principles and rules of the FRL, as well as recommendations and opinions for improving the conduct of fiscal policy. In addition to its annual report, the FC also publishes all the opinions, forecasts, analysis and recommendations that it issues during the year.

Role of the institution in the budgetary process: The FC issues opinions and recommendations on the main documents that are part of the budgetary process.

Obligation for the government to use the output of the institution: The FRL requires that the government and the parliament take into consideration the opinions and recommendations of the FC when elaborating and approving the MTBF and the annual budgets.

Status of the institution: The provisions related to the status of the FC are enshrined in the FRL. Although the FC is attached to the Romanian Academy, it is autonomous.

Composition and appointment of the governing board: The governing board comprises five members. The governor of the central bank, the Romanian Academy, the Academy of Economic Studies, the Romanian Centre for Economic Policies and the Romanian Banking Institute each nominate one person. The persons nominated have to be heard by the budget committees of the Romanian parliament and voted on to the board by the parliament. Their mandate is for one term only — a period of nine years. The only exception is if the first mandate of a FC member ceases after a period of three years, then that member can be reappointed once.

Decisions of the governing board: Decisions are adopted by a simple majority.

Staff: The FC is supported by a technical secretariat organised within the Romanian Academy. The secretariat consists of 10 employees receiving remuneration equal to that of corresponding staff in line ministries.

Comments on the functioning of the institution: The FC participated in the budget process in 2010 and has issued well-balanced and constructive opinions and recommendations. It is still in the process of compiling its tools for analysis and will continue to be supported by the Commission and the IMF as part of the multilateral financial assistance programme.

Medium-term budgetary framework in Romania

Time frame: Three years (i.e. t+1, t+2, t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

Institutional coverage: The whole of the general government sector

Accounting system: Cash basis

Target revisions and binding objectives: Total balance of the general consolidated budget as a percentage of GDP; personnel expenditure for the general consolidated budget as a percentage of GDP; the level under which the government and local authorities can issue guarantees; the nominal level of total personnel expenditure; the nominal balance of the consolidated general budget and the primary balance of the consolidated general budget. The ceilings for the total balance of the consolidated general budget and for personnel expenditure are binding for the first two years of the strategy.

Level of detail of expenditure projections: Multi-annual projections are presented for the main expenditure items of the general consolidated budget: personnel expenditure; goods and services; interest; subsidies; social assistance; other transfers and investment expenditure. Projections for total expenditure are presented for the
budgets making up the general consolidated budget. Finally, total expenditure and investment expenditure projections are also detailed by the main line ministries that constitute the state budget.

Level of detail of revenue projections: Multi-annual projections are presented for the main revenue items of the budget: profit tax; income tax; property tax; VAT; excise duties; other taxes on goods and services; other taxes on foreign trade; other fiscal taxes; social security contributions; non-fiscal revenue; capital revenue; grants; sums received from the EU. Projections are also presented for the total revenue of the budgets making up the general consolidated budget.

Link with the annual budget law: Fiscal targets included in the MTBF are binding and constitute an input for the annual budget law. The annual budget law cannot deviate from the fiscal targets specified in the MTBF.

Monitoring mechanisms: The government presents a half-yearly report on the budget execution for the first half of the year and projections for the remainder of the year and monitors the achievement of its fiscal targets on a quarterly basis. In addition, the FC issues an annual report which includes an assessment of the implementation of fiscal policy for the previous year.

Enforcement mechanisms: The FRL foresees a mix of individual and institutional sanctions if the fiscal targets are breached.

Targets for sub-central governments: The MTBF specifies ceilings on reimbursable funding that can be contracted as well as on the drawings from reimbursable funding that have been, or will be, contracted by local governments. It also specifies ceilings on the issuance of guarantees by local governments.

Comments on the functioning of the framework: The revised version of the MTBF has only been used since 2010 and more time is needed to properly assess its functioning. The results of the first year seem promising. However, going forward, some changes will need to be made to improve the MTBF, including the provision of more details on the calculations underpinning the fiscal consolidation path and the fiscal measures taken, as well as more information on off-budget items which represent a potential important contingent liability for the budget such as the losses and arrears of state-owned enterprises. It should also gradually move to the ESA 95 accounting system.

Domestic budgetary procedures in Romania

Prudent economic assumptions for the budget preparation

Romania suffered from an upbeat bias in macroeconomic forecasts which rendered proper budgetary planning more difficult. It was one of the factors that led to fiscal slippages during the boom years. Since the start of the multilateral financial assistance programme in 2009, the macroeconomic forecasts are checked, discussed and agreed with the EU and the IMF on a quarterly basis. Furthermore, the FRL now requires that the macroeconomic forecasts made by the authorities are accompanied by a statement on the consistency or the differences between the forecasts from the European Commission. In addition, the FC is also required to issue an opinion relating to the macroeconomic forecast.

Centralisation of the budget process at the planning stage

In the past, Romania had a weak centralisation of budgetary planning which exacerbated the deficit bias through the common pool problem. Given that the government is based on a multi-party coalition agreement, it does not favour a strong Finance Minister. Therefore, within the fiscal governance reforms recently implemented, it was decided to strengthen the centralisation of the budget process by embedding binding fiscal rules in the MTBF and imposing institutional and individual sanctions if these rules are not adhered to. Nevertheless, the role of the Finance Minister should be reinforced in the future. This could be done, for example, by delegating strong prerogatives or the power to veto spending decisions to this member of the Cabinet. Currently, negotiations take place between the Ministry of Public Finance and the other line ministries during the budget process, but in case of a disagreement, the final decision is taken collectively by the government.

The use of top-down budgeting

Romania currently uses a mix of top-down and bottom-up budgeting. The Ministry of Public Finance fixes the aggregate expenditure targets in the MTBF, which are binding. It then draws up a framework letter specifying these targets to the different line ministries and other budget entities. The latter prepare their individual budget proposals and negotiations then take place with the Ministry of Public Finance such that the aggregate expenditures fit into the overall fiscal targets. The introduction of binding fiscal targets should lead to an efficient top-down budgeting process.
Fiscal governance in Slovakia

1. DESCRIPTION OF THE FISCAL FRAMEWORK

Most features of the current fiscal framework were introduced during the fiscal governance reform that was completed in 2005. The reform improved overall transparency (e.g. reduction of budgetary chapters, introduction of accrual accounting), strengthened strategic planning (e.g. programme budgeting) and introduced medium-term objective setting. The main components of the current framework include triennial budgeting, an expenditure rule for the central government and a balanced budget rule and debt rules for territorial governments (40). These rules were adopted to strengthen the credibility of the government’s efforts to reduce high public deficits dating back to the beginning of the last decade.

The main building block of the fiscal framework is a detailed triennial general government budget. The budgetary process, enshrined in the General Government Budgetary Rules Act, consists of two phases. During the first phase, generally concluded by the end of April, the government sets and publicly announces the targets in terms of the general government balance (in ESA 95 terms) as a percentage of GDP for the following three years. Objectives are underpinned by up-to-date macroeconomic assumptions and resulting forecasts for tax receipts, as well as non-tax revenue projections (41). Expenditure ceilings are established on the basis of underlying revenue projections and the government’s objectives and are defined at line ministry level. The second phase encompasses the preparation of more detailed budgets by individual chapters within the established expenditure limits. This is an iterative process lasting until the end of September when the government adopts the general government budget. The Ministry of Finance (MoF) plays a pivotal role in this process during which expenditure ceilings may be adjusted, based on updated macroeconomic and tax receipt forecasts. The MoF has a strong position in setting final expenditure limits for the line ministries. Conversely, in the case of the budgetary institutions, which prepare their own budgets (42), and local governments, the MoF is only consulted. The final triennial budget is submitted to the parliament by mid-October.

Although the parliament does not vote on the triennial budget, the figures for the following budgetary year (i.e. t+1) are reflected in the annual State Budget Act (SBA), which is adopted by the parliament and specifies, in nominal cash terms, the aggregate revenue, expenditure and required balance for the state budget. Annexes include additional information on the revenues and expenditures of individual government entities, expenditures on thematic programmes and reserves. The outer years of the multi-annual budget are not binding in any way and are updated annually.

Since 2002, an expenditure rule has been in place in the SBA, which covers the state budget (the majority of central government entities) and is formulated in cash terms. The rule postulates that expenditures in year t+1 may only exceed the budgeted amount by a maximum of 1 % (43) and must not lead to a rise in the state budget deficit. Implicitly, the excess revenue has to be used for debt reduction.

Local governments are restrained by two rules, which are closely interrelated. The first stipulates that municipalities and higher territorial units must operate under balanced or surplus current budgets. Hence, with some exceptions, no borrowing is allowed to cover current expenditures. External financing may be used only for the capital budget and thus means it may be in deficit. However, borrowing is subject to two rules to limit debt levels. Firstly, the total amount borrowed by a local government entity cannot exceed 60 % of the actual current revenues of the preceding fiscal year. Secondly, the total amount of the annual instalments for loans cannot exceed 25 % of the actual current revenues of the preceding fiscal year. Both rules are codified within ordinary legislation. Consistent with the action taken at the central level, these rules were legally relaxed for 2009 and 2010.

(40) The expression ‘territorial governments’ is used interchangeably with ‘local governments’, which refers to governments at municipality and so-called higher territorial units (i.e. region) level.

(41) The tax and part of the non-tax revenue projections are prepared by the MoF. The remaining input is submitted by local government entities and other budgetary units, which prepare their own budgets (e.g. National Property Fund, Social Insurance Agency).

(42) These institutions are regulated by specific Acts, on the basis of which they were established. Generally, these laws do not contain the requirement of a balanced budget, but there is a common provision in the General Government Budgetary Rules Act, with the exception of public universities, not allowing external financing, i.e. outside the general government sector.

(43) This ceiling has been progressively lowered from 15 % in 2002 to 5 % in 2003: it was reduced to 1 % in 2005.
State closing account statements prepared by the MoF provide *ex post* information on the budgetary execution. Assessment of the debt rules is hampered by a lack of publicly available information; only aggregate figures are provided in a comparatively untimely manner for territorial governments and mostly in ESA 95 terms, although the rules are expressed in cash terms. The national authorities have not published an assessment of adherence to any of these rules.

In the update of the stability programme for 2009–12, the government outlined a major reform of the fiscal institutions. The proposed elements include: (i) the creation of an independent fiscal council; (ii) a constitutional debt rule; and (iii) binding multi-annual expenditure ceilings. The proposals are expected to be discussed at a political level in the near future.

### 2. Assessment of the current framework

The multi-annual planning helped to anchor the government’s consolidation efforts. The general government deficit objectives defined in the triennial budgets have generally provided an upper limit on public deficits (44). The public deficit was reduced from 12% of GDP in 2000 to below 3% of GDP in 2003 where it remained, with one exception, until 2008. The ratio of public debt to GDP fell by almost 15 percentage points to some 28% of GDP in 2008. Strong economic growth also played an important role.

The reform of the fiscal framework certainly improved the budgeting process by introducing multi-annual planning, programme budgeting and several fiscal rules. Nevertheless, the current set-up has not prevented the government running deficits even in years of high economic growth exceeding 8% in real terms. The recent crisis also showed that the current rules provide extensive leeway for the government’s spending without clearly predefined boundaries.

The main weakness of the existing MTBF is the non-binding nature of the fiscal targets for the outer years, which are revised annually. While the budget balance targets have been generally respected, expenditure has been repeatedly revised upwards reflecting greater growth of revenues on the back of strong economic growth. Furthermore, although the framework contains budget balance objectives for all government sectors, it lacks a coordination mechanism between the central and territorial governments to set and agree these objectives. Finally, the current MTBF does not provide for any direct relationship between the medium-term targets and long-term challenges related to the ageing population.

The 1% state budget expenditure rule in its current form has several drawbacks. Firstly, it may lead to procyclical fiscal policies as the ceiling definition allows for some overspending of greater-than-expected revenues in cyclical upswings (45). Secondly, the rule covers only the central government (with some exceptions), omitting territorial governments and social security funds. Thirdly, the rule is not backed by strong legal provisions. It is approved annually in the SBA giving the government discretion on its inclusion and strictness. As for the debt rules, they apply only to the local governments leaving borrowing of the major part of the central government subject only to limitations imposed by the Stability and Growth Pact and the financial markets. Finally, information on within-year monitoring and enforcement is not publicly available.

Well-developed fiscal institutions to address above mentioned deficiencies can be instrumental in view of the budgetary consolidation and to establish sound public finances. Given positive synergy effects between different parts of the fiscal framework, it is advisable to carry out any necessary changes simultaneously.

The MTBF would benefit from the introduction of binding multi-annual expenditure ceilings over its entire time horizon. This would enable each government to set its fiscal goals at inception over the whole term and would strengthen the element of accountability. Defining the ceilings at the aggregate level and encompassing a broad spectrum of expenditures would provide a certain degree of fiscal flexibility. The perimeter of application should be extended to cover as much of the general government as possible. Spending of the territorial governments, which have own decision-making powers without any direct influence from the central government, should also

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(44) Prior to the crisis, the deficit targets of the outer years have been always reduced rather than increased during an annual update of the tri-annual budget.

(45) The State Budget Act requires adherence to the deficit target specified within the law. This would imply that, during crisis years, lower-than-expected revenues need to be addressed through expenditure cuts to ensure that the originally planned balance is met, effectively aggravating the situation by limiting the full operation of automatic stabilisers. However, this has not occurred in practice. The response of the government during the recent crisis period was to adjust the State Budget Act during the fiscal year to reflect negative developments.
be defined for the medium-term. Finally, the medium-term ceilings could also take into account long-term challenges of public finances.

With a debt-to-GDP ratio of around 40 %, the Stability and Growth Pact (SGP) 60 % of GDP reference value for public debt does not represent a binding constraint for Slovakia and, therefore, does not constitute an anchor for fiscal policy. The recent experience of some Member States shows that countries may have problems financing their debts at even lower debt levels than currently exhibited by Slovakia. Arguably, a rule establishing a lower level of the debt threshold could usefully be introduced at national level, also considering the high growth rates likely in the context of continued catching-up. In formulating the rule, careful consideration may need to be given to the requisite for a catching-up economy to increase its endowment of real assets, which could require some degree of financing of infrastructure through public debt.

Slovakia could also consider establishing an independent institution, which would be directly involved in the preparatory works (46), monitoring, and assessment mechanisms related to the budget. Such an institution would increase the transparency of the budgetary process and out-turns, discouraging recourse to creative accounting practices or the loose application of the accounting rules (47). In addition, it could contribute to the budgetary process through analyses of fiscal issues and assessment of parliamentary proposals. It could also create a broad fiscal database, which would be available to the general public. Combined with more specific requirements on the publication of fiscal data, especially from local authorities, these arrangements could contribute to a more disciplined fiscal behaviour.

EPC policy advice

With the reform of 2005, which introduced multi-annual planning, programme budgeting and several fiscal rules, Slovakia significantly improved its fiscal framework. However, the current set-up is fragmented and has not prevented the government from running deficits even in years of high economic growth. In this context, national authorities should introduce the following measures.

- Implement enforceable, binding and well-designed multi-annual expenditure ceilings, covering the central government and social security system, consistent with the multi-annual objectives of the medium-term budgetary framework for the general government.
- Introduce an independent fiscal council to support the preparation, monitoring and evaluation of fiscal policies.
- Improve the transparency of public finances through the timely publication (on a quarterly basis at least) of budgetary data at all levels of government.

(46) When preparing macroeconomic and tax revenue projections, the MoF consults two committees of experts from the central bank, private sector and think tanks.

(47) For example, Slovakia classified the funding of railway companies and hospitals to cover their accumulated debt as loans and only in October 2010 did it reclassify them as capital transfers, with a negative impact on the 2009 general government balance.
3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

Fiscal rule in Slovakia: Expenditure rule

General description of the rule and target definition: This rule limits expenditure overruns of the central government relative to the budget adopted in the annual budget law, where both revenues and expenditures are defined in nominal terms. In the case of additional revenues compared to the baseline, the government may spend only up to 1 % of the originally budgeted expenditures, while leaving the overall budget balance unchanged.

Institutional coverage: The rule applies to most central government units, although the perimeter thus defined is not identical to the ESA 95 definition of central government. For example, some of the state funds (e.g. National Property Fund) or other (semi-)budgetary institutions (e.g. Slovak Television, universities) are excluded. These institutional units draft their own budgets (generally required to be in balance or surplus) which are included in the multi-annual general government budget and are approved by the parliament together with the SBA. However, they are not part of the SBA and hence the 1 % expenditure rule does not apply.

Implementation date: Applied since 2002

Accounting system: Cash

Escape clauses: While no escape clauses are defined, in cases where the government fails to ensure proper execution of the approved budget, it can change the State Budget Act (SBA) in the course of the fiscal year.

Time frame: One year

Details: The rule has been specified in the SBA since 2002 with an initial threshold of 15 %. This was later reduced to 5 % in 2003 and 1 % in 2005.

Statutory basis: Legal basis (State Budget Act)

Monitoring: The MoF is the main monitoring body that ensures the compliance of all the line ministries and other budgetary institutions included in the state budget. All expenditures are also subject to scrutiny by the auditing authority — the Supreme Control Office.

Enforcement mechanisms: The MoF can impose sanctions on the line ministries in case of expenditure overruns that were carried out without the approval of the MoF.

Comments on the functioning of the rule: No formal assessment of the rule has been carried out so far by the national authorities. The state closing account statements, which assess ex post budgetary execution, suggest that the rule has indeed been respected at the aggregate level. Nevertheless, audits have pointed out expenditure overruns at line ministry level, which breached the General Government Budgetary Rules Act.

Fiscal rule in Slovakia: Balanced current budget rule for territorial governments

General description of the rule and target definition: The rule stipulates that the current budget of local government entities (i.e. municipalities, higher territorial units) must be balanced or in surplus. Only capital budgets can be in deficit and be financed through external resources.

Institutional coverage: Local government

Implementation date: Since 2004

Accounting system: Cash

Escape clauses: The current budget may be in deficit if: (i) a subsidy from the state budget is envisaged; (ii) EU financing is budgeted for the fiscal year in question; and (iii) resources carried over from previous years are available. The capital budget may be in deficit if: (i) resources carried over from previous years are available; (ii) the current budget is in surplus; or (iii) the local entity in question takes up debt.

Time frame: One year

Details: This rule is closely related to the debt rule as it allows the use of external financing only to cover investment. Local government entities are required to budget for reserve funds, to be used in the case of unexpected events (e.g. floods).

Statutory basis: Legal (Local Government Budgetary Rules Act)
**Monitoring**: Local government entities themselves have a prime role in monitoring implementation of their budgets. They are required to provide the MoF with related information.

**Enforcement mechanisms**: In case of non-compliance, the MoF can fine the local entity in question or it can stop financing a local government entity until a path towards balanced budget is restored.

**Comments on the functioning of the rule**: An evaluation of the application and performance of this rule is hampered by the fact that currently published information on the general government budgetary development is not available at the level of an individual local government entity. According to the MoF, the budgets of local government entities are closely followed and evaluated, and potential breaches of rules are sanctioned. This would imply that the aggregate negative balance of, for example, municipalities (in ESA 95 terms) in 2009, 2007 or 2006 (despite budgeting balanced or surplus budgets) was primarily due to investment that was financed through new debt.

**Fiscal rules in Slovakia: Debt rules for territorial governments**

**General description of the rule and target definition**: The rule stipulates that local governments (municipalities and higher territorial units) may use external funds only to finance capital investment. Moreover, loans may be assumed only if the total amount of a local government entity’s debt does not exceed 60% of the actual current revenues of the preceding fiscal year and the total amount of the annual instalments does not exceed 25% of actual current revenues of the preceding fiscal year.

**Institutional coverage**: Local government

**Implementation date**: Since 2004 although this rule was suspended during the crisis years until the end of 2010 through an amendment to the Local Government Budgetary Rules Act.

**Accounting system**: Cash

**Escape clauses**: Several types of debt are excluded from the debt definition (e.g. debt incurred to ensure pre-financing of projects financed through EU funds).

**Time frame**: One year

**Details**: External financing can be used to cover current expenditure only in exceptional circumstances and on the condition that it will be repaid from current revenues by the end of the fiscal year. For large construction projects, local government entities are obliged to submit a proposal for a project to the MoF, which evaluates an impact of such a project on the debt of the entity in ESA 95. If the concerned project has an impact on public debt, the law stipulates under what conditions it can be carried out.

**Statutory basis**: Legal (Local Government Budgetary Rules Act)

**Monitoring**: Respect of this rule is monitored by a main controller of each local government entity on a regular basis or by auditors at the end of the fiscal year. The MoF also follows developments from available statements, which are submitted by local government entities on a quarterly basis.

**Enforcement mechanisms**: The main controller is required by law to inform the MoF about any breach of the rule. The MoF can fine the entity in question.

**Comments on the functioning of the rule**: Currently, publicly available information does not allow an assessment of the application of this rule. The MoF asserts that it follows and evaluates closely debt developments of local government entities and adherence to the debt rule.

**Medium-term budgetary framework in Slovakia**

**Time frame**: Three years (i.e. t+1, t+2, t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

**Institutional coverage**: General government

**Accounting system**: ESA 95

**Target revisions and binding objectives**: The main target is the general government balance as a percentage of GDP. The targets for the next budgetary year (i.e. t+1) are binding, whereas those for the outer years (i.e. t+2 and t+3) are only indicative.

**Level of detail of expenditure projections**: Projections are very detailed, broken down by chapters and specific programmes within each chapter, local governments and other (semi-)budgetary institutions and expenditure types (e.g. compensation of employees, purchase of goods and services).
**Level of detail of revenue projections**: Projections are broken down to specific tax receipts (e.g. PIT, CIT, VAT) and non-tax revenues (e.g. social security contributions, foreign transfers) for each entity (e.g. central government, municipalities, higher territorial units).

**Connectedness with the annual budget law**: There is a direct link between the MTBF and the annual budget. The first budgeted year of the MTBF is fully reflected in the annual budget law.

**Monitoring mechanisms**: Monitoring of the MTBF is closely related to the monitoring of fiscal rules and is carried out only with respect to year t+1 as this is the only binding year. Monitoring is carried out by the MoF, which internally audits units of respective entities as well as controllers at territorial government level.

**Enforcement mechanisms**: As the outer years are not binding, only targets for year t+1 can be enforced. Breaches of fiscal rules are sanctioned by the MoF mainly through fines.

**Targets for sub-central governments**: Local governments are required to have balanced current budgets. Only capital budgets can be in deficit and financed through external financing. Although, in the majority of cases, balanced or surplus budgeting is assumed for municipalities and higher territorial units, practice shows that this is not always the case.

**Comments on the functioning of the framework**: While the MTBF provides very detailed budgeting for three years in advance, the non-binding nature of outer years remains an issue. It is difficult to assess enforcement throughout the fiscal year as the relevant data is not published (e.g. the debt rule can only be enforced at the level of an individual constituency, but no such data is officially published).

**Domestic budgetary procedures in Slovakia**

**Budgetary centralisation at the planning phase**

The MoF plays a central role during the planning stage of the budgetary process. The MoF proposes expenditure ceilings for line ministries and budgetary chapters and leads the subsequent discussions about the final expenditure targets. Entities which prepare their own budgets (e.g. National Property Fund, Social Insurance Agency) have to consult their budgets with the MoF before submitting their draft budgets to the parliament.

**The use of top-down approach**

The MoF sets the global target in terms of headline deficit and it prepares — in cooperation with other general government units — a projection of tax and non-tax revenues. Subsequently, the aggregate level of expenditure is determined. This is then broken down into individual expenditures of general government units. Nevertheless, the MoF has little say in the budgets of the local governments.

**Performance budgeting**

The reform of the general government governance was accompanied by the process of decentralisation in 2002–05. One of the elements introduced during the reform was programme budgeting, which implies the setting of objectives and measurable outcomes. In this fashion, the purpose of allocated funds becomes clearer. Initially, programme budgeting was introduced at central government level. As of 2009, it was extended also to local governments. The majority of general government entities are thus obliged to prepare budgets that include goals, required tools, and measurable indicators to assess goal achievement. While budgeting has improved over time, the proper (qualitative) assessment of budgetary outcomes is lacking.
Fiscal governance in the United Kingdom

1. Description of the Fiscal Framework

The new UK government introduced a new fiscal framework after taking office in May 2010. The three key pillars are the setting of a new ‘fiscal mandate’ targeting the cyclically-adjusted current balance, the setting of a target date for net debt to be falling as a percentage of GDP and the establishment of the Office for Budget Responsibility (OBR), a body of independent experts tasked with producing the official forecast. As under the previous arrangements, multi-annual limits for predictable spending in every department are also specified in advance through departmental expenditure limits (DELs) set in regular spending reviews. Less predictable or non-discretionary expenditure is forecast but not capped in advance under the annually managed expenditure (AME) system.

The new arrangements address two key failings of the previous framework that was in place from 1997 to 2008 and which required the government to balance the current budget over the economic cycle and keep net debt at a sustainable and prudent level defined ceteris paribus as below 40% of GDP. The first failing of this framework was that the government itself decided the dates on which the economic cycle was deemed to start and finish and made ex post changes to its dating of the cycle which typically resulted in it gaining more fiscal leeway. This made the rule too flexible and damaged its credibility. The second failing was that it was mainly backward-looking, potentially requiring governments to make politically unfeasible cuts in spending at the end of a cycle in order to atone for past overspends. Both rules were suspended following the financial crisis.

The new government’s fiscal mandate requires that the cyclically-adjusted current budget (i.e. excluding investment expenditure) should be on track to be in balance by the end of a rolling five-year forecast period, currently ending in 2015–16 (48). This is supplemented by a debt sustainability target which currently requires that public sector net debt target as a percentage of GDP be falling by the fixed date of 2015–16. The government has indicated that it will consider a more stringent debt target once it has made progress with the current fiscal consolidation.

The OBR is tasked with producing the official forecast underlying annual budgets. It must also give a judgement on whether, based on the announced policies, the chances of the government meeting the fiscal mandate and debt sustainability rule are greater than 50%.

The aspect of the fiscal framework which the new government has largely maintained is the Spending Review. This is a document published every three or four years, setting multi-annual ceilings for expenditure falling within the DEL framework. Departmental expenditure limits cover expenditure which the government deems it practical to cap in advance — for example salaries, procurement and most fixed investment. The remainder of spending, mainly social security, debt interest payments, public sector pensions and EU contributions, is classified as ‘Annually managed expenditure’ (AME). While the government (and now the OBR) make forecasts for this expenditure, it does not set ex ante caps for it on the basis that the spending is not discretionary at the point at which it is incurred. However, in its 2011 Budget, the government announced its intention to increase the amount of AME which is subject to fixed budgets in order to improve spending control (49).

After the DELs have been set, departments are responsible for keeping to these spending limits. The track record of the DEL framework has generally been good with spending overruns unusual and typically small. However, the effectiveness of this part of the framework did not prevent the United Kingdom from running high deficits in the years leading up to the crisis, highlighting the ineffectiveness of other aspects of the previous fiscal framework. While immediate DEL spending reductions have been delivered in 2010–11, the DEL framework has just started to be tested in a prolonged period of contracting real budgets.

In its 2011 Budget, the government announced a new budget exchange system to be introduced in 2011–12 to replace the end-year flexibility system. This will allow departments to surrender an underspend in advance of the end of the financial year in return for a corresponding increase in their budget in the following year, subject to a prudent limit thereby providing departments with the flexibility to deal with expenditure slippages while strengthening spending control.

The remainder of budgetary policymaking is carried out in annual budgets, usually during March. These budgets are announced in a speech by the Chancellor to Parliament. This is followed by parliamentary scrutiny of a finance bill which enacts the aspects of the budget which require new legislation and of supply estimates which

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(48) Here and throughout, 20XX–XX refers to the UK fiscal year which begins on 1 April and ends on 31 March.

(49) The UK government will announce more detail on this amendment in the summer. There would be significant challenges in bringing the more volatile aspects of AME directly within the DEL system. However, there may be an intermediate option which could aim rather at ensuring that particular areas of AME spending could not rise significantly over time without government taking a positive decision to approve such a rise.
seek parliamentary approval for the budgets the government wishes to set for the year ahead, although this is not quite a ‘budget law’ in the sense of a piece of legislation which embodies the budget as a whole.

The National Audit Office (NAO) scrutinises public spending on behalf of Parliament. It verifies the way in which public money is spent and helps public service managers improve performance and service delivery. Local government spending is currently audited by the Audit Commission but the new government is in the process of disbanding the organisation and, in the future, audits will be carried out by private sector auditors.

The United Kingdom has two main levels of government below central government: the devolved administrations which control spending (but do not raise taxes) in Scotland, Wales and Northern Ireland, and local governments which provide local services such as waste collection, street cleaning and local public transport. The devolved administrations are financed through grants from central governments and cannot issue their own debt. Local governments are mainly funded by grants from central government but they also levy a tax based on residence and the value of individual’s homes. They are also prevented from issuing their own debt, but they are permitted to borrow to finance capital investment. Local governments have discretion over the level of this tax (council tax), subject to central limits. The latest Spending Review announced a cut in central funding for local government of 27% in real terms to be implemented between 2010–11 and 2014–15. At the same time, local governments were given more control over their spending but required to commit to a freeze in council tax in order to obtain part of the funding.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

The new fiscal framework has a number of important strengths, including the clearer targets and the independent nature of the OBR which adds credibility and transparency to the policy and forecasting process. Official analyses and forecasts, which benefit from full access to relevant data but which are free from political manipulation, provide a useful aid to public and external assessment of UK fiscal policy and should help constrain the government. The cyclically-adjusted nature of the fiscal mandate allows the automatic stabilisers to operate and the exclusion of investment from the deficit calculation should encourage much needed growth enhancing expenditure. The new fiscal mandate is also much more consistent with the principles of the Stability and Growth Pact and the requirement for Member States to set out a medium-term objective for fiscal policy.

A weakness of the current system is that, in spite of its advantages, the cyclically-adjusted balance is a subjectively calculated variable. History suggests a big risk of errors in assessing the cyclical components of revenues in particular. The creation of the OBR should improve the credibility of such estimates. Also, the forward-looking, rolling fiscal target is open to gaming if the government were to breach its medium-term spending framework and consistently announce plans to consolidate at the end of the forecast period which it postpones by a year every time the forecast period is extended. While this would clearly come with some costs to credibility, these may not always be sufficient deterrent, although the fixed debt target provides a backstop.

A further challenge is that the Spending Review framework has just started to be tested over a prolonged period of decreasing real spending. The risk of departmental overspends will be significantly greater over the coming Spending Review period than in the previous period when spending was consistently rising. The government has not yet set out the full detail of its plans to reinforce the spending control framework to mitigate these heightened risks or specific contingency plans to manage and remedy overspends if they do occur.

Finally, the framework does not include a revenue rule to ensure that any temporary windfall revenues are not used to fund current spending in a way which compromises ongoing stability. Excessive reliance on temporarily high revenues from taxes on financial sector profits and housing transactions was a central cause of the larger-than-average deterioration in the UK fiscal balance after the crisis.

EPC policy advice

With the establishment of a fiscal council (the Office for Budget Responsibility), a fiscal mandate and a net debt target, the UK’s new fiscal framework represents a significant improvement and a good basis for good fiscal policymaking. It could be strengthened further by the following measures.

- The Office for Budget Responsibility (OBR) should conduct and publish its planned detailed analysis of the impact of the economic cycle and asset prices on the fiscal balance. This would reduce the risk of allocating spending on the basis of unsustainable revenue streams and contribute to the credibility of the OBR’s point estimates of the cyclically-adjusted fiscal balance. Additional checks and balances, to avoid the use of revenue windfall increases to fund recurring spending, could be provided through the forthcoming revisions to the spending framework or by setting revenue rules.

- The addition of an explicit medium-term objective as defined in the Stability and Growth Pact. The government could build on the new fiscal mandate by introducing an explicit medium-term objective consistent with the Stability and Growth Pact.
• Strength spending control: as part of the further detail on its spending framework it plans to announce in summer 2011, the government could go further to ensure that the spending review framework will work in an environment of falling budgets by, for example, closer central in-year monitoring of spending performance and explicit contingency plans to manage and remedy any overspends.

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

Expenditure rule in the United Kingdom

General description of the rule and target definition: The Spending Review is a document published every three or four years. The most recent spending review sets out departmental spending plans for the four years until 2014–15. It sets departmental expenditure limits (DELs) for each central government department and for the devolved administrations. The 2010 Spending Review also announced reforms to some welfare spending and public sector pensions.

General government sub-sector(s) to which the rules applies: All spending by all sub-sectors which the government deems it practical to cap in advance. This covered 56 % of spending in 2009–10.

Implementation date: The most recent spending review sets thresholds for the four years to 2014–15. A new spending review is likely to be presented during 2014. In the intervening years, the DEL can be adjusted but this is at the discretion of the Treasury and is rare.

Coverage and exclusions: The main exclusions are social security transfer payments, debt interest, public sector pensions and EU contributions.

Accounting system: ESA 95

Escape clauses: There are no escape clauses.

Time frame: 2011–12 to 2014–15

Details: n/a

Statutory basis: Legal basis

Monitoring: The UK Treasury controls the release of funds to departments and, therefore, monitors respect of spending limits. The OBR monitors the overall fiscal position. The Public Expenditure Committee of the UK Cabinet (PEX) will oversee departments’ implementation of their spending review plans, holding them to account for their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services have been finalised. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

Enforcement mechanisms: The Treasury can refuse to provide additional funding for departments which overspend. Departments that overspend will normally have their budgets reduced by the corresponding amount the following year. Overspenders may also be investigated by the NAO and called to appear before Parliament.

Comments on the functioning of the rule: Breaches of DEL limits have been rare and are typically small. Underspends have been more common.

Fiscal institution in the United Kingdom: Office for Budget Responsibility (OBR)

Date of establishment and description of the main tasks related to fiscal policy: The OBR was created by the new UK government in 2010 to provide independent and authoritative analyses of the UK’s public finances. The OBR was established on a statutory basis (i.e. in UK law) on 22 March 2010. The OBR provides the economic forecasts for the annual budget and assesses whether the government’s policy is consistent with a greater than 50 % chance of achieving the forward-looking fiscal mandate set by the Chancellor. The OBR is also responsible for producing analyses of the sustainability of the public finances, an ex post evaluation of its forecasting performance, and any other analyses on the sustainability of the public finances as it sees fit.

General government tiers at which the institution carries out its tasks: All the fiscal policy decisions of central government: central government funding for local and devolved national governments is included in the overall calculation.

Main outputs released by the institution: The main output of the OBR is the production of the official economic and fiscal forecasts underlying the budgetary decisions. They are required to assess whether the government is on course to meet the medium-term fiscal objectives that it set itself and produce assessments of the long-term sustainability of the public finances and ex post evaluations of its own forecasting performance. The OBR also has the freedom to carry out analyses under its broad remit of ‘examining and reporting on the sustainability of the public finances.’
Role of the institution in the budgetary process: The OBR is in charge of providing the macroeconomic forecasts on which the budget has to be prepared.

Obligation for the government to use the output of the institution: The government intends to use the forecasts prepared by the OBR as the official forecasts (i.e. as the basis of their budgetary plans). The government retains a right to disagree with the OBR’s forecasts but, if it does so, it must explain why to Parliament.

Status of the institution: The OBR is now enacted in primary legislation. It is an independent body with its own funding and staff.

Composition and appointment of the governing board: The Budget Responsibility Committee (BRC) has three members: Robert Chote, the former director of the Institute for Fiscal Studies (IFS); Stephen Nickell, a former economics professor at the London School of Economics and now at Oxford University; and Graham Parker, a high-ranking former civil servant currently working at the IMF. Appointments to the BRC are approved by a parliamentary scrutiny committee. The board will also have two independent non-executives to support and challenge the OBR.

Decisions of the governing board: Decisions are adopted by unanimity.

Staff: The OBR has its own staff (15) and resources and is entirely independent of HM Treasury. The OBR interacts with various government departments and the Bank of England in order to obtain the necessary information and analyses to produce its forecasts. A Memorandum of Understanding (MoU) has been agreed between the OBR and relevant government departments. This MoU has been published and sets out how the OBR will work with key government departments in producing its analyses. The OBR is required to certify government policy costings, indicating whether or not it agrees with the costings and whether or not it has had sufficient time and information to carry out the certification. The Budget Responsibility and National Audit Act 2011 and the Charter for Budget Responsibility set out the full details of the OBR’s role in the fiscal framework.

Comments on the functioning of the institution: The OBR is a welcome establishment and fits neatly within a European trend whereby the conduct of fiscal policy is supported through domestic frameworks.

Medium-term budgetary framework in the United Kingdom

Time frame: Rolling five-year period, currently ending 2015–16, which includes the cyclically-adjusted current balance and debt rules.

Institutional coverage: The whole of the general government sector.

Accounting system: ESA 95

Target revisions and binding objectives: The main target is to achieve a cyclically-adjusted current balance by the end of the rolling, five-year forecast period, currently 2015–16. This is supplemented by a target for public sector net debt as a percentage of GDP to be falling by the fixed date of 2015–16.

Level of detail of expenditure projections: The 2011–12 to 2014–15 Spending Review set out expenditure ceilings for each government department as well as planned cuts in social security payments.

Level of detail of revenue projections: Revenue projections are broken down into each of the main taxes. The overall revenue projection is currently the sum of 32 individual tax receipt projections.

Connectedness with the annual budget law: Maintaining adherence to the five-year rolling fiscal target is a central part of the budget preparation process performed by the UK Treasury. However, the UK’s Finance Bill is different from other budget laws in that it does not give Parliament the opportunity to vote for or against the budget as a whole. Thus, while Parliament can vote for or against the legislative projects in the budget and the spending plans it embodies, it does not have a direct vote for or against the overall budgetary plans.

Monitoring mechanisms: The government has asked the OBR to assess whether policy is consistent with a greater than 50% chance of meeting the fiscal mandate and the target for debt. There is no follow-up or contingency plan in place in the case where the OBR assesses the chance of meeting the target at lower than 50%.

Enforcement mechanisms: If the OBR deemed that the government’s plans were not consistent with a 50% chance of meeting the fiscal mandate and debt target, the government would have to explain why this was the case. No further sanctions are in place.

Targets for sub-central governments: The UK’s sub-national and local governments are primarily funded by central government. Their spending is, therefore, covered implicitly by the controls on overall central government spending. They cannot issue their own debt.

Comments on the functioning of the framework: As the framework is new, there is no basis on which to assess its effectiveness in practice.
Domestic budgetary procedures in the United Kingdom

Prudent economic assumption for the budget preparation:

The creation of the OBR will provide independent and transparent forecasts and assessments of the government’s plans. The OBR’s independence should help to avoid the optimistic bias which appeared to be present in previous fiscal forecasts.

Realistic economic assumptions and reserves:

The forecast figures come from the independent OBR and are currently slightly more pessimistic than the Commission’s forecast. Provisions for a reserve fund are made in annual budgets. The government is also currently giving itself some margin for error by aiming to meet its targets of cyclically-adjusted current balance and falling debt one year ahead of schedule.

Multi-annual planning:

The budget planning is for 2015–16 and, therefore, commits the government to a predefined path for deficit and debt.

The use of top-down budgeting:

The budget is prepared centrally by HM Treasury and this office is responsible for setting the binding expenditure ceilings (i.e. DELs).

Budgetary centralisation at the implementation stage:

The institutional political setting of the United Kingdom means that it has to interact with the devolved assemblies and local governments. The government departments are responsible for defining the details of how they will adhere to the centrally defined DEL (as specified in the spending review); however, the ceiling must be respected.
Second session of the 2011 peer review (15 and 16 November 2011)
1. DESCRIPTION OF THE FISCAL FRAMEWORK

Austria is a federation, where government responsibilities are shared among three different territorial levels: federal, regional (Länder) and local. The Austrian fiscal framework consists of the Fiscal Equalisation Law and the Austrian Stability Pact encompassing all levels of government as well as the medium-term expenditure framework (MTEF), which concerns only the federal government. In addition, on 15 November 2011, the Austrian federal government adopted a proposal for a ‘debt brake’, with the transition to a structural general government deficit of 0.35% of GDP by 2017. It was foreseen in the reform package to extend the MTEF to the Länder level. Subsequently, following negotiations on the debt brake with sub-national authorities, the proposed deficit limit was raised from 0.35% to 0.45% of GDP.

The three layers of government coordinate their medium-term budgetary plans in the Fiscal Equalisation Law (Finanzausgleichsgesetz — FAG), which allocates the revenues to territorial authorities for the period of six years. The law specifies the types of taxes that are to be shared among the three levels of government, as well as the proportion at which they are to be divided among them. Revenues from most of the tax categories are collected by the federal government and then distributed to the three levels according to the key agreed on in the FAG negotiations. A part of the revenue from the shared taxes is withheld before the distribution to the various levels of government and earmarked for special purposes, for example to finance family benefits. The FAG also determines the horizontal distribution of revenues at the regional and local level.

The Austrian Stability Pact (ASP), which prescribes deficit/surplus targets (so-called stability contributions) to the federal, regional and local governments, was first set up informally in 1996 in the context of Austria’s preparation for entering the euro area, which required significant fiscal consolidation. The ASP was meant to solve the asymmetry created by the high degree of decentralisation of fiscal policy responsibilities at national level, on the one hand, and the introduction — at the European level — of rules (i.e. the Stability and Growth Pact (SGP)) on the other hand, assigning responsibility for the general government balance solely to central governments. In 1999, this enforcement mechanism was formalised for the first time. Its successors were then adopted for the 2001–04, 2005–08, 2008–13 and 2011–14 periods. The FAG foresees financial sanctions in the case that the state does not ratify the ASP. Once the ASP is ratified, it fixes the amount of the sanction in cases of non-compliance, which takes the form of an interest-bearing deposit. If, in the following year, the respective target is not reached, the deposit is supposed to be transferred to those governments that are in compliance. However, if the target is achieved, the deposit would be reimbursed. The sanction option has never had to be used under the Pact as it covered aggregated deviations from numerical targets (i.e. negative deviations at some government level were compensated by positive deviations in others).

The medium-term expenditure framework (MTEF) concerns only the federal government and is accompanied by a budget strategy report, which was introduced in January 2009 in order to enhance budgetary stability. Under the new rules, the parliament is obliged to adopt a four-year plan setting expenditure limits in nominal terms for the five main budgetary headings (rubrics) and then roll it forward by one year every spring. However, expenditure ceilings are divided into fixed (about 80% of total expenditure) and flexible (for the remaining 20%). The latter concerns, inter alia, areas which depend on cyclically-sensitive expenditure such as unemployment benefits. Ceilings are also set at sub-heading level (chapters), but these are binding only for the following year and have an indicative character for the remaining three years. At the same time, line ministries are given the freedom to build unlimited reserves from any unspent appropriations at the end of the year, thereby encouraging a more efficient use of resources.

The introduction of the MTEF constituted the first part of a far-reaching reform of the budgetary framework law. The second part of the reform, scheduled to come into force in 2013, foresees the introduction of a new budget structure (global budgeting instead of line item budgeting (50)), results-oriented management of administrative units, output-based budgeting (performance budgeting) and the modernisation of the public administration’s accounting system.

It is noteworthy that the budgetary law is prepared on the basis of economic projections provided by the Austrian Institute for Economic Research (WIFO), which is independent of the government. The Government Debt

(50) Currently, there are more than one thousand legally binding appropriations. As a result of the reform, only around 70 legally binding ‘global budgets’ will remain.
Committee (GDC) and the Institute for Advanced Studies (IHS) also play a substantive role by providing high-quality analyses of public finances and issuing recommendations aimed at fiscal consolidation.

2. Assessment of the current framework

Generally, Austria has a good track record for complying with the rules which the law sets for the process of the preparation and execution of the budget. The set-up of the Austrian fiscal framework has been conducive to enhancing budgetary discipline and avoiding procyclical policies. However, it has not brought about the achievement of one of the government’s fiscal strategy goals (i.e. a balanced budget over the business cycle). Therefore, certain aspects of the Austrian fiscal framework need improvement.

To begin with, it is widely acknowledged that the rules set out in the FAG, which define relations between the three layers of government, are rather complex and lacking transparency. Not only are revenues from most individual taxes shared among the different territorial levels by fixed proportions, but also decision-making in many areas is divided among various levels of authority. Revenue-raising and spending responsibilities for various activities do not reside within the same level of government. The Austrian health sector is a notable example of inefficiencies stemming from the current set up.

Secondly, the ASP is a useful tool aimed at involving all levels of government in the consolidation of public finances. In providing for legally enshrined budgetary commitments across various government levels, Austria may serve as a benchmark in the EU. Nevertheless, it should be noted that after an initial stage of general compliance with the Pact in the years 1999–2002, slippages occurred in individual years at all levels of government. However, since according to the ASP’s rule, the targets were met on average within the duration of the subsequent Pacts, sanctions foreseen by the ASP have never had to be used. Initially, budgetary surpluses were meant to make up only for the slippages in the past and were not supposed to be carried over to future years. Subsequently, the initial approach towards carry-overs was criticised as procyclical and the carry-over of surpluses was admitted with the aim of reaching the goals on average within the duration of the Pact. It should be noted that, striving to fulfil their obligation under the ASP, sub-national governments resorted to some methods that go against the spirit of the Pact, such as reclassification of public entities, transfer of real assets to various federal and regional real estate companies, etc. These were, however, not accepted as part of the stability contributions. Following the recent financial and economic crisis, the discrepancy between the ASP goals and the budgetary outcomes became so significant that the goals were revised in March 2011. This revision was accompanied by the strengthening of the enforcement mechanism of the Pact, which consisted, inter alia, shifting the focus back to attaining the budgetary goals in individual years, enhancing the role of the Court of Auditors and making the launch of the sanctioning procedure automatic. This may increase the effectiveness of the Pact but, at the same time, it should be noted that the revised budgetary goals under the Pact are significantly less ambitious than those in the past. In the Pact editions between 2001 and 2010, the local and state governments were required to run balanced budget or come up with surpluses, respectively, whereas now deficits (albeit gradually decreasing) are allowed on both levels. Furthermore, the federal government now has the right to close its books with much greater deficits than in the past (average deficit of 2.5 % of GDP in the period 2011–14 versus 1.2 % of GDP in the years 2001–10).

Thirdly, the introduction of the MTEF for the federal government is a welcome step on the way to making the budgetary process more predictable. Setting global expenditure ceilings before discussing specific appropriations should allow for a longer-term-oriented policy debate while, at the same time, fostering fiscal discipline. Making some of the ceilings flexible allows the government scope for manoeuvre during economic downturns. Last but not least, it should be borne in mind that the MTEF only encompasses the federal government expenditure, which amounts to about 50 % of total general government expenditure. The extension of the framework to sub-national authorities could complement the ASP and, thereby, significantly contribute to enhancing overall budgetary discipline. As the MTEF has only been in force since 2009, it is too early to judge its effectiveness in the long term. Nevertheless, it seems that in 2009 and 2010, the framework contributed to the general government deficit being lower than anticipated. The results were better than expected largely due to the change in the behaviour of the line ministries, which refrained from spending all the unused appropriations at the end of the year as they were given the possibility to carry them over to the next year. However, the accumulation of these reserves also constitutes a risk due to their relative size (at the end of 2010, they amounted to around 13 % of general government expenditure). A mitigating factor here is that the bulk of the reserves fall under the remit of the Ministry of Finance (MoF). Nevertheless, since they are being used to ‘finance’ the gap in a given category between the expenditure planned in the MTEF and the expenditure planned in the subsequent budget law for the given year, the size of these reserves somewhat diminishes the stringency and predictive power of the framework.
**EPC policy advice**

The set-up of the Austrian fiscal framework has been conducive to enhancing budgetary discipline and avoiding procyclical policies. However, it has not enabled Austrian authorities to achieve one of the government’s fiscal strategy goals (i.e. a balanced budget over the business cycle). In this context, national authorities should introduce the following measures.

- Align legislative, administrative, revenue-raising and spending responsibilities across the different levels of government, in particular in the area of healthcare.
- Ensure that the Austrian framework has a bearing on sub-national government levels, by extending the medium-term budgetary framework to them and enforcing the corrective mechanisms of the Austrian Stability Pact if need be.

### 3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

**Fiscal rule in Austria: The Austrian Stability Pact (ASP)**

**General description of the rule and target definition:** The ASP prescribes deficit/surplus targets (so-called stability contributions) to the federal, regional and local governments, supported by a sanctioning mechanism.

**General government sub-sector(s) to which the rules applies:** Federal, regional and local governments

**Implementation date:** Formally introduced in 1999

**Coverage and exclusions:** All levels of government

**Accounting system:** The targets are defined in terms of ESA 95.

**Escape clauses:** Firstly, until 2006, the ASP’s accounting rules were not fully in line with those of ESA 95. Secondly, revised deficit targets can be negotiated among the governments in case of an exceptional burden, in particular revenue shortfalls and expenditure increases due to a severe economic slowdown.

**Time frame:** Usually adopted for a period of four years

**Details:** Budgetary surpluses were initially intended to make up only for the slippages in the past and were not supposed to be carried over to future years. The initial approach towards carry-overs was criticised as procyclical and in the wake of major tax reforms turned out to be inflexible. As a consequence, the carry-over of surpluses was admitted. However, in March 2011, it was agreed to return to focusing on the attainment of prescribed goals in individual years.

**Statutory basis:** Legal basis

**Monitoring:** A coordination committee among the different levels of government monitors compliance and would, if necessary, ask the Court of Auditors to establish a violation. Following a report by the latter, a mediation committee would have to decide unanimously by February in the second year after the violation whether sanctions are due. The committee consists of two representatives of the federal government and two representatives of state or local governments. The latter cannot be nominated by the state or commune that failed to comply with the pact.

**Enforcement mechanisms:** The ASP fixes the amount of the sanction (the mechanism is similar to that applicable under the SGP), which takes the form of an interest-bearing deposit. If, in the following year, the respective target is not reached, the deposit is transferred to those governments in compliance, and reimbursed otherwise.

**Comments on the functioning of the rule:** After an initial stage of general compliance with the Pact in the years 1999–2002, slippages occurred in individual years at all levels of government. However, since according to the
ASP’s rule, the targets were met on average within the duration of the subsequent Pacts, to date, sanctions foreseen by the ASP have never had to be used.

Fiscal institution in Austria: Austrian Institute of Economic Research (WIFO)

Date of establishment and description of the main tasks related to fiscal policy: The WIFO was established in 1927. Its mission is to analyse economic developments in Austria and abroad, thereby contributing to the establishment of a sound basis for economic policy and entrepreneurial decision-making and ensuring that economic policy discussion is at an objective level. In particular, the WIFO provides independent forecasts and projections that are used for the budget preparation.

General government tiers at which the institution carries out its tasks: All layers of government

Main outputs released by the institution: Short-term economic forecasts four times a year; a medium-term economic forecast annually; analyses of fiscal policy developments

Role of the institution in the budgetary process: The WIFO provides macroeconomic forecasts — the budget is prepared on this basis.

Obligation for the government to use the output of the institution: No obligation, but a long-standing practice

Status of the institution: Private non-profit association

Composition and appointment of the governing board: Seventeen members who are representatives of various public institutions as well as the Austrian political, economic and academic community

Decisions of the governing board: Decisions are taken by a majority vote

Staff: The WIFO employs around 100 people working full-time.

Comments on the functioning of the institution: The WIFO is renowned for high-quality economic research based on the latest empirical methodologies and a solid knowledge of institutional and political structures. The Institute provides economic forecasts, which are realistic, unbiased and one of the most accurate ones.

Fiscal institution in Austria: Austrian Institute for Advanced Studies (IHS)

Date of establishment and description of the main tasks related to fiscal policy: The Institute for Advanced Studies, founded in 1963, is Austria’s premier postgraduate research and training institute. It combines theoretical and empirical research in economics and other social science disciplines. Through the interaction between scientific theory and practice, the IHS provides innovative value-added services to policymakers and business practitioners.

General government tiers at which the institution carries out its tasks: All layers of government

Main outputs released by the institution: Short-term economic forecasts four times a year; analyses and recommendations in the area of fiscal policy; long-term forecasts provided for the national pension projections.

Role of the institution in the budgetary process: No formal role, but the government generally consults the IHS on the budgetary plans.

Obligation for the government to use the output of the institution: No obligation, but the government typically provides a public statement on the assessment of the budget.

Status of the institution: Private non-profit organisation: at present nearly 40% of the Institute’s budget is accounted for by commissioned research. The remaining funding is provided by subsidies from the Federal Ministry of Education and Science, the Austrian National Bank, the City of Vienna and other institutions.

Composition and appointment of the governing board: The Kuratorium consists of 10–20 people. It elects a director (from academia, in charge of management, scientific issues and representation), a president and a deputy president.

Decisions of the governing board: Decisions are taken by a simple majority.
**Staff:** The institute counts approximately 80 scientific employees and 26 administrative employees. About 40 students are presently participating in the postgraduate course programmes.

**Comments on the functioning of the institution:** The IHS is renowned for high-quality economic research based on the state-of-the-art economic models and empirical methodologies. The Institute provides economic forecasts which are realistic and unbiased.

**Fiscal institution in Austria: Government Debt Committee (GDC)**

**Date of establishment and description of the main tasks related to fiscal policy:** The GDC was established in 1970 and is charged with the analysis of public finances and presentation of recommendations on the fiscal policy.

**General government tiers at which the institution carries out its tasks:** All layers of government.

**Main outputs released by the institution:** Evaluation and forecast of the financial and political situation regarding the goals of Austria’s fiscal policy and the development of money and capital markets; annual report on the recommendations made to the MoF.

**Role of the institution in the budgetary process:** Analysis of the sustainability and quality of the budgetary policy of public budgets; presentation of written recommendations concerning the government’s fiscal policy.

**Obligation for the government to use the output of the institution:** The Minister of Finance has to present to the parliament and the federal government the annual report on recommendations prepared by the GDC.

**Status of the institution:** Independent committee.

**Composition and appointment of the governing board:** The president is the member first ranked by the federal government. The vice-presidents are the first ranked members nominated by the other bodies.

**Decisions of the governing board:** Passed by a simple majority: in the case of a tied vote, the chairman’s vote determines the result.

**Staff:** The GDC consists of experts in financial and budgetary affairs: six members from the federal government; three from the Austrian Chamber of Commerce; three from the Federal Chamber of Labour; one member from each the following organisations: Austrian Association of Municipalities, the Association of Austrian Cities and the Conference of Provincial Governors. The Austrian central bank is authorised to take part in each meeting of the GDC in an advisory capacity. The staff of the GDC is paid for by the Austrian central bank.

**Comments on the functioning of the institution:** The GDC provides high-quality research analysis of Austria’s public finances. Whereas during the first two decades of its existence, the GDC concentrated on debt management as such, since the early 1990s, budgetary policy has become the focus of its analysis — making the GDC a relentless promoter of fiscal consolidation.

**Medium-term expenditure framework (MTEF) in Austria**

**Time frame:** Four years (i.e. t+1, t+2, t+3 and t+4): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

**Institutional coverage:** Only the federal government sector.

**Accounting system:** The targets are defined in terms of budgetary accounting.

**Target revisions and binding objectives:** The ceilings are binding at heading level for four years and at chapter level for the following year.

**Level of detail of expenditure projections:** The framework sets four-year expenditure limits in nominal terms for the main five budgetary headings (rubrics) and then rolls it forward by one year every spring. However, expenditure ceilings are divided into fixed (for about 80% of total expenditure) and flexible (for the remaining 20%). The latter concerns areas which depend heavily on cyclical fluctuations, such as labour market allocations. Ceilings are also set at subheading level (chapters), but these are binding only for the following year and they have only indicative character for the remaining three years.
Level of detail of revenue projections: A strategy report, which is produced with every MTEF, includes a projection of revenue which shows not only the whole amount of projected revenue but also its most important components.

Connectedness with the annual budget law: The MTEF is supposed to constitute a basis for the preparation and execution of the budget in the following year.

Monitoring mechanisms: None

Enforcement mechanisms: As the budget law has a constitutional fundament, a breach of the MTEF would not be in compliance with the constitution. The annual budget proposal would, as a consequence, be lifted.

Targets for sub-central governments: None

Comments on the functioning of the framework: Since the medium-term expenditure framework was only introduced in 2009, it is still too early to judge its effectiveness in the long term. However, because of its design, the new framework has great potential to enhance budgetary discipline and it clearly contributed to the 2009 and 2010 general government deficit ending lower than initially anticipated.

Domestic budgetary procedures in Austria

Prudent economic assumption for the budget preparation

The Austrian budget is prepared on the basis of prudent and realistic macroeconomic assumptions as these are based on independent forecasts provided by the WIFO (Austrian Institute of Economic Research). The good quality of these forecasts is further supplemented by a high degree of transparency in the dissemination of WIFO’s forecasts, including a public disclosure of the methodology and the main external assumptions of these projections.

Centralisation of the budget process at the planning stage

The MoF plays a central role in the budgetary process at the planning stage. Each year, it prepares a budget forecast, including consolidation targets and the measures underpinning them, which are then adopted at the political level. Subsequently, the Minister of Finance issues directives to line ministries concerning the design of their budgets, which sets global staff numbers, operating expenditure, revenues and maximum budgetary balances. Line ministries have the right to set their own priorities within the imposed limits. The Minister of Finance prepares a draft budget, which it presents to the parliament for debate and adoption.

The use of top-down budgeting

A top-down budgeting procedure was introduced in Austria in 1996 in order to improve the budgetary planning and bring public finances on to a sustainable path (51).

Fiscal governance in Belgium

1. Description of the Fiscal Framework

At the end of the 1980s, the large public deficits and increasing debt ratios coupled with a marked fiscal decentralisation resulting from a series of institutional reforms convinced Belgian authorities to reinforce the institutional fiscal setting. This strong need to improve fiscal policymaking was further underpinned by the launch of the European Monetary Union (EMU) process in the early 1990s, which gave Belgium an additional incentive to try to reduce its deficit and very large public debt (134.2% of GDP in 1993, the EU record at that time).

As a result, a thorough reform of the existing fiscal framework was undertaken. Its main features were an increasing recourse to independent fiscal institutions and the introduction of a set of ad hoc numerical rules. Independent fiscal institutions were put in place, although designed with an advisory character. Firstly, the National Account Institute (NAI) was established in 1994. This is an administrative body coordinating some activities of the Federal Planning Bureau (FPB), the National Bank of Belgium and Statistics Belgium. The FPB, which has existed as such since the late 1950s, is in charge of providing macroeconomic forecasts for the preparation of the budget. Secondly, the existing High Council of Finance (HCF) was reformed: a new section covering public sector borrowing requirements was set up in 1989, in order to advise the government on public finance issues. Since 1992, this section has also been in charge of monitoring the fiscal policy of regional governments and of formulating medium-term financial objectives for the federated entities (52). Finally, following various reports on population ageing and its impact on public finances, a study group on ageing was created within the HCF in 2001.

In parallel, the 1990s saw a significant reinforcement of the existing rule-based framework (Table 1). However, among these rules, only the ceiling on healthcare expenditure and the nominal balance (or surplus) of the regional governments (53) are still in force (54). As for the ceiling on health spending, it has been considerably watered down through the progressive increase from 1.5% to 4.5% a year in real terms (i.e. at a level which is hardly a binding expenditure ceiling).

As a consequence, in the mid-1990s, the whole general government finances were covered by numerical rules in a context of a high regionalisation of public expenditure. These developments were accompanied by a more explicit use of multi-annual fiscal planning with a view to promoting fiscal consolidation over the medium-term and ensuring Belgium’s membership of the EMU. It needs to be highlighted that the political will to secure this membership certainly played an important role as the institutional framework in the fiscal consolidation which took place at that moment.

(52) In theory, the HCF may recommend that the Federal government restrict debt issuance from a federated entity in case of fiscal slippages, but in practice this option has never been used.

(53) The Region and Communities have decided to reach this objective in 2011 (Flemish Community), in 2014 (Walloon Region and French speaking Community) and 2016 (Brussels Region).

(54) A nominal balance (or light surplus of +0.2%) in 2015 is a target for the general government. Budget balance rules for local authorities and Social Security are in force too.
Table 1: Domestic numerical fiscal rules in Belgium since the 1990s (current — obsolete)

<table>
<thead>
<tr>
<th>Type of rules and time span</th>
<th>Body subject to rule</th>
<th>Details</th>
<th>Sanctions/enforcement</th>
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<tbody>
<tr>
<td>Expenditure</td>
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<td></td>
<td>Social Security</td>
<td>Rule on the real growth of the expenditure ceiling for health spending: initially 1.5% p.a. in real terms, 2.5% 2000–04, and 4.5% since 2004</td>
<td>In law. Automatic compensation mechanism.</td>
</tr>
<tr>
<td>Balance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990–present</td>
<td>Local governments</td>
<td>Annual nominal budget balance</td>
<td>In law. Regions automatically responsible for correcting slippage.</td>
</tr>
<tr>
<td>1992–present</td>
<td>Social security</td>
<td>Nominal budget balance</td>
<td>In the coalition agreement. No sanctions planned.</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995–99</td>
<td>Federal government</td>
<td>Growth of revenues must follow nominal GDP growth</td>
<td>In the coalition agreement. No sanctions planned.</td>
</tr>
</tbody>
</table>

*Source: OECD, Belgian authorities*

As mentioned previously, fiscal decentralisation has increasingly become one of the main features of the Belgium fiscal setting. Currently, the federal state accounts for half of all revenues and more than 55% of the total expenditure of the general government (GG). However, more than half of its expenditure is from transfers to Entity II (sub-central government levels i.e. communities and regions, and local authorities) and social security. Conversely, two thirds of revenues of the communities and regions as well as half of the revenues of local authorities come from transfers from other sub-sectors of the general government, for the most part, the federal state. As far as social security is concerned, it accounts for about 40% of total government expenditure \(^{(55)}\), while one third of its resources come from transfers from the federal state (Table 2).

Table 2: Budget shares of main government entities in 2010

<table>
<thead>
<tr>
<th>% of total GG revenues and expenditure</th>
<th>% of GDP</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>Expenditure</td>
<td>Revenues</td>
</tr>
<tr>
<td>Federal state (Entity I) of which transfers from/to other government levels</td>
<td>54.4</td>
<td>56.1</td>
</tr>
<tr>
<td>(0.1) (32.9)</td>
<td>(0.1) (17.4)</td>
<td>—</td>
</tr>
<tr>
<td>Communities and regions (Entity II) of which transfers from/to other government levels</td>
<td>29.4</td>
<td>28.3</td>
</tr>
<tr>
<td>(20.0) (4.8)</td>
<td>(9.8) (2.5)</td>
<td>—</td>
</tr>
<tr>
<td>Local authorities (Entity II) of which transfers from/to other government levels</td>
<td>14.1</td>
<td>13.5</td>
</tr>
<tr>
<td>(7.0) (0.1)</td>
<td>(3.4) (0.1)</td>
<td>—</td>
</tr>
<tr>
<td>Social security (Entity I) of which transfers from/to other government levels</td>
<td>43.5</td>
<td>40.3</td>
</tr>
<tr>
<td>(14.1) (0.1)</td>
<td>(6.9) (0.1)</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*NB: Numbers in brackets account for amounts that are transferred from/to other government levels.*

\(^{(55)}\) Strictly speaking the Social security is not another full-fledged government level: decisions on social policy are made by the Federal Government.
In a context of the high and rising autonomy of communities and regions over their budgets, coordination of fiscal policy between the different levels is crucial. A key element of the coordination mechanism is the annual advice to the government of the public sector borrowing requirements section of the HFC on the budgetary policy to be adopted. This advice includes recommendations on the budgets of the various levels of government for the years to come. It forms the basis of a series of budgetary conventions, which lead to political agreements between governments at federal and regional level, setting the medium-term budgetary targets for the different levels of government and acting as ‘internal stability pacts’.

This institutional arrangement has included some enforcement mechanisms in case the budgetary targets for sub-central governments are not respected (e.g. restrictions on debt issuance). So far, this institutional mechanism for fiscal policy coordination has worked broadly satisfactorily, at least until the beginning of the crisis. However, there is no enforcement mechanism to ensure fiscal discipline at regional level in order to ensure that the regions are running sufficient surpluses to offset the deficits at the central level. Furthermore, the budget for social security is ‘balanced’ but only because of earmarked contributions from the federal government (and at the expense of increasing the federal government deficit).

The Belgian budget process has thus gradually taken the form of a series of agreements or conventions not only between the political parties of the governing coalition (56) but also between the different government layers. This entailed a strong emphasis on budgetary targets, mainly expenditure ceilings, negotiated among all members of the executive to centralise the budget preparation, which in turn are backed by a multi-annual fiscal programme as part of the coalition contract among the ruling parties. In this context, the Minister of Budget (57) is vested with rather strong monitoring powers at the implementation stage of the budget process but with relatively few agenda-setting powers. In the Belgian case, the use of independent macro-forecasts and the growing consideration of long-term sustainability issues for the budget preparation as well as the coordination across general government tiers are key features of domestic budgetary procedures. The main fiscal revenues (personal income tax, VAT, corporate income tax) are projected by the Ministry of Finance according to a fairly transparent macroeconomic method which uses the FPB’s forecasts as inputs (households’ disposable income, consumption, business profitability …). Other revenue forecasts are based on autonomous estimations from the Ministry of Finance.

Overall, this institutional approach has probably contributed to the rather positive results achieved by Belgium in terms of fiscal discipline and debt reduction (even though the political will to ensure the country’s accession to the EMU also certainly played a role). The debt had considerably declined from the peak reached in the early 1990s to the onset of the current crisis (50 percentage points of GDP in less than 15 years, from 131.2 % in 1993 to 84.2 % in 2007). Likewise, the framework proved its resilience in the 1990s by making budgetary consolidation compatible with a strong process of fiscal decentralisation. However, symptoms of "fiscal fatigue" clearly appeared after accession to EMU, which led to a gradual weakening of the fiscal framework: for example, the two fiscal rules applied to the central government were abolished in the late 1990s, while the target definition of the expenditure rule for the social security was significantly watered down in 2000.

2. Assessment of the current framework

As stressed in the previous section, the performance of the framework introduced about 20 years ago has been broadly positive. However, fiscal rules have been progressively relaxed as the budget balance and the debt ratio have improved: public debt had been very substantially reduced between the early 1990s and the onset of the economic and financial crisis (from a peak of 134.2 % of GDP in 1993 to a minimum of 84.2 % in 2007) but this decreasing path was reversed in the context of the crisis and the debt ratio is again close to 100 % (96.2 % at the end of 2010) (58). Furthermore, as in most EU countries, the adverse budgetary impact from ageing is expected to add further strain on public finances in the medium term. Additionally, the process of fiscal decentralisation is continuing and may complicate the implementation of sound and sustainable budgetary policies. The current Belgian fiscal framework will undergo non-negligible changes as a result of the new agreement on institutional reforms which was concluded in October 2011. This calls for adequate measures so as to reinforce the domestic fiscal framework with a view to tackling these challenges and ensuring the continuation of the stability-oriented policies implemented in Belgium since the 1980s.

(56) Primarily due to its proportional representation system, Belgium has nearly always had coalition governments (with only a few short-lived exceptions) since the end of World War I.

(57) In the past, controlling the execution of the budget was the responsibility of the Minister of Finance, as the two functions were not separated.

(58) However around half (6.1%) of the increase between 2007 and 2010 is linked to one-off interventions in the financial sector.
The current fiscal framework in Belgium strongly relies on the two existing independent bodies (i.e. the FPB and the HCF), which continue to positively influence public finance developments. By contrast, numerical fiscal rules and medium-term budgetary frameworks (MTBFs) appear to be less developed (as many of the former numerical rules have been abandoned) and show some shortcomings, which has contributed to frequent slippages in the past and constitute a risk in the current fiscal situation. In particular, the absence of a genuine binding multi-annual budgetary framework might hamper the consolidation process. The inclusion of a preview of the 2011 Budget in the 2010 Federal budget was a first step towards a more effective multi-annual budgeting, but it should be extended to all government levels, be elaborated in more detail, and cover a longer time period.

However, the reinforcement of the binding character of the MTBF only seems feasible if it is supported by more constraining fiscal rules paying more attention to expenditure growth on a multi-annual basis. Specifically, in order to avoid expenditure slippages in a context of strict budget consolidation requirements, the introduction of multi-annual and binding expenditure ceilings would be warranted. Such expenditure ceilings should be sustainable and thus in line with potential GDP growth. This also implies that the existing ceiling for healthcare expenditure (+ 4.5 % per year plus inflation) (59) should be made more constraining.

As previously mentioned, the strong — and increasing — decentralisation of public finances clearly requires an equally strong coordination across government layers within the budget process. In order to give the regional entities more incentive to contribute to the consolidation effort, it could also be envisaged that effective mechanisms are developed to ensure that the different government tiers comply with the predefined targets. Each government could then prepare detailed multi-annual budgetary strategies based on these targets. In addition, increasing the impact of the budgetary and economic choices of the regions and communities on their budgetary position can be useful. Such a concern has inspired some of the institutional changes that have recently been decided. However, the way their policies will be coordinated among themselves and with that of the federal government has not yet been determined.

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**EPC policy advice**

Following a significant and largely successful debt reduction strategy during the 1990s, in which a tight framework of fiscal rules played a non-negligible role, Belgium has relaxed the stringency of its fiscal setting in the past decade. Moreover, deficits and debt are again on the rise as a result of the crisis, though less so than in most other Member States. In this context, national authorities should introduce the following measures.

- In order to supplement the objectives defined in terms of budget balance, revive and possibly tighten (including at the regional and local levels) the system of expenditure and revenue rules, which was instrumental in markedly improving Belgium’s public finances in the 1990s. In particular, the authorities should embed the spending ceilings from the MTBF in a multi-annual expenditure rule with the broadest possible coverage in line with best practices.

- Taking into account the size of the fiscal challenge Belgium is facing, including its debt ratio and the pressures arising from population ageing, develop multi-year fiscal planning coordinated between all layers of government.

- Given the increasing fiscal autonomy of the regions, revive and strengthen the kind of ‘internal stability pact’ that was in place between the different government layers in the 1990s, allowing greater fiscal coordination.

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(59) Measured by the ‘health index’ which excludes car fuel, tobacco products and alcoholic beverages.
3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

Fiscal rule in Belgium: Expenditure rule

General description of the rule and target definition: Since 2004, the real growth in healthcare expenditure cannot be greater than 4.5% (originally 1.5% and increased to 2.5% between 2000 and 2003). Moreover, what was initially an expenditure ceiling de facto became a kind of guaranteed increase, since, in case of slower expenditure growth, surpluses (with respect to the limit) were used to build up reserves, which could subsequently be used to finance additional health expenditure.

General government sub-sector(s) to which the rules applies: Social security sub-sector (Entity I) (60)

Implementation date: The rule was approved in 1994 and implemented from 1995 onwards.

Coverage and exclusions: The rule covers healthcare expenditure financed by the social security, which accounts for more than 10% of general government expenditure. According to the regulation of the rule, due to (non-defined) ‘exogenous factors’, exclusions from the rule coverage can be decided case by case, which may allow increase to benefits on a discretionary basis.

Accounting system: The target is defined in terms of budgetary accounting, maintaining consistency with ESA 95 methodology.

Escape clauses: There are no predefined escape clauses. However, an expenditure ceiling of 4.5% in real terms does not make such clauses very necessary.

Time frame: Multi-annual framework: in 2003, a time horizon planning corresponding to the end of the prevailing legislature was introduced.

Details: The introduction of the rule was related to the Maastricht Treaty and to the obligation to submit the stability and convergence programme (SCP) annually, which called for a multi-annual fiscal strategy.

Statutory basis: Legal basis

Monitoring: There is no formal monitoring. However, the national parliament and two independent authorities (the Court of Auditors and the High Council of Finance) regularly assess respect of the rule. Internal monitoring is conducted by the Office of the Minister of Healthcare and by social partners participating in a specific committee dealing with public health issues.

Enforcement mechanisms: Mutual funds can be penalised if health expenditure surpasses the established limits. In cases of non-compliance, the following year’s health budget may be capped to restore an appropriate health spending growth consistent with the rule. The Ministry of Health is responsible for these enforcement measures but needs the approval of the Council of Ministers.

Comments on the functioning of the rule: The rule was significantly weakened after the first adjustment of the target in 1999. This reflected the same difficulties observed in other EU countries in efficiently controlling healthcare expenditure and some fiscal consolidation fatigue after EMU qualification. However, it is possible that, if the rule had not been implemented, health expenditure developments could have been even more adverse.

Fiscal Institution in Belgium: National Account Institute (NAI) (61) including the Federal Planning Bureau (FPB) (62)

Date of establishment and description of the main tasks related to fiscal policy: The NAI was established in 1994 in order to ensure the quality and the independency of the main Belgian economic statistics and macroeconomic forecasts upon which the budget is based, as well as to improve their credibility at the international level. It coordinates the production of main national macroeconomic statistics and assists national authorities in interpreting the ESA 95 Regulation. It covers, inter alia, the Federal Planning Bureau, which provides independent forecasts and projections that are used for the budget preparation (the Federal Planning Bureau itself was created in the late 1950s).

General government tiers at which the institution carries out its tasks: The whole general government sector

Main outputs released by the institution: The main output of the FPB ‘branch’ of the NAI is the preparation of macroeconomic forecasts, ensuring high-level quality.

(60) The Belgian Government is split into Entity I, which comprises the Federal Authority and Social Security, and Entity II, which consists of the Communities and Regions, and the local authorities.
(61) ICN-INR (Institut des comptes nationaux-Instituut voor de Nationale Rekeningen)
(62) FPB-BFP (Federaal Planbureau-Bureau fédéral du Plan)
**Role of the institution in the budgetary process:** The FPB ‘branch’ of the NAI is in charge of providing the macroeconomic forecasts on which the budget has to be prepared.

**Obligation for the government to use the output of the institution:** The current legislation does not make the use of the FPB’s forecasts compulsory for the budget preparation. In practice, however, the government has almost always resorted to those forecasts for the preparation of the annual budget law; in the few cases when the FBS’s forecasts were not considered, fiscal authorities based their projections on more prudent assumptions than those assumed by the FPB. However, the Ministry of Finance (MoF), which is responsible for translating these macroeconomic forecasts into revenue projections, nonetheless, has some leeway in forecasting the impact of new measures.

**Status of the institution:** The provisions related to the status of the NAI are enshrined in a law. Although it is attached to the Ministry of Economy, it is autonomous.

**Composition and appointment of the governing board:** The board consists of seven members: a high civil servant of the Ministry of Economic Affairs; the governor of the central bank; the FPB commissioner; the director-general and a civil servant from Statistics Belgium; and two members proposed respectively by the central bank and the FPB. The four first members are appointed for an unlimited period and the remaining three for a four-year period (renewable). They are appointed by the government.

**Decisions of the governing board:** Decisions are adopted by a majority

**Staff:** The NAI has been created to coordinate the production of the main national macroeconomic statistics and the macroeconomic forecasts underlying the federal budget and to ensure the independency and the quality of these statistics. It functions like a committee (i.e. it has no staff or resources of its own), consisting of representatives from the Ministry of Economic Affairs, the Federal Planning Bureau, the central bank and Statistics Belgium. The National Bank of Belgium (the central bank) is in charge of the production of statistics for the national and regional accounts, foreign trade statistics, and financial accounts; the Federal Planning Bureau is in charge of short-term macroeconomic forecasts, input-output tables, etc.; and Statistics Belgium is in charge of collecting the data.

**Comments on the functioning of the institution:** The FPB is a successful example of the role that these independent bodies can play in improving the conduct of fiscal policy domestically. Specifically, the FPB has been involved in the budgetary process through the provision of independent macroeconomic forecasts for the annual budget law. There is broad agreement that these independent forecasts have not only entailed the availability of unbiased macroeconomic projections for the budget preparation, but they have also provided more realistic macroeconomic scenarios on which economic policy decisions are adopted.

**Fiscal institution in Belgium: High Council of Finance (HCF)**

**Date of establishment and description of the main tasks related to fiscal policy:** Established in the 1930s and significantly reformed in 1989, the HCF is an advisory committee to the government, in charge of analysing budgetary, financial and fiscal problems and of proposing ‘desirable adaptations or reforms’.

The HCF is organised around three main themes related to fiscal policy: it comprises two sections, one in charge of public sector borrowing requirements and the other one of taxes and other revenues, plus a study committee on ageing (administered by the FPB).

**General government tiers at which the institution carries out its tasks:** All tiers — the HCF was reformed in full in 1989 to accompany the regionalisation of Belgium with the particular task of monitoring the fiscal policy of regional governments. It monitors the coordination of budgetary objectives at federal (central) and devolved levels.

**Main outputs released by the institution:** The ‘Public sector borrowing requirement’ section publishes an annual report assessing the execution of the stability programme of the previous year, and analysing the short to medium-term perspective for the upcoming stability programme (usually with a four-year outlook), with recommendations on fiscal targets. The study group on ageing produces an annual report including projections of age-related budgetary expenditures. The ‘Tax and revenue’ section publishes occasional opinions on key (long-term) fiscal policy issues.

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(63) The involvement in the national domestic process is a key element to ensure the success of these independent bodies in effectively influencing fiscal policymaking.

(64) HRF-CSF (Hoge Raad van Financiën-Conseil supérieur des Finances)

Role of the institution in the budgetary process: Production of policy recommendations on medium-term fiscal targets and assessment of stability programmes.

Obligation for the government to use the output of the institution: Advisory role

Status of the institution: Formally, affiliated to the Finance Ministry, but it is an independent body, established by special law.

Composition and appointment of the governing board: The HCF is chaired by the Minister of Finance, with two vice-chairmen: currently, a university professor specialising in financial and banking economics and a former governor of the National Bank of Belgium.

Staff: Each section consists of 12 or 13 members, who are high-level experts appointed by the Ministers of Finance, Budget and Social Affairs, by the National Bank of Belgium and the FPB, and by the governments of the regions and communities. Members of the secretariat of the two sections are provided by the research department of the MoF. The FPB is in charge of the secretariat of the study group on ageing.

Comments on the functioning of the institution: So far, the institutional mechanism for fiscal policy coordination based on the HCF’s budgetary recommendations has worked broadly satisfactorily, at least until the beginning of the crisis. However, there is no enforcement mechanism for fiscal discipline at regional level in order to ensure that the regions run sufficient surpluses to offset the deficits at the central level.

Medium-term budgetary framework in Belgium

Time frame: Three years (i.e. t+1, t+2 and t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection) (66).

Institutional coverage: The whole general government sector

Accounting system: ESA 95

Target revisions and binding objectives: The main target is the general government balance as a percentage of GDP. Medium-term budgetary targets are revised every year, usually in the context of the stability programme preparation. Therefore, fiscal targets incorporated into the MTBF are not binding.

Level of detail of expenditure projections: Expenditure projections are broken down according to national accounts classification (i.e. public consumption, public investment, etc.).

Level of detail of revenue projections: Projections are broken down into direct and indirect taxes.

Connectedness with the annual budget law: Fiscal targets included in the MTBF are not binding and, therefore, they do not constrain the preparation of the annual budget law (i.e. the multi-annual targets form the basis on which the budget is prepared, but there can be deviations).

Monitoring mechanisms: The Court of Auditors (Cour des comptes) is in charge of monitoring. In addition, the HCF releases an annual report on budgetary execution and the SCP.

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the envisaged medium-term targets

Targets for sub-central governments: Fiscal coordination across levels of government is carried out through specific consultation committees composed of representatives from the different government layers, which in turn adopt as a benchmark, the recommendations issued by the HCF (the independent fiscal body responsible, inter alia, for setting fiscal objectives for general government tiers). These recommendations have generally been accepted by these consultation committees and partly explain the good track record of Belgium public finances over the last 20 years, particularly in terms of debt reduction.

Comments on the functioning of the framework: While the Belgium fiscal framework strongly relies on the existence of two effective and efficient independent institutions (i.e. the National Accounts Institute and the High Council of Finances), multi-annual fiscal planning appears to be relatively less developed. Specifically, the absence of real binding medium-term objectives has hampered the effectiveness of the current MTBF for multi-annual fiscal planning, and helps explain the expenditure slippages observed in recent years. The adoption of a more stringent medium-term framework, encompassing enforceable multi-annual expenditure ceilings, seems an essential precondition to ensure the envisaged fiscal consolidation over the medium-term. In turn, in the context of a highly decentralised country such as Belgium, this enforceable medium-term fiscal planning should be extended to all general government tiers.

(66) This means that in t+1, an additional year, t+4, will be added. These rolling frameworks contrast with the so-called periodical MTBFs, in which a new multi-annual framework is always defined for a fixed period (usually three or four years coinciding with a new government term) and targets are neither revised nor extended on a rolling basis but only after the expiration of the relevant period (this is notably the case in the Netherlands).
Domestic budgetary procedures in Belgium

Prudent economic assumptions for the budget preparation

Belgium appears to be well placed in terms of prudent and realistic macroeconomic assumptions used for budget preparation. This contrasts with the existing situation in a number of other EU countries, in which the macroeconomic forecasts show an upbeat bias rendering more difficult proper budgetary planning and complicating the conduct of time-consistent fiscal policy. However, as already mentioned, the MoF has relatively large leeway when translating these macroeconomic forecasts into revenue projections.

This is explained to a great extent by the role played by the FPB, which provides independent forecasts for the design of budgetary plans. There is ample evidence confirming the absence of a permanent optimistic bias in these forecasts, which in turn helps estimate feasible and realistic revenues projections.

The good quality of these forecasts is further supplemented by a high degree of transparency in their dissemination, including a public disclosure of the methodology and the main external assumptions of these projections.

Centralisation of the budget process at the planning stage

Given its institutional political setting, Belgium mainly relies on the agreement of fiscal targets negotiated among the different ruling parties forming the executive to centralise the budget preparation. This leads to a fairly strong Ministry of Budget with respect to the implementation stage (to ensure respect of the agreed targets), but with relatively limited power to impose new measures on the basis of strong agenda-setting powers.

The parliament has unrestricted power, from a purely constitutional and legal point of view, to amend the budget proposed by the government. However, in practice, the internal discipline of the coalition considerably limits the use of this power.

The use of top-down budgeting

The OECD database provides a mixed picture in relation to the use of top-down budgeting. On the one hand, the use of expenditure ceilings seems to be well established. However, the fact that expenditure overruns can materialise before a supplementary budget is approved suggests that these expenditure ceilings are not really binding and, therefore, they do not always constrain spending developments effectively.
Fiscal governance in Bulgaria

1. DESCRIPTION OF THE FISCAL FRAMEWORK

The Bulgarian fiscal framework performed relatively well in the favourable economic environment prior to the crisis. Fiscal targets were consistently met and sizeable fiscal buffers were accumulated. That was due mostly to revenue consistently coming in above expectations and, to a lesser degree, containment of expenditures. Under the impact of the economic crisis, however, the 2009 deficit surprised negatively ex-post and the existing fiscal rules to keep the budget balanced or in surplus and the budgetary expenditure below 40% of GDP were breached. In response, the authorities introduced several reforms on budgetary procedures and implementation including a legislative package, the so-called Financial Stability Pact, aimed at introducing a framework of principles and rules to ensure fiscal discipline. It reinforces the existing rules and introduces new fiscal rules applied to the general government sector and covering the budget deficit, debt and total expenditure as well as the procedure to amend direct tax rates.

The fiscal framework includes rules for the budget balance, nominal expenditures, consolidated and municipal debt.

With respect to the budget balance, up to 2009 there was a soft, flexible and non-binding rule to keep the budget in surplus. After the outbreak of the crisis, it was amended to a requirement for a balanced national budget (excluding the resources from the EU funds and programmes) in 2009 and for a gradually decreasing deficit in 2010 and 2011 to ensure that it was brought down below the Stability and Growth Pact (SGP) reference value. A requirement to keep the consolidated budget deficit below 2% had already been already adopted with an amendment to the organic budget law and will be in force as of 2012. With respect to the size of the government, a rule foresees that general government expenditure including the EU contribution should not exceed 40% of GDP. The rule has been consistently applied on a cash basis since 2006. However, in 2009, expenditure on an accrual basis exceeded the 40% limit by 0.7 percentage point as a result of the crisis. It will be renewed as of 2012 and its binding character will be strengthened as part of the Financial Stability Pact (it is established with an amendment to the organic budget law). The Financial Stability Pact will also require a parliamentary majority of two thirds for amendments to direct tax legislation resulting in an increase. The rule is expected to be enshrined either in the Constitution or in the organic budget law and is still to be adopted after the conclusion of a round of elections in October 2011. The rules are formulated with respect to the consolidated fiscal programme (the concept is similar to the general government definition and includes the state budget, local authority budgets, the budgets of the two social funds and a number of extra budgetary funds and accounts) albeit no specific coordination, self-correction or enforcement procedures are foreseen at this stage.

The State Debt Law establishes requirements for three types of debt limits on: (i) annual additions to the debt stock; (ii) new sovereign guarantees; and (iii) the outstanding debt at the end of the year. According to the debt rule, the outstanding consolidated government debt cannot exceed the debt level recorded at the end of the previous year as long as the debt-to-GDP ratio is above 60%. The Municipal Debt Law limits local government borrowing to the financing of infrastructure investment and rollover of previously accumulated debt. There are no limits on the amount of borrowing of local governments; however, there are limits on the debt service payments: (i) the annual amount of payments on the debt during each particular year may not exceed 15% of the sum of the total of revenues from own sources and the balancing transfer from the central budget under the last audited report on the implementation of the budget of the municipality; (ii) the nominal value of the guarantees may not exceed 5% of the above mentioned sum.

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The existing medium-term budgetary framework (MTBF) includes three-year projections for the main budgetary aggregates and sets expenditures ceilings for the first level spending units (mostly the line ministries) that are binding for the first year and indicative for the outer years. In addition, it presents projections and assumptions for a series of other budgetary and macroeconomic indicators. The government uses the targets set in the MTBF as inputs when elaborating its budget for the following year, although this requirement is not legally binding, revisions are possible and the circumstances which could trigger them are not indicated. In recent years, the proposed draft budget aggregates have often deviated from the initial estimates, albeit that the expenditure appropriations were mostly in line with the ceilings adopted by the Council of Ministers.

Finally, the domestic budget process is close to the so-called contracting approach given the multi-party political system and the recent ruling coalition governments. The budget process uses a mixture of top-down and bottom-up budgeting. The Ministry of Finance (MoF) draws up the aggregate expenditure ceilings on which line ministries have to base their budget proposals. In principle, the expenditure ceilings should correspond to those in the MTBF; however, in practice, they often have to be updated in line with the recent increase in the volatility of forecasts (i.e. the proposed expenditure appropriations in the 2012 draft budget have been even lower than the ceilings fixed in the spring in order to reflect a downward revision of projected revenue). The line ministries take
into account their different policy objectives when making their proposals and a negotiation then takes place between them and the MoF in order to ensure that the aggregate expenditure ceilings are met. In case of a disagreement, however, the final decision is taken collectively by the government. The parliament receives the MTBF for information and adopts the draft budget by main budgetary aggregates. The budget is presented for parliamentary adoption by main spending items and functions and not by programmes. With the last budgetary procedures, efforts have been made to present the draft budget for adoption in the parliament earlier and to align the budgetary cycle with the European semester.

Recently, the authorities undertook several initiatives to improve expenditure control as well as the monitoring and reporting systems in order to limit the risk of expenditure overruns and a reappearance of arrears. A special clause in the 2011 State Budget Law gives the Council of Ministers the exclusive power to define and update ceilings for the contractual obligations of central government institutions and entities. This will enhance the central control at the planning and approval stages, and thus help in reducing the deficit bias, while preserving some flexibility at the budgetary execution stage. Preventive control would be strengthened with the amendments in the law on the financial management and control in the public sector permitting the Minister of Finance to appoint an official to work in enterprises in the general government sector with weak financial discipline and report monthly on the expenditure and debt dynamics. Recently, state-owned enterprises — mostly in the transport sector — have been a source of increases in expenditure with the reclassification of the National Railway Infrastructure Company in the general government sector contributing to the worsening of the fiscal position, particularly in 2007–08.

2. **Assessment of the Current Framework**

The fiscal governance reforms recently introduced by Bulgaria represent major steps in improving the budget process and establishing an institutional fiscal framework geared towards maintaining fiscal discipline and increasing the predictability of fiscal policy. As part of the excessive deficit procedure, the Council concluded on 13 July 2010 that the Bulgarian fiscal framework and, in particular, procedural weaknesses with respect to the monitoring and reporting of longer-term commitments on accrual bases and the accumulation of arrears have contributed, at least partly, to the worsening of the budgetary position in 2009 or, in any case, did not help to prevent it. The position may also have been reflected in the fact that the recent economic good times and the revenue windfalls resulting from buoyant economic activity and a very tax-intensive growth structure were not completely saved but instead were used to finance relatively high ad hoc expenditure increases and social security rate cuts. The debt rules have been very efficient in fostering decreases of the consolidated debt in good economic times and preventing the accumulation of debt at local government level. The limits on the use of local government borrowing seem to have been especially efficient. However, given the very low current levels of debt-to-GDP ratio (below 20 %), the debt rule is not likely to be constraining government policy in the short term.

The Financial Stability Pact will strengthen the binding character of the expenditure and the budget balance rules as now they are included in organic budget law. Some of the rules are defined on a nominal basis which provides greater transparency and facilitates timely monitoring. The budget balance rule which does not permit the deficit to increase above 2 % provides a clear numerical target that is more stringent than the SGP reference value and would ensure compliance with it. This should also help to internalise the possible budgetary effects of current policies in the medium term. With respect to further fine-tuning, the rules could be accompanied by specified actions in case of non-compliance which are defined *ex ante* as well as by pre-established sanctions. Furthermore, a self-correcting mechanism in case of deviation from the fiscal path would provide additional guidance over the cycle and ensure the compliance with the rules.
EPC policy advice

After taking major steps to improve its institutional fiscal framework through fiscal governance reforms aimed at strengthening the control over budgetary aggregates, the focus could shift to finalising the adoption of the new initiatives and proceeding with the necessary fine-tuning of the functioning of the new institutional fiscal framework. Going forward, efforts could be geared towards further strengthening the binding character and the contents of the medium-term budgetary framework, improving the budget process and the quality of the reporting and control systems.

In this context, the national authorities should introduce the following measures.

- Require that the macroeconomic forecasts made by the authorities are accompanied by a statement on the consistency or the differences with the forecasts from the European Commission. In case of non-compliance, reconsider creating an independent fiscal council with adequate funding.
- Further improve the content, transparency and binding character of the medium-term budgetary framework by embedding in it binding fiscal rules and by including information on off-budget items that could represent a potential contingent liability for the budget — such as the losses and arrears of state-owned enterprises or commitments under procurement contracts.
- Strengthen reporting on accrual basis, including improving the quality and timeliness of reporting by state-owned enterprises and sub-national governments as well as their cash and treasury management practices.

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

Fiscal rule in Bulgaria: Expenditure rule

Time frame: Since 2006

General description of the rule and target definition: The size of the government (the government expenditure-to-GDP ratio) cannot exceed 40 % of GDP (a nominal expenditure-to-GDP ratio ceiling).

General government sub-sector(s) to which the rules apply: The whole general government sector

Implementation: The rule has been applied since 2006. The government will strengthen its binding character as it is established with an amendment to the organic budget law and will then be part of the Financial Stability Pact.

Coverage and exclusions: The rule covers the consolidated general government expenditure including EU funding (the EU contribution, expenditure funded by EU funds and the corresponding national co-financing). There are no exclusions to its application.

Accounting system: National cash-based accounting

Escape clauses: There are no predefined escape clauses.

Statutory basis: Currently, the rule is a commitment by the governing party set in its management programme and approved by the Council of Ministers within the multi-annual financial framework for the period 2010–13. As of 2012, it is expected that its binding character will be strengthened as it will be part of the Financial Stability Pact (already adopted with an amendment to the organic budget law).

Monitoring: The MoF monitors the compliance with the rule as a part of the budgetary execution.

Enforcement mechanisms: No specific enforcement mechanisms

Comments on the functioning of the rules: Before 2010, the rule had a non-binding character and was considered rather as guidance than a real rule. It has been applicable since 2006. However, in 2009, under the impact of the economic crisis, the budget balance worsened considerably whereby government expenditures reached 40.7 % of GDP (on an accrual basis).

Fiscal rules in Bulgaria: Budget balance rule

Time frame: Since 2006

General description of the rule and target definition: Before 2009, a flexible rule to keep the budget balanced or in surplus; between 2010 and 2011, the budget deficit should be contained and brought progressively below the 3 % reference value of the SGP; and as of 2012, the budget deficit cannot exceed 2 % of GDP.

General government sub-sector(s) to which the rules apply: The entire general government sector

Implementation: Multi-annual
Coverage and exclusions: The rule covers the consolidated general government expenditure and revenue excluding the financing items.

Accounting system: National cash-based accounting

Escape clauses: There are no predefined escape clauses.

Statutory basis: Currently, the rule is a commitment by the governing party set in the convergence programme and approved by the Council of Ministers in the multi-annual financial framework for the period 2010–13. As of 2012, it is expected that its binding character will be strengthened as it will be part of the Financial Stability Pact (already adopted with an amendment to the organic budget law).

Monitoring: The MoF monitors compliance with the rule as a part of the budgetary execution.

Enforcement mechanisms: No specific enforcement mechanisms

Comments on the functioning of the rule: Before 2010, the rule had a non-binding character and was considered rather as a rough guiding indicator. As of 2012, its legally binding force will be strengthened.

Medium-term budgetary framework in Bulgaria

Time frame: Three years (i.e. t+1, t+2 and t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projections).

Institutional coverage: The whole of the general government sector

Accounting system: Cash basis

Target revisions and binding objectives: The expenditure ceilings are binding for the first year and indicative thereafter. However, the MTBF is taken into account in the preparation of the budget and is updated annually. The circumstances when revisions are justified are not explicitly indicated.

Level of detail of expenditure projections: Multi-annual projections are presented for the budget balance as well as the main revenue and expenditure items of the general consolidated budget: personnel expenditure, goods and services, interest, subsidies, social assistance, other transfers and investment expenditure. Projections for total expenditure are presented for the main budgets, making up the general consolidated budget, and for the main line ministries, first level spending units and agencies, excluding those for local governments.

Level of detail of revenue projections: Multi-annual projections are presented for the main revenue items of the budget: indirect taxes, direct taxes and grants and in particular for the profit tax, income tax, property tax, VAT, excise duties, other taxes on goods and services, other taxes on foreign trade, other fiscal taxes, social security contributions, non-fiscal revenue, capital revenue, grants, sums received from the EU are also indicated.

Link with the annual budget law: Fiscal targets included in the MTBF are not binding, although they constitute an input for the annual budget law. The annual budget law is based on the targets for next year specified in the MTBF but deviations are possible.

Monitoring mechanisms: The government presents an annual report on the budget execution which is included in the budget memorandum together with the other budget documents and estimates, accompanying the annual state budget.

Enforcement mechanisms: There is no predefined mechanism to enforce respect of the fiscal targets.

Targets for sub-central governments: The MTBF contains ceilings for the expenditure of the first level spending units, excluding local governments.

Comments on the functioning of the framework: To improve the MTBF, it is important to strengthen its binding character in the future. Furthermore, more details could be provided on: (i) the calculations underpinning the fiscal consolidation path and the fiscal measures taken; (ii) off-budget items which represent a potential important contingent liability for the budget such as the losses and arrears of state-owned enterprises; or (iii) projections for the total revenue of the budgets making up the general consolidated budget. It should also gradually move to the ESA 95 accounting system.

Fiscal rules in Bulgaria: (Consolidated) government debt rule

Time frame: Since 2003

General description of the rule and target definition: Outstanding consolidated government debt at the end of each year may not exceed that in the previous year, as a ratio to the projected GDP, as long as it is above 60 % of GDP.

General government sub-sector(s) to which the rule applies: The general government consolidated debt

Implementation date: Currently
**Coverage and exclusion**: Covers the central government, local government and social security. The budgetary elements that are excluded from the rule are interest and public investment (defined as general government investment excluding those with debt component)

**Escape clauses**: The debt rule is not activated and does not provide any guidance when the government debt is below 60 % of GDP.

**Time frame**: Compliance with the debt ceiling is verified annually at the end of the fiscal year.

**Details**: For Treasury bills issued at prices below or above the face value, the ceiling is calculated based on their face value. Government debt and guarantees denominated in foreign currency are recalculated in national currency using the Bulgarian central bank exchange rate at the date when the obligations have been assumed.

**Statutory basis**: Legal basis — the debt rule is defined in Article 10 of the State Debt Law. The State Budget Law for the relevant year determines: (i) the maximum amount of new government debt and government guarantees that may be undertaken during the year; and (ii) the maximum amount of government debt as of the end of the budget year.

**Monitoring**: The MoF is responsible for monitoring compliance with the debt rule. It prepares a three-year debt strategy and an annual report on debt management — both approved by the Council of Ministers. The report is presented to the parliament as an integral part of the report for the budget execution.

**Enforcement mechanisms**: If there is a danger that the rule fixed by Article 10 of the State Debt Law would not be complied with, the Council of Ministers could propose limits for the new issuance of debt to municipalities and social security funds in the annual State Budget Law for a given year. Ultimately, the parliament is responsible for the enforcement of the rule.

**Comments on the functioning of the framework**: Given the current low levels of government debt in Bulgaria (i.e. below 20 % of GDP), the debt rule is not likely to be binding in the short term. It has been always complied with since its introduction in 2003.

**Fiscal rules in Bulgaria: Ceilings for local governments’ debt payments and guarantees**

**Time frame**: Since 2005

**General description of the rule and target definition**: In any given fiscal year, the annual debt payments cannot exceed 15 % of the sum of the total own revenues and the total balancing subsidy under the last certified report for the municipal budget execution (**Debt rule**). The face value of municipal guarantees cannot exceed 5 % of the sum of the own revenues and the total balancing subsidy for the previous year based on the last audited report for the municipal budget execution (**Guarantees rule**).

**General government sub-sector(s) to which the rules applies**: Local governments

**Implementation date**: Currently, amended in 2010 — as of 1.1.2011, the debt ceiling has been decreased from 25 % to 15 %.

**Coverage and exclusion**: Municipal debt includes the principal, interests and commissions excluding: (i) non-interest loans from the central budget made available to local governments in order to finance projects and programmes co-financed by EU funds until their reimbursement; (ii) debt to the Fund for Local Authorities and Governments (FLAG) aimed at providing bridge financing for co-financing with EU projects; and (iii) debt assumed under the loan agreement for the structural programme loan between the Republic of Bulgaria and the European Investment Bank (pursuant to Section 15 of the Transitional and Final Provisions of the 2011 State Budget Law).

**Statutory basis**: Legal basis, the provisions for the municipal debt rule and guarantees are fixed, respectively, in Article 12(1) and Article 12(2) of the Municipal Debt Law.

**Details**: When, in previous periods, the accumulated municipal debt or guarantees exceeded 15 % or 5 % respectively of the sum of total own revenues and the total balancing subsidy under the last audited report for the municipal budget execution, local governments could not issue new debt or grant new guarantees until compliance with the requirements of the rules was reached. To prevent the accumulation of liabilities that should be serviced beyond the term of the local governments, they could issue long-term debt only in the first 39 months after their election.

**Monitoring**: The MoF monitors the application of the rules based on a public registry for municipal debt, securities and guarantees. The content and quality requirements for the information provided in the registry are fixed by the MoF.

**Enforcement mechanisms**: There is no specific mechanism to enforce respect of the rules.
Comments on the functioning of the framework: The rules were amended and further strengthened in 2010 in order to preserve fiscal sustainability and avoid an accumulation of municipal debt and guarantees, in particular by insulating local governments’ liabilities from the impact of political cycles. However, it is important to ensure that the capacity of highly indebted local government to provide the most important public services is not impaired.

Domestic budgetary procedures in Bulgaria

Prudent economic and budgetary projections

The revenue projections of Bulgaria have traditionally been rather conservative and prudent. During the boom years, the country applied the so-called 90% rule in order to ensure that revenue was sufficient to meet fiscal policy requirements, while avoiding revisions to the budget. According to that rule, spending units could use, during the budget year, only 90% of the approved annual appropriation allotment for non-interest expenditures and transfers from the republican budget, while the disbursement of the last 10% was dependent on revenue developments. The only exclusion was social security spending for pensions. The reduction was implemented with a Council of Ministers decree. In practice, before the crisis, revenues consistently came in above expectations. After the outbreak of the crisis, the rule was discontinued. The macroeconomic assumptions underlying the budget are prepared by the MoF.

Centralisation of the budget process at the planning stage

Given that in the recent years, governments were based on multi-party coalitions, the political system does not favour a strong Finance Minister. Therefore, within the fiscal governance reforms recently implemented, it was decided to strengthen the centralisation of the budget process by giving the Council of Ministers the right to impose ceilings on the contractual obligations of spending units. The proposed Financial Stability Pact with its predefined rules for budgetary aggregates provides support to the centralisation of the budget process. Nevertheless, the role of the Finance Minister may have to be reinforced further in the future. This could be done, for example, by delegating strong prerogatives or the power to veto spending decisions from line ministries at budget execution stage to the Finance Minister. In the current government, the role of finance minister has been strengthened by including the remit in the duties of the deputy prime minister. Furthermore, a more centralised approach to the financial management of capital budgeting and priority investment projects could be considered.

The use of top-down budgeting

Currently, a mix of top-down and bottom-up budgeting is used. The MoF fixes aggregate expenditure ceilings in the MTBF, which are binding for the first year. Then, within these targets, the different line ministries and other budget entities specify their needs given the programmes they manage. The latter prepare their individual budget proposals and a negotiation then takes place with the MoF such that the aggregate expenditures fit into the overall fiscal targets. The introduction of binding fiscal targets should lead to an efficient top-down budgeting process. Currently, the parliament only adopts the main aggregate budgetary items. It could be considered that presenting more disaggregated information on expenditures by programmes to the parliament would foster the parliament’s ability to discern the efficiency of spending in terms of achieving the programmes objectives.
Fiscal governance in the Czech Republic

1. Description of the fiscal framework

The current fiscal framework has been in place since 2004 when the last comprehensive reform of public finances was carried out. Fiscal policy before the reform was predominantly based on annual budgeting without any credible medium-term fiscal outlook. The reform introduced a series of new rules and principles which aimed to improve budgetary planning and the transparency of budgetary procedures. The most important components of the reformed fiscal framework included fiscal targeting within the medium-term budgetary framework and a new numerical expenditure rule. While the system represents a considerable improvement in the overall set-up of fiscal policy, several weaknesses have been identified in the course of its implementation. The Czech authorities have, therefore, recently started preparing a set of modifications to the current fiscal rules and institutions.

The medium-term budgetary framework (MTBF) in the Czech Republic is based on a triennial fiscal outlook and targeting. The process of setting the targets for different levels of the government involves several steps. Firstly, fiscal targets are set in the form of a general government balance (as % of GDP) for the next three years. These targets serve as a basis for a more narrowly defined fiscal target for the central government and the six state funds, following a top-down approach. In this step, the Ministry of Finance (MoF) first defines an autonomous fiscal scenario and then compares it to the desired fiscal policy targets. The autonomous scenario is based on the existing legal and institutional framework in absence of any new policy measures. The difference between the autonomous scenario and the planned fiscal target determines the extent of the active measures on both the revenue and expenditure side that are needed to achieve the medium-term targets. The fiscal targets are underpinned by up-to-date macroeconomic and revenue projections carried out by the MoF. Finally, overall medium-term expenditure ceilings in cash terms are established and broken down into two expenditure limits: one for the central government and one for the six state funds. Expenditure ceilings can be revised only in specific cases defined in the Budgetary Rules Act. The annual state budget must fully comply with the medium-term expenditure ceilings.

Nominal expenditure ceilings are the only numerical and binding fiscal rule in the Czech system and are embedded into the MTBF. They are only defined for the central government and the six state funds as these areas of the general budget fall under the direct control of the central government. Local governments and social security funds are, therefore, not covered by this fiscal rule. The expenditure ceilings are set on a rolling triennial basis and can be adjusted only in specifically defined cases which are enumerated in the Budgetary Rules Act. These include, for example, significant deviations from the macroeconomic forecast, natural disasters and changes in revenue from EU funds. The medium-term expenditure ceilings are presented to the lower house of the parliament each year in autumn together with the draft state budget. The Chamber of Deputies of the Parliament of the Czech Republic adopts them in the form of a resolution. According to the Budgetary Rules Act, the draft state budget for the current year must comply with the medium-term expenditure ceilings which were already approved in the previous year. In case the expenditure ceilings are exceeded beyond the exceptions permitted by the Budgetary Rules Act, the government must provide an explanation to the lower house of parliament.

Monitoring of budgetary developments focuses mainly on the current year and, more specifically, the central government (the state budget). Regular reports are submitted to the parliament every six months. The MoF also evaluates the performance of the state budget on an ongoing basis and reports to the government after the first and third quarter of the current year. Ex post information on budgetary execution is published in the form of a state closing account.

As previously mentioned, local and regional governments’ budgets are not part of the medium-term budgetary targeting. Under the current law, municipalities should conceive their budgets as balanced in principle. There are no strict rules concerning debt enshrined in law. The MoF carries out annual monitoring of municipalities’ budgets based on a set of predefined financial indicators. In case of serious liquidity and/or debt problems,

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(67) The six State Budget funds are outside the State Budget. They include the State Environmental Fund of the Czech Republic; the State Fund for Culture; the Czech State Fund for the support and development of Czech Cinematography; the State Agriculture Intervention Fund; State Fund for Transport Infrastructure; and the State Fund for Housing. The funds rely mostly on subsidies from the State Budget.

(68) Fiscal targets for the general government are set both in ESA95 and cash terms. Targets for the central government and the six State funds are derived in cash terms.

(69) According to the law on budgetary rules for local and regional authorities, budgetary deficit is permitted only if can be covered by financial resources from previous years or by a loan, credit, communal bond or similar.
municipalities are obliged to explain the situation and work on possible solutions with the Ministry of Finance and the Ministry of Interior.

**Plans for review of the current framework**

The government has recently launched a review of the existing fiscal framework with the aim of improving its functioning and ensuring compliance with new EU legislation. As a first step, an internal expert group at the MoF is identifying weaknesses in the current framework and proposed ways to solve them. In the second phase, the government will propose draft legislation which will also aim at complying with the new requirements on fiscal frameworks stemming from EU legislation. Implementation of some steps is already envisaged for 2012. Proposals currently under consideration include: possible ways of improving coordination between different levels of government; a new fiscal rule for local and regional governments; stronger enforcement mechanisms for the existing fiscal rules; better monitoring and ex post evaluation of budgetary performance; and introducing sustainability considerations in the fiscal targeting. Furthermore, establishing an advisory body on fiscal and budgetary matters is currently also under discussion. At the same time, the government is implementing a reform of the tax administration and new accounting and information systems for the state budget.

**2. Assessment of the fiscal framework**

When assessed against cross-country indicators measuring the strength of the fiscal framework, the Czech Republic ranks very close to the EU average. The 2004 fiscal framework reform brought a significant improvement in fiscal planning and programming. The introduction of the MTBF together with the numerical expenditure rule represents an important step forward compared to the previous system. The overall set-up of the framework appears sound and contains several standard elements necessary for successful medium-term planning and better budgetary discipline.

A closer examination of the results of the last reform reveals that despite many important advances, there are still several weaknesses and ample scope for improvement in implementation. While it is true that the general government deficits after 2004 were significantly reduced (with the exception of the crisis years 2009 and 2010), it is also true that this period was characterised by very strong economic growth and the current fiscal framework did not prevent the government from running deficits in very favourable macroeconomic circumstances.

One important weakness of the current system is linked to the functioning of the medium-term expenditure framework (i.e. the expenditure ceilings). They are formally enshrined in law and thus legally binding. Nevertheless, the expenditure ceilings have been revised upwards several times in the past beyond the exceptions permitted by the budgetary rules. Windfall revenues in the years of strong economic growth were used to increase expenditure. The expenditure ceilings could thus be complemented by a revenue rule ensuring that all windfall revenues are allocated to deficit reduction. The government is accountable to the parliament for respecting the expenditure ceilings. In case of non-compliance, the government is obliged to explain the reasons for slippages but no further correcting measures are formally required. Past years have also shown that public scrutiny of fiscal targets and expenditure ceilings in particular, is insufficient. This is partly due to their complexity and, therefore, a limited awareness and understanding of the general public. Expenditure covered under the ceilings does not entirely match the state budget expenditure and the link is not easily identifiable and clear. It is thus difficult, both for lawmakers and the general public, to assess the compliance and exercise pressure on the government to stick to the targets. Experience from other countries has demonstrated that reputational sanctions together with close public scrutiny provide incentives to comply with the rules and strengthen enforcement. The existence of an independent body that oversees the budgetary process can also enhance public awareness and reduce non-compliance.

Successful consolidation and sustainability of public finances depends crucially on budgetary performance of all parts of the general government. However, at present, only the central government and the state funds are covered by the expenditure rule. Other levels of government (local, regional and social security funds) are not currently explicitly constrained by any specific rule and do not formally participate in setting the medium-term fiscal targets. Some form of burden-sharing, particularly in bad times when important consolidation effort is required, would be warranted. More coordination between all levels of government is thus needed both in terms of agreeing medium-term fiscal targets and with respect to the annual budgetary process. Furthermore, a fiscal rule limiting indebtedness of the local and regional authorities could be envisaged to complement the expenditure rule at the central level.

With respect to preparation of the annual budget, transparency is an important issue. Budget documentation is very complicated and not easily accessible to the general public, which again limits the public scrutiny. The process of preparation of the annual budget is mainly based on an incremental approach rather than on performance budgeting. Individual line ministries base the requests for their respective chapters on the previous
year’s budget. Systematic evaluation of the efficiency and effectiveness of spending programmes is not carried out, which can lead to overspending in some areas and underfunding in others. If budget cuts are needed, these tend to be executed across the board.

Scrutiny of the budget is further complicated by the existence of the six state funds which often rely on subsidies from the state budget. These include, for example, the State Fund for Transport and Infrastructure which covers most of the Ministry of Transport’s spending programmes for road and railway infrastructure and which receives around 3% of GDP annual contribution from the state budget. The existence of funds outside the state budget renders the budget management more costly and less transparent.

Given the above mentioned weaknesses of the current system, establishing an independent institution (i.e. a fiscal council) could contribute to fostering fiscal discipline and better transparency and closer scrutiny of the whole budgetary process. Such an institution could be involved in the preparation and/or assessment of macroeconomic forecasts, monitoring of budgetary procedures and their compliance with law, assessment of fiscal policies ex ante and ex post, etc. The institution would take a longer-term and independent view on reforms and policies with significant fiscal impacts which is missing in the current institutional set-up.

**EPC policy advice**

The 2004 reform represented a considerable improvement in the framework for fiscal policy with the introduction of a medium-term budgetary framework together with an expenditure rule. However, expenditure ceilings have been revised upwards several times: levels other than the central government are insufficiently constrained and the transparency of some elements of the overall set-up for fiscal policy could be improved. In this context, national authorities should introduce the following measures.

- Consider introducing an independent fiscal council to support the preparation, evaluation and monitoring of fiscal policies.

- Improve enforceability of the expenditure rule by establishing a system by which good performance is rewarded and failings are clearly sanctioned. Enhance transparency by making a clear link between annual expenditure ceilings and state budget expenditure.

- Improve coordination between all levels of government in the budgetary process and involve sub-national governments in medium-term budgetary planning. Consider introducing some form of a fiscal debt rule for the local and regional levels.
3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

Fiscal rule in the Czech Republic: Expenditure rule

General description of the rule and target definition: The expenditure rule takes form of medium-term expenditure ceilings which are defined in nominal terms. The calculation of the expenditure ceilings is based on the deficit target for the central government and revenue projections for the next three years. Expenditure ceilings are approved annually by the lower house of the Chamber of Deputies of the Parliament of the Czech Republic and can be revised only in specific cases. According to the Budgetary Rules Act, the annual budget must fully comply with the medium-term expenditure ceilings.

Institutional coverage: The expenditure rule covers the central government and the six off-budget central government funds (the State Environmental Fund, State Fund for Culture, State Fund for the Czech Cinematography, State Agriculture Intervention Fund and the State Fund for Transport Infrastructure and State Fund for Housing). Local and regional government and social security funds are not covered.

Implementation date: Applied since 2004

Accounting system: Cash

Escape clauses: Expenditure ceilings can be revised in specific cases defined by the Budgetary Rules Act. These include inflation developments that are significantly different from initial assumptions, changes in tax assignment between central and local governments, developments in EU fund allocations, and major unexpected events such as natural disasters.

Time frame: Three-year time horizon (i.e. the year for which annual budget is prepared plus the two following years)

Statutory basis: Legal basis (State Budget Act)

Monitoring: Compliance with the expenditure ceilings is checked by the MoF twice a year.

Enforcement mechanisms: If the expenditure ceilings are exceeded, the government is obliged to explain the reasons for breaking the ceilings to the parliament. However, there are no clear sanctions in case of non-compliance with the rule.

Comments on the functioning of the rule: The expenditure rule has contributed to better fiscal planning and more discipline. Nevertheless, several important weaknesses in its implementation have been identified. The expenditure ceilings have been exceeded several times in the past beyond the exceptions permitted by the law, in particular in good times with greater than expected revenues. Furthermore, a limited public awareness and scrutiny of the expenditure ceilings renders their enforcement more difficult.

Medium-term budgetary framework in the Czech Republic

Time frame: Three years (t+1, t+2, t+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

Institutional coverage: General government

Accounting system: ESA 95 and cash

Target revisions and binding objectives: The main target is the general government balance as a percentage of GDP. The deficit target for the central government and state funds is derived as a difference between the general government deficit and the forecast balance of local governments and social security funds. This forecast is carried out by the MoF based on information from the local authorities and funds. Medium-term expenditure ceilings are then calculated using the deficit target and revenue projections for the central government. The general government balance targets (as a percentage of GDP) are not binding and are revised twice a year. Medium-term expenditure ceilings for the central government and state funds are binding and can be revised only in specific cases as defined by the Budgetary Rules Act.

Level of detail of expenditure projections: Expenditure projections are broken down into the main expenditure categories (i.e. social transfers, government consumption, gross fixed capital formation, compensation of employees, etc.).

Level of detail of revenue projections: Revenue projections are broken down into the main revenue categories (i.e. taxes on production and imports, personal income taxes, corporate income taxes, social contributions, capital taxes, etc.).
**Connectedness with the annual budget law:** There is a link between the MTBF and the annual budget. The first budgeted year of the MTBF is fully reflected in the annual budget proposal. According to the Budgetary Rules Act, the annual state budget must fully comply with the medium-term expenditure ceilings which form an integral part of the MTBF.

**Monitoring mechanisms:** Monitoring of the MTBF is carried out twice a year by the MoF: (i) in April, when a new target for the year t+3 is set; and (ii) in September, as part of the medium-term outlook attached to the draft annual budget.

**Enforcement mechanisms:** The general government targets set in the MBTF not binding *per se*. The only binding element is the medium-term expenditure ceilings for the central budget and state funds (as previously discussed).

**Domestic budgetary procedures in the Czech Republic**

**Budgetary centralisation at the planning phase:** The draft annual budget is prepared by the MoF in cooperation with line ministries, local governments and state funds. The first round of budget preparation starts with an update of the medium-term budgetary outlook, a preliminary estimate of total revenues and the main categories of mandatory expenditure. In the second round, individual budget chapter administrators submit their requests for financial resources based on existing commitments and planned projects and programmes. During the final round, a compromise between the requested and available resources is sought and planned expenditures are adjusted with respect to the expected revenues and the binding medium-term expenditure framework for the central government.

**Performance budgeting:** The budgetary process is based on an incremental approach. Line ministries and other entities responsible for individual budgetary chapters usually base their requirements on the previous year’s budget. In the past, this has lead to automatic increases in expenditure without proper reflection on policy priorities of the government and on fiscal responsibility (particularly in the boom years). Systematic evaluation of efficiency and effectiveness of spending programmes is not carried out, which can lead to overspending in some areas and underfunding in others. Recent experience has shown that incremental budgeting is problematic particularly in the situation when strong fiscal consolidation is needed. In the absence of a performance budgeting system, cuts are implemented mostly across the board and can also negatively affect growth-enhancing expenditure.
Fiscal governance in Germany

1. Description of the Fiscal Framework

The German fiscal framework encompasses budget balance rules, an established medium-term budgetary planning, and budgetary procedures conducive to sound fiscal planning as well as four independent institutions with relevance for fiscal policymaking.

German fiscal rules include constitutional budget balance rules for the federal and state governments (Länder) as well as budget balance rules for social security insurances and local governments. The constitutional rules for central and state governments date back to the first substantive reform of German fiscal federalism in 1969. This reform replaced the original provisions of Article 115 of the Constitution, which foresaw government borrowing only in case of extraordinary needs and only for profitable purposes, by the so-called golden rule in order to facilitate using fiscal policy as a tool for macroeconomic stabilisation. The golden rule stipulated that borrowing must not exceed budget expenditure on investments. Exceptional deviation from the rule was permitted only to ‘prevent a disturbance of the macroeconomic equilibrium’. However, the golden rule turned out to be ineffective in containing deficits and debt accumulation. Following its introduction, the debt ratio rose from around 20 % of GDP to more than 70 % of GDP in 2009.

The ratcheting-up of debt resulting from the stimulus package and financial sector stabilisation during the last crisis triggered widespread political debate on the sustainability of public finances, which finally led to another amendment of the Constitution in 2009 replacing the golden rule by the debt brake stipulating as a matter of principle balanced budgets for federal and Länder governments. For the federal budget, the debt brake has been in effect from 2011 and applies to the cyclically adjusted budget, i.e. it sets a ceiling for the federal structural deficit in normal times at 0.35 % of GDP from 2016 onwards with a transition period starting in 2011. The methodology for the cyclical adjustment follows the common OECD/Commission approach. As a major innovation, the implementation of the debt brake for the federal budget includes a (virtual) control account registering deviations in budget execution from the defined level of authorised new borrowing: with overruns booked as debit, and under-runs recorded as credit. Debits on the control account need to be reduced once they exceed 1 % of GDP, but only in an economic upswing and by no more than 0.35% of GDP per annum.

Länder budgets must be balanced as of 2020. Implementation at state level is the sole responsibility of the Länder. The Länder are free to specify the legal basis and relevant implementation provisions, including the choice with regard to applying the debt brake to nominal or structural budget balances, the methodology for cyclical adjustment or whether to use a control account. Consolidation efforts of five Länder in a particularly difficult fiscal position will be supported through assistance payments provided in equal shares by the federal government and the other Länder. Such assistance payments are conditional on compliance with an agreed consolidation path. For both the federal and Länder budgets the debt brake foresees escape clauses in case of natural disasters and extraordinary emergency situations outside of government control under the condition of simultaneously adopted repayment plans.

Furthermore, the constitutional amendment also included the establishment of a Stability Council with a view to enhancing the monitoring of budgetary developments at the federal and Länder level and introducing a federation-wide early warning system to prevent budgetary distress (70). In 2010, it replaced the former Financial Planning Council and consists of the federal ministers of finance and economic affairs as well as the state ministers of finance. The Stability Council is also in charge of monitoring compliance with the agreed consolidation path of the five Länder receiving consolidation assistance.

The implementation of the debt brake has also prompted a move towards top-down budget planning. As from 2011, the federal government will first approve the key figures for the annual federal budget and the medium-term financial plan, which will then serve as the basis for budgeting along departmental lines, finally leading to the joint adoption of the annual budget and the medium-term financial plan. In addition, the Federal Ministry of Finance has launched a pilot project on modernising budgeting and accounting. The pilot project aims to further standardise cost accounting, systematically develop the capital account, enhance the transparency of cash-based budgeting and expand the use of modern information technology.

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(70) The early warning system is based on the following four indicators at Länder level: structural budget balance per capita; borrowing-to-expenditure ratio; interest-tax ratio; and debt level per capita. When three of these four indicators cross their respective thresholds in one of the two time periods analysed, the system indicates a risk of budgetary distress. A threshold is defined for each indicator in relation to the Länder average: for example, the threshold for the indicator ‘structural budget balance per capita’ in a given year is the Länder average of the structural budget balance per capita minus EUR 200; the threshold for the indicator ‘debt level per capita’ in a given year is 130 % (220 %) of the Länder average for area states (city states). While thresholds will effectively catch outliers, the system does not aim to identify a situation in which the fiscal situation of the Länder in total worsens.
Germany has a long tradition of independent institutions supporting fiscal policy and budget planning by providing high-quality macroeconomic forecasts (the Joint Economic Forecast by leading research institutes has been in place since 1950) and fiscal policy advice (the German Council of Economic Experts has been in place since 1963 (Sachverständigenrat) and the Advisory Board to the Federal Ministry of Finance has been in place since 1950). Moreover, following a controversy over tax estimates, the Working party on tax revenue forecasting (Arbeitskreis Steuerschätzung) was established in 1955. This working party is an independent advisory council to the Federal Ministry of Finance and consists of representatives of the Federal Ministries of Finance and Economic Affairs, five economic research institutes, the Federal Statistical Office, the Bundesbank, the German Council of Economic Experts, the finance ministries of the Länder, and the Federal Union of Central Associations of Local Authorities. Based on the macroeconomic forecast of the federal government, the five research institutes, the Bundesbank, the German Council of Economic Experts and the Federal Ministry of Finance independently prepare their own projections for each individual tax, which are then coordinated within the working party at semi-annual meetings to reach consensus. The estimates for individual taxes are extrapolated to tax revenue for the federal government, the Länder governments, the local authorities and the EU. The federal government adopts the tax revenue forecast of the working party as the basis for the annual budget and the medium-term financial planning.

Finally, the German fiscal framework is characterised by the complex federal financial equalisation system (Finanzausgleich) which aims to reallocate revenues across Länder with a view to creating and maintaining equal living conditions all over Germany. The main elements are: (i) vertical distribution of tax revenues to the federation and the Länder: important taxes such as income tax, corporate tax and VAT are shared between the federation and the states, while other taxes are assigned exclusively to either the federation (e.g. energy taxes), the states (e.g. inheritance tax) or the municipalities (e.g. real property tax); (ii) horizontal distribution of tax revenues among the various states: a share of VAT revenue is redistributed to states with below average per capita revenues from income, corporate and Länder taxes; (iii) financial equalisation between fiscally strong and fiscally weak Länder: the deviation of the Länder's financial capacity per inhabitant (i.e. the sum of all receipts of the states and 64 % of the receipts of their municipalities) from the average financial capacity of all Länder is reduced by compensation payments from Länder with above-average financial capacity to those with below-average financial capacity; (iv) supplementary federal grants to poor Länder: general grants to further reduce the remaining gap in financial capacity after horizontal equalisation and grants for special needs to compensate states for particular burdens, for example for East Germany under the Solidarity Pact II (to be phased out by 2019). There is also a system of financial equalisation between municipalities within each Land.

2. Assessment of the current framework

The German fiscal framework includes rules, independent institutions, medium-term financial planning and budgetary procedures that can be considered as conducive to sound budget planning, although this has not prevented persistent deficits and the accumulation of debt. This deficiency has been addressed by the new constitutional debt brake. Detailed provisions in the Constitution and implementing rules suggest good prospects for the effective application of the debt brake at federal level.

However, an effective implementation at Länder level appears less certain. Only five states have enshrined or currently plan to enshrine balanced budget rules in their constitutions. Six further Länder have included balanced budget rules in their budget laws, which however could be modified through ordinary legislative procedures and thus provide less credibility than constitutional amendments. Moreover, implementing provisions have not yet been specified, or vary across states, pointing to some potential for inconsistent application and lacking political commitment. In principle, enforcement should be ensured by the option to challenge an adopted budget before the relevant constitutional court (i.e. the constitutional court of the Land concerned or, as from 2020, the Federal Constitutional Court in case the Land concerned has not enshrined a debt brake in its Constitution). On the other hand, the fact that for the time being, apart from Rhineland-Palatinate no Land is planning to use a control account may impede implementation and enforcement of the debt brake through constitutional challenges if deviations occur in budget execution, since deviations in budget execution may not be systematically registered and included in the setting up of the following annual budget. Additional sanctions are only available for the five Länder receiving consolidation assistance: it would be cancelled in case of non-compliance with the agreed consolidation path. Hence, further strengthening of implementation and enforcement at Länder level appears necessary to ensure the effectiveness of the debt brake.

The enhanced monitoring of budgetary developments through the Stability Council including the early warning system to prevent budgetary distress can effectively complement the implementation of the debt brake at state level. However, monitoring indicators and reference values, as currently applied, may not always be adequate to identify the risk of a budgetary crisis at an early stage, in particular due to the absence of an agreed methodology for the cyclical adjustment of budget balances at Länder level and the definition of reference values in relation to state averages. The suitability of monitoring indicators and reference values may therefore be reviewed.

In principle, an effective debt brake would usefully complement the fiscal equalisation system which has the potential to weaken incentives for fiscal discipline at the Länder level. On the other hand, the existing financial
relations between the federation and the Länder with a more limited tax and expenditure autonomy on the part of the states may impede a successful implementation of the debt brake at state level.

The medium-term fiscal planning contributes to consistent fiscal policymaking. Draft annual budgets need to be part of a plausible medium-term fiscal strategy. That said, the medium-term budgetary framework appears to be an indicative planning instrument describing the major fiscal policy strategy rather than setting strictly binding medium-term objectives or targets. It cannot, therefore, be conceived as an effective instrument to curb deficits or prevent the accumulation of debt.

The move towards top-down budget planning at the federal level should also contribute to fiscal discipline and, in fact, appears necessary to effectively implement the debt brake. Again, this raises the question to what extent is similar top-down budgeting also existing or envisaged at the Länder level. Furthermore, the pilot project on modernising budgeting and accounting at the federal level is likely to further improve the fiscal framework, but should be complemented by efforts to develop performance budgeting.

The traditional role of independent institutions in macroeconomic and tax revenue forecasting contributes to prudent and realistic assumptions of the federal government for its budget planning. Although the government is free to prepare the annual budget and medium-term financial plan using its own macroeconomic assumptions, considerable deviations from the Joint Economic Forecast by leading research institutes, for example, would certainly attract media and political attention and require reasonable justification. Moreover, the estimates of the working party on tax revenue forecasting are the result of consensus between several independent institutions and governmental authorities and are adopted by the federal government as a basis for both the annual budget preparation and the medium-term financial planning.

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**EPC policy advice**

The new constitutional debt brake has the potential to effectively curb deficits and to further strengthen the German fiscal framework. However, while detailed provisions in the German Constitution and related implementation rules suggest good prospects for effective application of the debt brake at the federal level, effective and consistent implementation at the Länder level appears less certain. Only some Länder have enshrined balanced budget rules in their constitutions, and provisions for their implementation have not yet been specified or vary across states. In this context, national authorities should introduce the following measure.

- Further strengthen the monitoring and enforcement of the debt brake at state level, in particular by ensuring consistent rules and provisions for their implementation across all Länder, adequate monitoring procedures and effective sanctions in case of non-compliance.

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**3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS**

**Fiscal rule in Germany: Budget balance rule (local governments)**

**General description of the rule and target definition:** Communal budget law obliges the communes to balance revenues and expenditure in its administrative and capital accounts. The regulation aims to safeguard the local governments’ sustainable financial capacity to act.

**General government sub-sector(s) to which the rule applies:** Local governments

**Implementation date:** Before 1990

**Time frame:** Budget year (annual, biannual)

**Accounting system:** Communal accounting rules

**Coverage and exclusions:** The rule covers local government expenditure accounting for almost 20% of general government total expenditure.

**Target definitions/specifications:** The rule targets a specific budget balance in nominal terms. Compliance implies a stabilisation of the nominal budget balance at a given level.

**Statutory basis:** Communal budget law

**Monitoring:** Communal supervisory agencies of the Länder

**Enforcement mechanisms:** The communal supervisory agencies of the Länder can refuse to authorise the communal budgets in case of non-compliance with the obligation of a balanced budget. The supervisory agencies can impose sanctions against the commune concerned. Communes with financial difficulties can be obliged to implement consolidation programmes. In particular cases, the supervisory agencies can also
temporarily take over the administration of the commune. In order to achieve a balanced budget, communes implement both increases in fees/taxes and reductions in disposable expenditure (usually investments). There are no predefined escape clauses.

**Compliance**: The rule has been respected in more than 50% of cases and contributes to fiscal discipline. Non-compliance is justified mostly by poor financial endowment of the communes.

**Fiscal rule in Germany: Budget balance rule (federal government)**

**General description of the rule and target definition**: Article 109(3) of the Constitution stipulates that, as a matter of principle, federal and Länder budgets are to be balanced without revenues from borrowing. Article 115(2) of the Constitution further specifies this rule for the federal budget. Accordingly, the balanced-budget rule is fulfilled when net borrowing does not exceed **0.35% of nominal GDP** (structural component applied to the cyclically-adjusted balance). Annual budgets can only be adopted if they comply with this rule. If budget execution leads to deviation of actual net borrowing from this ceiling, for example if estimates of the impact of a tax reform turn out to be incorrect, the amount exceeding or falling below the ceiling is recorded as credit or debit in a **control account**. The constitution requires reducing debits on the control account, once they exceed 1.5% of GDP, but only in an economic upswing (i.e. if the output gap increases) and by no more than 0.35% of GDP per annum. However, since this tends to delay repayment, implementation law requires reducing debits on the control account in an economic upswing already at a lower threshold value of 1% of GDP. In the event of natural disasters or extreme emergencies that are beyond the control of the government and cause considerable damage to the public fiscal situation, the maximum net borrowing limit may be exceeded. This emergency clause can only be applied if accompanied by a repayment plan within a reasonable time frame and adopted by the federal parliament by a qualified majority of 50% of the seats (not the members present) plus one.

**General government sub-sector(s) to which the rule applies**: Federal government

**Implementation date**: The ‘golden rule’ was introduced into the Constitution as part of the reform of the Financial Constitution in 1969. It was revised by an amendment to the Constitution in 2009 (71). The new rule applies to the federal budget with all its elements as from 2011, but a transition period is granted to gradually reduce the excess structural deficit by about 0.3% of GDP annually and to reach the ceiling of 0.35% of GDP as from 2016.

**Time frame**: Annual budgetary cycle

**Accounting system**: Cash-based accounting with cyclical adjustment

**Coverage and exclusions**: The old rule excluded public investments. The new rule covers all federal budget expenditure accounting for around 30% of general government total expenditure, though financial transactions (e.g. privatisation proceeds) are deducted when calculating the structural deficit.

**Target definitions/specifications**: The rule targets a specific budget balance as a percentage of GDP in cyclically-adjusted or structural terms. The rule limits the implementation of procyclical fiscal policies. Automatic stabilisers are allowed to take effect via cyclical adjustment that is established under non-constitutional law and that applies symmetrically in cyclical upturns and downturns. This ensures that, in the long term, cyclical deficits and surpluses will roughly balance out and, in particular, that surpluses are recorded in an upturn. The cyclical component is calculated at the beginning of the budgetary procedure by multiplying the estimated output gap by the budget sensitivity. The output gap is calculated based on the German government’s GDP growth projection and potential growth estimated in line with the methodology applied in the context of the SGP. The cyclical component is adjusted according to the actual GDP development once a deviation from the deficit ceiling within actual budget execution is established (i.e. on 1 March of the year following the budget year concerned), and is further updated up to the final estimate on 1 September of the year following the budget year concerned.

**Statutory basis**: Constitution (2009 amendment): Article 109 stipulates balanced budgets for the federal and the Länder budgets. Article 115 provides implementing provisions for the federal budget.

**Monitoring**: The Federal Ministry of Finance and the federal parliament (Bundestag) are in charge of monitoring the debt brake for the federal budget, within the usual budgetary procedures. Furthermore annual budget execution is monitored by the independent Federal Court of Auditors. Federal budget execution is monitored by the Federal Ministry of Finance on a monthly basis. In case deviations are expected towards the end of the year, (71) The “golden rule” previously enshrined in Article 115 of the Constitution permitted net borrowing up to the amount of expenditure on investments. Its ineffectiveness resulted from the inadequate budgetary definition of (gross) investment, the too-broadly defined exemption that could be applied in the event of economic disturbances, the lack of a link between compliance with the rule during budget preparation and execution, as well as the lack of an explicit obligation to balance out the additional deficits accrued in a situation of economic disturbances by accumulating surpluses in a cyclical upturn.
which would jeopardise the balancing of revenue and expenditure, the Federal Ministry of Finance must examine whether a suspension of expenditure should be imposed or even whether a supplementary budget will be necessary. Complementary to this, the newly established Stability Council monitors fiscal developments at the Bund and Länder level to prevent budgetary distress based on Article 109a of the Constitution.

**Enforcement mechanisms:** There is the option whereby constitutional bodies (i.e. the federal government, the federal parliament and the federal council) can file an action against the annual federal budget with the Federal Constitutional Court.

**Compliance:** The old ‘golden rule’ has not been effective in containing deficits and the accumulation of debt. The new rule has only been applied since 2011 and conclusive statements regarding compliance cannot yet be made. However, clear rules and implementing provisions suggest good prospects for effective implementation.

**Fiscal rule in Germany: Budget balance rule (state governments)**

**General description of the rule and target definition:** Article 109(3) of the Constitution stipulates that, as a matter of principle, federal and Länder budgets are to be balanced without revenues from borrowing. The Länder can implement rules for cyclically-adjusted budget balances. They can consider exceptions for natural catastrophes and other adverse events not under governmental control, though making use of these exceptions requires a repayment scheme. The new rule follows the previous ‘golden rule’ in Articles 109 and 115 of the Constitution and corresponding rules in the Länder. The new rule was agreed in 2009 in the context of the restructuring of political and fiscal competences between the federal and Länder governments.

**General government sub-sector(s) to which the rule applies:** Federal state governments (Länder)

**Implementation date:** The ‘golden rule’ was put in place by the Länder as part of the reform of the Financial Constitution in 1969. It was replaced by the new rule that applies as from 2011, but a transition period is granted to gradually reduce the excess structural deficit leading to full compliance with the rule as from 2020.

**Time frame:** Annual budgetary cycle

**Accounting system:** Cash-based accounting with cyclical adjustment

**Coverage and exclusions:** The old rule excluded public investments. The new rule covers all budget expenditure of the Länder accounting for around 30 % of general government total expenditure.

**Target definitions/specifications:** The rule targets a specific budget balance in nominal terms or cyclically-adjusted or structural terms. If applied in structural terms, automatic stabilisers are allowed to take effect via cyclical adjustment symmetrically in cyclical upturns and downturns. This would ensure that, in the long term, cyclical deficits and surpluses will roughly balance out.

**Statutory basis:** The ‘golden rule’ was enshrined in the respective constitutions of the federal states (Länderverfassungen). The new rule of balanced budgets for the federation and the states is enshrined in Article 109 of the Federal Constitution. However, the Federal Constitution specifies the implementation of the debt brake only for the federal budget, while specifying implementation for the state budgets is left to the Länder. Some states have already enshrined similar balanced budget rules in their respective state constitutions and others in their budget laws. Moreover, in some cases detailed implementing provisions are not yet specified or vary across Länder.

**Monitoring:** The ministries of finance and the parliaments of the Länder are in charge of monitoring at Länder level. This is complemented by the enhanced monitoring of budgetary developments at Bund and Länder level through the newly established Stability Council, including an early warning system to prevent budgetary distress. The Stability Council consists of the ministers of finance of the federal government and the Länder and the Federal Minister of Economic Affairs and Technology. It meets semi-annually and monitors budgetary developments based on annual reports submitted by the Bund and each Land. The monitoring indicators determined by the Stability Council include: (i) structural budget balance per capita; (ii) borrowing-to-expenditure ratio; (iii) interest-tax ratio; and (iv) debt level per capita. In case the majority of these indicators exceed certain thresholds, the Stability Council issues early warnings by establishing the risk of budgetary crisis at the Bund level or in a Land based on a specific evaluation procedure. On 23 May 2011, the Stability Council established, for the first time, the risk of a budgetary crisis in four Länder (Bremen, Saarland, Berlin, Schleswig-Holstein) and requested a submission of consolidation programmes by 15 October 2011.

**Enforcement mechanisms:** There is the option of filing an action with the Federal Constitutional Court (as from 2020) or, for those states that have taken incorporated the new rule into their constitution, with the constitutional court of the relevant Land (Landesverfassungsgericht). Additional sanctions supporting enforcement are available only for those states receiving consolidation assistance (Bremen, Saarland, Berlin, Sachsen-Anhalt, and Schleswig-Holstein), provided equally by the Bund and the other Länder. Consolidation payments would be suspended in case of non-compliance with an agreed consolidation path. Consolidation commitments are also foreseen under the early warning system to prevent budgetary distress. If the risk of a budgetary crisis is
established, the Stability Council agrees with the state concerned a consolidation programme based on a proposal from the state concerned including the consolidation measures envisaged and outlining the consolidation path. The Stability Council can require additional consolidation efforts if it considers the proposed measures or their implementation insufficient. However, there are no sanctions at the disposal of the Stability Council to enforce consolidation programmes.

**Compliance:** The old ‘golden rule’ has not been effective in containing deficits and the accumulation of debt. The new rule will only be fully binding in most of the states as from 2020 and conclusive statements regarding compliance cannot yet be made. The new budget rule should, in principle, lead to greater budgetary discipline. However, the effectiveness at the Länder level may be weakened by differing legal status, potentially inconsistent definitions of the rule, varying implementing provisions and the absence of sanctions beyond a constitutional challenge. For example, for the time being (apart from Rhineland-Palatinate) no Land plans to use a control account, which may impede the effectiveness of the debt brake if deviations occur in budget execution. In addition, the enhanced monitoring of budgetary developments at Länder level through the Stability Council can effectively complement the implementation of the debt brake at state level. However, the monitoring indicators and reference values may not always be adequate to identify the risk of a budgetary crisis at an early stage, in particular due to the absence of an agreed methodology for the cyclical adjustment of budget balances at Länder level and the definition of reference values.

**Fiscal institution in Germany: German Council of Economic Experts (Sachverständigenrat)**

**Date of establishment and description of the main tasks related to fiscal policy:** The German Council of Economic Experts was created by law in 1963 and is a body of academic policy advisers. It consists of five independent members with special academic knowledge of economics and experience with the national economy. The Council is supposed to provide independent and trustworthy information on options and requirements for stability policy.

**General government tiers at which the institution carries out its tasks:** The Council reports to the federal government, but its analysis covers the whole general government sector. It may also analyse individual fiscal sectors (central, regional or local authorities, social security) insofar as they are of relevance for public finances as a whole.

**Main outputs released by the institution:** In line with the mandate assigned to it by law, the Council publishes an annual report in mid-November on the state of the German economy and the expected developments. Since 2007, the Council has delivered an additional special report on a selected topic every spring. The government and the Council determine in a common decision the subject of the report. The government can also request the Council to deliver special reports. The Council provides independent macroeconomic forecasts and long-term projections for public finances of the whole general government sector. In individual annual reports, the Council also considers the long-term sustainability of public finances.

**Role of the institution in the budgetary process:** The Council plays no role in the drafting and adoption of the budget. The Council provides independent analysis on fiscal policy developments and contributes to ensuring that government policy is adequate in the prevailing cyclical conditions as well as to greater transparency in the conduct of fiscal policy, for example by analysing the macroeconomic and budgetary forecasts of the government. The Council is supposed to portray the macroeconomic situation and the foreseeable development and examines how price stability, high employment, balanced foreign trade and sustainable growth can be ensured. The Council points out undesirable trends and ways to avoid them without, however, recommending any specific measures to take. When drafting its annual report, the Council holds talks with the federal government and submits a catalogue of written questions, which are answered by the federal government.

**Obligation for the government to use the output of the institution:** The federal government is free to prepare the budget and the stability programme using its own macroeconomic assumptions, but is required by law to respond to the Council’s annual report in parliament within the eight weeks following its publication. This is done in the federal government’s Annual Economic Report.

**Status of the institution:** The provisions of the existence of the Council are enshrined in the Law on the creation of a Council of Experts for the assessment of overall economic trends, which was adopted in 1963. The Council is not formally attached to the government or parliament, is bound only to its legal mandate and is independent in its activities.

**Composition and appointment of the governing board:** The Council members include academics and policy experts. The members are appointed by the Federal President at the suggestion of the federal government. The Council members cannot hold political posts concurrently and must not belong to any trade association or association of employers or employees/trade union, either currently or in the year before their nomination. The Council has five members who are appointed for five years and who can be reappointed. Each year, the term of one Council member expires.
Decisions of the governing board: Resolutions must be adopted by at least three members. Minority votes are permissible.

Staff: Nearly 20, about half involved in research and half concerned with office/secretarial work.

Influence of the institution: As a result of the Council’s authority (it has the highest reputation of all councils in Germany) its statements receive a lot of attention in public debate. In this way, the Council does influence policymaking. For example, the Council’s suggestions for structural reforms were taken up by the federal government and largely implemented through the Agenda 2010 reforms.

Fiscal institution in Germany: Joint Economic Forecast

Date of establishment and description of the main tasks related to fiscal policy: The Joint Economic Forecast (JEF) by leading research institutes is a project conducted twice each year (spring and autumn) on behalf of the federal government. The JEF has been conducted since 1950. The main objective of the JEF is to give a common mandate to several research institutes whose theories and methods may differ. This initiates a process of coordination yielding results that demonstrate a high degree of certainty due to the mutual checking of data, assumptions and conclusions. The JEF is, therefore, assumed to be superior to studies carried out by single institutes.

General government tiers at which this institution carries out its tasks: The JEF is commissioned by the Federal Ministry of Economic Affairs and Technology. Its analyses cover the whole general government sector (central, regional or local authorities, social security).

Main outputs released by this institution: Each year, a spring report and an autumn report are published.

Role of this institution in the budgetary process: The JEF has no direct influence on the budget and the budgetary procedure. The role of the JEF encompasses the provision of independent forecasts on international and German economic trends and independent policy recommendations on fiscal policy (e.g. tax policy) and economic policies (e.g. employment policy, monetary policy). Forecasts on public finances include government expenditure (government consumption, public sector building investment), revenue (taxes, social contributions) and government balance and debt. The JEF has no privileged access to inside information.

Obligation for the government to use the output of the institution: The federal government is free to prepare the budget and the stability programme using its own macroeconomic assumptions and is not obliged to publicly respond to the JEF reports.

Status of this institution: The JEF is not explicitly defined by law, but operates within the framework of research mandates given by the German government. The JEF is not formally attached to the government or parliament. The participating institutes are reimbursed by the German government for the costs incurred while carrying out their mandate.

Composition and appointment: There is no appointment of individuals. The heads of the economic forecasting departments of the participating institutes are in charge of the JEF with the participating institutes contracted through a call for tenders. The institutes currently participating are: IFO Institute Munich in cooperation with the Swiss Institute of Business Cycle Research (KOF), ETH Zurich; the Institute for the World Economy Kiel in cooperation with Zentrum für Europäische Wirtschaftsforschung (ZEW) Mannheim; Halle Institute for Economic Research (IWH) in cooperation with Kiel Economics; Rhenish-Westphalian Institute for Economic Research Essen (RWI) in cooperation with the Institute for Advanced Studies, Vienna. The members can hold political posts concurrently but are expected to take an objective approach, independent of any political view.

Decisions of the governing board: The JEF should be agreed by consensus — any irreconcilable differences are made public (majority vote, minority vote).

Staff: About 60 economists are involved during the two weeks of the preparation of the JEF.

Influence of this institution: The forecast is considered to be of high quality and attracts high media attention. It contributes to transparency in macroeconomic trends and assumptions as a basis for adequate fiscal and economic policymaking.

Fiscal institution in Germany: Advisory Board to the Federal Ministry of Finance

Date of establishment and description of the main tasks related to fiscal policy: The Advisory Board to the Federal Ministry of Finance (the Board) was created in 1950 and is an independent body which advises the Federal Minister of Finance on all questions of fiscal policy. The Board is free to decide on the issues to consider, but it takes account of the requests of the Federal Minister of Finance. The Board deals with a broad range of issues including fiscal policies, regulatory issues (e.g. market regulations, questions of federalism, social
reforms) and European policy. The Board makes both analytical and normative statements and issues policy recommendations. However, it does not issue own forecasts or projections.

**General government tiers at which this institution carries out its tasks**: The Board was set up to advise the Federal Minister of Finance: it, therefore, focuses on issues relevant to the federal government and Germany as a whole. This includes the system of social security or the fiscal relations between the federal government and the Länder.

**Main outputs released by the institution**: The results of the work of the Board are documented in reports which are presented to the Federal Minister of Finance and later published. The Board produces reports at irregular intervals.

**Role of the institution in the budgetary process**: The Board does not have any direct influence on the budget or the budgetary process. The Federal Minister of Finance provides the Board with information relevant to its work and regularly on current fiscal policy trends and plans.

**Obligation for the government to use the output of the institution**: The government is not obliged to publicly respond to the analysis prepared by the Board. However, the Federal Minister of Finance carefully considers the Board’s recommendations and draws his own conclusions from them. The Board’s reports contribute to the public policy debate and help inform parliament, associations, the business community and interested citizens.

**Status of the institution**: The Board was created by ministerial decree in 1950. The mandate and activities of the Board are determined in its statute, which was adopted in 1971. The Board is not formally attached to the government or the parliament and deliberates with complete autonomy on an honorary basis. The board members are reimbursed by the German government for the costs incurred while carrying out their mandate (in particular travel costs and accommodation).

**Composition and appointment of the governing board**: The Board consists of about 25 honorary members who, as a matter of principle, are university professors of economics or law with special knowledge on the theory of public finance and fiscal policy. The Board members are appointed by the Federal Minister of Finance at the suggestion of the Board. The Board holds a secret vote on who to propose, with the majority of votes deciding the outcome. Board members are appointed as individuals for an unlimited term. The right to vote expires at the age of 70. Members can hold political posts concurrently but should not represent interest groups.

**Decisions of the governing board**: The majority principle does not apply to reports. Diverging views are presented in the report, this can also take the form of minority reports.

**Staff**: The Board does not have its own staff: secretarial services are provided by staff members of the Federal Ministry of Finance.

**Influence of the institution**: The Board has a good reputation and, as an independent body, provides valuable advice, contributes to political decision-making and the public debate. It is itself interested in dealing with topics which are relevant to public policy debate and are likely to attract public interest.

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**Fiscal institution in Germany: Working party on tax revenue forecasting (Arbeitskreis Steuerschätzung)**

**Date of establishment and description of the main tasks related to fiscal policy**: The Working Party on tax revenue forecasting (the Working Party) prepares independent high-quality tax revenue forecasts. It was established in 1955 as a consequence of a conflict over tax revenue estimates between the Federal Ministry of Finance and a leading research institute. Since 1968, the federal government has adopted the results of the Working Party for its medium-term financial planning. The Working Party meets twice a year and bases its projections on the economic forecast of the federal government. Some members of the Working Party (the five research institutes, the Bundesbank, the German Council of Economic Experts and the Federal Ministry of Finance) independently prepare their own projections for each individual tax. These estimates are discussed within the working party with a view to reaching a consensus. The estimates of the individual taxes are then extrapolated to tax revenues for the federal government, the Länder governments, the local authorities and the revenues transferred from Germany to the EU budget.

**General government tiers at which the institution carries out its tasks**: The Working Party is an independent advisory council to the Federal Ministry of Finance and consists of representatives of all general government tiers.

**Main outputs released by the institution**: Tax revenue forecasts

**Role of the institution in the budgetary process**: The Working Party provides independent forecasts for government revenues. When preparing its projections, the Working Party has privileged access to inside information, without having access to all information.
**Obligation for the government to use the output of the institution:** The federal government adopts the tax revenue forecast of the Working Party as basis for the annual budget (since 1955) and the medium-term financial planning (since 1968). The results form also part of the financial projections submitted to the Stability Council.

**Status of the institution:** Administrative agreement

**Composition and appointment of the governing board:** The Working Party consists of working-level representatives of the Federal Ministry of Finance, the Federal Ministry of Economic Affairs and Technology, five economic research institutes, the Federal Statistical Office, the Bundesbank, the German Council of Economic Experts, the finance ministries of the Länder, and the Federal Union of Central Associations of Local Authorities. This composition ensures the independence of the Working Party. The chairmanship is incumbent upon the relevant Head of Division in the Federal Ministry of Finance. The Working Party members are appointed by their respective member institution.

**Decisions of the governing board:** The Working Party discusses the revenues from each tax and main tax discounts until consensus has been found.

**Staff:** No information is available.

**Influence of the institution:** The Working Party provides high-quality tax revenue forecasts that form the basis of the annual federal budget and medium-term financial planning. Given its immediate relevance to budget planning, it attracts high media attention and contributes to public debate on the subject.

**Medium-term budgetary framework in Germany**

**Description of the medium-term budgetary framework:** The federal government adopts jointly with the draft annual budget a medium-term financial plan. Both are submitted to parliament which adopts the annual budget and takes note of the medium-term financial plan. In addition, the Federal Ministry of Finance issues the Finance Report on the situation and the presumed development in public finances, also considering the context of macroeconomic developments. The annual budget planning and the medium-term planning are directly transferred into the stability programme.

**Time frame:** Year t-1 until year t+3, where t is the budget year for which the draft budget plan is prepared.

**Institutional coverage:** Federal government

**Accounting system:** Cash-based accounting (for the stability programme, converted to ESA 95)

**Target revisions and binding objectives:** The medium-term financial plan is adopted anew annually. Therefore, medium-term budgetary targets can be revised every year and are not binding.

**Level of detail of projections:** The medium-term financial plan includes all revenues, including net borrowing, and all expenditures in absolute nominal terms. It includes detailed projections for the main expenditure items in the main spending areas (e.g. health, education, social spending). Revenues are broken down to different taxes (income tax, VAT, energy tax, etc.).

**Connectedness with the annual budget law:** The medium-term financial plan is the starting point for the preparation of the annual budget. The actual budget year is the first plan year of the financial plan. In case of deviations in the current budget year, the legal instruments of budget execution are applied. Any changes for subsequent years are entered into the new financial plan. Thus, the fiscal targets defined in the medium-term financial plan do not necessarily constrain the preparation of the annual budget.

**Monitoring mechanisms:** Annual budget execution is monitored by the independent Federal Court of Auditors. Medium-term fiscal planning is part of the negotiations in federal government. This ensures that the new draft is in line with either the maintained or revised medium-term budgetary objectives. Moreover, the Council of Economic Experts and the joint macroeconomic forecasts of leading research institutes independently comment on the medium-term financial planning as set out by the financial plan and the stability programme.

**Enforcement mechanisms:** In case of minor deviations in the current budget year, the existing legal instruments of budget execution are applied. Major deviations in the current budget year are dealt with by a targeted readjustment of revenue and expenditure targets via a supplementary budget. Deviations with an effect in subsequent years are taken into account in the preparation of the next financial plan.

**Targets for sub-central governments:** According to the constitutional situation, the federation and the Länder operate their budgets autonomously. Procedures for medium-term financial planning at Länder level correspond to the medium-term financial planning at the federal level. A legally not binding coordination of budgetary and financial planning is carried out by the Stability Council representing both the federation and the states. The Stability Council makes recommendations for budgetary discipline and, in particular, for a common line on expenditures. Twice a year, the Stability Council also discusses budget projections for the federation and the Länder as basis for the stability programme.
Comments on the functioning of the framework: The medium-term fiscal planning certainly contributes to consistent fiscal policymaking. Draft annual budgets need to be part of a plausible medium-term fiscal strategy which can be exposed to external scrutiny by independent institutions. That said, the framework appears to be an indicative planning instrument describing the major fiscal policy strategy rather than setting strictly binding medium-term objectives or targets. Therefore, the medium-term financial planning cannot be conceived as an effective instrument to curb deficits or prevent the accumulation of debt.

Domestic budgetary procedures in Germany

Prudent economic assumption for the budget preparation:

At present, the economic assumptions of the federal government for the budget preparation usually appear overall prudent and realistic. In particular, the independent Joint Economic Forecast carried out twice a year by leading research institutes on behalf of the federal government and the reports of the German Council of Economic Experts should contribute to transparency and realistic assumptions, even though the government is free to prepare the budget and the stability programme using its own macroeconomic assumptions. Considerable deviations from independent forecasts and advice would certainly attract significant media and political attention and require reasonable justification. In addition, the Working Party on tax revenue forecasting provides regularly independent high-quality revenue estimates that are adopted by the federal government as a basis for both the annual budget preparation and the medium-term financial planning.

Centralisation of the budget planning process and the use of top-down budgeting:

The Federal Ministry of Finance plays the central role in preparing the draft annual budget. In the past, however, budget requests of line ministries often exceeded the indicative ceilings set by the medium-term financial plan. As of 2011, the federal budget will be drawn up using a top-down approach. On 16 March 2011, the federal government approved the key figures for the 2012 federal budget and the financial plan up to 2015, which served as the basis for further budgeting along departmental lines. This outline was used in the government’s internal budget drafting procedure finally leading to the adoption of the federal budget and financial plan. The move to top-down budgeting should be conducive to fiscal discipline and actually appears to be necessary to effectively implement the new constitutional debt brake at the federal level. This raises the question to what extent is similar top-down budgeting also existing or envisaged at the Länder level.

Modernisation of budgeting and accounting:

A pilot project at the Federal Ministry of Finance aims to modernise the system of budgeting and accounting at federal level, in particular by further standardising cost accounting, systematically developing the capital account, enhancing transparency of cash-based budgeting and expanding the use of modern information technology. Another initial focus on a more output-oriented budgeting in which efficiency and effectiveness of public spending are regularly assessed has been discontinued due to resource constraints.
Fiscal governance in Denmark

1. Description of the Fiscal Framework

Denmark has a tradition of coalition or minority governments. Budget plans, therefore, usually build on a consensus reached in negotiations between political parties in and outside the government. A reform of the budget process was implemented in the early 1980s leading to a greater degree of centralisation. However, the budget process was not given a strong legal basis but kept its informal character, being regulated by circulars and institutionalised behaviour under the Ministry of Finance (MoF). Thus, the Danish budgetary framework has not been changed substantially since the early 1980s.

In 1997, the first medium-term fiscal framework was introduced, aiming to strengthen fiscal discipline towards 2005. It was subsequently followed by 2010, 2015 and 2020 plans. In these plans, the required financing for planned spending initiatives was usually assumed to be found in the future from unspecified measures that often proved difficult to adopt. The 2020 plan adopted in spring 2011 broke with this tradition and planned spending is now to be based on a scenario where only initiatives for which there is a majority in parliament are taken into account.

Denmark’s medium-term budgetary framework (MTBF) applies to all levels of government (i.e. central, regional and local) and specifies annual growth targets for real public consumption expenditure in multi-annual plans usually covering a period of four to 10 years. Although not explicitly codified, the MTBF is usually revised at four to six year intervals. The MTBF does not build on constitutional or legal acts, though; it is a political commitment to achieve fiscal sustainability over a longer term horizon. Plans are not agreed on a fixed time schedule and can include a wide range of non-formalised indicators. Nevertheless, the multi-annual plans receive parliamentary support and serve as a guideline for fiscal policy planning in the annual budget process.

Denmark applies a top-down approach in its annual budget procedure where the MoF assumes the functions of monitoring and enforcing body at the same time. Revenue and expenditure estimates are based on the MoF’s forecast. The forthcoming year’s deficit, expenditure and revenue targets contained in the MTBF are taken as fixed parameters for budget preparation. The spending targets include public consumption but not income transfers, subsidies, or investment. To ensure compliance with the MTBF, the government determines rates of real public consumption growth for expenditure areas in early spring for the upcoming year and three outer years. Individual ministries, local and regional governments allocate expenditure in the fiscal year within these envelopes. A draft budget is submitted to parliament in August and a political agreement on the fiscal bill between the government and one or more political parties is reached in November before the budget for central government is adopted by parliament in December.

Regional and local authorities play an important role in administrating public expenditure. Regions (20% of total expenditure) and municipalities (50% of expenditure) are responsible, in particular, for hospitals and social services respectively. Danish local government tax and expenditure levels are negotiated collectively between the Finance Minister and the Association of Regional Governments and the Association of Local Governments in June. The agreements determine, inter alia, the size of the annual ‘block grant’ from the central government which finances 20% of sub-central expenditure. The remainder is financed by local tax revenue and by reimbursements from the central government.

The agreements between central, regional and local levels are not legally binding for individual municipalities or regions. However, the 2010 Fiscal Consolidation Agreement and the fiscal bill for 2011 introduced new mechanisms to support expenditure control in municipalities and regions. For municipalities, this implies that they must present politically approved mid-year accounts. The block grant can be cut by up to DKK 3 billion (0.2% of GDP) in the relevant year if actual spending exceeds agreed spending. The municipalities which spend more than budgeted are charged 60% of the deduction while the rest is charged collectively. For regions, the continuous budget follow-up has been tightened and the budgetary control of hospitals strengthened.

Based on the overall fiscal rule index, Denmark ranks relatively favourably among the Member States. Denmark has adopted a set of expenditure and revenue rules. The overarching rule of budgetary policy is achieving a structural general government balance or surplus in the medium to longer term, as specified by the MTBF. Currently, the government targets a structural general government deficit of less than 0.5% of GDP in 2015 and a balanced structural budget in 2020. All rules specify targets that are limited in time.

Regarding revenues, a tax freeze on direct and indirect taxes was adopted in 2001 by the government at the time, thus reinforcing greater budget discipline and introducing an implicit cap on expenditure. Derogation from the rule is allowed if a tax rate is raised for environmental reasons or to fulfil Denmark’s EU obligations and if extra revenue is used to reduce other taxes. In line with the general tax freeze, legislation allows for a reduction in block grants to local governments by the same amount of extra revenue achieved if they raise taxes. In
connection with the 2010 Fiscal Consolidation Agreement and the 2011 budget bill, sanctions were tightened for municipalities that raise taxes in a situation where the municipalities overall do not comply with the tax freeze.

In spring 2011, the government put forward a proposal for multi-annual expenditure ceilings covering all levels of government to tighten spending control and to prepare for the effects of demographic ageing. The ceilings are to be underpinned by sanctions, for example reductions in appropriations and grants, and to be controlled by the Danish Economic Councils (DORS). Currently, the DORS monitor the implementation of the general government’s budget plans and quantify short-term and long-term budgetary effects of envisaged policy measures and reforms. Results are published twice a year in reports also including a forecast for the Danish economy, projections for the development of public finances and recommendations on fiscal policy. However, the DORS are not assigned a formal role in the Danish fiscal framework and the government is not obliged to follow the DORS’ advice. Nevertheless, as a result of the institution’s credibility and its weight in the public debate, the government usually consults the DORS at the planning stages of the budgetary process.

The track record of Denmark’s fiscal framework has been rather positive. Following sizeable general government budget deficits during the 1980s and 1990s, the budget balance turned positive in 1999 and stayed so until the outbreak of the financial and economic crisis. In 2007, the surplus reached almost 5 % of GDP and gross government debt was down to 27.3 % of GDP. However, the rapid improvement in public finances was facilitated by a period of sustained economic growth and rising unanticipated revenues, for example from oil extraction. These developments also compensated for recurrent expenditure overruns, but limited the ambition for a structural overhaul of expenditure control.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

Denmark’s MTBF and the introduction of the balanced structural budget rule embedded in the MTBF have helped to reduce public debt and to address the need for sustainability enhancing reforms early on. In addition, multi-annual public consumption targets ensure that new spending initiatives must be balanced by cost reductions elsewhere in order not to jeopardise the MTBF’s overall ceilings. Similarly, it ensures that necessary future cost savings are decided at an early stage, allowing sufficient time to phase in and to make the required legal changes. However, as, for example, the MTBF sets a target for public consumption as a percentage of GDP to be achieved by the end of the period covered, it does not impose ceilings for individual annual budgets, making the link with the multi-annual targets less transparent. Moreover, it opens the door to front-loading spending initiatives as the adjustment burden can be deferred to the outer years of the MTBF, increasing uncertainty as to whether multi-annual targets will be met, especially as their lifespan often goes beyond a government’s term of office.

The 2020 plan adopted in spring 2011 tried to address this weakness by: (i) introducing the obligation to specify concrete policy measures that ensure compliance with the medium-term objectives at the time of proposing new expenditure items; and (ii) by suggesting that political agreements be made immediately to secure adequate financing of measures. In addition, the government proposed that the DORS be given the task to evaluate, on an annual basis, the evolution of long-term sustainability of public finances and whether annual expenditure ceilings are in accordance with the medium-term fiscal policy objectives. Currently, the overall influence of independent fiscal bodies is limited and continues to rely to a large extent on media coverage and public debates. The DORS do not provide an independent reference forecast or revenue and expenditure estimates, either.

Denmark has a history of substantial expenditure overruns in particular at the regional and local government levels. Targets agreed between the Minister of Finance and Local Government Denmark concerning average tax levels and annual expenditure developments have repeatedly not been adhered to. The central government has often compensated expenditure overruns by reducing block grants the following year but such sanctions have been applied with varying resolve. Moreover, the difference in accounting methodologies and the reporting frequency between the central and the regional as well as local levels of government make timely and continuous follow-up on budgetary execution at the sub-central levels difficult. Although developing budget overruns cannot be observed in real-time, thus leaving little room for timely corrective action, sanctions reinforced recently seem to bear fruit, as local governments’ budgeted consumption expenditures for 2011 and 2012 are below agreed amounts. Nevertheless, introducing accruals together with timely quarterly or monthly cash-based data, as put forward by Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, would contribute to effective expenditure control at the local level (as previously mentioned, the continuous budget follow-up for regions has already been tightened).

Current expenditure targets focus on general government consumption, which cover only part of total government expenditure (about 50 %). Areas, such as income transfers, subsidies, foreign transfers are not covered. In the 2020 plan, the previous government proposed raising the expenditure rules’ coverage ratio to 80 % by excluding only cyclically-sensitive items expenditures, for example unemployment benefits. Interest payments on public debt and public investments are also excluded in order to allow sufficient room to manoeuvre in times of economic setbacks.
EPC policy advice

The track record of Denmark’s fiscal framework has been rather positive. Denmark’s medium-term budgetary framework (MTBF) and the introduction of the balanced structural budget rule embedded in the MTBF have helped to reduce public debt and address the need for sustainability, enhancing reforms early on. In addition, multi-annual public consumption targets ensure that new spending initiatives must be balanced by cost reductions elsewhere in order not to jeopardise the MTBF’s overall ceilings. However, Denmark has also a history of substantial expenditure overruns at the regional and local government levels. In this context, national authorities should introduce the following measures.

- Specify annual expenditure ceilings that comply with the structural balance objective set out in the multi-annual plan in order to improve the link with the MTBF.
- Improve reporting on budget execution at local level, providing accruals — together with cash-based information on a quarterly or monthly basis.
- Widen expenditure targets, so that they are not limited to public consumption expenditure but cover the main part of non-cyclical public expenditures.

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

Fiscal rule in Denmark: Structural balance rule

General description of the rule and target definition: The rule stipulates the target of the structural balance as a percentage of GDP in the medium term.

Implementation date: The implementation has been gradual. Since the early 1990s, a target interval for the structural balance surplus has been specified. The focus on the structural balance target has increased in recent years.

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 predefined escape clauses; however, the target has been revised several times. The government’s so-called 2010 Plan from January 2001 included a target surplus towards 2010. The 2015 Plan from August 2007 included a surplus range through 2010 and a target of at least balance in 2011 to 2015. The convergence programme for 2009 has a target of at least balance in 2015 but no target for the intermediate period. In the convergence programme for 2011, the target is a structural deficit of 0.5% of GDP in 2015 and structural balance in 2020.

Time frame: It varies but normally 4–10 years. The target is supposed to be achieved by the end of the time frame.

Details: Due to the tax freeze, it has not been possible to raise taxes to achieve budget balance.

Statutory basis: A medium-term agreement by the coalition partners

Monitoring: The MoF is in charge of monitoring the rule.

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the surplus target.

Comments on the functioning of the rule: Even though targets are revised, the rule has helped to maintain focus on required growth and sustainability-enhancing reforms and thus facilitated their implementation. The national authorities regard the rule as having contributed to budgetary discipline, to constraining the budget deficit of the sectors concerned, to reaching the medium-term objective (MTO) for general government and fostering compliance with the deficit criterion in the Stability and Growth Pact. Furthermore, it has helped reduce expenditure growth and the increase in public debt as a percentage of GDP.

Fiscal rule in Denmark: Expenditure rule

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 2011 convergence programme. The rule for real growth in
public consumption was added in 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 predefined 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 2011–13.

**Details**: The introduction of the rule was part of the May 2010 Fiscal Consolidation Agreement which, inter alia, 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 MoF 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 DKK 3 billion 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 rule seems to have contributed to budgetary discipline in 2011, especially as a result of the sanctions introduced along with the rule.

**Fiscal rule in Denmark: Revenue rule**

**General description of the rule and target definition**: A tax freeze implying that direct or indirect tax rates cannot be raised.

**Implementation date**: The rule was first introduced in 2001. In the meantime, three tax reforms have been implemented, of which the last was in 2009. The present rule has been in force since then; however, tax increases in 2011 and 2013 were decided in the May 2010 Fiscal Consolidation Agreement.

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

**Escape clauses**: Derogation from the rule is possible if a tax rate is raised due to environmental concerns or EU obligations, and the revenue is used to reduce other taxes.

**Time frame**: In the 2011 convergence programme, the tax freeze is included until 2020.

**Details**: The tax freeze was introduced in November 2001 in order to end the historical tendency towards higher tax rates.

**Statutory basis**: Medium-term agreement between coalition partners

**Monitoring**: The MoF is in charge of monitoring the rule.

**Enforcement mechanisms**: Legislation allows for a reduction in block grants to local governments by the same amount of extra revenue achieved by higher local government taxes. The strengthened mechanisms in relation to the consolidation agreement and the 2011 budget bill agreement have also implied a tightening of sanctions towards municipalities that have raised taxes in a situation where the municipalities overall do not comply with the tax freeze.

**Comments on the functioning of the rule**: The tax freeze implies that it is not possible to finance expenditure by higher taxes and there is, therefore, a perception that the tax freeze has contributed to fiscal discipline and lower expenditure growth. Non-compliance sometimes happens (e.g. in relation to the Fiscal Consolidation Agreement in 2010), and is well covered by media, invoking a public debate.
Medium-term budgetary framework in Denmark

**Time frame:** The medium-term plan covers a period of 4–10 years.

**Institutional coverage:** The whole general government sector

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

**Target revisions and binding objectives:** The main target is the general government structural balance as a percentage of GDP which is specified for the end of the period covered and not for each intermediate year. There is no procedure as to how targets can be revised as they are not enshrined in law. However, they are revised regularly in line with new policy initiatives (72).

**Level of detail of expenditure projections:** Expenditure projections are broken down at the lowest level (i.e. line item or appropriations).

**Level of detail of revenue projections:** Revenue projections are broken down by tax type.

**Connectedness with the annual budget law:** Fiscal targets included in the MTBF are not legally binding but the forthcoming year’s fiscal targets contained in the MTBF are taken as fixed parameters for budget preparation. The government determines the overall allocation of real public consumption growth to expenditure areas in early spring and the central government and local governments agree on the overall expenditure and tax levels in June. A draft budget is submitted to parliament in August before local governments adopt their budgets in October. In November, a political agreement on the fiscal bill between the government and one or more political parties is reached. The budget for central government is adopted by parliament in December.

**Monitoring mechanisms:** The MoF is in charge of monitoring.

**Enforcement mechanisms:** There are no explicit mechanisms to correct deviations in budget execution from the budget law nor the budgetary targets established in the stability and convergence programme (SCP) or the MTBF.

**Targets for sub-central governments:** Local and regional governments are subject to the medium-term budgetary targets. However, while the SCP is based on the national accounts and excessive deficit procedure definitions, the central and local budgets are based on different accounting and reporting rules with respect to the accruals concept (e.g. taxes) etc. In addition, some institutions that are covered by the budgets are not considered part of the central government sector in the national accounts and some institutions that are not covered by the budgets are considered part of the government sector.

**Comments on the functioning of the framework:** The MTBF and the subsequent introduction of the balanced structural budget rule, has helped to bring down public debt and to address the need for sustainability-enhancing reforms early on. The multi-annual public consumption targets are to make sure that new spending initiatives do not violate the overall ceilings. Similarly, it ensures that necessary future cost savings are decided at an early stage, allowing sufficient time to phase in and make the required legal changes. However, constraints for individual annual budgets imposed by the MTBF’s multi-annual plans have been rather weak. This tempted policymakers to front-load spending as they assumed it would be difficult to secure the required financing for unspecified measures to be taken in the future.

**Fiscal Institution in Denmark: Fiscal Policy Council (DORS)**

**Date of establishment and description of the main tasks related to fiscal policy:** The DORS is an economic advisory body established by law in 1962. The DORS has 26 members representing unions, employers, the central bank and the Danish government and independent economic experts. On 1 July 2007, the Danish Economic Council and the Environmental Assessment Institute (IMV) merged into the DORS. Both councils are presided over by four independent chairmen. The chairmanship prepares economic analyses and policy statements on fiscal and monetary policies to the Council. The DORS monitors the implementation of budget plans and quantifies short-term and long-term budgetary effects of envisaged policy measures and reforms. However, the chairmanship’s mandate goes beyond fiscal policy and it can decide to analyse just about any economic issue, for example labour market policies, environmental policies, monetary policies.

**General government tiers at which the institution carries out its tasks:** The entire general government sector

**Main outputs released by the institution:** The DORS provides a report twice a year. The report contains a forecast on the Danish economy, including the overall development of public finances and recommendations on fiscal policy, for example in relation to the overall fiscal stance or the deviation from medium-term plans.

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(72) For example, in the 2010 plan from January 2001, annual public consumption growth in the period 2002–05 was planned at 1 % and in the period 2006–10 at 0.5 %. However, in relation to the 2003 tax reform, tax reductions in 2004 were partly financed by reducing planned consumption growth to 0.7 % in 2004 and 0.5 % in 2005. The budget bills and agreements with municipalities in 2004 and 2005 were made on this basis.
Role of the institution in the budgetary process: No formal role, however, the government generally consults the fiscal institution in the planning stage of the budgetary process.

Obligation for the government to use the output of the institution: There is no formal obligation for the government to heed the advice of the DORS.

Status of the institution: Independent government agency

Composition and appointment of the governing board: The four chairmen are usually university professors appointed by the government.

Staff: The board is assisted by a secretariat of around 20 economics graduates.

Comments on the functioning of the institution: The recommendations of the Council enter the decision process primarily through the public debate and are likely to induce the government to react in public. The immediate impact of the recommendations is dependent on how well the proposals are in line with the current political agenda. Many analyses and proposals for reforms are, however, taken up and implemented in a modified form at a later stage. Hence, the council makes an important contribution to fiscal discipline and contributes somewhat to the quality of public finance.

Domestic budgetary procedures in Denmark

Prudent economic assumption for the budget preparation:
The macroeconomic forecasts underlying the budgetary preparation are generally not less accurate than other more independent institutes (as represented by the central bank or the economic councils) and do not show a bias. There is a high degree of transparency in the dissemination of the forecasts, including a public disclosure of the methodology and the main external assumptions of the projections.

Centralisation of the budget process at the planning stage:
Given the structural balance target, the budgetary process becomes centralised to the central government with respect to the implementation stage so as to ensure respect of the agreed target. This ensures a top-down budgeting process where the MoF establishes the aggregate amounts for expenditures for each spending ministry, with line ministries having to draw up budgets within clearly defined overall appropriations. Each ministry then has the responsibility for the final reallocation of funds within its portfolio. The MoF does maintain a capacity for detailed analysis of the expenditure programmes of ministries and intervenes if ministries do not keep within their set ceilings. Transfers that are mandated by law and capital expenditures are not included in the system of expenditure ceilings. Bids for capital expenditure are received from spending ministries at the same time as they submit their other requests. The MoF evaluates such requests in view of the government’s policy priorities.

The use of top-down budgeting:
The expenditure ceilings ensure a top-down budgeting process, with line ministries having to draw up budgets within clearly defined overall appropriations.
1. DESCRIPTION OF THE FISCAL FRAMEWORK

Considering Spain’s heavily decentralised executive structure and budgetary responsibilities, interaction between government levels is of particular relevance. The fiscal framework in Spain relies on budgetary stability rules established in 2001 by the General Act on Budgetary Stability (LEP) and the Complementary Organic Act on Budgetary Stability (LOLEP). The latter establishes the mechanisms of coordination between central government and the 17 Autonomous Communities (Comunidades Autónomas or CA, plural CCAA) in the application of budgetary stability rules, in compliance with the principle of budgetary autonomy of the CCAA fixed by the Spanish Constitution. Both LEP and LOLEP were reformed in 2006 in order to adapt the legislation to increasing fiscal decentralisation; in particular the LEP and LOLEP added a clause establishing that the central government cannot bail out CCAA’s or local authorities’ fiscal deficits or public debt. It is also specified that the budgetary objectives of each CA are the outcome of a negotiation with the central government.

The budgetary procedures were first established by the General Budgetary Act (LGP) in 1977. The LGP was reformed in 2003 to take account of the far-reaching decentralisation that had taken place in the meantime and to adapt it to the budgetary stability rules established in 2001. The LGP now only applies to the central government; for CCAA, the 1980 Organic Act on Financing (LOFCA) established that each one of the CCAA would regulate its own budgetary process. However, the LOFCA established limits to the CCAA’s indebtedness by imposing a central government authorisation on regional issuance of public debt. Local authorities are subject to similar constraints. The provisions of the LOFCA also included the creation of an Autonomous Communities’ Council for Fiscal and Financial Policy (CPFF) to ensure budgetary policy coordination between regional and central government. The CPFF brings together representatives from the Ministry of Economy and Finance and representatives from the CCAA.

In line with the LEP, budgetary stability objectives are determined annually for a three-year rolling period. Every year, the Council of Ministers fixes two real GDP growth rate thresholds which determine whether the budgetary targets for the next three years should present a surplus, a balanced budget or a deficit; in the case of a deficit, this will be limited to 1% of GDP to be distributed across the different levels of government. Once the thresholds are fixed, the Ministry of Finance (MoF) provides a report on the cyclical position of the economy. On this basis, the central government submits to parliament a proposal for the stability budgetary objectives (budgetary targets complying with the LEP provisions) for the following three years for general government and for each level of government. The proposal includes an expenditure ceiling for central government, compatible with the proposed budgetary target. Exceptional budget deficits must be justified and accompanied by a medium-term financial plan in order to correct this situation within the next three fiscal years. In the case of the central government, this plan must be submitted to the parliament. In the case of the CCAA, the plan must be submitted to the CPFF.

According to the LEP, the central government is responsible for monitoring budget execution and ensuring the compliance of budgetary objectives. To this end, by 1 October each year, the MoF has to provide a report on the degree of accomplishment of the budgetary objectives of the previous exercise, as well as information on the economic cycle of the exercise in progress.

Regarding enforcement, the LEP establishes that the central government is ultimately responsible for ensuring compliance with the budgetary objectives at all levels of government. In the case of a budgetary deviation at central government, a three-year rebalancing plan must be submitted to parliament. For a budgetary deviation by a CA, the central government informs the CPFF, which requests the CA to submit a three-year fiscal consolidation plan. The LEP also includes provisions that hold regional and local authorities responsible for an
eventual non-compliance with the Stability and Growth Pact. In addition, the central government can deny CCAA and municipalities the authorisation to issue public debt.

In response to the perceived weakness of the existing framework (Section 2, Assessment of the current framework), the fiscal framework was strengthened in 2010 to reduce the risk of non-compliance with the CCAA’s fiscal commitments. This included the obligation for CCAA to publish standardised economic and budgetary execution data on a quarterly basis. Other improvements were the implementation of an early warning system, which allows the central government to identify whether a CA risks breaching its fiscal target before the end of the budgetary exercise, and a new system for authorising debt that splits debt-issuance authorisations into three tranches (79). In addition, on 1 July 2011, the government introduced an expenditure rule in the LEP, according to which central government and municipalities cannot set an expenditure growth rate greater than the medium-term nominal GDP growth rate (80) in the setting of their budgetary stability objectives. At a CPFF meeting in July 2011, the CCAA took the political commitment to propose to their respective parliaments, within six months, an expenditure rule consistent with the rule approved for the central government and local entities. This rule will then be added to the existing legal framework governing regional deficit and debt financing.

On 2 September 2011, the parliament approved a constitutional balanced budget amendment, which should prohibit structural deficits in excess of targets set at the EU level and a limitation to the size of the aggregate debt of all levels of administration, which may not exceed the reference value set in the Treaty on European Union. The details regarding the definition of the structural deficit and the deficit ceilings, including the distribution of deficit and debt limits between the different levels of administration, the exceptional circumstances that can justify exceeding the limits, the manner and time of correction should deviations occur, the methodology for calculating the structural deficit, and the responsibility of each government in case of breach of the budgetary targets will be developed in a separate law to be approved before 30 June 2012. The constitutional balance budget rule will take effect from 2020 onwards.

2. Assessment of the Current Framework

The prevailing fiscal framework in Spain has been instrumental in promoting multi-annual fiscal planning and showed an overall good track record. The introduction of the principle of budgetary stability over the cycle in 2001 (LEP and LOLEP) allowed Spain to gradually improve fiscal balances and move from large deficits in the 1990s to surpluses between 2005 and 2007 and a continued fall in the government debt ratio.

However, the crisis has put Spain’s fiscal framework under strain. The dramatic deterioration of the general government deficit exposed a need to tighten the budgetary controls at all levels of government in order to reduce the risk of non-compliance. It also became clear that pre-crisis outcomes had benefited from a tax-friendly growth composition, rising asset prices, falling interest burden and some expenditure containment in earlier years. The shift to a less tax-rich growth pattern, including the severe contraction of the real estate sector, prompted a rapid and permanent decline in tax revenues. While the fiscal framework had allowed for the accumulation of budgetary surpluses during good times, this proved insufficient to compensate for the sharp budgetary deterioration in the wake of the crisis. This can be partly explained by the artificial discontinuities created by the use of real GDP growth rate thresholds to determine the nature of the budget target (surplus, balance or deficit): a real GDP growth projection of just a decimal point below the 2 % threshold allowed for budgetary deficits of 1 % (compared to a balanced budget if growth projection were 2 %); by contrast, a high GDP growth rate projection implied that the budget target had to be barely in surplus, which proved to be insufficient.

In a context of an increasing decentralisation, the inclusion in 2006 of a clause establishing that the central government cannot bail out CCAA’s or municipalities’ fiscal deficits or public debt was a positive step that paved the way for capital markets to discriminate between different regional or local authorities on the basis of their budgetary policies. The reforms introduced in 2010 contributed to improving the budgetary information provided by CCAA, which until then was not publicly available and suffered from a lack of homogeneity with regard to both the scope of their budgets and the accounting criteria.

The recent enshrinement in the Constitution of the principle of budgetary stability is also a positive step. Specifically, the constitutional amendment forces not only the national parliament, but also, and more

(79) A first tranche of debt is authorised at the time of the approval of the rebalancing plan, a second tranche is conditional on having no risk of deviating from the deficit target using information from the budgetary execution until the second quarter of the year, the remaining tranche is subject to the verification of final compliance with the annual target once the year is concluded.

(80) Average of the real GDP growth over a nine-year period (previous five years, current year, and three years of forecast).
importantly, regional parliaments, to comply with this principle. Indeed, the principle of balanced structural deficit introduces an implicit limit to the principle of budgetary autonomy of the CCAA, given that both principles now have the same statutory base. In addition, the inclusion of a reference to comply with the structural deficit limits included in the preventive arm of the Stability and Growth Pact (SGP) would allow, not only for fully translating into surplus the cyclical part of the budget balance at all levels of government, but also making this surplus proportional to the size of the output gap. This would have led to the build-up of much more important revenue buffers over the last decade (8% of GDP in 2007 compared to the observed 1.9%), thus providing a much better starting point from which to tackle the current crises, and preventing the general government deficit from reaching the levels observed in recent years (3.2% of GDP against the 11.2% observed in 2009 (81)). However, very relevant details, including the methodology to compute the structural deficit and the definition of 'economic recession', are not known yet. These features will be included in a separate law, which both main parties have pledged to approve before 30 June 2012, and which will need to be carefully examined.

**EPC policy advice**

Although the prevailing fiscal framework has been instrumental in promoting multi-annual fiscal planning and showed an overall good track record in a highly decentralised country, to some extent the significant deterioration of budget deficits at the central, regional and local government level can be explained by the fact that the fiscal framework did not sufficiently take into account the cyclical position of the economy. In addition, the fiscal framework was not sufficiently binding for regional and local governments. These issues are currently being addressed as evidenced by the recent introduction of an expenditure rule at central and local level and a balanced budget constitutional amendment.

In this context, national authorities should introduce the following measures.

- Adopt, as foreseen before the end of June 2012, the organic law to implement the new constitutional balanced budget rule, including the mechanisms needed to ensure compliance and implementing corrective action in case of deviation at all levels of government, to define the methodology for calculating the structural deficit, ideally following the methodology agreed at EU level, and clearly define a limited number of escape clauses.

- Strictly apply existing deficit and debt control mechanisms at sub-national government levels, ensuring that commitments are delivered; further improve reporting on budget execution at sub-national level; and adopt, as envisaged, binding expenditure rules at regional level.

(81) Source: Banco de España, Boletín Económico, September 2011.
3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

Fiscal rule in Spain: Budget balance rule

General description of the rule and target definition: In accordance with the LEP, each year, the government proposes a lower and an upper threshold (currently 2% and 3%) to determine budget balance targets.

When economic growth is projected to be up to the lower threshold (currently 2%), the budgetary deficit for general government is limited to 1% of GDP. This, in turn, is distributed across the different levels of government (0.2% of GDP for central government, 0.75% of GDP for CCAA as a whole and 0.05% of GDP for large local administrations; other local administrations should always present balanced or surplus budgets). In exceptional circumstances, the deficit has been allowed to reach 2%, as implemented in 2007–08–09 (and even this higher limit has been breached).

When growth is projected to be between the lower and upper threshold, the target is a balanced budget; over the upper threshold (currently 3%), the target is a surplus, but with no minimum requirement.

General government sub-sector to which the rules applies: The rule is applicable to general government (i.e. local government, regional government (CCAA), central government and social security).

Implementation date: The fiscal rule entered into force in January 2002 being applied for the first time to the budgets for 2003; the current version is the result of the 2006 revision.

Coverage and exclusions: The budget balance rule applies individually to each sub-sector of the public administration and, therefore, it covers the whole general government. Each sub-sector is thus obliged to introduce the regulations, instruments and procedures necessary to ensure the compliance with the budgetary stability objective.

Accounting system: ESA 95 accounting

Escape clauses: Exceptional budget deficits must be justified (e.g. natural disasters, exceptional slowdown) and accompanied by a medium-term financial plan in order to correct this situation within the next three fiscal years. In the case of the central government, this plan must be submitted to the parliament. In the case of CCAA, the plan must be submitted to the CPFF.

Time frame: The rule must be fulfilled on an annual basis but it is embedded in a medium-term budgetary scenario which covers three years on a rolling basis beyond the current one.

Statutory basis: Basic (i.e. other than constitutional/organic) law (LEP)

Monitoring and enforcement mechanisms: Enforcement is based on the principle of co-responsibility; each sub-sector is responsible for taking the actions needed so as to restore budgetary stability. Nonetheless, the central government is ultimately responsible for ensuring the compliance of the budgetary objectives. The government may also issue an early warning to sub-national governments when there is a risk of any administration failing to comply with the budgetary stability objective. The LOFCA contains provisions that allow the central government to deny regional and local authorities the authorisation to issue public debt.

Comments on the functioning of the rule: The crisis has unveiled shortcomings in the functioning of the rule. The fact of not taking into account output gaps in the rule has not allowed Spain to create the necessary buffers in times of robust economic growth that will help to smooth adjustment during cyclical downturns. The constitutional reform introduced in 2011 is expected to significantly improve the budget balancing of general government, and eventually supersede the provisions of the budget balance rule described above.

Fiscal rule in Spain: Expenditure rule (Central and local governments)

General description of the rule and target definition: This rule caps the growth in expenditure to a trend level of estimated growth in economic activity. The estimation is based on an average of the real GDP growth over a nine-year period (the last five years, the current year, and three years of forecast growth), to which an inflation reference of 1.75%, is added (below the ECB goal of 2%).

General government sub-sector to which the rules applies: The rule is applicable to Central and local governments.

Implementation date: The rule has been in force since 1 July 2011.

Coverage and exclusions: The rule applies to non-financial expenditure in central and local governments, excluding public debt’s interest payments and non-discretionary expenditure on unemployment benefits.

Accounting system: ESA 95 accounting
**Escape clauses:** In the case of an Excessive Deficit Procedure (EDP), the evolution of expenditure should strictly follow the one foreseen in the budgetary strategy leading to a correction of the EDP.

**Statutory basis:** Legal basis in the LEP, as amended 7 July 2011

**Monitoring and enforcement mechanisms:** The Ministry of Economy and Finance (MEH) (82) is in charge of monitoring respect of the rule. The monitoring is based on the report published by the MEH before 1 October each year.

**Comments on the functioning of the rule:** The rule is too recent for significant feedback.

**Fiscal rule in Spain: Debt rule (regional governments)**

**General description of the rule and target definition:** The CCAA’s indebtedness is subject to the following rules: (i) long-term debt is only allowed if it is to finance capital expenses, while short-term debt (less than one year) is allowed to finance transitory needs for cash; (ii) the sum of capital amortisation and interest payments cannot exceed 25% of current regional revenues; (iii) the stock of debt at the end of each year should not exceed the sum of the stock at the end of the previous year plus the net debt issued to finance the deficit target; any eventual excess of debt above this limit implies an equivalent reduction in the following year; (iv) issuing public debt requires authorisation from central government. The annual regional budgets contain a reference to the limit of indebtedness. A modification to the debt authorisation method was introduced in 2010 splitting the authorisation into three stages depending on the regions’ budgetary execution and implementation of their rebalancing plans. The MEH negotiate the tranches with the CCAA at the CPFF. For 2011, MEH’s authorisations for debt (83) issuance (to a maximum equal to the CCAA’s deficit target of 1.3% of GDP) will be split into the following three tranches requiring successive central government authorisations: 0.65%, 0.40% and 0.25% of their regional GDP. For 2012, total debt increase is also limited to 1.3% GDP, although the authorisation tranches have not yet been set by the CPFF.

**General government sub-sector to which the rules applies:** The rule is applicable to regional governments (CCAA).

**Implementation date:** The rule has been in force since 2009. A modification to the debt authorisation method was introduced in 2010 splitting the authorisation into three stages depending on the regions budgetary execution and implementation of their rebalancing plans.

**Coverage and exclusions:** The rule applies to all borrowing by regional governments (CCAA).

**Accounting system:** ESA 95 accounting

**Escape clauses:** The circumstances triggering the derogation are not fully specified; there is some margin of discretion.

**Statutory basis:** Legal basis in the LOFCA; implementation is through agreements between central and regional governments within the CPFF (i.e. Domestic Stability Pact).

**Monitoring and enforcement mechanisms:** The MEH is in charge of monitoring respect of the rule. The LOFCA establishes limits to CCAA’s indebtedness by imposing a central government authorisation on their issuance of public debt. If an autonomous community exceeds its indebtedness limit at the end of a year, the debt increase allowed for the following year is reduced by the amount of the excess. The monitoring is based on the debt at the end of each year as published by the Bank of Spain.

**Comments on the functioning of the rule:** The rule is considered to contribute to budgetary discipline and appears to be properly respected.

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(82) Ministerio de Economía y Hacienda.

(83) Initial misunderstandings had arisen regarding the scope of this rule (gross or net), which is now understood to cover all outstanding debt.
Fiscal rule in Spain: Debt rule (local governments)

General description of the rule and target definition: The rule establishes a debt ceiling for each local government as a percentage of current revenues (taxes, fees and fares, current transfers and property incomes), along with a surplus. The rule sets a requirement of authorisation on long-term borrowing if indebtedness exceeds 110% of current revenues or in case of a public deficit.

General government sub-sector to which the rules applies: The rule is applicable to local governments.

Implementation date: The rule has been in force since 1997.

Coverage and exclusions: The rule applies to all borrowing by local governments.

Accounting system: Cash/budgetary accounting

Escape clauses: There are no predefined escape clauses.

Statutory basis: Basic (i.e. other than constitutional/organic) law; act regulating local authorities (Royal Decree 2/2004 of 5 March)

Monitoring and enforcement mechanisms: The MEH is responsible for local authorities’ fulfilment of the rule in the following CCAA: Castilla-La Mancha, Madrid, Extremadura, Murcia, Canarias, Baleares and Cantabria. The regional governments are responsible for local authorities’ fulfilment of the rule in: Galicia, Asturias, La Rioja, Aragon, Navarra, País Vasco, Catalunya, Andalucia, Castilla y Leon, and Valencia. Local auditors (independent bodies from local authorities) must report on whether or not to seek authorisation or administrative approval prior to a credit operation. Although the fiscal rule refers to the current budget exercise, local governments which do not meet the rule must design a financial plan that has to be implemented over a horizon of three years in order to eliminate the negative saving of the local government.

Comments on the functioning of the rule: The rule is considered to contribute to budgetary discipline and appears to be properly respected.

Fiscal institution in Spain: National Committee of Local Administrations (Comisión Nacional de Administración Local, CNAL)

Date of establishment and description of the main tasks related to fiscal policy: The CNAL is a permanent body for cooperation between central and local administrations and was created in 1985.

General government tiers at which the institution carries out its tasks: Ministry for Public Administration

Main outputs released by the institution: The CNAL provides: (i) assessments on draft laws and regulations concerning local government’s administration and finances, and on criteria for state authorisations of the long-term credit operations of local governments; (ii) recommendations on local government’s administration, on the participation of local finances in state incomes and on the draft budget in those matters concerning local governments (i.e. it issues a report on the budgetary stability objectives for local governments fixed by central government and provides recommendations on the distribution of state grants to local governments).

Role of the institution in the budgetary process: This institution is in charge of assessing the draft budget prepared by the central government, but only those articles concerning local governments and finances.

Obligation for the government to use the output of the institution: The government is obliged by law to consult the CNAL. However, the CNAL only issues recommendations in the area of fiscal policy.

Status of the institution: This institution is enshrined in a legal act, Law 7/1985 (ordinary law), of 2 April, regulating local governments and in a Statute of the National Committee of Local Administration (Royal Decree 427/2005 of 15 April).

Composition and appointment of the governing board: The institution is composed of representatives of local governments, which are appointed by the main national local association (Federación Española de Municipios y Provincias, FEMP). The structure of the institution is as follows: board (28 members), two subcommittees (12 members each, who must be members of the board) and working groups for specific issues. One of the subcommittees is in charge of cooperation between central and local governments, and the other one is in charge of economic and financial cooperation.

Decisions of the governing board: Decisions are taken by (simple) majority.

Staff: 24

(*) The debt rule mostly concerns the largest urban areas which are actually allowed to run a small (< 0.5%) deficit.
Comments on the functioning of the institution: It contributes to improving the quality of public finances and the fiscal discipline of local authorities.

Fiscal institution in Spain: Court of Audit (Tribunal de Cuentas)

Date of establishment and description of the main tasks related to fiscal policy: The Spanish Constitution defines the Court of Audit (Tribunal de Cuentas) as ‘the superior audit organ of the accounts and financial management of the state and of the rest of the public sector’. The Constitution sets out the governing principles for the Tribunal and makes provision for further legislation to regulate its composition, organisation and functions. The Tribunal de Cuentas, in its current form, was established by the Constitution of 1978.

General government tiers at which the institution carries out its tasks: The governing board is appointed by the parliament. This institution is independent of the general government.

Main outputs released by the institution: The Court carries out technical auditing work on the management of public funds addressed to the parliament.

Role of the institution in the budgetary process: The Court has neither been attributed a consultative function in relation to the legislative process (financial regulations nor state Budget) nor for the creation of financial institutions or entities. But the Court can give recommendations and advice to the parliament for improvements in the management of the public sector and public funds as a result of its audit works.

Status of the institution: This institution was enshrined in the Spanish Constitution in 1978 (Sections 136 and 153.d). The Court of Audit has functional autonomy.

Composition and appointment of the governing board: The Court of Audit is composed of 12 members (Counsellors of Accounts). Six members are elected by the Congress of Deputies (lower house) and six by the Senate (higher house) of parliament. Each member must secure the support of at least 60% of the respective house. The members are elected for a nine-year period and are eligible for reappointment. All the members are independent and irremovable. They have the status of judges and have equal standing within the Court of Audit. The President of the Court for is elected by the Full Session among its Members and is subsequently appointed for a period of three years by the Monarch. The President represents the Institution and, among others, has the competence to convene and preside over the Full Session and the Ruling Committee, to exercise supreme authority in respect to the personnel and to order expenditures of the Court.

Decisions of the governing board: Decisions are taken by (simple) majority.

Staff: The Court of Audit has a staff of some 750 people including approximately 450 professional audit staff (200 senior and 250 junior Auditors).

Comments on the functioning of the institution: The Court of Audit performs an important role in verifying the degree of compliance of public finances at all levels of government with national fiscal rules.

Medium-term budgetary framework in Spain

Description of the national medium-term budgetary framework: The Ministry of Economy and Finance (MEH) produces a report on the cyclical position of the Spanish economy. The government establishes the budget stability objectives for the following three years and the limit of non-financial expenditure for the state for the next year. Budgetary targets for year T+2 and year T+3 are not binding. The budget stability objective is fixed for the public sector overall and for each government level, after consultation with the CPFF and the CNAL. The agreement is sent to parliament in the first half of each year. The MEH prepares scenarios of the forecasted public revenues and expenditures that detail the amount of expenditure committed annually and prepares the draft of the Budget Law (between July and September), which is submitted to the parliament before 1 October. Each of the CCAA regulates its own budgetary process and thus, enjoys a high level of fiscal policy autonomy.

Time frame: Three years (T+1, T+2 and T+3): the framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

Institutional coverage: General government (Ministry of Economy and Finance, representatives of regional governments and representatives of local governments)

Accounting system: Budgetary accounting (cash) is used for drafting the Budget Law. Budgetary accounting and national accounting (accrual) is used for executing and monitoring. Budget stability objectives are set in national accounting.
**Statutory basis:** Basic law (i.e. other than constitutional/organic) for central government and local authorities; organic law for CCAA

**Monitoring and enforcement mechanisms:** Prior to 1 October each year, the Minister of Economy and Finance presents a report to the government on the degree of fulfilment of the budgetary stability objective during the previous exercise, on the actual cyclical evolution during that year and on deviations from the initial forecast. The MEH recently adopted an early warning system, which allows the central government to identify whether a CA risks breaching its fiscal target before the end of the budgetary exercise, and a new system for authorising debt that splits regional requests for debt issuance into three tranches: a first tranche of debt is authorised at the time of the approval of the rebalancing plan; a second tranche is conditional on having no risk of deviating from the deficit target using information from the budgetary execution until the second quarter of the year; the remaining tranche is subject to the verification of final compliance with the annual target once the year is concluded.

**Connectedness with the annual budget law:** The preparation of the draft Budget Law must comply with the budgetary stability objective approved by parliament. Along the same lines, the non-financial expenditure of the central government cannot exceed the limit set. The budgetary stability objectives and the limit to the non-financial expenditure of the central government are set references during the annual budgetary process, as they cannot be surpassed; the regional and local authorities’ annual budgets should comply with the budgetary targets agreed at the CPFF.

**Domestic budgetary procedures in Spain**

**Budget preparation:** Around the month of April, the Ministry of Economy and Finance (MEH) launches the preparation of a draft Budget Law with the publication of a report on the cyclical position of the Spanish economy for the next three years. Then the government establishes a limit of non-financial expenditure for the draft Budget Law and defines two thresholds of growth (high and slow growth) that serve as basis for the application of the budget balance rule. It follows a proposal on the budgetary stability objectives for the following three years for the general government as a whole and for each level of government, on the basis of prior reports from the CPFF and the CNAL, in their respective scopes. Around June, the budgetary stability objectives as well as the expenditure limit are submitted for approval by the parliament. The MEH, on the basis of the proposals submitted by the other ministries, prepares the draft Budget Law between July and September. Before 1 October, the draft budget law is submitted to the parliament. The parliament adopts the budget law by 31 December at the latest. In the case of CCAA, they enjoy a high level of fiscal policy autonomy, which allows them to regulate their own budgetary process.

**Macroeconomic assumptions:** Underlying the draft Budget Law, macroeconomic assumptions are contained in the report on the cyclical position of the Spanish economy prepared in April. The report draws on a macroeconomic scenario for the next three years.

**Centralisation of the budgetary process for central government at the preparatory and approval stages:** The MEH prepares the draft Budget Law, on the basis of the proposals received from the other ministries, and sends it to the government for its approval and further submission to parliament before 1 October.

**Centralisation of the budgetary process for CCAA before the preparatory stage:** Prior to the proposal of an objective of budgetary stability for the CCAA as a whole, the MEH opens a consultation period with each of the CCAA that lasts 15 days. After that period, the MEH submits the budgetary stability objectives for the approval of the CPFF (coordinating committee gathering the MEH and regional representatives; the MEH has 50 % of the votes). Afterwards, bilateral negotiations between the MEH and each of the CCAA takes place on their individual budgetary stability objectives, which should consider the region’s economic situation, the scope of assumed competences, the level of debt and infrastructure needs. Individual regional objectives must comply with the budgetary objective set for the CCAA as a whole. If there is no agreement, the objective is eventually determined by the Ministry of Economy and Finance. In the case of local administrations, the CNAL plays a coordinating role and determines which (large) local entities prepare their budgets in accordance with the budgetary balance rule; it also determines the limit for admissible deficits, if growth falls below the established thresholds.

**Decentralisation of the budgetary process for CCAA at the preparatory and approval stages:** Autonomous Communities regulate their own budgetary process in compliance with the principle of budgetary autonomy fixed by the Spanish Constitution.

**Centralisation of the budgetary process at the implementation stage:** Central government is responsible for monitoring and ensuring the compliance of the budgetary objectives. To this end, by 1 October each year, the MoF has to provide a report on the degree of accomplishment of the budgetary objectives of the previous exercise, as well as information on the economic cycle of the exercise in progress.
**Supplementary or corrective budget:** In Spain, the supplementary or corrective budget does not exist as such. In the case of the state budget, the reform of the LEP in 2001 introduced a mechanism known as the Contingency Fund (Fondo de Contingencia), which amounts to 2% of the non-financial expenditure foreseen in the Budget Law. This fund is included in the Budget Law and allows for the financing of any unforeseen and non-discretionary expenditure, thus contributing to reduce the risk of slippage.

**The use of top-down budgeting:** The MEH determines the process of the elaboration of the Budget Law (central government), based on the submission of spending proposals by line ministries. In the case of CCAA, the MEH submits the budgetary stability objectives for the approval of CPFF and negotiates regional individual budgetary stability objectives. The CCAA regulate their budgetary process themselves.
1. Description of the Fiscal Framework

The current fiscal framework in Finland was introduced in 2003 and is anchored around multi-annual expenditure ceilings. Experience with the fiscal framework has been generally positive. The system is linked to parliamentary terms and experience with the framework suggests that governments abide by the rules.

The general government consolidated gross debt was 48.2% of GDP at the end of 2010, well below the euro area average of 85.8%. The general government deficit was 2.5% in 2010. However, the central government is still running deficits: net borrowing was 4.8% of GDP in 2009, 5.5% in 2010 and an estimated 3.8% in 2011.

The consolidation of public finances is a core element of the current government’s programme for 2011 to 2015. The programme is a public agreement between the coalition partners that is submitted to parliament as a government statement. The preparation and publication of the programme is mandatory as it is based on the Constitution. Although it is not legally binding, it remains very important from a political point of view. An implementation plan for the programme is issued as a governmental decree and the Prime Minister’s Office takes responsibility in follow-up tasks.

The current programme states that the government is committed to achieve a substantial reduction in the central government debt-to-GDP ratio by the end of the parliamentary term (2015). The government also commits to undertake further adjustment measures (expenditure decreases and tax increases) itself if the central government debt-to-GDP ratio is not shrinking or if the central government deficit stands above 1% of GDP.

This general objective of the government is translated into a fiscal rule by the means of a government decision on central government spending limits for 2012–15 (the current revision is dated 5.10.2011). This decision defines in essence the multi-annual financial framework.

The rule sets annual limits to government expenditure from 2012 to 2015 in 2012 prices. However, neither balanced budget requirements nor limits to annual deficits are set by the rule. According to the decision, the central government expenditure included in the spending limits should decrease, in real terms, by 0.35% in 2015 compared to 2012.

The current spending limits are set in 2012 prices. Each year, in connection with the annual decision on spending limits, the Ministry of Finance (MoF) adjusts the expenditure ceilings to the next year’s price level. Several indexes such as the central government transfer index, the national pension index and the university index are taken into account.

These expenditure ceilings cover 80% of the central government budget. Excluded items include unemployment assistance, the central government-funded social assistance, housing allowances, interest payments and expenditure items where expenditure and revenue are linked (external funding from the EU, government VAT expenditure, and lottery revenue). Proceeds from the auction of emission rights can be used without reference to the spending limits.

Exclusion of these items is crucial to allow automatic stabilizers on the expenditure side to work. It is important to note that expenditure effects generated by changes to the award criteria or level for cyclically-sensitive items, such as unemployment benefits, are included in the overall annual spending limits. This is to say that when the unemployment benefits expenditure increases during crises, the additional funds needed would be outside of the expenditure ceiling but if the government decides to raise benefits or extend their duration, resources have to be found within the ceiling.

The main technical work in setting the limits, as well as macroeconomic and budgetary forecasting and monitoring, is carried out by the MoF. The National Audit Office, a body accountable to parliament, checks the final accounts each year.

2. Assessment of the Current Framework

The basis for the fiscal framework has not been defined in legislation but relies heavily on political commitments taken at the beginning of an electoral term. The MoF is responsible for making the estimates that form the basis of the budgetary framework and budget for the next year. While there is no institution that is formally required to

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(85) The term ‘substantial’ is not defined in the programme and leaves room for political interpretation.
provide an independent assessment of the macroeconomic projections and the application of the spending rule, the budgetary process is scrutinised by a number of institutions such as the Bank of Finland and several other economic and independent research institutions. The expenditure ceiling framework has ensured sufficient discipline even in good economic times and central government increases in expenditure have been under control over the years when the rule has been in place. The rule, however, does not deal with the revenue side and does not force a balanced budget during a downturn in revenues.

The rule has countercyclical mechanisms built into it and Finland is deemed to have relatively large fiscal automatic stabilisers. Judging by the 2009 economic crisis, public finances proved relatively sensitive to economic shocks, with the general government fiscal balance declining by over 6 percentage points from 2008 to 2009 (from a surplus of 4.2 % to a deficit of 2.6 %). Over the past decade, the macroeconomic projections have proven prudent most of the time and have not resulted in negative budget surprises.

Municipalities play a relatively large role in the Finnish public sector, accounting for about 75 % of general government employment and spending close to 20 % of GDP. Local governments are obliged by law to keep their budgets balanced over a four-year period and municipalities abide by the law. So far, on the aggregate level, local government deficits and debt have remained modest (local debt amounts only to about 6 % of GDP). However, in the longer term, given the imminent population ageing challenge, local governments will face stronger expenditure pressures. Due to the set-up of public service provision in Finland, all the major ageing-related services fall under the responsibility of local governments. It is expected that the rise in expenditure pressures would lead to a rise in local tax rates, possibly counterbalancing tax policy objectives defined at the central government level. As local governments have constitutionally granted self-governance rights, the central government uses incentives to promote productivity advances in local governments through a wide range of measures. More binding approaches at expenditure control covering local governments have not been tried.

The right to levy taxes gives the local authorities the power to decide the grounds on which their finances are managed. The central government continuously identifies financially weaker municipalities and has set specific measures and financial incentives, including state grants for temporary or exceptional economic difficulties (86).

EPC policy advice

The strength of Finland’s fiscal framework lies in the long-standing commitment to agreeing the growth of central government expenditure at the beginning of a new parliamentary term. In this context, national authorities should introduce the following measures.

- In addition to expenditure ceilings, formalise a budget balance rule in legislation, complementing the expenditure rule and providing a robust correction mechanism in case of unwarranted cyclical developments.
- Considering the long-term cost pressures for municipalities arising from population ageing, reinforce the rules and incentives for municipalities to balance their finances.

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

Fiscal rule in Finland: Expenditure rule (central government)

General description of the rule and target definition: Central government expenditure over the parliamentary term is subject to limits, set in real terms at the beginning of a government’s term in office.

General government sub-sector to which the rules applies: The rule is applicable to the central government.

Implementation date: The rule has been in place since 2003 with modifications in 2007 and 2011.

Coverage and exclusions: The rule applies to about 80 % of the expenditure.

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

Escape clauses: If annual revenue from the sale of government-owned shares exceeds EUR 400 million, a maximum of EUR 150 million of the excess can be spent on one-off infrastructure and skills investments that promote sustainable growth. If economic growth is faster than anticipated, the increased revenue and decreased expenditure will primarily be used to reduce central government debt. However, if there is a clear reduction in the central government debt-to-GDP ratio before 2015, a maximum of 30 % of the improved fiscal position can be assigned to additional expenditure in line with the government’s strategic objectives.

Time frame: Four years, defined in fixed prices: each year the long-term framework is used to set specific expenditure limits in nominal prices.

(86) Overall, municipalities are considered to be sound borrowers as demonstrated by the fact that the Finnish municipal credit institution (Municipal Financial Pte) has received AAA credit rating.
**Statutory basis:** The government’s programme is an official document based on the coalition agreement and is submitted to the parliament. Implementing rules are defined by the MoF through a decree.

**Monitoring and enforcement mechanisms:** The MoF monitors the implementation of the annual budget. If supplementary budgets are used to correct deviations, changes arising from them are included in the expenditure ceilings.

**Comments on the functioning of the rule:** The system has been respected since its introduction.

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**Medium-term budgetary framework in Finland**

**Description of the national medium-term budgetary framework:** The spending limits decision that defines numeric targets also serves as a medium-term framework. It must be read along with the government’s programme which defines the (changes of) policy regarding both the revenue and the expenditure side.

**Time frame:** Four years (one term of government)

**Institutional coverage:** Central government

**Accounting system:** SNA is used.

**Monitoring mechanisms:** Line ministries and the MoF take the decisions/objectives of the government into account in their draft budgets.

**Link to the annual budget law:** Spending limits and objectives arising from the framework are taken into account in annual budgets.

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**Domestic budgetary procedures in Finland**

**Centralisation of the budget planning process and the use of top-down budgeting**

Ministries prepare their operating and financial plans for the next four years and receive directives from the MoF. In March, the government approves the spending limits based on the government’s first spending limits decision, in which the limit for the whole electoral period has been set. Ministries direct their departments and agencies. Agencies present budgets in spring and by the end of May, ministries present their drafts. After working with the drafts during the summer, final macroeconomic revisions are applied and the government presents the draft to parliament in September. Adoption occurs in December.

**Economic assumption for the budget preparation**

The MoF prepares macroeconomic and revenue projections that form the basis for the annual budget. There is no independent institution charged with the task of preparing economic forecasts but the forecasts of the Ministry are public, and thus subject to scrutiny by the public.

**Performance budgeting**

Performance budgeting is used in Finland. The section explaining the grounds for the main titles of expenditure in the budget proposal presents the most important targets of social policy for each administrative branch and the targets for the most significant reforms. The targets are shown by means of indicators and assessment criteria. The aim is to strengthen consideration from the perspective of performance and efficiency in decisions concerning the allocation of resources. The basis for the government’s work and, at the same time, for the strategic planning of central government operations is the government’s programme. The government’s strategy document is a government resolution, which comprises the government’s strategic policy outlining mainly in cross-administrative subject areas. Sectoral plans dealt with by the government are tools of political guidance for the sector in question. The aim of performance guidance is to ensure a balance between effectiveness and quality, efficiency, economy and productivity, and personnel targets. In performance guidance, a ministry allocates, on the basis of the Budget, appropriations for use by an agency or department and sets performance targets for the operating performance based on the joint opinion of the ministry and agency or department. The resulting targets are shown in a performance target document, also called the performance agreement. The agencies and departments also have to present reports on operations which include assessments of the performance targets.
1. DESCRIPTION OF THE FISCAL FRAMEWORK

France has experienced considerable changes in its fiscal framework in the past decade. They consisted in creating new fiscal rules or amending rules already in force, strengthening existing budgetary procedures, and establishing the multi-annual planning of public finances. Furthermore, a constitutional reform to strengthen the legal status of the multi-annual planning is currently under discussion.

A number of fiscal rules apply to the various sub-sectors of the general government. A dual spending norm applies to the central government level. According to the second multi-annual public finance planning act, covering the period 2011–14, central government expenditure excluding interest payments and civil servants' pensions is frozen in nominal terms. This rule comes on top of the zero volume rule introduced in 2004, which applies to all central government expenditure (\(^{87}\)).

Regarding social security, healthcare expenditure is subject to a nominal spending target fixed on an annual basis. This rule was strengthened in 2010, notably through: (i) an improved governance (establishment of a steering committee and a statistical committee within the administration, in charge of following healthcare expenditure on a monthly basis); (ii) an increased role for the independent committee in charge of alerting the authorities in case of substantial slippages; and (iii) setting aside funds at the beginning of each year, which are released in the course of the year depending on whether the target is (expected to be) met.

Concerning local authorities, the golden rule effective since the 1980s prohibits current expenditure to be financed by debt.

Finally, under the 2011–14 public finance planning act, any windfall revenues from the state and social security shall be used to reduce public deficit.

In addition to the strengthening of fiscal rules, the multi-annual planning of public finances has been improved. The constitutional reform of July 2008 created a new category of law for the purpose of defining multi-annual guidelines for public finances while striving towards balanced budgets. This reform transposed in concrete terms the contents of the stability programmes, which do not have any legal status in national law.

A first multi-annual public finance planning act was adopted in February 2009 and covered the 2009–12 period. It provided for a consolidation strategy which was based on an average annual target increase in central government and social security expenditure and also aimed at securing revenue. In particular, the three-year state budget is consistent with the overall spending norm and sets expenditure ceilings per programme; in addition, it stipulates targets for the increase in healthcare expenditure for the whole period and a freeze on transfers to local authorities in volume terms.

In December 2010, a second multi-annual public finance planning act was passed for the 2011–14 period. On the expenditure side, the target now covers the whole general government sector, including local authorities, and corresponds to a maximum increase in expenditure compared to that of 2010; on top of that already set in the previous law, central government expenditure excluding interest payments and civil servants’ pensions is now to remain unchanged in nominal terms; an annual ceiling is established for healthcare spending, and for the main mandatory funds of social security; finally, transfers to local governments are frozen in nominal terms. On the revenue side, the new act provides for a minimum annual amount of additional revenues stemming from new fiscal measures (mesures nouvelles); in addition, the total cost incurred on tax expenditures shall not increase in nominal terms.

The annual budgetary procedure has also undergone changes in recent years. In its current form, it allows for a draft state budget under a more detailed and revised format: more documents are annexed and the information is more complete and of higher quality. Likewise, the social security budget, in force since the mid-1990s, has been amended in recent years. It is now converging towards the rules applicable to the state budget, namely a multi-annual framework of expenditure and revenue. Finally, it should be noted that local authorities enjoy fiscal autonomy; therefore, they cannot be subject to targets set by the central government on revenue and expenditure under the current state of the law.

The Court of Auditors (CoA) is an administrative body, which performs its missions independently. It assists parliament in monitoring the government action. It also assists parliament and the government in monitoring ex post the execution of both the state budget and the social security budget. It assesses public policies, checks the compliance of the various provisions listed above and more generally gives an opinion on the situation and prospects of public finances.

\(^{87}\) This dual spending rule has been strengthened in the 2012 budget, with a decrease in central government expenditure excluding interest payments and civil servants' pensions in nominal terms.
In order to supplement the existing budgetary framework, the government has recently submitted a draft constitutional reform to make the goal of balanced accounts laid down in the Constitution since 2008 effective. Specifically, the targets embedded in the multi-annual planning law would become binding for the central government and the social security sub-sectors and open to scrutiny by the Constitutional Court. Inspired by the second multi-annual public finance planning act, the new framework laws would define expenditure ceilings and a minimum annual amount of additional revenues stemming from new fiscal measures. The draft law has already been passed by the two chambers of parliament. In order for the law to be adopted, both chambers have to meet in congress where a qualified majority (three fifths of the votes) is required.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

The reforms adopted in recent years have moved in the right direction and improved the French fiscal framework. The implementation of multi-annual planning of public finances defines a consolidation path for all general government sub-sectors. In particular, the planning for 2011–14 is based on a floor of new revenue measures and a cap on spending growth in volume terms, which, taken together, entail minimum structural effort to reduce the deficit. In addition, state spending planning per field of intervention over three years is essential to both document the achievement in controlling costs and provide programme managers with sufficient visibility. Regarding fiscal rules, the double-spending norm at the state level means that possible windfalls from lower-than-expected interest payments and savings resulting from the recent pension reform cannot be transferred to other expenditure items. As a result of the improved management of healthcare expenditure, the healthcare spending target was met in 2010 for the first time in more than 10 years. Finally, the rule of allocating any windfall revenues to debt reduction is also a step in the right direction.

However, the current budgetary framework shows several weaknesses that should be addressed. The fact that it is insufficiently binding constitutes the first major drawback. Indeed, fiscal rules, spending limits and other provisions contained in the first two multi-annual planning acts have not always been respected, despite a central reserve fund to meet unforeseen expenditure being included every year in the state budget. This is especially true because such acts do not supersede ordinary laws from a legal perspective. The draft constitutional reform endeavours to set a binding link between the multi-annual planning and the annual budgetary procedure. However, the former could be amended under conditions fixed by an organic law. This means that the binding nature of multi-annual planning will still very much depend on the authorities’ commitment not to deviate from the adjustment path initially envisaged.

A second challenge refers to the use of realistic macroeconomic assumptions. Indeed, growth and revenue-to-GDP elasticity assumptions presented in the successive stability programmes and planning acts have proved too optimistic on several occasions and thus contributed to the non-compliance with the deficit targets France had set forth. In this regard, the quality and effectiveness of the consolidation strategy would benefit from more robust and realistic macroeconomic and budgetary forecasts. In this respect, entrusting an independent body such as a fiscal council with the preparation of forecasts would be likely to reinforce the overall quality of the budget process, following some of best practices identified in the EU.

Another significant area of concern relates to tax expenditures. Their number and cost tends to weaken the effectiveness of fiscal rules. Tax and social security exemptions have often proved a substitute for direct expenditures, allowing the French authorities to formally meet existing spending rules. For example, the cost of tax expenditures at the central government level has picked up since the mid-2000s after the zero volume rule was introduced in 2004. Acknowledging the issue, the 2009–12 public finance planning act foresaw that the cost of new tax expenditure should be fully offset by other measures. However, the CoA noted in a recent report that the principle had not been applied in 2009–10. More recently, a report from the administration (Inspection Générale des Finances) has provided a comprehensive assessment of the existing tax and social security exemptions, notably in terms of a cost-benefit analysis. Against this background, the French authorities should step up efforts to remove outdated, inefficient or inappropriate tax expenditures as part of the ongoing consolidation of public finances.

Finally, the principle of autonomy of some sub-sectors, including local authorities, raises the question of consistency with the adjustment path, which covers the entire general government sector. The central government may encourage these sub-sectors to moderate their spending by limiting budget allocations, such as freezing transfers to local authorities as decided under the 2011–14 public finance planning act or affecting the fiscal autonomy of local authorities as is the case with the recent local business tax reform since 2010, but the impact of this remains rather uncertain (local authorities may increase local taxes and widen tax bases). For example, local government expenditure has doubled in nominal terms over the last 15 years. While decentralisation has undoubtedly led to an increase in spending, this is also due to discretionary measures decided at the local level. Thus, for the adjustment burden not to weigh too heavily on the areas directly controllable by the central government, more effective coordination structures with sub-sectors enjoying fiscal autonomy should be put in place.
EPC policy advice

With the establishment of real multi-annual planning of public finances and the strengthening of fiscal rules, France’s fiscal framework has improved significantly over the past few years. In this context, national authorities should introduce the following measures.

● Make multi-annual planning legally binding and of higher legal status compared to annual budgets while reinforcing the current coordination mechanism across general government sub-sectors.

● Build the consolidation strategy on realistic macroeconomic assumptions, through independent growth forecasts, and continue removing outdated and inefficient tax expenditures.

Fiscal rule in France: Double-spending norm at the central government level

General description of the rule and target definition: Central government expenditure is frozen in volume (real) terms. Furthermore, central government expenditure 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, Organismes divers d’administration centrale). This sub-sector represents roughly one third of total general government expenditure.

Implementation date: The rule concerning the spending freeze in volume terms has been in force since 2004. The rule concerning the 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. Some exceptional and temporary spending is also excluded: spending relative to the recovery plan in 2009-2010, the investissements d’avenir programme and spending relative to the local business tax reform.

Accounting system: Budgetary accounting (cash-based)

Escape clauses: There are no predefined escape clauses.

Time frame: Since the first multi-annual Public Finance Act, the norm is built over a period of four years, with a detailed implementation on the state multi-annual budget over a period of three years.

Details: The spending freeze excluding interest payments and pensions in nominal terms constitutes an additional constraint to the norm in volume terms: the scope of the norm, which excludes some items of non-discretionary expenditure, is more directly in the hands of Government. Moreover, it should be noted that the stricter of the two rules applies: an expected increase in interest payments implies de facto that the other expenditures should have to remain almost unchanged; on the contrary, a decrease in interest payments (due e.g. to a decrease in interest rates) or in pensions expenditure (due e.g. to the pensions reform voted in December 2010) cannot be compensated by an increase in other expenditure.

Statutory basis: Legal basis

Monitoring: In addition to the monthly monitoring of expenditure by the authorities, compliance with the double spending norm is detailed ex-post in the budget review act discussed and adopted by Parliament. Moreover, the CoA assesses ex post the increase of such 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 such exclusions are likely to distort compliance with the norm. Moreover, the CoA regularly issues recommendations in order to extend even further the scope of the norm so it includes certain supplementary budgets, which shall not differ from the general budget, according to the Court.

Enforcement mechanisms: There is no predefined enforcement mechanism.

Comments on the functioning of the rule: Assessing compliance with the norm is not easy due to repeated scope changes. Based on the perimeter effects such as estimated by the authorities, expenditure growth in recent years has roughly equalled inflation, and the objective of zero growth in volume terms has been met. Nevertheless, such a result should be seen in a relative light as tax expenditures have grown substantially over the same period and some items of spending have been ruled out from the perimeter.
Fiscal rule in France: Healthcare spending norm

**General description of the rule and target definition:** Each year, a healthcare expenditure ceiling is voted by parliament. This corresponds to an annual target spending level.

**General government sub-sector(s) to which the rule applies:** Social security, health insurance branch: this sub-sector represents roughly 15% of total general government expenditure.

**Implementation date:** The healthcare spending norm was introduced in 1997.

**Coverage and exclusions:** The norm covers healthcare expenditure supported by social security schemes (including outpatient, healthcare professionals and social medical expenses). It is often subject to scope changes aiming to take into account newly created benefits or already existing ones that the authorities decide to regulate.

**Accounting system:** Accrual accounting

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Since the first multi-annual public finance act, the norm is built over a period of four years.

**Details:** Despite the multi-annual timeframe, the savings needed to meet the expenditure target are comprehensively described only for the following year.

**Statutory basis:** Legal basis (organic law)

**Monitoring:** The authorities monitor expenditure on a monthly basis. The follow-up has been improved since 2010, namely by creating a steering committee and a statistical monitoring group. In addition, a committee composed of independent experts ("Alert Committee") is in charge of alerting the authorities when substantial slippages are envisaged. Its role has also been reinforced since 2010, and will now decide *ex ante* on the accuracy of the assumptions underlying the expenditure target. Finally, the CoA assesses *ex post* whether the target has actually been adhered to, and issues recommendations on a regular basis in order to improve overall monitoring of expenditure.

**Enforcement mechanisms:** Should there be a significant risk of expenditure slippages, the above mentioned committee formally alerts public authorities, which are then required to propose corrective action. The threshold above which the risk is considered as significant will progressively be lowered from 0.75% in 2010 to 0.5% in 2013 of the expenditure target. Furthermore, starting this year, funds will be set aside at the beginning of the year and cannot be spent unless the target is (expected to be) met.

**Comments on the functioning of the rule:** The expenditure target was never from 1998 to 2009, although annual growth had decelerated at the end of the period (from around 7% in 2002 to 3% in 2010). The recent improvement in the institutional framework led to compliance with the target in 2010. In addition, under the 2011–14 public finance planning act, a ceiling is established for healthcare spending in nominal terms (and not as a percentage increase), which represents an additional constraint in the sense that any slippage in a given year must now be compensated for the following year.

Fiscal rule in France: Golden rule at the local authority level

**General description of the rule and target definition:** Revenues must cover current expenditure (i.e. local governments have the right to borrow only for investment spending).

**General government sub-sector(s) to which the rule applies:** Local authorities: this sub-sector represents roughly 20% of total general government expenditure.

**Implementation date:** The rule has been in force since 1983 for the municipalities and departments, and since 1988 for the regions.

**Coverage and exclusions:** The rule covers the operating section of the budget.

**Accounting system:** Budgetary accounting

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Annual

**Details:** The term ‘budget’ as used under the rule refers to the voted budget. *Ex post*, the budget can be unbalanced, in the limit of 5% of revenues from the operating section (10% for small municipalities).

**Statutory basis:** Legal basis

**Monitoring:** In addition to the monitoring of expenditure by the administration, the regional chambers of auditors may participate in the audit of local government budgets, mainly at the request of the central government representative and, in some cases, an interested party.
**Enforcement mechanisms:** When budget implementation shows a significant deficit (see above mentioned thresholds), the regional chamber of auditors proposes corrective action within one month.

**Comments on the functioning of the rule:** The rule has always been complied with due to its binding nature. While preventing the financing of current expenditure by debt, it does not guarantee subdued spending growth due to the financial autonomy of local authorities (the latter may increase local taxes or widen tax bases, but only to a certain extent as their fiscal autonomy has recently been limited). It should be noted that local authorities’ expenditure has increased significantly since the early 2000s, only part of which can be explained by the decentralisation process. A deceleration has nonetheless been observed since 2007, with a contraction in 2010. This was mainly due to the local investment cycle, while some structural factors have also played a non-negligible role, especially the tightening of transfers from central to local government.

**Fiscal rule in France: Allocation of windfall revenues**

**General description of the rule and target definition:** Any windfall revenues shall be used to reduce general government deficit.

**General government sub-sector(s) to which the rule applies:** Central government and social security: these two sub-sectors together represent roughly 85% of total general government (tax) revenue.

**Implementation date:** Regarding central government, the rule has been in force since 2009 (2009–12 public finance planning act); regarding social security, the rule has been in force since 2011 (2011–14 public finance planning act).

**Coverage and exclusions:** n/a

**Accounting system:** The rule is defined under budgetary accounting (central government)/accrual accounting (social security).

**Escape clauses:** There are no predefined escape clauses.

**Time frame:** Annual basis

**Details:** Concerning central government, the rule has actually been in force since 2006 as each annual budget since then has provided for using windfall revenues to reduce deficit.

**Statutory basis:** Legal basis

**Monitoring:** There is no formal monitoring. Nevertheless, both parliament and the CoA regularly assess compliance with the rule.

**Enforcement mechanisms:** There is no predefined enforcement mechanism.

**Comments on the functioning of the rule:** The second multi-annual public finance planning act provides for an expenditure limit for each year of the period. Windfall revenues can thus not be used to finance new spending.

**Fiscal Institution in France: Court of Auditors (Cour des comptes)**

**Date of establishment and description of the main tasks related to fiscal policy:** Founded in 1807, the Court of Auditors (CoA) assists parliament in monitoring the government action. It also assists parliament and the government in monitoring the enforcement of both the state budget and the social security budget together with assessing public policies. More generally, it issues an opinion on the situation and prospects of public finances.

**General government tiers at which the institution carries out its tasks:** The CoA supervises all general government sub-sectors.

**Main outputs released by the institution:** The CoA’s works are published in the form of annual reports and thematic reports devoted to complex subjects corresponding to major challenges.

**Role of the institution in the budgetary process:** The CoA is in charge of certifying the accounts of the central government and the social security. It monitors the implementation of both the state budget and the social security budget, and checks results in terms of expenditure as well as revenue.

**Obligation for the government to use the output of the institution:** The CoA issues recommendations based on some of its observations, which, however, are not binding.

**Status of the institution:** The CoA is an administrative jurisdiction and fulfils its missions autonomously.

**Composition and appointment of the governing board:** The CoA is headed by the First President, a permanently appointed magistrate, appointed by a decree of the Council of Ministers. He is seconded by a General Prosecutor and by eight Chamber Presidents, permanently appointed magistrates as well, each of whom covers a given area of responsibility.

**Decisions of the governing board:** Draft reports are submitted for adoption by the First President, Chamber Presidents and senior magistrates.
Staff: Each chamber is composed of 30–40 permanently appointed magistrates. Rapporteurs and assistants also participate in audits. The Court may seek the assistance of independent experts for temporary assignments of a technical nature.

Comments on the functioning of the institution: Because of its institutional independence and given the quality of its work, the CoA plays a central role in improving the management of public finances. Even if not binding, its recommendations are, in fact, often implemented.

Medium-term budgetary framework in France

Time frame: There is no predefined time frame. However, the first two multi-annual public finance planning acts covered a four year period (2009–12, 2011–14).

Institutional coverage: Certain provisions cover the whole of the general government sector; others concern only one sub-sector or not all sub-sectors.

Accounting system: ESA 95 (all sectors)/budgetary accounting (central government)/accrual accounting (social security)

Target revisions and binding objectives: The medium-term budgetary framework sets targets for state and health-care expenditure and for the main social security mandatory funds, as well as a minimum amount of tax increases for each year. It also sets objectives for the general government balance and debt as a percentage of GDP. Nevertheless medium-term budgetary targets are insufficiently binding since multi-annual planning does not rank higher than ordinary laws.

Level of detail of expenditure projections: Expenditure ceilings per field of intervention over three years are set out at the state level.

Level of detail of revenue projections: n/a

Connectedness with the annual budget law: Maintaining adherence to the medium-term strategy is supposed to be a central part of the annual budget preparation. As far as the 2009–12 planning act is concerned, such adherence has not always been effective, and this is only partly due to changes in the macroeconomic environment.

Monitoring mechanisms: The government transmits an annual report on the implementation of the multi-annual public finance planning act to parliament. The CoA also assesses compliance with the act’s provisions.

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the envisaged medium-term targets.

Targets for sub-sectors of general governments: While partly funded by central government and, thus, implicitly covered by limits on central government spending, local governments enjoy fiscal autonomy. Therefore, they cannot be formally submitted to any targets on revenue and expenditure.

Comments on the functioning of the framework: While the implementation of multi-annual planning of public finances is clearly a step in the right direction in the sense that it defines a coherent consolidation path for all general government sub-sectors, the current medium-term budgetary framework (MTBF) shows several weaknesses that should be addressed for the fiscal consolidation to be fully effective. The fact that it is insufficiently binding constitutes the first major drawback. A second challenge the authorities face refers to the use of prudent macroeconomic assumptions. Finally, the principle of autonomy of some sub-sectors, including local authorities, raises the question of consistency with the adjustment path, which covers the entire general government sector.

Domestic budgetary procedures in France

Prudent economic assumption for the budget preparation: The Ministry of Finance (MoF) formulates the economic assumptions used in the budget. The methodology used is only partially available publicly although a panel of independent experts carry out systematic reviews of key assumptions. While included in the budget documentation, fiscal sensitivity analysis covers only selected activities. Moreover, fiscal risks associated with entitlements are not evaluated in the budget documentation. In recent years, macroeconomic forecasts have shown an upbeat bias —especially in the outer years (year t+2, year t+3, etc.) — making accurate budgetary planning and thus adherence to targets more difficult.

Centralisation of the budget process at the planning stage: The budget drafting process starts roughly 12 months before the beginning of the fiscal year, with spending ceilings or targets contained in the annual budget circular issued by the MoF to guide the preparations. According to the OECD database on budget practices and procedures, the MoF does not have the final say when major discrepancies with line ministries emerge in the course of the negotiations. On the other hand, the centralisation of the budget process is enhanced by the fact that parliament seems to have only limited power to amend significantly the government’s proposal. Article 40 of the Constitution stipulates that amendments introduced by Members of Parliament are not admissible where their
enactment would result in either a decrease of public revenue or the creation or increase of any public expenditure.

**The use of top-down budgeting:** The OECD database provides a mixed picture for top-down budgeting. On the one hand, the use of spending ceilings or targets at a very early stage of the budget process is conducive to fiscal discipline. On the other hand, the fact that overspending (for mandatory items) may occur before a supplementary budget is approved make these ceilings not fully binding although a central reserve fund to meet unforeseen expenditures is included every year in the budget.
Fiscal governance in Luxembourg

1. Description of the Fiscal Framework in Luxembourg

Luxembourg has different fiscal rules in place. The 2009 coalition agreement contains a reference to maintain the debt of the central government at a low level: ‘The government will keep public debt at a level substantially below limits foreseen by the Stability and Growth Pact (SGP), in order to avoid an increase in public spending on debt service and reimbursement’. There is no formal quantified target, but only an implicit target. This rule was also part of the government’s programme 2004–08 and similar provisions were in force in the previous period 1990–2003. The local authorities (communes and syndicats de communes) can only finance extraordinary expenditure by issuing debt if no other financing is possible or viable and only when a regular reimbursement of the annuities is ensured (88). The Interior Ministry is responsible for the budgetary surveillance of local authorities.

Since 1999, consecutive governments’ programmes have also included an expenditure rule to prevent central government expenditure from rising more rapidly than the medium-term growth rate of GDP (in nominal terms). Following the economic crisis, the 2009–14 coalition agreement adapted the formulation of the rule as follows: ‘once the counter-cyclical budgetary policy in response to the crisis comes to an end, the government will ensure that public expenditure growth will be maintained at a rate compatible with the medium-term economic growth prospects’. The precise time horizon covered by the ‘medium term’ is not clearly spelled out. For both the debt rule and the expenditure rule, there is no enforcement body and no predefined action in case of non-compliance.

Luxembourg also has an annual budget balance rule for the primary balance of the social security sub-sector with reserve obligations for different sub-schemes. A legal obligation exists to maintain reserve funds of 10% of the annual expenditure for healthcare (89) and long-term healthcare and of 150% of annual expenditure of the central government to the ESA balance, which includes revenue and expenditure of these funds (91). The precise time horizon covered by the ‘medium term’ is not clearly spelled out. For both the debt rule and the expenditure rule, there is no enforcement body and no predefined action in case of non-compliance.

The former Chambre des comptes was established as an independent auditing institution by a Royal Grand Ducal Decree in 1840. The current Court of Auditors was set up in 1999. Its tasks go beyond the ex post monitoring and analysis of fiscal developments. At the request of the parliament, the Court issues an opinion on the draft budget. In this opinion, the Court would normally sketch the situation of public finances, assess the plausibility of revenue estimates and formulate a number of recommendations related to public finances.

The budget law is structured around administrative units and not around policy objectives. A particularity of the Luxembourg central administration is the large number of special funds (29 in 2007). They are funded with yearly contributions from the central administration: as an exception to the annuity principle, their effective expenditure is not shown in the budget, which only mentions the yearly amounts transferred from the state. Since the 2008 draft budget, a ‘Volume III’ is prepared which presents in detail the transition from the working balance to the ESA 95 balance, which includes revenue and expenditure of these funds (90). The government body providing the economic outlook, the statistical office STATEC, enjoys scientific independence and administrative autonomy (92).

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Luxembourg’s public finances are sound. The general government accumulated large surpluses in the decade before the economic crisis, with the exception of 2004. The impact of the economic crisis and the stimulus
measures taken by the government have led to a small deficit since 2009: 0.9% of GDP in 2009 and 1.1% of GDP in 2010. The gross debt of 19.1% of GDP at the end of 2010 is one of the lowest in the EU. However, an ageing population and a very generous pension system will lead to rapidly rising ageing costs (the highest in the EU) after 2030. Moreover, changes in the international fiscal, financial and regulatory environment may erode Luxembourg’s tax revenues. Against this background, budgetary discipline is of growing importance.

2. **Assessment of the current framework**

Government revenues in Luxembourg are particularly volatile, notably because of the country’s small size and high openness and because of the economy’s strong specialisation in the financial sector. A fully fledged **medium-term budgetary framework** with multi-annual expenditure ceilings would provide guidelines for smooth revenue and expenditure evolution and ensure budgetary discipline in the medium and long term.

The current **expenditure rule** preventing central government expenditure from rising more rapidly than the GDP applies over a medium-term period rather than every year. This renders a countercyclical budgetary policy possible, provided that the rule is applied wisely, and permits that unexpected negative and positive shocks or forecast errors can be averaged out. However, it leaves the targets to the discretion of the budgetary discussions taking place every year. Compliance with the expenditure rule was rather uneven during the 1999–2004 term. This situation was corrected during the 2004–09 term. Although the central expenditure rule obviously does not apply to the social security sub-sector, it has an indirect bearing on it as half of its expenditure is financed by the central government. A more elaborate expenditure rule for all the sub-sectors could better take into account the economic cycle and the increasing costs of ageing.

The **budget balance rule** for the social security sub-sector contains a forward-looking element with the mandatory formation of reserves for future liabilities. However, the rule does not prevent the implementation of procyclical policies and limits the work of automatic stabilisers in bad times. The only budget rule for general government is the 3% deficit ceiling of the SGP. Such a ceiling is definitely too loose in view of the future liabilities of Luxembourg’s pension system. It could be worthwhile combining the expenditure rule with a budget balance rule for the whole government sector, or even a rule that ensures surpluses over the cycle, as the reserves — even though currently large — will not be sufficient to cover projected liabilities.

Finally, the wording of the **debt rule** could be better specified, with a target adapted to the low starting position of the debt level; because, even though gross debt has tripled from 6.7% of GDP in 2007 to 19.1% in 2010, such a level is still substantially below the SGP level as requested by the rule.

The **budget** contains little information on objectives, which renders an **ex post** evaluation of the efficiency and effectiveness of expenditure by the parliament or Cour des comptes difficult. The current approach focuses on providing resources to maintain existing programmes rather than on optimising spending efficiency. A shift towards a more performance-oriented system could increase spending efficiency.

Although STATEC provides independent economic outlooks, the government is free to prepare the budget using its own macroeconomic assumptions and projections. In practice, the budget is generally based on a prudent economic scenario and the budgetary projections have proved to be on the cautious side.

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**EPC policy advice**

*Luxembourg’s public finances are healthy. However, the estimated increase in pension and healthcare expenditure due to an ageing population is among the highest in the EU. Luxembourg is currently one of only a few Member States without a medium-term budgetary framework underpinning the budget law or the Stability Programme. In this context, national authorities should introduce the following measures.*

- Adopt a medium-term budgetary framework with multi-annual expenditure ceilings. The expenditure rule should cover all government sub-sectors and should take into account the increasing costs of ageing.
3. **Summary Information on the Main Elements of National Fiscal Frameworks**

**Fiscal rule in Luxembourg: Debt rule**

**General description of the rule and target definition:** The government has to keep public debt at a level substantially below limits foreseen by the SGP, in order to avoid an increase in public spending on debt service and reimbursement.

**General government sub-sector(s) to which the rules applies:** General government

**Implementation date:** 2004: the rule has been part of the governments’ programmes 2004–08 and 2009–14.

**Coverage and exclusions:** All sectors of general government are covered. In the 2004–08 wording of the rule, the government was allowed to issue new public debt to finance rail infrastructure projects.

**Accounting system:** Budgetary accounting, including capital expenditures (investment)

**Escape clauses:** There are no escape clauses.

**Time Frame:** Multi-annual framework

**Details:** Details are not specified

**Statutory Basis:** Coalition agreement

**Monitoring:** No monitoring body

**Enforcement mechanisms:** There is no enforcement body and no *ex ante* defined actions in case of non-compliance.

**Comments on the functioning of the rule:** Current debt levels are far below the 60% threshold foreseen in the Treaty.

**Fiscal rule in Luxembourg: Expenditure rule**

**General description of the rule and target definition:** Realignment of public expenditure growth with medium-term growth prospects once the countercyclical budgetary policy in response to the crisis comes to an end. No formal target, but implicit.

**General government sub-sector(s) to which the rules applies:** Central government (55 to 60 % of general government expenditure)

**Implementation date:** 2010: similar rules have been part of consecutive governments’ programmes: 1999–2004, 2004–08 (see Debt rule); this formulation is part of the government’s programme 2009–14.

**Coverage and exclusions:** All expenditure items of central government, including investments (the rule is applied on an aggregate basis and not on individual expenditure categories).

**Accounting system:** Budgetary accounting

**Escape clauses:** An exception is made for the current countercyclical budgetary policy.

**Time Frame:** Multi-annual framework, medium-term horizon, the precise time horizon is not clearly spelled out.

**Details:** Details are not specified

**Statutory Basis:** Coalition agreement

**Monitoring:** No monitoring body

**Enforcement mechanisms:** There is no enforcement body and no *ex ante* defined actions in case of non-compliance.

**Comments on the functioning of the rule:** Before 2005, compliance had been rather uneven. This situation has since been corrected during the 2005–09 term. The rule only includes the funding of the many special funds and not their effective expenditure.
Fiscal rule in Luxembourg: Balanced budget rule for social security

**General description of the rule and target definition:** Annual budget balance rule with the formation of reserve funds for healthcare (10% of annual expenditure) (\(^9^3\)), long-term healthcare (10% of annual expenditure) (\(^9^4\)) and private sector pension schemes (150% of annual expenditure) (\(^9^6\)).

**General government sub-sector(s) to which the rules applies:** Social security sub-sector (= 30 – 35% of general government expenditure)

**Implementation date:** The rule was approved in July 1992 and came into force in steps.

**Coverage and exclusions:** No elements are excluded.

**Accounting system:** Budgetary accounting, compatible with ESSPROS and ESA 95

**Escape clauses:** There are no predefined escape clauses, but the government has some freedom to adjust the ceiling.

**Time Frame:** Annual

**Details:** The rule targets the primary balance in nominal terms. The reserve requirements are not targets but thresholds.

**Statutory Basis:** Political agreement and legal act (Code of social security)

**Monitoring:** Government — Minister of Social Security; General Inspectorate of Social Security

The budget has to be approved on an annual basis at the general meeting of the healthcare insurance funds, regrouping social partners and the government.

**Enforcement mechanisms:** Bodies in charge of enforcement are the Ministry of Social Security and the General Inspectorate of Social Security (IGSS). For the healthcare and pension reserves, there is an obligation to take effective measures in case of non-compliance. If the budget doesn’t respect the requirement for reserves for healthcare, the contribution rate must be adjusted for the following year either by the Steering Committee or by the Ministry of Social Security. If the budget reserves for pensions are not reached, the government has to adjust the contribution rate, if the necessary change is greater than 1%.

**Comments on the functioning of the rule:** The rule has always been respected since its entry into force. The mandatory formation of reserves contributed to the accumulation of relatively high social security reserve funds, currently estimated at 29% of GDP \(^9^6\). According to the authorities, there is a perception that the rule has significantly contributed to fiscal discipline.

**Fiscal Institution in Luxembourg: Court of Auditors**

**Date of establishment and description of the main tasks related to fiscal policy:** The Court of Auditors was set up in 1999 in its current form. Each year, the Court is required by law to produce a general report with findings and recommendations on the accounts of the state of the preceding financial year. The Court controls the financial management of the instruments, administrations and services of the state. It is also entitled to examine other public bodies insofar as these are not subject to another system of financial audit prescribed by legislation. Finally, the Court can audit the use of public funds granted for a particular purpose to legal entities of the public sector and individual and legal entities of the private sector. As external auditor, the Court of Auditors also examines, in addition to the legality and regularity of the revenues and expenses, the sound financial management of public funds. Therefore, the Court of Auditors controls the effectiveness and efficiency of the public expenditure without, however, making any judgement on the appropriateness of the expenses.

**General government sub-sector(s) to which the rules applies:** Social security sub-sector (= 30 – 35% of general government expenditure)

**Main outputs released by the institution:** Each year, the Court is required by law to produce a general report on the accounts of the state of the preceding financial year. This report is transmitted to the parliament. Moreover, the Court can present at any time, either at the request of the parliament or on its own initiative, its findings and recommendations on specific areas of financial management in a special report. These special reports are also submitted to the parliament.

\(^9^3\) By law, reserves of the Caisse Nationale de Santé should be not less than 10% and not more than 20% of current annual expenditure. If the budget shows that the amount of reserves is outside these limits, an adaptation of the rate of contributions is compulsory. Because of the recession, the 2010 budget law exceptionally lowered the minimum requirement for the reserve to 5.5% of annual expenditure, in order to avoid a drastic increase in contributions or patients’ costs, while keeping the budget in balance. Between 2010 and 2015, a gradual increase to the initial level is foreseen.

\(^9^4\) For long-term healthcare, the law foresees a mandatory reserve of minimum 10% of annual expenditure

\(^9^5\) The funding of the general pension scheme is based on a system of division into seven-year coverage periods with the mandatory formation of a reserve fund exceeding one and a half times the total amount of annual expenditure. The contribution rate is set at the beginning of each seven-year period at such a level as to guarantee the funding of the scheme throughout the period.

\(^9^6\) However, these reserves are not sufficient to ensure the long-term sustainability of the pension system.
At the request of the parliament, the Court of Auditors delivers an opinion on the draft budget. Lastly, the parliament can request the Court to deliver an opinion on draft legislation which has a significant financial impact on public funds, and on proposals for legislation relating to the accounting system of the state and other public sector bodies.

**Role of the institution in the budgetary process:** The Court of Auditors is generally interviewed by the parliament in the course of the preparation of the budget although there is no obligation to do so. The Court provides for independent analysis on the budget and the implementation of budget plans. It provides independent revenue forecasts for the current year, but the government can deviate from them without justification. The Court formulates an opinion on the draft budget and assesses the compliance with fiscal rules, but its approval is not necessary in the budgetary process.

**Status of the institution:** The Court of Auditors is an independent public institution, in accordance with Article 105 of the Constitution as well as the provisions in the Law of 8 June 1999. The Court is formally attached to the parliament.

**Composition and appointment of the governing board:** The Court of Auditors comprises five members, namely the President, the Vice-President and three counsellors. The Grand Duke appoints the members of the Court from a list of candidates (experts) presented to him by the parliament. The members of the Court hold office for six years and can be reappointed.

**Decisions of the governing board:** The Court decides on a collegiate basis by majority vote. The President chairs the meetings and holds the casting vote in the event of a split decision.

**Staff:** Around 35 staff members assist the Court of Auditors in carrying out its functions. The Court of Auditors may also call on external consultants acting under the control and responsibility of the Court.

**Comments on the functioning of the institution:** The recommendations of the Court are generally followed. However, according to the authorities, the institution has little impact on fiscal discipline.

**Domestic budgetary procedures in Luxembourg**

**Prudent economic assumption for the budget preparation**

The economic outlook is provided by the statistical office STATEC, which enjoys scientific independence and administrative autonomy. However, the government is free to prepare the budget using its own macroeconomic assumptions and projections and there is no independent review of the assumptions used in the budget. In practice, the budget is generally based on a prudent economic scenario and the budgetary projections have proved to be on the cautious side.

**Centralisation of the budget process at the planning stage**

At the start of the budget process, the Minister of Finance sends out a circular to all the ministries asking for their spending requests. In this document, the Minister of Finance sets the expenditure evolution which all ministers are expected to respect. The Minister of Finance plays a central role in the subsequent preparatory stages of the draft budget, but final decisions are made by an extraordinary session of the Council of Ministers. The parliament seems to have unrestricted power to amend the budget proposed by the government.

**The use of top-down budgeting**

The OECD database provides a mixed picture in relation to the use of top-down budgeting. At the start of the budget process, the Minister of Finance sets the expenditure evolution which all ministers are expected to respect. Ministers can carry-over unused expenditure for investment, but not for current expenditure. Overspending can occur before a supplementary law or budget is approved but only for mandatory spending. Government managers are able to keep any savings from efficiency gains to finance other expenditures without restrictions. Agencies receive an appropriation with detailed expenditure specifications.
1. **Description of the Fiscal Framework**

The current trend-based fiscal framework in place in the Netherlands was proposed by the Budgeting Framework Commission (97) in 1993 and adopted and implemented by the government in 1994. It incorporated lessons learned from earlier frameworks (98). In particular, the anti-cyclical fiscal policy conducted during the 1950s showed the practical difficulties in determining the right timing, size and possible impact of measures aimed at smoothing the economic cycle. The structural budget policy during the 1960s and 1970s demonstrated risks arising from using overly optimistic economic growth forecasts.

The main characteristics of the trend-based fiscal framework are: (i) the use of real expenditure ceilings, which are determined once for the entire term of the government; (ii) automatic stabilisation on the revenue side; and (iii) the use of independent macroeconomic assumptions. The framework has a four-year horizon corresponding to the normal term of a government. After elections, when a new coalition government is formed, medium-term budgetary targets are set by defining the desired development of general government expenditures and the tax burden for each year until the end year of the government’s term. The targets are based on the required fiscal adjustment during the term of the government, which is explicitly linked to the sustainability gap (99) of public finances. Targets are not enshrined in law, but are embedded in a coalition agreement. As such, strong political commitment is crucial for the credibility of the Dutch fiscal framework. The framework covers the central government and the social security sector, but does not cover local governments.

The track record of the trend-based budgetary framework in the Netherlands can be considered quite successful. This is evidenced by the fact that in the period 1994–2008 the average budget deficit was 1.4 % of GDP (100), outperforming the euro area deficit average of 2.3 % of GDP. In practice, the expenditure ceiling has been well respected since its inception.

The level of spending, related to the budgetary targets of the coalition agreement, is then captured in an expenditure ceiling, one of the key elements of the trend-based fiscal framework. The ceiling is divided into three subcategories: the ‘core’ central government sector; the social security sector; and the healthcare sector (101). The ceiling is defined in net terms (i.e. gross expenditures minus certain non-tax revenues). Savings in one category may only be used to finance additional spending in the other categories in exceptional circumstances (although, in the past, this rule had been applied flexibly). In principle, this is even the case within the three subcategories. Within the ‘core’ central level, for example, every ministerial department has its own multi-annual expenditure ceilings. Ministers are required to compensate expenditure overruns within their own departmental budget, although compensation between departments is possible if allowed by the Ministry of Finance (MoF) after negotiation. The Minister of Finance has the overarching power and responsibility with regard to the development of government finances and as such has the final say (102). The expenditure ceilings are first set in nominal terms, at the start of the term of the government, 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 (103). In spring, when the budget for the current year is updated, the deflator forecast is reviewed and the ceiling is adjusted accordingly. This means that inflation developments are accommodated. After this review, the ceiling for the current year remains fixed in nominal terms for the rest of the year.

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(97) The Budgeting Framework Commission is a long-standing advisory council of high-level officials, including, inter alia, representatives of various ministries including the Ministry of Finance, the director of the Central Planning Bureau (CPB, see footnotes 98 and 105 and appendix) and an executive director of the central bank. It conducts periodic reviews of the functioning of the fiscal framework.


(99) Corrected for a one-off transaction involving housing corporations of 4.9 % of GDP in 1995.

(100) Based on CPB projections .

(101) Around, respectively, 45 %, 30 % and 25 % of central government expenditure. Social security covers areas related to social insurances and executive agencies related to the labour market, and healthcare mainly consists of health-related expenditures financed by healthcare premiums.

(102) When the general government deficit of the local authorities contributes to a (or a threat of a) breach of the requirements of the Stability and Growth Pact for the government balance, the Minister of Finance can intervene, but only if the regular administrative consultations on financial relations between the state, the Association of Netherlands Municipalities, interprovincial consultations and the Association of Waterboards have failed to produce the desired result. The Minister of Finance can, as an ultimate remedy, impose a discount on the municipal and/or provincial funds.

(103) Until 2002, the GDP deflator was used but this is much more sensitive to terms-of-trade shocks.
The revenue side is strictly separated from the expenditure side. Similar to the expenditure ceiling, discretionary changes in the tax rules and rates are determined for the entire term of the government. Thereafter, taxes and social contributions will only depend on non-policy factors, thus allowing revenues to act fully as automatic stabilisers (108). The underlying macroeconomic scenario is provided for by the National Bureau for Economic Policy Analysis (CPB) (105), which ensures the independence of the projections: the CPB is a statutory body outside of the MoF which prepares the budget.

The overall management of government finances is legally ensured by the so-called Comptabiliteitswet 2001. This law contains provisions regarding the general government budget, budgetary and operational management issues, supervision of ministers, asset management and the accountability of general government. The latter is the responsibility of the Dutch Court of Audit, which is entrusted with the task of checking that the government implements the budget and conducts policy as intended.

Over the years, the framework has evolved according to practical experience and changing challenges. In 2007, it was decided to exclude interest expenditure from the expenditure ceiling, as it is barely influenced by policy decisions. At the end of 2008, in reaction to the financial crisis, the government updated the fiscal rules, notably by removing expenditures and non-tax revenues (e.g. interest and dividend receipts) resulting from interventions in the financial sector from the expenditure ceiling. In March 2009, the government also decided that the cyclically-sensitive unemployment benefits would be removed from the expenditure ceilings. This measure was aimed at preventing procyclical budget cuts as a result of increasing unemployment and led to a strengthening of automatic stabilisers.

At the start of a new government’s term, the newly formed government may decide to revise the fiscal framework. To this end, the coalition usually takes into account the advice of the Budgeting Framework Commission (106), which presented its latest report in April 2010. The Commission advised, inter alia, to continue with the trend-based fiscal framework, to set ambitious targets for the general government balance and to increase the coverage of the expenditure ceiling.

In its September 2010 Coalition Agreement, following the advice of the Budgeting Framework Commission, the new government (which took office in October 2010) endorsed a set of budgetary rules based on the common rules governing expenditure and revenue as adopted in the past, enhanced by a few new rules as follows.

- The adoption of a signalling margin: this 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.
- Expenditures sensitive to cyclical trends (unemployment benefits, social assistance benefits and movements in the terms of trade) have been reintroduced within the expenditure ceiling frameworks. The previous government had excluded these items from the ceilings due to the economic crisis but there is a risk of procyclicality in an upturn.
- Interest expenditure has also been reinstated under the expenditure ceilings through the adoption of an interest windfall formula (107).
- The application of the rule that spending overruns should be compensated in a ‘specific’ manner (i.e. compensation should be delivered in the scheme involved or in the relevant budget chapter) was broadened: general compensation is limited to changes in the yield on government assets (e.g. interest, lease and dividend).
- A more stringent policy on budgetary risks stemming from loans and guarantees issued was implemented.
- A windfall formula for tax relief, but only in the event that the Netherlands complies with: (i) the medium-term objective for fiscal targets according to EU rules; and when (ii) the Netherlands records a multi-year general government surplus (108).

(105) The Netherlands Bureau for Economic Policy Analysis is better known as Centraal Planbureau (CPB) and is an independent governmental forecasting institution. See specific appendix.

(106) See footnote 97

(107) To ensure that interest expense windfalls do not result in extra expenditure but rather in the repayment of the national debt, the expenditure framework will be corrected (reduced) during the government’s term of office by the amount that the interest expenses are lower than the original estimate of the interest expenditure at the beginning of the government’s term of office. Higher than expected interest expenses will also need to be absorbed within the expenditure ceilings.

(108) When the Netherlands complies with the medium-term objective (MTO) as specified in the Stability and Growth Pact and the actual government balance shows a multi-year surplus at the time of the budgetary decision-making on the revenue side in August, then 50% of the surplus shall be allocated to the repayment of the national debt. In addition, the burden of taxation and social security contributions shall be reduced by 50% of the surplus in excess of 0% of GDP. The actual multi-annual EMU surplus shall be calculated taking into account the possible reduction in tax rates (so that the multi-annual government balance will still show a surplus after the possible tax reduction) and shall, moreover, take account of a prudent estimate of the deficit of the local government.
In addition, as committed in the Euro Plus Pact agreed on 25 March 2011 by the European Council, the government is working on draft legislation that will transpose the EU fiscal rules as set out in the revised Stability and Growth Pact (SGP) into national legislation. The purpose of this exercise will be twofold. First and foremost, the requirements stemming from the SGP will be anchored in national legislation, for the preventative as well as the corrective action. Secondly, the broad principles of Dutch budgetary policy will, for the first time, be anchored in formal national legislation.

2. **Assessment of the current framework**

The Dutch medium-term budgetary framework (MTBF) has regularly been assessed as one of the most developed examples of such frameworks (109). Despite the reversal of the decreasing path of the debt ratio in the context of the economic and financial crisis, the overall performance of the framework has been very good since its inception 17 years ago (110). It seems to be well placed to address the adverse budgetary impact of ageing in the medium-term, as it is a genuine binding multi-annual budgetary framework. Instrumental to the success of the framework are the reliance on fixed expenditure ceilings and the involvement of the Netherlands Bureau for Economic Policy Analysis (CPB) as a credible independent institution.

The comprehensive and broad-based nature of the expenditure ceilings has played an important role in expenditure restraint. The ceilings are based on a required fiscal adjustment during the government’s term, which refers to the sustainability gap of public finances. This creates a close link between the MTBF and long-term sustainability and, therefore, appropriately ties short to medium-term fiscal policy to long-term challenges. The success of the expenditure ceilings is linked to the fixed nature of the ceilings (111), which turns attention away from the total expenditure and gives incentives to line ministers to look for expenditure reallocations to finance new policy measures.

Finally, the CPB has a unique position in fiscal policymaking in the Netherlands. Its role with regard to the provision of independent projections of GDP growth, required structural balances linked to long-term sustainability, and other macroeconomic variables is central to a correct and credible implementation of the MTBF. It provides an institutional safeguard in separating the political and technical elements of macroeconomic policy, giving assurance of objective macroeconomic analysis underlying budgetary planning and execution. Crucial to this is its independence, which is based on well-established practice and general public and political support. The CPB’s calculations on the public finances in general, and the expenditure ceilings in particular, provide checks and balances regarding the monitoring of the fiscal framework. Apart from that, one of the most distinctive features of the CPB is the analysis of the economic effects of the election platforms of political parties in the run-up to general elections. This analysis helps to broaden the understanding of these election platforms and improves their comparability. It offers a comprehensive overview of the economic and financial implications of the political proposals and serves as an important input for coalition negotiations and ultimately for the government’s fiscal policy.

Turning to the weaker elements of the Dutch budgetary framework, whilst the use of real ceilings is appropriate to prevent the allocation of resources from being affected by changes in the aggregate price level, divergences in developments between the aggregate deflator used to calculate the ceiling and sectoral price trends can lead to an increase or a decrease in spending capacity under the ceiling. Nominal developments can thus interfere with the level of expenditure. A possible solution to this would be to correct the nominal ceilings for these divergences, as was done during the economic and financial crisis.

In addition, the coverage of the expenditure ceiling is extensive, but not exhaustive. The most important exceptions concern tax expenditures and the finances of local government. In the case of tax expenditures, this raises the question of circumvention. Although welcome steps have been undertaken to improve restraint of tax expenditures, for example by introducing a thorough assessment of all planned tax expenditures and a periodical review of the existing ones, consideration should be given to formally connecting them to the fiscal framework and, in particular, to expenditure ceilings (112). Despite issues of appropriate measurements and the time lags involved in the calculation of their budgetary impact, this could be done by setting ceilings for them. This could serve as a further moderating factor for new tax expenditures and increase awareness of their fiscal cost.

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(110) The public debt ratio was reduced by more than 30 percentage points to around 45% between 1994 and 2007.

(111) This goes for both the overall ceiling and the three sector ceilings.

(112) An example of tax expenditure is the tax stimulus for ‘green cars’. These are thus rather foregone revenues; as such, they cannot be easily integrated in the expenditure ceilings as there is no ‘visible’ expenditure but especially due to the strict division of revenues and expenditures.
With respect to local governments, the expenditure framework does not apply. Despite the fact that local governments rely for a large part on funding from the central government, the local government balance has proven to be volatile over time partly due to swings in the grant allocation from the central government. This factor contributed to the emergence of excessive deficits in 2003 and 2009. Although important steps have been taken to enhance data provision by local governments, for example through more frequent (quarterly) reporting, the predictability of the local government balance still warrants further improvements, as lags in information flows can still be substantial. An additional complication is that although local governments are required to balance their budget over the medium term, whilst this is in terms of accrual accounting, it is not according to ESA 95 systems. This means that, even when reaching balance in accrual terms (as required by the relevant national legislation), they can still run a deficit according to ESA 95. As such, keeping local government finances in check suffers from implementation setbacks. The monitoring of local government finances could be further improved by integrating them in the central government’s treasury system.

Another drawback of the Dutch budgetary framework concerns the recent reinsertion of cyclically-sensitive unemployment benefits, as this may prove counterproductive. In principle, this would help avoid unwarranted procyclical spending in an upturn. However, in the present circumstances, procyclical budget cuts following an increase in unemployment cannot be ruled out. This would weaken the functioning of automatic stabilisers should a cyclical downturn occur. This is reinforced by the inclusion of the so-called signalling margin in the budgetary framework. It is very likely that a realisation of a downward deviation of, for example, 1 percentage point relative to the path for the general government deficit adopted at the beginning of the term of office would be associated with a severe worsening of the macroeconomic outlook. Whilst this may desirable in case the Netherlands is still subject to the excessive deficit procedure, taking additional consolidation measures in such an economic context when this is not the case could aggravate the downturn and/or put an extra drag on recovery afterwards. Although the rule-based nature of the Dutch fiscal framework is commendable, the room for discretionary manoeuvre has now been limited to the extent that it may also have drawbacks in exceptional circumstances. The room for manoeuvre has also been reduced by the recent decision to place interest expenditure under the expenditure ceilings, as this could imply that expenditure cuts have to be realised in the event of an interest hike, which might be linked to events beyond the control of the Dutch authorities.

**EPC policy advice**

The overall performance of the Dutch medium-term budgetary framework has been very strong since its implementation in 1994. Checks and balances are well designed and reinforced by the independence of the CPB. However, whilst overall the recent modifications to the framework are to be welcomed, a number of new elements may limit the ability to conduct discretionary policy in warranted cases. In addition, the local government balance has proven to be volatile over time thus contributing to excessive deficits. In this context, national authorities should introduce the following measures.

- Remove cyclically-sensitive unemployment outlays from the expenditure ceilings to avoid procyclical and allow for full free working of the automatic stabilisers.
- Improve monitoring of local governments by integrating them into the central government’s treasury system.

### 3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

**Fiscal rule in the Netherlands: Real expenditure ceiling**

**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 healthcare sectors, which amounts to roughly 90% of total general government expenditure.

**Implementation date:** The rule has been in force since 1994.

**Coverage and exclusions:** The coverage of the expenditure ceiling is wide, but not exhaustive. The four main excluded items are expenditures from the Fund for Economic Structure enhancement (FES), interest payments, spending of local governments and tax expenditures. In view of the crisis, unemployment benefits have also been excluded, as well as (part of) the government interventions to stabilise the financial markets.

**Accounting system:** ESA 95
Escape clauses: Expenditure ceilings can be tightened if 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 occur in exceptional circumstances. The expenditure ceilings are first set in nominal terms, at the start of the term of the government, 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 MoF. As the framework is directly connected to the annual budget law, all expenditures and revenues are ultimately subject to scrutiny by the Court of Auditors.

Enforcement mechanisms: In case of non-compliance, the MoF 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 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.

Fiscal rule in the Netherlands: Revenue rule

General description of the rule and target definition: As for the expenditure ceiling, discretionary changes in taxes are determined for the entire term of the government. Thereafter, developments in taxes and social contributions will only depend on non-policy factors, thus allowing the revenues to act fully as automatic stabilisers.

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

Implementation date: The rule has been in force since 1994.

Coverage and exclusions: The rule covers the general government, there are no exclusions.

Accounting system: ESA 95

Escape clauses: Deviations from the revenue framework are permitted in the event that setbacks result in a threat of transgressing the government balance signalling margin (see Escape clauses in Real expenditure ceiling). Corrective measures will then have to be taken.

Time frame: Four-year coverage

Details: At the start of the government’s term, the government decides on the desired development of the overall tax rate. This multi-year path is adhered to during the period. Additional tax increases are compensated through tax relief and vice versa. Only changes in statutory tariffs are taken into account. Increases in the tax income due to economic developments are not considered.

Statutory basis: Coalition agreement

Monitoring: The adherence to the revenue rule is monitored by the MoF.

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

Comments on the functioning of the rule: In practice, the revenue rule is adhered to well. The functioning of this rule allows revenues to act fully as automatic stabilisers.

Fiscal institution in the Netherlands: Netherlands Bureau for Economic Policy Analysis (Centraal Planbureau, CPB)

Date of establishment and description of the main tasks related to fiscal policy: The CPB was formally established in 1947 and provides independent short-term, medium-term and long-term forecasts and projections that are used for the budget preparation.

General government tiers at which the institution carries out its tasks: The whole of the general government sector.
Main outputs released by the institution: CPB research covers a wide range of topics, for example the labour market, macroeconomics, international economics, public finances, welfare state, competition and infrastructure.

Role of the institution in the budgetary process: The CPB is in charge of providing the macroeconomic forecasts on which the budget has to be prepared. The CPB also analyses, on request by political parties or the government, the economic effects of election platforms, coalition agreements and alternative budgetary proposals. By making its own calculations with respect to public finances in general, and expenditure ceilings in particular, the CPB provides appropriate checks and balances for the monitoring of the fiscal framework.

Obligation for the government to use the output of the institution: The macroeconomic scenario for the budget is provided for by the CPB, which ensures the objectivity of the projections. This is part of the trend-based budgetary framework. In practice, all new governments adhere to this practice.

Status of the institution: The provisions related to the status of the CPB are enshrined in law. Although it is formally attached to the Ministry of Economic Affairs, it is autonomous.

Composition and appointment of the management board: The CPB is managed by a board of directors consisting of one director and two deputy directors. They are appointed by the Minister of Economic Affairs.

Decisions of the managing board: The CPB has no formal decision-making powers.

Staff: Around 170 persons are employed at the CPB.

Comments on the functioning of the institution: The CPB provides an exemplary model for separating the political and technical elements of macroeconomic policy, giving assurance of objective macroeconomic analysis. Crucial to this is its independence, which is based on well-established practice and general public and political support. The institution is generally considered to provide high-quality research, which was also confirmed by the latest CPB review committee in March 2010.

Medium-term budgetary framework in the Netherlands

Time frame: Four years, fixed for the entire term of the government

Institutional coverage: Central government, healthcare and social security sectors

Accounting system: ESA 95

Target revisions and binding objectives: The main target is the general government balance at the end of the government’s term, which is based on the sustainability gap as calculated at the start of the government’s term. During the government’s term, revenues act as automatic stabilisers and the attention of fiscal policy is focused on adhering to the expenditure ceilings.

Level of detail of expenditure projections: The expenditure ceiling is based on the state budget. This consists of several chapters, which are linked to individual ministries. The chapters consist of separate articles. All these articles are projected separately for the entire term of the government.

Level of detail of revenue projections: Projections are broken down to specific taxes and premiums.

Connectedness with the annual budget law: There is a direct link between the annual budget and the MTBF.

Monitoring mechanisms: Overall, monitoring of the MTBF is done by the MoF. Budget management is, to a large extent, delegated to the financial economic affairs directorates within line ministries. All government fiscal management policies are ultimately subject to scrutiny by the Court of Auditors.

Enforcement mechanisms: Expenditure ceilings have to be respected. In cases of overspending, the ministry directly responsible is held responsible for the required correction. If this is not feasible because of practical or political issues, the correction has to be made by the other ministries within the same sector for the expenditure ceiling. In exceptional cases, the correction can also be made by other sectors.

Targets for sub-central governments: Local governments are required to have a balanced budget over the medium-term. This balanced budget, however, is in accrual terms and not in ESA 95.

Comments on the functioning of the framework: The Netherlands has a very transparent and well understood system of fiscal management. The framework is supported by a well-established and open system of public management, with clearly defined and reliable procedures for budget formulation, execution, reporting and audit. The framework also benefits greatly from the involvement of the independent CPB, which ensures the objectivity of macroeconomic projections. Besides further possibilities to fine-tune the framework, the framework could be strengthened with respect to tax expenditures and local governments.

Domestic budgetary procedures in the Netherlands

Transparency

The OECD database on budget practices gives a clear indication that there are no problems regarding transparency. For example, the accounts are audited by the Court of Auditors and are made publicly available
within a year after the end of the fiscal year; furthermore, performance against the targets in the legislature is made available to the public.

Centralisation of the budget process at the planning stage

The planning stage of the budget process is highly centralised, with the MoF playing a central role. The budget process splits decision-making on major reallocations and expenditure ceilings from the detailed discussion of line ministry budgets. This two-step budget preparation model has developed as best practice amongst Organisation for Economic Cooperation and Development countries (OECD). The system sets expenditure ceilings per line ministry and budget chapter relatively early in the pre-budget year, and this enables the MoF and line ministries to have in-depth discussions on reallocations within the set ceilings.

The use of top-down budgeting

The level of spending, related to the budgetary targets of the coalition agreement is captured in an expenditure ceiling. The adherence to the real expenditure ceiling is monitored by the MoF. In case of non-compliance, the MoF proposes corrective measures to be taken. The budgetary system sets expenditure ceilings per line ministry, which gives incentives to line ministers to look for expenditure reallocations to finance possible spending overruns.

Realistic economic assumptions

The Netherlands appear to be well placed in terms of realistic macroeconomic assumptions used for the budget preparation. The budgetary framework makes use of realistic macroeconomic assumptions, which are provided by the National Bureau for Economic Policy Analysis (CPB), ensuring the objectivity of the projections. The quality of these forecasts is supplemented by a high degree of transparency and regular review by periodic internal and external evaluations.

Performance budgeting

The objectives and results are an integral part of the budget structure. The main tool used for performance budgeting is the VBTB (Beleidsbegroting tot Beleidsverantwoording) framework, which is mainly centred on the questions: What do we want to achieve? What are we going to do to achieve this? What is it allowed to cost? The VBTB structure of the budget preparation provides a logical format for understanding line ministry policies, activities and performance targets. The consolidated information provided in the budget memorandum on local government could be improved.
Fiscal governance in Sweden

1. DESCRIPTION OF THE FISCAL FRAMEWORK IN SWEDEN

The Swedish budgetary framework was gradually put in place in the second half of the 1990s in reaction to the significant worsening of public finances during the deep recession of the early 1990s. At that time, fiscal policy was on an unsustainable path as gross public debt increased with every business cycle. Since its introduction, the framework has been refined and continues to be subject to regular assessment.

The framework is centred on three main rules: (i) a surplus target; (ii) a nominal expenditure ceiling; and (iii) a balanced budget rule for local governments. The Fiscal Policy Council (a fiscal institution) is also part of the framework.

The surplus target encompasses the finances of general government (i.e. both central and local governments (counties and municipalities) and the pension system). After a phasing-in period of three years, the target came into full effect in 2000 stipulating that an overall surplus of 2% of GDP be achieved over the business cycle. In 2007, it was changed to 1% of GDP due to a reclassification of one of the pillars of the pension system from the public to the private sector. Since August 2010, there has been a legal obligation to define a surplus target. Its fulfilment is measured by a number of indicators, notably the average of the general government balance since the introduction of the target (i.e. 2000), a seven-year moving average (including the three preceding years, the current year and the three following years) and the structural budget balance. As the target is expressed as an average over the cycle, the first two indicators are also adjusted to the cyclical position of the economy during the period covered.

The three-year nominal expenditure ceiling covers the expenses of central government (excluding interest expenditure) and the pension system. It has been used since 1997 as a means of controlling budget overruns and, thereby, to strengthen the credibility of the surplus target. 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. This is formally done in the budget bill presented in the autumn of the year preceding the three-year period (with calculations of the planned expenditure ceilings having already been presented in the Spring Bill of that year). Practically, this means that, every year, an expenditure ceiling is defined on a rolling basis for one additional outer year. Under normal circumstances, the level of a particular expenditure ceiling is not changed, although the parliament has a right to reassess a ceiling at any time. The ceilings are in nominal terms and are not adjusted for changes in the inflation forecast. Technical adjustments can be made if, for example, responsibility for certain expenditure shifts from the state to the municipalities. To provide a buffer against expenditure exceeding the ceiling due to unexpected events, planned expenditure should always be somewhat below the ceiling. If the budgetary margin is large enough, and the surplus target fulfilled, this margin can be used in the end.

The balanced budget rule covers local governments (municipalities and counties) and came into effect in 2000, reinforcing the obligation, in place since 1992 in the Local Government Act, for municipalities and counties to practise ‘good economic management’. The rule stipulates that a municipality or county cannot decide on a budget where expenditure exceeds revenues. If, ex post, there is a deficit, it must be compensated by a surplus within three years. Local governments derive around two thirds of their income from local income taxes and a sixth from state transfers. The rest includes, inter alia, user fees and rental income. Since its introduction, the balanced budget rule has led to a significant improvement in the fiscal balance of local government.

In 2007, an eight-member Fiscal Policy Council (FPC) (Finanspolitiska Rådet) was established with the task of providing an independent evaluation of the Swedish government’s fiscal policy, including the extent to which the government’s fiscal policy objectives are being achieved and whether the development of the economy is in line with healthy long-term growth and sustainable high employment. The Council publishes an annual report each spring. The Council has a purely advisory role and its recommendations are not binding in any way. It reports directly to the government, which also has the final say on appointing its members.

The top-down budgetary process, whereby parliament establishes overall expenditure levels at an early stage for each expenditure area, forces line ministries to prioritise, as increased spending on any particular item must be matched by cuts on other items under the same heading. This prevents the previous bias towards adding new expenditure items as the budget bill passed through parliamentary committees.
The government is continuing its work on reviewing the fiscal policy framework in order to strengthen it. Regarding the surplus target, the government published a report in February 2010, concluding that the current 1% of GDP surplus target strikes a balance between inter-generational equity and stabilisation objectives and should remain unchanged over the coming 10 years. It also proposed that a code of conduct be established for the government’s fiscal policy. Furthermore, based on the conclusions of the report, the requirement to specify a surplus target has been included in the Budget Law as from August 2010.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

The track record of the Swedish fiscal framework is strong and is generally perceived to have contributed to the significant debt reduction observed since its introduction. As intended, it has allowed Sweden to conduct countercyclical fiscal policy without jeopardising long-term sustainability or breaching the budgetary rules laid down in the Stability and Growth Pact.

Importantly, the framework enjoys broad political support in all the main political parties, which has raised its credibility. It has also withstood the test of at least two cycles, coming out stronger as a result. The expenditure restraint imposed by the multi-year expenditure ceiling played a particular role in preventing strong tax receipts in good times from translating into procyclical spending increases and has forced government departments to prioritise. This has provided the necessary margin to allow automatic stabilisers to play their role in recessions and even making room for discretionary fiscal stimulus.

So far, the framework has mainly relied on ‘soft power’, with no formal legal consequences or sanctions for a government breaching its rules, but rather the potential negative reaction of voters and financial markets. However, as memories from the crisis of the early 1990s fade, a similar self-imposed discipline could be harder to maintain in the future. The decisions to require the government by law to lay down expenditure ceilings and to enshrine in the budget law that a surplus target should be defined (although not its level) is, therefore, a positive recent development, as it raises the political cost of breaching the rules. However, ultimately, it is arguably the broad political ownership of the fiscal rules that matters for compliance.

The existence of the FPC and other institutions assessing the government’s fiscal policy is important in this context. In this regard, the recent broad political agreement among most parties represented in parliament in support of the objectives of the FPC implies a reinforcement of the fiscal framework, as it raises the likelihood that the Council will be able to continue its work regardless of changes in government. When the Council was created in 2007, the opposition parties were opposed to the idea.

The positive fiscal outcomes achieved during the period when the fiscal framework has been in place can, to a large extent, be ascribed to the budgetary discipline imposed by the framework itself. However, in addition, a number of favourable factors contributing to growth and macroeconomic stability during this period may also have played a role, such as a period of strong global growth, tax reform, pension reform, EU entry, the establishment of an inflation-targeting regime by an independent central bank and reforms to the sickness and unemployment insurance systems.

Although the fiscal framework has worked well, there are areas where it could be further developed or clarified. Firstly, further clarification could be given on how the surplus target should be evaluated. Currently, it is unclear what relative weight the government puts on the various indicators used to assess its fulfilment. Secondly, the current regime with a balanced budget requirement on local governments combined with ad hoc decisions by the central government to increase or reduce state transfers to local government risks unnecessarily complicating financial planning and could lead to procyclical policies at local level.
EPC policy advice

Although the Swedish fiscal framework has worked very well, further clarification could be given to the relative weights the government attached to the indicators used to assess fulfilment of the surplus target. This uncertainty raises the risk of an ‘opportunistic’ interpretation of these indicators. In this context, national authorities should introduce the following measure.

● State more clearly the relative weight attached to each indicator in the assessment of the fulfilment of the surplus target.

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

Fiscal rule in Sweden: Surplus target

General description of the rule and target definition: A surplus of 1 % of GDP is to be achieved over the cycle. Its fulfilment is measured by five indicators:

(i) the average of the general government balance since the introduction of the target (i.e. 2000);
(ii) a corresponding cyclically-adjusted average;
(iii) a seven-year moving average (including the three preceding years, the current year and the three following years);
(iv) a corresponding cyclically-adjusted average; and
(v) the structural budget balance (net lending adjusted for the cyclical situation, for major one-off effects and extraordinary levels of household capital gains).

Implementation date: After a phasing-in period of three years, the target came into full effect in 2000.

Coverage and exclusions: Covers the general government sector

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

Escape clauses: There are no predefined escape clauses.

Time frame: No sunset clause provided.

Details: The rule was introduced to place public finances on a sustainable footing.

Statutory basis: Legal basis (as from August 2010)

Monitoring: Respect of the rule is assessed by the national parliament and two independent authorities (the Swedish National Audit Office and the FPC).

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the surplus target.

Comments on the functioning of the rule: The surplus target has fulfilled its role of anchoring fiscal policy on a debt-reducing path. Together with the expenditure ceiling, it has ensured that abundant tax revenues in good times have not been spent in a procyclical or unsustainable manner.

Fiscal rule in Sweden: Expenditure ceiling rule

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 was phased in from 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: No sunset clause provided.
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 is assessed by the national parliament and two independent authorities (the Swedish National Audit Office and the FPC).

Enforcement mechanisms: There are 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.

Fiscal rule in Sweden: Balanced budget rule for local government

General description of the rule and target definition: The rule stipulates that a municipality or county cannot decide on a budget where expenditure exceeds revenues. If, ex post, there is a deficit, it must be compensated by a surplus within three years.

General government sub-sector(s) to which the rule applies: Local governments (municipalities and counties)

Implementation date: The rule came into effect in 2000, reinforcing the obligation, in place since 1992, for municipalities and counties to practise ‘sound economic management’.

Coverage and exclusions: No exclusions

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

Escape clauses: There are no predefined escape clauses.

Time frame: No sunset clause provided.

Details: As local governments make up a large part of public spending, the rule helps fulfil the overall surplus target.

Statutory basis: Legal basis

Monitoring: Respect of the rule is assessed by the national parliament and two independent authorities (the Swedish National Audit Office and the FPC).

Enforcement mechanisms: Legal action

Comments on the functioning of the rule: Compliance with the rule has generally been good and played a major role in fulfilling the overall surplus target. A lack of clarity and predictability regarding state transfers risks leading to procyclical policies at local level.

Fiscal Institution in Sweden: Fiscal Policy Council

Date of establishment and description of the main tasks related to fiscal policy: The Swedish Fiscal Policy Council (FPC) is a government agency established on 1 August 2007. The mission of the Council is to provide an independent evaluation of the Swedish government’s fiscal policy. The council assesses the extent to which the government’s fiscal policy objectives are being achieved. These objectives include long-term sustainability, the budget surplus target, the ceiling on central government expenditure and that fiscal policy is consistent with the cyclical situation of the economy. The council also evaluates whether the development of the economy is in line with healthy long-term growth and sustainable high employment. Additional tasks are to examine the clarity of the government’s budget proposals and to review its economic forecasts and the economic models used to generate them. In its new directives from spring 2011, the FPC is also to evaluate the distribution of welfare. Finally, the Council should try to stimulate public debate on economic policy.

General government tiers at which the institution carries out its tasks: The whole of the general government sector

Main outputs released by the institution: The main output of the FPC is its annual assessment of the government’s fiscal policy.

Role of the institution in the budgetary process: No formal role

Obligation for the government to use the output of the institution: There is no formal obligation for the government to heed the advice of the FPC.

Status of the institution: Government agency
Composition and appointment of the governing board: The Council consists of eight members and is assisted by a secretariat of four.

Staff: Its members participate in the public debate on fiscal issues in a personal capacity and members need not always agree on a common position on all issues.

Comments on the functioning of the institution: The FPC has a rather short history, but already wields some influence in the public debate on fiscal issues. Thereby, it contributes to an open debate on and knowledge about fiscal policy issues.

Medium-term budgetary framework in Sweden

Time frame: The medium-term objective is identical to the surplus rule, which stipulates that a surplus of 1 % of GDP should be achieved over the cycle. The medium-term perspective is ensured by having a relatively long forecast horizon in the annual budget bill, stretching four years into the future. This allows the government to assess expected target fulfilment against forecasted growth and fiscal variables. This framework works on a rolling basis (i.e. an additional year is added each year at the end of the period covered by the previous projection).

Institutional coverage: The whole of the general government sector

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

Target revisions and binding objectives: The main target is the general government balance as a percentage of GDP. There is no procedure as to how the target can be revised as it is not enshrined in law.

Level of detail of expenditure projections: Expenditure projections are broken down at the lowest level (i.e. line item or appropriations).

Level of detail of revenue projections: Revenue projections are broken down by type of taxes.

Connectedness with the annual budget law: The surplus rule is not legally binding but the annual budget bill contains calculations of the relevant indicators measuring compliance with the rule.

Monitoring mechanisms: Respect of the rule is assessed by the national parliament and two independent authorities (the Swedish National Audit Office and the Fiscal Policy Council).

Enforcement mechanisms: There are no predefined corrective or enforcement mechanisms in case of deviation from the envisaged medium-term targets.

Targets for sub-central governments: Local governments are subject to the balanced budget rule.

Comments on the functioning of the framework: The medium-term objective is identical to the surplus rule, which stipulates that a surplus of 1 % of GDP should be achieved over the cycle. While the rationale behind the choice of target level and how compliance is to be assessed can be further clarified, the rule has been successful in bringing down debt levels. Consideration could be given to revising the target level at regular intervals, for example, every 10 years, to take on board new developments in factors affecting the long-term sustainability of public finances.

Domestic budgetary procedures in Sweden

Prudent economic assumption for the budget preparation

The macroeconomic forecasts underlying the budgetary preparation are generally not biased in any particular direction, as assessed by the Fiscal Council (FC) in its 2010 report. They are generally not less accurate than other more independent institutes (as represented by the National Institute for Economic Research) and do not show a bias due to the electoral cycle. The FPC also plays a role in this regard by assessing the quality and clarity of the forecasts.

Centralisation of the budget process at the planning stage

Given the balanced budget requirement on local governments, the budgetary process becomes centralised to the central government. Moreover, within the central government, the expenditure ceiling ensures a top-down budgeting process, with line ministries having to draw up budgets within clearly defined overall appropriations.

The use of top-down budgeting

The expenditure ceiling ensures a top-down budgeting process, with line ministries having to draw up budgets within clearly defined overall appropriations.
Fiscal governance in Slovenia

1. Description of the Fiscal Framework

The legislative basis for Slovenia’s fiscal framework is established in the Constitution (113) and in subordinate legislation where the Public Finance Act acts as a cornerstone. Since 2009, reforms have introduced: (i) a fiscal council; (ii) an expenditure rule; and (iii) performance-based budgeting; while (iv) new provisions on the source of the underlying macroeconomic scenario have also been enacted.

The preparation of the central government budget is a top-down process centralised in the Ministry of Finance (MoF). For the first time, the 2010/11 budget was prepared in accordance with performance-based budgeting principles. The annual budgetary procedure starts not later than 15 May (of year t-1) when the government’s first budgetary session discusses the draft budgetary memorandum. This document, which to some extent repeats the information in the stability programme but is entirely expressed in cash terms (not in ESA 95), presents, for the years t-1 to t+2: (i) the total envelope for general government expenditure derived from the application of the new expenditure rule (see Section 3); (ii) the corresponding general government deficit and debt targets; and (iii) the underlying macroeconomic scenario for the years t-1 to t+1. Total expenditure is then gradually allocated to 16 policy areas according to performance-based criteria. By 1 October, the government adopts the budget and budgetary memorandum and submits them to parliament which approves the budget (114).

An established feature of the budgetary procedure is the rolling two-year budget. However, only the deficit target for year t is supported by concrete consolidation measures; this, together with the need to reflect updated revenue and expenditure developments and macroeconomic projections, imply that the deficit target for year t+1 could be subject to change. That said, in recent years, temporary consolidation measures restraining the most dynamic expenditure categories have been adopted in a so-called Intervention Measures Act (in year t-1), sometimes covering not just year t but also year t+1 (115).

Various legal provisions (116) seek to limit deviations from the fiscal targets adopted by the government. During the budget execution phase, the government can impose a temporary 45-day moratorium on new expenditure by blocking new contracts from being signed (in place in 2011, for example, in the period June–September). If such a moratorium is not sufficient, the government must prepare a supplementary budget and can prolong the moratorium until this supplementary budget is approved. In practice, supplementary budgets are the rule rather than the exception (117). Finally, the Minister of Finance can, by decree, prohibit budgetary users signing off on new liabilities for certain expenditure items beyond a certain date (in 2011, such a provision was in place, with 26 September being the final day of the year for taking on new liabilities). All three instruments (moratorium, supplementary budget and decree) usually target capital expenditure.

The macroeconomic scenario underpinning the MoF’s budgetary projections comes from the biannual economic forecasts of the Institute of Macroeconomic Analysis and Development (IMAD). The forecasts for year t+1 have been below out-turns so do not have an optimistic bias. A 2010 amendment to the budgetary procedures foresees, however, a list of four possible forecasts from which the macroeconomic scenario can be drawn in future (the IMAD, the central bank, the European Commission and the OECD).

Entities not covered by the central government budget are the local authorities (municipalities), the Pension and Disability Insurance Fund (PDIF) and the Health Insurance Fund (HIF), which account for around 12 %, 26 % and 13 % of total government non-consolidated expenditure in cash terms respectively. The debt rule for local government, which has been modified a few times since its introduction in 1990, specifies that municipalities are only allowed to borrow if annual payment of liabilities does not exceed 8 % of revenue in the previous year. Moreover, they can only borrow domestically after obtaining authorisation from the Minister of Finance.

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(113) Article 148 of the Slovenian Constitution stipulates that all revenue and expenditure of the State and local communes shall be included in their budgets. If a budget is not adopted by the beginning of the year, budgetary users are financed according to the budget for the previous year.
(114) Parliament also approves the final accounts of the central government budget in cash terms and twice annually addresses its execution.
(115) To avoid the lengthy process of discussing and amending the individual legal bases of specific expenditure categories, parliament adopted in November 2009, together with the 2010/11 budget, an emergency Act on Intervention Measures due to the Economic Crisis to implement the planned restraint in the public sector wage bill and social transfers including pensions.
(116) These are stipulated in the Public Finance Act, Parliamentary Rules of Procedure and the Act on Budgetary Execution. During the parliamentary approval phase, only amendments that are offset so as to not raise the borrowing requirement are accepted; an increase in borrowing can be proposed by the government only.
(117) There was a supplementary budget in seven of the last 10 years (in 2009, there were two supplementary budgets).
Although municipalities appear to be, on average, at a safe distance from the 8% ceiling, their total debt in ESA 95 terms increased from 0.7% to 1.7% of GDP over 2007–10 (118).

The new expenditure rule for the general government (in cash terms) lays down expenditure ceilings on a rolling basis by limiting expenditure growth to potential GDP growth (both in nominal terms) and restraining it further as long as the primary deficit and the general government debt (as % of GDP) exceed their target values, although the parameters determining the degree of this further restraint are revisable. With the correction of the excessive deficit by 2013 as the near-term goal, such further restraint is currently in place. The resulting ceilings are fixed for the first two years (year t-1 and year t) and indicative for the following two years (year t+1 and year t+2). They are set by the end of April of year t-1 in the budgetary memorandum. In 2011, the first year of application of the new spending rule, a supplementary budget was needed to reduce expenditure significantly compared to the original budget in view of a large revenue shortfall.

The new Fiscal Council (FC) is responsible for an independent, ex post assessment of fiscal policy and structural reforms. It has limited financial and technical resources. In its two annual reports published to date, it has not provided new in-depth analysis of the Slovenian public finances.

The April 2011 stability programme announced amendments to the Public Finance Act envisaging ceilings for general government debt and contingent liabilities and a legislative base for a medium-term budgetary framework (MTBF) with multi-annual fiscal targets (119). Such amendments were adopted by the outgoing government in September but were not discussed or adopted by the now dissolved parliament.

2. ASSESSMENT OF THE CURRENT FRAMEWORK

In the years following EU accession, Slovenia’s fiscal strategy was marked by relatively limited progress towards the medium-term objective (MTO) for the budgetary position in spite of strong growth averaging almost 5% over the period 2004–08. Over this period, the deficit ratio averaged 1.4% of GDP, better than the average deficit of around 2% recorded in the euro area and EU, but the structural deterioration averaged 0.4 percentage point of GDP compared to the — admittedly modest — improvement in the euro area (0.2 percentage point). The very marked deterioration of the budgetary position in 2009, which was partly due to the global economic and financial crisis, has exposed some key weaknesses of the Slovenian budgetary framework, such as: (i) the non-binding nature of the multi-annual fiscal targets laid down in successive stability programmes; (ii) the inherent strong dynamics of specific expenditure items stemming inter alia from generous indexation arrangements (e.g. the wage bill and social transfers, including pensions); and (iii) the occurrence of expenditure overruns (120).

Against this background, the consolidation effort has been stepped up since 2009 but has been driven mainly by temporary interventions to limit growth in the most dynamic expenditure items (wages and transfers) and downward adjustments to (often over-optimistic) investment plans. The implementation of a credible consolidation strategy, based on permanent rather than temporary measures, would clearly be facilitated by a stronger, more binding budgetary framework. This would serve not only the short-term need to reduce the deficit below 3% of GDP by 2013 but also promote further consolidation beyond 2013 to achieve the MTO. A sustained consolidation effort is appropriate in the light of the clear challenges posed by the recent rapid increase in general government debt, the large scale of contingent liabilities and risks to the long-term sustainability of public finances.

While several important innovations have been carried out since 2009, their implications for the fiscal framework and strategy are at this stage either not entirely clear or significant.

In particular, and also in the light of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, the new expenditure rule, which is fixed for just two years, is generally poorly specified and relatively non-transparent and this hampers its effectiveness and monitoring as: (i) it is cast in terms of general government expenditure in cash terms, which makes for an uneasy translation into the rolling two-year budget for central government in cash terms or into the EU surveillance framework (ESA 95); (ii) several of its parameters are revisable; (iii) it encompasses interest expenditure as well as deficit-neutral expenditure financed with EU funds, which are outside the control of the government, so not geared

(118) For the PDIF, which covers the mandatory system of pension and disability insurance, transfers from the central government budget must fully cover any gap between PDIF expenditure and revenue; in 2011, this transfer is forecast to amount to around 4% of GDP. The HIF was in surplus until 2008; its deficits since then have been covered by reserves. The government’s proposed amendments to the Public Finance Act (not yet approved by parliament) include limits on HIF borrowing.

(119) While ceilings for general government debt and contingent liabilities had originally been announced to amount to 45% and 20% of GDP respectively, the proposed amended Public Finance Act set the debt ceiling at 48% of GDP.

(120) Macro fiscal assessment of the January 2010 update of the stability programme for Slovenia.
towards the reduction of discretionary spending; and (iv) there are no clear enforcement mechanisms or escape clauses setting out a limited number of specific circumstances in which temporary non-compliance is permitted.

Furthermore, there is no direct link between the rule and the achievement of the medium-term objective (MTO) for the budgetary position as is foreseen in the strengthened Stability and Growth Pact (SGP) (121). In this context, the introduction of a more binding MTBF laying down multi-annual deficit and debt targets that integrate a well-specified and transparent expenditure rule as well as adequate progress towards the MTO would appear to be an important step in the right direction. This could also foster the adoption of permanent, rather than temporary, consolidation measures and reduce the expenditure overruns which have occasionally occurred.

Secondly, the newly created FC has not yet built a strong reputation and is not yet well-integrated into Slovenian budgetary procedures (e.g. its analyses are not discussed in parliament). This is probably the result of: (i) limited financial and technical resources; and (ii) a narrow mandate limited to ex post assessments only. The FC could be made more effective and play a greater role in the ex ante elaboration of the fiscal strategy if these weaknesses were overcome.

Thirdly, the source of the macroeconomic scenario underlying the MoF’s budgetary projections is currently unclear (to date, it has been drawn from the IMAD forecast) as there are now four different possible sources. This calls for a clarification.

**EPC policy advice**

In spite of several recent innovations, the medium-term budgetary framework (MTBF) and the new expenditure rule are insufficiently binding and insufficiently focused on achieving the medium-term objective (MTO) and securing long-term sustainability, while the new Fiscal Council does not yet weigh on fiscal strategy development and the use of ESA 95 accounting in the national MTBF is not widespread. In this context, national authorities should introduce the following measures.

- Strengthen the MTBF and its legislative base to make it more binding and transparent. Gear it at making adequate progress towards the MTO and support it by a better targeted and well-specified expenditure rule. Express the MTBF and expenditure rule in ESA 95 terms and provide relevant information in ESA 95 terms on the annual budget.
- Reinforce the role and the resources of the Fiscal Council, possibly also through closer cooperation with other institutions analysing fiscal policy, so that it can provide a meaningful contribution to the ex ante development and ex post assessment of the medium-term fiscal strategy.

### 3. SUMMARY INFORMATION ON THE MAIN ELEMENTS OF NATIONAL FISCAL FRAMEWORKS

**Fiscal rule in Slovenia: Debt rule for local governments**

**General description of the rule and target definition:** The debt rule sets the annual ceiling for payment of loans principal and interest, financial leasing, trade credits and contingent liabilities at 8% of revenue in the previous year, excluding donations, investment transfers from the central government, EU funds and revenue from business activities. Municipalities are allowed to borrow on the domestic market only after authorisation from the Minister of Finance. Available information indicates that a municipality spends on average 5.4% of revenue on the payment of liabilities, which suggests they are generally complying with this rule by a relatively wide margin. Still, local government debt in ESA 95 terms increased from 0.7% to 1.7% of GDP over 2007–10.

**General government sub-sector(s) to which the rules applies:** Local governments (municipalities)

**Implementation date:** The debt rule for local governments was introduced before 1990. It was revised in 1990, 1995, 1999, 2005 and 2008.

**Coverage and exclusions:** All municipalities are covered: after the administrative reforms of 1994 and 1998, their number has risen from 64 to 211.

**Accounting system:** The debt rule is based on cash accounting only.

**Escape clauses:** There are no predefined escape clauses.

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(121) The rule reduces spending growth to below potential GDP growth as long as the primary balance and debt exceed their target values, whereas the strengthened SGP foresees that the growth rate of expenditure net of discretionary revenue measures should be below the reference medium-term rate of potential GDP growth in a way to ensure appropriate adjustment towards the MTO (Article 5(1) of the Regulation of the European Parliament and of the Council amending Regulation (EC) No 1466/97 on the preventive arm of the SGP).
Time frame: Annual
Statutory basis: The debt rule is enacted in the Local Communities’ Financing Act.
Monitoring: The monitoring body is the MoF.
Enforcement mechanisms: The MoF enforces the rule. Over-indebted municipalities are not authorised to borrow by the MoF and have to reduce their debts first.
Comments on the functioning of the rule: The rule generally appears to have ensured that municipalities curb expenditure and do not break the debt ceiling. However, the average indebtedness of local governments has increased in recent years and the number of municipalities with no debt has shrunk. To improve public finance surveillance at the local level, the government intends to launch an online tool for an up-to-date and comprehensive calculation of individual municipalities’ indebtedness in the near future.

Fiscal rule in Slovenia: Expenditure rule for the general government
General description of the rule and target definition: The expenditure rule limits nominal growth of general government expenditure in cash terms to nominal potential GDP growth, while correcting it for the distance from the targeted primary deficit and debt. According to the 2011/12 budgetary memorandum, the general government debt target is set at 45% of GDP and the primary deficit target (in cash terms) at 0.9% of GDP in 2013, consistent with the correction of the excessive deficit by that year.
General government sub-sector(s) to which the rules applies: The whole general government
Implementation date: The expenditure rule, as currently specified, was applied for the first time for the period 2011–14. It provides fixed ceilings for the first two years and indicative ceilings for the following two years.
Coverage and exclusions: The rule covers total general government expenditure in cash terms (including interest and expenditure financed with grants from the EU budget).
Accounting system: The rule is expressed in cash terms only.
Escape clauses: There are no clear predefined escape clauses to the rule but the underlying parameters have not been specified in a transparent manner.
Time frame: Four years
Statutory basis: The rule is specified in the Decree on development planning documents and procedures for the preparation of the central government budget. The plan to enshrine it into the legally stronger Public Finance Act, announced in the April stability programme, was implemented by the outgoing government, but parliamentary discussion was postponed due to early elections.
Monitoring: The rule is monitored by the MoF.
Enforcement mechanisms: The MoF applies the rule, but no predefined actions are specified in case of non-compliance.
Comments on the functioning of the rule: In 2011, the first year of implementation of the rule, spending growth had to be adjusted downwards significantly in a supplementary budget because of a large revenue shortfall compared to the original budget plans.

Fiscal institution in Slovenia: Fiscal Council
Date of establishment and description of the main tasks related to fiscal policy: The Fiscal Council (FC) was established in 2009. It is a consultative body tasked with the independent ex post assessment of fiscal policy and structural reforms. It is responsible for assessing the stability and sustainability of the fiscal policy set out in the budgetary memorandum and stability programme and its compliance with the SGP. It is also responsible for assessing the following aspects of fiscal policy: the adequacy of the fiscal targets given the medium-term macroeconomic projections and fiscal framework; the efficiency of public spending; the implications of trend developments in general government revenue and expenditure items on the sustainability of public finances; the consistency of fiscal policy with long-term sustainability of the public finances; the transparency of public finances and quality of the macroeconomic scenario underlying public finance projections; the efficiency of the implementation of structural policies; and finally general government policies on borrowing and guarantees.
**General government tiers at which the institution carries out its tasks:** The whole general government

**Main outputs released by the institution:** The main output of the FC is an annual report, published by 30 April, providing the above mentioned assessments. The FC has issued two annual reports to date, with the latest report annexing the contributions and views of individual Council members. Reports are independent and are not submitted to the government for adoption, agreement or prior acquaintance.

**Role of the institution in the budgetary process:** There is no involvement of the FC at the budget adoption and execution stages. Its *ex post* assessments are published just before the new budgetary cycle begins on 15 May with the first government budgetary session.

**Obligation for the government to use the output of the institution:** There is no formal obligation for the government to use output of the FC.

**Status of the institution:** The FC is an independent institution enacted in the Public Finance Act.

**Composition and appointment of the governing structure:** The FC has seven members appointed by the government following proposal by the Minister of Finance. Their term of office is five years and cannot be renewed. Administrative and technical support is provided by the general secretariat of the government.

**Comments on the functioning of the institution:** The FC has not yet established a strong reputation. It is a relatively young institution with limited financial and technical sources. Its two annual reports have not provided new in-depth analysis of the Slovenian public finances. Moreover, the variety of views contained in the members’ individual contributions annexed to the 2011 report highlights that the Council might have difficulty in achieving consensus on the topics in its remit.

**Domestic budgetary procedures in Slovenia**

**Transparency**

The Constitution stipulates that all revenue and expenditure of the state and local governments should be included in their budgets. Government accounts use the accounting standard of Government Finance Statistics (1986). The budgetary procedure and its timeline are set in the Decree on development planning documents and procedures for the preparation of the central government budget. Budget execution data in cash terms are regularly made public for all four sectors of the general government (central government, local government, the Pension and Disability Insurance Fund and the Health Insurance Fund). While these features ensure full transparency of the budget in cash terms, the availability of corresponding information in ESA 95 terms could be improved.

**Centralisation of the budget process at the planning stage and approval stage**

The preparation of the central government budget is centralised in the MoF. During the parliamentary approval stage, the financial effects of any budgetary amendments have to be offset and may not raise total borrowing above the amount adopted by the government. An eventual increase in borrowing can be proposed by the government only.

**Realistic economic assumptions**

The macroeconomic scenario underpinning the MoF’s budgetary projections has, to date, come from the biannual economic forecasts of the Institute of Macroeconomic Analysis and Development (IMAD). These forecasts do not seem to embody an optimistic bias. The 2010 Decree on development planning documents and procedures for the preparation of the central government budget reduced transparency as there is now a list of four possible forecasts (the IMAD, the central bank, the European Commission and the OECD) from which the scenario can be drawn, but no indications are provided as to how the choice will be made and/or whether these forecasts will be combined.

**Performance-based budgeting**

For the first time, the budget for 2010/11 was prepared using performance-based budgeting, whereby the budgetary lines are translated into 16 policy areas (*development policies*) representing the main strategic objectives pursued by the public administration. This budget method is expected to lead to a more efficient management of the budgetary process and of government expenditure through clearly defined goals and indicators to measure effectiveness and performance of public services.