4. *Fiscal governance in euro-area Member States: insights from a fiscal governance database*

Fiscal governance frameworks comprise the procedures and institutions that underlie the conduct of budgetary policies. Fiscal governance at national level has been gaining increased relevance recently, as reflected not least in the Commission's legislative proposals to enhance economic governance currently under negotiation. Based on an Ecofin Council mandate, the Commission services maintain a database on fiscal governance in EU Member States, focusing on three key dimensions: numerical fiscal rules, medium-term budgetary frameworks, and independent fiscal institutions. The data show that fiscal governance remains weak along the three dimensions in some Member States. Furthermore, the trend towards an increasing number of fiscal rules was reversed in 2009 (latest data available), with this fall being the first since 1990 and the average strength of such rules decreasing as well. In 2009, 16 euro-area Member States had a medium-term budgetary framework, although in many cases such frameworks showed considerable flaws. 21 independent fiscal institutions were operating in euro-area Members States in 2009. While the fiscal governance database captures the heterogeneity across euro area members, it also highlights that some Member States still have some way to go to reach the standards laid down in the draft Directive on budgetary frameworks of EU member states, which formulates the 'least common denominator' required for SGP compliance.

Introduction

Fiscal governance frameworks comprise the procedures and institutions that underpin all stages of the conduct of budgetary policies of general government (planning, approval, implementation, monitoring). A growing body of empirical research shows that well-designed fiscal governance frameworks can contribute to attaining sound budgetary positions, reducing the cyclicality of fiscal policymaking, and improving the efficiency of public spending, inter alia by placing constraints on time-inconsistent behaviour of policymakers and by forcing them to adopt a longer-term approach to fiscal policy making.

In recognition of this empirical evidence, national fiscal governance has gained increasing importance in the EU's policy framework. In recent years, the Ecofin Council has on several occasions reiterated the importance of national budgetary frameworks for the soundness of public finances. ([14]) In January 2006, the Ecofin Council asked the Commission to conduct a comprehensive analysis of existing national fiscal rules and institutions in the EU Member States and their influence on budgetary developments. In April 2009, the Ecofin Council invited Member States to annually update the Commission's database on fiscal governance. One year later, it launched the regular assessment of national fiscal governance frameworks. ([15]) In addition to this evaluation of national fiscal governance frameworks against non-binding standards of best practice, the Commission is proposing a number of binding minimum requirements for fiscal governance in EU countries in the draft Council Regulation on requirements for Member States' budgetary frameworks. This was tabled by the Commission in September 2010 and is currently under discussion between the Council, the European Parliament and the Commission (together with five other legislative proposals on economic governance). ([16])

Following the 2006 Ecofin Council mandate, the Commission services have built up a database on fiscal governance in the euro-area Member States that is updated annually. This unique database focuses on three specific areas: national fiscal rules, medium-term budgetary frameworks, and independent fiscal institutions. ([17]) The present section provides an overview of fiscal governance in the euro-area Member States in these three areas. It is based on the latest update of the dataset, reflecting the situation as of 2009. Naturally, owing to the design of data collection, this overview cannot do full justice to all facets of national fiscal governance, and in particular recent changes in the countries reviewed.

([14]) See the Ecofin Council conclusions of October 2006, October 2007 and May 2008.

([15]) This peer review is conducted in the Economic Policy Committee; the first review round took place in May 2011.

([16]) For an overview of these legislative proposals see European Commission (2010), *Quarterly Report on the Euro Area,* Vol. 9, No 3.

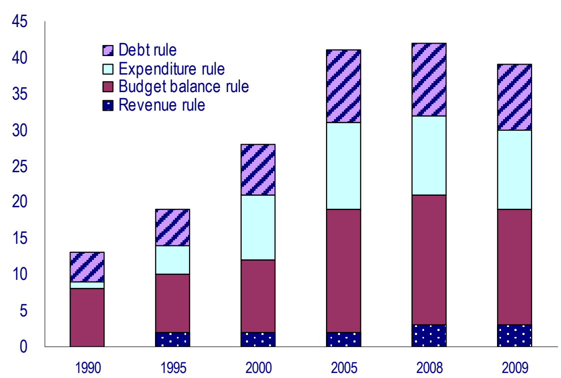
([17]) The fiscal governance dataset is available on DG ECFIN's website at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

Numerical fiscal rules

The Commission's fiscal governance dataset covers numerical fiscal rules ([18]) that target the main budgetary aggregates (i.e. budget balance, government expenditure and revenues, government debt or a major component thereof) in all sectors of government (central, regional, and local; general government; and social security). Procedural rules on the preparation of the annual budget are not considered.

Euro-area Member States had 42 numerical fiscal rules in place in 2009. Of these rules, which were in force across all euro-area members except Greece, Cyprus and Malta, budget balance rules were most widespread, with 18 such rules (42 %). They provide some form of ceiling for the budget balance (typically the deficit), e.g as per cent of GDP, or in absolute real or nominal terms, and often applying to the structural balance only. At the same time, euro-area Member States operated 11 expenditure rules and 9 debt rules, while there were 3 revenue rules and one combined rule constraining the budget balance and expenditure. Expenditure and debt rules also impose a ceiling on the respective budgetary aggregates, whereas revenue rules typically govern the allocation of unexpected revenues. Typically, a majority of budget balance rules (7) and debt rules (4) applied to local government, while expenditure rules were mostly in place for central government (5 such rules).

Graph 4.1: **Number of fiscal rules in euro-area Member States by type (1990-2009)**

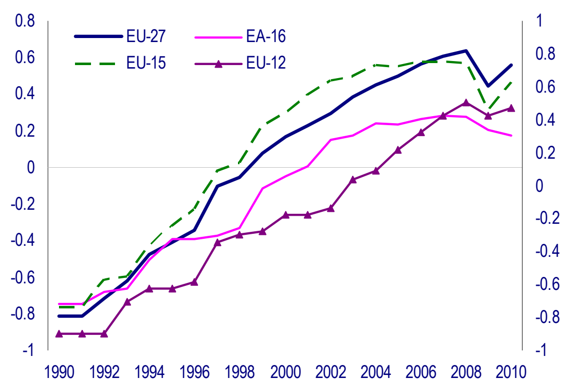


Source: Commission services.

2009 was the first year in the past two decades to witness a decline in the number of numerical fiscal rules in force (Graph 4.1). ([19]) Compared with 2008, three rules were abolished or put in abeyance (a budget balance rule in Finland and an expenditure rule and a debt rule in Slovakia). At the same time, Austria replaced a budget balance rule for all sectors of government except social security with an expenditure rule for general government.

The Commission services have devised a composite index measuring the strength of numerical fiscal rules based on five criteria: their statutory basis, the room for setting or revising objectives, the nature of the body in charge of monitoring whether the rule is complied with, enforcement mechanisms, and media visibility. The index also takes into account the coverage of general government. ([20]) In 2009, this fiscal rule index fell for the first time since 1990 for the euro-area average (see Graph 4.2). ([21]) This resulted from the decrease in the number of numerical fiscal rules together with the replacement of a rule with broader coverage by one applying to a smaller share of general government finance (Austria, as described above).

Graph 4.2: **The Fiscal Rule Index in the euro area and other selected aggregates (1999 to 2009)**



(1) The fiscal rule index is calculated by assessing five criteria (see text). The index is standardised so that the average over the 1999-2009 sample is 0 and the standard deviation 1.
Source: Commission services.

Medium-term budgetary frameworks

Medium-term budgetary frameworks (MTBFs) comprise the procedures for preparing, implementing and monitoring multi-annual budget plans. They improve the quality of fiscal policy making, as the implications of most fiscal

([18]) The survey adopts the definition of Kopits and Symanski (1998) whereby a fiscal rule is 'a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance'. See Kopits, G. and S. Symanski (1998), 'Fiscal policy rules', *IMF Occasional Paper*, No 162.

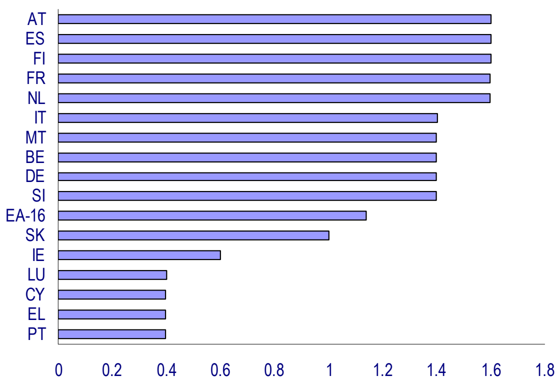
([19]) The dataset contains retrospective information back to 1990.

([20]) More information on the fiscal rule index can be found on DG ECFIN's fiscal governance website.

([21]) The weakening of the average strength of fiscal rules also applied to the EU-27 average, as well as the pre-2004 Member States (EU-15) and the new entrants (EU-12).

policy measures go well beyond the yearly budget cycle. In 2009, all euro-area Member States but four (CY, EL, LU, PT) had national MTBFs in addition to their Stability and Convergence Programmes (SCPs). ([22]) Most cover the whole of general government or large parts, typically with a three-year horizon — although the most developed MTBFs cover four (FI, AT) or five years (NL). In most MTBFs, the planning horizon is moved forward annually by a year, allowing earlier years' plans to be revised (rolling and flexible MTBFs). The main new development in Member States' MTBFs in 2009 was the introduction of the four-year expenditure framework in Austria.

Graph 4.3: **The Medium Term Budgetary Framework Index in the euro area (2009)**



Source: Commission services

From the survey information on MTBFs a composite index of their quality has been constructed on the basis of five criteria: (1) the existence of a domestic MTBF (beyond the requirements of the SCPs), (2) the link between the multi-annual budgetary targets and the preparation of the annual budget, (3) the involvement of national parliaments in the preparation of the medium-term budgetary plans, (4) the existence of coordination mechanisms between sectors of general government prior to setting the medium-term budgetary targets, and (5) the mechanisms for monitoring and enforcing multi-annual budgetary targets. Graph 4.3 shows the ranking of the euro-area Member States by this measure of MTBF quality. According to the MTBF index, four groups can be distinguished: the MTBFs of AT, ES, FI, FR, NL are most developed. IT, MT, BE, DE and SI have MTBFs of average quality, while in IE and SK there is scope for considerable improvement. Finally, CY, EL, LU and PT lack procedures for medium-term budgetary planning beyond those directly serving the European surveillance framework. In general, weaknesses relate to the lack of detail of budgetary projections, scant monitoring, the absence of correction mechanisms, and poor coordination of sub-levels of government.

([22]) Details on the MTBF index can be found on DG ECFIN's fiscal governance website.

Independent fiscal institutions

Independent fiscal institutions are a further institutional mechanism to improve budgetary performance by providing independent input (such as macroeconomic and budgetary forecasts), positive or normative analysis, assessment, and recommendations on fiscal policy making. The fiscal governance database includes institutions that are primarily financed by public funds but are functionally independent from fiscal authorities. ([23]) In 2009, there were 21 such institutions located in 11 euro-area Member States (CY, FI, IE, MT, SK had no such institution).

Typically, these institutions were far more common in the pre-2004 EU Member States, often with a long history, also due to the requirements of such institutions in terms of human resources, where smaller countries might have staffing difficulties.

In 2009, seven euro-area Member States had independent fiscal institutions mandated to monitor budget performance (BE, DE, ES, FR, IT, NL, PT). In four euro-area Member States, such institutions were providing budgetary forecasts (AT, BE, NL, SI) and non-binding macroeconomic forecasts (DE, FR, EL, LU). A notable development in 2009 was the establishment of a new independent fiscal institution in Slovenia, where one such institution, IMAD, had been operating already, being entrusted with evaluating the quality of public finances. The new council established in June 2009 has been assigned a consultative role in the area of fiscal policy and the implementation of

([23]) Independent fiscal institutions (also called fiscal councils) are non-partisan public bodies other than the central bank, government or parliament that prepare macroeconomic forecasts for the budget, monitor fiscal performance and/or advise the government on fiscal policy matters. Specifically, they may provide macroeconomic forecasts for the budget preparation that do not suffer from optimistic bias; they may impartially monitor the implementation of budget plans and adherence to budgetary objectives; they may raise awareness of the short- and long-term costs and benefits of budgetary measures; and they may assess whether fiscal measures are appropriate in terms of compliance with rules, stability, and sustainability. Courts of Auditors are included if their activities go beyond accounting control and cover any of the tasks mentioned above. Think tanks, Central banks and directorates of ministries of finance are not considered.

Box 4.1: **Examples of national fiscal frameworks: Belgium and Austria**

In **Belgium**, high deficit and debt levels in the late 1980s and the launch of EMU in the 1990s prompted the authorities to reinforce the institutional setting to fiscal policy making. The resulting institutional reform was centred around two independent fiscal institutions: the National Account Institute (NAI) was established in 1994 and was entrusted with providing macroeconomic forecasts for budget preparation, while the reformed High Council of Finance has been responsible for monitoring fiscal policy and formulating medium-term objectives at the regional level since 1992. As part of the reform, the existing rules-based fiscal governance framework was reinforced as well. On top of the budget balance rule for local governments, five new numerical rules were implemented throughout the 1990s: an expenditure rule and a revenue rule respectively for central government, a budget balance rule and an expenditure rule for social security, and a budget balance rule for regional governments. The resulting coverage of all general government by numerical fiscal rules was complemented by reinforced multiannual fiscal planning in order to foster consolidation and accede to EMU. Due to the high level of fiscal decentralisation in Belgium, co-ordination between different levels of government is crucial. A key role in co-ordination is assumed by the HCF, which issues recommendations on general government budget balances for the years ahead. These recommendations provide the basis for political agreements between the federal and regional governments that include medium-term budgetary targets and act as internal stability programmes. Enforcement of these programmes is ensured by restrictions on debt issuance in the event of non-compliance. Important elements of the fiscal governance framework are budgetary targets (mainly expenditure ceilings) 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. Finally, the Minister of Finance has strong powers to monitor budgetary implementation, but has limited agenda-setting powers.

In **Austria**, the main elements of the fiscal governance framework are the Austrian Stability Pact (ASP), which covers all levels of government, and the Medium-Term Expenditure Framework, which applies to the federal government. The ASP was first set up in 1996 to foster consolidation and fiscal discipline, as required under EMU. In 1999, the ASP was formalised; successors were adopted for 2001 to 2004, 2005 to 2008, and 2008 to 2013. The Pact was complemented by a consultation mechanism between levels of government to prevent legislation resulting in financial strain on other levels of government. The ASP sets deficit/surplus targets for the federal, regional and local governments, supported by a sanctioning mechanism. Initially, budgetary surpluses were not supposed to be carried over to future years. But because of the resulting pro-cyclicality such carry-over has been admitted, so that averages over the duration of the Pact are assessed instead. The ASP also includes sanctions that take the form of interest-bearing deposits that are distributed among compliant governments if targets are not reached in the following year. The sanction has not been used so far, however. A further important element of the Austrian fiscal governance framework is the Medium-Term Expenditure Framework (MTEF), introduced in 2009. It requires Parliament to adopt 4-year plans for nominal expenditure limits under five budgetary headings; these plans are annually rolled forward by one year. Expenditure ceilings are divided into fixed (about 80%) and flexible ones (for the remaining 20%); the latter cover areas that are subject to large cyclical fluctuations. Expenditure ceilings are also specified at the sub-heading level; they are binding for the following year and indicative for the three years thereafter. Line ministries can build reserves from unspent appropriations at the end of the year. Further reform initiated is expected to come into force in 2013, including performance budgeting, results-oriented management of administrative units, and a modernisation of the accounting system. Austria's fiscal governance framework is complemented by the operation of two independent fiscal institutions: the budget law is prepared using economic projections provided by the Austrian Institute for Economic Research (WIFO), while the Government Debt Committee (Staatsschuldenausschuss) provides fiscal analysis and consolidation recommendations.

structural reforms. It is authorised to evaluate fiscal policies in terms of sustainability and appropriateness under the given cyclical conditions, compliance with national and European fiscal rules, and the quality of public finance.

Conclusion

The trend towards an increasing number of fiscal rules in the euro area was reversed in 2009. Of the 45 numerical fiscal rules in force in 2008, three were subsequently abolished, ostensibly due to their unsuitability to accommodate the fiscal policy challenges posed by the crisis. Consequently, the average strength of numerical fiscal rules also dropped by around one third against the previous year. Concerning medium-term budgetary frameworks, a novel development in 2009 was the establishment of a four-year expenditure framework in Austria. In 2009, three quarters of euro-area Member States had a medium-term budgetary framework that exceeded the SCP requirements, but in some cases, these frameworks displayed serious flaws such as insufficient coordination across sub-sectors of general government and the lack of enforcement mechanisms; no change was registered along these lines in 2009. Finally, as regards independent fiscal institutions, the euro area saw the creation of a new body of this nature in 2009. Specifically, with the new Fiscal Council in Slovenia, the number of such institutions operating in 11 of the euro-area Member States increased to 21.

The above snapshot of fiscal governance in euro-area Member States relies on data as of 2009 and may therefore not correspond to the present situation in some cases. Besides, the dataset focuses on specific aspects of fiscal frameworks, which cannot fully reflect all the details of Member States' fiscal governance. Unfortunately, however, the quality of fiscal governance in the different areas portrayed above — numerical fiscal rules, medium-term budgetary frameworks, and independent fiscal institutions — tends to correlate, so that strengths and weaknesses in these areas reinforce each other, leaving a group of euro-area Member States with weak fiscal governance altogether. It can be conjectured that the quality of other characteristics of fiscal governance not discussed above, such as budgetary procedures other than those related to medium-term planning, also depends on to the quality of the elements described here, underlining the need for improvement in the weakest euro-area Member States. This conclusion gains further support from the requirements spelled out in the draft Directive on EU budgetary frameworks, which specifies a minimum standard for fiscal governance in EU Member States in order to foster compliance with the SGP.