1. INTRODUCTION

The conduct of budgetary policy is the competence of EU Member States. At European level, common commitments have been taken by EU countries to guide their national budgetary policies, in the form of the Stability and Growth Pact.

Public debt-to-GDP ratios across most EU countries have followed an upward trend since the mid-1970s. They have reached record levels during the recent economic and financial crisis and are now very gradually being reversed towards more sustainable levels (Q2 2016, debt-to-GDP ratio was 84.8% for the EU and 91.7% for the euro-area, according to Eurostat). In Q2 2016, EU deficit shrank to 1.8% of GDP (seasonally-adjusted, Eurostat).

Responsible budget making is fundamentally in the hands of executive and legislative authorities in each Member State. It should materialize into sustainable ratios of debt and deficit.

Having in place a strong national experience and preference for such budget making, irrespectively of the political majority in the short term, is a major asset.

Where such culture is not strong enough, setting pre-defined rules in the legal basis can on the one hand ensure that budgets are drafted responsibly, and on the other hand engrain a responsible budget behaviour.

2. DEFINITION

2.1. Building blocks

In particular, national fiscal governance, or framework, consists in the set of specific rules, procedures, arrangements, and institutions for budgetary policy in place in each of the 28 EU Member States. Every year, governments' budgets have to be prepared and executed according to these underlying foundations established for the long-term. The national fiscal frameworks can be broken down into five key building blocks:

- **Budgetary statistics** supplying detailed information on budgetary developments (expenditure, revenues, public debt etc.) which are critical for budgetary analysis and forecasts at all levels of governments;
- **Numerical fiscal rules** which "set in stone" quantitative thresholds for budgetary aggregates (for example, budget deficit cannot exceed a certain percentage of GDP);
- **Multiannual budgetary frameworks** defining strategic budget planning (in terms of spending, revenue, debt etc.) for more than one year, consistently with the traditional annual budget planning;
- **Independent national fiscal institutions** which, independently from governments and parliaments, assess

---

**1** For more information, see Sherwood M., 2015, "Medium-term budgetary frameworks in the EU member states", European Commission, Discussion Paper 021.
the quality of budget making in all transparency (for example, a fiscal council publicly assessing whether the annual budget complies with the national numerical fiscal rules);
- **Budgetary procedures** defining the methodology for forecasting, the coordination arrangements across government levels for budgetary matters and other processes.

2.2. Objectives

The **objective of national fiscal governance is to support fiscal responsibility**, in particular:

- **attain sound budgetary positions**, in particular by containing the deficit bias, i.e. the tendency to spend more than the effective revenues,
- **reduce the cyclicality of budget policy making,**
- **improve the efficiency of public spending**, by increasing transparency and facilitating the identification of options for resource reallocation (including for growth-enhancing purposes).

2.3. EU requirements

Prompted by the crisis, a strong impetus to the strengthening of national fiscal governance was provided by the European level. Three legal initiatives in particular have set requirements across EU countries:

- **EU Directive** setting minimum requirements for national budgetary frameworks across the five above-listed building blocks (adopted in 2011, for all Member States).
- **The Fiscal Compact** adding the commitment to have a balanced budget over the economic cycle flanked by a correction mechanism and independent national surveillance (it entered into force in 2013, for all 19 euro area countries plus Bulgaria, Denmark and Romania),
- **EU Regulation 473/2013** requiring the monitoring of national numerical fiscal rules by independent institutions and the independent production or endorsement of macroeconomic forecasts (adopted in 2013, for all euro area countries).

These requirements are consistent with budgetary rules set at European level in the Stability and Growth Pact and are meant to strengthen the ownership of European rules by national stakeholders (mostly governments and parliaments).

Every year, the progress and challenges of the national fiscal governance of each EU Member State is discussed in the Country Report published by the European Commission in the context of the European Semester.

In this factsheet, section 3 reviews the performance of the fiscal governance models of EU countries and challenges they face. Section 4 then discusses potential policy levers to address these challenges, while section 5 highlights a case study.

3. CHALLENGES AND PERFORMANCE IN EU MEMBER STATES

3.1. Challenges

**Deficit bias and pro-cyclicality are two challenges that national budgets are facing:**

- **Deficit bias** refers to the tendency of governments to spend more than effective revenues, reflected in budget deficit accumulating and increasing public debt burdening future generations.

---

2 The EU Directive and the Fiscal Compact have to be transposed into the national legal orders of the Member States concerned.
4 The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, an intergovernmental agreement signed on 2 March 2012 by 25 EU Member States (all except for the Czech Republic, Croatia and the United Kingdom).
5 Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.
• Pro-cyclicality means that, sometimes driven by short-term political objectives, governments increase spending when the economy is buoyant instead of generating surpluses to anticipate downturns, and cut expenditure when a slowdown or recession is hitting the economy aggravating the situation. For instance, in the pre-crisis period 1980-2005, a number of EU countries conducted pro-cyclical policies by overspending during economic upswings and lowering public spending in the downturns.

Strong national fiscal frameworks can contribute to addressing these challenges. They constrain budget making in the form of permanent rules and institutions established nationally with a legal grounding, and applying/operating independently of short-term political preference. This is widely confirmed by empirical research.

Improvements to national fiscal governance are only one component in the broader European response to the crisis, whereby the EU deficit went down from -6.6% of GDP in 2009 to -1.8% in Q2 2016 (source: Eurostat).

Strong national fiscal frameworks are defined by the quality of their design and the rigour and persistence in their implementation: rules and institutions have to be fit for attaining national budgetary targets, and have to be continuously complied with by the successive governments.

3.2. Performance in EU Member States

In terms of design, the quality of national fiscal frameworks across the EU has risen over the past years, prompted by the above-listed EU requirements.

• Numerical fiscal rules: all EU countries have such rules in force in their national legal order. Rules constraining the budget balance (i.e., deficit or surplus) are particularly frequent. Overall, the fiscal rules continue to strengthen (see Figure 1 based on an annually updated database of the Commission).

• Multiannual budgetary frameworks: all EU countries now produce budgetary targets beyond an annual horizon – for minimum 3 years. The level of detail, credibility of underlying measures and binding force continue to vary greatly though. How stable are these multiannual budgetary targets over time (see Figure 2)?

• In 4 Member States (the Nordic countries and the Netherlands), multiannual budgetary targets are meant to be relatively stable and reliable over time as they are not supposed to be revised,

• In 12 Member States, multiannual budgetary targets can be adjusted under specific circumstances and the adjustments have to be explained publicly,

• In other 12 Member States, there is no legal restriction to the possibility to adjust multiannual budgetary targets, which undermines their credibility.

• Independent Fiscal Institutions: to date, 31 of such institutions have been legally established in the EU. Notably, ¾ of them have been established or significantly reformed since 2010. Only the Czech Republic and Poland have not adopted legislation to establish a fiscal council, whereas in Slovenia, the

fiscal council is not operational in spite of legal basis having been adopted in July 2015. Across the EU, two patterns can be observed, as illustrated in the map below:

- In most countries, a "fiscal council" is mandated with the assessment of the compliance of budgets with national numerical fiscal rules and sometimes also with the assessment/endorsement of macro-economic forecasts;
- In a few countries (e.g. the Netherlands, Belgium, Slovenia, Luxembourg, Austria), in addition to a "fiscal council", a "forecaster" operates with the mandate of producing independent macro-economic forecasts used for budget planning.

In all cases, these assessments and forecasts have to be made public. In most countries, the government also has the obligation to either follow the assessment, or explain publicly why it departs from it.

**In terms of implementation of their fiscal governance models by the Member States, the track record appears very heterogeneous.** The effective functioning of the newly-established or upgraded fiscal governance arrangements remains a major challenge in many countries, which has to be addressed so that the frameworks can play in full the envisaged role in pursuing a responsible fiscal policy.

---

**Figure 1 – The fiscal rule index in the EU, 2013 and 2014**

![Figure 1](image)

**Source:** European Commission, DG ECFIN, Fiscal Governance Database

---

9 The Fiscal Rule Index is calculated by DG ECFIN annually based on self-declared data from the EU countries. The latest update has a cut-off date of end-2013. The index is based on five dimensions of the strength of all fiscal rules in place (legal base, room for revising objectives, monitoring and enforcement bodies, enforcement mechanism and media visibility) and adjusted for the sector coverage, for each country.
### Figure 2 – Level of strictness of national provisions in terms of respecting the budgetary targets set out in the medium-term planning documents, 2015

<table>
<thead>
<tr>
<th>Level of strictness</th>
<th>EU country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (Expenditure) ceilings/targets are not expected to be changed in whatever the circumstances (unless a new government comes to power or division of tasks between government levels is changed)</td>
<td>Finland, Sweden</td>
</tr>
<tr>
<td>2 (Expenditure) ceilings can only be increased provided that sources of funding of the additional expenditure are identified ex-ante</td>
<td>Denmark, the Netherlands</td>
</tr>
<tr>
<td>3 (Expenditure) ceilings/targets can be adjusted in response to changes in a number of specific parameters defined by legislation or other public procedural document (e.g. change in expenditure on pensions, unemployment benefits etc.) and such changes need to be explained publicly</td>
<td>Austria, Ireland, Latvia</td>
</tr>
<tr>
<td>4 (Expenditure) ceilings/targets can be changed in a number of situations foreseen by legislation or other public procedural document (e.g. in view of a substantial change in the macroeconomic forecast, new government coming to power, extraordinary circumstances, etc.) and such changes need to be explained publicly</td>
<td>Belgium, Bulgaria, Cyprus, Greece, Italy, Malta, Poland, Romania</td>
</tr>
<tr>
<td>5 (Expenditure) ceilings/targets can be changed at the discretion of government but changes need to be explained and reputational cost is involved</td>
<td>Czech Republic, Estonia, Hungary, France, Lithuania, Luxembourg, Portugal, Spain, the UK, Croatia, Germany, Slovenia, Slovakia</td>
</tr>
<tr>
<td>6 Ceilings/targets can be changed at the discretion of government without any public explanation</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** European Commission, Medium-Term Budgetary Frameworks in the EU, Monika Sherwood, DG ECFIN, Economic Paper N°021 of December 2015

### Figure 3 – Overview of independent fiscal institutions in the EU, August 2016

- **Country with no Fiscal Council and no independent forecaster**
- **Country with one Fiscal Council and no independent forecaster**
- **Country with one independent forecaster and one Fiscal Council**
- **Country with one body combining independent forecasting and Fiscal Council mandates**

**Source:** European Commission, DG ECFIN
4. POLICY LEVERS TO ADDRESS THE CHALLENGES

The quality of the design of national fiscal governance models and ensuring a rigorous implementation are the two major challenges that EU countries are facing across the five building blocks.

4.1. Effective measures

The correct transposition of EU requirements in relation to fiscal frameworks into national legal orders is the first and foremost pre-requisite for all Member States. The Commission is currently evaluating the way in which national transposition has been carried out, in dialogue with the Ministries of Finance of the countries concerned.

Regular assessments of the quality of the national fiscal governance in relation to the specific fiscal challenges are highly encouraged.

Some more specific effective measures can nevertheless be selectively highlighted for each building block:

- **Numerical fiscal rules**: effective consequences in case of non-compliance (comply-or-explain principle, correction, sanction etc.), avoiding recourse to loosely defined escape clauses triggered in case of specific circumstances as a way to circumvent the application of a rule;
- **Multiannual budgetary planning**: stricter rules for revising multiannual targets;
- **Independent fiscal institutions**: a clear mandate, a strong legal grounding, adequate resources and access to information (secured, for example, by a memorandum of understanding signed with the Ministry of Finance), a comply-or-explain principle applied in practice;
- **Budgetary procedures**: effective coordination mechanism (especially in federal countries) whereby central and sub-national fiscal rules work in tandem towards achieving the overall budgetary targets, evaluation of national forecasts in case of frequent slippages to correct bias.

Public commitment from governments to apply fully the national fiscal arrangements or else upgrade the governance model to align it with the particular budgetary challenges of the country.

4.2. Ineffective measures

"Automatic" transposition of EU requirements ("copy/paste") with no adjustment to the country-specific challenges would threaten the appropriate conduct of fiscal policy towards the set objectives.

The stability of the governance model enables to engrain its principles in the decision-making process at all administrative and political levels, and benefits the overall credibility of the budget adopted according to that governance model. Therefore, its frequent revision should be avoided.

Significant annual revisions to the medium-term budgetary trajectory which are not motivated by changes in the macroeconomic prospects risk undermining the credibility of underlying policies as the expenditure and revenues profiles are insufficiently predictable.

A fiscal governance model enshrined in the legal basis but which is not applied in practice – e.g. if there are constant deviations from the ceilings set by numerical fiscal rules – would not have the intended impact, and would undermine the credibility of a particular government in a country as well as externally vis-à-vis its European peers, rating agencies and financial markets.

5. CASE STUDY – IRELAND

The crisis had a massive impact on the budgetary profile of Ireland: in 2010, it recorded a 32.1% deficit for the general government, 12.6% in 2011. Debt reached 119.5% of GDP in 2012, almost multiplying by six its pre-crisis level of five years earlier. In 2015, the deficit shrank to 2.3% of GDP, with a gross government debt of 78.6%.
The experience of the crisis prompted major reforms in the Irish fiscal governance model over the past years. This materialized with the adoption of several texts, including: the Fiscal Responsibility Act in 2012, the Statutory Instrument Nº 508 in 2013 on the independent fiscal institution and the Circular 15/13 on medium-term expenditure ceilings. Selected features of the current Irish fiscal governance model are highlighted below:

- **Budgetary statistics**: fiscal data for the central government and the social security funds are published monthly on the website of the Minister of Finance, quarterly for local governments.
- **Numerical fiscal rules**: on the scope of the general government, there is a structural balanced-budget rule and a debt rule constraining deficit and debt developments in relation to GDP. For both rules, independent monitoring of the compliance of the budget is provided by a recently-established independent institution, the Irish Fiscal Advisory Council (IFAC). The government is obliged to either follow the assessments of the IFAC, or explain publicly why it departs from them. In case of deviation from the structural balanced-budget rule, a correction plan has to be submitted by the government to parliament within 2 months.
- **Multiannual budgetary planning**: Every year, Ireland adds an outer year to its multiannual budget plan, which is the Stability Programme. Multiannual expenditure targets are supposed to be revised only under specific circumstances, but the practice has been more flexible. Spending reviews conducted regularly inform budgetary plans.
- **Independent fiscal institution**: the IFAC is a standalone institution whose mandate includes the monitoring of compliance with national fiscal rules and the endorsement of macroeconomic forecasts underpinning budget planning. It has signed a memorandum of understanding with the Ministry of Finance to secure access to data it needs to carry out its mandate. In practice, it has delivered many insightful assessments since its establishment in 2012. Its work against its mandate has been evaluated in 2015 by an independent panel of experts.

Years of operation will be necessary to analyse to what extent this revamped governance has been consistently applied and has positively impacted budget making in Ireland.

Date: 14/11/2016.
6. REFERENCES

- European Commission, Fiscal Governance Database, DG ECFIN
- European Commission, 2016 Country Reports