1. INTRODUCTION

The conduct of budgetary policy is the competence of EU Member States. At European level, EU countries have committed to pursuing sound fiscal policies and coordinating their national budgetary policies, in compliance with the rules in the Stability and Growth Pact.

Public debt-to-GDP ratios across most EU countries have followed an upward trend since the mid-1970s. They reached record levels during the recent economic and financial crisis and are now very gradually dropping back towards more sustainable levels (the debt-to-GDP ratio was 83.2% for the EU-28\(^1\) and 88.9% for the euro area in 2016, source Eurostat). The deficit shrank to 1.7% of GDP in the EU-28 and to 1.5% of GDP in the euro area (source Eurostat).

Responsible budget-making is fundamentally in the hands of executive and legislative authorities in each Member State.

Following pre-defined rules and procedures can support transparent and responsible budget behaviour.

2. DEFINITION

2.1. Building blocks

National fiscal governance, or the national fiscal framework, is the set of specific rules, procedures, arrangements and institutions for budgetary policy in place in each of the 28 EU Member States. Every year, government budgets have to be prepared and executed according to these underlying foundations, which are established for the long term. 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 government;
- **numerical fiscal rules** which 'set in stone' quantitative thresholds for budgetary aggregates (for example, the budget deficit cannot exceed a certain percentage of GDP);
- **multiannual budgetary frameworks**\(^2\) setting strategic budget planning (in terms of spending, revenue, debt etc.) for more than 1 year, consistent with the traditional annual budget planning;
- **independent national fiscal institutions** which, independent of governments and parliaments, assess the quality of budget-making under conditions of transparency (for example, a fiscal council publicly assesses whether the annual budget complies with the national numerical fiscal rules);

\(^1\) The countries covered by data in this factsheet are the EU-28, unless otherwise specified.

\(^2\) For more information, see Sherwood M., 2015, *Medium-term budgetary frameworks in the EU member states*, European Commission, *Discussion Paper 021*.
• **budgetary procedures** laying down the forecasting methodology, 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 to:

• **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 making it easier to identify options for reallocating resources (including for growth-enhancing purposes).

### 2.3. EU requirements

Prompted by the crisis, a strong impetus to strengthen national fiscal governance came from the European level. Three legal initiatives in particular have set requirements across EU countries:

• **EU Directive 2011/85** setting minimum requirements for national budgetary frameworks, which cover the five above-listed building blocks (adopted in 2011, applicable to 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 (the Fiscal Compact entered into force in 2013 and is binding 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, applicable to 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 enhance the ownership of European rules by national stakeholders (mostly governments and parliaments).

Every year, as part of its 'European Semester' economic monitoring process, the European Commission publishes a country report discussing each Member State's progress and challenges in its national fiscal governance.

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

The thematic factsheet on the sustainability of public finances in the EU discusses the ability of a government to sustain its fiscal policies in the long run without threatening the government's solvency.

### 3. CHALLENGES AND PERFORMANCE IN EU MEMBER STATES

#### 3.1. Challenges

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

3 The EU Directive and the Fiscal Compact have to be transposed into the national legal orders of the Member States concerned.


5 The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The latter is an intergovernmental agreement signed on 2 March 2012 by 25 EU Member States (all except for the Czech Republic, Croatia and the UK).

6 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.
Deficit bias refers to the tendency of governments to spend more than effective revenues. This is reflected in accumulation of budget deficit and increasing public debt, burdening future generations.

Pro-cyclicality defines a fiscal behaviour whereby governments, sometimes driven by short-term political objectives, tend to 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 1980-2005 pre-crisis period, 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, which has resulted in the EU deficit going down from -6.6% of GDP in 2009 to -1.7% in 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 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 few years, prompted by the EU requirements mentioned above.

- Numerical fiscal rules: all EU-28 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, fiscal rules are continuing to strengthen (see Figure 1, based on an annually updated Commission database).

- Multiannual budgetary frameworks: all EU countries now produce budgetary targets that go beyond an annual time frame, covering a minimum 3 years. However, the level of detail, the credibility of underlying measures and the extent to which they are binding continue to vary greatly. How stable are these multiannual budgetary targets over time (see Figure 2)?
  - In four 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.

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9 http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm
In other 12 Member States, there is no legal restriction on the possibility to adjust multiannual budgetary targets, which undermines their credibility.

- **Independent fiscal institutions:** to date, 32 such institutions have been legally established in the EU-28. Notably, three quarters of them have been established or significantly reformed since 2010. Only Poland has not adopted legislation to establish a fiscal council, while in the Czech Republic, the fiscal council is not yet operational. Across the EU, two patterns can be observed, as illustrated in Figure 3:
  - In most countries, the fiscal council’s mandate is to: (i) assess the compliance of budgets with national numerical fiscal rules, and sometimes also (ii) assess/endorse macroeconomic forecasts;
  - In a few countries (e.g. the Netherlands, Belgium, Slovenia, Luxembourg, Austria), in addition to the fiscal council, a ‘forecaster’ operates under a mandate to produce independent macro-economic forecasts used for budget planning.

In all cases, these assessments and forecasts have to be made public. In most countries, the 'comply-or-explain' principle applies to some or all of the assessments of fiscal councils, i.e. the government has an obligation to either follow the assessment, or explain publicly why it departs from it.

**The Member States' track record on implementing their fiscal governance models is very mixed.** 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 fully play their envisaged role in pursuing a responsible fiscal policy.

Figure 1 – The fiscal rule index in the EU Member States, 2014 and 2015

Source: European Commission, Directorate-General for Economic and Financial Affairs (DG ECFIN), Fiscal Governance Database

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10 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-2015. The index is based on measures of five dimensions reflecting the strength of all fiscal rules in place (legal basis, room for revising objectives, monitoring and enforcement bodies, enforcement mechanism and media visibility).
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<th>Level of strictness</th>
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<td>(Expenditure) ceilings/targets are not expected to be changed whatever the circumstances (unless a new government comes to power or the division of tasks between government levels is changed)</td>
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<td>(Expenditure) ceilings can only be increased if sources of funding of the additional expenditure are identified in advance</td>
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<td>(Expenditure) ceilings/targets can be changed in a number of situations laid down in legislation or in another public procedural document (e.g. because of a substantial change in the macroeconomic forecast, a new government coming to power, extraordinary circumstances, etc.), and such changes need to be explained publicly</td>
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<td>(Expenditure) ceilings/targets can be changed at the discretion of government but changes need to be explained and reputational cost is involved</td>
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<td>Ceilings/targets can be changed at the discretion of government without any public explanation</td>
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<td>Czech Republic, Estonia, Hungary, France, Lithuania, Luxembourg, Portugal, Spain, the UK</td>
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4. POLICY LEVERS TO ADDRESS THE CHALLENGES

The two major challenges that EU countries are facing with regard to the five key building blocks of national fiscal frameworks are:

- the quality of the design of national fiscal governance models;
- ensuring rigorous implementation.

4.1. Effective measures

The correct transposition of EU requirements on fiscal frameworks into national legal orders is the first and foremost pre-requisite for all Member States. The Commission is currently evaluating how national transposition has been carried out, in dialogue with the finance ministries of the countries concerned.

Member States are strongly encouraged to carry out regular assessments of the quality of their national fiscal governance in the light of the specific fiscal challenges.

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

- **numerical fiscal rules:**
  - consequences in the event of non-compliance (‘comply-or-explain' principle, correction, sanction, etc.);
  - avoiding recourse to loosely defined escape clauses triggered under specific circumstances as a way to circumvent application of a rule;
- multiannual budgetary planning:
  - stricter rules for revising multi-annual 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);
  - the 'comply-or-explain' principle applied in practice;
- budgetary procedures:
  - effective coordination mechanism (especially in federal countries) so that central and sub-national fiscal rules work in tandem towards achieving the overall budgetary targets, evaluation of national forecasts to correct possible bias.

Furthermore, it is crucial that governments give a public commitment to fully apply the national fiscal arrangements or else upgrade the governance model to align it with the particular budgetary challenges of their country.

4.2. Ineffective measures

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

Significant annual revisions to the fiscal strategy originally planned for the medium-term 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 not applied in practice — e.g. there are constant deviations from the limits set by numerical fiscal rules — would not have the intended impact. Moreover, it would undermine the credibility of a particular government domestically as well as in the eyes of 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, the country recorded a 32.1% deficit for the general government, falling to 12.7% in 2011. Debt reached 119.6% of GDP in 2012, almost multiplying by six its pre-crisis level of 5 years earlier. In 2016, the deficit shrank to 0.7% of GDP, with a gross government debt of 72.8% of GDP (source: Eurostat).

The experience of the crisis prompted major reforms in the Irish fiscal governance model. This took the form of the adoption of several texts, including:

- the 2012 Fiscal Responsibility Act;
- Statutory Instrument No 508 in 2013 on the independent fiscal institution;
- 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 Ministry of Finance; for local governments, fiscal data are published quarterly.
- **Numerical fiscal rules**: for the general government, there is a structural balanced-budget rule and a debt rule constraining deficit and debt developments in relation to GDP. Independent monitoring of the budget's compliance with both rules 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. If the structural balance deviates from the balanced-budget rule, the government has to submit a correction plan to Parliament within 2 months.
- **Multiannual budgetary planning**: Every year, Ireland adds a year to its
multiannual budget plan, 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 feed into budgetary plans.

- **Independent fiscal institution**: the IFAC is a stand-alone institution whose mandate includes monitoring compliance with national fiscal rules and endorsing 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, the IFAC has delivered many insightful assessments since its establishment in 2012. Its work was evaluated in 2015 by an independent panel of experts to determine whether it is fulfilling its mandate.

Of course, 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: 22.11.2017.
6. REFERENCES

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