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Report on national fiscal rules and independent institutions

- *Exchange of country experiences*-

The conduct of an appropriate fiscal policy with a view to attaining sound and sustainable public finances is a crucial element in today's economic policy making in the EU. In the short-run, fiscal policy plays an important role in achieving a growth supportive environment. In the long-term, fiscal policy coupled with adequate structural and labour market reform measures to raise productivity and participation can help tackle the challenges resulting from an ageing population while also contributing to raise potential growth in line with the Lisbon Agenda and to achieve national economic policy objectives. In this context, those institutional arrangements that form fiscal governance are of utmost importance in order to ensure that well-suited budgetary policies are pursued.

- Overall, fiscal policy governance is based on a twofold national and EU dimension. The Stability and Growth Pact (SGP) constitutes the EU fiscal framework which aims at promoting stability-oriented budgetary policies and fostering sustainable fiscal positions. However, fiscal policy governance goes beyond the EU level. The national institutional setting is a key issue for conducting fiscal policy and its design is primarily a country-specific issue.

- Specifically, the reformed SGP endorsed by the European Council in 2005 states that "national budgetary rules should be complementary to Member States' commitments under the Stability and Growth Pact". It also considers that "national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level".

- In January 2006, the ECOFIN adopted conclusions in which further analysis and research in three specific areas of fiscal policy were requested, namely the influence of national fiscal rules and institutions on the conduct of budgetary policy, the analysis and monitoring of public expenditure composition and the measurement of the efficiency and effectiveness of public expenditure. Specifically, the Council emphasised the role played by national fiscal rules and institutions on budgetary outcomes as a key element for improving the composition of public finances, and invited the Commission, in co-operation with the EPC, to conduct a comprehensive analysis of the existing national fiscal rules and institutions in the EU and their influence on budgetary developments. With a view to carrying out this analysis, two surveys on national numerical fiscal rules and on independent institutions operating in the area of fiscal policy were conducted among Member States[1]. The questionnaires were filled in by national authorities and provided comprehensive and updated information on existing fiscal rules and institutions in EU countries. A first analysis of these surveys was included in the Commission's 2006 Public Finance Report and yielded interesting and relevant results in terms of policy making implications. In particular, it focused on the influence of independent institutions and numerical fiscal rules on key budgetary aggregates such as annual budget balance and public expenditure. In this context, the link between institutional arrangements and the quality of public finances remains an important issue for future work.

Main results from the analysis of national fiscal rules and independent institutions

There is a great variety of rules and independent institutions in Member States' fiscal governance settings, which largely reflects the country specific character of these arrangements.

National fiscal rules: features and impact on budgetary developments

Overall, it appears that Member States have been increasingly relying on national fiscal rules over the past twenty years.[2] Most fiscal rules currently in place in EU countries set targets on deficit and debt figures or limits on public revenue and expenditure developments of general government sub-sectors. However, their precise definition and features vary widely among countries. Additionally, they can be 'strong' rules, enshrined in legal texts, 'soft' arrangements,

[1] The survey on rules covered all types of numerical fiscal rules (i.e. budget balance, debt, expenditure and revenue rules). Therefore, other types of rules such as budgetary legal procedures were not considered. As for the questionnaire on institutions, its coverage concerned the existing national institutions, others than the government, the Central Banks and the Parliament, which may have a direct or indirect influence on the conduct of fiscal policy and are primarily financed by public funds (i.e. private think-tanks or banks' research departments were not covered). These independent institutions generally provide inputs for budget preparation (e.g. forecasts), analyses on fiscal developments and/or recommendations on fiscal policy issues.

[2] Fiscal rules may differ widely in their importance and scope: one 'major' rule may have a greater impact on national finances than several 'minor' rules.

based on political agreements or 'internal pacts' between different levels of government. A relatively recent feature has been the development of fiscal rules concerning the social security sub-sector, which may be instrumental in supporting structural reforms to contain social expenditure.

The analysis based on the survey points to the existence of a link between numerical rules and budgetary outcomes:

- While primary government expenditures tend to grow less, budgetary positions tend to improve in the years following the introduction of fiscal rules ;
- An increase in the share of general government finances covered by numerical fiscal rules seems to lead to lower deficits or higher surpluses;
- The different features of fiscal rules, e.g. the legal base, monitoring and enforcement mechanisms as well as media and political visibility, have an influence on the effectiveness of fiscal rules. For instance, rules enshrined in law and foreseeing automatic enforcement mechanisms, which apply more frequently to local and regional governments than to central governments, seem to have a larger impact on budgetary outcomes.
- Well-designed fiscal rules seem to be efficient instruments to limit the implementation of pro-cyclical policies particularly in good times. Experience shows that revenue rules pre-defining the allocation of higher-than-expected revenues to deficit reduction and adequate expenditure rules may contribute to limiting the conduct of pro-cyclical policies in the upswing of the business cycle. In this respect, according to empirical evidence, only a few rules are defined in cyclically-adjusted terms. However, there are other instruments that help address pro-cyclicality such as medium-term frameworks for budgetary planning.

Although these findings should be considered cautiously, particularly the results concerning expenditure rules based on a relatively small sample, they provide interesting insights into the beneficial effects of numerical fiscal rules on budgetary outcomes.

National independent institutions: main tasks and influence on the conduct of fiscal policy

According to the information provided by Member States, twenty-three independent fiscal institutions are currently operating in fifteen EU countries, thirteen of them being former EU-15 partners. These independent public bodies contribute positively to the fiscal policy making through different channels. Twenty-one of them are in charge of preparing independent forecasts and projections and/or conducting positive analyses on fiscal matters while fifteen issue normative statements or recommendations in the area of fiscal policy.[3] A number of interesting facts emerges from the analysis of the surveys:

- Independent and comparable forecasts provide benchmarks and ensure transparency in relation to those prepared by the government. In some countries, the delegation of forecasting tasks for the budget preparation seems to be one efficient way to address possible optimistic biases in macroeconomic projections and avoid systematic negative growth surprises.
- The independent institutions in place seem to have a considerable impact on the public debate as most of them enjoy a considerable reputation, which appears to be a key aspect to have real influence on policy decisions;
- The survey also provides evidence that recommendations formulated by the institutions covered by the study have a real influence on policy measures, and there is a general perception that such institutions have significantly contributed to fiscal discipline.

However, due to the large diversity of the institutions considered, the field of independent institutions is more difficult to outline than in the case of numerical fiscal rules and all findings should be considered with this caveat in mind.

Policy conclusions: general findings and the need for a country specific design

First analytical findings based on information provided by national authorities support the view that well-designed national fiscal rules foster attaining sustainable budgetary positions and help limit pro-cyclical policies, while independent fiscal institutions may also contribute positively to an appropriate conduct of budgetary policy. It follows from this analysis that these fiscal arrangements constitute a feasible and promising option for institutional reform in order to support national authorities in the conduct of sustainable fiscal policies and in the attainment of domestic economic policy priorities.

Elements influencing positively the functioning of national fiscal rules

The introduction of fiscal rules can be considered as a first alternative to reinforce the adherence of budgetary developments to the fiscal targets set by governments. Broadly speaking, rules may (i) provide guiding principles on the use of discretion for conducting fiscal policy and (ii) set benchmarks against which budgetary developments can be assessed.

[3] Obviously, some institutions carry out different tasks simultaneously.

Nevertheless, the design of fiscal rules falls under national competences and there is no one-size fits all solutions. Although the appropriate design of rules depend on the national situation and may vary according to the context in which they are designed, learning from best practices among EU country experiences suggest that some features may influence significantly their functioning:

- For instance, rules incorporated into medium-term budgetary frameworks, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances while making stabilisation and sustainability objectives more compatible. In addition, a multi-annual rule can generally be considered superior to a rule that only sets a target for one year. Rules covering a medium term horizon make circumvention more difficult and, therefore, reinforce credibility and prospects of fulfilment.

- In turn, the scope of the rule in terms of coverage and escape clauses must be clearly defined in order to avoid unjustified circumventions. This calls for an unambiguous specification of what items are excluded from the rule and under what exceptional circumstances, for example particular adverse economic developments, non-compliance with the rule can be permitted. This can favour the credibility of the rule and suggests that a trade-off between an adequate flexibility to allow dealing with unexpected economic circumstances and simplicity to facilitate the monitoring must be carefully considered when designing fiscal rules.[4]

- Rules enshrined in a legal text and accompanied by pre-established enforcement mechanisms may reinforce prospects for compliance and are likely to have a larger impact on budgetary outcomes. Nonetheless, in terms of transparency, the strength of the rule could also be supported by public information on the fulfilment of the rule and a high media visibility implying a large impact on public debate. Overall, enforcement mechanisms defined ex-ante coupled with a high degree of transparency may significantly strength the effectiveness of fiscal rules.

- More importantly, political and institutional settings are also of utmost importance to ensure a proper working of fiscal rules. Particularly, rules will only be effective if they are backed by a strong political commitment and ownership from national political representatives and by an appropriate monitoring and enforcement systems. This implies that expenditure commitment made by the government must be consistent with the

[4] The surplus target applied to general government in Sweden and the expenditure rule covering central government sub-sector in Finland provide some useful insights in this respect.

existing fiscal rules. Experience also shows that broad social and political consensus on the appropriateness of the rule is essential to ensure its success.

- Finally, apart from their influence on the containment of the deficit bias and the improvement of budgetary results, fiscal rules can also positively contribute to policy coordination among the general government tiers. This policy coordination is becoming increasingly important in the context of a growing fiscal decentralisation experienced by some Member States. This is an element that should be carefully considered when deciding what kinds of rules are implemented and what government levels they are applied to.

National independent institutions: useful approach to improve fiscal governance

A second option to support national authorities in their intention of pursuing sound and sustainable public finances consists in establishing independent institutions operating in the field of fiscal policy. Current independent fiscal institutions in EU Member States have different mandates: providing inputs for the budget preparation (e.g. macroeconomic forecasts), preparing independent analyses on fiscal policy issues (e.g. estimates of the budgetary cost of specific policy measures, compliance of current budgetary developments with existing fiscal rules, sustainability of government finances etc.) and/or issuing regular ex-post assessments and recommendations related to fiscal policy.[5]

Member States' experiences show that the influence of independent institutions critically depends on their capacity to have an impact on the public debate and on their ability to raise public awareness on the consequences of unsound fiscal policies. In this scenario, fiscal institutions need to enjoy high credibility and a strong political support, which in turn should be reflected in a large degree of autonomy and independence. These elements can be ensured through a public funding and some specific arrangements (legal provisions establishing a clear and unambiguous mandate, transparent appointment procedures etc). However, it must be stressed that special status is not always a pre-requisite for ensuring independence, which can also be achieved by a strong government ownership and commitment to the duties assigned to the institution.[6]

A relevant additional aspect refers to the involvement of the institution in the budget process, which is an important element determining its influence on fiscal decision-making.

[5] It should be kept in mind that all countries carry out some sort of ex-post assessment of fiscal developments (e.g. by the Court of Auditors). However, it must be clear that this report, which is based on the study included in the 2006 Public Finance Report, deals with institutions carrying out ex-ante analyses.

Arrangements currently in place in some EU countries have proved to be effective in conveying the policy messages issued by these independent bodies. The most widespread options consist of regular hearings by the Parliament, consultation by the government in the course of the budgetary process, or the obligation of the fiscal authorities to justify departures from the forecasts or recommendations released by the institution. According to some Member States' experience, delegating macroeconomic forecasts for the budget preparation may be considered one interesting example of involvement in the budgetary process that helps avoid possible optimistic bias on growth assumptions.[7]

Finally, those institutions that carry out independent fiscal policy analyses or issue normative statements on different aspects of public finances may also help governments to implement difficult economic measures or reforms.[8] For instance, independent fiscal bodies with a long-term forward looking approach in the content of their analyses and recommendations could play an important role in promoting pension reforms and supplementing government efforts to ensure the long-term sustainability of public finances.

However, it must be stressed that the resort to this kind of national institutions as well as aspects related to their implementation depend on national preferences and institutional features.

National fiscal rules and independent institutions: complementary policy instruments

Fiscal rules and institutions should not be seen as mutually exclusive. In some cases, they can complement each other. Thus, fiscal rules reflecting the main fiscal policy objectives of a country can help specify the mandate and facilitate the work of independent institutions. Fiscal institutions, for their part, can conduct an independent monitoring of the respect of the prevailing rules and effectively support government's commitment for compliance. Rules and institutions can also complement each other since they usually focus on different levels of government or aspects of public finances.

The role of national rules and independent institutions in the EU fiscal framework

It clearly follows from the previous reasoning that national rules and/or institutions may complement the SGP by increasing the national ownership of the EU fiscal framework.

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[6] This is the case of the CPB in the Netherlands, which is part of the Ministry of Economic Affairs but operates with full independence.

[7] The Belgium National Account Institute, which associates the National Institute of statistics, the Federal Planning Bureau and the Central Bank, constitutes an example within this typology of institutions. Within the Institute, the Federal Planning Bureau is responsible for the forecasts prepared for establishing the budget.

[8] The Economic Council in Denmark and the Government Debt Committee in Austria constitute a telling example within this typology of institutions.

Subject to their design, domestic fiscal rules may facilitate respecting the Stability and Growth Pact provisions and can also help to prevent pro-cyclical loosening of the fiscal stance in good times, which is one of the most important policy challenges as recognised by the 2005 reform of the SGP. While national institutions may be effective in monitoring compliance with national rules, they could also play an important role in the context of the EU fiscal surveillance mechanisms by assisting governments in the implementation of the SGP in line with the Code of Conduct. Although national fiscal rules and institutions are issues of national responsibility, these fiscal arrangements and their effects on budgetary developments deserve appropriate attention in the context of the EU fiscal surveillance mechanisms.

Final comments

The analysis conducted confirmed that national institutional arrangements are of utmost importance to ensure that well-suited budgetary policies are pursued and implemented. While it should be the case for all Member States that well-designed rules and/or institutions can improve fiscal outcomes, their desirable characteristics depend on domestic circumstances, such as the institutional and political setting and the nature of fiscal problems. Finally, it should be pointed out that the success of these arrangements critically depends on the existence of a broad consensus on the need to conduct sound fiscal policies.