4 Fiscal Governance

Rationale

Governments use fiscal policy to manage the economy: through spending on goods and services provided by the state, and on welfare support initiatives, which in turn, are to a large extent funded through tax revenues. Any shortfall is financed through the issue of debt. However, under this framework there exists a potential deficit bias, in the sense that governments have an incentive to run fiscal deficits, by delaying the imposition of the required taxation to sustain the yearly expenditures.

Within a monetary union, the deficit bias may be accentuated by the fact that a country might be able to shift part of the cost onto other member countries. Indeed, increased issuance of bonds, as a result of large and persistent fiscal deficits, may result in higher interest rates across the whole monetary union.[20] Another possible negative spill-over effect could occur, should the fear of government default in one country – because of elevated debt levels – make investors demand higher risk premia on government debt, across the whole monetary union. A further possibility could be that, in the event that differences in underlying economic fundamentals in different countries are not duly reflected in differential risk premia, weaker economies would be able to borrow at artificial cheaper rates, thereby undermining fiscal discipline.

> "... the primary usefulness of a well-designed and appropriately implemented set of permanent fiscal rules, that prevents a deficit bias, consists of establishing a depoliticized framework for fiscal policy – much like the depolitization of monetary policy under successful inflation targeting."
>
> George Kopits (2001) – Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?, IMF Working Paper 01/145

In order to address the deficit bias which may characterise unconstrained fiscal policy, the general consensus is that some restrictions on the conduct of fiscal policy may be necessary and indeed beneficial. Internationally this has popularised the use of fiscal rules, as a way to address the deficit bias.[21] Across the EU, fiscal governance has taken a broader

[20] This is particularly relevant in the case of large countries.
[21] Fiscal rules are constraints which are imposed on the conduct of fiscal policy.

perspective, comprising not only numerical fiscal rules, but also increased focus on medium-term budgetary frameworks and the creation of independent fiscal institutions (IFIs) to monitor compliance with fiscal regulations.

Fiscal Governance in the EU

The Maastricht Treaty, which was signed in 1992, introduced the 3% limit on the government deficit-to-GDP ratio and the threshold of 60% for the debt-to-GDP ratio (with some allowance in the case where the debt ratio was declining). This Treaty also specified the EDP, that is, the process through which, a country which breaches the stipulated fiscal requirements, would be given recommendations on how to rectify its position.

However, the Maastricht Treaty provisions alone proved to be insufficient to deter countries from running excessive fiscal deficits, as non-compliance was not sufficiently well addressed. As a remedy, in 1997, the SGP was introduced, allowing for better surveillance of the countries' budgetary positions. The SGP also introduced greater coordination of economic policies across the EU. The SGP further stipulated the content, the submission, the assessment and the monitoring of the stability and convergence programmes by each country.[22] These documents outline how a Member State plans to reach the MTO of a balanced budget or surplus. The SGP also clarified some aspects relating to the implementation of the EDP, in order to make it more rigorous, and more automatic. A country which is placed under the EDP has to follow the requirements stipulated under the corrective arm of the SGP. On the other hand, the other

1992	Maastricht Treaty was signed
1997	The SGP was formalised
1998	Preventive rules of SGP entered into force
1999	Corrective rules of SGP entered into force
2005	Amendments to the SGP rules took place
2009	Protocol enhancing the coverage and reporting of data
2011	A reinforced SGP through the formalisation of the 'Six Pack'
2012	TSCG agreement signed by 25 EU Member States
2013	SGP strengthened by the formalisation of the 'Two Pack'
2014	'Six Pack' and 'Two Pack' rules were reviewed
2015	The Commission issued guidelines on SGP Flexibility

[22] Stability Programmes are submitted by euro area countries while Convergence Programmes are submitted by the Member States that have not adopted the euro. These documents outline how the country is planning to meet its fiscal obligations, in terms of satisfying the numerical fiscal rules.

countries need to follow the requirements laid out under the preventive arm of the SGP. The corrective arm of the SGP is meant to address any fiscal slippage in a timely manner, while the preventive arm is meant to support further fiscal consolidation, even after the 3% deficit-to-GDP limit has been satisfied.

In 2005, amendments to the SGP were introduced, in order to introduce country-specific MTOs. In particular, for countries which were not at the MTO, the requirement of an adjustment path equivalent to 0.5% of GDP per annum was established, which could be more in good economic times, or less in bad economic times. The definition of excessive deficit was also clarified, while some easing of the rules was introduced, in the case of countries implementing structural reforms.

Another major milestone in European fiscal governance took place in 2011 with the introduction of the so-called 'Six Pack', which consists of five legislative acts and one Council directive. The 'Six Pack' established the European Semester, which is a yearly cycle for economic policy coordination. It also defined what a 'significant deviation' from the MTO, or the adjustment path towards it, refers to. Moreover, the debt criterion under the corrective arm was given greater importance. Another criterion, an expenditure benchmark, was also introduced under the preventive arm of the Pact. This placed a ceiling on the annual growth of public expenditure when compared to a medium-term reference growth rate. The 'Six Pack' also stipulated that compliance with the EU's fiscal rules should be monitored by national IFIs. [23]

Under the European fiscal governance framework, the COM and the European Council monitor individual Member States' budgetary positions and in the case of non-compliance with the existing numerical rules, the European Council issues an opinion and makes recommendations for the reversal of the fiscal policy stance. A deadline to take action is also imposed upon Member States, with the possibility of financial sanctions if such recommendations are not adhered to.[24]

In 2013, the Treaty on Stability, Coordination and Governance (TSCG) entered into force.[25] In the 'Fiscal Compact', as this Treaty is commonly referred to, Member States agreed on the need to enforce the medium term limit of 0.5% deficit to GDP ratio, or 1% to GDP in the case of countries whose debt to GDP is well below the 60% benchmark. The 'Fiscal Compact' also required that the EU's fiscal regulations relating to the deficit criterion and the debt criterion, be transposed into national law, in an attempt to boost compliance.

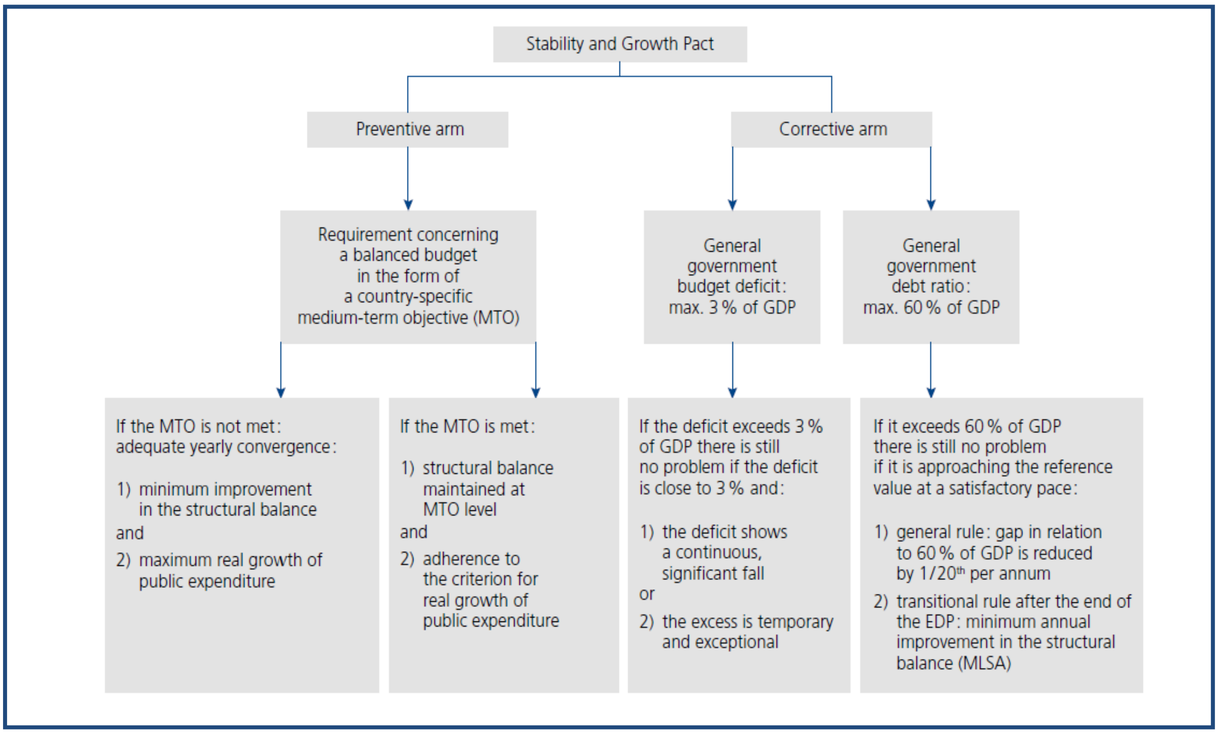
[23] The 'six pack' also created the Macroeconomic Imbalance Procedure (MIP), which aims to detect, prevent or correct macroeconomic imbalances, which refer to situations whereby macroeconomic developments adversely affect the functioning of a Member State's economy.
[24] According to the Reverse Qualified Majority Voting (RQMV) procedure in the context of the economic governance package, a COM recommendation is deemed to be adopted unless the Council decides by qualified majority to reject the recommendation within a given deadline that starts to run from the adoption of such a recommendation by the COM. Votes by country are weighted according to pre-established weights.
[25] This Treaty was signed by 25 EU Member States in 2012. The Czech Republic, the United Kingdom and Croatia did not sign this intergovernmental agreement.

In the case of euro area countries, two other legislative acts, referred to as the ‘Two Pack’ were introduced in 2013. The aim was to strengthen further fiscal surveillance in the euro area. The first legislation introduced an elevated level of surveillance for those countries facing financial instability. The other legislation introduced a common budgetary timeline, together with a set of specific reporting requirements, and in particular more requirements for Member States in the EDP. It also stipulated that every Member State should have in place independent bodies, to monitor compliance with fiscal rules. The EU fiscal framework was transposed into national legislation in Malta through the Fiscal Responsibility Act, 2014 which was passed in August 2014.

In 2015, the COM sought to clarify and extend some form of flexibility to the European fiscal rules, particularly in terms of the treatment of expenditures relating to investment for EDP purposes, concessions for countries undertaking structural reforms and clarifying issues relating to cyclical conditions and the corresponding fiscal effort required.

The current European fiscal rules are summarised in Diagram 4.1.

Diagram 4.1: Summary of the main European fiscal rules[26]



Source: National Bank of Belgium

[26] This diagram is reproduced from the Economic Review (September 2015) published by the National Bank of Belgium available on https://www.nbb.be/doc/ts/publications/economicreview/2015/ecorevii2015_h5.pdf

Independent Fiscal Institutions

To further strengthen fiscal surveillance and compliance to EU fiscal rules, EU legislation required the establishment of an 'independent body or body with functional autonomy' to monitor compliance with national fiscal rules. IFIs in the EU have two major functions; that of producing or endorsing the macroeconomic forecasts and that of monitoring compliance with the national fiscal rules. These include the activation of the correction mechanism with respect to significant deviation from the adjustment path towards the MTO or from the MTO itself, and any circumstances which allow for the temporary deviation from it. As a result of the strengthening of the EU fiscal framework and the increasing focus placed on the role of IFIs, the number of IFIs in the EU rose from 10 in 2008 to 25 in 2015.

From an organisational perspective, IFIs across the EU collaborate together and have formed platforms where they can exchange views on the challenges they are facing together and share expertise without prejudice to their respective mandates and independence. Thus in 2013 the COM set up an EU Network of IFIs to establish more effective communication lines between IFIs and the COM services, while sharing information on IFI best practices and other issues of common interest.

The number of meetings of this Network was increased from yearly in 2013 and 2014 to bi-annual as from 2015 in order to intensify the level of dialogue. During the course of 2015, EU IFIs were also provided with access to the COM's Communication and Information Resource Centre for Administrators, Businesses and Citizens (CIRCABC). CIRCABC is a platform which enables users to share information and documents with a number of European Committees such as the EFC and the EPC. Such access should contribute to better transparency of EU fiscal surveillance operations.

Another important development to enhance dialogue between IFIs and the relevant European Committees was the first formal meeting held in December 2015 between the EU Network of IFIs and the Alternate members of the EFC. Such annual meetings should enhance further the working relationship between IFIs and Ministries of Finance at EU level.

Concurrently with this development, EU IFIs also established an informal network in 2013 to provide a forum through which they can share experiences and expertise as well as pool resources in areas of common concern. To ensure better co-ordination, on 11 September 2015, this informal collaborative arrangement was formalised through an agreement among participating IFIs which set out its terms of reference (see Appendix B for a copy of the signed agreement). The agreement stipulates the role of IFIs, the importance of IFIs being independent and the recognition of doing the best possible for the effective functioning of the fiscal framework, at both national and EU level. The Network established a sub-Committee for EU Affairs to serve as a formal contact for consultations with the COM and to contribute to the ongoing dialogue on the EU fiscal policy architecture.

Well designed fiscal councils need to be based on a number of principles which ensure a sound framework, and in particular they need to be independent; have a well defined mandate; have sufficient resources; have access to all the relevant data; and have good presence in the public debate. In this respect, in 2014 the Organisation for Economic Co-Operation and Development (OECD), following consultations during the Third and Fourth Meetings of the OECD Parliamentary Budget Officials (PBOs) and IFIs held in 2011 and 2012, has adopted a set of 22 recommendations on principles for the effective functioning of an independent fiscal institution, which are grouped under nine broad headings (see Table 4.1).[27] The MFAC considers that the FRA adheres to these broad principles.

Table 4.1: OECD principles for IFIs

Principle	Description
Local ownership	Requires broad national ownership, commitment, and consensus across the political spectrum; Local needs and the local institutional environment should determine options for the role and structure of the IFI.
Independence and non-partisanship	Demonstrate objectivity and professional excellence; Leadership and staff should be selected on the basis of merit and technical competence, without reference to political affiliation; Term lengths and the number of terms that the leadership of the IFI may serve should be clearly specified in legislation, as should be the criteria and process for dismissal.
Mandate	The mandate of IFIs should be stipulated in law; There should be direct reference to the tasks needed to be carried out by IFIs in terms of the budget process; IFIs should be free to produce reports and other assessments as they deem necessary as long as they conform to their mandate.
Resources	The resources of the IFI should be commensurate with their mandate and should be published.
Relationship with the legislature	The budget timetable should cater for enough time for IFIs to submit their assessment on the budget, so as for the Parliament to scrutinise, assess and take into consideration the IFIs assessment; The legislature should also stipulate the IFI's role in terms of request for analysis from budget committees and sub-committees.

[27] These principles are available on http://www.oecd.org/gov/budgeting/OECD-Recommendation-on-Principles-for-Independent-Fiscal-Institutions.pdf

Principle	Description
Access to information	IFIs should be guaranteed in legislation to have full access to all relevant information, at no cost and in a timely manner, including methodology and assumptions underlying the budget and other fiscal proposals; Any reason for retaining information should be defined in the local legislature.
Transparency	IFIs should make their reports freely available; Release dates of major reports should be formally established.
Communications	IFIs should maintain constant communication with the media, civil society and other stakeholders for their analysis to be more effective.
External evaluation	IFIs should be assessed and evaluated externally by other similar institutions or experts in the field.

Source: OECD

Advisory European Fiscal Board

On 21 October 2015 the COM published a decision establishing an Advisory European Fiscal Board (AEFB) which was one of the measures included in the Five Presidents Report published on 26 June 2015 as a roadmap for completing the Economic and Monetary Union (EMU).[28] The AEFB is expected to start operating by mid-2016. According to the COM's decision "This Board will feed into the COM's work of surveillance and enforcement of the SGP. It will advise on the overall direction of fiscal policy of the euro area and evaluate how the fiscal governance framework was executed. The Board would neither replace national fiscal councils nor duplicate the COM's work on applying the SGP."[29]

[28] This document is available on https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en
[29] Refer to https://ec.europa.eu/priorities/sites/beta-political/files/factsheet-efb_en.pdf

"The AEFB is expected to carry out four main tasks:

- providing to the Commission an assessment of the implementation of the Union fiscal framework, in particular through the evaluation of the horizontal consistency in the decisions taken and the cases of serious non-compliance with fiscal rules;

- advising the Commission on the prospective fiscal stance appropriate for the Euro area, and on the consistency between national fiscal stances and the advised fiscal stance of the Euro area;

- cooperating with national fiscal councils, facilitating the exchange of best practices; and

- providing ad-hoc advice, on the request of the President of the Commission."[30]

"I have argued that, in the light of the European sovereign debt crisis and persistent sustainability concerns, it is more important than ever to make a credible commitment to stability-oriented fiscal policies. This is a necessary condition for fiscal policy to be in a position to support and complement the ECB's monetary policy. We can see today how much a lack of compliance with the rules has hampered the euro area's ability to deliver an efficient macroeconomic policy stance.... Setting up independent institutions such as the fiscal councils at the national level and the EFB at the European level could prove to be a decisive step in this direction."

Benoît Cœuré, Member of the Executive Board of the ECB, opening remarks at the workshop on "Fiscal councils, central banks and sound public finances", Frankfurt, 27 January 2016, available on the ECB website.

[30] Refer to a note by the Economic Governance Unit of the European Parliament available on http://www.europarl.europa.eu/RegData/etudes/ATAG/2015/542674/IPOL_ATA(2015)542674_EN.pdf