

The use and effectiveness of fiscal rules and independent fiscal institutions

L. Van Meensel
D. Dury

Introduction

It is widely acknowledged that sound public finances are essential to create the necessary conditions for price stability and strong, sustained growth conducive to employment. Moreover, past experience, particularly in Belgium, has shown how much an economy could ultimately suffer owing to a lack of fiscal discipline. In addition, it is increasingly recognised that fiscal rules and independent fiscal institutions other than governments and parliaments could make a major contribution to sound fiscal policy. In the context of the reform of the stability and growth pact, the European Council stressed in March 2005 that the commitments entered into by the Member States under the stability and growth pact needed to be supplemented by national budgetary rules, and that national institutions should be given a greater role in budgetary surveillance.

The article analyses the use and effectiveness of fiscal rules and independent fiscal institutions. Chapter 1 runs through the arguments put forward by the specialist literature on political economy in favour of such rules and institutions. Chapter 2 focuses on fiscal rules, examining them at European level and at the level of the EU Member States, with special attention to the situation in Belgium. In particular, it assesses the extent to which these fiscal rules have genuinely helped to increase budget discipline. The chapter ends with a discussion of the characteristics which the rules should ideally have in order to be effective. Chapter 3 looks at independent fiscal institutions, reviewing the existing institutions, their influence on fiscal policy and the conditions governing their success. The article ends with a summary of the main conclusions.

1. Use of fiscal rules and independent fiscal institutions

Past experience has shown that fiscal policy did not necessarily correspond to what is considered to be good governance from a macroeconomic point of view. Thus, over the last few decades, governments in many countries have often allowed their spending to increase faster than their revenue – even in times of economic prosperity – and have therefore sometimes built up substantial debt levels. The literature often attributes this lack of fiscal discipline to a “deficit bias”, suggesting that the democratic decision-making process may encourage deviation from the optimum fiscal policy.

This deficit bias seems to be due in particular to the fact that the population and politicians take an excessively short-term view. The population apparently focuses mainly on the short-term benefits of tax cuts or higher spending without always being aware of the possible adverse long-term impact on the budget of an expansionary fiscal policy. Politicians seem inclined to play on this in order to increase their chances of re-election. They may also tend to deliberately favour current generations and transfer the debt burden to future generations. Another explanation for the deficit bias might also lie in what game theory calls the “common pool problem”. In regard to fiscal policy, this concept means that each “player” or interest group looks after his own interests without taking account of the general budget constraints. This problem is sometimes linked to coalition governments.

The risk of a lack of fiscal discipline is even greater in a monetary union. In principle, if a country is not a member of a currency area, the financial markets can

discourage the pursuit of an inappropriate fiscal policy by incorporating a higher risk premium in the interest rates payable by authorities facing budget difficulties. Within a monetary union, this sanction mechanism is virtually non-existent since the impact on interest rates of an inappropriate fiscal policy in a given country is then confined to a small increase in the common interest rate, falling well short of the interest rate increase which the country in question would see if it were not part of a monetary union. That is particularly true in the case of a relatively small Member State. This argument applies not only to a monetary union comprising several countries, but also to local authorities or federated entities within a federal state.

The constant tendency of governments to record excessive budget deficits and the characteristics of a monetary union mentioned above justify the existence of fiscal rules and independent fiscal institutions. Such rules and institutions should restore the balance in the incentives of politicians, impose limits on the fiscal policy pursued and introduce fiscal coordination mechanisms. Politicians will in fact be more inclined to take unpopular but necessary economy measures if they have the support of independent fiscal institutions or existing fiscal rules, especially if the latter are imposed by a higher authority.

2. Fiscal rules

A fiscal rule may be defined as a permanent constraint imposed on fiscal policy in the form of a synthetic indicator of budget performance (Kopits and Symanski, 1998). It consists in setting a target or a numerical limit for the key aggregates of public finances, such as the budget balance, public revenue and expenditure, and the debt level.

This chapter presents the fiscal rules which exist at the various levels of power. First, it gives a brief description of the fiscal rules applicable at EU level. Next, it examines in depth the current or former fiscal rules applied in Belgium. It then describes some interesting results obtained from a survey of the national fiscal rules in force in the various EU Member States. Finally, the last section details the characteristics which fiscal rules need to have in order to be effective.

(1) The fiscal rules at EU level are discussed only very briefly here because they have already been examined in depth in the article *The stability and growth pact: an eventful history*, Economic Review, NBB, June 2005.

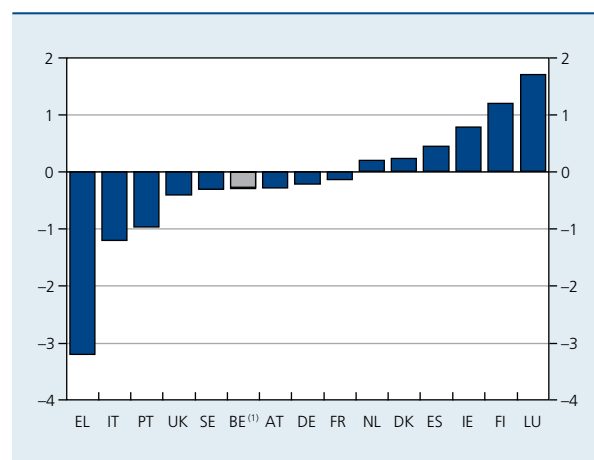
2.1 EU fiscal rules: Maastricht rules and the stability and growth pact⁽¹⁾

The Treaty establishing the European Community defines, under the convergence criteria which the Member States must satisfy in order to join the monetary union, reference values for the budget balance and the public debt. In 1992, an agreement was concluded on the subject in the form of the Maastricht Treaty. As a rule, the budget deficit must not be more than 3 p.c. of GDP and the public debt must not exceed the limit of 60 p.c. of GDP unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace. The Treaty introduced a correction mechanism linked to these criteria – namely the excessive deficit procedure – which aimed to ensure the maintenance of budgetary discipline after the creation of the monetary union. These fiscal rules, and the accompanying preventive and corrective procedures, were spelt out and reinforced by the stability and growth pact.

The preventive arm of the pact, which is intended to avoid excessive deficits, requires the Member States to draw up stability or convergence programmes defining the medium-term budget targets. Over the period 2001-2007, it appears that, on average, nine EU-15 Member States failed to meet the budget targets which they had set in their stability or convergence programmes. In Italy, Greece and Portugal, the actual figures even deviated substantially, on average,

CHART 1 BUDGET TARGETS UNDER THE STABILITY OR CONVERGENCE PROGRAMMES AND ACTUAL PERFORMANCE

(average difference between the budget balances achieved by the governments and the budget targets for the following year, over the period 2001-2007, as a percentage of GDP)



Source : EC.

(1) Without the effect of the assumption by the Railway Infrastructure Fund of the major part of the BNRC's debts at the time of the BNRC's restructuring on 1 January 2005, Belgium would not have deviated, on average, from its budget targets.

from the targets⁽¹⁾. Belgium did much better, but just as in the United Kingdom, Sweden, Austria, Germany and France, the actual figures fell short of the targets on average. However, it should be noted that, without the assumption of the major part of the BNRC's debt in 2005, Belgium would have achieved its budget targets overall. In contrast, in the Netherlands, Denmark, Spain, Ireland, Finland and Luxembourg, the fiscal balances achieved exceeded the stated targets.

2.2 Fiscal rules in Belgium

In Belgium, fiscal rules have been or are applied at the various levels of power. These targets or limits concern the government as a whole as well as its subsectors. These fiscal rules are described and then briefly assessed below.

2.2.1 Overview of fiscal rules in Belgium

TARGETS FOR THE GENERAL GOVERNMENT FISCAL BALANCE

In the early 1980s, the situation in Belgium's public finances was extremely worrying. The budget deficit actually exceeded 15 p.c. of GDP in 1981, a year of recession, while the debt ratio was escalating. However, great

progress has been made since then in the restoration of sound public finances. An initial consolidation phase took place from 1981 to 1987, years of significant improvement in the cyclically adjusted primary balance, which is an approximate indicator of the fiscal policy stance. A second consolidation phase began in 1992, after the adoption of the Maastricht Treaty defining the convergence criteria – the Maastricht rules – which determined whether the Member States could join the monetary union. To achieve these targets, the Member States had to draw up convergence programmes. Guided by such programmes, Belgium managed to cut the general government budget deficit below the limit of 3 p.c. of GDP in 1997, so that it could join the monetary union.

Under the stability and growth pact, Belgium then had to draw up a stability programme each year, defining the medium-term budget targets. The first stability programme – the one dated December 1998 – aimed at the gradual dismantling of the deficits which were by then relatively small. In accordance with the federal government agreement of 1999, the target then became somewhat more ambitious under the next stability programme, which aimed at a balanced budget for 2002. That balanced budget was actually achieved in 2000, thanks to highly favourable economic conditions. The targets were therefore made tougher in the next programme, setting the objective of growing budget surpluses, in view of the budgetary costs of population ageing. However, the targets previously set were later revised downwards, notably

(1) However, the fiscal balances of Greece and Portugal underwent significant downward adjustment after Eurostat detected serious shortcomings in the government accounts of those countries.

TABLE 1 TARGETS FOR THE FISCAL BALANCE UNDER BELGIUM'S SUCCESSIVE STABILITY PROGRAMMES
(percentages of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
December 1998	-1.3	-1.0	-0.7	-0.3									
December 1999		-1.1	-0.5	0.0	0.2								
December 2000			0.2	0.3	0.5	0.6	0.7						
December 2001				0.0	0.5	0.6	0.7						
December 2002					0.0	0.3	0.5						
December 2003						0.0	0.0	0.0	0.3				
December 2004							0.0	0.0	0.3	0.6			
December 2005								0.0	0.3	0.5	0.7		
December 2006									0.3	0.5	0.7	0.9	
April 2008										0.0	0.3	0.7	1.0
<i>p.m. Actual figures⁽¹⁾</i>	-0.5	0.1	0.6	0.0	0.0	0.0	-2.3	0.3	-0.2				

Sources: FPS Budget and Administrative Control, FPS Finance, NAI.

(1) Fiscal balance of general government according to the methodology used in the excessive deficit procedure.

on account of the adverse economic conditions prevailing during 2001-2003, and the primary aim was to maintain a balanced budget. However, the intention was to start creating budget surpluses from 2007. For that year, the plan was to create a budget surplus of 0.3 p.c. of GDP, which would then increase each year by 0.2 p.c. of GDP.

Up to 2004, Belgium always managed to meet its stability programme targets. However, in that connection it should be noted that, in some years, the budget balances were significantly improved by one-off measures such as capital transfers received in exchange for the assumption of the pension obligations of certain companies, the sale of fixed assets and tax regularisations. In 2005, the target was not met owing to the assumption by the Railway Infrastructure Fund of the major part of the BNRC's debts at the time of the company's restructuring. Without the impact of that exceptional operation, the public accounts would have ended with a surplus of 0.1 p.c. of GDP that year. In 2006, the result was much better than expected. In contrast, the stability programme target was not met in 2007, a year in which the public accounts ended with a small deficit.

The April 2008 stability programme aims at a balanced budget for 2008, the target for subsequent years being the gradual creation of a structural budget surplus, which should reach 1 p.c. of GDP by 2011.

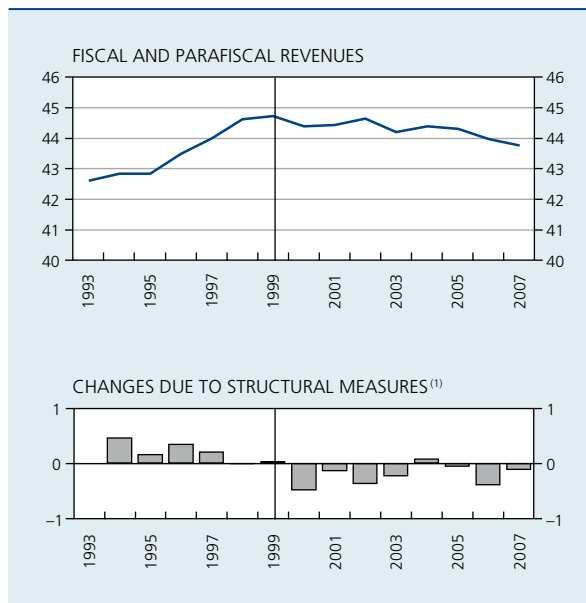
TARGETS FOR FISCAL AND PARAFISCAL REVENUES

In anticipation of the budgetary consolidation necessary to meet the criteria for joining the monetary union, the 1992 federal government agreement stipulated that fiscal and parafiscal revenues were to increase at least in line with GDP. That target was repeated in the 1995 agreement. As soon as Belgium joined the monetary union, the target for public revenues was adjusted, as the 1999 and 2003 federal government agreements specified that a budget margin was to be created in order to relieve the burden of fiscal and parafiscal levies.

Fiscal and parafiscal revenues increased from 42.6 p.c. of GDP in 1993 to 44.7 p.c. in 1999, then dropped to 43.8 p.c. in 2007. These movements are due partly to the government measures concerning taxes and social contributions, and partly to other factors.

During the period 1992-1998, fiscal and parafiscal measures boosted public revenues. The opposite occurred in the period commencing in 1999, when the measures were aimed at reducing the fiscal and parafiscal pressure. The only exception was 2004, since a number of indirect taxes were increased in that year⁽¹⁾. Overall, the measures

CHART 2 PUBLIC REVENUE TARGETS
(percentages of GDP)



Sources: NAI, FPS Finance, NBB.

(1) The 2003 corporation tax reform and the introduction of the venture capital allowance in 2006 were disregarded in calculating these figures, in view of the uncertainty surrounding their impact on the budget. When these measures were approved, it was assumed that they would be neutral for the budget.

concerning taxes and social contributions therefore conformed to the pre-set targets.

TARGET FOR FEDERAL GOVERNMENT EXPENDITURE

In Belgium, federal government spending cuts were among the main methods used for consolidating public finances. Thus, in connection with the measures designed to cut the budget deficit, the 1992 federal government agreement had aimed to limit the real growth of federal public spending excluding interest charges to zero, or actually to reduce expenditure. The 1995 government agreement confirmed this target of zero real growth, which should have been applicable, in principle, until 1999. In fact, the target was abandoned in 1998, the year following the assessment of compliance with the criteria for accession to monetary union set by the Maastricht Treaty. To permit the application of this relatively strict target, an even more stringent restriction was imposed on certain categories of expenditure. Thus, it was decided to apply zero nominal growth to the defence budget,

(1) Thus, the share of the VAT revenue collected in Belgium and accruing to the Belgian State increased by 0.1 p.c. of GDP in 2004, as a result of the reform of the method of financing the EU decided at the Berlin summit in March 1999. In addition, the energy contribution levied on electricity, heating oil, coal, petrol and diesel and the excise duty on tobacco, and on petrol and diesel (via the ratchet system) were increased, as was the advance which the pharmaceutical industry has to pay to fund the drugs budget overspend.

the public allocation to social security and the subsidies granted to public enterprises. The GNI contribution to the European Union was excluded from the scope of this target from 1996 onwards.

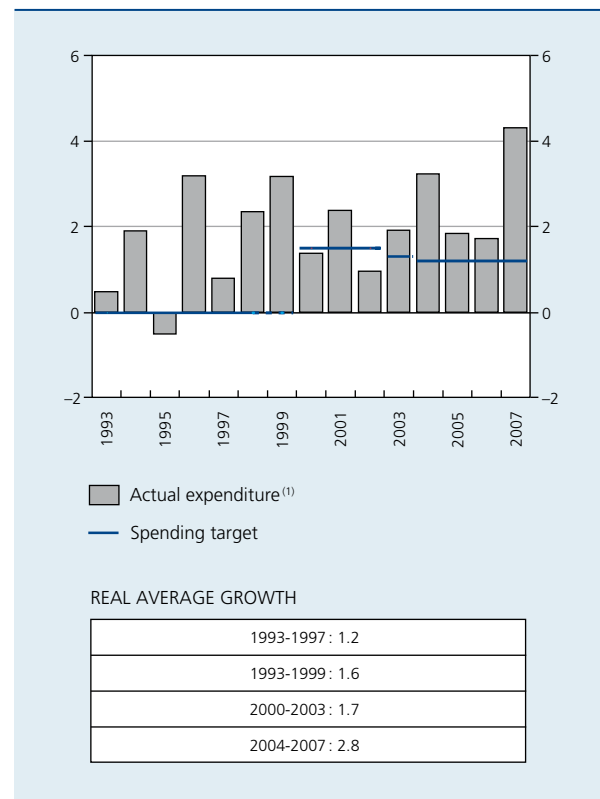
The 1999 government agreement and stability programme set a new target. Real expenditure growth was to be kept down to 1.5 p.c.⁽¹⁾. That aim was reinforced when the 2003 budget was drawn up, and it was decided to restrict the real growth of federal government expenditure to 1.3 p.c. The 2003 government agreement tightened that restriction to 1.2 p.c. This target did not apply to “reinvestment” in public enterprises. The March 2008 government agreement did not set any explicit, general target for expenditure, although the April 2008 stability programme expresses the intention to cut spending as a percentage of GDP.

In order to assess whether these spending targets achieved their objectives, a comparison was conducted with the real expenditure growth recorded in the federal government accounts according to the ESA 95. In this connection, it should be stressed that the federal expenditure target does not relate precisely to that aggregate. Most of the time, that target is defined on the basis of the expenditure recorded in the federal budget⁽²⁾. However, that comparison is highly informative. From an economic viewpoint, it is more significant to consider the expenditure as recorded in the general government accounts according to the ESA 95 than the budget expenditure in the strict sense, as the latter can be readily manipulated via operations such as de-budgeting and alternative forms of funding. That is far less true in the case of the general government accounts compiled according to the ESA 95, which are based on consolidated figures. That difference also explains why the target for federal expenditure was usually respected ex ante and on the basis of the budget performance, whereas the expenditure growth recorded in the general government accounts was often higher.

Except in 1995, the real annual growth of federal government spending as reported in the general government accounts (ESA 95) exceeded zero. In the period 1993-1997, however, the increase was only 1.2 p.c. Since that was well below the trend growth of GDP, federal expenditure expressed as a percentage of GDP declined.

CHART 3 PRIMARY EXPENDITURE OF FEDERAL GOVERNMENT

(percentage changes compared to the previous year, deflated by the HICP)



Sources: NAI, NBB.

(1) Real growth adjusted for non-recurring factors or factors which are neutral for the budget, and for the effects of indexation.

As indicated above, the target was not applied in practice in 1998 and 1999. The increase in federal expenditure was relatively substantial during those two years. During the period 2000-2003, the volume of federal expenditure increased by only 1.7 p.c. on average, barely exceeding the 1.5 p.c. growth target applicable at the time. Conversely, during the period 2004-2007, although the expenditure target was cut to 1.2 p.c., the real growth of federal government spending quickened pace during that period to reach an average of 2.8 p.c., or more than the trend growth of GDP.

HEALTH CARE EXPENDITURE TARGETS

A target for expenditure on health care was introduced in 1994, limiting the real growth of that expenditure to 1.5 p.c. per annum. The 1999 federal government agreement provided for this real growth target to be increased to 2.5 p.c. The 2003 government agreement raised this target again to 4.5 p.c. Consequently, the budget target which had originally served to impose restrictions on the

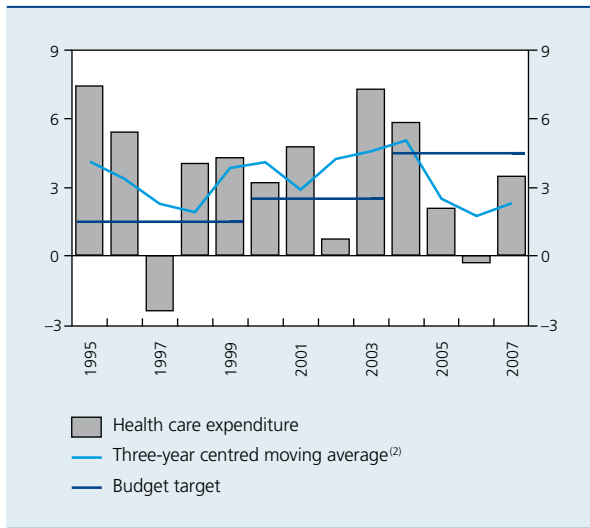
(1) The 1999 stability programme set the target of limiting real expenditure growth to 1.5 p.c. for general government. The 2000 programme restricted that target to the primary expenditure of the departments and social security. The 2001 stability programme specifies that this target applies to primary expenditure which comes under the responsibility of the federal government.

(2) The budget target also included transfers to other general government subsectors, such as the allocation to social security. The figures were compared with federal expenditure compiled according to the ESA 95, excluding transfers to other subsectors.

CHART 4

HEALTH CARE EXPENDITURE⁽¹⁾

(percentage changes compared to the previous year, deflated by the HICP)



Sources : NAI, NBB.

- (1) Public spending on health care, excluding sickness and invalidity benefits, benefits for the disabled, transfers to institutions caring for the disabled, and spending on long-term care insurance.
- (2) Real growth of 4.5 p.c. in 2008 was assumed for the purpose of calculating the 2007 moving average.

budget gradually became a signal indicating that the authorities were prepared to invest more in health care. The March 2008 government agreement confirmed the real growth target of 4.5 p.c. for health care, although part of that budgetary scope is to be devoted to the formation of reserves.

If the budget target for health care spending is compared with actual expenditure, it is evident that there is hardly any connection between the two.

TARGETS FOR THE COMMUNITIES AND REGIONS

In a federal state, it is logical that each entity should contribute towards attaining the budget targets set at general government level. In order to ensure the necessary fiscal coordination, the “Public Sector Borrowing Requirement” Section was set up as part of the High Council of Finance under the Special Finance Act of 16 January 1989. Since then, the Section has normally issued an annual opinion in which it makes recommendations concerning the budget balances for the government in general and for each of the communities and regions considered separately. These recommendations form the basis of the cooperation agreements relating to budget targets, concluded between the federal government and the governments of the communities and regions.

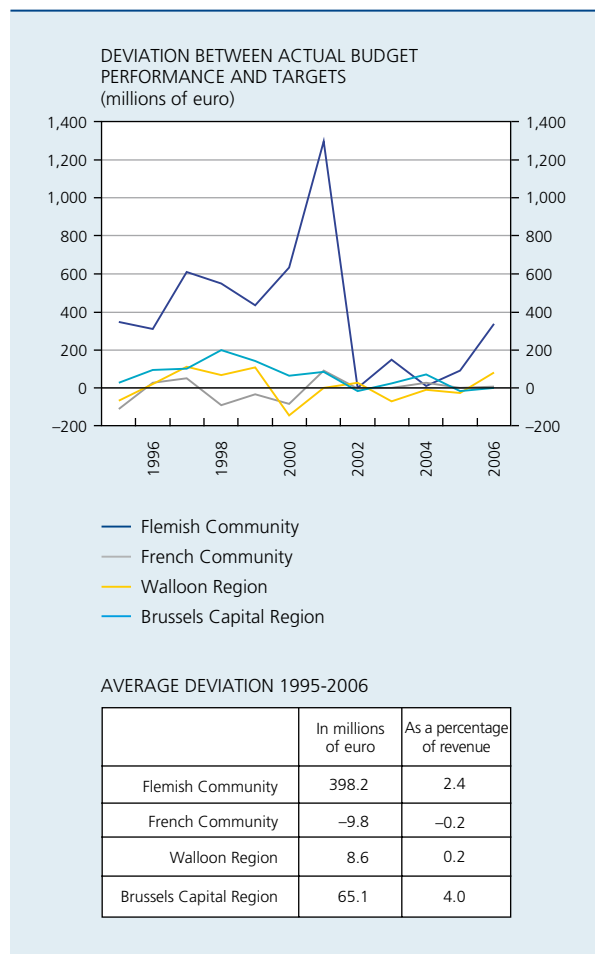
The first cooperation agreement was concluded in July 1994. That agreement defined the maximum deficits authorised in 1995 and 1996 for each community and region. These targets were intended to stabilise the debt as a percentage of the revenues in each entity from the year 2000. On the basis of the same principle, budget targets were set in the July 1996 cooperation agreement for the period up to 1999. These two cooperation agreements corresponded precisely to the convergence programmes intended to enable Belgium to join the monetary union.

The budget targets for the period 2000-2002 were incorporated in the November 1999 cooperation agreement. There was a new principle underlying those targets, namely that all the entities must achieve at least a

CHART 5

DIVERGENCE BETWEEN THE ACTUAL BUDGET PERFORMANCE OF THE COMMUNITIES AND REGIONS AND THE COOPERATION AGREEMENT TARGETS

(millions of euro, unless otherwise stated)



AVERAGE DEVIATION 1995-2006

	In millions of euro	As a percentage of revenue
Flemish Community	398.2	2.4
French Community	-9.8	-0.2
Walloon Region	8.6	0.2
Brussels Capital Region	65.1	4.0

Sources : HCF, NAI, NBB.

balanced budget by no later than 2010. This strategy was based on the European stability and growth pact which stipulated the objective of achieving budgets which were more or less in balance or in surplus in the medium term. For the Flemish Community, this plan meant a gradual reduction in its surplus. The other entities were still recording deficits which they were required to eliminate. In December 2000, the previous agreement was supplemented by targets applicable up to 2005, according to the same principle. There were a few subsequent adjustments to that agreement, which were mainly technical. The targets for certain years were also revised upwards for a number of entities, owing to the favourable movement in their resources.

As a result of these repeated adjustments, due in particular to the frequent budget consultations between the federal state and the communities and regions in recent years, the original plan was modified considerably. But as is evident from the latest cooperation report dated October 2005, the principle governing the budget targets of the communities and regions was nevertheless upheld: all the entities must achieve at least a balanced budget by no later than 2010.

Overall, the targets defined in the successive cooperation agreements were respected by the communities and regions. During the period 1995-2006, the Flemish Community systematically outperformed the target, sometimes by a large margin⁽¹⁾. On several occasions up to the year 2000, the French Community failed to meet its targets; nonetheless, it did in fact achieve them from 2001. As a general rule, the Walloon Region managed to meet its targets although there was some shortfall in certain years. Finally, in the past the results of the Brussels Capital Region have been systematically better than the targets, and even significantly so in terms of percentages of revenue.

LEGAL LIMITS ON THE BUDGET BALANCES OF THE LOCAL AUTHORITIES

The budget slippage confronting the local authorities in the early 1980s – the financing deficit of this subsector of general government had grown to 1 to 1.5 p.c.

(1) However, for 2002 the assessment is unclear. In the agreement of 21 March 2002 the federal State and the communities and regions had agreed that the budget outcomes would in future be assessed on the basis of the ESA methodology. For 2002, a transitional scheme was set up taking account of the balances of certain institutions which, according to the ESA are consolidated in general government. The balance thus calculated for the Flemish Community corresponded to the set target. However, the agreement also provided that the communities and regions could not take any decision which might cause a deterioration in the balances of other institutions consolidated in general government, but this last arrangement was not respected.

(2) However, the Flemish municipal decree of 15 July 2005 stipulates that the current system will ultimately be abolished in the course of the amendment of the provisions on local authority accounting (scheduled for 2013). The new definition of financial balance to be used in that connection has not yet been made clear.

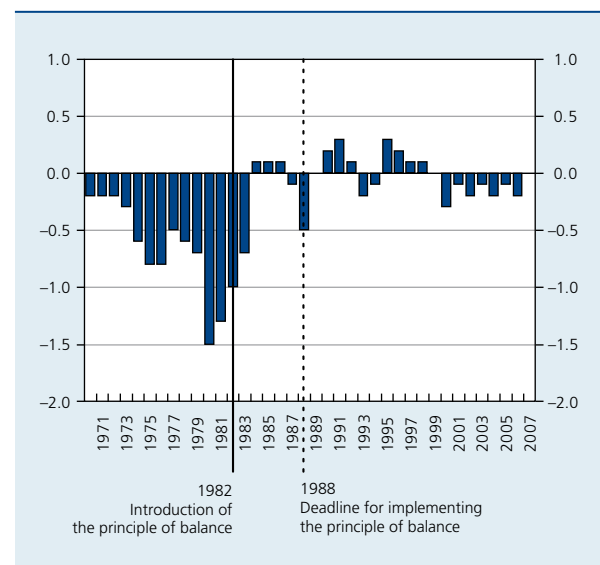
of GDP – led to the imposition of strict limits on their finances. The balanced budget principle was introduced by Special Powers Decree N° 110 of 13 December 1982; it was then incorporated in the municipal law and was to be implemented by 1988 at the latest.

The budget restriction refers to the obligation to balance the budget for “ordinary services”. Apart from current expenditure and revenue, this comprises expenditure on interest and repayments relating to loans, so that the capital transactions were also indirectly limited. This principle of balance does not have to be respected every year, since it is possible to take account of any surpluses achieved in previous years. That approach offers some flexibility and permits shifts across several years. For the Public Social Welfare Centres and police districts, the budget is balanced in practice, since any deficits have to be absorbed by local authority grants.

Although the reform of the Belgian State has now brought the local authorities under the control of the regions, the principle of a balanced budget still applies, and its implementation is monitored by the supervisory authorities⁽²⁾.

Thanks to this budget constraint which is based on the law, the slippage in local authority finances during the late 1970s and early 1980s was rectified. Since then, the finances of the local authorities as a whole – though not those of certain municipalities – have been more or less

CHART 6 FINANCING BALANCE OF LOCAL AUTHORITIES (percentages of GDP)



Sources: NAI, NBB.

in balance if the electoral cycles are disregarded; these cycles are typical of this level of power and they influence the pattern of local investment expenditure⁽¹⁾.

2.2.2 Assessment of the fiscal rules in Belgium

The fiscal rules which were or are applied in Belgium have a number of advantages and drawbacks. The most notable features are discussed below, although this account is not exhaustive.

The target of a balanced budget for general government is a very strict rule. This target, which is at the heart of fiscal policy, is actually respected overall. In recent years, however, relatively large amounts have been devoted to one-off measures designed to achieve that. Moreover, the budget target was not met in 2007.

In contrast, the assessment of the spending targets is less favourable. Yet robust rules on expenditure would do much to underpin the balanced fiscal rule applicable to general government and its subsectors. There is little if any link between federal government expenditure and, especially, health care spending and the targets. In the case of health care, the main reason is undeniably the open nature of the relevant budget, which is more of an estimate, so that in practice expenditure is difficult to control. In regard to federal expenditure, which largely consists of a fixed budget whereby the amount entered as expenditure represents a ceiling which can not be exceeded, the explanation is less obvious. However, the fact that this target is not clearly defined and the scope for circumventing it do constitute weaknesses. It also seems that this spending target has sometimes been used largely as window dressing, and that it has not always enjoyed the convincing support of the government. Nevertheless, the opinion on these targets is not entirely negative. Although it is difficult to judge, there are signs that they have led to restrictions on federal expenditure and on health care spending.

The targets for the communities and regions are fairly well respected. They have therefore been effective in that the budget position of the communities and regions can now be called sustainable. Nonetheless, there is no severe penalty in the event of failure to comply with these targets. Although the Finance Act of 16 January 1989 enables the Federal Finance Minister to prevent the issue of new loans, it is clear that such a severe penalty can be applied only in extreme cases of budget slippage. Parliamentary control and the pressure exerted by the other communities and regions and by the federal government have apparently been effective. However, there is scope for considerable further improvement in the transparency

of the fiscal rules of the communities and regions. The cooperation agreements and budget targets are not published. Moreover, the many agreements in principle which have been concluded in recent years between the federal government and the communities and regions have not always been translated into targets for specific amounts; that is a potential source of differences of interpretation and disputes.

Finally, the statutory budget constraint applicable to local authorities has yielded the desired results in that the budget of this subsector has almost always balanced in the past twenty years.

2.3 National fiscal rules in the EU Member States

In 2005 and 2006, the European Commission conducted a survey on the fiscal rules applied in the various EU Member States⁽²⁾. This showed that the number of fiscal rules in force in those countries has constantly increased over the past twenty years. The fiscal rule coverage, defined as the percentage of total public revenue or expenditure covered by the rules, has thus risen from around 25 p.c. in the early 1990s to roughly 75 p.c. today. However, there are significant differences between EU Member States.

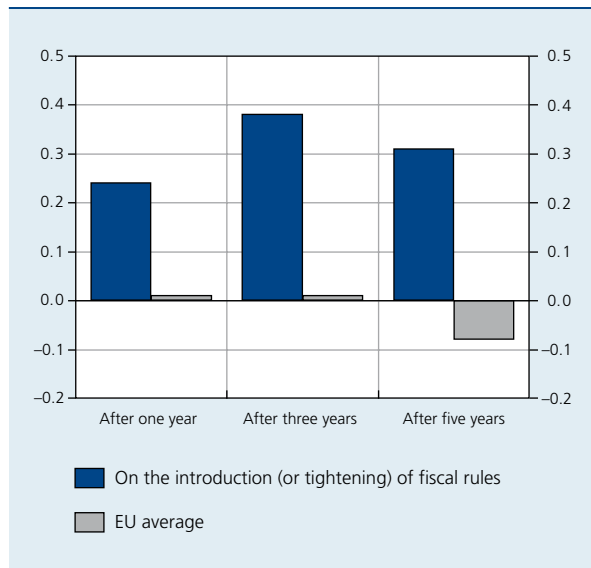
This survey also shows that the characteristics of the numerical fiscal rules vary greatly according to the level of power to which they relate. Thus, most of the rules relating to regional or local authorities are laid down by law, or even by the Constitution. There are often severe sanctions to ensure the proper implementation of these rules. Conversely, the rules concerning the central government or general government are based mainly on coalition agreements or political undertakings. The rules applicable at central government level are not generally accompanied by any formal sanction mechanism.

The characteristics of the fiscal rules also seem to depend on the form of government in the various EU Member States. In that regard, a distinction is sometimes made between "delegation countries" and "contract countries". The former are countries where the government consists of only one party or of several parties with the same political leanings. In that case, the Minister of Finance often has very extensive responsibility for the budget. In contrast, in the latter case, several parties have

(1) In this connection, it should be pointed out that the balanced budget principle refers to the local authority definition, which does not necessarily correspond to equilibrium on the basis of the financing balance of the general government accounts drawn up according to the ESA 95.

(2) The results of this survey and the accompanying analysis are set out in detail in the report entitled *Public Finances in EMU – 2006* (European Commission, 2006).

CHART 7 CHANGE IN THE CYCLICALLY ADJUSTED PRIMARY BALANCE DURING THE PERIOD FOLLOWING THE INTRODUCTION OR TIGHTENING OF FISCAL RULES IN THE EU MEMBER STATES
(change as percentage of GDP during the period 1990-2005)



Source : EC.

seats in the government and conclude mutual coalition agreements. On average, the number of rules is broadly similar in the two types of country, but it should be pointed out that in the delegation countries, the rules mainly concern the regional and local levels, whereas in the contract countries they are more concerned with the central government level and social security⁽¹⁾.

The statistical and econometric observations confirm that there is a link between fiscal rules and budget outcomes. Thus, on average, a noticeable improvement in the structural primary balance is apparent in the period following the introduction of the rules, whereas that balance is on average fairly stable during the period considered. The average improvement in the cyclically adjusted primary balance exceeds 0.2 p.c. of GDP in the first year following the introduction or tightening of fiscal rules. After three years it is actually almost 0.4 p.c. of GDP, and after five years it is still 0.3 p.c. of GDP. It is also apparent that the growth of primary expenditure slows down after the introduction of rules on spending.

Anticipating the section on the properties inherent in any ideal fiscal rule, it can already be pointed out that this survey by the European Commission also shows that the

characteristics of the fiscal rules are extremely important. Thus, strict rules based on the law, being subject to severe sanction mechanisms and receiving much attention from the media, evidently exert a greater beneficial influence on budget outcomes than rules which lack those characteristics.

2.4 Properties of an ideal fiscal rule

This account has made it clear that, while there are very large numbers of fiscal rules, they are not all equally successful. That is why the criteria which the fiscal rules should ideally satisfy are set out in more detail below. The specialist literature presents a broad consensus on a number of requirements, in which connection there are frequent references to the eight criteria advocated by Kopits and Symanski (1998). According to those authors, an ideal fiscal rule should have the following properties: it must be clearly defined, transparent, relevant, coherent, simple, credible, flexible and efficient. These various requirements are explained and discussed below.

A fiscal rule must be clearly defined and transparent. That implies that its scope is clear-cut and there is, in principle, no way round it. It must also form the subject of a clear presentation based on statistical conventions. That applies, for example, to the general government financing balance derived from the national accounts drawn up in accordance with the ESA 95, which is the main target budget figure both in Belgium and in the other EU Member States. The fact that the 3 p.c. deficit limit set by the Maastricht Treaty and the stability and growth pact refers to this aggregate undoubtedly counts for something. The characteristics of this fiscal policy criterion are clearly superior to those of, for example, the Treasury's net borrowing requirement, which was the key aggregate of Belgian fiscal policy up to the early part of the 1990s. Since the latter is a straightforward cash concept, it can easily be influenced by financial transactions or by shifts over time. That is far less true of the general government accounts compiled according to the ESA 95, for which – over the years – Eurostat has developed jurisprudence intended in particular to make these accounts coincide as closely as possible with economic reality.

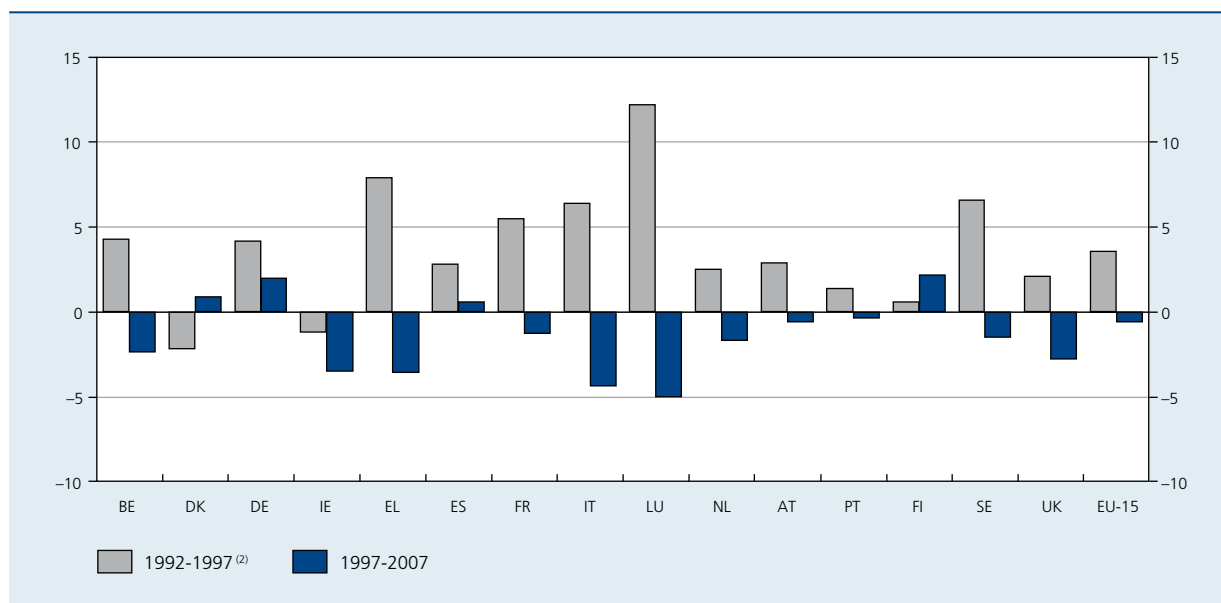
A fiscal rule must also be relevant to the objective pursued. This implies that the rule must concern the *ex post* budget outcomes rather than the targets set in the budget.

Furthermore, a fiscal rule must be consistent with the other rules and objectives of public policies.

(1) In Belgium, the fiscal rules seem to be distributed fairly evenly between the regional and local levels, on the one hand, and the central level on the other.

CHART 8 INFLUENCE OF THE MAASTRICHT TREATY CONVERGENCE CRITERIA ON FISCAL POLICY

(cyclically adjusted primary balance⁽¹⁾, percentages of GDP)



Source : EC.

(1) According to the methodology used in the excessive deficit procedure.

(2) From 1995 for Spain, from 1993 for Sweden ; for the EU-15, the average for the period 1992-1997 was calculated without these two Member States.

It should also preferably be simple, so that politicians and the general public can readily identify with it, thus increasing its influence.

Another property for an ideal fiscal rule is that it should be enforceable. That is the case if sanctions can be imposed for failure to comply with the fiscal rule. It is not absolutely essential to have a formal sanction mechanism ; the damage to reputation may also be regarded as a sanction. Obviously, the incentive to respect the fiscal rule increases the more severe the sanction.

In this regard, the divergent trends in the cyclically adjusted primary balance of the EU-15 Member States before and after permission to join the monetary union are revealing. Failure to comply with the Maastricht rules would in fact have attracted an extremely severe sanction, namely refusal of admission to the monetary union. While almost all the EU-15 Member States succeeded in making substantial improvements to their cyclically adjusted primary balance between 1992 and 1997, that ceased to be the case subsequently.

The fiscal rules must also be flexible. That means that, when the rules are implemented, allowance should be made for unforeseen circumstances, such as cyclical variations. In fact, it is obvious that economic growth

and its main components can exert a considerable influence on certain aggregates, such as the primary balance or the general government financing balance. In order to neutralise the impact of the cycle, it is therefore often advisable to specify budget targets based on cyclically adjusted budget balances or – if the impact of one-off factors is also excluded – structural budget balances⁽¹⁾.

However, it is extremely important to take account of the constraints inherent in the calculation of budget balances adjusted for cyclical and structural factors. It is in fact extremely difficult to calculate these balances, as it is not easy to determine the output gap, namely the difference between actual and potential growth. Since in the past the estimated output gap has sometimes been subject to major revisions, the estimation of the budget balances adjusted for cyclical and structural factors changes considerably over time. Even though fiscal rules based on structural budget balances are preferable in theory, it is therefore necessary in practice to apply them with all due caution.

(1) That was the case, in particular, when the stability and growth pact was reformed in March 2005. The report by the "Public Sector Borrowing Requirement" Section of the High Council of Finance (July 2007) also made a similar recommendation.

Finally, the fiscal rules must be efficient in the sense that the criterion to which they relate must not be biased in any way. On this subject, the specialist literature refers to Goodhart's Law, whereby a statistical indicator ceases to be useful as an indicator once it becomes a political instrument. In other words, a criterion ceases to be valid once it becomes an objective.

Goodhart's Law clearly applies to budget targets; a number of examples may illustrate this. It applies to the numerous one-off measures used by the federal government in some recent years to achieve the target set for the financing balance. There are also alternative forms of funding which, in many cases, aim to prevent investment expenditure from having an adverse influence on the general government financing balance. The impact on the budget is then spread over several years via rental payments effected by the government.

Some of the transactions effected in the period preceding 1997 in order to bring down the consolidated gross debt ratio as quickly as possible may be viewed in that light. At that time, the declared intention was in fact to cut the debt ratio, since that was one of the ratios referred to by the criteria for joining the monetary union. Apart from the endogenous debt reduction, the process was speeded up considerably by such measures as privatisation, the transfer by the National Bank of Belgium of the proceeds from gold sales, and the obligation imposed on certain

public bodies to invest their surplus cash in public debt instruments or to place it in Treasury accounts. The impact of this type of operation can be illustrated by means of the adjustments between deficit and debt, which were systematically very negative during this period. That was also the case in 2003, when the federal government had set the explicit objective of reducing the debt ratio below 100 p.c. of GDP⁽¹⁾.

However, it should be pointed out that it is not easy for a rule to conform to all these properties. Thus, making a rule more flexible reduces its simplicity. Also, a simple rule which makes no distinction between the policy actually conducted and the budgetary impact of events which are beyond the direct influence of governments is likely to be difficult to impose. Fiscal rules are therefore necessarily the outcome of an imperfect compromise between the various concerns mentioned.

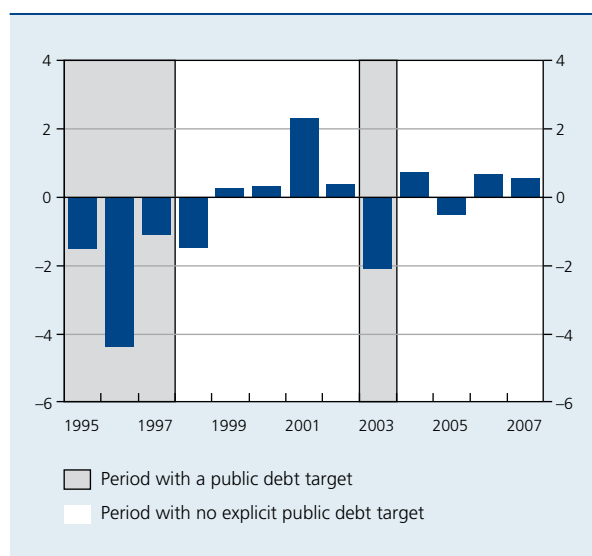
3. Independent fiscal institutions

This chapter deals with independent fiscal institutions – other than governments and parliaments – which play a key role in fiscal policy. These fiscal institutions may have positive or normative powers. Institutions such as those supplying macroeconomic forecasts, for example, belong to the first category while the second comprises institutions which make recommendations on the fiscal policy to be adopted and which in some cases assess budgetary developments. This chapter begins with a very brief description of the independent fiscal institutions in Belgium. It then presents some comments on similar institutions in the EU-15 Member States, first considering those which produce macroeconomic projections, after which it looks at normative fiscal institutions. Finally, it examines the conditions governing the success of independent fiscal institutions.

3.1 Independent fiscal institutions in Belgium

Various institutions supply macroeconomic forecasts in Belgium. The two leading institutions in the field of fiscal policy are the National Accounts Institute (NAI) and the Study Group on Ageing. Established in 1994, the NAI links three institutions: the Federal Planning Bureau, the Directorate General of Statistics and Economic Information of the FPS Economy, SMEs, the Self-employed and Energy,

CHART 9 IMPACT OF DEFICIT/DEBT ADJUSTMENTS ON THE DEBT RATIO IN BELGIUM
(percentages of GDP)



Source : NBB.

(1) Specific operations effected in that year concerned in particular the repayment by the regional housing companies of the bulk of their debt to the Social Housing Loan Amortisation Fund (SHLAF) and the sale of the mortgage loan portfolio managed by Credibe, an institution which was created in 2001 by the reorganisation of the Central Mortgage Credit Office and which has since then formed part of the general government sector.

and the National Bank of Belgium. On behalf of the NAI, the Federal Planning Bureau draws up the economic budget, an estimate of the main national accounts aggregates which are used for the preparation of the initial budget and for budget surveillance. The transfers of revenues generated by personal income tax and VAT to the communities and regions, organised under the Finance Act, are also based on parameters relating to economic growth and inflation derived from the economic budget. The Study Group on Ageing was set up by the law of 5 September 2001⁽¹⁾. Its task is to produce an annual report setting out the budgetary and social impact of population ageing.

The normative aspect is the responsibility of the High Council of Finance, and in particular its "Public Sector Borrowing Requirement" section. As already stated, this Section was established under the Finance Act of 16 January 1989. In the context of Belgium's conversion to a federal state, the presence of an independent advisory body in the public finance sphere was deemed desirable and, in some ways, essential in the light of the country's complex institutional structure. The Section assesses fiscal policy and issues an annual opinion formulating medium- and long-term budget objectives. The said law of 5 September 2001 specifies that, in so doing, the Section must take account of the expected budgetary effects of demographic changes, as estimated by the Study Group on Ageing.

The NAI and the High Council of Finance are both closely associated with the budget process in Belgium, although they have no power to take decisions on the subject.

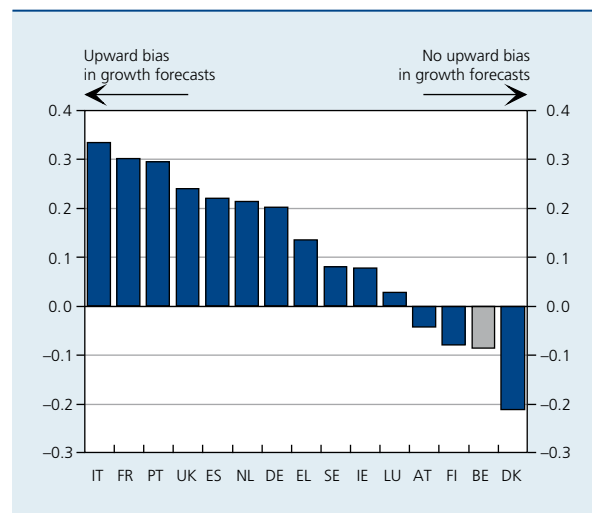
3.2 Macroeconomic forecasting institutions

There are independent fiscal institutions which regularly publish macroeconomic forecasts in ten of the EU-15 Member States: Austria, Belgium, Denmark, France, Germany, Greece, Italy, Luxembourg, the Netherlands and Sweden. However, the governments of most of these countries use their own calculations when drawing up the budget. In Belgium, the government makes systematic use of the macroeconomic forecasts of an independent institution in order to draw up the budget. The same applies in Austria (*Österreichisches Institut für Wirtschaftsforschung*) and the Netherlands (*Centraal Planbureau*).

Although uncommon, the systematic use of projections issued by independent fiscal institutions for the purpose of drawing up the budget does have theoretical advantages. Governments may in fact be tempted to use over-optimistic growth forecasts, increasing their budgetary scope and hence avoiding – *ex ante* – difficult consolidation measures. However, such practices subsequently have a negative impact on the budget balance, which will logically be worse than expected if real growth falls short of the forecasts. The authorities then often deny responsibility by attributing the less favourable budget outcome to bad luck, i.e. growth which was weaker than predicted.

In principle, independent institutions have no incentive to act in that way. They can therefore remedy a potential tendency on the part of governments to inflate the estimates of economic growth on which the budgets are based. In these circumstances, it could be useful to oblige governments to refer to growth estimates issued by an independent institution when drawing up their budget, a practice which applies to some extent in Belgium. However, in the absence of such a formal obligation, the temptation to over-estimate growth can still be curbed by the fact that the projections issued by the independent institution are a benchmark against which the government projections can be compared.

CHART 10 AVERAGE DIVERGENCE BETWEEN THE ESTIMATES OF ECONOMIC GROWTH IN THE STABILITY OR CONVERGENCE PROGRAMMES AND THE EC ESTIMATES
(GDP growth in volume, annual average percentage change over the period 2001-2006)



Source : EC.

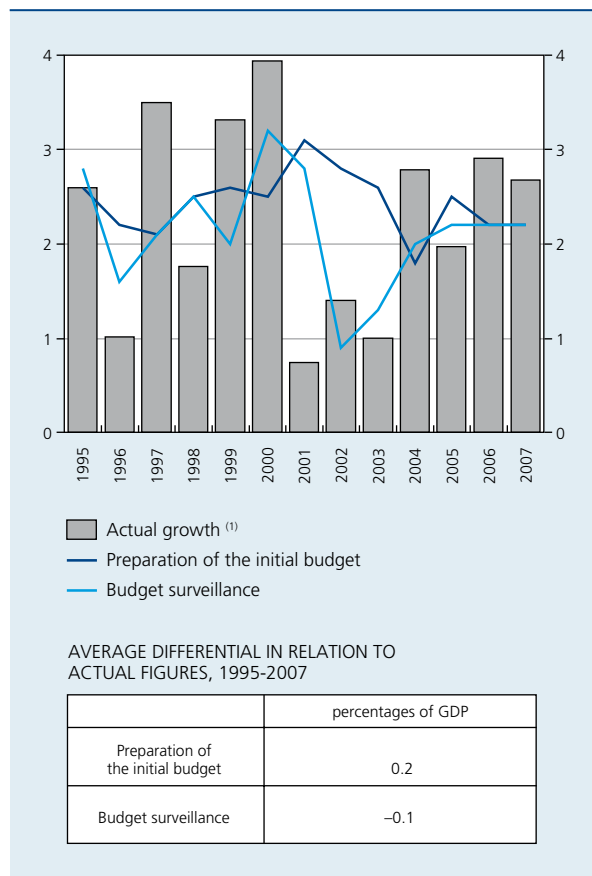
(1) Law of 5 September 2001 guaranteeing a continuous reduction in the public debt and creating an Ageing Fund.

In order to verify whether the economic growth forecasts used by the governments of the EU-15 countries to produce their budgets are too optimistic, the forecasts are checked against the European Commission projections. The growth forecasts are obtained from the successive stability or convergence programmes of each Member State covering the same period. Here it should be noted that the growth estimates forming the basis of the budgets are compared with the European Commission's estimates drawn up at more or less the same time⁽¹⁾.

This comparison shows that in the period 2001-2007 at least half of the EU-15 Member States exhibited excessive optimism, particularly Italy, France, Portugal and Germany. Having long been under severe pressure not to exceed the limit of a 3 p.c. deficit fixed by the stability and growth pact, these countries showed a tendency

to estimate economic growth by an over-optimistic approach. However, there were some countries which did not introduce an upward bias into their forecasts, or which even based their forecasts on estimates that were more cautious than those of the European Commission. Belgium and Austria, where the macroeconomic framework used as the basis for drawing up the budget is estimated by independent institutions, are among that group of countries. This seems to indicate that independent institutions can do much to help counteract the temptation to introduce an upward bias in the estimates used to draw up the budget. Conversely, the Netherlands which – like Belgium and Austria – uses independent projections for drawing up the budget, seems to have used over-optimistic forecasts for the period under review. Luxembourg, Finland and Denmark also used relatively cautious growth forecasts for drawing up their budgets. These countries in fact have little inclination to bias the forecasts since they have recorded large budget surpluses and low debt ratios in recent years.

CHART 11 NAI FORECASTS AND ACTUAL ECONOMIC GROWTH
(GDP growth, in volume, percentage changes compared to the previous year)



Source : NAI.

(1) These are the latest figures. In order to neutralise any effect of changes of method, the data are sometimes compared with the earliest available figures. Even in that case, the conclusions concerning the average deviation in relation to actual growth are the same.

Although the Belgian government does not tend to produce more optimistic estimates of GDP growth for the ensuing year than the European Commission, it seems worth comparing the NAI's growth estimates with the actual growth figures. Looking at the figures for the period 1995-2007, we find that the growth estimates used to draw up the initial budget are higher, on average, than the actual growth achieved. The average differential is around 0.2 p.c. of GDP. This difference is due largely to cyclical developments and more particularly to the unforeseen and unexpectedly long downturn in business activity from 2001 to 2003. The growth estimates used for budget surveillance are closer to the actual figures than the estimates which the governments used to draw up the initial budget, which is not surprising. Over the period as a whole, the growth estimates used for budget surveillance deviate little overall from the actual growth achieved.

3.3 Institutions making normative recommendations

Normative fiscal institutions are a useful and necessary complement to positive fiscal institutions. They influence budget discipline by setting targets and by measuring budget outcomes against the targets. They also help to encourage debate on public finances via various other recommendations which they make.

(1) A comparison with the growth actually achieved was considered inappropriate in view of the relatively brief period for which data are available and the very protracted period of weak economic activity extending from 2001 to 2003. Comparison with the European Commission estimates is also recommended from an institutional viewpoint, since it performs the function of guarding the stability and growth pact and therefore plays a leading role in EU budget surveillance.

According to the survey conducted by the European Commission in 2005 and 2006, there are independent institutions issuing normative recommendations on fiscal policy in twelve EU Member States (European Commission, 2006). These institutions differ considerably in their status and their mandate. Overall, they can be divided into three categories: advisory bodies, research institutions and audit offices.

The High Council of Finance is among the advisory bodies. Apart from Belgium, other countries which also have similar institutions are Denmark (*Økonomiske Råd*), Germany (*Wissenschaftlicher Beirat beim Bundesministerium der Finanzen*) and Austria (*Ausschuss für die Mitwirkung an der Verwaltung der Staatsschuld*).

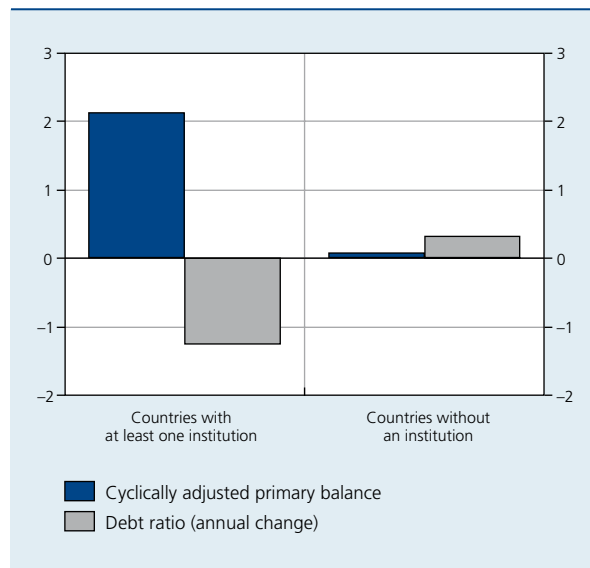
The Swedish *Konjunkturinstitutet* is the only one to belong to the research institution category. It regularly issues normative recommendations even though it has no formal mandate. However, in practice its recommendations influence the implementation of the budget via the public debates which it helps to stimulate.

Finally, some audit offices can also be regarded as normative fiscal institutions. This third category of institutions nevertheless requires a different approach, since their status and mandate – generally anchored in the Constitution – differ considerably from those of other normative fiscal institutions. Thus, there are audit offices in all EU Member States and their main task is to audit the public accounts. In seven Member States, the audit office is not confined to that function, but also assumes normative powers in regard to fiscal policy. This applies to Estonia, France, Hungary, Luxembourg, Portugal, Spain and the United Kingdom.

3.4 Impact of independent fiscal institutions and conditions governing their success

Independent fiscal institutions seem capable of making a substantial contribution to the necessary fiscal discipline. The results of the survey conducted by the European Commission in 2005 and 2006 in fact show that the countries which have at least one independent fiscal institution perform significantly better in terms of consolidating public finances (European Commission, 2006). Thus, these countries managed to improve their cyclically adjusted primary balance by around 2 p.c. of GDP, on average, during the period 1995-2005, whereas the balance remained virtually unchanged in the other countries. The movement in the debt ratio bears out these findings. In countries with at least one independent fiscal institution, the debt ratio declined fairly considerably over the period under review

CHART 12 BUDGETARY DEVELOPMENTS IN EU MEMBER STATES WITH OR WITHOUT INDEPENDENT FISCAL INSTITUTIONS DURING THE PERIOD 1995-2005
(change as a percentage of GDP during the period 1995-2005, unless otherwise stated)



Source : EC.

– by an average of just over 1 p.c. of GDP *per annum* – whereas it edged upwards in the other countries.

However, these results need to be interpreted with caution since it is not possible to make any pronouncement on the direction of the causal link between the variables considered. Did the independent fiscal institutions lead to greater budget discipline, or is the opposite the case? The institutional reforms accompanying the creation of such independent fiscal institutions are usually undertaken because there is a political will in favour of consolidation in a climate of disapproval of the prevailing laxity in fiscal policy. However, one might object that most of the institutions concerned were established long before the period considered and have changed little since then, which confirms the theory that independent fiscal institutions have encouraged budget discipline.

The impact – and consequently the success – of the independent fiscal institutions depends on various factors. For instance, the fiscal institution's mandate must be clear and unequivocal. The NAI, whose tasks and structure are clearly defined, is a good example. Although the Belgian public authorities are not under any formal obligation to use the NAI's estimates in drawing up their budgets, they do so systematically in practice. A second factor concerns the independence of the fiscal institution, which has to be ensured by both legal and financial guarantees.

The influence of an independent fiscal institution also clearly depends on its credibility. There may be various contributory factors here. A high degree of transparency is very important. It can be guaranteed by publication of the models and data used. The presence of representatives of various independent institutions – as is the case at the NAI – makes it possible to allocate the responsibilities among several fiscal institutions, thus reducing any political pressure on the individual institutions. For the same reason, it is preferable to separate the normative institutions from the positive institutions.

One final factor which determines the influence of an independent fiscal institution is its degree of involvement in the budget process. That is greater if the fiscal institution is heard by parliament and is regularly consulted by the government, if independent forecasts are used to draw up the budget, or if the government is required to justify deviations from the estimates or recommendations.

Conclusion

Fiscal rules can be extremely useful in the context of a sound fiscal policy. There are in fact clear indications that they facilitate the maintenance of budget discipline and encourage consolidation efforts, where necessary. In order

to attain that objective, however, it is essential for the fiscal rules to conform to the principal properties inherent in any ideal fiscal rule.

In Belgium, certain fiscal rules are strictly respected while in other cases there appears to be virtually no connection between the rule and what actually happens. There is still room for improvement in some of Belgium's fiscal rules.

Independent fiscal institutions can also play a key role in fiscal policy. Thus, it is evident that making such institutions responsible for the economic growth forecasts used in drawing up the government budget is an effective way of curbing excess optimism in those forecasts. Moreover, institutions issuing normative budgetary recommendations have fostered fiscal discipline in the countries where such institutions exist.

Belgian independent fiscal institutions – namely the NAI and the “Public Sector Borrowing Requirement” section of the High Council of Finance – are often cited as good examples, particularly by the European Commission and the IMF. They do in fact enjoy a good reputation, but it must also be clear that their credibility depends largely on the degree to which the decision-making bodies take account of their findings and opinions.

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