Expenditure rules - an EU perspective

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Why do EU Member States need robust fiscal frameworks (including rules)?

- Safeguards for prudent fiscal policy in the EU Treaties:
  - Headline deficit < 3% of GDP
  - Government debt < 60% of GDP
- Stability and Growth Pact → EU fiscal rules
  - Medium-Term Budgetary Objective, Expenditure Benchmark, Debt Rule
- Fiscal Compact – reinforced requirement to have balanced budgets in structural terms
- Domestic budgetary discipline is key for compliance with EU budgetary obligations (Great Recession as wake-up call)

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Numerical fiscal rules

- Permanent / long-lasting constraint on fiscal policy using numerical limits on budgetary aggregates

- Objective: improve fiscal discipline by
  - Counteracting deficit bias
  - Promoting counter-cyclical fiscal policy

- Conferring credibility on macroeconomic policy

- Types of rules
  - Budget balance (nominal or structural), expenditure, debt, revenue

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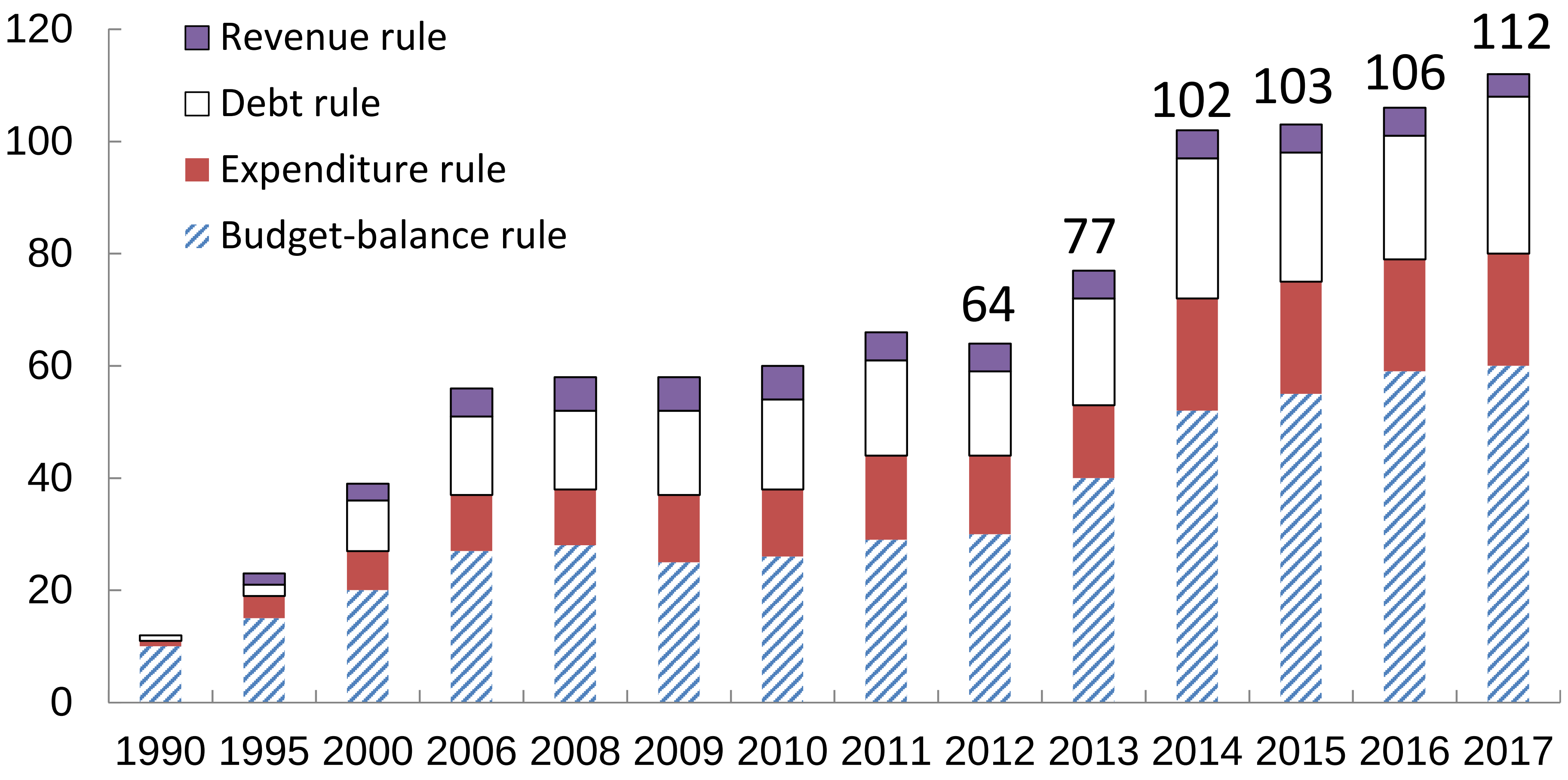
Numerical fiscal rules in the EU (1990-2017)



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Why expenditure rules (I)

- Appropriate balance between budgetary discipline and macroeconomic stabilization
- Instrumental for
  - ✓ *keeping spending in check in good times*
  - ✓ *expenditure-based consolidation*
- Appealing features: simplicity, transparency, monitoring and accountability
- Limitation: ERs only control for the spending side of the budget → need to be complemented by other types of rules and fiscal arrangements

e.g. structural BBR in 'Fiscal Compact' countries

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Why expenditure rules (II)

1. Focus on the part of the budget most directly controlled by the gov't → ***reducing uncertainty*** and ***promoting accountability***
2. Target formulation and monitoring are ***simpler*** than for other rules (e.g. CAB rules) and easy to communicate to the public opinion / politicians → ***transparency***
3. ERs hardly prevent ***automatic stabilizers*** from operating and may limit spending pressures in good times
4. Target the ***main source of the deficit bias***, i.e. recurrent spending overruns
5. ERs may improve ***expenditure composition*** by breaking down the overall spending ceiling into separate thresholds for each main expenditure area → ***clear policy guidelines*** for policy makers

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Considerations for ER design (I)

Numerical target definition

- level
- growth rate
- % of GDP

Real or nominal terms

- choice should take into account the <u>time horizon</u> of the expenditure objectives
- short-term, i.e. during budgetary execution, the annual spending target should be defined in nominal terms
- medium-term, multiannual nominal ceilings can be properly set if stemming from a previously established real expenditure path

Considerations for ER design (II)

Time horizon

- ERs incorporated into Medium-Term Budgetary Frameworks may better adapt to economic and country specific situations.
- A medium-term perspective allows setting expenditure targets consistent with macroeconomic prospects, tax revenue developments, sustainability issues and policy priorities.
- A multi-annual rule is superior to a rule/ceiling that only sets a target for one year

  → predictable spending path

  → circumvention more difficult (e.g. postponing spending)

☝ fixed medium-term expenditure ceilings ≈ expenditure rule

annual expenditure ceilings ≠ expenditure rule

Considerations for ER design (III)

Coverage

- Ideally all government layers (with coordination mechanisms)
- Ideally all items subject to expansionary pressures (to keep strong link with sustainability)
- Exclusion of some budgetary items may be justified:
  - ⌧ *Interest payments* - not under the direct control of the govt. in the short-run and not contributing to fiscal consolidation efforts
  - ⌧ *Cyclically sensitive items* (e.g. unemployment benefits) - outside the control of govt. in the short-run and their exclusion may enhance the counter-cyclical property of spending rules.
  - ⌧ *Public investment* – so as to avoid that largest part of an expenditure adjustment falls on growth-oriented items

    …. but 'golden rules' tend to favour creative accounting and opportunistic reclassification of spending items
- Policy experiences more favourable on excluding interest payments and cyclically sensitive items and less so on public investment.

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Considerations for ER design (IV)

Correction mechanisms

- they ensure effectiveness and credibility of the rule
- pre-established measures to be adopted (quasi-)automatically in order to redress budgetary developments in line with fiscal targets
- common principles for national correction mechanisms in a 2012 Commission Communication

Other elements influencing the functioning of spending rules/ceilings

- Statistical, accounting and forecasting issues
- Timely expenditure control: intra-year regular monitoring and expenditure commitment controls
- Sound budgetary procedures entailing a centralisation of the budget process (e.g. top-down budgeting and strong MoF)
- Regular spending reviews
- Comprehensiveness of the annual budget law (i.e. limited off-budget operations)
- Limited use of tax expenditures
- Other types of fiscal rules must supplement expenditure ceilings (e.g. high complementarity between ERs and budget balance and/or revenue rules)
- Independent monitoring (by fiscal council)

  + comply-or-explain principle

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National expenditure rules in the EU

- 20 ERs in 17 MS at end-2017; close to 20% of total rules in EU
- A third of the rules are mirroring the EU expenditure benchmark
- Vast majority of ERs enshrined in legislation, a few based on coalition agreements
- Comprehensive coverage for half of the ERs (≥75% of GG spending)
- Ceilings defined as growth level or in absolute terms
- 3/4 of rules in nominal terms, 1/4 in real terms
- Typical exclusions: interest payments, gov't expenditure fully matched by EU funds revenues, (cyclical) unemployment benefits
- Escape clauses: rarely used (e.g. severe economic downturn, natural disasters, martial law)
- Monitoring by independent body for ERs targeting GG and CG

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Binding nature – possible classification

	Level of strictness in terms of respecting spending plans set out in the medium-term planning documents	Member State
1	Ceilings/targets ***are not expected to be changed*** whatever the circumstances (unless a new government comes to power or division of tasks between government levels is changed)	SE, FI
2	Expenditure ceilings ***can only be increased provided that sources of funding*** of the additional expenditure are identified ex-ante	DK, NL
3	Ceilings/targets ***can be adjusted in response to changes in a number of specific parameters*** defined by legislation or other public procedural document (e.g. change in expenditure on pensions, unemployment benefits etc.) and such changes need to be explained publicly	AT, IE, LV
4	Ceilings/targets ***can be changed in a number of situations*** foreseen by legislation or other public procedural document (e.g. in view of a substantial change in the macroeconomic forecast, new government coming to power, extraordinary circumstances, etc.) and such changes need to be explained publicly	BE, BG, EL, IT, MT, PL, RO
5	Ceilings/targets ***can be changed at the discretion of government*** but changes need to be ***explained*** and reputational cost is involved	CY, CZ, EE, ES, FR, HU, LT, LU, PT, UK
6	Ceilings/targets ***can be changed at the discretion of government without*** any public ***explanation***	DE, HR, SI, SK

Some inspiration from EU peers

- Relevant experience with (fixed/semi-fixed) medium-term expenditure ceilings: Denmark, Finland, The Netherlands, Sweden
- Nominal or real ceilings, in absolute terms
- Covering 3-4 years; fixed for the whole period (FI, NL) or rolling 1 year (DK, SE)
- Enshrined in law (DK, SE) or coalition agreement (FI, NL)

  → require change of law/parliamentary approval (except FI)
- Comprehensive GG coverage (≥75%) for DK and NL vs. 20-30% for FI and SE
- Typical exclusions: interest payments, (cyclical) unemployment benefits; gross investment in DK
- Escape clauses: not specified
- Correction mechanism: DK, NL, SE; reputational cost in FI
- Monitoring by independent body

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Incorporation of the Fiscal Compact into EU law

Proposed Council Directive for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States (Dec 2017)

- Focusing on the underlying objective of the Fiscal Compact: convergence to prudent levels of public debt
- **Recalls the importance of adopting a credible and effective medium-term perspective at national level**
- Main features:
  - (national) medium-term objective in terms of structural balance, geared towards prudent gov't debt level + correction mechanism for significant deviations
  - **binding medium-term expenditure path net of discretionary revenue measures; set for the entire legislature as soon as new gov't takes office**
  - key role for national fiscal councils in setting the fiscal parameters and monitoring compliance with them
  - binding 'comply-or-explain' principle
- Applicable to euro area Member States + 'opt-in'

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Thank you
for your attention