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Rule Based Budgeting and Fiscal Institutions after the Crisis

1. Introduction[1]

The study surveys the institutional similarities and differences between the centre and the periphery of EU in budgeting. The hypothesis is that the periphery of the EU is not only imitator of the centre budgeting practices, but also innovative in application of new elements, items or instruments in the institutional aspect.

In most of the industrialized countries, there are many factors ruining fiscal sustainability beside the climate change costs. The aging population, the welfare state reform, the recovery from global crisis, the tax competition, the rigidities of labour markets already have resulted robust debt levels. (The approximately debt to GDP ratios have been the followings in 2011: USA 100%, Japan 225%, France 80%, Germany 75%, Britain 70% etc. source: Eurostat). The high developed countries have trouble with the general budget balance. Besides, the primary gap indicator even represents a longer term fiscal adjustment period necessity for these countries. Especially the big key economies (USA, Japan, Germany, France, UK) must face to drastic return to balance during decades after many years of fiscal stimuli. The global crisis of 2008-2010 caused a serious turmoil in many EU states' public finances. Only six EU countries could keep the deficit criterion in 2009. Four of them (Sweden, Denmark, Estonia, Bulgaria) have not introduced the euro. The other countries have diverged both in debt and deficit. Since 2010, during one and a half year many euro zone countries had difficulties in debt financing (Greece, Portugal, Ireland, Spain). Some euro zone members also have got closer to non-credible indebtedness (Italy, France).

The study will analyze the need of fiscal institutions for solving sustainability problems in EU member states. The rule based budgeting sets the framework of fiscal responsibility through the rules of procedures and transparency and the mechanisms of supervision and sanctioning. The applied frame of fiscal responsibility should be built from these rules and mechanism specified for the

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country characteristics. The rule based fiscal policy decreases the political decision-makers' room for manoeuvre, their discretional steps, and builds such mechanisms into the budgeting that can close significantly out the possibility of "human intervention". Instead, automatic stabilizers are applied, what means revenues and expenditures depending on business cycle, as they strongly correlate with the economic growth, consumption, export, investments etc.

There are fiscal councils existed already before the crisis 2008, like Sweden, Austria, Belgium, Canada, Denmark etc. But the crisis also implied the necessity of creation of councils, like the Irish Fiscal Advisory Council or the Romanian Fiscal Council. Or, contrary, the political interest changed, weakened the function of certain institutions, like the case of Hungarian Fiscal Council.

2. Rules after crisis

The fact, that many European countries have been facing to the risk of debt crisis after financial markets became undersupplied with money in the financial crisis of 2008, is the result of undisciplined fiscal policy making in the previous decades. This meant particularly ignoring the existing fiscal rules (expenditure caps, deficit limits, debt limits) and the introduction of veto-like institutions which serve the long term fiscal sustainability target against the short term political interests of the political decision-makers.

In advance, it must be stated that fiscal rules them-self can not be the trigger of long term balancing if strong political commitment exist only in speeches without actions. Benczes (2011:601) gathered the immense number of numerical rules adopted by European countries since 1990. His conclusion is that the main argument for national fiscal rules was the accelerating growth speed of public debt. Thus, mostly those countries introduced fiscal rules intensively, whose debt exceeded the 70% GDP-ratio. Typically, low ratio countries increased their indebtedness in the pre-crisis period of 1990-2007. Moreover, the countries aspired for euro-zone membership in the 1990s and that was why they reduced their debt level, after accession their debt level started to rise again, except the Netherlands and Finland. (see Mosley 2004:188, fig.1)

The damages caused by the global financial crisis in the credibility and solvency of European countries can turn again the focus of fiscal policy makers toward application of rules and strong political commitment, just like it has happened in Greece and Italy through resign of prime ministers and choosing technocrats for this position.

The economics literature on fiscal discipline emphasizes the importance of exit strategy from debt problems and the necessity of rules. Blanchard, Cottarelli and Vinals (2010) gathered the characteristics of the effective exit strategy, as follows: (1) integrated cooperation of policy making institutions, (2) flexible permanent adjustment in the strategy, (3) restoring the market role in the financing of public debt, (4) unambiguous communication of fiscal actions. They also warn for good timing of stopping the fiscal stimuli. They assert that "*[e]nsuring fiscal sustainability is a key priority and policy challenge, notably in light of the upsurge debts in many countries* ."

What type of rules should be revived? Blanchard, Cottarelli and Vinals (2010) suppose country specific debt target (for high developed ones 60% of GDP, for emerging ones lower than 60% as prudent level of debt), and structural primary surplus. Besides they miss the detailed fiscal reporting, the broad fiscal risk analysis, the comprehensive, medium term, obligatory budget framework, the numerical and procedural rules, the independent budget agencies in most of the countries. Their opinion is that more rigorous top-down budgeting approach could have been higher guarantee to the implementation of fiscal adjustment. However the process of budget planning is top-down, the "*rigidities and circumvention of the budget process diminish its disciplining impact.*" Their thesis is that the non-devoted implementation endangers the credibility of fiscal adjustment and political commitment. (Blanchard, Cottarelli and Vinals 2010:17-18)

Hallerberg and Scartascini (2011) view the budget institutions as part of common pool resource (CPR) problem, as the spending ministers are interested only in the highest magnitude of financing and taxation on own field of competence, and the regional representatives and MPs only in their own region. That is why the two experts prefer the centralized budgeting which is realizable through three ways: (1) numerical rules, (2) procedural rules, (3) transparency rules.

Schick (2010) hopes, that after the crisis, the governments are willing to create much "*sturdier*" rules than before. He mentioned three approaches on fiscal rules. The first one supposes to wit for normalization of economic circumstances. The second one urges the budget balancing (in a non-keynesian way) for economic growth. The third one wants to change the fiscal rules, as the pre-crisis rules failed because those were too rigid and unable to adjust to the changing business environment. That was why the old rules were pro-cyclical in growth years and resulted austere policy in recession times. Schick assumes that after the discretionary stimuli of 2009-2010, there is need for a discretionary consolidation before returning to fiscal rules. Schick's recommendations for renewal of rules are the followings:

- The primary rule should be the debt limit beyond the deficit limit as debt target expresses the long term characteristic.

- The budget balance and items must be understood broadly including the extra-budgetary and off-budget funds and items.

- The new generation of rules must contain the ability of counter-cyclical impact. They must force the budget institutions to generate surplus adequate to reduce the debt-to-GDP ratio.

- Namely, the rules should prescript limits to the structural measures.

- The rules should be trend based, i.e. the limits should be able to shift according to the GDP-trends or budget revenues, thus making the rules counter-cyclical.

- Independently from the characteristics above, it is preferable to have rigid expenditure rules for easy implementation and exclusion of rule circumvention.

- National rules are better than international (like the monetary and currency unions), as community rules must be uniformed, thus simple and rigid. However, national rules are more vulnerable by the majority of national parliaments.

- Regional and local governments can weaken the debt consolidation of central government. That is why limits and rules must be included into the existing institutional framework, and extended to the lower levels of governance. (framework based rules)

According to the flexibility, Creel and Saraceno (2010) modified the so called 'golden rule' of budgeting, namely the principal saying that only investment with income multiplying effect should be financed from credit and loan, but no current spending. Admitting the correctness of golden rule, the authors modified it with the "cyclically adjusted net-of-public-investment deficit".

$$DEF = DEF_{cyc} + DEF_{struct} \; ; \qquad (1)$$

where DEF is the overall deficit, DEF_{cyc} is the cyclical component of the deficit, DEF_{struct} is the structural component of the deficit.

$$DEF_{cyc} = -0.5 * OG * GDP \; ; \qquad (2)$$

$$DEF_{struct} = i^*B_{t-1} + I_{pub} + DEF_{D\&A} \; ; \qquad (3)$$

where OG is the output gap, i^*B_{t-1} is the interest rate burden on debt issued in the past, I_{pub} is the public investment, $DEF_{D\&A}$ is the deficit component from discretionary and autonomous decisions. The rule is the following:

$$DEF_{struct} - I_{pub} = 0 \; ; \qquad (4)$$

The modified golden rule:

$$DEF_{D\&A} = - i^*B_{t-1} \; ; \qquad (5)$$

Namely, the higher interest payable means lower deficit based on discretionary and autonomous decisions. Moreover, if the balance (actually surplus) of discretionary actions offsets the interest payable, namely their sum is zero, than the overall balance is the following composed from equations (1), (2) and (3):

$$DEF = I_{pub} - 0.5 * OG * GDP \; ; \qquad (6)$$

In this case the multiplying impact of public investments would make the output gap to go toward zero (lim OG $\rightarrow$ 0), since public investment to GDP ratio would start to decline by the investment multiplying impact. Finally, the overall deficit would start to diminish and logarithmically the public debt, too.

3. Supervising fiscal institutions

Blanchard, Cottarelli and Vinals (2010) establish that the strong budget institutions can improve the fiscal balancing performance by identifying the needful magnitude of budget adjustment, and creating and implementing credible consolidation strategy.

Schick (2010) outlines three ways to enforce the budget targets, limits and rules. The first one is the automatic recurring process of setting targets, implementing the plans. This is actually the system of automatic stabilizers with the weakness of no protection against political motivation for discretionary actions. The second way is the enforcement by a supranational/international organization. In this case, the international practice shows serious problem of information asymmetry and weak ability to impose sanctions. The third one is an empowered independent national agency (a fiscal council) which can have impact on processes, and according to its own macro forecast, warn for dangers and call for adjustment by relying on its own public credibility. As it is worded in IMF (2010), there is need for fiscal agencies to hold the government accountable in the context of targets, policies and plans.

In the followings, it will be surveyed from case studies, can the fiscal councils can strengthen the fiscal discipline, what are the weak points of such an institution. Besides, European practices appear in updated context.

The Fiscal Council (FC)[2] is an advisory body in budgeting question which is preferable to have independence from other government institutions, professional reputation and credibility. Its role is to assess fiscal targets, to assess appropriateness and soundness, to help policy makers reduce debt and see future risks, and to improve transparency of national budgeting. FC can have impact on fiscal decisions if its opinion is very credible and accepted by the public, thus setting pressure on political decision makers to change unsustainable fiscal objectives or actions. FC must analyse any budget-related proposals and estimate its impact on budget balance and public debt. It is also called a watchdog on budgeting.

Lars Clamforce, former head of Swedish Fiscal Policy Council defined the personal criteria and the institutional tasks of an FC as follows (Clamforce 2010a): The members of the FC must be independent from political actors, especially from the government. They must come from the academic sphere with high reputation. The academic record and the reputation can be the only guarantee for primacy of professional aspects beyond political ones. An academic expert is the less likely to risk his reputation and long term academic career for political “bribery”. (Of course, it is neither an absolute guarantee.) The tasks of an FC are the provision of objective macro forecast based on budget proposals, the costing of government initiatives, the *ex ante* and *ex post* evaluation, the sustainability analysis and the normative recommendation for policy making.

3.1. The etalons

3.1.1. Practices of federal states

Where the regional, provincial, local governments are strong, the central (federal) government alone is not enough to sustain the fiscal discipline and the

[2] Useful sources on FCs : http://www.finanspolitiskaradet.se ; http://mostlyeconomics.wordpress.com/2010/07/30/what-are-fiscal-councils/

solvency of debt financing. Thus it has been almost natural and automatic that some kind of body for reconciliation of regional budgets must be set up.

The best practice for federal fiscal supervisory body is the U.S. Congressional Budget Office making politically neutral, objective analysis on budget impacts to support the economic decisions of the U.S. Congress since 1974. Besides, other international imitating examples can be found for this type of FC motivated by federal coordination problem, just like the Australian or the Canadian Parliamentary Budget Office since 2011, the National Assembly Budget Office in South Korea since 2003.

There are several European examples, too, for body of federal budget and debt coordination. In Denmark and Belgium, there is a strong sub-national regional governance level which has significant influence on public expenditures, but the central government limits are not valid on it. The central government is under pressure to make agreement with the regional and local governments. In Denmark, there is annual agreement. In Belgium, the situation is more complex, as this is a federal state.

The Belgian regional governments has right to reach the so called 'natural debt' level, it looks reasonable. In practice, it means free deficit financing for regional budgets. The result was permanently excessive general (federal) deficit. This regional freedom, also, generated moral hazard. To treat the problem, the federal and regional level in agreement created the *High Council of Finance* (HCF). (Stienlet 2000) The HCF has issued every year an advisory report on necessary financial actions of several public institutions (central government, regions, social care systems, local governments etc.). Besides, in advisory report, it can recommend the narrowing of indebting of public institutions, if the measure of indebting endanger the EMU-related Belgian objectives, or can cause disturbance in financial balance, or ruins the structural fiscal balance. In the HCF, the members are the minister of finance, the delegated representatives from the ministry of finance, of economy, of social affairs, the National Bank, the committee of banking, the Office of Central Economic Planning, the regional governments, and other financial institutes. Besides, there are also financial, economic and taxation experts in the HCF. The HCF does not issue normative proposals on economic growth, but sets guidelines on general objectives of the formation of fiscal policy. The HCF is an advisory body, thus the implementation of its recommendations is voluntary for the fiscal institutions.

Similarly to the HCF, in Spain, there is the Fiscal and Financial Policy Council (*Consejo de Politica Fiscal y Financiera Financial*). The creation of the Spanish council was reasonable, as the tethers related to fiscal revenues have been significantly redistributed toward the regional self-governments since 1988, thus, since 2000, the regions decide about bigger amount of public finances than the central government. (Quintana és Torrecillas 2008)

The German Federal Republic is actually the most centralized version of the federal state. The federal member states (*Bundesländer*) have own budget, but the so called Financial Planning Council (*Finanzplanungsrat*) harmonize the budgeting among the different levels of governance. Since 2002, the Council has the task to enforce fiscal discipline in the federal member states. Actually, the council is responsible for preventing the fulfillment of Maastricht Criteria to be endangered by federal member states. (Lübke 2005)

Austria created a special version of FC with 14 members in 2002, the Government Debt Committee (Staatsschuldenausschuss). Even though officially it is a government committee, the construction is a clear example for federal coordination, as out of the members six are delegated by the federal government, three by the Austrian Chamber of Commerce, three by Federal Chamber of Labour, and one-one by the Austrian Association of Municipalities, the Association of Austrian Cities, and the Conference of Provincial Governors. The Committee gets analytical support from the National Bank of Austria. (http://www.staatsschuldenausschuss.at)

The federal-like FCs typically can not meet the condition of independence from other political actors, as their function is to coordinate among different political decision levels and dimensions. This is natural, since their way of efficiency is not to put pressure on government through the public and market opinion by relying on their own professional reputation and credibility, but to reconcile the rationalities of different levels of competences.

3.1.2. Watchdogs: Dutch and Swedish innovative best practice

For watchdog characteristic, the innovative best practices in Europe are the Dutch and Swedish FCs.

As an institutional regulator, in the Netherlands, the *Budget Inspectorate* and *Budget Directorates* have been created. The inspectorate surveys every expenditure of spending ministries, budget proposals, and the background of policies. The directorates are responsible for finances of ministries and ministers' proposals, and negotiate with the ministry of finance. (Blöndal & Kristensen 2002) In the Dutch system, the 23 different spending themes are separately proposed to the Parliament. The budget must contain: objectives, ways, costs. It is monitored by the state audit office. There is, also, an independent institute in the Netherlands, the '*Centraal Planbureau*' (its official English name: *Netherlands Bureau for Economic Policy Analysis*) which analyze the economic factors affecting on the public finances. (Debets 2007)

The Swedish FC was created relatively late in 2007 as a part of very disciplined, automatism based Swedish budgeting framework, but it became the ideal European version of FC in practice in the context of independence, credibility, professional reputation, methodology of ex ante analysis, influence on budgeting through pressure on government by shaping the public opinion. The Swedish model is defined by itself in the following way:

"*The Swedish Fiscal Policy Council* [Finanspolitiska rådet] *is a government agency established on 1 August 2007. The Council consists of six members and is assisted by a secretariat with four employees. The mission of the Council is to provide an independent evaluation of the Swedish Government's fiscal* *policy. The council assesses the extent to which the Government's fiscal-policy objectives are being achieved. These objectives include long-run sustainability, the budget surplus target, the ceiling on central government expenditure and that fiscal policy is consistent with the cyclical situation of the economy. The council also evaluates whether the development of the economy is in line with healthy long-run growth and sustainable high employment. Additional tasks are to examine the clarity of the Government's budget proposals and to review its economic forecasts and the economic models used to generate them. Finally, the Council should try to stimulate public debate on economic policy.*" (website of the FC www.finanspolitiskaradet.se)

Although Calmforce (2010) reports on political intentions to neutralize or terminate the FC in Sweden, the Council has reserved its competences, legitimacy, credibility, reputation and independence.

3.1.3. Political death of a watchdog: bad practice of Hungary

The 'Fiscal Council' has been introduced, as an independent institute for surveying, monitoring, analyzing anything, that related to public finances. The council could also make economic surveys and forecast, and evaluate budgetary proposals. The Council was composed from three independent economists with high professional credibility and reputation, and their job was helped by own Secretary Office ready for economic analysis and forecast. Namely, the state of FC in 2010 was very similar to the Swedish FC. This could have been the parallel best practice of FC together with the Swedish one, if the politics would not have interrupted the story.

After one year of promising formation of Fiscal Council (FC), the 2/3 majority of the government party in the Parliament dismantled the analytical institutional capacity, and restructured the three persons board. Instead of three independent experts, the head of State Audit Office (SAO), the chancellor of National Bank of Hungary (NBH) and an independent president compose the new version. Thus the FC president with international professional respect in field of budgeting (George Kopits) got into an impossible situation. Without independent analytical capacity, the transparency analysis of the public finances is not any more trustable for the markets. He resigned, and the current head of the state – who was delegated by the qualified majority of the government party – nominated a new president to the FC. Not the person of the new president(s) is incredible but the process of restructuring. Legally everything was correct, but the market actors, the international partners will not any more consider the new version of FC to be a credible watchdog monitoring the fiscal policy. Damage in credibility results less transparency in budgeting for the bond market.

In November 2010, the Hungarian governing party proposed a budget cut for the Fiscal Council. 825.5 million HUF was taken and only 10 million HUF remained, what forced to make the analytical staff redundant as a first step. This was a punishment, as few weeks earlier the FC criticised in budget and the lack of fiscal transparency.

By liquidating the independent analytical capacity and professional credibility, the institutional factor of fiscal discipline got a serious damage. Besides, the ministry of finances got assimilated into the ministry of national economy, thus, the responsibility for fiscal discipline got degraded to state secretary level inward the government. The Fiscal Council has formally kept without secretary office for analysis and credible independency. The FC can build on the analysis of NBH and SAO. However, latter two institutions has no veto, the SAO makes only ex post analysis on public finances, and the NBH first of all prefers monetary targets.

Although the government achieved improvement in the short term budget balance, the weakening of agencies with credible publicity or influence on decisions will have the public finances to move away from transparency and sustainability. Albeit politicians are able to stop the increase of debt, but only in case when it endangers directly their position, and right on time they return to discretionary easing if it serves better their short term political interest. Even though the State Audit Office and the National Bank continues the macroeconomic analysis, same time with elimination of FC's analytical capabilities, the competence on long term analysis of fiscal risks was not entrusted to somebody else, but it simply disappeared from the institutional framework.

Of course, transformation of FC will not shut the voice of rating agencies in the financial markets. The actors of bond markets still listen to the institutions of transparency, even though without credible FC this transparency got reduced.

Not only the Hungarian FC had to face with political challenges in its existence. Clamforce (2010a), former president of Swedish FC wrote that independence and survival of FCs are frequently endangered by political decision makers, as criticism by a credible and public opinion leader FC on the budget-related political actions ruins the credibility and popularity of politicians. This watchdog behaviour is mostly sensitive for the governing parties, as annual budget act depends on their objectives.

3.2. Newly established fiscal watchdogs in Europe: Imitating practices in the EU

The newly established European FCs are the result of global financial crisis 2008, more precisely its spill-over resulting increasing indebtedness and the threat of a debt crisis.

The proposal for British Office for Budget Responsibility (OBR) was a very quick reaction for budget deficit running out of control. In the end of 2008, the Conservative Party, still in opposition, proposed this agency. The realisation of the proposal could happen in 2010. (http://budgetresponsibility.independent.gov.uk/) The OBR is not the Swedish like watchdog in the sense, that in the public administration hierarchy it is subordinated to the Treasury. True, that OBR declared the classical watchdog tasks, just like forecasts for the economy and public finances, judgement on progress towards the Government's fiscal targets, assessment on the long-term sustainability of the public finances, scrutiny on the Treasury's costing of Budget measures. Clamforce (2010b) considers that "*a number of established principles for such bodies were actually violated*." His critics on dependence between OBR and Treasury are based on the situation that some Treasury employees have been working for the OBR, the rules afford to the OBR to "*consult the chancellor in preparing documents*". Besides, it is mentioned also as a sign off dependence, that "*there is a built-in flaw in its forecasting tasks. By providing a forecast and a judgment on the fiscal outlook at the same time as the budget is published, it would seem impossible to avoid behind-the-scenes "negotiations" on numbers with the Treasury.*" Calmforce (2010b) emphasizes that credibility and reputation of a watchdog agency can not afford any opportunity of behind-closed-door contacts and interlacement. His proposal is to isolate the OBR and the Treasury in physical, personal and operational sense.

Fiscal Council of Romania (Consiliul Fiscal) was established in March 2010 by the fiscal responsibility law (legea responsabilităţii fiscal-bugetare, legea 69/2010). As members of the council, there are five academic professors with relevant background on macroeconomic and budgetary policies. They are nominated by Romanian Academy, the National Bank of Romania, the Academy of Economic Studies, the Romanian Banking Institute and the Romanian Banking Association, and elected for nine years by the Parliament. This process of nomination strengthens the credibility and the independence of the FC. For independent analysis and opinion, the FC has the Secretariat of the Fiscal Council, which will operate within the Romanian Academy, and prepares analysis, forecasts and documents underlying the opinions, evaluations and recommendations. The Secretariat employees can be 10 persons who are chosen by the FC members. Namely, the Romanian FC imitates the original best practices of Swedish watchdog etalon, thus this is itself an example for good practice, too. (www.fiscalcouncil.ro)

The creation of Irish Fiscal Advisory Council (IFAC) connected to the Irish banking crisis and its side effect, the 31.3% budget deficit in 2010. It was internal and Community level demand, to improve the prudence, transparency and discipline of the Irish budgeting after all. So, in June 2011, the IFAC started its operation. The institutional standards are very similar to the Swedish watchdog type council model. It has own secretariat for analysis and five council members from the academic sphere, just like in the Romanian FC. The objective of the IFAC is determined in the following: "*The role of the Council is to independently assess, and comment publicly on, whether the Government is meeting its own stated budgetary targets and objectives. It measures the appropriateness and soundness of the Government's macroeconomic projections, budgetary projections and fiscal stance. The Council will also examine the extent of compliance with the (forthcoming) legislated fiscal rules.*" (www.fiscalcouncil.ie)

The Public Finance Act legislated by the Slovenian Parliament in 2009 prescribed the establishment of the Fiscal Council in Slovenia what was launched in March of 2011. (Fiskalni Svet) Tasks are very similar to the previous watchdog agencies. There are seven members from academic sphere nominated for five years. (www.fiskalnisvet.si)

There are some initiatives waiting for realization in Europe. In June of 2011, The Bulgarian finance minister announced the creation of Fiscal Board. (Novinite 2011) But there has been no any progress since the announcement. In case of Slovakia, the proposal of fiscal council appeared in a Discussion Paper of National Bank of Slovakia. (Horváth & Ódor 2009). The Portuguese government created a working group in January of 2011 for a later creation of Fiscal Policy Council. It is called Fiscal Policy Council Working Group (Conselho das Finanças Públicas Grupo de Trabalho). Until January of 2012 there has been no progress in start-up of the independent fiscal agency. (www.cfinpub.org)

4. Conclusions

The financial crisis of 2008 raised the fear from great depression. That was why European governments launched fiscal stimuli never seen before. The magnitude of public spending and the narrowing of bond markets took these countries close to a serial of debt crises. The conclusion of theorists and policy makers, too (see: formation of Euro Plus Pact), is that national budgeting should return to discipline, transparency, sustainability and credibility. The helpers to the mentioned objectives are the fiscal rules and watchdog agencies. About the fiscal rules, it is established that the post-crisis rules must be cyclically adjustable and country specific. In case of fiscal councils, there is a tendency in practice can be followed in Europe that application of such watchdog institutions is spreading as they can offer higher transparency of national budget. This is appreciated by the financial market actors. Of course, these helpers can not be effective without the strong commitment of policy makers.

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