EU **INDEPENDENT**
FISCAL INSTITUTIONS

# Medium-Term Budgetary Frameworks

A contribution to definitions and identification of good practices

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The Network of EU Independent Fiscal Institutions (EU IFIs) endorsed this Report at its meeting held in Rome on the 4th of May 2018.

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The WG-MTBF is chaired by Chiara Goretti and is composed by Michal Horvath, Permanent Secretary of the Network of EU IFIs, and by the following institutions:

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CPB Netherlands Bureau for Economic Policy Analysis, The Netherlands
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# 1. Introduction and main conclusions

The aim of this paper — prepared by an ad-hoc Working Group on Medium-Term Budgetary Frameworks (MTBF-WG) set up by the Network of EU IFIs — is to contribute to the discussion on MTBFs and, in particular, on how they should interact with domestic and EU medium-term fiscal frameworks (MTFFs) to maximise the benefits stemming from them. In particular, the paper aims to contribute to the clarification of concepts and identification of arrangements shaping an effective MTBF, also to better compare experiences across countries.

Cross-country analysis of MTBFs' effectiveness is a challenging task. Indeed, MTBFs have different characteristics across countries that do not necessarily imply different degrees of effectiveness; even terms or definitions are often heterogeneous across countries. Moreover, the available comparative analyses are often performed relying on questionnaires whose answers are mainly based on the description of the legislative framework, which may be different from actual implementation. Therefore, assessing the effectiveness of different MTBFs would imply an ambitious effort in defining and agreeing the main concepts of MTBFs not only in terms of arrangements but also in terms of aims and purposes for which these arrangements are considered helpful. The institutional part of this paper provides a contribution to this endeavour.

This paper includes also an empirical analysis of the main fiscal aggregates of the 2011-2017 Stability Programmes of the countries participating in the MTBF-WG. The objective of the analysis is to verify whether the stability of fiscal targets could be used as a reliable outcome indicator of effective MTBF arrangements in different countries as done in previous studies. The main results are summarised in the text while the details are given in the annex. The quantitative analysis shows evidence for most countries of moving targets and slippages that appear to be driven by many factors, which are difficult to disentangle. During the financial and economic crisis (2011-2013), increased uncertainty made it particularly difficult to gauge the true size of the cyclical phase, bringing about revisions of growth forecasts (including of potential growth) and in budget balances' forecasts. Revisions in fiscal targets were also determined by changes of priorities in policy strategies, from public finance sustainability (mainly during the phase of financial markets instability) to macroeconomic stabilization. Weaknesses of MTBFs in translating medium-term aggregate fiscal objectives presented in the Stability Programmes into operational targets may have been an additional determinant for slippages, albeit it is not easy to disentangle the single determinants. Thus, one conclusion of the quantitative analysis is that it could be misleading to use the stability of fiscal targets as an appropriate outcome indicator of effective MTBF arrangements.

In its institutional part, which is the core of this paper, the analysis helps to clarify some issues:

1. An MTBF is a set of interrelated systems, rules, and procedures ensuring that budgets are set with a medium-term perspective and are compatible with fiscal sustainability. MTBF is a mechanism for prioritization, reconciliation and presentation of multi-year expenditure envelopes; in general, it is derived from an

MTFF as part of a top-down approach to fiscal policy. As such, it does not prevent, but rather strengthen coordination with the more traditional bottom-up budgeting. Its role consists in determining the spending agencies resource needs and reconciling these with the overall (macro) resource envelope.

2. MTBF should not be confused with MTFF, which is a mechanism for setting multi-year macro-fiscal objectives and targets. In the context of EU fiscal framework, the Stability Programme (SP) is akin to an MTFF and not an MTBF. Some EU countries also have their domestic MTFF that could differ from the EU one. It is worthwhile noting that indicators built on the variables illustrated in the empirical part of the paper would refer to MTFFs, and should not be confused with indicators of MTBFs' effectiveness.

3. A certain degree of disconnection between MTFF at EU level (Stability Programmes or EU MTFF) and domestic MTBFs has been occurring. Practical experience shows that strong domestic MTBFs in EU countries have not been developed on the basis of the EU fiscal rules. At the same time, the current EU MTFF might not be conducive to the implementation of strong MTBFs, inter alia because of the instability of fiscal targets and the absence of a systematic reconciliation procedure. In this context, it is important that the concrete design of numerical expenditure rules underpinning the MTBF at the national level remains a responsibility of the Member States. Indeed, these expenditure rules should be based on "operational" variables and targets (see also point 5a below), which in general can be quite different among countries and of a significantly different nature compared to the expenditure benchmark underpinning the EU MTFF.

4. Exporting successful MTBFs' arrangements in different institutional and political contexts, i.e. where reputational cost is low or institutional capacity is not adequate, might be challenging and in these cases a more gradual approach would be commendable. Political commitment towards a stronger medium-term orientation of fiscal and budgetary policy is key for effective MTBFs as well as institutional capacity in implementing medium-term plans. The issue of political commitment to the stability of expenditure targets is crucial, along with the related issue of reputational cost. In some countries, the cost is high and the government or the parliament generally refrain from changing plans previously set. On the institutional side, some prerequisites are important like the ability to carry out reliable economic, revenue and expenditure forecasts or to implement cost-benefit analysis in a medium-term context.

5. Significant steps forward should be made at both EU and national level to implement more effective MTBFs. A possible step forward could be identifying a number of desirable qualitative features that domestic MTBFs in EU countries should have, avoiding to make them mandatory. A first attempt for identifying these desirable features is outlined in this paper and can be synthetized as follows:

    a. The existence of an operational expenditure rule to establish spending limits in a multi-year setting for each policy area. For "operational" it is meant a rule that could be easily discussed and established by policymakers, implemented by public managers, and understood by the public at large. In general, this implies the use of spending aggregates on a cash or accrual basis. As we stressed above, especially in this context one-size-fits-all proposals should be avoided, and the choice of operational variables and targets should be left at the country level.

b. Reconciliation among different accounting standards, as MTBFs translate macro-fiscal objectives and constraints into broad budget aggregates and detailed expenditure plans. MTFFs are usually defined on a (national account) accrual basis and often take into consideration the cyclical dimension while budgets are defined on a cash basis or on an accrual basis different from the national account one. Also classifications are often different. MTBFs would then be equipped with instruments to reconcile these different accounting criteria. In particular, all actors involved, notably Ministries of Finance and National Statistical Institutes, should make public their reconciliation criteria and practices.

c. Overall stability of expenditure targets over the years and reconciliation procedures in place when these targets are changed. One of the aims of MTBFs is to provide more stability and predictability of public resources and their allocation. This does not necessarily mean that changes are not possible but, if they are implemented, a full set of explanations would be provided to illustrate origins and causes of these changes so as to “reconcile” the new targets with the old ones.

d. The establishment of the MTBF at the beginning of each legislative term with no or limited renegotiation afterwards. If new priorities emerge, MTBFs would help to reconcile them within the existing ones, supporting changes and reshuffles among them.

e. Establishing in advance, to the most extent possible, the “rules of the game” among political and institutional actors in specific circumstances. For example, rules on revenue windfalls — i.e. revenues on top of those that could be expected from macroeconomic outcomes and “benchmark” tax elasticities — are required. In principle, windfalls would be “saved” to compensate for possible future shortfalls and would not be used to finance new policies. Another example are rules on how to treat expenditure carryovers, i.e. unspent allocations from the previous year. For example, they could be allowed to be spent in the current year but not to the full extent to avoid unfavourable surprises on expenditure or budget balance targets.

f. Being aware of the increased importance of defining a central MTBF in countries with multilevel expenditure structure, because of the impact that the central government expenditure envelopes have on the budgets of subnational governments mainly through transfers. Indeed, the need for local governments to know in advance the amount of resources they can lean on is essential to put them in a position to implement their own medium-term budgetary planning. Discretionary changes of the grants received from central government on an annual basis would inevitably bias the horizon of local expenditure policies towards the short term.

As already stressed, implementation of MTBFs should be carried out keeping in mind that, although successful MTBFs share a common approach, their actual design vary considerably across countries and there is no single way to do it. Many differences across existing MTBFs reflect pre-existing institutions. Thus, priorities towards the implementation of more effective MTBFs in any single country should take into account the main features characterising its institutional setting. Also for this reason, rating and ranking MTBFs is a highly judgmental exercise, not always desirable, especially if based on composite quantitative indicators trying to capture complex institutional arrangements.

Independent Fiscal Institutions (IFIs) can play an important role in promoting, within their institutional mandate, a medium-term approach for the implementation of budgetary policies. As a first step, IFIs could assess the quality of domestic frameworks, possibly through desirable features suggested in this paper or other features that may better fit the national contexts. Moreover, IFIs could promote and monitor the implementation of such features. Finally, where or when a satisfactory MTBF is in place, IFIs could have a role in verifying whether the medium-term orientation of budgetary policies is indeed followed through by the government in practice and not only in legislation. IFIs could also deliver the main technical parameters needed to establish an MTBF or could provide medium-term projections under no policy change. Nevertheless, the final decision on overall targets and allocations would always be left to policymakers. IFIs could finally have a role in the reconciliation process when an MTBF is being revised, and could assess the consistency of medium-term targets across levels of governments.

However, within the EU surveillance framework, the current EU MTFF has some shortcomings like the instability of annual fiscal targets (linked to the use of volatile estimates of unobservable indicators) and in general a short-term perspective. These weaknesses may limit the scope of reforms towards more effective MTBFs. This challenge should be taken into account in any reform proposal of domestic MTBFs.

In this respect, the Proposal by the Commission for a “Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States”, presented in December 2017, is a positive development as it contains a number of measures leading to a more decentralised MTFF system. This system is based on a medium-term growth path of public expenditure net of discretionary revenue measures consistent with the medium-term objectives for budget balances (as an intermediate target) and with the ultimate objective to ensure public debt sustainability. This Proposal could encourage a better link between the EU MTFF and domestic MTBFs.

Nevertheless, if the EU surveillance framework remains unchanged, its shortcomings would still limit the effectiveness of domestic MTBFs and attention could thus be shifted to two priorities: a) to support Member States in strengthening instruments towards medium-term expenditure planning in budget preparation; b) to enhance the medium-term orientation also for the EU framework.

As for the first objective, by the end of 2018 the Commission will review the suitability of the Council Directive 85/2011 on requirements for budgetary frameworks of the Member States. This review could be an opportunity to better identify features that would be desirable for more effective MTBFs. The ultimate aim could be to propose further initiatives ─ not necessarily legislative ones ─ to promote these features in Member States. IFIs are ready to cooperate with the Commission in this endeavour.

As for the second objective, progress could be made not necessarily by changing EU legislation but by fully implementing the existing one. For example, as already envisaged by the Stability and Growth Pact, Member States could better define their MTFF and present in the Stability Programmes the main expenditure and revenue aggregates of the general government in the short-to-medium-term and the main measures needed to reach both the short- and the medium-term objectives. Ideally, Stability Programmes could also indicate revenue and expenditure targets (ceilings or growth rates) resulting from the above measures.

## 2. The context

Since the establishment of the Stability and Growth Pact (SGP), at the EU level there have been proposals and some concrete steps towards introducing and reinforcing the multi–year framework of fiscal and budgetary policymaking.

In particular, for multilateral surveillance purposes the preventive arm of the SGP (Regulation n. 1466/97) requires Member States to submit to the Commission and to the Council stability programmes containing information for the current year and the next three years on the adjustment path of general government budget balances, expressed in ESA2010, towards the medium-term budgetary objective, the expected path of public debt, the planned growth path of government expenditure (including the allocations for public investment), the planned growth path of government revenue at unchanged policies and a quantification of the planned discretionary revenue measures.

Despite the significant amount of information requested by the Regulation, the surveillance procedures at EU level have been focusing on budget balances and public debt for the current year and the next one while overlooking the importance of monitoring the components of public budgets and of increasing the predictability of fiscal policy in the medium term.

Subsequently, the Council Directive 85/2011 on requirements for budgetary frameworks of the Member States has been a step forward in the efforts to promote pre-requisites and desirable standards for MTFFs and MTBFs of Member States. For example, the Directive introduces the obligation for Member States to have domestic plans for budgetary scenarios consistent with domestic fiscal rules and involving at least a three-year time horizon. Some of these provisions were better defined and reinforced by Regulation (EU) 473/2013, i.e. one of the regulations of the so-called "Two-pack". For example, this Regulation requires Member States to adopt a common timeline for national budget procedures, consistent with the EU timeline for fiscal surveillance.

It is worth recalling that the Directive 85/2011 itself provides for the Commission to publish a review of, inter alia, the suitability of: (a) the statistical requirements for all sub-sectors of government; (b) the design and effectiveness of numerical fiscal rules in the Member States; (c) the general level of transparency of public finances in the Member States.

In spring 2016, taking stock of the growing complexity of the European fiscal framework, the Dutch Presidency of the Council of the UE suggested an overhauling of the SGP, to improve predictability and transparency[1]. The proposal was focused around two tools: a) a single indicator, to be consistently applied in both the preventive and the corrective arm of the Pact, and b) a medium-term orientation.

Against a background of a large number of indicators employed in the SGP, the Presidency proposed to identify a single indicator that could serve as a real-time parameter for guiding

[1] Dutch Presidency's note (2016), *"Improving predictability and transparency of the Stability and Growth Pact"*, Informal ECOFIN, 23th April.

policymaking and for which policymakers can be held accountable ex-ante as well as ex-post. The Presidency pointed to an expenditure rule as an operational target that can help overcome current problems in fiscal surveillance.

As to the orientation, the Dutch presidency stressed that at present the cycle of European fiscal surveillance is foremost an annual cycle, where politicians are held accountable for year-on-year changes in unobservable indicators (structural balance). Against this background, a medium-term orientation could foster both the allocative efficiency of public finances and the implementation of structural reforms, improving policy makers' ownership of fiscal rules and enhancing their fiscal responsibility. According to the Presidency's proposal, the European fiscal framework should include the approval, at the European level, of national medium-term plans on main variables, such as the projected (structural) deficit path, while at the same time, monitoring, on a yearly basis, the execution of the plans, to ensure that annual budgetary obligations are met on a more operational variable such as the expenditure benchmark.

In April 2016, the Network of EU Independent Fiscal Institutions stressed that practical implementation of the Directive 85/2011 on budgetary frameworks has been uneven across countries and lagging behind with respect to MTBFs[2]. The Network thus proposed a number of actions, in cooperation with the European Commission, to provide impetus for national-level dialogue and initiatives concerning MTBFs, also with the view to reinforce the effectiveness of the EU fiscal framework.

Finally, in December 2017 the Commission proposed a "Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States", also with the aim of transposing the so called "Fiscal Compact" ─ i.e. Title III of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ─ into EU legislation[3].

The Commission Proposal requests euro area Member States and other Member States on a voluntary basis to set up a domestic framework of binding and permanent numerical fiscal rules. In particular, to maintain sound and sustainable public finances, the Directive establishes that there should be specific provisions in the national law to strengthen their fiscal responsibility and their medium-term budgetary orientation beyond the provisions of Directive 85/2011.

The proposed framework must in particular include two rules: 1) a medium-term objective in structural terms ensuring that the public debt ratio does not exceed 60 per cent or, if it is higher than this threshold, approaches it at a satisfactory pace; 2) a medium-term growth path of public expenditure net of discretionary revenue measures (DRMs) consistent with the medium-term objective or the adjustment path towards it. The net expenditure path must be set for the term of the legislature as soon as a new government takes office and must be respected by the annual budgets during the whole period. Some flexibility in the

[2] Network of EU Independent Fiscal Institutions (2016), "*Strengthening medium-term budgetary frameworks*", April.

[3] European Commission (2017), "*Proposal for a Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States"*, COM (2017) 824 final.

rules is allowed to take into account the implementation of structural reforms and the occurrence of exceptional circumstances.

Finally, the Proposal foresees that independent fiscal institutions (IFIs) have a stronger role in monitoring the respect and the implementation of the framework. In particular, in case of significant observed deviation from the rules, the IFIs should call on the budgetary authorities to activate a correction mechanism whereby measures are implemented to rectify the deviation over a defined period of time. Member States must ensure that budgetary authorities are subject to a "comply-or-justify" procedure vis-à-vis the recommendations issued by the IFIs in the context of their monitoring tasks.

## 3. Slippages of expenditure and budget balance forecasts in Stability Programmes

This section summarizes the main results of the empirical analysis conducted using public finance aggregates' estimates from 2011-2017 Stability Programmes (SPs). A more extended description of the results is presented in the Annex. The main aim is to show that revisions in budget-balance targets are not – per se – indicators of an inadequate medium-term perspective in budget decisions. A better indicator, though not perfect, is the stability of the expenditure paths, because a discretionary variable less influenced by the economic cycle.

To this purpose, some descriptive evidence is illustrated on the performance of several EU countries regarding stability of medium-term fiscal planning over the recent past. In particular, shifts in fiscal variables' forecasts over the various vintages of the programming documents are illustrated, looking at the stability of the entire planning horizon in each country.

On the one hand, the analysis explores to what extent revisions in fiscal programming have been linked to revisions in GDP projections, considering that accurate forecasts of business cycle developments are as difficult as essential to define a reliable medium-term fiscal strategy. On the other hand, the empirical investigation focuses also on revisions in expenditure developments (both in absolute values and as GDP ratio) that in principle should be less affected by the economic cycle. Thus, the degree of revisions of expenditures could be a better indicator of planning capacity as well as stability in policy priorities. Nonetheless, it is important to stress that this kind of evidence can be of some help in evaluating the effectiveness of the MTFF rather than that of the MTBF in each country.

As stressed by the MTBF-WG, some critical issues can arise concerning the data and the methodology of this exercise. First, an important issue regarding the data refers to the switch from ESA95 to ESA2010 (used in SPs 2015 for the first time), which prevents a consistent comparison of the targets. With respect to the methodology, doubts could arise on the reliability of the discretionary-component estimate of the budget revisions, carried out through the budget semi-elasticities used for the structural balance estimates, which are assumed to be constant over time. Moreover, further refinements of the analysis could cover also the stability of real expenditure aggregates, besides that of nominal expenditures, using the inflation forecasts contained in the SPs. Finally, the analysis is affected by (extraordinary) unanticipated expenditure – such as government interventions to support financial institutions. On this last point, more details can be found in the Annex.

Overall, the quantitative analysis shows evidence of moving targets and slippages in most countries. Slippages in both nominal and structural budget balances appear driven by many factors, which are difficult to disentangle. During the financial and economic crisis (2011-2013), increased uncertainty made it particularly difficult to gauge the true size of the cyclical phase, bringing about revisions in growth forecasts (included potential growth) and in budget balances forecasts. In general, there is a positive relation between revisions in economic growth forecasts and those of targets for budget balances, as it is expected. However, the correlation is relatively low and it is mostly driven by data points included in the 2014-2017 documents, whereas in the previous ones most countries adopted more pro-cyclical budget adjustments as downward revisions of GDP growth forecast went hand in hand with upward revisions of the budget balance. This kind of pro-cyclical bias is in part linked to the tendency of the EU methodology to underestimate – at least in some cases – the cyclical component of the budget balances in real-time, which in the current EU MTFF translates into budget constraints that are too loose in good times and too tight in bad ones.

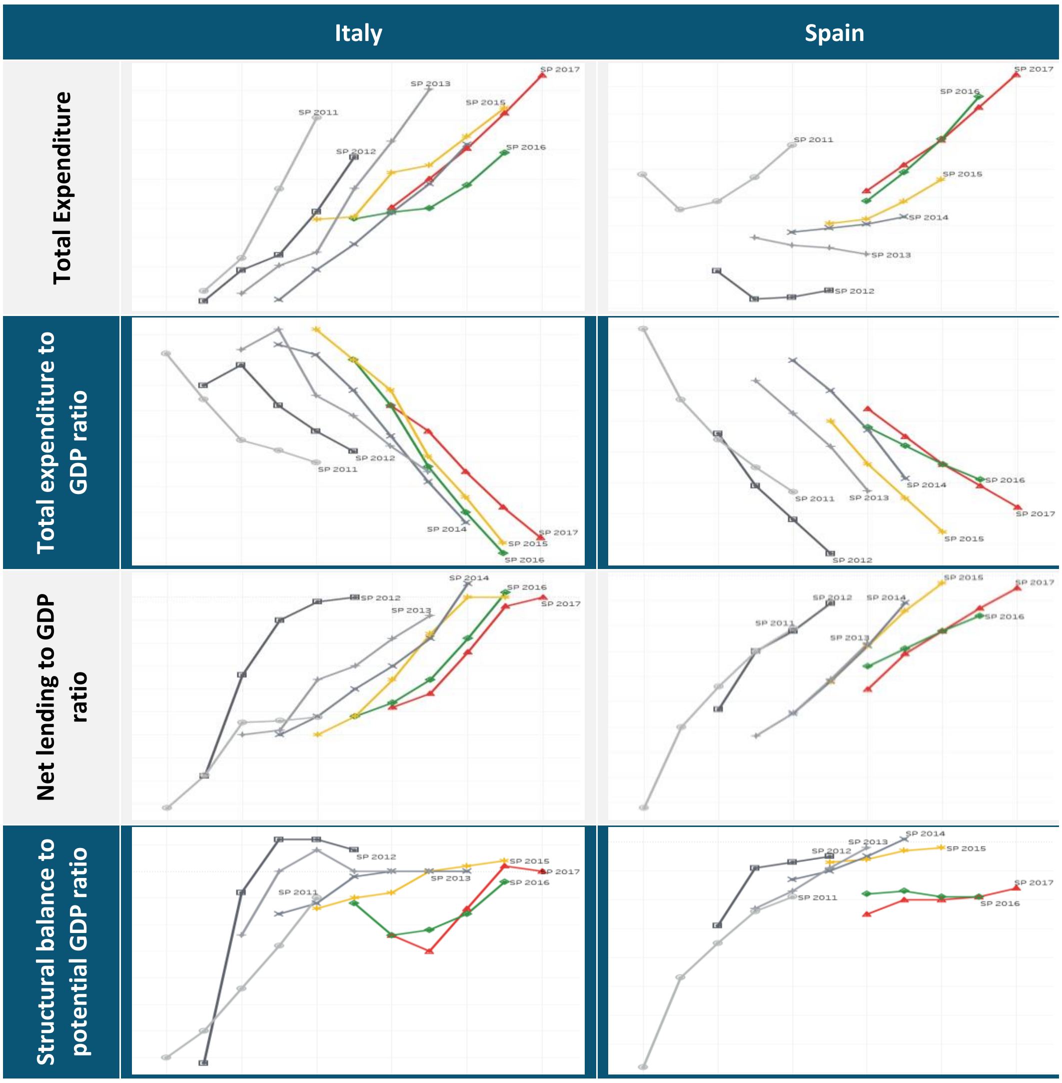
Expenditure data can help in assessing to what extent revisions of fiscal balance targets are due to (discretionary) revisions. Nominal expenditures (both total and primary) often show an upward path in each SP as expected. However, in those countries that were most exposed to the sovereign debt crisis, subsequent SPs have somewhat tried to offset this trend, shifting downward the expenditure path. This is especially true in the first part of the available time series, whereas in later years the same countries seem to have adopted a more counter-cyclical expenditure management approach. Other countries have managed to keep absolute value expenditure targets more stable, leading in some cases (also depending on business-cycle dynamics) to greater revisions of budget balances.

Expenditure-to-GDP ratios show a behaviour quite different from that of expenditure in absolute values. Indeed, the ratios usually show a downward path in each SP and mostly upward shifts over subsequent years, at least in larger countries where growth performances were in the mid-low range during the analysed time span. In smaller countries relatively high GDP growth rates made possible to reduce the expenditure to GDP ratios despite rising nominal spending.

Figures 1-2 provide examples of slippages in expenditure and budget balance targets in subsequent SPs for two couple of countries with quite different budgetary and fiscal frameworks.

Figure 1 shows that, in general, Italy and Spain have had the tendency to increase the deficit-to-GDP targets in the past few years. In many cases, this was due to the worse-than-expected economic performance due to the economic crisis. Indeed, in the same years the structural balance was much more stable, especially in Spain, with the exception of the SP2016.

**Figure 1** — Expenditure and budget balance targets in Italy and Spain
(millions of euros and percentage of GDP)



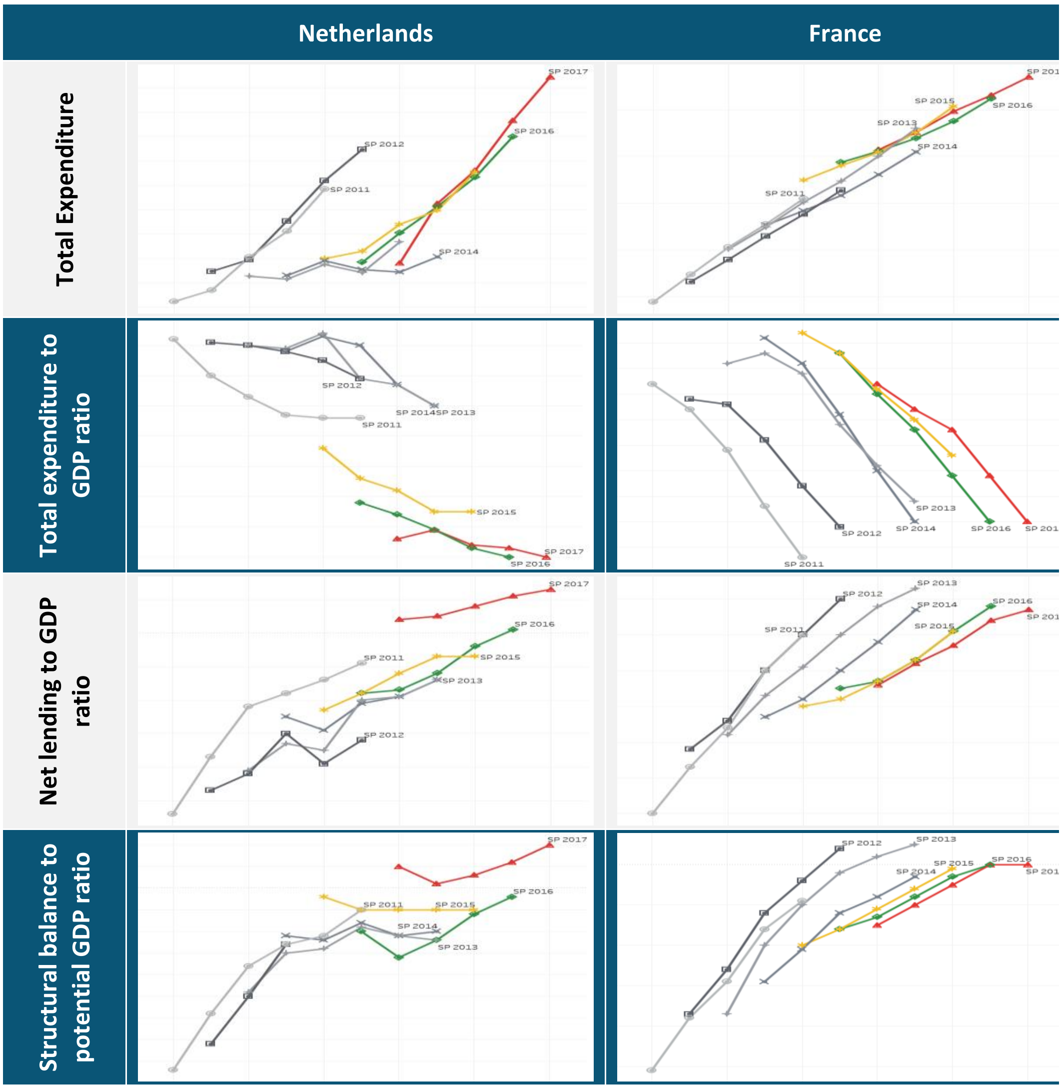

*Source: Stability Programmes from 2011 to 2017.*

Despite these similarities in the budget balance targets, the two countries show substantial differences in the revisions of expenditure targets. Indeed, with some notable exceptions, while in general over time Italy revised down the expenditure targets, Spain has been showing a tendency to revise them up. Because of the economic slump, however, in both countries upward shifts in the expenditure to GDP ratios are observed until a less tight fiscal stance supported the recovery.

As shown in Figure 2, even comparing countries with institutional settings potentially conducive to a more effective medium-term planning, like the Netherlands and France (see below), the data show considerable heterogeneity in the stability of macro-fiscal variables' forecasts. For example, France shows better performances than the Netherlands in programming expenditure in absolute value, an aggregate that should be easier to control for the government, while the opposite is true for nominal and structural balances, probably also thanks to a more favourable business cycle dynamics in the Netherlands.

The evidence summarized above reflects a different combination of several factors: business cycle developments could play a role, but also the design of institutions and their interaction with policy priorities is probably crucial. The rest of this paper focuses on a qualitative and institutional analysis to shed some light on these aspects.

**Figure 2** — Expenditure and budget balance targets in France and the Netherlands (millions of euro and percentage of GDP)




Source: Stability Programmes from 2011 to 2017 edition.

**Box 1A - Medium-term budgetary framework in the Netherlands**[4]

The Netherlands has a distinctive budgetary framework, centred on multiannual expenditures ceilings, with trend-based budgetary policy and longer-term perspective. This framework helps to ensure budget control and transparency, and it is considered a good example of national fiscal framework. Moreover, three additional elements of the unique Dutch model should be underlined: a) independent macroeconomics forecasts, b) non-partisan evaluation of the budget plans, both carried out by the national fiscal council, the Central Planning Bureau (CPB), and c) strong political commitment to adhere to the ceilings set at the start of the new legislature ─ as part of the agreement among the parties forming the parliamentary majority ─ over a term of 4 years.

*The MTFF*

The main target of the Dutch MTFF is the general government balance at the end of the government's term, which is based on the sustainability gap as calculated by the CPB at the start of the government's term. The sustainability gap is an important reference for the multiannual budget planning and represents the basis for the SBR's advice, a non-partisan national advisory group, which has issued recommendations on budgetary principles since 1971[5]. A balanced or positive position implies that current policy can be sustained without increasing the government deficit and debt in the long-run. In case of a negative sustainability gap, the SBR would usually recommend taking consolidation measures over the next legislative period[6].

*The MTBF*

Before elections, the CPB provides a macroeconomic medium-term scenario, called MLT, based on the assumption of unchanged policies; moreover, it provides political parties, on a voluntary basis, the opportunity to calculate the impact of their election manifestos on the medium-term scenario. The MLT serves as an important input for the report by the SBR. The SBR assesses the room for fiscal manoeuvre and defines quantitative budgetary objectives; it also assesses the effectiveness of the budgetary framework and may propose changes to budgetary rules[7]. Although not binding, the recommendations from the SBR usually have influenced the political party programmes and actual budgetary policies in the Netherlands.

After the elections, the CPB provides an update of the forecasts for the medium-term; after political negotiations, a new coalition government is formed, and the CPB calculates the impact of the new Coalition Agreement on the medium-term scenario. The Coalition Agreement and CPB's adjusted

[4] This box is based on the 2011 EPC's country fiche for the Netherlands, see European Commission (2012), *"Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review*", Occasional Papers n. 91/2012. Information and assessments on the Dutch framework are provided by Dutch Ministry of Finance (2013), "*Public finance in the Netherlands*"; Vierke, H., and M. Masselink (2017), *"The Dutch budgetary framework and the European fiscal rules",* European Commission, DGECFIN, Economic Brief 027*;* van Veldhuizen, S., (2018), "*The Dutch medium-term budgetary framework and the role of CPB*", intervention at the 12th meeting of the Network of Public Finance Economists, Brussel, 12 March 2018.

[5] The SBR consists of high-ranking officials from different ministries, the Director of CPB and the President of the Central Bank.

[6] Vierke and Masselink (2017) cit.

[7] The current trend-based budgetary planning, with multiannual fixed expenditure ceilings, was suggested for the first time by the SBR in 1993.

medium-term baseline are integrated in a new multi-annual budget by the Ministry of Finance (called Startnota). The new government determines budget targets for the next 4 years; these objectives include separate expenditure ceilings for three main budgetary areas: central government spending, social security, and health care. Thus, about 80 percent of total government expenditure is covered by the ceilings[8].

The new government changed the frame of the expenditure rules in November 2017. Indeed, following the SBR's advice, ceilings for the three budget categories are now initially set in nominal terms by the government at the beginning of its term, based on CPB's forecasts of wages and prices. Over time, the three ceiling levels are corrected additively for the estimated impact of updated CPB's forecasts during the government term. Moreover, the ceiling for social security is corrected over time for changes in business cycle related expenditure on social allowances during the government term. Furthermore, the Coalition Agreement sets benchmarks for the revenue side. Finally, it is worthwhile noting that in the Dutch framework local governments have their own targets, not necessarily a balanced budget.

Thus, the Dutch framework makes a strict distinction between the revenue and expenditure side. During the government's term, revenues act as automatic stabilisers and the attention of policymakers is focused on adhering to the expenditure ceilings set (in cash terms) by the Coalition Agreement. During the government's term, discretionary revenue-increasing measures cannot be used to finance expenditure in excess of the ceilings[9].

Monitoring of the MTBF is responsibility of the Ministry of Finance. Budget management is, to a large extent, delegated to the financial economic affairs directorates within line ministries. All government fiscal management policies are ultimately subject to scrutiny by the Court of Auditors. Expenditure ceilings have to be respected and in cases of overspending, the ministry directly responsible is held responsible for the required correction. If this is not feasible because of practical or political issues, the correction has to be made by the other ministries within the same sector for the expenditure ceiling. In exceptional cases, the correction can also be made by other sectors.

*The link with the EU fiscal framework*

The Law on Sustainable Government Finances, which implemented the provisions of the inter-governmental Treaty on Stability, Coordination and Growth (TSCG) into the national legal framework, has stated that measures shall be taken in case the deficit and debt thresholds, established at the EU level, are not respected, thus setting aside the trend-based framework[10]. Also the breach of the EU SGP's preventive arm rules (expenditure benchmark and path to the MTO) triggers corrective measures.

As underlined by Vierke and Masselink (2017), the Dutch framework does not necessarily ensure compliance with the European objectives. In fact, the track record with respect to the European fiscal

[8] Some expenses, such as interest payments on public debt, are not included in the ceilings. In the Netherlands, normally unemployment expenditure falls under the ceilings, but for pragmatic reasons this item was excluded from the limit during the recent economic and financial crisis. Moreover, also interventions in the financial system during the recent crisis were not included. See Sherwood, M., (2015), *"Medium-term budgetary frameworks in the EU Member States"*, European Economy, Discussion paper 021.

[9] Vierke and Masselink (2017) cit.

[10] Vierke and Masselink (2017) cit.

rules is mixed: since the introduction of the medium-term objective (MTO) under the Stability and Growth Pact, the Netherlands has deviated from the objective in most of the years.

Indeed, the Dutch MTBF is an example of potential frictions between a national framework, with a medium-term focus, and the European framework, with an annual focus. The outcome is a dilemma for Dutch policymakers, who use the same policy instruments to fulfil different policy objectives. Vierke and Masselink (2017) summarise the differences between the Dutch and the European frameworks (preventive arm of the SGP) as follows:

1) Long-term fiscal sustainability is assessed based on different indicators: the European "S2" indicator vs the Dutch sustainability gap, relatively more lenient[11];

2) The MTO is anchored in the Dutch legislation (Law on Sustainable Government Finances); however, it is not fully embedded in all national budgetary practices;

3) In the European framework, an annual (rolling) assessment of compliance with the MTO, where the European expenditure benchmark exerts a crucial role, is carried out, while national expenditure ceilings are fixed for 4 years;

4) Moreover, national ceilings and the European expenditure benchmark differ in the definition and treatment of certain budget items.

Finally, the objectives and benchmarks at European level are interlinked, at least in principle. Indeed, compliance with the expenditure benchmark would lead to compliance with the MTO, which ensures in turn a sustainable path in the long-run. This consistency is currently not reflected in the Dutch national framework.

*Annual budgeting*

It should be noted that there is a direct link between the annual budget and the MTBF, as annual budgets should be in line with the Coalition Agreement. It is also worthwhile noting that the procedure to set the annual budget for year t+1 begins in September/October of year t-1, when the Minister of Finance sends a 'budget notice' to the other Ministers, which contains technical and procedural instructions, which the Ministers must follow when drawing up their departmental budgets. In February/March of year t, Ministers send policy letters to the Minister of Finance, with policy priorities.

In March/April of year t, the Minister of Finance sets out in the "framework letter" the "possibilities and the problems" for the forthcoming budget, including cuts to be made in one or more of the 3 sectors (i.e. central government, social security and health care). In May of year t, the Council of Ministers decides on the main outlines of the budget and defines the "budget totals letter". The "budget totals letter" contains a summary of the decisions taken based on the "framework letter" and sets the total budget by ministry for the coming budget year. It thus sets the maximum limits for the departmental budgets. In mid-June of year t, Ministers submit initial draft budgets to the Ministry of Finance.

[11] The S2 indicator shows the required adjustment of the structural primary balance needed to stabilise the debt ratio over an infinite horizon, accounting for additional expenditure linked to an ageing society.

The final decisions on the budget is taken by the Council of Ministers, in August of year t, after the CPB has published its updated macro-economic outlook, taking into account the list of all new policy measures provided by the Ministry of Finance. Before 1 September of year t, the central government budget and the Budget Memorandum are submitted to the Council of State for an advisory opinion. Finally, the Minister of Finance presents the government's budget proposals and the Budget Memorandum for the year t+1 to the House of Representatives on the third Tuesday in September of year t, or Budget Day[12].

In the debate at the House of the Representatives, amendments, i.e. direct changes to the bill, are allowed, and have to be voted by the House. Motions, also allowed, are a request to the responsible Minister to change the budget or a policy. If an amendment entails an increase in spending, it is an unwritten rule that the House of Representatives also stipulates where the financing should come from. The approval process in the House of Representatives is concluded by voting on the amendments and on the budget bill as a whole. Once approved by the House of Representatives, the budget bill, amended or otherwise, is sent to the Senate. The Senate cannot make any changes to the bill, it can only approve or reject it as a whole[13].

**Box 1B - Medium-term budgetary framework in France[14]**

In 2008, in order to set a proper MTFF, an amendment to the French Constitution introduced public finance programming laws and the general principle of consistency of the multiannual guidelines for public finances, with the objective of balanced budget for the public administration.

Since 1996, fiscal strategy for the State budget has been based on an expenditure rule, which has generally been respected. However, the containment of public spending of other sub-sectors has been difficult, in particular local governments' spending. Therefore, over the years enforcing the expenditure rule and ensuring its credibility, both in budget preparation and execution, has become crucial for fiscal discipline[15].

*The MTFF*

In 2012, a French constitutional bylaw (Organic Law) implemented the inter-governmental Treaty on Stability, Coordination and Growth (TSCG) in national law. The 2012 Organic Law n. 1403/2012 (Loi organique relative à la programmation et à la gouvernance des finances publiques, LOPGFP) better defined the content of the public finance programming law (Loi de programmation des finances publiques, LPFP), which had been introduced by the Constitutional reform of 2008, with a view to provide medium-term guidelines for public finances[16].

[12] Dutch Ministry of Finance (2013) cit.
[13] Dutch Ministry of Finance (2013) cit.
[14] This box is based mainly on von Trapp, L., I. Lienert, and J. Wehner, (2015), "*Principles for independent fiscal institutions and case studies*", OECD Journal on Budgeting, Vol. 2/2015, and IMF (2014), *"G-20 budget institutions - Country valuations"*, IMF Policy Paper.
[15] Duplay, R., (2017), *"The French experience with developing a medium-term budget framework*", presentation at Italy's Ministry of Finance, Rome.
[16] The constitutional reform of July 2008 established a new category of law for defining multi-annual guidelines for public finances, while striving towards balanced budgets. This reform transposed in the domestic framework the contents of the Stability programmes, which did not have any legal status in national law.

The Organic Law states that the LPFP has to set a numerical target for general government deficit, both in nominal terms ─ with the break-up into general government's sub-sectors ─ and structural terms, over at least the next three years, and the structural adjustment effort for each fiscal year of the programming period, with a view to achieving the government's MTO. The 2012 Organic Law defines a procedural rule rather than a numerical one. Indeed, numerical fiscal targets are set in the LPFP, not in the Organic Law, though the latter contains many references to the EU Stability and Growth Pact objectives[17]. Indeed, the Organic Law specifies that a multiyear budgeting approach must be adopted with which annual budgets must comply.

Moreover, the 2012 Organic Law established the national fiscal council, the Haut Conseil des finances publiques (HCFP), and a correction mechanism, over which the HCFP plays a central role[18].

The 2012 Organic Law also introduced in budget laws and budget settlement laws an "introductory article" (article liminaire), outlining the forecasted structural and nominal balance, expressed in national accounting, for the general government.

*The MTBF*

The LPFPs are approved every two years (in general) and cover a period of at least three years. The LPFP covers the State budget (30 percent of general government expenditure) in detail (figures for each State budget's mission are provided) and the social security funds (40 percent of general government expenditure) in aggregate terms. State expenses are planned for three years and strictly capped for two years in nominal terms. The LPFPs establish targets for social security for three years, and also for health Insurance. A mechanism that facilitates the meeting of targets for health spending is in place.

Currently, the State budget is structured around several instruments[19] in the LPFP:

a) A volume rule (in force since 2004): state expenditure is frozen in volume (real terms).

b) A nominal rule (effective since 2011): state expenditure, excluding interest payments on debt and pensions of civil servants, is frozen in nominal terms; between rule a) and rule b), the stricter applies. Since the inception, this double rule has been broadly respected.

c) Three-year ceilings on spending for the state's budget missions, set every two years for a three-year period.

d) The so-called cross-cutting rules, which apply to certain spending categories: e.g. replacing only one out of every two retiring central government workers (staff costs), multi-year objectives to reduce operating expenditure, etc.

It is worthwhile noting that there is still a weak monitoring power of government on certain components of public administration, namely, local governments and funds managed by social

[17] Chevauchez, B., (2013), "*A PFM view of the new French Loi Organique*", Public financial management blog, IMF, http://blog-pfm.imf.org/pfmblog/2013/10/a-pfm-view-of-the-new-french-loi-organique.html.
[18] von Trapp, Lienert and Wehner (2015) cit.
[19] von Trapp, Lienert, and Wehner (2015) cit.

partners[20]. For example, a freeze (in volume and then in value) on central government financial assistance to local authorities (collectivités territoriales) has been established. Indeed, a decrease in the endowment to local authorities was observed between 2015 and 2017. Moreover, the Public Finance Programming Law for 2014-2019 of December 2014 has established a national target for the evolution of local governments' expenditure, however this target is not binding[21].

*The link with the EU fiscal framework*

The framework centred on the LPFPs has been assessed by the European Commission as compliant with the TSCG requirement of being "of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes"[22].

*Annual budgeting and the Social Security Financing Law*

Annual budget preparation follows a strict top-down sequence. The State budget is prepared within the limit of the annual aggregate and ministerial expenditure targets fixed in the LPFP[23].

The annual budget preparation starts with the definition of the strategic directions in the Budget Department of the Ministry of Finance in February-April[24]. The preparatory work allows the Prime Minister to address to his Ministers by April what is called the "lettre de cadrage", which sets the financial objectives of the government. Negotiations with ministries occur in April-June. Then the Prime Minister sends the "lettres plafonds", which fix the maximum amount of resources per mission and the maximum number of employees per department. During the summer, the draft budget law is finalized by the government. One week before its presentation, the text is sent to the High Council of Public Finance, whose opinion focuses on the consistency of the article liminaire with France's multi-year commitments (set in the LPFP) based on an assessment of the credibility of macroeconomic forecasts and the structural balance. Finally, the budget bill is adopted by the Council of Ministers in September and must be submitted to the National Assembly (Assemblée nationale) by the first Tuesday of October.

The 2001 Organic Budget Law (LOLF)[25] requires the budget bill to be accompanied by several documents, including an overall economic and fiscal outlook covering at least four years, new measures and their relationship with existing policies, performance-related information for programmes, as well as estimates of tax expenditures[26].

The government, on a yearly basis, must submit also the Social Security Financing Bill. Within the Social Security Financing Law, every year the ONDAM (National Health Insurance expenditure target) is set. The ONDAM has helped control the evolution of health expenditure, which amounts

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[20] Monier, F., (2016), "*Medium-term budgetary framework in France*", presentation at the OECD.
[21] Monier (2016) cit.
[22] European Commission (2017), "*Report from the Commission presented under Article 8 of the TSCG in the Economic and Monetary Union*", Country Annex, France, C (2017) 1201 final.
[23] IMF (2014) cit.
[24] Duplay (2017) cit.
[25] *Loi organique relative aux lois de finances*, LOLF. The LOLF overhauled the structure of the State budget, introducing about 30 missions (public policies) and about 140 programs.
[26] von Trapp, Lienert and Wehner, (2015) cit.

to 15 percent of total general government spending. The ONDAM, which is a French peculiarity, has the following main features, which have contributed to its success in allowing meeting targets: 1) existence of an “alert committee”, which closely monitors the monthly evolution of health insurance expenditure; 2) appropriations “put in reserve” at the beginning of the year, which may be frozen at the end of the year, if necessary; 3) existence of an “alert mechanism”, which obliges the government to take quick corrective measures, if the alert committee anticipates slippages. Until now, the alert mechanism has been implemented only once, in 2007.

Allocation between missions in the annual budget may be different from the original LPFP, but this has to be justified in the budget documentation[27]. While the LPFPs do not constitute formal legal constraints, the Court of Auditors (Cour des Comptes) assesses ex- post compliance with them when it audits implementation of the budget Law[28].

While LPFP's rules for the budget (volume and nominal rules) are set independently, the relevant balances at EU level offer guidance for the drafting of the annual budget. Occasionally, the annual update to the Stability Programme (SP) has been more ambitious than the LPFP in force at that time, also upon European Commission's request.

[27] IMF (2014) cit.
[28] von Trapp, Lienert and Wehner, (2015) cit.

## 4. MTBF: common understanding on definitions[29]

The debates on MTBFs and MTFFs are often mixed up and overlapped, since most of the time the two aspects are being treated as if they were the same institutional arrangements. This section aims to clarify the distinction between MTBFs and MTFFs, at the same time stressing the links between the two needed for a smooth functioning of the budget process.

MTBFs are defined as those arrangements that allow governments to extend the horizon for fiscal policy making beyond the fiscal year[30]. MTBFs should serve as a multiannual path for fiscal policy, with a guiding role for the yearly budgeting process. It is a tool to ensure that annual targets for the key fiscal parameters are set within a medium-term timeframe in line with the strategic fiscal policy objectives[31].

MTBFs are a framework for integrating fiscal policy and budgeting over the medium term by linking a system of aggregate fiscal forecasts to a disciplined budget process; a set of institutional arrangements for prioritizing, presenting and managing revenues and expenditures in a multi annual perspective[32].

However, these definitions are very general and therefore cannot deliver the complexity that MTBFs involve and require.

In particular, these definitions seem not to properly distinguish MTBFs and MTFFs. MTFFs consist in standing requirements to commit to, report against, and hence be held accountable for medium-term aggregate fiscal objectives (such as debt limits, deficit ceilings and so on) generally at the aggregate fiscal level (e.g., general government) relevant for macro-economic stability. MTBFs consist of institutional arrangements translating the MTFF onto the budget process, typically central government. As such, they require presenting certain medium term financial information at specific times, procedures for making multi-year forecasts and plans for revenues and expenditures, and obligations to set numerical expenditure targets beyond the annual budget horizon[33].

The OECD – increasing the complexity of the terminology used – adopts, in its Budgeting Practice and Procedures Survey, the term Medium Term Expenditure Framework (MTEF) as a synonym of MTBF. According to the OECD, MTEF is a framework for integrating fiscal policy and budgeting over the medium term by linking a system of aggregate fiscal forecasting to a disciplined process of maintaining detailed medium term budget estimates by ministries reflecting existing government policies. Forward estimates of expenditures become the basis of budget negotiations in the years following the budget to be reconciled with the final outcomes in fiscal outcome reports.

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[29] Definitions reported in this section are quotes from the publications mentioned in the text.

[30] European Commission, Note to the Alternates, January 2017.

[31] Sherwood, M., (2015), "*Medium-term budgetary frameworks in the EU Member States*", Discussion Paper 021, December.

[32] Harris, J., R. Hughes, G. Ljungman, and C. Sateriale (2013), "*Medium-term budget frameworks in advanced economies: Objectives, design, and performance*", Chapter 4 in "*Public financial management and its emerging architecture*", edited by M. Cangiano, T. Curristine, and M. Lazare, IMF.

[33] Harris, Hughes, Ljungman and Sateriale (2013) cit.

Also the World Bank adopts a similar terminology[34]. "MTEF translate macro-fiscal objectives and constraints into broad budget aggregates and detailed expenditure plans, guided by strategic expenditure priorities. With macro-fiscal policy increasingly being framed in a medium-term context, guided by debt sustainability analysis, multiyear fiscal targeting and in some cases permanent fiscal rules, MTEF establish a formal link between broad fiscal policy objectives and budgeting, which can strengthen the credibility of both" (World Bank, 2013, p. 8).

Domestic MTBFs have four key features in common (Cangiano et al, 2013):

- Multiyear expenditure limits that define the nature, level and terms of the restrictions being placed on future budget decisions;
- Expenditure prioritization mechanisms that ensure that expenditure is allocated within those multi-year restrictions in a manner that reflects government policy priorities;
- Forward looking expenditure controls through which the consistency of updated medium-term expenditure projections with approved medium-term expenditure plans is monitored and enforced;
- Dynamic accountability arrangements through which adherence to stated medium-term objectives can be assessed by parliament and the general public over time.

To sum up and clarify these definitions, MTBFs are procedures and tools devoted to translate multiannual fiscal targets into annual budgets. To this aim, MTBFs "speak the language" of national budgets, they are articulated in terms of budgetary accounting standard (often cash, nominal or real) and rely on budget classifications (often missions and programs), in such a way to be easily reconciled with the appropriations voted on by Parliament. Thus, even a more detailed exposition of tax and spending targets to be published in Stability and Convergence Programmes (SPs) could not be considered a proper MTBF, as it would adopt ESA 2010 in coverage and accounting criteria and thus follow the economic classification (and not the budgetary one).

According to the distinction between MTFFs and MTBFs and relying on above-mentioned definitions, it can be said that EU countries share a common MTFF, defined by the SGP and in general by the procedures of the European Semester, while differ in terms of domestic arrangements for translating the MTFF targets into multi-year budgeting (MTBFs). Indeed, under the European Semester all Member States are subject to common fiscal rules and reporting criteria, being requested to present annually SPs where they provide medium-term macroeconomic and fiscal forecasts for the whole of the general government sector.

Besides the EU MTFF, some countries are also characterized by a domestic MTFF to which a domestic MTBF is connected. The Netherlands and France are two examples of which more details are provided in Boxes 1A and 1B. In fact, some EU countries have a fully-developed MTBF, i.e. a framework setting multi-year spending plans as an intermediate step between the MTFF and the annual budget. None of them appear to be a derivation

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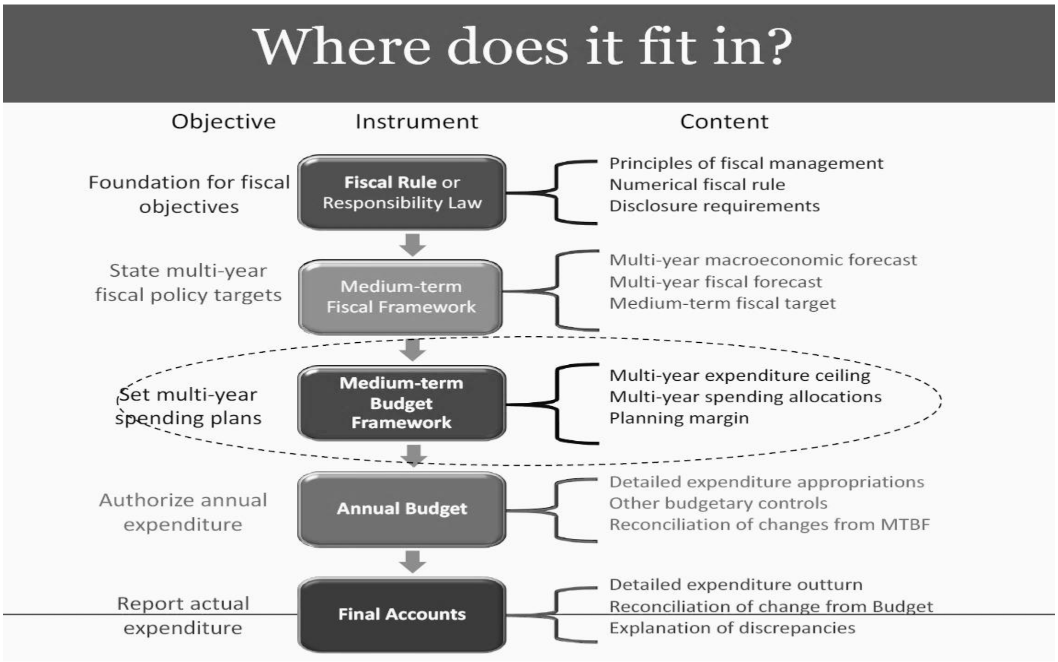
[34] World Bank (2013), "*Beyond the annual budget*".

from the SPs, but they were originally established as a set of procedures and tools not necessarily connected with the EU MTFF.




Source: Cangiano, M., (2017), "Presentation at the workshop on Top-Down Budgeting and MTBFs", RGS-MEF, Rome, February.

## *4.1* Other remarks on MTBF definitions

MTEFs constitute an approach to budgeting and public financial management (PFM) that addresses well-known shortcomings of annual budgeting, including short sightedness, conservatism, and parochialism (Wildavsky, 1986; quoted in World Bank, 2013).

In the past, not only in emerging but also in advanced countries, the government presented (and parliament approved) annual budgets. MTBFs or MTEFs were suggested to contrast the limitations coming from the annual perspective in budgetary decisions. The evolution to a medium-term dimension relied on transforming the bottom-up approach of annual budgets into a top-down, multi-annual approach, with the identification of general envelopes for public policies, where multiannual expenditure targets were set to support, within agreed budget balance constraints, proper allocation among priorities. However, MTBFs have always been related to a budgetary dimension rather than a macro-fiscal one, with a direct connection with annual budgets.

The ability of MTBFs to generate good fiscal performance, leaving aside the policies MTBFs are tasked to deliver, derives from their impact on the quality of budgeting and budget credibility. Contributing to stable revenue policies and spending decisions is crucial for giving more certainty to operators' expectations regarding the impact of the public sector in the economy. MTBFs help to reduce shortcomings of annual budgeting by achieving the following:

- budget realism (mainly on the revenue side);
- spending driven by medium-term sector strategies;
- budget presenting multiyear spending plans beyond the budget year (reasonable assurance about the resources spending departments are likely to receive over the medium term);
- greater fiscal transparency and accountability (provide a clear cut mechanism for monitoring government performance against approved plans).

MTBFs are a set of institutional arrangements intended to help governments to make sound fiscal policies. When an MTBF is implemented well, public expenditure is limited by the availability of resources, budget allocations reflect spending priorities and public goods and services are delivered cost-effectively.

## *4.2* MTBF: pros and cons of numerical indicators

The European Commission has made a considerable effort for evaluating the effectiveness of domestic MTBFs in EU countries. An extensive questionnaire was developed to create a database on MTBF characteristics on the basis of which numerical indices were developed. The questionnaire was recently updated (2015) to take into account the transposition of the EU fiscal framework in national legislation and rules, which was carried out in many countries during the previous years.

However, in general comparative approaches through questionnaires and numerical indicators have been the objects of several criticisms by part of the economic literature that has stressed the problems in using numerical indices to describe complex institutional aspects. Indeed, these indicators cannot capture all the factors and characteristics underpinning the different fiscal frameworks. In particular, one of the main criticisms is that these indicators measure the existence of normative-based best practices rather than actual implementation of MTBFs and their effectiveness in the context of the domestic budget process.

While highlighting the aforementioned critical issues, the literature has reckoned that the use of numerical indicators has been gaining large popularity, because of their simplicity, although at the cost of being somewhat simplistic, and even counterintuitive in some cases[35]. Indeed, indicators provide synthetic information of complex phenomenon, and may be useful for conducting ad-hoc analysis. However, it should be stressed the risk to use these indicators for country rating or ranking; the myopic use of these metrics should be avoided.

Numerical indicators have indeed the advantage of offering synthetic and comparable information. For this reason, it might be preferable not to abandon the pursuit of a quantitative measurement of MTBF effectiveness in each country, but trying to give a

[35] There is a rich and rapidly growing literature on “de jure vs de facto” reforms. Among others, Matt, A., (2013)*"The limits of institutional reform in development: Changing rules for realistic solutions"*, Cambridge University Press. Many items discussed for low income countries (LICs) appear also applicable to advanced economies.

contribution to progressively overcome the weaknesses and limitations that have been emphasized by the literature.

A first objective could be to increase the accuracy of the EU questionnaire, adding questions aimed to capture the actual implementation of MTBFs, rather than describing the mere formal legal-basis existence of their main characteristics.

A contribution to this effort could be provided by national IFIs, some of which find that the scoring based on the answers to the Commission questionnaire on their countries does not reflect entirely their perception about the effective implementation of the domestic MTBF. For example, IFIs could provide a critical assessment of the answers provided by governments to the EU questionnaire.

Nevertheless, although the informative basis for the numerical indicator can be improved, this quantitative information should be supported by a qualitative one through a more narrative approach based on common-ground criteria agreed by the Commission, governments and IFIs.

# 5. MTBFs: relationship with EU fiscal rules

This section aims at analysing the complex relationship between EU fiscal rules and domestic MTBFs. While EU Member States share a common MTFF, in the form of the Stability Programmes, they do not necessarily adopt a common set of national medium term budgetary arrangements. The question is whether the EU economic governance is consistent with an effective domestic MTBF, sustaining the development of a medium-term perspective in budgeting.

Trying to develop a proper MTBF from the EU fiscal framework could prove to be challenging.

The Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States provides for some common requisites and general principles (see Box 2). However, these requisites appear to refer to fiscal plans (for example, the Directive asks for general government figures), do not discuss about setting numerical expenditure limits beyond the annual budget horizon (only incidentally it mentions expenditure projections) and does not point to the need for a stronger link between medium-term fiscal plans and annual budgets, or the need for proper medium-term budgeting. Using the definitions presented in Chapter 4, the Directive language seems not to properly distinguish between MTFF and MTBF. It appears to increase the requirements and contents of the MTFF (that in many countries coincides with the Stability and Convergence Programmes).

Some elements of the EU MTFF may be at odds with the idea itself of medium term budgetary planning.

The timeline of the European Semester and that of the domestic political budgetary decisions, including on implementation, should be consistent. Even though national timelines for the presentation and approval of budget documents to Parliament are being made more consistent with the EU Semester, the budget preparation usually starts early each year, very often before the finalisation of targets at the EU level that takes place in June or (sometimes more recently) even in October. Therefore, if the EU institutions requested more ambitious targets than the ones underlying the rate of evolution entrenched in the MTBF previously established by the government, this would imply a weakening of the reliability of the domestic budgetary framework itself.

Moreover, in the context of the fiscal surveillance process of the European Semester, the MTFF covers only the current and the following year, providing only general comments for the medium term (also because the European Commission provides macroeconomic forecasts only for t+1).

**Box 2 - Extracts from Public Finances in EMU 2014**

Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States (henceforth "budgetary frameworks directive") which calls for the Member States to have in place, among other things, medium-term budgetary frameworks at national level by 31 December 2013. The directive follows mainly the "procedural" approach and defines an MTBF as a specific set of national budgetary procedures that extend the horizon for fiscal policy-making beyond the annual budgetary calendar, including the setting of policy priorities and of medium-term budgetary objectives.

According to Article 9.1 "Member States shall establish a credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning horizon of at least three years, to ensure that national fiscal planning follows a multiannual fiscal planning perspective".

Furthermore, the directive introduces a list of items for the production of which there should be dedicated procedures in place. This list includes:

a) comprehensive and transparent multiannual budgetary objectives in terms of the general government deficit, debt and any other summary fiscal indicator such as expenditure, ensuring that these are consistent with any numerical fiscal rules;

b) projections of each major expenditure and revenue item of the general government with more specifications on the central government and social security level, for the budget year and beyond, based on unchanged policies;

c) a description of medium-term policies envisaged with an impact on general government finances, broken down by major revenue and expenditure item, showing how the adjustment towards the medium-term budgetary objectives is achieved compared to projections under unchanged policies;

d) an assessment as to how in the light of their direct long-term impact on general government finances, the policies envisaged are likely to affect the long-term sustainability of the public finances.

Article 9.3 requires Member States to base their budgetary projections on realistic macroeconomic and budgetary forecasts. According to Article 10 Member States should make sure that their annual budgets are consistent with multiannual fiscal planning stemming from the national medium-term budgetary frameworks. Article 11 refers to the possibility for a new government taking office to "update its medium-term budgetary framework to reflect its new policy priorities", from which one can infer that in this particular case the MTBF also concerns the set of numbers and not only the underlying procedures.

Lastly, the process of frequent adjustments or revisions of an evolving interpretation of the fiscal rules could come at the expense of an effective multiannual planning capacity. For example, the domestic expenditure rules (or expenditure ceilings) have to ensure consistency between multiannual budget allocations and the supranational medium term fiscal targets[36]. Hence the domestic MTBF would need to be changed every year as a response to changing fiscal targets, unless planning reserves are in place[37]. In addition, the instability of results coming from the EU methodology based on the structural balance, an unobservable variable, could imply the breaking of the EU rules, while respecting the domestic ones, especially if they are based on observable parameters.

Focusing on expenditure rules, the domestic ones are usually set up in such a way as to drive budget preparation. In contrast, the one defined at the EU level aims to monitor fiscal performance (as any spending slippage is tolerated as long as is financed by discretionary revenue increases) and, moreover, it is prepared only for the current and the following year. In addition, in both cases these rules should ideally provide targets that are as stable as

[36] Moreover adjustment mechanisms should be defined to ensure a certain degree of resilience of the multiannual budgetary plans when facing minor exogenous shocks, so to maintain safety margins from the fiscal targets.

[37] It is worth noting that well-functioning MTBFs have some built-in flexibility that takes the form of planning (policy) reserves and/or contingencies.

possible. Nonetheless, at the EU level, absent any "freezing" procedure, the so called "expenditure benchmark", set as a 10-year average of potential growth estimates, would show substantial revisions over the years in case of revisions of potential growth estimates, as shown in the columns of Table 1. For example, for Italy the ex-ante expenditure benchmark in 2012 would have been 0.5 percent, according to the Commission's 2011 Spring Forecasts. However, ex post the benchmark should have been only 0.04 per cent according to the 2013 Spring forecasts. Moreover, still for the instability of potential growth estimates, the ex ante expenditure benchmark moves substantially each year compared to the previous ones, which is also an undesirable feature for an operational expenditure rule, as shown in the diagonals of Table 1. These revisions could put into question also the stability of the multiannual budgetary allocations provided for by the national expenditure rules.

The recent Proposal by the Commission for a "Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States" could be an opportunity for EU countries to solve some conflicts between the EU framework and the domestic one. Indeed since it is based on a medium term growth path of public expenditure, net of discretionary measures, consistent with the medium term objective, the Directive foresees a MTFF able to shape a domestic MTBF consistent and integrated with the EU Framework.

**Table 1** — EU expenditure benchmarks
(10-year average of potential GDP growth rate)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| **FRANCE** | | | | | | | |
| 2011 SF | 1,68 | | | | | | |
| 2012 SF | 1,34 | 1,26 | | | | | |
| 2013 SF | 1,19 | 1,14 | 1,10 | | | | |
| 2014 SF | 1,23 | 1,19 | 1,15 | 1,13 | | | |
| 2015 SF | 1,19 | 1,13 | 1,08 | 1,05 | 1,07 | | |
| 2016 SF | 1,15 | 1,08 | 1,02 | 0,97 | 0,99 | 0,99 | |
| 2017 SF | 1,16 | 1,10 | 1,05 | 1,02 | 1,05 | 1,06 | 1,06 |
| **ITALY** | | | | | | | |
| 2011 SF | 0,50 | | | | | | |
| 2012 SF | 0,17 | 0,15 | | | | | |
| 2013 SF | 0,04 | 0,00 | -0,04 | | | | |
| 2014 SF | 0,04 | -0,01 | -0,05 | -0,02 | | | |
| 2015 SF | -0,13 | -0,22 | -0,27 | -0,23 | -0,13 | | |
| 2016 SF | -0,17 | -0,28 | -0,35 | -0,33 | -0,23 | -0,12 | |
| 2017 SF | -0,12 | -0,23 | -0,31 | -0,30 | -0,22 | -0,13 | -0,08 |
| **NETHERLANDS** | | | | | | | |
| 2011 SF | 1,52 | | | | | | |
| 2012 SF | 1,33 | 1,29 | | | | | |
| 2013 SF | 0,90 | 0,82 | 0,75 | | | | |
| 2014 SF | 0,84 | 0,74 | 0,67 | 0,60 | | | |
| 2015 SF | 0,97 | 0,85 | 0,75 | 0,66 | 0,64 | | |
| 2016 SF | 0,92 | 0,85 | 0,79 | 0,74 | 0,74 | 0,78 | |
| 2017 SF | 1,02 | 0,97 | 0,93 | 0,90 | 0,95 | 1,02 | 1,06 |
| **SPAIN** | | | | | | | |
| 2011 SF | 1,41 | | | | | | |
| 2012 SF | 0,84 | 0,63 | | | | | |
| 2013 SF | 0,55 | 0,24 | -0,01 | | | | |
| 2014 SF | 1,14 | 0,85 | 0,57 | 0,37 | | | |
| 2015 SF | 1,18 | 0,88 | 0,58 | 0,39 | 0,37 | | |
| 2016 SF | 1,05 | 0,74 | 0,44 | 0,23 | 0,19 | 0,16 | |
| 2017 SF | 1,11 | 0,80 | 0,51 | 0,32 | 0,31 | 0,29 | 0,33 |

Source: European Commission Spring Forecast (SF), 2011-2017 editions.

# 6. MTBF: desirable features

## *6.1* MTBFs: preconditions

To build an effective MTBF, with the aim of integrating the annual budgets in a medium-term perspective, some preconditions must be fulfilled and a certain number of key factors have to be shaped.

The preconditions which must be fulfilled before defining multiannual budgetary targets and rules concern:

- The availability of unbiased macroeconomic forecasts to be used in the budgetary projections. Reliable data and forecasts, presented in a transparent and detailed way, enable greater accountability and thus stronger political responsibility. For this reason, the EU rules require that each country adopt macroeconomic forecasts produced or endorsed by independent fiscal institutions. Several studies have highlighted that this process has effectively improved the quality of official macroeconomic forecasts.

- The accurate formulation of baseline no-policy-change expenditure projections (as the revenue side of the budget is more closely linked to the reliability of the macroeconomic forecasts). Before fixing fiscal targets or defining multiannual expenditure ceilings, it is necessary a full understanding of the public finance implications of current policy commitments over the medium term. If an MTBF was fully implemented in the past, no need to change already approved spending actions should arise. If unforeseen events determined this need, knowing detailed medium-term projections of existing spending commitments would be essential for the political decision on which spending item to modify.

- The ability of MTBFs in delivering fiscal discipline depends also on developments of the revenue side. Indeed, prudence in forecasting revenues (budget realism) is an important prerequisite for a proper MTBF. Moreover, an effective in-year monitoring of developments on the revenue side is warranted. Both prudent forecasting and proper monitoring of revenues complement expenditure rules in the aim to stabilize public finances outcomes. This fosters in turn the stability of economic agents' expectations.

- In this context, any fiscal reform changing the overall design or the structural parameters of the tax system should preferably be announced by the government at the beginning of the legislature with an already planned timeline for its implementation, so that the expected changes in revenues are considered when deciding the expenditure growth needed to reach the medium-term anchor. Tax reductions decided after the MTBF parameters have already been stated, should be compensated only with measures on the revenue side.

- Moreover, rules on revenue windfalls ─ i.e. revenues on top of those that could be expected from macroeconomic outcomes and "benchmark" tax elasticities ─ are required. In principle, windfalls should be 'saved' to compensate for possible future shortfalls and should not be used to finance new policies. Indeed, the Dutch system does not allow windfalls on the revenue side of the budget to be used for additional spending. New policies are paid for by economizing on or abolishing existing arrangements. In France, a rule, concerning central government and social security, states that any windfall revenues must be used to reduce general government deficit[38]. In many instances, however, political pressures for spending at least part of revenue windfalls could arise and in these cases, it is advisable to state in advance a certain percentage of the windfall that is allowed to be used, avoiding policies that raise spending permanently.

## *6.2* MTBFs: key factors

Some key factors have to be in place to make an MTBF work properly. A prerequisite is that annual budgets of the period covered by each MTBF have to be properly linked with the MTBF itself.

### 6.2.1 Setting the top-down procedures for the definition of targets and ceilings

The national budgetary procedures should adopt a **top-down approach** to domestic budget preparation, with the prior definition of the overall medium term fiscal targets in terms of budget balances and fiscal macro-aggregates to be translated in operational targets. To this effect, countries having domestic MTBFs generally define a set of expenditure rules aimed to limit the evolution of spending. Other rules are generally set to influence the composition of spending.

A top-down approach implies that:

1. Fiscal targets have to be set in terms of their compatibility with other relevant macroeconomic targets and forecast. The macro-fiscal targets, articulated in planned expenditures and revenues, have to be translated into budgetary terms, such as growth rates or envelopes for expenditures.

2. Binding decisions on budget aggregates, such as the growth rate for expenditure, should be taken before defining expenditure priorities within those aggregates and should not be called into questions during the allocation process. These decisions on budget aggregates should have a medium-term perspective, such as the growth rates of expenditure for the following 3 years, and should remain stable. These targets should pave the way to the subsequent allocation of resources by the

[38] The rule is in force since 2009 for the State and since 2011 for social security. Central government and social security together represent roughly 85 percent of total general government (tax) revenue. See 2011 EPC's country fiche for France, European Commission (2012), "*Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review*", Occasional Papers n. 91/2012

Cabinet among the different multi-annual spending programmes. Subsequently, a bottom-up process should be adopted to finalise the spending-allocation procedures, defining individual programmes and actions within each budget line.

3. Expenditure limits (growth rates or envelopes) have to be operational; hence they have to be expressed in "budgetary language" appropriation structure and accounting basis, as they should be the basis for negotiations during budget preparation among Ministers and the point of reference for administrations when presenting proposals.

4. Expenditure targets have to be specified for several years and preferably should remain stable over the years. If changes are decided, a full set of explanations should be provided to illustrate origins and causes of these changes so as to "reconcile" the new targets with the old ones.

### 6.2.2 Defining the shape and the dynamics of the expenditure ceilings

MTBFs imply a cultural change in budgeting with a clear political commitment to the stability of the financial framework in which aggregate expenditure decisions are made. The crucial point is to avoid revisions if they are due to time inconsistency of fiscal policy decision making or to spending pressures from line ministries in the negotiations with the central budget authority. When expenditure targets are decided, current and new policies should be assessed in their medium-term dimension and should be transparently listed in a proper ranking in terms of political priority. If new priorities emerge, MTBFs should help to reconcile them within the existing ones, supporting changes and reshuffles among them. A full reconciliation between new and previous plans should disentangle what is due to the new macroeconomic environment or to unexpected events from what is due to new policy priorities. This could help to make clear the political commitment to expenditure targets.

Thus, for an effective MTBF stating the binding nature of expenditure ceilings is not enough. A complete and transparent information on the reconciliation process between the outcomes and projections has to be ensured, as well as between subsequent releases of projections. Reconciliation needs to be made also in case of possible revisions of spending ceilings as full disclosure of the reasons and factors explaining them is carried out to guarantee political accountability and commitment.

The shape of the ceilings may concern a plurality of factors, among which it is worth to mention:

1. Several approaches may be adopted concerning the coverage of the spending ceilings, which may concern only the central government or additional sectors such as social security or health care. Moreover, some MTBFs allow the possibility of **excluding spending** items from the overall expenditure ceiling. Some countries allow the exclusion of aggregates that are considered outside the control of policymakers (e.g. interest payments), or involving entitlements (e.g. health care,

pensions) or being mostly affected by the economic cycle (e.g. unemployment benefits). These exclusions find their rationale because it is difficult either to limit their amount through the budgetary planning activity or to forecast them in advance. However, these exclusions limit the comprehensiveness of the MTBF as an instrument of control on public finance. To limit these shortcomings, some countries (like the Netherlands) adopt separate ceilings for different kind of expenditures. Other countries (like France) adopt a dual approach[39], allowing more rigid expenditures to exceed the ceilings but ensuring compensative restrictions on other spending items that are more under control (for more details on the Netherlands and France see Boxes 1A and 1B).

Other exclusions from the ceilings may concern self-financed expenditures, i.e. fee-based expenditures or expenditures financed by discretionary revenue measures. On one hand, the exclusion of this kind of expenditure finds its rationale in its neutrality on the overall budget balances. On the other hand, if the expenditures excluded from the ceilings escape also from the monitoring procedures, these exclusions could lead to uncontrolled growth of certain expenditure items beyond the allocative preferences of voters[40].

2. Expenditure ceilings may be set at different **degrees of aggregation**, from overall expenditure to more disaggregated spending envelopes. There is a trade-off between degree of aggregation of the ceilings and transparency of the planned spending priorities. If spending ceilings are very detailed, expenditure management could be excessively constrained, weakening the ability of policy makers to deal with new priorities. On the other hand, if ceilings are set only at an aggregate level, information on policymakers' medium-term priorities could be less clear-cut. In general, considering that macroeconomic conditions as well as voters' priorities change over time, expenditure ceilings could be set in a less detailed way as the distance from the current year increases.

3. As mentioned in Chapter 7, several approaches are adopted by countries regarding the **binding degree** of their MTBFs. In case of a change in government, there is a consensus that MTFFs and MTBFs may change. With no change in government, countries adopting proper domestic MTBFs generally tend to limit the possibility to revise spending targets. In these cases, spending targets are set for a period of two or three years on a rolling basis or for a fixed period linked to the length of the ongoing government.

   In some cases, revisions of expenditure envelopes may arise from a top-down approach. For example, in the Netherlands expenditure ceilings are set to attain

[39] This implies a so-called "zero volume" expenditure ceiling for the overall spending of the State, which grows in line with the inflation rate, and a "zero increase" rule for State spending net of interest and pensions, which is kept frozen in nominal terms.

[40] For example, in Italy the fee-financed incentives to solar energy - not considered in ESA95 accounting system because of its fiscal neutrality - led to a relevant increase of the corresponding expenditure item during the 2007-2014 period. In 2015, when the amount of these fees-financed expenditures was made more transparent because it was included in ESA 2010 accounting system, corrective measures to reduce them were adopted.

budget targets consistent with fiscal sustainability in the medium term, with the possibility to adjust this framework in case fiscal targets are not consistent with those foreseen by the Stability and Growth Pact (see Box 1A).

The practice of revising the expenditure targets on an annual basis might weaken the beneficial effect of MTBFs in terms of political commitment and of managerial perception of the budget constraints. However, an excessively rigid requirement could prove to be not always desirable from an economic point of view and in any case unrealistic for most countries.

### 6.2.3 Reconciliation among different accounting standards

Since an MTBF translates macro-fiscal objectives and constraints into broad budget aggregates and detailed expenditure plans, a reconciliation among different accounting standards is needed.

Indeed, each aspect of the fiscal framework could in principle be defined on the basis of its specific accounting system:

- Medium term fiscal targets of the general government, in particular in the context of the EU fiscal surveillance (budget balance targets, expenditure limits and debt targets, expressed as ratio of GDP) are set on an accrual basis, following the accounting rules defined by ESA2010. These targets need to be translated in a more operative accounting system to be split among the different targets applicable to the single autonomous budget units that make up the budget of the whole general government.

- The State budget usually adopts different accounting criteria, like cash. In some countries, besides the cash basis, an additional criterion is adopted, aimed to define the legal limit to the budget commitments.

- In case of different levels of government with budget autonomy, the same criteria used for the State budget are usually applied also for the budgets of local governments (cash basis and, in some cases, commitments), but differences may occur in the classification of the budget items. In this case an effort of harmonization is required to avoid difficulties in comparing expenditures and revenues of different regional and local entities[41].

Thus, if MTFFs (the medium-term anchor) are usually defined in ESA2010 and often take into consideration the cyclical dimension, an effort to translate them in "budgeting language" is required. Budget languages differ from ESA2010 criteria in two dimensions: the accounting criteria and the classification dimension. The budgets are usually classified

[41] For example, in Italy until 2015 Regions and Municipalities adopted different accounting classification systems. Moreover, each Region could autonomously define its budget classification, hence there was a plurality of non-comparable regional budgets. Since 2015 a harmonization process is being implemented.

according a functional dimension (missions/programs) while the national accounts are presented according to an economic dimension. In this context, expenditure rules have to be set in a way that are functional to budget management; hence, they should be consistent with but independent from fiscal targets established using ESA2010 criteria and from annual revisions of MTFFs.

Statistical institutions, at both the national and EU level, have developed a wide and complex set of instruments to ensure the homogeneous application of ESA2010 in EU countries in terms of outturns[42]. While this set of instruments can be used for fiscal planning by governments, also because of its high degree of complexity it is not readily usable for operational purposes by single spending units with budget autonomy. Therefore, it is necessary to reconcile the different accounting systems and classification in a transparent and exhaustive way, both ex-ante and ex-post.

Countries have tried to cope with the need for reconciliation between different accounting standards with an array of solutions:

a. Ex ante:

- the reconciliation of general government targets with operational ones is often made by using the aggregates which are considered proxies of the accrual system (for example, adopting the budget cash criteria for investment expenditure and the budget commitment criteria for current expenditure); however, these proxies have often proved to be unsatisfactory;

- the fiscal impact of each bill could be often estimated by simultaneously recording the impact of each expenditure or revenue measure according to different accounting criteria. For example, in Italy every bill is accompanied by a prospect which records the impact of each measure on the basis of three accounting systems: legal authorization of commitments, impact on cash terms and in terms of ESA2010.

b. Ex post:

- the reconciliation process among the different accounting systems is implemented by the national statistical institutions, but the degree of transparency of the reconciliation process varies across countries. In most cases, this reconciliation process is not made entirely public.

### 6.2.4 MTBFs in case of different levels of government

While the EU MTFF is set for the general government, MTBFs are usually defined only at central government level to take into account the budgetary autonomy of local authorities. In countries where a large share of expenditure is delivered at the local level the problem

[42] See Eurostat (2016), "*Manual on government deficit and debt - Implementation of ESA 2010*".

of how to obtain the control of subnational expenditures requires a deepening of the analysis and remains an open issue.

In countries with multilevel expenditure structure, the importance of defining a central MTBF is even greater, due to the impact that the central government expenditure envelopes have on the budget of subnational governments mainly through transfers.

In fact, when financing to local governments relies mainly on transfers by central government, a ceiling on central expenditure together with a balanced-budget rule for local governments implies de-facto an extension of the ceilings for the central government to the local governments. Indeed, in many countries these are the main instruments employed to keep the expenditure dynamics of local governments under control.

In these cases, the need for local governments to know in advance the amount of resources they can lean on is essential to put them in a position to implement their own medium-term budgetary planning. Indeed, discretionary changes of the grants received from central government on an annual basis would inevitably bias the horizon of local expenditure policies towards the short term.

A stable MTBF at central level is needed even when local governments mostly finance their expenditures with autonomous taxes or with shares of centrally-levied taxes and when a component of their budget concerns entitlements decided at central level. For example, in Italy health care is a regional responsibility but the national health system requires equal funding in all Italian regions. For this reason, autonomous regional governments need to know from the central government the medium-term projections of the amount of resources that they are obliged to commit to this specific expenditure item.

Complexity may increase during periods of public finance consolidation requiring significant expenditure restrictions, whose burden has to be shared among different levels of government. In these cases, the need to commit politically a plurality of local governments on medium-term fiscal targets may encounter major political obstacles.

Indeed, autonomous decentralised governments may disagree with the criteria set by the central government to define aggregate fiscal targets at the central and local levels as well as to identify fiscal objectives for each region and municipality. Moreover, in countries where there is no common "election day" for central and local governments, unsynchronised political cycles might exacerbate possible disagreements.

The aforementioned difficulties may be an incentive to negotiate political agreements among different levels of government on a short-term horizon, negotiating year by year the total amount of the fiscal adjustment to be carried out by the local government sector. The result of this process would be to define on a yearly basis the spending items to be reduced, impairing any possible multiannual planning framework. On the other hand, even fixing a too ambitious multiannual consolidation pattern for local autonomies, not supported by a firm and shared political commitment, would inevitably be followed by significant policy changes in future budgets, leading again to ineffective medium-term budgetary planning.

Defining stable financial relations between central and local governments based on medium term planning horizon may be considered a first step to involve local governments in the cost control planning process thus leading to a stronger contribution of local governments to the respect of the MTFF.

A second step towards the same target is to define a set of fiscal rules so as to ensure a hard budget constraint for local administration budgets, ruling out any bail out commitment by central government.

In recent years, the fiscal rule that has been generally implemented by most countries to ensure budgetary discipline by local governments is the balanced budget rule. In some cases, some flexibility mechanisms are considered to take into account some complexities for the management of the budget of decentralized governments due to their different size. For example, the fiscal space in small municipalities' budgets could occasionally limit their investment spending, which usually presents some peaks exceeding the ordinary revenues. Especially during the recent crisis and in the subsequent period of fiscal consolidation, the budget constraints on local governments have indeed led to drastic public investment reduction.

## 7. Political commitment and the binding nature of MTBFs

As illustrated in previous chapters, MTBFs should have a guiding role for the yearly budgeting process within the medium-term objectives. Two elements, somehow related, seems to be key for the success of MTBFs: political commitment and the degree of tightness of MTBFs.

The definition of "political commitment" itself is not straightforward and would require some reflections. The level of political commitment associated with an MTBF is very different across countries. The common wisdom assumes that parliamentary endorsement, in the form of a law or of a resolution, may give more weight to the plans set within the MTBFs, facilitating the respect of these targets/limits. One could think that a law is more stringent than a political agreement, which is another form that MTBFs could take. However, a more in-depth analysis of MTBFs would require distinguishing cases in which a parliamentary vote is required (for a law, for a resolution setting ceilings or for a resolution on the political agreement), and cases where the parliament is not involved and plans are adopted at cabinet level.

However, some country experiences highlight that it is possible to have strong political commitment without a parliamentary vote. For example, in Finland and the Netherlands, the Coalition Agreement, which is negotiated between the political parties forming the governing coalition at the start of each legislative term, sets the medium-term priorities. The Coalition Agreement itself sets indeed the expenditure ceilings for the four years of the parliamentary session.

In fact, the Netherlands represents a good example of credible political commitment on an informal basis, i.e. without a law or parliamentary resolution (for details see Box 1A). At the start of a new government term, first the newly formed coalition may decide to revise the previous fiscal framework, usually taking into account the advice of the SBR. Afterwards, the government determines budget rules for the next four years, laid down in an agreement among the parties of the coalition. These rules include separate expenditure ceilings for social security, health care and other government expenditures[43]. There is always the possibility of renegotiating the Coalition Agreement and raising the ceilings but a financing source to compensate for the budget impact would have to be identified in advance.

Also in the case of Finland there is no legally binding requirement. The current fiscal framework in Finland was introduced in 2003 and is anchored around multi-annual expenditure ceilings. The general objective of the government's programme is translated into a government's decision on central government spending limits for the parliamentary term. This decision defines in essence the multi-annual financial framework. The MTBF is set for a fixed period of four years, the expenditure ceilings for the central government are defined in real terms and then adjusted for inflation, and generally no other revisions to

[43] In the Netherlands, interest payments on public debt and measures for the financial system are excluded from the ceiling. Normally unemployment expenditure falls under the ceiling, but this item was excluded from the limit during the recent economic and financial crisis.

them are foreseen. The government's programme is a public agreement between the coalition partners that is submitted to parliament in the form of a government statement. The preparation and publication of the programme is mandatory as it is based on the Constitution. Therefore, although it is not legally binding, it remains very important from a political point of view. An implementation plan for the programme is issued as a government decree, and the Prime Minister's Office takes responsibility in follow-up tasks[44].

Another key element of the MTBF, interrelated to the issue of the commitment, is the binding nature of the framework adopted. In the literature, many studies try to classify MTBFs in two groupings: binding MTBFs and indicative ones[45]. Harris et al. (2013) define as indicative an MTBF where the multiyear expenditure and revenue estimates presented with the annual budget are intended to reflect the future costs of current policies and decisions but are not intended to bind future policies and decisions. These medium-term revenue and expenditure estimates are reset every year. Conversely, in a binding MTBF the multiyear expenditure and revenue estimates presented with the annual budget are intended to both reflect the future costs of current policies and bind future policy changes. The Netherlands and Finland (and Sweden) are examples of binding MTBFs under this definition (for the Netherlands see Box 1A).

Sherwood (2015) suggested a more nuanced approach, considering the degree to which fiscal plans within the MTBF are binding. Instead of a binary taxonomy (binding versus indicative), a continuous scale can be drawn, with six different degree of tightness[46].

However, both taxonomies are not fully satisfactory and further reflection is warranted. In fact, "binding" should not be seen as a legal notion; after all, also ceilings approved with a law, on paper the most stringent type of MTBF available, can be changed with a subsequent law. Revising or not the ceilings adopted depends basically on the willingness of (both) government and parliament. Instead, there are cases in which ceilings/targets, adopted by means of a political agreement, hence on an informal basis, are not expected to be changed and actually are not changed. This is the case of Finland as we described before.

Another interesting experience is that of Sweden. As from 2010, the Swedish government is obliged by law to lay down expenditure ceilings for the three following years. This is formally done in the budget bill presented in the autumn of the year preceding the three-year period (with calculations of the planned expenditure ceilings having already been presented in the Spring Bill of the same year)[47]. Expenditure ceilings for the central government are set in nominal terms and they are to remain unchanged. The ceilings are not being adjusted for inflation. Even though there are no formal obstacles for the Swedish Parliament to reassess established ceilings, there is a strong expectation that the ceilings

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[44] See European Commission (2012), "*Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review"*, Occasional Papers n. 91/2012.

[45] For example, Harris, J., R. Hughes, G. Ljungman, and C. Sateriale (2013), *"Medium-term budget frameworks in advanced economies: Objectives, design, and performance",* Chapter 4 in *"Public financial management and its emerging architecture"*, edited by M. Cangiano, T. Curristine, and M. Lazare, IMF.

[46] Sherwood, M., (2015), "*Medium-term budgetary framework in the EU Member States*", European Economy, Discussion Paper n. 21/2015.

[47] See European Commission (2012) cit.

will be applied as set unless a new government comes to power. If risk of exceeding an approved ceiling is detected during the year, the government is required to take measures to avoid it. It should be noted that there is no formal enforcement procedure based on mandatory corrective action and only reputational cost is involved[48]. The Swedish framework seems thus to be the strictest among EU Member States: ceilings are adopted by law and are not expected to be revised, thanks to budgeting margins for coping with unforeseen developments[49].

The evidence provided by Sweden and Finland highlights that the same result, i.e. a very high degree of political commitment, is reached with completely different institutional arrangements: a law in Sweden, a coalition agreement in Finland. This emphasizes the fact that there is no single way to implement a successful MTBF, and national institutions and long-standing procedures are to be carefully considered. Country-tailoring MTBF design should be seen as a key success factor[50].

Secondly, in general, the reputational cost is an important element of binding MTBFs: in some institutional contexts, such as those of the Netherlands, Sweden and Finland, the cost is high and the government or the parliament generally refrain from changing plans. After all, public opinion in those countries expects that no change will be made. Actually, reputational cost can make the difference across institutional environments. This also points, again, to the issue that exporting successful arrangements in different cultural and political contexts, i.e. where reputational cost is low, might be challenging.

Lastly, taking into account these successful MTBF experiences, one might say that the binding nature of MTBFs has to do with the stability over time of the ceilings adopted. In fact, what really makes the difference between MTBFs has to do with the number of revisions adopted, both in the year and over the years. As a matter of fact, the frequency of policy revisions of the medium-term commitment (in terms of envelopes) vary substantially across countries.

Finally, one should note that the aforementioned taxonomies refer to the ex-ante aspect of the medium-term planning documents, but there are also important differences in terms of dealing with unforeseen slippages ex-post. For example, the Dutch MTBF provides for a correction mechanism whereby the slippage incurred in a year has to be made up for in the following budget year. In other models the catching up can be spread over a period of years (e.g. Ireland) and more discretion is given as to the decision on the timing of the correction. However, Sherwood (2015) notes that in the majority of current EU frameworks the focus

[48] See Sherwood (2015) cit.

[49] To deal with unforeseen cyclical developments, in Finland and Sweden the expenditure ceiling set for the central government includes a buffer to be used for expenditure arising from unforeseen cyclical developments. Budgeting margins are larger for the outer years. Moreover, some expenditures are excluded from the ceiling: interest payments on public debt (Sweden and Finland), or unemployment benefits (Finland). In Finland, however, increases in cyclical spending due to changes in the eligibility criteria are included. See Sherwood (2015) cit. It is worthwhile noting that the institution framework has not prevented the adoption of discretionary policies in Sweden to cope with the unprecedented financial and economic crisis.

[50] Cangiano, M., (2017), *"Top-down budgeting and MTBFs",* Presentation at Italy's Ministry of Finance, Rome 6-8 February.

is only on ensuring that plans for the future are in line with the existing fiscal rules, while no making up for past slippages is considered.

# Annex 1

## Slippages of expenditure and budget balance forecasts in Stability Programmes

The main aim of this chapter is to present some descriptive evidence on the performance of several EU countries regarding the stability of medium-term fiscal planning over the recent past. To this aim, public finance aggregates' estimates from 2011-2017 Stability Programmes are used, trying to assess the stability of the targets with a medium-term perspective.

The chapter will thus illustrate the shifts in fiscal variables' forecasts over the various vintages of the programming documents. Differently from other institutional analyses on this topic[51], the focus will not be on the average implementation slippage (the change in a given target occurring between two consecutive documents) at the EU level. The analysis will instead concern the steadiness of the entire mid-term programming horizon for the main public finance aggregates in each country.

One focus of the analysis is to understand to what extent revisions in fiscal programming has been linked to revisions of GDP projections. Indeed, an accurate forecast of the business cycle developments is as difficult as essential to define a reliable medium term fiscal strategy, especially when large shocks realize and it is harder than ever to predict macroeconomic developments. Even if the various institutional settings entail a different degree of flexibility for some relevant fiscal aggregates, abrupt changes in growth forecasts heavily affect the budget balance, in particular on the revenue side.

Another focus will be on revisions in expenditure developments that in principle should be less affected by the economic cycle. Thus, the degree of revisions of expenditures could be a better indicator of planning stability and therefore of MTBF effectiveness.

In section A.1-A.2, for each country, the programmed paths of net lending and structural balance resulting from each Stability Programme are shown which confirm an important role for the underlying growth prospects. Section A.3 and A.4 give prominence to the expenditure side. Section A.3 presents the forecasted paths in per cent of GDP and in absolute values for total and primary expenditure, with a specific focus on public investment spending' programs. Section A.4 illustrates, for each forecast period, the changes in nominal total spending occurring through in-year revision of the target and the deviations observed in the outturn with respect to the in-year forecasts: those figures provide some information about the "last-minute" flexibility and the "budget execution" flexibility allowed within the institutional setting of each country. To conclude, Section A.5 deals with the composition of the discretionary fiscal impulse foreseen in each Stability Programme, focusing on its distribution over the programming horizon: from this perspective it is possible to assess the mid-term consistency of subsequent discretionary fiscal policy actions.

[51] European Commission (2014), "*Report on Public Finances in EMU*", in European Economy, 9/2014.

Countries participating to the MTBF-WG sent the outturns/estimates/forecasts for the (t-1)/(t+3) time span of a number of fiscal variables included in each Stability Programme (SP, April release)52, generally covering the years from 2011 until 2016. For some countries, the database has a different starting point (SP 2012 for Malta, SP 2013 for Cyprus and SP 2015 for Luxembourg). Malta included also data from SP 2017.

As for SP 2017 and other missing data from previous SPs, PBO has retrieved them from each Stability Programme published on the European Commission website53. In general, the tables in the SPs include data in percentage points of GDP for the whole forecast period, while including absolute values only for t-1. For this reason, 2017 estimates in absolute values are calculated applying the forecasted growth rates of nominal GDP to the 2016 level and then using the per cent of GDP estimates of each variable. In light of this, the results in absolute value variables resulting from the SP 2017 data should be taken with caution.

## A.1 Budget-balance slippages

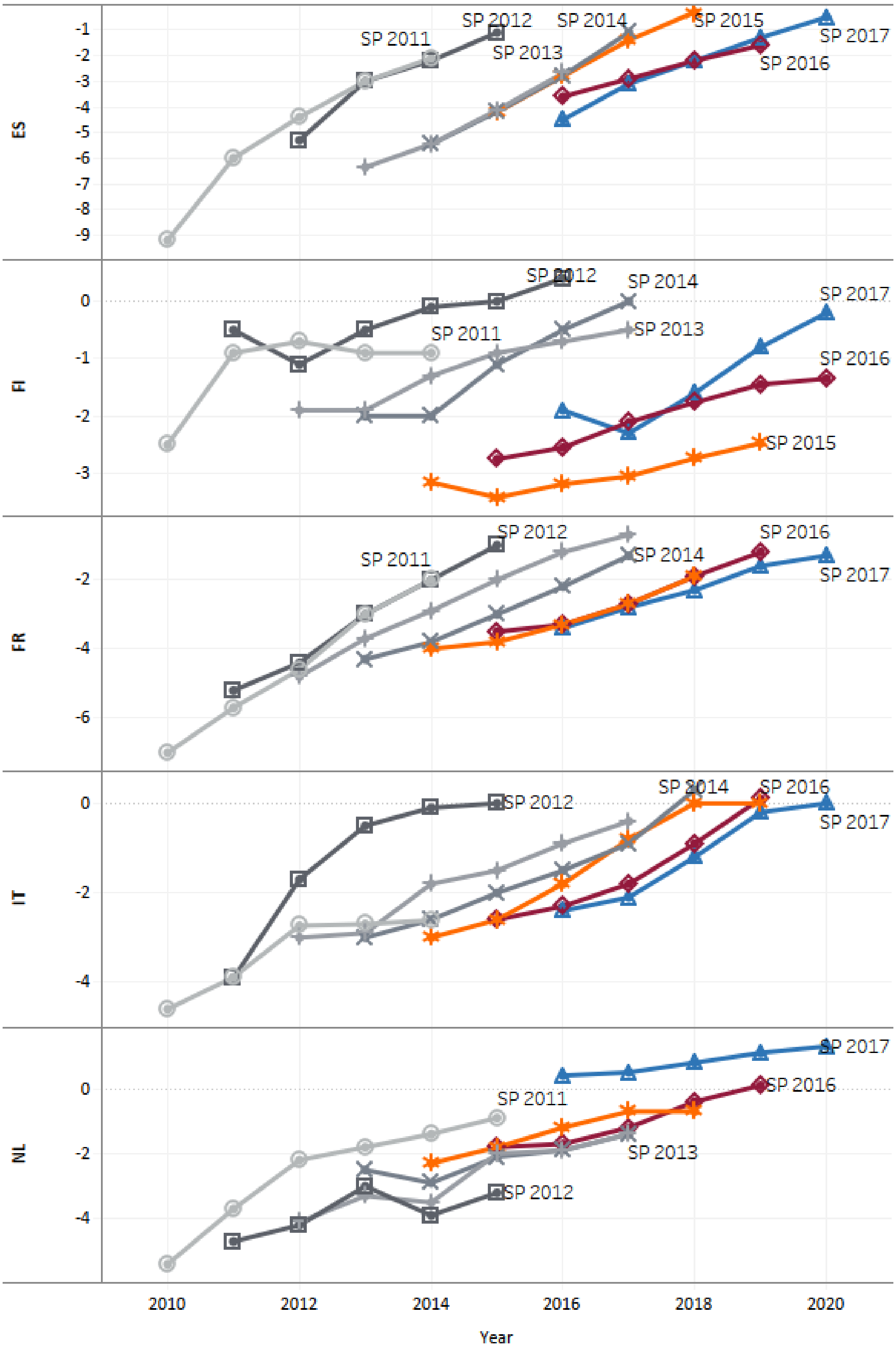
The available fiscal data show evidence of moving targets in fiscal balances in most countries, but to a different degree. Indeed, the sign and the size of the slippages differ across countries and over time. In general, revisions in the first part of the period considered in the analysis (2012-13) are larger.

For nominal net lending as a percentage of GDP (Figure A1 and Figure A2) in several cases (Finland, France, Malta, Portugal and Spain) with the exception of some years the slippages show parallel movements, since the slippage in the first year is spread over to the following years. In other cases (Cyprus, Italy), subsequent revisions imply a steeper shape of targets, since the slippage of the first year is planned to be corrected in later years. However, over time this could lead to a weakening of the credibility of the expected fiscal consolidation. In other cases the revisions do not present systematic regularities (Luxembourg and the Netherlands) or are very limited (Ireland and Latvia). Data from SPs 2017 show a stabilization in targets of net lending ratios for almost all countries, with the exception of Netherlands, Finland and Malta that show a substantial improvement in deficit forecasts. In the case of Finland, the downward revisions of deficit targets involve in particular the final part of the programming horizon (2019-2020).

[52] In some years, some countries issued a different but related document. For example, following the signature of the Memorandum of Understanding (MoU) related to the financial assistance program, from 2011 to 2014 Portugal issued the Fiscal Strategy Document (FSD). As another example, Latvia issued a Convergence Programme until adopting the euro in 2014. For simplicity, in what follows "Stability Programme" (SP) indicates the programming document issued in the spring related to the EU framework.

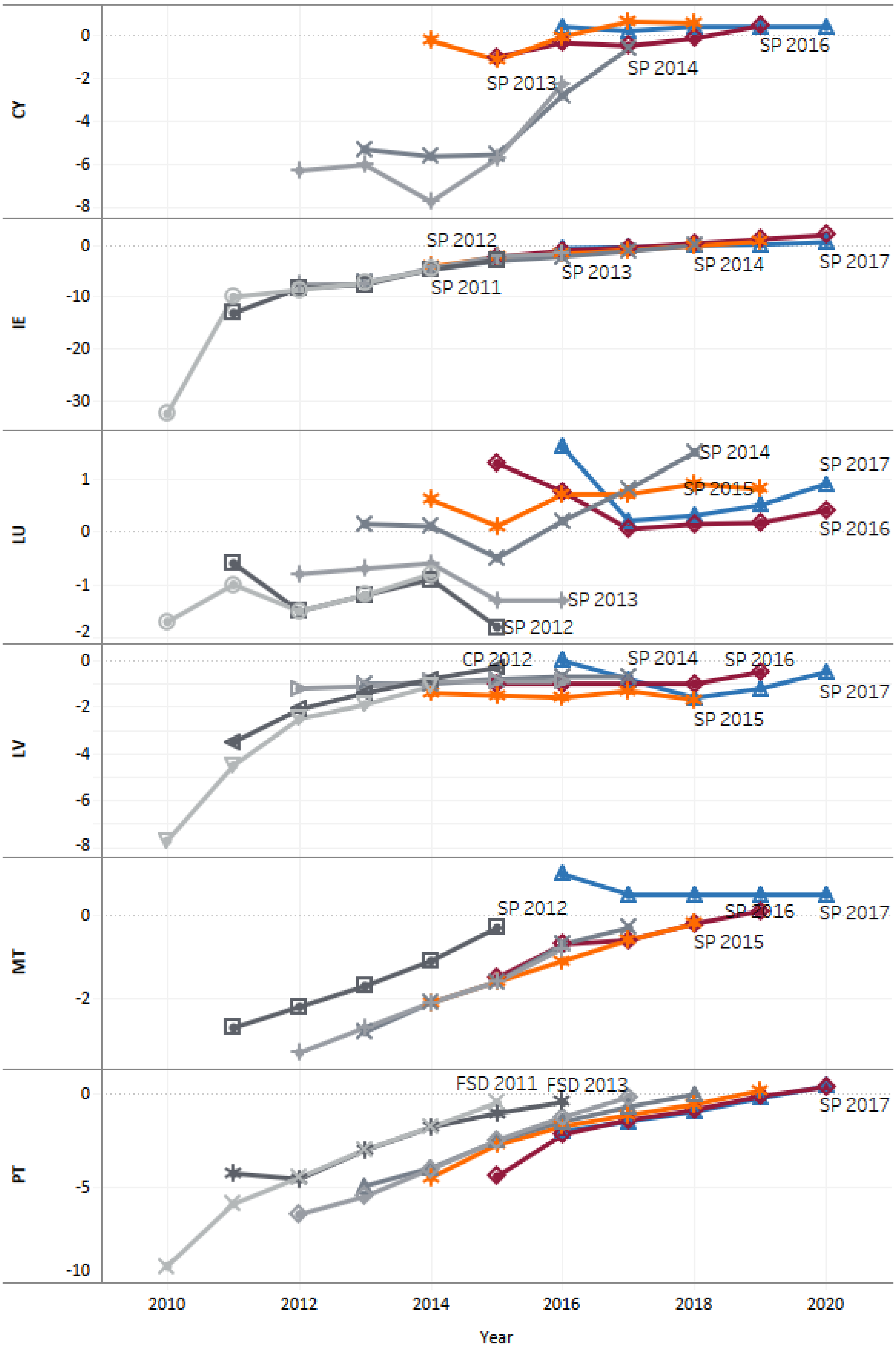
[53] https://ec.europa.eu/info/2017-european-semester-national-reform-programmes-and-stability-convergence-programmes_en.

**Figure A1 –** Budget balance (net lending of general government) forecasts in large countries (1)
(percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A2** – Budget balance (net lending of general government) forecasts in small countries (1)
(percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

Regarding the revisions to nominal budget balances, it is worth stressing that in the time span under consideration many countries incurred in unpredictable one-off interventions linked to extraordinary circumstances. The most relevant examples, common to several EU countries, are the government interventions to support financial institutions. As it can be seen from Table A1, except for Malta and Finland these interventions have impacted on budget balances of all countries in the period considered in this analysis. In absolute values, the impact has been particularly strong in Ireland in 2010 and in Spain in 2012. As a percentage of GDP, the impact of the interventions to support financial institutions was also relevant in Cyprus in 2014, again in Ireland in 2011 and in Portugal in 2014.

**Table A1** – Impact on the budget balance of government interventions to support financial institutions (1)
(millions of euros and percentage of GDP)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| IE | -35.543 | -6.370 | 355 | 439 | 15 | -1.834 | -20 |
| *% gdp* | *-21,2%* | *-3,7%* | *0,2%* | *0,2%* | *0,0%* | *-0,7%* | *0,0%* |
| ES | 772 | -3.515 | -38.289 | -3.277 | -1.350 | -552 | -2.389 |
| *% gdp* | *0,1%* | *-0,3%* | *-3,7%* | *-0,3%* | *-0,1%* | *-0,1%* | *-0,2%* |
| FR | 995 | 601 | -2.198 | 238 | 28 | -18 | -46 |
| *% gdp* | *0,0%* | *0,0%* | *-0,1%* | *0,0%* | *0,0%* | *0,0%* | *0,0%* |
| IT | 88 | 177 | -86 | -150 | 362 | -3.299 | -8 |
| *% gdp* | *0,0%* | *0,0%* | *0,0%* | *0,0%* | *0,0%* | *-0,2%* | *0,0%* |
| CY | 27 | 25 | 6 | -84 | -1.568 | -245 | -84 |
| *% gdp* | *0,1%* | *0,1%* | *0,0%* | *-0,5%* | *-8,9%* | *-1,4%* | *-0,5%* |
| LV | -402 | -70 | -102 | -3 | -4 | -7 | 6 |
| *% gdp* | *-2,2%* | *-0,3%* | *-0,5%* | *0,0%* | *0,0%* | *0,0%* | *0,0%* |
| LU | 48 | 52 | 29 | -27 | 14 | 19 | 22 |
| *% gdp* | *0,1%* | *0,1%* | *0,1%* | *-0,1%* | *0,0%* | *0,0%* | *0,0%* |
| MT | - | - | - | - | - | - | - |
| *% gdp* | - | - | - | - | - | - | - |
| NL | -1.082 | -112 | -221 | -1.188 | -50 | 407 | 345 |
| *% gdp* | *-0,2%* | *0,0%* | *0,0%* | *-0,2%* | *0,0%* | *0,1%* | *0,0%* |
| PT | -2.218 | -865 | -935 | -663 | -5.123 | -2.832 | -384 |
| *% gdp* | *-1,2%* | *-0,5%* | *-0,6%* | *-0,4%* | *-3,0%* | *-1,6%* | *-0,2%* |
| FI | - | - | - | - | - | - | - |
| *% gdp* | - | - | - | - | - | - | - |

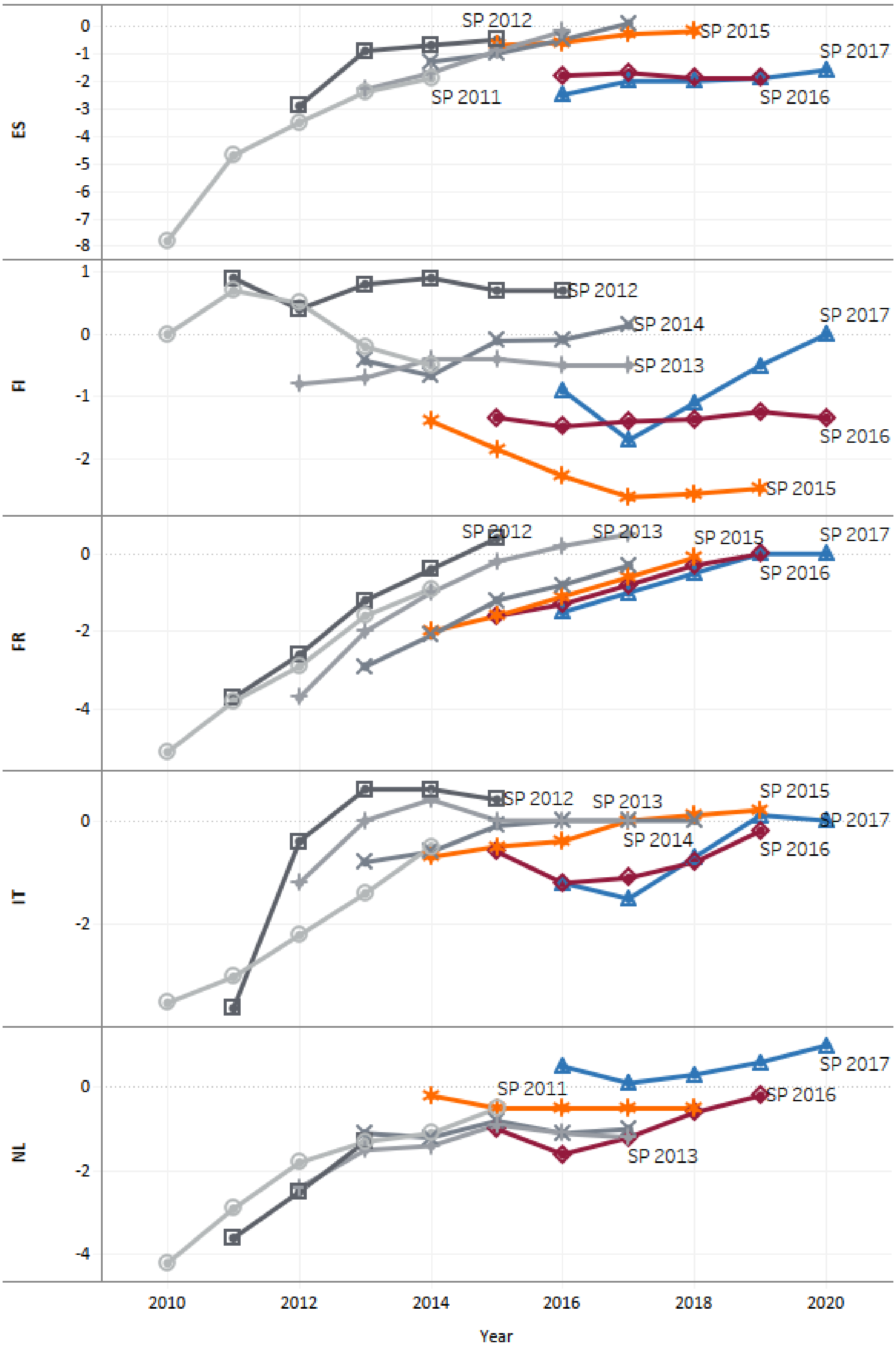
Source: Eurostat, EDP notification, October 2017.
(1) In Malta (MT) and Finland (FI), no intervention took place to support financial institutions in the period 2010-2016.

Structural balances are netted out both by one-off measures and by the cyclical components of the budget; thus, they are a better indicator of discretionary shifts in fiscal policy.

Structural balances' forecasts contained in SPs 2011-2013 implied a considerable consolidation effort (a steep slope of the lines in Figures A3 and A4) in the group of relatively large countries, in Portugal and in Ireland, especially concentrated in the 2011-2014 time span and mostly as a response to the sovereign debt crisis affecting many countries in 2011-12. The more recent SPs show a flatter adjustment trend (except SP 2017 for Finland).

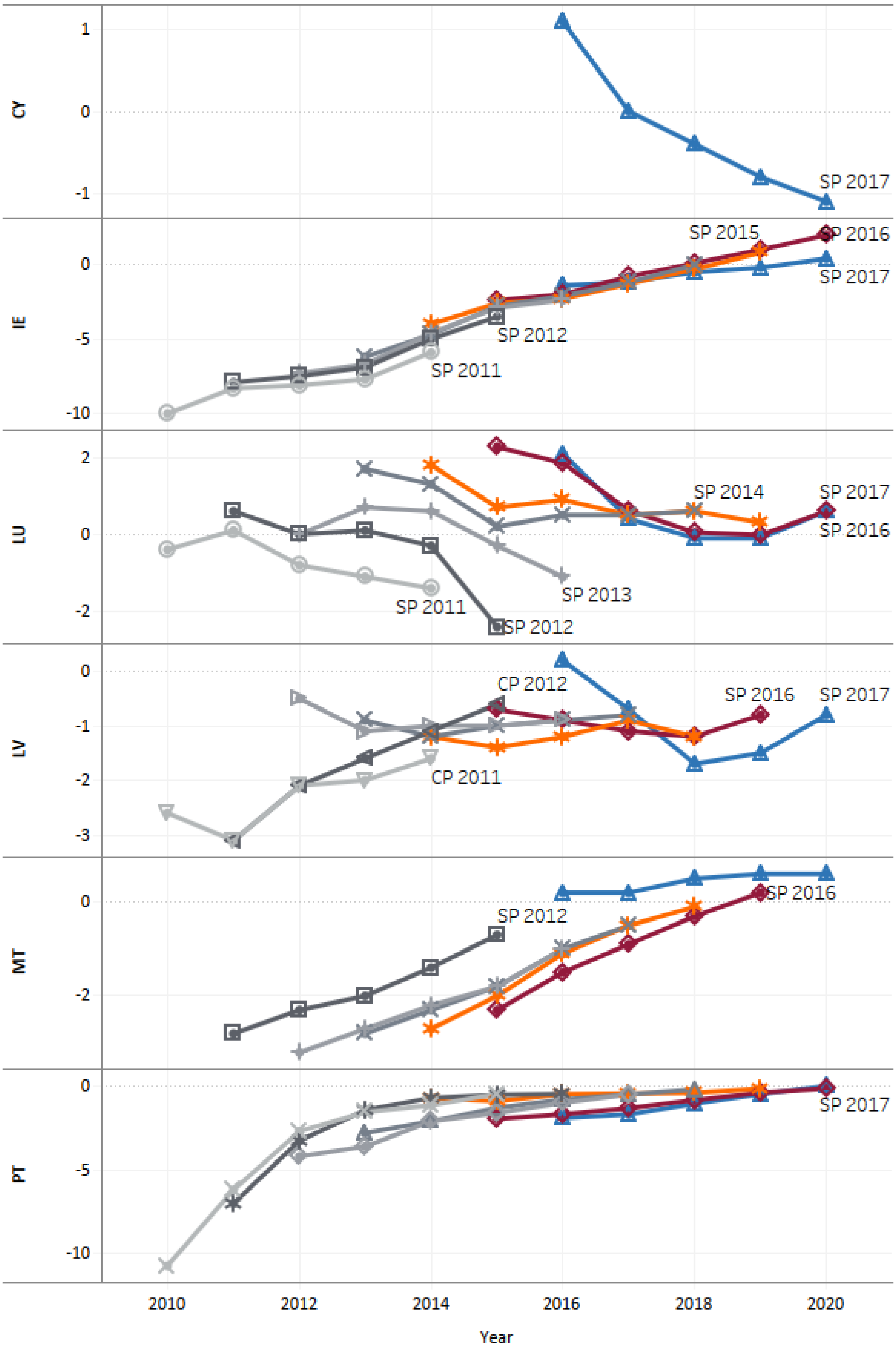
As regards revisions, in some cases (the Netherlands, Portugal, Spain, and partly France and Italy) slippages in structural balances are smaller than in nominal ones. However, in many cases revisions in structural and nominal balances appear of a similar magnitude. Considering SP 2017, Netherlands and Malta highlight significant upward revisions to the structural balance with respect to the SP 2016 forecasts.

**Figure A3 –** Structural balance forecasts in large countries (1)
(percentage of potential GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A4 –** Structural balance forecasts in small countries (1)
(percentage of potential GDP)



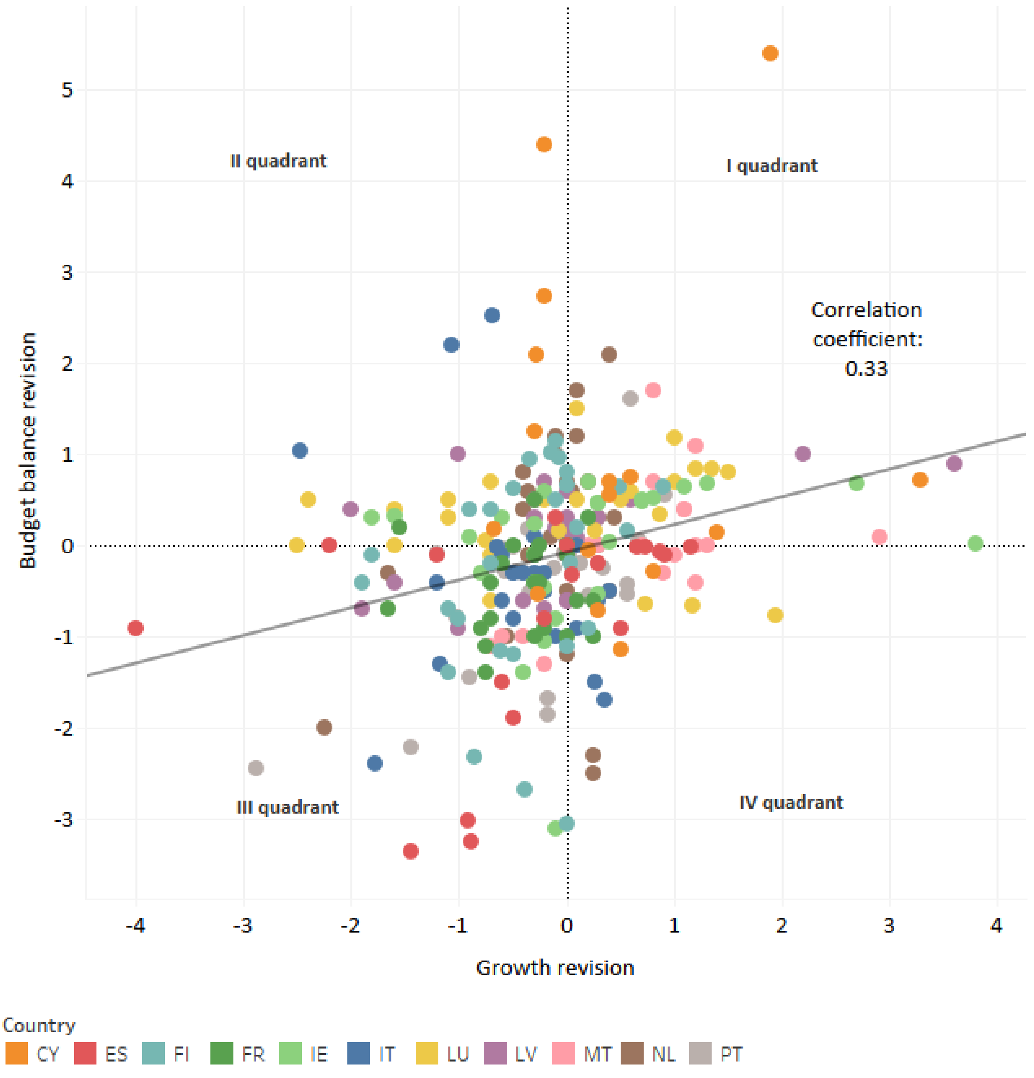

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

## A.2 Discretionary/non-discretionary slippages in budget balance forecasts

In some cases, slippages in fiscal balances could reflect the effect of forecast errors in economic growth, mainly during the period 2012-2013. Indeed, slippages in fiscal balances can be the consequence of lower than expected real growth or may be the result of a deliberate fiscal policy decision. But the direction of targets' revisions is not always clear.

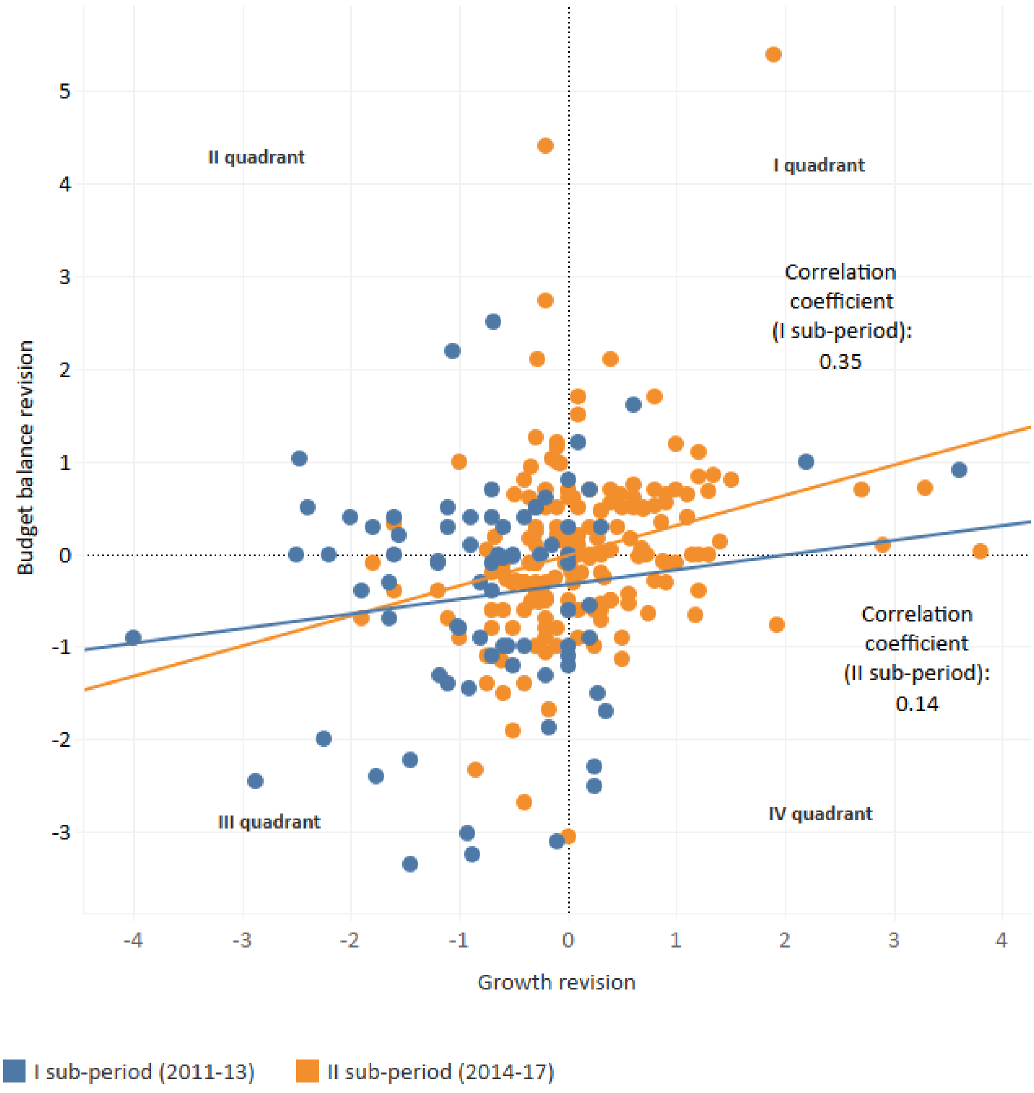
Figures A5 and A6 offer at a single glance the revisions in budget balance targets and in expected economic growth made by each country, in each SP document, for each year of the forecast period.

**Figure A5 –** Targets' revisions of budget balance ratios versus GDP growth rates' revisions in each adjacent Stability Programmes (2011-2017) (by country)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.

**Figure A6 –** Targets' revisions of budget balance ratios versus GDP growth rates' revisions in each adjacent Stability Programmes (2011-2017)
(by sub-period)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.

Figure A5 shows that in general there is a positive relation between revisions in economic growth forecasts and those of targets for budget balances, as it is expected. However, the correlation is relatively low and, as shown in Figure A6, it is mostly driven by data points included in the 2014-2017 documents. Indeed, data from 2011-2013 SPs in the figure are spread on a wider area of the scatterplot, indicating large revisions of the forecasts, both in real growth and in budget balance, with no clear relation. A negative cycle remarkably deeper than expected called into question the whole medium term planning for most of the countries.

It should be noticed in particular that any point in the second and fourth quadrant of Figures A5 and A6 indicates a discretionary slippage (whereas the other two quadrants may include both discretionary and non-discretionary slippages). For example, Figure A5 (second and fourth quadrant) shows that most countries in some years adopted a more pro-cyclical budget adjustments as downward (upward) revisions of GDP growth forecast went hand in hand with upward (downward) revisions of the budget balance. In particular, Figure A6 shows that this happened mainly during the first period of the present analysis (2012-13) with strong consolidation efforts in those countries most exposed to financial instability. In the second quadrant, it may be noticed for example the position of Italy in SP 2012, revising upward the budget balance targets despite a downward revision of growth forecasts and the same country in the fourth quadrant showing positive revisions of real growth and a deterioration of deficit targets in SP 2013. This kind of pro-cyclical bias is in part linked to the tendency of the EU methodology to underestimate – at least in some cases – the cyclical component of the budget balances in real-time, which in the current EU-MTFF translates into budget constraints that are too loose in good times and too tight in bad ones.

The above evidence is confirmed by a more detailed analysis isolating the discretionary component of the budget balance (i.e. net of the cyclical component) and comparing its revisions with the ones in the growth forecasts (Figure A7). In this exercise, consistently with the methodology adopted by the European Commission[54], non-discretionary revisions of the budget balance are defined as those revisions of net lending strictly linked to the revisions of GDP. This component is obtained using the elasticity of the budget balance to GDP estimated by the OECD[55]. The remaining part of the revisions is considered as the discretionary component[56].

For each country and for each planning document, Figure A7 shows the average of the revisions for the period from t-1 to t+2. Thus, the distance of the points from the x-axis measures, for each country, the average size (over the planning horizon) of the discretional revisions of net lending targets estimated in each SP with respect to the previous one. It can be seen that the number of points relatively close to the x-axis ($\pm$ 0,5) is lower for 2012-2013 than for the following years, when the stabilization of the cycle helped also to stabilize the medium term planning of fiscal policies. Moreover, the position of the points in the different quadrants shows that the majority of them moves from an upward discretionary revision of deficit targets (above the x line) in SP 2012 despite a downward revision of growth forecasts to a downward revision of the same targets (under the x-line) in the following years.

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54 European Commission (2014), "Public finance in EMU".

55 Price R., Thai-Thanh Dang, Guillemette Y.: "New tax and expenditures elasticity estimates for EU budget surveillance" OECD Economics Department Working Papers 1174, 2014.

56 Let $x_{t+i}^{t}$ be the forecast of the variable *x* at time *t+i* published in the SP issued in year *t*; then, the revision of variable *x* in the SP issued in *t+1* is equal to:

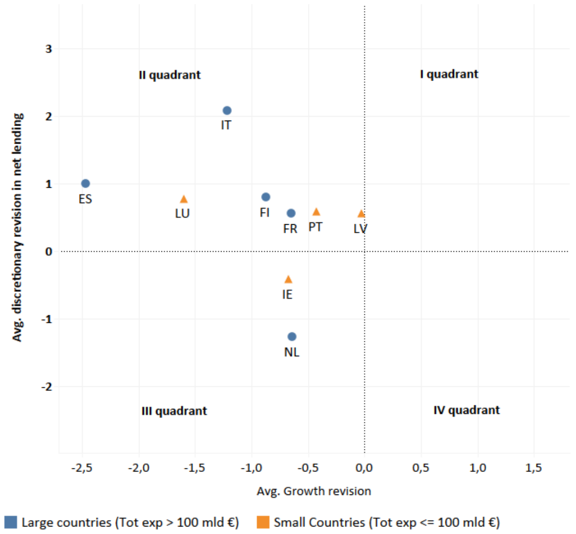
$$R_{t,t+1}(x_{t+i}) = (x_{t+i}^{t+1} - x_{t+i}^{t})$$

Discretionary revisions of the variable $x_{t+i}$ between the two SPs are defined according to the methodology presented in European Commission (2014), i.e. using the budget semi-elasticities ($\varepsilon_x$) estimated in OECD (2014) and the growth forecast revision for the same period ($g_{t+i}$) to calculate the non-discretionary component of the revision. In formulae:

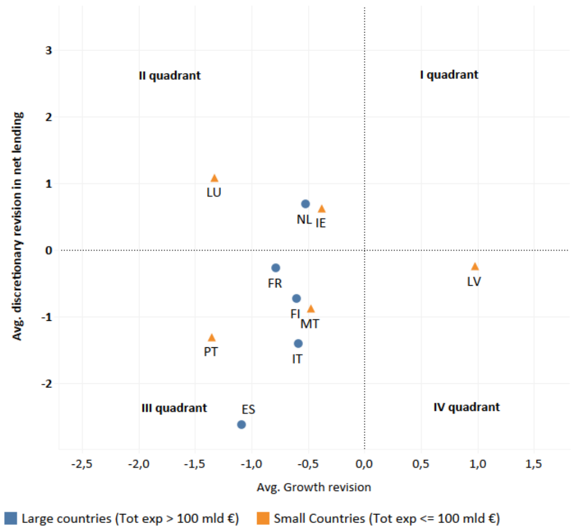
$$R_{t,t+1}^{d}(x_{t+i}) = R_{t,t+1}(x_{t+i}) - \varepsilon_x \cdot (g_{t+i}^{t+1} - g_{t+i}^{t})$$

**Figure A7 –** Average discretionary revisions in net lending versus average growth revisions in each SP (2012-2017), average over the t-1/t+2 time span of the SP (1)
(percentage values)

2012




2013




In the SPs of 2012 and 2013 all the countries (with the exception of Latvia) revised downward economic growth forecasts.

During this period medium term planning was unfavorably affected by the difficult task of predicting such a long and deep economic crisis.

The revision of the budget balance targets following the growth revisions was similar across countries, for several reasons:

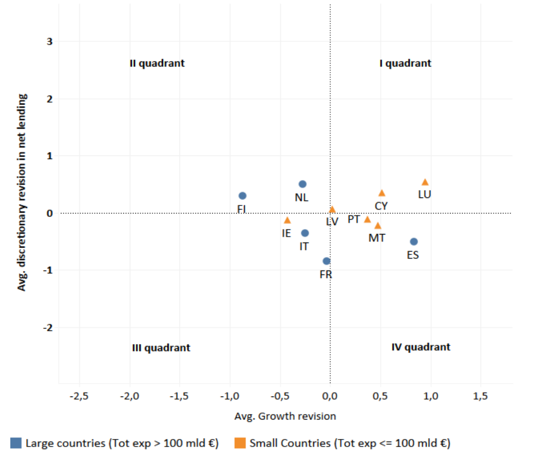
- in 2012 the underestimation of the depth of the crisis and of the level of the output gap required additional fiscal efforts to comply with the EU fiscal rules;

- the financial instability which affected some sovereign debts required even deeper fiscal efforts to re-establish confidence on countries' ability in maintaining fiscal sustainability;

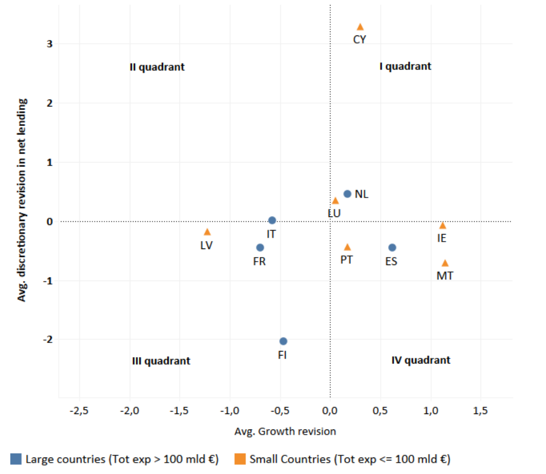
- in 2013 economic growth forecasts were still being revised downward and many countries revised discretionary budget balances downwards as it emerged the need to tame somewhat the procyclical fiscal policy of the previous year, which was contributing to the deepening of the crisis.

**Figure A7 –** (cont.) Average discretionary revisions in net lending versus average growth revisions in each SP (2012-2017), average over the t-1/t+2 time span of the SP
(percentage values)

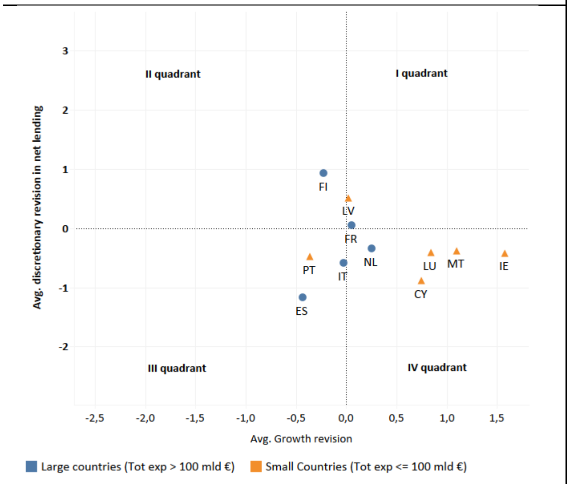
2014




2015




2016




In the following years several countries showed upward revisions of growth (ES, PT, CY, LU, IE), but other countries kept revising downward their forecasts (IT and FI), or confirmed them.

The majority of countries kept revising downward their budgetary targets, implying a relatively less stringent fiscal consolidation policy to avoid harming the feeble economic recovery, without any apparent relation with growth revisions.

Indeed, the countries which during the period 2014-2016 improved their budget forecasts are relatively few and some of them had specific reasons:

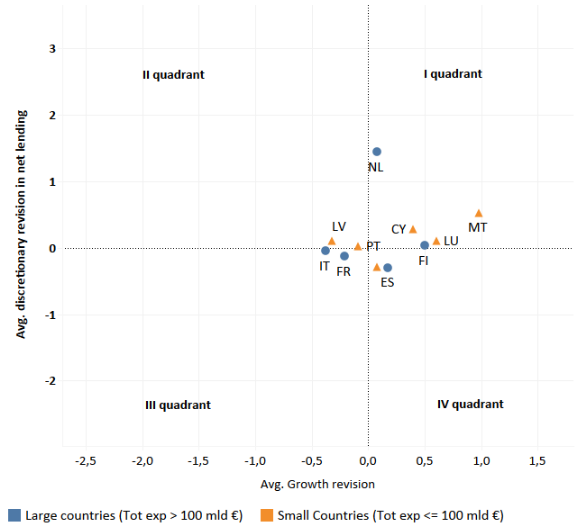
- having to fulfill conditions for financial assistance programmes (CY);

- having peculiar features that affected revisions of both growth and the budget estimates (size of the multinational sector for IE, or high volatility for small countries like LU and LT)

- introducing some changes in the definition of the data release (e.g. for FI the SP 2015 reports budget estimates at unchanged policies rather than targets as in the SPs of all the other years, so that comparison with the previous and subsequent SPs should take into consideration this different definition).

**Figure A7 –** (cont.) Average discretionary revisions in net lending versus average growth revisions in each SP (2012-2017), average over the t-1/t+2 time span of the SP
(percentage values)

2017




Regarding SP 2017, the average magnitude of growth revisions is close to zero; it exceeds 0.5 percentage points only for Luxembourg and Malta. In this context, in general the analysed countries did not plan a significant discretionary revision of the budget balance over the relevant time horizon (2017-2020). One major exception is the Netherlands that foresees an average improvement of 1.5 percentage points (despite an almost null revision of growth on average). With the greatest upward growth revision (about 1 percentage point, on average), Malta plans to implement a relatively small upward discretionary revision of the budget balance (half of a percentage point).

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

## A.3 Expenditure slippages

To assess to what extent revisions of fiscal balance targets are due to revisions of public expenditure**,** it is useful to analyze expenditure data both in absolute values – which is usually the operational budgeting instrument – (Figures A8-A11), and as a percentage of GDP – mostly a policy variable (Figures A12-A15) [57]. Apart from some exceptions, it can be noted that slippages in expenditure forecasts in terms of absolute values appear relatively small[58], suggesting that the expenditure side of the budget is more under control by the government compared to the revenue side.

In general, nominal expenditures (both total and primary) show an upward path in each SP as expected. However, in some countries (Cyprus, Italy, Portugal and Spain) that were most exposed to the sovereign debt crisis subsequent SPs have somewhat tried to offset this trend, shifting downward the expenditure path: this is especially true in the first part of the available time series (SP 2011-2013).

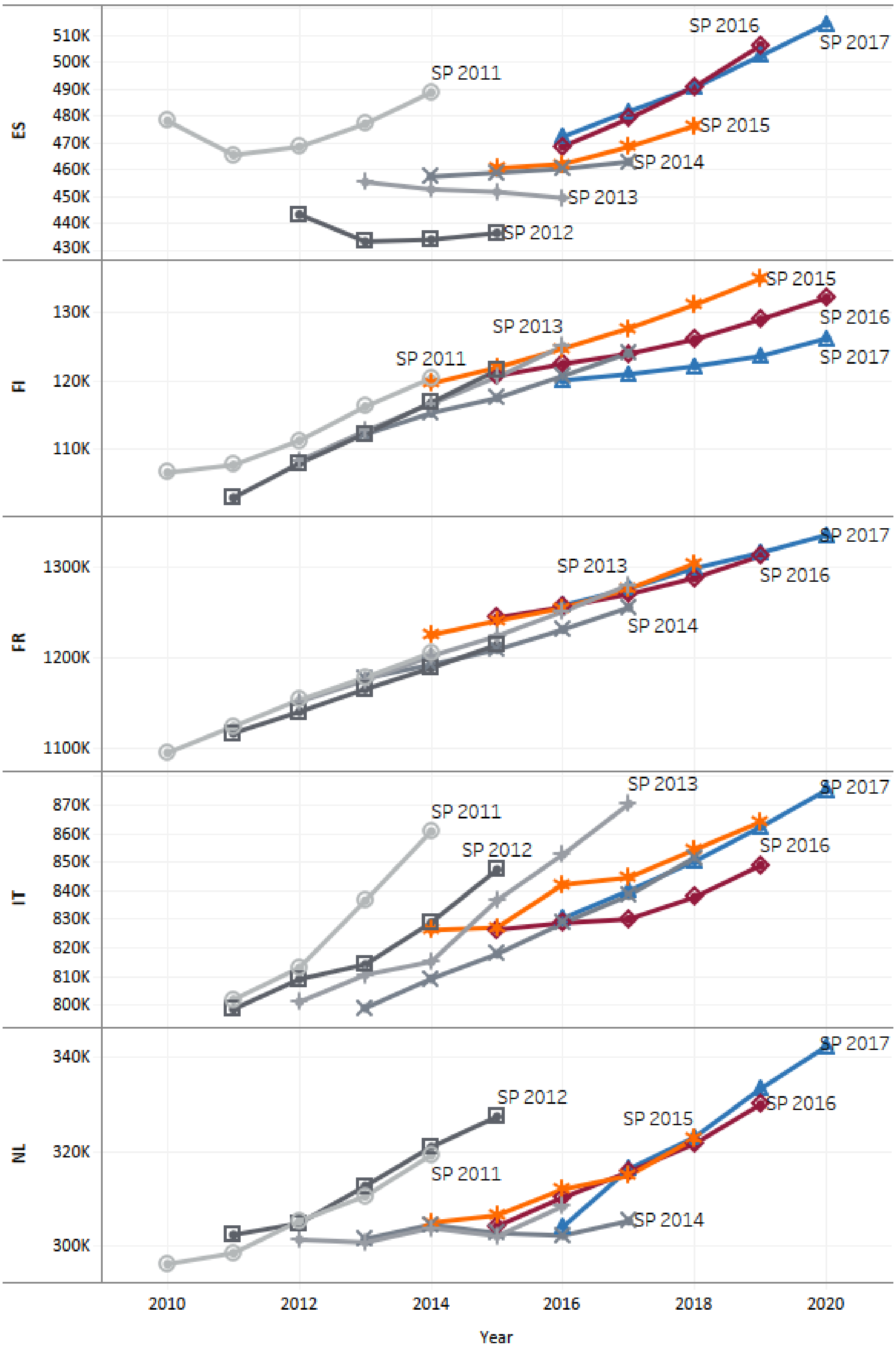
[57] When analyzing public expenditures or revenues, both in absolute values and as a percentage of GDP, it has to be born in mind the accounting change in fiscal data due to the adoption of ESA 2010 in 2015, which partly explains the slippages between the years 2014 and 2015.

[58] In general, while net lending variables (nominal and structural) are targets in SP documents, revenues and expenditures are formulated on the basis of unchanged policies (they may be considered as proxies of previous year's targets rather than of current year's targets). For this reason, the revisions of revenues and expenditures examined in this document do not necessarily correspond to the revisions of the budget balance previously examined.

Among the economies with relatively small expenditure levels[59], only Cyprus carried out downward revisions of the expenditure forecasts (along with upward revisions of the budget balance), both in absolute values and as a per cent of GDP until 2015, also having to comply with the adjustments required by the financial assistance programme. The following year, however, the budget balance was revised downward. Similarly, Portugal, which also was under the financial assistance programme until 2014, changed in the same year from negative to positive the sign of its expenditure revisions in absolute values, while as a percentage of GDP the expenditure slippages were always upward, due to the lower than expected GDP growth. Malta and Ireland maintained moderate upward revisions in expenditures, both in absolute values and as a percentage of GDP, thanks to higher than expected growth, which provided these countries with some fiscal space[60]. Other idiosyncratic factors could have an impact on the stability of medium-term expenditure programming; for example expenditures could intentionally be underestimated to exert downward pressures on spending by line ministries[61].

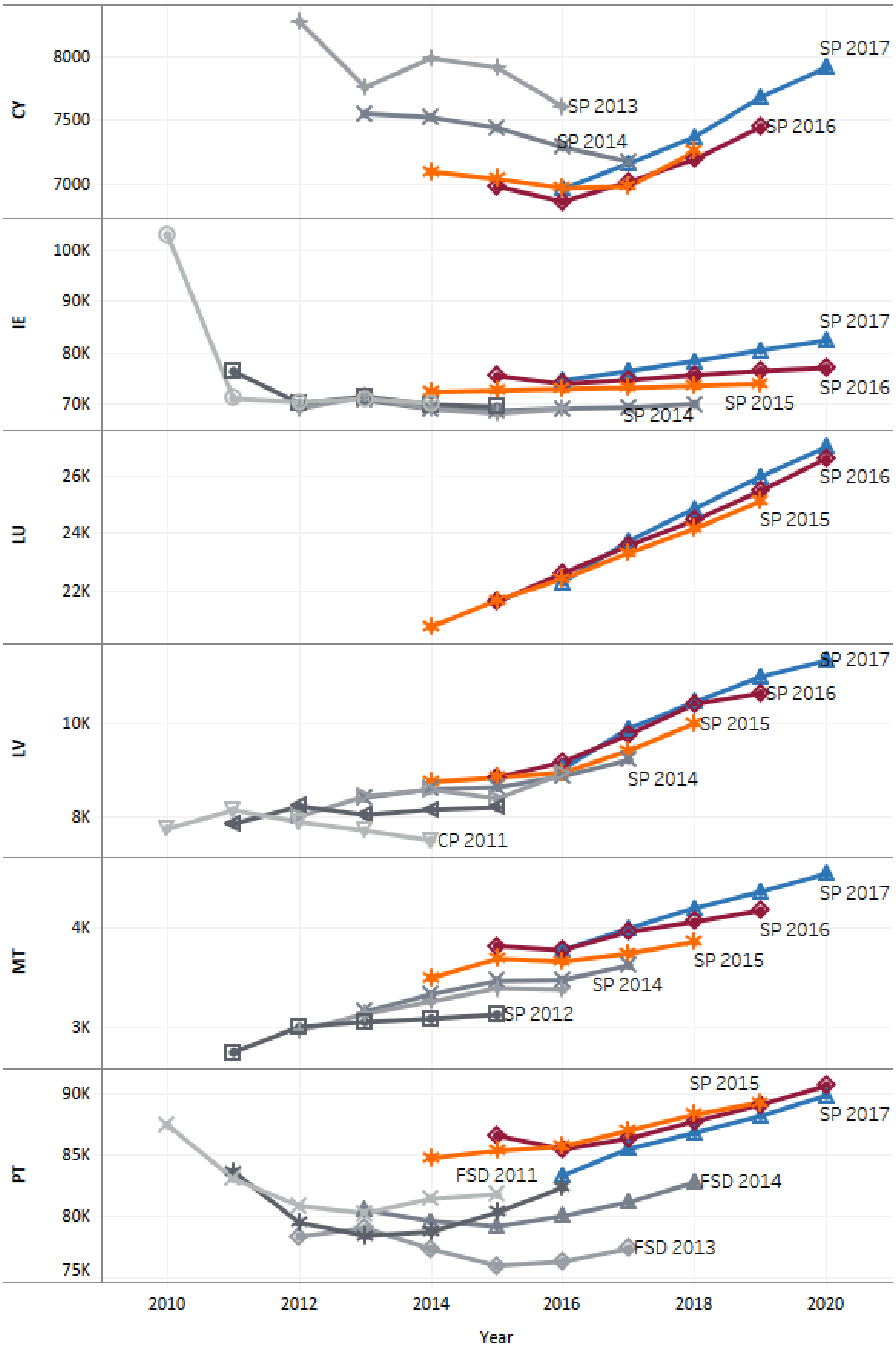
[59] Countries with total public expenditure under 100 billion euros.
[60] The data in levels used for Portugal were provided by the Portuguese fiscal council but have not been published in official documents. Regarding Latvia, the database does not include public expenditures in levels, while for Luxembourg this variable is available only for two years.
[61] In Ireland, for example, the Department of Public Expenditure and Reform has a stated policy of using expenditure ceilings to help to drive efficiency gains and productivity. Price pressures are underestimated in its forecasts: this leads to upward revisions when those price pressures subsequently emerge.

**Figure A8 –** Total expenditure (general government) forecasts in large countries (1) (millions of euros)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A9 –** Total expenditure (general government) forecasts in small countries (1) (millions of euros)

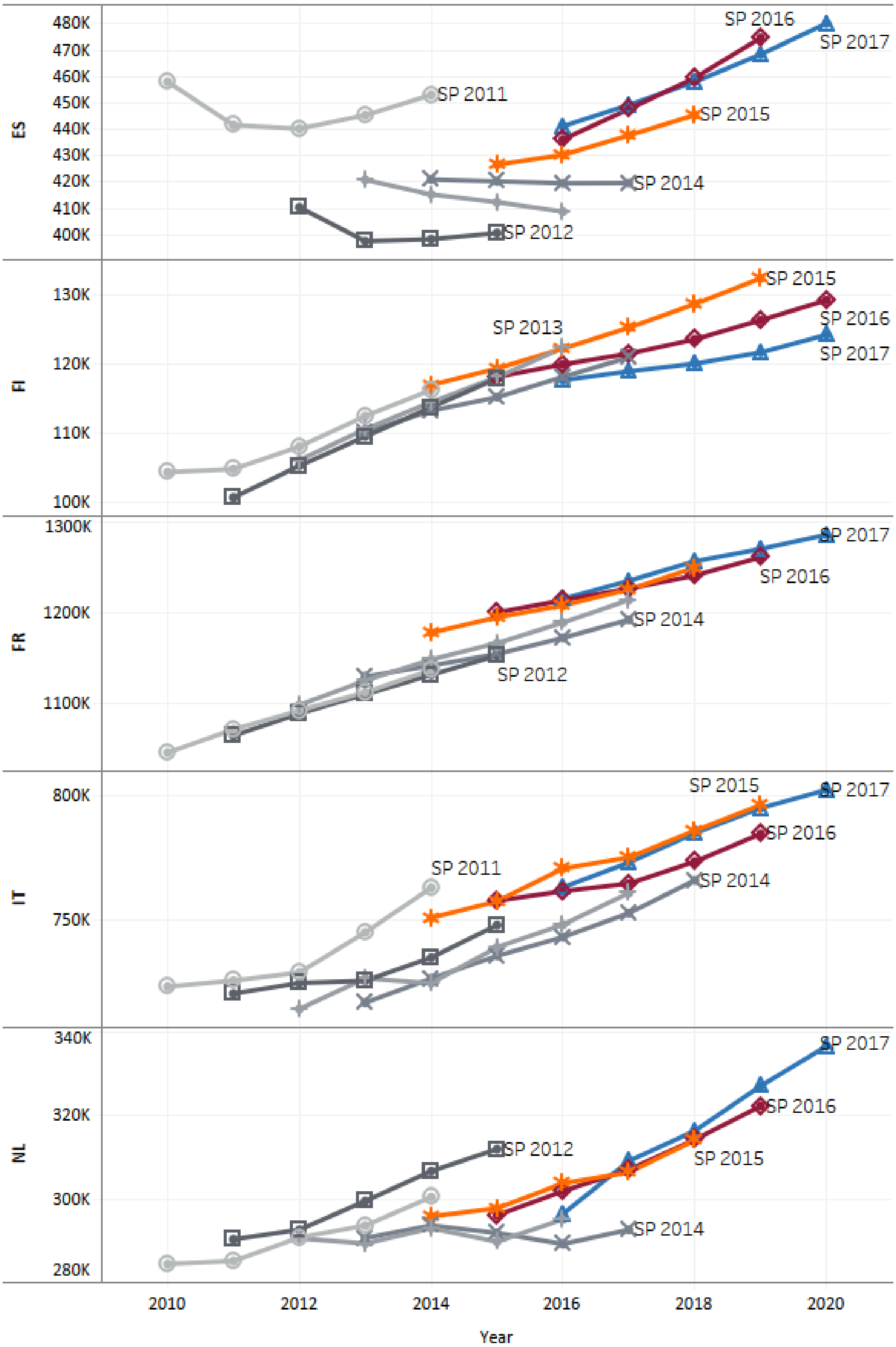



Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

It is useful to highlight some differences in the dynamics of total and primary nominal expenditures, looking at the group of countries with relatively high expenditure levels (Figures A8 and A10). At the outbreak of the crisis, Italy and Spain responded with large primary expenditure cuts compared to previous plans, in a context of rising interest-rate spreads that put upward pressure on interest payments. At the same time, other countries (the Netherlands) benefited from flight to quality that lowered their interest expenditures: in this country, comparing SP 2011 with SP 2012, the total expenditure path remains the same, while the primary expenditure path shifts upward. In later years, the decrease of sovereign bond yields' spreads led to savings in interest expenditure that in some cases made possible primary spending upward shifts (Spain, SP 2014-2015) or contributed to further reduction in total expenditures compared to previous plans (Italy, SP 2013-14).

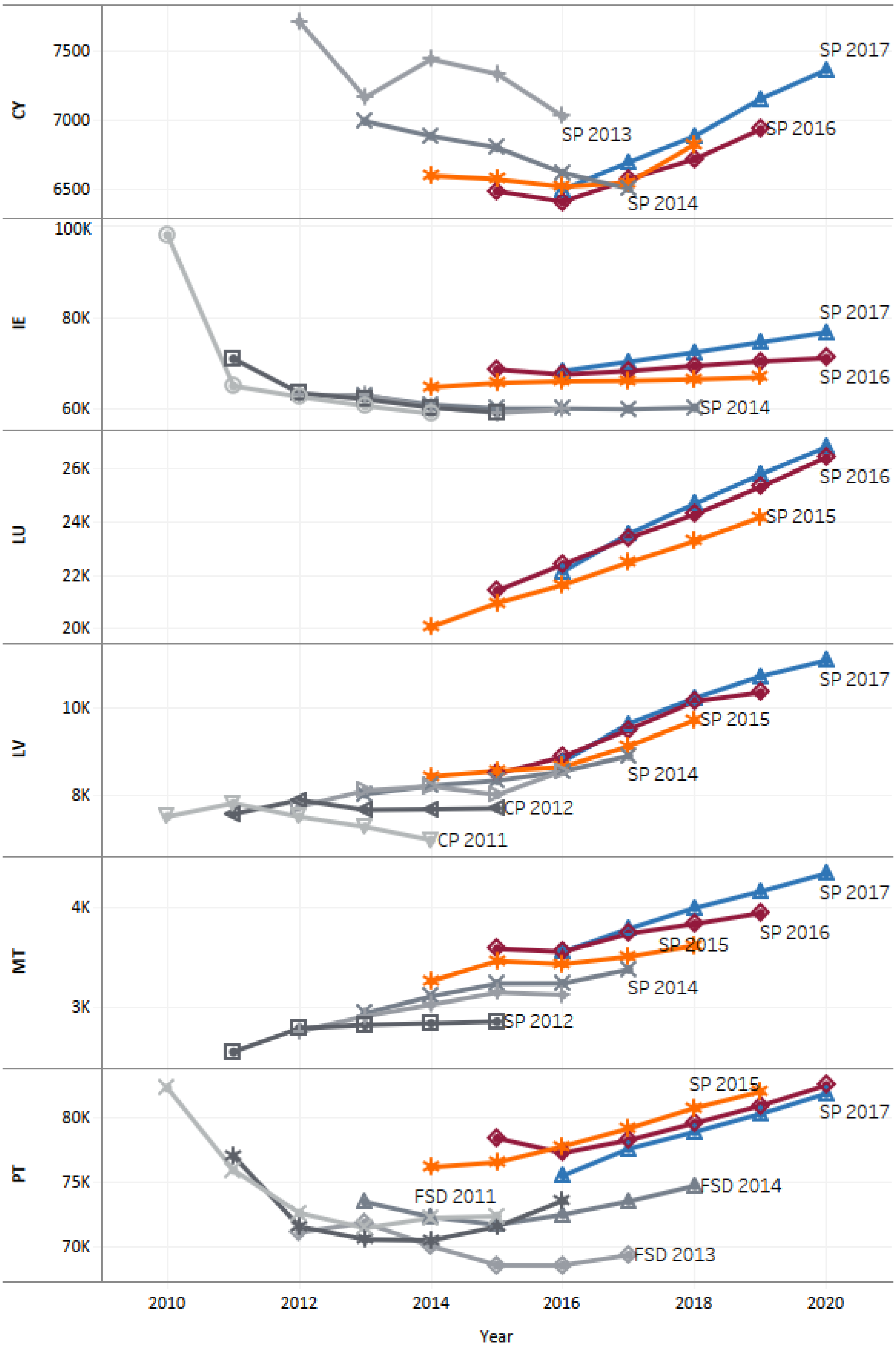
Expenditure-to-GDP ratios show a behaviour quite different from that of expenditure in absolute values (Figures A12-A15). Indeed, the ratios usually show a downward path in each SP and mostly upward shifts over subsequent years, at least in larger countries (with the exception of Netherlands from SP 2015 onward and Finland in SP 2016-17), where growth performances were in the mid-low range during the analysed time span (Figure A12). In smaller countries (Figures A9 and A13) relatively high GDP growth rates make possible to reduce the expenditure to GDP ratios despite rising nominal spending (Luxembourg, Ireland and Malta).

**Figure A10** – Primary expenditure (general government) forecasts in large countries (1) (millions of euros)



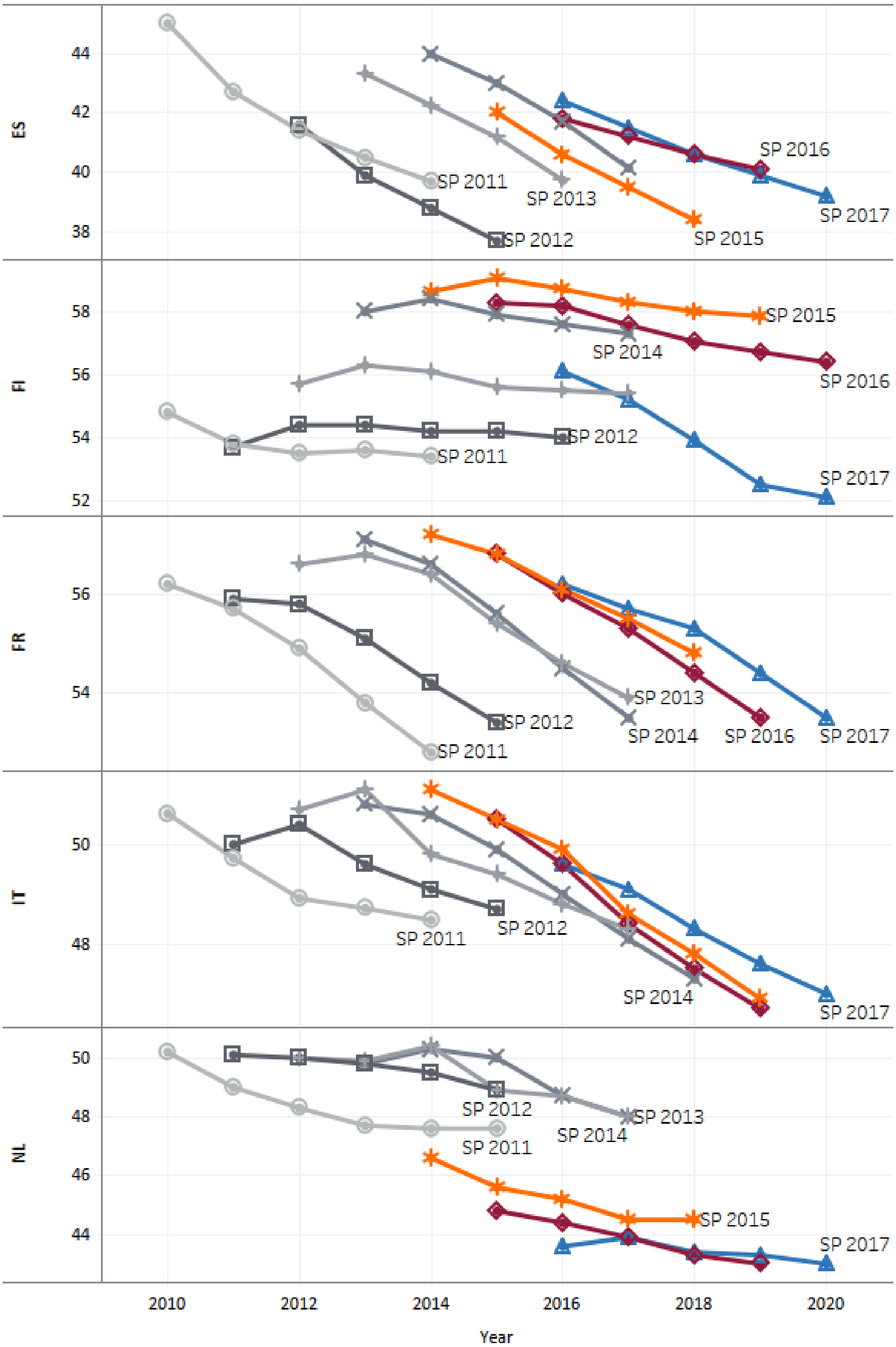

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A11** – Primary expenditure (general government) forecasts in small countries (1) (millions of euros)



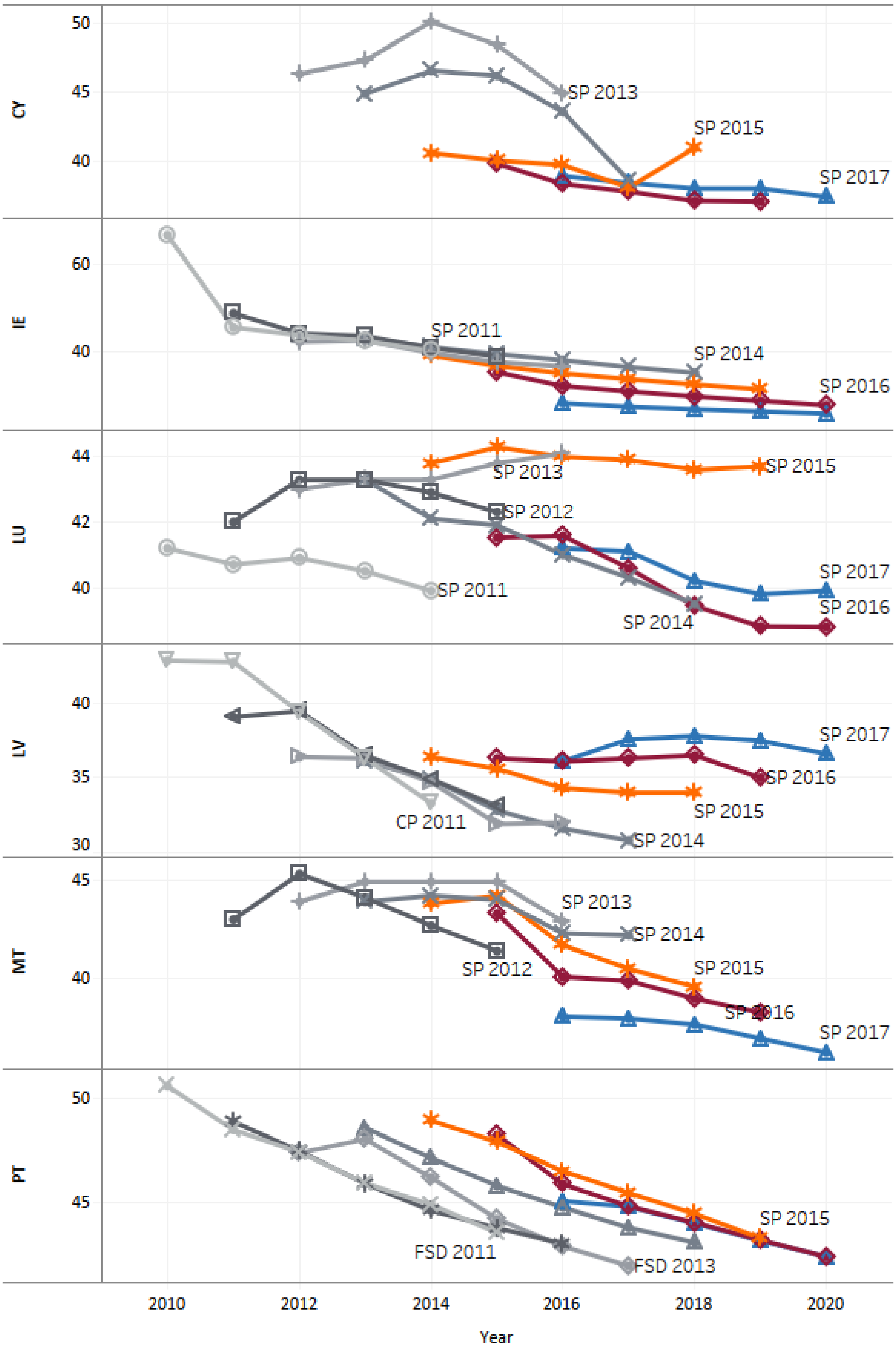

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

**Figure A12** – Total expenditure (general government) forecasts in large countries (percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017. Note: Large countries refer to those with total expenditure > EUR 100 billion

**Figure A13** – Total expenditure (general government) forecasts in small countries (1) (percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

There is country heterogeneity on the relation between the revisions of the expenditure side of the budget and those of GDP growth forecasts. This is partly due to heterogeneous expenditure rules. In some countries, for example France and Finland, the stability of expenditure planning in terms of absolute values implies the frequent revisions of the ratio of expenditure over GDP following revisions on growth. Nevertheless, the Netherlands has managed in most years to reach stability of expenditures in absolute values, as it should be expected considering their fiscal rules, without major shifts in the expenditure ratios over subsequent SPs. Also Latvia shows a relatively stable medium term programming for absolute value expenditure (in particular within the t+2 horizon), which translates in upward slippages of expenditure to GDP ratios from SP 2015 onward, due to frequent downward revisions in growth.

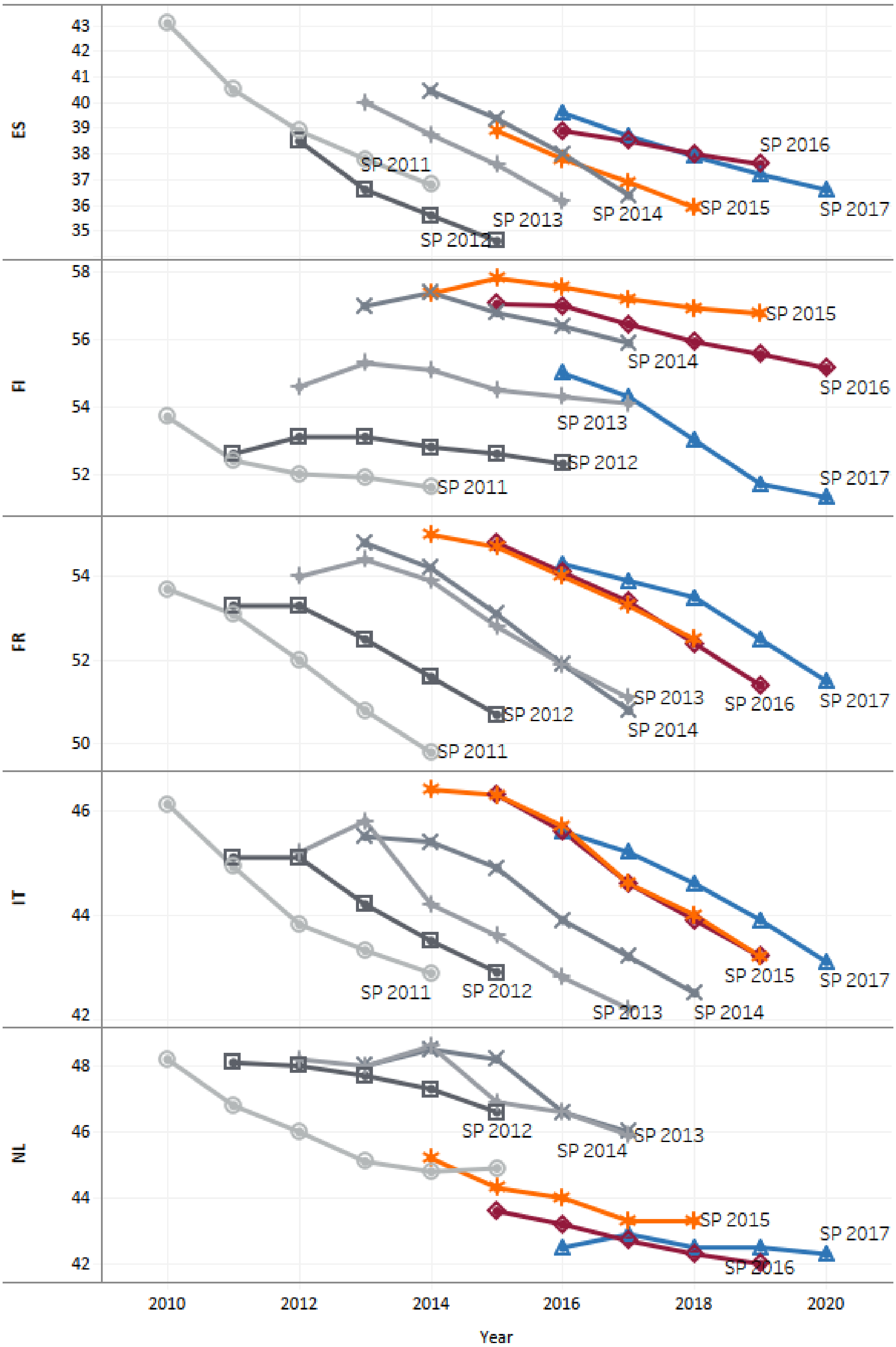
The relationship between deficit slippages and expenditure slippages is also heterogeneous across countries. For example, deficit slippages as a per cent of GDP in Spain have been accompanied by an increase in public expenditures both in levels and as a percentage of GDP. In Italy, slippages on the deficit as a per cent of GDP are associated with slippages on the ratio of expenditure as a per cent of GDP but not in levels, which instead show a downward shift over subsequent SPs.

It is interesting to look at one particular budget item – gross fixed capital formation expenditure (Figures A16 and A17) – as in this case the stability of mid-term programming is crucial for the successful implementation of the related projects. Indeed, in well-functioning MTBFs the path of this aggregate should be expected to be quite stable over subsequent SPs. However, in the interpretation of the results it should be taken into account the switch from ESA95 to ESA2010 that affected considerably the definition of this aggregate.

From the figures, it is clear that the sovereign crisis in 2011-2012 led to a downward revisions of investment expenditure in the countries especially hit (Italy and Spain in particular, but also Cyprus and Ireland). In these same years, gross fixed capital formation remained stable in other countries (France, Finland and Malta).

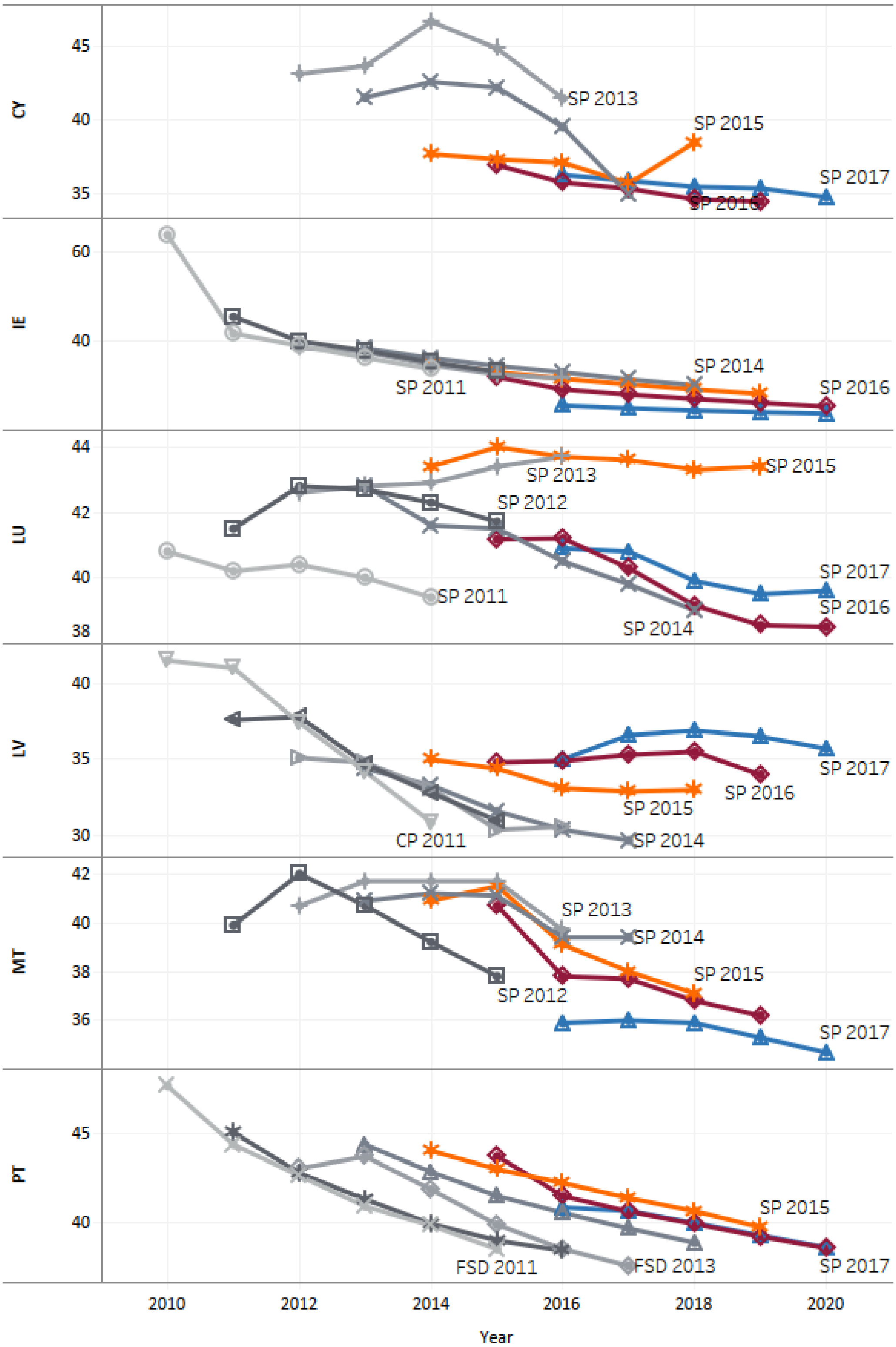
In post-crisis years and after implementation of ESA2010 (therefore in SPs 2015-17), public investments appear relatively stable in larger countries with the exception of Italy in SP2017 and, although to a less extent, in Luxembourg and Portugal.

**Figure A14** – Primary expenditure (general government) forecasts in large countries (1) (percentage of GDP)



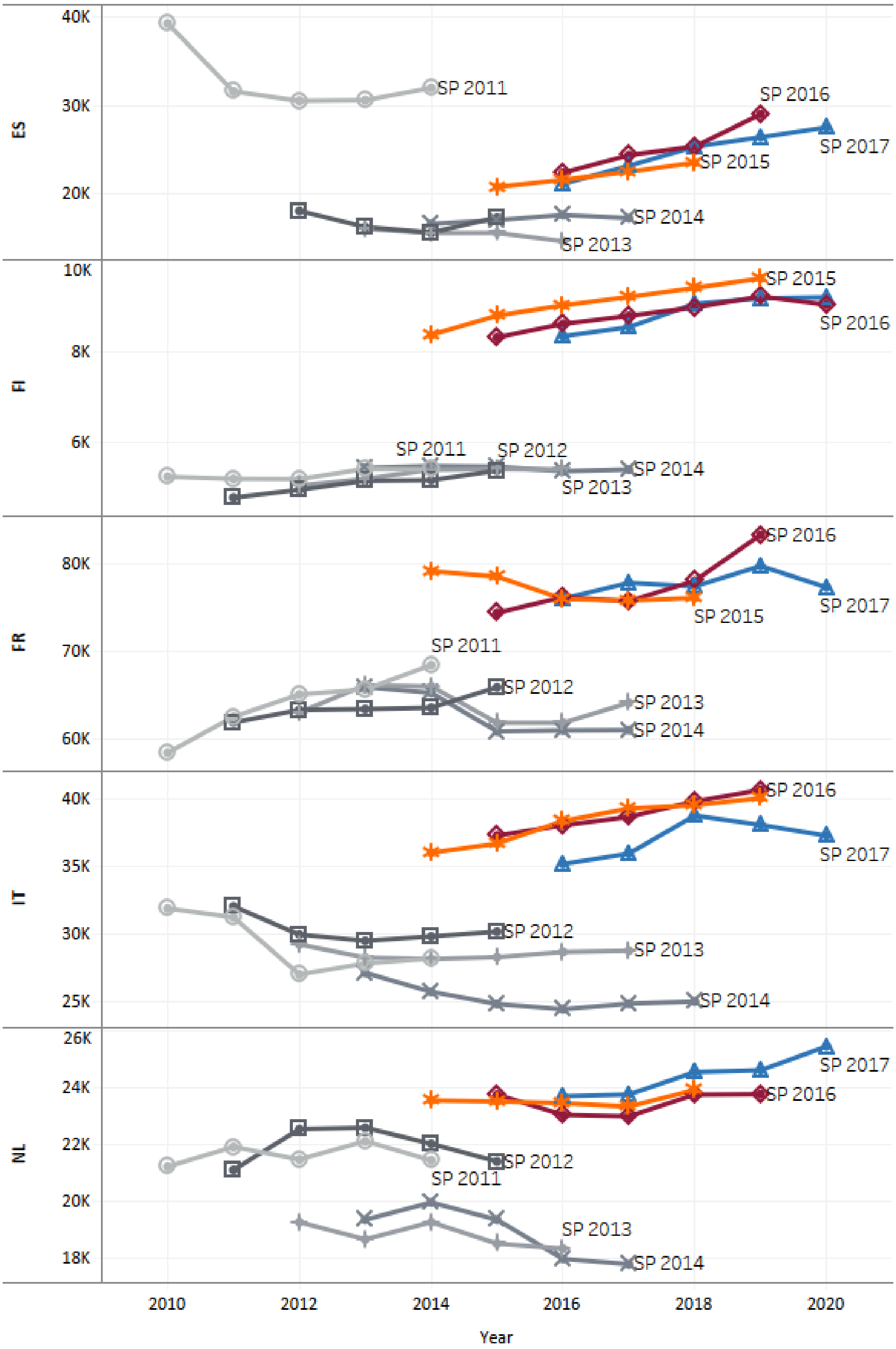

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A15** – Primary expenditure (general government) forecasts in small countries (1) (percentage of GDP)



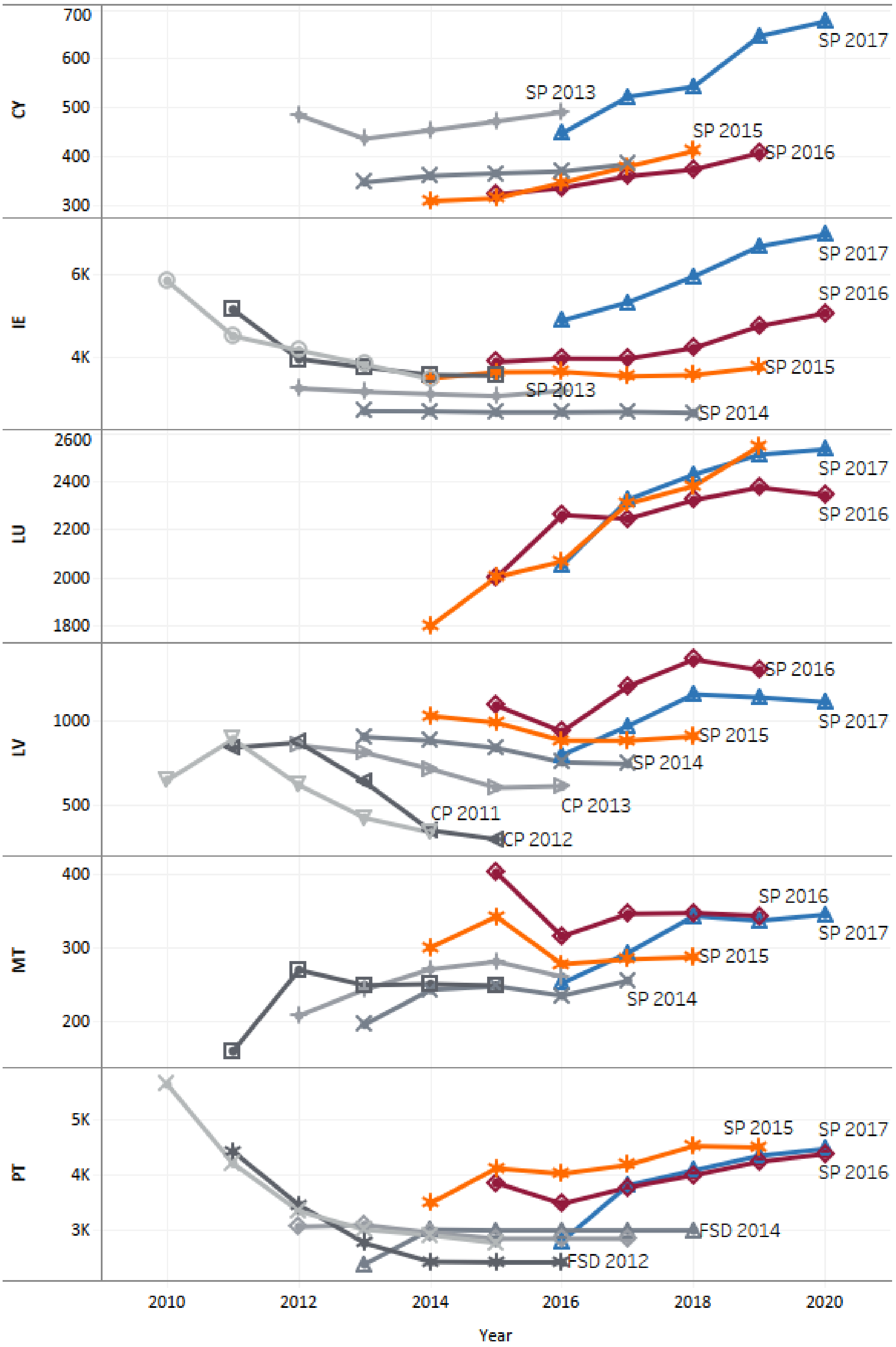

Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

**Figure A16** – Gross fixed capital formation (general government) forecasts in large countries (1)
(millions of euros)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A17** – Gross fixed capital formation (general government) forecasts in small countries (1)
(millions of euros)

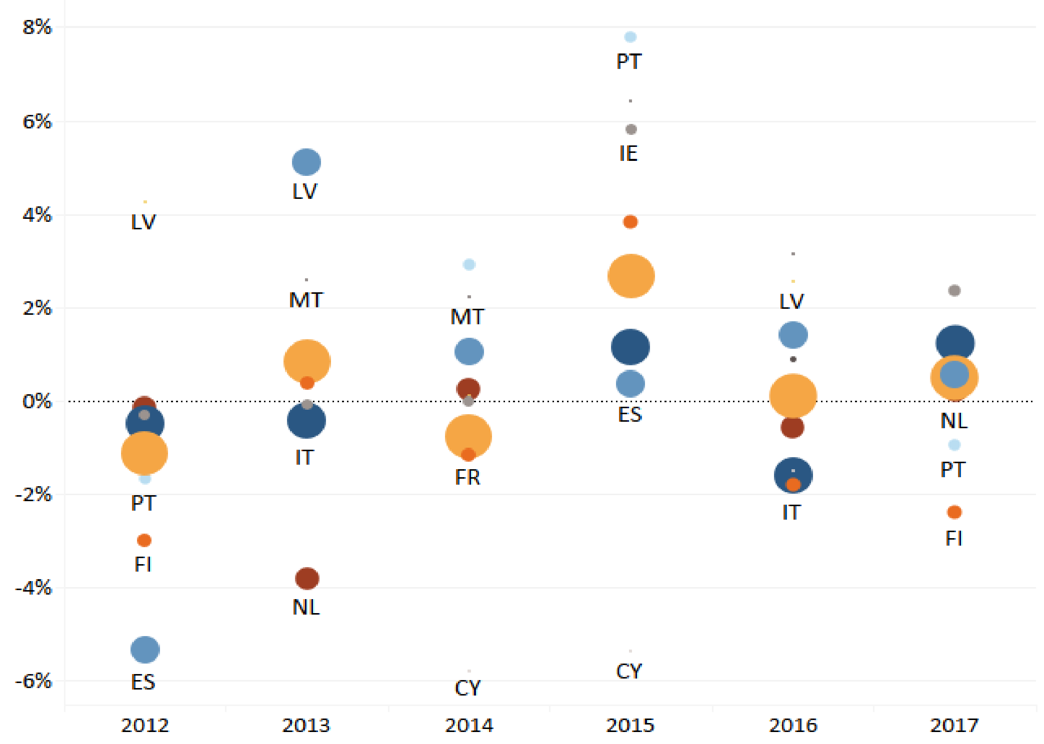



Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Small countries refer to those with total expenditure < EUR 100 billion.

## A.4 Slippages in short-term expenditure estimates/forecasts

Figure A18 shows for each year t the percentage change of the in-year estimate of total expenditures (in absolute values) with respect to the forecast in the previous year (i.e. the last forecast for year t). In formulae this is equal to: $\left(\frac{x_t^t}{x_t^{t-1}} - 1\right)$. This variable is an indicator of the degree of reliability of next-year forecasts contained in each programming document: the larger the indicator, the lower the programming value of the previous-year forecasts. Leaving aside 2015 (affected by the ESA change), France and Netherlands show favourable values of the indicator, with in-year adjustment of the expenditure forecast greater than 1 percentage point just in one out of five years (2012 for France, 2013 for Netherlands, both downward revisions). Also Italy shows a relatively good performance in this respect, with major revisions only for 2016 (-1.6 per cent) and for 2017 (+1.2 per cent). From 2014 onward, Spain approximately stands in the +/- 1 per cent band, while it had two major revisions in 2012-2013. Finland and countries with lower expenditure levels (<100 billions) often show greater (upward) revisions, generally between 1 and 3 per cent.

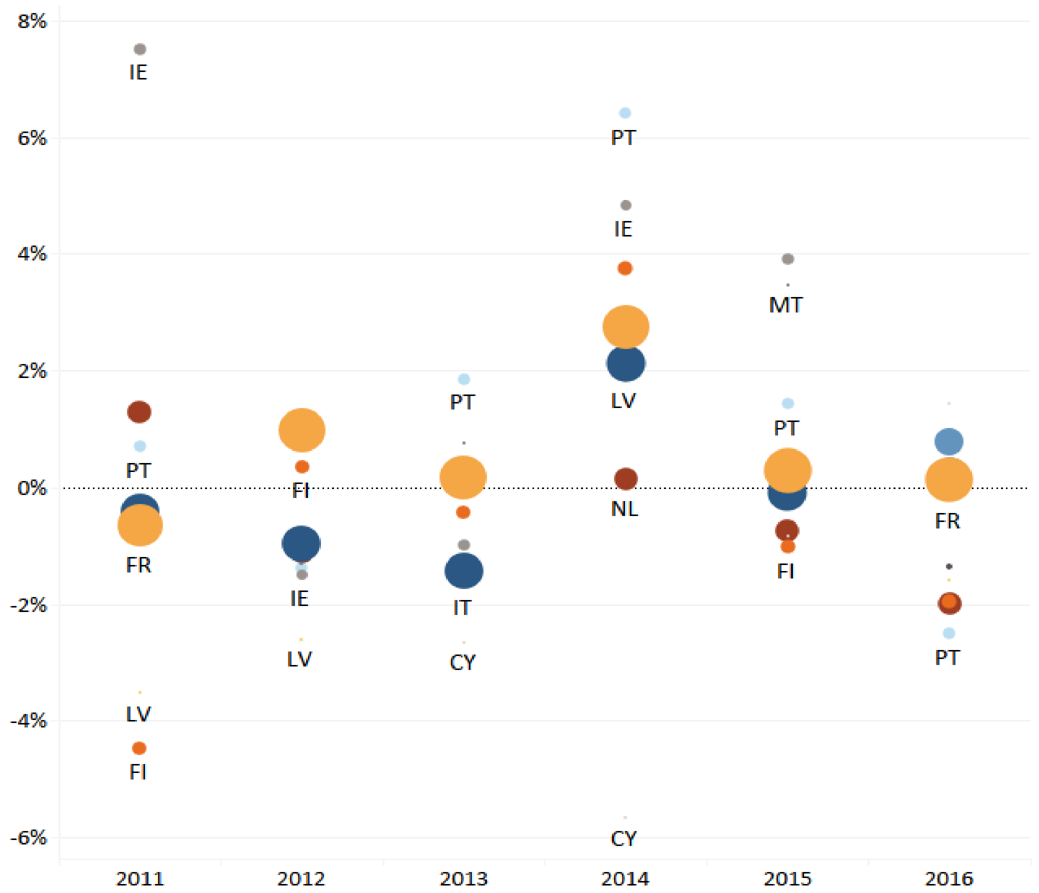
**Figure A18** – Revisions of nominal total expenditure: in-year estimate compared to previous-year forecast (1)
(percentage change.)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) The slippages for 2015 are affected by the changeover to ESA 2010 in September 2014, which implied an upward revision of expenditure (and revenue) levels in some countries, also as a result of a more comprehensive definition of the general government sector. In general, the results are also considerably influenced by one-off interventions in the banking sector linked to the financial crisis (see Table A1 in Section A.1).

Figure A19 displays for each year the percentage change of the first release of outturn data of total expenditure (in absolute values) with respect to the in-year estimate. In formulae this is equal to: $\left(\frac{x_{t-1}^{t}}{x_{t-1}^{t-1}} - 1\right)$. This variable can be considered an indicator of budget execution slippages, although it should be kept in mind that there could be discretionary revisions of expenditure targets after the spring in-year estimate. For this variable the ESA switch has an impact on 2014. France still shows good performances, as it is for Italy (exceeding the +/- 1 per cent band just in 2013, because of a downward revision). Finland presents a considerable downward slippage in 2011, whereas the Netherlands made a +1.3 per cent slippage in the same year and a -2 per cent one in 2016. Smaller countries exhibit somewhat lower accuracy according to this index, with the Ireland 2011 outturn correction (+7.5 per cent) probably due to accounting issues on special operations.

**Figure A19** – Revisions of nominal total expenditure: first outturn release compared to in-year estimate (1)
(percentage change)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) The slippages for 2014 are affected by the changeover to ESA 2010 in September 2014, which implied an upward revision of expenditure (and revenue) levels in some countries, also as a result of a more comprehensive definition of the general government sector. In general, the results are also considerably influenced by one-off interventions in the banking sector linked to the financial crisis (see Table A1 in Section A.1).

A sort of trade-off could be at work between the two indicators presented above: major in-year revisions of the previous year's expenditure forecasts could imply minor deviations during the budget execution. In any case, both of them highlight some weakness in the MTBF's functioning: data points significantly different from zero stress the need of last-minute revisions of the planned expenditure path or the occurrence of outright deviations from it during the budget execution, both of which are justified only in exceptional macroeconomic circumstances (like in the 2011-2013 period). In this regard, it should be noted that upward or downward revisions are equally relevant in evaluating the MTBF's effectiveness (the former showing a failure in respecting the ceilings and the latter a failure in fully implementing the spending programmes).

In assessing these results, it should be kept in mind that for many countries in the period under consideration (for example Portugal in 2014) the shifts in expenditures are due to one-off interventions in the banking sector linked to the financial crisis (see Table A1 in Section A.1) [62]. One way to deal with this caveat could be to use data net of one-offs, exploiting the information contained in the SPs to calculate the structural balances. However, it should be noted that not all the one-off measures are related to unforeseeable events and, therefore, the choice of which measures to net out would risk to be subjective. Another possibility to be explored in the future could be the use of expenditure data net of the support to the financial sector.

## A.5 The composition of the budget: discretionary revenues versus discretionary expenditures

After having analysed the revisions of the targets regarding the total amount of public expenditures, it is useful to examine specifically their discretionary component, comparing it with the discretionary component of revenues (Figures A20-A21).

Discretionary revisions of expenditure and revenue forecasts are measured as changes of their values as a per cent of GDP and net of the effect of the economic cycle. The cyclical component is estimated using the elasticity of revenues and expenditures with respect to GDP (see footnote 6).

Figures A20 and A21 shows the discretionary revisions in total revenue and expenditure (in per cent of GDP) defined in each SP for year t and for the next two. The vertical distance between the green mark (revenues) and the red mark (expenditures) for the same year indicates the magnitude of the discretional revision: when the green mark lies above the red one, the document foresees a discretionary revision towards budget tightening for that year, and vice versa; green and red marks' overlapping indicates a neutral discretionary revision. When they are both above or below zero, one side of the budget partially compensates the discretionary revision of the fiscal impulse provided by the other one. When green marks are above zero and red marks are below, both sides of the budget are revised to provide a restrictive discretionary fiscal impulse, and vice versa.

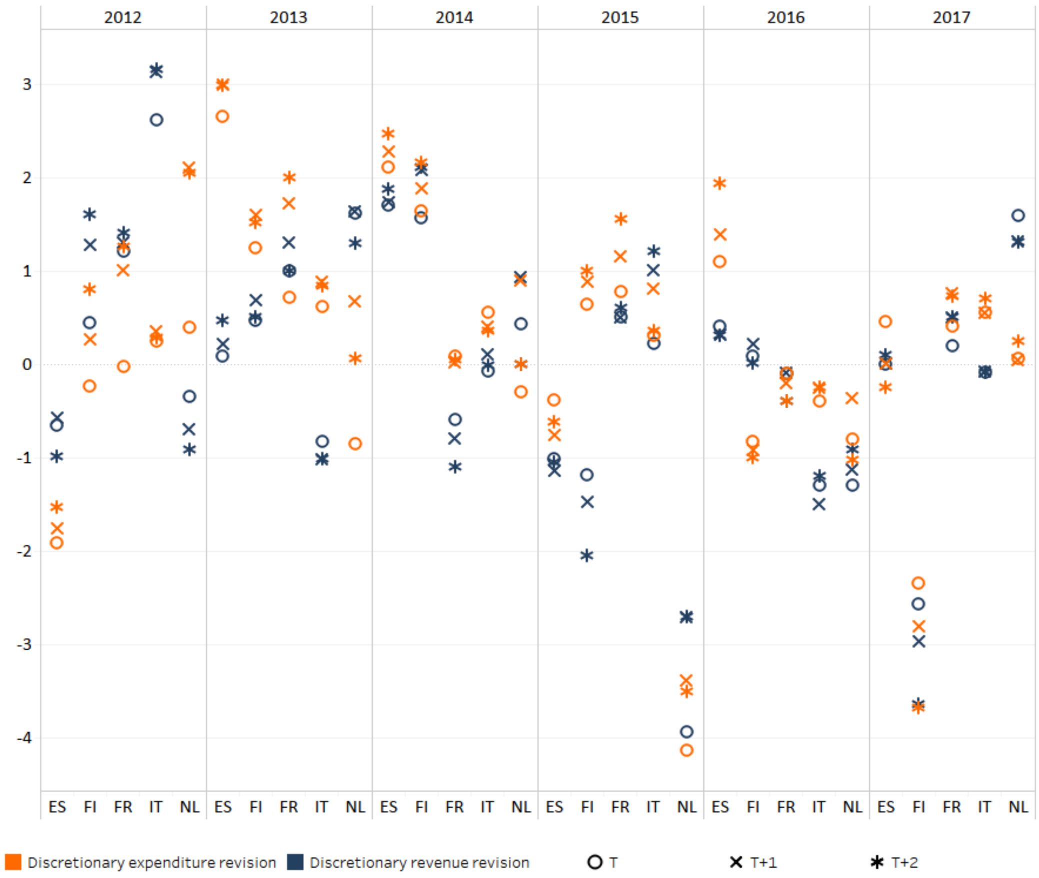
Also in the interpretation of this figure, it should be kept in mind that the results for 2015 are affected by the change of accounting system from ESA95 to ESA2010, which changed significantly the total amount of revenues and expenditures. Although this produces a

[62] These interventions can be of different nature (current/capital transfers, acquisition of financial assets, issuance of guarantees) and for this reason they can receive a different treatment in national accounts.

modest (or null) impact on net lending, some distortions may arise in measuring the discretionary components of revenues and expenditures.

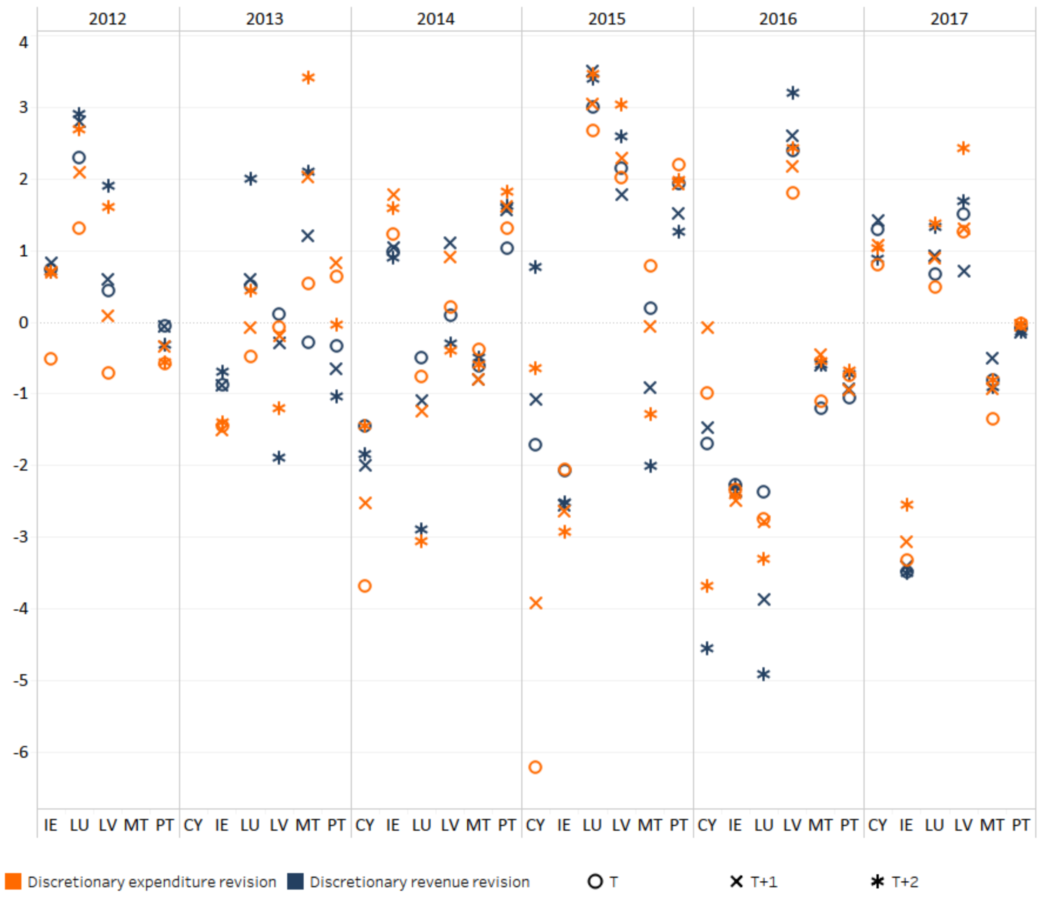
In SPs 2012, Italy, Spain and Finland provided significant restrictive revenue-based revisions over the whole forecast horizon, partially softened with the subsequent SPs. Luxembourg, Latvia and Portugal also applied revenue-based restrictive revisions of their budget balances. France and Ireland implemented a discretionary restrictive revision of revenues just for the year t, whereas the Netherlands devised a quite large and expansionary discretionary revision for t+1 and t+2, mainly through upward expenditure revisions.

**Figure A20** – Discretionary revisions of total revenue and expenditure in large countries, by publication year and programming horizon (1)
(percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

**Figure A21** – Discretionary revisions of total revenue and expenditure in small countries, by publication year and programming horizon (1)
(percentage of GDP)




Source: IFIs based on Stability Programmes (2011-2017) and PBO based on Stability Programme 2017.
(1) Large countries refer to those with total expenditure > EUR 100 billion.

From SP 2013 onward, restrictive discretionary revisions are quite rare: SP 2013, 2015 and 2017 for Netherlands, SP 2015 for Italy, SP 2016 for Finland and in some cases in relatively small countries (SP 2015 for Cyprus and, to a lesser extent, SP 2013 for Ireland and Luxembourg).

It is interesting to note that the discretionary revisions for t+1 and t+2 are generally greater (in absolute value) than the ones for year t and that revisions in one SP are often reversed by revisions of the opposite sign in the next SP. Looking at Figure A20, examples of this pattern are Italy between SPs 2012 and 2013 and between SPs 2015 and 2016; Spain between SPs 2012 and 2013 and between SPs 2014 and 2015; France between SPs 2013 and 2014; Netherlands between SPs 2016 and 2017.

To sum up, the data show that during the period 2012-2013 discretionary revisions of revenues and expenditures have been quite frequent as a response to the deepening of the economic crisis, as already noted in the paragraph A.2, referred to the analysis of budget balance slippages. Afterwards, the fiscal position of the countries tends to stabilize at least in terms of budget balances. However, the size and the composition of the budget varies considerably over time as illustrated by the position of the marks (rarely close to the x-axis).