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Fiscal rules and other rule-based mechanisms in practice: introduction to case studies of four Member States

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1 Introduction

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One of the most striking economic governance trends of recent years has been the increased resort to fiscal rules. In the EU as a whole, the number of fiscal rules recorded by the European Commission in its fiscal rules database[2] has risen nearly tenfold since the early 1990s. Such rules have varied considerably across countries, with some having many of the ideal features set out in a seminal paper by Kopits and Symansky (1998), while others have evident shortcomings. Nearly all EU Member States have also now established Fiscal Councils as independent agencies to monitor the conduct of fiscal policy.

Starting with the Stability and Growth Pact (SGP – originally launched in 1997, then reformed in 2005), the EU has been a prime mover in stimulating rule-based governance. Many of the reforms enacted in response to the years of crisis since 2008 were intended to tie the hands of governments even more by establishing norms not only for fiscal discipline, but also for curbing other macroeconomic imbalances. The changes also provide for more intensive monitoring of national policy-making by the EU level and undeniably constitute a far-reaching package.

Thus, as part of what has become known as the 'six-pack' of measures adopted in 2011, the SGP was further reformed, notably adding a debt rule to a Pact that had hitherto been confined to deficit rules and amending its decision-making. Further measures included the Fiscal Compact, part of the separate inter-governmental Treaty on Stability, Coordination and Governance, now signed by all bar the UK and the 'two-pack' of measures applicable only to the Eurozone. A key element of the latter is the obligation for draft budget plans to be submitted for scrutiny to the European Commission in the autumn, prior to being adopted.

The six-pack also obliged Member States to introduce domestic rules intended to strengthen compliance with the SGP, and complemented these obligations on fiscal policy with a new Macroeconomic Imbalances Procedure (MIP) which, like the SGP, has preventive and corrective arms. In both mechanisms, Member States which fail to deal in a timely manner with fiscal or other imbalance can be fined, although no finance minister has yet been obliged to transfer money to Brussels for this reason.

However, a perennial difficulty at EU level has been in ensuring that the mechanisms of governance function effectively in enforcing rules. so as to assure compliance with the underlying objectives. High profile instances of fudging, such as over the excessive deficits of

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[1] European Institute, London School of Economics and Political Science. I am grateful to the authors of the case studies on Italy, Poland and Slovakia for their comments on the introduction

[2] http://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/numerical-fiscal-rules-eu-member-countries_en#database-on-numerical-fiscal-rules

France and Germany in 2002/3, or the 2016 decision to impose fines of zero euros on Portugal and Spain damaged the credibility of rules (Begg, 2017).

In addition, there is compelling evidence of, at best, limited action to deal with the country-specific recommendations issued annually under the aegis of the European Semester. This process was meant to be at the heart of efforts by 'Brussels' to coordinate national policies in the common interest – as foreseen in articles 121 and 136 of the Treaty on the Functioning of the European Union – but is prone to be marginal in domestic policy debates.

1.1 Aims of the case studies

The national case studies in this document provide a detailed examination of fiscal and other rules in four EU Member States: Italy, Poland, Slovakia and the UK. Two of these are members of the Euro Area, Poland is a non-Euro signatory of the Fiscal Compact, but the UK, even before the Brexit referendum result, was (not least because of its Maastricht opt-out from participation in the euro) bound much more loosely by EU rules.

The case studies have examined the application of the rules, drawing on a range of documents and on interviews with public officials responsible for the implementation of the rules and with experts knowledgeable about the respective countries. They sought to explore how the processes and mechanisms of fiscal governance function , the interplay between national and EU rules and what they imply for the coherence of the policy system and , more generally, to investigate the political economy of rules. We are grateful to all the interviewees for taking the time to help with the research, but have chosen not to quote any of them directly.

Within reason, given the varied institutional structures and histories of the countries, the case studies adopted a common approach, using a questionnaire drawn-up by the four research teams and comprising questions for all four countries, together with specific questions for each. The questionnaire was intended as a guide to information gathering, not a template to be followed rigidly. The mix of interviews was determined by the individual case study teams and was partly conditioned by the availability of information from other sources. Rather than trying to be representative, their purpose was to obtain a well-grounded understanding of how fiscal governance, generally, and the various rules (especially those introduced at the behest of the EU) are working.

1.2 Selective overview of findings

The findings reveal a diversity of experience and applications of rules. For example, in Slovakia a key conclusion is that the rules are useful, whereas Italy has struggled to abide by them. Some rules, such as the constitutional debt limit in Poland, are seen as inviolable, whereas both a softer debt rule in Poland and the debt reduction targets in the UK and Italy are not. The cases of Poland and Slovakia show that hard constitutional rules on debt do bind governments more tightly than rules with a lesser legal base. A persuasive message from both studies is that governments feel compelled to act to prevent a breach of their respective debt limits, with no obvious room for manoeuvre in avoiding them.

Generally, rules in the UK seem to be much less constraining, with recent governments regularly breaching them and facing few consequences, other than mild political embarrassment. In Italy, the picture appears to be more blurred, with extensive use being made of escape clauses, and persistent efforts to interpret the rules as flexibly as possible. Poland and the UK have, in addition, made use of non-obvious means of circumventing rules on debt, such as reclassifying pension obligations or altering the treatment of public-private finance initiatives. There is also evidence from some of the case studies that the complexity of expenditure rules (Poland) or their limited coverage (UK) can detract from their effectiveness.

The influence of EU rules is varied. They provide a framework and, insofar as national rules are structured towards complying with their EU equivalents, typically constitute the 'model' of fiscal governance to be followed. This is by no means insignificant if the distinction between the UK and the other three cases is probed. The lack of resonance or influence of EU rules in the former is striking and arguably reflects the non-participation in much of the economic governance around the euro, including the Fiscal Compact. Simply put, the UK pays little heed to having been inside the EU's excessive deficit procedure since 2009, with the projected exit from it in 2017 even serving as the basis for a joke in the Chancellor of the Exchequer's (finance minister) March 2017 budget speech.

An important question is, nevertheless, whether acquiescence with EU governance norms and compliance with rules consistent with them has (which can be interpreted as 'effective' policy in the sense of conforming to the targets) led to better results (the 'utility' of the policy framework in enhancing social welfare). It is hard to provide an unambiguous answer. The fiscal indicators of Poland and Slovakia are manifestly superior to those of Italy and the UK, and it can be argued that their economic performances are also better as measured by macroeconomic aggregates such as GDP growth or the extent of imbalances.

Yet there is a more tricky matter of whether the manner in which rules have been applied has been *appropriate* as opposed to *compliant with the precise numerical thresholds*. On this, the Italian case study offers a mixed verdict: Italy has kept its deficit in check, helped by the balanced budget rule inserted in the constitution, but has made scant progress in debt reduction, partly because GDP itself has been so sluggish. The UK, similarly, has not made progress in reducing debt, but its higher deficit may well have helped to maintain growth. What these broad findings suggest is that efforts to comply with fiscal rules, in these unusual times of exceptionally loose monetary policy, may have been at variance with sound macroeconomic policy.

The advent, in three of the cases, of a fiscal council, has altered the nature of fiscal governance, and was found to be a welcome innovation, although in Italy, it is early days.

Despite not having a formally constituted fiscal council, other agencies in Poland are found to fulfil some of the functions of such a council. A conclusion is that rules and the watchdog function provided by independent fiscal councils can complement one another if sensibly configured.

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2 In-depth case study of the implementation of coordinating mechanisms for Italy

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2.1 Evolution of national fiscal and (where relevant) other macroeconomic rules

In 2009, with the new accounting and public finance law, Italy decided to pursue a more rigorous fiscal discipline, through the introduction of the principle of budget planning in the medium to long term and the planning of policies, objectives and resources over three-year periods. The European Council of March 24th-25th, 2011 reaffirmed the commitment of Member States to transpose into their national legislation the fiscal rules of the EU set in the Stability and Growth Pact (SGP). The exact forms of the rules were decided by each country, but they had to guarantee budget discipline at both the national and sub-national levels. The Domestic Stability Pact constituted the main pillar of Italy's institutional fiscal governance system on local government bodies, until it was modified by the financial package in 2012. The national (SGP) rule was accompanied by a local one (Domestic Stability Pact), which required local government bodies to limit spending each year to the amount of current expenditure registered on average in the previous three years.

With the launching of the Excessive Deficit Procedure (EDP) against most European countries in 2009, Italy was asked to bring its deficit under the limit of 3% of GDP by 2012 and to guarantee an average annual budget correction equal to at least 0.5% of GDP during 2010-2012. Since Italy was subject to the EDP from 2009 to 2012, for the years 2013 to 2015 it was subject to the transitional debt rule. As a country exiting the EDP, in the following three years it is not strictly required to follow the fiscal rules as revised in the 'Six Pack' of governance reforms agreed by the EU in 2011, but just to follow a convergence path for the deficit/GDP ratio towards a balanced budget, at least to keep it below the 3% benchmark. Even if Italy was not constrained by the cap on public expenditure and the Medium Term Objective (MTO) for the structural deficit/GDP ratio was not binding, so that it was not required to reduce gradually its structural debt/GDP ratio towards the 60% target, the Italian Government was required to design a plan to comply with the new national fiscal rules starting from 2015.

From 2011, the National Reform Programme (NRP), complementing the Stability Programme (SP), was made an integral part of the Economic and Financial Document (EFD). It was designed to coordinate actions at the national level to exit from the crisis and to reach the objectives established in the Europe 2020 Strategy. Thinking about national economic policy within the European framework and over the long term is one of the most important changes introduced in the European Union's economic governance with the "European Semester". The Europe 2020 Strategy constitutes an integral part of the national reform agenda because it sets medium-term objectives that Italy must comply with in any case, even without the stimulus of Europe, to enable the economic and productive system to emerge stronger from the crisis. The Euro Plus Pact is situated in this framework. It includes a strengthened coordination of economic policies in the Euro Area, with the objective of consolidating EMU as an economic pillar by adopting actions at the national level aimed at increasing competitiveness and convergence.

With a view to enshrining in the Constitution the country's collective awareness of the need to make financial stability the mainstay of its national economic policy, on April 17th 2012 the Government supported the adoption by Parliament of the draft of the constitutional law amending art. 18, thereby making the balanced budget rule a constitutional requirement and linking it to a sustainability constraint for general government debt. The new rules have been implemented since 2014, with the exception of the decentralized ones, for which the implementation is foreseen from 2016, which will overcome the Domestic Stability Pact. All Public Administration is required to achieve an MTO, which is currently for Italy a balanced structural budget, defined by the EU, and a balanced nominal budget for sub-national governments, defined by the Italian government. The objective may, however, take into account the financial impact of structural reforms with a significant positive impact on the sustainability of public finances. The law also states that temporary deviations of the structural balance from the objective might be authorized by Parliament upon Government request, only in the case of exceptional circumstances and with the contemporaneous definition of a recovery plan. These include periods of severe economic downturn and extraordinary events outside the control of the government. During recessions or in case of exceptional events, the Central Government will transfer additional funds to local administrations, but in more favourable periods local administrations will contribute more to the fund to reduce Central Government debt. Local authorities can fund their expenditure by issuing debt only to cover investment costs and with several limits. Starting from 2011, to comply with a balanced budget rule, the Stability Law includes a safeguard clause for which an increase in taxes or a decrease in tax breaks is automatically activated if the budget is not balanced.

The national fiscal framework was significantly strengthened in 2012 through the establishment of an independent fiscal council and the setting of new numerical fiscal rules with Law 243/2012, and important fiscal reforms have been implemented in a difficult economic environment. This has helped to stabilise the increase in debt levels and has improved the financial markets' perception of the sustainability of public finances, thus lowering sovereign bond spreads. However, there has been a significant delay in setting up the board of the Parliamentary Budget Office (PBO), but following the European Council's Recommendation, asking the country to guarantee the independence and full operationalisation of the fiscal council (the PBO) no later than September 2014, it was established in April 2014. The PBO is responsible for assessing macroeconomic and fiscal forecasts and for verifying compliance with national and European fiscal rules. Although European regulations only require validation of the policy forecasts, the PBO has reached an agreement with the Ministry of Economy and Finance (MEF) to extend the validation exercise to comprise the trend forecasts on a current legislation basis.

2.2 Description of fiscal governance framework and key institutions

As described in the previous paragraph, in 2012 a constitutional amendment introduced a balanced budget rule, effective from 2014, which applies to the whole government sector and takes into account cyclical fluctuations and exceptional circumstances. In the same year Parliament established a Fiscal Council and introduced a spending rule, effective from 2013, which limits planned growth rates of public expenditure to the European benchmark. The debt rule, only coming into force from 2016, requires an annual reduction in the debt/GDP ratio of at least 5% of the difference with respect to the 60% target, calculated over the previous three years. According to the balanced budget rule the general government balance is in equilibrium when it is at its MTO in structural terms, which for Italy is a zero structural balance. Government deficits or surpluses in nominal terms are allowed depending on the cycle (output gap). Temporary deviations from the MTO in exceptional circumstances must be approved by Parliament. Other provisions include that the sub-national level of government must be in equilibrium in nominal terms, the creation of a fund to finance social expenditures, which moves in line with cyclical developments, and the creation of an Independent Fiscal Council. Both the domestic rules and the fiscal council are strictly intended to help the national government to comply with EU rules and national legislation has followed EU requests literally, bringing value added to the achievement of national fiscal objectives.

The Independent Fiscal Council of Italy is the Parliamentary Budget Office (PBO) estabilished within Parliament. It is responsible for monitoring public finances and the compliance with numerical fiscal rules. It is also mandated to assess the underlying assumptions of fiscal projections, as well as macroeconomic effects of major legislative packages and public finance sustainability. Moreover, it verifies the activation of corrective mechanisms and assesses exceptional events. The office also contributes to ensuring the transparency of the public accounts at the service of Parliament and the general public. The PBO also reports to the appropriate parliamentary committees on its analysis of the fiscal policy documents and the Stability Bill. The PBO conducts its validation of the macroeconomic forecasts published in the EFD, its Update and the Draft Budgetary Plan (DBP), which for the first time in 2014 distinguished between a current-legislation (trend) scenario and a policy scenario (which reflects the impact of public finance measures to be adopted with the Stability Bill). It has no role in policy recommendations or distributive conflicts. The PBO Governing Body is a three-member board appointed by the Presidents of the two Houses of Parliament. Members of the board are selected among qualified persons of recognized independence with a six-year non-renewable mandate. It has full access to economic and public finance databases managed by other administrations and all public administrations must provide information on public finance developments as required. If the PBO assessments are significantly different from those of the government, upon request of at least one third of the Members of the Parliamentary Budget Commissions the government shall explain to the Parliament the reasons why it intends to confirm its own assessments, otherwise it shall align with those of the PBO. The PBO, in any case, does not have any enforcement power on the government, but Parliament does and could ask for a vote of no confidence and, in extreme cases, a fall of the government.

Law 196/2009 brought forward to April the start of the budget cycle by aligning planning documents with the European semester. The law anticipated some of the requirements of EU Directive 85/2011 like the harmonization of balance sheets in the public administration and the strenghthening of multi-year planning. Since 2014, in line with the requirements of the Two Pack (EU Regulation n. 473/2013), by October 15th Italy must submit to the EU Commission its Draft Budgetary Plan (DBP), which contains the update of the macroeconomic and public finance forecasts set out in the Stability Programme and the details of the public finance measures. The DBP also includes some information about how the measures outlined in the budget respond to the EU Council's specific recommendations to Italy. The European Commission Opinion on the DPB is also based on the PBO's analysis, which, after validating the macroeconomic forecasts[3] within an acceptable interval, issues two reports every year: the Budgetary Planning Report after the EFD and the Budgetary Policy Report after the Update of the EFD and the DPB.

The PBO's Budgetary Policy Report 2015 was the first report issued by Italy's Independent Fiscal Council, which analyzed the Update of the EFD 2014 and the DPB 2015. European legislation requires the validation of macroeconomic policy projections only. In agreement with the Minstry of Economy and Finance (MEF), the PBO has also extended the validation process to macroeconomic trend scenario projections. The PBO also assessed the realism and reliability of the macroeconomic scenarios presented in the Update for 2016-18. In its Budgetary Planning Report 2015, the PBO assessed the macroeconomic scenarios published in the 2015 EFD for the entire 2015-19 period. The PBO conducted the validation exercise using projections developed independently by a number of public and private forecasters (Istat, CER, Prometeia and REF Ricerche, referred to as the PBO panel) using their own macroeconometric models. This is because of the unavailability in the PBO's start-up phase of its own macroeconomic forecasting model and also because of the importance, in view of the intrinsic uncertainty of macroeconomic forecasts, of using multiple forecasting models in combination, to produce more reliable and robust estimates than those based on a single model. Combining the estimates produced by the panel forecasters, the PBO constructed specific validation ranges for each variable in both the trend and policy scenarios to use in assessing the plausibility of the forecasts developed by the Government.

The regulatory framework for local public finance has been completely redefined in recent years. In 2015, the full-scale accounting harmonisation of territorial entities and, in

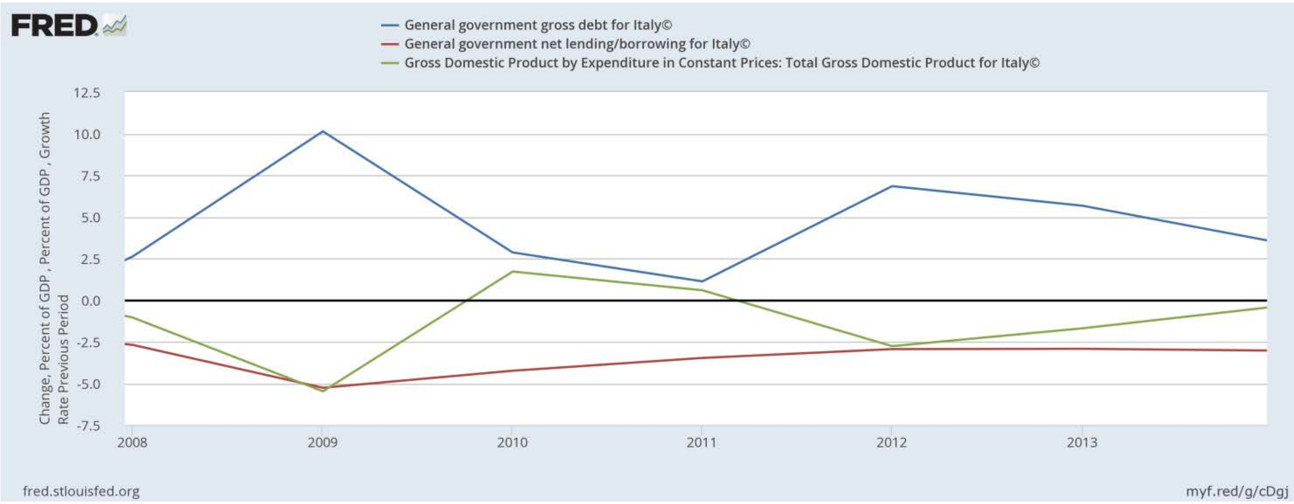
[3] Regulation EU No 473/2013 requires the draft budget to be based on independently endorsed or produced macroeconomic forecasts.

particular, the application of the principle of ‘enhanced’ financial accrual, made it possible to achieve greater substantial equilibrium in budgeting, and to support more precise planning of investments. As from 2016, the balanced budget rule has permanently replaced the Domestic Stability Pact. The achievement of national public finance targets thus involves all levels of government, regardless of the number of inhabitants. Namely, Law No. 243 of 2012, with the objective of freeing up available funds, states that local governments must achieve a non-negative balance (accruals basis) between final revenue and final expenditure, net of the items referring to the procurement or reimbursement of loans.

2.3 Compliance with rules

Figure 1 shows the evolution of GDP growth, the growth of Gross Government Debt and the level of net lending, or the government deficit, annually in Italy from 2008 to 2014.

FIGURE 1: Government Debt/GDP Growth, Deficit/GDP and GDP Growth



In 2011 net borrowing decreased from 4.7% to 3.9% of GDP, in line with the Excessive Deficit Procedure (EDP) objective. The effects of the strong deterioration in the macroeconomic environment during the year have been almost offset by the corrective measures decided in the summer of 2011. In particular, due to worse cyclical conditions and to tensions in financial markets, the government approved three ambitious budget plans, of which one aimed at anticipating a balanced budget in 2013, while another one was designed to reduce the sovereign risk premium.

Starting with the 2011 Recommendations from the EU Council of Ministers, the ECB and the European Commission pressed the Italian authorities to restore investor confidence and boost growth through the implementation of consistent, radical and credible reform packages. Therefore, 2012 was characterized mainly by a large set of structural reforms and a bold fiscal consolidation strategy, by means of both a higher tax burden and a deep spending review, which allowed the Government to meet the 3% deficit/GDP target and to exit the EDP in June 2013. The additional fiscal consolidation effort made since the summer of 2011 focused on increasing revenues by raising the tax burden from 42.6% to 44%, far above the European average. The Italian government followed the Council Recommendation to shift the tax burden away from labor towards consumption and property, by increasing VAT and by introducing a property tax. However, the partial suspension of the first payment of the property tax and the failed adoption of the tax reform in early 2013 negatively affected the Italian government's credibility.

Since Italy was subject to the EDP from 2009 to the end of 2012, for the years 2013-2015 it was not strongly constrained by the debt rules. However, large efforts had been undertaken to both keep the deficit/GDP ratio below 3% and to start a debt reduction path. Since 2013 has been characterized by the acceleration of the payments of the Public Administration's past due debts, requested by the EU, the deficit reached 3% of GDP and made the debt/GDP ratio increase from 127% to 132%. To reduce public debt, the Government started a 3-year privatization plan (2013-2015). Furthermore, the divergence of the structural deficit from target in 2013 was justified by the application of the investment clause. However, in 2013 the assessment of the European Commission underlined the weaknesses in the Italian fiscal measures, which further undermine the credibility of the Government in effectively achieving its MTO. Finally, the tightest constraint on Italian fiscal policy is determined by the newly introduced spending rules, which set the maximum limit on the growth in the expenditure aggregate for 2014-2016 to -1.07%, which was not achieved in 2013 (when it was set at +0.3%). The 2013 Macroeconomic Imbalance Procedure (MIP) pointed out that the reform efforts so far appeared to be insufficient to re-launch productivity growth and re-align unit labour costs to European standards, also due to inadequate implementation and, at times, inconsistent policy strategies.

The annual structural adjustment of only 0.1% of GDP forecast for 2014 fell short of the 0.7% of GDP Minimum Linear Structural Adjustment (MLSA) that, according to the European Commission, was required to comply with the debt benchmark in the 2013-2015 transition period. In 2014 the balanced budget target was not met following the return to recession in 2012, because net borrowing had been almost constant and the primary surplus had been 3.9 points lower than planned in 2012. However, the ex-post assessment suggested that Italy's adjustment path towards the MTO was compliant with the requirement under the preventive arm of the SGP in 2014. On 27 February 2015, the Commission issued a Report under article 126(3) of the TFEU[4], as Italy was not expected to make sufficient progress towards compliance with the debt rule in 2014-2015. Italy would have complied with the debt reduction benchmark only thanks to an allowed deviation of 0.25% of GDP, which was not granted because of the risk of non-compliance with the debt-reduction benchmark in the following year. The analysis concluded that the debt criterion should be deemed as complied with at that time.

[4] Treaty on the Functioning of the European Union.

The DPB 2015 stated that Italy's fiscal policy would continue the pursuit of the fiscal consolidation shown in recent years, which has been one of the most significant efforts at a European level. For 2014, exceptionally severe economic conditions[5] justified in the Commission's view that Italy was not asked to fulfil the requirement of a structural adjustment towards the MTO. For 2015, given the persistence of bad economic conditions, an improvement in the structural balance of 0.3% of GDP, followed by a zero structural effort in 2016, was compliant with the required adjustment towards the MTO (a structural effort of at least 0.25% of GDP). However, the planned adjustment fell short of the required MLSA for 2015 under the transitional debt rule. Overall, the Commission was of the opinion that the updated DPB 2015 was at risk of non-compliance with the requirements of the SGP.

In the EFD 2015 the policy scenario excluded the activation of the safeguard clauses for 2016 that would have ensured the achievement of the public finance objectives through tax increases equivalent to 1% of GDP. This had been made possible due to the improvement of the macroeconomic framework and the decrease in interest expenditure compared with the previous forecast, and due to the effect of the spending review measures. In 2016, the government intended to make use of Europe's clause for structural reforms to allow for flexibility with respect to public finances. Specifically, the Italian government used the flexibility allowed for national share of co-financing of European investment projects[6]. Italy was allowed a temporary deviation of 0.4% of GDP from the 0.5% required adjustment towards the MTO. It follows that the path towards improvement of the structural balance would be more gradual, with the achievement of a balanced budget in structural terms in 2017. The government likewise requested greater leeway in relation to the immigration emergency. As in the previous years, in 2016 the government planned to comply with the debt reduction benchmark thanks to ambitious privatizations.

The cut to property taxes on first residences from 2016 was not consistent with repeated Council recommendations to shift taxation away from productive factors onto property and consumption. Relative to other Member States, the tax burden weighs more on the factors of production, which may have a negative impact on growth. The abolition of the property tax on primary residences further aggravates this problem. The long awaited revisions of tax expenditures and cadastral values have been further postponed and the frequent changes in tax policy increase uncertainty for economic operators.

The Commission 2016 spring forecast expected Italy's structural balance to deteriorate by 0.7% of GDP, followed by a stable structural balance in 2017. This fiscal path is broadly compliant with the required adjustment towards the MTO in 2016, once taking into account

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[5] Specifically, negative growth and a negative output gap larger than 4% of GDP.

[6] This flexibility is in accordance with Article 5 paragraph 5 of European Regulation No. 1466/97, and Article 3, paragraph 4 of national Law n. 243/2012. To date, Italy is the second-ranking European country in terms of investments accorded through the Juncker Plan (the European Fund for Strategic Investment, EFSI) with 13 financed projects equal to €1.8 billion invested, whose leverage effect is €5.7 billion.

the maximum temporary deviation of 0.75% of GDP from the required 0.5% of GDP adjustment towards the MTO, allowed for investments and the implementation of structural reforms. Overall, Italy was broadly compliant with the required adjustment path towards the MTO in both 2015 and 2016, but rigorous implementation of the 2016 budget remained essential and the conclusion for 2016 crucially hinged upon the admissible temporary deviation for exceptional expenditures related to the refugee inflow in 2015 (for an amount of 0.03% of GDP) and for the structural reform and investment clause in 2016 (for an overall amount of 0.75% of GDP).

In the 2016 Update of the EFD the deficit target for 2017 was raised from 1.8% of GDP to 2% of GDP. The policy scenario takes into account a deficit increase by 0.9% of GDP due to the repeal of the January 2017 VAT hike envisaged in previous Stability Laws. For the second consecutive year, the most significant budget measure was the cancellation of the increase in VAT rates for the subsequent year. Assuming the Government intends to deactivate the clause again in the following years, the same scenario seems destined to be repeated in future budgets. The DBP indicates that the draft budget for 2017 comprises exceptional expenditures amounting to about 0.4% of GDP, in relation to the ongoing refugee crisis and to a preventive investment plan for the protection of the national territory against seismic risks. Regarding the exceptional inflow of refugees, the DBP confirms its projected budgetary impact at 0.2% of GDP in 2016 and at 0.22% of GDP for 2017. Through the DBP, the Italian authorities make the case for a further temporary deviation from the adjustment path towards the MTO of 0.16% of GDP in 2017. The Commission granted temporary deviations amounting to 0.07% of GDP in relation to the additional costs incurred in 2015 and 2016 due to the refugee crisis. The DBP sets out expenditures related to the emergency management and to the so-called "preventive investment plan for the protection of the national territory against seismic risks". The 0.18% of GDP earmarked by the government for this purpose in 2017, according to the authorities, could be considered eligible for the "unusual event clause". The Commission is of the opinion that the DBP is at risk of non-compliance with the provisions of the SGP. Italy has taken steps to reduce the labour tax wedge and reform the taxation system at large. However, the recommended reform of cadastral values and all-encompassing revision of tax expenditures have not been implemented.

On 26 September 2016 the PBO validated the trend macroeconomic scenario for 2016-2017 published in the Update. This came after the PBO had announced, on 14 September, its comments on an earlier provisional version of the Government forecasts. The Government took account of those comments in preparing the definitive trend scenario, which was therefore validated by the PBO. The PBO did not feel it could validate the 2017 policy scenario published in the Update, as the forecasts, as discussed in the parliamentary hearing of 3 October on the Update, were out of line with the interval of projections produced by the PBO panel forecasters. The Government, following the PBO’s projections, updated its forecasts in the following DBP, which for the two-year period were then considered plausible and, accordingly, on 17 October the PBO validated the macroeconomic policy scenarios.

In the Country Report 2017 for Italy the European Commission assesses the progress made with the 2016 Country Specific Recommendations. Substantial progress has been made in reforming the budgetary process and ensuring that the spending review becomes an integral part of it, and some progress has been made in shifting taxation away from productive factors. However, there has been limited progress in implementing the privatisation programme, revising tax expenditure, reforming the cadastral system and improving tax compliance. Some progress has been made in implementing the reform of active labour market policies and with regard to the national antipoverty strategy, while limited progress has been made in facilitating the take-up of work by second earners. High public debt, which is forecast to broadly stabilize at around 133% of GDP in 2016-2018, remains a major source of vulnerability for Italy. Despite the gradual improvement of the labour market, long-term and youth unemployment remain high. The long-term unemployment rate was around 7% in 2016. The youth unemployment rate is around 40% and more than 1.2 million young people are not in education, employment or training. Economic growth and efficiency are hindered by the tax system because, despite a recent modest reduction, the tax burden on production factors remains among the highest in the EU.

Considering weak but improving economic conditions, there is a risk of non-compliance with the preventive arm of the SGP in 2016-2017 and a slowdown in implementing structural reforms. In absence of other measures, Italy is not compliant with the debt rule. A decision on whether to recommend opening an EDP should be taken in May 2017, considering outturn data for 2016 and additional measures of at least 0.2% of GDP to be taken by April 2017.

2.4 Commentary on the influence/visibility of rules and commitment to them

In this and the following chapter we interpret thoughts and ideas collected from our interview panel, to try to understand the influence of rules and commitment to them in this chapter, and the effectiveness and utility of rules in the next chapter.

Before 2010, the Lisbon Strategy did not have much influence on national fiscal policy because it was designed in a period in which the focus was on growth, while since 2009 the focus has shifted towards the recovery from the financial crisis. Nowadays the Lisbon Strategy might be considered more of a failure than a success because it is not possible to observe the effects of this strategy in terms of integration and convergence. In the past, the Lisbon Strategy implied higher public investment to boost long-term growth, but it was perceived as a growth in current fiscal expenditure because any European growth policy was seen like a pure fiscal stimulus. On the contrary, recently there is more attention to fiscal sustainability in the EU oversight of national policies.

There is some awareness that the recession, sometimes blamed on the introduction of the new rules, is instead mainly due to the turbulence in financial markets, whose rules are more penalizing than the European fiscal rules. Indeed the new fiscal rules did not have a large impact on the design of national fiscal policies because the EDP was not considered by interviewees to have changed much; instead it was the sovereign bond crisis that shaped the Italian commitment to rules. There is a lack of enforcement of the fiscal rules at the European level and hence the commitment to them depends on the interaction with other countries. Commitment to rules would be higher if monitored by a proper supranational fiscal institution. Italy does not discuss the rules, but looks for higher flexibility through an alternative interpretation of them, mainly after the recent EU directive on flexibility in 2015. Since the Italian government complained about the lack of flexibility, in 2014 it pushed for greater flexibility and imposed the “veto” over a European system of automatic safeguard clauses. However, the large use of this flexibility led public debt to grow in recent years. Several factors determined the lack of commitment to rules: the lower sovereign risk following the ECB’s unconventional monetary policy, the complexity and low accountability of the rules and the constant denigration by several Italian politicians. Furthermore, there is a weakening of the ownership of rules that follows from Italy’s lack of power in Europe, even if the media has recently shown an increase in the interaction with other Member States.

Innovations in governance following both the Six-Pack and the Two-Pack increased the awareness of European institutions and rules. For instance, the higher interaction between the Government and the European Commission enhanced the visibility of the rules and public opinion’s sensitivity towards them. According to several experts, the revised European Semester procedure has made the monitoring process clearer, while others believe that the role of the European Commission grew after the recent innovations and its supervision is more intrusive. Indeed there is the feeling of a growing interest by the Commission towards violation of the rules. Furthermore, the introduction of the PBO initially reinforced this feeling, and only recently the strong independence shown by this institution improved its public image. The obligation to submit planned budgets to the Commission for scrutiny and their validation by the PBO improved the programming skills of the governments, their commitment to rules and their accountability, but the increased flexibility offered by the Commission has possibly also encouraged a search by officials for ways to circumvent rules. Moreover the interaction with the PBO guarantees higher transparency and visibility of economic policies already during the programming stage. Despite the budget planning and the assessment of the European Commission, the government is concerned with satisfying the deficit requirements only in the last months of the year, just to avoid the activation of the “safeguard clauses” imposed by the Italian Parliament. Ideally, budget planning and the implementation of budget policy should be run by an independent institution to further improve Italian fiscal policy, according to certain interviewees.

The greater interaction with the European Commission has made only part of the Public Administration aware and well prepared on fiscal topics and on European fiscal rules. Most of the Ministries, in defining their economic policies, interact only with the MEF and not with the European Commission. Furthermore, the greater flexibility in the application of the rules since 2015 has induced the Public Administration to cope with the higher uncertainty in this framework. Local governments are aware of the European fiscal rules because the Domestic Stability Pact, now substituted by the balanced budget rule, is aligned with the European SGP. However, since local governments are more directly affected by public opinion, there is higher resistance to the application of the rules, mainly relating to health expenditure. Furthermore, there is a big gap between the north and the south, with delays and obstacles in the latter to the full implementation of the fiscal federalism, which makes them highly dependent on the central government regarding the interactions with the EU (i.e. structural funds) and the compliance with the domestic fiscal rules.

Historically, public opinion and the media have influenced the design of fiscal policies more than in other European countries, because in the last 20 years Italy has faced a political transition and, hence, the Government has been more sensitive to public opinion. After the negative experience of the technical government in 2012, public opinion has had diverse effects on compliance with the rules. Nowadays, public opinion is divided between those in favour of European integration and those against it. Interestingly, from both sides, European legislation is considered too intrusive and there is a view that Italy has been too eager to please the European Commission. This shift in public opinion towards anti-EU arguments is due to the lack of a common political perspective, to the low awareness of public opinion of the need for debt sustainability and to the perception that Italian Governments have been over-zealous in discharging their responsibilities. Initial pro-EU attitude mainly changed because austerity did not lead to economic recovery and the strong commitment to rules turned out to be penalizing for Italy.

Although few experts believe that the last wave of structural reforms was pushed by the European Commission’s Recommendation regarding macroeconomic imbalances, the introduction of the Alert Mechanism Report (AMR), along with the country report and the Macroeconomic Imbalance Procedure (MIP) did not influence significantly Italian economic policy because the debate focused on fiscal adjustment. The MEF and, to a minor extent, the Ministry of European Affairs, are the only ones who deal with the AMR, because they must account for the Country Specific Recommendations (CSRs) while drafting the fiscal documents. The effects of the AMR and of the Country Report are scarcely visible outside the official documents. The conclusion to draw is that these processes have little impact on Italian policy-making.

There are two main explanations for the lack of interest in these mechanisms of macroeconomic surveillance. First, the construction and definition of the macroeconomic equilibrium is not clear (there is little transparency on the underlying macroeconomic model implicit in the approach of the EU institutions). Second, there is an asymmetry with respect to the fiscal rules, because the violations relative to macroeconomic imbalances are subject to less stringent sanctions. Furthermore, both the asymmetry in the application of the rules across countries (notably the verdicts concerning Germany being only on imbalance and not excessive imbalance, despite its higher than acceptable trade surplus) and the fact that the MIP has never been activated for any European country, have strongly reduced public awareness on this topic.

Debate in Italy on the evolution of European Integration following the Five Presidents' Report (FPR) is scarce and there is not much public awareness on the topic. Although the European debate is currently focused on the dilemma between risk-sharing and risk-reduction, in Italy the widespread idea is that these two things must evolve jointly. Even if Italy is supportive of the introduction of new European fiscal instruments, if the introduction of new rules, as foreseen in the FPR, means more intrusive surveillance, these will hardly be accepted by the Italian public opinion and, consequently, by the Italian government.

2.5 Overview of effectiveness and utility of rules

The general view that emerges from our interview panel is that fiscal rules in Europe are not well designed because they are generally procyclical, are often violated and time-inconsistent. The countries hit harder by the recession are those most penalised by the new rules. The Italian presidency of the European Council in 2014 favoured a more flexible vision of the SGP, so there is no expectation of more intrusive control and constraints by the EU. The EDP would not have a big impact because many European countries risk being subject to it.

The Domestic Stability Pact was not effective because it lacked the right incentives. In 2014 Italy introduced the balanced budget rule for sub-national governments making sanctions more binding. This approach should be followed also at the European level, where there are not enough incentives to follow the rules, because either sanctions are absent or they are not imposed. Italy enacted several economic reforms, most of which were recommended by the EU, but it is necessary to convince citizens that these reforms are useful because their positive effects are not immediate, so they are seen with a lot of skepticism. Even if the introduction of the balanced budget principle in the Italian Constitution enforced Italy's credibility, the measures taken to reduce public debt have not been effective: Italy has generally met the deficit limit since exiting the EDP, but debt reduction has not occurred so far. The safeguard clauses show that there is a lack of accountability and the increasing degree of complexity in the rules pushes national governments to shirk their responsibilities.

There is a huge problem in the rules related to potential output, which generate distortions. For instance, the 3% deficit/GDP limit refers to nominal variables and was designed to be consistent with a 60% debt/GDP ratio and a 5% GDP growth rate. Taking into account the current economic framework, this rule would imply today a 4% deficit/GDP ratio. This shows that the nominal constraint should be changed. Things are worse when we consider the structural constraint, which is a good theoretical rule because it is countercyclical, but is based on the estimation of potential output, which is not robust to any sensitivity analysis. As a consequence, even a small estimation error is able to change significantly the economic and financial outlook and, hence, several limits to fiscal instruments, such as public expenditure. Both the national fiscal council and the Italian government are aware of this problem but, since it is a very technical issue, it is difficult to communicate and a policy effort is needed in order to overcome the weakness of this rule. A debate between the Italian government and the EU on output gap estimation is ongoing, since it is crucial in identifying compliance with rules.

The creation of the PBO in 2014 is perceived as a necessary step after the introduction of the balanced budget rule in the constitution. Its additional role of validation of the Government's trend macroeconomic forecast (the Two Pack requires validation of only the policy macroeconomic forecast) has increased the effectiveness of this institution in influencing fiscal policy and the commitment to rules. Although it is strongly independent, nowadays the role of this institution is still limited and its contribution is similar to the moral suasion of other institutions (e.g. Bank of Italy, Istat, etc.). For instance, it has no enforcement powers on the Government, as it depends on the decisions of Parliament, which hears the PBO but decides independently. Furthermore, it is still strengthening its technical skills because at the moment its forecasts rely mainly on the economic outlook of other institutions.

Although since the introduction of the MIP Italy has been experiencing macroeconomic imbalances (excessive imbalances from 2014), the country has undertaken several structural reforms, which were less effective than expected, mainly because the economic environment is not responsive to change and because there is a communication shortage regarding their scope. The lack of political consensus on reforms and their mistrust are obstacles to future reforms and they are due to the unfulfilled promises on how rapidly they would deliver benefits. To solve the problems of low productivity and competitiveness, an implausibly large effort is necessary and, while Europe focuses on productivity growth, Italian public opinion is more interested in welfare. However, through the MIP, Europe has influenced the flow of reforms more than Governments are willing to admit.

The current framework in the EU is not sustainable in the long run because it lacks a unitary vision on common objectives. Therefore, the Five Presidents' Report's proposals would be effective only with greater political integration, but today this is not feasible. Whenever national Constitutions have a higher legislative power than the European one, Member States will not accept to limit more their decisional capacity. Italy would agree with debt mutualisation to achieve higher fiscal integration in Europe. However, it would be necessary to reduce or eliminate the asymmetries in terms of government debt, because this would make the creation of rules, which solve the moral hazard problem, easier. Debt mutualisation or some form of fiscal transfers, such as Eurobonds, implies a permanent redistribution of resources, which is a necessary condition for an Optimal Currency Area, as shown by Mundell in 1973. To reach this objective more fiscal discipline is necessary. A similar reasoning can be applied to the bail-in rule and the common deposit insurance: financial risk-sharing can be achieved only by reducing total risks. Summing up, mutualisation, Eurobonds, fiscal capacity and a unique Treasury are two sides of the same coin, because fiscal risk-sharing must go hand-in-hand with fiscal discipline. This can be reached if the rules are good and enforceable, hence sanctions are needed to be effective. Governments will not accept permanent transfers to other Member States without requiring their fiscal discipline in exchange. The same mistake made with the creation of the EMU should not be repeated: mutualisation and other forms of transfers cannot drive the political process. It must be the other way around.

2.6 Conclusions

This analysis of the fiscal governance framework in Italy, in relation to the coordination of fiscal policy among Member States in the EU, draws on the main fiscal policy documents[7] issued by the MEF (the EFD, the Update of the EFD and the DBP), the PBO (the Budgetary Planning Report and the Budgetary Policy Report) and the European Commission (Assessments and Recommendations on the EFD and Opinions on the DBP) and on the 11 interviews run[8]. What is striking about the fiscal documents studied is that every six months the government updates its forecasts downwards with more negative outcomes on the business cycle, on the government budget and consequently on government debt, and requests greater flexibility, as allowed by the European Commission in its Communication on the use of flexibility in the SGP rules of the beginning of 2015. This way, in the past years, Italy has been postponing the achievement of the MTO of a zero structural balance and has asked for a deviation from its requested structural adjustment in view of the global and European recession, structural reforms, the immigration crisis, the earthquakes and investments, which brought to an increase in public debt and a further loss in credibility.

Since Italy was subject to the EDP from 2009 to 2012, from 2013 to 2015 it was subject to the transitional debt rule. However, 2011 and 2012 were characterized mainly by a large set of structural reforms and a bold fiscal consolidation strategy. Even if the introduction of the balanced budget principle in the Italian Constitution enforced Italy’s credibility, the measures taken to reduce public debt have not been effective: Italy has generally met the deficit limit after the end of the EDP, but debt reduction has not occurred so far. To this extent, the revised EU rules can be considered to have failed. One of the most significant factors behind the lack of commitment to the rules is that, after the ECB’s unconventional monetary policy in response to the 2011 sovereign debt crisis, the perceived urgency of fiscal discipline decreased. Although there was initially acceptance in the public opinion that financial markets, not just EU rules, were to blame for the lack of growth in the Italian economy, the lack of improvement and the perception that rules were unfair to Italy have damaged public confidence. This change in the public opinion has strongly affected the government’s commitment to rules.

[7] See Annex II with the list of all documents used in the report.
[8] See Annex I with the list of all interviewees.

What can be judged, also based on the interviews, is that, although Italy was one of the European countries pushing for greater flexibility and is in fact taking advantage of it, this has complicated the enforcement of rules and has not increased compliance with them, which was already an issue in the past. The flexibility in the rules means it is easier not to comply, invoking exceptional circumstances, and this brings to policies that do not achieve the objectives of the SGP. National rules have imposed the balanced budget principle enshrined in the Constitution onto local governments, but their very limited fiscal capacity makes coordination and compliance more difficult, also because of discretionary government transfers. Both domestically and at the European level, the requests for flexibility in terms of additional fiscal space has led to continuous bargaining between different levels of government, complicating interactions and consequently commitment, compliance and effectiveness.

The creation of the PBO and its analysis and validation of the DBP has pushed the government to be more cautious in its forecasts and to update them in a quicker and easier way compared to before. This has reduced the gaps between the forecasts of the MEF and the European Commission and resulted in a more careful budget planning strategy. Overall the PBO and the DBP have increased compliance and effectiveness of rules, as shown by the recent non validation of the macroeconomic policy forecasts in the Update of the EFD and the following validation of the forecasts in the DBP updated by the MEF to be aligned with those of the PBO. However, the flexibility clauses have had the opposite effects, as shown by the risk of significant deviation from the required adjustment path for both the structural balance and the expenditure benchmark pillars for 2017, but hopefully they might increase the utility of rules and welfare of citizens, although postponing compliance and effectiveness.

Italy has shown great skill and expertise in managing its huge public debt also during the crisis, but it is perceived as a difficult case and as a risk for the stability of the European system because of the size of its public debt, which in the past years has also grown despite the introduction of a debt reduction target. The weaknesses of the Italian economy, namely high public debt and low productivity, and the fact that governments have not effectively tackled these problems in the past, negatively affect the bargaining power of Italy in Europe, even if the interaction with the other European countries has increased recently. The lack of ownership of rules reduces commitment even more. Furthermore, the credibility of Italian governments has been compromised by two major factors: the cut to the property tax and the repeated postponement of the tax reform, both requested by the European Commission, and the compliance with the deficit requirements achieved only at the end of the year to avoid the activation of the “safeguard clauses”. These exampes suggest a lack of accountability.

Overall, national rules have been tailored to be aligned with EU rules and are both quite appropriate in achieving fiscal discipline and a balanced budget, although they have not been effective in debt reduction. Rules have not been very useful in welfare terms because of the negative impact of the increase in government debt and the austerity measures implemented in times of recession. Additionally, the greater flexibility of fiscal rules has increased their appropriateness at the cost of weakening compliance, feeding into the compliance-appropriateness dilemma. Also the proliferation of rules has reduced their importance and visibility, especially those related to the MIP, because too many rules create confusion and bring governments to focus on respecting only some of them. In the end, the PBO is being useful in bringing visibility to and increasing budgetary planning and cautious macroeconomic forecasting, enforcing EU monitoring through an independent domestic institution.

Annex I : list of interviewees

Davide Ciferri, Cassa Depositi e Prestiti
Fabrizio Saccomanni, Bank of Italy
Federico Arcelli, Oliver Wyman
Francesco Boccia, House of Deputees Budget Commission
Luca Rizzuto, Parliamentary Budget Office
Luigi Marattin, Presidency of the Council of Ministers
Paolo Guerrieri, Senate of the Republic Budget Commission
Pierpaolo Benigno, LUISS Guido Carli University
Pietro Reichlin, LUISS Guido Carli University
Roberto Petrini, La Repubblica
Stefano Fantacone, Centro Europa Ricerche

Annex II: documents used in report

Alert Mechanism Report by European Commission
Annual Report by Bank of Italy
Assessment of Stability Programme by European Commission
Budgetary Planning Report by Parliamentary Budget Office
Budgetary Policy Report by Parliamentary Budget Office
Country Report by European Commission
Draft Budgetary Plan by Ministry of Economy and Finance
Economic and Financial Document by Ministry of Economy and Finance
Economic Surveys Italy by OECD
Opinion on Draft Budgetary Plan by European Commission
Recommendation on National Reform Programme by European Council
Update of Economic and Financial Document by Ministry of Economy and Finance

3 In-depth case study on the national implementation of coordinating mechanisms in Poland

Grzegorz Poniatowski and Krzysztof Głowacki, CASE

3.1 Introduction

The present study analyzes the fiscal rules that Poland has used to keep its fiscal policy disciplined and coordinated within the EU. This Report is divided into six sections. The first two sections set the stage for the analysis by listing the national fiscal rules in Poland, recounting their evolution and presenting their institutional setup. The next two sections provide an account of the compliance and commitment to the national and EU fiscal rules from the side of the Polish policy makers. The fifth section is an assessment of the effectiveness of the fiscal rules, and the sixth section concludes the paper. The report has three Annexes: Annex I contains graphs, Annex II is an account of the field work done for the purposes of the study, and Annex III enumerates the documents and other sources that were consulted.

3.2 Evolution of national fiscal rules

The fiscal rules in Poland include national fiscal rules and EU fiscal rules. Currently, the national fiscal framework in Poland comprises the debt rule, the prudence thresholds, and the expenditure rule.

The UE fiscal rules include those originating from the Stability and Growth Pact (including the Medium-Term Budgetary Objectives and the Excessive Deficit Procedure) and from the Six Pack (including the Macroeconomic Imbalance Procedure)[9] and are partly coordinated under the European Semester framework. These EU fiscal rules are common to the EU Member States and will not be recounted in the first section of this Report.

Debt rules

The debt rule is the oldest element of the Polish fiscal governance framework. It has been in place since 1999, when the provisions of the 1997 Constitution of the Republic of Poland[10] became operational. Article 216, Clause 5 of the Constitution prohibits the general and local governments to take loans or provide guarantees when the public debt exceeds 60 per cent of GDP. In addition to the Constitutional provisions, the Public Finances Act[11] recognizes prudence thresholds in form of two quantities, namely 55 per cent and 60 per cent debt-to-GDP ratios. Each threshold, if breached, triggers a set of countervailing fiscal measures, whose impact and scope increases proportionally to the threshold level. Above the 55 per cent debt-to-GDP ratio the government is obliged not to increase wages and not to index

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[9] The fiscal rules stemming from the Fiscal Compact, to which Poland is a signatory, are not binding for the country, because it is not a member of the Eurozone. Participation in the Compact is voluntary for Poland, and Polish governments were mainly interested in the opportunities to participate in summits offered by the Compact. See e.g. Klukowski (2013).

[10] Journal of Acts of 1997, no. 78, item 483.

[11] Journal of Acts of 2009, no. 157, item 1240.

pensions above the inflation rate. Besides that, it is obliged to decrease the debt-to-GDP ratio when it prepares its annual budgets. Moreover, if the ratio debt to GDP breaches 60 per cent, the government is obliged to present a roadmap for reducing the debt overhang.

Since 1997, the debt rule and prudence thresholds have been strengthened gradually. First provisions reinforcing the Constitutional limit of 60 per cent debt to GDP ratio were introduced in the Public Finances Act[12] and included three prudence thresholds of 50, 55 and 60 per cent of debt-to-GDP ratio. In 2009, the amended Public Finances Act[13] added new precautionary measures to the existing rules and thresholds, introducing the obligation not to increase wages and not to valorize pensions if the 55 per cent debt to GDP ratio is breached. The first provisions reducing the strength of the automatic measures against debt accumulation were introduced in 2013, notably suspending the obligation to decrease the deficit (in relation to the previous year) whenever the limit of 50 per cent debt to GDP ratio is breached.

In 2010, the 50% threshold was breached, which prohibited the government from increasing the ratio of budget deficit to budget revenues. This situation persisted until 2013, when the Parliament suspended the 50% threshold at the initiative of the government. The suspension of the threshold did not follow from activation of any escape clause, but was a result of the government’s own discretion to override the rule.

Expenditure rules

The stabilizing expenditure rule was passed by the parliament in 2013 and has been binding in Poland since 2015. Currently, the rule caps expenditure at the level set by the GDP growth forecast, CPI forecast and a correction component, which is contingent on the value of debt-to-GDP ratio[14]. The rule could be characterized with the following formula:

$$EXP_t = EXP^*_{t-1} \times E_t[CPI_t] \times (FGDP_t + C_t) + E_t[DA_t]$$

where:

EXP_t – is programmed government expenditure in time *t*,

EXP^*_{t-1} - is expenditure programed for *t-1* corrected by the actual CPI,

CPI_t – consumer price inflation,

$FGDP_t$ – adaptive real GDP forecast,

C_t – correction component, which depends on the value of debt-to-GDP ratio (-2 pps,-1.5 pp., 0 or 1.5 pp.),

DA_t – value of discretionary spending.

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[12] Journal of Acts of 2005, no. 249, item 2104.
[13] Journal of Acts of 2009, no. 157, item 1240.
[14] General government expenditure except of Social Insurance, Labour Fund, Bank Guarantee Fund, and funds created, assigned or transferred to Bank Gospodarstwa Krajowego.

The stabilizing expenditure rule was implemented as a substitute to the precautionary measures abandoned in 2013, when the 50 per cent debt-to-GDP threshold was eliminated. The implementation of the rule was preceded by two years of operation of a temporary rule. According to the temporary provisions passed in 2011, discretionary spending and all newly enacted spending could not exceed 1 pp. in real terms. The rule was also modified more recently. To give the government fiscal leeway, the method of adaptive estimation of inflation forecast was substituted with the inflation goal of the central bank in 2015. Over the period of low inflation, the target of the central bank was much below the forecasted inflation rate, and thus the amendment in the rule has made it weaker.

Although the expenditure rules have been applied in Poland since 2011, the first expenditure rule, the so-called "Belka anchor", was introduced as early as in the 2002 budget year. Named after the then Finance Minister Marek Belka, the rule aimed to cap the expenditure at the inflation rate plus one percentage point. However, the rule was applied only to the 2002 budget, as the subsequent Minister of Finance, Grzegorz Kołodko, abandoned the rule the same year it was introduced.

Other

Currently, neither a national balanced budget rule nor a revenue rule is in place in Poland. In 2006, the government implemented the rule of setting the limit for the annual general government deficit to a fixed value of 30 bln PLN, which amounted to ca. 2.8 per cent of GDP in 2006. The rule was operational in 2006 and 2007. It was abandoned with the outburst of the crisis.

3.3 Fiscal governance framework and key institutions

Government budget, debt rules and prudence thresholds

According to the Public Finances Act, the government budget comprises the government revenue, expenditure, deficit, and other elements such as sources of deficit financing, limits on employment by public sector entities, financial plans, list of entities receiving special grants and values of the grants. The budget is prepared by the government with the advisory role assigned to the Bureau of Research of the Chancellery of the Sejm.[15] The control over the implementation of the budget is taken by the Parliament, through the Supreme Audit Office, and the Council of Ministers.

The budgetary acts need to comply with all the fiscal rules and prudence thresholds. If the debt-to-GDP ratio as announced by the Minister of Finance is in excess of a given prudence threshold, a number of corrective fiscal measures are triggered. If the debt-to-GDP ratio exceeds 55%, but is below 60%, the following measures are initiated:[16]

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[15] The Sejm is the lower house of the Polish parliament.

[16] Public Finances Act, Art. 86, clause 1, sentence 2.

1) the state budget for the following fiscal year is not to have a deficit, or in any case the state budget is to be such that the ratio of the State Treasury debt to GDP is decreased;
2) the wages of the public sector employees are not to be increased;
3) the indexing rate of pensions and disability pensions is not to exceed the previous year's CPI rate;
4) no new loans and credits are to be disbursed from the state budget;
5) no increase of expenditures in a range of state institutions is to take place;[17]
6) the Council of the Ministers is to review multiannual financial programs and expenditures financed by foreign loans;
7) the Council of the Ministers is to review the existing legislation, including VAT rules, with a view to increasing state revenues;
8) the Council of Ministers is to present a consolidation program designed to reduce the debt-to-GDP ratio;
9) in the following fiscal year, the expenditures of territorial governments may not exceed the sum of their revenues, budget surpluses from the previous years, and foreign-sourced funding.

If the debt-to-GDP ratio exceeds 60%, the following measures are initiated[18]:

1) the measures 1-7 from as above;
2) within one month from the announcement of the debt-to-GDP ratio, the Council of Ministers (the government) is to present a consolidation program designed to bring the debt-to-GDP ratio below 60%;
3) starting from the seventh day after the announcement of the debt-to-GDP ratio, public sector entities are not to extend financial warranties and guarantees;
4) in the following fiscal year, the expenditures of territorial governments may not exceed their revenues.

Until 2013, if the debt-to-GDP ratio exceeded 50%, but was below 55%, the following measure was to be initiated:[19]

1) the state budget in the following fiscal year is to be such that the ratio of the budget deficit to revenues does not increase.

In addition, by May 31st of each year, the Minister of Finance is supposed to announce the amount of the public debt and the debt-to-GDP ratio as of the end of the previous fiscal year in *Monitor Polski*, the Official Journal of the Republic of Poland.[20]

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[17] These institutions include Chancellery of the Sejm, Chancellery of the Senate, Chancellery of the President, Constitutional Tribunal, Supreme Audit Office, Supreme Court, Supreme Administrative Court, courts, and other.
[18] Public Finances Act, Art. 86, clause 1, sentence 3.
[19] Public Finances Act, Art. 86, sentence 1 (before amendment).
[20] Public Finances Act, Art. 38. Other pieces of information that the Minister is supposed to announce include the amount of the State Treasury debt, the amount of public debt expressed in the national currency (Art. 38a),

Expenditure rules

The implementation and monitoring of the expenditure rule is mainly performed by the Ministry of Finance. The beginning of the process in April corresponds to the yearly update of the Convergence Program required by the EU, which in an opportunity to prepare first estimates of the expenditure rule for a given year. The Convergence Program is updated in a way that is consistent with the national expenditure rule and the EU expenditure benchmark, but not necessarily the Midterm-Budgetary Objectives (see below). When selecting baseline economic indicators for the budgetary act, the Ministry of Finance relies on the forecasts of the Central Statistical Office, National Bank of Poland, and the European Commission.

EU fiscal coordination

The Ministry of Development coordinates the European Semester and the Macroeconomic Imbalance Procedure, while the Ministry of Finance specifically addresses the fiscal components of these programs. The Medium-Term Budgetary Objectives are included under the European Semester framework, and they have appeared in every set of the Country-Specific Recommendations for Poland since the country graduated from the Excessive Deficit Procedure. In particular, the Recommendation calls for fiscal adjustment of 0.5% of GDP towards the Medium-Term Objective.

The public officials responsible for the implementation of the European Semester in Poland have established procedures to coordinate the process and involve stakeholders in it. For example, the so-called *Group for Europe 2020 Strategy*[21] was established in 2012 to coordinate Poland's progress in the European Semester in the context of the Europe 2020 strategy. Among others, it advises on the National Reform Programmes. The group is led by the Minister of Development and composed of representatives of the Ministry of Development, Ministry of Finance, representatives of local administration (with no voting right) and a wide spectrum of stakeholders.[22] The Group gathers at least once a quarter, and each session is divided in two parts: one to discuss current affairs, and another to debate one selected matter related to the European Semester.

In general, both the Ministry of Development and the Ministry of Finance assess the cooperation and coordination between national institutions as adequate. However, the

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and other. The entire procedure is tied to the presentation by the Council of Ministers of the report on the budget implementation to the Sejm (Constitution, Art. 226, clause 1).

[21] *Zespół do spraw Strategii „Europa 2020".*

[22] Among others, these include the Presidents of the Central Statistical Office and Office of Competition and Consumer Protection, employer organizations, trade unions, NGOs, and research institutions.

Ministry of Development (which coordinates the European Semester) indicates that conflicts of priorities sometimes do occur, with individual institutions attempting to enforce their own agenda to the disadvantage of the general process.

3.4 Compliance with the fiscal rules

Debt rules

The debt-to-GDP ratio in Poland has never exceeded 60% since the debt rule was introduced into the Constitution in 1997. While the debt-to-GDP ratio never exceeded the 55% threshold as calculated using the national methodology, it did exceed this threshold in 2013 if the EU methodology is applied (see Graph 1, Annex I). After a period of significant increase in the debt to GDP ratio, the prudence threshold of 55% became a serious limitation to expansionary fiscal policy in 2014. Then, the government decided to introduce amendments in the pension system, which aimed to decrease the debt-to-GDP ratio in accordance with the definition included in the Public Finances Act. As a result, the transfer from public to private pension funds gave the government a leeway of 7-8 per cent for future spending. The 50% threshold has elicited the least compliance. The debt-to-GDP ratio has been above 50% since 2010, but the 50% threshold was suspended in 2013. The amendment of the Public Finances Act concerning the suspension has been enacted by the Parliament in a particularly speedy manner.

Expenditure rules

Following the introduction of Belka's rule, the Ministry of Finance commenced work on a fiscal reform to reduce social spending. However, the rule was abrogated by the next Finance Minister Grzegorz Kołodko, who insisted that the government should have flexibility in adjusting public expenditure to the state's current financial capacities instead of being constrained by a "political rule".

EU fiscal coordination

According to the analyses published by the European Commission in its Country Reports, Poland's advancement in meeting the fiscal-related Country-Specific Recommendations has been in the range of "no progress" to "some progress" in the recent years. In particular, the Commission noted that achieving the annual fiscal adjustment of 0.5 % of GDP towards the medium-term objective had "limited progress" or "lack of progress". The Commission also noted "no progress" with regard to establishing a fiscal council and limiting the use of reduced VAT rates. In the 2017 Country Report, the Commission additionally remarked that some of the reforms introduced by the government go in the opposite direction than that required by the Country Specific Recommendations. In this context, the Report explicitly mentions the reduction of the retirement age and implicitly the 500+ program. "Some progress" has been noted in increasing tax compliance, but this optimism may in fact be premature. While the government did enact a series of reforms with the aim of increasing tax compliance,[23] their effectiveness is yet to be seen.

Poland was under the Excessive Deficit Procedure in the years 2009-2015. The Procedure was initiated by the Commission based on the "existence of a severe economic downturn"[24] in the country and the general government deficit exceeding the 3% of GDP reference value in 2008. The Commission concluded that the breach of the reference value was not an exceptional situation, but a consequence of insufficient consolidation of public finances and a generous social policy in the previous years. At the same time, the public debt criterion was not triggered, as public debt was well below 60% of GDP. In the course of the Procedure, Polish governments (the First Cabinet of Donald Tusk until 2011 and the Second Cabinet of Donald Tusk thereafter) took measures to reduce the deficit and cooperated with the Commission and the Council to exit the Procedure. The following measures were implemented, among others: cautious macroeconomic assumptions and fiscal consolidation, introduction of the temporary expenditure rule and the stabilizing expenditure rule, pension reform (including the increase of the retirement age and the reduction of the scope of special pension arrangements), changes in tax law, and the transfer of the treasury bonds representing pension rights of the insured from the private Open Pension Funds to the public Social Insurance Institution. The initial deadline set by the Council for exiting the Procedure was in 2012, but it was not met and it was consequently extended to 2014, and then to 2015. The deficit reference value was still hovering above 3% in 2014, but the Council found Poland to be eligible for specific provisions given that the deficit was close to the reference value, the debt-to-GDP ratio was below 60%, and the country had implemented the crucial pension reform. Consequently, the deficit was forecast at below 3% for the following two years, and on June 19, 2015, the Council concluded the Procedure.

3.5 Commitment to the fiscal rules and their influence

Debt rules

Due to its entrenchment in the Constitution since 1997 and the relatively high level of debt-to-GDP ratio that it relates to, the debt rule is widely regarded as one not to be transgressed. Indeed, Poland's debt never exceeded nor even approached 60% of GDP after 1997.

The decision of the Tusk cabinet to suspend the 50% threshold in summer 2013 was widely perceived as a hard blow to the credibility of the threshold mechanism, and it cast doubt on the political commitment to it. Some experts interpret it as abandonment of fiscal prudence for the sake of short-term political gains. However, there are also voices arguing that the decision was economically sound. In particular, it is argued that a further tightening of the fiscal policy might have stalled the economy in the conditions of sluggish recovery.

[23] Some of these reforms are not free from controversies, e.g. increasing the maximum penalty for VAT fraud to 25 years imprisonment.

[24] At the time, the European Commission forecast a GDP drop of 1.4% for 2009, but the Polish economy did not contract after all.

Expenditure rules

The introduction of Poland's first fiscal rule in 2002 by Minister Belka aimed to enforce fiscal discipline at a time when Poland faced serious problems in servicing its debt. As the rule was relatively rigorous, capping real growth of expenditure at one percent appeared to be too restrictive for the subsequent Minister of Finance, Grzegorz Kołodko. Moreover, the rule had a weak legal base, which might have been another reason for the lack of commitment that it elicited.

History repeated itself in 2015. The stabilizing expenditure rule, binding since 2015 budget, was watered down soon after its introduction. As the complicated formula to ensure anticyclicality of fiscal policy is relatively easy to modify, a change in one of the parameters, namely forecasted inflation, gave the government a leeway of ca. 2% of GDP in its spending in 2016.

EU fiscal coordination

The Polish authorities do not consider the European Semester to be indispensable to the national fiscal policy. They rather see it as a useful complement that helps to stimulate discussion, mobilize the flow of ideas, and coordinate the timetables of the institutions engaged in fiscal policy. On the other hand, the European Semester is seen as a useful tool for the EU to coordinate the fiscal policies of the individual Member States.

The introduction of the Six Pack regulations (in fact, one of the six documents is a directive), together with the agreement of the Fiscal Compact has significantly increased the importance of EU fiscal coordination. In particular, the implementation of macroeconomic conditionality, which ties the European Structural and Investment Funds to macroprudential performance, has been described as a powerful incentive to increase compliance in the context of the Macroeconomic Imbalance Procedure and the Excessive Deficit Procedure.

Country-Specific Recommendations

There are three types of criticism about the Country Specific Recommendations for Poland from the side of national officials. First, it has been suggested that in spite of its name, the recommendations are not specifically tailored for Poland. For example, the Polish side considers the Medium-Term Budgetary Objectives to be an inadequate measure for Poland (see below). Another example concerns the Recommendation calling for the establishment of a fiscal council in Poland, equipped with the following functions: ex-ante and ex-post verification of compliance with national and EU fiscal rules, assessment of macroeconomic and fiscal forecasts, and evaluation of long-term sustainability of public finances (European Commission, 2016). While Poland does not have a single body called "fiscal council" (as the only Member States of the EU), it has long used a number of institutions that jointly perform many of the functions of a fiscal council. For example, the Monetary Policy Council issues official opinions regarding the drafts of budgetary acts, and the Supreme Audit Office monitors the implementation of the budget, including adherence to the provisions of law. There seems to be a consensus among the Polish authorities that the Polish diffused model of a fiscal council is an adequate and sufficient equivalent of a decentralized fiscal council, and that the European Commission is enforcing its own vision in an unduly bureaucratic manner. The interviewees report that the European Commission acknowledges the existence and merits of the Polish model for achieving the outcomes of a fiscal council. However, in its Country Reports (e.g. 2016), the Commission observes that not all the functions of a fiscal council are covered by the Monetary Policy Council and the Supreme Audit Office. The Commission also pejoratively labels the functions of a fiscal council performed by other bodies as "scattered", but it does not provide constructive reasons why they should be performed by a single body. Indeed, literature does not provide arguments for such a supposed necessity.

Secondly, some of the Recommendations are described by the Polish side as contradictory. For example, the Recommendation calling for a reform of the preferential pension arrangements, according to the officials, contradicts the Recommendation on social inclusivity and poverty reduction. However, this argument can be seen as at best partially valid: although some policies may be socially difficult in the short run, they may nonetheless be necessary to improve social welfare in the long run. Indeed, the instruments of social inclusion and poverty reduction should be deployed in the process to mitigate the negative effects of the pension system rationalization.

Finally, the Polish officials disagree with some of the Recommendations. For example, some public officials question the Commission's claim that the extensive use of reduced VAT rates negatively impacts the collection rate, arguing that there is no such effect. Moreover, the Ministry is currently conducting its own research, and the results have been described as showing no causal link between the variables of interest. In the experience of CASE, it can be stated that such a link does exist, but the strength of the effect is not significant, especially in comparison to other measures that could be undertaken to improve VAT compliance[25].

Medium-Term Budgetary Objectives

The MTO, which is covered in the Country Specific Recommendations, has met with criticism from some Polish officials. They believe that this measure on its own is inadequate for some Member States, including Poland, due to the methodological difficulty of observing the structural deficit. This difficulty is related to the revenue side of public finances, mainly the significant tax gap that Poland struggles with. Despite this critique, Poland integrated the MTO into its national stabilizing expenditure rule. In particular, the correction component of the expenditure rule (currently 1.5 pp.) is designed to correspond with the fiscal adjustment prescribed by the MTO for Poland (currently 0.5% of GDP). In fact, when introducing the national expenditure rule in 2013, the economists from the Ministry of Finance stated that one of its goals was to reach the MTO of 1% (wGospodarce.pl, 2013).

[25] See Barbone et al. (2013).

However, Poland has continued to seek to complement the MTO with the expenditure benchmark, including throughout the EDP process. There seems to be a slow progress in this regard: at a session of the Economic and Financial Affairs Council (ECOFIN) in December 2016, it was agreed that the expenditure benchmark would be applied next to the MTO (in the so-called economic reading). However, the Country Report for Poland from February 2017 did not mention this methodological update, which provoked questions during the stakeholder meeting at the Commission's Representation Office in Poland a few days later. At the meeting, the answers to those questions were postponed.

Excessive Deficit Procedure

According to Polish authorities, the primary objective of fiscal policy (including the work on the state budgets and the Convergence Programmes) in the years that Poland was under the Excessive Deficit Procedure was to exit the Procedure. The measures which were taken by the two governments in that period make this statement credible. However, one measure – the transfer of treasury bonds representing pension rights of the insured from OFE to ZUS – was highly controversial. Although it contributed significantly to the reduction of the budget deficit, many observers interpreted it as an attempt at creative accounting and a maneuver that would erode commitment to macroprudential policy in the long-term. This move, much like the suspension of the 50% prudence threshold, has to be considered from both sides. On the one hand, it is an example of action that may have a sound economic rationale, but on the other hand it can distort the incentives to comply and has a potential to be abused in the future.

3.6 Effectiveness of the fiscal rules

Debt rules

The debt rule is an effective constraint on the general government debt. However, it does not provide an effective limit on expenditure or the deficit and is procyclical in nature.

Much like the debt rule, the prudence thresholds do not impose an effective constraint on public expenditure until after a significant rise in public has been incurred. In particular, the 50% threshold, when it was still binding, was limited in scope and did not ensure sufficient fiscal discipline. The 50% threshold allowed for expenditure growth provided that it was lower than the economic growth. Another important disadvantage of the prudence thresholds is their procyclical character, which means that the government has to be particularly prudent in times of economic slowdown. Finally, insufficient legal entrenchment means that this rule may be circumvented if there is enough political will, as was the case with the suspension of the 50% threshold in July 2013.

Expenditure rules

The temporary expenditure rule only applied to so-called flexible expenditures, which accounted for approximately 10-12% of the general government (Ministry of Finance, 2013).

Hence, its impact was limited. The currently binding stabilizing expenditure rule applies to approximately 90% of the general government expenditure (Ministry of Finance, 2013). The expenditure rule is anticyclical, as it depends on the average GDP growth in the last eight years (including the current year). It also enables a degree of flexibility: when the budget deficit is below 3%, the limit on expenditure is lower. However, its complicated formula enables the governments to modify its parameters without making them politically accountable for breaching the rules. Although it would be straightforward to simplify the complicated formula for the expenditure rule, the budgetary acts in Poland in recent years have proposed expenditure at the verge of breaking the rules. This shows that the rules are somewhat effective in limiting spendthrift decisions and thus increase the transparency of fiscal policy.

EU fiscal coordination

Some representatives of the Polish non-governmental economic community are of the opinion that the national fiscal rules have been warped by policy makers to the extent that they had lost potency and credibility. Therefore, the crucial fiscal rules are now those based on the Stability and Growth Pact. While this opinion may be too strong (for example, there exist national rules that were never breached and SGP rules that were breached at some point), there is a consensus that the EU fiscal framework has added value with respect to the national fiscal rules. As the Polish officials themselves admit, the EU fiscal rules provide a sense of guidance and facilitate coordination, including internal coordination between institutions within a single Member State.

On the other hand, the EU may be perceived as unduly insisting on some measures that are considered misguided or inadequate. A prime example is the recommendation regarding the introduction of a fiscal council in Poland, while the country has developed its own, decentralized model of fiscal monitoring. Instead of replacing it with an entirely new, unproven body, the current autonomous model could simply be developed further, capitalizing on previous experience. As noted in the literature (e.g. IMF, 2013), a fiscal council should respect country-specific characteristics. Moreover, it is in fact not the existence of a fiscal council per that guarantees macroprudential governance, but a widely understood and supported commitment to fiscal rules.

3.7 Conclusion

The preceding sections show that at least some fiscal rules in Poland have been derogated from. This has been the case with rules that were a result of a temporary political agreement (Belka's rule) or even rules that were enacted by way of a parliamentary statute (the 50% threshold). Such rules did not have sufficient legal standing and could be tampered with by successive Finance Ministers depending on the fiscal stance of their cabinets. In contrast, the rules that have a strong legal base, and could therefore not be easily derogated from, were complied with. This has been the case with the debt rule, which is entrenched in the Constitution. This has also been the case with the rules stemming from the Stability and

Growth Pact, which are entrenched in an international treaty. After Poland breached the 3% of GDP deficit reference value, it was called on to consolidate its public finance under the Excessive Deficit Procedure, which it did.

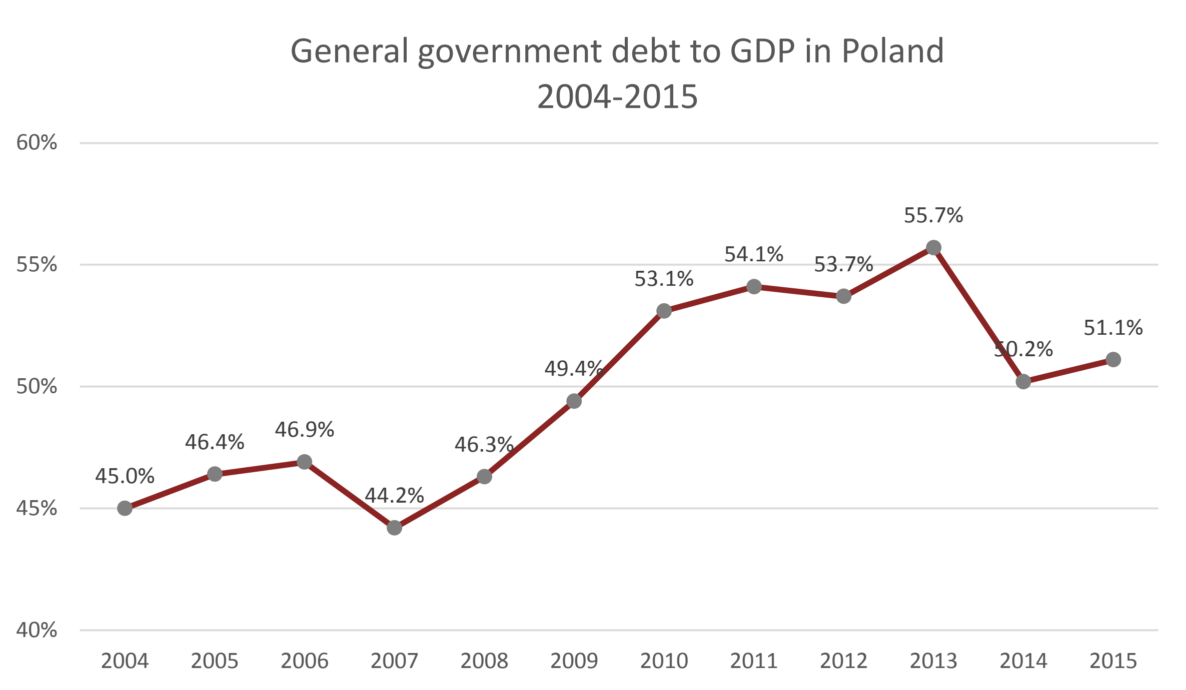
The evolution of fiscal rules in Poland shows a gradual tendency away from debt-based rules and towards very effective anticyclical expenditure-based rules. However, compliance with the complicated parameters of such rules is difficult to achieve, as the modification of the stabilizing expenditure rule in 2015 shows.

There is no consensus as to how important the EU fiscal framework is to Poland: some believe that it is crucial, because it cannot be manipulated, others claim that national rules are more important still. In any case, decision makers, experts, and stakeholders tend to agree that the EU fiscal framework brings added value to the country. In particular, the European Semester has served to increase coordination and dialogue not only with the other Member States, but also between the national authorities involved in fiscal policy domestically. The Macroeconomic Imbalance Procedure has so far been relevant to Poland only to the extent of its embodiment in the European Semester (in particular, the Alert Mechanism Report within the autumn package). Poland has never subjected to an In-Depth Reviews and has consistently been adjudged to have no imbalances.

All in all, despite being breached, modified and abrogated, fiscal rules have had an important impact on fiscal policy in Poland in recent years. All actions aimed at watering-down or breaching rules have been noted by the media, criticized by various institutions and opposition politicians. Inevitable political losses were often a sufficient sanction to prevent the governments from profligate fiscal policy.

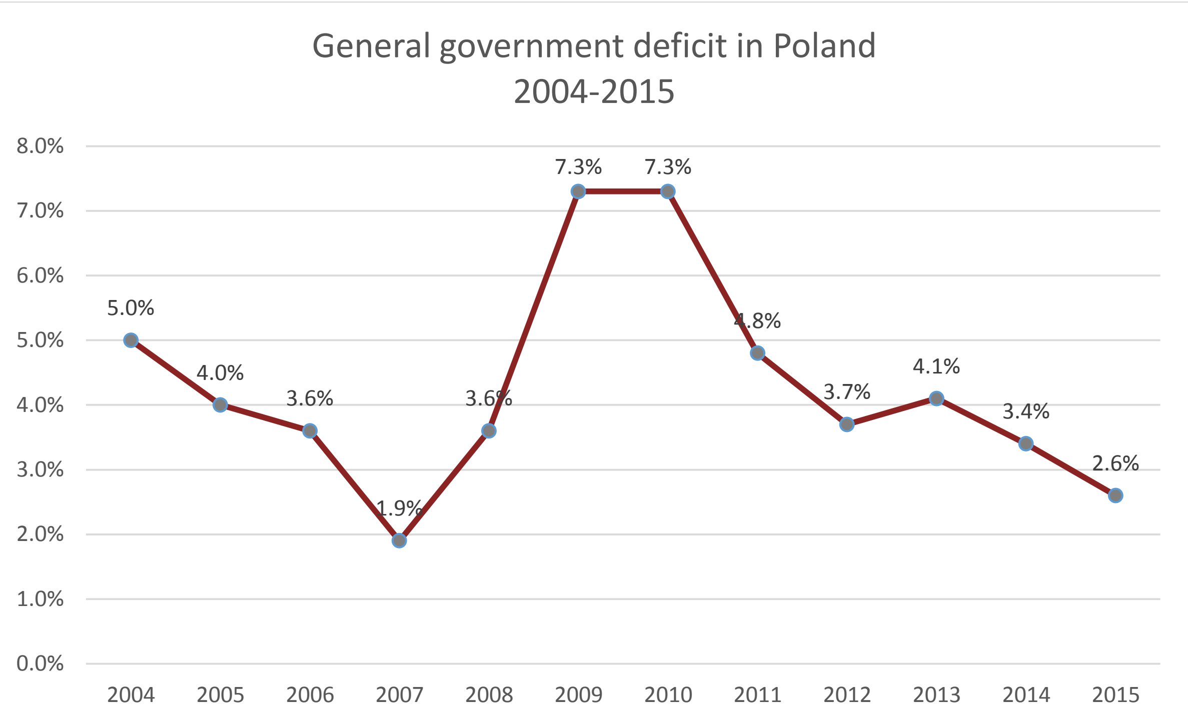
Annex I: Graphs

Graph 1



Source: own work based on European Commission (2017)
http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1

Graph 2



Source: own work based on European Commission (2017)
http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00127&plugin=1

Annex II: Field work done for the study

Table 1: List of persons interviewed

Name	Organization	Unit	Function	Date of interview
Ms. Joanna Bęza-Bojanowska	Ministry of Finance	Macroeconomic Policy Department	Vice-Director	Feb 13, 2017
Mr. Tomasz Gibas	European Commission	Representation Office in Poland	Economic Advisor	Feb 27, 2017; March 13, 2017 (expected)
Ms. Dominika Hasińska	Ministry of Foreign Affairs	EU Economic Department	Lead Specialist	Feb 13, 2017
Mr. Aleksander Łaszek	Forum Obywatelskiego Rozwoju (Civil Development Forum, an economic NGO)	-	Chief Economist and Vice-President	Feb 7, 2017
Ms. Aneta Piątkowska	Ministry of Development	Department of Development Strategy	Vice-Director	Feb 23, 2017
Mr. Marek Belka			Former Prime Minister, Minister of Finance	Mar 13, 2017

Table 2: List of events attended

Event	Organizer	Venue	Participants	Date
Seminar for Financial Institutions representatives on the European Commission's Economic Agenda	European Commission, Directorate-General for Economic and Financial Affairs	Brussels, Belgium, premises of the organizer	Financial institutions from MSs	Feb 21-22, 2017
Working breakfast for stakeholders to discuss the 2017 Country Report for Poland	European Commission, Representation Office in Poland	Warsaw, Poland, premises of the organizer	Ministry of Development Ministry of Finance Social partners NGOs	Feb 27, 2017

Annex III: Documents and other sources used in the Report

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4 The National Implementation of Coordinating Mechanisms Rules: In-depth Case Study for Slovakia

Tomáš Domonkos, IER SAS and FSES CU; Ivana Šikulová, IER SAS; Viliam Páleník, IER SAS

This report aims to provide an overview of the current state of the national implementation of coordinating mechanisms and rules in Slovakia. Additionally, future perspectives of European integration, as well as likely national stances on the Five Presidents' Report, are discussed. The paper draws on recent literature and a survey of ten practitioners.[27]

4.1 Evolution of National Fiscal Rules

Constitutional Act on Fiscal Responsibility

In December 2011, *Constitutional Act No. 493/2011 on Fiscal Responsibility* (the so-called *Debt Brake Law*) was approved, which aims to ensure the long-term sustainability of public finance. Thus, Slovakia joined the group of countries which have set their own thresholds for public indebtedness. The Act limits the amount of general government debt, introduces automatic measures to inhibit increases in debt to an unsustainable level, and, generally, significantly limits the government's room for manoeuvre to implement an expansive fiscal policy in subsequent years. The Act introduces a new institutional element into the management of public finances – the *Council for Budget Responsibility* (CBR), and redefines the hitherto applied fiscal responsibility and fiscal transparency rules.

In the area of fiscal responsibility, the Act defines limits for government debt measured as a ratio to GDP. The highest debt threshold for public finances was set at 60% of GDP initially and will be lowered gradually (by 1 percentage point [p.p.] per year) to 50% of GDP in the period of 2018 - 2027. Sanctions are activated already at the level of 10 p.p. below this threshold; they are implemented automatically, while they cumulate. If government debt exceeds the lowest threshold of 50% of GDP (until 2017), the Ministry of Finance of the Slovak Republic (MF SR) will be obliged to send a written justification to the National Council of the Slovak Republic explaining the reasons and proposing remedial steps. If the debt reaches 53% of GDP, the government will be obliged to adopt a package of measures and freeze its own salaries. At 55% of GDP, it will be necessary to freeze 3% of the total state budget expenditure, with the exception of certain expenditure items, to freeze the prime minister's reserve, and it will be impossible to increase expenditure for the following year. At 57% of GDP, the government will have to prepare a balanced budget. If these measures fail and the debt still reaches the 60% of GDP ceiling, the government must initiate a vote of

[27] The commentaries in sections 1 and 2 as well as sections 3 to 6 are a combination of authors' judgements and the information collected from interviewees.

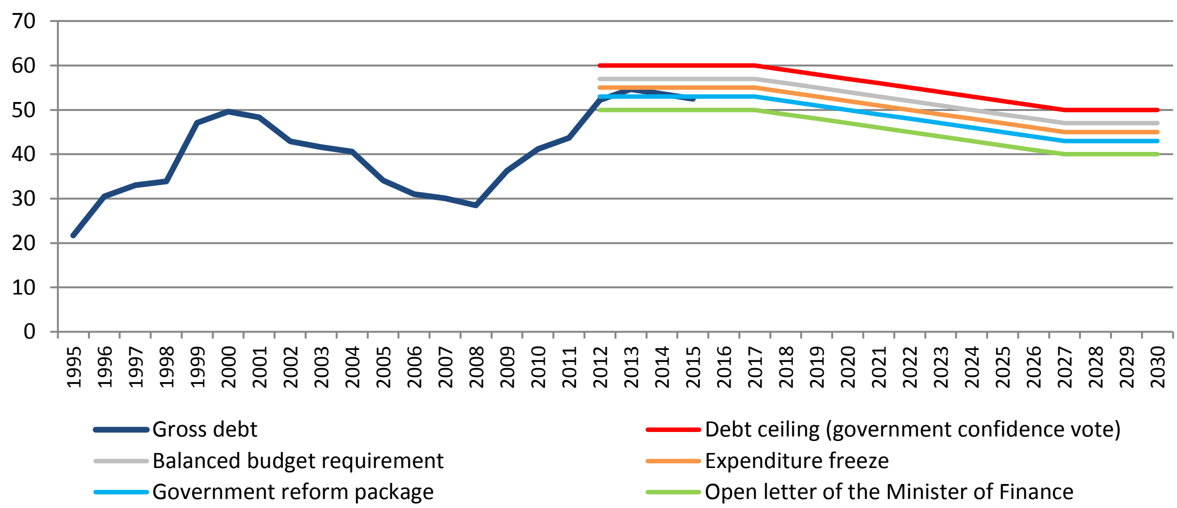
confidence in parliament. Figure 1 shows the constitutional debt limits and the development of general government gross debt since 1995.

Balanced Budget Rule

As explained by the Council for Budget Responsibility (2017), an assessment of compliance with the balanced budget rule (the annual structural balance of the general government, i.e. the annual cyclically-adjusted balance net of one-off and temporary measures) for the previous year has been prepared since 2014. The rule was transposed into national legislation[28] on the basis of an obligation included in the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*. Under Title III of the Treaty (the Fiscal Compact), Member States should define their medium-term objective (MTO) in order to assess, on annual basis, whether progress towards their MTOs has been sufficient. In case any deviation occurs, an automatic correction mechanism would be launched to bring the key indicators back into line with their initial adjustment path. In Slovakia, the MF SR is responsible for the assessment of compliance with the rule. The credibility of this national rule is enhanced through compliance monitoring by the CBR as an independent fiscal institution. Following each assessment, the MF SR has to provide its stance to the CBR according to the principles of the European Commission (EC).

F i g u r e 1

General government gross debt and constitutional debt limits in Slovakia (% GDP)



Source: Constitutional Act No. 493/2011 on Fiscal Responsibility, Eurostat (2017).

[28] Act of 29 November 2013, (§ 30a) amending and supplementing Act No. 523/2004 Coll. on the General Government Budgetary Rules and on amendments to certain other Acts, in the wording of subsequent regulations.

Commentary on National Fiscal Rules

A good and healthy fiscal policy is definitely important for a small country such as Slovakia, since positive evaluations of the EC can have a significant impact on government bond spreads. Both European and national fiscal rules constrain policy-making in Slovakia to a great extent. From the perspective of the EC, the Constitutional Act on Fiscal Responsibility is a highly appreciated measure; however, it has not yet been completed because it still lacks an implementation of its branch regulating expenditure ceilings. In practice, national fiscal rules enshrined in the constitutional law set out the domestic fiscal political framework. It seems that the impact of the constitutional law is more direct than that of EU rules. However, the best results could certainly be achieved with combined pressure of EU rules and national fiscal rules.

National fiscal rules (the debt brake), as well as EU fiscal rules, have opportunity costs in Slovakia. The enforcement of national fiscal rules is ensured by sanctions, but there is currently pressure to relax the debt ceilings to enable the current government to invest more in infrastructure and, for this purpose, more financial resources are required. Moreover, there are also worries that *one-size-fits-all* EU fiscal rules do not work well because national circumstances are not taken sufficiently into consideration.

4.2 Fiscal Governance Framework and Key Institutions

Ministry of Finance of the Slovak Republic

The competencies of the MF SR are laid down in *Act No. 575/2001 Coll. on Organisation of Government Activities and Organisation of Central Government*, as amended. According to the Ministry of Finance of the Slovak Republic (2017):

"The MF SR is a central body of state administration responsible for the areas of finance, taxes and fees, customs, financial control, internal audit and government audit. The MF SR is also a central body of state administration responsible for the informatisation of society, coordination of state aid in the area of pricing and price control, except for the pricing and price control of goods regulated by separate laws.

The Ministry develops and implements policies in the areas referred to in the previous paragraph, including the budgeting of the aggregate general government deficit; develops and implements the central government budget and financial market policy, including consumer protection in the provision of financial services; and develops and implements a policy for the management of assets owned by public administration, public-service sector and non-business sphere. Furthermore, the Ministry performs the functions of state administration in the management of state financial assets and liabilities of the Slovak Republic, mortgage banking and building societies." [29]

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[29] The Slovak budgetary process is described in detail by Dumbrovsky (2014).

Council for Budget Responsibility

The CBR was formed in 2012 as an independent body set up to monitor and evaluate the fiscal performance of the Slovak Republic. The CBR has three board members. Through its expertise and use of state-of-the-art analytical tools, the CBR aims are to act as a "watchdog" on the government, improve public awareness in the area of public finances, and facilitate better decision-making in the parliament.

According to Council for Budget Responsibility (2017), the main roles of the CBR enshrined in *Constitutional Act No. 493/2011 on Fiscal Responsibility* are as follows:

"*1. Each year, the CBR prepares the Report on the Long-Term Sustainability of Public Finances, pointing to potential issues which might induce excessive debt growth under the present budgetary policy setup. The report seeks to determine the extent to which current fiscal burdens are being passed on to future generations.*

2. The CBR submits to parliament its Report on Compliance with the Fiscal Responsibility and Fiscal Transparency Rules. The report seeks to answer the question as to whether the government has respected its own fiscal rules, and whether or not the data have been obfuscated and/or transparency has been compromised.

3. The CBR may, acting on its own initiative or if invited to do so by a parliamentary caucus, draw up its own opinions on the legislative proposals submitted to parliament. The purpose of these opinions is, in particular, to scrutinise the impact of such proposals on the long-term sustainability of public finances and their budgetary consequences. The parliament will thus have an independent opinion to feed into the law-making process.

4. The CBR also performs other activities related to the monitoring and assessment of how public finances develop. In other words, the CBR provides information on potential risks, presents alternative scenarios and, for example, puts forward suggestions on how to improve the methodology for the calculation of various indicators in the area of public finances.

As of 1st January 2014, the amended Act No. 523/2004 on General Government Budgetary Rules defined additional new tasks of the CBR. The Act implemented the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, i.e. a fiscal rule on the structural balance, including a correction mechanism in case of non-compliance into national legislation. The CBR has to: (1) assess and publish evaluations of activation of the correction mechanism in cases of significant deviation from the medium-term budgetary objective or the path towards it; (2) assess and publish evaluations of circumstances for triggering and exiting escape clauses that suspend the correction mechanism. Should the need arise, the CBR may also perform other activities stipulated in the Act. In the pursuit of its mandate, the CBR publishes (on its website) the methodology as well as studies relating to the analytical tools employed by the CBR. The results of the CBR's budget implementation are published by means of Annual Reports submitted to the National Bank of Slovakia which, under law, decides about the funding of the CBR's activities."

Financial and Budgetary Committee of the National Council of the Slovak Republic

The Financial and Budgetary Committee's (FBC) role is to be a supervisory and initiative body of the National Council of the SR in the area of finance, budget, banking sector and financial market. The FBC discusses government bills, bills introduced by members of the national Parliament, international agreements in accordance with the EU law, reports and information in terms of budgetary policy, financial and economic development of the Slovak Republic as well as the Government Manifesto and drafts of the state budget and State closing account (Financial and Budgetary Committee of the National Council of the Slovak Republic, 2017).

Commentary on the Governance Framework

Slovakia has a relatively centralized system of economic governance in which the bulk of policy coordination for EU purposes is managed at the national level and only a limited amount dealt with at the regional level. However, there are shortcomings in the way this coordination is organized.

The agenda of the European Semester and the issues of fiscal rules are mostly covered by the MF SR, which plays a key role in this regard. However, it seems that there is a need for a body to ensure cooperation between ministries. Perhaps, the Government Office of the SR would be the most appropriate to ensure this communication. Currently it appears that the Government Office does not have sufficient analytical and administrative capacities to carry out such an extensive agenda. Communication in terms of EU issues between the ministries and the Governmental Office is managed by the Ministry of Foreign and European Affairs; thus, there is lack of direct contact in this regard. In practice, cooperation between the ministries is complicated by strong sectionalism and cooperation in common issues is often slow and weak, which complicates overall governance.

The administration seems to be able deal with EU demands and can address them at an acceptable level. According to one interviewee, the functioning of the national administration in terms of EU affairs could be improved if the staff trained for and engaged through the Slovak presidency of the European Council in 2016 were enabled to build on these experiences in their future work at the ministries. What should also be improved is the communication of EU topics towards stakeholders and the general public. Mostly marginal issues are discussed in the media, and important problems are overlooked.

Although, in general, governmental institutions are appropriately configured, the functioning of the national administration as a whole can still be considered rather inefficient, with the exception of the MF SR (in particular the Institute of Financial Policy of the MF SR[30]). Additionally, the MF SR has recently launched the *Value for Money* project

[30] Currently, there is a clear effort to establish similar institutions at other ministries (e.g. Ministry of Education, Science, Research and Sport of the SR).

aiming to enhance public expenditure efficiency in Slovakia. Other ministries still have considerable room for further improvement. For example, there is a large room for improvement in the IT infrastructure of public administration, which lags seriously behind the desired level.

The existence and activities of the CBR are perceived very positively. It is an independent body located in the building of the National Bank of Slovakia, with a clear mandate and a relatively good access to information and human resources. The CBR performs its role well as a "watchdog" and has strong influence on the design and interpretation of the rules. Its recommendations certainly have some influence on the Slovak budget; however, the final decisions are usually political. The CBR is not generally expected to have a greater impact on budgetary decisions in the future. There is even a fear of the debt ceilings specified in the Constitutional Act on Fiscal Responsibility being weakened for political reasons. The impact of the CBR could be enhanced if it acted simultaneously with EU bodies, as national rules complemented by EU rules have the greatest potential to enforce budgetary responsibility. Public opinion and the media have a rather weak effect on budgetary decisions in Slovakia. Most of the relevant communication is carried out by the MF SR, the CBR and the EC.

As regards relationships between the Slovak Republic and the EU, they can be assessed as relatively good, although recent differences of opinion on migration issues have created some tensions between Slovakia and "Brussels".

The Slovak presidency of the European Council in 2016 was perceived as relatively well managed, contributing to the better visibility of Slovakia, although, it is too soon to assess its impact on relations between Brussels and Slovakia. What can be considered problematic is the afore-mentioned insufficient communication of European issues to the public in Slovakia, which can allow a certain kind of anti-European attitude to develop.

4.3 Compliance with rules and implementation of country-specific recommendations

Public finance

General Government Gross Debt

The Slovak general government gross debt exceeded the first limit of 50 % of GDP set in the debt brake law in 2012 and the second limit (53 %) in 2013. In April 2014 the government debt increased above the third limit (55 %); however, after methodological changes (introduction of ESA2010), it again dropped below 55 % of GDP (Figure 1). In 2015 the debt was slightly reduced below the second limit. As the debt limits have been violated every year since 2012, these outcomes triggered the automatic sanctions described above. An extensive overview of the application of sanctions is published annually by the CBR in its *Report on Compliance with the Fiscal Responsibility and Fiscal Transparency Rules*.

As stated in the Report on Compliance with the Fiscal Responsibility and Fiscal Transparency Rules (Council for Budget Responsibility, 2014), the MF SR sent a letter to the National Council of the Slovak Republic explaining the reasons of exceeding the first threshold in 2012. However, the CBR drew attention to the fact that the 2014 budget did not achieve further consolidation of the public finances.

According to the Eurostat database from April 2014, the government debt was 55.4% of GDP in 2013, but because of the switch to ESA2010, the reported debt dropped to 54.6% of GDP (Council for Budget Responsibility, 2015). Thus, application of sanctions related to the third constitutional threshold was relaxed and only sanctions resulting from exceeding the second threshold were applied. The obligations related to exceeding the first threshold, i.e. sending a written justification to the parliament, as well as obligations related to exceeding second threshold, i.e. submitting proposal for debt reduction measures to the parliament and freezing the salaries of Cabinet members, were met.

The second constitutional threshold was violated in 2014, which implied similar sanctions as in the previous year. According to the CBR, both obligations were fulfilled (Council for Budget Responsibility, 2016b). In 2016, sanctions related to the 2015 violation of first threshold should be addressed, and will be finally evaluated by the CBR in a report to be published in August 2017. The CBR points out an issue, that in 2014 and 2015, the decrease of government debt was achieved only thanks to one-shot measures, which could not be sustainable (Council for Budget Responsibility, 2016b).

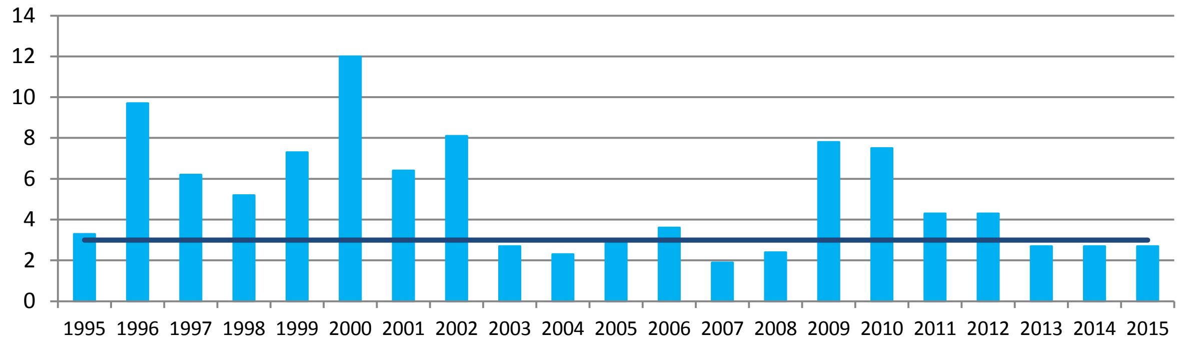
According to the *Stability Programme of the Slovak Republic for 2016 to 2019* (2016), government debt was supposed to stay below 53 % of GDP in 2016. Due to expected faster growth of the economy in the following years, the debt is supposed to decrease, and is projected to fall below 50 % of GDP in 2018. Nowadays, there is an ongoing discussion concerning changing the constitutional law on the debt brake by introducing an investment exception and by a few methodological changes. The reason for such a change is the need to supplement available European Funds in financing infrastructure projects, in particular road infrastructure.

General Government Deficit and the Balanced Budget Rule

Nowadays, there is no ongoing Excessive Deficit Procedure (EDP) for Slovakia. However, in the past, Slovakia was twice under the EDP, namely in the periods 2004 – 2008 and 2010 – 2014. It exited from the first EDP after reducing the deficit to 1.9 % of GDP in 2007 and from the second EDP thanks to a reduction of the deficit to 2.7 % of GDP in 2013 (Figure 2).

After exiting from the EDP, achieving the MTO of annual structural balance of the general government structural deficit up to 0.5 % of GDP has become the main goal of fiscal policy in Slovakia. In the *Stability Programme of the Slovak Republic for 2014 – 2017* (2014), as well as in the Programme for 2015 – 2018 (April 2015), the MTO was planned to be achieved in 2017. However, in the most recent *Stability Programme of the Slovak Republic for 2016 - 2019* (April 2016), the meeting of the MTO has been pushed back by two years, from 2017 to 2019. In the years 2017 - 2019, the fiscal framework expects a gradual decrease in general government deficit to 1.29% of GDP in 2017, 0.44% of GDP in 2018 and finally a surplus of 0.16% of GDP in 2019.

F i g u r e 2
General government deficit in Slovakia (% GDP)



Source: Eurostat (2017).

The foregoing very ambitious deficit targets have been relaxed since 2014 (although the Slovak economy is performing relatively well) and the MTO of attaining a nearly balanced budget will not be achieved in 2017. With all relevant factors taken into consideration, the Council for Budget Responsibility (2016a) concluded that *the 2015 "deviation from the adjustment path was significant and it would be necessary to trigger the correction mechanism*".[31] However, according to the statement of the MF SR on the evaluation of the CBR, no significant deviation occurred in 2015 (Ministry of Finance of the Slovak Republic, 2016), and hence there is no need to trigger a correction mechanism.

Apparently, relatively significant deviation of the general government structural deficit from the adjustment path occurred in 2015. Both key institutions CBR and MF SR published slightly different structural deficits, one at the level requiring the corrective action, the other one just slightly above the threshold not to trigger the corrective action. Thus, it is very difficult to conclude who is correct. Both institutions rely on state-of-the-art analytical tools; however, according to its mandate, the CBR tends to be stricter in evaluation then the MF SR. Regardless of the exact values of the structural deficit, a fiscally responsible government should consider adopting measures to mitigate the substantial deviation from the adjustment path.

Macroeconomic Imbalances

Since the introduction of the Macroeconomic Imbalance Procedure (MIP) in 2012, Slovakia has not been identified as having experienced macroeconomic imbalances. Thus far, the Commission has not carried out any in-debt review in Slovakia. In the first Alert Mechanism Report (AMR) published in 2012, the values for net international investment position, unemployment rate, current account balance, real effective exchange rate and

[31] In contrast to this conclusion, in its evaluation of compliance with the balanced budget rule in 2014 and 2013, the CBR concluded that no significant deviation occurred and hence there was no need to trigger a correction mechanism.

nominal unit labour costs indicators violated the threshold values as can be seen in Table 1. Since 2013, Slovakia has exceeded thresholds only for two indicators - the net international investment position and the unemployment rate.

The high value of net international investment is the result of substantial foreign direct investment inflow. This is not considered as an imbalance, which can lead to serious macroeconomic problems in Slovakia. The high level of unemployment is a long-term structural problem in Slovakia, which certainly deserves the attention of policymakers. However, the role of the unemployment indicator as a contextual variable is to signal the capacity of the economy to adjust to shocks (European Commission, 2015a) rather than signalling future risks of imbalance, thus it need not be considered as a major issue leading to an in-depth review. Based on this argumentation, the decision of the Commission on not initiating an in-depth review is commensurate.

Currently, it seems that the preventive arm of the MIP has had no impact on national reform programs and policy decisions. The MIP rules are perceived as complex, should be more forward-looking than retrospective, lack sufficient awareness among policy-makers and their enforcement is perceived as weak in Slovakia. The last observation is based on past experience of how EU rules have been enforced in other member states. Moreover, the MIP is not sufficiently discussed with the general public in Slovakia. Good exceptions are stakeholder meetings annually organized by the Representation of the EC in Slovakia, where all relevant stakeholders, including academics, are invited.

Although it appears that the MIP does not receive too much attention, in cases where imbalances occur, the launching of the in-depth review may be politically inconvenient in Slovakia and abroad. However, serious reforms would more likely be launched according to domestic incentives than as a consequence of the MIP results.

Country-Specific Recommendations

In recent years, several recommendations have been included in the Country-Specific Recommendations (CSRs) for Slovakia. Firstly, fiscal policy has been addressed, in particular attaining long-term fiscal sustainability, reducing the deficit of public finances below 3% of GDP, progress towards achieving the MTO, establishing the national Fiscal Council, adoption of expenditure ceilings and the effectiveness of tax administration. Secondly, CSRs have focused on several labour market issues, in particular long-term unemployment and youth unemployment. Furthermore, the quality of the education system, the quality of the business environment, levels of investment, the effectiveness and quality of the public administration and the justice system have been considered problematic (European Commission, 2017b).

Recent developments have shown that CSRs tend to be more focused and defined by the EC to be implementable within a one-year horizon. Contrary to past experience, when the recommendations had a rather wide and long-term nature, e.g. substantial unemployment, they have recently been specified in terms of long-term unemployment issues, youth unemployment issues etc. These sorts of recommendations can be addressed in a more targeted way in national policy reforms.

The CSRs are, in general, perceived as being useful, since they are usually highly relevant recommendations for national policy makers. They are, in fact, integrated into the national policy frameworks. However, their implementation usually lags behind. Only a few of the EU recommendations have been taken on board, e.g. reducing the deficit of public finances to below 3% of GDP and establishing the CBR. The majority of recommendations have been regularly postponed from year to year, e.g. the adoption of the binding expenditure ceilings, independence of the Slovak Regulatory Offices, increased transparency in public procurement or transparency of public administration. An exception, in this regard, is the adoption of the Act on Public Service, which was included also among the ex-ante conditionality. As one interviewee mentioned, the quantitative assessment by the EC suggests that the implementation of the CSRs in Slovakia has remained below EU average in the course of the past few years. However, due to the problematic methodology of the assessment (e.g. costs and difficulty of various reforms), strong conclusions are not possible.

As stated in the most recent country report for Slovakia (European Commission, 2017a, p. 14), "*Slovakia's track record since 2011 in formulating policies to address the CSRs and underlying structural problems shows a mix of policy progress and persistent challenges.*" However, the EC points out that the 2016 CSRs have not been addressed sufficiently. Improving human resource management in the public administration, improving activation measures for the long-term unemployed as well as raising the attractiveness of the teaching profession are among relatively well evaluated areas. Progress in the area of tax compliance, the cost-effectiveness of healthcare, practices in public procurement and the effectiveness of the justice system is considered as limited. According to the EC, no progress has been achieved regarding the administrative and regulatory burden on businesses.

All in all, it seems that national governmental priorities have more influence on national policy-making than recommendations from the European Semester. Moreover, the national priorities overlap in many regards with the CSR priorities. Thus, some of the EU recommendations would probably be addressed regardless of the existence of EU rules. It appears that the influence on national policy is most significant when the requirements of the EU and domestic authorities coincide, thus it is almost impossible to isolate the effect of EU recommendations on their own.

T a b l e 1

Indicators of the MIP Scoreboard in Slovakia

External imbalances and competitiveness		Indicative thresholds	2012 AMR	2013 AMR	2014 AMR	2015 AMR	2016 AMR
Current account balance	% of GDP, 3 year backward moving average	+6% and -4%	-4,2	-3,4	1,8	0,2	1,0
Net international investment position	% of GDP	-35%	-63,1	-65,5	-64,1	-65,1	-69,4
Real effective exchange rate	42 trading partners, HICP deflator, 3 years % change	±5% (EMU), ±11 (non-EMU)	10,9	3,4	-3,2	2,1	1,3
Export market share	% of world exports, 5 years % change	-6%	31,3	21,1	3,2	-2,2	3,2
Nominal unit labour cost	2010=100, 3 years % change	9% (EMU), 12% (non-EMU)	9,7	6,3	1,2	2,5	2,2
Internal imbalances							
House price index	deflated, 1 year % change	6%	5,0	-5,2	-5,9	-0,5	1,5
Private sector credit flow	consolidated, % of GDP	14% (previously 15%)	3,1	2,7	3,1	5,4	3,9
Private sector debt	consolidated, % of GDP	133% (previously 160%)	68,7	71,1	71,2	74,8	76,2
General government gross debt	% of GDP	60%	41,1	43,5	52,1	54,6	53,5
Unemployment rate	3 year backward moving average	10%	12,1	13,4	14,1	14,0	13,8
Total financial sector liabilities	non-consolidated, 1 year % change	16.5%	2,0	1,0	2,8	-0,3	7,0
New employment indicators							
Activity rate	% of total population aged 15-64, 3 years change	-0.2 p.p					1,6
Long-term unemployment rate	% of active population aged 15-74, 3 years change	0.5 p.p.					0,0
Youth unemployment rate	% of active population aged 15-24, 3 years change	2.0 p.p.					-4,0

Note: Figures highlighted are the ones falling outside the thresholds established by the AMR.

Source: European Commission (2016a).

4.4 Commentary on the Influence of Rules and Commitment to them

Slovakia had already had to adhere to rules before the European Semester came into being, because the country had to fulfil the Maastricht criteria to adopt the euro in 2009. Undoubtedly, the European semester brought transparency into the assessment's methodology and data, which significantly improved the reliability of the country report on Slovakia. The European Semester has had a certain influence on national policy making, but it appears rather formal (the Semester itself is a tool of coordination). Perhaps among the notable and tangible effects has been the afore-mentioned issue of keeping the Slovak deficit of public finance under the 3% of GDP threshold thanks to the pressure of the EDP in 2013. This indicates that the government was strongly committed to respect the SGP rules.

A rather vague impact of the European Semester may be a result of the relaxation of rules and their heterogeneous enforcement across the EU member states, which has resulted in a weakening of the motivation of member states to follow EU recommendations. On the other hand, implementation of ex-ante conditionalities seems to have been an effective tool, which has affected Slovakia's fiscal policy choices, since the threat of a reduction in European funds is a serious motivation for adherence to rules.

According to one of the interviewees, the applicable legislation of Common Provisions Regulation for the European Structural and Investment Funds (Official Journal of the European Union, 2013) distinguishes automatic and optional strands of macroeconomic conditionality:

1. Automatic strand: the Slovak Constitutional debt brake law and the SGP are to be considered as sufficient incentives for a responsible and sustainable fiscal policy.
2. Optional strand: has certainly motivated Slovakia to consider the European Semester in a wider investment context, thus, investment strategy should be formulated in a way to prevent issuing new Council recommendations. If new relevant recommendations occur, the Slovak authorities would likely initiate dialogue with the EC on re-programming (probably before formally triggering the macro-economic conditionality procedure).[32]

Under the 'two-pack' regulations, the EC scrutinizes the Slovak Draft Budget Plan (DBP) as a whole (Table 2), as well as the progress made towards achieving the MTO. Slovakia has not been criticised by the Commission for pushing the MTO back by two years, but rather for making weak progress towards achieving it. Opinions on the impact of the Commission's scrutiny on changes in the Slovak budget are rather mixed, from having no impact to improving the reporting of information as well as the budgetary preparation process. The

[32] The interviewee also pointed out a philosophical concern regarding the macro-economic conditionality: *"whether a centrally designed macroeconomic solution should or can be successfully implemented in a given national or regional context (due to lack of ownership, mismatch with local economic environment, inconsistency with other national policies etc.)."*

Slovak public are partially informed about the positive assessments of the Slovak budget by the Commission; however, there is still room for improvement in the communication of EU issues towards Slovak society in general.

Table 2

Commission Opinions on the DBP of Slovakia (2013 – 2016)

Year of scrutiny	2013 (Draft budgetary plan for 2014)	2014 (Draft budgetary plan for 2015)	2015 (Draft budgetary plan for 2016)	2016 (Draft budgetary plan for 2017)
Key conclusions of the Commission	- DPB broadly compliant with the rules of the SGP - General government deficit within 3% of GDP - Fulfilment of the correction is uncertain - The plan relies on one-off revenues, which should be replaced by structural ones - Structural adjustment towards MTO does not fulfil the requirements - Progress in terms of fiscal recommendations' structural part is not sufficient	- DPB compliant with the rules of the SGP - Some uncertainties regarding the deficit in 2014 - Slovakia is eligible for the investment clause in 2014; the deviation from the MTO in 2014 should be compensated in 2015 - Progress in terms of fiscal recommendations' structural part from 2014 is not sufficient	- DPB compliant with the rules of the SGP - Limited progress with regard to CSR issued in 2015 relating to fiscal governance - Risk of deviation from the MTO adjustment path	- DPB compliant with the rules of the SGP - Some progress relating to the structural part of the fiscal CSR issued in 2016 - Further progress in the area of improving tax compliance is required - Risk of deviation from the MTO adjustment path

Source: European Commission (2013, 2014, 2015b, 2016b).

Prior to 2010, Slovakia did implement several reforms liberalizing the economy. With regard to the Lisbon Strategy, it appears that it has had no significant effects in Slovakia (perhaps, because of the soft nature and the absence of sanctions of the open method of coordination[33], which does not rely on strong pressure to introduce or amend national laws in accordance with EU legislation). The Slovak government approved the *Strategy of Competitiveness of Slovakia until 2010* (the so-called *Lisbon Strategy for Slovakia*) and later a national reform program called *Minerva* was adopted. The Europe 2020 Strategy has been reflected in the National Reform Programs. However, implementation of these documents lags behind and the results are not clear, since there are still problems, e.g. with the weak education system, little innovation, low R&D expenditure, as well as the low revenues of public finance.

4.5 Overview of the Effectiveness and Utility of Rules

Being a member of the euro area as well as the EU entails many benefits for Slovakia; in particular, it strengthens the stability of the economy. Slovakia mostly accepts EU rules and

[33] The open method of coordination is explained on:

http://eur-lex.europa.eu/summary/glossary/open_method_coordination.html.

has not signalled significant pressure against the EU so far. However, there is still room for improvement in terms of perceiving traditional European values, which also results from weak communication of European issues towards the Slovak public. In general, EU membership has increased welfare and stability in Slovakia, although it is difficult to conclude whether it has exclusively been due to the existence of EU rules. Moreover, the pressure of EU rules and the overall EU agenda have contributed to the employment of qualified personnel in the Slovak ministries. This has certainly helped to enhance the professionalism and credibility of the civil service and hopefully will lead to sustainable improvements in this regard.[34]

Structural funds resources have helped Slovakia to implement many necessary strategic investments. On the other hand, the availability of resources from structural funds has led to a lack of mobilisation of national resources (e.g. for science, education, or active labour market policy), which implies a risk for a future with less or even without EU funds.

Although EU rules are certainly useful, there is a risk that they become a means of avoiding responsibility in domestic politics; however, it is not significant in Slovakia. Another problem of EU rules is that they are rather complex but their enforceability is usually very weak, which reduces the incentives of member states to follow the rules.

Slovakia can provide good examples for other member states in several cases, including the tax reform implemented in 2004, the introduction of the debt brake as a Constitutional Act, institutional setting and functioning of the CBR, establishment of the Debt and Liquidity Management Agency or the activities of the recently established Value for Money Department within the MF SR. On the other hand, negative example include: Slovakia's low, and usually inefficient, public investments; slowing down reform efforts after the first successes; as well as ongoing problems in the area of public procurement.

4.6 Views on the Future of the European Integration Process

Slovakia can be characterized as a country with a relatively clear consensus on its pro-EU and pro-integration stance. However, there is no consensus on the exact form of further integration. Slovakia mostly supports the European consensus. It is a fiscally responsible and pro-reform-oriented country, which, despite its small size, has had a relatively tangible impact on EU fiscal rules. Examples include considering the impact of the pension reform (multi-pillar pension system) within the assessment of fiscal rules, adjusting the EFSF rules, as well as partially incorporating the fight against tax evasion in the assessment of adherence to fiscal rules. In Slovakia, perhaps the most relevant body affecting the opinion on further integration, not only in terms of fiscal rules, is the MF SR.

It is rather obvious that further deepening of fiscal integration will lead to enhanced surveillance. However, there is no need for more intrusive surveillance today, but enforcement of the existing rules should be significantly enhanced. Otherwise, any kind of

[34] The European Commission (2016c) pointed out that one of the key objectives of the civil service is implementation of effective human resource management. The Slovak government adopted a Strategy on Human Resource Management in Civil Service (2015-2020).

surveillance will not deliver on expectations. Moreover, it seems that more EU rules lead to even more exceptions and, thus, a relaxation of the rules such that they become merely guidelines. In the area of structural reforms, seeking a kind of common agreement on national reform strategies between the EC and member states could be useful (instead of merely underling the challenges).

When it comes to specific issues, the stances in Slovakia are as follows:

- *Debt mutualisation* could help to stabilize the EMU economy. However, the preference of Slovakia, as revealed by one interviewee, would be for an automatic tool to deal with asymmetric shocks, and not debt mutualisation, which is linked with clear fears of the issue of moral hazard. Debt mutualisation may lead to a halt in, or at least a relaxation of, the efforts in corrective action being taken in some member states. If there should be a shared responsibility, then it is conceivable only in cases of new debts, or common European debts. An important element of this process is to clarify future political integration, which could finally reduce the mistrust among member states and thus also the threat of moral hazard. The issue of moral hazard is certainly linked to Germany. On the one hand, the Germans' moral hazard objections could be mitigated by creating confidence through fiscal and economic discipline, better enforced by the EC, and interconnecting risk-sharing mechanisms with adherence to EU rules. On the other hand, the Germans' stance could be changed, if the country admits that it benefits a lot from the existence of the EMU.
- In general, Slovakia supported the integration steps included in 2nd stage of the Five Presidents' Report; however, it had objections regarding the *national productivity boards*, in particular duplication with existing surveillance framework should be avoided and interference in national wage setting was not supported. There is no clear consensus on what the benefits might be from introducing the productivity board. Thus, it is perceived rather sceptically and considered useless.
- *Common deposit insurance* as the third pillar of the Banking Union is considered as an inevitable step, but before this pillar is introduced, Slovakia, in line with the German position, supports progress on risk reduction measures (in particular on the capital requirements directive) in the Banking Union. Whenever it is introduced, the common deposit insurance should not cover 100 percent of deposits, but an upper ceiling might be useful, not least because it would put some of the responsibility on citizens to invest carefully.
- The *European Fiscal Board* (EFB) is not considered to be an independent body, because it is an advisory body to the EC, under the EC. The institutional framework of the EFB appears to be not appropriate and is not in line with the OECD *Recommendation of the Council on Principles for Independent Fiscal Institutions* (OECD, 2014) in terms of independence. Thus, it is not clear how the EFB board can evaluate the policy of the EC. Since the EFB is a relatively new institution, it is too early to assess its relationship to the CBR.
- There is no clear consensus in society in terms of the final shape of the Transfer Union. According to one interviewee, before deepening fiscal integration, it might be useful to have

progress on common border policy, Schengen, European defence, transportation, unemployment insurance, education or research and development.
- The MF SR had the ambition to support fiscal capacity suitable for all EU countries and progress in the debate on the EMU counter-cyclical tool to deal with asymmetric/symmetric shocks were presented as key issues during the Slovak presidency of the European Council in 2016.
- The *European Ministry of Finance* and *Treasury* is considered as a very ambitious project, but is unlikely to be implemented, as it would mean a big loss of sovereignty. It is above all a political issue and should be preceded by agreement on political union, despite the evident lack of enthusiasm nowadays for this initiative.
- The ESM has the potential to act as a *European Monetary Fund* in the future and Slovakia seems to be open to such change. Transformation of the ESM to such a fund is a useful way of utilizing its available capital. Before such steps occur, its analytical capacities need to be expanded, independence should be ensured and enforcement of its rules should be defined clearly in order to avoid future relaxation of these rules.
- *Eurobonds* have the potential to stabilize the EMU; however, it seems that they are not feasible in the current state of integration. Eurobonds could act as a preventive tool, but they would probably not solve the current crisis of the EU periphery.
- *Own resources* of the EU budget could possibly connect Europe more in terms of reducing tensions between net contributors and net beneficiaries. Genuine own resources could also strengthen European views compared to national ones, which prevail nowadays, and increase links between EU activities and the lives of citizens. Improved VAT collection could be one of the possible own resources, which would, on the one hand, decrease tax evasion at the European level and, on the other hand, reduce national contributions to the EU budget. Another alternative could be e.g. European environmental tax.
- It is not necessary to change the basic functions of the *ECB*; however, the inflation target could be reviewed as well as the framework of financial markets' surveillance. Furthermore, purchases of bonds should be properly embedded into legislation. Reducing pressure on reform efforts of some member states as a result of current ECB policy is also considered problematic.

4.7 Conclusions

EU membership is in general perceived positively by Slovak society. Along with the many advantages (structural finds, common market, free movement of labour, Schengen etc.) it brought several commitments. The European semester and the enhanced EU economic surveillance are among the obligations the Eurozone member states are expected to respect, and Slovakia is not an exception. Thus, several rules and principles had to be implemented and followed. This report has aimed to depict the current state and perspectives of the national implementation of coordinating mechanisms rules in Slovakia. Slovakia can in general, be characterized as a country with a relatively clear consensus on holding a pro-EU and pro-integration stance. However, there is no clear consensus on the exact shape of further integration.

Without a doubt, that EU fiscal rules and the enhanced surveillance procedure are useful measures, setting the borders and principles for all member states to behave in a fiscally (and macroeconomically) responsible manner. However, a perceived major issue is the often lax application and enforcement by the EC. This can affect negatively the behaviour of member states and they might tend to ignore or, not put enough effort into meeting the EU fiscal recommendations. From the Slovak perspective, along with the inconvenience resulting from breaking the rules, Slovakia has another incentive to follow the rules, since according to one interviewee, the evaluation of national fiscal policy by the EC affects the evaluation of Slovakia by foreign investors. Moreover, the EU agenda initiated the employment of officials able to tackle the new tasks. This certainly increases the effectiveness and professionalism of the state's public administration.

A good example of putting pressure for the fulfilment of the fiscal rules and behaving responsibly in terms of the state budget is the existence and activities of the Slovak CBR and the Constitutional debt brake law, which is perceived very positively at home as well as abroad. The mandate of the CBR is clear; it is independent and its recommendations have certainly had marked impact on the Slovak budget. Its competence as a "watchdog" appears useful. However, there is a likely risk of the debt thresholds being relaxed by creating an exception for higher public investment. Further improvement of this law could be achieved by implementing binding expenditure ceilings. The key institution involved in the EU agenda with regard to fiscal policy is the MF SR. It has a very solid position and power in terms of fiscal policy issues and budgetary decisions.

The EU rules and in particular the fiscal rules have a favourable effect on policy making in Slovakia. They brought rules end the expertise of the EC into the evaluation process, which certainly helps to increase the transparency of the budgetary process. Evaluation of the DBP, MTO, SGP or MIP put pressure on the government to behave responsibly and not to increase the debt and the deficit and thus not increase the burden on future generations. Moreover, the joint pressure from the CBR and the EC has the potential to foster substantial changes. When comparing the national and the EU rules and priorities, currently it seems that national governmental priorities are considered to have more influence on national policy-making than recommendations resulting from the European Semester. The national priorities overlap in many regards with the CSR priorities, thus, some of the EU recommendations would probably be addressed regardless the existence of EU rules. From another perspective, it appears that EU rules and priorities work best when they coincide with the national interest. This makes it hard to reach an unambiguous conclusion on the effects of EU rules on national policy-making.

Annex I: list of interviewees (alphabetically ordered)

Roman Dojčák	Director of the European Affairs Department at the Ministry of Finance of the Slovak Republic
Karol Frank	Researcher at the Institute of Economic Research
Radovan Geist	Publisher of EurActiv.sk
Eugen Jurzyca	Member of the Financial and Budgetary Committee of the National Council of the Slovak Republic
Ľudmila Majláthová	Economic Counsellor at the Representation of the European Commission in Slovakia
Ľudovít Ódor	Member of the Council for Budget Responsibility
Michal Polák	Advisor at the Ministry of Finance of the Slovak Republic
Martin Šuster	Head of the Research Department at the National Bank of Slovakia
Juraj Šuchta	Financial Attaché, Permanent Representation of the Slovak Republic to the EU
Vladimír Vaňo	Chief Economist of Sberbank Europe AG, Head of CEE Research

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5 Fiscal and other rules: case study of the United Kingdom

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The UK, as the result of the referendum held on June 23rd 2017 reaffirms starkly, has long had an uneasy relationship with the EU, including with its mechanisms of policy coordination. However, the UK approach to rules-based economic governance also offers interesting comparisons with other Member States. This paper looks both at the current fiscal framework in the UK and how it compares with previous attempts to discipline the public finances, notably in the run-up to the crisis which erupted in 2008, a shock to the economy which saw the near collapse of the UK financial system. It also explores the role of the EU level in UK economic governance, prompting questions about the value of supranational surveillance where the national level is both resistant to top-down monitoring and only loosely bound by it.

This case study draws on a range of documents and publications produced by the UK authorities, the Office for Budget Responsibility (OBR – the UK's fiscal council), the European Commission and the House of Commons Treasury Committee, as well as independent research. It has also benefitted from interviews, conducted under the Chatham House rule, with a number of experts on UK fiscal policy and the country's model of economic governance.[35] The first section of the paper presents an overview of present and past rules, and a subsequent section discusses the approach in more detail. Section 3 examines the institutions of fiscal governance and is followed by a discussion of the effectiveness of rule-based approaches in the UK. Conclusions complete the paper.

5.1 Evolution of national fiscal and other macroeconomic rules

Fiscal rules have been a feature of the UK economic governance landscape for decades, yet have something of a chequered history. In 1976, the UK had to seek an IMF loan to shore-up shaky public finances, leading to a wide-ranging reappraisal of macroeconomic policy and the transition away from Keynesian principles to the variants of monetarist thinking that characterised the Thatcher governments after 1979. Over much of the period since then, UK governments have sought to establish a framework for fiscal policy in which explicit numerical rules have played a part, albeit without ever becoming as binding politically, let alone constitutionally embedded, as in many other Member States of the EU.

Since the *Budget Responsibility and National Audit Act* was passed by the coalition government in 2011, the key document setting out UK fiscal framework has been the *Charter for Budget Responsibility,* which is regularly updated. As specified in the Act, the Charter must set out the Treasury's (the Finance Ministry) objectives for fiscal policy and for managing the national debt, the means by which it will achieve these objectives, and the matters to be reported in the annual *Financial Statement and Budget Report*, the publication containing the government's budgetary plans. The Act stipulates that the Treasury 'must lay the Charter before Parliament, a phrase that means it has to be approved by a resolution of Parliament, but may modify the Charter at any time, with the obligation also to lay the modified Charter before Parliament. Once approved, it has to be published.

[35] The author is grateful to all those consulted for their willingness to contribute and their candour.

The latest version of the Charter[36] was published in January 2017, following the Chancellor of the Exchequer's Autumn Statement to the House of Commons in November 2016. It has two main purposes:

- To explain the framework under which the government conducts fiscal policy
- To define the role of the Office for Budget Responsibility – the entity charged with independent oversight of fiscal policy and its relationship with government. However, the government is not permitted under the Act to specify the methods by which the OBR performs its duties.

5.1.1 The rules described

Since the mid-1970s when the fragile state of the public finances led to the IMF bailout, the UK has adopted a series of measures to discipline the public finances. Restoration of sustainable public finances in the late 1970s saw a focus on the Public Sector Borrowing Requirement (PSBR) and, under the Thatcher government, the framing of a medium term financial strategy (MTFS), still focused on the PSBR, but with rolling plans for three or four years ahead.

The primary aim of the MTFS was to curb inflation, but it sought to do so by plotting a path for the PSBR that would ease the pressure on monetary policy from the extent of government borrowing. The logic was that disciplining the deficit would allow lower interest rates than would otherwise be the case (Miller, 1981). An assessment by Thain (1985: 279) of the evolution of what, at the time, was a radical innovation in economic policy highlights the pragmatic adjustments that occurred to the strategy. He observes that the 'most conspicuous failure during the 1980-84 period was the non-implementation of the strategy's public expenditure plans'. In short, the outturn was a sizeable increase in spending rather than planned cuts and it is one of the ironies of the Thatcher period that public expenditure rose as a proportion of GDP during her tenure as Prime Minister. Thain takes the view that the Treasury was educated by events and by the reactions of other stakeholders. Building on his analysis a key political economy conclusion would be that rules are bound to be affected by learning-by-doing.

Expenditure ceilings continued to be at the heart of the fiscal framework by successive Conservative governments and were maintained in the early years of the 'new' Labour government which assumed power in 1997. Significant changes in macroeconomic governance were, nevertheless introduced by Gordon Brown at the outset of his long tenure as Chancellor of the Exchequer, starting with the granting of independence to the Bank of England in setting monetary policy. A further move by Brown, in his first budget after the change of government, was to introduce new fiscal rules. Two reasons underpinned these decisions: first, the previous expenditure ceilings had consistently been breached; and, second, there had been persistent under-investment by the public sector. With some reservations, Kell (2001) broadly endorses this criticism of the pre-1997 governments and argues that the then new UK approach had innovative characteristics, certainly compared with the more standard balanced budget rules most prevalent where rules were in force

[36] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/583547/charter_for_budget_responsibility_autumn_2016_update_final_for_laying_web.pdf

elsewhere at the time. As testified to by interviewees, the rules established in 1997 reflected considerable thought.

There were two explicit fiscal rules. Both were embedded in a (non-statutory) code for fiscal stability, provided for in the 1998 Finance Act.[37] The first is described as the golden rule which stipulated that government borrowing should only be for public investment, while public consumption should be in balance or in surplus. However, this rule was not to be applied on an annual basis, but over the economic cycle. This provision implied predictability of the cycle, even though its duration was ine. Second, there was a 'sustainable investment' rule concerned with keeping public debt at the end of each financial year at a stable and prudent level, deemed to be 40% of GDP. The code for fiscal stability also had a commitment to 'restore the path of the public finances to a position consistent' with the (plainly limited) UK commitments under the SGP, although there is, in practice, no evidence that this ever affected policy decisions. A clear message from interviewees is that the EU rules were regarded in the UK as poorly conceived, not least because they paid no heed to pubic investment.

Kell (2001) identifies certain facets of these rules not fully in line with the principles for optimal fiscal rules set out by Kopits and Symansky (1998). These include their limited constraint on discretionary spending, the difficulty of explaining to the public the adjustment over the cycle and consistency between the rules, although he also stresses that some trade-offs are unavoidable. He nevertheless reaches a generally positive conclusion about the design of these rules. However, over time these rules came in for criticism.

Thus, Chote et al (2009), in an assessment published after the rules had to be suspended when the crisis struck in 2008, note a number of shifts in the detail of the rules (for example, changing the start date of the cycle), many of which were widely believed to be intended to ensure continued compliance with the rule when it was at risk of being breached: in other words, moving the goalposts, although some interviewees dispute this assessment. However, Chote et al. also find that even without these changes, the Labour government over its first decade in power was roughly compliant with the golden rule, achieving a very small surplus on average. This contrasts with the two previous cycles under the Thatcher and Major governments, during which there were persistent current deficits on current transactions. The debt rule was also met over the 1997-2006 cycle.

When the crisis hit in earnest in 2008, the existing rules rapidly became so far out of reach they were irrelevant, and were, instead, replaced by a temporary operating rule to come into force when the economy stabilised, of aiming to improve the cyclically adjusted budget deficit each year until it reaches balance. In effect, although the parameters have shifted, this is a description of the current approach.

In the latest version of the Charter for Budget Responsibility, the fiscal framework comprises three components which, although the term used in the document is 'mandate for fiscal policy' can, albeit with some reservations, be interpreted as fiscal rules. These are, as stated in the charter:

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[37] HM Treasury, *The Code for Fiscal Stability*, November 1998 http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/the_code_for_fiscal_stability_uk_economy.htm

- “a target to reduce cyclically-adjusted public sector net borrowing to below 2% of GDP by 2020-21”
- “a target for public sector net debt as a percentage of GDP to be falling in 2020-21”
- “a target to ensure that expenditure on welfare in 2021-22 is contained within a predetermined cap and margin set by the Treasury at Autumn Statement 2016”

5.2 Description of fiscal governance framework and key institutions

The main institutions of fiscal governance in the UK are the Treasury, generally seen as the most powerful ministry in the government, various cabinet committees, the OBR and two Committees of the House of Commons: the Treasury Committee (most focused on macroeconomic, macro-prudential matters and financial regulation) and the Public Accounts Committee which looks at public expenditure. The House of Lords Economic Affairs Committee has a complementary role in monitoring economic policy. External scrutiny of fiscal policy is also considerable, both from the media and research institutes, notably the Institute for Fiscal Studies (IFS, a research organisation independent of government) which publishes an annual ‘Green Budget’ analysing and commenting on the government’s performance, plans and options. News media and opposition politicians regularly use IFS research in criticising government policy, obliging ministers to be aware of what the IFS says and to respond where needed.

The UK Treasury has always been a powerful ministry with an ability to exercise discipline over spending ministries. In doing so, having a fiscal framework supplemented by rules is a useful instrument. Evidence from several interviewees suggests that having rules – some would argue any rules serve the purpose, whether good or bad – can be helpful in curbing spending overall. To this extent, the various iterations of rules could be said to have strengthened the control function of the Treasury

The de facto power of the Treasury can also be influenced by the relationship between the Prime Minister – formally known also as ‘the First Lord of the Treasury’, the label engraved on the door of 10 Downing Street – and the Chancellor of the Exchequer. The latter performs the role of Finance Minister, but is often also seen as the Minister with the most clout in government, particularly (as occurred in the new Labour government from 1997 to 2007) when Gordon Brown, as Chancellor was apt to be regarded as the Chief Executive to Tony Blair’s more ‘presidential’ image in government. In the UK government system, the Cabinet Office can, within reason, be thought of as a Prime Minister’s department, although its ministers tend to be lower profile and one of its key functions is to coordinate policy across the line ministries. In practice, the Cabinet Office has limited sway over fiscal policy and there have been many instances of tension between No. 10 and No. 11 (the official residence of the Chancellor) Downing Street.

The UK (at least until the Brexit process is concluded) is subject to scrutiny from the EU institutions, as are other non-members of the Eurozone (plainly, less intrusive than for Eurozone members) and is formally within the preventive arm of the Stability and Growth Pact. However, the impact of EU monitoring is muted and often invisible in UK discourse on fiscal policy; more attention tends to be paid to what is said by the IMF in its annual Article IV assessments. As explained by one interviewee, this lack of impact is not just because of the opt-out the UK has from an obligation to join the euro, but also a more fundamental disagreement over the thrust of rules, one aspect of which is that EU approach does not give priority to public investment.

From the perspective of the European Commission, its role in monitoring the UK economy differed, even before the launch of Brexit, from that in relation to other Member States because of the much more limited formal expectations. Despite being consistently under the EDP since 2009, there is no pressure to adjust because of it, while the response in British public discourse to the country-specific recommendation issued each year as part of the European semester is often a rejection of 'interference from Brussels' rather than action to address the recommendations. Partly for historic reasons, but also because of a generally sceptical British perception of 'Brussels' (pre-dating the Brexit referendum) the UK seems to be more receptive to the analyses and recommendations of the IMF or the OECD.

Since its creation in 2011, the OBR has rapidly become a significant and effective component of the fiscal governance system. Among the tasks delegated to it is producing the official forecasts underpinning government decisions on fiscal policy (something, incidentally, not delegated to a number of other fiscal councils across the EU[38]). Irrespective of the quality of these forecasts, having them done by an independent agency largely takes the politics out of this facet of fiscal governance. A widespread view is that the OBR has discharged its responsibilities well. Interviewees also mentioned its useful work in analysing the longer-term sustainability of UK public finances, particularly as a result of population ageing, and the fact that it probes the spending plans of individual departments and, by doing so, exercises a worthwhile audit and scrutiny role that feeds into expenditure planning.

It is difficult to identify unambiguously to what extent the OBR has affected policy-making and whether, as a result, outcomes ae better. An external review of the OBR[39], carried out in 2014, was generally positive about how it had been set up and was carrying out its role, although the review noted some concerns about the Office's 'joint accountabilities to the Chancellor and to Parliament – two different constitutional branches'. The review also noted the dependence of the OBR on inputs from government to carry out its functions and its reliance on a limited pool of expertise. The external reviews, reinforced by the opinions of interviewees, consider the OBR's evident transparency as an asset. Three years on, there is no real sign that any of this is much of a problem and the consensus from those consulted is that the OBR is fulfilling its mandate well, with one interviewee arguing that concerns about the pool of expertise would prove to be unwarranted. However, being constrained to look at only the government's policies and targets is a limitation compared with practice elsewhere (for example the Netherlands, where the CPB is entitled to examine alternative fiscal targets and the fiscal proposals of other political parties).

As is customary in the UK model of governance, the scrutiny of fiscal policy exercised by the House of Commons Treasury Committee (and, to a lesser extent, the House of Lords Economic Affairs Committee) is robust. The Committee takes written evidence and has hearings not only with Ministers and representatives of the OBR, but also from external experts. On occasion, its reports can be not only critical of government, but also sufficiently incisive to attract media attention and thus to influence public debate. For example, in preparing its forthcoming reports on the government's spending and budget plans, the Committee on evidence from a number of experts (cited elsewhere in this paper) to comment on the functioning of the UK fiscal framework.

[38] For further information on fiscal councils see: http://www.euifis.eu/
[39] http://budgetresponsibility.org.uk/docs/dlm_uploads/External_review_2014.pdf

5.3 Compliance with rules

There is an intriguing pattern to UK fiscal rules: they tend to hold, or nearly hold, for extended periods, but (as one interviewee explained) are then revised when they become politically uncomfortable. A recent exchange in a formal hearing of the Treasury Committee between Andrew Tyrie M.P. (who chairs the Committee) and Paul Johnson (Director of the IFS) is instructive. The former claims to have identified 13 fiscal rules in the UK since 1997 and, when invited to comment, the latter responds as follows:

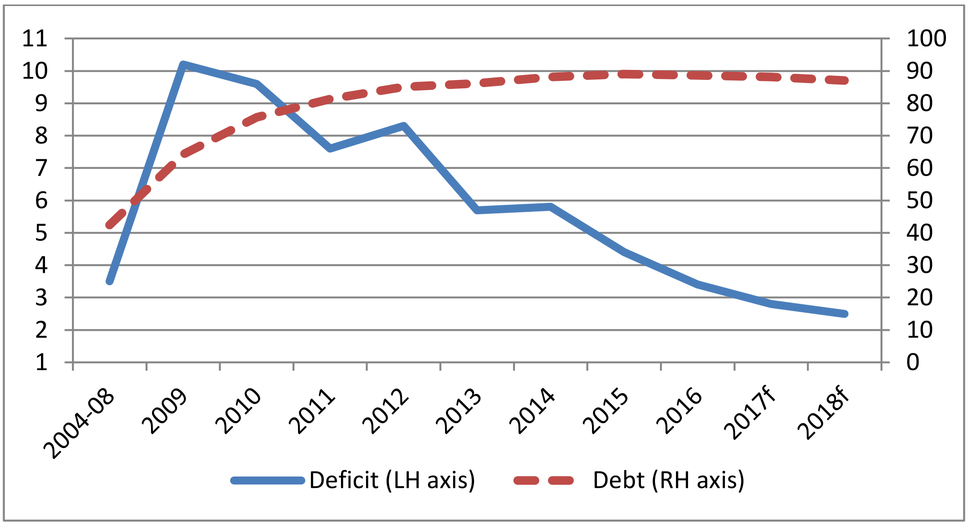
> 'We have come up with 12, so you may have found one more than we have and we reckon that 10 of those have been broken or abandoned at some point. That said, I am not wholly cynical about the usefulness of fiscal rules.'[40]

Johnson goes on to make the point that, despite being breached so often, the rules 'have clearly constrained behaviour while they have been there, even to the extent that they may have been gamed'. His colleague, Carl Emmerson says, in the same hearing, that the rules of the coalition government which set a target several years ahead for restoring balance in the public finances, had credibility, because they allowed for flexibility if circumstances changed (as, indeed, they did as a result of the intensification of the euro crisis in 2011/12. However, if tested purely by compliance with what is written in the Charter for Budget Responsibility, the UK simply would not pass. In this regard, the verdicts of the IMF and the European Commission on UK fiscal rules are intriguing. The Commission accords the UK a fiscal rules strength index score around the EU average, above (for example), Estonia where the rule derives from the constitution. The IMF records the targets as rules but does not comment further.

Judged by the EU rules, the UK over the last decade has been persistently non-compliant. Since the economy was blown off-course by the crisis, the deficit rose to 10% of GDP in 2009, largely because of a sharp fall in tax revenue, notably from the financial sector. Despite claims that an austerity policy was being implemented, it is belied by the trends in public finances over the last decade. The deficit remained above 5% of GDP throughout the collation government from 2010-15, while debt, unsurprisingly, jumped sharply in the early crisis years and is only now stabilising. The trajectory of the public finances is shown in figure 1. The data also show that, in real terms, public spending has been stable up to 2017, in contrast to the rhetoric on cuts, and there has been a sizeable public sector deficit in every year since 2007.

[40] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/autumn-statement-2016/oral/43886.pdf

Figure 1 UK deficit and debt ratios, 2004-18 (% of GDP)



Source: Ameco database

The frequent redefinitions of the fiscal framework in place since 2010 make it hard to give a categorical verdict on UK compliance with its current fiscal rules. The November 2016 assessment by the OBR (2016: 22)[41] concludes that the government will fail to meet all three of its medium-term fiscal targets 'by considerable margins': instead of a surplus by fiscal year 2019-20, the new projection is for a deficit of 1% of GDP. With growth still due to be above 1%, the escape clause from the rules will not be triggered. Commenting on the revised (looser) targets announced in the Autumn Statement, the OBR (in its central forecast) expects them to be met, but draws attention to the sizeable chance (based on recent experience) that even this softer target will be missed. According to the OBR, the partial expenditure rule prescribing a cap on welfare spending will overshoot by as much as 7% by the fiscal year 2020/21.

Moreover, the detailed analysis by the OBR finds the UK's public finances to be structurally weaker than previously thought, meaning even the higher growth now forecast will not improve the public finances as much as previously expected. Further analysis accompanying the 2017 budget in March[42] paints a more positive picture for 2017, but also projects a worsening of public finances in 2018. Significantly, although the government is expected to meet its targets for the structural deficit and the debt, the OBR finds that:

> 'the Government 'does not appear to be on track to meet its stated fiscal objective to "return the public finances to balance at the earliest possible date in the next Parliament". The deficit falls little in 2020-21 and 2021-22'.

The political economy of rules has been affected by the last set of revisions embodied in the current version of the Charter for Budget Responsibility. As Emmerson and Pope (2017: 78) stress in the latest issue of the IFS *Green Budget*, UK 'fiscal policy is not currently subject to any fiscal targets that can be met or missed in the remainder of this parliament'. They also examine the welfare cap and find it has not only been postponed along with a commitment to examine outcomes every five years instead of annually, but relaxed by having a higher

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[41] http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/
[42] http://budgetresponsibility.org.uk/overview-march-2017-economic-fiscal-outlook/

margin of 3% rather than 2% for over-shooting the target. The paper concludes that the longer-run objective of UK fiscal policy of balancing the public finances is likely to be a difficult task. The significance of the pushing-out to the fiscal year 2020/21 of the targets is twofold: first, it means the government faces no direct constraint on fiscal policy in aggregate from numerical rules during its projected period in office; and, second, rules passed under the current Parliament cannot necessarily bind a successor government.

Intriguingly, the chapter makes no reference to EU rules or the UK continuing to be under the EDP, nor do corresponding chapters in previous editions of the Green Budget. Given the relatively low proportion of public spending covered by the welfare cap, and the exclusion of significant welfare payments (notably pensions and cyclical unemployment benefits, its standing as a rule is questionable. Similarly, the transcripts of the hearings on the fiscal position of the UK and adherence to rules conducted by the Treasury Committee are equally devoid of any mention of EU rules or of the UK being under the EDP. Nor do EU judgements appear to affect monetary policy decision-making, as part of which the Bank of England takes the government's fiscal plans as a given.

5.3.1 Macroeconomic imbalances

All EU Member States are supposed to be bound by the Macroeconomic Imbalances Procedure (MIP) and to be monitored as part of the European semester. However, the UK (in common with other non-members of the Euro Area) cannot be placed in the corrective arm of the MIP. Having refused to be a signatory of the *Treaty on Stability, Coordination and Governance*, the UK does not have to respect the terms of the Fiscal Compact, with the result that scrutiny by Brussels is qualitatively different from other Member States, for example in relation to a medium-term objective for fiscal consolidation.

In the first few years of the new MIP, the Commission analyses of the 'alert mechanism scorecard' nevertheless found evidence of imbalances, as a result of which the UK was subject to an in-depth review (IDR) as provided for in the relevant EU regulation. The ensuing outcomes are summarised in table 1. In both the 2016 and 2017 exercises, the verdict on the UK was 'no imbalances' despite continuing concerns about the housing market and the external side of the economy. Indeed, in 2017, the decision was not even to have an IDR, even though the number of warning 'flashes' shown by the alert scoreboard is higher. It reflects the judgements in the country report (Commission, 2017) on the gradual improvement in the indicators most likely to undermine sustainability. While it is not difficult to guess the political imperative behind a verdict in a report issued in the spring of 2016 adjudging the UK to have no macroeconomic imbalances, the three persistent sources of imbalance shown in the table have not evolved, making it hard, objectively, to justify the change of categorisation. The Commission's reasoning is:

> "High household sector debt and elevated house price levels as well as the large current account deficits may constitute vulnerabilities. However, household balance sheets are strong in aggregate and both household debt levels and house price growth have fallen since 2014. Moreover, risks associated with the large current account deficit are mitigated by a favourable institutional framework and low foreign currency liabilities, and the deficit is expected to decline as adverse cyclical conditions unwind. Several government initiatives have yet to exert a material impact on the imbalance between housing supply and demand."

However, the persistent current account deficit grew further in the last reference year and the further postponement of fiscal consolidation is hard to reconcile with the Commission view that 'risks to stability in the short-term appear limited', the more so when the analysis goes on to the refer to the uncertainty associated with Brexit. The cynical explanation could be, simply, that the Commission has already given up on the UK, although some interviewees insisted that the UK continues to take its obligations towards the EU seriously. A point made by interviewees in this regard is that the UK in previous years has, in any case been classed as having the lowest level of imbalances and has been adjusting towards greater balance. This arguably highlights a shortcoming in the MIP of using indicators from year t-2 to signal alerts.

Table 1 **Macroeconomic imbalances in the UK assessed**

Year	Commission assessment	Key elements of imbalance		
		Current account deficit, % of GDP	Housing price increase, % YoY	Private debt
2017	No in-depth review	4.8 (5.4 in 2015)	5.7	157.8
2016	No imbalances	4.3 (4.9 in 2014)	8.3	157.7
2015	Imbalances which require monitoring & policy action	3.2 (4.2 in 2013)	1.6	164.5
2014	Imbalances which require monitoring & policy action	2.8 (3.8 in 2012)	-0.9	179
2013	Imbalances which require monitoring & policy action	2.2 (1.7 in 2011)	-5.4	205
2012	Imbalances which require monitoring & policy action	3.0 (2.6 in 2010)	3.4	212

Notes:

The data in the table are those contained in the respective annual assessments, as they were what fed into the judgments made. Subsequent data revisions may result in different values.

Shaded cells are values above the reference thresholds

The alert threshold for the deficit on current account of the balance of payments is 4% of GDP, averaged over three years, and for private debt it is now 133% (it was previously 160%), meaning that the UK was above the threshold for all three in the 2016 exercise. Although the Commission insists that it does not use these alert thresholds mechanically (and there are several other indicators, on some of which the UK is well under the threshold, although it is well above the threshold for its fiscal deficit).

Source: European Commission alert mechanism reports and their statistical appendices

5.4 Commentary on the influence, visibility and utility of UK rules, and the commitment to them

Despite the clarity of the fiscal framework and its statutory base, together with the requirement for any change in the Charter for Budget Responsibility to be agreed by Parliament, the evidence suggests the fiscal mandate does not effectively constrain government. There is neither a binding limit in the legislation, nor any prescribed path to follow if the limit is breached, and no provision for sanctions, whether financial or disciplinary in relation to ministers or officials. On the contrary, the ease with which the government can revise the Charter implies substantial discretion in the conduct of fiscal policy.

The cap on welfare expenditure has attracted political criticism, but has done little to restrain spending. As explained by Emmerson et al., (2016):

> "If the cap is deemed by the OBR to have been breached, the government must hold a debate on a votable motion in the House of Commons, normally within 28 sitting days, giving an assessment of the reasons for the breach and following one of three possible courses of action:
>
> - Propose policy measures to reduce welfare spending below the cap.
> - Seek the approval of parliament for the cap to be lifted.
> - Explain to parliament why the breach is justified.

The last of these means that the welfare cap could, in practice, be a weak constraint and essentially allows the government to take no action at all if it deems that the breach is 'justified'". In practice the third option is what has happened, suggesting the welfare cap is at most a pretty weak constraint and is simply ignored when political factors, such as objections to government plans to curtail welfare spending, come to the fore. Emmerson et al. (2016: 74) leave open the question of whether 'this condemns the cap to irrelevance and failure in the longer term', but their scepticism is evident. It is also instructive that the European Commission database of fiscal rules does not record the cap as a fiscal rule.

In the opinion of one interviewee, introducing 'the welfare cap was absurd', although another argues that although soft in implementation, it still has value by drawing attention to a segment of public spending prone to rise inexorably. Not including pensions within the definition of welfare spending, in combination with the repeated commitments to safeguard the value of pensions[43], undermines the logic of a welfare cap. In addition, in a recent demonstration of the difficult politics surrounding welfare spending, cuts were announced, prompting the minister who announced them to resign – attracting derision from the former head of the Treasury, Sir Nicholas Macpherson[44] – followed by his successor cancelling the cuts.

Why does this apparently relaxed view of rules arise? One answer is pragmatism and it is also clear that the UK body politic would be highly resistant to rules (such as those written into constitutions elsewhere) incapable of being over-ridden if circumstances (as opposed to formal escape clauses) require it. In a hearing of the House of Lords Economic Affairs Committee, responding to a question from his predecessor but one, Lord Darling, on the interplay between fiscal and monetary policy when interest rates are at the zero bound the chancellor, Philip Hammond, argues: 'it would be perfectly possible to design a set of fiscal rules that provides headroom without necessarily using that headroom at the same time'.[45] In subsequent evidence to the House of Commons, Hammond stated:

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[43] The present government, for example, has what is known as the 'triple-lock' on maintaining the growth of pensions, ensuring they rise by at least 2.5% per annum.

[44] *Financial Times* Interview, 14th April 2016 https://www.ft.com/content/295dd92e-ff21-11e5-99cb-83242733f755

[45] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/economic-affairs-committee/chancellor-of-the-exchequer/oral/37979.html

‘I have made the judgment that postponing into the next Parliament the point when we reach fiscal balance, but continuing to make clear that we will reach fiscal balance, is the right compromise here. Many representations have been made that we should abandon the idea of overall fiscal balance altogether. I do not share that view and neither does the Prime Minister’

5.4.1 EU analyses and rules

Monitoring from the EU does not seem to have had much effect on UK policy-making. It was ‘news’ when the UK was put into the EDP in 2009, but remaining within it ever since has neither had any obvious consequences nor featured in public debate. One interviewee suggested that had the Chancellor (as he might have done) chosen to use the EDP or EU rules to justify more restrictive fiscal policy, it would probably have backfired by becoming a narrative of the EU ‘imposing austerity’. Similarly, the MIP is not at all visible and, according to interviewees, does not seem to have had any effect on how policy-makers think about their fiscal or monetary policy. The implication is that governance mechanisms designed to discipline and coordinate Eurozone Member States’ economic policies in the common interest are ineffective in countries not participating in the euro, although it could be argued that the UK is the extreme case.

A corollary is that although UK officials are said to have been constructive in the various EU bodies charged with surveillance of Member State fiscal and other policies, the expectation (even prior to the Brexit decision) was that these would be confined to others and not relevant for the UK. Indeed, UK ministers have made a number of statements cajoling the euro area to deepen its fiscal governance, though with the emphatic sub-text that this should not in any way engage the UK. Former Chancellor, George Osborne, for example said in a speech in Berlin in 2015: ‘we, in Britain, can support you in the Eurozone make the lasting changes that you need to see strengthen the euro’ while making the case for the rights of non-members to be respected.[46]

EU analyses of the UK can, according to some interviewees, have some value inside government by offering a different perspective and some benchmarking, even though they do not percolate into public debate. An example is in the latest issue of EU Public Finances[47] where the analysis of the UK public finances points to the high public debt as a source of vulnerability, but suggests there are ‘no substantial short-term fiscal risks’, although risks are higher in the medium term. As for many other EU countries, the longer term analysis suggests a challenge related to ageing of the population. There is little to distinguish the Commission analysis from that of the OBR or, indeed, the IMF and the OECD, with the implication that there is little added value from multiple channels of surveillance. According to data in the report the UK was on course to have the second highest budget deficit in the EU in 2016 (3.5% of GDP), only exceeded by Spain (4.6%). Adjusting for the cycle, the UK had the joint highest structural deficit (3.8% of GDP, the same as Spain) and the highest structural primary deficit (1.4%). The UK debt to GDP ratio in 2016 (at 89.2%) is close to the EU average of 86% and has been within a couple of percentage points of the average over the last five years, although it has edged up from below to above the average.

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[46] https://www.gov.uk/government/speeches/let-britain-and-germany-work-together-as-partners-for-a-european-union-that-works-better-for-all-of-us-says-chancellor
[47] http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2016-12-19-public_finances_2016_en.htm

In the European Commission's 2017 country report on the UK, the discussion of responsiveness to the country-specific recommendations suggests only lukewarm compliance – a verdict of 'some progress' – despite the rather limited and bland content of the three put forward in 2016, covering, respectively, public finances, housing and infrastructure, and skills and child-care. The issues covered in the CSRs are long-standing and, to a degree, intractable concerns in UK economic policy. Successive government have sought to tackle them but with only limited success, explicable by a range of political economy constraints, such as the influence of a land-use planning system hostile to encroachment on 'green-belt' land or short-termism in skills policies.

The plausible explanation for the limited effects of EU surveillance on UK policy offered by those consulted in the preparation of this report is twofold. First, any critique of the UK emerging from the EU is very much of second-order significance in influencing either decisions or public debate. The UK government regards financial markets as the key arbiter of the quality of its economic management, implying a need to exercise discipline in the public finances so as to avoid being penalised in borrowing rates. From this perspective, being criticised as a result of EU processes would only matter if it affected market sentiment, but since the data behind the likes of the UK being in the EDP are already 'out there', subjection to the formal process makes little, if any, difference. It was also noted by interviewees that the UK has not sought to invoke any of the escape clauses written into the SGP.

More tellingly, in his speech to the House of Commons presenting the UK budget plans for the fiscal year 2017, the Chancellor of the Exchequer alludes (very unusually) to EU rules, but does so in an openly contemptuous manner in what is his only substantive reference to the EU. Commenting on the projected reduction of the budget deficit to 2.6% in 2017 after years in which it has been significantly higher than 3%, he mocks the EU rules that the UK has been in breach of since 2008:

> "And for those who care about such things, it means we are forecast to meet our 3% EU Stability and Growth Pact target this year for the first time in almost a decade. But I won't hold my breath for my congratulatory letter from Jean-Claude Juncker!"

The second reason concerns how UK officials approach EU monitoring. Insider accounts suggest the UK is a respected voice inside Committees such as the EFC or the EPC which exercise oversight over Member State economic policies. But underlying this observation is the political economy point that an important objective for UK officials is often to forestall or deflect potential public criticism of UK ministers. According to one interviewee, a political aim could often also be news management, and there were occasional instances of 'picking a fight' with the Commission with a view to making ministers look robust.

5.5 Overview of effectiveness and utility of rules

Fiscal and other rules have had some influence in the UK, but are manifestly less onerous or rigidly applied than in many other EU Member States. They have to be seen more as part of a broader fiscal framework than an end in themselves. In some respects, the UK fiscal framework is attractive. Rules can, however, be blunt instruments, leading some commentators on UK policy to question the government's fiscal stance in the aftermath of the crisis years and the risk of rules resulting in inappropriate policy. Equally, when the public finances are over-stretched, they need to be brought under control. The dilemma was highlighted by the recently retired top civil servant in the UK Treasury, Sir Nicholas

Macpherson, in a review of a book by a prominent economic journalist (Keegan, 2015) criticising the 2010-15 coalition government's 'austerity' policy:

> "the longer a Government runs a large deficit, the greater the risk that it hits an inflection point where the markets take fright, and the cost of funding rises sharply: in this respect the Eurozone experience is relevant. The problem for policy makers is that ex ante it is difficult to know where the inflection point is, and that strengthens the case for erring on the side of caution. That's why the last Government set a debt rule of 40 per cent of GDP and the current one is seeking to get debt on a downward path".

For Crawford et al. (2015: 62) the UK framework 'is undoubtedly simple and transparent, particularly beyond 2019/20', the then deadline for attaining a surplus in each year. They also argue that by not having any form of cyclical adjustment, it avoids the (potential) opacity of previous UK rules which were susceptible to judgements and methodological disputes about the calculation of the output gap or the duration of the cycle. In addition, an escape clause allows the government to suspend the rule if GDP growth falls below 1% and to decide when to restore it. However, a dismissive view by one expert consulted is that the 'welfare cap is absurd'. Moreover, any expenditure rule (the critique probably also applies to revenue rules) has the normative drawback that it concerns the size of the state, whereas deficit rules are neutral in this regard.

One observer, Simon Wren-Lewis, considers that 'the new Charter for Budget Responsibility is honestly not worth the paper it is written on'.[48] In evidence to a House of Common Treasury Committee Inquiry commenting on the Charter, Philip Booth pointed out that in just one sentence it 'had four different ways of describing it—an objective, a charter, a mandate and a target. In the two sentences either side, it is a commitment and a framework. That is six different ways of describing it in three sentences …. Of all those six ways of describing it, "a rule" does not appear as any of them'.

In the same evidence session, Simon Wren-Lewis argues that for ten years the fiscal rules adopted by the Labour government when Gordon Brown was Chancellor were 'broadly kept to' until the extreme event of the crisis. However, after the coalition government started with what he describes as 'a moving target' which he characterises as 'quite a nice form of rule' in the context of the then recovery from severe crisis, 'changes since then have been going backwards, in terms of what a sensible rule looks like'. What Wren-Lewis stresses, reinforced by some of those interviewed for this paper, is the importance of relating the fiscal framework to the exceptional circumstances of monetary policy at the zero lower-bound (ZLB). However, other interviewees maintain that even with interest rates effectively at zero- there is still latitude in monetary policy through quantitative easing.

Cyclical adjustment and rules over the cycle (as tried in the UK during the New Labour years) are open to the manipulation of fiscal rules be redefining either the approach to adjustment (techniques as well as principles) or the duration of the cycle by the government. Even if the duration of the cycle can be clearly identified, a rule based on it can give rise to sub-optimal policy if it implies too big a fiscal correction in the later years of the cycle. The various changes adopted by the New Labour government up to 2007 to maintain compliance with the rules can be criticised on these grounds. A further observation is that rule, especially if

[48] https://mainlymacro.blogspot.co.uk/2016/11/2016-autumn-statement.html

they are overly complex, are vulnerable to creative accounting, for example in how private finance initiatives are accounted for in public debt data. There is also a legitimation question. In the UK there is a constitutional convention that a Parliament cannot bind its successor, yet the current rules and those in place under the Labour government had fiscal obligations well beyond the lifetime of the then Parliament.

Fiscal councils and fiscal rules complement one another (Calmfors and Wren-Lewis, 2011), rather than being alternatives, and this complementarity can be seen in how the OBR interacts with government in the UK. By assessing the expected compliance with the Charter for Budget Responsibility ex-ante, the OBR signals compliance, and by also monitoring the change envisaged in the Charter, the OBR can appraise the likely future compliance. The clear consensus view from interviewees is that the OBR has done a good job. Having the official forecasts done by an independent body has the considerable advantage of depoliticising a key input into policy-making, not because the forecasts are necessarily superior, but because they counter the accusation that they employ politically convenient assumptions.

5.6 Conclusions

Plainly, the onset of the financial crisis in 2008 was a watershed for UK fiscal rules. Those that had been in place under new Labour and which had essentially been respected up to 2006-7 (although with some reservations about the credibility of relating them to a cycle of uncertain duration) could not be sustained. The new framework that then emerged relies less on precise numerical rules. According to interviewees, this was a necessary evolution, affording room for flexibility in the conduct of fiscal policy. A (positive) conclusion to draw is that rigid rules – both those favoured in EU level fiscal governance and the sorts written into the hardest of law elsewhere – are ill-suited to difficult times, implying the UK has a system better equipped to deal with diverse economic conditions. The (potentially much more negative) conclusion would be that the UK allows expediency to over-ride consistency in how fiscal constraints (the overall framework, rather than rules per se) are applied with longer-term repercussions still to be seen.

In some ways, the UK is an exemplar of the absence of what has been called an 'implementation incentive' (Portes and Wren-Lewis, 2015) because there is no real penalty for failing to achieve the target. Portes and Wren-Lewis also put forward the concept of a 'realizable target' which can lead to different problems especially if optimal adjustment is slow. The UK rolling target can be understood as realizable in the Portes and Wren-Lewis sense, despite being at odds with the implementation problem. However, the longer-term history of fiscal rules in the UK suggests, as pointed out by one interviewee, that the UK will respect rules up to the point when they become politically uncomfortable, then they will be recast or more fundamentally re-thought.

To sum up, what the UK now has is a fiscal framework within which numerical targets have a role, but not a decisive effect on disciplining policy decisions. In unusual times, this combination has much to commend it, as governments may need flexibility if, for example, productivity is not growing or there are fiscal implications of financial instability. The framework may be helpful within government by enabling the Treasury to discipline spending ministries and other agencies of government, but this could, in principle, be true of any constraining framework, leading one interviewee to stress that the time frame and nature of conditionality still have to be well-conceived.

Because EU rules apply in only a limited way to the UK, they have had little obvious impact on UK policy-making, summed up by one interview as the UK 'being in the system, but not bound by the system'. The low salience of EU rules also reflects the sentiment that they are not well-conceived. One interviewee highlighted the lack of attention to investment in EU rules as deeply flawed, and several referred to the well-known propensity to pro-cyclicality. One specific criticism is that EU rules are too orientated towards sanctions and discipline and do not contain positive incentives.

Perhaps the acid test is that there has been no adverse market reaction to the regular shifting of the goal-posts in recent years. It is also arguable that the UK does not face the legitimacy challenges of having rules with a rigid constitutional basis, because the system still affords considerable discretion. An overall conclusion is the UK system is flexible enough to accommodate changing circumstances, but this could be at the cost of certainty, highlighting one of the many dilemmas around fiscal rules. A possible inference, dare it be said in these febrile times of Brexit, is that EU governance could learn from UK experience.

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Annex I: list of interviewees

Sir Charles Bean, Office for Budget Responsibility

Gordon Brown, former Prime Minister and Chancellor of the Exchequer

Chris Giles, *The Financial Times*

Lord Nicholas Macpherson, former Permanent Secretary, HM Treasury

Stephen Pickford, Chatham House, formerly HM Treasury

Jonathan Portes, Kings College London

Martin Weale, former member of Bank of England Monetary Policy Committee

Florian Woehlbier, Samuel Whittaker, Allen Monks, Laszlo Jankovics and Matthew McGann, all of DG Ecfin of the European Commission

Simon Wren-Lewis, University of Oxford

NB: at their request, some others consulted have not been named