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Fiscal rules in CEE – fiscal masochism, or necessary clean-up?

Besides the reinforced Stability and Growth Pact, which aimed to improve fiscal surveillance in the European Union, many CEE countries have introduced country-specific fiscal rules and debt brakes. On top of that, many CEE countries have started to ratify the Fiscal Compact. What are the positive and negative features of the fiscal rules for CEE5* countries?

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My thanks for comments go to Zoltan Arokszallasi, Birgit Niessner and Katarzyna Rzentarzewska

*Note: *CEE5 = Czech Republic, Hungary, Poland, Romania and Slovakia*

CEE5* countries should benefit from structural benchmarks introduced by the six-pack on the EU level, as they are less harmful to growth and increase the sustainability of public finances in the long run better than nominal targets. Expenditure benchmarks reflect some important features of small CEE5 countries and reduce the incentive for consolidation through cuts of public investments or reversals of reforms, which has a long-term positive impact on the sustainability of public finances. Due to the higher potential growth and lower debt level, the Czech Republic, Poland, Slovakia and Romania (among all EU members) can afford the highest real growth of expenditures before and after adjustment to their structural deficit target.

CEE countries are still committed to meeting the nominal 3% of GDP deficit target before quitting the Excessive Deficit Procedure (EDP). This is the only stage at which the Czech Republic, Hungary, Poland and Romania could be confronted with financial punishment. The new sanctions mechanism does not apply to non-Euro Area members, but any EU member can be suspended from cohesion fund financing for lack of corrective action within the EDP. The threat of temporary suspension from cohesion fund financing, which averaged about 0.7% of GDP in CEE5 in 2012, is a strong motivating factor for CEE5 countries to leave the EDP procedure. CEE5 countries should leave the EDP within two years; some of them may get a one-year extension of their current deadline, referring to the recession in the Euro Area as a legitimate escape clause.

After CEE5 countries meet their 3% deficit target, they have to continue in consolidation in structural terms, according to benchmarks outlined in the six-pack. However, after quitting the EDP, non-Euro Area countries do not face the risk of any financial punishment for non-compliance with the structural rules, which creates a potential window for fiscal loosening. Local debt brake rules, albeit not always compatible with the new structural benchmarks, are of high importance at this stage. They make politicians accountable to the public and increase their awareness about fiscal responsibility, probably more than 'externally-set' EU rules. The debt brake rules could be seen as complementary to structural benchmarks and partially substitute for the debt reduction rule from the six-pack and fiscal compact. While Euro Area countries with public debt of about 60% of GDP have to reduce their excessive debt, according to the debt reduction rule, the local debt brakes in CEE prevent the debt from growing to the 60% of GDP level.

	The old SGP			Six-pack after leaving the EDP				Fiscal compact		Local legislation	
	MTO % of GDP	The EDP Deadline	Sanctions % of GDP	Minimum adjustment	Expend. Rule	Debt red. Rule	Sanctions % of GDP	Adoptions of Rules	Sanctions % of GDP	Debt brakes	Fiscal Council
Czech Republic	-1.0	2013	CF		yes		no	no	no	40/45/48/50***	prepared
Hungary	1.5	2012	CF	>0.5pp	yes	yes	no	no*	no	50	yes**
Poland	-1.0	2013	CF		yes		no	no*	no	50/55/60	yes
Romania	-0.7	2013	CF		yes		no	no*	no	yes	yes
Slovakia	-0.5	2013	CF + 0.2	0.5pp	yes		up to 0.5	yes	up to 0.1	50/53/55/57/60	yes

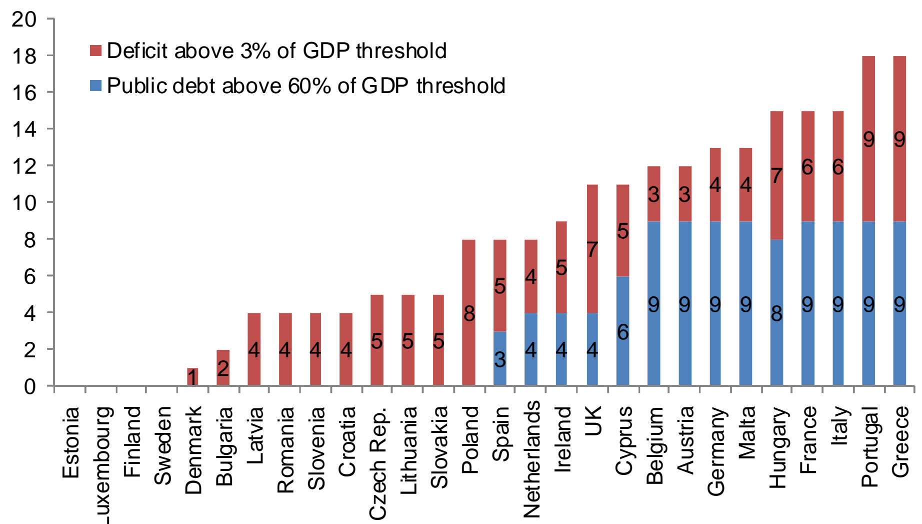
Notes: CF = suspension of Cohesion Fund financing
* countries signed the fiscal compact but they have to adopt rules by date w hen they adopt euro currency
** Hungarian fiscal compact is not recognized by the OECD as an independent fiscal w atchdog, the EC required to increase the analytical capacity of the council
*** not approved yet

Fixing old rules

Original rules proved to be insufficient to enforce fiscal discipline, especially in 'good times'

Since becoming EU members, CEE5 countries have had to comply with fiscal deficit criteria in accordance with the Stability and Growth Pact (SGP). The well-known nominal criteria of a maximum of 3% fiscal deficit and 60% public debt as a percentage of GDP are still in place, but have been breached by many EU member countries over the last decade.[1] The SGP proved to be insufficient to enforce fiscal discipline, especially during 'good times'. Since 2004, with the exception of Hungary, all CEE5 countries complied with the public debt threshold during the entire period, while only breaching the deficit threshold, predominantly in the aftermath of the financial crisis.

Number of years from 9-year period 2004-12 during which countries did not comply with fiscal criteria

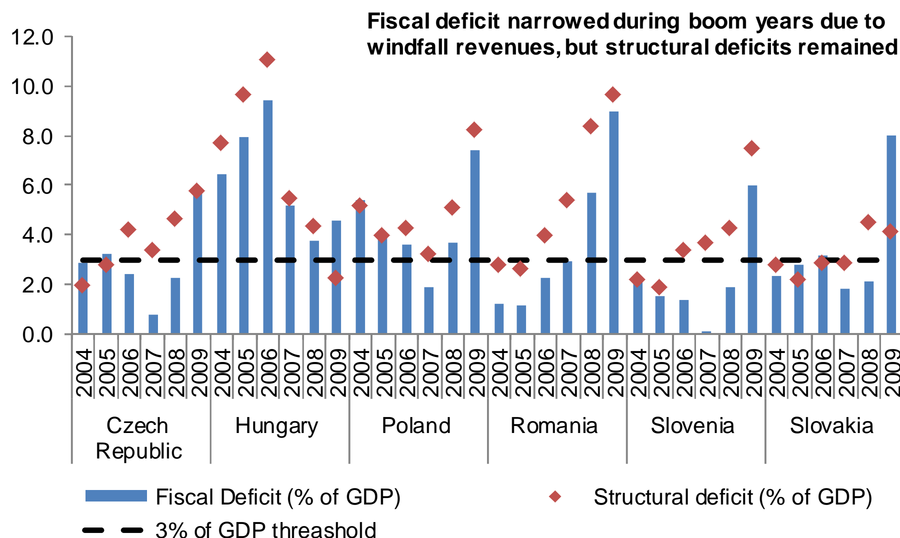


Source: AMECO, Erste Group Research

The main drawback of the original SGP was that the 3% deficit ceiling was 'too soft' for periods of excessive growth and did not force countries to use windfall revenues for more ambitious deficit reduction to a balanced budget. Too much focus on the nominal target (the deficit below 3% of GDP) helped mask increasing structural imbalances, which in turn reduced the fiscal space for governments to stimulate the economy during the crisis. Furthermore, the toothless corrective procedures in SGP and the fact that financial sanctions have never been imposed on any EU member have loosened fiscal discipline across the EU.

[1] Greece, Portugal, Italy and France have been leading the pack of 'fiscal sinners' in the Euro Area, while Hungary has been the most pronounced representative from CEE.

Fiscal deficits vs. structural deficit (% of GDP)



Source: AMECO, Erste Group Research

Six-pack, which increases importance of structural benchmarks, is binding for all CEE5 countries, with strongest impact on Slovakia and Hungary

The six-pack, which entered into force in December 2011 and is also binding for non-Euro Area members, has helped to fix the main shortcomings of the SGP. The most important part of the six-pack is the new framework for speeding up of adjustment towards the Medium Term Objective (MTO) target (so-called preventive arm). The MTO refers to the country-specific structural balance (cyclically-adjusted fiscal balance net of one-offs) as a percent of GDP, which is desirable for the long-term sustainability of public finances of the member country and is agreed upon with the European Commission. The six-pack sets the minimum floor for MTO, at a structural balance of -1% of GDP, but many countries have actually had more ambitious targets close to

Main pillars of six-pack

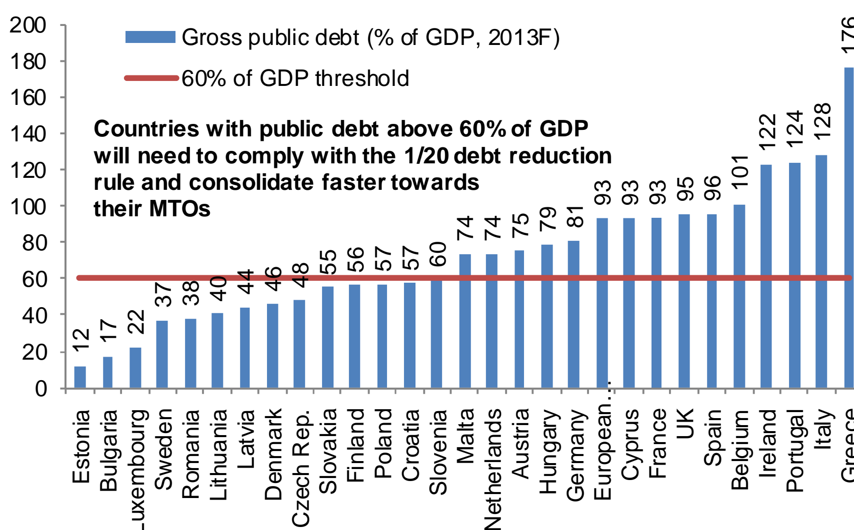
- A minimum target for structural deficit as well as the minimum pace of annual adjustment towards the target
- Expenditure benchmarks which prevent countries from excessive spending
- 1/20 debt reduction rule which aim to reduce debt topping 60% of GDP
- Stricter assessment for non-compliance with the rules, but new sanctions apply only for Euro Area members, they are automatically approved unless Council rejects Commission recommendation by qualified majority
- Alignment of Convergence/Stability Reports with preparation of budgets on a national level. Governments have enough time to address the issues raised by the EC and take those actions which are necessary to meet their budget goals
- Commitment to establish an independent fiscal council and introduce fiscal responsibility laws, which should limit room for the excessive expansion of public debt
- Macroeconomic Imbalance Procedure – an early warning signal for excessive macroeconomic imbalances and correction mechanism

zero, or they even target surplus (Hungary). The structural balance has to converge towards its MTO at an agreed pace for Euro Area members and countries in the ERM-II with 0.5pp of GDP set as a benchmark and countries with public debt above 60% of GDP by at least 0.5pp of GDP. Among CEE5 countries, only Slovakia and Hungary will be affected by the prescribed minimum pace. All countries should follow expenditure benchmarks that put a cap on the growth of expenditures, which are under control of governments and reflect the adjustment path towards MTO.

Debt reduction rule should keep Hungary in check after 2016

Something which was completely new with the six-pack was that an Excessive Deficit Procedure (EDP) can be started not only in the case of an excessive deficit (above 3% of GDP) but also in case of an excessive debt (above 60% of GDP) if the progress in debt reduction is slow. Countries with public debt above 60% should follow the 1/20 debt reduction rule. This rule is not going to affect any CEE5 country except for Hungary, as none of them is supposed to exceed the 60% of GDP threshold in the near future. There is a 3-year transitional period[2] for the evaluation of this criterion for those countries which were under the EDP as of 2011, and thus if Hungary leaves the EDP this year, a new EDP triggered by non-compliance with the debt reduction benchmark can start only after 2016. However, during the transitional period, the EC will ask member states to adjust their structural deficit in accordance with the debt benchmark rule and in the case of increased cumulative deviation from the adjustment path, the EC can trigger the EDP. Given the long list of escape clauses, we see this chance as very unlikely.

Gross public debt (% of GDP, 2013)



Source: Forecasts of the European Commission (AMECO)

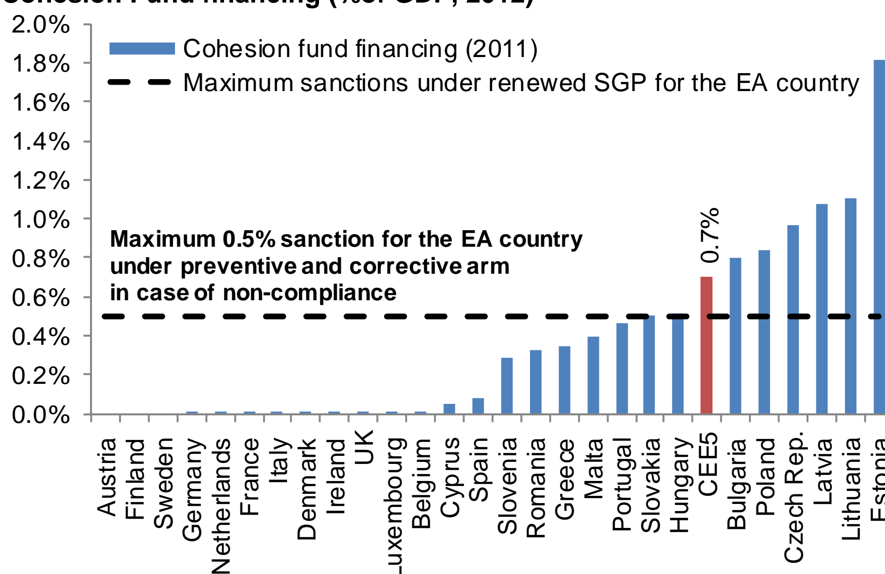
Suspension of Cohesion Fund financing is only possible financial punishment for non-Euro Area members…

The six-pack punishes non-compliance with renewed SGP more strictly, but imposes direct financial sanctions for Euro Area countries only. Thus for non-Euro Area members, the major punishment could be the suspension of Cohesion Fund financing until the excessive deficit is corrected, but the country needs to be in the EDP and fail to take effective action to correct their deficits. That means once CEE5 countries quit the EDP (expected within the next two years), they do not face any risk of the Cohesion Fund being suspended based on a lack of progress towards their MTO, unless they enter

[2] 3-year transition period starts after quitting the EDP.

the EDP again based on excessive deficit (above 3% of GDP) or violate the debt rule by having government debt above 60% of GDP which is not diminishing at satisfactory pace (theoretically possible in Hungary, but unlikely).

Cohesion Fund financing (%of GDP, 2012)



Source: Eurostat, AMECO

… but more costly than newly introduced financial sanctions for Euro Area members

It is a paradox that the possibility of punishment through the temporary suspension of Cohesion Fund financing is strongly asymmetric and comes at a much higher cost for CEE countries. In 2012, CEE5 countries received funds worth 0.7% of their GDP on average. The majority of Euro Area countries were getting almost nothing from the Cohesion Fund, while southern countries were getting about 0.3% of GDP. That means than non-Euro Area countries would pay a much higher price for fiscal irresponsibility than many Euro Area countries, which risk sanctions only up to 0.5% of GDP in total. Thus, Slovakia, as a Euro Area member and Cohesion Fund recipient, could face the highest combined financial punishment from CEE5 countries if it drastically derails from the consolidation path (which we see as unlikely).

Even with the six-pack in place, some shortcomings in the EU fiscal framework remain, especially in the decision making process – with wide maneuvering room for the Council for discretion under the reinforced SGP and a lack of automaticity. The fiscal compact had to deal mainly with the enforcement of rules and stronger role of the Commission in steering the process, while balancing it with higher national ownership of the rules.

Is the fiscal compact relevant for CEE5?

Originally, the fiscal compact (TSCG - The Treaty on Stability, Coordination and Governance) was intended to take the form of the EU Treaty. However, as two member states (the Czech Republic and UK) were not willing to support the initiative, the fiscal compact took the form of an intergovernmental treaty, which had to be ratified in the national parliaments. This is seen as a transitional solution, because the TSCG contains the explicit aim of incorporating the main parts of the fiscal compact into the EU legal framework within five years.

Fiscal compact strengthens enforcement of six-pack and introduces local ownership of its fiscal rules

The fiscal compact replicates the structural benchmarks from the six-pack, without any significant changes in minimum requirements. The most relevant part of the fiscal compact is that countries commit to implementing into their national legislation a fiscal rule that follows the principles of convergence towards MTO and criteria already outlined in the six-pack, including the minimum pace of adjustment and expenditure rule. Transposing rules into local legislation, preferably constitutional, should increase national ownership of the consolidation process and align it with the budget surveillance within the EU.[3] National ownership is also relevant for better democratic accountability of the fiscal surveillance process, which could be otherwise seen as too centralized and 'Brussels-driven'.[4]

Non-Euro Area countries can voluntarily apply to transpose rules into their local legislation without risk of being fined

At this moment, the fiscal compact is relevant only for the Euro Area countries, so only Slovakia from CEE5. According to the TSCG, nothing precludes non-Euro Area countries from voluntarily applying for TSCG – particularly Articles III and IV, which deal with the fiscal rules and their transposition into the local legislation. Poland has already indicated that the Treaty should apply for Poland at the time of its joining the Eurozone. However, earlier adoption by non-Euro Area countries and implementation of fiscal rules based on structural benchmark deficits into national laws could improve the national ownership of the fiscal surveillance process, which is run on the EU level according to the same principles (renewed SGP/six-pack).

Do nominal criteria still matter in Europe?

Discussion on fiscal multipliers, self-defeating austerity and the recently adopted benchmarks in the six-pack as well as the Fiscal Compact point to the growing importance of structural benchmarks over nominal targets. However, nominal criteria have been decisive for the current consolidation efforts of CEE countries and necessary for meeting the criteria for quitting the current Excessive Deficit Procedure (EDP).

Quitting EDP would require meeting old nominal criteria

All CEE countries are currently in the EDP, together with other 11 Euro Area members. Hungary is supposed to leave the EDP this year, while the other CEE countries plan to bring their deficit below the 3% threshold, in accordance with the Stability and Growth Pact, by the end of this year. However, slower recovery puts meeting this target this year at significant risk. Hungary can quit the EDP this summer, unless the EC puts into its Spring Forecasts deficits above 3% of GDP for 2013-14. Given the much better fiscal development over the last year, the only potential risk is that the EC forecast on the fiscal deficit for 2014 edges above 3% of GDP under a scenario of no policy change and some temporary measures running out.

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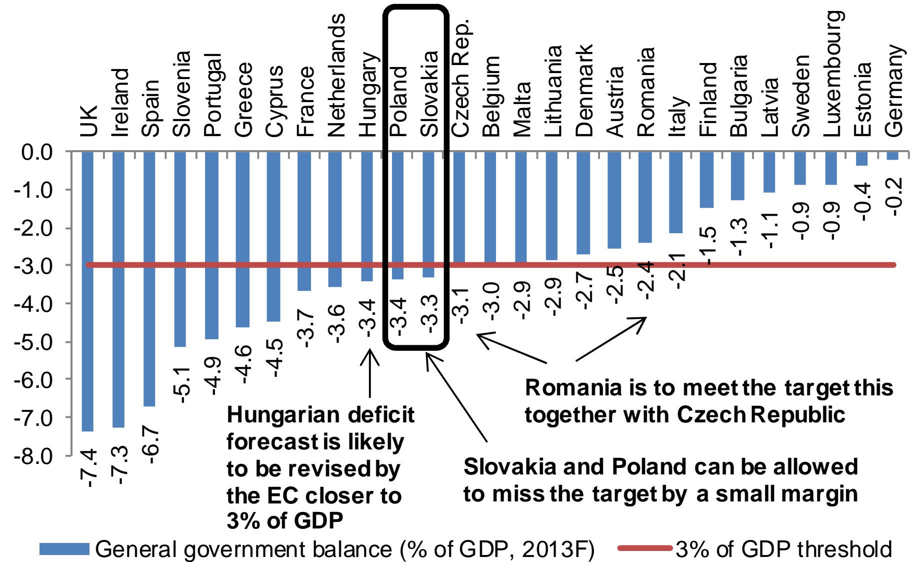
[3] According to the TSCG, the European Court of Justice can impose a fine of up to 0.1% of GDP if a country fails to transpose the fiscal rules into national law with one year from the time when the Treaty comes into effect.

[4] Contracting parties of the Treaty are committed to automatically support the initiative of the Commission in the Council, instead of the need to have a positive vote in the Council. However, they can still block decisions by the Commission (in line with the principle of a reverse majority).

Fiscal balance (% of GDP, 2013)



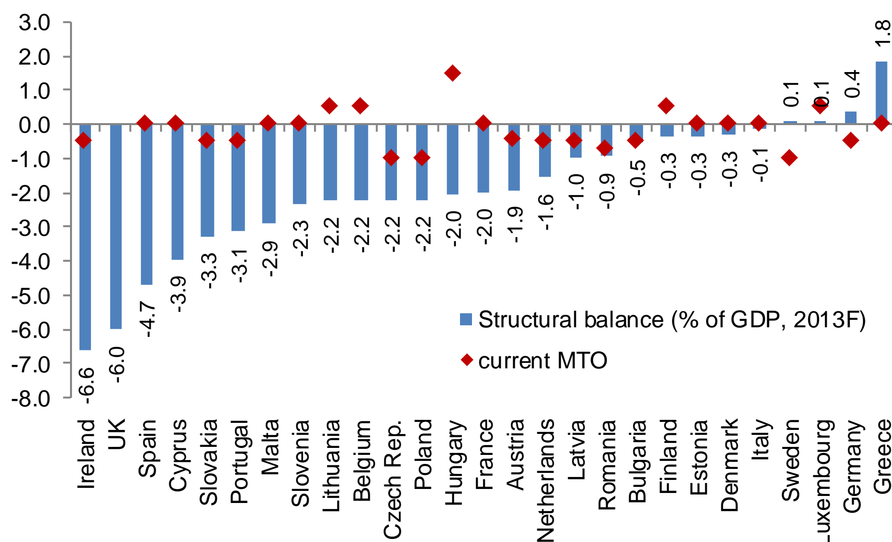
Source: Forecasts of the European Commission (AMECO)

The Czech Republic and Romania are expected to meet their EDP deadline based on data for 2013, so they can formally quit the EDP in summer 2014. In the case of the Czech Republic, it could be a close call, due to the deficit being close to the 3% of GDP threshold. It will be a challenge for Slovakia and Poland to bring their deficits below 3% of GDP this year, as required by their EDP. These countries can adopt additional measures, but more ambitious consolidation in time of already weak growth could be 'too harsh' and would be in conflict with the intentions of the recently adopted framework.

Slovakia and Poland can deduct pension reform costs or may get one-year extension of EDP deadline

However, Poland and Slovakia can deduct part of their transition costs related to pension reform in order to meet the 3% deficit target by 2013 or use the explicit escape clause which says that special circumstances like severe economic downturn or unusual events which are outside of control of the country can be used for an extension of the EDP deadline for the purposes of correction. Thus, in the worst case we expect the EDP to be extended by one year without any problems.

Structural deficit (% of GDP, 2013F)



Source: Forecasts of the European Commission (AMECO), Staff Working Documents (2012)

EU surveillance process will be driven by structural rather than nominal criteria in the future

So the nominal rules remain in place, but are becoming less important in Europe. Even the debt reduction rule introduced with the six-pack, which is definitely a nominal one, has so many escape clauses that a country would need to significantly deviate from consolidation in structural terms and simultaneously breach the expenditure rule in order to trigger opening the EDP (after the transitional period of three years). On the other hand, many local debt brakes are strongly focused on nominal thresholds, with a potential risk of backfiring in times of economic downturn.

Too much austerity?

The new fiscal rules based on structural deficits take the cyclical development into account and thus are less harmful to growth in times of economic downturn than if the consolidation is set according to nominal criteria. However, some pro-cyclicality during a downturn and anti-cyclicality during an upturn will remain in place, as countries have to adjust to their MTOs.

Risk of self-defeating austerity is reduced by reference to structural benchmarks and wide range of escape clauses

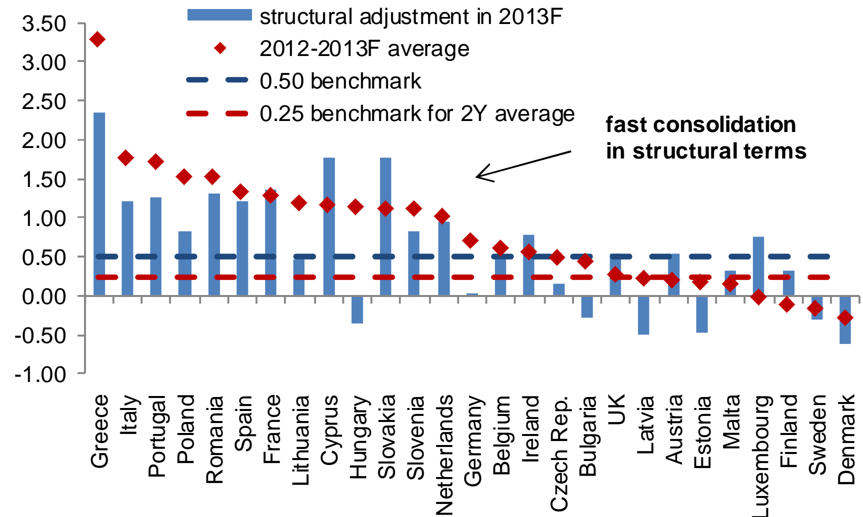
To avoid self-defeating austerity, both the six-pack and fiscal compact explicitly mention a wide set of escape clauses via which rules are treated more softly. The most pronounced are a severe economic downturn in the Euro Area or EU as a whole, or unusual events outside the control of the government with a major financial impact. On top of those two, which can without doubt be applied during the current financial and economic crisis, there is more variability in adjustment to MTOs, depending on the stage of the cycle. During ‘good times’, countries are recommended to progress faster in consolidation; during ‘bad times’, slower consolidation is accepted.[5]

According to the six-pack country significantly deviates from its adjustment path only if it breaches two rules at the same time. Its structural balance has to deviate at least 0.5% of GDP from its appropriate adjustment path in a single year or cumulatively in two consecutive years (meaning 0.25% on

[5] ‘Good times’ are defined as a period when the economy is above-potential or accelerating strongly, while ‘bad times’ are defined as a period when GDP is below its potential or decelerating strongly.

average) and the country has to miss its expenditure benchmark by 0.5% of GDP in one single year or cumulatively in two consecutive years.

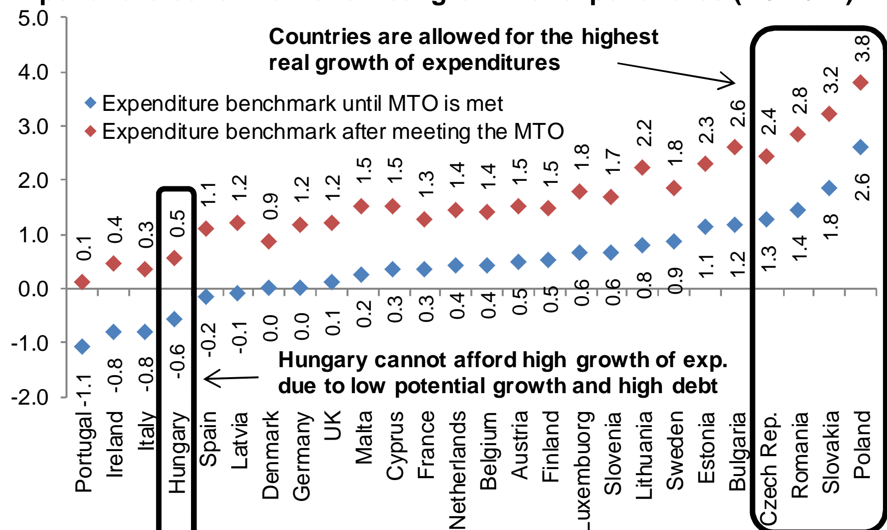
Adjustment in structural deficit in 2012-13 (% of GDP)



Source: Forecasts of the European Commission (AMECO), Erste Group Research

The expenditure benchmark requires that, once a country meets its MTO, growth of expenditures[6] should not exceed the growth of potential output, unless it is fully matched by discretionary revenue measures. During adjustment towards MTO, a stricter expenditure benchmark is set, which replicates minimum requirements for adjustment in the structural deficit. A lower redistribution rate (government expenditure/GDP), lower public debt and higher growth of potential output should provide solid space for CEE5 countries to allow expenditure growth in real terms both before and after adjustment towards MTO. Hungary is the only outlier, given its low potential growth and high public debt.

Expenditure benchmarks for real growth of expenditures (EC 2012)



Source: EC Working Staff Documents (2012)

[6] Interest expenditure, expenditure on EU programs and unemployment benefits are excluded from the benchmark.

Expenditure benchmarks are more favorable to CEE5 countries

For small EU countries, including all CEE countries, due to the high variability of investment expenditure, the four-year moving average of investment expenditure is used in the calculation of their expenditure benchmark. This is quite an important element of the expenditure benchmark for CEE because it should reduce incentives for too short-term-oriented consolidation through a cut of investment expenditure. Squeezing of investment can backfire not only in the long term, but later in the expenditure benchmark, when a country decides to normalize the level of investment expenditure from depressed levels.

Countries are incentivized to do reforms, as their front costs can be deducted when assessing structural benchmarks

A temporary deviation from the adjustment path is allowed if countries implement major reforms that improve the long-term sustainability of public finances (like pension, healthcare and labor market reform). Explicitly, the commission refers to costs related to introducing a multi-pillar system, as well as transfers of pension obligations, in cases of both the introduction and reversal of reforms. This action came a little bit too late, as Poland and Slovakia (due to high transitional costs) have already downsized their contributions to the private pillar and Hungary transferred all savings to the government in order to reap a short-term windfall profit. Thus, the perverse incentive to conduct consolidation through the demolition of the private pension pillar - because it was counted in the consolidation effort - has been substantially reduced for governments.

National fiscal watchdogs and local debt brakes

It is quite important that CEE countries follow the EU recommendation from renewed SGP to adopt their local fiscal responsibility laws, which include self-disciplining rules preventing countries from cumulating excessive public debt. The local 'debt brake' legislation had already been put into effect in many CEE countries even before the fiscal compact was proposed. The Czech government just recently approved the proposal of a constitutional fiscal responsibility law, which has to be fine-tuned by the Parliament in the next few months. The Hungarian government is to have a fiscal responsibility law, but valid only from 2016. However, the current local rules do not comply with rules and structural benchmarks from the six-pack and fiscal compact. Legislative changes for transposition of these rules will be necessary only in the case of Slovakia. Other CEE5 countries that have signed the fiscal compact have to transpose the rules to local legislation shortly before joining the Euro Area.

Debt brakes cannot substitute for deficit rules, but are useful complement

Debt brakes are no cure-all. In periods of severe stress, such as a banking crisis or a recession of the 2008-09 scope, debts tend to spiral upwards and debt brakes are almost powerless to prevent it. Similarly, when the economy is booming, debt-to-GDP tends to go down by itself and the debt brake has no provision that would entice governments to create buffers for bad times. Saving is easier when the economy is booming and rules for structural deficits are more powerful than debt brakes with regards to anti-cyclical policy.

Nevertheless, the debt brake might still occupy a significant place in the fiscal framework. Debt brakes tend to work best in periods of mild stress when the debt is building up gradually. The semi-automatic kick-in measures might be good enough to prevent the debt from rising further. In addition, the local debt brakes make politicians accountable to the public and increase their awareness about fiscal responsibility, probably more than 'externally set' EU

rules. In addition, they might prevent situations when the debt is building up without being reflected in the deficit, such as excessive purchases of private assets.

Local watchdogs might see local specifics even where ESA is blind…

Local watchdogs might also be able to understand local specifics, which are not covered by EU rules. For example, nationalizing private pension assets is, from the point of view of ESA-95, a surplus-creating operation, even though long-term liabilities are attached to the transferred assets. Or state companies such as railways might take up significant new debt without being consolidated into the general government. There are other ESA workarounds, as the EU found out in Greece not so long ago.

Local watchdogs have the potential to call these bluffs. For example, the Slovak watchdog employs a concept of 'net wealth'. If currently acquired assets are matched by future liabilities, the operation is neutral for the net worth, even though ESA-95 might say otherwise at times and report a surplus (or a deficit at another time).

… but independence is essential

For proper functioning, independence is the key. After the Hungarian fiscal watchdog moved away from the government's line, it was stripped of its own analysts and funding. After personnel changes, what remains is a three-person council with two members from the ruling party. In contrast, other watchdogs are funded by the central bank, making them somewhat more independent of the government.

Watching net debt is economically purer, but data availability still speaks for gross debt

Which is better, gross government debt or net debt adjusted for financial assets? One drawback of gross debt is that it does not take into account the government's reserves. For example, pre-financing for future redemptions might be a sensible thing to do at a time of heightened market uncertainty. A debt brake tied to gross debt might discourage it when the country comes close to legal thresholds. Also, not all state-owned enterprises are part of ESA-95 gross debt. The reason why many watchdogs opt for the gross rather than debt is the advantage of having a credible external institution, which 'evaluates' the fulfillment of criteria. The gross debt is released by Eurostat, while any national data might be viewed with some suspicion.

Croatian rules

The Fiscal Responsibility Law (FRL) came into force at the beginning of 2011. While it does not set an explicit debt ceiling, it aims for a reduction on the expenditure of 1% of GDP each year until the primary budget reaches zero or a positive balance. When a positive primary balance is achieved, the aim then is to ensure a positive cyclically-adjusted primary balance, which is of lesser importance at present. Meeting the 2012 target will be a close call, while 2013 seems out of reach, according to the current budget. According to the law, the government has to report violations to the Parliament and undergo a no-confidence vote. However, given the current situation, this should be easily defeated. Nevertheless, rating agencies view the lack of commitment to the FRL negatively. Potential amendments to the FRL are not being addressed at the moment. Nevertheless, the public debt trajectory and financial markets suggest limited maneuvering space in the medium term.

Czech rules

There are no fiscal rules in the Czech Republic at the moment, but a draft of the constitutional law is in the Parliament. The draft stipulates three barriers in terms of the debt-to-GDP ratio and provides for the establishment of a National Fiscal Council. When the debt is between 40% and 45% of GDP (as it currently is), the government has to notify the Parliament about the reasons. Beyond 45% of GDP, the government is required to lower expenditures, lower

salaries of government officials (by 20%) and freeze public sector salaries. The problem is that the draft lets the government off the hook in cases 'stipulated by law'. Hence, if needed, the government can approve a law that says that expenditures do not need to be lowered (a simple parliamentary majority is enough). Beyond 48% of GDP, the submitted budget must be balanced. Once 50% of GDP is breached, the government is required to ask the Parliament for confidence (but needs only a simple majority to gain it).

All in all, while the draft provides some barriers, just a simple majority is needed for them to be overcome. Sanctions are non-existent or, where they do exist, they are easily overruled.

Hungarian rules

The debt brake law is in effect at the moment, but the regulation is complex and fragmented, as one part of it is contained in the constitution, while the other part is regulated by the 'stability law', parts of which can only be amended by a two-thirds majority. By constitution, the Parliament is forbidden from adopting a budget that allows the state debt to exceed 50% of GDP. If the debt exceeds this threshold, the Parliament may not approve a budget that increases the debt-to-GDP. However, in exceptional circumstances, such as economic recession, the rule might be broken to the extent required to achieve economic balance. The 'stability law' states that the growth of government debt in nominal terms has an upper bound, which is tied to inflation and real GDP growth (the higher the inflation or the lower the GDP growth, the higher is the allowed debt growth). However, this link will only start to be valid in 2015. By then, the government has to follow explicit budget deficit limits. Upon current targets, the deficit may be no higher than 2.7% of GDP in 2013 and 2.2% of GDP in 2014.

The budget has to be approved by the Budget Council, which thus has a strong position in the fiscal framework and an ability to influence budget policy. The fiscal council, which was 'reformed' in 2010, has three members: the Chairman, the head of the CB and the head of the State Audit Office. Currently, two of these individuals are former members of the ruling party. Since 2010, the council has not had its own staff.

Polish rules

Poland currently has national fiscal rules concerning public debt. Poland has three legislative limits concerning the ratio of public debt to GDP. They aim to keep public finance stable by implementing restrictions on the deficit and debt figures. If the 50% limit is exceeded, then the government cannot increase the deficit-to-revenue ratio in the following year. Exceeding the 55% limit brings more severe consequences, aimed at reducing the deficit and debt-to-GDP. Once the public debt is higher than 60%, the government must reduce the debt-to-GDP ratio, there can be no state budget loans and credits and local governments must run a balanced budget. The highest debt ceiling of 60% is regulated by the Constitution, while the two lower thresholds are regulated by the Public Finance Act. Recently, changes were introduced with regards to the calculation of the exchange rate and pre-financing if the debt is above 50% of GDP. This aims to avoid breaking the debt brake for other than economic reasons (such as a volatile exchange rate).

Serbian rules

The debt brake in Serbia came into force in 2011, with the key element being a public debt ceiling at 45% of GDP and the mid-term budget deficit target at 1% of GDP. The convergence to 1% should be achieved by the formula taking into account the previous deficit, the convergence dynamic to the 1%

target and the economic cycle (i.e. deviation from potential output growth). Parameters are set by the Fiscal Council for a minimum period of three years. Upon violation of the 45% of GDP threshold, the government has to present a mid-term fiscal plan with the intention to bring the public debt to GDP down. Please note that the debt is currently approaching 60% of GDP.

Slovak rules

In 2011, Slovakia approved a constitutional fiscal responsibility law, which sets penalties once fiscal debt levels are surpassed. Relatively mild penalties kick in at 50% and 53% of GDP (the current Slovak debt is around 53%), such as the finance minister's explanation and freezing of ministers' wages. More serious measures come at 55%, when the finance ministry is obliged to tie up 3% of expenditures and present a budget with flat or declining expenditure compared to a year ago. Above 57%, the government has to have a balanced or surplus budget. At 60% of GDP, the government has to undergo a no-confidence motion. There are some exemptions, but these are only temporary. Despite the law being constitutional, it only obliges the government, not the Parliament. Hence, the latter needs just a simple majority to overrule it. Please note that, starting in 2018, all of the thresholds are to drop by 1% of GDP a year for a decade, thus lowering the debt thresholds by 10% of GDP in total (i.e. the upper limit would then be 50% of GDP).
The law also established a fiscal council, which additionally focuses on long-term fiscal sustainability and may calculate the fiscal impact of legislative proposals. It also calculates the overall net wealth. In doing so, it also looks at state-owned enterprises and other non-ESA entities. All three council members are named by the Parliament, but the chairman of the council needs a constitutional majority and the other two members have to be referred by the CB governor and president, respectively.

Slovenian rules

In Slovenia, the debt brake has been planned for some time. Nevertheless, the government has so far failed to make the deal with the opposition to get the constitutional majority. The government has an expenditure rule that prohibits growth of expenses from exceeding nominal GDP growth. Further restraints exist if the primary deficit and government debt are above targets. Slovenia has a Fiscal Council, which acts as an advisory body to the government, but its published analyses focus primarily on the past.

Romanian rules

The Fiscal Responsibility Law approved in March 2010 introduced expenditure-based fiscal rules, established an independent fiscal council and streamlined budgetary procedures. The annual nominal increase in public expenditures should be kept below the annual nominal increase of GDP. If the government increases the taxation level, the annual growth rate of public expenditures should not exceed the annual growth rate of public revenues. The government is not allowed to raise public wages six months before the end of its term. Personnel expenditures cannot be increased through budget rectifications. The government can approve only two budget rectifications per year and only in the second half of each year. All the proposals that lead to a reduction of budget revenues should be accompanied by measures that compensate for the negative impact by raising other categories of revenues.

The law also established a fiscal council with members separately appointed by the Parliament, the NBR and the academic and banking spheres. The law is not constitutional and thus might be overruled by a simple majority.

Glossary

Debt brake
Limit on government debt that triggers certain corrective actions. For example, the government might be obliged to present a balanced budget once a certain debt level is reached.

European semester
Yearly cycle of economic policy coordination, which takes place over the first six months of the year. The European Commission undertakes a detailed analysis of EU Member States' programs of economic and structural policies and the European Council and the Council of Ministers provide policy advice before Member States finalize their draft budgets.

Excessive deficit
It refers both to situations in which either the deficit or the debt is above the Maastricht reference value (and debt is not diminishing at a satisfactory pace).

Excessive Deficit Procedure (EDP)
A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State. Countries have to meet the Maastricht criteria for the deficit and reduce the debt at a satisfactory pace to leave the procedure.

Expenditure benchmarks
A subset of fiscal rules that target public expenditure. The benchmarks are estimated by the European Commission. They do not cater to other risks such as unexpected budgetary developments or interest rate shocks.

Fiscal compact
An intergovernmental treaty that increases the enforcement of fiscal discipline and commits Euro Area member states to implementing structural benchmarks from the six-pack into their national legislation.

Fiscal consolidation
An improvement in the budget balance through measures of discretionary fiscal policy, such as tax hikes or expenditure cuts.

Fiscal rule
A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, etc. Examples include a debt brake or expenditure rule setting a maximum limit on growth of expenses.

Medium-term budgetary objective (MTO)
A country-specific targeted structural budget balance, which takes into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances. Countries have to converge to this target within a set amount of years and compliance with the path is monitored. At worst, MTOs are set at a 1% of GDP deficit, but many countries have more ambitious targets.

Six-pack
The set of five EU regulations and one Directive (thus: six-pack) approved in 2011 that reforms the SGP and ensures stricter application of fiscal rules in the EU.

Structural benchmarks
The threshold values for structural budget balance or growth of expenditures that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations.

Stability and Growth Pact (SGP)
Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. In the fiscal area, the most important rules are a fiscal deficit no higher than 3% of GDP and general government debt no higher than 60% of GDP. There are significant exemptions, though.

Structural budget balance
The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance. The cyclical component reflects the phase of the economic cycle the country is in. In general, booms help the fiscal income. Hence, in good times, the actual deficit tends to be lower than the structural one (and the opposite in bad times). The focus on the structural deficit instead of the actual deficit forces governments to save more in good times and gives them more space in bad times.

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