THEORETICAL EVALUATIONS ON THE LEGISLATIVE FRAMEWORK OF FISCAL GOVERNANCE IN THE EUROPEAN UNION

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Abstract: *The fiscal governance process aims at synchronizing the consolidation of fiscal positions and supporting the medium and long-term structural reforms of the adhering member countries through monitoring, evaluation and incidence of fiscal processes on the economic environment at each stage of its design, ex-ante implementation / execution and ex-post results, thus having the potential to identify slippages from the objectives and their adjustment during the current fiscal exercise or in the next fiscal exercise. To achieve its goal, this process is based on rules, regulations and procedures that provide the framework for national government planning, implementation and guidance of fiscal policy. In the present paper, we deal with the theoretical fiscal governance from the theoretical point of view, the legislative evolution and the effectiveness of this process, through the successive reforms it has undergone.*

Key words*: fiscal governance, fiscal discipline, fiscal framework, budgetary policy.*
JEL Classification*: H11, H6, K34.*

1. Introduction

Fiscal governance is the process of monitoring national fiscal policies to achieve and maintain quantitative and qualitative coordination on the basis of rules, regulations and procedures that pre-emptly influence the way fiscal policy is designed, implemented and guided by national governments. This process, built on the foundations of fiscal coordination, implemented through the Stability and Growth Pact (SGP) and the Maastricht Treaty (MT), has been consolidated around the objective of fiscal discipline, bringing the perception of the existence of the fiscal policy of deficits justified by a more careful mid-term assessment of a country's economic position, depending on a number of relevant factors such as the quality of budget expenditure, the cost of structural reforms and external economic shocks.

The initial monitoring procedures of the SGP to ensure compliance with fiscal rules and regulations were largely based on the announcement of the budgetary targets and their coordination at European level, without the existence of a national delegated entity monitoring the compliance with fiscal regulations, which which has diminished interest in fiscal rules and perpetuated their non-compliance. Signals of deviations from the fiscal targets were late, and decisions on deviation had to be put to the political vote. Thus, the lack of individual country monitoring led to alternative approaches to the application of fiscal rules and to the achievement of multi-annual national targets, with frequent difficulties in formulating appropriate decisions for all member countries and fragmentation in their transmission and application.

The successive reforms of the SGP aimed, in short, at eliminating these deficiencies by: implementing monitoring institutions at national level; the personalized / flexible approach; strengthening of preventive and coercive anchors.

2. The structural dimension of fiscal governance

Fiscal governance is, according to the European Commission (EC), "the institutional part of fiscal policy because it includes the set of rules and procedures for determining how budgets are prepared, realized and monitored", which includes, in its structure, all the elements through which limits the trend of expansion of budget deficits and expenditures generated by the behavior of decision-makers.

The structure of the fiscal governance process is made up of four components that correspond to the implementation stages of the governance process, namely: setting targets; monitoring and evaluating results; orientation and budgetary procedures.

Numerous fiscal rules set government deficit and debt targets within the limits of the Treaty or within the limits of exceptional adjustments to provisions and promote, in particular, their compliance with and the adoption of a multiannual budgetary planning horizon with respect to medium-term budgetary objectives.

Independent fiscal institutions are an important dimension of the process of implementing fiscal governance, independent of national budgetary authorities, with the objective of monitoring, preventing and limiting the risks associated with fiscal policy through relatively different country-to-country actions, but addresses common issues in providing: independent analyzes of promoted fiscal policies; independent forecasts on the fiscal policy path and relevant indicators; evaluations and recommendations on legislative initiatives in the fiscal-budgetary field; recommendations on the multi-annual fiscal-budgetary strategy.

Medium-term budgetary frameworks are the extent to which fiscal mechanisms are in place to enable fiscal authorities to broaden the fiscal policy horizon beyond the annual budgetary timetable under the following conditions:

- The annual budget remains the key stage in taking important budgetary policy decisions, but some fiscal-budgetary measures have budgetary implications that go beyond the regular annual budget cycle;
- The medium-term budgetary objectives included in such a budgetary framework do not incorporate binding targets but are weaker commitments that can help ensure fiscal discipline by assessing the impact of current fiscal policies on the budget deficit in the coming years and by providing points of a benchmark against which budgetary developments can be evaluated over time;
- A properly framed budget framework must reflect the impact of previous budgetary commitments and the future costs of new fiscal policy measures.

The budgetary procedures are the last dimension of fiscal governance that provides a strong link with other dimensions of fiscal governance, as budgetary procedures are used in the preparation, approval and execution of the budget.

The four dimensions of fiscal governance presented correspond to specific objectives, converging with the achievement of the goal, namely:

- Achieving sound budgetary positions by removing the tendency to adopt unsustainable fiscal policies that lead to increased deficits and public debt;
- Reducing the pro-cyclicality of implemented fiscal policies;
- Improving the efficiency of public spending and increasing fiscal policy transparency;
- Consolidation budgetary procedures and increase their autonomy in limiting their dependence on political influences and decisions.

Starting from this dimension of fiscal governance, we will continue to present the legislative evolution of the European fiscal framework, with the presentation of the functional aspects and weaknesses of the fiscal framework, the issues covered by its successive revisions.

3. Legislative evolution of fiscal governance in the European Union

Fiscal regulations on fiscal policy coordination at European Union (EU) level have emerged with the emergence of the euro area, with explicit criteria for public finances being introduced. The European fiscal framework, which provides regulatory support for fiscal governance, consists of:

- **The Maastricht Treaty** (1992) - sets out rules for the Economic and Monetary Union (EMU) and limits for the main fiscal-budgetary indicators - deficit and public debt;
- **The Stability and Growth Pact** - adopted in 1997, in force since 1999, aims to ensure sound public finances by supporting the implementation of the provisions of the MT by implementing preventive and coercive elements to achieve and maintain fiscal criteria. The original SGP was reformed into two stages, namely:
  - The 2005 SGP reform aimed at introducing the structural budget deficit indicator, which is intended to provide an additional anchor for the maintenance of the conventional budget deficit excluding some temporary economic cycle influences and certain flexibility in the medium-term objective (MTO) to extraordinary economic and financial events. These changes have made the SGP more adaptable to country-specific characteristics and have been a prerequisite for improving the fulfillment of fiscal criteria;
  - The 2011 SGP reform (generated by the effects of the financial and economic crisis on fiscal and budgetary indicators) targeted the implementation of a six pack package aimed at strengthening macroeconomic governance and budgetary surveillance in the EU by:
    - The launch of the European Semester (ES), which synchronises the multi-stage surveillance processes of the budgetary and economic policies in the member states, ex-ante drafting and approving them;
    - To pay more attention to the public debt ratio and the excessive deficit procedure may be triggered if this criterion is violated;
    - The structural balance requirement converging with the MTO is streamlined and supplemented with explicit quantitative criteria for the dynamics of government spending and the reduction of public debt for situations where it exceeds 60% of GDP.
- **The Treaty on Stability, Coordination and Governance within the Economic and Monetary Union** (TSCG) - The fiscal compact - adopted in march 2012, which came into force in january 2013, has as its core the Fiscal Compact - a mechanism for strengthening, supervising and coordinating policies (all EU member states except the Czech Republic and the United Kingdom) in order to strengthen fiscal discipline.

Overall, the successive revisions of the European fiscal legislative framework have pursued several objectives, namely:

- *Provide stronger economic bases for the fiscal framework* – fiscal regulations have often focused on fiscal actions and less on tax outcomes, the latter being affected by economic conditions beyond rigorous control by government authorities (crises, cyclical fluctuations). In this context, the methodology for assessing fiscal outcomes, in this case indicators, has been improved by introducing elements to eliminate the effects of the economic conditions mentioned;
- *Increasing the public debt indicator* - compared to the initial SGP version, which focused more on the budget deficit, without sufficiently capturing public debt dynamics in the deficit target - in the current version, the public debt indicator is seen as an important source of vulnerability, being assigned prerogatives in establishing the level of structural deficit and in triggering the excessive deficit procedure;
- *Strengthening mechanisms for implementing the fiscal framework* by: transposing rules of the European fiscal framework into national law and better integrating European budgetary surveillance with national budgetary calendars, which ensures better incorporation of Commission recommendations into national budgets and

policies; the early introduction of sanctions in the event of budgetary slippages, outside the conditions of exclusivity, and a level that eliminates the non-credibility and counterproductivity characteristics of the previous system of sanctions; the creation of independent fiscal institutions which are entrusted with monitoring national fiscal frameworks / regulations in line with the European fiscal framework;

- *Implementation of more flexible fiscal regulations* - previous experience has shown that rigid carcass regulations, which do not provide for procedures applicable in exceptional economic circumstances, are frequently contested and suspended. To mitigate this risk, a certain flexibility of the fiscal framework has been brought about by expanding the scope and by allowing for deviations from the objectives, given that structural reforms involving short-term budgetary costs and multiplying effects are adopted long;
- *Some clarifications of fiscal provisions / regulations* - fiscal regulations characterized by ambiguity are difficult to implement (this was a major critique of the initial public debt criterion, which did not provide a measure / threshold for assessing sufficient debt mitigation).

The reinforced architecture of EU fiscal governance reflects the reaction of European institutions with budgetary and economic responsibilities to the limited effectiveness of macroeconomic, financial and fiscal policies promoted in member countries from a sustainability perspective.

The structure of fiscal governance seeks to emphasize the individual responsibility of each member country and the establishment of effective institutions to eliminate the effects of macroeconomic imbalances and their spread within the EU. Stopping the challenges that may arise from the promotion of conjunctural macroeconomic policies is to be pursued in several stages, notably through fiscal-budgetary mechanisms, through the introduction of the ES and the implementation of six legislative changes.

An overview of the EU fiscal governance framework, including the additions and legislative changes presented, is further developed. There was a structure based on three main pillars:

- **The fiscal framework** - has legal support in the SGP and in the national fiscal frameworks and targets the results in part in the six 6 economic governance measures addressing the results of the economic governance implemented by the SE, namely the budget deficit and the public debt. The main element of the SGP is the strengthening of coercive mechanisms;
- **The macroeconomic framework** - the coercive phase's novelty aims both to punish the excessive deficit situation and to overcome the allowed level of public debt, paying more attention to the previously ignored indicator - the public debt - in an attempt to make it operational;
- **The coordination policy** - aims at an enhanced synchronization of fiscal-budgetary policies with economic policies through the ES. Coordination takes place in a number of stages of the fiscal and budgetary policies of the member states ex-ante for their elaboration and approval in agreement with macroeconomic frameworks.

As it has been noted, the SGP failed to impose the observance of the fiscal discipline in order to achieve sustainable fiscal and budgetary positions neither in stable economic times before the crisis nor in the period of its manifestation, with violations of the deficit criterion, corrected unevenly, revenue management and budget expenditures were achieved without pursuing the promotion of fiscal consolidation, and the public debt criterion was largely ignored. Preventive and coercive procedures, in the case of non-compliance with the deficit and public debt criteria, did not have automatic mechanisms, and therefore the political decision left room for discretion and political reciprocity, which led to the non-application of any financial penalty for breach of these criteria. For this reason, the SGP's preventive and coercive components have been reformed. The preventive component has been matched by the introduction of the MTO, through which member states commit themselves to achieving and maintaining a budget objective specific to each of them, such as the structural deficit close to balance or surplus. The purpose of the MTO is triple: to maintain a safety margin with respect to the 3% of the GDP reference value; ensuring continued and relatively speed progress in setting and guiding fiscal-budgetary policies on sober trajectories and prudent public debt levels; allowing for fiscal-budgetary maneuver margins with availability, especially for public investment needs.

The commitments of the SGP member countries are monitored by the EC on the basis of the stability and convergence programs submitted annually by them, but also on the basis of fiscal-budget execution. The new approach to the preventive arm emphasizes its purpose, namely to address fiscal policies that have jeopardized their sustainability by triggering the excessive deficit procedure (EDP) and a public debt level that exceeds 60% of GDP. Based on the reports presented and the ex-post fiscal-budgetary situation, the EC makes preventive recommendations for the implementation of effective measures in a given timeframe. The reformed preventive arm sought to strengthen this procedure by introducing the following elements:

- **The request to a member state to strengthen the adjustment path for stability and convergence programs** - the preventive arm consists of two main procedures: ex-ante evaluation of stability and convergence programs and ex-post evaluation of deviations from fiscal adjustments for countries that have not yet reached their medium-term objectives. Concerning the first (ex-ante) procedure, the additional possibility for the Council to issue an ex-ante opinion on the adjustment path in line with the stability and convergence programs is introduced. Through this advice, if necessary, the Council may invite a member country to strengthen the fiscal adjustment path. As regards the second (ex-post) procedure, the provisions remain unchanged, but are complemented by the possibility of imposing a financial penalty;
- **The determining public debt consolidation requirements** - when defining MTOs specific to each country, public debt levels are taken into account both in the ex-ante procedure and in the ex-post procedure of the SGP component. In the case of member states that have not yet reached the MTO and have a government debt level above 60% of GDP or a high degree of sustainability risk, an structural deficit of more than 0.5% of GDP is needed / year, which constrains debt consolidation;
- **The introducing a rule on public spending dynamics** - the preventive arm has focused in the past, exclusively on the deficit, the current reform has brought a preventive extension, and a spending rule. The rule, included in both precursors of the preventive arm (ex-ante and ex-post), requires a level of adjusted primary expenditure that should not exceed potential GDP growth over the medium term. The spending rule plays an important role in the preventive component in close correlation with the MTO. Thus, if a Member State has exceeded the MTO, it is allowed a temporary increase in expenditure that would exceed the potential GDP growth over the medium term. If a member country has reached but has not exceded the MTO, the expenditure level should not exceed GDP growth over the medium term, in order to avoid pro-cyclical fiscal policies. If a member state is still on the medium-term adjustment path (targeted to the MTO), the evolution of expenditure must generate an annual improvement of the structural deficit of 0.5%, effectively promoting fiscal consolidation through expenditure;
- **Explicit definition of significant deviations from the MTO or from the adjustment path towards its achievement** - quantitative criteria (for structural deficit

and for expenditure developments) needed to ensure effective fiscal surveillance within the preventive arm were required to assess compliance both for the ex-ante procedure and the ex-post procedure. In this respect, with regard to the structural deficit, a significant deviation from the adjustment path is considered to be a deviation of at least 0.5% of GDP in one year or an average of at least 0.25% of GDP in two years consecutive. For expenditure, a significant deviation is estimated to have a negative impact on the conventional deficit of at least 0.5% of GDP in one year or 0.5% of cumulative GDP over two consecutive years (without discretionary measures). Nonetheless, failure to comply with one of the above criteria is not sufficient for an assessment indicating significant deviation from the adjustment path, but significant deviation is considered when both criteria are simultaneously violated;

- **The consolidation of the procedure to be followed after the significant deviation from the MTO is detected** - the procedure that is triggered after the significant deviation from the MTO or the adjustment path has been established, brings some elements to reinforce this preventive component: EC may issue a warning directly after diagnosing significant diversion from the MTO; a possible rejection of the recommendation to give a warning to the Council by a qualified majority gives the EC the possibility of renewing the recommendation and the Council can decide by a simple majority; the introduction of a financial penalty in the form of an interest-bearing deposit of 0.2% of GDP, which may be proposed by the EC if no action has been taken to break the state of significant misconduct. This sanction is automatically approved, unless the Council rejects the EC recommendation by a qualified majority.

The reformed coercive component has been strengthened by introducing elements to strengthen the excessive deficit procedure (EDP), consisting of:

- **The introducing a quantitative benchmark for public debt relief** - since its inception, the SGP has foreseen the possibility of initiating an excessive deficit procedure based on the public debt criterion. The weak influence of this criterion in triggering the EDP was due to the fact that there was no quantitative criterion for reducing public debt. To establish the debt criterion, a quantitative reference criterion has been introduced whereby Member States whose debt exceeds the reference value or the obligation to reduce government debt (by 1/20 of its stock per year).

The triggering of an EDP is preceded by an EC report on the existence of this situation and the fulfillment of the following criteria: the debt-to-GDP ratio must exceed 60% of GDP; the diminution of public debt over the last three years is not sufficient; the insufficient diminution of public debt can not be explained by the evolution of economic cycles; it is not to be expected that the debt-to-GDP ratio will fall sufficiently in the next year. The quantitative debt reduction criterion will apply after a three-year transition period, specifying the countries in this situation, during which member states must make sufficient progress towards complying with the new rule.

- **Ehe EDP opening procedure is not automatic** - PDE is not automatically opened if a member country is "eligible" under this procedure (either for deficit or debt reasons), but an assessment report is produced at the request of the EC, of "relevant factors", grouped as follows: the evolution of the medium-term economic position; the evolution of the medium-term budgetary position; the evolution of the medium-term public debt position, its dynamics and its sustainability. The role of this report is to eliminate the application of a PDE for possible temporary deviations and also real evaluation, which may aggravate or mitigate the situation with respect to the initial one and, as a consequence, start or avoid starting a PDE.
- **The increasing the pressure of the group by setting up supervisory missions** - the finding of an excessive deficit means starting a procedure, already existing in the SGP,

being easily adjusted in this reform process. The element introduced is that after the first decision on non-implementation of "no effective action" and all subsequent stages of the procedure, the EC can send a surveillance mission to the country in this situation to assess the current economic situation and to identify any risks or difficulties to meet the goal;

- **The activation of previous financial penalties** - compared to the original SGP, the reformed one foresees / allows the application of previous sanctions in the event of non-compliance with Council recommendations or notices. If there is already a deposit with interest constituted during the "stay" of the preventive component or in more particular cases of non-compliance, a situation that provides for the establishment of a non-interest-bearing deposit four months after the reporting of the deficit and public debt indicators, and the actions taken continue to be ineffective for six months, the repeat country can be amended or the existing deposit can be turned into fine. The amount of the fine will contain a fixed component of 0.2% of GDP and a variable component amounting to one tenth of the absolute amount of the difference between the budget deficit of the previous year and its current year's benchmark.

3.1. Remedies and weaknesses of the fiscal framework after the reform of the SGP

The reform of the SGP, in particular, of its two components, brings important elements for strengthening the EU's fiscal governance framework.

The reformed preventive component now offers the possibility of issuing EC opinions on stability and convergence programs that can be set up in early reporting of deviations and avoiding imbalances. Strengthening the public debt criterion and introducing a spending rule when defining a country-specific MTO are positive aspects that integrate risks to sustainability resulting from high levels of indebtedness, and are the conditions under which exceptional revenue does not flow into expenditure but are focused on the process of fiscal consolidation. The operationalization of significant deviations from the MTO or from the adjustment path towards it, based on the structural deficit and expenditure rule, increases the transparency of supervision and can help increase compliance with fiscal rules. While consolidating the applicable procedure in the event of a significant deviation from the MTO or the adjustment path (by: immediate warning, reducing the majority of the decision on the results of the actions taken and introducing a sanction), the group pressure may increase and may reduce the margin political influence.
The reformed coercive component has been strengthened by introducing a quantitative benchmark on public debt reduction, which gives the debt criterion a more important role and increases prudence in terms of a possible upward trajectory. Also, the introduction of oversight missions and the application of early financial penalties can help increase the rigidity of the EDP, increase the pressure of the group and reduce the margin of political influence.

The consolidation elements of the SGP, on its two major components, undoubtedly bring improvements to the EU's fiscal governance framework, but at the same time bring and / or maintain some weaknesses. One of these is the excess of exceptional situations that occurs at different procedural stages, which in turn can weaken the reformed SGP framework.

Under the preventive component, we are referring to the newly introduced eviction clause relating to the economic downturn due to an unusual event (in the nature of a strong financial or economic crisis) outside government control with a major financial impact, a clause that has the potential to weaken the procedure. Some weaknesses also appear in the procedure for detecting significant deviation from the MTO or the adjustment path, meaning that this procedure may be applicable if all the criteria (deficit, expense) are simultaneously violated, which means that the deviation of the structural budget deficit from the MTO is not sufficient to establish the significant deviation if the expenditure criterion is met.

Under the coercive component, there are some mitigating circumstances that need to be taken into account when deciding whether the deficit or debt is excessive. Thus, non-compliance with the deficit or public debt criterion will not necessarily result in the opening of the EDP.

The EU's Enhanced Financial Framework does not yet have a fully automated mechanism for initiating procedures in the event of non-compliance with its rules, with the Council continuing to play an important role in the assessment and decision-making within the SGP (both the finding of a significant deviation from the MTO and the finding and PDE triggering).

The rigorous application of fiscal rules and, implicitly, the overall effectiveness of the EU's fiscal framework largely depend on a single EC institution, which has a determining role in assessing the existence of the excessive deficit, in assessing the results of the measures taken to correct excessive deficit and the reduction or cancellation of financial penalties.

3.2. Fiscal Compact - to help the SGP

The implementation of the Fiscal Compact, through the TSCG, aims to promote fiscal discipline, especially in the Eurozone, but also outside it, as a support for the SGP. Its structure has two main modules, like SGP, each contributing to strengthening / supporting the two components of the SGP - preventive and coercive. The constraints of the fiscal compact refer to:

- The budgetary position must be balanced or in surplus. This rule is considered to be met if the annual structural deficit respects the medium-term budgetary objective with a lower limit of the structural deficit of 0,5% of GDP but may add up to 1% of GDP for countries with a public debt below 60 % of GDP and with low risks to long-term fiscal sustainability;
- Establishing a correction mechanism that would trigger automatically in case of significant deviations from the medium-term objective or from the adjustment strategy;
- The budget rule should be introduced (within one year of the entry into force of the Treaty) by national mandatory and permanent, preferably constitutional or other, provisions ensuring full compliance with the budgetary process national.

The fiscal compact brings some improvements as well as the weaknesses (mentioned above) in the strengthened SGP (2011), which will be presented below, namely:

- From a legal point of view, the Fiscal Compact brings key elements of the SGP, from EU secondary legislation, into an intergovernmental treaty that requires the introduction of these elements in the constitutions of the signatory parties or legal acts with the same force, which is a more anchor firmly in ensuring fiscal discipline and creating a stronger commitment to fiscal rules;
- From an administrative point of view, the Fiscal Compact increases faster convergence with MTO by developing ambitious and binding convergence calendars that go beyond the requirements of the SGP. Compliance with them will lead to entry into the MTO, sustainable fiscal policy orientation and credibility;

- From an institutional point of view, it is strengthened to monitor the effective compliance of the European fiscal framework and national budgetary frameworks by strengthening the role of independent fiscal institutions in the accession countries;
- In terms of coercive measures, the degree of automatism in the application of EDP to euro area countries has increased, making enforcement of the rules more stringent and reducing the margin of political influence in applying sanctions.

4. Conclusions

Overall, the EU's strengthened fiscal framework is more complex, which could have negative consequences in terms of transparency, effective implementation and accountability. The assessment of the progress made in the fiscal governance process is based on the structural deficit and expenditure, and the increase in the complexity of the fiscal framework makes it difficult to methodologically verify all the necessary data.

The setting of quantitative benchmarks for national budgetary frameworks, sanctions for non-compliance, and the existence of an "independent institutional supervisor" do not provide enough to consolidate them, but they depend to a large extent on the political will of countries to enforce fiscal rules strengthened.

Successive reforms of the SGP and the Fiscal Compact have obviously brought improvements to the EU's overall fiscal framework. However, the SGP has been partially improved, further perpetuating weaknesses in exemption situations, automation of procedures and high EC dependency. These issues may further weaken the application of the provisions of the SGP and, overall, affect the effectiveness of the strengthened European fiscal framework.

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