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Fiscal governance and budgetary outcomes

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Fiscal governance and budgetary outcomes

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Abstract

At the backdrop of severe fiscal problems now facing many EU countries, including Greece, this paper tries to shed light on the link between budgetary outcomes and aspects of fiscal governance (such as the existence of numerical fiscal rules, medium term budgetary frameworks, budgetary procedures and independent fiscal authorities). It reviews fiscal developments in Greece over the last decade and challenges the widely held view that optimistic macroeconomic assumptions adopted by the Greek government, as well three international organisations, were responsible for unrealistic fiscal deficit forecasts. Instead, the weak institutional budget framework emerges as the main reason for weak fiscal performance. In this light, the paper puts forward some ideas for improving the institutional framework for conducting fiscal policy in Greece.

Keywords: fiscal governance, fiscal forecasts, fiscal discipline, budget institutions, public financial management, Greece

JEL codes: H61, H62, H68, H11, E62

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1. Introduction

The fiscal imbalances that emerged after the recent financial and economic crisis, have alerted many international organizations and governments about the risks that these imbalances may have on the sustainability of public finances in many countries. The soaring public deficits and debts in countries like Ireland, Spain, Portugal, and Greece, have already had important consequences on the cost of borrowing of these countries. For Greece in particular the very high fiscal deficit of 2009 and the considerable increase of the already high public debt triggered the outbreak of a fiscal crisis. As a consequence the cost of financing its deficit became prohibitive, and the government resorted to the help of the International Monetary Fund and the European Union. In exchange, the Greek government undertook a number of commitments, including amongst others, major cuts in public expenditures, considerable increases in tax rates and several structural reforms, some of them to be implemented in the coming months.

It is true that Greece has been living with a high public debt for a long period of time. In the 1990s, in its effort to join the EMU, the government made a major effort to reduce fiscal deficits and control the rise of public debt, and succeeded in fulfilling the criteria for becoming member of the Euro area. Unfortunately, this effort was not continued in the following years, and with the turmoil of the international markets after the recent economic crisis, Greece found itself in the brink of a financial collapse.

It is also true, that since the early 1970s, budget deficits and public debts increased considerably in almost all OECD economies. The explanation of this development attracted the interest of both policymakers and researchers, since fiscal imbalances often reflect a variety of both domestic and external shocks that have a direct impact on budgets as well as a broader impact on the economic activity. The extensive literature that was developed over the last fifteen years suggests that the main factors that contributed to the high deficits and debts relate to inadequate fiscal discipline and weak fiscal management (see, for example, Van Riet, 2010). As a consequence, the fiscal policy should aim at, on the one hand, reducing the discretion of governments to change frequently fiscal policies, and on the other hand at building institutions and setting rules that would eliminate or reduce considerably the deficit bias that characterised the fiscal system of many countries.

The policy debate regarding how to best deal with the tendency of national governments to run excessive deficits affected greatly the shaping of the Stability and Growth Pact (SGP), which is a prime example of a rules-based fiscal policy framework. Within this framework, the governments of the member states are required to have general government deficits that do not exceed 3% of GDP and general government debts that are below 60% of GDP, or are on a sustained declining trend. Moreover the governments are required to develop medium-term fiscal plans showing how these aggregates are expected to develop and explaining the policies adopted to achieve the planned targets.

The SGP's record to date has been mixed. On the whole, the framework contributed to greater fiscal discipline across the European Union. But at the same time, improvements have fallen short of requirements, as the "close to balance or in surplus" target in particular remained out of reach for many countries. The SGP has been conducive to fiscal discipline, and all countries that wanted to join the EMU made considerable efforts to reduce their fiscal deficits to levels below the threshold of 3% of GDP. However, after 1999 some countries violated the SGP rules but up to now no sanctions were ever imposed. One prominent example is Greece. As we said earlier, the country has entered a period of tough fiscal adjustment, and one important question is how the mistakes of the past can be avoided in the future. It is our belief that if Greece wants to change course on a sustainable basis, it must attempt a radical reform of its fiscal system.

The purpose of this paper is to examine why Greece did not conform to the requirements of the SGP, and what could be done so that the country enters a period of sustained sound fiscal policy. In the second part, we shall examine briefly the theoretical and empirical literature relating to the instruments that have been proposed in order to contain the fiscal deficits bias observed in several countries. In the third part, we shall attempt to review the fiscal developments in Greece since the country's accession to the EMU, and detect the main reasons for the huge deviations of fiscal outcomes from the fiscal targets. In the fourth part we will make some proposals that could improve the institutional and legal framework for conducting fiscal policy, and analyze in more detail the idea for a parliamentary budget office. In the last part we will summarize the main findings of our analysis.

2. Fiscal governance and budgetary outcomes: a review of the literature

Over the past twenty years an extensive literature, both theoretical and empirical, has suggested that governments do not always follow sound fiscal policies conducive to long term growth. As a result of fiscal indiscipline the general government deficits and debts increased in many countries, and the problem has been accentuated with the recent global financial and economic crisis. One basic conclusion is that fiscal institutional arrangements, such as legally binding fiscal rules, transparency, and budgetary procedures or independent fiscal agencies, can play a critical role in helping to contain the tendency of policy makers for excessive deficits.

The need for such arrangements is also recognised by the European Council, that when, on 22 March 2005, endorsed the reform of the SGP stressed the importance of *national rules and institutions* for budgetary discipline and that *national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact.* It also said that *national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level* (Council of the European Union, 2005).

The same point is raised by Blanchard and Cotarelli (2010) when they note that *"sustaining fiscal adjustment over time requires appropriate fiscal institutions. The current ones allowed a record public debt accumulation before the crisis. They are insufficient. This requires better fiscal rules, including in Europe; better budgetary processes, including in the United States, where, at least for Congress, the budget is essentially a one-year-at-a-time exercise; and better fiscal monitoring, including through independent fiscal agencies of the type recently created in the United Kingdom.*

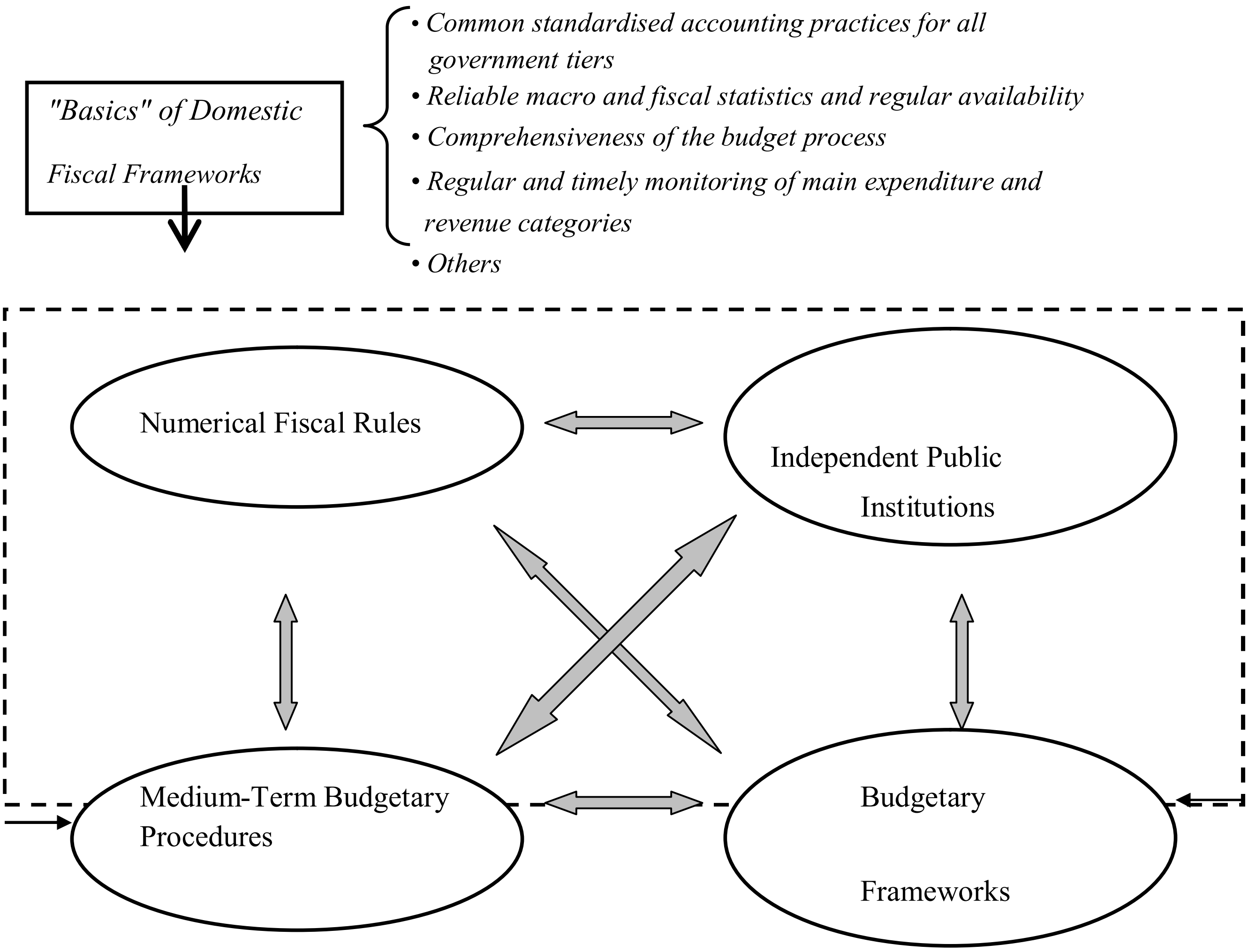
It is clear, therefore, that we need a new framework for fiscal governance that can help governments to stick to fiscal discipline and sound fiscal policies. The existing literature recognizes four such elements of fiscal frameworks that shape the institutional policy setting (European Commission, 2009a), i.e.:

1. Numerical fiscal rules,
2. Medium term budgetary frameworks
3. Budgetary procedures, and

4. Independent fiscal institutions

Figure 1 below represents graphically the composition of domestic fiscal frameworks.

Figure 1. Main elements of domestic fiscal frameworks



Source: European Commission (2009a).

In the following section we will attempt to review briefly the experience with the above types of fiscal frameworks, and examine the relative position of Greece in the framework of the Stability and Growth Pact.

2.1 Numerical fiscal rules

According to Kopits and Symanski (1998, p. 2): a fiscal rule is '*a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major* *component thereof'*. These rules could be classified according to their objective. According to IMF (2009), we have the following types of fiscal rules:

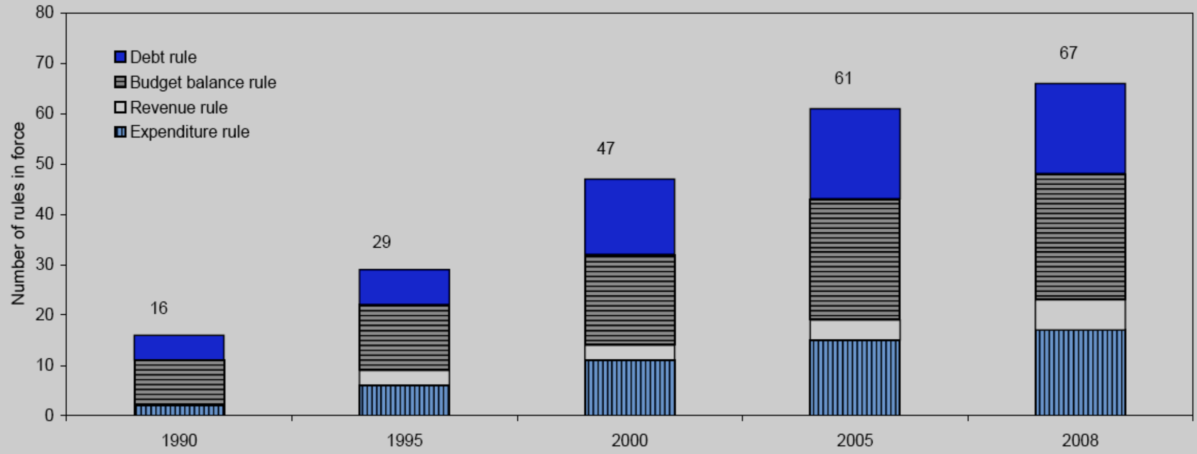
1. ***Budget balance rules,*** which can be specified as overall balance, structural or cyclically adjusted balance, and balance "over the cycle" can help ensure that the debt-to-GDP ratio converges to a finite level.
2. ***Debt rules that*** set an explicit limit or target for public debt in percent of GDP.
3. ***Expenditure rules that*** usually set permanent limits on total, primary, or current spending in absolute terms, growth rates, or in percent of GDP.
4. ***Revenue rules*** set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden.

The adoption of a fiscal rule per se is not, however, a sufficient condition for improving fiscal outcomes. The influence that a rule has on fiscal behaviour depends on its design and the way in which it is implemented. In particular, the rule and its rationale need to be understood and supported by all parties concerned (i.e. politicians, voters and markets), and credible enforcement mechanisms need to be in place. A survey conducted by the European Commission in 2008 confirmed the tendency for a growing use of fiscal rules in the EU countries. The same tendency is confirmed in a more recent evaluation of fiscal governance reforms in EU Member States (Ayuso-i-Casals, 2010). It is worth noting that, as shown in Figure 2, only three countries members of the European Union remain without national fiscal rules, namely Greece, Malta and Cyprus.

What is the empirical connection between institutions, budgetary processes and fiscal policy outcomes? This is not an easy question to answer, since measuring the quality of institutions is to a great extent a subjective issue and, in addition, until recently we did not have examples of countries that had adopted numerical fiscal rules.

Statistical and econometric analyses that were conducted by the European Commission (Public Finances in EMU, 2006) confirm the existence of a link between numerical rules and budgetary outcomes. The analysis showed two interesting results. First, it was observed that, in the years following the introduction of fiscal rules, the primary cyclically adjusted balance improved. Secondly, the decline in the ratio of primary government expenditure, adjusted for the cycle, has been significantly larger

Figure 2. Number of numerical fiscal rules in force in the EU member states, by type of rule, 1990 to 2008



	In force	New rules since last time			
	1990	1995	2000	2005	2008
ER	DE, LU	BE, BE, *DK*, NL	IE, *FR*, *FR*, *IT*, *FI*, *SE*, **-BE**	CZ, IE, *IT*, SK	BG, LT
RR		BE, LV, NL	FI, **-BE**	DK	FR, LT
BBR	BE, BE, DE, DE, DE, FR, *LT*, *LU*, RO	BE, *DK*, EE, *FI*	*AT*, *FI*, *SE*, *SE*, UK	IE, *ES*, *IT*, *IT*, *PT*, *PT*	HU, PL, PT, **-PL**, **-IT**
DR	DE, ES, ES, LU, SI	LV, FI	*CZ*, EE, LT, HU, PL, RO, SI, UK	BG, ES, SK	FR, **-FI**

Notes: If a country abbreviation is used twice in one year, it means two fiscal rules were introduced. Rules marked with a minus have been abolished, while rules where the scores have been changed since the inception are marked in italics. GG = general government; CG = central government; SS = social security; RG = regional government; LG = local government.

Source: European Commission, document: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/documents/1-f1_fiscal_rules_by_type_of_rule_en.pdf.

in the years after the introduction of numerical expenditure rules than the average change observed over the sample period. The analysis also shows that an increase in the share of government finances covered by numerical fiscal rules leads, ceteris paribus, to lower deficits. Finally, the analysis suggests that the characteristics of fiscal rules matter for their influence on budgetary outcomes. Strong rules, enshrined in law or constitution and foreseeing automatic enforcement mechanisms, seem to have a larger influence on budgetary outcomes.[1]

The above findings are also confirmed by a number of other studies. In particular, von Hagen and Harden (1994) and von Hagen et al. (2009) find a strong correlation between an index of fiscal policy institutions and the sustainability of budgetary plans. Alesina et. al (1996) show that better institutions lead to lower deficits for a group of 20 Latin American countries in the years 1980-1992. These results are confirmed in a larger sample of 62 advanced and emerging economies by

[1] See also Ayuso-i-Casals, et.al. (2007).

Fatas (2009). For the US, Bohn and Inman (1996) find that the stringency of the balanced-budget rules improves fiscal policy discipline. Some other studies, like those of Calmfors (2005), Kopits (2004), and Morris et al (2006), also conclude to the often beneficial role of such rules. In a very recent paper, von Hagen (2010) also finds that “strong fiscal rules are associated with more cautious economic growth projections underpinning fiscal plans as well as with more cautious projections for government revenues and expenditure”.

We could therefore, argue that, in general, budget processes and fiscal rules matter for the outcome of fiscal policy. The recognition of these positive effects have led to an increasing number of countries adopting fiscal rules that constrain the behavior of fiscal policy and improve the designing of budgetary processes. The recognition of the importance of fiscal rules is confirmed by the fact that, according to IMF (2009), in 2009 there were 80 countries that had some kind of national or supranational rules and, it is very likely that this trend will continue, given the need for significant fiscal adjustment in many countries after the recent financial and economic crisis.

The literature, however, is far from unanimous, with some influential observers arguing that rules-based fiscal frameworks *per se* need not deliver fiscal discipline: rather under quite plausible and realistic assumptions, they are likely to end up meeting the same fate as monetary rules because their effectiveness is based on the same faulty premise, namely the assumed capacity of rules to permanently suppress or constrain discretion (Wyplosz, 2005). Indeed, the argument goes, there will always be circumstances in which scrapping or ignoring rules will be preferable for policymakers, suggesting a serious credibility problem. It follows from this argument that a credible solution to biased policies cannot be to suppress discretion but to find mechanisms through which it could be exerted more wisely.

2.2. Medium Term Budgetary Frameworks

Medium term budgetary frameworks (MTBFs) are usually defined as the fiscal arrangements that allow the government to delineate its fiscal policy in a medium term horizon. The rationale of the MTBF is that in each year’s annual budget many adopted measures have budgetary implications for the budgets of the following years. Although, the objectives included in the MTBF are a weaker form of commitment than a numerical rule, they are considered as a useful instrument that can enhance fiscal discipline, by making more apparent the impact of current policies on the budget of the coming years.

MTBFs are typically based on a macroeconomic scenario, which describes the available government resources in the medium term to finance policies. On the basis of projections for GDP growth, inflation, and other macroeconomic variables, fiscal authorities provide medium-term projections for the main aggregates of the government budget (government balance and debt; government expenditure and revenue and their composition), usually for the whole of the general government sector.

The situation of the EU Member States varies considerably concerning the degree to which their fiscal policy is placed in a medium-term perspective. While in some EU member-states national MTBFs have been introduced a long time ago and play a key role in fiscal policymaking, in some other States the only instrument putting annual fiscal policy decisions in a multiannual context, is the Stability and Growth Program (SGP for Euro area members), or the Stability and Convergence Program (SCP for non-Euro area members). It is worth mentioning that from the 27 member countries of the European Union, five members do not have national MTBFs and simply submit the SGP or SCP to the European Commission.

In some countries, the medium-term budgetary targets are prepared by the government with no or little coordination with other levels of governments and virtually no involvement of the national parliament. In other countries, the medium-term budgetary targets are set following coordination between all levels of governments and the approval of the national parliament. The situation also varies substantially concerning the link between the MTBF and the annual budgetary procedure. In a number of EU countries, this link can be assessed as relatively strong while in other cases the medium-term budgetary projections seem to be only indicative and hardly taken into account in the preparation of the annual budget laws.

In order to better assess the relation of MTBF to fiscal outcomes, it may be useful to make the distinction between ‘flexible’ and ‘fixed’ MTBFs. Flexible frameworks allow for revisions of the overall objectives from year to year to adjust in order to take into account more recent economic developments or changes in the priorities of fiscal policy. Fixed frameworks, on the other hand, set targets for a medium-term path for government expenditure which cannot be revised from year to year, unless exceptional events occur.

Another useful distinction is that between 'rolling' and 'periodical' MTBFs. A periodical framework covers a definite period of time, in the sense that a new framework is not drawn up before this period ends, unless exceptional events occur. The period covered by a periodical framework is generally aligned with the term of a legislature. In a rolling framework, on the contrary, a new year is added at the end of the period covered by the previous projections at the occasion of every annual update. It should be stressed that rolling frameworks can incorporate fixed elements. However, practice shows that most of the rolling frameworks turn out to be flexible, as in the annual process of adding a new year to the framework the opportunity also to revise targets for the intermediate years is typically exploited. A typology of the MTBFs is presented in Table 1.

The experience suggests that although there are complementarities between a multi-annual expenditure rule and medium-term budgetary framework, medium-term budgetary objectives represent a weaker form of commitment than a pure rule incorporating binding targets. However, they may help ensure fiscal discipline by making more apparent the impact of current policies on the government balance in the coming years. Likewise, the existence of a MTBF may facilitate monitoring by providing benchmarks against which budgetary developments can be assessed over time.

Table 1. Medium-term budgetary frameworks — A typology

	Fixed frameworks	**Flexible frameworks**
Rolling frameworks	**Rolling fixed frameworks** A new year is added every year, but the targets already set in the previous years for the intermediate years are not updated.	**Rolling flexible frameworks** A new year is added to the framework every year, and at the same time the targets for the intermediate years are revised.
Periodical frameworks	**Periodical fixed frameworks** The medium-term targets are set once and for all for a definite time period. There is no updating of the targets during the period.	**Periodical flexible frameworks** The medium-term targets are set for a definite time period, but the targets are revised during the period.
Source:European Commission, 2007.		

According to a survey conducted by the European Commission (EC, 2009b) MTBFs implemented across EU Member States tend to show some common shortcomings. These weaknesses mainly refer to the non constraining character of fiscal targets, recurring revisions of the main fiscal aggregates and lack of political commitment. It is worth noting that the MTBFs are not approved by Parliaments, and are only discussed on the side of the approval of the annual budget. Finally, the lack of an independent monitoring and regular reporting and the absence of corrective mechanisms in case of deviation from the envisaged fiscal path further weaken the use of MTBFs as a policy instrument.

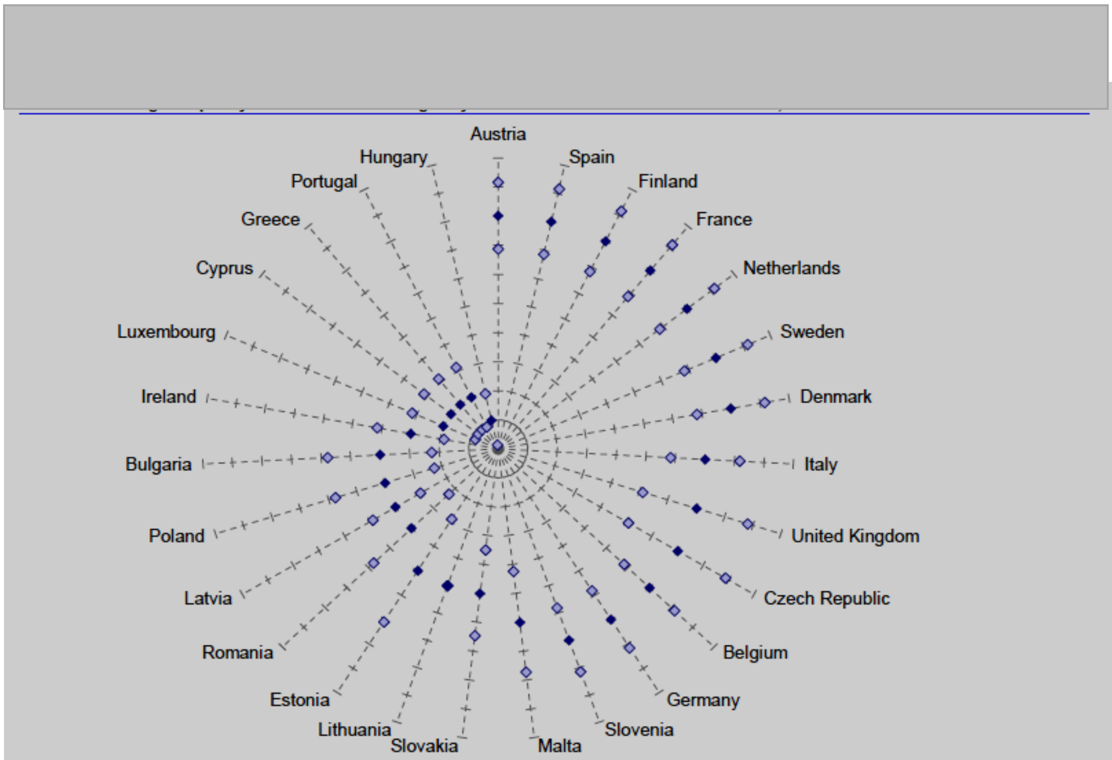
The empirical research on the effectiveness of MTBFs shows generally a positive impact of MTBFs on budgetary outcomes. Von Hagen (1992) reaches the conclusion that the influence of MTBFs is in most cases positive, but that a MTBF alone is not sufficient to overcome the problems of fiscal indiscipline for a country where budgeting procedures have structural weaknesses. Also, Filc and Scartascini (2004) find that the existence of a MTBF is significant to explain differences in budget outcomes. In a more recent study, Lundbäck (2008) suggests that most countries with MTBFs have had stronger fiscal balances than could have been expected given GDP growth. However, the existence of many other factors that affect fiscal outcomes make it difficult to isolate the effects of institutional arrangements. The conclusion is therefore confined to noting that simply studying the fiscal track records of countries with MTBFs in place suggests that such frameworks can contribute to prudent fiscal policies.

The European Commission in an effort to measure the quality of MTBFs calculated a synthetic index that takes into account both the existence and properties of national MTBFs and the preparation and status of SGPs and SCPs. The synthetic index is made of the following five components:

1. Existence of a national MTBF (on which the SGP or SCP is based).
2. Connectedness between the multiannual budgetary targets and the preparation of the annual budget (domestic MTBF, SGP or SCP).
3. Involvement of the national parliament in the preparation of the medium-term budgetary plans (domestic MTBF, SGP or SCP).
4. Existence of coordination mechanisms prior to setting the medium-term budgetary targets (domestic MTBF, SGP or SCP).
5. Monitoring and enforcement of multiannual budgetary targets.

Figure 3, below shows how EU countries rank with respect to the index.

Figure 3. Index measuring the quality of medium-term budgetary frameworks in the EU Member States, 2008



Notes: The quality of medium-term budgetary framework (MTBF) index was calculated by assessing five criteria: (i) existence of a domestic MTFB, (ii) connectedness between the multi-annual budgetary targets and the preparation of the annual budget (domestic MTBF or Stability and Convergence Programme (SCP)), (iii) involvement of national parliaments in the preparation of the medium-term budgetary plans (domestic MTBF or SCP), (iv) existence of coordination mechanisms between general government layers prior to setting the medium-term budgetary targets (domestic MTBF or SCP), and (v) monitoring and enforcement mechanisms of multi-annual budgetary targets (domestic MTBF or SCP). The criteria were aggregated using random weights drawn from a uniform distribution. The dark points show the median index value, the light blue points indicate the limits within which 90% of the index values fall.
Source: Commission services.

Source: European Commission, document: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/documents/3-f1_index_measuring_the_quality_of_mtbf_in_eu_ms-2008_en.pdf

It is clear from this index that Greece ranks very low. It is true that Greece does not have a national MTBF. The above index, however, takes into account the medium term programs that are included in the Stability and Growth Program, which means that the low value of the indicator reflects important weaknesses in the MTBF of Greece.

2.3. Budgetary procedures

When examining whether fiscal rules or MTBFs yield results or not, we must also consider the broader framework, political and administrative, within which the government operates. The efficient and effective implementation of rules requires political commitment, supporting structures and disciplined *budget procedures*. By domestic budgetary procedures we mean all the procedural rules that are laid down in law and cover the three stages of the budget process, namely, planning, approval and execution. Some basic features of a system of sound budgetary procedures could be the following:[2]

1. - Transparency: This is a crucial element to ensure that fiscal authorities are held accountable. Transparency mainly requires reliable and timely budgetary data, standard accounting practices and a comprehensive coverage of the budget law (i.e. limited off-budget operations).

2. Multiannual budgetary planning: A medium-term budgetary framework provides the basis for designing and implementing a fiscal strategy beyond the yearly budgetary cycle. This allows fiscal authorities to commit to a pre-defined path for the main budgetary aggregates and to take into account the multiannual budgetary impact of current policies.

***3. Budgetary centralisation at the planning and approval stages*:** This is one of the most important dimensions of the budget process and heavily influences fiscal outcomes. In general, a fragmented budget preparation involving a large number of deciding actors leads to deficit bias due to the common pool problem.

4. Budgetary decentralisation at the implementation stage: In contrast to the planning and approval phase, certain decentralisation during the execution of the budget may be needed in order to better reallocate resources. While the overall spending ceiling should always be respected, some flexibility to change the distribution of resources among spending programmes can be appropriate if efficiency gains are within reach.

5. Top-down budgeting: This budgeting approach starts the budgetary planning with a binding ceiling limiting the total amount of resources. Subsequently, this amount is distributed among expenditure areas and programmes. This is more conducive to fiscal discipline than the traditional bottom-up approach, in which the total spending is obtained by the sum of the individual expenditure requests of all line ministries and agencies.

6. Realistic economic assumptions and reserves: Prudent and plausible macroeconomic assumptions should avoid systematic and overly optimistic budgetary projections, which in turn should facilitate a more credible and effective fiscal

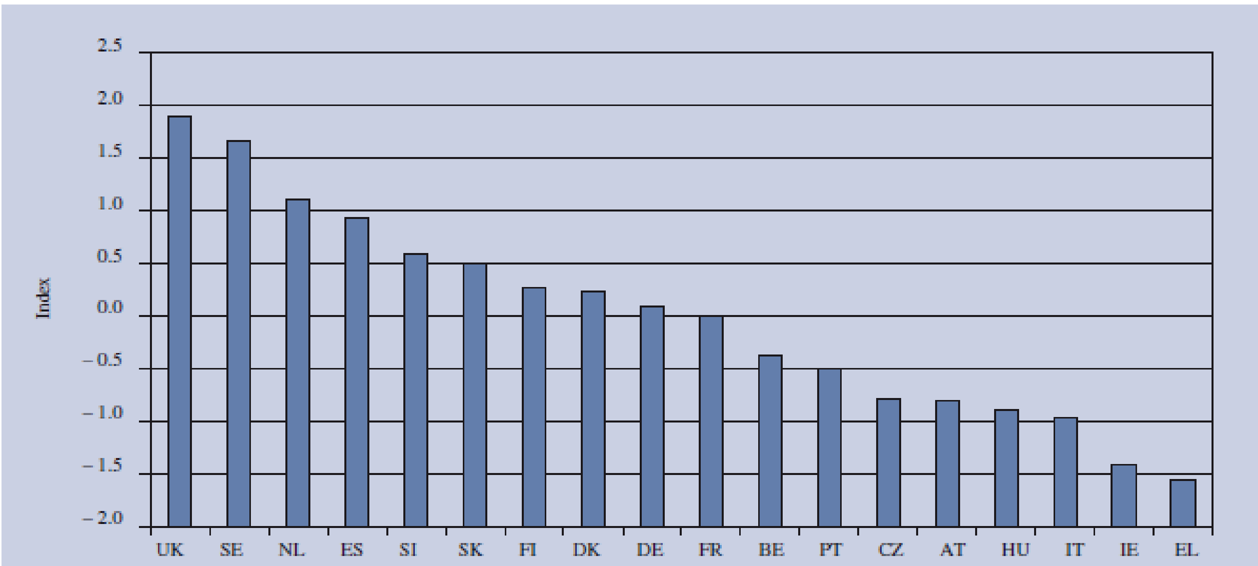
[2] This section rests heavily on European Commission (2009a). See also European Commission (2007), and Blöndal (2003).

planning. As for reserves funds, they provide flexibility to deal with unexpected budgetary developments.

*7. **Performance budgeting:*** This budgeting practice is based on the evaluation of spending programmes vis-à-vis the achievement of their policy objectives. A link between the resource allocation and the efficiency of these programmes should promote a more adequate resource allocation in the budget preparation.

Several studies show that developed budgetary procedures can contribute to improve budgetary performance. Moreover on the basis of the evaluation by the European Commission (2007), Rapanos (2007) and Vraniali (2010), we can conclude that the score that Greece can achieve in budgetary procedures is very poor.[3] This is also confirmed by an index that was developed by the European Commission in order to evaluate the budgetary procedures mentioned above. This overall index incorporates a number of sub-indices that refer to: budget transparency, multi-annual planning horizon, centralization of the budget process, top-down budgeting, prudent economic assumption, performance budgeting and numerical fiscal rules. The scores of the index for a number of EU countries are presented in Figure 4.

Figure 4. Overall index of budgetary procedures, EC (2007)



Source: European Commission, 2007.

[3] For a detailed and quite comprehensive review of procedural rules and public financial management in Greece, see Vraniali, (2010). For a review of budgeting in Greece see OECD (2008), and Rapanos (2007).

2.4 The role of Independent Fiscal Institutions

The fourth element of a domestic fiscal framework that is conducive to fiscal discipline is, as mentioned above, the establishment of non-partisan public bodies acting in the field of budgetary policy. In fact, the idea of independent fiscal councils acting as "national watchdogs" has started gaining ground as a way of institutionally strengthening domestic fiscal frameworks (see van Riet, 2010 and European Commission, 2009b).

The successful delegation of monetary policy to independent central banks led some authors to propose the setting-up of independent fiscal policy councils (Eichengreen et al, 1999, Calmfors, 2003, Wyplosz, 2002, 2005). The delegation of fiscal policy to an independent council does pose a number of serious problems (Wyplosz, 2008, Debrun et al, 2009), but in practice independent fiscal councils have been established in a growing number of countries, perhaps the most recent example being the formation of the UK Office for Budget Responsibility last May. The precise mandate of such councils varies considerably across countries (see European Commission, 2009b), yet none is responsible for the conduct of fiscal policy. As a general rule, the operation of most of them involves making independent assessments of the public finances and the economy, publicly making recommendations regarding the country's economic policy, assessing the forecasts on macroeconomic aggregates and examining the reliability of the state's budget forecasts on expenditure and revenue, and therefore deficit. The mandate of such councils often includes the assessment of the long-term sustainability of public finances, and especially of public debt.

More specifically, most independent fiscal councils in operation today perform, at least, the following three core functions:

1. They produce independent economic forecasts, on which forecasts on fiscal aggregates are based. Fiscal policy planning relies on a series of assumptions regarding the future course of the economy. Therefore, successful budget implementation relies upon the adoption of realistic and prudent macroeconomic forecasts. In fact, in some countries, the macroeconomic forecasts produced by fiscal councils are binding for the government's budget planning process. This is the case of the WIFO in Austria, the Federal Planning Bureau in Belgium, the Central Planning

Bureau (CPB) in the Netherlands, the Hungarian Fiscal Council, the Slovenian Fiscal Council and the Swedish Fiscal Council.

2. They analyse and assess the forecasts on public revenue and expenditure, and highlight possible risks of deviation from the targets set in the budget. In several countries – see e.g. Calmfors (2010) for Sweden and Chote et al (2010) for the UK- fiscal councils evaluate whether fiscal policy and measures announced by the government are consistent with the fiscal targets the government itself has set (e.g. the deficit that appears in the Stability and Growth Programme).
3. They monitor the budget implementation process throughout the year, and provide relevant information and statistical data at regular intervals.

Through the above functions, an independent fiscal council aims to safeguard a high level of economic policy discussion by ensuring that policies are explained and motivated in a proper way and that they are based on sound analytical foundations. It contributes to fiscal transparency and accountability, strengthens democratic control and raises the political cost of "bad policies" in terms of credibility of the policymakers.

The scope and type of activities vary among countries, depending on each country's institutional framework, historical evolution, challenges to be met and, not least, on the resources and personnel devoted to the council. Such activities may include, for example, the assessment of policies over a short- and medium- term horizon, the examination of the long-run sustainability of public finances, institutional analysis of specific sectors, cost-benefit analysis of public infrastructure projects, etc.

Just to cite a few examples, the oldest fiscal council is the Central Planning Bureau (CPB) in the Netherlands, which has provided governments and political parties with independent opinions and analyses since 1945. It employs around 150 staff members and has a really broad scope of activities. Its reports and studies are widely accepted and constitute points of reference in public debates. The Congressional Budget Office (CBO) in the US is an independent authority that reports to US Congress. It has the highest number of staff members (around 235) and its primary objective is to provide the Congress Members with quantitative and qualitative information regarding proposed policies. In the case of Belgium, the country's transformation into a federal state raised concerns that budgetary stability would be jeopardized due to lack of coordination among the various levels of government. The Belgian fiscal council (the High Council of Finance), in addition to its other activities, plays an important coordinating role, setting medium-term targets for the budget of the central government and of the regions. In Chile, the role of the independent advisory committee (ACRCP) is to provide, among other things, forecasts on the potential level of world copper prices, which determine a sizable part of public revenues.

Similar councils have been recently established in other counties as well, e.g. Sweden, Hungary and Canada, while the most recent example is the Office for Budget Responsibility (OBR) in the UK, which was formed in May 2010 with the mandate to make independent assessments of the public finances and the economy.

The above brief review points to the conclusion that the independent fiscal councils currently active are, according to Wyplosz's (2008) terminology, "soft" fiscal policy councils, in the sense that their role is mainly advisory. The question naturally arising is under what conditions such councils can play an effective role, even if their decisions are not binding for government action. This is a point to which we turn later, especially in view of the recent initiative of the Greek government to establish a Parliamentary Budget Office last summer.

Having described rather briefly the main features of a modern system of fiscal governance, mainly in the context of the European Union, we turn now to examine in more detail the fiscal performance of Greece over the last ten years, and try to find out the main reasons for the very poor performance of the political system regarding the control of fiscal deficits.

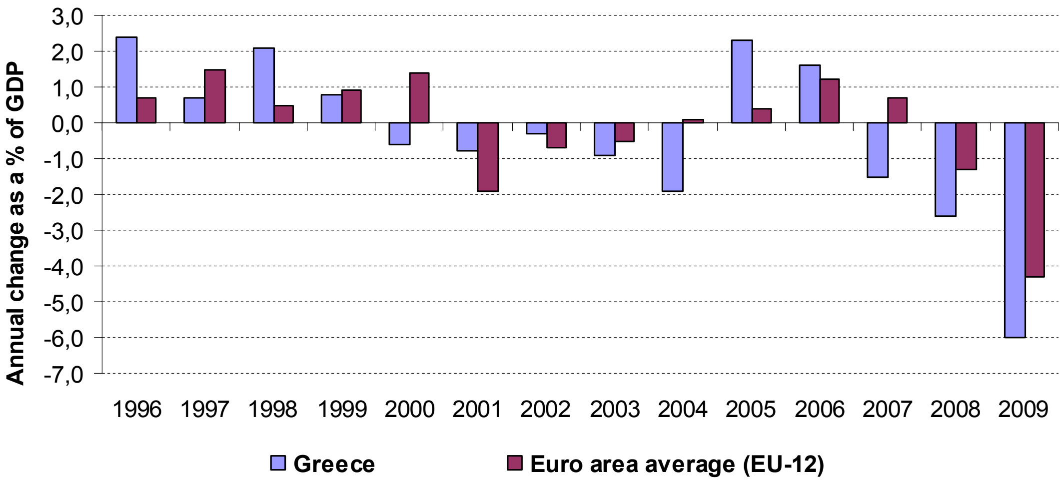
3. Greek Fiscal Governance and Budgetary Outcomes

It is rather generally agreed that a root-cause of the ongoing Greek fiscal crisis was not only the soaring public deficit in the last couple of years, but also the opacity of public accounts. As it became evident almost a year after the change in government, the budget deficit for 2009 was not only far larger than anticipated, but it has been revised at least three times since October 2009. As a result Greece suffered a sharp erosion of credibility and financial markets reacted with a huge increase in the spreads of the Greek state bonds that made borrowing by the Greek state impossible. A short story of Greek public finances over the last fifteen years allows one to draw some rather revealing conclusions regarding the effects on budgetary outcomes of the weak fiscal governance framework within which fiscal policy was set.

During the 1993-1999 period, Greek public finances were set on an ambitious fiscal adjustment path in an effort to comply with the relevant Maastricht criteria and enter the Eurozone. Indeed, the budget deficit, which stood at almost 13% of GDP in 1993, was reduced to below 3% by 1999[4], while the public debt-to-GDP ratio started declining. At the same time, the Greek economy attained impressive growth rates, among the highest within European Union countries.

In the period after the introduction of the euro, fiscal consolidation efforts lost momentum in almost all euro zone countries, despite the fact that the Stability and Growth Pact envisaged the attainment of balanced budgets over the medium term. In fact, the period 2001-2003 witnessed significant increases in budget deficits, as shown in Figure 5. In many countries, the general government deficit breached the 3% of GDP limit, and as a result these countries were subjected to the Excessive Deficit Procedure, as envisaged in the framework set by the Stability and Growth Pact. The same was the case with Greece in 2004.

Figure 5. Annual changes in the general government balance (% of GDP), 2000-2009



Source: Authors' calculations based on European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010.

The governments of these countries adopted fiscal consolidation packages which brought the deficit below the 3% limit and managed to bring the EDP to an end (see Figure 5). In the case of Greece, in June 2007 the Council of the European

[4] This figure was revised to 3.1% after a fiscal audit that took place in 2004.

Union, based on the European Commission's recommendation that the public deficit had been brought below the 3% to GDP reference value in a sustainable way, decided that the excessive deficit had been corrected and brought the excessive deficit procedure to an end. Nevertheless, by the end of 2007, the general government deficit had once more surpassed the 3% limit.

The eruption of the global financial crisis in mid-September 2008 and the subsequent worldwide economic recession had a marked negative impact on the fiscal positions of euro area countries (Figure 5). In 2009 all euro area countries recorded deficits which, with exception of Finland and Luxembourg, exceeded 3% of GDP. Public deficits rose as a result of both direct fiscal costs of bank and other enterprise rescue operations and of policies aimed at sustaining domestic demand within an environment of rapidly weakening economic activity (for an overview, see van Riet, 2010). Nevertheless, blaming the world financial turmoil for the recent explosion of fiscal deficits in Greece would be rather misleading (see Bank of Greece, 2009 and Rapanos and Kaplanoglou, forthcoming). For example, the banking system in Greece maintained sound capital positions throughout the crisis, while any present liquidity problems are the result rather than the cause of the unsustainable fiscal position of the public sector.

Despite the fact that the Greek economy attained high growth rates throughout the last decade, fiscal imbalances were never effectively brought under control. One can find many explanations for high deficits. In the first instant, one could draw attention to the incompetence of the government to control expenditures and to collect budgeted revenues. The most fundamental reason, however, has been the weak institutional framework of budgeting and tax administration. A basic weakness of the Greek fiscal system is the poor mechanism of setting up the budget, and the lack of any systematic monitoring of its implementation. While the Parliament has a powerful constitutional role in voting the state budget, not only as a whole but also by Ministry, it does not have any kind of mechanism to follow up on the budget execution, and to monitor developments on public expenditures and revenues.

It would be rather revealing to give a retrospective account of the budget data the Parliament was presented with and was called to approve of over the last decade. Every November the Parliament is presented with the Introductory Report of the State Budget for the following year and is asked to approve it. Information for local government, public hospitals and social security funds finances appears only in a fragmentary manner and largely missing. During the course of the following year, the only information regarding the developments on the execution of the budget is presented to the Parliament in October or November of the budget year (already too late to address any deviations). The Parliament is finally asked to approve of the final outcome of the budget in November of the year following the budget year. Just to take an example, the 2007 State Budget is approved by the Parliament in November 2006, its implementation progress is approved in November 2007 and its final outcome is approved in November 2008. Therefore, there appear to be large gaps in the flow of information regarding the execution of the budget, thus rendering the monitoring role of the Parliament ineffective.

Had deviations from the targets not been large, the problem would perhaps not have been important. However, apparently that was not the case. How had major fiscal components of the state budget (total revenues, primary expenditure and interest

Figure 6a. Deviations of within-year estimated of major fiscal aggregates from the targets set at the Introductory Report of the State Budget, 1999-2008 (excluding "outlier" 2009)

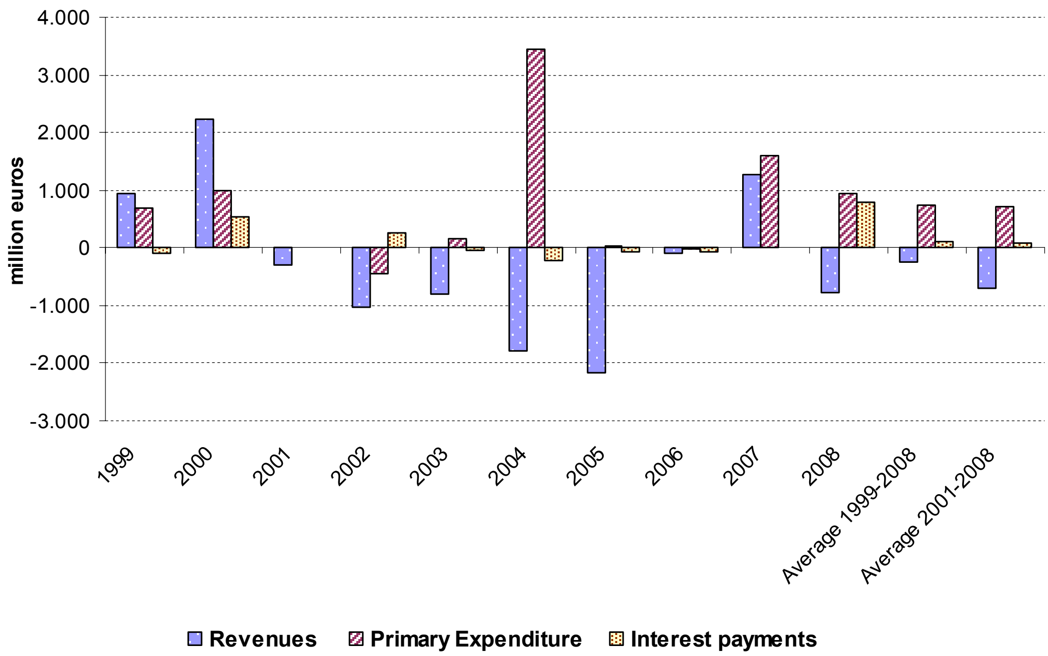
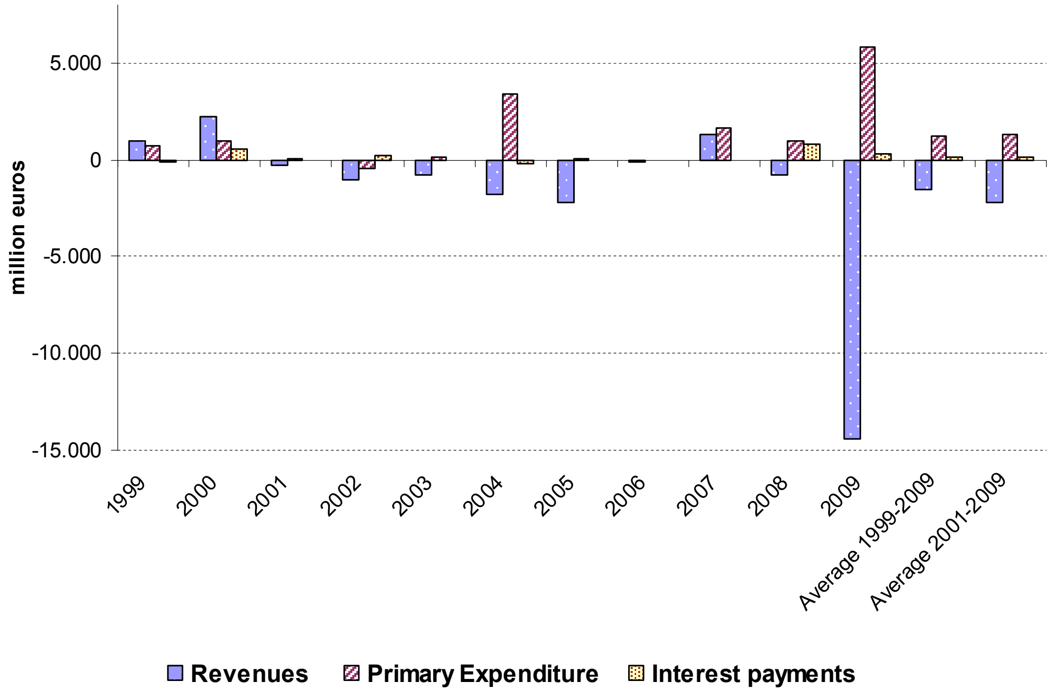


Figure 6b. Deviations of within-year estimated of major fiscal aggregates from the targets set at the Introductory Report of the State Budget, 1999-2009



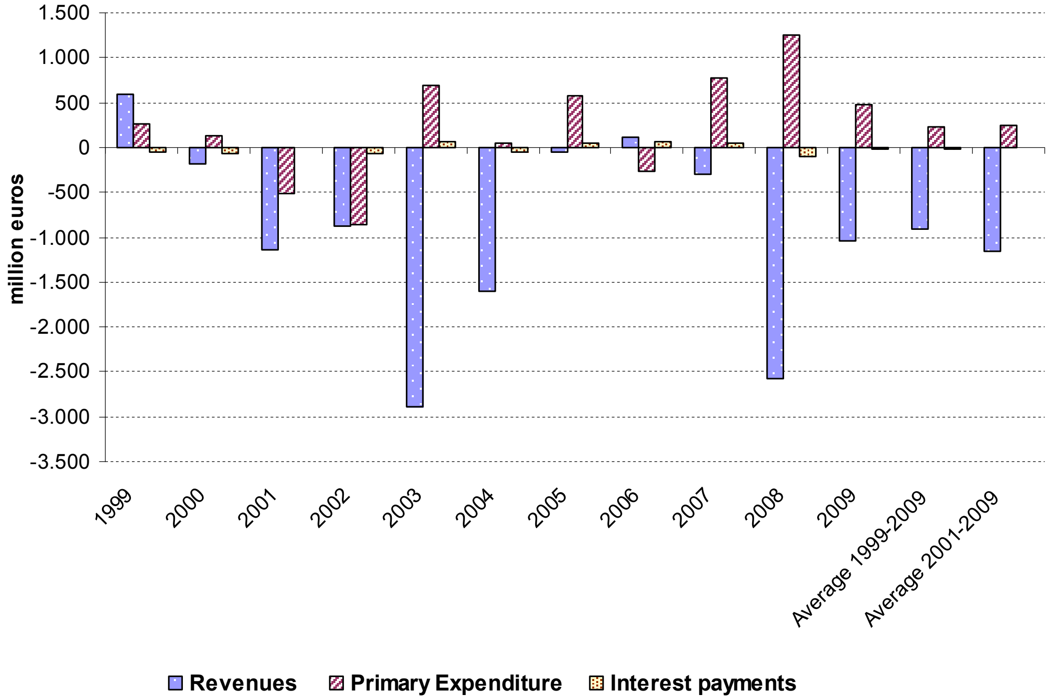
Source: Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

payments) evolved one year after the approval by the Parliament of the respective targets? As Figures 6a and 6b show, not particularly well, with deviations varying from year to year[5]. Smaller deviations and even positive surprises coincide with the periods of fiscal consolidation episodes imposed by the European fiscal framework, as described earlier in this section. On the whole, however, total revenues and primary expenditure were not evolving according to plan. In most years, there were significant shortfalls in revenues and serious expenditure overruns.

More notably, the Parliament apparently could not impose any corrective action in the cases where the targets for revenue and expenditure were evidently going to be missed. The final outcome instead exhibited a further deterioration. Figure 7 presents the deviations of within-year estimates of the same fiscal aggregates from the final outcomes. Deviations from both the revenue and the expenditure targets expand further.

[5] Despite the fact that deviations from targets were usually rather high almost all years, they appear condensed once the exceptionally high revenue shortfalls of 2009 are added. Therefore, we present the data both including and excluding the "outlier" year 2009.

Figure 7. Deviations of within-year estimates of major fiscal aggregates from final outcomes

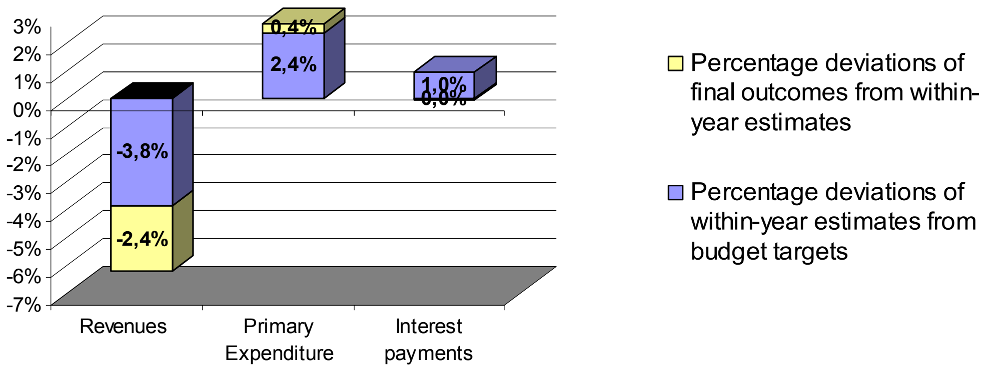


Sources: Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

Figure 8 presents the size of the average *percentage* deviations of final outcomes from the targets set in the budget over the 2001-2009 period. The within-year estimates presented to the Parliament indicated that revenues were falling short of the budgeted amount by 3.8%, while primary expenditure was going to exceed the targeted amount by 2.4% and interest payments by 1%. The final outcome drew an even bleaker picture, with revenue shortfalls reaching over 6% and expenditure overruns having further increased. The deviations of revenues and expenditures in percentage terms might not strike too large, but when fed into the State Budget deficit, they imply that the final figure for the state budget deficit stood on average 67% higher than the budgeted amount.

An inherent inconsistency of the Greek budgeting system stems from the unbalanced power of the Parliament over *state* budget vis-à-vis *general government* data. The Stability and Growth Pact, which sets the framework for conducting fiscal policy at the EU level, requires fiscal aggregates to be reported at a *general government* level respecting the accounting rules set in the European System of

Figure 8. Percentage deviations of major fiscal aggregates of the State Budget (average 2001-2009)

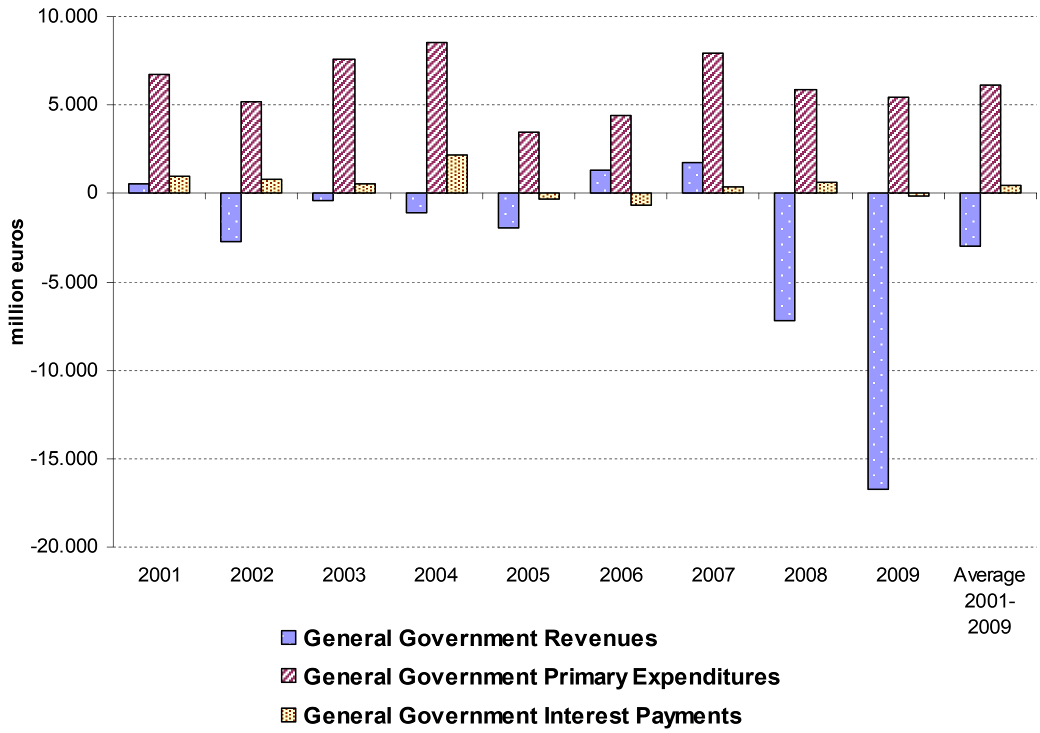


Sources: Authors' calculations based on Ministry of Economy and Finance, *Introductory Report of the State Budget*, Athens (various issues).

Integrated Economic Accounts (ESA 95). State budget data have, therefore, to be adjusted to a national accounts basis and be aggregated with data covering local authorities, social security funds and hospitals. The approval of fiscal forecasts included in the Stability and Growth Programs submitted to the European Commission is simply a responsibility of the Ministry of Finance, therefore the Parliament is rarely presented with such data, let alone asked to monitor them.

The even greater lack of monitoring at a national level of the targets set for the general government balance and its components goes, not surprisingly, hand in hand with even higher deviations. Figure 9 has been constructed in a similar way with Figure 6. It compares the targets set at various updates of the Hellenic Stability and Growth Programme for the revenues, primary expenditure and interest payments at a *general government* level. When we move from the state to the general government level, deviations appear slightly lower in absolute amounts in the case of revenue shortfalls, but almost three times higher in the case of primary expenditure overruns. The relative improvement in the performance of revenue once we move to the general government level is primarily attributed to the considerable surpluses recorded every year by social security funds, an issue that has attracted the attention of Eurostat more than once.[6] One could argue that from 2004 onwards Greek fiscal data have been revised many times (see European Commission, 8.1.2010 Report) and such ex post

Figure 9. Deviations of final outcomes of major fiscal aggregates from targets set at the Hellenic Stability and Growth Programmes



Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), and European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010.

revisions could not have been possibly anticipated by Greek governments. Figure 10 presents similar information with Figure 9, excluding the effect of ex post revisions of general government revenue and expenditure data. Deviations from targets now appear much smaller in the case of government expenditure, which is to be expected since most revisions referred to the methodology in recording expenditure items (e.g. military expenditure).

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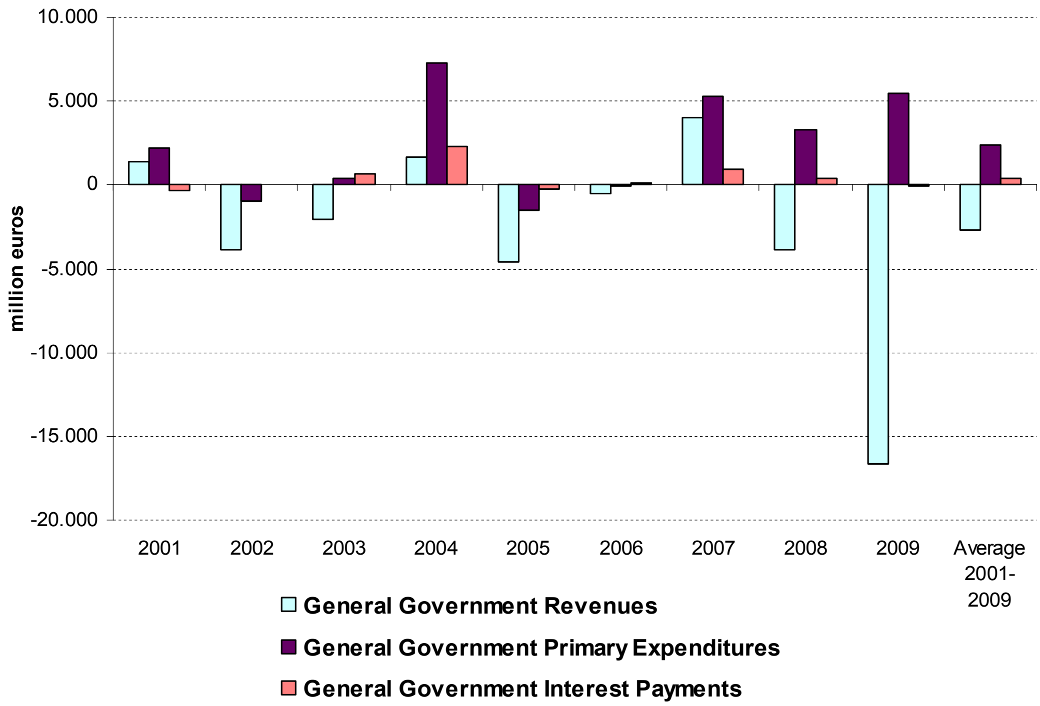
[6] Regarding the size and revisions of the surpluses of social security funds and the explanations provided by the Greek authorities, the European Commission notes in it's latest report on Greek statistics that "it does not find these explanations sufficient and will carry out in the coming months a thorough investigation of the process of calculation by the Greek authorities of the surplus/deficit of the social security sector" (European Commission, 2010).

Figure 10. Deviations of final outcomes of major fiscal aggregates from the targets set at the Hellenic Stability and Growth Programmes (excluding the impact of ex-post statistical revisions)



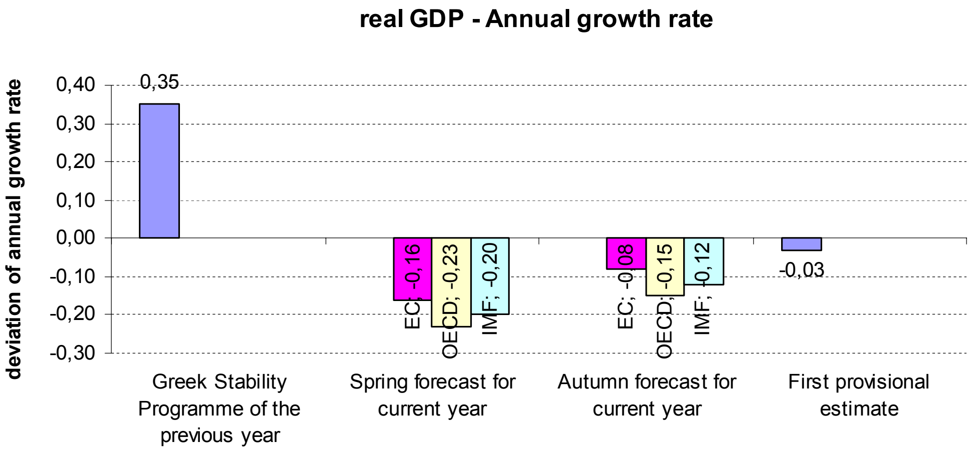
Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), and European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010.

One fact can be established with hardly any doubt: on the whole fiscal targets were systematically being missed by a wide margin. A natural question arises: is there something intrinsically flawed in the way fiscal targets were set either at the state or at the general government level? A view widely held among both national and international organizations is that the problem can be traced to the fact that the government consistently based its fiscal forecasts on an overly optimistic outlook for the economy as a whole, thus inflating government revenue forecasts and underestimating expenditure. In other words, GDP growth was being overestimated and subsequently, when the harsh face of reality revealed itself, public revenue and expenditure targets were being missed. Despite its popularity, this view can be challenged rather easily.

Referring to the period 2000-2009, the first column of Figure 11 shows the average deviation of the forecast for the real growth rate adopted by the Stability and Growth Programme for the following year from the final outcome. It appears that

Greek governments do tended to overestimate real GDP growth, yet by a rather small margin of 0.35 percentage points. The European Commission, as part of the monitoring of the finances of member states, conducts biannual forecasts (each spring and autumn) for major economic aggregates. As becomes evident from Figure 11, the within-year forecasts for GDP growth were rather conservative, marginally underestimating the Greek GDP growth rate. The magnitude of the underestimation halves in the autumn forecast as the calendar year approaches its end.

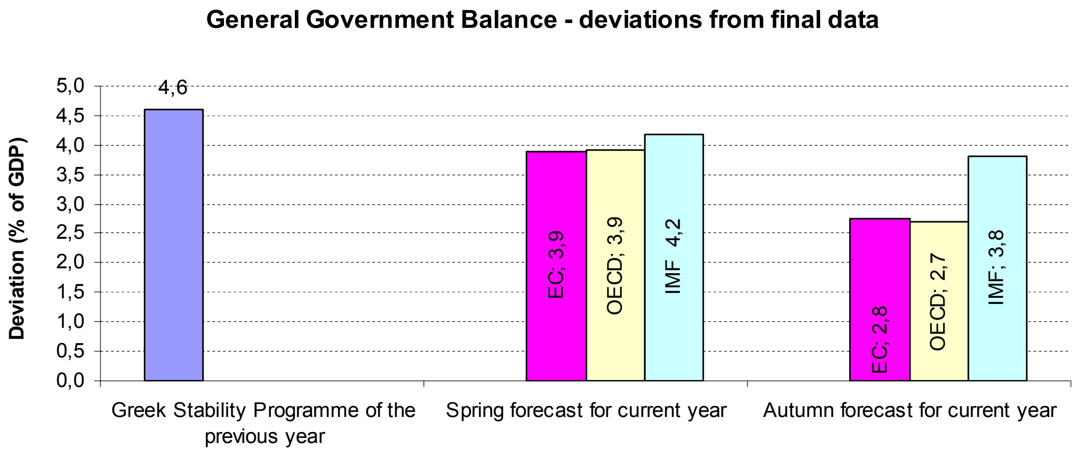
Figure 11. Deviations of GDP growth rate (2000 – 2009)



Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010 and European Commission, European Economy, Brussels (various issues).

Forecasts for the general government balance convey an entirely different picture (Figure 12). The targets set in the Stability and Growth Programmes were highly unrealistic and therefore unreliable, since they were missed by a large margin (on average the deficit was 4.6% of GDP higher than the target). More surprisingly, the prudency of European Commission GDP forecasts does not translate into analogous prudency when it comes to public deficit. The EC forecasts appear to highly underestimate public deficits, even in the autumn forecasts, just one month before the end of the year in question.

Figure 12. Deviations of General Government balance from final data (% of GDP), 2000 - 2009

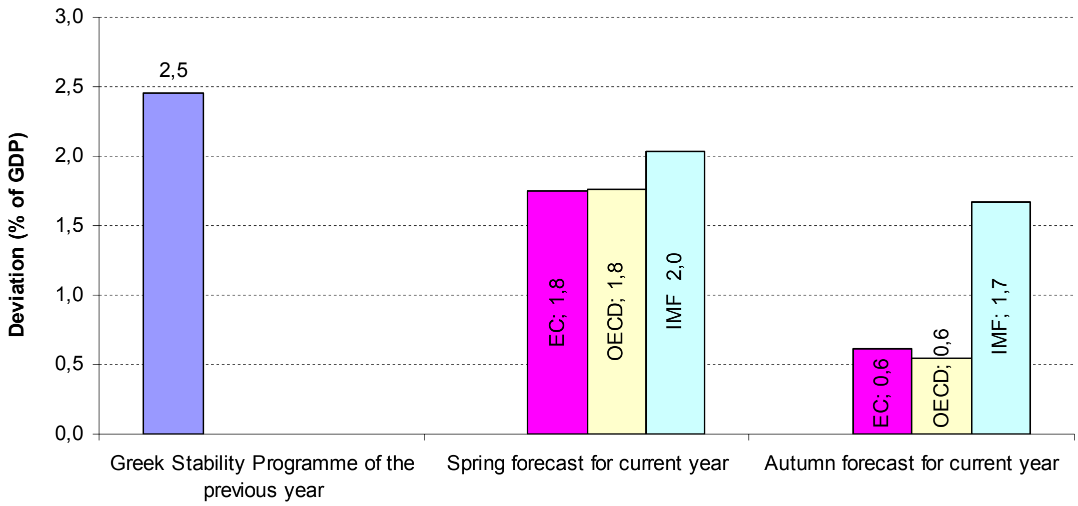


Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010 and European Commission, European Economy, Brussels (various issues).

One could argue that Greek fiscal deficits were subject to multiple ex-post statistical revisions, which of course the government or other institutions such as the EC could not foresee. If we take these revisions into account,[7] the performance of forecasts certainly improves, but still falls short of what could be expected (see Figure 13). The spring forecasts underestimated fiscal deficit on average by almost 2pp of GDP, while the autumn forecast still underestimated deficits by more than 0.5% of GDP. Figures 11-13 also present the spring and autumn forecasts for GDP and fiscal deficit of two other international organizations (the OECD and IMF). These forecasts are similar to those of the European Commission, i.e. prudent on GDP and seriously underestimating fiscal deficits, with IMF forecasts most unreliable (partly owing to the fact that they are conducted slightly earlier than those of the other two international organizations).

[7] Revisions are defined as the differences between the final outcome of each year and the figure appearing as the first provisional estimate (in the EDP of March the following year).

Figure 13. Deviations of General Government balance from final data (% of GDP), excluding the impact of ex-post statistical revisions, 2000 – 2009



Sources: Authors' calculations based on Ministry of Economy and Finance, *Update of the Hellenic Stability and Growth Programme*, Athens (various issues), European Commission (2010), *General Government Data, Part II: Tables by series*, Spring 2010, European Commission, European Economy, Brussels (various issues), OECD, *Economic Outlook*, Paris (various issues) and IMF, World Economic Outlook, Washington D.C. (various issues).

The major conclusions one can draw from this short analysis are rather clear. Budget balance targets in Greece were being missed, while on the whole revenue shortfalls and expenditure overruns appear to be equally responsible for missing these targets. Despite the fact that the Greek constitution envisages a powerful role for the Parliament in the approval of the State budget, in practice the Parliament had little information and, therefore, power to monitor the execution of the budget it had approved. At the same time, international organizations failed to effectively act as signaling mechanisms. The previous analysis has also demonstrated that the widely held view that optimistic assumptions on GDP growth are largely responsible for unrealistic forecasts for public revenue and expenditure is not accurate. Despite the fact that the economy did appear to grow in line with what the government (and other international organizations) had assumed, budgeted revenues did not find their way into the public purse, while expenditures (especially primary expenditures) were not kept under planned control. All these conclusions point to the same direction: the weak institutional framework for setting up and monitoring the execution of the budget is the fundamental reason for the weak fiscal performance and, therefore, any attempt to correct fiscal imbalances is rather doomed to fail unless the reform of this framework is also given serious thought. The following section puts forward some ideas on possible ways of improving this institutional framework.

4. Improving the domestic fiscal framework in Greece: some proposals

A detailed analysis of the ways in which the institutional framework for setting, executing and evaluating the budget should be reformed is perhaps beyond the scope of the present paper.[8] We will, however, attempt to lay out some key dimensions of such reform in the areas of budgetary procedures, tax administration and also regarding the possible role of an independent fiscal council.

4.1 Budgeting procedures

The issue of poor budget management in Greece, already identified in section 2 of this paper, is neither neglected nor newly discovered. There is indeed a long series of studies identifying the key aspects of this issue and proposing ways for reform, see for example HM Treasury (2002), Diamond et al (2005), IMF (2006), Rapanos (2007), Hawkesworth et al (2008), OECD (2010), Vraniali (2010). A very brief outline of the main weaknesses of the budgeting framework in Greece can be summarized as follows[9]:

- Lack of transparency. The drafting of two separate budgets (the ordinary and the investment budget) with overlapping expenditure categories, the existence of significant off-budget operations, the lack of coherent reporting of the finances of general government bodies not included in the central government (i.e. local authorities, social security funds and hospitals), are the main elements introducing confusion and ambiguity regarding fiscal aggregates and impede any meaningful breakdown of these aggregates.
- Lack of a medium-term budgetary framework. The budget drafted each November concerns the following calendar year. Although the approval of an annual budget involves important decisions on budgetary policy and is a key step, most fiscal measures have budgetary implications that go well beyond the yearly budgetary cycle (see section 2.2 above). Therefore, a single year perspective provides a poor basis for fiscal planning. The government did

[8] For a recent review of several aspects of public financial management and budgeting, see Shah (2007) and, more specifically on Greece, see Rapanos (2007), Vraniali (2010) and OECD (2010).
[9] For more detailed comprehensive reviews, see Rapanos (2007) and Vraniali (2010).

submit every December an update of the Stability and Growth Programme with a three-year horizon. Such updates, however, were usually not submitted to Parliament, while fiscal targets set for the medium-term were not binding. They were drafted in order to meet the obligations set in the Stability and Growth Pact, but did not reflect in a reliable way the strategic goals and objectives of the government.

- No program budgeting. International practice has shown that public funds are more effectively used in the framework of a program budgeting system with a focus on policy objectives, which addresses the quality of expenditure, reviews program results and addresses value for money. In the Greek case, the expenditure control and accountability framework is characterized by excessive and overlapping ex ante controls and ex post multiple expenditure controls inclined towards compliance and legality (Vraniali, 2010). Furthermore, input budgeting in the framework of an extremely detailed budget structure makes the budget inflexible and results in thousands of budget adjustments per year (OECD, 2010).[10]
- Weak top-down budgeting process and lack of real accountability. The Greek budget preparation is to a large extent a bottom up exercise. Line ministries enjoy a large degree of freedom to propose their spending wishes with little early guidance from higher levels of government. They have little incentives to think in terms of reallocation and prioritizing instead of asking for additional funds. In the present system, the Ministry of Finance interferes at all stages of the budget process at a very detailed level, thus eliminating any sense of ownership of the line ministries budget, attenuating their accountability and removing any incentive for improvement in the management of public funds.
- Organisational weaknesses. The General Accounting Office, which is entrusted to monitor the execution of the Ordinary (but not the Investment) Budget, has no coherent information system that will enable it to have an overview of total public revenues and expenditures at any point in time. Local information systems managed by e.g. local fiscal audit offices or different bodies of the central or general government are not on-line with the General

[10] In 2007, for example, there were 6,650 budget adjustment decisions, which regarded reallocations of expenditures (OECD, 2010).

Accounting Office, thus making the collection of information on both the revenue and the expenditure side a hard task.

The directions of desired reform are rather self evident, if the above weakness of the Greek budgetary framework are set against the main features of a system of sound budgetary procedures identified by, for example, the European Commission (2009a) and briefly outlined in section 2.3 above. The list of budgeting reform recommendations is indeed long and has been analysed in detail by other authors (e.g. OECD, 2010, Rapanos, 2007, Vraniali, 2010), but its main elements can be summarized as follows:

1. Consolidate budgeting procedures by merging the ordinary and the public investment budgets and placing them under the auspices of the General Accounting Office. The latter should be given more autonomy, with a permanent undersecretary as its head.
2. Introduce a new accounting system compatible with the International Public Accounting Standards for all bodies of the general government.
3. Improve the timeliness and reliability of budget execution reports. There should be full computerization of all transactions, while all offices of public expenditures should be connected on line. The General Accounting Office should draft and make available monthly reports monitoring **all** expenditures of central government, local authorities and public entities.
4. Introduce a new effective internal auditing system, but also use external auditors. Audits should not be limited to checking formal compliance with procedures, but should also address the quality of expenditure, make performance assessment, or even assess risks in terms of "sustainability". The French case of *Cour des comptes* could serve as a useful point of reference (Lefas, 2010).
5. Introduce stronger top-down budgeting. As OECD (2010) notes, a more top-down process, where early decision is taken on overall expenditure which is then subdivided into ministerial ceilings has shown to be more effective in constraining costs and making the line ministry feel ownership for fiscal decisions within the ministry. In this context, line ministry autonomy and accountability should be strengthened, while the primary responsibility for budget execution should be transferred to spending units.

6. Introduce program budgeting. More focus should be given to policy objectives and more attention should be paid to the quality of public expenditure and the results of public expenditure programs (for a comprehensive review of program and performance budgeting, see OECD, 2002 and 2007).
7. Introduce national fiscal rules, incorporated in law, which should be open, transparent and comprehensive of all fiscal activity of the public sector. Greece could benefit from the international experience on the implementation of national fiscal rules (see section 2.1 above).
8. Introduce a medium term fiscal framework, incorporating multiyear estimates (e.g. on a three-year horizon) which reflect the strategic goals and objectives of the government. Such estimates could serve as the basis for top-down budget ceilings.
9. Consider the introduction of "accruals accounting". Such a system could enhance transparency in the allocation of public funds and the impact of commitments, and improve the decision making progress (Blöndal, 2003). Cash accounting practices need not, however, be removed, as they serve as a necessary basis for the operating, investing and financing activities of the government (Vraniali, 2010).

In recent years, there have been some attempts to address some of the weaknesses listed above. The Introductory Report for the 2007 Budget, for example, attempted to introduce a unified expenditure classification system covering both the ordinary and the investment budget (see Ministry of Economy and Finance, 2007). Beginning with the 2008 Budget, the Greek government launched reforms to its public financial management, through e.g. establishing a Government Budget Reform Unit with the aim of introducing initially at a pilot basis a results oriented program budgeting system.

Perhaps the most wide-ranging attempt to reform public financial management in Greece has been Law 3871/2010 on "Fiscal Management and Responsibility", which was voted in August 2010. A detailed description and evaluation of the new provisions are perhaps beyond the scope of the present paper, but it is worth mentioning a few points of key importance. The new Law introduces a medium-term budgetary framework for the general government to be approved by the Parliament. This framework includes detailed fiscal targets, a clear reference of the macroeconomic assumptions on which fiscal forecasts are based, sensitivity analysis of fiscal targets, identifications of main upside risks, etc. A top-down approach is introduced for public expenditure, since ceilings for all levels of general government (and also by Ministry) will be included in the budget on a three-year horizon. All bodies of the central government, local authorities and social security organizations (including hospitals) are required to draft annual budgets and communicate to the General Accounting Office on a monthly basis reports including data on expenditures, revenue, financing and liabilities, on a cash basis. The General Accounting Office is required to submit to Parliament and make available to the press consolidated reports at a general government level covering public revenue, expenditure, liabilities and financing on a monthly, quarterly and biannual basis. In this way, the execution of the general government budget will be closely and transparently monitored. Internal audit procedures for public expenditures are specified in detail and a double-entry accounting system is introduced for the central administration. A unified expenditure classification system is introduced for all levels of government and the scope for expenditure reallocations is seriously limited. Important amendments to the approved budget (e.g. if public borrowing requirements exceed the budget forecast by more than 10%) have to be approved by the Parliament, after the Minister of Finance has submitted a Complementary Budget.

The scope of the proposed reforms to the Greek budgeting framework is indeed ambitious and the extent to which they will transform the quality of fiscal governance remains to be seen in practice. However, close scrutiny allows one to identify some areas of potential concern. International experience has shown that national fiscal rules (e.g. expenditure rules, balanced-budget rules for certain levels of general government, etc.) can play an important disciplining role. No such rules are introduced. Furthermore, the medium term plan has to be submitted to Parliament by mid-April and be approved by mid-May. In case the Minister of Finance realizes that the assumptions or forecasts of the plan have changed by September, he has the right to submit to Parliament an update of the medium term plan, which will be more in line with the annual budget to be approved for the next year. If we also take into account the obligation of the Greek government to submit an update of the Stability and Growth Programme to the European Commission every December, one starts wondering about the degree of commitment to and binding power of "rolling" medium-term targets.

Given the mounting level of public debt, one would expect draconian measures to be introduced regarding public borrowing procedures for all levels of general government. The new Law indeed envisages such procedures regarding the financing of the State budget (i.e. central government). The discretion left to other levels of general government (for example local authorities) regarding both levels of borrowing and borrowing procedures is inexplicably large and rather worrying.[11]

One of the apparent intended aims of the new Law is to introduce accruals accounting. In general, reporting on an accruals basis implies that revenues are recorded when they are “earned” (verified), while expenditures are recorded when they are incurred. Several developed countries (e.g. the United States, France, the UK, Australia and New Zealand) have opted for such an accounting system for their government accounts, with a view of making the cost of government action and the impact of commitments more transparent and to improve the decision making process (Blöndal, 2003, Khan and Mayes, 2009). In the Greek case, a kind of accruals accounting is introduced for public revenues, since the budget of a certain year will include revenues verified within this year or verified, but not cashed, in the previous year. Strict accruals accounting would not allow the transfer of the latter kind of revenues. In case verified revenues are not cashed within the budget year, the possibility is open for negative surprises at the end of the year regarding the size of the budget deficit. Furthermore, one can not see why accruals accounting is not introduced for public expenditure as well.

Despite the above points of criticism, the importance of the Law 3871 should not be underestimated. It could be the starting point of a radical reform in public financial management in Greece. Whether this will indeed be the case depends on a number of factors. As international experience shows, any reforms in fiscal governance are foremost political processes, and not just technical ones, have to be based on realistic timescales, need country ownership and political commitment and, most importantly, be in line with a country’s historical, political and social heritage.

[11] The Minister of Interior Decentralization and E-Government announced in late January 2011 that a series of measures will be endorsed for containing local government debt, once the recording of the financial position of municipalities has been finalized by end February 2011.

4.2 Tax reform and tax administration

The large revenue shortfalls identified in section 3 can at least partly be attributed to the poor performance of tax administration mechanisms in Greece and the related problem of widespread tax evasion.[12] Most Greek governments, in the recent past, have acknowledged this issue and announced their firm intention to address it, mainly through adopting new pieces of legislation that would supposedly enhance revenue collection and intensify tax controls. The numerous tax reforms introduced year by year involved mainly changes of tax bases and tax rates, while the structural weaknesses of the tax and tax administration systems remained intact.

The recent fiscal crisis spurred renewed interest in the aim of containing tax evasion, as an effective way of raising tax revenue and spreading the costs of fiscal adjustment fairly. Over the last months, the government has announced a series of measures involving increases in tax rates on the one hand, and ways of combating tax evasion on the other, including intensified tax controls and lifting bank secrecy. In general the adopted measures aiming at the containment of tax evasion are in the right direction, but a more ambitious approach is necessary in order to address the weaknesses of the institutional framework of the tax system and tax administration mechanism.[13]

The importance of tax administration in the proper functioning of any tax system has long been recognized. The main mandate of tax administration mechanisms is the enforcement of tax laws, which are indeed extensive in their range and nature, involve many persons and businesses and result in the collection of a vast bulk of revenues needed to support the state (Crandall, 2010). In this respect, the effectiveness, efficiency, fairness and impartiality of revenue collection mechanisms are key ingredients of a good tax system. In Bird's (2004) terms, effectiveness requires establishing an environment in which citizens are induced to comply with tax laws voluntarily, while efficiency requires that this task be performed at minimum cost to the community.

As perhaps expected, there is no single set of prescriptions that, once introduced, will automatically ensure improved tax administration in any country. Nevertheless,

[12] For a recent attempt to estimate its extent, see Mylonas et al (2010).
[13] For a recent insightful view on the weaknesses and ways of improving the tax administration mechanism in Greece, see Bank of Greece (2010), pp. 170-181.

certain aspects seem to characterize good tax administration systems (Bird, 2004 and 2008). First, a tax administration must have adequate resources in terms of manpower, infrastructure and an appropriate organizational structure. Second, a tax administration needs an information system to ascertain the existing and potential tax base, including the collection of information from potential taxpayers themselves, from third parties, and from internal sources of the tax administration through an internal communication system. Third, a tax administration needs a system of penalties for non-complying taxpayers, where the structure, severity and coverage of penalties are carefully planned, and perhaps also a system of rewards for complying taxpayers. Fourth, a tax administration must select strategies and set out administrative rules to counter each type of non-compliance by different groups of taxpayers. Finally, since no tax administration is flawless, provision must be made to redress mistakes, aiming at both redressing taxpayer grievances (appeals, administrative remedies, ombudsmen), and identifying and correcting (or preventing) errors by the tax administration (internal reviews, inspection and anti-corruption).

Based on this set of principles and also taking into account international experience, as well as the features of the Greek reality, an approach aimed at improving tax administration in Greece could indicatively (though not exhaustively) include the following:[14]

1. Reorganising and consolidating tax administration offices and appointing members of staff on the basis of meritocracy and not party affiliation criteria. Giving more autonomy to tax administration by, e.g. appointing a permanent undersecretary as its head with a term of office exceeding the electoral cycle could enhance its effectiveness.[15]
2. Simplifying and rationalizing the entire tax system. It is not possible to address issues of enhancing the efficiency of tax administration without taking into account both the degree of complexity of the tax structure and the extent to which this structure remains stable over time.[16] Tax provisions are currently scattered in numerous pieces of legislation, complicating the task of tax auditors and tax payers alike. Tax provisions should be encoded in one body

[14] For a more detailed analysis, see Rapanos and Kaplanoglou (forthcoming).
[15] There are several studies on the various aspects of autonomy in tax administration and on the international experience regarding the ways to improve the effectiveness of tax administration, see e.g. Crandall (2010), Kidd and Crandall (2006), Kidd (2010).
[16] Complexity and its implications for tax administration has long been an issue of concern in many developed countries, see for example IRS (1988).

that the Ministry of Finance would upload and continuously update on its website.

3. Radically changing the tax audit system. Tax audits should be organized on the basis of centralized controls that identify individuals or enterprises with high risk of evasion. This method should replace the current enormous discretion of individual tax officers which creates incentives for corruption.
4. Stopping resort to "tax amnesties". In theory a tax amnesty could be effective if it is given to wipe off old offences in order to launch a new era of tough tax enforcement. International evidence shows that *repeated* tax amnesties generally signal that the government is unable to enforce taxes effectively. Such policies have been proved common in Greece whenever revenue receipts fell short of targets, have worked clearly for the benefit of those who evade taxes and have created strong incentives for tax evasion.
5. Creating an effective dispute resolution mechanism, so that resort to tax courts becomes the last solution.
6. Improving the efficiency of the judicial system. Currently revenues worth millions of euros are blocked in courts for several years until decisions are taken. Tax courts should make decisions in a speedier manner.
7. Aligning tax audit practices with those of other OECD countries for the purpose of tackling new forms of tax evasion in a globalised setting.

Reforming tax administration is not a short-term exercise, and quickly increasing the tax take through more vigorous collection efforts does not guarantee sustainable improvement.[17] Improving tax administration is rather a long-term game of building up adequate domestic institutional capacity, while the chances of success rest with a number of factors, such as a clear recognition at high political levels of the importance of this task and the cultivation of a higher level of trust between the citizens and the government. The latter could certainly be reinforced in the case of Greece, if taxpayers were viewed by the tax authorities as "clients", who are not necessarily willing ones but whose needs must be met, and not simply thieves to be caught. Last but not lease, such trust

[17] The example of Argentina is particularly interesting, where better tax administration increased revenues markedly (from 13 to 23 percent of GDP over the 1989-92 period. However, this increase was not sustained over time since political pressures soon offset the increase in the tax ratio (Martinez-Vasquez, 2001).

would also buttressed if the soundness and perceived fairness of public expenditures that tax revenues finance also increased.

4.3 The Greek Parliamentary Budget Office: can it be a success story?

The potential role of an independent fiscal authority in improving fiscal performance has already been analysed in section 2.4 above. However, the setting-up of an independent fiscal authority does not automatically imply that its role will be played effectively. The experience of countries where such councils do act effectively shows that establishing and maintaining an independent research unit that provides objective budgetary information and exerts peer pressure in the formation of fiscal policies is an important challenge. It seems that certain fundamental characteristics must be present in order for the council to be successful.

Foremost is its independence from the government, all political parties and any pressure groups, that is its nonpartisan character. As Anderson (2009) stresses, "'nonpartisan' is much different from 'bipartisan': the former connotes lack of political affiliation; the latter connotes affiliation with both (or all) political parties." It is, therefore, of critical importance the members of the independent fiscal council to be appointed on the basis of their merit and professional capability, and not in a way that satisfies the political parties that will be called to appoint these members, in an effort to seek a bipartisan equilibrium. If the composition of the independent fiscal council turns out to be the result of a political compromise, its effectiveness and credibility will be seriously undermined from the very outset (Rapanos, 2010). To cite a recent example, the appointment of Robert Chote as the new Chair of the Office for Budget Responsibility in the UK in October 2010 was justified on the grounds that "he is very well qualified professionally for the post, having demonstrated his independence of mind and expertise during his time at the Institute for Fiscal Studies" (UK Parliament, 2010). In order to further enhance the independence of the PBO, one of its members could be a public finance expert from abroad, as is the case with e.g. the Swedish Fiscal Policy Council. Another parameter that contributes to the actual independence of a fiscal council relates to the duration of its members' mandate. It is advisable for this duration to exceed the government's term of office. In several countries it has been set to 5 years, and council members can only be replaced in case of a serious breach of their duties. Their dates of appointment could be different, so as for their terms not to expire simultaneously.

A further issue relates to where the fiscal council is accountable to and its sources of financing. The practice followed in other countries is not universal. In some countries (e.g. the US and Canada) the council reports to parliament (Congress); in others it operates under the Ministry of Finance (e.g. the Netherlands, Chile); while in certain others it reports to government (Sweden) or is a totally independent authority. In the case of countries with powerful single-party governments that enjoy absolute control over budget preparation and implementation, placing the independent fiscal council under the auspices of the parliament is a rather appropriate choice (see Anderson, 2009, Schmidt-Hebbel, 2010). As regards the financing of the council, in other countries this is usually covered by government or parliament funds, while a small fraction is offered by the private sector. Financing an authority with funds from the government, the policies of which this authority is called to transparently and objectively assess, could potentially be a problem. In practise, however, reducing the funds available to the council as a result of its criticism is rarely attempted since it entails a huge political cost for the government, exactly because such actions are widely publicised.

A connected issue relates to the recruitment of specialised and properly trained personnel for the council. The number of people supporting the work of fiscal councils varies significantly across countries, from 4 people in Sweden to roughly 250 people in the US (CBO), and the scope of activities these councils can undertake is of course conditional on that number. Regardless of their precise number, strong professional leadership and high quality analytical staff are a key aspect (Rivlin, 2010).

A final issue of critical importance for a fiscal council to gain credibility for its assessments is to make all of its reports and analyses available to the public and the press, and try hard to make them clear and readable to all. Enhancing the transparency in the conduct of fiscal policy is possible, only when information is disseminated, accessible and understandable to all, and not just to a small number of technocrats or to the members of parliament. This has been the case with all active independent fiscal councils, which have managed to build up the reputation of providing reliable assessments, and of being truly independent and unbiased.

Perhaps the best blueprint for an effective independent fiscal council is given by Alice Rivlin, the first director of the Congressional Budget Office of the U.S.. She eloquently identifies four aspects on which the acceptance of CBO by the political players rests (Rivlin, 2010):

1. It has had strong professional leadership and attracted high quality analytical staff.
2. It has been aggressively non-partisan and never allowed politicians to appoint members of staff.
3. It never makes recommendations on policy matters, but offers estimates of budgetary costs or analysis of options and alternatives. It has always tried to help politicians evaluate their choices and steadfastly refused to tell them how to choose.
4. It makes all of its reports and analyses available to the public and the press and tries hard to make them clear and readable.

In Greece, in July 2010, the government submitted to Parliament a Draft Bill, which envisages the establishment of a Parliamentary Budget Office under the aegis of the Parliament. Establishing such an office is with little doubt a move in the right direction. What Greece lacks today is credibility, not only in its fiscal policy but also in the quality of its fiscal data. Rebuilding confidence is a long process and the Parliamentary Budget Office could play the role of a catalyst in this process. But what are its chances of doing so?

According to the legal provisions, the Greek Parliamentary Budget Office administratively belongs to the Secretary General of the Parliament and submits its reports to the Special Standing Committee responsible for examining the Financial Statement and the General Balance Sheet of the State.[18] Its mandate is defined rather generally as “collecting information on the State Budget, classifying it in a systematic way, and providing general support to the Parliament work”. The Ministry of Finance and other government agencies are required to provide all necessary data. The Parliament is responsible for financing the Office, which will be staffed by 10 members in total with university or high school education.

Financing the parliamentary budget office with funds from the Parliament’s own budget (approved only by the Parliament itself and not by the Ministry of

[18] This committee is a sub-Committee of the Standing Committee on Economic Affairs.

Finance) and placing it under the auspices of the Parliament are right choices in the case of Greece, because the legislature can now potentially be on a more equal footing with the executive branch.

However, the prospects for this office to effectively fulfil its intended goals are not favourable. First of all, its mandate appears rather poor and imprecise. Most importantly, the key requirement for wide publicity of the office's reports is not met. If the office's reports are accessible only to Members of Parliament, the amount of peer pressure to the executive branch does not increase, and hence fiscal transparency is not enhanced. The structure of the office is not clear, neither is the way the staff members will be appointed, while the impression is given that high professional skills, experience and competence, are not an evident requirement. Terms of appointment are not specified and the non-partisan character of the Office's leadership is also under question. Evaluating the design of the Greek PBO in terms of Rivlin's four points, one feels that it does not score high in any single one of them.

The above criticism is not meant to imply that the Office is doomed to fail. The legal provisions for the creation of the Office do allow sufficient flexibility, for its effectiveness to be enhanced. The choice of a chairman with high professional qualification and independence of mind, the recruitment of competent staff, the specification of the core functions to be performed along the lines described earlier and the accessibility by all to the Office's analyses are profoundly issues of critical importance. All these, however, remain to be seen in practice.

5. Conclusions

The activist fiscal policies in response to the recent financial crisis and the deep recession, and the serious fiscal imbalances now facing many countries, including those of the euro area, suggest that the mechanisms for ensuring fiscal discipline face new challenges. A broad consensus has emerged that the domestic institutional settings of a country are of primary importance for the conduct of sound fiscal policies, since such settings create the environment, the incentives and the constraints under which fiscal policy decisions are taken. Thus, recent discussion on fiscal governance has focused on precisely how *domestic* fiscal frameworks can be institutionally strengthened.

Greece is a prime example of how poor fiscal governance, if combined with other negative factors such as the instability of global financial markets, can indeed lead an economy to the brink of financial collapse and at the same time create a systemic problem for a common-currency area as a whole. In the case of Greece, as well as of quite a few other European countries, primary public deficits and a high level of public debt are likely to persist for a long period of time. So is the skepticism of world financial markets and, thus, an even distant threat of default. In such an environment, the adoption of fiscal consolidation packages that will reduce the size of the public deficit is simply inadequate, unless institutional mechanisms that will enhance commitment to credible, sustainable and growth-enhancing long-run fiscal plans are also put in place.

As our research has shown for Greece, the accumulation of public deficits appears to have been a choice of governments, rather than the unfortunate result of macroeconomic conditions turning out less favourably than expected. At the same time, there were no mechanisms in place, either internal or external, that would effectively pinpoint the systematic deviations of public revenues and expenditures from the targets set, and act on their containment. In this respect, the fundamental reason underlying poor fiscal performance in Greece has been weak fiscal institutions and inadequate public financial management. Thus, unless serious effort is directed towards increasing the effectiveness of such institutions and in strengthening public financial management at all levels of government, Greece runs the danger of seeing the fruits of the very painful fiscal effort undertaken being wasted once the severity of the present situation has been hopefully overcome in a few years time.

The news is not all bad. There is a growing accumulation of both theoretical studies and practical experience of countries around the world which have faced in the past or are currently facing similar challenges. The importance of certain elements of sound fiscal governance like national fiscal rules or well structured budgetary procedures, seems to have been established beyond much doubt. The optimal balance between different forms of fiscal restraints, e.g. rules versus fiscal councils, is still a matter of ongoing debate (see Krogstrup and Wyplosz, 2007, and Debrun and Kumar, 2007), and as perhaps expected a "one size fits all" approach is an unavailable luxury. Furthermore, Greece appears to be in such an embryonic stage regarding almost all aspects of fiscal governance, that the potential gains to be yielded from a serious reform of the national fiscal framework along the lines proposed in this paper are indeed large. Such gains do not simply refer to the arithmetic reduction of the fiscal deficit, but range from promoting a fair distribution of the tax burden through the effective tackling of tax evasion to enhancing economic growth through addressing issues of the quality of public finances.

The need for reforming public financial management in Greece seems to have been realized by Greek authorities and to have been highly prioritized by the international organizations surveilling the Greek economy. The first steps have been done, but a lot more is still under question and remains to be seen in practice. Moreover, as Pretorius and Pretorius (2008) note, the successful implementation of such institutional reforms requires high-level political commitment and public support. From a political economy perspective, Greece’s record on both has been particularly low in the past. Under the present situation political commitment is at least in the medium term strengthened by the commitments the government has undertaken vis-à-vis the three international organizations, but is an open bet after these organizations will stop their surveillance. Regarding public support, in our view it can be built up only if the public is convinced that the burden of fiscal adjustment will be spread fairly and that this adjustment will not seriously hamper the growth prospects of the economy and destroy social cohesion.

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