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- Budgeting in Luxembourg: Analysis and recommendations

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OECD Journal on Budgeting

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Budgeting in Luxembourg: Analysis and recommendations

by
Dirk-Jan Kraan, Lisa von Trapp, Valentina Kostyleva *and* Joachim Wehner*

This report surveys fiscal planning, financial reporting, internal audit, policy evaluation and steering of executive agencies in Luxembourg, and provides recommendations to the Ministry of Finance of Luxembourg to adjust its institutions in these areas. The report also looks at the consistency of the budgetary institutions of Luxembourg with new requirements of the European Union, and makes recommendations for adjustments in order to ensure that European requirements are met.

JEL classification: H300, H600, H800

Keywords: budgeting, Luxembourg, fiscal planning, financial reporting, internal audit, evaluation, European requirements, fiscal rules, medium-term budgetary framework, steering of executive agencies

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Executive summary

Aim and content of the report

In the summer of 2010, the Minister of Finance of Luxembourg asked the OECD Secretariat to support an internal analysis of the budget process. The analysis was to be based on guidelines. For that purpose, a team of the OECD Secretariat[1] undertook a mission to Luxembourg on 29 and 30 November 2010 and studied documents made available by the Ministry of Finance. During the mission, the team met with various divisions of the Ministry of Finance and with the officers responsible for finance of two line ministries.

The guidelines for the analysis are basically threefold:

- adjustment and development of instruments for a more strategic budget process that reflects the policy priorities of the government and that complies with the new requirements of the European Union;
- better control of the central government budget through enhanced short-term, medium-term and long-term planning;
- more focus on the quality of public expenditures by enhancing transparency and accountability concerning outputs and outcomes, simplification of the budget classification, and more emphasis on evaluation of policies.

In view of the guidelines, the current report focuses on a limited number of subjects, notably:

- fiscal planning;
- financial reporting, internal audit, and evaluation;
- the consistency of institutions with new European requirements as currently considered by the Commission and the Council of the European Union;
- the steering of executive agencies.[2]

Fiscal planning

Concerning fiscal planning, the OECD Secretariat recommends the following set of reforms for consideration by the authorities of Luxembourg:

a) The incorporation of medium-term baseline figures into the budget estimates, at the line-item level, and for the same number of years (between three and five) covered by the expenditure framework.

b) The adoption of a medium-term expenditure framework, covering the same period as the new medium-term estimates. At a minimum, this framework should impose an aggregate ceiling on expenditures in the central government budget, including interest payments on debt; the number of sub-ceilings (at the ministerial level), and whether to adopt a rolling or periodic framework, should be subject to further discussion.

c) The adoption of a fiscal rule in the form of a trend-based balance rule; this will allow for counter-cyclical fiscal policy and predictable expenditure in uncertain times. In addition,

the authorities may consider putting some constraint on tax expenditures and tax relief, for instance by a "pay-as-you-go" rule for the revenue side of the budget.

d) The implementation of a programme-based budget classification but without a complex performance measurement regime. This reform requires strong budget units in line ministries, political support from the relevant minister, and early consultation with Parliament on the design of programmes. Performance information can be added to the budget documentation if it can be shown that such information has impacted on allocational decisions.

e) The introduction and publication in the budget documentation of systematic sensitivity analysis of the impact of deviations from key assumptions, to enhance awareness of key fiscal risks and promote prudent policy choices.

f) The imposition of specific sub-ceilings on aggregate expenditure for each line ministry in the budget circular; these sub-ceilings should not add up to the maximum total decided in the medium-term framework, but should leave a "budget margin" or contingency reserve of about 2% of the total planned expenditures.

g) The introduction of horizontal explanations (comparing figures across fiscal years within the same set of estimates) and vertical explanations (comparing figures for a given year across successive sets of estimates) as an integral part of the budget documentation, to complement the new medium-term programme-based baseline estimates.

h) The creation of a spending review mechanism co-ordinated by the Ministry of Finance. This should be closely aligned with revision of the expenditure framework, regardless whether it is fixed or flexible (periodic review is more fitting to the former; continuous review is more fitting to the latter).

i) The conversion of extra-budgetary special funds that are used for managing earmarked taxes, fees and other non-tax revenues, into budgetary funds.

j) The abolition of all special funds that are fed exclusively by budgetary appropriations. Simultaneously, the carry-over rules should be reviewed and revised in order to make sure that appropriations for investment projects can be more easily transferred to the next budget year in cases of unexpected delays.

Financial reporting, internal audit, and evaluation

Concerning financial reporting, internal audit, and evaluation, the OECD Secretariat recommends the following set of reforms for consideration by the authorities of Luxembourg:

k) In line with best practice and European requirements,[3] Luxembourg should publish monthly financial reports. In addition, an explanation of the reasons for the differences in the data from the government budget, from ESA95 and from STATEC would help mitigate potential confusion on the part of Parliament and the public. Luxembourg may also wish to consider a mid-year report, which could be of particular use for informing the parliamentary committees overseeing the budget.

l) Luxembourg should seek to move from a system of *ex ante* control to *ex post* controls in the form of internal audit, in connection with the introduction of a more programme-oriented budget classification. In line with other countries that have introduced internal audit, Luxembourg could maintain a preventive *ex ante* check by the Financial Control

Directorate of the Ministry of Finance on compliance for expenditures exceeding certain thresholds or of certain types.

m) The introduction of internal audit requires a central harmonisation unit, based in the Ministry of Finance, and internal auditors working independently in, and reporting to the management of, ministries or agencies. A relationship of trust between the internal auditors and management is critical to successful risk management. Internal audit units in ministries or agencies should remain small and focused. Ultimately, while internal auditors and external auditors have common interests, the OECD Secretariat does not recommend that internal auditors be given an assurance task; this should be left to external audit. The Financial Control Directorate can be reorganised to form the central harmonisation unit (CHU) and be partly decentralised to form the internal audit units of the ministries and agencies.

n) Luxembourg may wish to consider introducing periodic performance evaluations to enable line ministries to assess the efficiency and effectiveness of their programmes. The credibility of such evaluations is enhanced when they include outside experts. Luxembourg has some experience with using universities and research institutes, and such partnerships could be expanded. It is useful to develop both criteria for the selection of programmes to be evaluated and a set of rules regarding evaluation. Concrete examples which Luxembourg can draw upon exist in many OECD countries.

Consistency with the new European requirements

The budget institutions of Luxembourg are mostly consistent with new European requirements as currently considered by the Commission and the Council of the European Union.

However, some of the recommendations on fiscal planning, and on financial reporting, audit and evaluation, formulated by the OECD Secretariat for domestic purposes, are also important for compliance with the new European requirements. This concerns the recommendations *a)*, *b)*, *c)*, *e)* and *k)* above.

In addition, the OECD Secretariat makes some recommendations that are specifically aimed at meeting European requirements:

o) The improvement of local statistics and accounting should also become a part of the reform agenda in Luxembourg. In this connection, it is also important that the authority of the Court of Accounts be extended to the audit of local accounts and statistics in order to ensure compliance with the new European legislation.

p) Concerning the formulation of escape clauses in fiscal rules, the OECD Secretariat sees no need to formulate such clauses. In the absence of such clauses, the European requirement that escapes should be limited is automatically complied with.

q) Regarding the introduction of an expenditure rule, as it is foreseen by the revised preventive arm of the Stability and Growth Pact, the authorities may wish to study the consequences of such a rule for Luxembourg more thoroughly. If Luxembourg were to adopt a "pay-as-you-go" revenue rule in addition to a medium-term expenditure framework based on a trend-based balance rule, the "principle of prudent fiscal policy" suggested by the European Commission and which the rule should promote would automatically be complied with.

r) Luxembourg should step up its efforts to provide medium-term baseline estimates for sub-national expenditures and revenues.

s) Luxembourg should step up its efforts to publish detailed information on tax expenditures and their impact on government revenues. The best way to proceed might be to develop a good national definition of tax expenditures and to participate further in the international and European discussion in this regard.

Steering of executive agencies

Concerning the steering of executive agencies, the OECD Secretariat recommends the following set of reforms for consideration by the authorities of Luxembourg:

t) To formulate a clear policy with respect to the status of executive units, containing explicit criteria for the application of each status. Such a policy can take the form of a multi-year administrative reform plan.

u) To require that all arm's-length and independent agencies establish a financial administration based on accrual accounting.

v) To abolish all exceptions to government-wide standards of operational management for arm's-length and independent agencies that carry out administrative tasks, and formulate special standards of operational management for arm's-length and independent agencies tasked with service delivery in kind.

w) To separate the budget process from the output steering process in arm's-length agencies. The financing of agencies should be based on robust rules reflecting the capacity to handle a certain workload (capacity budgeting) and not on the basis of specific estimated outputs. Output steering should be organised in a separate process that can be characterised as a permanent performance dialogue. Independent agencies need a budget process based on capacity, but not a permanent performance dialogue, since the minister by definition is not responsible for executive policy in independent agencies.

x) To establish capacity in the financial directorates of line ministries and in the Ministry of Finance to support a line minister in the budget discussions with agency heads under his/her responsibility.

y) To make sure that the minister is supported by output experts, notably the heads of division for policy making, in the permanent performance dialogue with the heads of arm's-length agencies.

z) To introduce an automatic productivity cut of 1 or 1.5% and apply it to the last out-year of the medium-term baseline estimates of the operational costs of all executive units inside the state (executive units in the core ministries and *services à gestion séparée*).

aa) To consider applying the annual productivity cut also to the operational costs of the *secteur conventionné* (notably including social insurance institutions and hospitals) which is outside the general government sector but mostly financed by public means.

1. Introduction

1.1. Aim and contents of the report

In the summer of 2010, the Minister of Finance of Luxembourg asked the OECD Secretariat to support an internal analysis of the budget process. The analysis was to be based on guidelines. For that purpose, a team of the OECD Secretariat undertook a mission to Luxembourg on 29 and 30 November 2010 and studied documents made available by the

Ministry of Finance. During the mission, the team met with various divisions of the Ministry of Finance and with the officers responsible for finance of two line ministries.

The guidelines for the analysis are basically threefold:

- adjustment and development of instruments for a more strategic budget process that reflects the policy priorities of the government and that complies with the new requirements of the European Union;
- better control of the central government budget through enhanced short-term, medium-term and long-term planning;
- more focus on the quality of public expenditures by enhancing transparency and accountability concerning outputs and outcomes, simplification of the budget classification, and more emphasis on evaluation of policies.

In view of the guidelines, the current report focuses on a limited number of subjects. It does not cover the entire budget process and can thus not be seen as a "traditional" budget review. In particular, the report briefly surveys the basic economic and political statistics of Luxembourg, its budget institutions and fiscal policy (this section), and then discusses fiscal planning (Section 2), financial reporting, internal audit and evaluation (Section 3), consistency with new European requirements as currently considered by the Commission and the Council of the European Union (Section 4), and the steering of executive agencies (Section 5).

1.2. Basic statistics

Luxembourg is a relatively small country in terms of geographical area and number of inhabitants (its population is greater than only Malta's among members of the European Union). A substantial proportion of its inhabitants hold foreign nationality. Gross national income per head is the highest in the European Union, due partly to the large proportion of cross-border workers that are not counted in the denominator. The gross domestic product is determined in a large part by the service sector (mainly financial services and services to business). Table 1 summarises the basic economic and political statistics of Luxembourg.

1.3. Budget institutions

1.3.1. Parliament, government and Court of Accounts

Luxembourg is a parliamentary democracy. The Cabinet is appointed by the Grand Duke and needs the confidence of the unicameral Parliament. The ministers are responsible for every act of the government. In the area of fiscal policy, the Chamber of Deputies holds ultimate authority over the budget which takes the form of a formal law. Parliament must approve both the expenditure and revenue side of the budget, as well as the accounts after the completion of the budget year. Apart from the approval of the revenue side of the budget, the Chamber controls taxation through the constitutional requirement that no tax can be levied other than by law. All tax laws refer to a specific budget year and expire unless they are extended for a new budget year. In addition, all loans to the state, contracts with important financial consequences, alienation of real estate, acquisition of important real estate and large construction projects of infrastructure or buildings need approval by law – the thresholds of what is important or large being determined by a general law.[4] Furthermore, all contracts establishing financial obligations of the state for more than a budget year need approval by a special law.

Table 1. **Basic economic and political statistics of Luxembourg, 2009**

Geography	
Area (km^2)	2 586
Agricultural area (2008)	86%
Population (thousands)	
Population	494
Cross-border workers	146
Employment	352
Agriculture	*5*
Industry	*37*
Financial services, services to business	*101*
Other	*209*
Production	
Gross domestic product (EUR millions)	37 755
Origin of GDP in per cent	
Agriculture	*0.2%*
Industry and construction	*13%*
Financial services, services to business	*45%*
GDP per head, current prices (USD PPP, 2008)	64 958
Parliament	
Number of seats	60
Christian Social People's Party (CSV)	*26*
Luxembourg Socialist Workers Party (LSAP)	*13*
Democratic Party (DP)	*9*
Alternative Democratic Reform Party (ADR)	*4*
The Greens (Déi Gréng)	*7*
The Left (Déi Lenk)	*1*

Source: OECD (2010), *OECD Economic Surveys: Luxembourg*, OECD Publishing, Paris.

There are 19 ministries in Luxembourg and 15 ministers; some ministers lead more than one ministry. There are basically three types of executive units in Luxembourg:

- "*Services généraux*": These are the main units executing governmental policy. They are under ministerial responsibility and have no legal personality. They have a certain autonomy in operational management based on legal or ministerial mandate. Examples are the Tax Administration, the Administration for Registration and Domains, the Customs and Excises Administration, the Directorate of Health, the Labour Inspectorate, and the Employment Administration.
- "*Services de l'État à gestion séparée*" (47): They are under ministerial responsibility and have no legal personality. They have a certain autonomy in operational management based on law. These units are mainly establishments of secondary education (*lycées*), museums, the National Library, and the National Archives. They are mostly concentrated in a limited number of ministries.
- "*Établissements publics*" (35): They have public or private legal personality. The minister is not responsible for executive policy and not (directly) for operational management (but keeps an indirect responsibility for efficiency due to his/her overall responsibility for funding). These units are mainly research institutions and cultural institutions (theatres, orchestras, etc.). Other examples are the *Fonds de lutte contre les stupéfiants*, the *Centre de prévention des toxicomanies*, the Luxembourg Casino, and the University of Luxembourg.

Parliament must approve the accounts. The Court of Accounts provides advice on the budget bill, on bills concerning the accounts of the state, and on the annual accounts of some *établissements publics*. The court can also be asked to provide advice on all other bills that have significant impact on the public finances. Finally, Parliament can ask the court to give an opinion on all subjects of financial management, including those that concern more than a single budget year.

1.3.2. Components of public finance

The public finances of Luxembourg consist of the finances of the state (central government), of social security and of the local governments.

The budget of the state consists of three parts: expenditures, revenues and a "*budget pour ordre*". The last budget consists of revenues and expenditures on behalf of third parties. It serves in particular to authorise revenues owed to third parties and to authorise the distribution among those parties. For example, the yields of the value-added tax (VAT) and the distribution of those yields among the European Union, the local governments and the state are authorised by the *budget pour ordre*. Similarly, the yields of the motor vehicle tax and the distribution of those yields among various special funds and the state are authorised by the *budget pour ordre*. In the expenditure budget and the *budget pour ordre,* the expenditures are split into current and capital expenditures and presented under different titles.

In general, the state budget complies with five principles anchored in the Constitution:

- Annuality: the budget is annual and authorises expenditures and revenues only for the calendar year to which it applies.
- Unity: the budget is unique – namely, there are no other documents than the budget that authorise expenditures and revenues.
- Universality: all expenditures and revenues are authorised by the budget; there are no expenditures or revenues that are not authorised by the budget.
- Non-earmarking: all tax revenues accrue to the general revenue fund.
- Specificity: all expenditures are specified in the budget; an appropriation cannot be increased with windfalls from another appropriation without budgetary authorisation.

However, there are important legal exceptions to these principles, notably:

- There are 32 special funds that can freely carry over their appropriations to the next budget year (in spite of the annuality principle). These funds were mainly created for the financing of large investment projects, for which the distribution of commitments over budget years is sometimes difficult (in view of delays).
- The *services à gestion séparée* have a certain autonomy in their operational management (including the input mix and, within legal limits, the fees charged for their services); only the net government contribution to these units is included in the budget (in spite of the principles of unity, universality, non-earmarking and specificity). In addition, these units can freely carry over their budgetary appropriations (in spite of the annuality principle).
- There are a number of appropriations that can be used to pay for invoices of a budget year that is already closed (*crédits sans distinction d'exercice*), mainly in the sphere of contributions to social security funds (in spite of the annuality principle).
- There are a number of appropriations that can be overspent (*crédits non limitatifs*), mainly in the sphere of mandatory spending programmes (in spite of the universality principle).[5]

The expenditure budget of the state consists mainly of eight types of appropriations:

1. operational expenditures (salaries, procurement);
2. investments;
3. grants to the other sectors: local government and social security funds;
4. contributions to special funds;
5. contributions to *services à gestion séparée*;
6. grants to *établissements publics*;
7. grants and subsidies to private foundations and corporations;
8. interest payments on public debt.

The revenue side of the budget consists of tax revenues (taxes and levies) and non-tax revenues (mainly from tariffs and sales of assets).

In Luxembourg, expenditures and non-tax revenues are authorised on a commitment basis, while tax revenues and financial transactions are authorised on a cash basis (Articles 8 and 9 of the Budget Code). A special feature is that commitments concerning expenditures and non-tax revenues have to be paid before 30 April of the year following the budget year (Article 9, sub 2 of the Budget Code). If they are not paid before that date, the commitments cannot be attributed to the budget year in which they are made and have to be renewed in the next budget year. As a consequence of this particularity, the budget resembles a cash-based budget. Only commitments that are actually paid in the 16-month period between 1 January and 1 May of the year following the budget year can be attributed to the budget year. Another consequence is that the accounts of the budget year cannot be made up before 1 May. In view of the current plans for financial reporting to the European Commission (see Section 4 of this report), this situation may lead in the near future to a very tight time schedule for the compilation of the accounts.

The state can borrow for capital expenditures (rail infrastructure, roads, canals, large buildings). The state can also borrow in the short term to cover temporary liquidity needs.

The finances of social security are entirely determined by substantive laws, both on the revenue side and the expenditure side. Parliament does not vote a special social security budget. The budgets of social security are prepared by the *établissements publics* that execute the social security laws, and are approved by the Minister of Social Security. Only the contributions from the state budget to the social security funds are authorised in the budget voted by Parliament. A survey of the social security finances is submitted to Parliament as part of the budget documentation.

In Luxembourg, there is only one layer of local government: the municipalities (*communes*). Municipalities have public legal personality and their own budgets which are approved by elected municipal councils. Their revenues consist of own revenue (mainly municipal taxes and levies, sales of assets, and fees for services) and grants from the state: general-purpose grants, block grants and earmarked grants. For important capital expenditures, municipalities can borrow. All municipal taxes, levies and fees must be approved by the municipal council and the Minister of the Interior. The municipal budget for the following budget year has to be approved by the municipal council.

1.3.3. Supervision of budget preparation and execution

The preparation and execution of the state budget are supervised by the Inspectorate of Finance (*Inspection générale des Finances*) that is within the Ministry of Finance. The Inspectorate advises the Minister of Finance on the strategic aspects of the budget in view of the economic and social policy of the government, co-ordinates the budget preparation process, and plays an active role in the formulation of the budgets of line ministries. The Inspectorate also advises the Minister of Finance on all bills with budgetary consequences. The Inspectorate supervises the efficiency and effectiveness of expenditures and their consistency with general government policy during budget preparation and budget execution, and advises the Minister of Finance in case no agreement with a line ministry can be reached. The Inspectorate follows budget execution in co-ordination with the Treasury and informs the Minister of Finance regularly about the development of revenues and expenditures.

The organisation of budget execution is based on the separation of the functions of the budget holder (who commits an expenditure or incurs a financial liability), the financial officer (who pays the expenditure or collects the revenue), and the financial controller (who checks the legality of the expenditures and revenues). The budget holders are part of the line ministries; the financial officers are part of the Treasury, which belongs to the Ministry of Finance; the financial controllers also belong to the Ministry of Finance but are granted an independent status. Physically, financial controllers reside mostly in the line ministries. Whereas the financial controllers check the legality and regularity of commitments and payments, the Inspectorate of Finance checks the efficiency, effectiveness and regularity of commitments and payments. Within the Ministry of Finance, the Financial Control Directorate is separated from the Treasury (and equally from the Inspectorate).

The finances of the local governments are supervised by the Agency for Municipal Financial Control within the Ministry of the Interior. The agency verifies the legality of expenditures and revenues, and leaves the supervision of effectiveness and efficiency to the local councils. The finances of social security are supervised by the General Inspectorate of Social Security of the Ministry of Social Security. The General Inspectorate of Social Security looks into the legality and the regularity of expenditures and revenues.

1.3.4. Financial reporting and audit

The Treasury is responsible for the financial reporting of the central government. Accounts are prepared at the end of the budget year and submitted to Parliament by the latest at the end of May following the budget year. Financial reports drawn up during budget execution, in co-ordination with the Inspectorate of Finance, are sent to the Minister of Finance but not published.

Parliament annually authorises the state accounts by law after receiving advice from the Court of Accounts. Ministers are responsible for financial irregularities.

The authority of the Court of Accounts extends not only to the state (including the *services à gestion séparée*) but also to the *établissements publics* insofar as their expenditures are financed by earmarked state contributions and grants. The court's authority does not extend to the finances of local government nor to social security.

1.4. Fiscal policy

1.4.1. Fiscal policy in the recent past

Luxembourg is a small open economy. Its GDP originates for a large part in the financial sector (see Table 1). This implies that, even in normal times, there is a relative fluctuation of tax yields, due to the volatility of financial markets. In the current situation of financial crisis, this fluctuation is greater than in countries that are less dependent on their financial services sector.

Luxembourg has no national fiscal rule. It basically steers its fiscal policy on the criteria of the European Stability and Growth Pact (SGP), which requires a budget close to balance in the medium term and no deficit larger than 3% of GDP from year to year. In addition, the SGP requires that the public debt remain below 60% of GDP, but this requirement does not constrain fiscal policy in Luxembourg in the short or medium term because Luxembourg's debt is far below the threshold (less than 10% until 2007 and currently 18%).

After the downturn of 2001-03 that pushed the general government balance into deficit, the government initiated a consolidation policy in order to bring the balance back to zero. Measures focused on expenditures but there was also a revenue component. The policy was successful in that the balance equilibrium was restored as from 2006. However, the current crisis is of a different order than that of 2001-03. It led to a downturn of GDP in 2009 of 3.4%. In view of the cash base of revenues in the budget, the effects on the balance have mainly been felt in 2010 and are expected to continue in 2011 in spite of the recovery that began in 2010 (see Table 2). The problem was further exacerbated by the need to stabilise the financial sector in the second half of 2008 by providing loans and guarantees to that sector (this support shows up only marginally in the balance because it mostly concerns financial transactions).

Table 2. **GDP and government balance**

Year-to-year GDP growth, balance in per cent of GDP according to ESA95

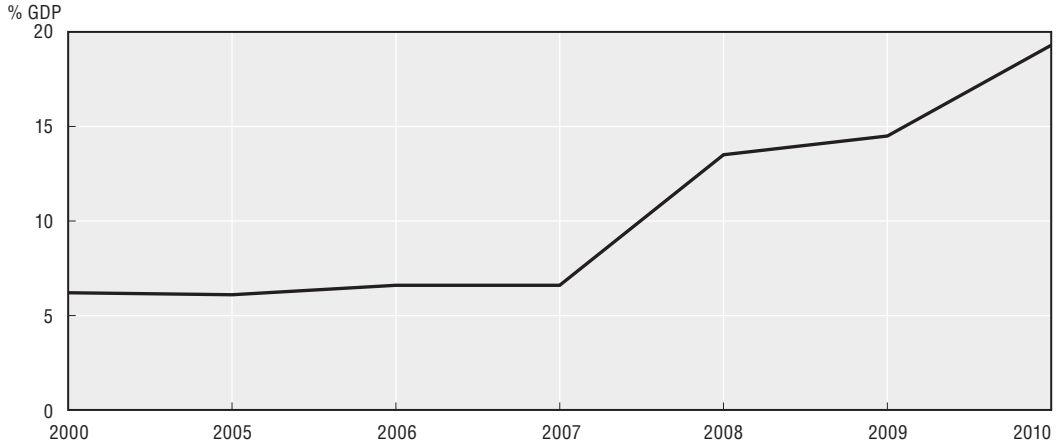
	2008	2009	2010	2011
GDP	0.0	-3.9	3.5	3.2
General government balance	2.5	-0.7	-1.7	-1.0
Central government balance	-0.2	-2.7	-3.2	-2.5
Local government balance	0.0	0.0	0.0	0.1
Social security balance	2.7	2.0	1.5	1.4

Source: Government of the Grand Duchy of Luxembourg (2010), "Programme de stabilité Luxembourg 2010", Ministry of Finance; Government of the Grand Duchy of Luxembourg (2010), "Excessive Deficit Procedure notification tables (2010)", Ministry of Finance; Government of the Grand Duchy of Luxembourg (2011), "Programme de stabilité Luxembourg 2011", Ministry of Finance. These figures do not include the last update since the October 2011 notification.

Luxembourg mainly followed European Union guidelines in reaction to the crisis. Following the guidelines of the European Council of December 2009, the Luxembourg government approved a fiscal stimulus package aimed at sustaining the economy until the recovery would set in. This package has led to a further negative impact on the budget in 2010 and 2011. Table 2 shows that the increase of the budget deficit as from 2009 is mainly due to the central government. The deterioration is mainly due to setbacks in the tax yield, but partially also by further increases of expenditures.

Figure 1 shows the impact of the deteriorating fiscal situation on the public debt.

Figure 1. **Gross debt**
ESA95, per cent of GDP



Source: OECD (2010), *OECD Economic Surveys: Luxembourg*, OECD Publishing, Paris. These figures take into account an exceptional EUR 2 billion loan invested in two banks in 2008 (about 5% of GDP).

As from January 2010, in the context of the establishment of the "Stability and Convergence Programme", the government has embarked on a national fiscal plan aimed at restoring the balance at the level of public administration by 2014. The government has also committed itself to again comply with the requirements of the SGP, and to make sure that the long-term sustainability of the public finances in the light of demographic developments would be assured. In particular, the government has formulated a guideline that the future growth of expenditures should not exceed the growth of GDP.

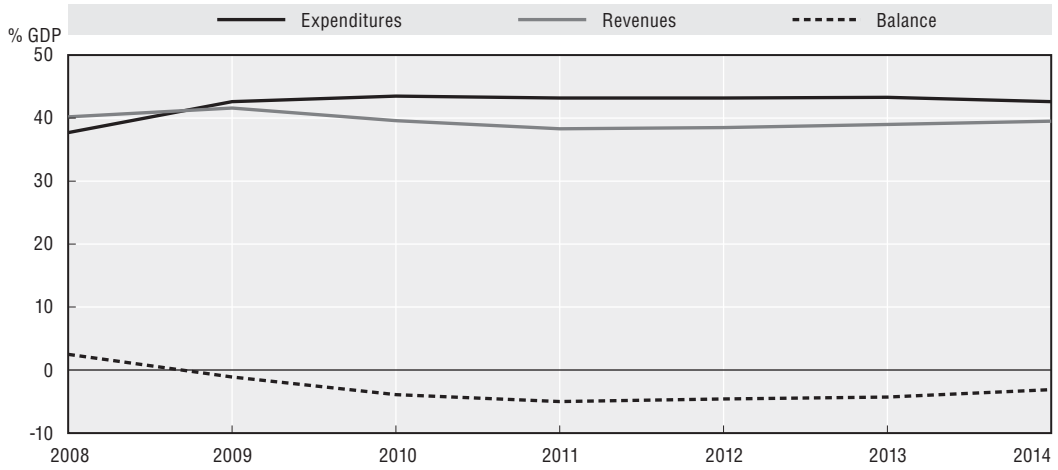
1.4.2. Budget 2011

In the budget for 2011, the government announced that it will proceed with the implementation of the fiscal plan. For that purpose, the government approved a consolidation package, emphasising that this will help to avoid an excessive deficit in the sense of the SGP. The government also noted that the successive consolidation packages will only gradually be reflected in budgetary outcomes and will have their effects also after 2011. Similarly, given the cash base of tax receipts, the negative effects of the crisis will be felt in 2011 and 2012 in spite of the economic recovery. The resulting developments, based on outcomes and provisional outcomes until 2010 and forecasts for later years, are depicted in Figure 2.[6]

The consolidation package included in the budget of 2011 amounts to EUR 648 million (1.8 percentage points of GDP), including the effects in 2011 of the package of 2010. The 2011 consolidation package consists of EUR 482 million of expenditure savings (75%) and EUR 166 million of revenue enhancements (25%). The savings concern the operational expenditures of the central government, student loans and facilities, the adjustment of pensions, capital transfers (including subsidies to the corporate sector), and investment expenditures. The revenue enhancements concern a tariff increase of the third bracket of the income tax, a tariff increase of the solidarity tax, and the introduction of a crisis levy. The package will affect all three sub-sectors of general government (central government, local government and social security) but mostly the central government. According to the government, the package will help to restore the budget balance in 2014 as announced in the fiscal plan.

Figure 2. **General government expenditures, revenues and balance**

ESA95, per cent of GDP



Source: Government of the Grand Duchy of Luxembourg (2010), "Programme de stabilité Luxembourg 2010", Ministry of Finance.

2. Fiscal planning

This section covers a range of inter-linked mechanisms that together enable credible medium-term planning and budgeting. We start by explaining the role of medium-term baseline estimates in evaluating the budgetary impact of proposed policy. We then discuss medium-term frameworks which serve to guide fiscal policy and constrain annual budgets, and how fiscal rules provide a normative anchor for them. The sub-section on spending reviews elaborates how allocative decisions that are locked into a medium-term framework can be based on regular reappraisals of existing policy measures, in order to align the budget as closely as possible with the policy priorities and commitments of the current government. We also explain rules of budgetary discipline that protect a medium-term framework from being derailed by unexpected economic developments and new spending pressures. In addition, we highlight possible improvements in the way the budget is presented to allow for better analysis and debate of how it is aligned with government policy, including the role of a programme classification as well as horizontal and vertical explanations. In the final sub-section, we discuss whether there is still a justification for maintaining a large number of special funds if the above reforms are implemented.

2.1. Baseline estimates

Informed decisions about policy options require careful comparison ("scoring") of the fiscal effect of new initiatives against the status quo "baseline" (Schick, 2000:56-60). The baseline estimates capture the cost of current law and/or current policy over the medium term. Each programme has its own particular set of factors that will affect expenditures – for instance, economic variables, demographic developments, price changes or participation rates. To serve their primary purpose as a descriptive tool, baseline estimates should be prepared on the basis of clear and transparent rules. They should also be frequently updated (usually monthly or quarterly) to reflect any changes in the underlying variables. Medium-term estimates should be prepared at a line-item level (*i.e.* the same level of detail as the annual budget) and they should be part of the annual budget proposal submitted to Parliament (OECD, 2002). Such estimates typically cover a three to five-year

period. This extension beyond a single budget year is useful in times of fiscal consolidation, when savings need to be accumulated over a period of time and first-year budgetary yields of structural measures are often small or absent. Medium-term estimates can also capture the cost of new programmes more comprehensively, which is particularly important for policies with low initial spending but significantly increasing costs in future years (a budgeting tactic sometimes referred to as the "wedge" or "camel's nose").

In Luxembourg, volume one of the budget documents currently does not include medium-term estimates. In accordance with the reporting requirements of new economic governance put into place in the EU, medium-term aggregate figures including three-year forecasts are reported, but not line-item level estimates. However, capital expenditures, reported in volume two, include medium-term estimates. The total period covered in volume two is $b - 1$ (the current budget year) to $b + 3$ (for the purpose of this report, b is the upcoming budget year and $b + 1$, $b + 2$ and $b + 3$ are out-years). In line with best practices in OECD countries, and in aid of budgetary planning, current expenditure estimates, too, should include medium-term figures. This will allow Parliament and the public, as well as the government, to ensure that current policy is consistent with medium-term fiscal objectives and an expenditure framework (see Section 2.2). Given the familiarity of the $b + 3$ format for capital expenditure, one option is to include estimates for current expenditures over the same period. However, in order to optimise the use of the expenditure framework, which we discuss in the following sub-section, it is preferable to align the number of years covered in the estimates with those decided in the expenditure framework.

2.2. Expenditure framework

In contrast to expenditure estimates, which have a descriptive purpose, an expenditure framework is normative and captures the policy intentions and objectives of the government over the medium term. An expenditure framework imposes limits on spending over a certain period (typically three to five years). The design of expenditure frameworks differs across countries. Such frameworks can be either flexible (annually updated) or fixed (the figures remain unaltered once they have been set). Frameworks are sometimes set on a rolling basis, which means that a new year is added at the end of the framework period when the first year (or budget year) expires (Austria, the Netherlands, Sweden), while others are reset periodically towards the end of the period covered (France, United Kingdom). For instance, until 2010 the United Kingdom had a three-year fixed framework for departmental spending that was renewed every two or three years. In 2010, the United Kingdom government extended the framework period to four years to cover the entire electoral term. In contrast, Sweden maintains a three-year forward ceiling that is updated on an annual basis by adding a new ceiling for the second out-year (this was legally required in 2009). A fixed framework need not necessarily bind successive governments. For instance, in the Netherlands the framework can be reset at the beginning of an electoral term, allowing a new incoming government to implement new policies at the beginning of its term.

Various mechanisms exist to allow governments to deal with economic uncertainty without breaching a ceiling on total expenditure. To cope with economic downturns, many countries use contingency reserves or budget margins. For countries that use comprehensive expenditure ceilings, the resources set aside for this purpose are equal to the gap between the total expenditure appropriated in the annual budget and the total expenditure ceiling established by the expenditure framework. In addition, some countries have developed detailed rules for unexpected revenue windfalls so that they do not give rise to political

pressure for additional expenditure that may breach the ceilings. These mechanisms are designed to maintain the integrity and credibility of a medium-term framework. A fuller discussion of such rules of budgetary discipline is provided in Section 2.5.

The credibility of the framework should not be undermined by legislative action, while at the same time any medium-term system cannot ignore the formal authority of the legislature in budgetary matters. Broadly, two mechanisms exist to ensure the compliance of legislative action on annual budgets with multi-year frameworks. One approach is to have the legislature approve the framework, which can take the form of separate legislation. This was the original role of Sweden's "Spring Fiscal Policy Bill" which precedes the presentation of the annual budget in the autumn (Blöndal, 2001). In other countries, the ceilings imposed by the medium-term framework have such fundamental political importance that any legislative violation of them would constitute a vote of no confidence in the government. During the periodic spending reviews in the United Kingdom, for example, Parliament and its committees may discuss the departmental expenditure ceilings, but these are not formally approved (apart from their implicit approval with the annual budget) and in practice the decisions on these multi-year ceilings are never challenged. Which approach is more suitable depends on the formal authority and actual impact of the legislature. In a context where the legislature has strong formal authority and regularly amends government budget proposals, a formal vote on the medium-term ceilings may help to ensure broad consensus and political commitment. Such a formal commitment would also make breaches more visible and, hence, politically costly. It should be kept in mind that respecting the multi-annual framework does not deprive Parliament of its authority to change the budget through reallocation, as long as the ceilings of the framework are respected.[7]

Expenditure frameworks can be distinguished along several other dimensions, notably the number of budget years covered, the number of ceilings they establish, and their comprehensiveness (*i.e.* how much of government spending is subject to the framework). In terms of future budget years covered, many frameworks cover a three-year period (France, Sweden) or a four-year period (Finland, the Netherlands). The United Kingdom moved from a three-year to a four-year forward framework with the 2010 "Comprehensive Spending Review" which confirmed the ongoing year's totals (2010-11) and added ceilings for four upcoming budget years (2011-12 to 2014-15).

In terms of the number of sub-ceilings, some frameworks establish only a single aggregate ceiling on expenditures (Sweden), while others contain a number of sub-ceilings at the departmental level (United Kingdom) or the policy level (France). The Netherlands has a binding overall ceiling, with sub-ceilings for three broad sub-sectors relating to the core central government, health care, and social security; the first sub-sector is further divided over 13 sub-ceilings for ministries. In countries that set sectoral or unit-specific sub-ceilings, this decision is often informed by a spending review mechanism (discussed in more detail in Section 2.4). The purpose of such a spending review is to examine and challenge existing programmes so as to ensure that the budget is properly aligned with the political priorities of the current government rather than a mere extrapolation of past spending.

In terms of comprehensiveness, some governments argue that particularly volatile items should not be subject to multi-year ceilings. Many countries (Finland, France, Sweden, United Kingdom) exclude interest payments on debt from the ceiling. In the Netherlands, interest payments were under the ceiling until 2008, but then removed as

part of the European "stimulus package". Since 2011, interest payments are back under the ceiling. In addition, some countries exclude certain cyclically sensitive items such as unemployment benefits and other entitlements (Finland, France, United Kingdom), but others do not (Netherlands, Sweden). In principle, the fiscal steering potential of a medium-term framework is undermined when the ceiling becomes too partial (Ljungman, 2008:6-13). Ideally, a framework should be as comprehensive in coverage as possible given a country's particular context.

At present, Luxembourg does not have a medium-term expenditure framework. While the preparation of the annual budget is guided by the requirements of the Stability and Growth Pact, this process does not provide firm guidance for the preparation of the annual budget (see Section 2.5). At a minimum, the government should consider the imposition of an aggregate ceiling on expenditures in the state budget. In order to provide even more stability and to avoid difficult interministerial reallocation discussions during budget preparation, it might also be worth considering establishing firm sectoral ceilings (at the level of ministries). As for the period to be covered, one option might be to establish an expenditure framework for the same period that policy makers are already acquainted with in the context of European budgetary surveillance procedures, namely three years (the upcoming budget plus two out-years). A second option is for a newly elected government to set a framework for the entire five-year period until the next election. Indeed, a longer period may enhance the ability to capture "camel's nose" effects and savings from structural measures. Whichever option is chosen, an incoming government must have the opportunity of resetting any existing ceilings so that they reflect new spending priorities and political commitments made during the electoral campaign. With regard to comprehensiveness, it is interesting to note that, compared with other EU and OECD countries, Luxembourg has a very low debt burden. As a result, the risk of annual fluctuation of interest payments is relatively contained and could easily be accommodated from the budget margin or the contingency reserve.

2.3. Fiscal rules

Kopits and Symansky (1998:2) define fiscal rules as "a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance". Fiscal rules can be applied to various fiscal aggregates, *e.g.* measures of expenditure, revenue, budget balance or debt. The boundary between a fiscal framework and a fiscal rule can be fluid, since a fiscal framework may also contain multi-annual constraints. For the purpose of this report, a fiscal rule will be assumed to provide constraints for an indeterminate period. For instance, a rule – as it is now foreseen in the European Union (see Section 4) – specifying that in each budget year expenditures cannot grow faster than a reference rate below medium-term potential growth of GDP is an expenditure rule. A fiscal framework that complies with this rule but is limited to a period of three or four years is not an expenditure rule but a temporary expenditure constraint.

Broadly speaking, a fiscal rule provides a normative anchor for a multi-year framework. Apart from the fiscal rules in the Stability and Growth Pact, many EU member states have adopted domestic fiscal rules, which research suggests are an important determinant of fiscal policy outcomes, especially in a context of coalition government (Hallerberg *et al.*, 2009). The potential role of fiscal rules in budgetary consolidation is widely recognised (IMF, 2009). However, not just any rule will do; the specific design matters (Anderson and Minarik, 2006). Rules work when they can be enforced and when

they apply not just to the approved budget but also to actual outcomes. Empirical research further suggests that constraints on spending increase the size and duration of consolidation (Guichard *et al.*, 2007). However, fiscal rules require a high degree of budget transparency; otherwise they induce "creative accounting" (Milesi-Ferretti, 2003).

Early examples of fiscal rules tried to impose fixed deficit targets without taking economic circumstances into account (Gramm-Rudman-Hollings law in the United States). Similarly, the fiscal rules enshrined in the European Stability and Growth Pact can be criticised for not being stringent enough in economic good times, while being too strict during downturns, thus resulting in pro-cyclical fiscal policy. Indeed, one of the main lessons from the early experiments with fiscal rules is that a key to their success is that they must constrain policy makers in good economic times. For this reason, a second generation of fiscal rules has emerged which explicitly takes the economic cycle into consideration. One way of achieving this is with rules that target a cyclically adjusted indicator.[8] A second option is to require compliance with a fiscal rule over the entire economic cycle.

Sweden and the Netherlands provide good examples of fiscal rules that account for economic conditions using one of these mechanisms. Since the end of the 1990s, the Swedish government has used a surplus target, according to which general government net lending (the difference between revenue and expenditure) is to be 1% of GDP over a business cycle. However, the Swedish Fiscal Policy Council (2010:8-9) has criticised the fact that five different indicators have been used to evaluate whether the surplus target was achieved, principally by adjusting the reference period used to evaluate whether the target had been met. This problem is well known in countries with fiscal rules that apply over a business cycle.[9] The Swedish council has recommended the use of two indicators: a ten-year rolling backward-looking indicator to assess whether the target has been met, and a similar rolling forward-looking indicator to aid fiscal planning (without any cyclical adjustment). The Netherlands has a four-year forward expenditure framework which is based on the trend growth of GDP so as to exclude cyclical effects. The government requires a "surplus or close to zero" budget balance, which is anchored in long-term sustainability considerations (population ageing, gradual reduction of public debt, other demographic conditions). The close-to-zero condition is stated in headline terms. Given the trend growth assumption and the GDP elasticity of tax revenues, the balance target leads directly to a ceiling on expenditures in all years of the framework. In the current crisis situation with large deficits, the ceilings for the intermediate years are set to bring the balance back as soon as possible to the medium-term target.[10]

The OECD Secretariat recommends the adoption of a trend-based balance rule in Luxembourg. One of the benefits of combining a trend-based balance rule with a multi-year expenditure framework is that it allows the deficit to fluctuate around a stable expenditure path, which provides predictability.

A point worth noting is that the imposition of an expenditure rule or framework may give rise to incentives to increase tax expenditures, which are targeted benefits financed from the revenue side of the budget (such as exemptions, allowances, credits, etc.) that can be used as functional equivalents of direct expenditure (Kraan, 2004). In the absence of a revenue-side constraint, tax expenditures will soften the expenditure constraint, with possibly adverse consequences for fiscal discipline and budget transparency (Anderson and Minarik, 2006). For this reason, countries that use an expenditure framework have sometimes established a "pay-as-you-go" rule for the revenue side of the budget that requires compensation for all legislated

tax relief (not to be confused with the economically induced fluctuation of tax revenues). This was the case, for instance, under the Budget Enforcement Act in the United States (until 2002), and it is currently the case in the Netherlands.

2.4. Spending reviews

A number of countries use spending review mechanisms in order to allocate funds or to reprioritise and, particularly at the start of a new cabinet period, to set medium-term frameworks. The need for such reviews is a consequence of a fundamental asymmetry in the annual budget process, which basically incentivises line ministries to develop detailed proposals for new spending initiatives but not for savings. Spending reviews, on the other hand, can entail the compulsory consideration of savings options (*e.g.* 5, 10 or 20% cuts), thus forcing line ministries to reconsider both the need to maintain existing programmes and their appropriate mix. Spending reviews also lead to an assessment of the impact in terms of outputs and the outcomes of different funding scenarios, which directly informs decisions about future budgets. In contrast to evaluation activities carried out by line ministries, the finance ministry has a central role in spending reviews, often within terms of reference established by the finance ministry itself or by the cabinet, sometimes involving support from external experts.

The exact nature of spending review mechanisms differs greatly across countries (Kraan, 2007:25-28; Mullen, 2006). Some systems are continuous and selective, involving the review of a limited number of programmes every year. This approach fits well with a flexible expenditure framework, which by definition can be adjusted from year to year. Other countries use spending reviews that are periodic and comprehensive/universal. An example of the latter is the United Kingdom's "Comprehensive Spending Review" (see Box 1). This procedure informs the setting of departmental expenditure limits on a periodic basis (see Section 2.2). In 2010, the United Kingdom's new coalition government used a "Comprehensive Spending Review" to distribute large-scale expenditure reductions planned over a five-year period across the various ministries.

Box 1. **Spending reviews in the United Kingdom**

The United Kingdom introduced spending reviews in 1998 to support expenditure planning over the medium term. The reviews introduced fixed ceilings over several years for each department, leaving it up to them to decide how best to manage and distribute this spending within their areas of responsibility. Around 60% of total spending was subject to fixed multi-annual "departmental expenditure limits" (DEL), split between resource and capital budgets. The remaining share was considered "annually managed expenditure" (AME), such as social security and debt interest, and was allowed to fluctuate for automatic stabilisation purposes. However, the latest spending review in 2010 also covered significant elements of AME, setting out plans for savings and reform in social security, tax credits and public service pensions.

The 2010 "Comprehensive Spending Review" was unusual in several respects. First, the medium-term period was extended by one year to cover the four-year period from 2011-12 to 2014-15, up until the end of the current government's electoral term. Second, the process was used to deliver unprecedented spending cuts amounting to GBP 81 billion. These decisions were made collectively by the government, based on the advice of a powerful committee of senior ministers known as the Public Expenditure Committee (PEX),

Box 1. **Spending reviews in the United Kingdom (cont.)**

also sometimes referred to as the Star Chamber. In addition, the 2010 "Comprehensive Spending Review" discontinued the public service agreements – which had supplemented previous iterations with performance information including targets – in favour of separate departmental business plans that set out the reforms necessary to comply with departmental allocations.

Other *ad hoc* spending review mechanisms are often used to inform large-scale spending cuts and consolidation efforts, for instance in Canada during the 1990s. The Dutch spending review procedure was conceived in the early 1980s as an annual procedure but has recently been put on a quadrennial basis in order to align it more clearly with the revision of the expenditure framework (see Box 2).

Box 2. **Spending reviews in the Netherlands**

The Netherlands introduced spending reviews, now called "Interdepartmental Policy Reviews", in 1981 during a period of fiscal crisis. Areas to be reviewed are decided by the Cabinet. While the first set of reviews was quite comprehensive (with around 70 reports in the first two years), the number averaged around 10-12 in the 1980s. Since 1992 (introduction of the trend-based medium-term expenditure frameworks), the annual number of reviews gradually declined (to 3-5 in the 2000s). The financial crisis in 2009 saw a revival of the process, with 20 reports in 2010 covering 80% of central government expenditures. There is always a mixture of reports on specific policy areas and "horizontal" reports (in total 44 horizontal reports out of 243 reports in the period 1981-2006).

The process is co-ordinated by the Ministry of Finance, which also provides a secretariat that may be shared with the line ministry. Working groups comprised of civil servants from across several ministries and external experts prepare the reports. The chairs of these working groups are independent (they do not bear any responsibility for current policies). All reports are submitted to Parliament and made public. The reports propose reform options or savings. The 70 reports of the first two years led to savings of some 7 billion guilders (EUR 3.2 billion). In the period between 1984 and 1997, savings of some 9 billion guilders (EUR 4.1 billion) were made. The savings options considered in the reports were usually much higher than these figures, averaging about 25% in the period 1981-91.

While the Netherlands initially had a selective and annual spending review procedure, the introduction of a fixed framework in 1992 meant that this procedure became less effective, particularly in non-election years, because the results could henceforth only be used for interministerial reallocation, which by definition is very contentious and difficult. The procedure has now been revised as a quadrennial procedure that is carried out only in election years.

A similar mechanism is not currently in place in Luxembourg. The introduction of a medium-term expenditure framework requires underlying information to prioritise the budget, and it should be coupled with the creation of a spending review mechanism. The principal options are the creation of continuous and selective reviews, or more fundamental reviews of expenditures at regular intervals. Partly, this choice will depend on the type of expenditure framework that Luxembourg adopts. A fixed expenditure

framework with departmental sub-ceilings, as used in the United Kingdom, should be informed by a comprehensive and periodic review. The continuous and selective approach might be more suitable for a flexible framework.

2.5. Budgetary discipline

The strengthening of top-down decision-making procedures and the maintenance of budgetary discipline throughout the budget process have been major trends across OECD countries over the past decade (Blöndal, 2003; Ljungman, 2009). The idea behind a "top-down" approach is that the totals are decided prior to the decision on how to allocate expenditures across various ministries or sectors. It contrasts to a "bottom-up" approach, where the budget is the sum of a range of separately developed and decided ministerial budgets, and where totals are not known until the very end of the process. These two approaches require a very different role to be played by the central budget authority or finance ministry (Schick, 2001). Under a bottom-up approach to budget formulation, great emphasis is placed on bilateral negotiations of detailed spending items between the finance ministry and individual spending ministries, in an attempt to whittle down an often inflated and exaggerated draft proposal from the line ministry. Top-down budgeting involves the central budget authority setting firm departmental ceilings early in the budget formulation process, but in return allowing greater autonomy for line ministries to decide the detail of expenditure as long as the totals are not breached. This approach allows the central budget authority to focus on fiscal steering and important allocative decisions.

In this respect, it is important to distinguish between OECD countries that operate a fixed medium-term framework and those that operate a flexible framework. With a fixed framework, the ceiling of total expenditures cannot be changed from year to year. This makes departmental totals inflexible, even if they are not formally part of the framework, since every additional allocation to a ministry has to be compensated by a decrease in another ministry. Obviously this simplifies the task of the central budget authority in setting the departmental totals, as the major allocational decisions will already have been taken when the medium-term framework was decided.[11] The only addition consists of the ceilings for the new out-year. Experience shows, however, that these out-year allocations are in practice much less contentious than the decisions for the next budget year. With flexible frameworks, used by the large majority of OECD countries, the framework serves as a disciplinary device during budget preparation and execution once it has been established, but in principle not from year to year. The difference in this respect between fixed and flexible frameworks should not be exaggerated. Many countries with a flexible framework try nevertheless to minimise changes to any previously established ceilings, which simplifies the tasks of the central budget authority.

It might be thought that the tasks carried out by the central budget authority with such a framework approach are relatively small and that the workload of the budget division of the finance ministry (*Inspection générale des Finances* in Luxembourg) during budget preparation would be substantially reduced. Experience shows that in practice this is not the case. It does lead, however, to a profound shift in the nature of the work. Under a framework procedure, ministries have an interest in reducing multi-annual estimates, particularly in the out-years. This allows them to avoid difficult programme decisions as long as the estimates can be squeezed under the ceilings. As the relevant out-year approaches, they can request additional resources, especially under a flexible framework. It is the main task of the budget division to see to it that the multi-annual estimates remain

realistic and are not artificially reduced, and that programme decisions are taken if estimates cannot remain under the ceilings for the next out-years. Indeed, the biggest advantage of multi-annual ceilings is that problems can be discovered early and adequate action taken in a timely manner. The main duty of the budget division is to discover such problems, since it is sometimes not in the interest of the line ministries to do so themselves (particularly if the problems can no longer be solved at a later stage and if they have become so big that the line ministries think they can evade compensation by claiming additional resources in the next budget year).

Top-down approaches have also been propagated for the parliamentary approval process, so that individual amendments do not lead to increased expenditures and higher deficits. This is particularly important in countries where parliamentary amendment authority is extensive.

However, top-down budgeting during formulation alone will not guarantee budgetary discipline. The budget can be easily derailed when the framework is not enforced during budget preparation or during the fiscal year when it is implemented. In practice, effective frameworks cannot exist without explicit and generally agreed rules of budgetary discipline.

Such rules should allow every minister to reallocate within her/his budget during budget preparation and, within certain limits, during implementation but only under the strict condition of compensation. Rules of budgetary discipline during implementation tend to be more complicated than during budget preparation. For instance, rules may stipulate that reallocation from programme expenditures to operational expenditures is not allowed, or they may prescribe an asymmetric treatment of setbacks and windfalls on entitlement spending (setbacks have to be compensated; windfalls are available to the finance minister to help ministries that demand reallocation in their favour). For the effective operation of a framework (be it flexible or fixed), it is essential that the rules of budgetary discipline are codified in an executive regulation or explicitly agreed by cabinet decision.

The maintenance of fiscal discipline depends on a realistic, credible budget. The OECD Secretariat regards deviations from key economic assumptions underlying the budget as "the government's key fiscal risk", with "no single factor more responsible for 'de-railing' fiscal consolidation programmes" (Blöndal, 2003:12). Institutional arrangements can insulate forecasts from an often typical and understandable government bias towards optimism. In Canada, the Department of Finance uses an average of private sector forecasts and systematically revises these downwards as a further measure of prudence. Other countries have used fiscal councils to protect fiscal forecasts from political manipulation. In the Netherlands, the independent Central Planning Bureau (Bureau for Economic Policy Analysis) prepares key economic assumptions, and a "cautious" rather than the most likely growth scenario is used to prepare the budget. The United Kingdom's Office for Budget Responsibility, created in 2010, was inspired by such examples.

A further mechanism to ensure that spending ceilings are not breached as a result of economic and other shocks takes the form of an explicit contingency reserve. In Sweden, for instance, the amount of spending authorised in the annual budget is below the spending ceiling amount for that year, thus leaving a "budget margin" to deal with uncertainty. As a result of cautious planning and the existence of the budget margin, the Swedish expenditure ceiling has never been breached since its introduction in the late 1990s, even during the recent economic crisis. Many OECD countries have similar arrangements.

In Luxembourg, macroeconomic assumptions used in the budget are prepared by STATEC (*Institut national de la statistique et des études économiques du Grand-Duché du Luxembourg*), which is a professional and independent statistical body. However, there is no systematic sensitivity analysis of the fiscal impact of deviations from key variables. The OECD Secretariat recommends that such analysis be carried out and published as part of the annual budget documentation. This is important for the adjustment of baseline estimates that are sensitive to macroeconomic developments and for judging the resulting size of the "budget margin" under the aggregate ceiling imposed by a multi-year expenditure framework. Second, the OECD Secretariat recommends that top-down techniques in the budget formulation process be strengthened. At present, the budget circular does not contain firm overall ceilings for line ministries, putting a heavy burden on the Ministry of Finance to adjust departmental plans to reasonable levels during a series of bilateral negotiations. A top-down approach would allow the finance ministry to focus on enforcing the rules of budgetary discipline (with a fixed framework), on limiting upward adjustment of the aggregate ceiling (with a flexible framework) or on facilitating reallocation between ministries if political necessity so requires. Departmental ceilings should not add up to the maximum total decided in the medium-term framework. Rather, a margin between the spending total in the annual budget and the expenditure ceiling would constitute a contingency reserve. Luxembourg's existing crisis fund is far too small to protect the budget from uncertainty, and it is not linked to an explicit expenditure framework. The size of the margin can be variable, but similar contingency funds are typically in the area of about 2% of the expenditure total under the ceiling.

2.6. Budget classification (programme budgeting)

Traditional budgets typically include a combination of administrative (entity-based), economic (type-based) and functional (purpose-based) classifications (Jacobs *et al.*, 2009). While an administrative classification aids compliance, an economic classification supports fiscal control (including adherence to fiscal rules that make a difference between current and capital expenditures or between social benefits and other expenditures), and a functional classification supports resource allocation. Increasingly, governments are restructuring the presentation of budgets according to objective-based categories, or programmes. One reason for this change is that a programme-based classification is a necessary element of performance evaluation. While there is an international norm that can be used to devise economic and functional classifications (Government Financial Statistics, GFS 2001) which is important for statistical reporting to international bodies, administrative and programme classifications rely on country-based customs that reflect the government structure and political priorities, among others. Sometimes, a programme-based classification can replace an administrative classification if programmes are clearly attributed to one particular unit, such as a directorate within a government ministry or department, but not when programmes cross-cut administrative units. The simplicity of aligning programme-based classifications with organisational boundaries also avoids potential co-ordination and accountability problems that can be associated with cross-cutting programmes (Kraan, 2007:12).

Since the exact design of a programme-based structure is country-specific, there is no single template. However, programme budgeting usually entails a reduction in the number of line items. In a typical programme budget, a government ministry may have somewhere between five and ten programmes which can be further broken down into a similar

number of sub-programmes. Parliamentary approval is at the programme level, allowing for limited transfer or reallocation between programmes within the same ministry. Some countries have numerical limits on such shifts (*e.g.* 5% in New Zealand), while others have specific rules for different programmes. Information at the level of sub-programmes is presented in the budget submitted to Parliament, but for information only. Countries that have moved to a programme classification have sometimes kept operational expenditures apart from programmes. This applies particularly for operational expenditures of the core ministry that cannot easily be split between programmes, especially because the workload of divisions and top officials shifts continuously between programmes (for instance, the work of support units for human resources, finance, procurement, ICT, etc.). Sometimes the operational expenditures of executive agencies are also kept apart from the programme classification. In this case, the reason may be that executive agencies implement various programmes, so expenditures cannot be easily split on a permanent basis. Another argument for keeping operational expenditures of agencies apart is that this facilitates monitoring of such expenditures and provides better guarantees that programme expenditures do not leak into operational expenditures (in particular increasing the size and remuneration of staff).

The budget of Luxembourg contains a large number of line items (a total of 4 214 in the 2011 draft budget), classified to provide information on an administrative, economic and functional basis. The OECD Secretariat recommends the implementation of a programme-based classification in Luxembourg. Such a reform would also allow the incorporation of some performance information – such as measures of outputs or outcomes – into the budget documentation. However, the OECD Secretariat cautions against the introduction of complex performance measurement systems and against attempts to give exhaustive information, for all programmes, on the realisation of programme objectives. Output and outcome indicators in particular should be included in the budget documentation only when they are shown to have directly impacted on the determination of allocations. The budget documents should not be cluttered with excessive and only tangentially relevant performance information, as this tends to obscure rather than clarify the background of allocational decisions. Moreover, OECD country experience shows that performance information in the budget documentation tends to be biased in favour of proposed programme allocations rather than to serve as an objective basis for discussion among parliamentarians and civil society. On the relevance of performance information for allocational decisions, see also Section 5.

In addition, it is important to build consensus around the new programme format prior to its formal introduction. In particular, line ministries need to own the reform and understand it as being much more than a technical exercise – more as a chance to rethink objectives and the allocation of expenditures. This requires strong budget units in line ministries, with political support from the relevant minister. It is also important to engage with Parliament from an early stage, including key committees that use budgetary information, to explain the change and to reassure legislators that it will not result in a loss of control nor impair their oversight functions. A realistic timetable for this reform should also include pilot projects in selected line ministries, to help identify challenges ahead of a government-wide rollout of the programme classification.

2.7. Budget documentation (horizontal and vertical explanation)

The budget documentation should contain "vertical" explanations of why and how line-item estimates – in the case of a programme-based classification, these would be

programme-level expenditures – differ from the figures provided in the previous year's documentation. This discussion should distinguish differences due to policy changes (*e.g.* a decision to adjust the level of unemployment benefits) from differences in the demand for services under current policy (*e.g.* an unexpected rise in the number of unemployed claiming support). Each ministerial budget should provide reconciliation tables for each programme, either in the printed version or on the website (see Kraan, 2007:34).

In addition, the budget documents should contain a "horizontal" explanation of the estimates for the next budget year and of the medium-term estimates, focusing on the factors that determine the price and quantity of the services provided. This explanation should clearly describe the assumptions about the development in the demand for services (*e.g.* the number of claimants for unemployment benefits) and the costs of providing those services under current policy (*e.g.* the level of support). Again, the OECD Secretariat cautions against adding further "performance information" that is not directly relevant to understanding the figures for the next budget year and the out-years. The introduction of medium-term programme-based estimates in Luxembourg should be complemented with the introduction of horizontal and vertical explanations as an integral part of the budget documentation.

2.8. Special funds

There are 32 special funds in Luxembourg. These funds mostly aim to finance expenditures that concern more than a single year, in particular expenditures for investment projects. Special funds have no legal personality. They are managed by the responsible ministerial unit under the same rules of operational management as any other account. Appropriations to special funds can be carried over to the next budget year without any constraint. Each special fund is based on a specific law that stipulates which expenditures it can finance. The funds are fed by budgetary appropriations and sometimes by certain revenues from earmarked taxes, fees and other non-tax revenues. The budget documentation contains an overview of the expenditures and revenues as well as the financial assets of the fund at the beginning and end of the budget year. The Treasury administers the financial resources of the special funds.

The special funds of Luxembourg can be characterised as "extra-budgetary funds" in view of the fact that only the annual contributions from the state to the funds are included in the state budget, not the gross expenditures of the funds. However, the budget documentation provides full transparency about gross expenditures and gross revenues, and complies in this respect to principles of budget transparency required by international organisations (OECD, 2002; see also EU requirements in Section 4).

Regardless of compliance with principles of budget transparency, the OECD Secretariat generally cautions against the use of extra-budgetary funds. They tend to distort the allocational process (by net budgeting, which hides gross expenditures from scrutiny) and may lead to an unnecessary and inefficient accumulation of resource stocks.

In the view of the OECD Secretariat, the use of special funds in Luxembourg is especially problematic because there are many of them (32), more than in many OECD countries. There are also indications that the funds have been used to avert political pressure for additional expenditures that may arise from substantial budget surpluses, and as buffers to enable counter-cyclical budgetary policy during less favourable economic circumstances. Although perhaps understandable from the perspective of the Ministry of Finance, the protection of resources from full parliamentary scrutiny is not a defensible

justification for the use of extra-budgetary funds (Allen and Radev, 2006:17). Moreover, should Luxembourg implement an expenditure framework as outlined above, the budget margin or contingency reserve would be the appropriate means to cope with the budgetary implications of economic uncertainty.

Many OECD countries have infrastructure funds. The main reason for these funds is the efficient administration of earmarked taxes, fees and other non-tax revenues (such as proceeds from privatisation or mineral extraction). Indeed, the establishment of infrastructure funds is the most practical way of keeping earmarked revenues apart for special expenditures. However, these funds need not be extra-budgetary, in the sense of net budgeting. They can be a regular part of the budget, meaning that their gross expenditures and gross revenues are authorised in the regular budget. Budgetary funds of this kind can also be used to finance expenditures other than for infrastructure that are (partly) financed by earmarked revenues. One can think of investment funds (partly) financed by proceeds from mineral extraction, or civil service pension funds (partly) financed by premiums. However, apart from budgetary funds fed by earmarked revenues, the OECD Secretariat generally discourages the establishment of special funds.

The question remains whether special funds, be they extra-budgetary or budgetary, are necessary or useful for the management of expenditures that are supposed to cover several budget years, in particular investment expenditures. There are good reasons to infer that this is not the case. First, most OECD countries have carry-over rules in place that make it possible to transfer appropriations to the next budget year. This is particularly relevant for expenditures, such as investment expenditures, for which spend-out rates are difficult to plan in advance (because of the frequency of unexpected delays). Usually, carry-over rules contain certain checks to avoid the unnecessary build-up of resource stocks. A much-used constraint is that carry-over requires special permission, often from the Minister of Finance. Another often-used constraint is that carry-over is only allowed up to a certain percentage of the original appropriation. An advantage of an *ad hoc* decision by the Minister of Finance is that each case can be assessed on its merits and, more importantly, that the Minister of Finance can see to it that proper compensation is found in the next budget year either in the budget of the responsible minister or in that of another minister, so that total expenditures in the next budget year are not affected. Second, the vast majority of investment expenditure in the budgets of OECD countries is part of the regular budget and thus not financed by special funds. It is hard to see why certain investment expenditures, and particularly those of the special funds in Luxembourg, are so different from other investment expenditures that they would justify the use of special funds, let alone extra-budgetary funds.

Finally, it should be noted that abolition of the special funds will improve the budget balance. Since the special funds are used to reserve resources for specific future use, expenditures will be reduced if the funds are abolished. These resources could then be used to pay off the public debt. However, since the public debt is low in Luxembourg, it may occur in the future that surpluses have to be reserved. It is important to carry out a long-term sustainability analysis of public finances, taking into account the cost of ageing. If Luxembourg needs to build up a reserve to cover the future costs of ageing, budget surpluses could be transferred to a public pension fund. If not, or if the fund is at a sufficient level, the authorities could consider using budget surpluses to move towards a funded pension fund for civil servants, as exists in many OECD countries. The current pension fund for civil servants in Luxembourg is on a pay-as-you-go basis, with some

reserves to temporarily cover the costs of ageing. If Luxembourg were to move to a funded pension fund for civil servants, budget surpluses could be used to build up the fund. This would lead to lower premiums in the future, which would have to be reflected in lower gross public sector wages (in order to avoid having taxpayers' money end up in the pockets of civil servants). Finally, it is important to keep in mind that if structural tax revenues (as opposed to cyclical windfalls) exceed structural expenditures, there is room for tax relief.

2.9. Conclusions

To summarise, the OECD Secretariat recommends the following set of reforms for consideration by the authorities of Luxembourg:

- The incorporation of medium-term baseline figures into the budget estimates, at the line-item level, and for the same number of years (between three and five) covered by the expenditure framework.
- The adoption of a medium-term expenditure framework, covering the same period as the new medium-term estimates. At a minimum, this framework should impose an aggregate ceiling on expenditures in the central government budget, including interest payments on debt; the number of sub-ceilings (at the ministerial level), and whether to adopt a rolling or periodic framework, should be subject to further discussion.
- The adoption of a fiscal rule in the form of a trend-based balance rule. This will allow for counter-cyclical fiscal policy and predictable expenditure in uncertain times. In addition, the authorities may consider putting some constraint on tax expenditures and tax relief, for instance by a "pay-as-you-go" rule for the revenue side of the budget.
- The implementation of a programme-based budget classification but without a complex performance measurement regime. This reform requires strong budget units in line ministries, political support from the relevant minister, and early consultation with Parliament on the design of programmes. Performance information can be added to the budget documentation if it can be shown that such information has impacted on allocational decisions in the relevant ministries.
- The introduction and publication in the budget documentation of systematic sensitivity analysis of the impact of deviations from key assumptions, to enhance awareness of key fiscal risks and promote prudent policy choices.
- The imposition of specific sub-ceilings on aggregate expenditure for each line ministry in the budget circular. These sub-ceilings should not add up to the maximum total decided in the medium-term framework, but should leave a "budget margin" or contingency reserve of about 2% of the total planned expenditures.
- The introduction of horizontal explanations (comparing figures across fiscal years within the same set of estimates) and vertical explanations (comparing figures for a given year across successive sets of estimates) as an integral part of the budget documentation, to complement the new medium-term programme-based baseline estimates.
- The creation of a spending review mechanism co-ordinated by the Ministry of Finance. This mechanism should be closely aligned with the revision of the expenditure framework, regardless whether it is fixed or flexible (periodic review is more fitting to the former; continuous review is more fitting to the latter).
- The conversion of extra-budgetary special funds that are used for managing earmarked taxes, fees and other non-tax revenues, into budgetary funds.

- The abolition of all special funds that are fed exclusively by budgetary appropriations. Simultaneously, the carry-over rules should be reviewed and revised in order to make sure that appropriations for investment projects can be more easily transferred to the next budget year in cases of unexpected delays.

3. Financial reporting, internal audit and evaluation

3.1. Financial reporting

The main goal of financial reporting is to account for the use of public resources. While the year-end report is the government's main measure of accountability, in-year reports (monthly, quarterly and/or mid-year) are also important to help identify budget implementation issues and to develop appropriate responses in a timely manner. Two-thirds (21) of OECD countries publish information on actual budget revenues and expenditures on a monthly basis.

Luxembourg's accounting is on a cash basis. Apart from information submitted to the European Commission, Luxembourg does not publish interim financial reports. However, Parliament receives information on the revenue side on a monthly basis. In addition, in line with the law on state accounts, government ministries send to the Inspectorate of Finance a statement of commitments incurred (not yet paid) and future commitments for the current year and subsequent years, as well as information on expenditures under special funds within their jurisdiction. STATEC, the state statistical agency, publishes revenue and public debt information on line. Among the arguments for not providing more frequent reports is the fact that, given Luxembourg's small size, revenues are sensitive to *ad hoc* events (*e.g.* a company paying its tax liability can cause a peak in revenues). Finally, the figures in the government budget, in ESA95 and in the data published by STATEC are different, causing confusion for both Parliament and the public. While this can no doubt be disconcerting to some, it is nevertheless a problem faced by many countries and is easily mitigated by providing a brief explanation of how the figures are calculated and the different methodologies that are used.

3.2. Internal control

Luxembourg's internal control system is characterised by strong *ex ante* controls. These are mainly carried out by the Financial Control Directorate, although the Inspectorate of Finance may also be asked to undertake controls (see Section 1.3.3). These controls focus for the most part on ensuring that funds are properly accounted for and that regulations are complied with. This approach contrasts with the trend in many OECD countries towards stronger *ex post* controls in the form of internal audit.[12] *Ex post* control speeds up the commitment and payment process and is less costly, as it can focus on transactions characterised by relatively high risk. It should be mentioned, though, that in countries that have moved to internal audit, preventive control is usually not entirely abolished. In general, budget holders need the approval of the financial director of the ministry for commitments above certain thresholds or of certain types or in virtue of decrees on internal delegation. However, these decrees can be focused on specific risks and can be changed in the light of circumstances. This is a more flexible and less costly form of preventive control than the current control by the Financial Control Directorate. It should also be noted that, to the extent that budget line items are larger and more programme-oriented and that the legal expenditure constraints become fewer, there will be less need

for control from a compliance point of view. On the other hand, there is more to control from a performance point of view, and this can only be done through internal audit.

The *Law of 8 June 1999 on the State Budget, Accounts and Treasury* created the Financial Control Directorate. Prior to this law, the Court of Accounts controlled financial transactions and could block payments, often causing delays. Today, the financial controllers intervene twice. First, they approve any proposed commitments within ten days at most. Second, they approve payment orders within eight days at most. At either stage there may be occasional delays, mainly due to the need to seek additional legal advice.[13] The focus of controls is on compliance with financial and accounting regulations. In addition to this main task, the financial controllers conduct *ex post* controls for 42 *services à gestion séparée*. Financial controllers also review and certify certain operations receiving assistance from EU structural funds (level 1 control).[14]

The Financial Control Directorate is housed in the Ministry of Finance and plays a co-ordinating role providing methodological guidance. The Directorate's financial controllers are based within the ministries and carry out their work independently. In total, the Financial Control Directorate employs around 37 people (some part-time) with an average of four financial controllers assigned to each group (and each group covers an average of three ministries), depending on the volume of work. Each financial commitment and payment must be approved by a financial controller.[15]

In the first stage of controls, the financial controller grants or refuses a "visa" which would allow the commitment of funds. If a visa is refused, the financial controller informs the relevant minister and the Ministry of Finance. The relevant minister then writes an official response which the financial controller can either accept or refuse for a second time. In the case of a second refusal, the minister can still override the financial controller by issuing a "*passer outre*" provided there are sufficient funds available. This allows for a certain autonomy, although the minister must assume political responsibility for his or her decision, as underlined by the fact that a copy of the *passer outre* is sent to Parliament. In practice, this is a fairly rare occurrence. In the second stage, the financial controller checks legal compliance and verifies that payment orders have been correctly entered into the accounts, and again issues or refuses a visa. As such, Luxembourg's financial controllers play a role largely left to accountants in most OECD countries.

A recent report from the Financial Control Directorate shows that during the period from 1 January 2010 to 31 January 2011, the financial controllers verified 29 509 commitments and 174 473 payment orders. During this period, 199 visas were refused (down from 257 in 2009) with 56 refused twice (down from 71 in 2009). In 27 of the cases which received two refusals, the minister used the *passer outre*. It should be noted that in most cases when a dossier is judged incomplete, rather than refuse a visa the financial controller will go back to the person responsible for more information/completion. The number of returned dossiers during the period from 1 January 2010 to 31 January 2011 was 3 680. A global view of the results of controls during the past ten years can be seen in Tables 3 to 5 which are drawn from the 2010 annual report of the Financial Control Directorate.

3.3. Internal audit

The Institute of Internal Auditors (IIA) defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a

Table 3. **Visas refused and *passer outre* in 2001-10**

Number of visas refused	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010[1]
First refusal	594	744	591	458	424	301	257	272	257	199
Second refusal	37	106	112	94	64	54	54	68	71	56
Passer outre	11	58	69	45	33	31	34	43	51	27

1. 13 of 16 months. Payment on commitments for a given fiscal year can be made up to four months after the end of the fiscal year.

Source: Ministry of Finance (2010), "Le rapport d'activité 2010", Ministry of Finance, Luxembourg.

Table 4. **Visas and returned dossiers in 2001-10**

Budget year	Visas approved	Visas refused			Total visas	Visas refused in %
		Refused	Returned dossier	Total		
2001	229 830	594	6 410	7 004	236 834	2.96
2002	237 123	744	5 961	6 705	243 828	2.75
2003	246 629	591	4 418	5 009	251 638	1.99
2004	254 861	458	3 990	4 448	259 309	1.72
2005	244 488	424	4 350	4 774	249 262	1.92
2006	225 419	301	3 717	4 018	229 437	1.75
2007	217 405	257	3 613	3 870	221 275	1.75
2008	220 268	272	3 772	4 044	224 312	1.80
2009	214 609	257	3 036	3 293	217 902	1.51
2010[1]	200 103	199	3 680	3 879	203 982	1.90

1. 13 of 16 months.

Source: Ministry of Finance (2010), "Le rapport d'activité 2010", Ministry of Finance, Luxembourg.

Table 5. **Reasons for refusal of visas, 2001-10**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Absence of legal basis/legal basis incorrect	94	74	44	25	44	52	26	42	86	61
Ex post commitment	130	209	179	129	126	74	73	76	59	45
Non-compliance with the law or with procedures	47	112	78	53	49	35	36	57	32	43
Non-compliance with procurement legislation[1]	103	108	124	97	83	79	55	34	25	22
Budget allocation error	98	47	71	53	44	18	19	10	13	10
Non-compliance with legislation on travel and related expenses	53	110	31	18	17	13	11	22	11	2
Payment not due	2	20	13	10	14	8	15	6	6	3
Other	67	64	51	73	47	22	22	25	25	13
Total	**594**	**744**	**591**	**458**	**424**	**301**	**257**	**272**	**257**	**199**

1. A new procurement law (25 June 2009) sought to bring national procurement legislation in line with European procurement legislation.

Source: Ministry of Finance (2010), "Le rapport d'activité 2010", Ministry of Finance, Luxembourg.

systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (IIA, 2004). At present, Luxembourg does not have a procedure of internal audit. This is in contrast to the majority of OECD and EU countries (and the European Commission[16] itself). In countries with established internal audit, its function is generally to support the relevant ministry or agency by evaluating and improving the effectiveness of risk management.

The concept of risk may include the following elements: misuse (including waste) of human and technical resources, including external aid; failure to execute budgetary and other policy decisions in a regular and efficient manner; fraud and error; unsatisfactory accounting records; and failure to produce timely and reliable financial and resource management information.

As demonstrated in Table 6, 26 OECD member countries have internal audit units and, of these, 21 indicated comprehensive coverage, with internal audit units in 81-100% of ministries. In 20 of these countries, internal audit is prescribed by legislation.

Table 6. **Internal audit units within ministries**

Response option	Number	Countries
81-100%	21	Australia,[1] Austria, Canada, Czech Republic, France, Germany, Hungary, Ireland, Italy, Japan, Korea, Mexico, Netherlands, Poland, Portugal, Slovak Republic, Sweden, Switzerland,[2] Turkey, United Kingdom, United States[3]
61-80%	1	Denmark
41-60%	1	Finland
21-40%	1	Greece
0-20%	2	Belgium, New Zealand
None	4	Iceland, Luxembourg, Norway, Spain[4]

1. Australia: The role of audit units is detailed in the *Financial Management and Accountability Act 1997*. Internal audit units operate in support of audit committees and are also guided by best practice guidelines issued by the Auditor-General (an officer of Parliament) and by international standards for internal audit.
2. Switzerland: With one exception, the financial inspectorates are assigned to specific administrations, *i.e.* at a sub-ministerial level.
3. United States: All cabinet agencies and major agencies have internal audit units; small agencies do not.
4. Spain: There are internal audit units in all ministries; they depend on the Treasury and carry out permanent financial control.

Source: Based on Question 66 ("Do any line ministries have internal audit units?") in OECD (2007), *OECD Budget Practices and Procedures Survey*, *www.oecd.org/gov/budget/database*.

The main international standards underpinning internal audit are the INTOSAI "Guidelines for Internal Control in the Public Sector" and the ECIIA "Position Paper on Internal Audit in Europe". The OECD (2002) has also noted the importance of internal audit in the "OECD Best Practices for Budget Transparency" which state that a dynamic system of internal controls, including internal audit, should be in place to assure the integrity of information provided in the reports.

Typically, internal auditors are tasked with carrying out both financial and performance (or "value-for-money") audits. Performance audit is generally seen as a necessary complement of a more programme-oriented budget process. At present, no performance audits are being carried out in Luxembourg. The Court of Accounts does, however, undertake some work on its own initiative which looks at aspects of financial management which may include performance. This work can be found in the Court's "special reports".

When setting up internal audit, it is recommended that there be a central harmonisation unit (CHU) located within the Ministry of Finance to set standards for internal audit and functionally independent internal audit units in the ministries and agencies (see Box 3). However, internal auditors are not representatives of the Ministry of Finance, and they carry out their work independently in the ministries and agencies where they are assigned. As such, this structure is fairly similar to the one already in place in Luxembourg for the Financial Control Directorate.

Given that internal auditors report to the management of the line ministry or agency where they are located, it is essential that there be a relationship of trust between internal auditors and management. Again, internal auditors should not be seen as the eyes and ears of the Ministry of Finance. An additional point is the importance of ensuring that internal audit reports are of high quality and that they focus on risks that need attention or action. In other words, internal auditors should think strategically about prioritising the information reported to management.

Finally, it is important to define the relationship between internal and external auditors. The IIA recommends that internal and external auditors co-ordinate to: discuss

Box 3. **The European Union and public international financial control (PIFC)**

The PIFC model of the EU attempts to "assist national governments in re-engineering their internal control environment and in particular to upgrade their public sector control systems in line with international standards and EU best practice". The main international standards underpinning the PIFC model are the INTOSAI "Guidelines for Internal Control in the Public Sector" and the ECIIA "Position Paper on Internal Audit in Europe". These are complemented by the INTOSAI "Lima Declaration of Guidelines on Auditing Precepts of 1977" which constitutes key international standards for public external audit.

An essential element of the PIFC model is a central harmonisation unit (CHU) that is "empowered to manage the development of PIFC". According to the European Commission, a CHU is defined as "a policy unit attached and directly reporting to the Minister of Finance on the status of internal control in the entire public sector, responsible for redesigning, updating and maintaining the quality of the internal control systems, for harmonising and co-ordinating definitions, standards and methodologies, for networking between all actors (managers, financial officers, internal auditors), for the establishment and co-ordination of sustainable training facilities, including the setting of criteria for the certification of public internal auditors, and for all other actions to improve public internal control systems".

Ideally, the tasks of a CHU are facilitated by "close co-ordination and co-operation with the State Audit Office, professional private organisations (such as the local IIA) and academic circles".

Source: European Commission (2006), *Welcome to the World of PIFC: Public Internal Financial Control*, Directorate-General for Budget, *http://ec.europa.eu/budget/library/biblio/documents/control/brochure_pifc_en.pdf*.

common interests; benefit from their complementary skills, areas of expertise, and perspectives; gain understanding of each other's scope of work and methods; discuss audit coverage and scheduling to minimise redundancies; provide access to reports, programmes and working papers; and even jointly assess areas of risk. Countries like the United Kingdom have gone so far as to produce good practice guidelines on co-operation between internal and external auditors which look at the potential benefits of co-operation, how to build co-operation, and opportunities for co-operation in practice. However, while internal and external auditors have mutual interests regarding the effectiveness of risk management and internal financial controls, the scope of their work differs. Internal auditors are located in the line ministry or agency and, while they carry out their work independently, they report to the management of the line ministry or agency. External auditors are autonomous bodies that typically report to Parliament. Their primary mission is to provide an independent opinion on ministries' and agencies' annual financial statements. In rare cases, internal auditors are also asked to provide opinions on financial statements. This is currently the case in the Netherlands, and Denmark is considering moving in this direction. In the Netherlands, the result has been a dramatic growth in internal audit units (from around 50 employees in the late 1980s to around 800 employees today). Furthermore, duplication may arise, and role confusion, with external auditors becoming increasingly dependent on the work of the internal auditors. In the light of this experience, the OECD Secretariat does not favour assigning this assurance task to internal auditors as part of the reform. Rather it recommends that internal audit units remain small – in Luxembourg's case for example, around three to four internal auditors per ministry.

3.4. Evaluation as a tool of policy development

In thinking about potential reforms to enhance the budget process, Luxembourg may wish to consider performance evaluations (in addition to spending reviews that were addressed in Section 2). Performance evaluations are widespread in OECD countries, where line ministries typically commission or conduct reviews of ongoing, new or completed programmes. At present, Luxembourg does not use performance evaluations, although there are a handful of examples where ministries have requested evaluations of certain policy areas, for example broad evaluations of policies for the elderly (in the 1980s) and (more recently) for handicapped and disabled persons, as well as several evaluations (on an annual basis) on quality assurances for youth housing.

Performance evaluation[17] is an important tool for line ministries when developing or seeking to improve policies, particularly when forced to prioritise within certain budgetary restrictions. However, several competing incentives come into play for line ministries when deciding to undertake performance evaluations. Ministers have an incentive to demonstrate that their policies are effective, as they are held accountable for them in Parliament and thus before the public. At the same time, ministers may be wary of critical assessments of policies for which they bear the primary responsibility. This creates an incentive for evaluations early in their tenure, as the results of such evaluations are attributable to their predecessors, and makes it more likely that evaluations undertaken later in their tenure remain internal. Given the long tenure of ministers in Luxembourg, performance evaluations may prove difficult to institute.

The criteria to help select priority programmes for evaluation include the following: large spending programmes or programmes of particular policy importance; programmes being considered for scaling up; and programmes that have shown signs of problems. Governments must also consider the timeliness of an evaluation to ensure that it feeds into decision making. While evaluations may be commissioned by government departments, they should include independent evaluators to ensure objectivity and to avoid potential conflicts of interest. Another option is to contract out evaluations to research institutes, consultancy bureaus, or universities. Both options increase the perceived credibility and reliability of the evaluations.

In a number of countries, a governmental body may be charged with performance evaluation on an *ad hoc* or more regular basis, particularly in the economic and social domain (*e.g.* Australia's Productivity Commission, Mexico's National Commission of Evaluation of Social Development Policy, the Netherlands Bureau for Economic Policy Analysis, and the Swedish Stadskantoret). A large amount of evaluation may also be undertaken by independent bodies on their own initiative or at the behest of a ministry or agency, for example universities, specialised research institutes, advisory councils, think tanks, political parties, lobbying groups, labour unions, and business associations.

Arguably, the general trend towards a more active culture of evaluation in many OECD countries has mitigated, to a certain extent, the reputational risks to ministers discussed above. In addition, a number of OECD countries (for example, Canada, the Nordic countries, and the United Kingdom) have formulated rules to bring some uniformity to the procedures for sectoral evaluation undertaken by line ministries and to impose quality standards. These rules may concern the inclusion of evaluations in the budget documentation, quality criteria for policy evaluations, publication of the reports, and independence of evaluators (who are often research institutions under contract). Given Luxembourg's small size, it may be useful to invite experts from abroad to participate in evaluations if local capacity is lacking.

Box 4. **United Kingdom Treasury: *The Green Book – Appraisal and Evaluation in Central Government***

In 2003, the Treasury of the United Kingdom produced *The Green Book* which provides a framework for the appraisal and evaluation of all policies, programmes and projects. This includes appraisals to support a government decision to adopt a new policy – or to initiate, renew, expand or re-orient programmes or projects – which would result in measurable benefits and/or costs to the public, as well as retrospective evaluations of a policy, programme or project at its completion or revision. In addition, *The Green Book* describes how the economic, financial, social and environmental assessments of a proposal should be combined.

The Green Book covers the following activities:

- Policy and programme development: Decisions on the level and type of services or other actions to be provided, or on the extent of regulation.
- New or replacement capital projects: Decisions to undertake a project, its scale and location, timing, and the degree of private sector involvement.
- Use or disposal of existing assets: Decisions to sell land, or other assets, replace or relocate facilities or operations, and whether to contract out or market test services.
- Specification of regulations: Decisions, for example, on standards for health and safety, environmental quality, sustainability, or to balance the costs and benefits of regulatory standards and how they can be implemented.
- Major procurement decisions: Decisions to purchase the delivery of services, works or goods, usually from private sector suppliers.

In addition to the overall framework in *The Green Book*, there is a wide range of detailed supplementary guidance on particular issues, including: valuation of public sector assets; competition; crime; discounting; environment; evaluation; health; multi-criteria decision analysis; optimism bias; private finance initiative; regeneration and the regions; risk; stated preference techniques; and transport. The United Kingdom Treasury also provides related guidance on spending proposals and business cases, and on regulatory proposals and impact assessments.

The Green Book aims to ensure consistency and transparency in the appraisal process throughout government and, while departments' and agencies' own manuals or guidelines may provide supplementary guidance in their specific areas, they must be consistent with *The Green Book* principles.

The Green Book is available at *www.hm-treasury.gov.uk/data_greenbook_index.htm*.

3.5. Conclusions

To summarise, the OECD Secretariat recommends the following set of reforms for consideration by the authorities of Luxembourg:

- In line with best practice and European requirements,[18] Luxembourg should publish monthly financial reports on a cash basis. In addition, an explanation of the reasons for the differences in the data from the government budget, from ESA95 and from STATEC would help mitigate potential confusion on the part of Parliament and the public. Luxembourg may also wish to consider a mid-year report, which could be of particular use for informing the parliamentary committees overseeing the budget.
- Luxembourg should seek to move from a system of *ex ante* control to *ex post* controls in the form of internal audit, in connection with the introduction of a more programme-

oriented budget classification. In line with other countries that have introduced internal audit, Luxembourg could maintain a preventive *ex ante* check by the Financial Control Directorate of the Ministry of Finance on compliance for expenditures exceeding certain thresholds or of certain types.

- The introduction of internal audit requires a central harmonisation unit, based in the Ministry of Finance, and internal auditors working independently in, and reporting to the management of, ministries or agencies. A relationship of trust between the internal auditors and management is critical to successful risk management. Internal audit units in ministries or agencies should remain small and focused. Ultimately, while internal auditors and external auditors have common interests, the OECD Secretariat does not recommend that internal auditors be given an assurance task; this should be left to external audit. The Financial Control Directorate can be reorganised to form the central harmonisation unit (CHU) and be partly decentralised to form the internal audit units of the ministries and agencies.
- Luxembourg may wish to consider introducing periodic performance evaluations to enable line ministries to assess the efficiency and effectiveness of their programmes. The credibility of such evaluations is enhanced when they include outside experts. Luxembourg has some experience with using universities and research institutes, and such partnerships could be expanded. It is useful to develop both criteria for the selection of programmes to be evaluated and a set of rules regarding evaluation. Luxembourg can draw on concrete examples which exist in many OECD countries.

4. Consistency with new European requirements

4.1. Outline of the European Commission package

The global economic and financial crisis and ensuing developments (sovereign debt crisis) have exposed the need for greater co-ordination and enhanced surveillance of economic policies in the European Union. The strategic elements of reinforced economic governance were outlined in the Commission's Communication of 12 May 2010, and a concrete toolbox was presented in a second Communication on 30 June 2010. On 29 September 2010, the Commission adopted a package of legislative proposals transforming these policy initiatives into concrete legal instruments (see Table 7 and Annex A1 for a detailed description).

The six legal instruments proposed in the legislative package cover three main subjects. First, the Commission proposes to reinforce member states' compliance with the Stability and Growth Pact (SGP) and to deepen fiscal policy co-ordination. Excessive debt must be addressed more seriously than in the past. Fiscal responsibility is encouraged by setting minimum requirements for national fiscal frameworks to make sure they are in line with EU Treaty obligations.

Second, the Commission proposes to broaden economic surveillance to prevent, detect and correct macroeconomic imbalances and divergences in competitiveness. This proposal is designed to tackle intra-EU imbalances, and especially those of the euro area, in a preventive and effective way. In practical terms, this means creating a scoreboard of economic and financial indicators and carrying out in-depth country analyses. When necessary, the Commission will send country-specific recommendations to member states. Euro-area members who show insufficient compliance with their respective recommendations could also face sanctions.

Table 7. **European Commission legislative package of 29 September 2010**

Fiscal surveillance	Macroeconomic surveillance
Preventive arm of the Stability and Growth Pact: principles of prudent fiscal policy making (amendments to Reg. 1466/97 – ordinary legislative procedure)	New procedures for monitoring, preventing and correcting macroeconomic imbalances (new draft regulation – ordinary legislative procedure)
Corrective arm of the Stability and Growth Pact: benchmark for sufficiently diminishing debt ratio (amendments to Reg. 1467/97 – special legislative procedure; Parliament and European Central Bank consulted)	
Minimum requirements of national fiscal frameworks (new draft Directive – Council decides after consulting Parliament)	
Enforcement	**Enforcement**
New disincentives/sanctions in case of non-compliance in preventive and corrective arm of the SGP (new regulation – ordinary legislative procedure)	New disincentives/sanctions in the case of non-compliance with provisions of new macro surveillance (new draft regulation – ordinary legislative procedure)

Source: European Commission (2010), "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", consolidated version endorsed by the ECOFIN Council on 7 September 2010, Brussels, *http://ec.europa.eu/economy_finance/sgp/pdf/coc/2010-09-07_code_of_conduct_ (consolidated)_en.pdf* (accessed December 2011).

The third element of these proposals aims at strengthening the enforcement mechanisms. Effective, timely and fairly applied enforcement mechanisms are crucial for the functioning of the economic surveillance framework. This requires the introduction of a wider range of sanctions and incentives, which would be applied gradually and at an earlier stage of the surveillance process than is currently the case in the euro area.

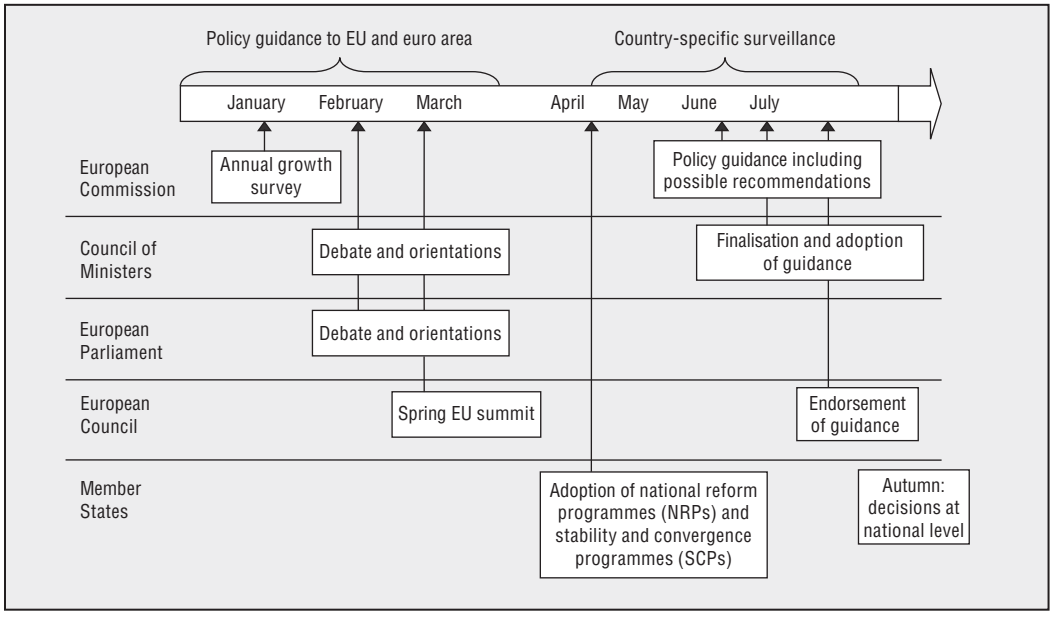
On 29 September 2010, the European Commission presented a legislative package. These proposals were welcomed by the European Council in October and December. The Commission, the European Parliament and the Council agreed that they should be "fast-tracked" and adopted by summer 2011, and thus be part of the new governance cycle for 2011. On 17 December 2010, mid-2011 was confirmed as a target date by the ECOFIN Council.

The Commission's package must still be approved by the European Council, but the proposals do not require any change in the current treaties, so the adoption date is realistic. Moreover, the Commission's proposals are largely in line with proposals developed by EU finance ministers in the Taskforce on Economic Governance chaired by European President Van Rompuy.

On 12 January 2011, the European Commission issued the Annual Growth Survey which recommends priorities to member states in the areas of economic and budgetary policy. The adoption of the AGS marks the beginning of the first cycle of co-ordination of the member states' macroeconomic, budgetary and structural reform policies, known as the "European Semester". In this context, member states are required to take into account the common EU goals in accordance with the rules of the Stability and Growth Pact.

The European Semester is a period of co-ordination during which member states will have the chance to review each other's economic policies before they have been implemented (see Figure 3). The European Semester cycle will start early in the year with a horizontal review, in which the Eurogroup,[19] the Council of Ministers (ECOFIN Council) and the European Council will identify common economic challenges and give strategic guidance on policies. Member states will take these broad policy orientations into account when preparing their stability and convergence programmes and national reform

Figure 3. **The European semester**



Source: European Commission (2010), "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", consolidated version endorsed by the ECOFIN Council on 7 September 2010, *http://ec.europa.eu/economy_finance/sgp/pdf/coc/2010-09-07_code_of_conduct_(consolidated)_en.pdf* (accessed December 2011).

programmes, submitted in April. Based on the Commission's assessment, the Council of Ministers will subsequently provide its assessment and guidance to member states in June and July, when important budgetary decisions are still in a preparatory phase in most member states. During its term of EU presidency, Hungary will be responsible for guiding the implementation of the first European Semester in the history of the European Union.

4.2. *Reinforced EU requirements for national fiscal frameworks*

Of all the proposals for reinforced economic governance, the new requirements for national budgetary frameworks[20] are probably the most relevant to national budgetary policy making. The requirements cover five main areas of financial management: *i)* accounting and statistics issues; *ii)* forecasting practices; *iii)* numerical fiscal rules; *iv)* medium-term budgetary frameworks; and *v)* transparency and comprehensive scope of the national fiscal framework. Each of the five areas is elaborated briefly in a separate chapter of the draft EU Directive.

4.2.1. *Accounting and statistics issues (Chapter II of the draft Directive)*

Common accounting practices for all sectors of general government fully in line with the EU regulations are an important precondition for the production of high-quality and comparable statistics across member states, which in turn is crucial for a proper functioning of the EU fiscal surveillance framework. Recent fiscal distress episodes underscore the importance of the availability of timely and reliable fiscal data.

Article 3(1) requires that member states' public accounting systems should be subject to internal control and independent audit.

- Internal control refers to internal supervision of the integrity of data production systems. This is a well-established practice in most advanced economies with solid institutional frameworks and should not pose major problems for member states.

- The term "audit" refers to external auditing. This is already in place in most member states and is mainly based on the regular auditing and control carried out by bodies such as the court of accounts. A problem identified by Eurostat is that, in some countries, such external audit applies to the central government while the remaining institutional sub-sectors are only occasionally or rarely audited. This Article of the Directive is intended to make sure that all government layers are subject to this regular control.

Finally, in a context of evolving and increasing fiscal surveillance, Article 3(1) seeks also to ensure that accounting rules ensure the production of data based on EU standards. National systems of public accounting and statistics should remain consistent across all government layers and provide policy makers with reliable data to facilitate proper budgetary surveillance.

Article 3(2)(a) requires member states to publish cash-based fiscal data at a monthly frequency, covering central government, state government and social security funds before the end of the following month, and at a quarterly frequency for the local government sub-sector before the end of the following quarter. See Box 5 for the motivation behind this requirement.

Article 3(2)(b) requires member states to provide a detailed reconciliation table showing the elements of transition between cash-based and ESA95-based data. The table should also contain methodological explanations of how cash data is translated into ESA95 figures.

Box 5. **Arguments for monthly cash-based data***

While the informational content of monthly data taken separately (*i.e.* each single monthly figure) may be very low, the time series can reveal patterns warranting closer surveillance, which the corresponding ESA95 figures would confirm only at a later stage. In general, differences between cash and accrual figures stem mainly from a different timing of recording. Thus, statistical discrepancies between effective cash payments and the underlying expenditure commitments, between interest paid and interest accrued, and between effective cash receipts and the existent revenue claims should approximately cancel each other over the medium term. Large and protracted differences between accrual and cash data suggest the existence of budgetary problems not yet identified through the use of national accounts statistics.

Recent studies undertaken by the European Central Bank show that the so-called mixed-frequency models, which are based on the use of monthly, quarterly and annual budgetary data, can provide forecasts of fiscal variables that are in some respects superior to methods relying exclusively on annual or quarterly data. Specifically, the three-frequency structure of these models allows to now-cast quarterly figures by using monthly fiscal statistics and in turn to use quarterly and monthly figures to now-cast annual data. A rich set of intra-annual fiscal data may provide useful information for real-time fiscal monitoring.

Last but not least, country experiences in other statistical fields consistently show that the compilation of data with a higher frequency (*i.e.* monthly and quarterly figures) has a favourable impact over the medium term on the quality of statistics with lower frequency (*i.e.* annual data). The provision of these monthly data and the gradual improvement of their quality may help in the future to reduce the size of the revision of fiscal figures experienced by some member states in the context of the notifications for the excessive deficit procedure (EDP).

At present, the United Kingdom is the only country with a tradition of monthly cash data collection for the general government sector. Greece, in the context of its adjustment programme, aims to produce these monthly data by establishing a central collection

Box 5. **Arguments for monthly cash-based data*** **(cont.)**

mechanism with a summary questionnaire to be completed by all ministries, which in turn will be responsible for its completion by all bodies and agencies under their supervision. A number of member states already produce monthly data for some sub-sectors (mainly central government), and some other highly decentralised countries are ready to provide monthly statistics for regional governments (*e.g.* Germany).

Admittedly, the benefits of having monthly data must be assessed against the cost of their collection. For instance, if the local government tier represents only a small percentage of all general government finances, this sub-sector could be exempted from the provision of monthly data. This option would imply the need to establish appropriate thresholds to adequately balance the benefits of the availability of monthly cash data against the costs of collection.

* Internal note of the European Commission.

4.2.2. Macroeconomic and budgetary forecasting (Chapter III of the draft Directive)

Budgetary discipline relies on a realistic and credible budget, and deviation from key economic assumptions underlying the budget is a government's key risk (see Section 2). Transparency, which is crucial for responding to risks, includes the availability for scrutiny of the methodologies, assumptions and parameters used in the official forecasts. The consideration of alternative scenarios is necessary for assessing the impact of different economic assumptions on the budget. The reliability of the forecasts used for budgetary planning can be usefully enhanced by comparison with forecasts of other bodies or institutions, where the Commission forecasts might serve as a natural reference depending on the timing of their publication.

Article 4(1) stipulates that macroeconomic and budgetary forecasts shall be prepared based on the most probable macro scenario or on a more prudent one. Significant differences between the chosen macro-fiscal scenario and the Commission forecasts shall be explained.

Article 4(2) establishes that macroeconomic forecasts for fiscal planning shall comprise alternative scenarios to examine the path of fiscal variables under different economic conditions. The presentation of these scenarios has to be seen as a sensitivity analysis showing how the main fiscal variables could evolve under different macroeconomic assumptions. Therefore, the practice does not entail the preparation of alternative budgets. This is a well-established practice in other economic policy exercises (*e.g.* the stability and convergence programmes) and is also carried out by some member states for the preparation of the annual budget.[21]

4.2.3. Numerical fiscal rules (Chapter IV of the draft Directive)

Member states must formulate numerical fiscal rules conducive to the respect of the deficit and debt thresholds and steering the expenditure side. The thresholds are defined in the Stability and Growth Pact (SGP) and the criteria are further developed in Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies (see Box 6).

Article 5(1) specifies that member states shall formulate country-specific numerical fiscal rules that effectively promote the compliance of a multi-annual framework for

Box 6. **EU deficit, debt and expenditure requirements**

The corrective arm of the Stability and Growth Pact is meant to avoid gross errors in budgetary policies, which might put at risk the sustainability of public finances and potentially endanger the European Economic and Monetary Union (EMU). This translates into the obligation for member states to avoid excessive government deficits, which are defined against numerical thresholds for the headline deficit (3% of GDP) and for debt (60% of GDP or sufficiently declining toward it). The procedure that implements the ban on excessive deficits (EDP) provides for a sequence of steps which, for euro-area countries, includes the eventual imposition of financial sanctions.

While the 2005 reform of the SGP confirmed the fundamental requirements for the deficit (3% of GDP) and debt (60% of GDP), member states were allowed to temporarily deviate from these thresholds on the condition of undertaking reforms with a positive impact on public finance sustainability in the long term. Therefore, the 2005 revisions of the preventive arm of the SGP have given an important role to the debt developments as well as to country-specific circumstances.

According to the preventive arm of the SGP, since 2005 member states are required to outline their plans to achieve their medium-term budgetary objectives (MTOs) in their stability and convergence programmes. MTOs are defined as a percentage of GDP in structural terms and vary across countries around a close-to-balance position, to reflect the level of public debt and liabilities related to ageing. For member states that have adopted the euro, the country-specific medium-term budgetary objectives should be specified within a defined range between –1% of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures. Member states not having reached their medium-term budgetary objectives are expected to converge towards them at an annual pace of 0.5% of GDP in structural terms.

One of the proposals in the Commission's package of 29 September 2010 includes amending the Council Regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies. The amendment aims at putting constraints on the expenditure side by making expenditures more dependent on GDP growth. It prescribes that, in member states that have achieved their MTOs, annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. In member states that have not yet reached their MTOs, annual expenditure growth should not exceed a rate below the same reference rate, unless the excess is matched by discretionary revenue measures.

general government as a whole with their respective obligations deriving from the Treaty (the existing thresholds). The influence of fiscal rules on the conduct of fiscal policy depends on a number of features related to their design (*e.g.* monitoring mechanisms, enforcement procedures, escape clauses, etc.). Chapter IV of the draft Directive takes due account of these design features and establishes a number of requirements accordingly.

Article 6(1) establishes that, without prejudice to the Treaty provisions on budgetary surveillance, numerical fiscal rules shall contain specifications on the targeted objectives and the scope of the rules, the effective and timely monitoring of compliance with the rules, and consequences in the event of non-compliance. Article 6(2) requires that escape clauses, if provided in the fiscal rules, should set out a limited number of specific circumstances or define stringent procedures in which temporary non-compliance is permitted.

During negotiations on the draft Directive, the European Commission clarified that consequences in case of non-compliance with the existent fiscal rules should be understood in the broad sense, and therefore the consequences should not necessarily entail the imposition of financial or "hard" sanctions. These sanctions could be of a simple reputational nature, *e.g.* the obligation for the finance minister to publicly explain why the rules were not respected.

The establishment of well-defined escape clauses, specifying under which circumstances deviations from the target are permitted, should be seen as a key element of fiscal rules. Such clauses normally refer to natural disasters or acute economic slowdowns or recessions. Clear and detailed escape clauses may reinforce credibility by limiting the list of events allowing for non-compliance with the rules. On the contrary, vague and non-concrete clauses facilitate circumvention and may entail the ineffectiveness of the rules. Overall, the definition of escape clauses requires particular attention, and their final design should ensure that they are only applied in a limited number of circumstances.

The EU reinforced governance package includes a new "principle of prudent fiscal policy". Notably, the Commission proposes that annual general government expenditure growth should not exceed a prudent medium-term rate of growth of GDP, unless the excess is compensated by measures on the revenue side. The new principle must be seen as an expenditure rule, as it constrains general government expenditures for an indeterminate period (see Section 2.3 and Box 6).

4.2.4. *Medium-term budgetary framework (Chapter V of the draft Directive)*

Although the approval of the annual budget bill remains the key step for making important budgetary policy decisions, most fiscal measures have budgetary implications that go well beyond the annual budgetary cycle. Therefore, the Stability and Growth Pact already required the inclusion of a multi-annual perspective in the annual stability and convergence programmes. This requirement would allow the assessment of compliance with the thresholds of the Pact.

A medium-term budgetary framework (MTBF) is a necessary pre-condition for ensuring consistency between national fiscal policy and the EU thresholds. For this purpose, the Directive requires medium-term revenue and expenditure estimates in an appropriate breakdown.[22] In addition, broad coverage of general government sub-sectors is essential. Against this background, the draft Directive sets out some minimum requirements concerning domestic budgetary frameworks:

- Article 8(1) requires member states to establish a medium-term budgetary framework with a planning horizon of at least three years. The European Commission specified that the three-year period includes the forthcoming budget year and the two following years. This provision does not imply the adoption of a multi-annual budget, which remains optional for all member states.
- Article 8(2) requires member states to provide detailed baseline estimates of each major expenditure and revenue item by general government sub-sectors for the period covered by the framework.

4.2.5. *Transparency of general government finances and comprehensive scope of budgetary frameworks (Chapter VI of the draft Directive)*

Comprehensive coverage is crucial for ensuring that the national fiscal framework provides an accurate picture of the current and expected state of public finances. This chapter of the Directive adopts a twofold perspective to promote these elements.

First, the growing fiscal decentralisation in a significant number of member states calls for a comprehensive scope for the rules governing domestic fiscal policy. Apart from the inclusion of medium-term baseline estimates for sub-sectors (see Section 4.2.4), this implies the existence of appropriate co-ordination mechanisms across government sub-sectors, including the establishment of numerical fiscal rules for all layers.

Second, Chapter VI also promotes the transparency and reliability of public finances by requiring information on specific elements of domestic fiscal policy making that are frequently outside the standard budgetary process. Recourse to extra-budgetary funds and to tax expenditures and the creation of contingent liabilities (guarantees) may obfuscate the true situation and the development of public finances, thereby hampering the planning and conduct of fiscal policy.

Article 12(1) establishes that all general government bodies and funds which do not form part of the budgets at sub-sector level shall be identified and presented in the framework of the annual budgetary process. This shall comprise the inclusion of detailed information on extra-budgetary funds and their operations in the budget documentation (not necessarily in the budget itself; the provision is meant to make sure that all extra-budgetary funds are clearly identified and that their final impact on the budget balance and debt in the framework of the annual budgetary process and the medium-term budgetary plans is properly taken into account).

Article 12(2) requires member states to publish detailed information on the impact of tax expenditures on government revenues. In a significant number of member states, the growing recourse to tax expenditures is partly undermining fiscal planning and is also being used to circumvent some of the fiscal rules currently in place. Comprehensive and transparent information on the existing tax expenditures and reliable estimates of their impact on the general government balance may help reduce their extensive use by raising awareness of their budgetary cost.

According to Article 12(3), member states must publish information on contingent liabilities with potentially large impacts on their budgets, including government guarantees, non-performing loans, and liabilities stemming from the operation of public corporations. Member states shall also publish information on general government participation in the capital of private and public corporations for economically significant amounts.

4.3. Budgetary practices in Luxembourg versus the new EU requirements for national fiscal frameworks

4.3.1. Accounting and statistics issues

According to the analysis carried out by the European Commission, almost all member states meet most of the requirements included in the chapter of the Directive on accounting and statistics. The Luxembourg system is broadly in line with the minimum requirements of the Directive: adequate control and audit mechanisms are in place, accounting rules are properly developed to take due account of innovative transactions, and a detailed description of the transition from cash to ESA95-based data is given in Volume 3 of the Luxembourg budget law.

To fully meet the new requirements, Luxembourg should start publishing cash-based fiscal data at a monthly frequency, covering the sub-sectors of central government and social security, before the end of the following month, and at a quarterly frequency for the local government sub-sector before the end of the following quarter.

The new requirements also apply to the sub-national level; therefore the improvement of local statistics and accounting should also become a part of the reform agenda in Luxembourg. In this connection, it is also important that the authority of the Court of Accounts be extended to the audit of local accounts and statistics in order to ensure compliance with the new European legislation.

4.3.2. *Forecasting practices*

Current arrangements in Luxembourg – in particular macroeconomic forecasting practices by STATEC – are in line with the draft Directive requirements.

In order to comply with the EU requirements for budgetary forecasting, Luxembourg must introduce medium-term estimates (or baseline estimates) for both current and capital expenditures as well as for public revenues. Specific recommendations for the development of baseline estimates are provided in Section 2.

The use of alternative macroeconomic scenarios in the context of annual budget preparation is another area where current practice in Luxembourg is not yet fully aligned with the new EU requirements. Specific recommendations are provided in Section 2.

4.3.3. *Fiscal rules*

Considering the data from the EU fiscal governance database (see Annex A2), the OECD Secretariat concludes that, at present, there are no numerical fiscal rules in place in Luxembourg. The *Déclaration du gouvernement sur la situation économique, sociale et financière* (government declaration on the economic, social and financial situation), which is approved by Parliament annually at the beginning of the budget cycle and contains a broad economic evaluation, does not correspond to the criteria for numerical fiscal rules. The only fiscal rules currently applicable in Luxembourg are the Maastricht requirements, but – in the view of the OECD Secretariat – these rules are not strict enough for domestic purposes, especially in normal times (in the absence of a financial crisis). Specific recommendations are provided in Section 2; if Luxembourg were to follow these recommendations, the Maastricht thresholds would be amply satisfied.

Concerning the formulation of escape clauses, the OECD Secretariat sees no need to formulate such clauses in the national fiscal rules. In the absence of such clauses, the European requirement that escapes should be limited is automatically complied with. In the case of national disasters or severe financial crisis, fiscal rules can always be suspended *ad hoc* if European legislation so allows. Trying to formulate escape clauses in advance may only stimulate the application of such clauses.

According to section 118 of the Municipal Act of Luxembourg, municipalities may use a loan for investments to balance their budgets provided that the resources in the regular budget are sufficient to repay the loan (basically the golden rule, requiring budget balance on the current account). The application of this rule is supervised by the Ministry of the Interior. This constraint is similar to the one used in most EU countries and complies with Chapter IV of the draft EU Directive.

Regarding the introduction of an expenditure rule which would link expenditures to economic growth, as is foreseen in the revised preventive arm of the Stability and Growth Pact, the authorities may wish to study the consequences of such a rule for Luxembourg more thoroughly. This rule comes very close to the trend-based balance rule as proposed in Section 2 (note that when a country has reached its medium-term budgetary objective, it

allows expenditure growth larger than GDP growth if matched by an enacted tax increase). In that case, the difference seems to hinge upon the difference between GDP growth and growth in the autonomous tax yield (if the output elasticity of the tax yield is at unity when compared to production, both fiscal rules coincide). But it should be noted that the EU expenditure rule is less constraining than a revenue rule of the "pay-as-you-go" type mentioned in Section 2.3. If Luxembourg were to adopt such a revenue rule in addition to an expenditure framework based on a trend-based balance rule, total expenditures could not increase as a share of GDP under any circumstance[23] (since an enacted tax increase, recognised by the draft Directive as a condition for an allowed expenditure increase in excess of the growth of GDP, would be excluded).

4.3.4. *Medium-term budgetary framework (MTBF)*

The introduction of an MTBF must be one of the priorities for the Luxembourg reform agenda. Luxembourg is one of only five countries (together with Cyprus,[24, 25] Greece, Hungary and Portugal) which declared in 2008 that they did not have an MTBF framework.[26] It should be emphasised, however, that many countries fail to comply fully with the requirements of the Directive.[27]

The OECD Secretariat recommendation to Luxembourg to introduce a medium-term expenditure framework for a period covering the coming budget year and three out-years (specific recommendations are provided in Section 2) would be compliant with Article 8 of the draft Directive, which requires that an MTBF covers a fiscal planning horizon of at least three years (the budget year and the two following years).

The introduction of a medium-term expenditure framework should be coupled with the introduction of baseline estimates (budgetary forecasting) as described in Section 2. The combination of an expenditure framework and baseline estimates will satisfy the European requirement to provide estimates of all major expenditure items. It is also important that the number of years covered by the baseline estimates is the same as for the expenditure framework, *i.e.* the budget year plus three out-years.

The European definition of a medium-term budgetary framework is broader than that of a medium-term expenditure framework as described in Section 2, as it includes revenue projections. Therefore, the introduction of a medium-term expenditure framework and multi-annual estimates would not fulfil the European requirement to provide estimates of major revenue items of the general government, with additional details regarding the central government and the social security funds. The OECD Secretariat recommends that medium-term estimates for non-tax revenues be established at the line-item level in the same way as the expenditure estimates. Line ministers are responsible for these medium-term estimates just as they are responsible for the medium-term estimates for the non-tax revenues of the next budget year. The tax revenues are chiefly the responsibility of the Minister of Finance (apart from some specific levies) and he/she (or the relevant other responsible minister) should supply the medium-term estimates. Of course, the macroeconomic forecasts of STATEC play a major role in the preparation of these estimates. However, it must be emphasised that, under an expenditure framework, the medium-term fluctuation of tax revenue estimates, other than a fluctuation resulting from structural measures, should have no consequence at all for the expenditure side of the budget. Thus, the line-item tax revenue estimates fulfil exclusively an informative role (and no role in fiscal policy making). This message should be clearly communicated to the domestic audience as well as the European one.[28]

4.3.5. *Transparency of general government finances and comprehensive scope of fiscal frameworks*

Overall, budget institutions in Luxembourg comply with the requirements for transparency and for a comprehensive scope of the fiscal framework. The budgetary documentation is transparent and provides information on extra-budgetary funds and contingent liabilities (guarantees).

Luxembourg should step up its efforts to provide baseline estimates for sub-national expenditures and revenues. The European Commission seems to be aware that the submission of this information is still a big problem in many European countries and is willing to consider a transition period, but the requirement is part of the draft Directive and should ultimately be met.

Luxembourg should also step up its efforts to publish detailed information on tax expenditures and their impact on government revenues. In this regard, it should be mentioned that there is still considerable discussion about the definition of tax expenditures and the methods to measure their size, and that no international agreement has been reached on this point (neither in the OECD nor in the European Union).[29] The best way to proceed might be to develop a good national definition, with which Luxembourg feels comfortable, and to participate further in the international and European discussion in this regard.

4.4. *Conclusions*

The OECD Secretariat concludes that budget institutions in Luxembourg are mostly consistent with the new requirements of the European Union. However, some of the recommendations formulated in Sections 2 and 3 by the OECD Secretariat on the basis of domestic considerations are also important for compliance with the new European requirements. In addition, the OECD Secretariat now puts forward some recommendations (not included in Sections 2 and 3) that are specifically aimed at meeting European requirements:

- Luxembourg should start publishing cash-based fiscal data at a monthly frequency, covering the sub-sectors of central government and social security, before the end of the following month, and at a quarterly frequency for the local government sub-sector before the end of the following quarter. Specific recommendations for monthly reporting are provided in Section 3.
- The improvement of local statistics and accounting should also become a part of the reform agenda in Luxembourg. In this connection, it is also important that the authority of the Court of Accounts be extended to the audit of local accounts and statistics in order to ensure compliance with the new European legislation.
- In order to comply with the EU requirement of budgetary forecasting, Luxembourg must introduce medium-term baseline estimates for both current and capital expenditures as well as a medium-term expenditure framework. Specific recommendations are provided in Section 2.
- The use of alternative macroeconomic scenarios in the context of annual budget preparation is another area where current practice in Luxembourg is not yet fully aligned with the new EU requirements. Specific recommendations are provided in Section 2.
- Luxembourg should consider introducing a fiscal rule, in particular a trend-based balance rule. Specific recommendations are provided in Section 2. If Luxembourg were to follow these recommendations, the Maastricht thresholds would be amply satisfied.

As to the fiscal rules for local government, the golden rule applying in Luxembourg complies with the requirements of the draft EU Directive.

- Concerning the formulation of escape clauses, the OECD Secretariat sees no need to formulate such clauses in the national fiscal rules. In the absence of such clauses, the European requirement that escapes should be limited is automatically complied with.
- Regarding the introduction of an expenditure rule, as it is foreseen by the revised preventive arm of the Stability and Growth Pact, the authorities may wish to study the consequences of such a rule for Luxembourg more thoroughly. If Luxembourg were to adopt a "pay-as-you-go" revenue rule in addition to a medium-term expenditure framework based on a trend-based balance rule, the "principle of prudent fiscal policy" suggested by the European Commission and which the rule should promote would automatically be complied with.
- Luxembourg should step up its efforts to provide baseline estimates for sub-national expenditures and revenues covering the same period as the expenditure framework (the forthcoming budget year and three following years).
- Luxembourg should step up its efforts to publish detailed information on tax expenditures and their impact on government revenues. The best way to proceed might be to develop a good national definition of tax expenditures with which Luxembourg feels comfortable, and to participate further in the international and European discussion in this regard.

5. Steering of executive agencies

5.1. *Organisation of government*

5.1.1. *The traditional pattern of organisation*

The organisation of central government is widely different among OECD countries. In the European Union, there is a bit more uniformity, the pattern basically being:

a) 10 to 30 core ministries;

b) in many ministries, a number of executive agencies without legal personality under the umbrella of ministerial responsibility but with a certain mandated autonomy in the sphere of operational management;

c) in some ministries, one or more executive and judicial agencies without legal personality but with constitutionally or legally guaranteed independence in their policy area (the judiciary, the supreme audit office, the electoral council, the statistical office, etc.); the minister remains responsible for operational management;

d) a number of public and private non-profit institutions with legal personality, controlled by central government (therefore belonging to the central government in ESA95[30]), for instance universities, research institutions and cultural institutions (theatres, orchestras, etc.); the minister is not responsible for executive policy and not directly responsible for operational management, but keeps an indirect responsibility for efficiency based on his/her responsibility for funding.

The differences among countries mainly concern the executive agencies under point *b)*. The great outlier has always been Sweden, where the executive agencies enjoy constitutionally guaranteed independence as far as decisions in individual cases are concerned (this situation goes back to the 19th century and is inspired by the concern to limit the power of the Crown).[31] However, in the 1980s and 1990s, various countries

– starting with the United Kingdom[32] – began giving more mandated autonomy to their executive agencies, not only in the sphere of decisions in individual cases but also in the sphere of operational management.

5.1.2. *Arm's-length and independent agencies*

Such new developments led to the "agency movement" inspired by the ideas of "New Public Management". Countries that have followed the British example include Austria, Denmark, the Netherlands and Norway. The new-style agencies were called "arm's-length" agencies. The defining characteristic was that their financial administration was separated from that of the parent ministry and put on the basis of accrual accounting. The agencies were granted the freedom, within certain limits, to decide on their input mix (personnel, purchase of goods and services), including investments in operational equipment. For the latter purpose, they were allowed certain freedoms to carry over savings and to borrow from the parent ministry. The autonomy concerning the input mix could take the form of a single appropriation for operational costs, implying that internal activities (involving salary costs and operational investments) could be contracted out (leading to procurement costs), but sometimes with restrictions on the inverse shift. It could also mean that agency heads could decide more freely on grade levels and remuneration of their staff. The other side of the coin was supposed to be a more transparent picture of the costs of agency operations as provided by the separate financial administration based on accrual accounting. This information would allow the relevant core ministry to negotiate the agency budget on the basis of costs per service and would in theory lead to more efficient agency operations.

Partially as a consequence of the increased focus on efficiency in arm's-length agencies, increased attention was also given to operational management in executive and judicial agencies with constitutionally or legally guaranteed independence [point *c)* in the list above]. Traditionally these agencies, more recently called independent agencies, were largely left to manage themselves. However, since it was generally recognised that the minister remains responsible for their operational management, in various countries attempts were made to steer these "independent" agencies on the same footing as "arm's-length" agencies, implying a separated financial administration based on accrual accounting and funding on the basis of service costs. These attempts often met with considerable resistance and were not always successful.

5.2. *Separation of budgeting and performance steering*

5.2.1. *Problems with output budgeting in agencies*

In the last few years, a certain swing back is noticeable in the approach to the steering of agencies, particularly in the countries that have gone far in the transfer of competencies for operational management (the Netherlands and the United Kingdom being the clearest examples). This swing back is motivated by a number of considerations:

- Outputs (services delivered) are often hard to define or to measure. Pressed to define outputs, agencies come up with classifications of widely different detail. However, regardless of the extent of detail, these classifications necessarily subsume under the same type of output substantially different services. For instance, the handling of an income tax declaration by the tax service may involve quite a different workload in individual cases, even if the declarations are further subdivided into several sub-groups. Similarly, the guarding of a prisoner by the penitentiary service may involve quite different

efforts, even if the prisoners are further subdivided into sub-groups. Classifications necessarily remain artificial and consequently lead to perverse incentives to spend less effort on the "difficult cases" in each classification or to postpone or shift these cases away to other branches of the organisation.

- Output definitions are subject to permanent reformulation because political priorities shift. Ministers are responsible to Parliament and society for what they attempt to achieve. If the mishandling of a tax declaration gets into the papers, the responsible minister will order an overhaul of the case-handling procedures of the tax service. If a dangerous prisoner escapes, the responsible minister will order a revision of security arrangements in the prison concerned. Output definitions will also shift in the light of new economic and social research about the relationship between outcomes (in which politicians are ultimately interested) and outputs. Experience in the countries concerned shows that there is very little continuity in output definitions and hence no basis for the assessment of efficiency development over the years.
- It is unclear what the consequences are if, in a given year, an agency has produced more or less outputs than the quantity on which its budget is based. More outputs will generally not lead to more funding either in the budget year or in the next year (unless budgetary discipline is relaxed), which creates a perverse incentive to relax the pursuit of efficiency and to constrain output, even if demand requires more outputs (leading to waiting lists). Fewer outputs than planned may in principle lead to budgetary cuts, but this will not only increase efficiency: it will also lead to a perverse incentive to stimulate demand. Alternatively, if outputs stay behind the forecasts because of an unexpected amount of "difficult cases", cuts will lead to a deterioration of the situation in the next year. In practice, the typical consequence of lagging output is that more rather than less resources are generally made available to the agency in the next year because the primary interest of the minister is the production of outputs for which she/he is responsible. In short, budgeting for agencies on the basis of their outputs is increasingly seen as artificial and distortive and not conducive to the promotion of efficiency.
- The shift from budgeting on the basis of inputs to budgeting on the basis of outputs has largely been fictitious. In general, government services have no close substitutes in the market sector and, in the absence of market prices, costs can only be assessed with full knowledge of the input mix and the input prices. Even if, formally, budgeting has been put on the basis of outputs, informally input budgeting has often continued (for instance, in the Netherlands). When agencies are no longer required to divulge the input mix and input prices, the position of the parent ministry in budget negotiations is weakened.
- Loosening the standards of agencies' operational management has led to inefficiencies in agency operations. These standards include all government-wide rules for the use of operational means (human resources, procurement, accommodation, ICT, finance, etc.). This consideration is connected to the previous four dot points above. If efficiency cannot adequately be controlled by financing on the basis of outputs, it is not surprising that efficiency will deteriorate if standards of operational management (that are meant to control inputs) are loosened.[33]
- Loosening the standards of operational management has led to the creation of support units in agencies (both arm's-length agencies and independent agencies). Support units provide advice and services to line divisions and agencies of the ministry in the areas of: human resources, organisation, procurement, accommodation, real estate, facilities

(office equipment, reproduction, cars, catering, security), information and ICT, finance (budgeting and accounting), internal audit, and communication. In particular, the loosening of rules for the recruitment of personnel has enabled agencies to develop their own support units in all areas, separated from the central support units of the parent ministries. This tendency was in some cases reinforced by the separation of the financial administration of agencies from that of the relevant core ministry, requiring the agencies to pay for the services of central support units.

5.2.2. Recent developments in vanguard countries

In reaction to these unexpected consequences of the increased autonomy of agencies, a distinct reorientation has taken place in some countries, particularly those that have gone far in promoting agency autonomy (the Netherlands, the United Kingdom) or where agency autonomy was always large (Sweden). This reorientation comes down to the separation of the processes of budgeting and of performance steering in agencies.[34] It does not entail the reintegration of agencies into the organisation of the parent ministry, since the separation of their financial administration has undeniably led to better insight on the costs of policy execution.

In this approach, output steering should take place on the basis of a permanent performance dialogue. Sweden has recently developed annual performance-steering procedures for its agencies that to a large extent bypass the budget process. Important elements are the performance dialogue with the minister on the basis of the annual agency report, the meeting with the National Audit Office on the basis of the audit report, and various forms of evaluation. In addition, Sweden intends to reduce the instructions attached to the annual appropriation and to introduce informational requirements on outputs in the agency statutes.

If output steering becomes a separate process that provides for more frequent interaction between the core ministry and the agency head than the annual budget cycle provides, the budget process can focus more pointedly on efficiency. In the absence of market prices, this requires complete transparency on the input mix and input prices, even if the input mix remains largely under the control of the agency. In this regard, the knowledge in the parent ministries concerning agency operations that has been lost under the influence of the New Public Management reforms has to be regained. A good way to reinstate such knowledge would be to create agency funding units in the financial directorates of core ministries.

The financing of agencies can be based on robust rules, usually split into a base budget for fixed costs and a variable component based on need indicators, as was the case in Sweden before New Public Management reforms were introduced and is still mostly the case in countries where such reforms have not taken place (in practice it is still informally the case in countries, such as the Netherlands, where agency financing has formally been put on the basis of output costing). This way of financing agencies can be called "capacity budgeting" since it reflects the fundamental principle that executive agencies are financed on the basis of their capacity to handle a certain executive workload and not on the basis of their specific estimated outputs.

Efforts to gain insight on the efficiency of agencies should not only be stepped up in parent ministries but also in the Ministry of Finance. In view of the fact that some 90% of the operational costs of central government are incurred in executive agencies (OECD, 2010b), it is clear that savings on operational costs have to come mostly from agencies. In

these times of fiscal consolidation, this means that special efforts have to be made to study and understand the opportunities for cutting back on agency costs. Such efforts cannot only be left to the spending ministries. In this connection, the OECD Secretariat has recommended the establishment of an agency efficiency centre in the Ministry of Finance that can support the financial directorates of the line ministries by providing data and analysis (OECD, 2011 and 2012).

It should be noted that, even if the processes of budgeting and output steering are separated, the players remain the same. In both processes, the minister deals with agency heads but he/she is supported by different advisors. In the budget process, the focus is on efficiency, which makes it useful that the minister is supported by his/her finance director and possibly an advisor of the Ministry of Finance. In the second process, the focus is on quantity and quality of outputs, which makes it useful that the minister is supported by "output experts" – notably the division heads of the core ministry who are responsible for policy in the area that the agency executes.

5.2.3. *Standards of operational management*

The countries that have introduced financial administration in their agencies based on accrual accounting have usually also created the possibility to borrow from the parent ministries for operational capital costs (real estate, buildings, important office equipment). However, in order to stimulate autonomy, other standards of operational management have also been loosened, in particular in the spheres of human resources (pay scales), office space and procurement. In some countries, the result has been a considerable variety of labour conditions and office equipment (each agency has its own type of computers and software, etc.) and consequent cost increases. The motivation for such variety is not always clear. It is true that some agencies, particularly those tasked with service delivery in kind, have special business needs – for instance, the police, the penitentiary service, the army and the forest conservation agency. It is logical that exemptions on standards of operational management that apply to the government as a whole are possible for such agencies. However, the large majority of agencies in most countries carry out administrative tasks that, from the perspective of operational management, are fully comparable with the tasks of the core ministries. There is no reason for exemptions on government-wide standards of operational management for such agencies, apart from the exemptions that are immediately connected to the accruals-based administration (borrowing facility).

As to the use of ministerial administrative support services by agencies, the separation of agencies' financial administration from that of each parent ministry and its corollary that agencies have to pay for the use of support services provided by the central support units of the ministry do not constitute a valid reason for the creation of support services in agencies. In this respect, it is important that standards of human resource management should be strengthened in order to prevent such a situation. Alternatively, the government could encourage the establishment of shared service centres outside central support units that could benefit from optimal scale conditions (not too small but also not too large) and that could contribute to service quality through competition.[35]

5.3. *Steering of agencies in Luxembourg*

5.3.1. *The organisation of policy execution in Luxembourg*

In Luxembourg, there are three kinds of executive units: *services généraux*, *services de l'État à gestion séparée*, and *établissements publics* (see Section 1.3.1).

The *services généraux* comprise many of the executive units that in other European countries have been turned into "arm's-length agencies" or "independent agencies" (Tax Administration, Administration for Registration and Domains, Customs and Excises Administration, Labour Inspectorate, Employment Administration, etc.). Compared to the current status of these units in Luxembourg, turning them into arm's-length or independent agencies would have important consequences:

- separation of their financial administration from that of the parent ministry;
- introduction of financial administration based on accrual accounting in these agencies (but not in the parent ministry);
- payment for the (administrative support) services provided by the parent ministry.

The *services à gestion séparée* comprise many executive units that in other European countries have the status of public or private non-profit institutions with legal personality (schools for secondary education, cultural institutions such as theatres and orchestras, etc.). Compared to the current status of these units in Luxembourg, turning them into public non-profit institutions with legal personality would have important consequences:

- establishment of legal personality;
- general introduction of financial administration based on accrual accounting;
- payment for the (administrative support) services provided by the parent ministry;
- net budgeting;
- abolition of remaining (direct) constraints flowing from government-wide standards of operational management (*i.e.* employee remuneration, public procurement, etc.).

Furthermore, the *services à gestion séparée* also comprise executive units that in other European countries have the status of arm's-length or independent agencies (National Library, National Archives). Compared to the current status of these units in Luxembourg, turning them into arm's-length or independent agencies would equally have important consequences:

- introduction of financial administration based on accruals;
- payment for the (support) services provided by the parent ministry.

The *établissements publics* comprise mostly public and private non-profit units with legal personality controlled by the central government (the University of Luxembourg, the Commission for the Surveillance of the Financial Sector, research institutions, and institutions in the social and cultural sphere).[36] In Luxembourg as elsewhere, these units have a separate financial administration based on accrual accounting. They are financed on the basis of net grants and subsidies, and are not (directly) subject to government-wide standards of operational management.

5.3.2. *Observations and recommendations*

A first observation on the pattern of organisation of the central government in Luxembourg is that there is no clear policy concerning the status of executive units. The OECD Secretariat has not been able to identify explicit criteria for decision making about the status of executive units.

A second observation is that the "agency movement" that has affected the organisation of policy execution in many European countries has thus far hardly impacted on the organisation of government in Luxembourg. It is true that there are *services à gestion séparée* that in certain respects resemble the arm's-length or independent agencies in other

European countries, but these units are not financially managed on the basis of accruals and do not pay for support services delivered by the parent ministry. More importantly, this status is mostly used for very different executive units (schools of secondary education; cultural institutions) which, in other countries, often take the form of public and private non-profit institutions.

A third observation, connected with the previous one, is that thus far in Luxembourg there has been no concerted effort to steer executive units – be they *services généraux* or *services à gestion séparée* – on the basis of outputs. In view of the problems that vanguard countries have experienced with output funding of agencies, this fact is perhaps not to be regretted by the Luxembourg authorities. Late movement in this area will probably make it possible to avoid the difficulties that vanguard countries are now trying to correct.

In the light of these observations, the OECD Secretariat recommends that the Luxembourg authorities follow a "no regret" policy in the area of agency financing and output steering. These recommendations will perhaps not propel Luxembourg into the vanguard of European countries, but they will allow the country to reap the generally recognised benefits of the reform – notably the improvement of efficiency in agency operations – and will minimise the risks.

The OECD Secretariat recommends in particular:

- formulating a clear policy with respect to the status of executive units, containing explicit criteria for the application of each status; such a policy can take the form of a multi-year reform plan;
- giving the status of public or private non-profit institution with legal personality to all executive units for which the minister does not need, or does not wish, to bear responsibility for executive policy (notably establishments for secondary education and cultural institutions that currently have the status of *services à gestion séparée*);
- giving the status of arm's-length agency or independent agency to all other executive units (including some establishments that currently have the status of *services à gestion séparée*, other than the ones mentioned under the previous dot point);
- requiring that all arm's-length and independent agencies establish a financial administration based on accrual accounting;
- requiring that all arm's-length and independent agencies pay for (administrative support) services provided by the parent ministry;
- abolishing all exceptions to government-wide standards of operational management for arm's-length and independent agencies that carry out administrative tasks; formulating special standards of operational management for arm's-length and independent agencies tasked with service delivery in kind;
- reserving the status of independent agency only for those executive or judicial units that have been guaranteed independence regarding executive or judicial policy by the Constitution or by law (judiciary, Court of Accounts, statistical office, electoral council, etc.);[37]
- separating the budget process from the output-steering process in arm's-length agencies; the financing of agencies should be based on robust rules reflecting the capacity to handle a certain workload (capacity budgeting) and not on the basis of specific estimated outputs; output steering should be organised in a separate process that can be characterised as a permanent performance dialogue; independent agencies need a budget process based on capacity but not a permanent performance dialogue, since the minister by definition is not responsible for executive policy in independent agencies;

- establishing capacity in the financial directorates of line ministries and in the Ministry of Finance to support the line ministers in their budget discussions with agency heads;
- ensuring that the minister is supported by output experts, notably the heads of division for policy making, in the permanent performance dialogue with the heads of arm's-length agencies.

5.4. *Productivity cuts*

A number of OECD countries apply procedures known as "automatic productivity cuts" (Australia, Denmark, Finland, New Zealand and Sweden, among others). The aim of these procedures is to avoid an automatic increase of service levels due to productivity gains. A tactical advantage mentioned by the countries that use them is that automatic productivity cuts change the baseline of current policy (multi-year estimates) that serves as the point of departure for the annual budget process. This is seen as by finance ministers as a strategic advantage in budget negotiations.[38] Automatic productivity cuts do not mean that the budget of all ministries is reduced from year to year. First, the cuts only apply to operational expenditures, which are generally a small part of ministerial budgets. Second, most baseline estimates show increases due to the growing costs of current policies or to new spending initiatives. Automatic productivity cuts tend to lead to more moderate growth rather than to decreases.

Procedures for automatic productivity cuts differ between countries in the following respects:

- the base to which they are applied;
- exemptions;
- differentiation of the annual cut percentage between policy areas;
- size of the cut percentage.

In most countries, the base is current operational costs. In Denmark, the cuts are applied to the last year of the multi-annual estimates (three years after the upcoming budget year). In this way, the cuts are "gradually phased in" and are integrated into the multi-annual estimates that serve as the basis for budget preparation every year. Denmark has been working with automatic cuts since the early 1980s. In Sweden, the multi-annual estimates are in real terms and are translated from year to year in nominal terms through an aggregated wage and price index. If the tasks are not changed, the operational budgets are the same as the previous year, corrected by the index. In order to put productivity pressure on the agencies, the index does not fully take into account the real increase of wages in the market sector: the index is decreased by a moving average of the last ten years of productivity gains in the market sector. New Zealand uses nominal current operational costs as the baseline in the annual budget cycle; this implies that inflation has to be absorbed (around 2 or 3% in recent years), but adjustments may be made for wage developments in the market sector.

Some countries exempt sizeable portions of current operational expenditure from the productivity cuts. Australia applies the efficiency dividend only to ministries and agencies whose staff members are employed under the Public Service Act (the civil service), and it exempts certain research institutions, the armed forces, a large part of the cultural sector, and the Customs Service. Denmark exempts defence. The fact that certain domains are exempted from the automatic productivity cuts does not mean that these sectors are exempted from targets for efficiency savings. In Denmark, for instance, the exemption of

defence has been traded against a multi-annual agreement for defence spending that includes sizeable retrenchments. The principle of the automatic cut makes such special agreements easier to attain.

In principle, there are two approaches to the cut percentage. One is to differentiate the percentage on the basis of empirical productivity studies, either for the public sector units that produce the services or for private sector organisations providing similar services. The other is to use a government-wide percentage based on a reasonable average. The first approach was followed by Denmark in the late 1980s (Denmark had used the second approach in the early 1980s). However, this attempt was short-lived, since the empirical estimates were generally seen as unreliable and open to all kinds of criticism. Finland differentiates the cuts between the ministries – not on the basis of empirical studies but rather on the basis of ministerial productivity plans (that in turn may be based on empirical studies). However, there is an average requirement of 1% for the government as a whole, which obviously is a strong incentive for convergence around the 1%.

Apart from Finland, all countries now use a uniform percentage. In New Zealand and Sweden, the percentage is dependent on inflation and/or wage development in the market sector; in Australia and Denmark, it is set by a political decision somewhere between 1 and 2% (subject to occasional revision in the last decades).

If Luxembourg were to consider introducing automatic productivity cuts, it may wish to apply them to all executive units inside the state (executive units in the core ministries and *services à gestion séparée*). The policy-making units in the core ministries are generally very small in Luxembourg, and productivity gains in policy development are hard to demonstrate. The most logical base may be operational costs (including administrative investment costs, *i.e.* office space and equipment, ICT hardware). The cuts could be applied to the new out-year of the multi-annual estimates (the Danish system) so that, after the phasing-in period, they show up in all out-years and everybody can see that they will occur and thus plan for measures to accommodate the cuts. In view of country experience, the OECD Secretariat recommends a uniform, fixed percentage of 1 or 1.5%, substantially below the annual productivity increase in the market sector. In the light of the Danish experience, exceptions are discouraged since they lead to attempts to evade the cuts, even if the default applicability of the cuts may strengthen the negotiation position of the Ministry of Finance in special deals.

The Luxembourg authorities may wish to consider applying the annual productivity cut also to the operational costs of the *secteur conventionné* (including, for example, social insurance institutions and hospitals) which is outside the general government sector but mostly financed by public means. Formally, these expenditures are not operational costs but transfers to the corporate sector; nevertheless, the rationale of automatic productivity cuts applies to these expenditures as well.

5.5. *Conclusions*

In summary, the OECD Secretariat recommends the following set of reforms for consideration:

- To formulate a clear policy with respect to the status of executive units, containing explicit criteria for the application of each status; such a policy can take the form of a multi-year administrative reform plan.
- To require that all arm's-length and independent agencies establish a financial administration based on accrual accounting.

- To abolish all exceptions to government-wide standards of operational management for arm's-length and independent agencies that carry out administrative tasks; to formulate special standards of operational management for arm's-length and independent agencies tasked with service delivery in kind.
- To separate the budget process from the output-steering process in arm's-length agencies; the financing of agencies should be based on robust rules reflecting the capacity to handle a certain workload (capacity budgeting) and not on the basis of specific estimated outputs; output steering should be organised in a separate process that can be characterised as a permanent performance dialogue; independent agencies need a budget process based on capacity but not a permanent performance dialogue, since the minister by definition is not responsible for executive policy in independent agencies.
- To establish capacity in the financial directorates of line ministries and in the Ministry of Finance to support the line ministers in their budget discussions with agency heads.
- To ensure that the minister is supported by output experts, notably the heads of division for policy making, in the permanent performance dialogue with the heads of arm's-length agencies.
- To introduce an automatic productivity cut of 1 or 1.5% and apply it to the last out-year of the medium-term baseline estimates of the operational costs of all executive units inside the state (executive units in the core ministries and *services à gestion séparée*).
- To consider applying the annual productivity cut also to the operational costs of the *secteur conventionné* (in the wide sense, including social insurance institutions and hospitals) which is outside the general government sector but mostly financed by public means.

Notes

1. The team consisted of Dr. Dirk-Jan Kraan (lead), Ms. Valentina Kostyleva, Ms. Lisa von Trapp and Dr. Joachim Wehner (consultant from the London School of Economics).
2. Executive units of ministries and public non-profit institutions.
3. These requirements include the publication of monthly expenditure and revenue data for central government and social security, and three-monthly data for local government.
4. Currently the threshold is fixed at EUR 40 million.
5. Overspending on *crédits non limitatifs* is only possible after formal authorisation by the Minister of Finance.
6. In the EU notification of October 2010 and in the "Stability and Convergence Programme" of April 2011, the balance numbers were slightly adjusted (-0.7% in 2009; -1.7% in 2010; -1.0% in 2011). These numbers have not been inserted into Figure 2.
7. In the United Kingdom, however, the government traditionally does not allow any parliamentary interference in the budget, but this is a matter of political custom not of constitutional law.
8. Such adjustments are complicated and involve methods such as the calculation of potential GDP based on a production function, or an econometric estimate by means of the Hodrick-Prescott filter.
9. Under one of the United Kingdom's previous fiscal rules, abandoned in October 2008, current spending had to be balanced over the economic cycle. Since the measurement of what constituted the business cycle was the responsibility of the Treasury, this led to frequent and often controversial adjustments to the reference period.
10. This way of setting the framework for the last few years is a deviation from customary Dutch practice since 1992. It comes down to recognition of the fact that the growth trend of GDP (excluding cyclical effects) has been broken and that a new base point for the trend has to be established. In fact, nominal GDP in 2010 has been taken as the base point for the new trend assumption underlying the 2011-15 framework.

11. With fixed frameworks that include departmental ceilings, no decision is required for the out-years of the previous framework, including the upcoming budget year. This makes the departmental totals even more inflexible. In the Netherlands, reallocations between ministerial ceilings from year to year are possible in theory, but very difficult to attain and rare in practice.
12. For example, the Nordic countries, the Netherlands and the United Kingdom have abandoned preventive controls and opt instead for internal audit.
13. The law, which states the maximum time limit, allows exceptions.
14. The vast majority of EU structural funds, however, fall under separate control procedures. The regulatory framework for member states' management and control systems is laid down in Regulation (EC) 1083/2006 (Articles 58-62 and 70-71 in particular). In addition, it should be noted that Commission officials or authorised Commission representatives may carry out on-the-spot audits to verify the effective functioning of the management and control systems, which may include audits on activities included in operational programmes, with a minimum of ten working days' notice, except in urgent cases. These audits (level 2 control) are sometimes delegated to the national control authorities (in Luxembourg, the *Inspection générale des Finances*).
15. On 1 October 2003, the Minister for Treasury and Budget set the ceiling for such payments at EUR 2 500.
16. In 1999, a committee of independent experts recommended that the EC set up a professional and independent internal audit service reporting directly to the president of the Commission. The recommendation was accepted in 2000, and an internal audit unit was established in 2001 as part of a broader package of administrative reforms.
17. Performance evaluation involves retrospective analysis of a project, programme or policy to assess how successful or otherwise it has been, and what lessons can be learnt for the future.
18. These requirements include the publication of monthly expenditure and revenue data for central government and social security, and three-monthly expenditure and revenue data for local government.
19. The Eurogroup is a meeting of the finance ministers of the euro area. These ministers meet a day before a meeting of the Economic and Financial Affairs Council (ECOFIN) of the Council of the European Union.
20. "Budgetary framework" means the set of arrangements, procedures and institutions that underlie the conduct of budgetary policies of general government [Article 2 of the Proposal for a Council Directive on requirements for budgetary frameworks of the member states, 29 September 2010, COM(2010)523 final].
21. The European Commission argues that, contrary to the opinion of some countries, the inclusion of alternative macroeconomic developments usually involves a higher degree of reliability and transparency *vis-à-vis* economic agents and markets. Such inclusion implicitly shows that fiscal policy makers acknowledge possible deviations from the central scenario and provides an estimate of the budgetary adjustment needed to reach the initial fiscal targets in the case of lower-than-expected growth.
22. Although criteria are provided in the Directive for the procedures associated with a medium-term budgetary framework (MTBF), the Directive does not contain a definition of the MTBF. The Internet page of the European Commission on the topic of "economic databases and indicators/medium-term budgetary framework in the EU member states" provides the following: "MTBFs usually cover the preparation, execution, and monitoring of multi-annual budget plans, and contain both expenditure and revenue projections as well as the resultant budget balances" (see *http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm*).
23. Apart from an output elasticity of the tax yield larger than unity.
24. Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
25. Note by all the European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
26. *EU Domestic Fiscal Governance Database* (see Annex A2).

27. This failure to comply is mainly due to either the lack of an appropriate breakdown of the major expenditure and revenue categories, or the exclusion of some government tiers from the medium-term fiscal planning, or both at the same time.

28. But, under an expenditure framework, variations in the tax yield due to structural tax measures can be relevant for policy making. This depends on the nature of the framework (fixed or flexible) and the rules of budgetary discipline. If, under a fixed framework, the overall expenditure ceiling can be adjusted, under the condition of compensation through tax measures (as is for instance the case in the Netherlands), the estimated change in the tax yield flowing from these measures is a policy-relevant variable. Similarly, under a flexible framework, the structural tax yield (cleaned of all cyclical variations) is a policy-relevant variable for the annual revision of the overall ceiling. Furthermore, if a country has a revenue rule in place – for instance, a "pay-as-you-go" rule (see Section 2.3) – the estimated structural tax change is a variable for checking compliance.

29. For details on this discussion, see OECD (1996) and Kraan (2004).

30. Non-profit institutions that are not controlled by government belong to the corporate sector in the sense of the national accounts if they are less than 50% publicly funded, and to the sector of non-profit institutions serving households if they are more than 50% publicly funded.

31. Independence of decision making in individual cases, as enjoyed by the Swedish agencies, should not be confused with independence of executive policy which is a characteristic of the agencies under point *c*. In Sweden, the minister remains responsible for the executive policy of executive agencies under point *b* (as well as, of course, for legislation and substantive policy).

32. In the United Kingdom, the new-style agencies were called "Next Steps" agencies.

33. There is a large literature of institutional economics that supports the inverse relation between autonomy in operational management and efficiency ("economic theory of bureaucracy"). For an overview, see Mueller (2003).

34. The idea that providers of services (as opposed to tangible goods) cannot efficiently be steered by output agreements is a long-standing result of institutional economics that goes back to Coase (1937). In the 20th century, a large literature explored different forms of output steering in the private sector. A well-known conclusion of this literature is that the provision of services can only be steered efficiently on the basis of "relational contracting" that allows the buyer to specify outputs during contract execution within certain limits flowing from the agreed price.

35. On shared support services in OECD countries, see OECD (2010b).

36. The *établissements publics* formally also comprise financial institutions that belong to the state (Banque centrale de Luxembourg, Banque et Caisse d'épargne de l'État) or to the corporate sector. They are not part of the central government and are not further considered in this report.

37. In OECD (2011), it is recommended that all inspectorates charged exclusively with supervision and enforcement of regulation should be given the status of independent agency (this does not apply to the *Inspection générale des Finances* in Luxembourg, as this inspectorate is essentially a policy-making unit of the Ministry of Finance).

38. For more information on automatic productivity cuts, see OECD (2010b).

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ANNEX A1

Six proposals for reinforced economic governance in the EU[1]

1. The preventive arm of the Stability and Growth Pact

The preventive arm of the SGP is meant to insure that member states follow prudent fiscal policy so as to not put fiscal sustainability at risk with potential negative consequences for European Economic and Monetary Union (EMU) as a whole. Accordingly, member states are required to present stability and convergence programmes[2] outlining their plans to achieve medium-term budgetary objectives (MTOs), which are defined as a percentage of GDP in structural terms. Member states not having reached their MTO are expected to converge towards it at an annual pace of 0.5% of GDP in structural terms.

However, progress towards MTOs has been generally insufficient, leaving public finances exposed to the economic downturn. Moreover, the structural balance has in practice proved to be an insufficient measure of a country's underlying fiscal position owing to the difficulty of assessing the cyclical position of the economy in real time and to insufficient or inaccurate account being taken of revenue windfalls and shortfalls not directly related to the economic cycle.

Therefore, it was proposed to introduce a new expenditure rule – the principle of prudent fiscal policy – providing an additional operational tool to monitor the sustainability of member states' fiscal development. In particular, the Commission proposes that annual expenditure growth should not exceed a prudent medium-term rate of growth of GDP, unless the MTO has been attained or the excess is compensated by measures on the revenue side. The essential aim is to prevent that revenue windfalls are spent rather than being allocated to debt reduction.

2. The corrective arm of the SGP

The corrective arm of the SGP is meant to correct deviations in budgetary policies which may put at risk the sustainability of public finances and potentially endanger EMU. Member states are obliged to avoid excessive government deficits (more than 3% of GDP) and debt (more than 60% of GDP or sufficiently declining toward it). The excessive deficit procedure (EDP) currently foresees a sequence of steps which, for euro-area countries, include the eventual imposition of financial sanctions. The EDP has been consistently applied, even against the background of the exceptional circumstances of the financial crisis, leading to 24 out of 27 EU countries now undergoing an excessive deficit procedure.

However, a number of shortcomings have emerged. While the deficit and debt criteria were on an equal footing, in practice the 3% of GDP threshold has been the nearly exclusive focus of the EDP, with the debt threshold playing a marginal role so far.

The existing EDP is backed in principle by a strong enforcement mechanism, as financial sanctions can and should be imposed in the case of persistent failure to correct an excessive deficit. However, such sanctions arguably come into play too late in the process to represent an effective deterrent against gross fiscal policy errors, not least because the financial situation of the concerned country may be so deteriorated as to make the threat of a fine less credible or counter-productive.

To respond to these shortcomings, the Commission proposes to reform the corrective arm as follows. The debt criterion of the EDP is to be made operational, notably through the adoption of a numerical benchmark to gauge whether the debt ratio is sufficiently diminishing toward the threshold of 60% of GDP. Specifically, a debt-to-GDP ratio above 60% is to be considered sufficiently diminishing if its distance with respect to the 60% reference value has reduced over the previous three years at a rate of the order of one-twentieth per year. If that is not the case, the decision to place a country in excessive deficit would not be automatic and would still take into account all relevant factors, such as whether very low nominal growth is hampering debt reduction, as well as risk factors linked to the structure of debt, private sector indebtedness and implicit liabilities related to ageing.

3. National fiscal frameworks

Effective enforcement of the EMU budgetary co-ordination framework cannot be expected to derive only from provisions established at EU level. The objectives of the EMU budgetary co-ordination framework should be reflected in the national budgetary frameworks.

On 29 September 2010, the European Commission adopted a proposal for a Directive on national budgetary frameworks to complement the reform of the SGP.

4. Fiscal policy enforcement

Failure to respect the agreed principle of prudent fiscal policy as required by the preventive arm of the SGP will make the concerned member state liable to a warning from the Commission and, in the case of a persistent and/or particularly serious infraction, a Council recommendation to take corrective action, on the basis of Article 121 of the Treaty. For euro-area members, such a recommendation would be backed by an enforcement mechanism, based on Article 136 of the Treaty, in the form of an interest-bearing deposit amounting to 0.2% of GDP.

Enforcement of the corrective arm of the SGP is strengthened by introducing a "reverse voting" mechanism as well as a new set of financial sanctions for euro-area member states, which would apply much earlier in the process according to a graduated approach.

A non-interest bearing deposit amounting to 0.2% of GDP would apply upon the decision of placing a country in excessive deficit. This would be converted into a fine in the case of non-compliance with the initial recommendation to correct the deficit. The amount of the fine is equal to the sanctions already foreseen in the final step of the EDP. The fine also bears a link with the minimum amount that member states currently receive in annual commitments from a relevant subset of EU expenditure categories. Further non-compliance would result in an increase of the fine, in line with the already existing provisions in the Stability and Growth Pact.

To reduce discretion in the enforcement, the procedure of the "reverse voting" mechanism is foreseen for the imposition of the new sanctions in connection with the successive steps of the EDP. In concrete terms, upon each step of the EDP, the Commission will make a proposal for the relevant sanction which will be considered adopted unless the Council within ten days decides against it by qualified majority. The size of the non-interest bearing deposit or the fine can only be reduced by the Council on the basis of a specific proposal of the Commission following a reasoned request by the member state concerned.

Moreover, the Commission proposal clarifies the criteria for assessing compliance with the recommendations at each step, including the possibility of allowing an extension of the deadlines for the correction of the excessive deficit, by placing explicit emphasis on the fiscal variables that can be assumed to be under the direct control of the government, notably expenditure. Beyond these country-specific circumstances, the possibility of extending the deadlines is also introduced in the case of a crisis threatening the smooth functioning of EMU.

5. Preventing macroeconomic imbalances

The crisis has revealed that major macroeconomic imbalances among EU economies could potentially undermine economic cohesion, with greater risks for the euro area. Some member states have accumulated large current account deficits and experienced losses in competitiveness. These trends were associated with a misallocation of capital and labour, unsustainable accumulation of debt, and housing bubbles. Conversely, other member states with external surpluses capitalised on their competitive export sector, but domestic demand lagged somewhat behind, amplifying the gap between deficit and surplus countries within the euro area.

Therefore, the Commission's proposal implies adopting a number of measures aiming to broaden macroeconomic surveillance and to better integrate structural reform in overall policy co-ordination within EMU so that the EU growth potential can be increased. There are several elements to be highlighted in this proposal.

5.1. The alert mechanism through a scoreboard

Surveillance would start with an alert mechanism that aims to identify member states with potentially problematic levels of macroeconomic imbalances. The alert mechanism would consist of a scoreboard complemented by expert analysis:

- The scoreboard would be composed of a set of indicators in order to identify timely imbalances emerging in different parts of the economy. The set of indicators should be sufficiently large to cover any possible case of major imbalance and should be sufficiently sensitive to detect imbalances early on. Possible indicators would most likely include both external elements (*e.g.* current accounts, real effective exchange rates) and internal ones (*e.g.* private and public sector debt).
- The composition of the scoreboard may evolve over time due to changing threats to macroeconomic stability or advances in data availability.
- Thresholds for alerts would be defined and announced for each indicator. The thresholds should be seen as indicative values which would guide the assessment but should not be interpreted in a mechanical way. They should be complemented by economic judgment and country-specific expertise.

5.2. Preventive surveillance based on discussions with member states and in-depth reviews

The Commission would release the results of the scoreboard on a regular basis and attach a Commission report putting them into perspective. On the basis of all available information, the Commission will draw up a list of member states deemed at risk of imbalances.

The early discussion of such a list within the Council and the Eurogroup will enable the Commission to get appropriate feedback from member states and ensure transparency of the Commission deliberations.

Following such discussions, the Commission will provide country-specific in-depth reviews. The in-depth reviews will consist of a detailed investigation of the underlying problems in the identified member states, in particular taking into account the severity of the imbalances and possible spillovers to other member states, as well as the assessment of findings from stability and convergence programmes and the national reform programmes.

If macroeconomic imbalances are considered unproblematic, the Commission will propose that no further steps are undertaken. If the Commission considers that macroeconomic imbalances (or the risk thereof) do exist, it will come forward with preventive recommendations for the member state(s) concerned. Consistent with the macro-structural surveillance process and depending on the nature of the imbalance, the preventive recommendations may address policy challenges across a range of policy areas.

6. Correcting macroeconomic imbalances: The excessive imbalance procedure (EIP) applying to EU member states

When the alert mechanism points to severe imbalances in a member state, the European Council, on a recommendation from the European Commission, may adopt recommendations in accordance with Article 121(4) of the Treaty, declaring the existence of an excessive imbalance and recommending that the member state concerned take corrective action within a specified deadline.

- Member states in excessive imbalance would be subjected to a regime of peer pressure. Depending on the nature of the imbalance, the policy prescriptions could potentially address fiscal, wage and macro-structural as well as macro-prudential policy aspects under the control of the government authorities. Following the launch of an EIP, the member state concerned will be obliged to adopt a corrective action plan to set up a roadmap for implementing policy measures.
- The Council would set an appropriate deadline when issuing corrective recommendations, taking into account the nature, scale and urgency of the imbalances and the capabilities of policies to remedy the situation. Unlike fiscal policy, not all policy levers are under the direct control of national governments when it comes to the resolution of imbalances. The Commission will monitor the implementation of corrective action by the member states concerned, which would issue progress reports on a regular basis.
- On the basis of a Commission recommendation, the Council will decide – when the initial deadline expires – whether or not the member state concerned has taken the recommended corrective action. Three outcomes are possible:
  - If the Council decides that the member state concerned has taken appropriate action and that the member state is no longer experiencing excessive imbalances, the EIP will be closed.

- If the Council decides that the member state concerned has taken appropriate action but that, due to the possibly long lags between the adoption of corrective action and its effect on the ground, imbalances are not yet corrected, the procedure will be placed in abeyance (the member state is making satisfactory progress with corrective action). The member state concerned would then be subject to periodic reporting and surveillance until the EIP is effectively closed.
- If the Council decides that the member state concerned has taken insufficient action, the Council will issue revised recommendations, possibly with tighter deadlines. Repeated non-compliance with this second set of EIP recommendations may lead to sanctions for euro-area member states.

For the euro-area members, an enforcement mechanism has been proposed. The Commission argues for further extending the reach of the enforcement procedure of the EIP and allowing for financial sanctions for the euro-area member states:

- If a member state fails repeatedly to act in compliance with the Council recommendations to address excessive macroeconomic imbalances, it will have to pay a yearly fine until the Council establishes that corrective action has been taken.
- Moreover, repeated failure of the member state to draw up a corrective action plan to address the Council recommendations should be equally subject to a yearly fine as a rule, until the Council establishes that the member state has provided a corrective action plan that sufficiently addresses its recommendations.
- The fine should, as a rule, equal 0.1% of the GDP of the member state concerned in the preceding year. The fine will be adopted on the basis of a reverse voting mechanism in the Council on proposal of the Commission. The Council may decide, on the basis of a Commission proposal, to cancel or to reduce the fine.

Notes

1. This Annex summarises the proposals of the European Commission published on 29 September 2010. It therefore does not take into account the adjustments flowing from the negotiations that have taken place until October 2011 when an agreement was reached between the Council of the European Union and the European Parliament on the package of these six proposals.
2. Euro-area member states prepare annual stability programmes and other EU member states prepare convergence programmes.

ANNEX A2

EU data on the fiscal rules of Luxembourg and the medium-term budgetary framework (MTBF)

The position of the European Union regarding the potential compliance of the fiscal framework of Luxembourg with the new EU requirements depends, on the one hand, on the data available to the European Commission and other European Union institutions and the EU assessments done on the basis of these data and, on the other hand, on the EU understanding and definitions given to respective budgetary institutions. At present, the European Union uses its own database (described below) and provides evaluations and recommendations on the stability and convergence programmes (SCPs).

1. EU Domestic Fiscal Governance Database[1]

Commission services have compiled a database on domestic fiscal rules in force in the time period 1990-2008 across EU countries by collecting the information directly from the EU member states. The database covers all types of numerical fiscal rules (budget balance, debt, expenditure, and revenue rules) at all levels of government (central, regional, and local; general government, and social security). The information was collected in two rounds of surveys in 2006 and in 2008. Based on the fiscal rule strength index[2] for each rule, a comprehensive time-varying fiscal rule index for each member state was constructed by summing up all fiscal rule strength indices in force in the respective member state weighted by the coverage of general government finances of the respective rule. Table A2.1 containing the data on Luxembourg's central government fiscal rules is extracted from the database. The rank of scores for EU country indexes is presented in Figure A2.1.

Article 5 of the proposal for a Council Directive on requirements for budgetary (or fiscal) frameworks of member states defines a national medium-term budgetary framework (MTBF) as the set of arrangements, procedures and institutions that underlie the conduct of budgetary policy of general government. This includes expenditure frameworks but also other elements (constraints on the revenue side of the budget and procedures and institutions supporting the framework).

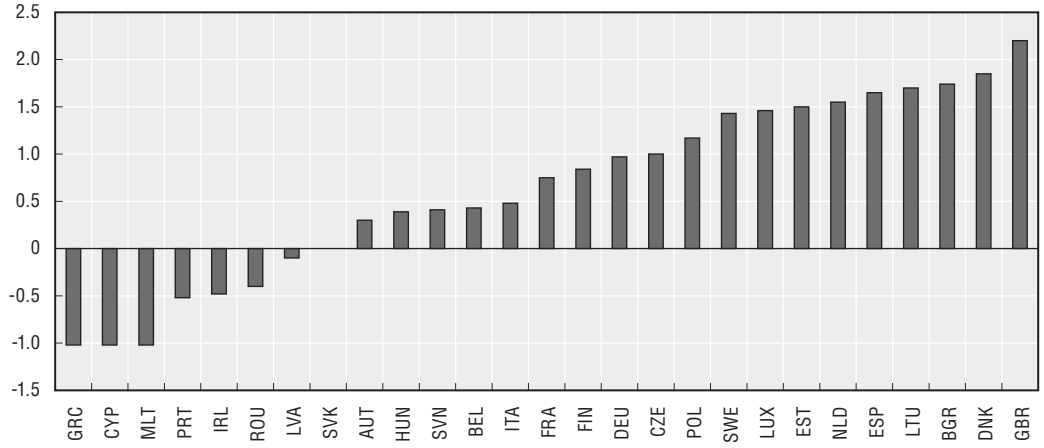
MTBFs are those policy instruments that allow extending the horizon for fiscal policy making beyond the annual budgetary calendar. Although in all member states the adoption of the annual budget is the key moment at which crucial decisions on fiscal policy are taken, most fiscal policy measures have budgetary implications that go well beyond the yearly budgetary cycle. As a result, a single-year budgetary perspective provides a poor basis for sound fiscal policy management. This is the main reason why a majority of EU countries have currently adopted an MTBF for fiscal planning.

Table A2.1. **Fiscal rules in Luxembourg (central government, 2008)**

Type	Target/ constraint	Description	Accounting system	Time frame (years)	Statutory base	Monitoring body	Enforcement body	Non-compliance actions	Exclusions	In force since	In force until	Additional information
Debt rule	Debt ceiling in terms of debt/ GDP ratio	The central government maintains public debt at a low level. New public debt can be issued to finance rail infrastructure projects. No formal quantified target, but implicit	Budgetary accounting system, including capital expenditures (investment)	Multi-annual	Coalition agreement	No body	No body	No pre-defined action	Yes	Although this specific rule was introduced in 2004, similar rules were in force in the previous period 1990-2003	2008+	
Expenditure rule	Nominal expenditure growth rate	In the course of the legislative period, public expenditure growth is maintained at a rate compatible with the medium-term economic growth prospects (no formal quantified target, but implicit)	Budgetary accounting system, including capital expenditures (investment)	Multi-annual	Coalition agreement	No body	No body	No pre-defined action	No	1999	2008+	1999 is the starting date of the previous government programme (1999-2004)

Source: EU Domestic Fiscal Governance Database, http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

Figure A2.1. **Standardised fiscal rules index (2008)**



Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
Note by all the European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
Source: EU Domestic Fiscal Governance Database, http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

Similarly to fiscal rules, the information provided by the EU surveys was summarised into a composite index to assess the quality of MTBFs. The index originally developed in 2006 was reviewed and updated in 2008. Like the fiscal rules index, it is based on information reported by member states. The index captures the quality of MTBFs through five criteria:

- existence of a domestic MTBF;
- connectedness between the multi-annual budgetary targets and the preparation of the annual budget;
- involvement of national Parliaments in the preparation of the medium-term budgetary plans;
- existence of co-ordination mechanisms between general government layers prior to setting the MTBF:
- monitoring and enforcement mechanisms of multi-annual budgetary targets.

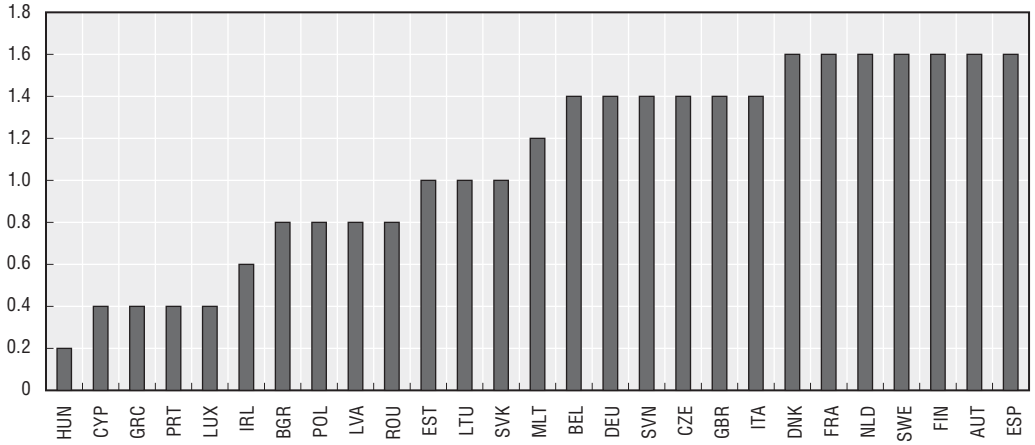
Luxembourg is one of only five countries (together with Cyprus,[3, 4] Greece, Hungary and Portugal) which declared that they did not have an MTBF in place in 2008. Thus Luxembourg has a low score in the MTBF index rank of EU countries shown in Figure A2.2.

Considering that Luxembourg has no MTBF, its index score was raised by the following parameters: preparation and status of the SCP, follow-up to the Council opinion on the SCP, monitoring of SCP implementation, supplementary and corrective budgets (see Table A2.2).

2. Macro-fiscal assessment and Council opinion on the 2009-10 SCP

On the basis of the information contained in the *EU Domestic Fiscal Governance Database* (fiscal rules and MTBFs), the European Commission calculated respective indices and assigned all EU member states to four quadrants according to the quality of their fiscal frameworks. Luxembourg (together with five other countries: Bulgaria, Estonia, Lithuania, Poland and the Slovak Republic) belongs to the quadrant where the rules-based framework is above average and the medium-term budgetary framework is below average.

Figure A2.2. **Medium-term budgetary framework index (median 2008)**



Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
Note by all the European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
Source: EU Domestic Fiscal Governance Database, http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

The Commission assessed that the current fiscal rules and MTBF of Luxembourg, with the exception of the multi-annual capital spending programmes, do not appear to play a significant role. However, according to the conclusion of the Commission, this does not seem to have led to significant budgetary slippages in the past. The 2009-10 SCP did not announce any plans in this respect, and the Council opinion on the programme did not provide recommendations to the Luxembourg government on improving the current state of the budgetary framework.

3. Report prepared in accordance with Article 126(3) of the Treaty

At present, 24 member states of the EU are undergoing an excessive deficit procedure. Luxembourg is one of the three countries which are not on this list. In itself, that is a good indicator of the current financial situation in the country. In the 2010 report on the application of the Stability and Growth Pact in the crisis situation and current budgetary developments in Luxembourg prepared in accordance with Article 126(3) of the Treaty, the Commission concluded that Luxembourg has complied with the deficit and debt criteria in the Treaty.

With respect to the EU assessments and EU data, the fiscal framework of Luxembourg appears to be efficient enough not to cause "significant budgetary slippages in the past". The main Maastricht criteria are met and the public finances are managed in Luxembourg in a responsible manner. However, this situation may also be due to other factors than fiscal rules and the MBTF. Furthermore, the new legislative package of the European Commission contains explicit requirements on fiscal frameworks that are currently not met by Luxembourg.

Table A2.2. **MTBF index construction for Luxembourg (central government, 2008)**

Existence of MTBF	Co-ordination with territorial levels of general government	National Parliament involvement in SCP preparation	Independent fiscal body intervenes in SCP preparation	Media coverage when new SCP unveiled	Council opinion formally discussed within government	Council opinion status *vis-à-vis* national Parliament	Council opinion follow-up by government	Media coverage of Council opinion when issued	Implementation of previous SCP assessed by government	Implementation of previous update discussed in national Parliament	Implementation of previous SCP assessed by independent body	Budget/SCP prepared by same department	Same accounting/reporting rules in SCP and budget	SCP or preliminary version annexed to budget bill	Targets for t and *t + 1* in budget and SCP identical	Frequency of corrective budgets	Macro-budgetary forecasts in the revised budget during the year	Link forecast revisions – supplementary/corrective budgets	Rules/limitations for supplementary/corrective budgets
5	8	9	10	11	12	13	14	15	16	17	18	20	21	22	23	24	27	28	29
1 = yes	1 = yes		1 = yes		1 = yes				1 = yes			1 = yes	1 = yes	1 = yes			1 = yes		1 = yes
0	1	3	0	1	1	2	1	1	1	0	0	1	1	0	3	5	1	2+3	0

9)5-derived from NP-approved document; 4-sent, discussed, voted; 3-presented, but no vote; 2-not sent/sent but not presented; 1-not sent.
11)3-high; 2-some; 1-low.
13)3-presented and discussed; 2-presented but not discussed; 1-not presented; 0-other.
14)3-recommendations followed immediately; 2-recommendations not followed immediately; 1-recommendations followed in next budget; 0-other.
15)3-high; 2-some; 1-low.
17, 18)2-formal session; 1-indirectly; 0-no.
23)3-yes; 2-no, different times of adoption; 1-no, different accounting rules; 0-no, other reasons.
24)5-very rare; 4-relatively rare (every 4-5 years); 3-frequent (every 2-3 years); 2-very frequent (almost every year); 1-every year.
28)3-yes, when major deviations appear; 2-yes, when risks to budgetary execution are identified; 1-other; 0-no.
Source: EU Domestic Fiscal Governance Database, *http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm*. Only the parameters applicable to Luxembourg are shown.

Notes

1. See *http://ec.europa.eu/economy_finance/articles/db_indicators/article16351_en.htm (accessed 6 November 2012)*.
2. Sub-criteria used to construct the fiscal rule strength index (FRSI) include statutory base, monitoring body, alert mechanism, enforcement body, non-compliance actions, escape clauses, and media visibility. See more at *http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm*.
3. *Note by Turkey:* The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
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