EU Fiscal and Economic Governance Review

A Contribution from the

Network of Independent EU Fiscal Institutions

National independent fiscal institutions (IFIs) in EU Member States are independent official bodies with mandates to monitor and assess different aspects of fiscal policy. The EU IFI Network is an independent group of 32 national IFIs that provides a platform to exchange views, expertise and pool resources in areas of common concern.

The European Commission is currently undertaking a review of the EU economic governance framework, and is seeking the views of the EU IFIs. National IFIs have substantial experience and expertise in monitoring fiscal policy in EU countries and in the application of the EU fiscal rules. This paper draws on those experiences as a contribution to the wider debate.

This paper was prepared by the Secretariat of the Network of EU IFIs and an ad hoc Working Group of the Network of EU IFIs; the paper is published under the responsibility of the Leadership of the Network. It does not represent the views of each institution individually.

Main messages

- There is a need to clarify the fiscal governance framework that will be applicable as of 2023, while addressing shortcomings in the existing framework.
- The current EU governance framework suffers from three main interrelated problems: weak compliance, procyclicality and excessive complexity.
- A simple and transparent multi-year approach to enforceable numerical fiscal rules should be prioritised.
- The focus should be narrowed to fewer numerical rules, while detailed implementation should be streamlined.
- The role of national IFIs in supporting sound fiscal policy should be enhanced. National IFIs are well-placed to carry out assessments of fiscal developments and sustainability at national level, taking into account domestic economic conditions.
- There should be an obligation on the EU institutions to take these assessments into account, as an input, when taking decisions on the application of the EU fiscal framework. National IFIs should retain their independence, receive timely access to information and receive an adequate level of resources in order to continue providing the objective and well-founded assessments required.
- The effective functioning of IFIs should therefore be supported by minimum national framework standards in EU Member States. This may require a broadening of national IFI mandates in some cases.
- Fiscal rules should be supported by better data and other information.

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Background

National independent fiscal institutions (IFIs) in the EU Member States are independent official bodies with mandates to oversee different aspects of fiscal policy. EU IFIs have a combined annual budget of more than EUR 45 million and employ more than 500 full-time equivalents. Some EU IFIs are long-established institutions, while most were created in the early 2010s around the post-financial crisis EU governance reforms.

There is an EU requirement for national IFIs to make/endorse official macroeconomic forecasts that underlie budgetary projections, and to monitor national fiscal rules derived from EU rules. IFIs often have other mandates at national level to carry out other tasks. IFI roles include: economic and budgetary forecasting; assessment of economic and budgetary forecasts; long-term fiscal projections; costing of government policies; monitoring compliance with domestic fiscal rules; government debt sustainability analysis; and assessment of the national fiscal stance.

The EU IFI Network is an independent group of 32 national IFIs that provides a platform to exchange views, expertise and pool resources in areas of common concern.

In early 2020, the Commission launched a public debate on the reform of the EU Economic Governance Framework. The economic situation has changed markedly since the aftermath of the Global Financial Crisis, and completion of previous reforms (EC, 2020). The focus of the Review has been placed on the surveillance part (six- and two-pack legislation) of the EU Economic Governance Framework. As the Review is currently suspended due to Covid-19, The European Commission will seek the views of the EU IFIs as part of this review, once the immediate challenges have been addressed (EC, 2020).

National IFIs have substantial experience and expertise in fiscal policy in EU countries, and in the application of EU fiscal rules. This paper draws on those experiences as a contribution to the wider debate.

This paper focusses on EU fiscal rules and national fiscal frameworks in EU Member States. EU fiscal governance raises wider questions of how fiscal policies are coordinated, e.g. the completion of the Banking and Capital Markets Unions, the 2021 EU Recovery and Resilience Facility, the potential role of a fiscal capacity and the potential role of green investments. However, these kinds of fundamental questions are beyond the scope of the work of the EU IFI network and IFI mandates, and need to be addressed on a political level.

Introduction

National fiscal policies should ensure long-run fiscal sustainability, while pursuing appropriate counter-cyclical policies and contributing to sustainable growth, social and climate objectives. EU Member States have committed to sound public finances and to coordinate their economic and fiscal policies through the EU Economic Governance framework. The framework features a number of rules and recommendations that can be broadly categorised into three main building blocks: surveillance, prevention and correction.

Government debt ratios have been rising in many countries in recent decades, reaching peaks during the Covid-19 crisis. While long-term fiscal pressures have increased, interest rates have been on a declining trend. Experience has shown that governments often fail to run appropriate countercyclical policies or to save sufficiently during economic expansions. However, experiences differ greatly across countries.

Fiscal frameworks at the EU and national levels remain essential to sound fiscal policy and maintaining fiscal sustainability, including oversight by the Commission and national independent fiscal institutions (IFIs). Fiscal rules and frameworks should provide incentives and constraints for governments to make prudent fiscal choices, while building public support for sound fiscal policies. Numerical rules increase transparency about fiscal choices by comparing plans or outcomes with the requirements of the rules. They provide governments with fiscal policy guidance to pursue sustainability and can provide a focal point for public discussion about fiscal policy choices. The credibility of rules is strengthened by oversight from national IFIs, which can provide an objective assessment of compliance with the rules, both ex ante and ex post.

In the euro area, fiscal rules in addition are needed to address the risk that policy choices in some Member States could create material risks or spillovers for others or the area as a whole. For instance, loss of confidence in fiscal sustainability in one Member State could have implications for financing conditions in other countries and the monetary union as a whole. The ‘common good’ nature of the monetary union may distort the sanctioning role of financial markets. Growth spillovers from policy in one country may impact policy making in other Member States.

This paper is structured as follows from the perspective of the IFI’s, i.e. their experience and expertise with monitoring fiscal rules: the first section introduces the design of the fiscal framework as whole; the second section considers the functioning of numerical fiscal rules; the third section looks at data and information to support fiscal monitoring and assessment; while the fourth section looks at the role of IFIs within the EU fiscal framework.

Design of the EU fiscal framework

Issues with the existing fiscal framework and current challenges

Current EU fiscal governance suffers from three main interrelated problems: (1) weak compliance; (2) procyclicality; and (3) excessive complexity. These problems are interrelated in a number of ways. Complexity for example contributes to weak compliance and ineffective enforcement, which can lead to procyclicality. The combination of these problems reduces buy-in from Member States, key stakeholders and citizens. Addressing these issues in the EU fiscal framework would help to improve EU fiscal rules and ensure the sustainability of public finances after the Covid crisis.

Compliance with the current EU economic governance framework has been weak. Overall, compliance with EU fiscal rules has been largely heterogenous across countries, years and rules (EFB, 2020). Over the past decade, many EU numerical requirements under the Preventive and Corrective arms of the SGP have not been complied with (Darvas et al, 2018). A significant number of Member States consistently did not progress towards their MTOs during favourable economic periods (De Jong & Gilbert, 2018, Hessel et al, 2017). Although the corrective arm of the SGP has been overall effective in bringing excessive deficits in the euro area below the 3% reference value, there have been cases where countries placed in the Excessive Deficit Procedure have continued to miss the ex-ante adjustment requirements (Gern et al., 2020). This has also been due to the fact that the macroeconomic outlook ex-post was often worse than expected ex-ante.

Some features of the rules limit their procyclicality, but have contributed to weak compliance with numerical fiscal targets. For example, the 1/20th debt reduction rule[1] has a number of significant drawbacks that limit its effectiveness. Notably, in the low-growth and low-inflation environment and for countries with a large budget balance, the 1/20th rule to achieve the 60% target implies very high frontloading of the fiscal effort (Network of EU IFIs, 2021). Some high-debt countries have consistently not complied with the numerical requirement to reduce debt, and the available flexibility to take into account relevant factors was used to the fullest extent in order not to open an EDP (Darvas et al, 2018). While Member States are ultimately responsible for complying with EU fiscal rules, there has also been weak enforcement of the numerical benchmarks and requirements by EU institutions, which made use of flexibility in the rules and procedures.

The implementation of EU fiscal rules has shown long-standing problems of procyclicality. In the pre-Great Financial Crisis period, a number of countries ran procyclical policies while remaining largely compliant with the EU framework. This contributed to overheating and the building up of fiscal risks. The structural balance used to define countries' Medium-Term Objectives (MTO) is particularly prone to procyclicality due to potential output under the EU Commonly Agreed Methodology (CAM) (Darvas, 2019), particularly in some countries (Barnes and Casey, 2019)[2].

In the run-up to the Covid crisis, many countries did not use the good times to build sufficient fiscal buffers (EFB, 2019). National fiscal policies were overall procyclical or neutral, predominately among countries with high public debt or countries previously placed in the EDP with deficits remaining slightly larger but close to 3% rather than converging towards their MTOs (EC, 2020, Caselli and Wingender,

[1] Countries with debt-to-GDP level beyond 60 % are required to reduce their debt by 1/20th of the distance between the actual debt-level and the 60 % reference value on annual basis.
[2] According to the Commission, potential output estimates are procyclical 'only to a reasonable degree' (EC, 2019).

2018). This reflects in part the procyclicality embedded within the SGP's corrective arm and overall weak compliance with the fiscal rules.

A central difficulty of the current EU fiscal framework is its complexity. The number of rules, indicators, exceptions and implementation procedures has increased substantially over time, becoming more complex and effectively limiting predictability. This finding is supported by the Commission in its review of EU economic governance (EC, 2020). Moreover, additional complexity is created by the inconsistencies between EU and national fiscal frameworks originating from the Fiscal Compact. The Fiscal Compact, signed in 2012 by 22 EU Member States, enshrined some EU fiscal rules in national fiscal frameworks. The Fiscal Compact, unlike the EU fiscal framework, has not been updated since 2012, giving rise to many inconsistencies between national and EU rules (Deroose et al, 2018). Finally, the reliance on the unobservable variables that are frequently revised, such as the output gap used to determine the structural balance, also limits political ownership of the rules (EC, 2020). This makes the rules inaccessible to all but a very narrow audience, while still leaving many technical issues open to political and policy judgement. A solid framework should aim to achieve the greatest simplicity, while still achieving a good outcome.

Box 1: Rationale behind fiscal rules in the EU and the euro area

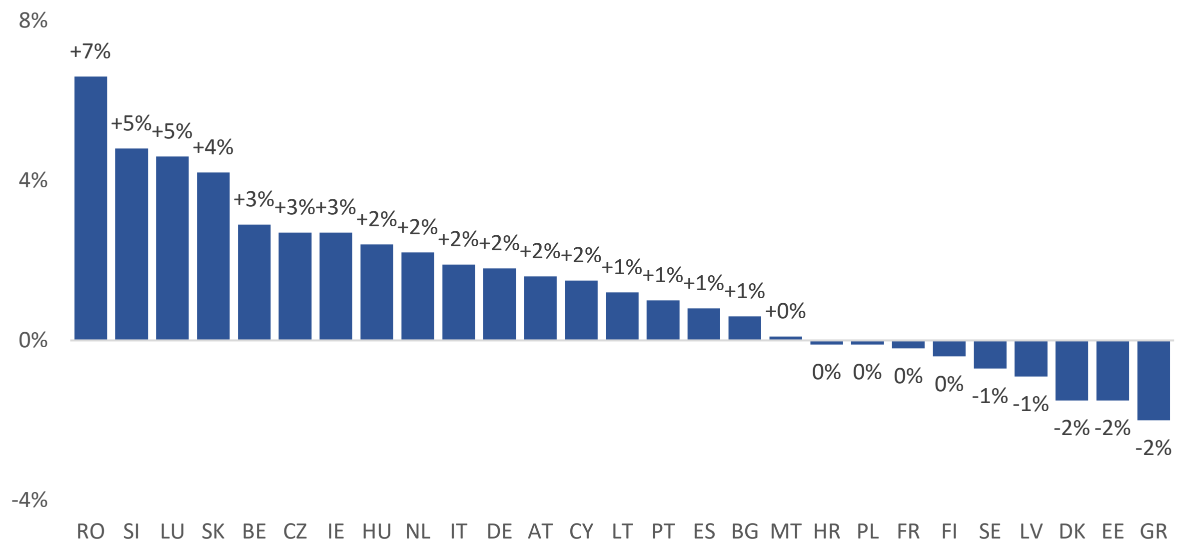
The main rationale behind the introduction of common fiscal rules was to address the important negative externalities that could arise in the currency union, which could put its stability at risk. Negative externalities occur when the costs from actions of one country spill over to other countries. These cross-border effects are amplified by the growing economic integration of Member States (EC, 2018).In the EMU, the main fiscal externalities are demand and debt externalities. Demand externalities occur through either fiscal stimulus or consolidation, which impacts aggregate demand in other countries (Alcidi et al, 2015). This externality can be aggravated by the lack of fiscal space in some Member States, in the presence of large output falls (Micossi, 2020) or by the inability of the Central Bank to further reduce the policy rate (Martin et al, 2021). Debt externalities occur because in the euro area, monetary policy is common and thus not available to individual Member States to stabilise their sovereign debt market. Excessive debt issuance by one Member State, without complementary monetary policy actions, may render public debt levels unsustainable, thus risking a default. In the case of monetary union, the default of one Member State presents substantial danger to the stability of other members, as seen during the euro-area crisis (EC, 2018).EU fiscal rules predominantly target debt externality by restraining public debt to ensure its sustainability. Demand externality has been less prominent, although it becomes more relevant when the ECB's policy rate is close to its effective lower bound, leading to clearer effects through the overall fiscal stance (Martin et al, 2021).

Looking ahead, EU fiscal governance will need to manage fiscal policy in the post-Covid environment. The global outbreak of the novel coronavirus in March 2020 led to a deep fall in output. To allow countries to counter the economic damage caused by the Covid-19 pandemic, the Commission together with the Council activated the general escape clause, effectively suspending all enforcement of budgetary requirements under the SGP (EC, 2020). To respond to the crisis, Member States have adopted a large discretionary fiscal stimulus that, together with the operation of automatic stabilisers and the decline in nominal GDP, helped to stabilise the economy and manage the crisis, but have resulted in rapid increases in public debt levels (Network of EU IFIs, 2021). The EU economic governance review has also been put on hold.

Clarity about the fiscal framework should be in place from 2023. The general escape clause was helpful in managing the Covid crisis, highlighting the value of such a provision for exceptional times. The clause is intended to be de-activated once the economies reach the pre-crisis GDP levels and no earlier than the end of 2022 (EC, 2021). However, returning to a numerical rules-based framework would help to manage post-Covid-19 fiscal challenges and support the credibility of EU fiscal governance. There is a risk that an extended period without clarity on the fiscal rules will create incentives for countries to run unsound fiscal policies. The monitoring role of the EU and national IFIs could also be weakened if no fiscal rules were applied. It is therefore urgent to make progress on the fiscal governance framework so that a rules-based system is in place by 2023, while addressing shortcomings in the existing framework.

The Covid-19 pandemic has created new challenges for the EU fiscal framework and aggravated existing issues, including the need to ensure that debt ratios are reduced over time to safer levels, despite lower interest rates. While the debt-to-GDP ratios were high in many EU countries prior to the Covid-19 crisis, the pandemic has pushed public debt in the EU to new peaks. According to the most recent estimates, 16 out of 27 Member States will be above the 60% reference value in 2022 (EC, 2021). At the same time, ageing populations and rising health costs are creating long-term fiscal pressures in many countries that are not directly reflected in public debt. In fact, 18 Member States face increasing gross public pension expenditure as a share of GDP over the medium-term (see Figure 1).

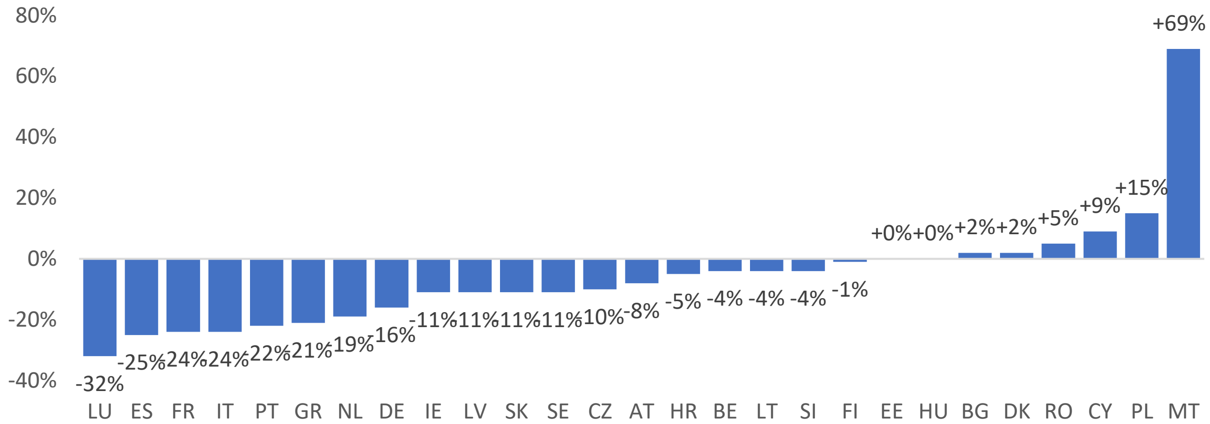
Figure 1: Total change in gross public pension expenditure over 2019-45 (%/pps of GDP)



Source: 2021 Ageing report (EC, 2021)

There is a need to raise productivity and achieve climate and social objectives, in part by ensuring that adequate levels of public investment are undertaken to support these objectives. Sluggish productivity growth in recent years has led to slow progress in wages and living standards. At the same time, achieving ambitious climate targets will require a major investment effort over the coming decade, as well as a range of other fiscal adjustments. For instance, most EU countries have stepped up their ambition to improve energy efficiency (see Figure 2) and plan to finance this through grants or loans (Economidou et al, 2020). Public investment in the euro area fell to low levels in the years prior to the Covid-19 crisis and significant investments may be needed to address climate objectives. A sound fiscal framework could help to support sustainable investment and sound public sector budgeting and management, with the aim of improving the quality of public finances.

Figure 2: Change in national contribution to the EU target of 2030 final energy consumption reduction by country (% of 2005 targets)

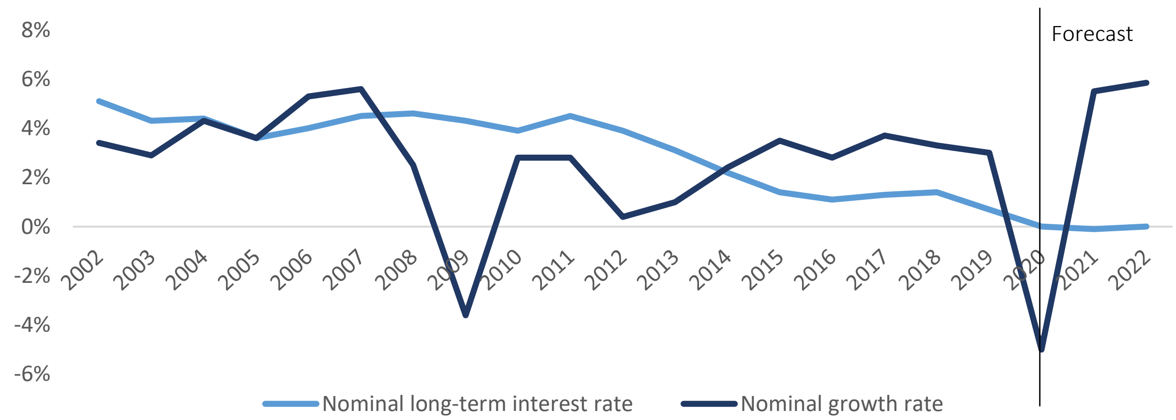


Note: Negative values show planned reduction in consumption

Source: Economidou et al, 2020

Even if the current low interest rate environment allows today higher debt levels than in the past to be financed, high debt remains risky and problematic. The euro area experienced historically low interest rates in the years preceding the Covid-19 pandemic, which contributed to a favourable debt environment for some countries (see Figure 3). Nevertheless, higher debt ratios imply greater sensitivity to a reversal in favourable conditions, notably a shortfall in future growth (Network of EU IFIs, 2021). While low interest rates have helped to create space for governments to borrow during the pandemic, reducing the debt-to-GDP ratio in many countries in the years ahead will be necessary to reduce the risks of adverse debt developments, and to address longer-term challenges. This will need to be achieved without unduly depressing demand or creating imbalances.

Figure 3: Nominal long-term interest rates and nominal growth rates for euro area



Source: 2021 Spring forecast (EC, 2021) and ECB Macroeconomic projections (ECB, 2021)

The approach to the EU fiscal framework in this paper is based on three pillars: continued reliance on simpler numerical fiscal rules, improved information on budgetary-relevant metrics and an enhanced role for IFI analyses and assessments in the context of the EU surveillance cycle. Taken together these should contribute to a more robust framework that is better enforced and less procyclical. Each element should reinforce the other to achieve better outcomes. In particular, many reform proposals referenced in this paper envisage a strengthened role for IFIs in the reformed EU economic governance framework, especially when it comes to defining the medium-term assessment of debt sustainability and compliance with fiscal rules/standards.

There exist proposals for more fundamental reforms, calling for abandoning fiscal rules and focusing on fiscal standards. For instance, Blanchard et al, (2021) propose a fiscal standards framework, that would rely on assessments of current or projected policies with respect to probabilistic assessments of debt sustainability. This builds on the notion that in the low interest rate environment, public debt can be sustainable at levels higher than the 60% Maastricht Treaty's reference value. Although the approach offers substantial simplification of the fiscal framework, it is likely to face a number of practical changes, including the difficulty of making standards effective in many EU political systems and the need to develop stochastic debt sustainability analysis.

Numerical fiscal rules

The Network does not take a position on the set-up of EU fiscal rules, which belongs to the political domain, but assesses that a simpler, more transparent and less procyclical multi-annual fiscal framework needs to be achieved to ensure public finances are on a sustainable path.

Numerical rules should remain a core part of the overall framework and need to be better designed to improve compliance, reduce risks of procyclicality and be simpler. There are strong advantages to numerical rules that provide a transparent benchmark and objective basis for setting and assessing policy. This could be achieved in many different ways, with approaches offering different advantages and disadvantages. Whatever set of rules is pursued, it should help to achieve a more multi-year and stable approach to managing public finances. Key design details can be critical. No simple set of rules is likely to achieve optimal or even reasonable outcomes in all circumstances and across all countries over time, but good design can help. Monitoring and interpretation by national IFIs can also help, both in assessing how rules apply to specific issues like the measurement of discretionary revenue measures (DRMs) and the overall provision of fiscal sustainability assessments to ensure that compliance delivers satisfactory outcomes.

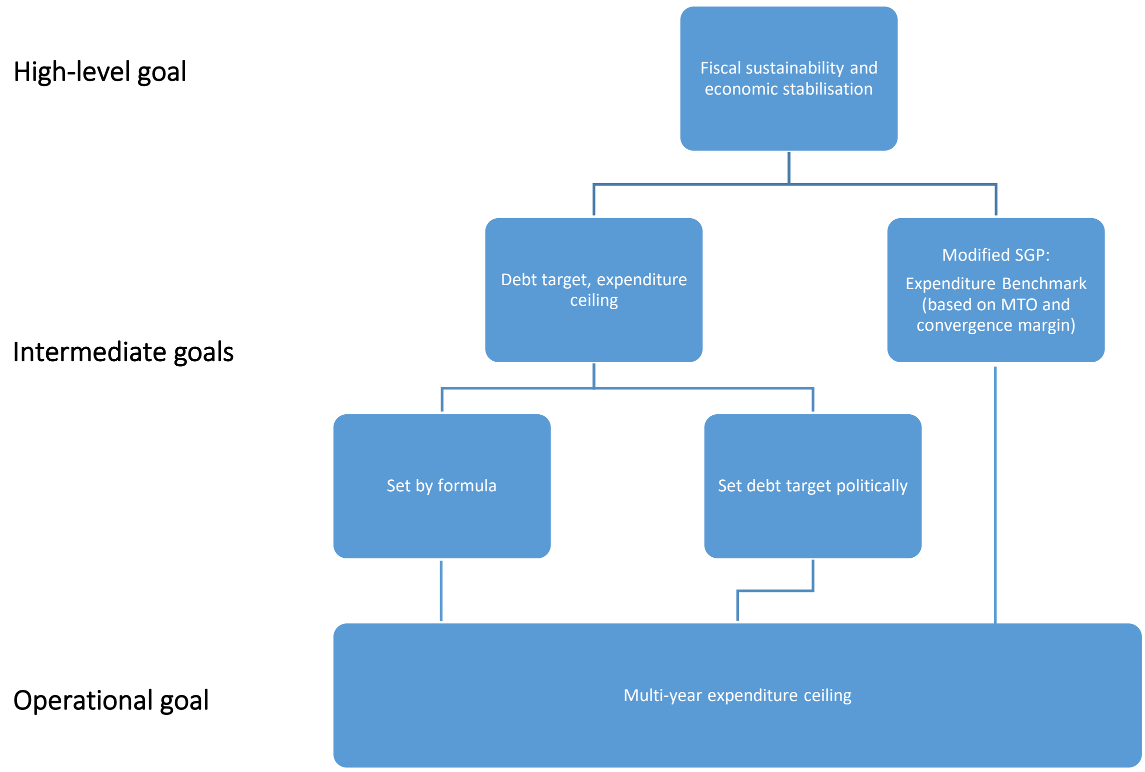
Two main approaches have been proposed for EU fiscal rules. While other models may be possible, most proposals focus on two approaches. These approaches share a number of common features, though differ in some dimensions (see Figure 4). The proposals aim to reduce the number of rules, revisit the link to the debt-to-GDP ratio and focus more on a measure of spending as the operational target:

- The first approach is the **'debt anchor, expenditure ceiling' concept**. This approach aims to bring (or keep) debt levels below a certain threshold deemed sustainable (debt anchor) by using a single operational rule (expenditure ceiling) as a lever. The expenditure ceiling is set in such a way as to achieve the required debt reduction (derived through a formula or determined politically). For example, (Darvas et al, 2018) envisage a rolling (5 to 7 years ahead) medium-term debt reduction objective operationalised through a multi-year expenditure ceiling. These proposals are based on the argument that expenditure is mostly under the direct control of the government, builds on largely observable variables and is easy to communicate. This approach has been advocated by the European Fiscal Board (EFB, 2020) and others (including Bénassy-Quéré et al, 2018, Constancio, 2020, Martin et al, 2021). Most proposals retain the current 60 % public debt reference value while others set the debt anchor through a formula or politically.

Most proposals suggest to set the operational target as a rather fixed multi-year expenditure ceiling.

- The second approach is to **modify the existing EU SGP framework** with some simplification in the number of rules and their application ([Feld et al, 2020](#)). This could be achieved by focussing more on the expenditure benchmark, continuing the trend in previous years towards growing emphasis on this approach. The expenditure benchmark sets a ceiling for allowable expenditure growth, adjusted for discretionary revenue measures based on the ten-year-average growth of potential output and a convergence term intended to progress towards the MTO – for those Member States that have not attained it or have departed from it. While still reliant on measures of potential output, it is less sensitive to measurement error along the path of potential output. Further, for the most part it does not rely on estimates of the cyclical elasticity of tax revenues, as it is effectively a bottom-up measure of the structural balance. The expenditure benchmark could be further improved by setting it at levels for several years at a time and using a less cyclical and revision-prone measure of potential or trend output. Improvements in the estimation of potential output would also support this approach.

Figure 4: Two main approaches to the reform of the EU fiscal rules



Source: The Network of EU IFIs (2021)

In theory, the two main proposed approaches can be viewed as two ways of achieving a similar outcome for the public finances. Both could be used to set a multi-annual expenditure target, whether anchored directly in a debt objective or through the structural balance[3]. In practice, there may be advantages and disadvantages to how each performs, and this will depend on specific design features of their implementation. The 'debt anchor, expenditure ceiling' approach is simple, transparent and easy to

[3] In practice, the EU experience shows that targeting debt directly would rarely allow for same outcome as targeting expenditure.

enforce. However, the main drawback of this approach may be around how the debt target is set. If the debt target is set politically at national level, this could lead to unrealistic or inappropriate debt targets, and could be difficult to find agreement on at the EU level. This problem could be partially addressed by involving national IFIs in the assessment of the proposed national debt path or debt anchor. Setting debt through a formula might fail to take into account all the macroeconomic circumstances of different countries. The 'modifying existing SGP framework' approach focussed on the expenditure benchmark relies on already existing notions that are widely used in the EU and therefore does not require major legislative changes. However, the main drawback of the approach is its reliance on potential output, which has been criticised for its unobservability and procyclicality (Darvas, 2019).

Reliance on the government expenditure ceiling as an operational tool is common for both approaches and also has its strengths and weaknesses. The government expenditure ceiling could help to foster political ownership. The expenditure ceiling, set either in nominal or real terms, is a good operational tool because government expenditures are mostly under the direct control of governments, largely independent of the business cycle, and have smaller forecast errors (Feld et al, 2018) than structural balances. However, there are also several challenges to using the expenditure ceiling. These include, for example, potential complexity in the operationalisation of the expenditure ceiling caused by important add-ons (e.g. debt reduction target) for high-debt countries, and a lack of focus on the level or composition of the government expenditure when setting the ceiling (Gros and Jahn, 2020).

A key issue for policymakers in real-time is to set policy based on stable and accurate assessments of future economic and budgetary conditions. Both proposed approaches here reduce reliance on the structural balance, which has shown procyclicality and volatility. However, in both cases the medium-term orientation requires some assessment of growth prospects in the years ahead, whether in actual or potential output terms.[4] It is key that these estimates are unbiased and relatively stable.

Ensuring the rules reduce risks from high debt

Among other objectives, the calibration of numerical rules should aim to reduce risks from high debt. The current 60% debt reference value is far from actual levels of debt in most EU Member States and would be hard to achieve anytime soon for many. There is no consensus on which exact level of debt represents an acceptable level of risk or whether 60% is still an appropriate target in the current low-growth-low-interest-rates environment (Blanchard et al, 2021, Darvas et al, 2018, Kamps and Leiner-Killinger, 2019). This will depend on circumstances including nominal growth, interest rates and a capacity to commit to a medium-term fiscal strategy, and may also depend on the initial debt level. In addition, there are other off-balance sheet commitments, including in many countries unfunded pension costs, that are relevant to fiscal sustainability. Ultimately, these topics require political decisions.

The pace of debt reduction is also difficult to determine in a simple way, in particular given the need to maintain a reasonable time profile and level of the primary balance (Kamps and Leiner-Killinger, 2019). The pace of debt reduction should be simple, but needs to lead to reasonable outcomes across the range of countries. Moreover, it must take into account the current macroeconomic environment where growth and interest rates could remain low in the long run. In such an environment, frontloading the fiscal effort could be self-defeating if it leads in to anaemic growth, potentially generating hysteresis effects and therefore undermining future sustainability. The pace of fiscal adjustment should be calibrated so that debt ratios are reduced steadily with a focus on the medium-term.

[4] At long horizons, these will tend to converge.

Future fiscal rules could set the requirement to reduce debt either by some new formula, allowing it to be determined by other parts of the rules or through a political decision possibly vetted by the national IFI. In any event, this choice itself would require a decision about what outcome is deemed appropriate. This is inherently a political decision that requires choices about risk, and about how the fiscal burden is distributed across generations. IFIs can provide an analysis of alternative outcomes but cannot determine how this choice should be made. Reaching a coherent political agreement may be difficult, and there are risks that short-term political choices may dominate. On the other hand, it may not be easy to find a simple numerical rule that is appropriate to all country situations. At EU level, the decision on the appropriate debt target could draw also on evaluations of long-term issues by the Ageing Working Group, and at national level it could draw on assessments of national IFIs. In particular, decision-making would greatly benefit from assessments of medium-to-long-term sustainability from national IFIs, which may be better able to capture specific challenges in individual countries.

Designing expenditure ceilings

Multi-year expenditure ceilings could help as an operational requirement to achieve fiscal objectives. A well-designed multi-year expenditure ceiling should avoid the risk of increasing spending in a procyclical way during good times. A ceiling provides some leeway for the government to avoid overspending; resetting it periodically should avoid major policy errors if outcomes diverge from what was expected. The expenditure ceiling or benchmark needs to be predictable yet flexible enough to allow some adjustment if the economy follows a very different path from what was originally planned. Some lower bound (i.e. expenditure floor) can also be envisaged in order to smooth out expenditure and avoid sharp cuts in times of economic downturn.

Expenditure ceilings can be set in nominal or real terms. Setting spending ceilings in nominal terms is simpler and more predictable relative to nominal choices around public spending. However, setting an expenditure ceiling in real terms and then adjusting for inflation allows adjustment for nominal shocks, which may be appropriate or necessary in many cases. Either approach is simpler and more predictable than setting spending as a share of GDP, and better supports macroeconomic stabilisation (Andrle et al, 2015). Aligning the setting of the multi-year limits with the national electoral cycle, and making the targets binding, would avoid unjustified annual revisions (Network of EU IFIs, 2021). However, some adjustment would be inevitable if some parameters used to set expenditure ex-ante (for example prices, interest rates or number of unemployed persons) turn out significantly off-mark in the following years.

The current EU expenditure benchmark is prone to revision, even with 10-year averaging, because of its reliance on a volatile measure of potential output (Barnes and Casey, 2019). Furthermore, the level depends on spending the previous year, including small tolerated overruns that raise the base or underspends that limit future spending. Setting the expenditure benchmark based on a level of spending of multiple years would improve its design. For many countries, moving the focus to a truly functional - rather than *pro forma* - multi-year cycle would be a significant step towards a more long-term and stability-oriented fiscal policy. This would imply fixing the nominal expenditure ceiling several years at a time, for example for at least 3 years. This would balance the need to provide stability while avoiding fixing the requirements for too long so that they remain relevant. This would strongly support domestic medium-term budgetary frameworks.

In practice, the commitment to meet multi-year expenditure ceilings has been helpful to countries in managing the public finances. In the Netherlands, a four-year fixed expenditure budget is set at the beginning of each political term as part of the coalition agreement. In Finland and Sweden, expenditure targets are also set at the beginning of each political term, and although less formalised (i.e., no coalition agreement), are followed strictly (Network of EU IFIs, 2021). The top-down spending aggregates expressed in budgetary accounting help to fix departmental spending over the medium-term[5]. Achieving a steady pace of spending increase below growth, under certain conditions, implies that rising ageing or health spending need to be either financed by a structural increase in revenue, spending reductions in other parts of the budget or through discretionary increases in taxation.

There are several design issues that must be considered in setting the expenditure ceiling:

- ***Setting the medium-term spending path.*** For high-debt countries, a multi-year expenditure path can be established in such a way as to bring debt levels to a chosen target. This requires an assessment of revenue growth and interest rate cost. Given that a medium-term perspective is required, it is inevitable that some assessment of the underlying trajectory of the economy will be needed. Shorter horizons imply that cyclical factors will play a greater role. Given that the focus is on the growth rate, an expenditure ceiling relying on medium-term potential growth delivers less uncertainty and revisions than the structural balance estimates, which are frequently revised[6] (Andersen & Darvas, 2020). It would still be important to ensure that a sound and reasonably stable measure of potential or trend GDP is used.

- ***Expenditure measure*** - Using a modified aggregate measure allows governments to run predictable and steady budgetary policies without distortions due to one-off factors. This also helps to ensure that spending is sustainable and does not rely on temporary measures. The targeted expenditure ceiling should adjust for one-offs and some temporary factors. Adjustment could be made for cyclical factors, particularly changes in cyclical unemployment spending, which can be relatively easily achieved if appropriate techniques are used (Reuter, 2020). Many existing proposals suggest excluding interest spending, as it allows for more counter-cyclicality (Bénassy-Quéré et al, 2018) or because these expenditures are not directly under the control of government (Feld et al, 2018). Considering different levels of both risk premia and public debt across the EU as well as persistent sovereign debt market fragmentation, exclusion of interest expenditures from the expenditure measure might however lead to an insufficient reduction in debt.

- ***Harmonising the accounting and variables*** used to determine the expenditure ceiling. Currently, most national governments in the EU use expenditure ceilings to operationalise the structural balance rule and achieve the MTO. However, there are many cross-country differences in how ceilings are set, particularly in underlying accounting perspectives. For instance, in some countries, targets are set using national accounting standards, which differ from country to country. This also makes it hard to reconcile targets with operational budgets that are often specified in cash terms. Reconciliation with fiscal rules can also be problematic if the targets are not binding or are frequently revised.

- ***Adjusting for discretionary revenue* measures.** The expenditure ceiling should be adjusted using an appropriate method for any discretionary revenue measures, to ensure that there is no bias towards revenue measures and that governments, provided adequate funding, have the option to raise expenditure. The estimation of the budgetary impact of discretionary revenue measures is often contentious, as governments have a tendency to overestimate revenue-increasing discretionary measures and underestimate revenue-decreasing discretionary measures. IFIs could contribute to a more accurate assessment of the budgetary impact of

[5] For the expenditure ceiling to be effective and easy to enforce there should be an EU-level agreement on country-specific fiscal objectives and appropriate level of expenditure ceiling that later could be transposed at the national level.
[6] Although any revision of the structural balance would have a direct and equivalent effect on the level of debt reduction.

discretionary revenue measures by providing independent and objective estimations, if adequate access to information on data and assumptions is provided to them.

- ***Allowing for deviations from the rule***. Some proposals for expenditure rules (Bénassy-Quéré et al, 2018, Feld et al, 2018, Constancio, 2020) include an ability to deviate from the expenditure ceiling or requirement. These include: (a) allowing an adjustment margin for overruns, or (b) allowing to 'bank' savings, including through a 'rainy day fund' (Constancio, 2020). These can allow for additional flexibility and improve fiscal management, for example allowing for more active countercyclical policies. However, all these adjustments create complexity. In addition, a large margin of adjustment could effectively decouple spending from spending rules, both while the deviations are accumulated and as they are wound down. This may undermine their effectiveness, although sustainability concerns can be reduced if Member States only spend accumulated funds in this way, rather than 'borrowing' from an adjustment account. In any case, allowing for deviations needs to be carefully balanced with the complexity it brings, and any exceptions need to be carefully controlled and protected by safeguards. These include assessments by national IFIs of the appropriateness of using such facilities.

A 'through the cycle' approach provides room for automatic stabilisers to operate but limits the scope for countercyclical policy. Using an expenditure ceiling as an operational target with a medium-term perspective while aiming to achieve steady and appropriate spending growth in steady-state implies that the budget balance will fluctuate through the cycle[7]. While this provides a strong basis to stabilise the economy, it may be insufficient either during severe downturns where more stimulus may be warranted, or where countries are experiencing overheating and need to tighten fiscal policy more aggressively. Re-evaluating the appropriate fiscal trajectory once the shock has hit would be one way of addressing this. Allowing some 'adjustment account' or 'escape clause' around rule requirements would be another method of allowing countries to run a tighter fiscal policy during 'good times,' while providing more stimulus in 'bad times'. This however would require significant safeguards.

Simplifying the rules

Complexity could be addressed through reducing the number of rules that are the focus of enforcement, or by simplifying their interpretation. This could be achieved without making the rules weaker. Simplification could contribute to supporting enforcement and helping to foster buy-in from the public and key stakeholders.

The number of rules that are the focus of the governance framework could be reduced in a number of ways. Many rules ultimately impact the same variables, so there is a degree of overlap that could be reduced. The 'debt target, expenditure rule' concept would increase the focus on two measures – one anchor (debt target), one operational target (expenditure ceiling) against which governmental fiscal policy choices are assessed. This could be compatible with removing other rules entirely or keeping them as inputs and/or benchmarks against which the broader sustainability assessment can be performed. An approach based on implementing a version of the existing rules could also put operational emphasis on some metrics, such as the structural balance, in favour of simpler ones - with

[7] Assuming steady-state starting point, budget balance would fluctuate through the operation of the automatic stabilisers only as revenue varies over the cycle and due to unemployment-related spending. Assuming high (low) debt starting point, budget balance fluctuations can show fiscal contraction (expansion) as well as the functioning of automatic stabilisers.

the growing emphasis on the expenditure benchmark in recent years – while their role as a medium-term reference for assessing the sustainability of public finances could be maintained.

There are a number of options that could reduce the complexity of how a given set of rules is implemented without necessarily reducing their effectiveness.

- First, a number of features have been added to the rules. These cumulatively amount to many additional details with modest impact. For example, the 'investment' and 'structural reform' clauses included detailed numerical rules for how they are applied. However, while they may respond to legitimate needs, the leeway they offer to Members States is often too small to be economically meaningful. At the same time, the conditions are so onerous that very few countries have used these facilities, even if they were entitled to them (EC, 2018). Countries undertaking major supply-side measures could still be granted some leeway, but this should be conditioned on a full economic assessment rather than numerical criteria only, including an assessment by the national IFI.
- Second, some of the complexity in the way that rules are specified reflects specific measurement problems, notably with the Commonly Agreed Methodology for calculating potential output (discussed in more detail below). The volatility of this measure has led to the inclusion in the rules of a range of smoothing, timing and averaging assumptions. Moving to a more stable measure could largely eliminate any need for these features, as well as helping to reduce procyclicality.
- Third, existing rules and guidance rely heavily on very detailed numerical implementation or complex sets of rules. Key concepts such as discretionary-revenue measures (DRMs), one-offs and the structural balance should be set out in a simple way based on clear principles and with examples, but without trying to cover every possibility. Efforts to develop detailed agreed understandings can lead to a 'lowest common denominator' approach that may be flawed, leave significant gaps or be too complex. These approaches may at times suffer from a 'one-size fits all' approach or end up with very complex numerical specifications that increase the opacity of the requirements without clear benefits.[8] An approach with a more prominent role for assessment by national IFIs could result in some differences of treatment across countries, but should provide a better picture of the fiscal issues in each Member State.
- Fourth, information on the rules remains spread across multiple documents. Besides primary and secondary legislation, the Commission has produced two codes of conduct and multiple communications. Each of these documents contains many additional details on the application of the rules. The main compendium of the interpretation of the current fiscal rules - the *Vade Mecum* - runs to 108 pages. Even this is not sufficient to understand the rules, with important information only available in references, for examples in boxes in past editions of the Commission's Public Finances in EMU publication. There should be a simple and timely consolidated guide to the rules that is designed to address the necessary issues but does not add complexity. To facilitate the monitoring of compliance with the fiscal rules by the IFIs, it would help if any changes to the fiscal rules were communicated to the IFIs well in advance and in a more direct way. Annual changes to fiscal rules approved by the Commission and governments, which are not flagged to the IFIs, have so far been one of the biggest challenges IFIs have faced in monitoring and assessing compliance with the fiscal rules.

[8] See for example Box 1.6 of the Vade Mecum that proposes 5 measures of economic circumstances or Box 1.9 on convergence measures.

A single escape clause could increase simplification and transparency of the current EU fiscal framework. Most existing proposals to reform the EU fiscal rules (EFB, 2020, Bénassy-Quéré et al, 2018, Darvas et al, 2018, Feld et al, 2018) favour a single escape clause over a current set-up that includes the general escape clause. Having one escape clause that would allow countries to deviate from the rules in case of 'exceptional circumstances' would strengthen political accountability. The final decision to trigger the escape clause in relation to Member States could be based on clear pre-defined criteria or a Commission assessment in case of external shocks (e.g. natural disasters). This decision should take into account the independent assessment by IFIs, which are well-placed to assess the situation that a country faces.

Other design issues for fiscal rules

Investment may warrant special treatment and recognition in the design of the rules. Public investment in the EU has been on a declining trend in most European countries since the Global Financial Crisis (ECB, 2016), even though interest rates have declined to very low levels. The Commission in its EU economic governance review also acknowledged that the quality of public finances, in particular public investment, is one of the areas for improvement (EC, 2020). The reasons behind the decline in public investment should be investigated and addressed. Looking ahead, very large investments could be required over the coming decade to address the climate transition. To meet EU climate goals, about 0.5 % - 1 % of GDP of additional public investment will be required annually for the next ten years (Darvas & Wolff, 2021). Increasing public investment to meet the climate goals could be challenging as current rules make no provision for such a prolonged increase in investment spending. These investments may be necessary and cost-effective, particularly at low interest rates, and it may be appropriate to spread the cost of ramping up the capital stock over a longer period. However, there are also significant challenges in taking investment into account in fiscal rules, and the outcome should not imply a worsening of fiscal sustainability.

While the current framework is neutral regarding the composition of public revenues and expenditures, it may in practice have contributed to a distortion in policy choices. In certain occasions (e.g. rising social spending pressures), fiscal consolidation induced by rules may have had an indirect adverse impact on public investment (Delgado-Tellez et al, 2020). This was previously the case for several countries, where public investment cuts were made following substantial fiscal consolidation needs[9] (ECB, 2016). It may be politically more expedient during periods of fiscal consolidation to cut public investment, rather than to cut current expenditure. In principle, spending on investment differs from current spending in that it should deliver a future gain, either in terms of higher national income or, for some projects such as toll roads, direct government revenue. There could therefore be a case to treat it differently in the fiscal rules from a sustainability point of view. Investment spending however can worsen public deficits at the time it is spent, and increase the debt ratio for a long time. A sound framework should be in place to ensure that the investment will actually boost potential output in future years.

Consideration could be given to adjusting the fiscal framework to give special treatment to investment, but the advantages and drawbacks would need to be carefully weighed. Excluding certain measures of investment from the expenditure rule would need to be approached carefully, and should not simply be used to loosen fiscal policy. Darvas and Wolff propose, for example, excluding some measure of 'green' investment from EU rules. Measures based on National Accounts definition of gross fixed capital formation would likely be the most straightforward to implement, although this may not coincide with

[9] The largest cuts however were recorded in countries with initial high ratio of public investment, notably related to pre-crisis booms.

the full scope of productive government investment activities.[10] Any measure should be based on the net increase in the public capital stock rather than gross measures of investment that include current consumption of capital. A key difficulty is that the cost-effectiveness of investment is hard to assess, in particular considering the financing alternatives and their impact on output and public finances (ECB, 2016). National IFIs could provide independent assessment of the fiscal and economic impact of public investment.

To enhance compliance with fiscal rules, changes may be required to enforcement mechanisms and surveillance in the EU governance framework. As discussed above, compliance with fiscal rules has been mixed and selective. This should be supported by improvements in the design of rules to make them simpler and less procyclical. Changes could also be made to the enforcement mechanisms and sanctions themselves. Surveillance of compliance with fiscal rules should also make more use of assessments undertaken by national IFIs as discussed below.

It is essential that any proposed change to fiscal rules be tested. Many proposals for rules are made without working out their implications across a variety of situations, for example based on simulations for a single set of parameters or purely a priori reasoning. This can lead to poor outcomes or unintended consequences when the rules are applied. For example, the high frontloading of consolidation requirements under the SGP debt reduction benchmark would have been exposed had the implications of the rule been drawn out in a simple model under different nominal growth assumptions. At a minimum, the implications of proposed rules should be fully developed based on real-time forecasts for all Member States. These should also be developed for a range of alternative scenarios, or in stochastic simulations. Given that the economic data or forecasts that feed into the rules is often revised, these exercises should reflect data and forecast uncertainty, including looking at how the rules would have operated in pseudo real-time based on historical data. The risks of strategic manipulation of the rules, and likely weak spots in their application, should also be assessed and made public.

Reforming the EU fiscal governance framework may require major legislative changes, while inconsistencies with national budget rules should be reduced. Such aspects, which may require Treaty changes, face the highest hurdle in terms of implementation from a legal perspective, while others may require various legal changes or only procedural modifications. One of the main legal challenges in reforming the current fiscal framework would be the EU Fiscal Compact. The Fiscal Compact was signed in 2012 by 22 EU Member States. It requires signatories to maintain a budget balance in structural terms, or to make progress towards it. This requirement must be enshrined in domestic legislation of a constitutional nature. This gave rise to many inconsistencies between national and EU rules, since interpretative changes to the EU framework that were adopted after 2012 were never included in the Fiscal Compact and thus national rules[11] (Deroose et al, 2018). Such inconsistencies often resulted in de facto two different frameworks (EU-level and national) that apply in parallel and could be inconsistent. This has negative implications for the transparency of both the EU and national fiscal frameworks, as well as national ownership of fiscal rules. The Fiscal Compact therefore would require an overhaul to bring national rules in line with the future EU framework. Alternatively, a solution should be found to align it effectively.

[10] The GFCF definition also excludes routine maintenance and repairs, which can bias governments towards new investments at the expense of maintaining old investments. Investment grants (D.92 of the national accounts) are also excluded because the investment is undertaken by bodies outside the general government sector.

[11] Unless national rules made a direct link to EU legislation.

Role of IFIs in the EU fiscal framework

EU fiscal governance has had a decisive role in developing national IFIs in many EU Member States. National IFIs have been established for a long time in some EU Member States, notably the Netherlands and Sweden, while various institutes, councils and other bodies have played similar roles in other countries. Many experts and academics were calling for national independent IFIs to be established during the 2000s. However, many countries did not establish them until after the Global Financial Crisis. They were a requirement in Member States subject to macroeconomic adjustment programmes. In the EU framework, the development of IFIs was introduced in several steps. First, the need to involve IFIs in the budgetary processes was referenced in the Six-Pack (Directive 2011/85). Furthermore, the Fiscal Compact within the Treaty on Stability, Coordination and Governance in the EMU (TSCG) introduced requirements for the independence of EU IFIs and the 'comply or explain' principle. Finally, the Two-Pack (Regulation 473/2013) formalised the role of EU IFIs in official macroeconomic forecasting and monitoring of compliance with fiscal rules[12].

Multiple studies point to substantial positive impacts of the EU IFIs on fiscal transparency and sustainability. The presence of IFIs is associated with more accurate and less optimistic fiscal forecasts (Beetsma et al, 2018) as well as greater compliance with fiscal rules (Lledo, 2018). IFIs also contribute to fiscal sustainability by persuading policymakers to opt for sound fiscal policies (Beetsma et al. 2017). Indeed, IFIs were proven to contribute to deficit reduction (Capraru et al, 2020) and foster compliance with EU fiscal rules through their ability to engage with the public through national media (EC, 2021).

IFI effectiveness is conditional on strong and sustained political commitment to the mandate of a fiscal council (Hageman, 2011). However, wide space for national discretion in the current fiscal framework has led to substantial differences across EU IFIs in breadth of mandates. Cross-country differences also persists in funding and access to information. The Network of EU IFIs has consistently called for strengthening the role of IFIs and setting minimum standards (Network of EU IFIs, 2015, 2016 and 2019).

Enhancing the role of national IFIs in EU fiscal governance

The capacity of national IFIs to make independent objective assessments of national fiscal dynamics and to raise transparency could be used more effectively in the EU fiscal framework. National IFIs have expertise to make independent assessments of economic and fiscal developments based on national conditions. The current role of national IFIs is set out in Box 3.

IFI assessments should feed into the surveillance process at the EU level as undertaken by both the Commission and the Council through an obligation to take these into account, alongside their own assessments, when taking decisions on applying the EU fiscal framework. While national IFI assessments are already used extensively by national governments and the Commission, this would codify some existing practices and ensure it is undertaken on a systematic basis. The EU institutions would continue to undertake their own analysis and would be fully responsible for their own decisions regarding enforcement of the EU fiscal framework. However, the obligation to consider assessments by national IFIs could provide a basis for ensuring that EU requirements are applied in line with national circumstances where appropriate. This would increase the status and recognition of IFI assessments and potentially help to provide a bridge with national budgetary discussions and debates.

[12] Euro-area members only.

At the same time, it is vital that national IFIs retain their independence, including from judgements made at EU level, so they are able to provide objective assessments of national circumstances. Many IFIs also have separate mandates connected to national fiscal frameworks that should not be compromised. National mandates of IFIs are a key part of their legitimacy and ability to engage with national stakeholders. This could be ensured if the timing of IFI assessments were such that they could be taken into consideration in the official assessments by the Commission and Council, so appropriately anchored into the EU Semester cycle.

Box 2: Responsibilities of national IFIs and EU fiscal rules

Many national IFIs were established to meet the requirement under the EU governance framework for monitoring budgetary rules at national level, while in other cases this task was assigned to existing independent institutions.

National IFIs have three main sets of tasks in relation to fiscal rules:

- - In all EU Member States, monitoring compliance with domestic fiscal rules (EU Directive 2011/85).
- - For euro area Members, plus three countries voluntarily bound by the Fiscal Compact (TSCG) (Bulgaria, Denmark, Romania), monitoring of compliance with national laws required under the Fiscal Compact (TSCG) that focus on achieving budget balance and the medium-term objective, including national corrective mechanisms.
- - For euro area members, undertaking or endorsing macroeconomic forecasts used in national budgets and stability or convergence programme updates as well as monitoring compliance with all fiscal rules in force ('Two-Pack' Regulation 473/2013).

This implies a complex structure for monitoring compliance. At EU level, there is a two-tier structure where both the Commission and national IFIs monitor compliance. However, only the Commission's assessment feeds directly into the decisions and possible sanctions agreed by the Council. At the same time, national IFIs alone are tasked with monitoring compliance with often analogous requirements in national level.

In addition, national IFIs are often assigned a range of other roles, including monitoring national budgetary rules that are independent of EU requirements.

More recognition of national IFI assessments at EU level is warranted in several areas:

- **The contributions of national IFIs on a number of measurement issues should be taken into account**. As noted above, this could include the identification of one-offs, estimation of potential output and structural balances and the measurement of discretionary revenue measures (DRMs). National IFIs are well-placed to understand and assess specific national circumstances and the implications for the overall fiscal position.

- **Moreover, IFIs should be more involved in discussions about methodological developments when it comes to the estimation of the 'one-offs' and the DRMs.** Under TSCG, IFIs are mandated to assess national compliance with a number of fiscal rules[13] (structural balance and debt rules and expenditure benchmark) that require estimation of the 'one-offs' DRMs. However, IFIs

[13] As transposed in the national legislation.

currently have generally little to no access to the information on the key inputs from national governments and the Commission. IFIs should be included in the information flow between national governments and the Commission, and have a structured dialogue with the Commission services on the classification of such non-observables. National IFIs should also have timely access to any methodological changes, including versions of data and software that are used to derive the non-observable economic cycle variables for the annual assessment. This would enable all stakeholders (national authorities, national IFIs, and the European Commission) to reach their own conclusions based on the same dataset of information, eliminating the asymmetry of information of the current setup.

- **More prominence should be given to national IFIs assessments of compliance with rules that monitor requirements at the EU level**. Within the current EU governance framework, national IFIs in the euro area, Bulgaria, Denmark and Romania are tasked with monitoring compliance with EU numerical fiscal rules as transposed at national level. These include deficit and debt reference values set out in the TFEU as well as adherence to the medium-term budgetary objectives[14]. Within this task, IFIs are mandated to assess the activation of the correction mechanism in case of deviation from the MTO, exceptional circumstances and correction of the deviation (Jankovics & Sherwood, 2017). However, these types of assessment monitor compliance ex-post, potentially after the rules have been breached. Due to extensive knowledge of national specificities as well as competences in compliance assessment, IFIs could also be tasked with ex-ante assessments of compliance with fiscal rules. Some EU IFIs already carry out such assessments within their national mandates (Network of EU IFIs, 2021). National IFIs, together with national fiscal rules, are key to reinforce the national commitment to sound fiscal policies. National IFIs can make a substantial contribution to promoting responsible fiscal policies within the context of the SGP thanks to two main strengths: excellent knowledge of country specificities and recognised national acceptance. The Commission and the Council should take into greater consideration the role of IFIs in the assessment of national macroeconomic and fiscal frameworks.

- **National IFIs could be mandated to make an assessment at national level, on a regular basis, of overall fiscal sustainability and the underlying fiscal position**. Most national IFIs already produce debt sustainability assessments (Network of EU IFIs, 2021). However, in light of mounting fiscal costs arising over the long-term (related to population ageing, climate change, etc.), an independent multi-angular overview of fiscal sustainability encompassing all aspects of public finances is required to inform and advise fiscal choices. IFIs are well-placed to carry out such an assessment due to their technical expertise and national experience. This requirement should be the responsibility of a national IFI. It could take the form of a separate report that would be made public or covered as part of existing publications. National IFIs should be free to choose how they undertake this assessment.

There may be cases where the assessment of the Commission and national IFIs differs either on compliance with numerical benchmarks under the fiscal rules; the treatment of specific issues, such as one-offs; or the overall fiscal position. In general, it would be desirable that the two assessments align to ensure predictability and avoid confusion, although ultimately EU and national IFIs have their own mandates and have responsibility for implementing them. This may lead to some differences in

[14] Article 5 of the Regulation 473/2013.

assessments on compliance with the rules. On many occasions, national IFIs have imposed stricter interpretations than the Commission. The proposed approach for the Commission to recognise and take into account the assessment of national IFIs – as well as the enhanced exchange of information between EU institutions and national IFIs - could lead to fewer differences in interpretation for specific countries, though there may be a trade-off with consistency across countries. This may reflect the difficulties of imposing common standards over diverse circumstances. Given the common principles and guidance, any differences across countries and between national IFIs and the EU institutions are likely to be small, and may have limited significance for the overall assessment of compliance with rules and the fiscal position. Any differences that arise should not be used to provide a loophole for countries to run risky fiscal policies. Taking into account assessments by the national IFIs should help to reduce the scope for divergence, while maintaining the independence of the national IFIs. This would potentially allow the Commission some margin to adapt their assessments to national circumstances, reflecting the wide variety of fiscal situations of Member States.

In the existing framework, these differences can be narrowed by providing clearer and more comprehensive common principles and guidance. The complexity of national situations means that this common guidance is often at once very complex, as it tries to cover a wide range of issues, and incomplete in that many situations remain undefined. It is possible that the level of detail in the EU frameworks could be reduced significantly, while filling gaps in key areas (such as one-offs and DRMs) and without widening the scope for disagreement between the two levels of monitoring. There should be clear and comprehensive common principles and guidance set out in all areas of the rules. Moreover, IFIs are not currently formally informed or consulted in the methodological discussions that take place at the EPC/EFC, between the European Commission and national governments and in case of changes to the interpretation agreements to the existing framework. EU IFIs must have direct access to methodological discussions that take place between the European Commission and national governments to allow effective monitoring.

Ensuring capacity and strengthening the mandate of IFIs

Setting minimum institutional requirements would help to ensure that IFIs are strong enough at national level to fulfil these functions without compromising practices. At present, there is a wide range of capacity across EU IFIs, reflecting differences in mandates and resources. To fulfil their potential to play an enhanced role in monitoring compliance with fiscal rules and ensuring fiscal sustainability across Member States, it is key that all EU IFIs have the mandates, institutional features and resources to function effectively and independently.

The implementation and enforcement of existing supranational independence safeguards[15] is limited in some countries. The review of the Fiscal Compact implementation has shown that there are critical capacity and access to information constraints that must be addressed, in order to improve the functioning of the EU IFIs (Horvath ,2017). In line with previous statements and OECD Recommendations of the Council on Principles for Independent Fiscal Institutions (OECD, 2014), the Network proposes the following list of minimum standards for IFIs:

- **Mandate to address government and parliament, and mandate to publicly disclose reports and recommendations**. To ensure sufficient transparency and maximum accountability of national

[15] Laid down in the Fiscal Compact and broadly re-confirmed in the euro area two-pack Regulation 473/2013.

governments, IFIs should be able to directly address national authorities as well as issue and disclose reports and recommendations at their discretion.

- Good and timely access to information. Full, stable and real-time access to information is paramount to ensure that IFIs can fulfil their functions. IFIs should be able to obtain accurate information on demand from national statistical offices, national governments and the Commission without an undue delay and at no cost. Any restrictions on access to information should be clearly defined in law. IFIs should also be able to participate in committees at national level related to accounting or measurement aspects of fiscal policies.

- Effective implementation of the 'Comply or Explain' principle. This principle is a key instrument in the IFI toolbox to enhance national ownership under the TSCG. The details on implementation of this principle should be included and clearly defined in national regulations. Moreover, all official correspondence between national IFIs and public administrations under the 'Comply or Explain' principle should be made public immediately.

- Adequate level of resources and management flexibility. A sufficient and stable level of resources (both financial and staff) is essential to ensure that IFIs can fulfil their functions effectively at all times. IFI budgets should be protected from political interference, potentially through a multiyear budgetary appropriation that stretches beyond the national electoral cycle. IFI funding should also be sufficient to allow for the production of own-initiative reports. Finally, IFIs should have adequate flexibility to manage their resources (incl. hiring and firing staff) as they see fit, to ensure that their independence is preserved.

- Sufficient safeguards against political pressures. It is essential that board members are selected under a transparent procedure based on their merit and competence. The hiring process should be subject to strict rules on conflict of interest, and board member terms should be independent of an electoral cycle. Moreover, it is paramount that IFIs are able to produce reports and analysis on their own initiative, so long as the reports are consistent with the mandate of IFIs.

Including these minimum standards in the EU fiscal framework will strengthen national IFIs individually and collectively, enhancing national ownership of fiscal policies.

Data and information to support fiscal monitoring and assessment

The setting and enforcement of fiscal rules should be supported by better data and information. This would aid the wider assessment of fiscal policy needs and sustainability based on a broad range of indicators. The existing requirements to provide reliable statistical data on the general government fiscal position in a timely and comparable way is a key achievement of EU fiscal governance. It has led to an overall improvement in fiscal transparency and the information available on the public finances.

While some indicators have shown limitations when applied to EU fiscal rules, they can nevertheless provide relevant information. There is scope to improve and add to these measures. In addition, some key concepts, such as one-offs and discretionary revenue measures, would need to continue to be measured under any EU fiscal framework.. The incentive to meddle with certain public finance metrics, in order to appear to perform better, should be minimised by making relevant metrics of public finances simpler and more transparent. Moreover, IFIs could provide independent objective assessments of the various measures of public finances as well as budgetary forecasts to ensure the information is reliable and accurate.

A number of specific improvements to economic and budgetary information could be made:

- **Member States should be required to produce credible medium-term fiscal projections covering 4 years[16], that are consistent with the stability/convergence programme updates**. This would help to understand the fiscal position, strengthen the medium-term orientation of fiscal choices and allow exceptional changes (if any) to be tracked over time. Although producing reliable medium-term estimates might prove challenging, especially during significant economic shocks, it should not weaken the medium-term focus. Medium-term projections are necessary to provide more stability and predictability of public resources and their allocation (Network of EU IFIs, 2018). These projections should be subject to assessment and/or endorsement by national IFIs and be based on realistic 'no policy change' assumptions. IFIs could also be tasked with the production of medium-term projections. The current requirement in the EU fiscal framework 'extrapolates past revenue and expenditure'. The approach should assume that countries continue to provide the same public services and benefits as well as the same level of public investment with the same tax system unless there are explicit policies to the contrary or clear deviations from this in practice. This includes taking into account the impact of inflation and rising costs and changes in population dynamics. The IFIs would also welcome publication of medium-term fiscal projections covering the same period by the European Commission.

- **Simplification, increased transparency and methodological improvements are required in the assessment of output gap estimates**. The output gap is a key fiscal indicator, regardless of its exact role in the fiscal rules. The existing potential output measures under the EU Commonly Agreed Methodology (CAM) are procyclical (Darvas, 2019), especially at the end of the sample or of the forecast period. Consequently, output gaps are under-estimated (in absolute terms), particularly in some countries (Barnes and Casey, 2019).[17] Any method to estimate the output gap or potential output is likely to face challenges, including the procyclical nature of many economic forecasts, and imply trade-offs. However, some methods perform better than others

[16] Documents should cover year$_{t-1}$ - year $_{t+3}$, with fiscal projection from year$_t$ onwards.
[17] According to the Commission, output gap estimates are procyclical 'only to a reasonable degree' (EC, 2019).

in terms of cyclicality and stability in real time. The EU CAM method, in some cases, can be relatively procyclical and volatile (Casey, 2018).

To address this, one approach would be to reduce the emphasis on potential output and the output gap in numerical fiscal rules, for example by putting less weight on the structural balance and the MTO. In addition, a greater role could be given in surveillance to alternative methodologies, including country-specific approaches developed at national level that provide alternative guidance. A suite of models seems to offer a relatively favourable approach in many cases. Most IFIs use their own national models of potential output (Network of EU IFIs, 2018). While the Commission may continue to use the standard CAM method for assessing compliance with the rules, greater focus on alternative measures of potential output designed for national circumstances could improve the assessment of fiscal policy and how the rules should be applied. The methodology behind alternative measures of potential output may benefit from recognition by the domestic IFIs.

- Improved treatment of one-off measures is necessary to improve the monitoring of the underlying fiscal position. Proper identification of one-off measures is crucial for the analysis of headline budget balance developments and the underlying fiscal position (e.g., structural budget balance). However, the current fiscal framework does not provide a clear definition of one-off measures. The most comprehensive EU document on one-off measures - Public finances in the EMU 2015 - only presents guiding principles for the classification of the one-off measures and an indicative list of one-off characteristics. Nevertheless, many questions about the definition and measurement of one-offs are left unanswered. This results in substantial differences in the treatment of one-offs across countries and limited coverage of one-offs, particularly those that last longer than a year. More guidance on the classification of one-off measures would lead to better treatment of one-offs across countries and improved quality and reporting of data.

- Better measurement of the discretionary-revenue measures (DRMs) would enhance fiscal monitoring. Discretionary revenue measures are essential for the assessment of the government fiscal stance and play an important role in both preventive and corrective arms of the current fiscal framework (EC, 2013). Despite recent efforts to reach a common definition of DRMs and improve the quality and transparency of their reporting, more progress is required to improve the measurement and set out clear standards for doing this. Such estimates should be based on the permanent change in fiscal position. This is particularly important given that the size of adopted DRMs can reach as much as 2% of GDP in some EU counties (Carnot & de Castro, 2015). Measurement of DRMs should pay particular attention to their duration and the phase of the cycle. For instance, measuring multi-annual DRMs at the peak of the cycle could lead to unrealistic estimates for the following years. Instead, computation of a successive incremental impact over the years could produce more accurate estimates. IFIs could be tasked with estimation or assessment of DRMs as they are well-placed and, if provided with adequate information on data and assumptions, have sufficient technical expertise to produce accurate and reliable estimates or to endorse those of the government.

- More transparency is warranted with regards to the disbursement and usage of the EU funds. EU funds make up a substantial part of national budgets in some countries, where total transfers from the EU over 2014-2020 amount to about a quarter (25%) of GDP in 2020 (EC, 2020). As in the case of DRMs, there is no harmonised treatment of funds received from the EU budget -

both the allocation and accounting of received funds vary from country to country in the national budgetary systems. In some countries, EU funds are directly redistributed to local governments (DE) or conglomerates (FR) and therefore are not reflected in the central government budget. In other countries, EU funds are booked as income of different ministries (AT) (Mortensen et al, 2014). This hinders ample analysis of the size, beneficiaries and economic impact of the receipts from EU budget within and across countries. At the same time, in the European System of National Accounts, the principle of EU flows neutrality is well established and its implementation is continuously verified by Eurostat (see Eurostat (2019): Manual on Government Deficit and Debt: Implementation of ESA 2010, pp. 121-134.). In particular for the ex-ante perspective, fiscal policy assessment would greatly benefit from transparent and timely information on the use of EU funds from the Commission and EU Member States.

- **There should be a requirement to produce debt sustainability analysis at national level, either by governments subject to national IFI oversight or by national IFIs**. In light of debt reaching historical heights and long-term fiscal pressures (e.g., ageing population, climate change), rigorous well-calibrated analysis of debt sustainability is essential. Given large uncertainties and other challenges to model long-term fiscal indicators more transparency is warranted about adopted fiscal measures (incl. contingent liabilities) and modelling assumptions. Including stochastic approaches in the DSA analysis toolbox (Network of EU IFIs, 2021) would be useful, but national bodies should be free to choose their own approaches, depending on the macroeconomic environment and the level of uncertainty.

- **Net debt and net worth statistics and projections should be measured and published in order to enhance the assessment of government debt stocks**. The current fiscal framework only regards public debt in gross terms, without taking into account government asset positions. Reporting on net measures could contribute to a more accurate and comprehensive overview of government finances, as well as a more accurate assessment of the overall financial position of the general government (Ferrer & Musmeci, 2019). Net debt measures should be based both on the national accounts approach - subtracting government holdings of financial assets from total public liabilities at a given year – and also on the narrower liquidity basis by deducting liquid financial assets (Eurostat, 2014). Additionally, measurement and reporting of the net worth should be refined.[18] Net worth indicators give an extensive overview of the government's capacity to meet its financial obligations (OECD, 2015). Measurement and reporting of so-called 'hidden-debt' such as contingent liabilities has recently been given prominence in many countries but should also be improved (e.g. uncalled guarantees) (ECB, 2011). To develop consistent and coherent reporting of the net debt and net worth, more progress should be made towards harmonising public sector accounting standards in the EU (EPSAS). The adoption of accrual-accounting would also improve the quality of national accounting data used in the rules-based framework.

- **Gross and net financing needs should be projected and published in order to enhance the assessment of flows of government debt**. Gross financing needs have a substantial impact on the costs of borrowing for countries with high debt stocks. In particular, research finds that high levels of public debt are more likely to be sustainable when gross financing needs are manageable (Gabriele et al, 2017). Therefore, accurate and reliable information on gross financing needs is necessary for the accurate analysis of risks to debt sustainability. Gross financing needs should take into account the budget deficit, required deficit-debt adjustment

[18] There are a number of concepts for the General Government: net worth; net worth (including pension liabilities); financial net worth (All financial assets – financial liabilities); and net debt (EDP debt instruments - EDP debt instrument assets).

and maturing debt to be rolled-over. Additionally, net financing needs could be calculated by subtracting the use of liquid financial assets (currency and deposits) from gross financing needs on annual basis. This would allow for the measurement of market conditions and short-term liquidity risks to debt sustainability (Bouabdallah et al., 2017).

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The Network of EU Independent Fiscal Institutions

The Network is composed of 30 Independent Fiscal Institutions representing 25 EU countries and the UK. It is a voluntary and inclusive institution, open to all independent fiscal oversight bodies operating in the EU. It provides a platform to exchange views, expertise and pool resources in areas of common concern. The Network supports the efforts to review and reinforce the EU fiscal framework, seeking to better exploit the synergies between rules and institutions, as well as between different levels of administration, whilst respecting the principle of subsidiarity and enhancing local ownership and accountability.

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