EU Economic Governance Proposal Reform: Issues and Insights from EU IFIs

The Network welcomes the publication of the European Commission Communication on Orientations for a Reform of the EU Economic Governance Framework on 9 November 2022 .

The Network supports the objective to reach a consensus on reform ahead of Member States' budgetary processes for 2024. The extended reliance on the "exceptional circumstances" clauses risks undermining EU and national fiscal frameworks, which could make it increasingly difficult to return to a rules-based approach at a time when public debt is high.

This note raises key issues and offers some insights based on EU independent fiscal institutions' expertise and experience in fiscal policy in EU countries. It draws on the Network's "EU Fiscal and Economic Governance Review: Contribution from the Network of Independent EU Fiscal Institutions" (Network of EU IFIs, 2021) and subsequent papers on the "Potential Role of National IFIs in the EU Framework" (Network of EU IFIs, 2022a) and the "Capacity of IFIs" (Network of EU IFIs, 2022b). These called for a three-pillar strategy based on: (1) a numerical rules-based approach, (2) an enhanced role for national independent fiscal institutions (IFIs) and (3) improved statistical information.

The Network of EU IFIs takes no position on the Commission's overall proposal as this raises fundamental questions beyond the scope of the work of the Network of EU IFIs and IFI mandates that need to be addressed on a political level. This note focusses on fiscal governance rather than wider economic governance issues.

This paper was prepared by the Secretariat 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.

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Main points

- The Network notes that the Communication envisages a larger role for national IFIs, recognising their role in relation to the EU framework more fully than in this past. This should include an explicit requirement to take into account at EU and national level IFIs' assessments of economic and budgetary forecasts in the setting of national fiscal trajectories and analysis of risks, and assessment of *ex post* compliance. This role should be reflected in the EU Semester timelines. However, this should not include a normative role in proposing an adjustment path.

- The proposal to strengthen national IFIs is welcome. Not all IFIs currently have the capacity to provide the required assessment and would require some additional resources to bring all institutions up to the standards in peer countries and substantial further resources would be required in most cases if IFIs are to make some assessment of the fiscal impact of reforms. Measures to set minimum standards for institutional independence and access to information are key priorities to increase the capacity of national IFIs. This makes the case for an updated Directive on provisions for the national IFIs.

- The European Fiscal Board (EFB) is also a key player in the institutional setting of the fiscal framework. The EFB's role should therefore be continued to ensure the evaluation and assessment of the new framework.

- The Communication sets out an approach based on national medium-term fiscal-structural plans approved by the Commission (EC) and the Council, guided by a reference adjustment path set out by the EC that would put the debt ratio on a "plausibly and continuously" declining path for countries assessed as having a substantial or moderate debt challenge. This would be operationalised by a net spending path.

- The Commission should publish its proposed reference adjustment paths as an input to debate about its proposal.

- There are a number of key issues that need to be clarified[1], including:
    - The definition of "plausibly and continuously" declining debt paths and the standard for "sufficiently detailed" reforms should be clarified. It is also crucial to undertake and publish the results of thorough testing of any new set of requirements to ensure that they are robust to a range of outcomes and uncertainties, including with regard to errors in long-term economic forecasts;
    - Unobservable variables and long-term forecasts that feed into the Commission's reference adjustment paths should be as robust as possible. Given that the Commonly Agreed Methodology (CAM) is very complex and not easy to reproduce, methods based on the CAM have proved to be inaccurate and procyclical in the past, and this may raise new issues as the forecast horizon is extended;
    - It is unclear how commitments "to a set of reforms and investment that help bring debt on a sustainable path" would be used to permit a longer adjustment period and a more gradual adjustment path. This may raise methodological challenges;

[1] The Network of the EU IFIs has duly taken note the recently published "Q&As of the Commission services on the written questions received by Member States" (European Commission, 2023)

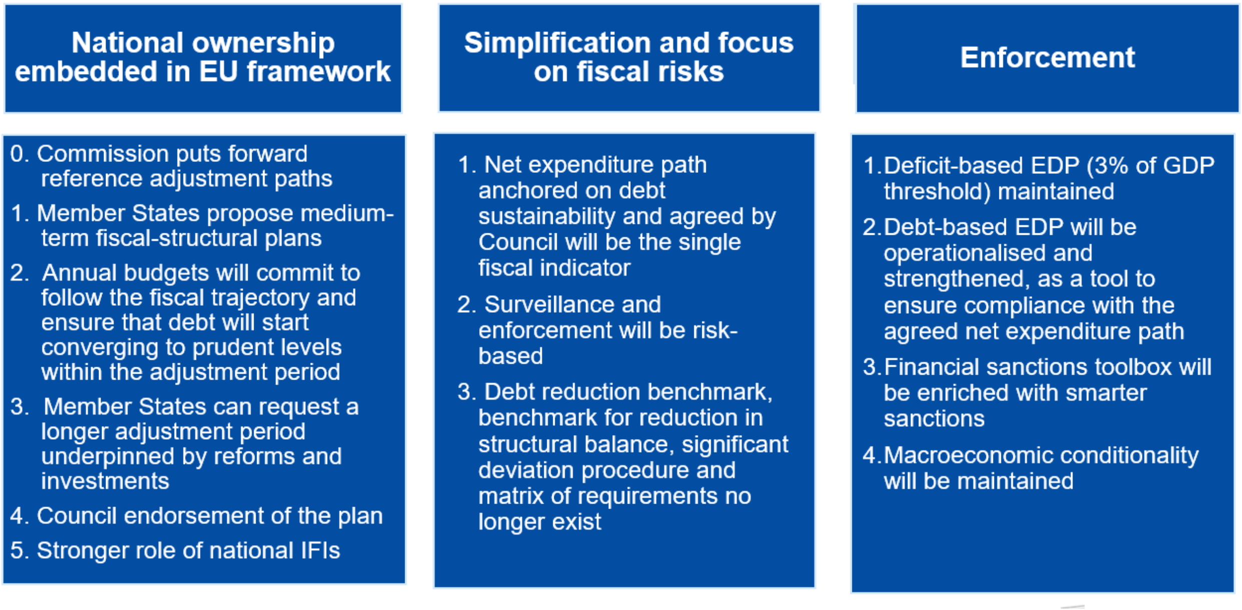
- The net expenditure path under the agreed national fiscal trajectory is measured using a similar approach to the existing Expenditure Benchmark, but some details are unclear:
    - It is unclear in Commission publications whether the measure is in terms of the level or growth rate of spending. Setting the path in terms of level is more stable ;
    - It should be clarified how national fiscal trajectories would be revised (or not) from year-to-year. Paths should normally be fixed for at least four years, although the optimal window merits careful consideration;
    - It is unclear whether the one-offs are included in the net expenditure path or not. Allowing for genuine one-offs is needed, subject to appropriate oversight, to allow governments to deal with temporary situations;
    - Existing EU guidance on one-offs and discretionary revenues should be consolidated into one clear document with a clearer treatment of indexation;
    - Correcting the net spending measure for cyclical unemployment spending should be carefully considered given measurement problems of an unobservable variable and greater clarity should be provided around national expenditure financed by EU funds;
- The role of existing EU rules and regulations that will no longer be followed at EU level needs to be clarified, including where they are transposed into national law or through the EU Fiscal Compact;
- Better documentation and transparency will be required. The process for reaching the national fiscal trajectories should be clarified and measures put in place to publish all the underlying data, methods and decisions in a timely way.

Section 1 of this note provides an overview of the Communication proposals. Section 2 notes some issues and questions in the proposed design for national medium-term fiscal plans, including how the Commission will determine the reference adjustment plans. Section 3 assesses the proposed role of national IFIs in the proposed EU fiscal governance and measures to reinforce the independence and effectiveness of national IFIs.

1. Overview of the Communication proposals

The Communication sets out an approach with "national medium-term fiscal-structural plans as the centrepiece of the new governance architecture". The aim is to simplify the rules and strengthen national ownership and compliance with EU requirements.

Member States would propose a fiscal trajectory to ensure that the debt ratio is on a "plausibly and continuously" declining path after an adjustment period of 4-7 years for countries with a moderate or substantial debt challenge as defined in the framework, which can be extended due to structural reforms or public investment. This trajectory would be endorsed by the Council and operationalised by a net expenditure path. The 3% deficit-based Excessive Deficit Procedure would remain and new types of sanctions introduced, alongside macroeconomic conditionality, but many of the existing requirements would be dropped.



Source: European Commission

The Communication calls for an enhanced role for national IFIs:

> **"To increase ownership and transparency at the national level, independent fiscal institutions could play a role in the monitoring of compliance with the national medium-term fiscal-structural plans in support of the national governments.** Independent fiscal institutions could provide an ex-ante assessment of adequacy of the plans and their underlying forecasts, which would help national government in the design phase. This would increase the ownership of the plans at the national level and strengthen transparency before endorsement of the plan at the EU level. Moreover, independent fiscal institutions could strengthen enforcement at the national level by being responsible for providing an assessment of ex-post compliance of budgetary outturns with the agreed multiannual net primary expenditure path and, when applicable, an assessment of the validity of explanations regarding deviations from the path. The Commission and the Council, in charge of EU surveillance, could take into account the assessment of independent fiscal institutions but would necessarily retain the power to propose and adopt the final decision."

The risk-based approach to surveillance at the EU level could also increase the reliance on national IFIs to assess the public finances in countries with stronger fiscal positions.

The future mandate and role of the ***European Fiscal Board*** **(EFB)** is left as an issue for further consideration.

2. Issues in the design of the framework

There are a number of key issues that need to be clarified:

- ***The Commission should define how the concept of "plausibly and continuously declining" is interpreted in setting the reference adjustment paths.*** The Communication states that the expectation of meeting the condition would depend on "realistic risks, under a standard set of adverse scenarios such as those considered in the Commission's Debt Sustainability Analysis (DSA) framework there should be a sufficiently low probability that debt increases in the five years following the plan's horizon.[2]" One interpretation of this is that the Commission would set the path to ensure the debt ratio to be on a continuously declining path with a 70% probability. This would imply in many cases a clear downward path so that the debt ratio would not rise even if the budget balance were to be hit by significant shocks.

  It is also unclear how statistical adjustments to the debt ratio would be treated. These may lead to changes in the debt ratio independent from the fiscal balance, including through the realisation of contingent liabilities.

- ***The Commission should provide indicative reference adjustment paths and it is crucial to undertake thorough testing of any new set of requirements to ensure that the overall framework and the underlying assumptions are robust to risks***. The Commission has not yet published indicative reference adjustment paths. This makes it difficult to evaluate the real implications of the proposals and their sensitivity to model assumptions. It should provide these publicly. In addition, it should publish results of comprehensive testing of the methodology and assumptions, including a range of scenarios and analysis using pseudo real-time approaches applied to historical data, thereby ensuring that there is transparency around the economic implications and that the framework will be robust to different economic and fiscal errors (Barnes and Oliinyk, 2022). All the hypotheses and data supporting these simulations should be made available so that they can be reproduced and appraised.

- ***The role of unobservable variables in deriving the reference adjustment paths will continue to underpin the Commission's reference adjustment paths but should be clarified and carefully considered given concerns about its accuracy.*** While the Communication emphasises the use of observable variables in the new framework, the Debt Sustainability Analysis framework is based on inputs derived using the existing Commonly Agreed Methodology (CAM).[3] The new framework will require assumptions to extend CAM projections to longer horizons, which may lead to further complications. While projections of potential output growth may be more stable than output gap estimates and enter the framework in a different way, some of the same issues remain and others may arise as the forecast horizon is extended. There is considerable uncertainty about long-term projections, which will feed into the calculation of the reference adjustment paths, and many IFIs have expressed reservations with the use of the Commonly Agreed Methodology for their respective countries. Estimates of potential output produced under the Commonly Agreed Methodology have tended to be highly sensitive to recent conditions. Lower potential growth rates

[2] It is not clear whether that probability would be based on the likelihood of the adverse scenarios or results from a separate stochastic DSA exercise or both.

[3] "The Commission's DSA framework is a well-established analytical toolkit for assessing debt sustainability risks. It includes a baseline projection for the debt trajectory over 10 years...Real GDP growth is in line with the latest Commission medium-term projections using the EU commonly agreed methodology""

have been produced under the method during and after downturns as compared to higher rates when conditions are more favourable. Incorrect estimates of the potential growth rate could lead to an inappropriate setting of the net spending path under the operational rule.

- ***It is unclear how commitments "to a set of reforms and investment that help bring debt on a sustainable path" would be used to permit a longer adjustment period and a more gradual adjustment path***. Many reforms have limited fiscal benefits and many public investment projects do not yield a return in terms of higher revenue, although they may have important social benefits. The impact of reforms and investment measures is typically highly uncertain and difficult to predict or evaluate reliably.

- *The net expenditure path under the agreed national fiscal trajectory is measured using a similar approach to the existing Expenditure Benchmark,[4] but some details are unclear*:

    - It is unclear from Commission publications whether the rule is applied in terms of ***levels]or as it is now in terms of growth rates***. This should be clarified. Setting requirements in terms of levels provides the greatest stability and transparency, and could avoid over/underspends in earlier years feeding into the base level of consumption. This would be a change from the current application of the Expenditure Benchmark, which focusses on the growth rate relative to the previous year. This approach would provide greater stability from year-to-year. Unlike under the current approach, there would be no need for notional accounts to measure the deviations as requirements could be set to return to the original path. The treatment of inflation in the context of a levels rules is complicated issue and would need to be resolved in an appropriate way.

    - *It is unclear how often the expenditure path and the fiscal trajectory would be revised*. The fiscal rules should provide some predictability in the public finances, although this needs to be balanced against the risk of material change in the economic outlook over time. Revising the analysis each year and the expenditure path would damage this predictability and increases the risks of procyclicality. Paths should normally be fixed for at least four years, although the optimal window merits further empirical study and should take into account parliamentary cycles and the possibility of unusual and extreme events.

    - There is no reference to adjusting for ***one-offs*** in calculating the expenditure path. Allowing for genuine one-offs is needed to allow governments to deal with temporary situations and factors as we seen in the pandemic, although should be subject to robust controls. The net expenditure path should be defined net of one-offs, subject to appropriate oversight of their use (including by national IFIs). Existing ***EU guidance on one-offs*** should be consolidated into one clear document. Such guidance should focus on providing greater clarity, particularly in cases where these one-off factors impact more than one fiscal year. In addition, this document should be updated regularly as needs arise.

    - Existing ***EU guidance on discretionary revenues*** should be consolidated into one clear document with a clearer treatment of indexation.

    - ***Net expenditure is to be corrected for cyclical unemployment spending.*** This is linked to estimates of (unobserved) cyclical unemployment that have been problematic in the past.

[4] The existing Expenditure Benchmark is based on primary spending and allows to exclude cyclical unemployment spending and one-offs expenditure, and expenditures financed from EU funds.

This link should be carefully considered against simpler alternatives,[5] given that the structural balance would no longer play a central role.. Discretionary policy changes in unemployment spending could be reflected in the net spending path.

- *The possibility that the role of existing EU rules and regulations will no longer be followed at EU level needs to be clarified, including where they are transposed into national law including through the EU Fiscal Compact*. The simplification of the rules cannot be achieved if legacy obligations remain in place. There is potential for conflict between EU and national requirements if redundant EU obligations remain transposed in national law, although some countries may choose to keep and follow national frameworks designed along the lines of the current framework. Updating national law may be particularly difficult in terms of the Fiscal Compact, where it is translated into constitutional law. A failure to remove redundant provisions can undermine national IFIs where they are required to assess compliance with them, particularly if decisions about which commitments to follow are made in an opaque way at the EU level.

- *Greater clarity is needed on how transparency would be achieved.* The Communication states that "multilateral discussions in the relevant committees of the Council would ensure transparency and accountability, with the Council endorsing the adequacy of the plan". Given these discussions are confidential (including to national IFIs) and only limited information is provided publicly, it is unclear whether this would be achieved.

  All relevant information should be made public in a timely way, including the Commission's reference adjustment paths and all aspects of the underlying methodologies, projections and data. As argued by the Network, the Commission and Eurostat should continue to publish all data and projections as required by the current rules, including estimates of the structural balance and the output gap, to enrich the fiscal debate. All decisions on the interpretation of aspects of the new framework should be made public in any timely way. Greater clarity should be provided on the timing and use of EU funds.

  Finally, the European Fiscal Board (EFB) is a key player in the institutional setting of the fiscal framework. The EFB's role should therefore be continued to ensure the evaluation and assessment of the new framework.

3. Enhancing the role of national IFIs and increasing their capacity

The Communication envisages an enhanced role for national IFIs and higher minimum standards for these institutions as part of the overreaching objective to enhance national ownership of the EU fiscal framework and improve fiscal outcomes. This enhanced role could mark an important step forward from the existing EU fiscal governance: while the many national IFIs owe their existence to specific tasks created under the existing EU governance framework, the Communication recognises for the first time the national IFIs as a key institution in the future framework. This goes beyond the current narrow requirements that national IFIs undertake/endorse official forecasts and assess deviations from compliance with certain rules.

[5] By adjusting for any relevant discretionary changes in welfare rates.

The role of national IFIs in the proposed framework

The Network welcomes the proposal that:

> "The Commission and the Council, in charge of EU surveillance, could take into account the assessment of independent fiscal institutions but would necessarily retain the power to propose and adopt the final decision."

This provision could strengthen the coherence between EU and national fiscal frameworks, ensuring that relevant analysis is available at the EU level, reducing the risks of divergent analysis and increasing national ownership without compromising the position of the Commission and the Council. The explicit recognition of the assessment of independent fiscal institutions by the Commission and the Council could strengthen the credibility of national IFIs at national level. It also codifies existing constructive relations between Commission country desks and national IFIs. The Network has argued that an obligation to take into account IFI assessments should be established in law. The IFIs' role should be reflected in the EU Semester timelines. It should include an explicit requirement to consider both at EU and national level IFIs' assessments of economic and budgetary forecasts when setting national fiscal trajectories, analysing risks, and assessing ex post compliance. However, this should not include a normative role in proposing an adjustment path.

The Commission proposals would involve the role of IFIs at two stages of the EU process:

1) "[National IFIs] could provide an ex-ante assessment of adequacy of the plans and their underlying forecasts, which would help national government in the design phase"

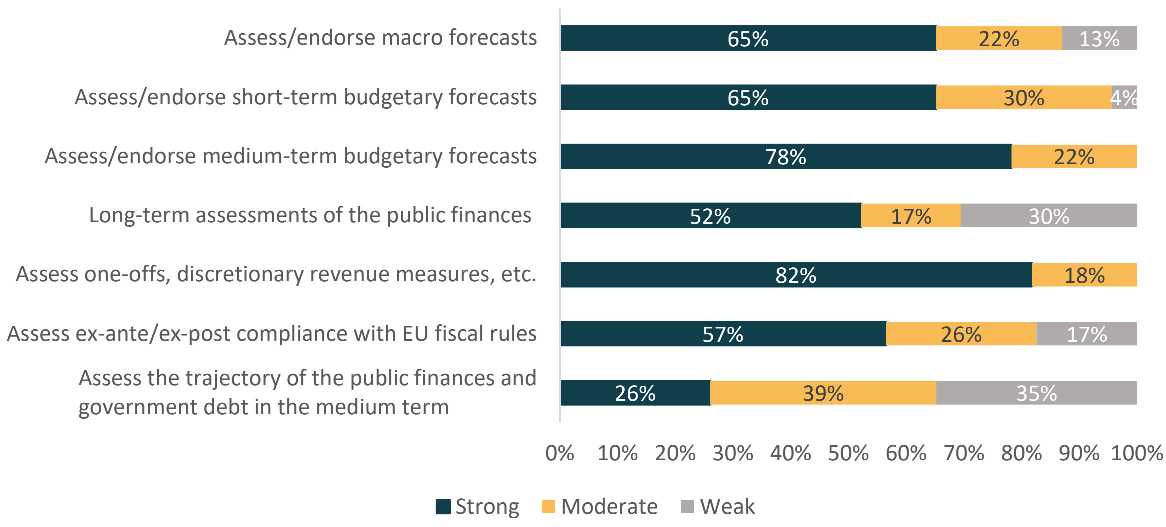
2) "strengthen enforcement at the national level by being responsible for providing an assessment of ex-post compliance of budgetary outturns with the agreed multiannual net primary expenditure path and, when applicable, an assessment of the validity of explanations regarding deviations from the path"

There are a number of concrete roles national IFIs could play in this context:

- ***National IFIs should be involved with undertaking/endorsing/assessing all the underlying economic and budgetary forecasts produced by their national governments in the context of the EU framework*** (Network of EU IFIs, 2021). Oversight by national IFIs would help to avoid biased or mis-leading forecasts guiding the national fiscal trajectories. It would be a natural extension of the existing requirements to undertake/endorse the economic projections to t+1 in annual budgets and t+3 in SGP/CPs to apply this requirement overall the full forecast horizon..

  National IFIs should be well-prepared to play this role (Figure 1) (Network of EU IFIs, 2022c). In fact, more than four-fifth (87%) of EU IFIs already report having strong or moderate capacity to assess or endorse macro forecast. This number is higher for short-term (95%) and medium-term (100%) budgetary forecasts. Most IFIs already carry out these tasks to some extent as part of their mandate or on their own initiative.

Figure 1 Existing capacity of IFIs to undertake a range of tasks



Source: Network of EU IFIs, 2022c

The scope of this oversight could be widened formally to national budgetary forecasts. This raises some technical challenges, but many national IFIs already have experience and capacity in these areas (Network of EU IFIs, 2022c). The scope of assessment of budgetary forecasts would need to be clarified in this context: this might not necessarily imply a large-scale costing of all government policies, but could rely on assessing the coherence, assumptions and methods of government plans at a high level relevant to assessing fiscal sustainability. This approach requires governments to provide the necessary information to national IFIs, including greater transparency on ESA adjustments to expenditure.

- ***National IFIs could assess the impact of structural reforms and public investment, which could be taken into account in setting the fiscal trajectory, although this raises a number of challenges***. There is a clear risk that countries will overstate the impact of often politically costly reforms to avoid taking appropriate fiscal action. However, this is a technically challenging area and potentially requires specialist skills, such as modelling of structural policies and evaluation of ex ante investment returns. This would in any case require substantial additional resources for most national IFIs. In addition, the nature of the scrutiny would need to be carefully specified and could be limited in some cases to reviewing modelling assumptions in the approach proposed by the government.

- ***National IFIs are well-placed to monitor compliance with the numerical path and to assess the validity of explanations for deviations from the path, including the use of one-offs if these were part of the definition adopted and evaluating discretionary revenue measures***. National IFIs have expertise in assessing developments in the public finances, including policy changes to spending and discretionary revenue measures. Many IFIs have a strong ability to communicate these to parliamentarians and the public, raising the political costs of unjustified deviations from existing commitments.

A difficulty could arise if the national fiscal path is set *ex ante* in a way that is not conducive to sound economic management or fiscal sustainability. National IFIs could make an assessment of *ex post* compliance, however, they should also have the ability, in any extreme case, to signal both *ex ante* and *ex post* their assessment of risks associated with the path.

The risk-based approach to surveillance may leave a greater role for national fiscal frameworks, including national IFIs, particularly in those countries with low debt:

> **"A risk-based surveillance framework would allow to adapt the existing debt reduction benchmark to the country-specific debt ratio, while the requirement to maintain budget deficits credibly below 3% of GDP would be preserved.** The current debt reduction benchmark (the so-called 1/20th rule) implies, in the current circumstances of high debt ratios post-COVID, a too demanding frontloaded fiscal effort that risks jeopardising growth and is pro-cyclical. (8) It should be recognised that high-debt Member States cannot abide by the existing 1/20th debt reduction benchmark, since reducing their debt ratios at this speed would have a very negative impact on growth and thereby on debt sustainability itself. Therefore, it is proposed to move to a more risk-based surveillance framework that puts debt sustainability at its core and differentiates more between countries by taking into account their public debt challenges, while adhering to a transparent and common EU framework consistent with the 3% of GDP and 60% of GDP reference values of the Treaty."

This approach would be welcome and would help national fiscal frameworks to flourish also in countries with relatively low debt, while reducing the risk of contradictory signals arising from an EU level. Retaining some EU surveillance as a back-stop to domestic arrangements would be helpful.

Strengthening IFIs and their mandates

While national IFIs are in principle suited to take up a bigger role in the future EU fiscal framework, the Communication notes that "This would entail improving the set-up and performance of independent fiscal institutions". The institutional requirements, alongside a minimum required mandate for national IFIs in the EU corresponding to the tasks, should be established in EU law and applied in national law.

A proposal for a directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States was previously put forward in 2017 (EC, 2017). The proposal envisaged strengthening the role of the national IFIs along with mandating national governments to implement and uphold basic standards in relation to domestic IFIs. This would provide a good starting point for a future Directive.

The Network's own analysis based on self-assessment suggests that most national IFIs do have the capacity to undertake these tasks while others would require a significant strengthening of their set-up to allow them to play a wider role and to reach the level of the well-equipped IFIs in other Member States (Network of EU IFIs, 2022c).

In terms of resources, this analysis suggests that some increase in resources would be required in most national IFIs with larger increases needed in certain cases and in others where modelling of structural reform impacts needs to developed. While there are large differences in the responsibilities and size of IFIs, IFIs overall require greater full-time analysts and related resources than are currently available to carry out the bulk of tasks proposed in the Communication. A larger increase in full-time analysts might be needed in some countries to bring capacity up to the level of EU peers. For those IFIs performing additional tasks as required by national legislation, the required minimum number of full-time analysts would remain higher.

Additionally, establishing minimum standards at the EU level in legislation for all IFIs beyond euro area countries' IFIs would underpin IFIs' capacity to deliver on proposed tasks at national level and strengthen the EU's future fiscal framework. The Commission should in addition step up enforcement of existing and future requirements and clarify how it intends to conduct this enforcement. This would ensure that all Members States fully comply with obligations regarding their national IFIs and that relevant provisions are transposed appropriately into national law.

Building on previous work (Network of EU IFIs, 2022a and Network of EU IFIs, 2022b), the mains areas where minimum standards for national IFIs should be further developed are:

- **Minimum resources.** Legal requirement for governments to provide IFIs with sufficient minimum resources would uphold IFIs' independence and ensure that IFIs have sufficient capacity to carry out their mandates. The funding should be provided on a multiannual basis. The size of minimum resources could be established in relation to the minimum mandate of IFIs under the new fiscal framework. For better comparability, minimum resources could be specified in the number of full-time equivalent analysts. For IFIs that undertake broader set of tasks in line with domestic legislation the resources provided should be larger.
- **Right to information.** Legal requirement for governments to provide IFIs with sufficient, good and timely information is paramount in a situation where fiscal rules are determined during the bilateral negotiations. IFIs should have a legal right to obtain accurate information on demand on relevant issues from governments and national statistical offices, without any undue delay and at no cost. Any restrictions on access to information should be clearly defined in law. Additionally, national IFIs should also have timely information on relevant EU-level developments, including on the methodological discussions taking place in the relevant EU committees.
- **Protection of independence**. Legal safeguards to the independence of national IFIs are necessary. These include freedom to govern own (financial and human) resources, legal requirements for the recruitment of IFI members on the basis of expertise and political independence with a transparent process for appointments. Board members to the national IFIs should be elected for minimum four years and be protected from arbitrary dismissal.
- **Right to publish.** Legal provisions to allow IFIs make their assessment s public would help to ensure transparency when it comes to public finances and enhance ownership. IFIs should be able to make their assessment public and to publish own-initiative reports on any topic that they deem relevant to the sustainability of public finances.

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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. It. 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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