AIReF's CONTRIBUTION TO THE PUBLIC CONSULTATION OF THE EUROPEAN COMMISSION ABOUT THE REFORM OF THE EUROPEAN FISCAL FRAMEWORK

WORKING PAPER 1/2022

Independent Authority *for* Fiscal Responsibility

The Independent Authority for Spanish Fiscal Responsibility, AAI (AIReF) was founded with the mission of overseeing strict compliance with the principles of budgetary stability and financial sustainability set out in Article 135 of the Spanish Constitution.

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Nature of the Working Paper

This document reflects faithfully and literally the contribution AIReF did to the European Commission's Consultation on the 31st of December 2021 about the European Fiscal Framework and its reform. In each section we reflect the question asked, the extension boundary of the response and the final answer delivered.

In order not to deviate from pure fidelity of the response we have not included any executive summary or initial brief.

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1. Improving the framework

In the light of experience, effective delivery on the objectives of ensuring sustainable public finance positions and avoiding macroeconomic imbalances is key. Effective economic coordination and surveillance is a cornerstone for ensuring resilience in the EU and the Economic and Monetary Union in view of potential negative spillovers resulting from the building up of unsustainable positions. While there has been progress overall in terms of debt sustainability and correction of macroeconomic imbalances, that progress has not always been sufficient, with large differences across Member States. Therefore, an effective framework needs to ensure the sustainability of public debt, including where it is most necessary, and the prevention and correction of macroeconomic imbalances.

Question: How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising? (6000)

[We concentrate our comments mainly on the fiscal framework, which is our area of expertise].

From a broad general perspective, three elements could be stressed in relation to improving the framework in the current context: first, the need to promptly clarify the rules that will be applicable to Member States (MS); second the need to provide better fiscal policy guidance (based on simpler rules designed on the basis of less volatile variables, more medium-term oriented in view the variety of unexpected factors potentially affecting fiscal positions in the short-term) coupled with political engagement, and third, the need for the framework to be more country-specific with a more prominent role of National Independent Fiscal Institutions (IFIs) (some of these very relevant reform elements are dealt with in the following questions that specifically ask about various concrete aspects of reform).

Regarding the need to clarify the framework as soon as possible, it should be borne in mind that MS will have to submit (and IFIs assess) medium-term fiscal plans in four months' time. At that point, current expectations imply that the escape clause will be deactivated for 2023, meaning that these fiscal plans will already need to contain adjustment plans. Whether the current preventive or corrective arm would apply (if the latter, with the adjustment path proposed by the Commission calibrated according to which variables or references?) or there would be a different system to set fiscal requirements remains very unclear. Given the overall level of uncertainty regarding economic prospects, this additional layer of policy

ambiguity should be reduced to the extent possible.

Second, improving the current framework should imply providing with overall more appropriate fiscal policy guidance than was the case in the past. And this in relation to at least two elements: the pace of adjustment and the stability of requirements. The last episode of coordinated fiscal consolidation took place after the Global Financial Crisis (GFC). At that time, fiscal strategies relied on very large fiscal requirements asked from those MS which public finances had deteriorated more intensely during the crisis. The stark fiscal adjustment is assessed by many to have resulted in a double dip recession in the euro area. Furthermore, fiscal fatigue kicked in at the end of that period in many MS, so that once Excessive Deficit Procedures (EDPs) were abrogated, enforcing requirements under the preventive arm proved generally difficult. Against this background and bearing in mind the uncertain economic environment and future challenges we are facing, fiscal adjustments this time round should revolve around gradual, growth-friendly, stable and realistic targets. The appropriateness of the fiscal policy guidance also relates to the way fiscal paths are formulated. In this sense, establishing requirements based on the structural balance (or the change thereof) has proven extremely problematic both ex ante and ex post. In fact, ex ante requirements based on that metric can only be established for the short term, given the volatility of the underlying variable used for its computation. Moreover, ex post assessment of compliance is also cumbersome when based on the structural balance. Previous experience in the Stability and Growth Pact (SPG) framework clearly attest to this (as illustrated by the so-called alpha and beta corrections to name just an example, or the attempt translate structural effort requirements in EDP recommendations into comparable net expenditure developments). Public trust and political commitment with respect to future fiscal paths is indispensable if they are to be effectively implemented. In this sense, the current system that relies upon yearly requirements being adopted by EU institutions based on unstable and permanently questioned underlying variables seems clearly suboptimal to gather political traction.

Finally, improving the framework should necessarily involve paying more attention to country specificities. Although some of the legacies of this crisis remain uncertain, there is no doubt that its effects will weigh on public finances in all EU MS. But it is not only that debt levels are clearly higher than they were two decades ago. In addition, the dispersion has also become noticeably more pronounced. While the situation of public finances in the various MS has always been heterogeneous, this diversity has widened over time. And, undoubtedly, the different impact of the last two crises on the countries of the euro zone has increased this

heterogeneity which refers both to the starting situation of public finances and to the broader economic context. In this context, it is increasingly questioned whether the current approach to fiscal rules - homogeneous for all countries, especially within the euro area and signatories of the Fiscal Compact - is the right mechanism to provide appropriate guidance for future national fiscal policies.

Moreover, the euro area is undergoing fundamental economic changes with strong effects on fiscal developments. A periodic assessment of the fiscal framework is necessary in this context, announced for a specific year.

2. Safeguarding sustainability and stabilisation

Fiscal policy guidance supports MS in ensuring the long-term sustainability of public finances and in pursuing counter-cyclical fiscal policies to contribute to a better macroeconomic stabilisation in both good and bad times. While an effective framework should aim to be counter-cyclical in good and bad times, it has often not been achieved in practice. An appropriate fiscal effort and debt reduction in good economic times helps to create the space to use fiscal policy in bad times. Appropriate medium-term policy planning, both regarding fiscal targets and structural reforms to promote productivity and investment, and an appropriate policy anchor help in that regard.

Question: How to ensure responsible and sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilisation? (5800)

Two different elements should be distinguished when addressing this issue: the first relates to national fiscal policies and how to frame them in a way that tackles both sustainability and stabilization objectives; the second relates to how to proceed when shocks are too large for the size of some MS.

When it comes to fiscal rules constraining national fiscal policies, we broadly support the consensus emerging. Experts seem to be converging on several broad aspects - basically, articulating the fiscal framework around one long-term debt anchor, one operational expenditure rule and one escape clause.

Following Bindseil (2004) the operational target can be defined as an economic variable, which the authorities want to control, and indeed can control to a very large extent on a regular basis through the use of its fiscal

policy instruments (i.e. the budget). It is the variable the level of which communicates the stance of fiscal policy to the public and, as such, includes an indication of the discretionary element of fiscal policy. In this sense, having a net primary expenditure rule as operational variable is generally acknowledged as the most adequate way forward. This would imply rethinking the role the structural balance plays in the fiscal framework: it would be released from its current operational role – that is, the structural balance would cease to be the variable used for fixing requirements and assessing compliance – while it could retain a central role in the broader evaluation of the underlying soundness of public finances and sustainability pressures. As such, the structural balance should be among the elements taken into account when judging the severity of sustainability concerns and gauging the appropriate fiscal policy response.

A related topic is whether debt anchors should be differentiated across countries. On the one hand, the long-term anchor could be the same for all MS to keep the 60% treaty reference. On the other hand, for the debt reference to play an "anchor" role, country-specific medium-term intermediate references should underpin the convergence path towards the long-term anchor. This does not mean that these intermediate debt references should be considered as fiscal policy targets against which authorities are assessed. On the contrary, compliance would be only evaluated with respect to the operational net primary expenditure rule - a single, discretionary and observable rule that allows automatic stabilizers to operate. However, the adequate expenditure path should be established considering different fiscal references, such as the intermediate debt references or the structural balance among others.

In that sense, under normal circumstances, fiscal rules should focus primarily on the sustainability objective -particularly bearing in mind the current high levels of debt- while allowing room for the automatic stabilizers to operate. Discretionary short-term stabilization should be activated upon an escape clause. In that sense, the strong and coordinated reaction to the pandemic demonstrated the framework's existing flexibility to respond to macroeconomic shocks, as well as its relative effectiveness in ensuring that MS carry out countercyclical actions. Thus, the reformed framework should contemplate an escape clause to be triggered in case of exceptional circumstances that may warrant the suspension of the general framework and the adoption of expansionary measures. However, preserving the integrity and internal consistency of the framework advises that the occurrence of such circumstances be gauged by an independent institution.

However, the activation of an escape clause can be an effective

countercyclical tool for certain type of shocks - but not all shocks. Recent experience suggests that the frequency of severe shocks may be higher than we expected. This time NGEU is playing a vital role in supporting the recovery and structural transformation in economies. But challenges go well beyond the time horizon of this instrument. In this context, dealing with extraordinarily large shocks would require the setup of a EU central capacity, used primarily for macroeconomic stabilization as proposed by different institutions such as the IMF, the ECB and the EFB. A central fiscal instrument could support timely stabilization of the EU economy in the case of a major shock to the entire EU, especially when the monetary policy is constrained at its effective lower bound and, consequently, concentrated fiscal action is more powerful as multipliers raise. Moreover, a centralized fiscal capacity would function as an insurance mechanism against the idiosyncratic or common shocks with asymmetric effects on the euro area economies and public finances. Countries deviating from the requirements of new fiscal framework without justification (as assessed by IFIs and the EC) would not be allowed to access to this capacity.

3. Incentivising reforms and investments

The framework should be consistent with today and tomorrow's challenges. It needs to be discussed what the appropriate role of the EU surveillance framework is in helping to promote a growth-friendly composition of public finances and for MS to sustain adequate levels of investment. In particular, significant investment will be required to meet the broader ambition of the European Green Deal. This raises the question of the extent to which the fiscal framework can support the investments needed for the transition to a climate-neutral, resource-efficient, and competitive economy, in a manner that leaves no one behind. This includes re-assessing the appropriateness of the current flexibility clauses in terms of their scope and eligibility, in order to facilitate the right type and level of investment while preserving debt sustainability. In addition, thought should be given to the role of the fiscal framework in greening national budgets.

Question: What is the appropriate role for the EU surveillance framework in incentivising MS to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability? (5200)

Generally, we should avoid overburdening the SGP within the wider economic policy coordination process in the Semester. Not least because an EU focus on the composition of domestic fiscal and economic policy raises legitimacy questions.

However, for reforms and investments with a clear link to long-term fiscal sustainability the case is clearer. But the way to take them into account in the reformed framework should depart from the current "clause proliferation" approach and be considered in the context of a wider legislature-long fiscal plan.

Ideally, medium term fiscal plans should reflect legislature political commitments when it comes to net primary expenditure levels or growth rates. The latter should be established following a general assessment of the underlying situation of public finances, the cyclical position, future sustainability challenges and reforms or investments with a clear fiscal link. In any case, the reformed framework should rely upon more systematic and thorough evaluation of the composition of public finances at the national level.

The synergies between pursuing sustainability and having a sound composition of public finances are obvious and they should be exploited in the revamped framework, so that early warning could be made regarding composition that could be detrimental to growth. Carrying out spending reviews and regularly evaluating the quality of public finances by IFIs and/or other national institutions can generate benefits in terms of allocative efficiency of fiscal policy, medium-term sustainability, stabilizing capacity and redistributive impact.

This is different, however, from ensuring the necessary investments needed to help tackle environmental challenges among others, in a context where fiscal sustainability is already frail. The RRF will allow substantial public investment but only temporarily, so concerns over the composition of public spending will return as distributions start shrinking past 2023-2024.

There are different options on the table, ranging from golden rules to moving certain investments off balance and a central fiscal capacity to name just three of them. We find that numerous problems can be associated with the first two options. When it comes to golden rules, we find two main problems (often cited in the literature).

The first one relates to its definition, that is, specifically identifying the categories of government investment spending worth protecting. Drawing the eligibility line is technically controversial and politically costly.

The second (relevant also for special purpose vehicles) relates to its impact on sustainability – regardless of whether such investment is excluded or not

for SGP purposes, it will still need to be financed and it will still result in an increase in debt over the coming years. This may be problematic for countries departing from already high debt levels. All in all, the overall effectiveness of such investment clause – green or multicolor - is questionable.

Firstly, eligibility criteria should be relatively strict and be applied conservatively if we want to avoid that the SGP metrics are left void of relevant fiscal information. This is at odds with the large investment needs identified for the green transition. Moreover, there is a strong case that governments of MS with high debt levels will be reluctant to take on additional levels of debt regardless of their SGP treatment. Even with the COVID escape clause activated, there is clear evidence that high-debt countries have biased the composition of their support packages towards measures that did not increase levels of deficit and debt – such as public guarantees and loans - as opposed to direct aid measures, more prevalent in the case of less indebted MS.

So, there might be a genuine aversion towards further increases in debt on the part of most indebted countries that would not be overcome by an SGP waiver per se. We do not support the idea of generating off balance-sheet investment vehicle, with green debt not qualifying as general government debt. This is a step into diluting fiscal information from core fiscal metrics that would render the framework less transparent and more prone to statistical manipulations.

All in all, solutions to this dilemma must be looked for elsewhere, beyond the SGP. We believe that the first and main step should be acknowledging that common, global and indistinguishable needs – such as responding to the pandemic – must be addressed through centralized fiscal instruments. Thus, we favour the idea of establishing some form of EU central capacity to finance green investments. Green investment needs are also extensive across lower-debt MS, which would potentially allow moving away from the redistributive logic of many past debates.

Finally, the creation of National Productivity Boards in all MS would be a significant step forward to evaluate the implementation of the reform-leg of NGEU and enhance national debates on reform proposals.

4. Simplification and more transparent implementation

Whereas the current fiscal surveillance framework has included elements of flexibility and discretion through a complex set of provisions adopted against a background of lack of trust amongst key stakeholders, an

effective application of economic judgement within a rules-based framework needs to be done in an objective and transparent manner. This includes, for example, considering whether a clear focus on gross policy errors as set out in the Treaty, based on clearly defined objectives and operational policy targets, could contribute to an effective implementation of the surveillance framework. A simpler framework and implementation could contribute to increased ownership, better communication, and lower political costs for enforcement and compliance.

Question: How can one simplify the EU framework and improve the transparency of its implementation? (4800)

As a starting point, stakeholders should avoid the naiveté of considering that we can come up with a simple and at the same time economically meaningful fiscal framework. Any kind of fiscal rule that tries to be nuanced and achieve at the same time different goals would need to be complex.

The key issue, thus, is not so much whether the system is complex or not, but rather whether it is unnecessarily complex. In a first step sources of unnecessary complexity should be identified and tackled. As a second step, and once the framework is left with the useful complexity, it should still be identified where does the complexity lie and who bares the cost of that complexity.

Regarding the first step, several sources of unnecessary complexity can be identified in the current framework: up to four different numerical rules have come to operate in the common framework, to which the national regulations of each Member State must be added. The existing clauses add additional layers of complexity while having proven of little use in practice. All in all, a complex compendium of rules designed to be applicable to a wide range of possible situations has in the end unnecessarily raised the degree of complexity.

Moving towards a fiscal framework with one debt anchor, one operational expenditure rule and one escape clause as suggested above (cf supra) – and having national frameworks realign with that scheme to avoid the cacophony of two potentially colliding frameworks– would already result in a considerable simplification of the framework. The remaining fiscal metrics (such as the structural balance or the headline deficit figure) could remain useful as input in the sustainability assessment conducted to judge whether a proposed expenditure path is appropriate.

Turning to the second step, any fiscal rule that tries to account for the cyclical position of the economy to avoid prescribing procyclical policies, would necessarily entail a certain degree of complexity and reliance on unobservables, estimates or projections, as opposed to outturn data. This is some degree of complexity the fiscal framework cannot dispense of in our view.

The crucial point there is that the framework's current set up exacerbates the visibility and implications of this unavoidable complexity by setting fiscal targets and fiscal requirements in cyclically adjusted terms. Thus, both the ex-ante policy guidance and the ex-post assessment of compliance needs to continuously cater for such complexity. However, the elements can be rearranged in a way that complexity is less impactful on the functioning of the framework. This could be done by adopting fiscal requirements in terms of observable fiscal metrics, which computation is less volatile and more transparent and over which fiscal authorities have more control, such as net primary expenditure. Even though, theoretically, the change in the structural balance aims to precisely guide (ex ante) and then capture (ex post) the extent of discretionary fiscal policy decisions, in practice governments have little control over the (Commission's final estimate of the) change in the structural balance.

Illustrative in this regard is the fact that fiscal targets for countries in macroeconomic adjustment programs were established in terms of the primary balance. Even if fiscal requirements were expressed in terms of less volatile and more directly controllable fiscal metrics, the whole framework would remain exposed to the possibility of the cyclical position turning out to be different than anticipated. The difference would be that, in this case, if fiscal authorities deliver on their commitment and the agreed expenditure path is adhered to, outturn fiscal metrics could be different than previously anticipated – maybe the elasticities were wrong or the expected cyclical contribution was wrong or inflation projections were wrong. But fiscal guidance should be simpler to translate into concrete draft budgets and then fiscal compliance should also be simpler to evaluate.

If other variables relevant to the framework (multiple, interconnected and complex by nature) turn out being different than anticipated this should be incorporated into the next medium-term round (cf infra/supra). Such distinction between fiscal actions and fiscal outcomes implies holding governments accountable with respect to an obligation of conduct as opposed to an obligation of result.

IFIs, well acquainted with country-specific issues, could produce analysis that helps draw the line between these elements and establish – in case

fiscal outcomes disappoint – the extent to which this is attributable to the complex, unobservable variables that interfere in fiscal metrics or insufficient expenditure restraint. An objective analysis of these elements can disentangle the complexity without changing requirements or unnecessarily complicating assessments. This would require sound data and statistics, proper minimum standards for IFIs.

5. Focus on pressing policy challenges

Surveillance should be commensurate to the gravity of the situation, with a stronger focus on the most pressing cases and less-intrusive procedures where overall risks are low. Therefore, it is to be considered whether the surveillance framework, in order to be effective, should focus more on 'identifying gross errors' [i.e. on MS whose policy Cf. Article 126(2) of the Treaty on the Functioning of the European Union.] strategy puts public debt on a potentially unsustainable trajectory or leads to other macroeconomic imbalances. Moreover, a strong policy dialogue with MS and stakeholders is key, especially in a multilateral setting, but also bilaterally with the Commission.

Question: How can surveillance focus on the MS with more pressing policy challenges and ensure quality dialogue and engagement? (2100)

Continuous monitoring of all national fiscal dynamics by EU institutions on the basis of very volatile metrics has proven to be very costly for the overall effectiveness of the framework and its communication to stakeholders and the general public.

Streamlining the surveillance system should imply as a first step a realignment of national and EU fiscal frameworks and then a clearer division of tasks between national institutions as EU ones.

We support the idea of having national IFIs undertake fiscal surveillance under low risk and/or compliant circumstances, with regular reporting to EU peers at relevant fora (ECOFIN). However, there must be safeguards to ensure that the center can intervene when the IFI considers there is a gross policy error and on its own initiative. Furthermore, safeguards should ensure that the central level can discuss fiscal policy choices that – even though not risky from a national, short-term perspective - could be inadequate from a euro are wide perspective.

This approach would be consistent with more political agency at the national level when it comes to putting forward country-specific, binding expenditure paths for the medium term (cf infra). This expenditure path

should build on independent, objective projections that national IFIs could provide. In this case, they will be well-placed to assess the extent to which possible fiscal slippages are attributable to underlying elements outside the control of the government or rather to discretionary fiscal policy making. When the latter is identified and constitutes a gross policy error in the sense that it puts sustainability at stake, the center could intervene, thus increasing the reputational costs of non-compliance.

National expenditure paths should in any case be discussed and approved by EU Institutions which would strengthen the commitment to the objectives of the legislature and could also facilitate the coordination at the level of the euro area.

Such reorganization of surveillance tasks between national and EU institutions would need to come hand in hand with a reinforcement of national IFIs, widening their mandates as appropriate depending on each country-specific case and endowing them with enough resources to fulfill these new tasks (see the Contribution from the EU IFIs Network to the EU Fiscal and Economic Governance Review)

6. Lessons from the RRF

The RRF's commitment-based approach to policy coordination, with strong national ownership of policy design and outcomes, is expected to support implementation of agreed reforms and investments. This approach takes into account the complexities that arise from the simultaneous pursuit of various national and EU objectives, in a context of differences in socioeconomic structures and national preferences. It underpins ownership and trust. Rapidly-evolving developments since the start of the pandemic (and even before it) have illustrated the difficulty of designing comprehensive rules that are able to cater for all possible circumstances. Taking into account the lessons from the RRF, the economic governance review should consider how national ownership, mutual trust, the effective delivery of the framework on its key objectives, and the interplay between economic and fiscal dimensions can be best ensured.

Question: In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions? (3.600)

The RRF governance structure is praised because it simultaneously gives countries ownership over their national reforms and investments while allowing EU level supervision, with agreed milestones and reform commitments. The possibility that national fiscal paths could be structured around a similar model is surely worth exploring.

The fact that national administrations led the design of their own plans, with an appropriate guidance from the Commission, can create stronger national and political engagement and allow for greater country-specificity.

Actually, the 2022 DBP exercise somehow illustrates that already. Heterogeneity in starting fiscal positions, different access to RRF funding and diverse economic impact from the COVID crisis have resulted in MS planning different nationally-funded fiscal trajectories for 2022, within the broad guidelines provided by 2021 Country Specific Recommendations – ranging from a planned nationally-financed fiscal adjustment of -1.4% of GDP in the case of Slovakia to an expansion of almost 2% of GDP in Latvia, according to Commission's estimates. Differences can also be identified within the narrower high-debt countries group. In the specific case of Spain the contribution of nationally-financed current primary expenditure to the overall fiscal stance is estimated by the Commission at -0.8 pp of GDP. From a political economy perspective, it is fair to wonder whether such a considerable adjustment would have similarly been planned in case it would have been recommended in a CSR.

We consider there is large scope to leverage in a more bottom-up kind of process - as opposed to the previous top-down process whereby national governments were basically communicated their annual fiscal requirements in the Commission's proposal for Council CSRs. This would be similar to the drafting of National Recovery and Resilience Plans (NRRPs) which are judged to have increased the level of national ownership and allowed for country-specific prioritization across sometimes competing objectives. Its concrete, multiannual plans and milestones are viewed as shifting the focus to actionable long-term outcomes rather than annual processes. National political incentives for compliance with own plans are substantial and are perceived as having substantially increased.

Of course, funding is a key driver for national engagement and political ownership of NRRPs. Expectations should be realistic, nevertheless this approach could still be an improvement over the status quo Eventually, it could be explored whether compliance with national fiscal plans could unlock access to a central fiscal capacity (see below in this same reply).

One area of criticism in the case of NRRPs has been the lack of participation of national stakeholders (including regional) and

parliaments due to the very tight deadlines national governments faced when drafting the plans. Decentralization happened to a certain extent, since the process remained quite centralized in national capitals. The fact that cross-border pan European projects were very limited (with a very strong focus on national dimension, somehow missing the wider EU or EA one) was also criticized. This should be dealt with in the fiscal framework.

In practice, national governments could propose a legislature-long fiscal path with annual benchmarks for net expenditure aggregates, on the basis of independent no-policy-change projections provided by national IFIs. Similarly, to the RRF governance structure, MS should agree on some common guidelines that national medium-term fiscal plans should comply with. Regular and continuous monitoring of compliance could be undertaken by the national IFI, with the center intervening in case of gross policy errors.

Apart from that, the implications of the RRF for the case of a greater EU fiscal capacity are obvious. Establishing a permanent capacity funded by Eurobonds would allow MS to firstly, commit to sufficiently large fiscal expansions when needed; secondly, contribute to financing common European public goods such as the green transition, and thirdly, could also strengthen fiscal discipline if access to it is made conditional on compliance with national fiscal plans.

7. National fiscal frameworks

It has to be considered whether a stronger role for national fiscal frameworks, in particular independent fiscal institutions, would contribute to better compliance with EU fiscal rules and improve ownership of the framework at the same time. Moreover, given that high quality statistics are key for a transparent fiscal framework, it has to be assessed what further improvements in data quality would be needed.

Question: Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework? (4700)

There is wide scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework. In fact, the current set up suffers from stark incongruity stemming from at least two elements. On the one hand, national fiscal frameworks often differ from the EU one, at times resulting in clear inconsistencies. On the other hand, and focusing solely on national frameworks, in most MS there is a wide gap between what is established in the legislation and what is actually implemented in

practice. Similarly, with what happens in the EU framework – that a mere reading of the SGP pieces of legislation could not possibly provide an idea about how the framework is actually implemented in practice; one needs the vademecum for that – this also holds for national frameworks. At times, for instance, the elements that are most politically binding for the design of fiscal policy are not the ones enshrined in legislation. This has only widened after COVID – many MS have not fulfilled the deadline for the attainment of fiscal targets such as the MTO as established in their national framework (often with constitutional rank).

This opens a very uncertain situation from a regulatory perspective, with deadlines unmet and no clear legal provision so as to how to proceed in these cases. At the same time, given the very high legal ranking of national fiscal rules, it is very difficult to reach political consensus within national parliaments to amend them. Against this background, a European initiative (such as a proposal for a directive) pushing for a realignment of national and EU fiscal frameworks could be very useful at this stage.

The many specificities, peculiarities and subtleties of the fiscal policy process – in its different stages of design, adoption, execution – especially in decentralized contexts, asks for a very country-specific expertise when assessing it. Also, because experience has shown that often implementation differs very much from legislation. Knowing which fiscal policy variables are most binding from a political point of view in the national context – regardless of whether they are the codified ones or not; knowing how aggregate targets for the general government are subdivided into subsector ones and whether this process is conducive to overall fiscal responsibility or rather the opposite are, to name just a couple of circumstances - is crucial to guide and assess fiscal policy in the different phases of the process. IFIs are particularly well-placed to identify and monitor these issues. In fact, they often provide nuanced national insights that can complement – or challenge – the MoF narrative and provide useful input for national debate. Input specifically tailored to the way fiscal policy discussions take place in the national context and tailored to the specific decentralization arrangements in the national context.

This is why we consider IFIs could play a strengthened role in the fiscal surveillance landscape. In particular, some tasks IFIs could take on include participating in debt sustainability analyses at national level and a more prominent role in the day-to-day assessment of compliance with the fiscal framework. The latter could take shape by providing medium-term, unchanged policies projections that could serve as a starting point for national governments to plan their fiscal policy in a multiannual fashion.

Turning to the data and statistics issue, there is room for improving the transparency and comparability of certain elements that are crucial to any fiscal assessment and monitoring of underlying positions – regardless of the outcome of the reform in terms of fiscal rules – such as the treatment of 'one-off' measures and DRMs, the disbursement and usage of EU funds. Moreover, IFIs are not currently formally informed or consulted in the methodological discussions that take place at the EPC/EFC, between the Commission and MS 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. A reinforced role of IFIs would need to come hand in hand with two elements at least. First, minimum institutional requirements would help to ensure IFIs are strong enough at national level to fulfil their functions without compromising practices. It is critical that all EU IFIs have the mandates, institutional features and resources to function effectively and independently. Second, compliance with IFIs' strengthened institutional requirements should be regularly monitored at the EU level to ensure that national IFIs are effectively preserved from political interference and can adequately carry out their mandate.

8. Effective enforcement

The appropriate balance between pecuniary sanctions and tools incentivising macroeconomic stability and sustainable growth, such as a Budgetary Instrument for Convergence and Competitiveness or the Convergence and Reform Instrument, has to be carefully considered as an element to ensure an effective implementation of the framework.

Question: How can the framework ensure effective enforcement? What should be the role of pecuniary sanctions, reputational costs and positive incentives? (2300)

The debate on the design of fiscal rules should go hand in hand with the debate over the challenges of trust (political trust both inside each MS and across MS within the EU) and effective supervision which must also be addressed. The institutional and political mechanisms that govern the application of the rules must reflect this, acknowledging the fact that proposals for wider flexibility or national agency must also address

concerns over wasteful public spending or insufficient adjustment efforts that could ultimately spill over to other MS.

Pecuniary sanctions have proven ineffective in the past and should be abandoned as enforcement mechanism. In fact, in the aftermath of the Great Recession the degree of automatization of sanctions was increased when enforcing the rules. The reasoning was sound: if it is politically difficult to enforce the rules, enforcement should be automatic and not subject to political discussion. However, political constraints always operate and just end up being internalized elsewhere.

That is why enforcement should in a way operate ex ante rather than ex post – that is, the framework should try and ensure that is in the national governments' interest to comply with the rules, because if it is not, then it is very unlikely that any ex-post enforcement mechanism could change that.

In short, enforcement should revolve around reputation and positive incentives.

The split of surveillance tasks between the national and the central layer discussed above (cf supra) could constitute a relevant enforcement mechanism, leveraging upon reputational costs. Past experience has shown that the intervention by the center is a strong deterrent for gross policy errors in many national capitals. The reputational price associated to the intervention of the center is extremely costly from a political point of view. Therefore, chances for compliance with nationally proposed fiscal plans could be maximized if otherwise the center would intervene. Reputational rewards could also be contemplated, introducing a system by which national IFIs could share with peers those elements on which their respective national governments perform positively.

Moreover, a clearer and more transparent definition of the operational fiscal variable used to assess compliance could also help with enforcement, by simply making non-compliance more obvious to everyone and thus more politically costly.

Additionally positive incentives could take the form of restricting access to the central fiscal capacity to those MS that comply with their national fiscal plans, thereby linking potential funding to sound fiscal performance as already done in other instruments.

9. Interplay between the SGP and MIP

Multiple surveillance streams partially overlap but the links have not always been fully exploited. While the integration of the MIP and the SGP within the framework of the European Semester has helped to strengthen the interaction between those surveillance strands, there is further scope to make them work better together while avoiding overlaps between them when addressing at the same time macroeconomic imbalances, potential growth challenges and risks to public fiscal sustainability. MIP surveillance may also have so far insufficiently taken account of interactions between new emerging economic challenges, notably related to climate change and other environmental pressures.

Question: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels? (2400)

While COVID-19 is a symmetric shock to all EU economies, different EU economies will exit the crisis in different stages of their business cycles and with different crisis legacies. In this regard, it is essential to return to the path of convergence among MS and the MIP is well positioned to play a key role.

Three elements concerning the MIP could be improved

Firstly, the MIP has some design issues. The current MIP is quite disconnected from the SGP. Even though they deal with different issues their complementarity could be improved by introducing additional assessments that could cover for instance the impact of national fiscal plans on EU's imbalances into the MIP process. For instance, at some point in the aftermath of the Great Recession some MS recorded too a strict government surplus while at the same showing a lack of public investment. This translated into a current account surplus that pushed other MS to compete in terms of prices instead of quality due to the little room for product differentiation. This external imbalance was properly identified by the MIP and should have been taken into account when designing fiscal policy.

Furthermore, the current MIP is partly designed in a backward-looking fashion to capture structural deviations. Instead, the early warning part of the procedure should be strengthened, instead of the ex-post identification of structural imbalances.

Secondly, the current functioning of the MIP is very costly in terms of continuous monitoring with little policy implications. This is an area where the governance framework could probably also benefit from the center focusing on the riskiest emerging imbalances from a EA perspective, trying to exert more political traction on the most challenging cases.

Thirdly, the MIP enforcement has been problematic and should be addressed. Actually, when it comes to economic coordination and structural policies, one of the main criticisms that can be made on the European semester is the fact that its impact on wider national debates is relatively shallow, with little national ownership at political levels. Both the European and national parliaments play limited roles, if any. For the MIP specifically, even among experts, the process is apparently not well-known or the basis for substantive policy discussions. National Productivity Boards could also contribute to enhancing the debate.

All in all, surveillance – both fiscal and macroeconomic - could focus on a selected number of key priorities with potentially high spillovers to the rest of the EU. This is also important in the context of the RRF and NRRPs. Given the sums and political capital at stake it is appropriate that the Commission monitors countries receiving large RRF funds closely. However, there must be safeguards to ensure that the other countries' economic challenges and structural imbalances also receive appropriate attention.

10. Euro area dimension

There are a number of concrete links between the economic governance framework and the broader agenda to complete the Economic and Monetary Union. First, both the SGP and the MIP focus exclusively on national policies, in particular on the prevention and correction of high public debt levels and current account deficits. In such a context and in the absence of a central fiscal capacity with stabilisation features, the ability to steer the fiscal stance for the euro area as a whole remains constrained. The introduction of a stabilisation capacity of appropriate size would allow fiscal policy to contribute more to macroeconomic stabilisation at the level of the euro area as a whole. Second, the completion of the financial union (Banking Union and Capital Markets Union), the introduction of a common safe asset and the review of the regulatory treatment of bank sovereign exposures, could – depending on the specific design – facilitate market discipline and allow further simplification of the design of an effective fiscal surveillance framework. Third, a vibrant and resilient Economic and Monetary Union, resting on solid foundations, is the best means to increase financial stability in Europe. It is a prerequisite to strengthening the international role of the euro, which

in turn is a tool to enhance Europe's clout in the world and on global markets, thereby helping protect European firms, consumers and governments from unfavourable external developments.

Question: How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union? (2600)

The Treaty on the Functioning of the European Union (TFEU) mandates a clear division of responsibilities between European and national policy-makers in EMU. Monetary policy is common for all in a monetary union and thus is conducted at the supranational level. In contrast, fiscal and structural policies, have remained largely the competence of national governments, reflecting national and democratic political preferences. This dichotomy isolates essential ingredients of the policy mix and in the aftermath of the Great Recession a set of reforms was introduced to improve coordination across MS and coherence of the policy mix at national level. However, this coordination has not proven very effective in delivering an adequate policy mix.

As previously stated, we should avoid overburdening the fiscal surveillance framework. EMU's decentralized economic policymaking limits what can be achieved. Addressing pan-European issues with high spillovers by coordinating the policy of autonomous MS is extremely challenging.

In this regard, EU fiscal policy needs to acknowledge the need for a stabilization capacity of appropriate size, able to borrow in response to an external shock and the need for common instruments such as the EU budget to be more focused on EU investment priorities. A supranational stabilization instrument would allow for risk sharing in the face of asymmetric and symmetric shocks suffered by the EMU economies, in particular to facilitate the absorption of high-intensity shocks.

The instruments of fiscal policy "centralization" could be automatic, such as a common unemployment insurance (reinsurance on national ones) or a more general stabilizing instrument contingent on the cyclical situation. They could also take the form of ad hoc and temporary arrangements, financed with common debt, which would be expected in the face of severe shocks, such as the measures adopted in the context of the COVID-19 health crisis, notably the NGEU package, loans from the unemployment assistance fund (SURE) or the European Stability Mechanism (ESM) liquidity lines to cover healthcare costs linked to the coronavirus crisis. This type of instrument reduces the likelihood that MS will suffer sovereign stress episodes and, therefore, the eventual need to resort to the existing rescue

network, within the framework of the ESM.

However, it should be noted that risk sharing, financed by common debt or increased tax capacity at the European level, must be accompanied by a system of incentives that avoids the emergence of negative externalities between countries and moral hazard phenomena, which is of crucial importance in a monetary union. The incentives could be anchored in a "no bail-out" clause, which already exists in current legislation.

In any case, providing a cross-cutting European perspective is fundamentally the role of EU institutions, the Commission in particular, and CSRs and guidance to specific countries should reflect these issues and be consistent with a wider European perspective.

11. New challenges due to the COVID-19 crisis

Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far? (1000)

The unprecedented COVID crisis implied that the review was restarted in October this year in a drastically different world compared to February 2020 when it was first launched. Government debt has increased significantly. Moreover, regional, economic and social divides are exacerbated, new macroeconomic imbalances and structural scars may arise from the pandemic and economies face inflationary pressures for the first time in decades. Some countries, especially those characterized by an overreliance in tourism, will need to promote a transition in their growth model if the pandemic persists or if it has provoked changes in preferences. In addition, COVID 19 triggered the creation of new instruments with deep implications for the EU's economic architecture.

COVID 19 has strengthened the case for, on the one hand, more country-specific fiscal policy planning and, on the other hand, the need to ensure a congruent policy mix for the euro area. The review of the EU economic governance provides a unique opportunity to rethink the interplay between national and EU fiscal capacities, complementing the fiscal framework with the possibility of providing direct policy support at the central level. A more structured "vertical" coordination between national and EU fiscal policies can lead to a more balanced policy mix.

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