PRESS RELEASE
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Technical Paper on the Reform of the Fiscal Governance Framework

AIReF PROPOSES THAT GOVERNMENTS SHOULD SET A DEBT ANCHOR AND COMMIT TO A FOUR-YEAR SPENDING PATH AT THE START OF THE LEGISLATURE

- **The Independent Authority for Fiscal Responsibility, the body responsible for ensuring compliance with fiscal rules in Spain, presents a concrete proposal with specific elements for each country**

- **The debt anchor will be specific to each country and the annual spending path will have to be approved by the national parliament and the EU authorities**

- **The budgets for each year should be aligned to this legislative path in order to promote steady convergence towards more prudent debt paths**

- **This new fiscal framework would include an escape clause so as to be able to revise the promised path in exceptional circumstances**

- **AIReF's proposal includes a greater role for IFIs in fiscal supervision in low-risk situations, while maintaining the Commission's central role**

The Independent Authority for Fiscal Responsibility (AIReF) today published on its website a technical paper on the reform of fiscal governance. In this paper, AIReF proposes that each incoming government should propose at the start of its mandate a specific debt anchor for its country and commit to the resulting expenditure path throughout the legislature. This path, which must be approved by the national parliament and the EU authorities, would be the binding benchmark for the next four years. However, it could be modified in exceptional circumstances by activating an escape clause.

AIReF is the body responsible for overseeing the sustainability of public finances in Spain and ensuring compliance with fiscal rules. In this paper, it presents a proposal for reforming the fiscal framework, with country-specific aspects. The current fiscal framework has not been sufficient for designing stable and predictable national fiscal policies and the consensus for reform is unanimous.

As stated by AIReF at the beginning of the paper, public debt in the Spanish economy has reached levels not previously seen in peacetime. In this context, it is essential to design a medium- and long-term fiscal policy strategy that generates room for manoeuvre to deal with future economic challenges and shocks. In AIReF's view, this fiscal strategy should be based on a fiscal framework that allows the stabilising role of fiscal policy to be preserved in adverse situations while ensuring the sustainability of public finances.

The fiscal framework in place following the changes introduced with the Great Recession, despite the huge web of rules and procedures it contains, has not thus far been sufficient for designing stable and predictable national fiscal policies. In general terms, national fiscal policies have been pro-cyclical in nature and have not prevented the gradual increase in government debt ratios to values that raise the vulnerability of economies to any changes in market sentiment that may jeopardise the stability of the EMU itself.

Aware of these weaknesses, the European Commission (EC) initiated a review process of the fiscal framework in February 2020, which was interrupted by the COVID-19 pandemic. The consultation resumed in October 2021 and allowed the EC to gather opinions on how to ensure the long-term sustainability of public debt while allowing short-term economic stabilisation; how to encourage investment and structural reforms; ways to simplify the rules and improve their transparency and how to improve the coordination of fiscal policies and take into account the position of the euro area economy as a whole.

AIReF took part in this consultation and published its contribution in January this year. Now, with this paper, it seeks to make this proposal operational, taking into account that the current fiscal framework has operated with three fundamental problems: the anchoring of budgetary policy through nominal deficit targets, which has exacerbated its pro-cyclical nature; the major volatility of fiscal targets – both in the medium, and in the short and very short term; and scant political ownership by national governments of the fiscal paths, since the initiative to propose and approve them has mainly fallen on EU institutions.

Therefore, and in the context of the debate on the reform of economic and fiscal governance in the EU, this technical paper addresses three elements that should be included in the reform: the timing, material and institutional aspects applied to the specific context of the Spanish economy.

The proposal

With regard to the timing aspects, the framework must combine, on the one hand, the flexibility necessary to respond to shocks that have become more frequent in recent years than previously thought and, on the other hand, a medium-term orientation of fiscal policy that makes it possible to internalise the implications that current decisions have for future debt sustainability.

Regarding the material aspects, since 2018 AIReF has worked on the proposal of structuring the reform of the fiscal framework around a debt anchor and an operational expenditure rule in the short and medium term. This framework would allow for a better combination of feasibility and enforceability of commitments.

On this basis, the technical paper proposes a methodology for setting a specific debt anchor for Spain that will generate a feasible path of reduction. When establishing this anchor, the country's information regarding the level of starting (present) debt, the historical evolution of the ratio (past) and the trend projections of public revenue and expenditure (future) are taken into account so as to consider the implications of the fiscal policy commitments made. Once the debt anchor has been derived, its implications for fiscal policy in the short and medium term are reflected through a path of primary spending in levels, net of new revenue measures. To illustrate this, the technical paper proposes an example based on a simulation exercise.

Relating the timing aspects to the material aspects, the proposal of this paper would imply that each incoming government would propose to the EU institutions at the start of each mandate a debt anchor and a corresponding expenditure path which will be feasible and will contribute to a sufficient reduction in the ratio over the legislature. This path, which must be approved by the national parliament and the EU authorities, would be the binding benchmark for the next four years. However, this path could be modified, for example, in the event of a change of government, if the conditions of the debt market deteriorate drastically or in exceptional circumstances through the existence of an escape clause linked to a context of recession. The independent authorities would continue to play an important role in assessing the existence of these exceptional circumstances.

This would mean that the governance scheme of the Recovery and Resilience Facility would be replicated to some extent at a fiscal level. This would give each government the opportunity to set its own priorities and paths, within common guidelines for all Member States, which would promote greater political ownership. At the same time, the investment of political capital in the design and approval of the fiscal path would increase the reputational cost associated with its non-compliance or modification, thus providing more stability to the medium-term paths. A binding path proposed at the start of the legislature could significantly raise the political cost associated with its modification.

The role of IFIs

Finally, regarding institutional aspects, the need for the new fiscal framework to better reflect the specific features of each country can be strengthened by the work of national independent institutions. These institutions are particularly well positioned to provide useful information to the national debate in aspects such as the debt sustainability analysis and medium-term and long-term fiscal projections under a no-policy change scenario that are required in the proposed approach. They can also oversee compliance with the rules and the degree of realism of the macroeconomic and budgetary projections.

The fiscal institutions could assume fiscal oversight in low-risk circumstances, with regular reports to EU counterparts at the relevant forums. The European Commission would maintain its central role in providing country-specific fiscal policy guidance and guidance for the euro area as a whole. In addition, in the event of non-compliance by governments, supervision would pass entirely to the EC, which could set stricter requirements, thus increasing the reputational cost of non-compliance.