OPINION ON THE EUROPEAN UNION FISCAL GOVERNANCE REFORM

OPINION 1/24

EXECUTIVE SUMMARY

July 3, 2024

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

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Date of publication: July 3, 2024

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The economic governance of the European Union (EU) consists of a set of rules and institutions that have been created since 1992, with the aim of preventing and correcting fiscal and macroeconomic imbalances that may jeopardize the proper functioning of this area and, in particular, of the Economic and Monetary Union. In February 2024 the EU institutions and governments reached an agreement on the reform of the fiscal governance framework articulated around the Stability and Growth Pact. In contrast to previous review processes, this time it is a far-reaching reform, the result of in-depth reflection and negotiation at EU level.

The reform of the EU fiscal framework entered into force on April 30, 2024, so Member States will be required to submit the first round of national medium-term fiscal-structural plans in September. The process has culminated in a framework that presents important novelties with respect to the previous one, both in terms of the underlying consensus regarding the role and design of fiscal policy, and in terms of its practical implementation. The reform has been permeated by the realization of a macroeconomic environment that is very different from the one in place when the original Pact was designed, both in terms of lower growth, greater presence of shocks and large public spending and investment needs to face a complex geopolitical environment and other trends such as climate change or population aging.

The main principles of the reform can be summarized in four:

(i) The new framework is anchored on the analysis of debt sustainability risks for each country. This entails a medium- and long-term perspective on the situation of the public finances, in way in which the adjustment commitments are differentiated by

country and are determined not only by the initial situation but also by future pressures associated, for example, with aging.

(ii) Adjustment commitments are established through a single operational variable, primary expenditure net of discretionary revenue measures, cyclical unemployment and expenditure financed entirely with EU funds, as well as national co-financing expenditure. This variable is more predictable and controllable by fiscal authorities than the concept of the structural balance (and its variation) on which the previous framework was based. The use of limits on net primary expenditure helps to generate room for manoeuvre in expansionary phases or if extraordinary revenues are recorded, while the exclusion of cyclical unemployment is intended to leave room for the automatic stabilizers to operate.

(iii) To incorporate the lessons learned during the fiscal consolidation phase that followed the financial and sovereign crisis, the system incorporates incentives for investment and growth-promoting reforms in the form of a longer adjustment period; in addition, two escape clauses are incorporated, both at the European and country level, to allow fiscal policy to play a stabilizing role in exceptional circumstances.

(iv) Finally, the aim is to improve compliance with the fiscal framework by strengthening each country's commitment to its adjustment path (so-called country ownership) and to develop credible mechanisms for implementing the framework.

In contrast to some proposals to dilute the barrier between the preventive and corrective arms of the Pact, the reform preserves both procedures, although the adjustment variable will always be the net primary expenditure path. The reform also introduces some provisions aimed at ensuring consistency between the magnitude of the adjustments required in the preventive and corrective arms.

In addition to amending the Stability and Growth Pact Regulations, the reform also introduces changes to Directive 2011/85 on national fiscal frameworks. This Directive was introduced with the purpose of improving national budgetary processes to complement the European framework of rules through the reinforcement of Member States' accountability. Among other elements, it provided the first impetus for the creation of Independent Fiscal Institutions (IFIs), such as AIReF, in the euro area countries, with the aim of reducing asymmetries in information between citizens and governments and increase the reputational costs for the latter of an inappropriate design of public finances.

The most recent amendments to the National Frameworks Directive focus on three aspects: improving budgetary statistics, adapting national budgetary frameworks to the reform of the Pact and preserving the role of the IFIs. In particular, the minimum standards to be provided to these Institutions in terms of independence, funding, resourcing and access to relevant information to carry out their mandate are codified. In terms of the tasks assigned to the IFIs, the European legislation maintains a minimum approach leaving each country the power to delimit in detail the mandates of their respective Institutions. However, in addition to the task of analyzing, endorsing or producing the annual and multi-annual macroeconomic forecasts accompanying budgetary planning documents and verifying compliance with national rules, a new task is explicitly introduced, consisting of analyzing the consistency, coherence and effectiveness of the national fiscal framework.

The reform of the Preventive and Corrective Arm Regulations entered into force the day of their publication in the EU Official Journal, while the deadline for transposition of the Directive into national legislation extends to December 2025. The Regulations are immediately applicable to all EU Member States as of April 30, the day of their publication in the Official Journal of the EU. For its part, the Directive must be transposed into national legislation within approximately one and a half years, respecting the integrity of its objectives.

Applied to Spain, the new fiscal rules will require, according to AIReF's current estimates, a fiscal adjustment of 0.63 GDP points per year during the period 2025-2028 or 0.43 points per year during the period 2025-2031, in the event that the adjustment period is extended to seven years, linked to the implementation of reforms and investments. This adjustment will take the form of a primary expenditure path net of revenue measures committed for the next four years. Compliance with this fiscal path will guarantee with a high probability that the public debt-to-GDP ratio of our economy will fall in the medium and long term, even in more unfavorable scenarios than the one considered as the central scenario. However, certain methodological details of the new framework have yet to be made public, which could cause these calculations to change. Similarly, changes in the forecasts affecting the starting position could also change these estimates.

In AIReF's view, the reform of EU economic governance entails four key improvements that can enhance rationality and the effectiveness of the way fiscal policy is planned and monitored. First, the reform explicitly places sustainability at the center of the new fiscal rules, which makes sense given the current high levels of debt, with a differentiated view by country and a strengthening of medium-term planning. In addition, the new framework seeks a better balance between fiscal consolidation and economic growth by seeking to preserve investment. Another key innovation is the streamlining of the

operational indicators used for fiscal policy monitoring, as unobservable variables such as the structural balance play a less central role in the new framework. Finally, calibrating the necessary adjustment in the new framework remains complex as it requires numerous inputs of a prospective nature (among others, medium-term potential growth, trend revenues and expenditures, the impact of aging on public spending, etc.) However, the complexity is relocated to a more justified scope, focusing on diagnosis rather than on the realm of implementation and supervision, which relies on a single operational variable, net primary expenditure.

At the same time, its implementation at the national level poses four significant challenges. The first one has to do with the objective of strengthening national ownership of the adjustment path. Achieving this goal will require not only the political commitment of the government presenting the medium-term plan, but also that of all institutions and actors with fiscal policy responsibilities - especially in a country with such a high degree of expenditure decentralization as ours. The fact that the plans must be established for a minimum period of four years, with no possibility of revision except in exceptional circumstances - including a potential change of government - makes it advisable to seek consensus on the measures underlying those plans.

The second challenge is related to the need to adapt our national fiscal framework to update it and make it consistent with the reform of the Pact. The transposition of the reform of the National Fiscal Frameworks Directive provides an opportunity to update Spanish legislation on financial sustainability. These amendments - which should help reduce discrepancies between the national and EU framework - must be adopted by 31st December 2025. Empirical evidence suggests that the IFIs are well placed to contribute to the diagnosis of national budgetary frameworks, in line with the task envisaged in Article 8a.5.d) of the reform of the Directive, related to assessing the soundness, consistency and effectiveness of the national budgetary framework.

Alongside the challenge of establishing national rules consistent with the European framework, there is also the task of distributing the objectives and their implementation among the different levels of administration. The level of decentralization of the Public Administrations in Spain makes it even more necessary for both frameworks to be coherent and consistent. Unlike other countries, this process of distributing fiscal policy objectives is more complex due to the high degree of decentralization in our country and the need to address it taking into account that the possible reform of the territorial financing system and the extraordinary financing mechanisms could have relevant effects on this distribution.

A final challenge will be to make debt reduction compatible with growing public spending and investment needs, in a context where, on the one hand, the latter are large and growing (defense, industrial policy, climate change, digital transition or population aging) and, on the other hand, a real common central capacity at the European level is still lacking.

To meet these challenges, AIReF makes the following proposals:

1. To publish the Commission's reference trajectory so that the different territorial levels of the Administration and other Institutions can be aware of it. Similarly, the subsequent negotiation process with the European Commission, prior to the presentation of the medium-term fiscal-structural plans, must be transparent and consensual.
2. The dissemination of the specific technical analyses for Spain, which are necessary to be able to carry out a robust and transparent diagnosis of the adjustment needs of our economy, prior to each round of approval of the medium-term structural fiscal plans.
3. To immediately initiate dialogue with all public administrations to reach a consensus on a distribution of objectives that guarantees compliance with the commitments acquired at European level from the earliest stages of implementation of the structural fiscal plan.
4. To address the process of reforming the national fiscal framework, especially the distribution of objectives among Public Administrations, alongside the reform of the territorial financing system and extraordinary financing mechanisms. This is the only way to achieve a comprehensive solution to these three closely interrelated issues.
5. Address medium-term fiscal planning in a comprehensive manner, making explicit the estimated investment needs of the Spanish economy and the measures envisaged to meet them.

AIReF recalls that, in order to promote national ownership, it has been recommending in its reports, as for example in the 2023 Rebalancing Plan report, to count on the participation of all the institutions, relevant national stakeholders and representatives of the different territorial levels in the design of the new structural fiscal plans. Likewise, AIReF also recalls the recommendation issued in the Initial Budget Report of the Public Administrations 2024, to initiate the work on reforming the national framework to ensure consistency and coherence with European rules.