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A New EU Economic Governance and Fiscal Framework: what role for the national independent fiscal institutions (IFIs)?*

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The EC communication on orientations for a reform of the EU economic governance framework asks the European Fiscal Board (EFB) and national IFIs to play a more significant role in it. This vision has plenty of merit, but one needs to be careful in how to implement it. Structural reforms and public investment analysis demands an expertise hardly existing at most IFIs now. Involvement in policy design would make its assessment tricky when IFIs are part of the process; an inescapable conflict of interest ensues. It could also be perceived as a technocratic encroachment on a democratic decision-making process. National IFIs need more resources according to EU wide acceptable standards of operation, and, first of all, they need to bolster their macroeconomic and debt sustainability analysis capabilities.

*This is a shorter version of the text that is on the site of the Romanian Fiscal Council. The author bears sole responsibility for the views expressed herein.

For more than a decade, a debate has been going among experts and policy-makers on the need to overhaul the economic governance and the fiscal rules of the EU, with the euro area in focus primarily. And the European Commission (EC) issued various documents to this end. The debate was relaunched in 2021, against the background of extreme events. The resurgence of high inflation and a consequent sharp tightening of monetary policies while public debts were already a major concern, make the reform of the EU economic governance more salient. A recent EC document on this reform is *the Communication* of November 9th 2022.[1]

In what follows I share some thoughts on the EU economic governance and the role of national IFIs in it. My perspective is that the adequacy of EU fiscal rules has to be judged in relation with the overall structure of economic governance in the Union.

1. A new EU fiscal framework is needed

The pandemic, the energy crisis and the invasion of Ukraine, have delayed the overhaul of fiscal rules and of the EU economic governance framework; several tracks of action are however clear:

- The need to simplify and make the rules more transparent, reduce their complexity;
- To make the rules attuned to national circumstances, that should encourage compliance and make adjustment of imbalances feasible;
- To create tools to deal with asymmetric shocks, such as a "fiscal capacity", and a *safe asset* as a risk-sharing tool, that should operate together with risk-reduction measures;
- Debt sustainability, a major issue already, is compounded by the tightening of monetary policies which is asked for by a resurgent high inflation; a "debt trap" is looming here;
- To strengthen the role of the European Fiscal Board and of the national IFIs.

Some of the guidelines mentioned above are mentioned in *the EC Communication*. This document speaks about the need of more "national ownership of polices". The European Fiscal Board has been quite vocal in advocating the revision of fiscal rules and stressed the need of a joint fiscal capacity and of a *safe asset*. The IMF[2], too, stressed the need of a fiscal capacity, as did many other experts.

National IFIs have supported a revision of fiscal rules as well, but there has been less agreement in favor of a joint fiscal capacity, of risk-sharing instruments. It can give food for thought that views in this respect have overlapped with official positions of the respective member states. Opinions inside the IFIs network have varied also on whether to judge the fiscal rules in conjunction with the adequacy of the EU economic governance framework -- some views being that the overhaul of the EU economic governance structure is a "political decision" *par excellence*.

I believe that one can hardly judge the EU fiscal rules unless the design/structure of the euro area economic governance, of the EU as a whole, is addressed; and this structure demands stabilization and risk-sharing instruments --such as a *central fiscal capacity* and a *safe asset* together with consistent implementation of risk-reduction measures. It is worthy to highlight that the EC Communication says that the ability to steer the fiscal stance of the euro area remained limited in the absence of a central capacity with stabilization features (p. 3).

[1] *Communication on orientations for a reform of the EU economic governance framework*, Communication from the Commission to the European Parliament, The Council, The European Central Bank, The European Economic and Social Committee and the Committee of the Regions, (Brussels, 9 November 2022).

[2] Arnold N et. al, "Reforming the EU Fiscal Framework –strengthening the fiscal rules and institutions", Washington DC, IMF, 2022. This study suggests, inter alia, turning the EFB into a European Fiscal Council, with more prerogatives.

2. What role for the IFIs?

The *EC Communication* stresses that national IFIs have to "play an important role in assessing the assumptions underlying medium term structural fiscal plans, providing an assessment on the adequacy of the plans with respect to debt sustainability and country specific medium terms goals, and monitoring compliance with the plan" (p. 10).

Whereas up to now IFIs have provided, basically, assessments/endorsements of macroeconomic and budget forecasts[3], the EC new vision would extend the remit to **an assessment of structural reforms and public investment** (*the medium-term fiscal-structural plan*). This proposal has a rationale. But it cannot avoid the raising of significant questions. Thus, how would reforms in various sectors, in education and medical systems for instance, be evaluated? A few national IFIs may have expertise in such undertakings, but most of them do not. In addition, investment projects are hard to fathom out in terms of concrete results. The outcome of structural reforms, of investments, may take years to show up whereas national IFIs would be asked to provide assessments on a regular basis. Arguably, the EC has to come up with clarifications in this regard.

The concerns of the EC are fully justified in view of the enormous challenges that the Union is facing –an energy crisis, climate change, digitalization, artificial intelligence, a productivity problem, security, etc. On the other hand, national IFIs have a validated niche of work that concerns fiscal/budget policy, tax regimes which impact budgets; they can also judge, and some of them do it increasingly, the overall macro policy-mix.

Nonetheless, getting involved in an analysis of structural reforms and public investment could become "mission impossible" unless proper conditions exist. One can examine the impact of public investment, as an aggregate, on potential economic growth, but to get into an analysis of resource allocation, of the composition of public investment is, arguably, very tricky. Spending reviews are done by a few national IFIs (but not by most of them), aside from what is required on the part of national governments.[4] Spending review assessments, which are different from spending reviews per se, may become a component of the work of EU IFIs in the years to come.[5] But to have IFIs involved in a detailed analysis of spending, of investment, is an open issue.

National IFIs are asked, apparently, to be involved in the design of policies. For the *Communication* says, …"IFIs could provide an ex ante assessment of adequacy of the plans and of their underlying forecasts" (p.16). Examining underlying forecasts makes sense, but an involvement, be it subtle, in the policy making process can be problematic. There are at least two relevant aspects here. One relates to the broader scope of assessments that would be asked of national IFIs. And here, it should be said, IFIs may not necessarily have the best views, be they presumed to be an embodiment of "technocracy", of "independent thinking". For "independence" does not imply best judgement automatically. For instance, public agencies/entities failed as regulatory bodies with their light touch regulation of financial systems. The same happened with fiscal rules, when these were implemented during the sovereign debt crisis and austerity measures were enforced pro-cyclically and with neglect of spillover effects. The procrastination of regulatory agencies in dealing with shadow banking, as well as with the crypto activity, is also unfortunate. And examples can continue.

[3] Many EU IFIs do not undertake macroeconomic forecasts themselves.

[4] In almost 2/3 of OECD member states, governments undertake spending reviews on a regular basis.

[5] For instance, Romania's national recovery and resilience plan envisages for the Romanian Fiscal Council to undertake spending review assessments.

Macroeconomic models can hardly cope with *radical uncertainty* and non-linearities. In addition, economists themselves may have different theoretical propensities, which influence their policy recommendations. Therefore, caution should accompany policy prescriptions. That rigor is needed so that major policy blunders be avoided is very much true, and national IFIs can help shape policy construction to this end and enhance good practices. But one should not take for granted that independence secures best policies by itself.

For the sake of fairness in considering the *EC Communication*, however, it is plausible to assume that the suggested broadening of national IFIs' mandates is an attempt to better capitalize on their knowledge of national circumstances.

A second aspect about IFIs' involvement, direct or indirect, in policy design is that, to make its assessment would be hard when you are part of this process –an inescapable conflict of interest ensues. If IFIs get involved, one way or another, in the policy design process, then a "third party" would presumably have to come into the picture, as a genuinely neutral assessment entity.

That the Commission wants independent assessments of national recovery and resilience plans implementation, and more "national ownership" of such plans, is easy to comprehend, but one needs to be careful in asking national IFIs to change their remit in ways that may expose them unnecessarily; reputational risks could ensue thereby.

In not a few in member states, policies have been seen, especially after the eruption of the financial crisis, as being imposed by external institutions; and this perception added likely to the decried "democratic deficit" rhetoric in the Union. **To think that IFIs could, simultaneously, help strengthen "national ownership of policies" by getting involved in policy design while also staying independent, as neutral guardians of fiscal rectitude and economic policy rationality, is to be pondered on, for it can turn to be counter productive**. Some may even see it as a surreptitious "technocratic encroachment" on what are and should be democratic policy making processes. De facto, IFIs would become a sort of "independent economic policy councils".

There are national IFIs in the EU that operate as large think tanks (ex: in Belgium, in the Netherlands); they undertake a large array of analyses, including of economic platforms of political parties. But to view such entities as role models, that can and should be replicated all over the Union, no matter what, can be misleading. Apart from their current mandates and available resources, cultural, political and institutional settings in the various EU member states are quite varied, and they condition what is feasible and, probably, desirable to do in upgrading national IFIs. There could be an argument in substantiating a very broad policy analysis activity and possible involvement in policy design: when there is high, endemic political and governance instability that may harm policy making, such an involvement could operate as an "economic policy stabilizer". But is such an argument convincing? Besides, economic policy design and implementation cannot be put on an *automatic pilot*, that may itself be flawed. It is undeniable, however, that IFIs must be strengthened and the Commission and the EFB are right to emphasize that minimum common standards have to exist to this end.

At the same time, there should not be a normative approach to national IFIs' assessment of fiscal adjustment paths which derive from official economic and fiscal forecasts. That IFIs can influence policy-making by their opinions, assessments, is nonetheless to be expected.

National IFIs may also have to judge national macro-prudential policy stances as the latter may impact external imbalances. And heads of national IFIs should attend the meetings of national supervisory bodies that deal with overall systemic risks.

To sum up, national IFIs should be stronger institutionally and operationally; but there are limits to what they can do effectively and without incurring reputational risks.

Table 1: EC proposal of bolstering IFIs' mandate vs. current status

Current status of IFIs	EC proposal	Pitfalls of EC proposal
Ex ante: large variety of mandates and capabilities, but a common denominator focus on economic forecasts and budget construction analysis	Ex ante: evaluate assumptions underlying country medium term plans, including **reforms and investment programs**; assess assumptions underlying forecasts and debt development	1) hardly existing expertise for assessing structural reforms and investment plans 2) getting involved in policy making may create a conflict of interest and incur reputational risks
Ex post: assessment of budget performance and compliance with national and EU rules	Ex post: monitor compliance with medium term plans and of budgetary outturns with the expenditure path	Summing up: IFIs need to evolve toward EU wide minimum standards of operation and focus on what they can do best. New tasks should be realistic

Final remarks

The *EC communication* on orientations for a reform of the EU economic governance framework puts emphasis on medium term plans that should target robust economic growth and public debt sustainability, feasible adjustment paths for public debts, fiscal risk-based assessments and surveillance. More national ownership of these plans is a valuable aim, though the "technology" to achieve it is still to be elaborated.

The EFB and national IFIs are asked to play a more significant role in the EU economic governance framework. While this vision has plenty of merit, one needs to be careful in how to conceive and implement it. There are benefits, but also pitfalls of broadening the national IFIs' mandates.

IFIs have a niche of work that concerns fiscal/budget policy, tax regimes which impact budgets; they can also judge overall macro policy. Getting them involved into an analysis of structural reforms and public investment could backfire unless proper conditions exist. An involvement of national IFIs in the policy design process can be problematic. National IFIs may not necessarily have the best views, be they presumed to be an embodiment of independent thinking. And IFIs' involvement in policy design would make its assessment hard when they are part of the process; an inescapable conflict of interest ensues. It could also be perceived as a technocratic encroachment on a democratic decision-making process.

What is clear, however, is that national IFIs have to make a bigger contribution in discouraging populist temptations and demagoguery, help instil public governance with common sense and good practices.

About the author

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