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National Independent Fiscal Institutions (IFIs) need to be stronger, but they should be asked to do what they can deliver effectively

-- a sober view on the national IFIs' role in the EU fiscal framework -- [1]

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Abstract: *In April 2023 the European Commission issued a directive proposal on EU economic governance reform that followed its communication of November 2022. While this proposal seems to scale down the role of IFIs compared to the Communication, a train of thought underlying the latter persists. In December 2023, the Council cut some tasks of IFIs that were in the EC directive proposal; whether this cutting is justified is an open question. The vision of the EC that wishes to involve IFIs in the assessment of fiscal-structural plans is not groundless. But structural reforms and investment analysis demands expertise hardly existing in most national IFIs, and their involvement in policy design could be perceived as a technocratic encroachment on democratic decision-making. Reservations of some IFIs in this respect met the reluctance of MSs to condone it. In order to play a more significant and effective role national IFIs need adequate resources and enhanced analytical capacity; their activity much depends on the structure and the policy design of the EU economic governance. National IFIs should view their role from a macro-prudential perspective too. National IFIs should be asked to do what they can deliver effectively, so that no harm to their status and reputation be incurred.*

Keywords*: debt sustainability, EU Council, EC, economic governance, fiscal rules, fiscal capacity, fiscal-structural plan, IFIs, investment, risk sharing, reforms, safe asset, transparency.*

JEL codes*: E61, E62, F15, F33, F34, F36, H6, O52.*

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[1] This text revises the paper that was posted on the website of the Romanian Fiscal Council in February 2023 (with a short version published as SUERF Policy Brief, 23 February 2023). The views presented herein were aired at various debates, including with representatives of national IFIs. The author bears sole responsibility for these views, which should not be construed necessarily as those of the Romanian Fiscal Council.

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Introduction

For more than a decade, an intense debate has been ongoing among experts and policy-makers on the need to overhaul the economic governance and the fiscal framework of the EU, with the euro area in focus primarily. The financial crisis and the sovereign debt crisis in the euroarea, more than anything else, have made obvious that the EU economic governance is suboptimal, that it is lacking key elements – although, this was known from the very beginning of the euro area. As Otmar Issing, the first chief economist of the European Central Bank (ECB) often said, a monetary union cannot function properly by sitting on a single leg, its monetary policy. Therefore, fiscal rules and frameworks function at both the supranational and national levels, as the EU is a political and institutional construction among member states that maintain strong and broad sovereign prerogatives.

The European Commission (EC) encouraged the public debate on the reform of the EU economic governance framework, including its fiscal rules, and issued various documents to this end. The debate was relaunched in 2021, against the background of extraordinary, extreme events. The resurgence and persistence of high inflation and a consequent sharp tightening of monetary policies while public debts were already a major concern, have made the reform of the EU economic governance, of its fiscal framework, more salient, urgent. An EC document on this reform is *the Communication* of 9 November 2022,[3] This document was followed by a directive proposal in April 2023[4] which says that the EFB and the national IFIs have a significant role to play in the EU fiscal framework. The EC directive proposal seems to scale down IFIs' tasks as against the November Communication of 2022. In a key regard, instead of asking the IFIs to make assessments of national medium-term fiscal-structural plans, the Proposal talks about assessments of policies that have an impact on fiscal sustainability (pag.16)[5]. But this wording is vague as it

[3] *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), available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022DC0583&qid=1669888504282.

[4] *Proposal for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the member states*, Brussels, EC, 26 April 2023.

[5] Idem.

can imply IFIs' being involved in assessing medium term fiscal-structural plans. The Council's directive proposal of December 2023 has dropped any reference to such involvement[6]. In December last year a political deal was reached among EU governments regarding the fiscal rules. The EU Parliament has to react on this political deal and on the Council directive proposal. It is worthy to say that both directive proposals do not deal with key missing elements of the design of the euro area, of the EU economic governance – such as a *fiscal capacity*, a collective deposit insurance scheme (EDIS), a *safe asset*.

This paper takes a look at the EU economic governance framework (including its fiscal rules) and the role of national Independent Fiscal Institutions (IFI). It argues that IFIs' role has to be wisely calibrated and not go beyond what most of them can deliver effectively; overburdening them would cripple their status, *voice* and effectiveness. More than formal assignments, national IFIs' effectiveness depends on analytical resources, reputation, and involvement in public debate; it hinges also heavily on the design of the EU economic governance. The adequacy of the EU fiscal framework has to be judged in relation with the overall structure of EU economic governance. IFIs should view their role also through larger lenses, from a macro-prudential perspective.

1. The context

Since the start of the single currency area, it was clear that *formal*, institutionalised fiscal rules are necessary against the backdrop of no fiscal integration. I say "formal" rules since economic common sense, as an informal constraint, should induce rational decision makers to a fiscal and budgetary policy conduct that shuns recurrent large deficits and unsustainable public debts. In the euro area, market discipline (visible through sovereign bond yields) was blurred by the introduction of the single currency and a single monetary policy. The formal institutionalised fiscal rules, encompassed by the Stability and Growth Pact (SGP), operate in conjunction with the one-size-fits-all monetary policy of the ECB, with its pluses and minuses.

For the EU non-euro area member states, financial markets, despite their erratic dynamics, continue to exert a disciplining effect on macroeconomic policies. However, liquidity squeezes and solvency crises can occur when strong boom and bust cycles are at play.[7]

The sovereign debt crisis, which occurred in 2009, indicated the inadequacies of the fiscal rules, which were pro-cyclical and paid insufficient attention to the big differences in the macroeconomic conditions of member states and their structural features. The latter would relate also to the existence, more or less, of a *Stabilitatskultur* in the member states that formed the euro area; this "stability culture" would differentiate largely countries between those that embrace

[6] Council of the European Union, Presidency compromise text on Commission Proposal for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, Brussels, 8 December 2023.

[7] Several new EU member states had to be supported through official financial assistance programs after the global crisis struck and financial markets froze. These countries had run very large current account deficits caused primarily by massive capital inflows which went into non-tradable sectors. Consequently, painful adjustment processes had to be introduced.

strong fiscal responsibility and those that take o relaxed view on fiscal constraints[8]. Likewise, the rules underestimated spill-over effects, which made things worse for the euro area as a whole in the absence of stabilising instruments – such as a joint *fiscal capacity*, and of tools to deal with the *doom loops* between sovereign debts and bank balance sheets. In this regard, a EU *safe asset* would be a useful instrument.

The ECB turned out to be, as a *lender and buyer of last resort*, the *de facto* rescuer of the single currency area via unconventional operations,[9] by a massive injection of base money as counterpart to the acquisition of sovereign bonds. Quantitative Easing (QE), however much maligned by some for its unintended consequences (among which an alleged perpetuation of resource misallocation[10]), prevented the euro area from a possible collapse by bringing down the skyrocketing bond yields of highly indebted member states.

The EU sovereign debt crisis, as a reflection of the financial crisis, showed that its root causes were both ***public and private over-borrowing***, and the ECB and other central banks received a strong reminder that price stability is not synonymous with financial stability. Here one finds a main explanation for the introduction of macro-prudential rules and regulations, that should help keep macro-imbalances under control by influencing the flow of credit. The European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) are the new European regulatory institutions created in the aftermath of the financial crisis with a view to deal with systemic risks. The European Stability Mechanism (ESM), too, was instrumental in helping contain the sovereign debt crisis. These new institutions are a response to the monumental failure of the *light touch regulation* paradigm, that invited the financial debacle which erupted 15 years ago.

While macro-prudential regulations were enacted promptly and have undergone refinements over time, fiscal rules at the EU level stayed basically the same over the years, although the need to respond to peculiar circumstances forced their tweaking, nuancing and reinterpretation.[11]

A European Fiscal Board (EFB) and national Independent Fiscal Institutions (IFIs) were set up in order to monitor policy compliance with the EU and the national fiscal frameworks.

2. A new EU fiscal framework has been long overdue

[8] See also Markus Brunnermeier, Harold James and Yves Pierre Landau, "The Euro: The Battle of Ideas", Princeton University Press, 2016.

[9] QE was also a response to *the zero-lower bound*, the inability to use conventional monetary policy to prop up economic activity in periods of sharp downturns.

[10] This line of reasoning one finds in Bank for International Settlements (BIS) documents. See, for instance, Jaime Caruana, "Stepping out of the shadow of the crisis: three transitions for the world economy", Speech at the BIS General Meeting, 29 June 2014, available at: https://www.bis.org/speeches/sp140629.pdf.

[11] During 2023 a frantic effort has been undertaken by the EC and the Council to revise the fiscal rules and fiscal frameworks within the broader demarche to reform the EU economic governance framework.

The pandemic, the energy crisis and the invasion of Ukraine have delayed the overhaul of fiscal rules and of the EU economic governance framework; within this extraordinary context, numerical fiscal rules were suspended. Nevertheless, several action guidelines, widely supported by experts and national and international officials, have become clear over the years:

- make overall rules more transparent, simpler, reduce their complexity;
- do not abandon the numerical references of 3% of GDP for budget deficit and 60% of GDP for public debt[12], be the latter contested in view of the big rises in public debts owing, primarily, to strong adverse shocks[13];
- adapt the rules to take into account national circumstances, encouraging compliance and making the adjustment of imbalances feasible;
- use net expenditure (excluding one-offs and debt service payments) as the single operational tool in pursuing debt sustainability;
- create tools to deal with asymmetric shocks, such as a *fiscal capacity* and a *safe asset* as an instrument of risk-sharing, that should operate in conjunction with risk-reduction measures;
- put debt sustainability at the forefront of concerns (as this is hightened by the tightening of monetary policies, that has been required by a resurgent inflation) while a "debt trap" is looming;
- protect investment to cope with future major challenges;
- strengthen the role of the European Fiscal Board and of the national IFIs.

Some of these action guidelines are found in the EC directive proposal on the reform of the EU economic governance framework. But this proposal seems to scale down IFIs' role compared to its *Communication* in one major respect, though the wording is vague. At the same time, the Proposal refers to more "national ownership of polices", for reasons that are easy to figure out. The European Fiscal Board (EFB) has been quite vocal in advocating the revision of fiscal rules and stressed repeatedly the need of a joint *fiscal capacity* and a *safe asset*; it also asked for the protection of growth enhancing investment.[14] The IMF[15], too, stressed the need of a *fiscal capacity*, as did many other experts. Not least, the ECB, in its opinion of 5 July 2023 on the EC directive proposal for economic governance reform, argues in favour of an "appropriately designed permanent fiscal capacity" (p. 3).[16]

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[12] However criticized are numerical rules by some, their termination would be like having the euro area, in particular, rudderless with ensuing augmenting uncertainties; numerical benchmarks are needed.

[13] Enrique Feas, "An insufficient reform of the EU fiscal rules", Real Institute Elcano, Madrid, 19 June 2023.

[14] See also Niels Thygesen at.al: "Reforming the EU Fiscal Framework: now it the time", Voxeu, 26 October, 2020

[15] Arnold, N. *et al*., "Reforming the EU Fiscal Framework – strengthening the fiscal rules and institutions", Washington DC, IMF, 5 September 2022, available at: https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2022/08/31/Reforming-the-EU-Fiscal-Framework-Strengthening-the-Fiscal-Rules-and-Institutions-The-EUs-518388. This study suggests, *inter alia*, turning the EFB into a European Fiscal Council, as an independent European institution, with more prerogatives.

[16] *Opinion of the European Central Bank on the reform of the EU economic governance*, 5 July, 2023.

National IFIs have supported a revision of fiscal rules and have expressed concerns, *inter alia*, about access to good and timely information, safeguards to independence, the possibility to make assessments at their own initiatives, the effective implementation of the "comply or explain" principle and, not least, the existence of a legal obligation at the EU level to consider national IFIs assessments in various areas[17]. National IFIs also ask for more consultation with the EC, with other EU authorities, so that harmful differences in assessments be avoided. Establishing minimum standards for IFIs at the EU level is viewed as a prerequisite for the effectiveness of these institutions[18].

But there has been less agreement among IFIs in favour of a joint fiscal capacity and of risk-sharing instruments. It can give food for thought that views in this respect have overlapped with the official positions of the respective member states, with the well-known divide between "frugal" states and other states.

Opinions within the IFIs network have varied also on whether to judge the adequacy of the fiscal framework and rules, in conjunction with the adequacy of the EU economic governance framework, some views being that the overhaul of the EU economic governance is a "political decision" *par excellence.* This reluctance to tackle fundamental issues is intellectually uncomfortable, tough its origin is not hard to comprehend. This reluctance is a big difference as compared to what the EFB does; the latter tackles *die Grossen Fragen* (the big issues), does not refrain from making innovative proposals on key issues.

I believe that one can hardly judge the adequacy of fiscal rules unless the design/structure of the economic governance of the EU and of the euro area, in particular, is addressed. If this structure cannot overcome major flaws (as it the case until now), fiscal rules can operate only sub-optimally. This structure demands stabilisation and risk-sharing instruments, such as a *central fiscal capacity* and a *safe asset*, together with consistent implementation of risk-reduction measures. It is fair however to say that reaching the right balance between risk-sharing and risk reduction measures is not easy to define. Moreover, policy compromises on such sensitive issues are very difficult to achieve, owing to the high heterogeneity of economic circumstances and divergent interests among EU member states.

The functioning of economies and the effectiveness of macroeconomic policies depend on the structure of the global financial system**.** When the global financial cycles are derailed by a wide-ranging and deep deregulation of finance,[19] against the backdrop of the dominant position of a major central bank, as is the case of the Fed, however prudent fiscal and monetary policies are, they can easily be overwhelmed, and pursuing a "corridor of stability"[20] is likely to be ineffective.

[17] EUNIFI, "EU fiscal and economic governance review –a contribution from the Network of Indipendent EU Fiscal Institutions", 2021.
[18] See also Sebastian Barnes, "EU fiscal governance reforms a perspective of independent fiscal institutions", Intereconomics, no.1, 2022.
[19] As it happened with the waves of deregulation of finance that started with the *Big Bang* in the City of London in 1986 and continued in the US.
[20] The goal of such a corridor is mentioned by Claudio Borio and Piti Disyatat, "Monetary and fiscal policies: in search of a corridor of stability", presentation made at the DG ECFIN workshop "Fiscal policy in times of high debt and economic turbulence", 31 January 2023, Brussels.

In addition, fiscal and monetary policies need to be complemented by macro-prudential rules and policies, since excessive private debt can be no less dangerous than large public debt.[21] This is a major lesson derived from the sovereign debt crisis in the euro area, and other episodes of balance of payments crises around the world.

One could even think of the need for an overall macro-prudential policy as, currently, such a means is only in the toolbox of central banks. Fiscal/budget policy may also need to have a macro-prudential thrust**.**

It is worthy to highlight that the EC *Communication* notices that the ability to steer the fiscal stance of the euro area remained limited in the absence of a "central capacity with stabilisation features" (p. 3). This remark is quite telling, namely that, while there seems to be an analytical prevailing train of thought in favour of a *central fiscal capacity*,[22] a political stalemate among member states impedes its creation. The same happens, presumably, with the European Deposit Insurance Scheme (EDIS). It is telling in this regard that the EC directive proposal of April 2023 no longer refers to *a joint fiscal capacity*, whereas the ECB mentions it in its opinion of July 2023. For some member states this is a redline not to cross, for it smacks of a transfer union in the open[23].

3. What role for the national IFIs?

The role envisaged for IFIs in the new EU economic governance framework, as it is reflected in the Council directive proposal of December 2023, reduces the tasks envisaged by the EC directive proposal. Thus, task b) -- producing debt sustainability assessments underlying the government medium term planning or endorsing those provided by the budgetary authorities, and task c) -- producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities, are eliminated. What remained are the tasks mentioned below:

a/ producing the annual and multiannual macroeconomic and budgetary forecasts underlying the government's medium-term planning or endorsing those used by the budgetary authorities;

d/ monitoring compliance with country-specific numerical fiscal rules unless performed by other bodies in accordance with Article 4;(???)

e/ undertake tasks in accordance with relevant articles of the regulation (XXX preventive arm of the SGP) and of the Regulation XXX corrective arm of the SGP;

[21] Ricardo Reis, among others, highlights the role of macro-prudential policy in the structure of a policy mix (see also "What can keep euro area inflation high?", 76th Economic Policy Panel Meeting, Berlin, 20-21 October 2022, available at: https://cepr.org/events/economic-policy-panel-what-can-keep-euro-area-inflation-high).

[22] See also Marco Buti and Marcelo Messori, "A central fiscal capacity to tackle stagflation", VoxEu, 3 October 2022, available at: https://cepr.org/voxeu/columns/central-fiscal-capacity-tackle-stagflation. It is telling that Marco Buti is the head of cabinet of EU Commissioner Paolo Gentiloni and a former Director General of DGECFIN.

[23] The ECB operations could be deemed as having performed functions of a transfer union for the sake of rescuing the euro area in moments of immense stress.

f/ assessing the consistency, coherence and effectiveness of the national budgetary framework;

g/ upon invitation, participate in regular hearings and discussions at the national Parliament.

Does this clash of proposals (the EC and the Council) implies a big setback for the activity of IFIs? Yes and no! On one hand, one could say that fewer tasks dents the capacity of IFIs to promote fiscal responsibility and influence policy making in the right direction. On the other hand, actual effectiveness depends, fundamentally, on the quality of assessments, reputation, and the involvement of IFIs in public debate. In addition, IFIs vary a lot when it comes to their mandates and resources –as George Kopits rightly highlights[24]. This situation, he argues, diminishes the relevance of data that cover IFIs and that are not comparable across countries, not amenable to quantification, and include entities that do not necessarily conform to minimum standards of good practice. And in the 2021 EFB Report, one can read: "Absent a conscious effort to harmonise the role and functions of these entities, the Commission and the Council roles in monitoring performance and formulating recommendations will remain essential" (Foreword).[25] IFIs have a significant role to play in this respect, but one should not overblow it.

The IFIs should do what they can deliver effectively

The EC Communication's vision prescribed for national IFIs to get involved in the design of fiscal-structural plans, while the Proposal of April 26 2023 alluded to it in vague terms. The Council directive proposal of December 2023 drops such a task. Why is it so? Clearly, member states have reservations about IFIs' new, or reinforced tasks. I would mention below a few thoughts on why the ambitious new vision of the EC *Communication* regarding IFIs met resistance and is questionable. It is an interesting case study. One could say that this is history, *deja passe,* but not only the EC thinks that such involvement makes sense. And ideas never die…

The EC *Communication* stressed that national IFIs have to "play an important role in each member state in assessing the assumptions underlying the 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"[26]. The *Communication* called for an extension of the IFIs' mandates. Whereas up to now most IFIs have provided, basically, assessments/endorsements of macroeconomic and budget forecasts and compliance with fiscal rules,[27] the EC Communication would extend the mandate to an assessment of structural reforms and public investment (*the medium-term fiscal-structural plan*).

[24] George Kopits, *Strenghtening EU Independent Fiscal Institutions*,presentation made at the annual conference of the EFB, Brussels 11 May 2023.

[25] Niels Thygesen et.al, *The EU fiscal framework –a flanking reform is more prefereble than quick fixes*, VoxEU, 14 January, 2022.

[26] *Communication on orientations for a reform of the EU economic governance framework*, p. 10.

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

The vision in the Communication on IFI's role in assessing fiscal-structural plans has a rationale, but it raises significant questions. One could argue that it does not pay to make comments after this idea was put away by the Council directive proposal. As a matter of fact, what the Communication proposed is not something eerie, and there are high profile experts[28] who support it. But, how would reforms in various sectors, in education and healthcare 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 discern in terms of concrete results. The outcome of structural reforms and investments may take years to show, whereas national IFIs would be asked to provide assessments on a regular basis. And one can read in its 2023 Report, "the EFB doubts whether the proposed merge of fiscal and structural surveillance in relation to national plans is a realistic vision for the future when the one-off NGEU, involving EU funding, fades out" (Niels Thygesen, Foreword, p.2). *Nota bene*: in its dialogue with IFIs', the EC recurrently has asked whether they have been involved in the working out and, later, in the assessment of the implementation of recovery and resilience plans. Arguably, as adjustment paths of large public debts and deficits have to be realistic, new tasks of the national IFIs should be approached similarly.

The concerns of the EC are fully justified in view of the enormous challenges that the Union is facing: the energy crisis, climate change, digitalisation, the impact of artificial intelligence, an overall productivity problem, security concerns etc. And there is also a concern that the NGEU money should be used properly. On the other hand, national IFIs have a validated niche of work that concerns fiscal/budget policy and tax regimes that impact budgets. They can also judge, and some of them do it increasingly, the overall macro policy-mix, though, inadvertently or not, they can insinuate themselves in the realm of monetary policy evaluation. By the way, the ECB and other EU central banks refer often to fiscal policy, which shows that the overall policy mix can hardly be shunned in policy analysis in such a complicated and complex environment.

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 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.[29] *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.[30] Nonetheless, having national IFIs involved in a detailed analysis of spending and investment is questionable.

[28] This view is supported by Olivier Blanchard, Andre Sapir and Jerome Zettelmeyer as well in "*The European Commission's fiscal rules proposal: A bold plan, with flaws that can be fixed*", PIIE.com, 30 November 2022, available at: https://www.piie.com/blogs/realtime-economics/european-commissions-fiscal-rules-proposal-bold-plan-flaws-can-be-fixed.

[29] In almost two thirds of the OECD member states governments undertake *spending reviews* on a regular basis.

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

The *Communication* asked national IFIs to be involved in the design of policies, as it says, "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" (p. 16). Examining underlying forecasts sounds sensible, but an involvement, albeit subtle, of national IFIs in the policy-making process is problematic. There are at least two relevant aspects involved in this matter.

The first aspect pertains to the substance, in view of the broader scope of assessments that would be asked of the national IFIs by the suggested new mandate**.** And here, it should be noted that the IFIs may not necessarily have the best views, although they are presumed an embodiment of "technocracy" and "independent thinking". "Independence" does not automatically imply best judgement. 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. Similarly, the EU energy market, with its underpinning rules, has flaws that have been conspicuously highlighted by the energy crisis, and examples can continue.

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. Inside the IFIs there can also be opposing views, with a bearing on their public documents. 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.

IFIs themselves have to be monitored, be subject to an auditing of their performance; the OCDE recommendation to have IFIs audited externally, from to time, makes a lot of sense.

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

A second aspect about national IFIs' direct or indirect involvement in policy design refers to their participation in this process, resulting in an inescapable conflict of interest**.** If national IFIs get involved in the policy design process, then a third party would presumably have to come into the picture, as a genuinely neutral assessment entity.

It is easy to comprehend that the Commission would like independent assessments of the national recovery and resilience plans implementation, coupled with more "national ownership" of these plans. However, one needs to be careful in asking national IFIs to change their mandates in ways that may unnecessarily expose them publicly, since reputational risks could ensue. Their effectiveness and status, their *voice* (in Albert Hirschman's meaning[31]) may be seriously crippled if they try to do what they cannot.

[31] Albert Hirschman, "Exit, voice and loyalty", Cambridge (Mass), Cambridge University Press, 1970.

As central banks and governments were humbled by the great financial crisis, IFIs, themselves, canNOT be a *deus ex machina* when it comes to thinking what is best, optimal, in fiscal matters! Not least because economics is not a *hard science*, and there are numerous uncertainties. But IFIs bring as value added an assumed non-partisan approach, common sense and technical expertise. By asserting this, I firmly believe that IFIs should not shun from thinking about the big issues, challenges, that the EU, its member states, are facing. This is why I think that IFIs should view their role also imbued conceptually with a macro-prudential thrust, considering overall systemic risks. Sure, budgetary authorities themselves should have such a policy thrust together with central banks.

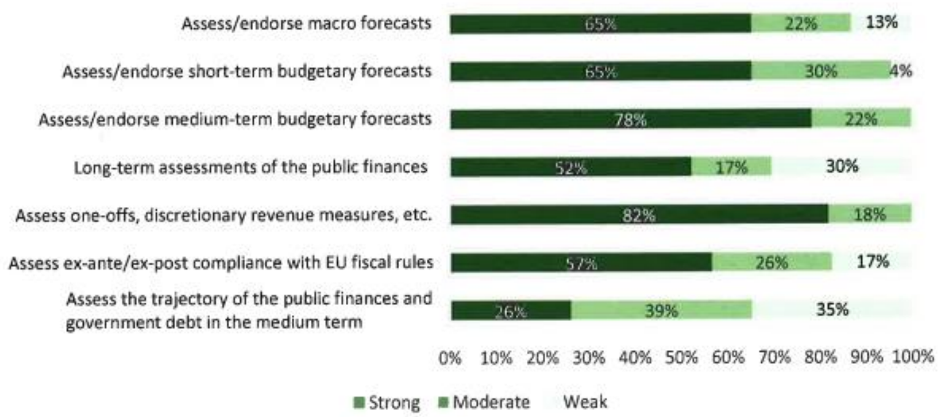
It is the *secret of Polichinelle* that policies in several EU member states have been perceived as being imposed by external institutions, especially after the eruption of the financial crisis. This perception likely added to the decried "democratic deficit" rhetoric in the Union. It is necessary to reflect on the possibility of IFIs simultaneously helping the strengthening of "national ownership of policies" by getting involved in policy design while also staying independent, as independent/neutral guardians or arbiters of fiscal rectitude and economic policy rationality. There could also be a reinforcement of the perception some people have that IFIs are entities imposed by European authorities. Such a situation can become counter-productive. Some may even see it as a surreptitious "technocratic encroachment" on what are and should be democratic policy making processes. *De facto* and semantically, IFIs would have to change, and become a sort of "independent economic policy councils."

A confounding variety of national IFIs

What some people (from the EC as well) seem to underplay are implications of the large variety of national IFIs in terms of mandates and capabilities**.** There are national IFIs that operate as large think tanks (e.g., in Belgium, in the Netherlands, in Spain, in Denmark), which undertake a wide range of analyses, including the economic platforms of political parties –as in the Netherlands. In Germany, there is a web of major economic research institutes –such as IFO, DIW, HWWA, etc. that can perform tasks of IFIs, and there is the highly visible German Council of Economic Experts. But such entities may be hard to replicate all over the EU.

Apart from IFIs' current mandates and available resources, the varied cultural, historical, political and institutional settings within the EU member states condition what is feasible and, probably, desirable to do in upgrading their mandates. And what matters, sometimes, more than formal assignments, is the level of their analytical capabilities and reputation**.** It is interesting to see how many IFIs produce macroeconomic forecasts (or debt sustainability analysis) themselves vs. how many make only endorsements; this would give a flavour of the differences among IFIs with regard to expertise, capacity (figure 1 below).

Figure 1 IFIs capacity by type of task



Note: This figure is based on the survey responses of 29 IFIs from 25 EU countries. The category 'strong' includes IFIs that reported having sufficient or complete capacity, and the category 'weak' includes all IFIs that reported having minor or no capacity to carry out the proposed tasks.

Source: Network of EU IFIs (2022)

There could be an argument in substantiating a very broad policy analysis activity and possible involvement in policy design: when there is a high turnover of succeeding ministers and governments, which can be seen as an endemic political and governance instability with the potential to harm policy making, therefore such an involvement could operate as an "economic policy stabilizer". Nevertheless, such an argument is not so convincing, since economic policy design and implementation cannot be put on *automatic pilot*, that itself may be flawed.

It is undeniable, however, that IFIs must be strengthened and the Commission and the EFB are right to emphasise that minimum common standards have to exist to this end. But even common minimum standards need to be enriched in meaning for "the devil is in detail"; what seems to be common at surface may hide big qualitative differences.

The Council directive proposal's dropping of IFIs' involvement in the assessment of medium-term fiscal-structural plans is, arguably, realistic under the circumstances, but it should not have eliminated the overall task of IFIs of examining the impact of various policies on fiscal sustainability. Just think about changes in tax regimes and their influence on economic activity. IFIs are fully entitled to make judgements in this regard as such changes can affect heavily tax revenues, increase deficits. Likewise, the Council directive proposal goes too far, arguably, in dropping task (b), of producing DSA or endorsing those provided by the budgetary authorities. It is true however that many IFIs do not have (yet) the capacity to produce a DSA; and there is a difference between producing a forecast and endorsing a forecast, which is presumably related to individual institutional capacity, aside from what national legislations say. As a survey made by the national IFIs Network notices, less than half of the them have the capacity to provide long-term assessment of public finances.[32]

[32] EUIFI, "*The Capacity of national IFIs to play en enhanced role in the EUs fiscal governance"*, Brussels, 2022.

The Council directive proposal talks about the possibility of having several IFIs in member states. This idea can help when it comes to tasks that exceed the analytical capacity of many IFI's – e.g.: demographic analysis, spending reviews.

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. IFIs can influence policy-making by their opinions and assessments.

There is a sense that governments do not wish national IFIs to interfere too much, to oversee too much. But this is not an unusual reaction and would require a separate discussion.

Table 1. EC communication and directive proposal of bolstering IFIs' mandate vs. current status; the Council directive proposal that scales down the EC's vision

Current status of IFIs	EC communication/proposal	Pitfalls of EC proposal
Ex-ante: large variety of mandates and capabilities but a common denominator focuses on economic forecasts and budget construction analysis	*Ex ante*: evaluate assumptions underlying country medium-term plans, including **reforms and investment programs (**the proposal refers to it indirectly, vaguely**)**; assess assumptions underlying forecasts and debt development	1)very limited expertise for assessing structural reforms and investment plans at most IFIs 2) getting involved in policy design entails 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.**

Source: compiled by the author

Adequate resources

Adequate resources should be seen in conjunction with the aim of establishing minimum standards of operation. But this constant goal has become a sort of a mantra; it needs more concrete definition in order to help not a few IFIs overcome big hurdles in their activity. What about a case when a national IFI cannot hire more staff owing to austerity measures imposed by a government all across the board (as the experts of the IFI are seen as public sector employees, while its budget would permit it). The pay issue can also be a major stumbling block in hiring experts. And these are not hypothetical cases. How to translate the general statement and principle of adequate resources into concrete reality is a problem begging, not unfrequently, for solutions.

There is also the situation when IFIs rely on resources (human and material) provided by other public entities (e.g.: central banks). This is not necessarily bad to the extent this is a transition phase, that would allow IFIs to grow up. But such a situation creates a "dependency', with pluses and minuses. The EFB itself relies on resources provided by the EC.

Debt sustainability analysis

The Council proposal eliminated the task on debt sustainability analysis from the IFIs mandates. But this, arguably, should not impede IFIs from undertaking such assessments provided they have analytical capacity.

Regarding debt sustainability analysis, it is useful to have common conceptual constructs when factoring in aging and climate change costs in national IFIs assessments. As the IMF departmental paper suggests, a common methodology for debt sustainability analysis should be used by the national IFIs.[33] IFIs are right to say that a joint working group, made up of EC and IFI's experts, other experts, should come up with a common methodology.

It is necessary to consider the costs of the war in Ukraine and the probable significant rise in defence expenses in many EU member states in the years to come: *the peace dividend* has probably come to an end. Against the backdrop of the energy crisis and the war in Ukraine, some economies are becoming a sort of *sui generis* "war economies" and resource allocation is heavily impacted. De-globalisation and *decoupling* in the world economy would also influence potential economic growth and debt sustainability.

The energy crisis, with the ensuing high rise in the relative price of energy (and of other critical materials), impacts incomes and resource allocation heavily, with massive distributional effects. All these evolutions affect public budgets, and debt sustainability analysis should take them into account.

Debt sustainability assessment has to consider *hidden liabilities* that come into the open ever more due to monetary policy tightening (and *quantitative tightening* – QT). EC documents do consider this challenge.

Tax regimes and *spending reviews*

National tax regimes should be considered as well in view of very low fiscal revenues in some member states (e.g.: in Romania tax revenues, including contributions, are cca. 27% of GDP, in Bulgaria about 31% of GDP, in Hungary, Czechia and Poland about 35% of GDP –while the average in the EU is 41% of GDP). IFIs should examine how tax regimes can be changed so that tax revenues be bolstered.

[33] Arnold, N. *et al.*, "Reforming the EU Fiscal Framework – strengthening the fiscal rules and institutions", Washington DC, IMF, 5 September 2022, available at: https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2022/08/31/Reforming-the-EU-Fiscal-Framework-Strengthening-the-Fiscal-Rules-and-Institutions-The-EUs-518388.

Likewise, the international fiscal regime needs to be reformed in order to reduce tax evasion and avoidance, however ambitious this objective is due to extremely powerful vested interests. Tax-havens jurisdictions in the EU need to be eliminated, even if this is done gradually. IFIs should not refrain from speaking up on these issues.

Where expertise exists, *spending reviews* should be a priority in view of the increasing strains under which public budgets operate. Where such capacity does not exist, adding such a task all of a sudden would be a mistake; overburdening IFIs where such capacity does not exist is not going to work – quick fixes should be avoided.

Fiscal rules and macro-prudential rules: an overall macro-prudential policy?

An evaluation by the EFB of the overall fiscal policy stance of the euro area does make sense, but it cannot be done separately from examining the macro-prudential policy stance in the euro area, as private sector deficits can harm the euro area as much as public sector deficits. Such an evaluation must consider the functioning of the global financial system as well, in which a dominant role is played by the monetary policy of the Fed.[34] It is justified for the EFB to consider overall systemic risks, which go beyond the remit of judging fiscal policies.

National IFIs may have to judge national macro-prudential policy stances as the latter influence external imbalances. National IFIs should be concerned about the rise in private debts, that, in worst case scenarios, may force again national governments (and central banks) to step in and took over some parts of those debts; it is not sufficient to have only the EFB voice concerns in this respect.

There should be instruments available to discourage excessive private debts, which should complement what central banks do with their macro-prudential instruments[35]. Would governments interfere with the functioning of free markets? Yes, but this is not bad in an environment in which speculative behaviour is rampant and there is little productive investment. Rating agencies have always played a role in this regard, but, as the financial crisis and various scandals have glaringly shown, they are ridden with conflicts of interest and their judgements are not faultless, may be biased. Finance ministries should be deeply worried about rising private debts and speculative conduct.

Heads of national IFIs should attend the meetings of national supervisory bodies that deal with overall systemic risks. In this context, national IFIs should judge the appropriateness of budget/fiscal policies related to overall systemic risks.

[34] As Helene Rey says, the trilemma is a dilemma for most emerging economies and capital flows controls can be useful ("International channels of transmission of monetary policy and the Mundellian trilemma", IMF Economic Review, vol 1, no.64, 2016, 6-35).

[35] As banks are asked to have adequate capital and liquidity reserves, similar requirements could operate for companies. Then, the question is who should be in charge of imposing such requirements. Rating agencies do play a role in judging companies' performances, but their history of conflicts of interest and numerous scandals should make us cautious about non interference by public authorities. Banks can also restrain over-borrowing when they perform due dilligence to grants credits. But banks played a nefarious role in the years preceding the financial crisis. There seems, therefore, to be a role of governments in this respect.

It should be noted that the European Systemic Risk Board (ESRB) and the ECB examine the application of macro-prudential regulations, and increasingly this is extended to the non-bank financial sector, which poses growing systemic risks since it is poorly regulated.

Apart from their own soul-searching and their own surveys that try to monitor the evolution of national IFIs, it would be good to have opinions of outsiders, too, regarding the role of IFIs in the EU and national fiscal architectures.

4. The EU economic governance: risk reduction and risk sharing[36]

The *EC Communication* does not tackle the risk-reduction *vs*. risk-sharing issue, though it says that a missing "central fiscal capacity" is limiting the stabilisation policy options. The EC directive proposal and the Council directive proposal make no reference to it either, as they do not regarding the European Deposit Insurance Scheme (EDIS). This situation is consequential for the new EU and national fiscal frameworks, and for the work of national IFIs and of the EFB as well.

Nonetheless, it is ominous that the Recovery and Resilience Facility (NextGeneration EU) is funded by issuing joint bonds, that may prove to be more of a permanent instrument eventually, especially of one considers the enormous investments the EU needs in order to cope with climate change, competitiveness defence major challenges etc. Such a development is one venue of action in the EU regarding its economic governance framework.

Nota bene: after the ECB announced the QT, a tightening of monetary conditions in the euro area, a special instrument – the transmission protection instrument (TPI) was announced as a means to deal with the situation of highly indebted countries.[37]

Risk-reduction vs. risk-sharing

Some member states highlight the need to reduce non-performing loans (NPL) – a *legacy problem* – as a *risk reduction* measure, prior to implementing a *risk-sharing* scheme (such as EDIS – a collective deposit insurance scheme, and a central fiscal capacity). However, over time, the flow of non-performing loans hinges essentially on economic performance, and not on a particular level of NPLs. In the absence of mechanisms and instruments fostering economic convergence in the euro area, the NPL stocks at national levels would tend to diverge again. One can imagine a diversification of the banks' loan portfolio that would diminish the threats posed to their balance sheets by activities in weaker economies. However, a complete decoupling of banks from the economies of the weaker member states is not realistic and, more importantly, is not welcomed, while contagion effects can still be significant. If banking groups diversify their government bond

[36] I referred to it in "In the euro area discipline is of the essence, but risk-sharing is no less important", SUERF Policy Note, Issue No. 30, April 2018, available at: https://www.suerf.org/policynotes/2437/in-the-euro-area-discipline-is-of-the-essence-but-risk-sharing-is-no-less-important.

[37] At that time, big spikes in Italian, Spanish and Greek bond yields took place. The announcement of the new special ECB facility brought them down.

portfolios while considerable competitiveness gaps persist among member states, and if sovereign bond ratings are no longer “risk-free”, a strong preference for holding safer bonds would ensue.

European “safe assets” and financial integration

Eurobonds, as risk-pooling assets, would make the euro area more robust, but mutualisation of risks is rejected for fear of a “transfer union”. Hence came the idea of a synthetic financial asset (sovereign bond-backed securities – SBBS)[38], which results from the pooling and slicing of sovereign bonds into tranches without joint liability.[39] Nevertheless, the SBBS pose a key problem: the supply of senior tranches depends on the demand for junior tranches, and this demand is likely to fall dramatically during periods of market stress, when some member states’ market access may be severely impaired.

Would the Capital Markets Union (CMU) and Banking Union (BU) overcome market fragmentation and economic divergence in the absence of arrangements that would enable accommodation of asymmetric shocks and foster economic convergence? Some argue that a complete BU (and CMU) would dispense with the need of public risk-sharing. But is it sufficient for a robust Euro area (EA) that risk-sharing applies to finance only? Additionally, would private risk-sharing be sufficient to cope with systemic risks? What about the lender of last resort function in capital markets in view of the expansion of shadow-banking? Would a collective deposit insurance scheme involve private money only? Fiscal risk-sharing may be needed in worst case scenarios.

The progress of the euro area and of the banking union demands a reconciliation between rules and discipline on one hand, and private and public risk sharing on the other.[40] Finding an adequate calibration between rules and risk-sharing, and between private and public risk-sharing, remains however an open question.

Arguably, only private risk-sharing schemes (CMU) would not make the euro area more robust. Financial markets are too fickle and produce systemic risks recurrently. Unless it will get adequate risk-sharing schemes, the euro area will continue to be rigid and prone to recurrent tensions. ECB special operations are a *de facto* risk-sharing instrument.

The euro area needs several elements: liquidity assistance during times of market stress; schemes to cushion asymmetric shocks; non-automatically triggered sovereign debt restructuring

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[38] Brunnermeier, M. K., Garicano, L., Lane, P., Pagano, M., Reis, R., Santos, T., Thesmar, D., Van Nieuwerburgh, S., & Vayanos, D. (2011). “European Safe Bonds (ESBies)”. The Euronomics Group. Available at: https://personal.lse.ac.uk/vayanos/euronomics/esbies.pdf .

[39] A senior tranche (deemed to be equivalent in strength to the German Bunds), a mezzanine (medium-risk) tranche, and a junior (seen as highly risky) tranche, with the latter bearing the brunt of losses in case of default.

[40] See also A. Benassi-Quere *et al*, “Reconciling risk-sharing with market discipline: A constructive approach to euro area reform”, Centre for Economic Policy Research, Policy Insight No. 91, January 2018, available at: https://cepr.org/system/files/publication-files/103106-policy_insight_91_reconciling_risk_sharing_with_market_discipline_a_constructive_approach_to_euro_area_reform.pdf; J. Bini Smaghi, “Reconciling risk-sharing with market discipline”, LUISS School of European Political Economy Policy Brief, 30 January 2018, available at: https://sep.luiss.it/wp-content/uploads/2022/09/PB3.18-RECONCILING-RISK-SHARING-WITH-MARKET-DISCIPLINE.pdf.

(automaticity as a condition for ESM support programmes would cause panic in the markets); rules for adjusting imbalances should not be pro-cyclical; the macroeconomic imbalance procedure (MIP) should operate symmetrically (for both large external deficits and surpluses countries); a euro area-wide macroeconomic policy that should reflect in the fiscal policy stance over the business cycle; no de-regulation of finance and a strong regulation of non-bank financial entities including crypto assets.

5. Final remarks

The EC directive proposal for a reform of the EU economic governance framework is more than timely and adds value to a series of earlier documents. It puts emphasis on medium-term plans that should target robust economic growth and public debt sustainability, feasible adjustment paths for public debts, fiscal risks-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 significant role in the architecture of the EU economic governance framework. Particularly the EC Communication was pretty bold in propounding a role of the IFIs' in the formulation of fiscal-structural plans. The EC directive proposal scaled down that vision, which was further diminished by the Council directive proposal, which dropped any reference to IFIs being involved in the assessment of impacts of policies on fiscal sustainability (task (c) in the EC directive proposal).

There are benefits, but also pitfalls of broadening the national IFIs' mandates. IFIs have a niche of work that concerns fiscal/budget policy and tax regimes which impact budgets, compliance with fiscal rules. They also judge overall macro policy. Getting them involved into an assessment 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. There are at least two aspects involved here. One is of substance in view of the much broader scope of assessments that would be asked of IFIs. And here, national IFIs may not necessarily have the best view, be they presumed to be an embodiment of independent of thinking. A second aspect about IFIs' involvement in policy design refers to their participation in the process, while they are expected to perform its assessment: an inescapable conflict of interest ensues.

To think that IFIs could, simultaneously, help strengthen "national ownership of policies" by getting involved in policy design while also being independent, supposedly neutral guardians of fiscal rectitude and economic policy rationality, can become counter-productive. It could be perceived as a technocratic encroachment on a democratic decision-making process, and there are cases of "technocratic" governments which had modest results, or even failed. The Council directive proposal seems, therefore, realistic in this regard.

But the Council directive proposal may have gone too far in dropping tasks (b) and (c) completely, without qualifications, from the EC directive proposal.

What the Council directive proposal does not achieve is making progress on fundamental weaknesses of the euro area design, of the EU economic governance. The EC proposal does not either. A common *fiscal capacity*, an EDIS, a *safe asset*, remain in the realm of wishful thinking due to seemingly intractable political constraints. It is, therefore, not an accident that the banking union and the capital markets union can hardly advance in the euro area, in the EU.

National IFIs should continue to ask for better access to good and timely information, safeguards to independence, the possibility to make assessments at their own initiatives, the effective implementation of the "comply or explain" principle and, not least, the existence of a legal obligation at the EU level to consider national IFIs assessments across a range of areas. National IFIs need to obtain a more structured consultation with the EC so that mutually detrimental differences in assessments be avoided.

Establishing minimum standards for IFIs at the EU level, that is still a distant goal, is a prerequisite for their effectiveness.

Apart from their own soul-searching and internal surveys that try to monitor the evolution of national IFIs, it would be good to have opinions of outsiders, too, regarding their performance and status. Surveys could be conducted in this respect regularly. However candid IFIs may be about their strengths and weaknesses, regular glimpses from outside would help.

What is clear is that national IFIs can enhance their contribution in discouraging egregious populist temptations and demagoguery, to help instil public governance with common sense and vision, enhance fiscal responsibility and consolidate good practices. They should try to imbue their activity framework with a macro-prudential thrust as well.

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