Conselho das Finanças Públicas

THE NEW EUROPEAN FISCAL FRAMEWORK: RULING OUT FISCAL POLICIES OR WHAT ELSE?

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The New European Fiscal Framework:
Ruling out Fiscal Policies or What else?

Nazaré da Costa Cabral [1] [2] [3]

Conselho das Finanças Públicas

Abstract

In this paper I discuss whether the replacement of a 'rule-based system' relying on common quantitative benchmarks, as is the case with the current Stability and Growth Pact framework, by a 'standard-based model', the model underlying the proposal for a revised Fiscal Framework presented by the Commission, has managed, on the one hand, to overcome the previous criticisms made of SGP's main legal elements (its 'preventive' and 'corrective' arms) and, on the other, to verify whether this proposal risks 'ruling out' Member State fiscal policies with its intended 'national ownership' goal and new flexibility devices. Using insights from political economy, I address this latter point in the light of four contraposing perspectives: firstly, fiscal rules versus fiscal standards (or rules versus discretion); secondly, centralization versus decentralization of budgetary restraints; thirdly, accepting or not accepting Independent Fiscal Institutions; finally, procyclicality versus anti-cyclicality of fiscal policies in the presence of budgetary restraints.

JEL Classification: E6; F02; H50; H6

Keywords: Fiscal Framework; Fiscal Rules; Independent Fiscal Institutions; Fiscal Policy; Macroeconomic Stabilization

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[2] I would like to thank Miguel St. Aubyn for his very pertinent comments and suggestions. All remaining errors are mine.
[3] The opinions expressed in this article are the author's alone and do not represent any position or point of view of the CFP.

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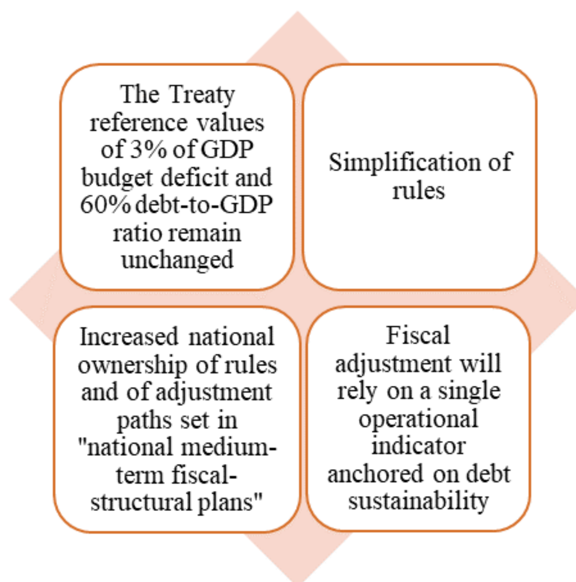
1 Introduction

Last April, the European Commission proposed a new legislative package embodying the reform of the EU economic governance framework (and with it introducing major changes in the Stability and Growth Pact, SGP). This package involves three main elements – firstly, a proposal for a regulation of the European Parliament (EP) and the Council concerning the effective coordination of economic policies and multilateral budgetary surveillance and the repealing of Council Regulation (EC) No 1466/97 (also including seven Annexes); secondly, a proposal for a Council regulation amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure; thirdly, a proposal for a Council Directive amending Directive 85/2011/EU on requirements for budgetary frameworks of the Member States. Political negotiation involving both the EP and the Council is to take place in the last quarter of 2023, and, if a swift consensus is reached by the end of the year, the new framework may come into force in 2024. In the meantime, the existing fiscal rules mostly enclosed in the Stability and Growth Pact remain suspended as they were in 2020, following the COVID-19 pandemic outburst.

It should be noted, however, that the discussion involving the revision of the EU fiscal/economic legal framework started before the pandemic. The necessity to carry out such reform was mostly grounded on the weak enforceability and complexity of the existing system of EU fiscal rules that ultimately had jeopardized its intrinsic goals, namely fiscal discipline as a necessary condition both to ensure macro stabilization at the national level through Members States' own fiscal policies and to prevent negative externalities coming from lenient Member State's fiscal action to other members of the Euro area and to the currency area as a whole (recall Eichengreen, 1996). Indeed, the initial debate around the reform of the fiscal governance was officially launched by the Commission at the beginning of 2020,[4] then suspended due to the pandemic and eventually reactivated in October 2021. After that, a rich and intense technical discussion took place involving EU bodies and services, academics and other relevant institutions (including national Independent Fiscal institutions, IFIs, and the European Fiscal Board, EFB) and several revision proposals were made. In November 2022, the Commission adopted a communication setting out orientations for a reformed EU economic governance framework.[5] [6] At that point, the main general objectives of the reform were outlined (Figure 1).

[4] Positions about the necessity to modify the system of fiscal rules had been taken before, for example, on institutional grounds, EC (2017) and EFB (2018, 2019).
[5] COM (2022) 583 final, of 9.11.2022.
[6] See Gonçalves et al. (2022) for a brief introduction to the reform of EU's economic governance.

Figure 1 – General objectives of the reform of the EU fiscal governance framework



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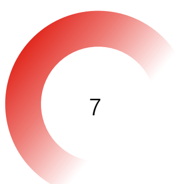
In March 2023, the Council drew some conclusions regarding the Commission's legislative proposal, expressing a position of general agreement with these aforementioned objectives. However, the Council also lifted the veil on the remaining points of contention, including those about "the appropriateness and design of common quantitative benchmarks to support the reformed framework" [7] (italics added).

This opinion is the departing point for this paper. In this analysis it is intended to discuss whether the replacement of a 'rule-based system' relying on common quantitative benchmarks, as is the case with the current SGP's framework, by a 'standard-based model' such as the one under discussion, has managed, firstly, to overcome the previous criticisms to the SGP's main legal elements (the 'preventive' and the 'corrective' arms) and, secondly, to verify whether this proposal risks ruling out Member State fiscal policies with its intended 'national ownership' goal and flexibility devices. Using insights from political economy (and political science), I address this latter point under the light of four perspectives: firstly, when replacing fiscal rules by fiscal standards the proposal seems to open up room for more discretion and flexibility along with a risk of downgrading fiscal discipline among Member States; secondly, it is then considered in which way this reform means a shift from the centralization of fiscal rules to the decentralization of budgetary fiscal restraints[8] given the new core principle of 'national ownership' and possible associated caveats; thirdly, a reflection on the increasing role of Independent Fiscal Institutions (which are also instruments of budgetary restraint) resulting from this proposal and the political opposition they might attract; finally, I analyse in which way the proposed new framework is able to improve compliance in order to favour/allow for counter-cyclical policies to be adopted across the economic cycle. I then draw a number

[7] Paragraph 7 of the Council Conclusions.

[8] As a semantic option, the expression 'budgetary restraints' will be preferably used in this paper instead of 'budget constraints' (which is mainly a microeconomic concept), to the benefit of a broader, including legal, approach.

of conclusions, the main one being that the standard-based system to which the Commission's proposal drains must be tempered with some hardening of formal/institutional/procedural budgetary restraints, as this involves the increasing role of IFIs within the framework, in order to ensure a better connection between 'national ownership' and policy discretion with compliance and fiscal discipline.



2 The current fiscal rules framework

2.1 Brief description and its applicability in the case of Portugal

As properly noted by Carnot *et al*. (2015, p. 5) "the current architecture of EMU relies on decentralized fiscal policies under a rule based-framework".

The legal basis for this rule-based system, together with the TFEU (Articles 121 and 136), is the SGP, adopted in 1997, both in its preventive and corrective arms (respectively, Council Regulations (EC) 1466/97, of 7 of July 1997 and 1467/97, same date). The current set of fiscal rules (including the European Semester) results from the SGP's revision in 2005 subsequently reinforced with the 2011 (the so-called legislative 'Six Pack') and 2013 ('Two Pack') reforms, and also with the adoption of the Treaty on Stability, Coordination and Governance of the EMU (TSCG) - also known as *Fiscal Compact -,* in 2012.

The rules are: the nominal balance budget rule (with a deficit limit of 3% of GDP); the debt rule (with a limit of 60% of GDP); the structural balance rule to be reached through the 'Medium-Term Objective - MTO' (set for each member state);[9] and the expenditure benchmark.[10] Fiscal rules were suspended in 2020 (activation of the SGP's general escape clause) to allow governments to better address the effects of the pandemic. The suspension was maintained in the aftermath of the invasion of Ukraine and the inflationary shock, during 2022 and 2023, and are to be lifted in 2024. Table 1 describes the main developments in the E(M)U's fiscal framework, since its inception in 1992 until the suspension in 2020.

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[9] The MTOs are defined in structural terms, meaning that they represent the cyclically-adjusted general government budget position, net of one-off and other temporary measures (EC, 2019, p. 7). Regulation (EC) 1466/97 specifies that euro-area and Exchange Rate Mechanism (ERM II) Member States must have an MTO that corresponds to at least -1% of GDP. Contracting Parties of the TSCG have further committed themselves to MTOs of at least -0.5% of GDP, unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance remains at -1% of GDP (EC, 2019, p. 7). According to the same Regulation, the MTOs should be set so as to: (i) provide a safety margin with respect to the 3% of GDP deficit limit. For each Member State, that safety margin is estimated in the form of a minimum benchmark which takes past output volatility and budgetary sensitivity to output fluctuations into account. (ii) ensure sustainability or rapid progress towards sustainability. That criterion is assessed against the need to ensure the convergence of debt ratios towards prudent levels, with due consideration given to the economic and budgetary impact of ageing populations. (iii) in compliance with (i) and (ii), allow room for budgetary manoeuvre, in particular considering the needs for public investment (Idem, 2019, p. 7).

[10] The expenditure benchmark relies on two main aspects: i) The definition of modified aggregate expenditure for time t (Gt) which is the aggregate expenditure (net of interests, financed by national funds, including t-3 to t moving average investment expenditure and removing the cyclical component of unemployment benefit expenditure) net of discretionary revenue measures (DRMs); ii) The calculation of the benchmark – the authorized annual variation rate of expenditure is limited by the average growth rate of pf potential output over 10 years (from t-5 to t+4). For countries that have not yet reached the respective MTO (which was the case with Portugal until 2019), the so-called 'convergence margin' is subtracted (in line with the annual improvement in the structural balance required to reach the MTO).

Table 1- Developments in the framework of fiscal rules

EU: Developments in the framework of fiscal rules		
1992	Treaty of Maastricht	The Treaty of Maastricht introduces the euro as a common currency and limits government deficits and public debt levels to 3% and 60% of GDP respectively.
1997	Stability and Growth Pact	The Stability and Growth Pact, followed by the introduction of the Preventive Arm and the Corrective Arm, set fiscal rules designed to prevent countries in the European Union from spending beyond their means.
1998	Preventive Arm	
1999	Corrective Arm	
2005	Structural Balance	Introduction of the MTO and structural balance concepts.
2010	European Semester	The European Semester is a cycle of economic and fiscal policy coordination within the EU and it is part of the European Union's economic governance framework. During the European Semester the member states align their budgetary and economic policies with the objectives and rules agreed at the EU level.
2011	Six Pack	The six regulations aimed at strengthening the procedures to reduce public deficits and address macroeconomic imbalances.
2012	Fiscal Compact	Strengthening fiscal guidance. Euro area member states agree to make the goal of balanced budgets part of their national constitutions.
2013	Two-Pack	EU lawmakers approve legislation in which euro area member states agree to prepare their budgets according to common standards and a common timeline, submitting drafts to the Commission and each other.
2015	Communication Flexibility	Guidance on how the EC will apply the SGP rules to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth
2020	Suspension of the SGP	SGP is suspended following the Covid-crisis

Source: EC, Oxford Economics

As can be seen above, in 2015, in the Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank, making the best use of the flexibility within the existing rules of the Stability and Growth Pact (COM(2015), 12 final), of 13/1/2015, the Commission set out four reasons for flexibility in the adjustment path to reach each country's own MTO:

(1) The 'Economic Cycle' Clause: The required annual fiscal adjustment is varied so that Member States can adapt their fiscal efforts over the economic cycle while considering their fiscal consolidation needs. Therefore, the larger the positive (negative) output gap, the greater (lower) the required adjustment effort. The matrix of requirements[11] takes into account the direction in which the economy is moving, i.e., whether the economic situation is improving or deteriorating, by distinguishing whether the real GDP exceeds or falls short of a country-specific potential growth rate.

(2) The Investment clause: Member States in the preventive arm of the Pact can deviate temporarily from their MTO or adjustment path towards it to accommodate investment, provided that: their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3% deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State's Stability or Convergence Programme.[12]

(3) The Structural Reform clause: The Commission will consider the positive fiscal impact of structural reforms under the preventive arm of the Pact, provided that such reforms (i) are major, (ii) have verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are fully implemented.

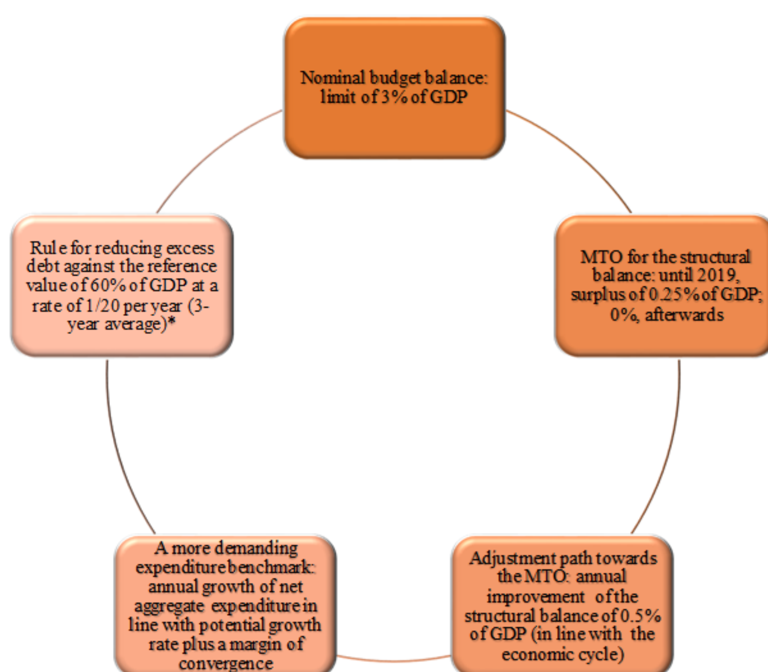
[11] Paragraph 7 of the Council Conclusions.

[12] See the components of this matrix in EC (2019, p. 17).

(4) The Extreme Events clause: temporary deviations with respect to the required fiscal adjustment towards the MTO can either be allowed ex ante or can be left out of consideration ex post, provided that they result from: i) an unusual event; ii) that is outside the control of the Member State; iii) with a major impact on the financial position of the general government; and iv) not endangering fiscal sustainability in the medium term. Typically, that clause had been considered as being intended to allow for events such as natural disasters.

As a member state of the euro area under an adjustment programme in the aftermath of the sovereign debt crisis (the so-called 'Troika' programme), between 2011 and 2014, Portugal had to meet from this date onwards specific targets in terms of its own MTOs and debt reduction trajectory. Figure 2 summarizes the applicability of the SGP to Portugal in the post-Troika period (but still under a surveillance programme) until 2019, the last year where the rules were in force in the EMU before the pandemic crisis. Specific fiscal rules were then to be met by Portugal, the assessment of which was annually made by the Portuguese Public Finance Council (the national IFI), notably in the analysis of the annual Budget drafts. [13]

Figure 2– Specific fiscal rules and trajectories applied to Portugal until 2019



*with a transitional period of three years after the end of the excessive deficit procedures in place from 2011 to 2016: minimum linear adjustment (MLSA)
Portugal was in 2019 in the last year of application of this transitional regime.

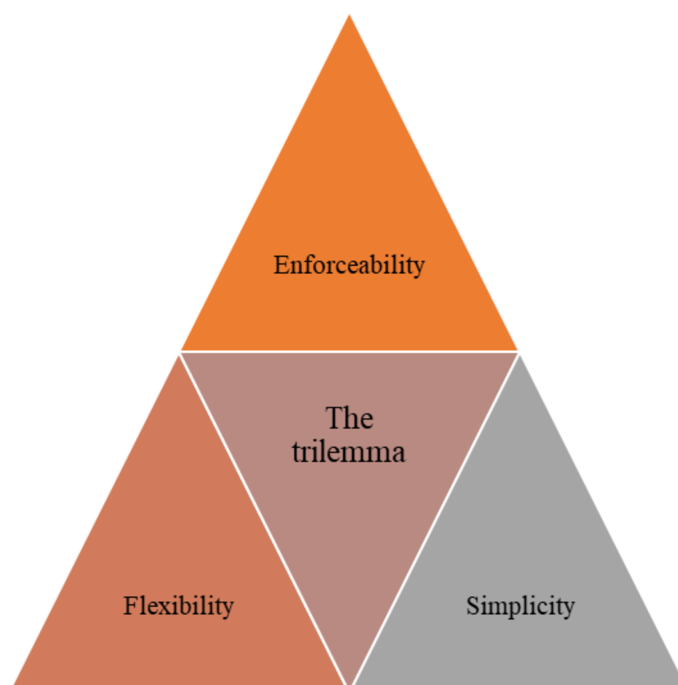
Source: Created by the author

[13] The last assessment, before the suspension of the rules, was made in the Analysis Report of the 2020 Budget (CFP, 2019).

2.2 Criticisms of the current fiscal framework

Starting from the seminal contribution of Kopits and Symansky (1998), a 'good' fiscal rule – to be discipline-inducing – has to present three main characteristics: it has to be enforceable, flexible and simple. However, as noted by Debrun and Jonung (2019), the practical applicability of fiscal rules has shown that of these three properties, only two can be simultaneously fulfilled. There is hence a trilemma in this 'good' fiscal rule set (Figure 3). Simple and enforceable rules (e.g. constitutional balance-budget requirement) tend to conflict with good economics, therefore they are inflexible. Simple and flexible rules cannot be subject to strict enforcement because flexibility implies some tolerance for sensible deviations from numerical limits. Finally, flexible and enforceable rules are complicated, because many contingencies need to be spelled out for the sake of simplicity (Debrun and Jonung, 2019).[14]

Figure 3 – The trilemma in Kopits and Szymanski's 'good' fiscal rule set



Source: Created by the author inspired by Debrun and Jonung (2019)

Against this background, several pervasive critics of the SGP's framework, especially after the reforms implemented in 2005, 2011 and 2013, were echoed both at an institutional and academic level. Some authors were even keen to conclude that the SGP had failed

[14] See also on this matter, Beetsma and Larch (2019).

(Wyplosz, 2019, p. 3). Such critics relied upon four aspects that obtained increasing consensus over the years:

(1) Complexity: the overlapping of several layers of rules as a consequence of several changes in the SGP made the system inconsistent, opaque and to a large extent ineffective. [15] Such overlapping was due to the gradual addition of new rules relying on new budgetary aggregates, that is, the gradual usage of distinct indicators that eventually led to different conclusions in the interpretation, application and assessment of those same rules.

(2) Weak enforceability and the political management 'bias' of the SGP: various flexibility clauses (supra) are applied on a regular basis and the excessive deficit procedure (EDP) has failed to be opened against countries with high debt ratios, partially due to increasing political discretion both at the Commission and Council levels in the assessment of fiscal rule compliance by the Member States. Political negotiation between governments and EU institutions superimposed over legal arguments, ultimately making some parts of the European fiscal legislation a 'dead letter'.

(3) Pro-cyclicality of the fiscal framework as a whole: although in theory the current set of rules is conducive to counter-cyclical fiscal policy (allowing for automatic stabilizers to fully operate), in practical terms estimates related to certain variables - e.g., potential output - have shown themselves to be procyclical (Darvas and Anderson, 2020, p. 19). "Such procyclicality of estimates has important implications for the structural balance rules. In an expansionary phase, the level of potential output seems higher, thereby the output gaps seem lower and the structural balance higher. (…) On the contrary, in a recession phase, the level of potential output seems lower, thereby the output gap higher and the structural balance lower. This induces more fiscal consolidation than the fiscal consolidation requirement would be in the absence of pro-cyclical estimates" (Darvas and Anderson, 2020, p. 20). The estimation of potential growth is therefore extremely sensitive to the estimation of real GDP, which in turn affects the estimation of the output gap and the calculation of the structural balance. [16]

(4) The (excessive) reliance of the fiscal framework on unobserved variables (e.g., potential output, output gap, non-accelerating wage rate of unemployment - NAWRU[17]), which are subject to great uncertainty and estimation revision (as seen above), undermining the suitability of real-time fiscal decision making (Darvas and Anderson, 2020, p. 18).

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[15] Blanchard *et al.* (2021, p. 15) compare the current architecture of EU fiscal rules with that of the Cathedral of Avila (which over the centuries suffered the addition of new building blocks of different types and styles): "The original structure is still recognizable, but many additions make it hard to see the consistency of the whole".

[16] The same authors provide an example of such revision, which took place in the aftermath of the pandemic crisis. 2019 had been a year of expansion, while 2020 turned out to be one of (major) recession. The 2018 level of potential output was estimated to be significantly larger in 2019 than the estimate made in 2020 (*Ibidem,* p. 19). Moreover, as noted by Francová *et al.* (2021, p. 7), potential output could be underestimated because standard measures cannot capture an increasing share of intangibles or, conversely, overestimated by any failure to account correctly for capital stock obsolescence, especially after large shocks or recessions.

[17] Used to compute the 'cyclical component of unemployment benefit' relevant for defining the 'net aggregate expenditure' within the expenditure benchmark (see *supra*).

3 The main ingredients of the reforming proposal of the Commission

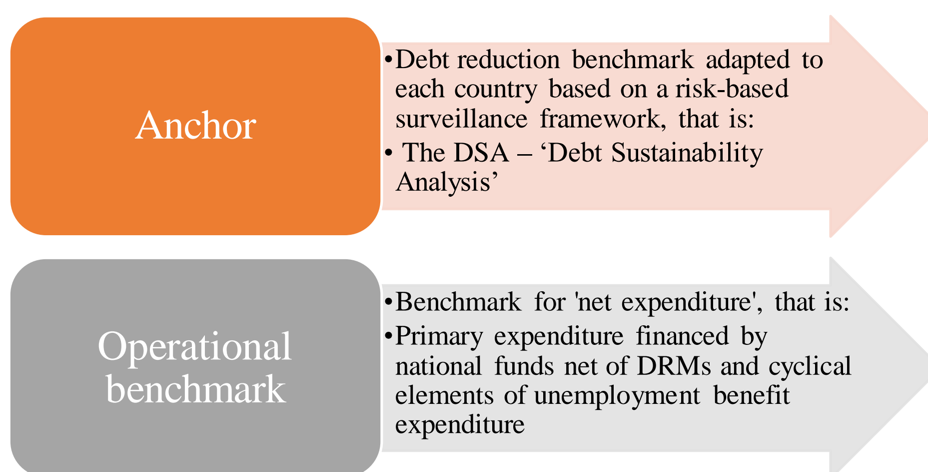
3.1 Description of the new legal elements of the reforming proposal - the revised preventive and corrective arms of the Stability and Growth Pact

In the various proposals to revise the SGP' framework, we can find convergence in the diagnosis of the mal-functioning of the current framework and convergence around some of the basic features of the reform to be implemented. This convergence is well captured by Beestma and Larch (2019). The new rules should: i) be transparent and simple; ii) target the fiscal indicators directly under the government's control; iii) allow for countercyclical fiscal stabilization and; iv) offer an escape when a very large shock hits the economy. In this sense, "a combination of government debt as the long-term anchor and a cap on net expenditure growth as the operational rule to move toward the anchor is generally considered to satisfy these conditions" (Beestma and Larch, 2019).

As mentioned in the Introduction, one of the cornerstones of the legislative proposal presented by the Commission in April of 2023 is indeed the idea that fiscal adjustment should rely on a single operational rule anchored on debt sustainability (Figure 4). Moreover, it can be seen that this proposal conforms to Blanchard's view – even if combined with other proposals and contributions[18] - on how fiscal framework reform should be designed. Indeed, Blanchard, Leandro and Zettelmeyer (2021) had proposed "the abandonment of fiscal rules in favour of fiscal standards, that is, qualitative prescriptions that leave room for judgement together with a process to decide whether the standards are met. Central to this process would be country-specific assessments using stochastic debt sustainability analysis, led by national independent fiscal councils and/or the European Commission. Disputes between member states and the European Commission on application of the standards should preferably be adjudicated by an independent institution, such as the European Court of Justice (or a specialized chamber), rather than by the Council of the EU."

[18] See e.g. Andrle et al. (2015), Beetsma *et al.* (2018), Feld *et al.* (2018), Beuve *et al.* (2019), Debrun and Jonung (2019), Wyplosz (2019), Darvas and Anderson (2020), Thygesen *et al.* (2020), D'Amico *et al.* (2022), Debrun and Reuter (2022) and IMF (2022). For a brief description of these and other proposals, and of their main ingredients, see also Dullien *et al.* (2021), Francová *et al.* (2021) and Maduro *et al.* (2021). D'Amico *et al.* (2022), for example, propose setting a ceiling on the growth rate of primary spending, with the ceiling revised over intervals of three years. Such a growth rate is chosen so that, if following a ten-year horizon, under realistic macroeconomic scenarios, it would yield a reduction in the debt-to-GDP ratio (according to the debt target). The innovative point in this proposal resides in splitting such a debt-to-GDP ratio into two parts, the fast-adjusting and the slow-adjusting portions of debt, and assuming different speeds of adjustment to the two parts. Slow-adjusting debt includes both debt accumulated in response to 'crises' defined as the periods when the EU general escape clause is active and deficits are needed to mitigate the adverse effects of large recessions and debt accumulated to finance 'spending for the future', which includes productive public investment and expenditure related to the provision of European public goods that will benefit future generations. The fast-adjusting portion of debt is the residual stock of debt (the speed of adjustment being faster in this case).

Figure 4– The two blocks of the fiscal framework proposed by the Commission



Source: Created by the author

The Commission's legislative proposal includes three elements:

(1) A new Regulation of the European Parliament and the Council on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97 (preventive arm of the SGP): [19]

- The announced end of stability programmes and their replacement by "national medium-term fiscal-structural plans";
- These plans are based on 'prior guidance' by the Commission which includes (for countries with a nominal deficit > 3% of GDP or Debt > 60% of GDP) a 'technical trajectory' for net expenditure and the corresponding structural primary balance. [20] Plans are assessed by the Commission and endorsed by the Council;
- The plan has a duration of four years and can be extended for another three if countries wish to implement a set of reforms or investments that support debt sustainability and are in line with common EU priorities (e.g., Energy and Climate Plans and National Digital Decade Roadmaps). Despite the multiannual nature of these plans, the follow up of the respective implementation will be made on an

[19] COM (2023) 240 final, of 26.4.2023.

[20] The technical trajectory must ensure the expenditure adjustment effort places the public debt on a 'plausibly' downward path or that it maintains it at 'prudent' levels. Annex V to the proposal explains that the debt will be reduced or will remain at prudent levels according to the deterministic scenarios contained in the 2022 Debt Sustainability Monitor. Assumptions to the 'No-Policy Change' (NPC) central scenario regarding GDP growth rate, inflation rate, interest rate, primary balance incorporating rising costs of ageing in line with the Ageing Report (see in this regard, EC, 2021)

annual basis through progress reports monitored by the EC and involving assessment by national IFIs.

(2) A Council Regulation amending Regulation 1467/97 on speeding up and clarifying the implementation of the Excessive Deficit Procedure (corrective arm of the SGP): [21]

- When based on the debt criterion, this procedure will be activated whenever a country with debt exceeding 60% of GDP deviates from the multi-year trajectory of net expenditure previously agreed in the adjustment plan endorsed by the Council.

(3) A Council Directive amending Directive 85/2011/EU on requirements for budgetary frameworks of the Member States: [22]

- Strengthens the role of the IFIs not only in the field of macroeconomic projections, but also in the field of budgetary projections;
- Includes rules to improve the quality of spending in line with the EU's new priorities (e.g., digital and energy transitions).

3.2 Critical view of the major changes behind the proposal

3.2.1 Insufficient resolution of the caveats found in the current set of fiscal rules

Let me check whether the abovementioned criticisms concerning the current set of SGP rules have been overcome with the Commission's proposal. [23]

Firstly, regarding the criticism of complexity, although one main objective of the current reform is to simplify the system making it to rely on one single anchor and on one single operational rule (recall Figure 1) – therefore clearing it from having several rules for several fiscal aggregates within the current framework – the fact is that such a simplification should not be taken for granted. In fact, the two nominal rules of the TFUE (the 3% of GDP for budget deficit limit and the 60% of GDP for debt limit) have not been abandoned and references to the structural balance and structural primary balance remain in the proposal (see Article 2 of the proposal for the Regulation related to the SGP's preventive arm). As such, there is not just one single anchor and one single operational rule… Moreover, on technical grounds, the fiscal adjustment effort contained in the "national medium-term fiscal-structural plans" departs from a DSA which in turn relies on 10-year NPC projections, among other variables, for (nominal) primary balance (including the projected costs associated with the ageing of population), which is another variable, and another rule… The idea of deriving an expenditure benchmark (i.e., a medium-term growth rate of expenditure) from this DSA and from this projected primary balance in the medium run, in order to ensure debt follows a reduction trajectory (and to ensure its sustainability), is also very problematic both in technical and in political terms. Finally, this exercise seems difficult to communicate to the public and risks being

[21] COM (2023) 241 final, of 26.4.2023.
[22] COM (2023) 242 final, of 26.4.2023.

[23] See Wyplosz (2023).

even more technocratic (i.e., to be dealt with only by the services of the Commission in close alignment with the technical departments of national governments) and so less transparent.

Secondly, regarding the critic of weak enforceability and the political management 'bias' of the SGP, the proposed framework not only does not overcome these deficiencies but it may even increase them. In fact,

i) The new framework relies more on standards – each country will have its own path to reduce the new aggregate of net expenditure ensuring a descending trajectory of the debt ratio and/or its stabilization (prudent levels) – than on strict numerical common rules. In particular, there is no clear common quantitative benchmark with respect to the annual debt ratio reduction for highly indebted countries as is the case in the current framework (it should be recalled that a reduction of 1/20 each year for the amount of debt in excess in relation to the 60% limit).
ii) The new framework relies too much on political negotiation between (individual) Member States, the Commission and the Council both during the stage of implementation of the plan (e.g. through the so-called 'technical dialogue' between the Commission and the Member State – cf. Article 10 of the new Regulation on the preventive arm – and through the 'endorsement' of the national plans by the Council and the possibility of making recommendations to the Member State involving some discretion and political negotiation) and in its implementation, including the possibility of revision before the end of the plan's medium-term horizon (cf. Article 14). For example, in case of a change of government (after elections), the new administration can request such a revision, which although justified on democratic terms, can have disturbing effects on the attainment of fiscal consolidation objectives contained in the plan. This political management throughout the entire period of adoption and implementation of the plan also results from the nature of the framework itself, relying more on fiscal standards than on true fiscal rules and given its stronger embodiment within the national reality of each Member State (to be detailed later).
iii) Despite the inclusion of instruments for assessment and control during the execution of the plan by the Commission itself and by the national IFIs - during the stage of the presentation of annual progress reports by national governments – the fact is that the proposed assessment system seems weakly anchored with regard to the timeliness, the effectiveness and even the feasibility of such an assessment. In fact, at this annual stage, the assessment refers to the net expenditure path (see Articles 21 and 22) but the most relevant verification – to check the debt to GDP trajectory to monitor if it is kept on a sustainable path – is only made at the end of the plan's implementation (that is, after four or even seven years, in the event of an extension requested by the Member State). This might be too late (see remarks in Box 1). Moreover, upward deviations from the net expenditure path are allowed by this system provided they are compensated for in the year(s) ahead with downward deviations in order to ensure that at the end of the adjustment period the net expenditure path is attained. Such annual deviations will be registered by the Commission in a 'control account' to be analysed by the IFI: will this be feasible on technical grounds? (the flow of information between these institutions, and between them and national governments has to be smooth and complete, and this uses to be problematic).

Box 1– Debt dynamics as a (not always pleasant) surprise package

> It should be noted that the proposed framework assumes, from an operational point of view, that the sustainability of debt mostly depends on the variable that is most controllable by the government, which is the budget balance and, within it, public expenditure. The fact is that debt dynamics result from the interaction of multiple variables – growth rate, inflation, interests and 'residuals' (e.g., captured by the so-called stock-flow adjustment term) - that feedback into the process. The public debt market is subject to multiple equilibria and to volatility: the change in the 'market sentiment' is due to the aforementioned 'fundamentals' but also to reputational factors (e.g. credibility of fiscal institutions and rules), the interaction between fiscal policy and other policies (e.g. public policies, structural reforms, monetary policy), interaction between the internal account (the budget balance) and the external account (the Balance of Payments), and to 'animal spirits' (that contribute to booms and busts and to self-fulfilling prophecies).

Finally, regarding the two previously mentioned latter criticisms of the current SGP's framework - pro-cyclicality of the fiscal framework as a whole and the (excessive) reliance of the fiscal framework on unobserved variables – the new proposal relies, as seen, on a new operational benchmark (the net expenditure benchmark) which seems to offer a better fit for stabilization purposes. Indeed, previous research showed that expenditure growth rules, apart from their greater transparency, are more adapted than nominal balance and even structural balance rules to ensure macroeconomic stabilization, that is, to ensure a greater degree of counter-cyclicality, notably by benefitting from the role of automatic stabilizers (see Andrle at al. 2015, p. 13 ss.). On the other hand, a source of concern is how to link this goal of macroeconomic stabilization to the medium to long-term objective of debt sustainability. In this regard, Carnot (2014) showed that a rule targeting primary expenditure growth (adjusted for discretionary revenue measures) relative to trend output growth can strike a good balance between long-term sustainability and short-term stabilization objectives, while still being tractable. Indeed, although expenditure growth rules are not directly linked to the debt-sustainability objective (since they do not directly constrain the revenue side), they can trigger a required fiscal consolidation consistent with fiscal sustainability when they are accompanied with a debt brake - yet such a debt brake makes the system more complex again and more difficult to communicate to the public (Andrle at al. 2015, p. 13).

The two elements of the proposed framework take into due consideration these, and other previous simulations made in this domain. However, it is not sure that the idea to set a technical trajectory for net expenditure growth over a consolidation period of four years will provide clear guidance for proper management of expenditure throughout the cycle in order to ensure e.g. the creation of buffers in the good moments of the cycle (anti-cyclical management in periods of economic growth), including, for highly indebted countries, a solid reduction of the debt-to-GDP ratio in those good moments. Moreover, the fiscal consolidation strategy to be followed is not clear even if the national plan starts to be implemented in a good moment of the cycle. In particular, it is not clear whether the strategy should be more front-loaded or if it can be softened in the initial years of implementation to eventually become a back-loaded, and therefore a riskier, trajectory from a debt reduction point of view. The new 'control account' for annual deviations from the net expenditure trajectory can indeed have this counterproductive effect of being an antechamber for myopic or opportunistic expenditure management more in line with the political than with the economic cycle.

Other loopholes of the Commission proposal relate to the technical design of the operational system itself. In fact, it is not certain that criticisms made of the current SGP system – the excessive reliance on non-observed variables – are overcome in the new framework. In particular, practical problems of implementation and assessment denoted with respect to the existing expenditure benchmark due to its high complexity and excessive reliance on non-observed variables (see Marinheiro, 2021) do not seem to have been fully addressed. [24] In turn, the proposal, although intending to reduce the framework to a single operational indicator - the net expenditure growth – does not abdicate (as seen previously) from other indicators, e.g. the primary structural balance, which makes it prone to similar inconsistencies between these two indicators, as already denoted within the current system (see Marinheiro, 2021). Moreover, the governmental justification for the extension of the adjustment period (from four to at most seven years) based on the need to implement reforms and investments does not (yet) seen sufficiently detailed, front-loaded, time-bound and verifiable, as advocated by the European Central Bank (ECB). [25]

3.2.2 The 'political economy' of the Commission's proposal: the risk of ruling out Member States fiscal policies

Fiscal standards instead of fiscal rules / Discretion rather than rules

The economic governance framework is a winding and sensitive terrain. The legislative proposal analysed here has not only to rely on good technical support but also implies previous political negotiation with other institutions (e.g., the European Parliament) and the Member States to be accepted in the first place. The Council position presented on March 2023, albeit expressing a general acceptance of the main objectives of the reform (recall Figure 1) has also lifted the veil on points of contention, including the appropriateness and design of common quantitative benchmarks to support the reformed framework. Resistance from Member States regarding a reform of economic/fiscal governance remains strong, although for different reasons (Beetsma and Larch, 2019, p. 10). Indeed, "there are those who very much appreciate the adaptability of the rules and the political approach taken over the years to their implementation. Others see a reform of the SGP as highly risky with no guarantee of coming up with a better framework; they have a strong preference for simply implementing rules with greater determination and less politics" (Beetsma and Larch, 2019, p. 10).

The new framework – with a focus on national ownership and flexibility - has been advocated by France (representing some Southern countries, also most indebted countries) but has raised resistance from frugal countries, who fear governments would enjoy excessive discretion to rein in their public finances. Germany, in particular, did (does) not wish to abdicate from numerical fiscal rules, notably a benchmark based on debt that would impose a debt reduction at a pace ranging between 0.5% and 1% every

[24] As seen previously, the adopted concept of net expenditure still excludes the cyclical component of the unemployment expenditure, which involves computing a non-observed variable, e.g. NAWRU or similar.

[25] Opinion issued by the ECB on 5 July 2023, on the proposal for economic governance reform in the Union (CON/2023/20).

year, with a possible exemption in times of recession. [26] In view of this, last June 2023, on a joint opinion piece firstly published in the German newspaper Die Welt, Germany's Minister of Finance together with other EU finance ministers (Czechia, Austria, Bulgaria, Denmark, Croatia, Slovenia, Lithuania, Latvia, Estonia and Luxembourg) submitted various comments to the Commission legislative proposal under discussion. Although recognizing the advantages of moving towards a greater medium-term focus on budgetary policymaking, the proposal entailed the risk of postponing the fiscal adjustments required in the present. A subtle criticism of the Commission was also lifted: "As the guardian of the EU treaties, the European Commission has an essential role to play in terms of fiscal surveillance. But it must have clear guidelines and jointly defined and verifiable targets". [27]

These countries are clearly reluctant to shift from a rule-based system, based on objective and numerical rules (as, despite all its flaws, the current system is), to a standard more vague model, furthermore relying on undetermined concepts,[28] opening the door to more policy discretion and possibly hindering assessment and control (including judicial control). In the case of Germany, this position is grounded in its own ordoliberal tradition, which is based on well-known ingredients (see Brunnermeier et al. 2016 and Beck and Kotz (eds.), 2017), such as: i) a strict approach to government debt and to debt ceilings; ii) a strong emphasis on accountability and responsibility; iii) a belief that formal or binding rules can shield monetary policy from fiscal dominance. In turn, from a political science perspective, it can be said that Germany's preferences, regarding the type of fiscal policy integration, are based on the idea of 'supranational control of national capacities' (Schoeller and Karlsson, 2021, p. 199) instead of European 'capacity building' (Howarth and Schild, 2021, pp. 210-211). Such a view also anchors the legal provisions of the TFEU (in particular, Article 126) where the exercise of political powers by the EU in the fiscal domain is made by means of 'regulation' instead of 'capacity'.[29] The point is whether the Commission's proposal opens space for more political discretion

[26] Source: https://www.euronews.com/my-europe/2023/04/11/fiscal-rules-germany-wants-binding-debt-reduction-targets-for-eu-countries.

[27] See the full joint opinion here https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Press_Room/Namensartikel/2023-06-15-reform-of-europes-fiscal-rules.html.

[28] For example, Article 6 (a) of the new Regulation on the Preventive Arm of the SGP states that debt is put and remains on a 'plausibly' downward path or should stay at 'prudent' levels. As can be seen, both 'plausible' and 'prudent' are in their essence vague concepts and even the clarification that is provided in Annex V to the Regulation is not sufficient to overcome that ambiguity. In fact, it is mentioned here that the methodology for the assessment of plausibility is based on the condition that public debt ratio should be declining or staying at 'prudent' levels under the deterministic scenarios of the Commission's medium-term public debt projection framework described in the Debt Sustainability Monitor 2022. No additional specification, notably on numerical grounds, is given.

[29] For a distinction between the institutional design of powers in the EU – regulation versus capacity – see Freudlsperger and Jachtenfuchs (2021), also analysing the change in the strategy followed by Germany during the pandemic crisis - the (partial) shift from a regulation approach to a capacity-building approach that culminated in the agreement given by Germany to the new and huge financial support package created in 2020, *The Next Generation EU*. The significance, from a political point of view, of this shift of Germany's position vis-à-vis this new redistributive transfer has been analysed by several authors (discussing whether that meant a change in Germany's preferences or just a change in strategy): see Ladi and Tsarouhas (2020), Ferrera, Miró and Ronchi (2021), Howarth and Quaglia (2021), Howarth and Schild (2021), Miró (2021), Schoeller and Karlsson (2021), Freudlsperger and Jachtenfuchs (2021), Schelkle (2021, 2022) and Alexander-Shaw *et al.* (2022).

(instead of rules) through flexibility mechanisms (as idiosyncratic national consolidation plans are in first place) and of political negotiation between each State and the Commission and between Member States at the Council to the detriment of legal enforcement and strict compliance.

Decentralization versus centralization of budgetary restraint instruments

Besides this tension between two intellectual traditions – the 'German' versus the 'French' – opposing a rules-based system to a standard-based (more flexible) one (and which also means contrasting different perspectives of the EU political powers in the fiscal domain – a 'regulation' versus a 'capacity-building' approach), the tension also relies on this other shift from 'centralization' (at the EU level) to 'decentralization' (at the Member State level) of regulatory powers. Indeed, the idea of enhancing 'national ownership' of budgetary restraint instruments points precisely to that decentralization. With this Commission's proposal for a new economic governance framework with the DSA being a sort of starting-off point, it seems the EMU is moving to a more decentralized model of ex ante hard budget constraints within the national ownership of fiscal discipline devices, which somehow tends to offset the centralized and very stark model of ex post hard budget constraints resulting from the Treaty with its 'non-bailout clause' (Article 125 of the TFUE). The idea of assigning Member States with the responsibility of adopting 'national medium-term fiscal-structural plans' based on their own projected debt paths is thus justified by the need to balance, in the right dose, the decentralization and centralization of hard budget constraints, and to calibrate better national policy flexibility with self-responsibility.

A source of concern, especially for those countries with an historical record of weak compliance and weak enforceability of fiscal rules is to know whether this national ownership-based framework will open the door, once again, to a more lenient attitude towards fiscal discipline. In turn, the enclosed possibility of revising the consolidation fiscal plan during the adjustment trajectory may also affect the medium-term perspective and induce a deviation towards short-term interests, including the electoral interests of the national government in question. Government changes along the plan's course may also have disturbing effects on the accomplishment of its objectives. Moreover, spillover effects to other Member States from this possible increased leniency should not be neglected.

Independent Fiscal Institutions: Do we like them or not?

Instruments of budgetary restraint can be of two sorts – numerical (the case of fiscal rules) or formal (or institutional). The latter relate to budgetary procedures that usually enclose a conventional system of 'checks and balances' co-natural to democratic regimes (e.g. the surveillance role of the Parliament throughout the budget process, including the political opposition role, or the control powers of an independent court of auditors), but can also include the intervention of technical institutions, especially independent ones monitoring fiscal policy and informing the public about the short to the long-run impacts of that policy (respectively, impacts on the budget balance and debt sustainability).[30] In particular, with their action, IFIs contribute to limit the fiscal policy implementation

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[30] See on this issue, the collective Ebook, Beetsma and Debrun (eds.), 2018.

deficit bias, mainly when such bias is due to partisan opportunism associated with the political-electoral cycle. In Europe, most of the national Independent Fiscal Institutions (IFIs) were created in the aftermath of the Great Financial Crisis and were assigned the role of scrutinizing fiscal rules compliance by the respective Member State and to produce or endorse macroeconomic projections underlying the two main elements of the national budgetary process – the stability programme and the budget draft. These national fiscal institutions, despite their different nature, size and specific tasks (Axioglou et al., 2023), pursue common basic principles with firstly, the very idea of independence (e.g., from political powers), and secondly the promotion of transparency in public finances. Transparency (timely disclosure of information about macroeconomic and fiscal aggregates) contributes towards enhancing the quality of fiscal policy and of public policies in general. Rivlin (2013) adequately identifies such a core function, stating that IFIs "can play an important role in ensuring realistic and well-informed debate based on honest numbers, focusing attention on the consequences of action (or inaction), and identifying more or less sustainable solutions to budget dilemmas. They cannot instil political courage to make unpopular decisions. Political leaders have to do that for themselves" (p. 20). Although IFIs are not directly engaged in the democratic process, one can say they contribute to improving democracy, favouring more informed citizens' choices, whenever the latter have to vote for a certain political programme or candidate.

Even if of a different nature, these two instruments of budgetary restraint – fiscal rules and IFIs – go hand in hand (Wyplosz, 2018, p. 35). They complement each other and this combination is likely to lead to improvements over time. "Good councils[31] will learn how to better interpret the rules and to suggest improvements. Good rules will make the task of councils easier to perform and less controversial than poorly designed or weak rules. The complementarity goes even further as it also concerns design. Rules and councils ought to be fully compatible lest both are undermined. A poorly designed rule stands to unduly constrain the council if the latter is required to support inadequate policies. Conversely, councils need to have as complete information as the government does about the state of the economy, if they are to be able to evaluate policy decisions and, when needed, to call for the application of an escape clause. Consequently, the rules must be designed so as to make it feasible for councils to determine whether the rule has been obeyed and whether invoking an escape clause is justified" (Wyplosz, 2018, p. 35). This latter remark is important. In my view, a rule is well-designed if it is understandable, objective (avoiding indeterminacy and vagueness), binding (sanctions applied) and controllable.

In the Commission's proposal[32] we find an increased role for national IFIs both at the design and implementation stages of the national medium-term fiscal-structural plans. Indeed, IFIs are here assigned new tasks, such as: (a) producing annual and multiannual budgetary forecasts (besides the macroeconomic projections they already do) or endorsing those used by the budgetary authorities; (b) producing debt sustainability assessments underlying the government's medium-term planning or endorsing those provided by the budgetary authorities; (c) producing assessments on the impacts of fiscal sustainability policies and sustainable and inclusive growth or endorsing those provided by the budgetary authorities. This proposal – from the point of view of national governments – has most likely gone too far. In fact, as noted by Beetsma (2023), "in its

[31] Fiscal councils and parliamentary budgetary offices (PBOs) are the two main categories of IFIs.
[32] In particular, the proposal of amending Directive 85/2011/EU.

Conclusions of 14 March 2023 the Ecofin Council has shown itself less than enthusiastic about enhancing the IFIs' role in the revised governance framework, by writing 'IFIs should not play a role in the design phase of the national plans'". The Commission has strategically overstepped the mark so that it could have space to pull back during the negotiations and reach a reasonable deal with the Council.

This is the moment of truth for the EU and for national governments: do they like IFIs or not? The effectiveness of IFIs in the improvement of fiscal discipline has been already shown (Beestma et al., 2019). However, several governments (starting with their Ministers of Finance) maintain a certain reluctance and mistrust towards their existence and increasing role within the EU fiscal/budget framework. To some extent, this attitude is understandable: IFIs are often an unpleasant voice bringing bad news. As 'fiscal watchdogs' they have to bark and sometimes they bark too loudly. However, this lack of support from governments may eventually be counterproductive. As noted by Beetsma (2023), "the current situation resembles the payoffs of a prisoner's dilemma. The government of some Member State X may prefer to weaken the role of its own IFI, but it benefits from a strong role of IFIs in other Member States, because this leads to better fiscal policies elsewhere with more benign cross-border spill-over effects (such as reduced threats of a sovereign debt crisis). Hence, collectively, governments would all be better off with a set of IFIs with strong roles throughout the EU than with each IFI having a weak role." This is especially the case with countries traditionally more fiscally disciplined – e.g., the case, as seen, of Germany. Usually, some of these countries do not invest in IFIs as much as highly indebted countries do (e.g., the case of Portugal, Spain and Italy), probably because they assume this is not necessary – they comply with (fiscal) rules anyway. "However, this seems a miscalculation of these countries' own interests, because they benefit from responsible foreign fiscal policies that avoid negative cross-border spillover effects. By giving their own IFI a strong role, they set a good example for countries with less disciplined fiscal policies" (Beetsma, 2023). Moreover, compliance with fiscal rules is clearly associated with the quality of governance. Larch et al. (2023) show that a higher compliance score tends to be associated with a longer tradition of national IFIs. [33] Countries that set watchdogs before 2011 when the Six Pack reform of the SGP introduced elements of independent scrutiny in the EU fiscal framework have a compliance score that is on average 20 percentage points higher than countries with later watchdogs (Larch et al., 2023, p. 39).

Against this background, some remaining questions and doubts have to be addressed concerning the final design of the new framework as far as national IFIs are concerned:

i) It is critical for the quality of the job of IFIs to rely on a solid set of fiscal rules – simple, objective and controllable. As seen, the subsistence of vague and indeterminate concepts in the present proposal – such as 'prudent' levels of debt – not based on any numerical benchmark can limit the effectiveness of the work of the IFIs and can be a source of conflict between them and Member States and/or the Commission. A model based more on fiscal standards than on fiscal rules may indeed put into jeopardy the utility and raison d´être of IFIs;
ii) At a more technical level, IFIs should be given all the conditions required to undertake their own DSAs, whether deterministic scenarios or stochastic projections, to confront the official ones and to better anchor their future

[33] The case of the Netherlands, Denmark, Luxembourg and Sweden.

assessment. To achieve that, it is fundamental to have access to information, data, code files, assumptions and qualification criteria, not only from the Government but also from the Commission, in order to also obtain a proper understanding of the national plan and the respective consistency with the required reduction of debt level during the period being covered.

Counter-cyclical versus pro-cyclical policies in the presence of budgetary restraints

It should be remembered that one of the reasons justifying the revision of the EU fiscal framework was that the current SGP rules had not been able to avoid pro-cyclicality despite the previous reforms that had intended to make it conform more with the economic cycle. Larch et al. (2020) analyse this point recalling, firstly, the findings of previous research showing that fiscal policy tends to be pro-cyclical, i.e., expansionary in good times and restrictive in bad times. The reasons for such a result are different: in good times, it can be explained by policymakers' preference to magnanimously help with tax cuts, staying away from unpopular tax increases and expenditure cuts. In bad times, the drivers are different and this counteracts the usual deficit bias: fiscal tightening in downturns is not only politically difficult to implement, but it is also less likely in the presence of expenditure rigidities (Larch et al. 2020). However, the presence of a high-debt level tends to limit the counter-cyclical capacity of the fiscal policy and the long-term (in)sustainability of debt works as a fundamental constraint (ibidem).

The capacity of running countercyclical policies in bad times, supporting the economy, is linked to this intertemporal budget constraint. Debt is sustainable when its ratio to the GDP is below (let me call that way) the 'limit of tolerance by country creditors'. This limit is very different from country to country, it has reputational bases and it is related to country's historical record of fiscal adjustment (Ostry et al., 2010). The larger the difference between the current level of debt and that idiosyncratic limit, the larger the country's fiscal space will be, that is, the capacity of the government to improve the primary balance as a response to an increase in the debt servicing in order to bring the debt ratio down or to stabilize it at a reasonable level (Ostry et al., 2010).[34] On the other hand, fiscal fatigue (when the fiscal space is none or very small) is linked to an 'explosive' debt dynamics, which occurs when that limit of tolerance is passed. In these cases, despite the Government's final effort to reduce primary deficits (e.g. through 'austerity' measures), such effort will not be effective anymore in avoiding a very strong downgrading from the market, leading to an increase in the country's risk premium, making interest rates reach unbearable levels and eventually cutting access to financing. Ultimately, the country can default on its debt.

The capacity to run anti-cyclical policies is linked to debt sustainability in two ways: i) Debt sustainability is a necessary but not sufficient condition to be able to deploy counter-cyclical policies in bad moments of the cycle: if the country's fiscal space is small, the Government will be focused on adopting pro-cyclical measures (fiscal adjustment) in order to stabilize the debt ratio and avoiding debt dynamics becoming explosive; ii) The further the debt is from unsustainability (i.e. the greater fiscal space is), the greater the capacity to increase it in bad times, because public finances are controllable and can even be shielded by certain buffers or reserves (which therefore amplify the Government's 'room for manoeuvre'). Only when this happens can we find the capacity to adopt

[34] For different concepts of debt sustainability, see Bouabdallah *et al.* (2017).

discretionary anti-cyclical measures in these bad moments in the cycle. The creation of these buffers (that can be of different sort, e.g., typical 'rainy day' funds, liquidity reserves, strategic investment funds relying in expenditure with high multipliers, etc.) is a precautionary policy strategy which is very difficult to reach (in the first place, for political reasons) and that requires the tasks involving warning to prevent distraction and a certain level of pedagogy against possible myopic attitudes both from political leaders and the public.

Again, instruments of budgetary restraint – fiscal rules complemented by IFIs – can play a role in this matter. Larch et al. (2020) show that deviations from fiscal rules and the accumulation of government debt foster pro-cyclical fiscal policies. Moreover, the likelihood of a pro-cyclical fiscal stance increases exponentially with the debt to GGDP ratio. In this regard, more important than the nature and strength of the rule is the degree of compliance. Responsible fiscal behaviour is not a matter of finding the optimal design of rules. The interplay between ownership, discipline and enforcement play an important role (Larch et al., 2020). Of course, a well-designed fiscal rule (understandable, objective, binding and controllable) eases the work, but the 'fiscal discipline tradition' also relies on non-written law and civic culture.

Flaws in the compliance of fiscal rules by certain Member States within the current EU framework (see the same research work of Larch et al. 2020) do not offer perspectives as good as the proposed new framework. Standards instead of rules (if deprived of any sort of numerical operational benchmark) seem even weaker and less binding (see Box 2).

Box 2– Fiscal rules, a territory of 'timid law' (with weak enforceability)

Within a certain State (or constituency), fiscal rules are most of the times 'timid law' with weak enforceability, for the following reasons: i) they are self-imposed (the state or the government 'ties its own hands') and so they can be more easily lifted, especially when they are based on ordinary legislation or regulations that can be easily modified (it is not the same if it is the Constitution, but it is troublesome to set numerical rules within a Constitution); ii) it seems difficult for a Court to control compliance with the rule, because these rules tend to rely on economic concepts which are difficult to access from a strictly legal basis and because they usually also have attached escape clauses or exceptions as well as being dependent on fluid economic factors (as seen above, these are flexibility clauses); iii) this is hence very much 'shifting ground' from a legal point of view, where it is moreover difficult for a court to decide on the applicability of sanctions, e.g. fines, which depend on the gross fault of the liable entity/body/person, and in the first place it is difficult to determine whether this involves individual or collective fault (of the entire government?, of the prime-minister?, of the minister of finance?, even (!) of the opposition when this results from its action?); iv) other types of sanctions besides financial sanctions seem difficult to judicially apply due to the very economic fluidity of the rule, which moreover is subject to varying conditioning in its applicability. The ultimate effective sanction to be applied to a non-compliant government is its resignation, but this type of sanction operates in the political arena, not in the judicial one – at a certain point, electors will decide if and how that fault can be considered serious political misconduct or not, in renewing the term of that government. Once again, electors' preferences play a role (e.g., accepting more expenditure in a certain area even if this is to the detriment of the budget deficit) as well as the abovementioned 'tradition of fiscal discipline' of the country (or the lack of this).

It should be recalled than in the relationship between different levels of government (as is the relation between Member States and the EU) fiscal rules can work out as hard budget constraints whenever their compliance is linked to financial sanctions applied by the top-level or supra-national government to the intermediate or 'national' level (e.g. fines and/or suspension of financial transfers or grants). The SGP's corrective arm relies on this 'philosophy'. The Commission proposal also revises' this corrective arm, aiming at speeding up and clarifying the implementation of the excessive deficit procedure (EDP). However, it is not clear if the historical political bias of the EDP (because this is more dependent on political negotiation than on strict legal/technical reasoning) will be overcome with the current new set of rules. The more these rules are evasive in their formulation the more difficult it will be to ensure their legal effectiveness and control (including judicial review).

For all these reasons, what seems more important now is to reinforce the role of IFIs not only to promote strict debt sustainability but also for macro stabilization purposes – even if their tasks will not be easier on technical grounds due to a certain vagueness of the proposed 'standard-based system'. This is the case for the following reasons:

i) National ownership – in fact, the leading objective of this reform – requires acknowledgement of national specificities (e.g., the economy, the functioning of the government and the public administration of the country): the technocratic view of a national IFI is more nationally embedded and can thus be more sensitive to the national reality than a technical assessment made elsewhere;
ii) IFIs can, through their pedagogical efforts with citizens, contribute to cementing a national 'tradition of fiscal discipline' fostering compliance with (national) fiscal rules even if they risk being timid rules in their enforceability. Moreover, IFIs can provide technical support or guidance for the definition/modification of national fiscal rules (enclosed in internal legislation) that should be not only well-designed but also well adapted to the new EU fiscal framework;
iii) IFIs are not Courts and therefore they do not have competence to make rules enforceable, through applying sanctions in case of non-compliance. Moreover, they are deprived of democratic legitimacy (in the sense their members are not elected) , and they cannot be considered, in any circumstance, either a form of political power or a sovereign body. The relationship with sovereign bodies (the Parliament, the Government and Courts) is always an unequal one: they cannot superimpose their views over those of these bodies. Ultimately, the latter are the ones who decide. For this very reason, IFIs do not produce normative acts of any sort (including instruments of soft law – such as communications and certain resolutions). The standard act they produce are 'opinions' (which are never binding in the legal sense). Therefore, pressure upon decision-makers can only be made through atypical mechanisms, the effectiveness of which depends on the technical quality of the opinion that is issued and on the credibility of the institution that produces such an opinion. The 'reputation-building' is the most challenging and critical job an IFI has to do in order to be appreciated and respected by policymakers and by the public. Those atypical mechanisms (principles) that help IFIs' voice to be heard and acknowledged are the following: a) The 'name and shame' principle – accusing someone (a public entity or publicly responsible) of not complying with legal obligations (e.g. giving the IFI information or data) pointing out the damage caused by non-compliance (e.g. the

IFI's incapacity to produce a report in due time); [35] b) The 'comply or explain' principle - now comprehensively foreseen in the Commission's proposal for amending Directive 2011/85. In Article 8 where new enlarged tasks are assigned to IFIs, paragraph 5 states: "Member States shall ensure that the budgetary authorities of the Member State concerned comply with the assessments or opinions issued by the institutions in the context of the tasks referred to in paragraph 4. Where such budgetary authorities do not comply with those assessments or opinions, they shall publicly justify the decision not to comply within a month from the issuance of such assessments or opinions." Although these mechanisms of non-peer pressure can be used where legal enforceability is weak, they can prove to be quite effective should the IFI manage to become, through its daily work, a well-embedded national institution and acknowledged as a credible one by the public. The weakness can paradoxically become a strength;

iv) IFIs, when monitoring fiscal policy and when signalling risks faced by domestic public finances, help to protect the country against negative changes in market sentiment and prevent distress in the debt market, thereby contributing to ensuring medium-term debt sustainability. The involvement of IFIs in the new operational DSA (by producing them or endorsing those made by the government), assessing debt dynamics on the basis of stochastic, no-policy change scenarios, will play a role in this matter. It should be noted in this regard that budgetary restraints, whether numerical or formal, are a demanding 'preventive' against debt distress, whereas market discipline can be a painful 'curative';

v) In this regard, the pedagogical and informative work of IFIs can favour the creation of buffers (including the reduction of the debt ratio when this is too high) in the good moments of the cycle, explaining to the public that a non-prudent fiscal policy in such a moment (e.g. increasing expenditure or cutting taxes excessively) can impair the capacity of the government to further address a recession through the adoption of anti-cyclical measures and even to control debt when those bad moments arrive. It should be noted that certain fiscal rules can also be designed precisely to foster such anticyclical management of fiscal policy, thereby ruling the destiny of budget surpluses. The existence of such rules makes the scrutinizing task of IFIs easier, and in turn, IFIs can exert pressure towards compliance with the rule;[36]

vi) Moreover, IFIs can contribute to improvements in the expenditure management (e.g. spending review) so that it can be used to improve potential growth as well as the capacity/efficiency/quality of public services;

vii) IFIs can limit the tendency of governments to use more anticyclical measures, in bad moments, than really necessary, which happens not only for political/electoral reasons but sometimes also due to informational problems

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[35] The Statutes of the Portuguese Public Finance Council (CFP) (Law 54/2011, of 19 of October) enshrines this principle in Article 8 stating: "5 - Should any public entity not fulfil the duty of providing the information in good times, this shall be stated on the Council's webpage. 6 — Should the Council consider such non-fulfilment serious, the President of the Republic, the Assembly of the Republic, the Tribunal de Contas and the Banco de Portugal shall be duly informed."

[36] Interestingly, the Portuguese Budgetary Framework Law (Law 151/2015, of 11 September, modified) states in its Article 21 that budget surpluses are preferably used in the amortization of public debt (as long as the debt limit of 60% to GDP is not complied with) and in the constitution of a stabilization reserve intended to perform a countercyclical function in times of economic recession (a 'rainy day' fund).

(due for example to forecasting errors). In particular, evidence has already been found of a pessimistic bias in real-time estimates of the output gap which can be related to the methodology used to estimate potential output (Larch et al., 2019). IFIs, through use of their own macro-econometric work, can therefore help governments and citizens to address this informational issue that leads to a miscomprehension of the stage of the cycle, and avoid for example the use of discretionary measures to support aggregate demand when no overheating measures are required (e.g. the economy no longer has a negative output gap).

viii) Through all of this, again based on the promotion of transparency (disclosure of information regarding the moments within the cycle and explanation of the impacts of fiscal policy and its own time lags), IFIs can ultimately contribute to better coordination between fiscal and monetary policies in order to achieve effective macroeconomic stabilization.

4 Conclusions

If the new framework provides Member States with the autonomy to set their own path of fiscal adjustment (even if as part of a strict dialogue with the Commission) – i.e., the medium-term evolution of the relevant aggregate of net expenditure – in order to ensure a descending trajectory of debt ratio and/or its stabilization (to 'prudent' levels) it must also assure that 'national ownership' means national responsibility as well.

The increasing role assigned to national IFIs within this revised framework can be justified precisely by the need to temper this shift from a rule-based system to a standard-based one, with some hardening of formal/institutional budgetary restraints. At the same time, as national institutions, IFIs are in good position to embody the new core principle of the reform, 'national ownership', precisely because they are nationally embedded and can thus be more sensitive to the national reality than another kind of technical assessment conducted elsewhere. Even if their tasks will not be easier on technical grounds, due to a certain fluidity of the idiosyncratic 'standard-based system', they seem to be able to contribute to a better link between that 'national ownership' and policy discretion, on the one hand, and compliance and fiscal discipline, on the other. This is, nevertheless, a landscape of weak legal enforceability where the success of an IFI mandate to foster compliance will mostly depend on its 'good-reputation-building' to be eventually acknowledged as a credible institution by decision-makers and the public. The legal weakness of the landscape where IFIs operate can paradoxically become a strength, should proper conditions be given to IFIs (e.g., access to data and information, resources and guarantees of independence) for them to make Governments comply or provide explanations. Otherwise, the proposed idiosyncratic standard-based model risks ruling out fiscal policies of Member States, which could imply losses of welfare in the currency area as a whole and be detrimental to the capacity of those Member States to ensure macroeconomic stabilization in their own territory. Compliance with rules, regardless of their legal strength, is indeed a pre-condition not only for the sustainability of public finances, but also to ensure the capacity of each Member State to run counter-cyclical policies when a recession hits the economy.

Outside the scope of the present article is the discussion involving the creation of a central fiscal capacity at the EU level – which has become more plausible after the 2020 financial package 'Next Generation EU' – with a new stabilizer role for the area (in particular the euro area). The conception of a fiscal capacity (a 'micro-budget', in the words of Cabral, 2021 and 2023) with this stabilizing property suggests a reflection about the design of new fiscal rules for the EU budget (or similar) and the reinforcement of the EU independent fiscal institution. In fact, with increasing functions, expenditures and revenues (including a new and strong borrowing capacity) to be assigned to the EU central budget, the European Fiscal Board can evolve to become the EU's IFI, with the role of assessing EU debt sustainability and its capacity to run a single counter-cyclical policy for the entire area.

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