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Reforming the EU Fiscal Framework Strengthening the Fiscal Rules and Institutions

Prepared by Nathaniel Arnold, Ravi Balakrishnan,
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W. Raphael Lam, Paulo Medas, Julia Otten,
Louise Rabier, Christiane Roehler, Asghar Shahmoradi,
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Acronyms and Abbreviations

CIF	Climate Investment Fund
DSA	Debt Sustainability Analysis
EDP	Excessive Deficit Procedure
EFB	European Fiscal Board
EFC	European Fiscal Council
EU	European Union
FCEU	EU Fiscal Capacity
MTFF	Medium-Term Fiscal Framework
NGEU	Next Generation EU
NFC	National Fiscal Council
RRF	Recovery and Resilience Facility
SGP	Stability and Growth Pact
SURE	The European Instrument for Temporary Support to Mitigate Unemployment Risks in an Emergency

Executive Summary

The EU's fiscal framework needs reform. While existing fiscal rules have had some impact in constraining deficits, they did not prevent deficits and debt ratios that have threatened the stability of the monetary union in the past and that continue to create vulnerabilities today. The framework also has a poor track record at managing trade-offs between containing fiscal risks and stabilizing output. Finally, the framework does not provide sufficient tools for EU-wide stabilization. This was most visible during the decade following the euro area sovereign debt crisis, when structurally low real interest rates stretched the policy tools of the European Central Bank (ECB), leading to a persistent undershooting of its inflation target.

This paper proposes a new framework based on risk-based EU-level fiscal rules, strengthened national institutions, and an EU fiscal capacity. First, risk-based EU-level fiscal rules would link the speed and ambition of fiscal consolidation to the level and horizon of fiscal risks, as identified by debt sustainability analysis (DSA) using a common methodology developed by a new and independent European Fiscal Council (EFC). The 3 percent deficit and 60 percent debt reference values would remain. Second, all member countries would be required to enact medium-term fiscal frameworks consistent with the EU-level rules—that is, to ensure convergence over the medium-term to an overall fiscal balance anchor by setting expenditure ceilings. Independent national fiscal councils (NFCs) would have a much stronger role to strengthen checks and balances at the national level (including undertaking or endorsing macroeconomic projections and performing DSAs to assess fiscal risks). The European Commission (EC) would continue to play its key surveillance role as articulated in the Maastricht Treaty and the EFC would be the center of a peer network of fiscal councils. Third, building on the recent experience with the NextGenerationEU (NGEU), an EU fiscal capacity (FCEU) would improve euro area macroeconomic stabilization and allow the provision of common EU public goods—a task that has become more urgent given the green transition and common security concerns.

Central to the proposal is a mutually reinforcing relationship between EU rules and national-level implementation. Strengthening implementation requires both better national ownership of the rules and their application and greater congruence of national-level frameworks with EU-level rules. The former can only be achieved by rules that convincingly balance the needs of members with the avoidance of negative externalities across members. This argues for a risk-based approach—the first pillar of our proposal. The latter requires a stronger role for significantly upgraded national level frameworks—the second pillar of our proposal.

The capacity and mandates of independent fiscal institutions need to be significantly enhanced. NFCs must be strengthened through upgraded minimum standards for their mandates, resources, and independence. The EFC would serve as a node in a network of NFCs, helping promote good practices and standards, and provide an independent voice both on debt risks and the execution of the framework. The credibility and transparency of the proposed reforms would also require a major revamp in the quality of government finance statistics.

Establishing a well-designed EU fiscal capacity would enhance resilience and address longer-term challenges facing the EU. Such a fiscal capacity could have two roles. First, helping avoid procyclical cuts to growth-friendly spending during downturns, particularly when monetary policy is constrained at the effective lower bound, via a macroeconomic stabilization instrument. Second, enhancing resilience through provision of common public goods—including via a climate investment fund. This could reduce adverse spillovers within the EU and facilitate the implementation of EU fiscal rules.

Reform of the EU fiscal framework cannot wait. Multiple unprecedented shocks on top of already high debt levels complicate the conduct of fiscal policy. Interest rates have been rising, and monetary policy normalization continues apace. In this context, agreeing a timely reform of the EU fiscal framework is essential to

navigate the difficult trade-offs among the tasks of reducing fiscal risks, accommodating new spending mandates, and executing them at the most efficient level (EU or national). The extension of the general escape clause through the end of 2023 provides a window of opportunity to do just this. It should not be wasted.

1. Introduction

The EU's fiscal framework is in urgent need of reform. While existing fiscal rules have had some impact in constraining deficits, they did not prevent deficits and debt ratios that have threatened the stability of the monetary union in the past and that continue to create vulnerabilities today. As a result, the framework has failed at its most basic purpose: to reliably contain fiscal risks and their associated externalities across members. The framework also has a poor track record at managing trade-offs between containing fiscal risks and stabilizing output. In the past, this trend has manifested itself in too little fiscal adjustment in good times and too much in bad times; while application of the rules to today's sharply higher debt ratios would imply an excessively rapid fiscal consolidation for most high-debt countries as soon as the escape clause is deactivated. Finally, the framework does not provide sufficient tools for euro area stabilization. This was most visible during the decade following the euro area sovereign debt crisis, when structurally low real interest rates stretched the policy tools of the ECB, leading to a persistent undershooting of its inflation target.

This departmental paper offers a blueprint designed to address these problems—and, more generally, strengthen fiscal governance at both the national and EU levels. It is based on three main ideas.

- First, risk-based EU-level fiscal rules. These rules would link the speed and ambition of fiscal consolidation to the level and horizon of fiscal risks, as identified by debt sustainability analysis (DSA) using a common methodology developed by a new and independent European Fiscal Council (EFC), in consultation with the European Commission (EC), national fiscal councils (NFCs), and other stakeholders. High-risk countries would be required to enact expenditure ceilings consistent with a zero or positive overall fiscal balance over the medium term (three to five years). The 3 percent deficit and 60 percent debt reference values would remain. Countries with fiscal risks that are not assessed to be high, and with debt below 60 percent and not projected to rise above 60 percent of GDP, would have more flexibility, but would still need to consider fiscal risks when formulating their medium-term fiscal plans. Such a framework would imply a reduction in debt vulnerabilities and the building of buffers in good times, providing space for countercyclical policy within the 3 percent of GDP deficit ceiling in response to shocks.
- Second, a much stronger role for national fiscal frameworks and institutions. All member countries would be required to enact medium-term fiscal frameworks (MTFFs) consistent with the EU-level rules. NFCs would be required to undertake or endorse macroeconomic projections, undertake DSAs and assess fiscal risk, and take a view as to whether the expenditure ceilings and fiscal plans proposed by governments are consistent with these risks. To play this role, NFCs would need to be upgraded to a common EU-wide standard. The EC would continue to play its key surveillance role as articulated in the Maastricht Treaty. The EFC would complement this by providing technical support to the NFCs; reviewing and commenting on their assessments and recommendations, including on fiscal risk; and being the center of a peer network of fiscal councils.
- Third, an EU fiscal capacity (FCEU) funded by common debt issuance and an income stream to service this debt. The fiscal capacity would have two key roles: (i) improving euro area macroeconomic stabilization in face of adverse shocks, especially when monetary policy is operating at the effective lower bound; and (ii) allowing the provision of common public goods at the EU level—a task that has become more urgent as a result of the green transition and common security concerns.

The logic behind the proposal is that the quality of EU-wide rules and the quality of national-level implementation should be mutually reinforcing. The main reason the present framework has failed to contain debt risks has been weak national-level implementation. Strengthening implementation requires both better national ownership of the rules and their application and greater congruence of national-level frameworks with

EU-level rules. The former can only be achieved by rules that convincingly balance the needs of members with the avoidance of negative externalities across members. This argues for a risk-based approach—the first pillar of our proposal. The latter requires a stronger role for national-level frameworks, acting in a coordinated fashion—the second pillar of our proposal.

The credibility and transparency of the proposed reforms depend materially on improving the quality of government finance statistics and fiscal information. Europe should commit to a major revamp in the quality of government finance statistics and the comprehensiveness of easily available information on MTFs, budgets and policy plans, even though understandably it would take time to fully implement. This should include consolidated EU-level fiscal statistics, alignment of budgets with outturn information, comprehensive public sector balance sheets, and accrual accounting reform; and upgraded information sharing with the EC for surveillance and publication.

This paper draws on previous proposals and ideas, reviewed in the following chapter (Table 1). The argument that fiscal risks should be identified by DSAs rather than debt thresholds was forcefully made by [Blanchard, Leandro, and Zettelmeyer \(2021\)](#) and [Martin, Pisani-Ferry, and Ragot \(2021\)](#). A stronger role for national fiscal frameworks and institutions has been proposed by many authors, including [Wyplosz \(2005, 2019\)](#); [Pench and others \(2019\)](#); [Martin, Pisani-Ferry, and Ragot 2021](#); [EFB 2021](#); [EU IFIs \(2021\)](#); and [Debrun and Wolff \(2022\)](#). The main difference between these and the present proposal is that the latter places greater emphasis on a design that is likely to be conducive to satisfactory implementation. As a result, the main elements of the proposal—in particular, how fiscal risk assessments could be undertaken and incorporated in the process and how national fiscal frameworks and institutions should be strengthened—are covered in more depth than is typical for this literature. With respect to the FCEU, we draw on previous work at the IMF, particularly [Allard and others \(2014\)](#); [Arnold and others \(2018\)](#); and [Berger, Dell’Ariccia, and Obstfeld \(2018\)](#).

The rest of the paper is organized as follows. Chapter 2 diagnoses the existing system with the aim of deriving some conditions that a reformed system would need to meet and discusses existing proposals. Chapter 3 describes the main building blocks of the proposed EU-level framework and the relationship among them. Chapter 4 discusses complementary reforms to strengthen the national fiscal frameworks and institutions. Finally, Chapter 5 lays out the rationale for an EU fiscal capacity and its design features.

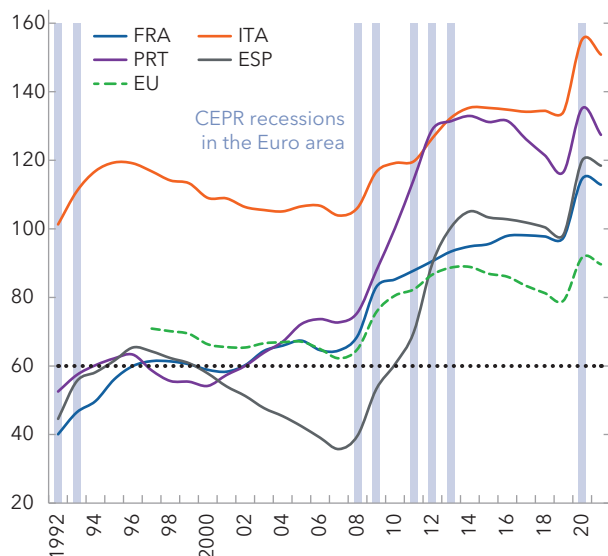
Table 1. Comparison of the EU Fiscal Rules and IMF Staff Proposal

	The Current Framework	IMF 2022 Proposal
Anchor	3 percent of GDP overall fiscal deficit ceiling	Yes
	60 percent of GDP overall public debt level	Yes
	Country-specific medium-term objective (MTO) for the structural fiscal balance	Medium-term overall fiscal balance anchor, more ambitious for countries with higher fiscal risks
Operational instrument	Expenditure benchmark based on potential output growth	Multiyear expenditure ceiling paths to reach the medium-term budget balance anchor and to reduce debt vulnerabilities.
	Minimum structural fiscal balance adjustment if below MTO	No
	Debt correction benchmark (1/20th rule)	No
Escape clause	Yes	Yes
Enforcement	European Commission through Excessive Debt Procedure	Yes
Institutional features	Modest mandate for national fiscal councils and European Fiscal Board	Strong mandate and expanded role for independent national fiscal councils, and a well-resourced and independent European Fiscal Council to replace the European Fiscal Board
	Weak application of medium-term fiscal planning	Strong role for medium-term fiscal frameworks at national level
EU fiscal capacity	No	Yes

2. Problems with the Current Framework

While the existing fiscal framework has contributed to fiscal discipline, it has prevented neither the euro area debt crisis nor the steady rises in debt ratios that are a source of vulnerability in several EU countries today (Figure 1). There is evidence that the framework created incentives to keep the fiscal deficit below 3 percent, as member states seek to avoid an Excessive Deficit Procedure (Caselli and Wingender 2021).

Figure 1. Select Countries: Public Debt to GDP (Percent)¹



Sources: Annual macroeconomic database (AMECO) of the European Commission; and Centre for Economic Policy Research (CEPR).

Note: Data labels use International Organization for Standardization (ISO) country codes.

¹Bars represent periods of recession based on CEPR’s assessment of the state of the economic activity of the euro area.

But these incentives have clearly not generated sufficient debt reduction in relatively good times, such as 1998–2007 or 2015–19, to buffer shocks in bad times. High sovereign debt was a contributing factor (although not the only one) to the 2010–12 euro area debt crisis, and it is a significant source of vulnerability today, leading to high fiscal sustainability risk in 10 EU countries (EC 2022). As a result, it is difficult to avoid the conclusion that—notwithstanding several reform attempts (Box 1)—the rules have failed in their most basic objective, namely, preserving fiscal sustainability and preventing debt crises and their associated negative spillovers across member countries.

The main reason behind the failure to keep debt risks in check is that the rules have not been followed. One reason for the failure of the rules relates to their original design: while the 3 percent of GDP fiscal deficit ceiling may have helped to prevent higher deficits, it did not provide any guidance or incentives on overperformance in good times.¹ However, this problem was in principle addressed by the introduction of an MTO for the structural balance in 2005 and a minimum debt reduction requirement in 2011. For the most

part, the rules failed because fiscal outcomes have diverged from what the rules prescribe. While most countries have respected the 3 percent deficit ceiling in good times, it has been breached in bad times. Moreover, only a few countries have consistently complied with the MTO, which requires euro area and Exchange Rate Mechanism II member states to respect a deficit ceiling of less than or equal to 1 percent of GDP (Figure 2). This lack of implementation, together with a focus on yearly budgets rather than credible medium-term plans (Larch and others 2021a) and weak enforcement, has resulted in continued debt accumulation. Countries such as France, Italy, and Portugal could have seen substantially lower debt if they had respected the rules. Simulations show that if Italy, for example, had adhered to the rules, including the MTO, it could have entered the euro area debt crisis with a debt ratio of 70 percent of GDP, instead of 100 percent

¹ Indeed, as argued by Caselli and Wingender (2021), it may have been counterproductive for countries with lower deficits that moved closer to the ceiling.

Box 1. The Evolution of the EU Fiscal Framework

The EU fiscal framework has undergone numerous reforms. The current framework reflects successive reforms to the original 1997 framework, including the 2005 reforms; the 2011 Six Pack (five regulations and one directive); the Treaty on Stability, Coordination, and Governance of 2012 (TCSG, relevant articles referred to as the Fiscal Compact); and the Two Pack 2013 (two regulations). In brief:

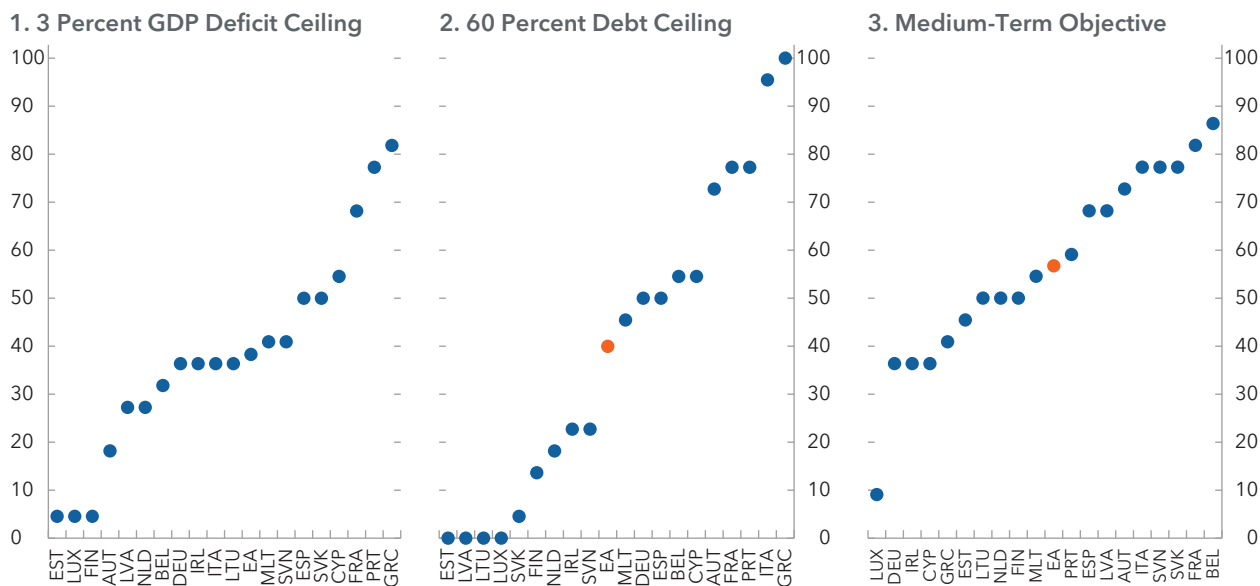
- The 1997 Stability and Growth Pact (SGP) included three EU-wide rules: ceilings of 3 percent of GDP for the overall fiscal deficit and 60 percent of GDP for public debt (corrective arm), and a requirement for medium-term budget positions to be “close to balance or in surplus” (preventive arm).
- The 2005 reform of the SGP aimed at enhancing the economic rationale underlying the rules and improving their flexibility by introducing country-specific medium-term objectives (MTOs) set in terms of structural fiscal balances.
- The Six Pack reform in 2011 was designed to improve enforcement by adding an expenditure benchmark to the preventive arm and making the debt criterion in the corrective arm operational by adding a debt correction rule that requires a country reduces by 1/20th the difference between its debt ratio and 60 percent of GDP.
- The 2012 Two Pack reform reinforced monitoring and surveillance in the euro area.
- The 2013 Fiscal Compact, building on a 2011 Directive, called for countries to anchor the EU rules at the national level.
- The 2011-13 reforms also set out responsibilities for national independent fiscal institutions, while the European Fiscal Board as an advisory board to the EC was established in 2016.
- In 2015, revised guidance on the implementation of the SGP increased its flexibility to encourage investment and structural reforms, and to account for economic cycles.

of GDP (Figure 3 and Annex 2).² The successive reforms have also led to a multiplicity of rules that have been criticized for hampering implementation. However, given the need for well-defined common fiscal rules—which should co-exist with national fiscal rules—and the difficulty in enforcing common EU rules, some degree of complexity is unavoidable ([Deroose and others 2018](#)).

Given low compliance, the fiscal framework has resulted in procyclical fiscal policy (Figure 4). Larch and others ([2021b](#), [2021c](#)) show that compliance with the EU fiscal rules tends to reduce the risk of running procyclical policies, by allowing the build-up of fiscal space. However, since compliance was low, insufficient savings were undertaken in good times, with countries tending to treat the 3 percent of GDP deficit reference value as a target rather than as a ceiling ([ECOFIN 2005](#)). As a result, the framework fosters procyclical fiscal policy in a downturn: in the absence of deficit buffers, the only way of staying within the 3 percent limit is by tightening (unless the general escape clause is invoked). This can be a serious problem when

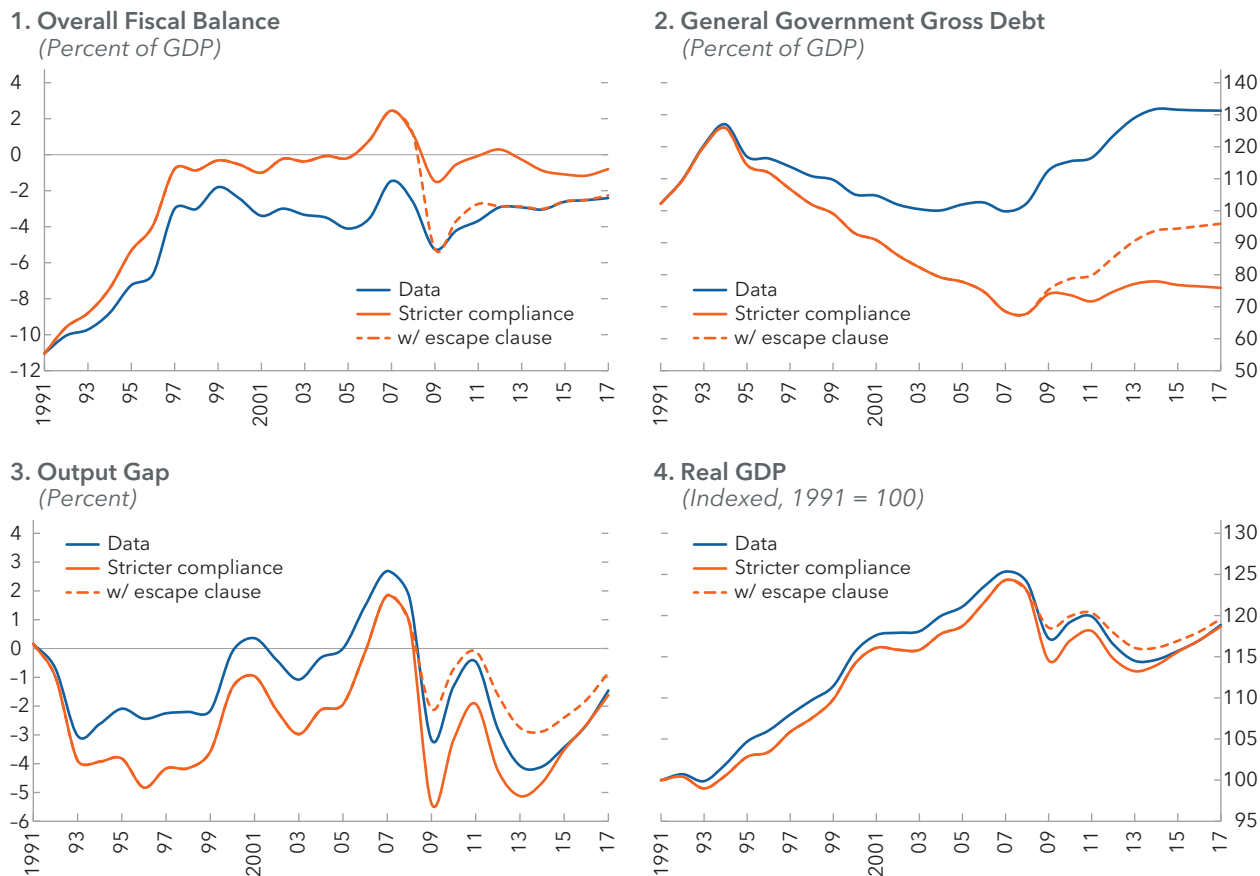
² This is based on a counterfactual analysis of scenarios with closer adherence to the EU fiscal rules using a debt dynamics framework. The framework takes the actual data as the starting point and models the effects of an alternative path of structural fiscal adjustment prescribed by the EU fiscal rules on fiscal balances, interest rates, output, and debt. The effect on output is determined by fiscal multipliers, which are a decreasing with the output gap, whereas the interest rate on new issuances increases with the debt level. The first scenario looks at the impact of stricter adherence to the rules regardless of macroeconomic conditions, while the second scenario consider the effect of stricter adherence when an escape clause can be activated in a severe economic downturn.

Figure 2. Euro Area: Fiscal Aggregates and Reference Values¹
(Percent of rules violation incidents)



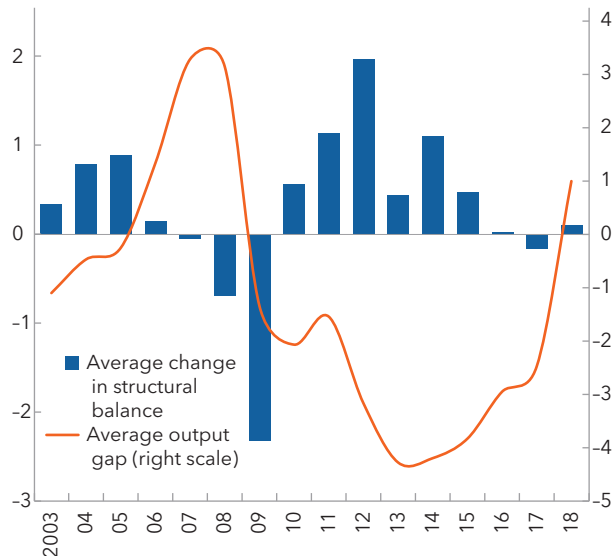
Sources: Compliance Tracker of the secretariat of the European Fiscal Board (EFP) of the European Commission; and IMF staff calculations.
Note: Data labels use International Organization for Standardization (ISO) country codes.
¹Compliance with European rules from 1999 through 2020.

Figure 3. Italy Simulations



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

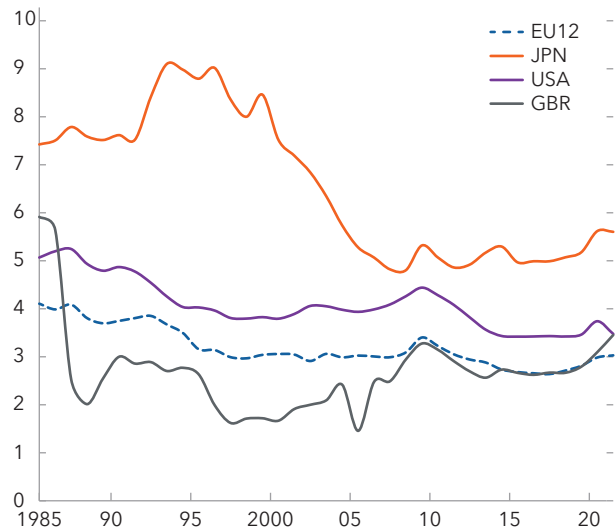
Figure 4. Euro Area: Structural Balance and Output Gap
(Average change)¹



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

¹This measurement illustrates excessive deficit procedure (EDP), the average change in the structural balance and average output gap for countries subject to the EDP in a given year. No countries were in the EDP before 2003. With the exception of a few years, notably 2009, fiscal policy is tightening when the output gap is negative, making it procyclical.

Figure 5. Advanced Economies: Gross Public Investment
(Percent of GDP)



Sources: IMF Capital Stock Database; IMF, *World Economic Outlook*; and IMF staff calculations.

Note: EU12: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, and Sweden.

monetary policy cannot be eased to address the downturn, either because the ECB is constrained by the effective lower bound on interest rates (see below) or because the ECB's price stability objective requires tighter policy.

Furthermore, the fiscal framework lacks a tool that can contribute to macroeconomic stabilization of the euro area as a whole when monetary policy tools are insufficient. When monetary policy is constrained by the effective lower bound, as was the case during the euro area's low-inflation period during 2013–20, a coordinated aggregate fiscal policy response would help provide a better mix between fiscal and monetary policy. As argued by [Christiano and others \(2011\)](#), [Eggertsson \(2011\)](#), and [Woodford \(2011\)](#), fiscal policy could be particularly effective in response to a shock when the economy is near the effective lower bound given higher public spending multipliers. However, during 2013–20, the EU countries with fiscal space were the ones with positive output gaps. Addressing this problem requires a central fiscal capacity for macroeconomic stabilization at the EU level.

The pandemic, climate change, and war in Ukraine have brought new challenges to the fiscal framework. Several EU countries would face important challenges implementing the rules due to pandemic-related surges in debt and sizeable public investment needs. The application of the current rules, once the escape clause is lifted, would require unrealistically large—and counterproductive—adjustments by some high-debt countries. For example, in the case of Italy the 1/20th debt reduction rule would imply debt reduction of about 5 percent of GDP per year. Large public investments are also needed to support energy security and the green transition, as well as strategic defense interests. Yet EU public investment has declined significantly since 2010 and is well below levels seen in Japan and the United States (Figure 5).

The ideas developed in this paper stand on the shoulders of several recent proposals but go further in seeking to strengthen implementation by member states (Table 2). To varying degrees, Blanchard, Leandro, and Zettelmeyer (2021), Martin, Pisani-Ferry, and Ragot (2021), [EFB \(2021\)](#), [ESM \(2021\)](#), D'Amico and others (2022), The Netherlands and Spain Joint Proposal (2022), and Hauptmeier and others (2022) all seek to address the procyclicality of the current framework and avoid counterproductive adjustment in the current high-debt environment (Table 2). In addition, Blanchard, Leandro, and Zettelmeyer (2021) and Martin, Pisani-Ferry, and Ragot (2021) develop new ideas on how to make the framework more sensitive to the prevention of sovereign risk, which are taken up in the next chapter. Most recent proposals (as well as earlier proposals by [Allard and others 2014](#), [Arnold and others 2018](#), [Bénassy-Quéré and others 2018](#), and [Berger, Dell'Ariccia, and Obstfeld 2018](#)) also argue for a central fiscal capacity. At the same time, few proposals are explicit as to how they would address lack of implementation by member states (and some of those that do, such as Blanchard, Leandro, and Zettelmeyer 2021), would require changes in either the EU Treaty or national constitutions). In contrast, this paper emphasizes implementation, as elaborated in the next two chapters.

Table 2. Recent Proposals for Reform of the EU Fiscal Rules

Source/study	Rule proposal	3 percent of GDP deficit ceiling	60 percent of GDP debt limit	Escape clause	Green golden rule	Common fiscal instrument
IMF (2022)	Expenditure ceilings consistent with a zero or positive overall fiscal balance over the medium term for high-risk countries. For countries that are not high risk but have debt above 60 percent of GDP, expenditure ceilings consistent with an anchor based on the overall balance that—while not necessarily zero or positive—leads to declining debt over the medium term.	Yes	Yes	Yes	No	Yes, for stabilization and common public goods (e.g., climate investment, energy security, defense R&D, pandemic preparation)
EFB (2021)	Long run debt ceiling, with intermediate country-specific medium-term targets. Expenditure rule as operational target, and no explicit debt reduction rule.	Yes	Yes	Yes	No	Yes, for stabilization
ESM (2021)	Annual debt correction of 1/20 th when debt above 100 percent of GDP (acting as an anchor)	Yes	Modify to 100 percent	Yes	No	Yes, for stabilization, investment, and crisis resolution
Giavazzi, Guerrieri, Lorenzoni, and Weymuller (2021) and D'Amico et al., (2022)	Medium-term debt targets (10 years), with different speed of adjustment depending on purpose of debt, which helps provide counter cyclical. Multi-year ceiling on primary spending, net of automatic stabilizers, and “spending-for-the future EU public goods”: The ceiling is revised every three years but the economy must meet the medium-term debt target in 10 years.	No	Yes	Yes	Yes	Yes, a common fund to acquire pandemic and crisis-related debt
Netherlands-Spain Joint Proposal	Expenditure rule with country-specific medium-term fiscal plans to make the rules more comprehensible, easier to enforce and more countercyclical	Yes	Yes	Yes	No	EU-financed investment in public goods in strategic areas, especially climate change mitigation
Martin, Pisani-Ferry, and Ragot (2021)	Country-specific medium-term debt targets (assessed by the domestic independent fiscal institution on the basis of a common methodology, monitored by the EFB, and endorsed (or rejected) by the relevant EU bodies) based on a DSA and implemented through 5 year primary expenditure growth ceilings	No	No	Yes	No	Yes, for stabilization and investment
Blanchard, Leandro, and Zettelmeyer (2021)	Abandon quantitative rules in favor of qualitative standards and use stochastic DSAs to assess debt sustainability, with the pace of debt reduction depending on the monetary policy stance	No	No	Yes	No	Yes, under certain conditions

Source: IMF staff.

3. A New EU-Level Fiscal Governance Framework

This chapter presents the building blocks of a proposal designed to address the weaknesses of the present framework. It focuses on the main building blocks of an EU-level framework designed to improve national fiscal policy for the benefit of both individual members and the union as a whole. The remaining chapters in this paper deal with national fiscal frameworks and the creation of an EU-level fiscal capacity, respectively.

The proposal aims to prevent fiscal vulnerabilities and reconcile the prevention/reduction of fiscal vulnerabilities with output stabilization more effectively than is the case today (Table 1).

Better prevention of fiscal vulnerabilities would be achieved through:

- Fiscal rules that link the speed and ambition of fiscal consolidation to the level and horizon of fiscal risks, as identified by DSA using a common methodology.
- Improved national fiscal frameworks, including independent fiscal institutions, and hence a more robust national policy dialogue and greater ownership, to strengthen the implementation of the framework.

The trade-off between the containment of fiscal risks and output stabilization would be improved by:

- Allowing lower-risk countries more flexibility in the formulation and execution of their medium-term fiscal frameworks.
- Using multiyear expenditure ceilings as the operational rule to reach a medium-term overall budget balance anchor. The expenditure ceilings help buffer output shocks through automatic stabilizers.
- Carefully designed general and individual escape clauses.

While the proposal would replace the Fiscal Compact and the Stability and Growth Pact as laid out in secondary legislation, both the EU Treaties and the treaty protocol would remain unchanged. Hence, the 60 percent debt-to-GDP and 3 percent deficit-to-GDP ceilings would be maintained in their current roles as reference values that help the EC identify an excessive deficit. In addition, the 60 percent debt-to-GDP ratio would play a role in the proposed risk-based framework, by defining a category of countries that would not be required to further reduce their debt over the medium term.

The proposal is elaborated in the two subsections that follow. The first summarizes the main building blocks. The second explains how the proposed framework would be implemented and explains the role of governments, independent national fiscal institutions, the EC, and an upgraded European Fiscal Council.

A. Main Elements

Medium-term fiscal plans. All members would be required to develop credible national MTFs, based on macroeconomic forecasts transparently assessed or even provided by independent forecasters,³ to provide transparency on fiscal policy design and facilitate commitment to an agreed policy package and the numerical fiscal rules. These nationally agreed medium-term fiscal plans would form the basis for reporting to the EC.

³ The independent forecasts could be provided directly by the NFC or consist of an independent forecast (for example an average of professional forecasters) endorsed by the national fiscal council. A weaker option would consist of a government forecast that is endorsed by an independent body or the NFC itself (consistent with EU “two pack” Regulation 473/2013, Article 4(2)).

A common DSA methodology. This would provide the basis for the analysis of debt risks in the short, medium, and long terms. It would be based on an EU regulation laying out minimum requirements, including the ability to make probabilistic risk assessments at several horizons. As is the case with existing horizon-based methodologies, such as the EC [Fiscal Sustainability Report](#) or the IMF [Debt Sustainability Framework for Market Access Countries](#), the methodology would leave some room for judgment but constrain such judgment using quantitative indicators.

A risk-based medium-term fiscal balance anchor. This anchor would be set to reflect the level and horizon of fiscal risks, as identified by a risk assessment based on the common DSA methodology. Countries with higher risk would need to place greater priority in rebuilding fiscal buffers, while others could do it at a more gradual pace, accommodating other priorities. Specifically:

- If the risk assessment identifies high fiscal sustainability risks in the short or medium term, the anchor would take the form of a zero or positive overall fiscal balance over the medium term (3–5 years).
- Countries whose fiscal risks are not identified as high, but whose debt levels are above 60 percent of debt to GDP or projected to rise above 60 percent of GDP over the medium term, would be required to adopt an overall fiscal balance anchor that—while not necessarily zero or positive—leads to declining debt ratios over the medium term. The ambitiousness of the targeted decline should depend on fiscal risks as well as cyclical considerations and investment and reform plans.
- Countries whose fiscal risks are not assessed to be high, and whose debt levels are below 60 percent of debt/GDP and not projected to rise above 60 percent of GDP over the medium term, would still be required to develop credible MTFs and lower fiscal risks unless these are low already, but would be given more flexibility in setting fiscal anchors.

Using the overall fiscal balance as medium-term anchor has the advantage of being easy to communicate and avoids the difficulty of determining country-specific medium-term debt anchors (Box 2).⁴ It encourages the building of buffers in good times and provides space for countercyclical policy within the 3 percent of GDP deficit limit in response to shocks.

Expenditure ceilings as the operational rule. Governments would set multiyear binding expenditure ceiling paths, over four to five years, such that, given the baseline macroeconomic forecast, the overall balance would converge to (or stay above) the anchor over the horizon of the MTF. Such expenditure ceilings would contribute to more stable and predictable policies and allow automatic stabilizers to operate, since cyclically lower revenues would not need to be matched by lower expenditures (Box 2). Annual budgets would be required to allow for a buffer with respect to the expenditure ceiling to accommodate modest unforeseen spending needs or spending overruns. The expenditure ceilings should apply to the general government, cover a broad definition of expenditures, and be set consistent with planned revenue measures to ensure that the medium-term anchor is achieved. The latter is also important so that the ceilings do not constrain changes to the desired size of the government, as long as they are paid for by additional revenue.

Escape clauses. The general escape clause would remain unchanged. However, the framework could also include an explicit escape clause for individual cases. This could be activated in response to severe idiosyncratic shocks such as when growth falls below a low threshold or other major natural disasters or national emergencies occur beyond the control of governments. Under those exceptional circumstances, complying with the expenditure ceilings could require excessive (economically counterproductive) adjustment and available FCEU transfers would likely not be sufficient to respond to the shocks. To avoid disruptive

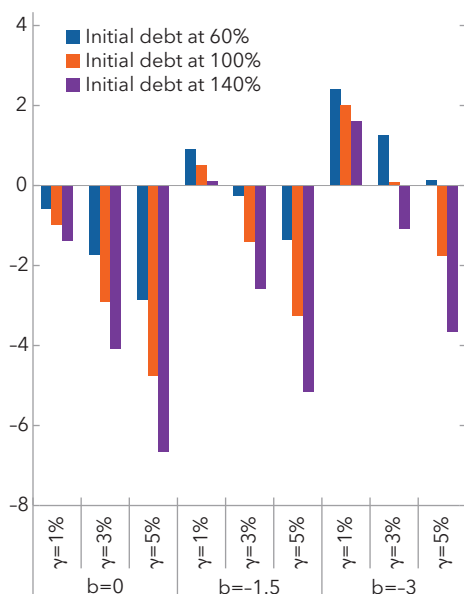
⁴ Note that the budget balance is a medium-term anchor and not an annual target (that could lead to excessive procyclical policies). As such, countries can set medium-term plans with a gradual path to converge to the anchor under a macro-economic baseline based on a stable path for expenditures and revenues and taking into account effects of public investment and reforms. Investment and reform that raise output and growth over the medium term will have an impact on debt sustainability and hence fiscal risk.

Box 2. The New Anchor and Operational Rule

The overall fiscal balance has several advantages as a medium-term anchor. The overall balance is simple and easy to communicate, which serves to improve its salience with politicians and the public. It also avoids the difficulty of having to set a common debt anchor that would be relevant for all countries over time. At the current juncture, several EU countries have debt well above the current 60 percent of GDP anchor. There is very little governments can do to commit credibly to a prudent debt anchor in the medium term. However, governments can commit to an overall fiscal balance anchor that is consistent with reducing debt vulnerabilities and rebuilding fiscal buffers at a pace consistent with country-specific conditions. Conditional on a nominal growth projection, a medium-term overall fiscal balance anchor is equivalent to a debt anchor. Putting the focus on a medium-term anchor allows governments to set fiscal plans that take into account economic conditions and can avoid disruptive fiscal adjustments.

The combination of the medium-term overall balance anchor and a deficit limit of 3 percent of GDP also balances the need for achieving debt sustainability and maintaining flexibility. Targeting an overall fiscal deficit that creates fiscal buffers (even if not necessarily a zero balance) would create fiscal space, allowing countries to deviate from their deficit paths in response to adverse shocks (for example, a fall in tax revenues due to a recession) as long as the deficit is below 3 percent of GDP. Countries with high debt sustainability risks would need to target a zero overall balance or a surplus over the medium term to ensure a high probability of reducing debt.

Box Figure 2.1. Initial Reduction in Debt-to-GDP Ratio
(Percentage points)



Source: IMF staff calculations.

Note: The figure shows the first-year change in debt-to-GDP ratio across scenarios (the changes would decline as debt approaches steady state), where “b” denotes overall balance and “γ” refers to nominal GDP growth rates.

Targeting a balanced budget would imply larger improvements in fiscal positions for countries with higher debt. The higher the existing debt ratio, that larger the medium-term debt reduction that is implied by setting the medium-term fiscal balance anchor at a particular level (Box Figure 2.1). This can be seen by a debt equation:

$$\Delta d_{t+1} = -b_t - \frac{\gamma_t}{1 + \gamma_t} d_t$$

where d_t is the debt-to-GDP ratio at time t , γ_t is the nominal GDP growth rate, and b_t is the overall balance as a share of GDP. Under a balanced budget ($b=0$), debt would fall faster for countries with higher debt levels, everything else constant.

Countries with higher debt would also need to run larger primary balances (for a given overall balance) to compensate for a higher interest bill, to ensure that fiscal policy reacts to the price signal from interest rates over time (Box Figure 2.2):

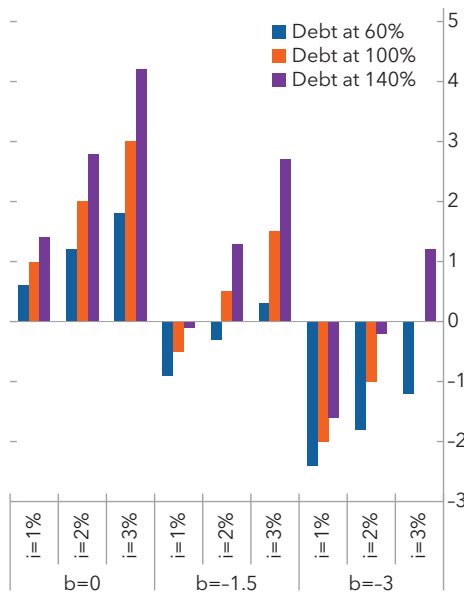
$$P_t = \frac{i_t d_{t-1}}{1 + \gamma_t}$$

where i_t is the effective nominal interest rate. While interest payments largely fall outside the control of the government in the short term, changes in market rates

may take time to materially affect interest payments depending on the maturity profile. Indeed, in the case of many high-debt member countries, using the overall balance as a medium-term anchor

Box 2. The New Anchor and Operational Rule (continued)

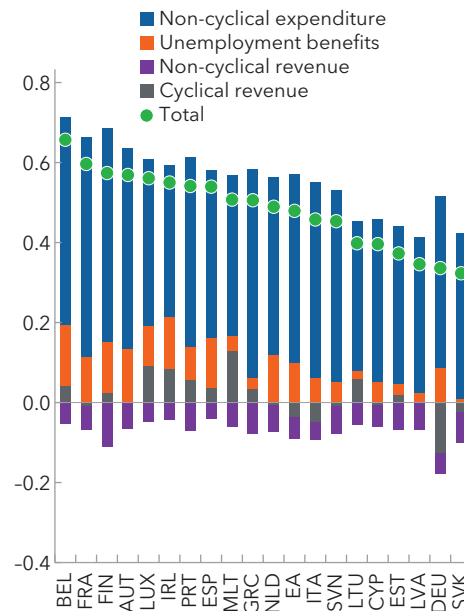
Box Figure 2.2. Implied Primary Balance
(Percent of GDP)



Source: IMF staff calculations.

Note: The figure shows the implied primary balance across scenarios, where “b” denotes overall balance and “i” refers to effective nominal interest rates.

Box Figure 2.3. The Size of Fiscal Stabilizers in the Euro Area
(Percent of GDP)¹



Source: European System of Central Banks. Data provided by the European Central Bank (ECB).

Note: Data labels use International Organization for Standardization (ISO) country codes.

¹The size of automatic stabilizers is estimated as a semi-elasticity multiplied by a standardized output gap of 1 percent of potential GDP. Due to the fact that the ESCB method incorporates the lagged response of a budget to macroeconomic shocks and the lagged effect of tax collections, the presented automatic stabilizers are expressed in cumulative terms over three years (T-T+2). The euro area average is indicatively calculated as a weighted average of individual semi-elasticities for all euro area countries, using nominal GDP in 2019.

would allow a gradual adjustment to changes in market interest rates. Annex 2 also shows simulations as to how this proposed rule compares to a structural balance rule and the 1/20th rule. Compared to the structural balance rule, the pace of debt reduction is more gradual under the proposed rule, and the adverse impact on the output gap is also more modest.

Expenditure ceilings would be the operational rule used to ensure the medium-term overall balance anchor is achieved. Expenditure rules have already been widely used among EU countries (Manescu and Bova 2020) as they have well-known benefits. Expenditures are under the direct control of policy-makers, and rules are relatively simple and transparent, making it easier to monitor and communicate. Moreover, expenditure rules can contribute to stability of expenditures over the medium term,

limiting the risk of fiscal policy procyclicality. Noncyclical spending is already a key source of fiscal stabilization in EU countries (Box Figure 2.3). At the national level, expenditure rules have also been successful in reducing forecast biases (see Annex 3 for further details).

The expenditure ceilings should have broad coverage. The expenditure ceilings should apply to the general government and cover a broad definition of expenditures to ensure a clear link with fiscal sustainability and support proper resource allocation across different spending priorities.

Box 2. The New Anchor and Operational Rule *(continued)*

The expenditure ceilings would need to be consistent with planned revenue measures (either revenue enhancing or decreasing measures) to ensure the medium-term anchor is achieved. The latter is also important to prevent the ceilings from constraining changes to the desired size of the government, as long as they are paid for by additional revenue. Countries would have incentives to mobilize revenues (such as a carbon tax) to finance spending while meeting their overall balance anchors.

adjustment following a large widening of deficits, the escape clause could include a transition period after its activation (that is, it could allow not only a deviation from a previously set expenditure ceiling, but a revision of the forward path of expenditure ceilings, giving countries more time to gradually return to the fiscal anchor). Importantly, greater flexibility provided by an escape clause for individual countries would have to be accompanied by improved checks and balances in the institutional implementation of the rules, as outlined below.

B. Institutional Implementation

Under the proposed framework, some institutions will face significant changes in their mandates, especially at the national level. The purpose of these changes is to promote a robust national policy dialogue and greater national ownership, and hence improve implementation. At the same time, the proposal preserves the existing institutional competencies at the EU-level in overseeing the functioning of fiscal rules and frameworks consistent with mandates to address common concerns and coordinate economic policy.

Independent NFCs would play a central role in promoting adherence to the new framework and in strengthening transparency and credibility of national medium-term fiscal plans. The role of NFCs would be strengthened through upgraded minimum standards for their mandates, resources, and independence—set by an EU directive—and a peer network (see next chapter for more details). NFCs would need to be more integrated in fiscal planning and budget processes. Some of the core functions of the NFCs would include:

- Undertaking or endorsing medium-term projections (output, interest rates, and other economic variables) and costing of fiscal measures planned by governments that are inputs to the MTFF and debt sustainability analysis.
- Assessing the degree of fiscal sustainability risks, using the EU common methodology. This is a key input to prepare fiscal plans and decide on the anchor based on the overall fiscal balance.
- Commenting on the implications (for deficits, debt, and fiscal risks) of the MTFF and expenditure ceilings proposed by governments and publishing an assessment of the medium-term plans, expenditure ceilings, and annual budgets prior to their enactment.
- Assessing whether the conditions for invoking the individual escape clause are present.

A new and independent EFC. The NFCs could be organized as a network with an independent EFC at its core. The EFC (which would build on, and replace the current European Fiscal Board) would concentrate specific competences concerning overall fiscal policies in the euro area and the European Union, including the EU budget.⁵ Its responsibilities would include:

⁵ Currently, the European Fiscal Board serves some of the fiscal oversight functions for the European Union and member states. It could be upgraded to serve as the EFC if it is granted full operational independence from the European Commission and strengthened to retain competencies concerning fiscal policies and sustainability in the union.

- Developing the common methodology for assessing fiscal sustainability risks of country members—in consultation with the EC, NFCs, and other stakeholders—and improving it over time.
- Reviewing and commenting on the DSAs and risk assessments of the NFCs and on the recommended expenditure ceilings.
- Promoting sharing of knowledge and experiences across countries and providing technical support to NFCs.
- Issuing regular reports that assess the operation of the fiscal framework and the role of various institutions that are part of the framework, including the NFCs and the EC, and making suggestions for improvement. This should include an analysis of the cross-country consistency of the risk ratings.
- In addition, the EFC should evaluate the fiscal policy stance and the monetary-fiscal policy mix for the euro area as a whole; it should also produce macroeconomic projections for the euro area and the European Union. If the EU budget is to assume a broader role in the provision of EU wide public goods and in macroeconomic stabilization, there is a strong case for reinforced transparency and accountability.

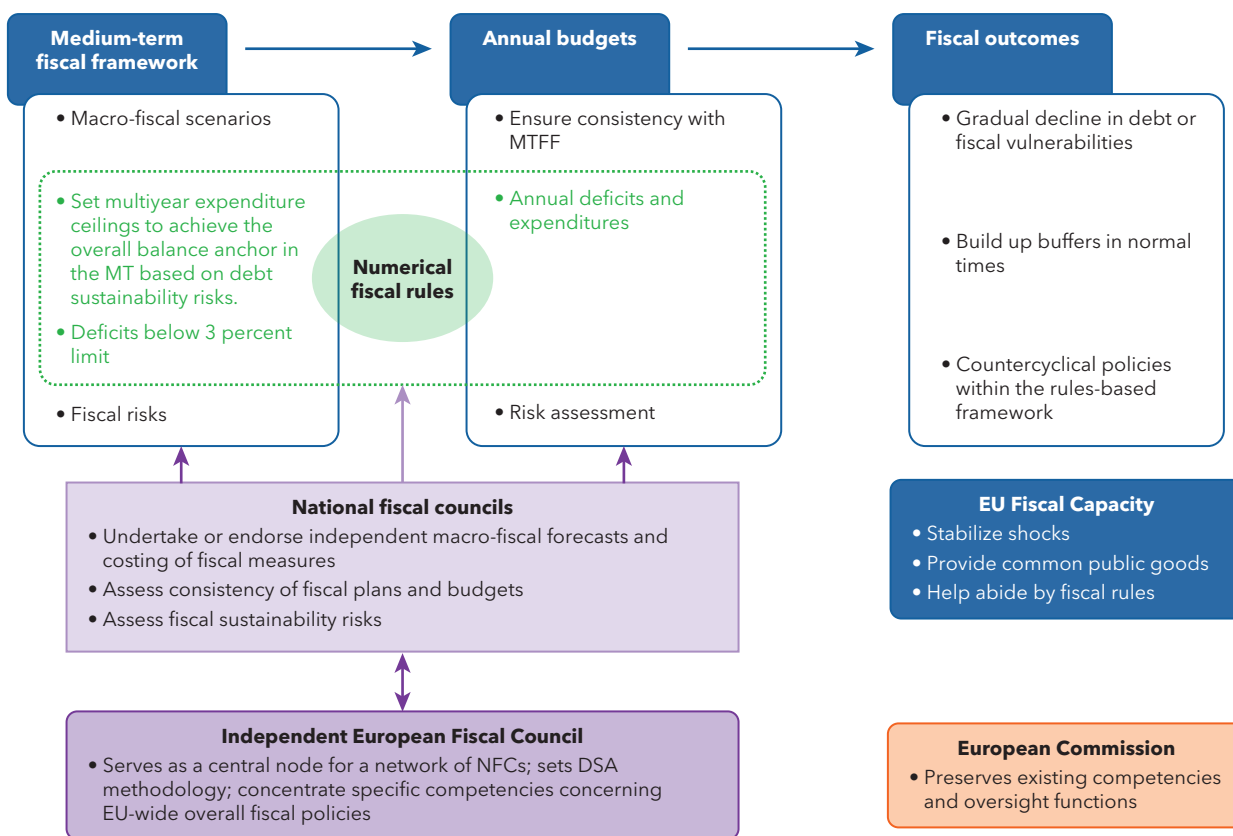
The EC and the Council of the European Union would continue to exercise their current mandates, assessing member states' compliance with fiscal rules and giving effect to new elements of the framework. Specifically, the EC would:

- Enforce the directives laying out minimum requirements for DSAs, MTFs, and NFCs.
- Provide an opinion on the risk assessments of the NFCs and undertake its own assessment.
- Opine on the consistency of the MTFs, expenditure ceilings, and annual budgets with the risk-based fiscal rules.
- Approve any request to trigger the individual escape clause, taking into account the NFC assessment.
- Contribute to the enforcement of the new framework by exercising its power to open an excessive deficit procedure (EDP) in accordance with Article 126 of the TFEU. Specifically, an EDP could be triggered by either (1) failure of the expenditure ceilings and MTFs to follow the rules, leaving them out of line with the EC's risk assessment (that is, a prospective excessive deficit) or (2) failure of government to stay within the expenditure ceilings (excessive deficit ex post), also taking account of the size of the deficit and other relevant information.

The Council of the European Union would continue to play the role envisaged in Article 126 of the TFEU, including deciding on sanctions.

Figure 6 summarizes the proposal. The starting point would be to develop a national MTF that sets risk-based fiscal plans with annual expenditure ceilings consistent with the overall balance anchor over the medium term. Budgets would set expenditures with a margin below the ceilings. National fiscal councils would be heavily involved in the process of preparing the medium-term fiscal plans and budgets providing checks and balances on key aspects (macro forecasts, costing of fiscal measures, assessment of risks), and could raise concerns. Their channels of influence will be stronger given their participation in a network of fiscal councils and the proposed independent EFC. As in the current framework, the fiscal plans would be subject to scrutiny at the supranational level by the EC. The framework incentivizes the rebuilding of fiscal buffers in normal times, while allowing for countercyclical responses to negative shocks. The EU fiscal capacity would help respond to adverse shocks and provide financing for common public goods.

Figure 6. EU Fiscal Governance: Key Reform Areas



Source: IMF staff.
 Note: DSA = debt sustainability analysis; NFCs = national fiscal councils.

4. Fiscal Institutions: Strengthening the National Policy Dialogue and National Ownership

The fiscal governance reform will need to involve an ambitious upgrade of the institutional framework. A crucial objective is to strengthen incentives for national governments to adopt sound policies, including through greater transparency and checks and balances at the national level. Fiscal policies for the EU remain grounded in national policies while the EU-level institutions conduct surveillance, facilitate coordination across all member states, and monitor adherence to the EU treaties and legislation. As outlined in the previous chapter, the totality of the EU's fiscal policies would be shaped by processes and procedures for designing, approving, implementing, monitoring and assessing fiscal policies at both the national and EU levels. This remains the case even when attention is limited to the narrower objectives of ensuring fiscal and debt sustainability and avoiding negative spillovers from national fiscal policies to other member states and the EU as a whole. The proposal in this paper intends to strengthen national ownership via well-specified national MTFs.

A. Upgrading National Medium-Term Fiscal Frameworks

More robust and better-articulated medium-term fiscal frameworks in all EU member states would improve transparency and accountability for fiscal policies. MTFs (or multiyear budgets for countries with adequate capacity) provide the strategic framework to guide the annual budget process. EU legislation already requires countries to establish medium-term budgetary frameworks for fiscal planning and to ensure that annual budgets are consistent with these frameworks.⁶ However, in some member states, there is a weak link between national medium-term plans submitted to the European Commission, national multiyear economic plans and the national annual budgets. Moreover, many member states have weak capacity in risk assessment when preparing budgets.

The medium-term framework would cover the next three to five years and ideally be presented in the context of a comprehensive fiscal strategy and a fiscal risk assessment. It should include three key elements:

- A set of macroeconomic and macro-fiscal projections, containing a (no-policy change) baseline, transparent costing of new fiscal measures, and alternative scenarios.
- A strengthened assessment of fiscal risks and debt sustainability analysis. This would help to increase the credibility of the fiscal strategy and consistency with the numerical fiscal rules, as well as to manage potential fiscal risks such as the materialization of contingent liabilities. The expanded risk analysis of NFCs will provide additional and independent input into the government's own risk assessment. As discussed above, this will inform the medium-term fiscal balance anchor.
- Consistent with this anchor, expenditure ceilings for the next three to five years. Annual budgets would need to be consistent with these ceilings, and ceilings could not be changed except in exceptional circumstances. This is consistent with existing practice in some countries. For example, Sweden sets a nominal expenditure ceiling over a three-year period with the outer year added annually. The Netherlands introduces four-year expenditure ceilings over the government term.

⁶ See [EU Directive 2011/85 on national budgetary frameworks](#). EC (2020a) reviews the experience with linking annual budgets to medium-term fiscal frameworks.

Table 3. Comparison of Fiscal Councils

		NLD ¹	GBR	ESP	DNK	SWE	ITA	DEU	FRA
Analysis	Forecast preparation	Yes	Yes	Yes	Yes	No	No	No	No
	Forecast assessment	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Normative analysis	Yes	No	Yes	Yes	Yes	No	No	No
	Recommendations	Yes	No	Yes	Yes	Yes	No	Yes	No
	Costing of measures	Yes	Yes	No	No	No	Yes	No	No
	Monitoring of rules	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Long-term sustainability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Budget process	Forecasts used in Budget	Yes	Yes	No	No	No	No	No	No
	Binding Forecasts	Yes	No	No	No	No	No	No	No
	Comply or explain	No	Yes	Yes	No	No	No	No	No
Admin	Right to select staff	Yes	Yes	Yes	Yes	Yes	Yes	No	No
	Members and other FTE staff	120	20	36	46	12	21	15	11

Source: IMF Fiscal Council Dataset.

¹Includes both the Netherlands Bureau for Economic Policy Analysis and the Raad van State.

A fiscal strategy document would provide context for the MTFF and set out the government's policy plans for budgetary programs and risk containment. It should also respond to any concerns formally raised by NFCs.

The formulation of annual budgets by governments should be linked to and consistent with their medium-term fiscal frameworks. While medium-term fiscal frameworks evolve in a rolling process and governments have flexibility to adjust their budgetary programs, the key parameters such as the overall balance target or expenditure ceilings would need to be consistent with the binding targets set in the medium-term fiscal plans. There should also be a close linkage among the MTFF, annual budgets, and plans submitted to the European Commission.

B. Strengthening Fiscal Councils

Fiscal councils should play an essential role in building credibility of fiscal policy at the national level by enhancing transparency and fostering accountability. By representing an independent voice and providing technical expertise for credible external oversight, national fiscal councils can provide the right incentives for sound fiscal policy design, deter a backloading of adjustment in MTFFs, increase the reputational costs of policy slippages and violation of fiscal rules, and strengthen the national policy dialogue through checks and balances on fiscal policy, and thereby enhance national ownership. Recent proposals consistently highlight the need for a more visible and enhanced role of national fiscal councils.

Strengthening national fiscal councils is a crucial element of the proposed reforms and represents a major shift from the current situation. There is currently considerable heterogeneity across countries in terms of institutional capacity, proficiency, and experience; operational independence; and key functions such as mandates, tasks, and access to information (Davoodi and others 2022). Moreover, only about two-thirds of national fiscal councils in the EU have some media impact. Yet, Mohl and others (2021) show that more media visibility makes fiscal rules more effective as judged by higher rule compliance. Several fiscal councils, such as those in Belgium and The Netherlands, have prepared macroeconomic forecasts that are used in government budgets. Some longstanding fiscal councils have broad mandates, independence, public visibility, and a demonstrated impact in terms of bringing greater transparency to public finances, such as the United Kingdom's Office for Budget Responsibility, the CPB Netherlands Bureau for Economic Policy Analysis (CPB), and Sweden's Fiscal Policy Council (Annex 4).

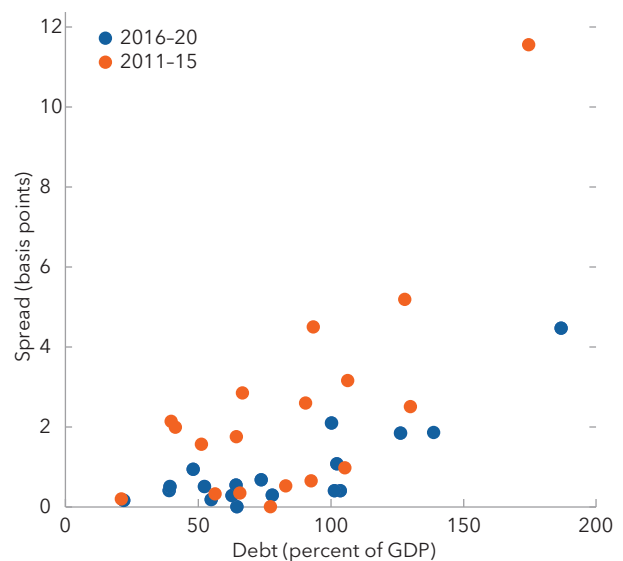
Minimum standards for mandates, resources, expertise, and access to information should be established for national fiscal councils to become effective watchdogs in respect of macro-fiscal management. Fiscal councils should have the mandate to prepare or endorse independent macroeconomic and macro-fiscal forecasts, cost key expenditure and revenue policies, conduct forecast error analysis, assess debt sustainability, and assess whether the government’s medium-term fiscal plans and annual budgets (in particular, the deficit and debt paths), are consistent with fiscal rules. Beyond a core set of expected outputs, fiscal councils should assess and voice views on fiscal risks and concerns on fiscal sustainability. The assessments of fiscal councils should be communicated and published regularly, supplemented by additional outreach as deemed useful by NFCs. Governments must also be held accountable for sharing key macro-fiscal data in a timely manner with NFCs, as underscored recently by the [EU network of IFIs \(2021\)](#). Moreover, governments should commit to the principle of “comply or explain” where the government can use its own forecast—with the obligation to justify publicly deviations from the forecasts of fiscal councils—or a forecast accredited by the fiscal council.

Fiscal councils could have a voice in the activation and deactivation of escape clauses for country-specific shocks. A country’s government could request activation of the national escape clause, in consultation with the fiscal council. Fiscal councils could also assess the adequacy of the government’s fiscal plans once the escape clause is activated. The views of national fiscal councils should also be taken into account in the assessments of European institutions.

A fully independent European Fiscal Council should become the center of an EU-wide network of fiscal councils and exercise the “checks and balances” function at the EU level. The European Fiscal Council (that would replace the EFB) should be made fully independent from the European Commission and be endowed with sufficient financial resources and a dedicated full-time staff with requisite skills. The European Fiscal Council would serve as the central node for a network of national fiscal councils. The creation of a community of practice across Europe among independent fiscal councils would lead to the development of best standards over time.

Better transparency, coupled with the network of independent national fiscal councils, should facilitate market participants’ risk assessments and foster adherence through market discipline. Higher debt is usually associated with higher government bond yields, implying that market mechanisms may play an important role in fostering compliance. Market discipline in the past was procyclical, notably in the runup to the Eurozone crisis, but enhanced forward-looking transparency of fiscal plans could help make it more effective. Kalan and others (2018) show that countries placed under an EDP have significantly higher spreads, which suggests that better communication and transparency, for example, through more potent signaling about a member country’s debt and fiscal sustainability, can foster compliance through market discipline (Figure 7). Especially when risks are assessed as low or medium but debt is on an increasing trajectory, public statements and reports by the national fiscal councils could help deter a further buildup in debt.

Figure 7. Euro Area: Debt to GDP and Spreads vs. German Bunds, 2011-20



Sources: European Central Bank; Eurostat; and IMF staff calculations.

Note: Debt refers to general government gross debt, as defined in the Maastricht Treaty. Interest rates for long-term government bonds are denominated in euros for euro area Member States and in national currencies for Member States that have not adopted the Euro at the time of publication.

C. Upgrading Fiscal Information: Coverage, Consistency, and Consolidation

Continued upgrades of the quality of fiscal information, covering both accounting and government finance statistics, should be an important pillar of the reforms. The source data from accounting information should be developed to complement cash accounting with accrual and balance sheet information. Implementation of European Public Sector Accounting Standards (EPSAS) across all member states would permit the presentation of a comprehensive and reconciled public sector balance sheet that would allow a full view of government actions and risk exposures. Full accrual accounting in all EU members would also provide an improved basis for preparing EU-wide statistics, including consolidated statistics. Yet a more incremental approach is also conceivable. A systematic inventory of assets and liabilities would provide an improved basis for better analyzing government net worth and allow a sounder valuation of public sector investments.

Another important area of improvement is the full alignment of information presented in reports on medium-term fiscal frameworks, budgets, and fiscal outturns. As budgets are typically presented using national standards, their definitions and coverage usually deviate from the harmonized statistical fiscal information used by EU institutions, monitored by other EU member states, and used for EU-level fiscal policy coordination. The greater weight placed on national MTFFs in making EU-level fiscal commitments, elevates the need for transparency and alignment of national fiscal information with EU-wide standards.

Reporting and transparency on the overall EU fiscal position should be improved, expanding the coverage to also include the EU-level budget, fiscal operations, and EU-level debt. Consolidated reporting on EU-level fiscal developments and debt, including the EU budget and funds, should supplement national fiscal reports in order to monitor overall debt and fiscal capacity. This approach would become more important if a central fiscal capacity were to be established for the provision of common public goods or macroeconomic stabilization in the EU. It would also facilitate coordination with monetary policy. Data development work will be required (see above). EU budget execution is complex and operates with long lags, making harmonized reporting between the EU and its member countries a challenge.

D. Upgrading Information Sharing with the European Commission

Fiscal information shared with the Commission should be suitably standardized and expanded, including for the benefit of all other member states and independent observers such as NFCs. Information shared under the European Semester is governed by the “Code of Conduct of the SGP.” It already covers essential information for macro-fiscal monitoring and drivers of fiscal pressures. As this information is also published by the Commission, these submissions form the core of forward-looking harmonized fiscal information easily available for all member states. However, reporting, especially on policy plans, is uneven across member states. It will be important to expand the information to suitably cover national MTFFs and ensure close linkage among MTFFs, annual budgets, and commitments submitted to the European Commission.

The proposed reforms on fiscal institutions preserve the existing oversight at the EU level. All member states would remain subject to regular surveillance and the provision of a core set of information on their fiscal positions and plans. EU institutions would remain entitled to seek additional information and consultation appropriate to the degree and source of risk and mitigating actions already taken by the member states. In extremis, the excessive deficit procedure foreseen in the treaties could be opened.

5. An EU Fiscal Capacity

The pandemic and war in Ukraine have highlighted longstanding vulnerabilities in the EU's economic architecture, illustrating the need for an EU Fiscal Capacity. Important progress has been made in improving the EU's architecture, including through the establishment of the Banking Union and the creation of the European Stability Mechanism. However, as argued previously (for example, [Allard and others 2014](#); [Arnold and others 2018](#); and [Berger, Dell'Ariccia, and Obstfeld 2018](#)), a key remaining architectural reform is the establishment of a well-designed EU fiscal capacity (FCEU) to enhance resilience, address emerging longer-term challenges through the provision of common public goods, and to better respond to adverse shocks through stronger macro-stabilization. Such a fiscal capacity would also help avoid procyclical cuts to growth-friendly spending during downturns, in particular when monetary policy is constrained at the effective lower bound for interest rates. By enhancing resilience and reducing the potential for adverse spillovers within the EU, an EU fiscal capacity would help improve the implementation of EU fiscal rules.

A. Role of the EU Fiscal Capacity

IMF staff have long argued for an instrument to improve euro area macroeconomic stabilization and reduce the burden on monetary policy. A macroeconomic stabilization instrument to smooth macroeconomic shocks would fill an important gap in the euro area architecture ([Allard and others 2014](#), [Arnold and others 2018](#)). It could help smooth country-specific shocks, which monetary policy cannot do, and facilitate an appropriate mix of fiscal and monetary support in the face of common shocks to the union, especially when monetary policy is constrained at the effective lower bound. It could be designed as a rainy-day fund, which builds assets in good times and makes transfers to support countries in bad times. It could also be a common fund targeted to a specific cyclical expenditure, in line with the European Instrument for Temporary Support to Mitigate Unemployment Risks in an Emergency (SURE) instrument that helped countries finance job retention schemes which proved to be effective stabilizers during the pandemic. Alternatively, the [ESM \(2022\)](#) has recently proposed a loan-based fiscal stability fund, arguing that such a fund could better address moral hazard and be more easily set up than other proposed macroeconomic stabilization schemes.

A separate function for an FCEU could be the provision of common public goods for the EU as a whole. This would help address externalities or market failures in the green transition and the under-provision of common public goods, supporting long-term growth with positive spillovers among member states. In this respect, the introduction of the [Recovery and Resilience Facility \(RRF\)](#), as a common EU funding instrument to support the recovery, finance green and digital investment needs, and address legacies from the pandemic, was an important step. In addition, the current energy shock arising from the war in Ukraine reinforces the need to enhance EU energy security by accelerating the green transition. By safeguarding a steady stream of spending on public goods, the FCEU could act as a stabilizing instrument in the face of cyclical shocks.

A climate investment fund (CIF) under the FCEU would help the EU achieve its emission reduction goals more efficiently. Addressing climate change is urgent and will require frontloaded but decades-long efforts, strengthening the case for a permanent EU CIF to complement ongoing carbon pricing reforms. Indeed, reducing GHG emissions is best achieved jointly, as the return to individual action is limited given externalities (from emissions), leakage (of emission generating activity moving across borders), and spillovers and network effects (from investment in new technologies). An EU CIF could (1) better internalize spillovers from reducing greenhouse gas (GHG) emissions, (2) exploit differences in abatement costs across countries, (3) better coordinate cross-border investments and R&D, and (4) ensure required investments occur in the face of political or fiscal constraints. The CIF would require top-down prioritization of some investments

(for example, cross-border grid interconnections, R&D). But, for a large share of the funds, it could borrow elements of the RRF, to allow countries proposing their own emission reduction projects (including ones such as job reskilling programs for labor reallocation to green sectors) to be financed by the CIF.

An EU CIF could be designed to limit the extent of cross-border transfers over the long term. Cross-border transfers stemming from an EU fiscal capacity are politically sensitive. An EU CIF that places a greater weight on cost-effective emission reductions may entail a larger allocation of funding (at least as a share of GDP) to some countries (for example, to replace coal-fired power plants in Eastern Europe) in the short to medium term (that is, until the mid-2030s). But, over the long term (to 2050) cross-border transfers would likely be limited as cumulative investment needs across countries are similar (as a share of GDP). Moreover, the CIF could be explicitly designed to ensure similar cumulative investments, though potentially with some efficiency costs.

Views differ on the pros and cons of mutualizing legacy-related debt, which will be covered in a separate forthcoming paper. Giavazzi and others (2021), among others, lay out potential benefits of a one-off legacy debt mutualization such as lower national debt levels combined with a revised EU fiscal framework, the creation of a larger stock of an EU-wide safe asset, and a better alignment of fiscal and monetary incentives going forward. Others have raised concerns about moral hazard if the mutualization is not perceived as a one-off event, and some argue that the NGEU de facto mutualizes more than 40 percent of pandemic-related debt, questioning whether more is needed. A careful analysis of these issues is beyond the scope of the current paper.

B. Financing Modalities for the FCEU

The FCEU should have a borrowing capacity, paired with an income stream to allow it to service its debt. Similar to the NGEU, the FCEU should be able to tap capital markets to raise funds to finance investments in common goods and provide macroeconomic stabilization. This would also have the added benefit of creating an EU-level safe asset for a prolonged period, as NGEU debt will be extinguished by 2058.

The exact design of the financing mechanism and burden sharing among countries will be a political choice. Establishing an FCEU would either require new EU “own resources” or some form of country contributions. For example, to service the NGEU debt, one proposal is for the EU to receive a share of any additional corporate income tax (CIT) revenue stemming from international CIT reform. This would have the added benefit of being a cyclical source of revenue, enhancing the FCEU’s countercyclicality. Country contributions (for example, based on gross national income (GNI)) are another option, though equally difficult politically. Ultimately, the FCEU may need to be funded with a mix of negotiated country contributions and new own resources. If EU-level revenues were earmarked, revenues from the emission trading schemes (ETS) would be a possibility, although the associated tax base would shrink as climate objectives are reached

As already noted, the financing needs for the green transition are large and frontloaded. Preliminary estimates suggest additional public investments of about ½ to 1 percent of GDP per year on average (or 15–30 percent of EU GDP by 2050) are needed to achieve the EU’s emissions reduction goals (EC 2021, [Darvas and Wolff 2021](#)). Any EU CIF should aim at covering a significant fraction of this amount. The war in Ukraine and the recent push for faster decoupling from fossil fuels are likely to affect these estimates, in particular investments in renewables will need to be brought forward to advance energy security.

C. Other Considerations for the FCEU

Operationally an EU FCEU could borrow elements from the design of the RRF. Investments financed by the FCEU could be identified either centrally (top-down) or by countries (bottom-up). While the RRF is based on decentralized project selection, the FCEU would need to be more top down, as there is a greater need for coordination and directing investment for common public goods. However, there would still be a role for countries to propose projects for financing, potentially accounting for a large share of the total. This requires a robust methodology for prioritizing investment projects.

An FCEU should be accompanied by a strengthening of public financial management, especially regarding green investments. Developing and implementing common green budgeting and green public financial management (PFM) practices will be necessary ([Gonguet and others 2021](#)). Over time, the PFM strategy of an FCEU should focus on fiscal transparency and accountability through independent assessments by national fiscal councils and the EFB. Regular communication and engagement with EU citizens, parliamentarians and policymakers would also be essential to ensure buy-in from stakeholders. A strong public investment management process would limit practical shortcomings identified previously regarding a golden rule.

The design of the FCEU should allow sufficient flexibility for it to evolve over time. As an FCEU would potentially operate for decades, there is scope for learning and improving processes over time. One option would be to incorporate an FCEU into the EU budget process, for example, as a separate layer similar to the RRF. This would allow for investment priorities and plans to be reassessed periodically and incorporate lessons learned in the operation of the fund.

Annex 1. Counterfactual Simulations of Adherence to the Fiscal Rules¹

Methodology

A framework of debt dynamics based on Abbas and others (2013)² is used to examine the impact of stricter adherence to the EU fiscal rules on the macroeconomic and fiscal outcomes of euro area countries. The framework models the effects of an alternative path of structural fiscal adjustment on fiscal balances, interest rates, output and debt, departing from the data baseline.³

In a nutshell, the model is built around a debt dynamics equation. Changes in public debt over time are a function of primary fiscal balances—which are affected by structural adjustment and the output gap—and of the interest expense—which is the sum of interest paid on different bond vintages. Obviously, changes in output also influence the evolution of the debt-to-GDP ratio.

Two key general equilibrium channels are captured in reduced form. First, fiscal multipliers are assumed to be a decreasing function of the output gap (varying over the [0,1] interval, with the multiplier set at 0.5 when the output gap is zero). Second, the nominal interest rate paid on new bond issuances is increasing in the existing debt level.

A simplified version of the equations describing the impact of the fiscal stance on output growth is outlined below. The counterfactual fiscal effort path $\{ft\}_{t=0}^T$ defined as deviations from the baseline structural primary balance, is the key input to the model. Variables with a superscript b are taken from the data baseline. All variables are set equal to the data baseline before the counterfactual fiscal path begins in 1992, the year the Maastricht Treaty was signed. Potential output \bar{y}_t is unchanged from the baseline for the whole period.⁴

Nominal output y_t grows in proportion to baseline output y_t^b , times a fiscal impulse term F_t and a risk premium term rp :

$$y_t = y_{t-1} \left(\frac{y_t^b}{y_{t-1}^b} \right) (1 + F_t)(1 - rp).$$

The fiscal impulse term is a function of current and past fiscal effort f_t (defined as a share of GDP), with a multiplier dependent on the output gap:

$$F_t = -(m(\hat{y}_t)f_t - m(\hat{y}_{t-1})f_{t-1}),$$

where $m(\cdot)$ is a monotonically increasing function bounded between [0,1] and the output gap is $\hat{y}_t = y_t - \bar{y}_t^b$. This captures the fact that a fiscal relaxation (that is, a negative fiscal effort f_t) has a more positive effect on growth if there is slack in the economy.⁵ For simplicity, the formulation of F_t assumes that the impact of f_t on GDP growth fully reverses after one year, hence the second term in the equation.⁶

¹ Based on a forthcoming IMF working paper titled “Adherence to the Stability and Growth Pact: Counterfactual Scenarios” (Arnold and Garcia-Macia).

² See Annex 5 of IMF Staff Discussion Note 13/07 “Dealing with High Debt in an Era of Low Growth.”

³ The underlying paper with the full details of the framework and simulation results is available upon request.

⁴ The assumption that fiscal policy does not affect potential is a simplification in line with standard macroeconomic theory. However, in reality, channels such as job market hysteresis induced by fiscal austerity or uncertainty from high debt levels could have an impact on potential output. Moreover, if tighter fiscal policy is achieved by cutting public investment, this could also weigh on potential growth.

⁵ This abstracts from how the composition of the fiscal effort may change the growth impact, as the framework just uses an overall measure of spending for simplicity.

⁶ The effects of fiscal effort on output may be more persistent in the data.

The risk premium term is determined by the debt level, and calculated in deviations with respect to the baseline-implied risk premium:

$$rp_t = \theta \left(\frac{1}{(d_{max} - d_{t-1})^\alpha} - \frac{1}{(d_{max} - d_{t-1}^b)^\alpha} \right),$$

where θ , α , $d_{max} > 0$ are parameters. Higher levels of debt are assumed to increase sovereign borrowing rates, which in turn pass through to private lending rates and exert a drag on economic growth. Note that in this formulation the risk premium asymptotes to infinity as debt approaches the level d_{max} . The parameter d_{max} thus reflects the debt level beyond which the sovereign debt market breaks cannot clear at any interest rate.

These assumptions imply that when a country with high debt implements a fiscal expansion (relative to the baseline) and the output gap is closed or positive, the impact on output is relatively small, while the fiscal deficit and debt rise more quickly because of the risk premium effect on borrowing costs. Conversely, when a country implements a fiscal consolidation and the output gap is negative, the negative output impact is worse and the reduction in the deficit and debt correspondingly smaller.

Counterfactual Scenarios

The fiscal path in the data—corresponding to partial compliance with the SGP—is compared against two counterfactual scenarios: (1) stricter adherence to the rules regardless of macroeconomic conditions and (2) stricter adherence with an escape clause in the event of a severe economic downturn.

Stricter Adherence (Without Escape Clause)

The first counterfactual scenario models a fiscal adjustment rule consistent with stricter compliance with the SGP.⁷ The rule is anchored on the medium-term objective minimum balance (MTO MB) published by the EC for each country.⁸ Departing from 1992 data values, it requires a cumulative adjustment to the primary balance which is increasing (in absolute value) in the distance between the overall balance and the MTO MB.

Specifically, fiscal effort is equal to its previous-year value plus the minimum between 0.25 percent of GDP and the amount consistent with an overall balance equal to the MTO MB. This adjustment is applied with opposite (and stabilizing) signs to balances above and below the MTO MB, so the rule induces convergence to the MTO MB (Annex Figure 1.1).⁹

As an additional clause, if the current overall balance is below -3 percent of GDP, the adjustment increases by an extra 0.25 percent of GDP (or the minimum needed to reach a -3 percent balance if it is less than 0.25 percent). This captures the Excessive Deficit Procedure of the SGP, which dictates a minimum 0.5 percent of GDP adjustment for countries with deficits below 3 percent.

This counterfactual starts applying the rule in 1992, the year when deficit and debt limits were first agreed to as part of the Maastricht Treaty.¹⁰

⁷ There exists a multiplicity of rules consistent with stricter compliance. The rule modeled here tries to remain as close as possible to the spirit of the SGP.

⁸ See SGP Vade Mecum, EC (2018, 2019). Values of the MTO MB are kept constant at 2018 levels.

⁹ The SGP is asymmetric and does not require countries overperforming their MTO to ease fiscal policy. But this aspect of the “rule” in the stricter compliance scenario aims to reflect that overperforming the MTO would likely entail sacrificing productive public spending, which would be suboptimal.

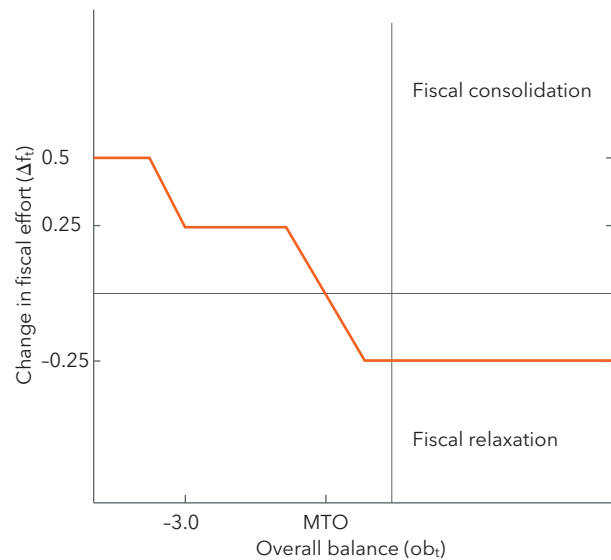
¹⁰ The Maastricht Treaty came into force in 1993, but in anticipation of the requirements we would expect countries far from the deficit and debt benchmarks to begin tightening in advance.

Stricter Adherence with Escape Clause

The third counterfactual scenario introduces an escape clause into the stricter compliance scenario after 1999. The escape clause is triggered when the output gap is below -1.5 percent of potential GDP.¹¹ When the escape clause is activated, the fiscal rule is modified, setting the fiscal effort such that the overall balance matches its value in the data. Compared to the stricter compliance scenario this results in a looser fiscal policy response during severe downturns.

It is important to note that we design the escape clause based on an output gap threshold for the simplicity of modeling it. And it should not be confused with the “general escape clause” added to the SGP in 2011. The general escape clause in the SGP is a discretionary instrument that can be activated if there is a severe shock to the union. It was activated for the first time in March 2020 in response to the COVID-19 crisis.

Annex Figure 1.1. Stricter SGP Compliance—Illustration of the Fiscal Rule



Source: IMF staff.

Note: Assuming the cyclical component of the primary balance is zero, the overall balance is equal to the structural balance.

MTO = medium-term objective.

Summary of Results

In general, as seen for Italy in Figure 3 in the main text, under the scenario of stricter adherence to the rules in all periods, the level of debt in 2007, before the global financial crisis (GFC), would have been much lower than in the data. For Italy, pre-GFC debt would have been about 30 percent of GDP lower than in the data. This would have come at a cost of a slightly lower level of real GDP—about 1 percentage point—in 2007. The figures are the same for the scenario of stricter adherence with the escape clause, as the escape clause as we define it would not have been activated before 2008.

While pre-GFC, the cost of *stricter adherence* to the fiscal rules was relatively modest in terms of output costs, these costs would have increased substantially during the GFC and euro area debt crisis. Stricter adherence would have resulted in a more procyclical policy response, particularly during the GFC, than seen in the data. The tighter fiscal policy path would have exacerbated the output impact of the crisis, nearly doubling to size of the output gap in Italy, for example. Even with the more negative output impact, the stricter adherence scenario does generate lower debt levels. For example, the debt ratio for Italy in 2017 would have been about 55 percent of GDP lower than in the data.

The scenario of *stricter adherence with an escape clause* still delivers relatively good fiscal outcomes, at much less of an output cost during severe downturns. Having a lower level of debt going into the GFC allows for a stronger countercyclical fiscal response to the GFC, as well as avoiding a procyclical response during the euro area debt crisis. As a result, the output gap is less negative than in the data during 2008–17, with the level of real GDP nearly 1 percentage point higher in 2017. At the same time, Italian debt in the scenario would have reached about 96 percent of GDP in 2017, 35 percentage points below the level seen in the data.

¹¹ This trigger level is motivated by the Commission’s matrix of required adjustment for different levels of the output gap.

Annex 2. Simulations of Proposed Rule Versus Current Rules

Methodology

The paper uses a modified version of the stochastic simulation approach developed in Caceres and Ruiz-Arnaz (2010), which uses a Vector Autoregression (VAR) framework to simulate projections for key macro-fiscal variables under different rules, subject to shocks to the output gap and real interest rate.

In addition to modeling two of the rules in the current framework—the debt correction mechanism known as the “1/20th rule” and a structural balance rule—we model an illustrative example of how a country could implement our proposal, with a medium-term anchor in the form of a zero overall balance and medium-term expenditure path that delivers a gradual, but sustained, fiscal adjustment to reduce debt.

Specifically, we model our proposal as follows:

Let \bar{y}_t be the output gap, and let \bar{y} be its unconditional mean.¹ For periods $t = 0, 1, \dots, T$ (where T is the period in which we want to reach zero deficit), the nominal expenditure will grow at a rate G^E such that

$$1 + G^E = \left(\frac{rev_0 + \varepsilon^R \bar{y}}{exp_0} \right)^{\frac{1}{\pi}} (1 + \bar{g}^y)(1 + \bar{y})^{\frac{1}{\pi}} (1 + \pi)$$

where \bar{g}^y is the constant growth rate of potential output, π is the inflation rate, and ε^R is the elasticity of revenue with respect to the output gap.

The evolution of expenditure as a fraction of GDP is given by

$$exp_t = exp_{t-1} \frac{(1 + G_t^E)}{(1 + g_t^y)(1 + \pi)}$$

where g_t^y is the growth rate of real output. Iterating backwards, we have that

$$exp_T = exp_0 \frac{(1 + G^E)^T}{(\prod_{t=1}^T (1 + g_t^y))(1 + \pi)^T}$$

Using the nominal expenditure growth rate from the first equation, we have

$$\begin{aligned} exp_T &= (rev_0 + \varepsilon^R \bar{y}) \frac{(1 + \bar{y})(1 + \bar{g}^y)^T}{\frac{Y_t}{Y_0}} \\ &= (rev_0 + \varepsilon^R \bar{y}) \frac{(1 + \bar{y})}{(1 + \bar{y}_T)} \end{aligned}$$

which means that the balance at time T will be approximately zero except for deviations of \bar{y}_t from its long-term mean \bar{y} .

After T , let us assume that the nominal expenditure grows at a rate $1 + G^E = (1 + g_t^y)(1 + \pi)$.

¹ The output gap is the first element of the vector Y_t , which follows a VAR(2) when the fiscal multiplier is zero:

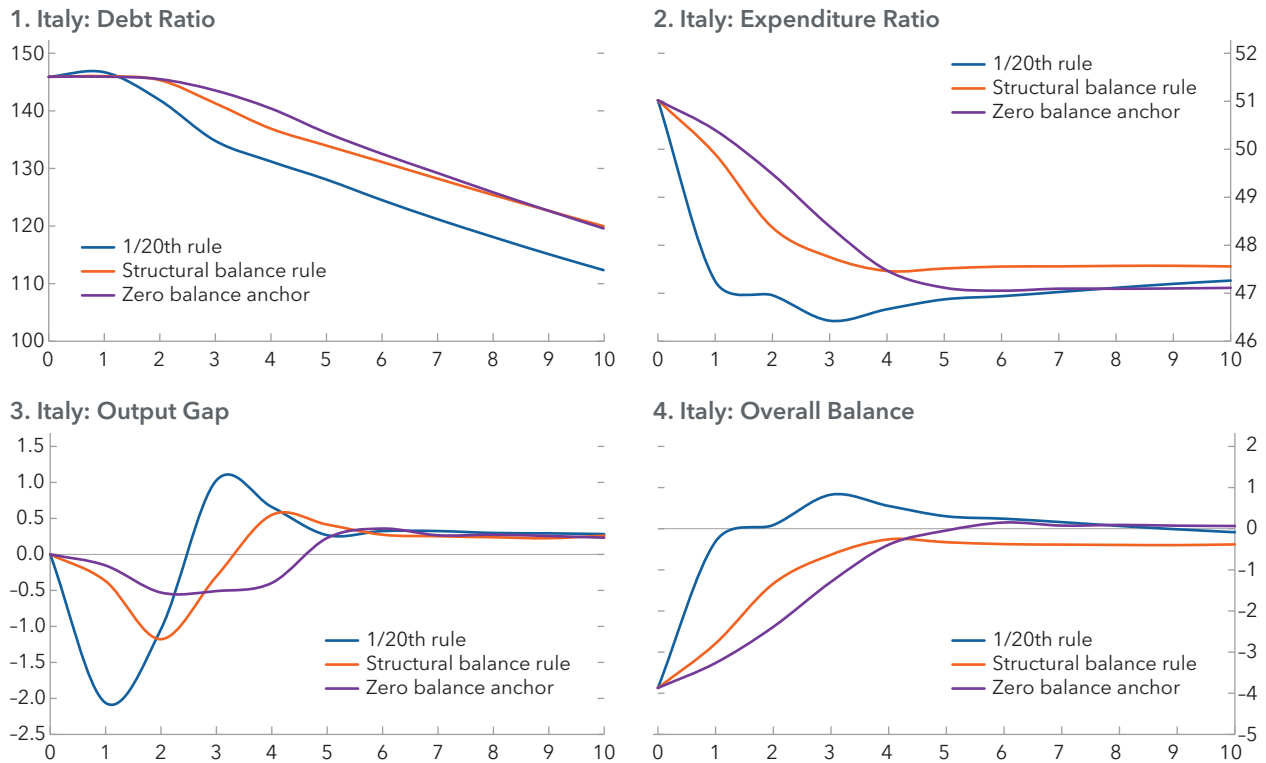
$$Y_t = C + A_1 Y_{t-1} + A_2 Y_{t-2}$$

The unconditional mean of the output gap (with zero fiscal multiplier) is therefore

$$\bar{y} = e_1 (I_3 - A_1 - A_2) C$$

where I_3 is a 3x3 identity matrix and $e_1 = (1, 0, 0)$. Alternatively, instead of the unconditional mean, we could use the mean conditional on a zero-output gap in the first period. The results don't change significantly.

Annex Figure 2.1. Italy Simulations—Medians
(Median, percent of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

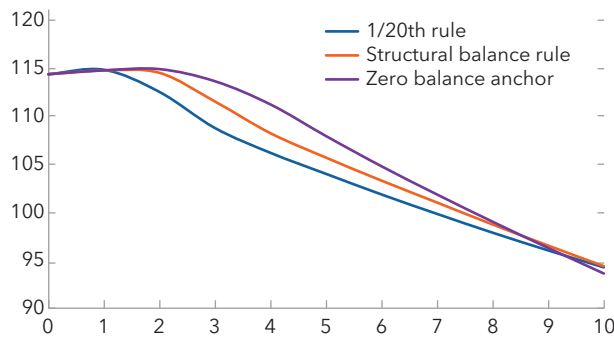
Annex Figure 2.1 displays the median results of the simulation for the case of Italy. Note that in year 5 the median overall balance is effectively zero (-0.04% of GDP). Given the output drag from the fiscal adjustment, in order to achieve an annual deficit of zero in year 5, the simulations require targeting a zero balance in the second quarter of year 4. This suggests countries may need to try to overshoot or build in buffers to their expenditure plans to compensate for the growth impact of their fiscal adjustment.

It should be noted that the simulations assume a fiscal multiplier of 0.5 (the factor by which structural balance or expenditure adjustment impacts output), which would imply that expenditure reduction efforts are achieved by curtailing low quality or unproductive public spending. If expenditure reductions are achieved by cuts to productive spending, such as public investment and education, or transfers to low-income households, the multiplier would likely be larger. In general, a higher multiplier would amplify the negative impact on output and argue for extending the convergence to the anchor by a year or two. Moreover, the simulations do not incorporate hysteresis effects that could make the impact more persistent.

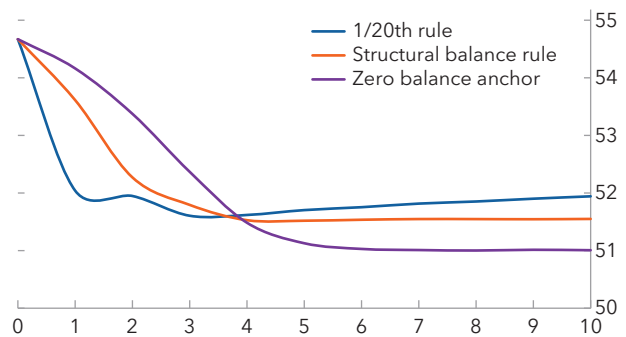
The figure illustrates that for the medians of the simulations, in which there are effectively no shocks to the output gap and real interest rate, the proposal delivers as much debt reduction as the current structural balance rule over 8-10 years. However, the pace is more gradual, leading to a less negative impact on the output gap. This latter point is even stronger when compared to the "1/20th rule," which would require a politically infeasible fiscal adjustment of more than 4 percentage points of GDP in the first year. Of course, over the longer term, in the model the mechanics of such a sharp adjustment delivers a lower debt ratio than our proposal.

Annex Figure 2.2. France Simulations—Medians
(Median, percent of GDP)

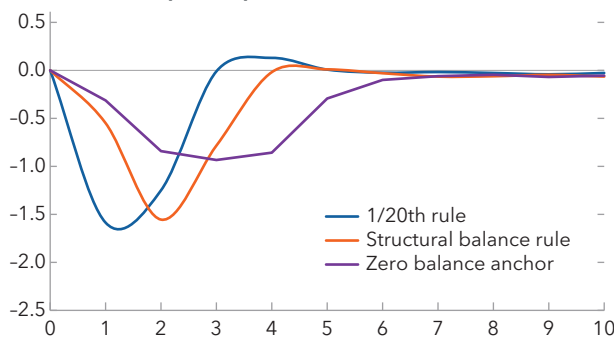
1. France: Debt Ratio



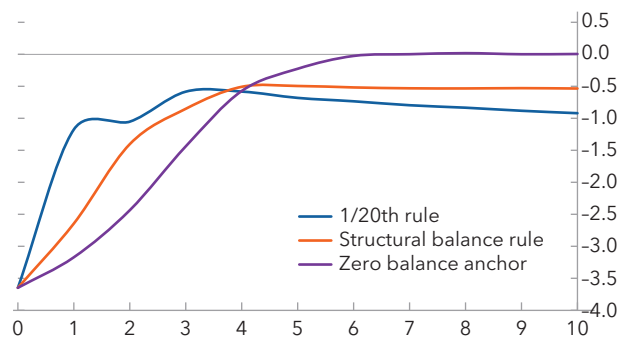
2. France: Expenditure Ratio



3. France: Output Gap



4. France: Overall Balance



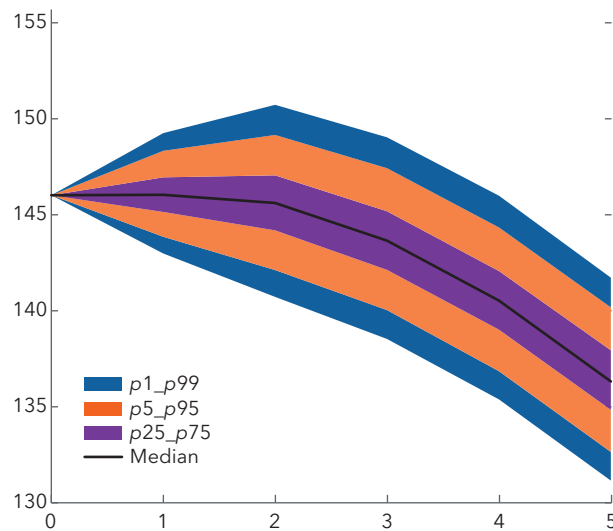
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

Similar simulations are conducted for France, again comparing a zero overall balance anchor to a structural balance rule and the “1/20th” debt correction mechanism. France’s debt ratio is lower than Italy’s so the differences between the rules are smaller, particularly between the 1/20th rule and the others. The medians of the simulations (Annex Figure 2.2) exhibit similar dynamics to those for Italy, with debt coming down more slowly initially as the reduction in the expenditure ratio is more gradual but ultimately delivering similar levels of debt reduction over a 10-year horizon. As in the case of Italy, the more gradual expenditure reduction under the proposal has a less deleterious impact on the output gap than the other rules, while requiring slightly more ambition over a longer time horizon.

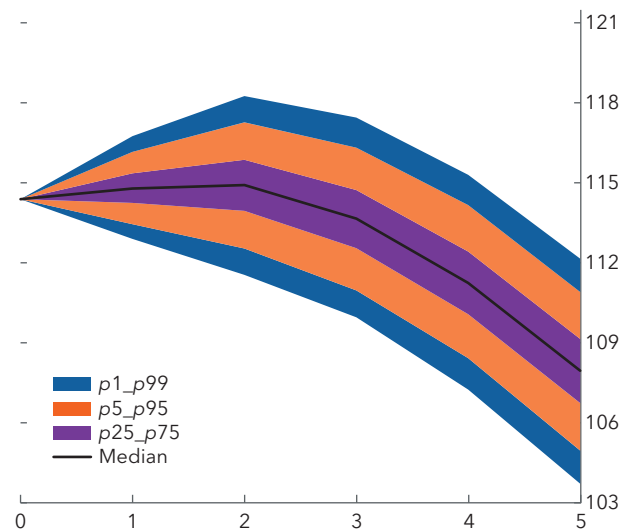
In addition to the median paths for different rules, we can use fan graphs of the distribution of the debt ratios generated by the simulations to examine whether the proposed rule is likely to reduce debt with high probability (Annex Figure 2.3). The fan graphs of the debt ratios of Italy and France suggest that the zero overall balance anchor would be sufficient to stabilize or reduce debt over a 5-year period with high probability (as defined by the 95th percentile of the distribution). This comes with the caveat that fan graphs exclude tail risk events, and the spread will be determined by the properties of the data during the period from which it is drawn. In this case the data covers 2000:Q1–2019:Q4, which includes the global financial and euro area debt crises, so the degree of volatility in the output gap and real interest rate series are likely to be sufficient to generate reasonable fan charts, barring another very severe shock.

Annex Figure 2.3. Italy and France Debt Fan Charts (Percent of GDP)

1. Italy: Debt Ratio Fan Chart, Zero Balance Anchor



2. France: Debt Ratio Fan Chart, Zero Balance Anchor



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

Note: The fan graphs in panels 1 and 2 depict the distribution of the debt ratio given shocks drawn from the data over 2000:Q1-2019:Q4. It can be read as indicating that the debt ratio will remain below the upper end of the distribution (upper blue range) with high probability, while the likelihood it will fall below the lower end (lower blue range) is small.

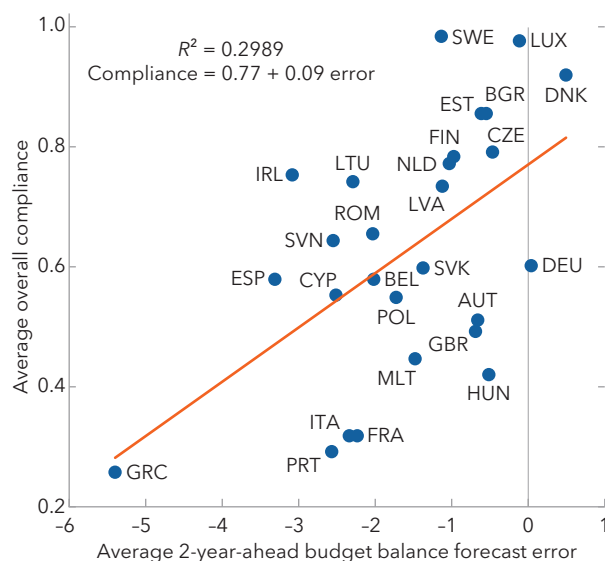
Annex 3. Strengthening Compliance by Reducing Forecast Biases

Improving medium-term expenditure planning and fiscal forecasts as proposed in this paper would go a long way in achieving better compliance. Most governments are too optimistic in their medium-term fiscal forecasts, as shown by the negative average forecast error for budget balances two years ahead. There is a large degree of cross-country variation, but countries with larger forecast errors are associated with less compliance with the EU fiscal rules. Forecast errors and noncompliance are sometimes driven by economic shocks, which lead to revenue shortfalls and larger deficits. For example, during 2008–11, average compliance dropped to 43 percent, down from 70 percent for previous years. A lack of scope within the rules for countercyclical fiscal policies likely explains part of the drop in compliance (see, for example, Darvas, Martin, and Ragot (2018) and Blanchard, Leandro, and Zettelmeyer (2021)). At the same time, the negative forecast errors mostly reflect an under-projection of expenditures (Annex Box 3.1). Taken together, this implies that deficiencies in medium-term expenditure planning is undermining compliance with the rules.

Expenditure rules at the national level have been successful in reducing forecast biases. EU countries that had an expenditure rule in place at the national level exhibited on average significantly lower over-optimism ($\frac{1}{2}$ – $\frac{3}{4}$ percent of GDP lower forecast error for the budget balance) due to lower under-projection of expenditures in the near and medium term (Annex Box 3.1). Multiyear expenditure ceilings, stronger legal backing, a mechanism for monitoring outside the government, and broader coverage of the expenditure rule appear to further strengthen the expenditure rule's effectiveness.

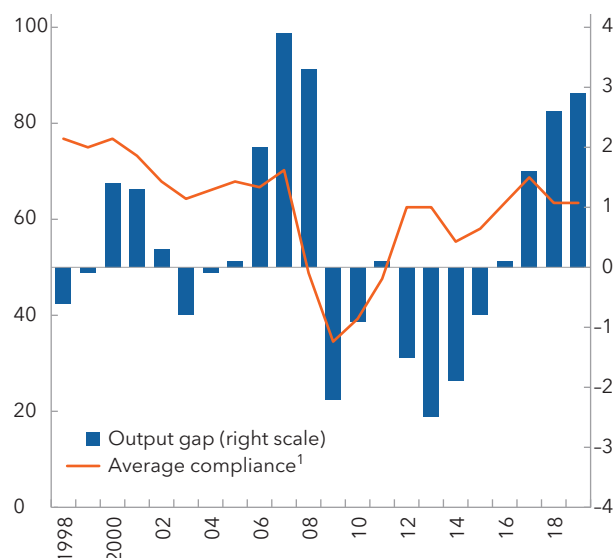
To ensure that the expenditure ceilings proposed in this paper operate effectively, they should ideally be underpinned by strong medium-term budget frameworks. While the Code of Conduct of the SGP already requires some reporting on fiscal and expenditure policies, this is currently an area of uneven reporting

Annex Figure 3.1. Fiscal Rule Compliance and Medium-Term Forecast Error
(Fraction of cases complied; percent of GDP)



Source: IMF staff calculations.

Annex Figure 3.2. Compliance and Output Gap, 1998–2019
(Average overall rules, percentage of potential GDP)



Sources: Compliance database of the Secretariat of the European Fiscal Board; Ameco Database; and IMF staff calculations.

¹Average compliance refers only to rules that were in place at a given year.

practices across countries and relatively weak adherence. This paper proposes multiyear expenditure ceilings under a medium-term fiscal framework. Furthermore, more scrutiny, through a regular and visible analysis of deviations from medium-term forecasts, covering forecast errors and implementation of past policy commitments, would encourage governments to improve their medium-term budget planning. Finally, systematic regular spending reviews should be conducted, that analyze the effectiveness of national expenditure policies and find ways to release fiscal space for priorities (Bova and others 2020, EC).

Annex Box 3.1. Expenditure Rules and Forecast Biases

Low compliance with EU fiscal rules is partly explained by an optimism bias in budget projections, especially for expenditures. Over a two-year ahead horizon, the average forecast error across EU countries for the episode 2005-19 is about 1½ percent of GDP. Countries that comply better with EU fiscal rules also have an optimism bias, but they tend to compensate expenditure under-projection with overly prudent revenue projections.

A panel regression framework is used to assess the role of expenditures rules for the observed variation in forecast errors. A first OLS regression is used to estimate the effect of the expenditure rule¹:

$$\Delta FB_{i,t}^{t+k} = c^k + \alpha^k \cdot ER_{i,t} + \beta^k \cdot POL_{i,t} + \gamma^k \cdot ECO_{i,t} + \delta^k \cdot X_{i,t} + \varepsilon_{i,t}^k$$

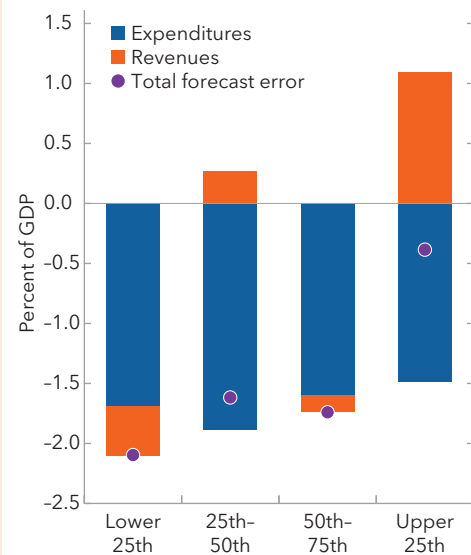
where $\Delta FB_{i,t}^{t+k}$ is the k-years ahead forecast error of the fiscal balance (in percent of GDP) in country i ; c^k is a constant; $ER_{i,t}$ is a dummy for the presence of a national expenditure rule, $POL_{i,t}$ and $ECO_{i,t}$ are covariates describing the presence of political factors (extent of government majority and election year dummy), and economic conditions (current account openness and GDP growth forecast error), respectively; $X_{i,t}$ describe other controls (education level and year dummies); and $\varepsilon_{i,t}^k$ is an error term.

A second regression analyzes the design elements, conditional on an expenditure rule being in place (which diminishes the sample size):

$$\Delta FB_{i,t}^{t+k} = \mu^k + \eta^k \cdot FIS_{i,t} + \theta^k \cdot X_{i,t} + \nu_{i,t}^k$$

where μ^k is a constant; $FIS_{i,t}$ are covariates describing the characteristics of the fiscal rule and supporting institutions—specifically, dummies for (1) existence of multiyear expenditure ceilings, (2) legal basis of fiscal rules, (3) existence of monitoring of rules mechanism outside the government, (4) sectoral coverage of the fiscal rule, and (5) existence of a formal enforcement procedure of the rule; $X_{i,t}$ describe other controls (GDP growth forecasts error and year dummies); and $\nu_{i,t}^k$ is an error term.

Annex Box Figure 3.1. European Union: Bias Decomposition 2-Year Ahead
(Average by countries' compliance percentile rank)



Source: IMF staff calculations.

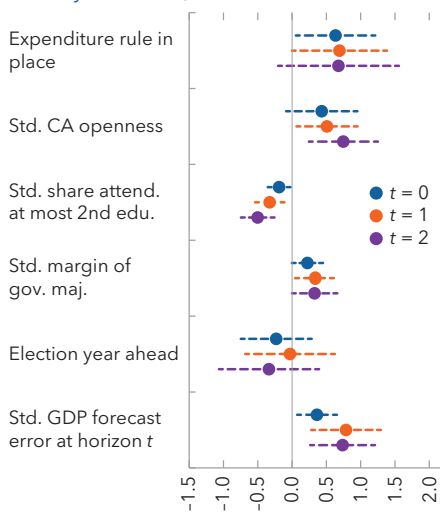
¹ The database for the forecast errors has been compiled by the IMF's Fiscal Affairs Department drawing on the national forecasts published in the context of the Stability and Convergence Program, and the IMF World Economic Outlook data for realized data. The information on fiscal rules and institutions is taken from the IMF Fiscal Rules Dataset, 2021. Data covers all EU countries with available data from 2005-19.

Annex Box 3.1. Expenditure Rules and Forecast Biases (continued)

Expenditure rules are associated with lower forecast biases, which are further reduced by stronger institutional backing. Annex Box Figures 3.2 and 3.3 report the coefficient estimates (dots) and confidence bands (lines) from the two regressions for three forecast horizons. Positive values correspond to the amount (in percent of GDP) by which a given variable reduces the forecast bias. Coefficient values reflect the response to a one standard deviation change. For instance, the forecast error for the fiscal balance is about 0.6 percent of GDP lower for countries that have an expenditure rule than in countries without such a rule (at all three forecast horizons). Similarly, the forecast bias is about ½ (2) percent of GDP lower in the contemporaneous year (two years ahead) if expenditure covers the entire general government as opposed to only parts of the expenditures. However, coefficient estimates, especially of the second regression, should be interpreted with caution, given the limited sample size and collinearity amongst some of the covariates, which are primarily dummy variables.

Annex Box Figure 3.2. European Union Fiscal Balance Forecast Error

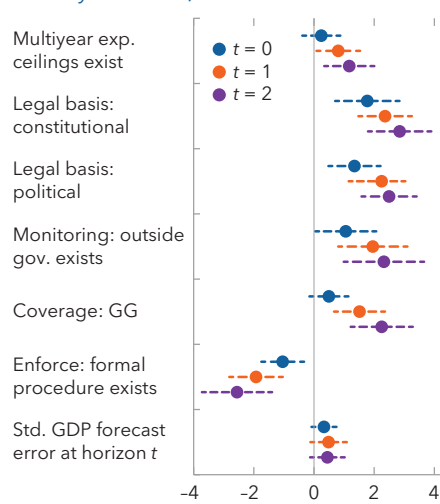
(Difference from sample average in percent of GDP; effect of one standard deviation change or one unit change for dummy variables)



Source: IMF staff calculations.

Annex Box Figure 3.3. European Union Fiscal Balance Forecast Error

(Difference from sample average in percent of GDP; effect of one standard deviation change or one unit change for dummy variables)



Source: IMF staff calculations.

Note: Results are conditional on having an expenditure rule in place.

Annex 4. Effective Fiscal Councils

International experience and sound principles of fiscal management have shown that effective fiscal councils have many desirable features ([IMF 2013](#), [OECD 2014](#)).¹ Effective fiscal councils have clear mandates (for example, monitoring and reporting fiscal rules, assessing or preparing macroeconomic and fiscal forecasts, costing of fiscal measures), enjoy broad national/local ownership across the political spectrum, are endowed with strict operational independence from politics, are given sufficient resources commensurate with their mandate, have in place mechanisms for accountability to the legislature (through reports and formal consultations or testimonies to budget committees), have full access to macro-fiscal information in a timely manner, are fully transparent in their decision making process and reporting (to the government and the legislator), have a mechanism in place for regular external evaluation and peer review of their work as well as have a strong internal governance structure (an expert advisory board to oversee the quality of the work program).

There is no one size that fits all national fiscal councils. The mandate, tasks, and institutional models of fiscal councils are bound to reflect country-specific characteristics, such as available human and financial capacities, political traditions and the specific causes for excessive deficits and debts.² However, it is also recognized that there must be a minimum set of standards for national fiscal councils in a monetary union such as the EU with a common monetary policy and decentralized national fiscal policies. Analogous to the central bank literature, which is the inspiration that led to the widespread creation of international financial institutions (IFIs) and adoption of good principles of IFIs ([IMF 2013](#), [OECD 2014](#)), these minimum standards will minimize cacophony in fiscal policy messaging, fiscal policymaking, and assessment of EU rules, and ensure that national fiscal councils enjoy strong positions at the national and EU levels to conduct their tasks and contribute to common EU-wide fiscal rules ([Network of EU IFIs 2016, 2021](#)). The same principles led to the creation of the EFB in 2015 with its five distinct [mandates](#).

There are a number of effective national fiscal councils that discharge their mandate with a demonstrated impact.³ These councils include but are not limited to longstanding fiscal councils (Belgium, Canada, Denmark, The Netherlands, Sweden, United Kingdom, United States) and relatively younger fiscal councils (Chile, Germany). Effective fiscal councils have a measurable impact on the design and implementation of fiscal policy and fiscal rules:

- An external review of the Office for Budget Responsibility (OBR), the United Kingdom's fiscal council, concluded in 2020 that the OBR has established itself as an important fixture of the United Kingdom's fiscal institutional landscape, delivering high-quality publications, reducing bias in official forecasts and bringing greater transparency to the public finances (OECD 2020).
- Sweden's fiscal council, along with the strength of Sweden's fiscal policy framework, has been given credit for bringing down debt from more than 70 percent of GDP in the mid-1990s to 35 percent of GDP (Jonung 2018).

¹ In this regard, experiences of the oldest fiscal councils have been instrumental: Belgium (1936), The Netherlands (1945), Denmark (1962), Austria (1970), and the United States (1974).

² For example, Poland is the only country in the European Union with no fiscal council.

³ See also [EFB \(2021, October Annual report\)](#) for a discussion of national fiscal councils in Italy and Austria.

- In evaluating The Netherlands' Spring 2021 Stability and Convergence Plans, The Netherlands' two IFIs (Council of State and CPB Bureau for Economic Analysis) exercised their voices, raising concerns about medium-term projections. Similarly, eight EU national fiscal councils raised concerns about the content, lack of information about the projected reforms, and implementation and prioritization of their national Recovery and Resilience Plans (European Fiscal Monitor June 2021).
- There are also important lessons from the Dutch CPB, one of the oldest in the world—that reputation of quality and independence is crucial for the success of a watchdog, that building such a reputation takes time, and that the broad scope of CPB's analyses has contributed to a shared public understanding of relevant trade-offs and policy options.
- Fiscal councils in advanced economies (Germany, Sweden, United Kingdom) have contributed to the analysis of monetary-fiscal policy interaction—given the zero lower bound and a more potent stabilization role for fiscal policy—by analyzing risk and return trade-offs from the current low interest cost of servicing public debt; the maturity structure of government debt; and more generally the analysis of asset-liability management of the balance sheet of the financial and nonfinancial public sector.

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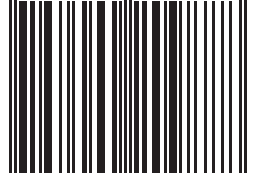


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