Independent Authority for Fiscal Responsibility

Opinion on the European Union fiscal governance reform

AIReF

July 3, 2024

AIReF publishes today the Opinion on the new European fiscal framework which came into force on April 30

AIReF has been working on this reform for years and, in fact, in view of the anticipated changes, it has made recommendations to the Public Administrations (both the Ministry of Finance and the regional governments) with the aim of being prepared for the return of fiscal rules and the new European framework.

Background

- Exchanges with EU institutions and IFIs
- Publication of two technical documents: June 2018 and October 2022.
- Opinion on Fiscal Transparency in Public Administrations in Spain (April 2021)
- Contribution to the Commission's public consultation on the reform of the European fiscal framework (Jan-2022)
- Development of methodologies for sustainability analysis (DSA)
- Opinion on the budget procedure (November 2023)
- Working out the practical implications for the Spanish case

Content of the Opinion

- Description of the reform
- Adjustment calibration
- Valuation of improvements
- Identification of challenges
- Proposals are formulated
- Recommendations are reminded

The new European framework entails a profound reform of the economic and fiscal governance scheme

Change of focus

Main objective: to reduce debt on a sustained basis in countries with ratios above 60% of GDP and to do so in a viable manner

National ownership: transferring the initiative to the countries

Compatibility with growth: investment and reforms enable longer time frame to achieve fiscal commitments

Countercyclical fiscal policy: pivots on net expenditure variable

Practical implementation

How are fiscal commitments and their monitoring formulated?

New variable for defining commitments and monitoring: net primary expenditure from discretionary revenue measures

Stable commitments over time: no annual changes

More transparent monitoring: observable control variable, easier to monitor and under the direct control of the Public Administrations.

IFIs consolidation

- Institutional reinforcement
- New role: analysis of the consistency, coherence and effectiveness of the national framework
- Link between national and European frameworks

And it requires the definition of a stable medium-term strategy that consistently reduces public debt: an economic challenge for Spain

Required by the new European fiscal framework

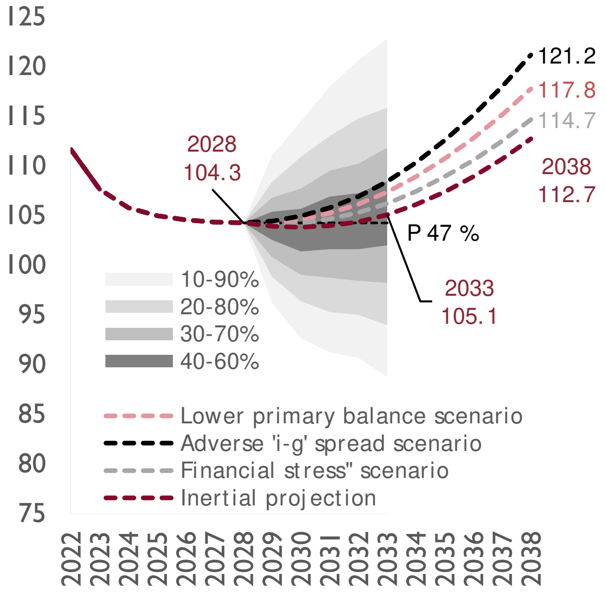
- It is not enough to stabilize the public debt-to-GDP ratio
- In countries with debt above 60% of GDP, the strategy should aim to converge towards this threshold

Demanded by the situation and perspectives of public finances

Growth alone does not seem sufficient to continue reducing deficits and debt on a sustained basis.

AIReF inertial scenario

INERTIAL PROJECTION DEBT (%GDP)



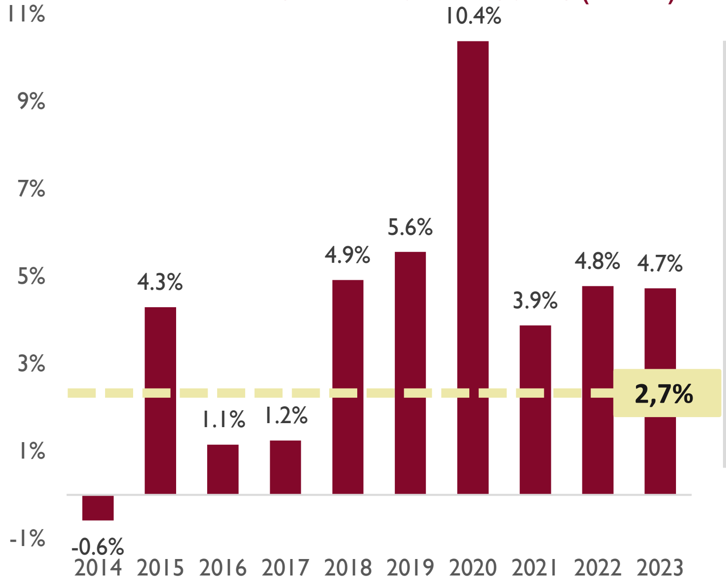
Public deficit: In the order of 3% of GDP

Average primary expenditure growth: 3,8%

Source: AIReF

Calibrated adjustment over 7 years: annual adjustment of 0.43% of the GDP and maximum average net expenditure growth of 2.7%

EVOLUTION OF NET PRIMARY EXPENDITURE OF REVENUE MEASURES (% VAR)



Stringent adjustment given the historical context

Source: AIReF and IGAE

The Opinion formulates proposals so that the Fiscal-Structural Plan achieves a real strengthening of national ownership

The structural fiscal plan is the fixed fiscal commitment reflecting national preferences

Government commitment is just a necessary condition given the challenges

Technical challenge

Calibration to determine adjustment paths is based on established but complex methodologies. Closed Commission-Member State dialogue

Economic and institutional challenge

The magnitude of the challenge and the decentralized reality require the involvement of all Public Administrations from the outset

PROPOSAL

- To publish the Commission's reference trajectory and ensure that the subsequent negotiation process is transparent and consensual
  - ✓ Austria and the Netherlands have already published their trajectories
- Dissemination of technical analyses specific to Spain

RECOMMENDATION REMINDER

To promote national ownership, involve all institutions, relevant national stakeholders and territorial representatives in the design of the Fiscal-Structural Plans

High level of decentralization in Spain implies an asymmetry in the control of the key variables of the new framework

Objective: reduce debt → Central government accounts for more than 70% of public debt

Operational variable: primary expenditure → almost 50% managed by tax administrations.

Upward pressures: pensions (Central Government) and health/long-term care (regional governments)

Proposes to initiate a dialogue to reach a consensus on the distribution of targets to ensure that European commitments are met

The gap between the national and European frameworks worsens after the reform

All public administrations must be involved in the establishment and fulfillment of feasible and realistic commitments

- EFP 2025-2028: to be submitted in September
- 2025 Budgets must be consistent with the FSP
- Calibration: a challenge given the inertial dynamics of spending
- Coordination and consensus in the distribution of the rules

Lack of consistency with new regulations. Example: national spending path does not have to be equivalent to the European one. Discrepancies can undermine credibility

Need for transposition of the reformed Directive

PROPOSAL: to immediately initiate a dialogue with all Public Administrations to reach a consensus on a distribution of objectives that guarantees compliance with the commitments acquired at European level from the earliest stages of implementation of the structural fiscal plan

RECOMMENDATION: initiate dialogue and work with all the Public Administrations, both bilaterally and through multilateral mechanisms (CPFF and CNAL) or the Conference of Presidents, in order to lay the foundations for the reform of the national fiscal framework and reach a consensus on the distribution of fiscal rules

And formulates proposals on the practical implementation of the reform

Comprehensive view of the sustainability of public finances at the level of all sub-sectors to meet the challenge of target delivery

Perceptions of funding shortfalls or excessive debt burdens can undermine the credibility of the rules.
Less indebted administrations are the ones that manage more spending → more reluctant to contribute.
Multiple reasons to contribute for all

PROPOSAL: to address the reform of the fiscal framework, especially the distribution of objectives, together with the reform of the territorial financing system and the extraordinary financing mechanisms, given the interconnection between these issues

Regional financing system ⇄ New fiscal governance based on sustainability ⇄ Extraordinary financing mechanisms

Treatment of investment needs

What are the measures envisaged to address them considering the challenge of reducing debt levels?

→

PROPOSAL: to make explicit the spending and investment needs, as well as estimated international commitments (aging, defense and ecological transition)

Description of key aspects and preliminary calibration for Spain

The Reform has brought about four fundamental improvements

1

Sustainability explicitly at the center of the framework

2

Strengthening the medium-term dimension

3

Streamlining of operational indicators for fiscal supervision

4

A certain degree of simplification or, rather, better localization of complexity

1. Sustainability at the center of the framework

It can be argued that the previous fiscal framework already took care of sustainability, but BEFORE	• Poorly reflected in the concept of the MTO: the connection between the fiscal target and the evolution of indebtedness was diluted and not explicit. • In addition, the homogeneity of MTOs across countries did not reflect the heterogeneity of debt situations
NOW	• Country-specific and differentiated calibration of adjustment requirements, based on debt sustainability analysis • Seeking a better balance between fiscal consolidation and economic growth by seeking to preserve investment
WHY IS IT IMPORTANT?	• Makes explicit the connection between fiscal targets (or, in other words, the availability of fiscal space) and the evolution of indebtedness (i.e. makes explicit the intertemporal budget constraint)

2. Strengthening of the medium-term dimension

It can be argued that the fiscal framework already had a medium term dimension, but BEFORE	• In most member-states (including ES) it had become a purely formal exercise: medium-term planning documents were adopted every year, being modified on a recurrent basis with each update • Fiscal targets changed without explanation, sometimes asynchronously → they were more aspirational than truly binding
NOW	• Medium-term structural fiscal plans are fixed for a 4-year horizon. • They can only be changed under objective circumstances and upon formal request to the EC • They propose adjustment paths that reflect national preferences within a common framework
WHY IS IT IMPORTANT?	• Enables better design of fiscal policy: today's decisions depend on early warning signals of potential future sustainability problems • Improves the quality and stability of the decision-making process and results in more predictable fiscal policies • Allows considering the multi-year impact of expenditure and revenue measures, contributes to fiscal discipline • Improved efficiency in the allocation of budgetary resources, providing the various management centers with stable financial conditions that help in planning their expenditures

3. Relevant indicators for fiscal surveillance purposes...

BEFORE the reform

Fiscal framework applicable to Spain

- EU - PEC
  - Preventive arm
    - **Structural Balance**: 0.5 pp adjustment as a general rule until the MTO is reached.
    - **Expenditure benchmark**: Excluding interest payments and cyclical unemployment spending. Convergence margin modulates the maximum expenditure growth until the MTO is reached.
  - Corrective arm
    - **Nominal deficit**
    - **Debt rule**: Excess over 60% should be reduced at a rate of 1/20 per year on average over three years.
- National - LOEPySF and its development
  - **National Structural Balance**: 0.8 pp adjustment to reach structural balance
  - **National expenditure rule**: Also excludes pension spending. The maximum growth rate is not modulated depending on the underlying public finance situation.
  - **National debt rule**: Excess over 60% must be reduced at a rate of 2 pp per year when d(GDP) >0

...are rationalized under the new fiscal governance framework

AFTER the reform

Fiscal framework applicable to Spain

EU - PEC

- **Net primary expenditure path**
  Excludes DRMS, interest expense, cyclical unemployment, one-offs, expenditure financed by EU funds.

National - LOEPySF and its development

- **National Structural Balance**
  0.8 pp adjustment to reach structural equilibrium
- **National expenditure rule**
  Also excludes pension spending. The maximum growth rate is not modulated depending on the underlying public finance situation.
- **National debt rule**
  Excess over 60% must be reduced at a rate of 2 pp per year when dGDP >0

This rationalization of indicators is key for fiscal surveillance purposes

WHY IS IT IMPORTANT?

It is key in two dimensions: number of indicators and type of indicator

Changing the indicator to which the entire framework is anchored was essential to strengthen the medium-term dimension of fiscal policy

If targets are formulated for fiscal variables whose estimates vary widely from one forecast to another - as in the case of the structural balance - having fixed targets is suboptimal: they become outdated and no longer provide an adequate guide for fiscal policy.

Therefore, having objectives that changed from year to year may have been the best option in the previous framework, considering the prevalence of the structural balance as an operating variable.

Facilitates ex-ante monitoring: expenditure limits are more easily reconcilable with budgetary elements → allows a more transparent and immediate correspondence between macro-fiscal objectives (in ESA terms) and budgetary objectives (in budgetary accounting).

Facilitates ex-post supervision: checking compliance with a spending limit is easier than with unobservable variables - also, calculating the magnitude of additional measures, if any, that need to be taken to meet the target

4. The Reform allows for a relocation of complexity

AFTER the reform

Fiscal framework applicable to Spain

EU - PEC

How is this net primary spending path calibrated with income measures?

Calibrated in a complex manner

Net primary expenditure path

Excludes DRMS, interest expense, cyclical unemployment, one-offs, expenditure financed by EU funds.

National - LOEPySF and its development

National Structural Balance

0.8 pp adjustment to reach structural equilibrium

National expenditure rule

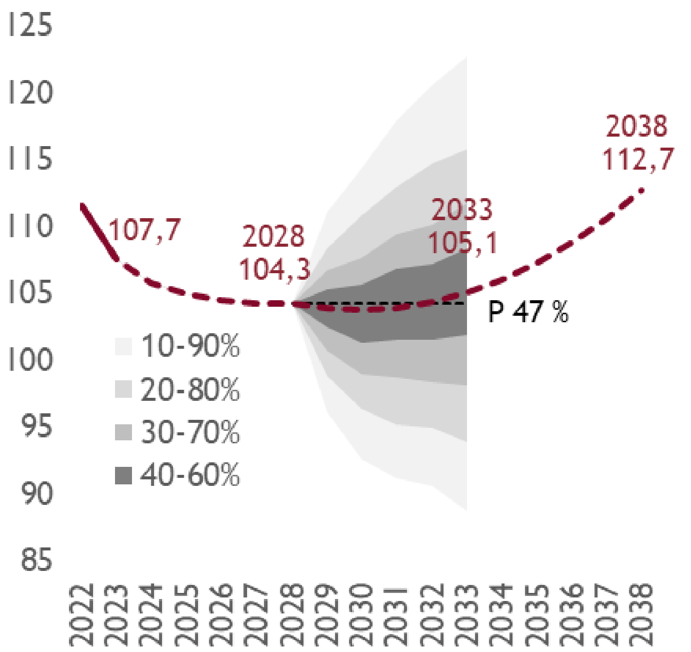
Also excludes pension spending. The maximum growth rate is not modulated depending on the underlying public finance situation.

National debt rule

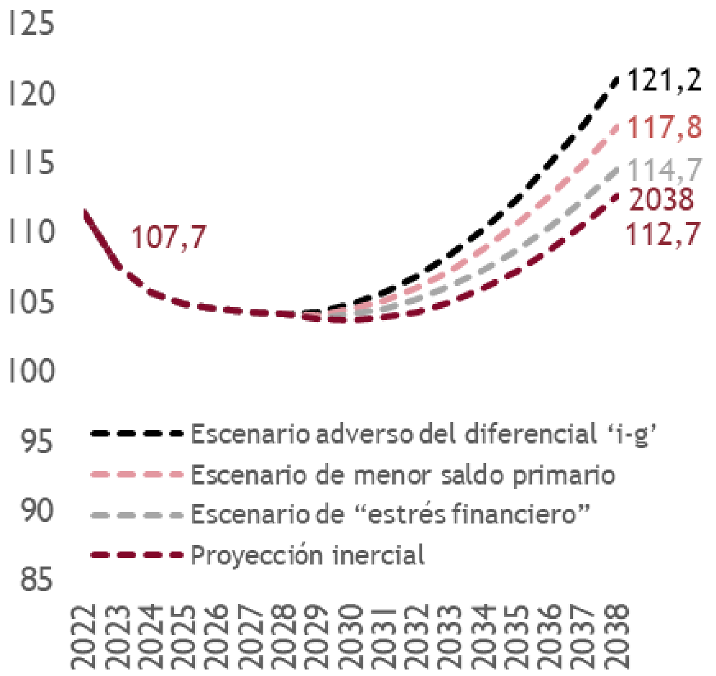
Excess over 60% must be reduced at a rate of 2 pp per year when dGDP >0

The reference trajectory: inputs to calibrate the fiscal path

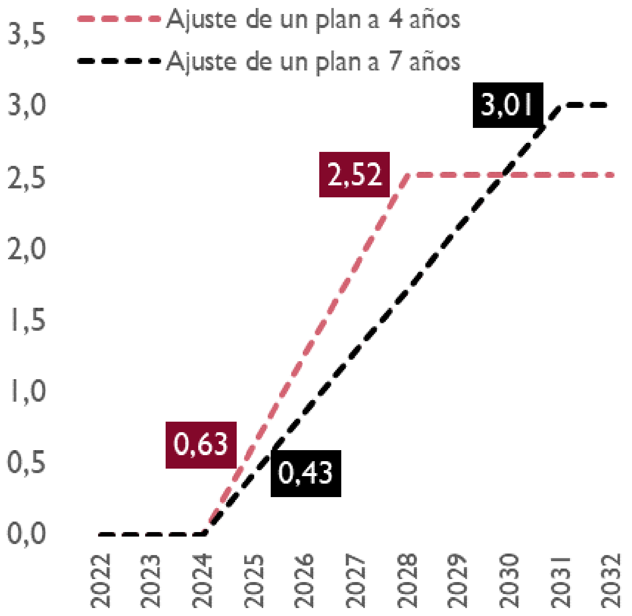
INERTIAL SCENARIO OF DEBT EVOLUTION WITH UNCERTAINTY BANDS AFTER 2028



INERTIAL DEBT EVOLUTION SCENARIO AND WORST-CASE SCENARIOS FROM 2028 ONWARD



PRIMARY STRUCTURAL ADJUSTMENT SATISFYING THE MOST RESTRICTIVE CONDITION OF THE NEW FRAMEWORK (4 AND 7 YEARS)

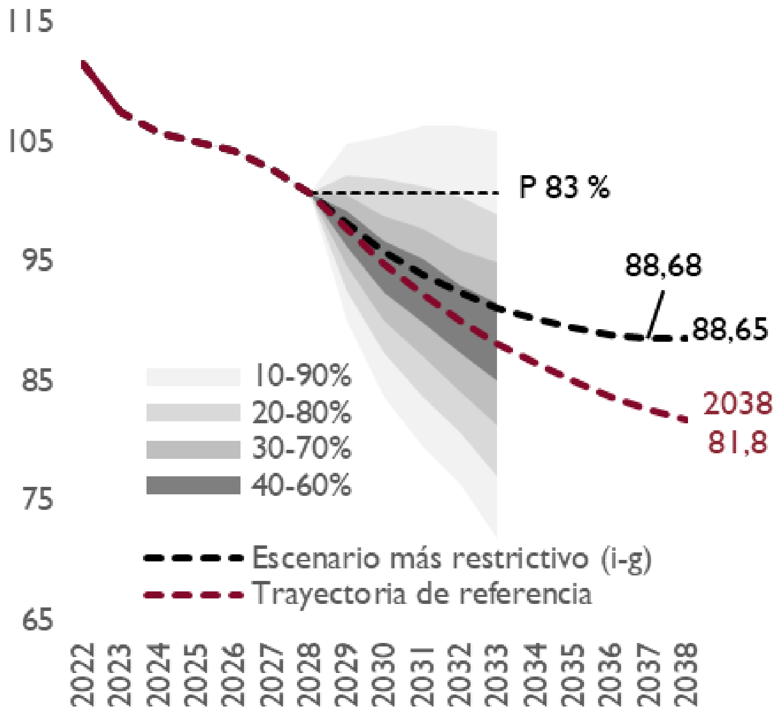


Source: AIReF

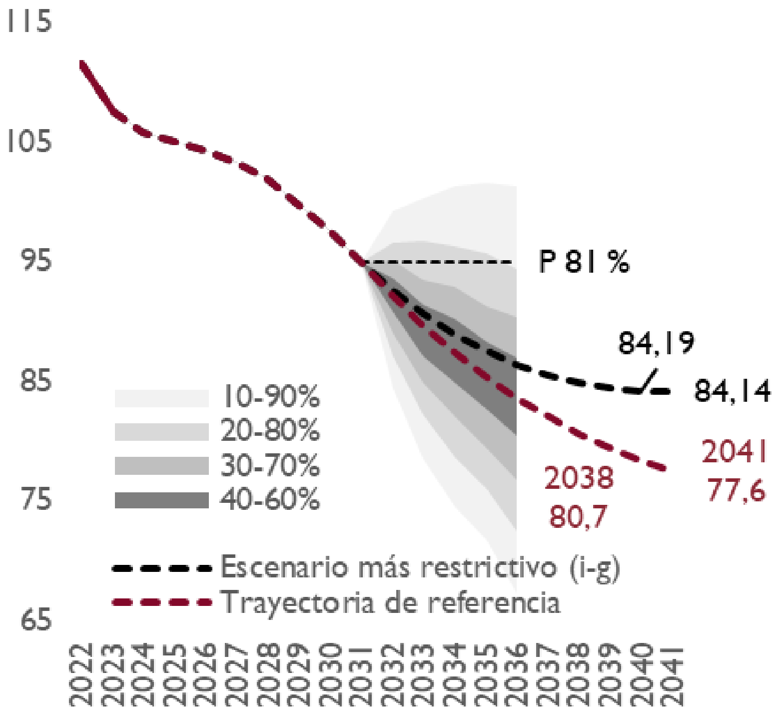
- **Calibration is not simple**
- **However, the ultimate enforceable fiscal path refers to a single operational variable, essentially observable and under the control of governments**

Adjustment calibration according to current AIReF projections

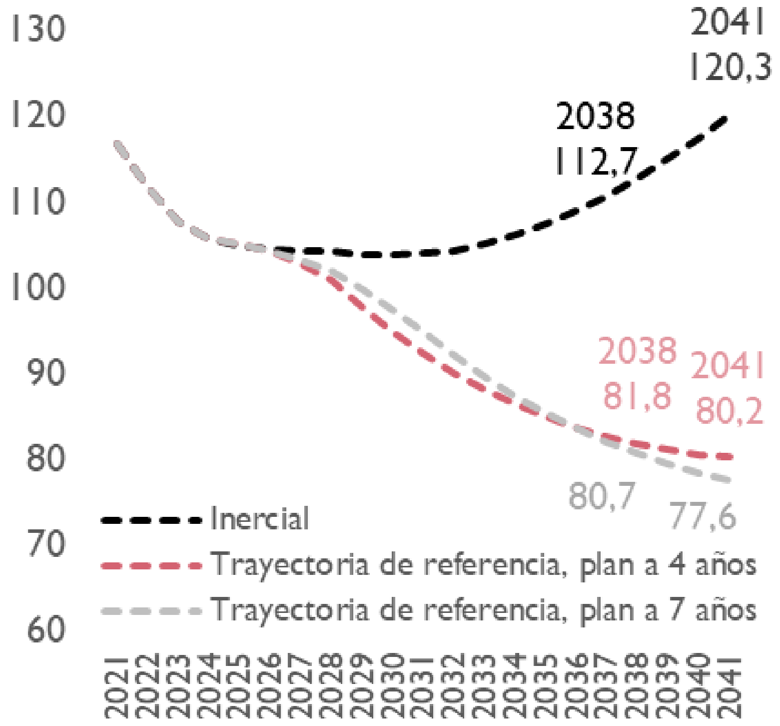
BENCHMARK TRAJECTORY IN A 4-YEAR ADJUSTMENT PLAN



BENCHMARK TRAJECTORY IN A 7-YEAR ADJUSTMENT PLAN



DEBT (% GDP) INERTIAL PATH AND 4-YEAR AND 7-YEAR ADJUSTED PATHS



Source: AIReF

The relocation of complexity makes it possible to distinguish between diagnosis and treatment

- **Diagnostics should be as robust and sophisticated as available technologies allow.**
- **Instead, the treatment should be simple, understandable and controllable by the "patient"**

In the previous framework

- Simple diagnostics based on conventions or ad hoc calibrations (e.g. the preventive arm requirements matrix)
- The treatment, complex and unobservable - no government could be certain in the autumn of year t-1 (when the Budget was adopted) that this Budget would result, ex post, in the required structural effort according to the Commission's forecasts of the spring of t+1.

In the reformed framework

- Complex diagnosis, based on standard equations
- Treatment is simpler and, in principle, it can be controlled by the government.

Implementation challenges

The Reform poses four major challenges for its implementation in Spain

A

Investment needs.
Is the current treatment sufficient within the framework?

B

The real strengthening of national ownership with respect to the fiscal path

C

The interaction between the national and the EU fiscal frameworks

D

Comprehensive vision of the sustainability of public finances at the level of the different territorial administrations

A. Investment needs

The new framework includes incentives for investment and reforms

- Extension of the adjustment period from 4 to 7 years
- Cofinancing of projects carried out with traditional European funds is excluded, in addition to those financed entirely with EU funds such as the NGEU
- It is expressly contemplated that the plans contain information on estimated public investment needs

The investment needs facing EU countries in the coming years are very substantial

- Green and digital transition, energy security, defensive capabilities, and economic and social resilience of countries

The challenge

- Reducing debt levels in the absence of a common central capacity to address part of the investment needs
- Medium-term fiscal planning should make explicit the estimated investment needs of the Spanish economy and the measures envisaged to meet them

B. The real strengthening of national ownership with respect to the fiscal path

Strong political commitment is a necessary condition for the effectiveness of fiscal frameworks

The political commitment of a given government is not the same as national ownership

- The latter requires the involvement of other relevant institutions and actors, including national parliaments and other sub-sectors of public administrations
- If some aspects of the RRF governance are to be exported to the fiscal framework, the experience with the design of the NRRPs must also be taken into account: very tight deadlines that left no room for a real dialogue at the country level

WHY is it IMPORTANT?

- **The broader the national consensus among the different stakeholders, the stronger the legitimacy of the adjustment path and the more likely its success**
- **Especially now, when fiscal targets are going to be fixed for four years, and spending policies must be prioritized in a context of very large and growing investment needs**

C. The interaction between the national and EU fiscal frameworks

National fiscal frameworks are based on the consensus that was forged more than a decade ago during the financial crisis

- Attempt to gain credibility through (i) very intense codification - both in terms of the number of provisions and in terms of their rank within the legal system - and (ii) (overly) ambitious fiscal adjustments

The new EU fiscal framework is based on a new consensus

- It is more effective if consolidation plans are based on realistic, stable targets that are easily reconcilable with budgetary tools - rather than very drastic adjustments that are then constantly changed or simply missed.
- Fiscal consolidation is not possible without economic growth: extension of the adjustment period with reforms and investments

The challenge

- **Given that the national frameworks were regulated a decade ago in very high-ranking standards**
- **Given the increasing fragmentation and polarization of parliaments in many EU MS**
- **Are we doomed to have national fiscal frameworks that are out of step with the EU framework? Which one can be expected to prevail in practice? What does this imply for the soundness of our legal system?**
- **Strengthening of national rules at the sub-national level, involving territorial administrations in the preparation of medium-term fiscal-structural plans**

D. Integral vision of the sustainability of public finances at the level of the various territorial administrations

The Structural Fiscal Plan will set an evolution path for nominal growth rates from 2025 to 2028 for all levels of public administrations

There are technical aspects pending, but AIReF has already made an approximation of its calculation by subsectors.

% average nominal VAR 2025 - 2028	Non-financial expenses	Primary	Sub-sector consolidation	Exclusions	Revenue measures
AAPP	3,3	3,0	3,0	3,8	3,8
AC	2,1	1,2	0,3	3,4	3,7
FSS	4,1	4,1	4,2	4,3	3,9
CCAA	2,6	2,4	3,8	3,7	3,7
CCLL	2,5	2,5	3,7	3,7	3,7

Definition of the starting point in 2024.
Control account, decentralized application?
More sensitive measure than the deficit: a deviation of 0.1% of GDP represents between 0.5 and 1.2 points of the expenditure rule in the regions (0.8 points in the subsector).

Applying the same criteria as for the national expenditure rule

- **Cyclical unemployment**
- **Expenditure on European projects (including national co-financing)**

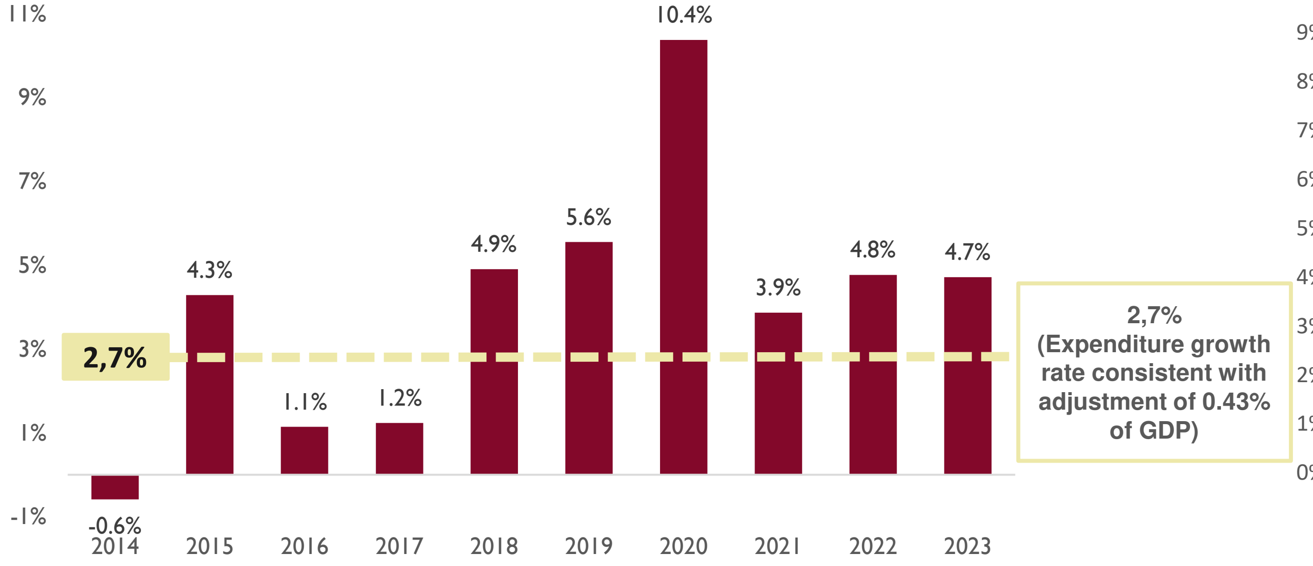
Includes temporary and permanent

Spending constraints pose a challenge for the overall public administrations and for the sub-sectors: recent evolution of net primary spending measures

Net spending growth has been above 4.5% since 2018, with the exception of 2021

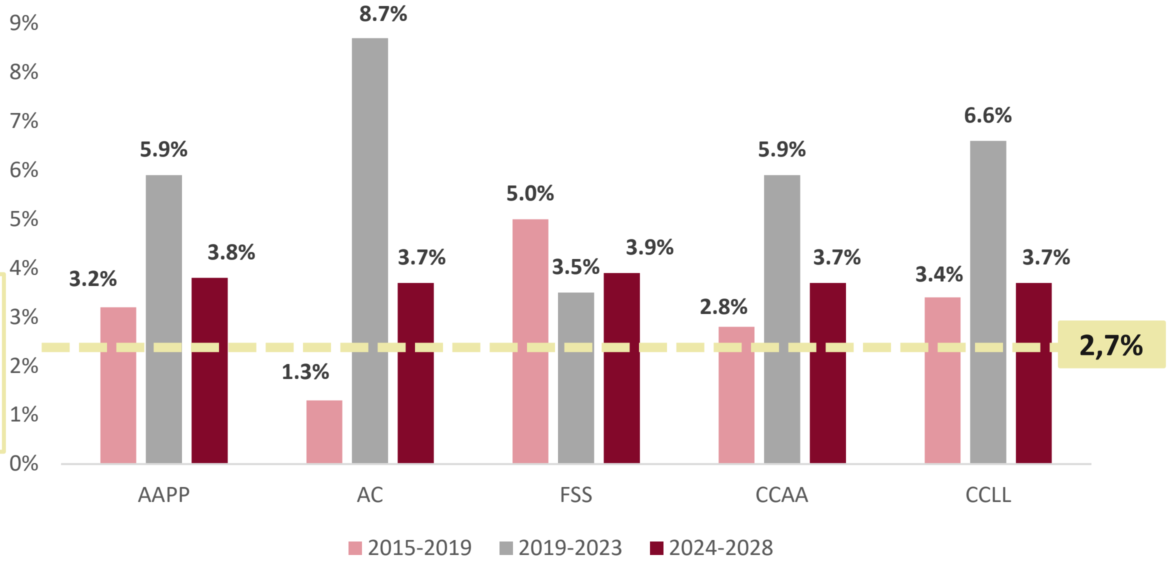
On average, net spending grew by 5.9% between 2019 and 2023, compared to 3.2% in the previous four-year period

EVOLUTION OF NET PRIMARY EXPENDITURE OF REVENUE MEASURES (% VAR)



Source: AIReF and IGAE

BREAKDOWN BY SUBSECTOR OF THE EVOLUTION OF PRIMARY EXPENDITURE NET OF REVENUE MEASURES (%)



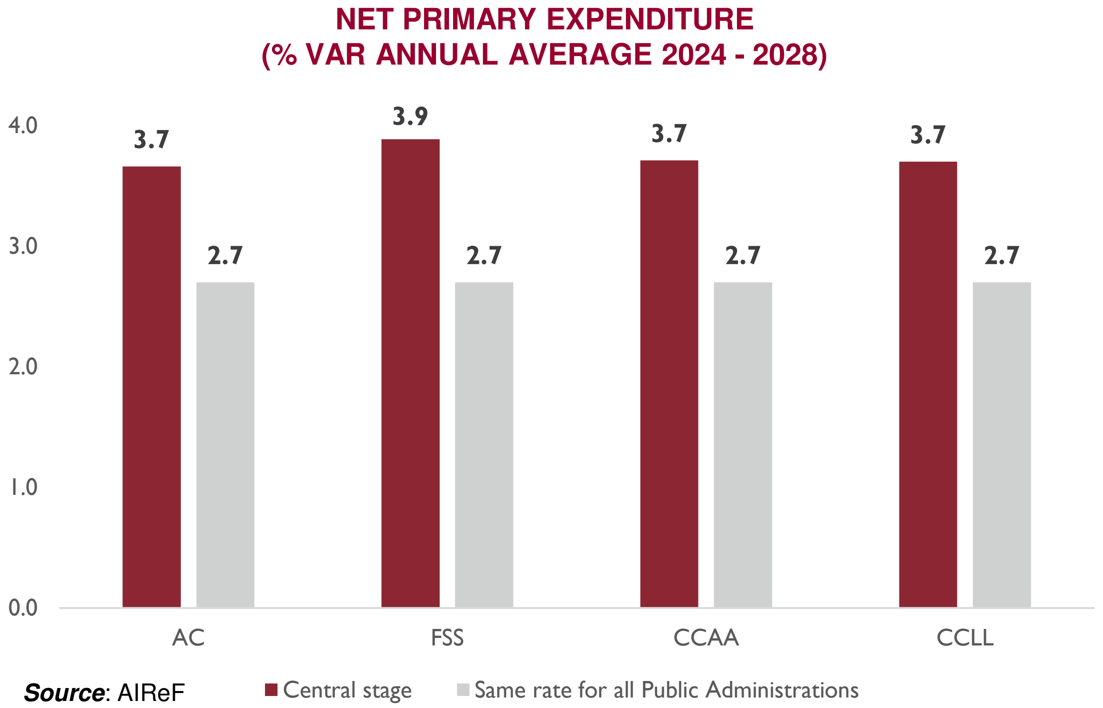
Source: AIReF and IGAE

Consolidation years between 2014 and 2017 show lower rates

In the medium term, a smaller adjustment will be necessary than in the previous crisis, but sustained over time

The most similar response to current Spanish regulations and practice: same rate for all administrations, including the HSS

All Public Administrations contribute to the adjustment: those with higher inertial growth make a greater effort



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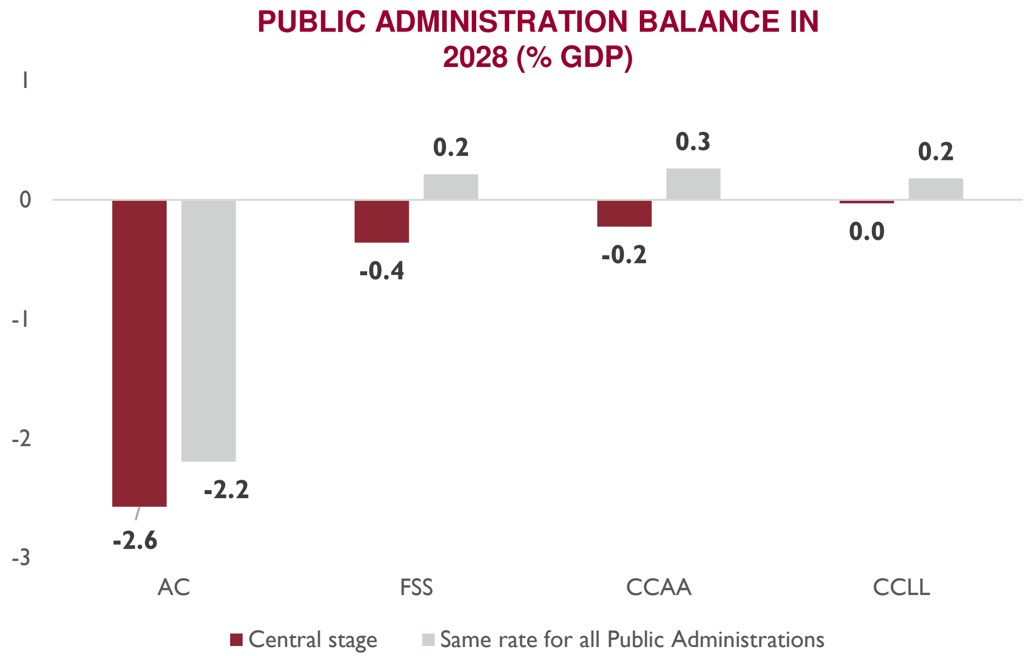


Advantages

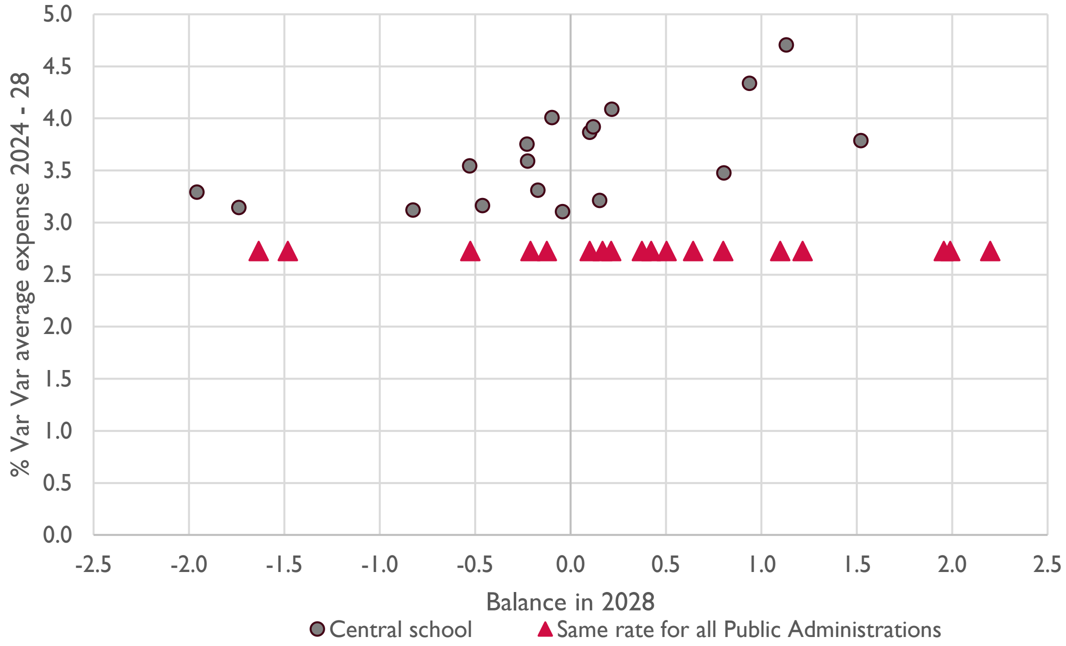
- ✓ **Simplicity**
- ✓ **Transparency**
- ✓ **Continuity: similar to the current expenditure rule**

Vertical imbalances: CA deficit and surplus of other sub-sectors (including HSS)

At the sub-sector level, it involves greater heterogeneity in terms of balance and debt

Horizontal imbalances

% VAR NET EXPENSE VS. BALANCE IN 2028 (MM€)

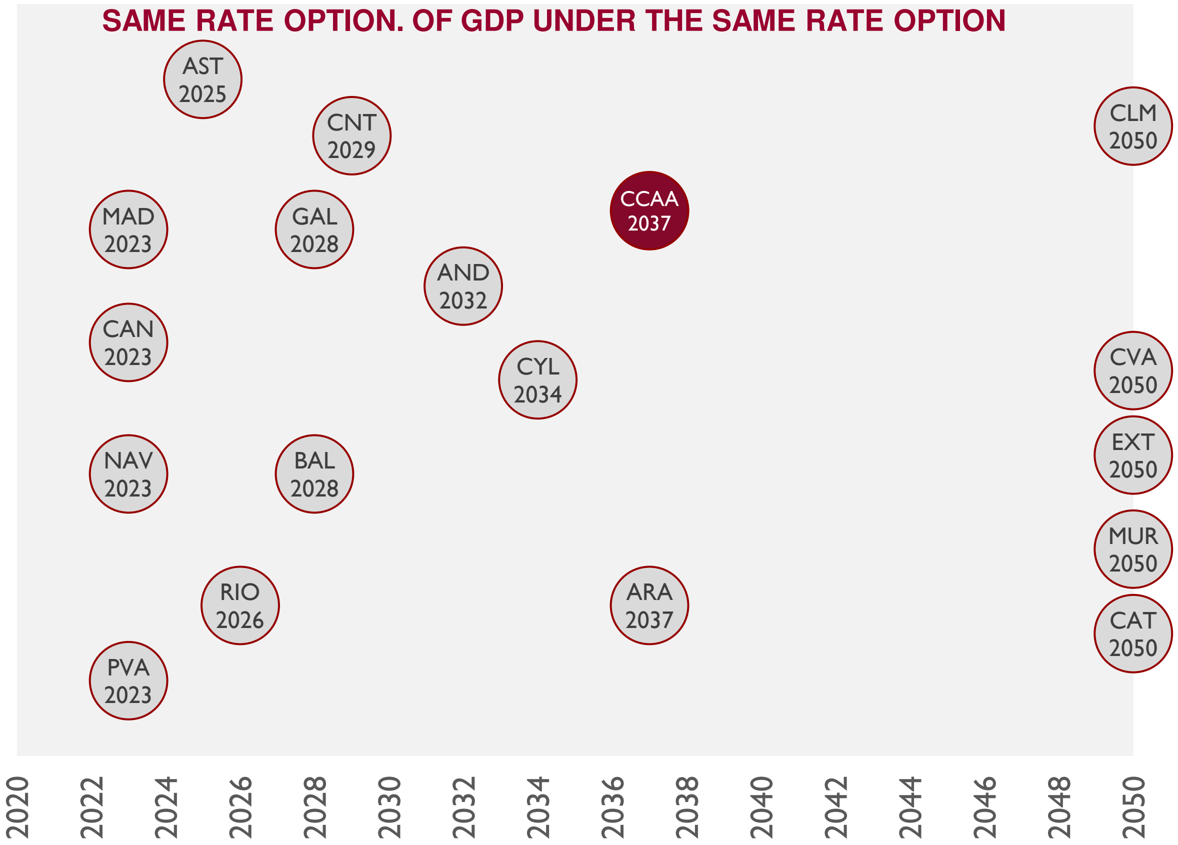


Source: AIReF

Greater heterogeneity among Autonomous Regions in terms of balance of payments

Not all Autonomous Regions will reach the current debt threshold of 13% of GDP in the medium term

YEAR IN WHICH THE CURRENT THRESHOLD OF 13% OF GDP IS REACHED UNDER THE SAME RATE OPTION. OF GDP UNDER THE SAME RATE OPTION



Source: AIReF

It is advisable to approach distribution alternatives that define differentiated rates according to the sub-sector and the situation of the administration

	It is not easy, there are multiple approaches
Well-managed Public Administrations	Comply with a spending limit? Several options: Nominal GDP, potential GDP, an inertial reference rate....
FSS	Need for consistency with its own expenditure rule: leaving the HSS to its own evolution would imply an expenditure rate of 2.2% for the rest of the subsectors
Autonomous Regions with imbalances	An adjustment that is feasible and allows for the cleaning up of their accounts in the medium term
Local Corporations	Difficulty in establishing different and complex criteria. It would be desirable to differentiate between large LCCs and the rest
Central Administration	Closing rule to comply with aggregate? Feasibility condition?

A differentiated distribution could help alleviate vertical and horizontal imbalances in terms of deficit and debt, but their complete resolution will only be possible if the reform of the national fiscal framework is approached comprehensively, taking into account the regional financing system and the extraordinary financing mechanisms for the Autonomous Regions

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