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National Independent Fiscal Institutions Need to Be Stronger to Perform Effectively

In April 2023, the European Commission issued a directive proposal on EU economic governance reform. The Council cut some tasks of Independent Fiscal Institutions (IFIs) that were in the Commission directive proposal; whether this cutting is justified is an open question. Early this year, the Council and the Parliament reached a provisional agreement on the proposed reform of the EU economic governance framework. The vision of the Commission that would involve IFIs in the assessment of fiscal-structural plans is not groundless. But structural reforms and investment analysis demand expertise that hardly exists in most national IFIs, and their involvement in policy design could be perceived as a technocratic inroad into democratic decision-making. In order to play a more significant and effective role, national IFIs need adequate resources and enhanced analytical capacity; their activity depends heavily on the policy design of the EU economic governance. National IFIs should view their role from a macroprudential perspective, too. The role of IFIs should not go beyond what most of them can deliver effectively, so that their status and reputation are not harmed.

Against the background of an incomplete design of the euro area (Buti and Corsetti, 2024), the sovereign debt crisis highlighted inadequacies of the EU fiscal rules, which were pro-cyclical and paid insufficient attention to large differences in the macroeconomic and structural conditions of member states. These conditions also relate to large differences in *Stabilitätskultur* philosophies in the member states, in the vein of the old rules vs. discretion debate (Brunnermeier et al., 2016). The fiscal rules underestimated spillover effects, which made things worse for the euro area as a whole in the absence of stabilising instruments, such as a joint fiscal capacity, and of tools to deal with the doom loops between sovereign debts and bank balance sheets. The European Central Bank (ECB) turned out to be the de facto rescuer of the single currency area via unconventional operations.

The sovereign debt crisis made clear that its root causes were both public and private over-borrowing, and the ECB

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and other central banks were reminded that price stability is not synonymous with financial stability. This is the main reason for the introduction of macroprudential rules and regulations, the setting up of the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority as European regulatory authorities. While macroprudential regulations were enacted promptly and have undergone refinements over time, fiscal rules at the EU level stayed basically the same over the years.

The European Commission (EC) encouraged public debate on the reform of the EU economic governance framework, including its fiscal rules, and issued documents to this end. Such a document is the EC communication of 9 November 2022 (hereafter referred to as the “communication”), which was followed by a directive proposal in April 2023 (EC, 2022, 2023). This directive proposal says that the European Fiscal Board (EFB) and the national independent fiscal institutions (IFIs) have a significant role to play in the EU fiscal framework. The EC directive proposal seems to scale down the tasks of the national IFIs as compared to the communication. In a key regard, instead of asking the national IFIs to make assessments of national medium-term fiscal-structural plans, the directive proposal talks about assessments of policies that have an impact on fiscal sustainability (EC, 2023, 16). But this wording is vague as it can imply that national IFIs are involved in assessing medium-term fiscal-structural plans. The Council’s directive proposal of December 2023 has

dropped any reference to such involvement. That same December, a political deal was reached among EU governments regarding the fiscal rules. And early this year the Council and the Parliament reached a provisional political agreement on the proposed reform of the EU economic governance framework.

It is worthwhile mentioning that both directive proposals do not deal with basic missing elements of the design of the euro area and of the EU economic governance – for example, a fiscal capacity, a collective deposit insurance scheme and a safe asset.

This paper takes a look at the EU economic governance framework and the role of national IFIs. It argues that the role of IFIs has to be wisely calibrated and not go beyond what most of them can deliver effectively. National IFIs' effectiveness depends on adequate resources, reputation and involvement in public debate; it also hinges heavily on the design of the EU economic governance framework. National IFIs should view their role from a macroprudential perspective as well.

A new EU fiscal framework has long been overdue

The extreme events of recent years have delayed the revision of fiscal rules and of the EU economic governance framework; within this extraordinary context, numerical fiscal rules were suspended. Nevertheless, several guidelines have developed over the years:

- make overall rules more transparent, and reduce their complexity
- do not abandon the numerical references of 3% of GDP for budget deficit and 60% of GDP for public debt,¹ even if the latter is contested in view of the big rises in public debts due, primarily, to strong adverse shocks
- adapt the rules to take into account national circumstances, which will encourage compliance and make the adjustment of imbalances feasible
- use net expenditure (excluding one-offs and debt service payments) as the single operational tool in pursuing debt sustainability
- create tools to deal with asymmetric shocks, such as a fiscal capacity and a safe asset as an instrument of risk-sharing, that should operate in conjunction with risk-reduction measures
- put debt sustainability at the forefront of concerns
- protect investment to cope with future challenges
- strengthen the role of the EFB and of the national IFIs.

¹ However criticised numerical rules are by some, their elimination would be like having the euro area, in particular, rudderless with ensuing augmenting uncertainties; numerical benchmarks are needed.

Some of these guidelines are found in the EC (2023) directive proposal on the reform of the EU economic governance framework. At the same time, this proposal advocates more “national ownership of policies”. The EFB has been quite vocal in advocating the revision of fiscal rules and stressed repeatedly the need for a joint fiscal capacity and a safe asset; it also asked for the protection of growth-enhancing investment (Thygesen et al., 2020). The IMF (Arnold et al., 2022) also stressed the need for fiscal capacity, as did many other experts. Not least, the ECB, in its opinion of 5 July 2023 on the EC directive proposal for economic governance reform, argues in favour of an “appropriately designed permanent central fiscal capacity” (ECB, 2023, 18).

National IFIs have supported a revision of fiscal rules and have expressed concerns, inter alia, about access to good and timely information, safeguards to independence, the possibility to make their own assessments, the effective implementation of the “comply or explain” principle and, last but not least, the existence of a legal obligation at the EU level to consider national IFI assessments in various areas (Network of Independent Fiscal Institutions, 2021). National IFIs also ask for more consultation with the EC and with other EU authorities, in order to avoid harmful differences in assessments. Establishing minimum standards for IFIs at the EU level is viewed as a prerequisite for their effectiveness (Barnes, 2022).

But there has been less agreement among IFIs in favour of a joint fiscal capacity and of risk-sharing instruments. It gives food for thought that views on this follow the official positions of the respective member states, i.e. mirroring the well-known divide between “frugal” member states and other countries.

Opinions within the IFI network have varied also on whether to judge the adequacy of the fiscal framework and rules in conjunction with the adequacy of the EU economic governance framework. A frequent non-committal view is that the overhaul of the EU economic governance is a political decision par excellence.² The reluctance to tackle fundamental issues is intellectually uncomfortable, though its origin is not hard to comprehend. This provides a stark contrast to the EFB, which tackles the big issues and does not refrain from making proposals on key matters.

² This is stated in a position paper of the Network of Independent Fiscal Institutions (2023, 1): “The Network takes no position on the Commission's overall proposal as this raises fundamental questions beyond the scope of the work of the Network of EU IFIs and the IFI mandates that need to be addressed on a political level.”

Arguably, one can hardly judge the adequacy and effectiveness of fiscal rules unless the design of the economic governance of the EU and of the euro area, in particular, is addressed. If this design cannot overcome major flaws (as has been the case until now), fiscal rules can operate only suboptimally. Economic governance design demands stabilisation and risk-sharing instruments, such as a central fiscal capacity and a safe asset, as well as consistent implementation of risk-reduction measures. It is fair, however, to say that the right balance between risk-sharing and risk-reduction measures is not easy to define because member states have common but also divergent interests.

The functioning of economies and the effectiveness of macroeconomic policies depend on the structure of the global financial system, in which capital flows can be destabilising. In addition, fiscal and monetary policies need to be complemented by macroprudential rules and policies, since excessive private debt can be no less dangerous than large public debt. One could even consider the need for an overall macroprudential policy, which is currently only in the toolbox of central banks. Fiscal and budget policies may also need to have a macroprudential thrust.

The EC communication notices that the ability to steer the fiscal stance of the euro area remains limited in the absence of a “central capacity with stabilisation features” (European Commission, 2022, 3). It is quite telling that while there seems to be an analytical prevailing train of thought in favour of a central fiscal capacity, a political stalemate among member states impedes its creation. The same happens, presumably, with the European Deposit Insurance Scheme (EDIS). It speaks volumes in this regard that the EC directive proposal of April 2023 no longer refers to a joint fiscal capacity, whereas the ECB mentions it in its opinion of July 2023.

The role for national IFIs

The role envisaged for IFIs in the new EU economic governance framework (Article 8), as it is reflected in the Council directive proposal of December 2023, reduces the tasks envisaged by the EC directive proposal. Thus, task b) producing debt sustainability assessments underlying the government medium-term planning or endorsing those provided by the budgetary authorities, and task c) producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities, are eliminated. What remains are the following tasks:

a) producing the annual and multiannual macroeconomic and budgetary forecasts underlying the government's

medium-term planning or endorsing those used by the budgetary authorities

d) monitoring compliance with country-specific numerical fiscal rules unless performed by other bodies in accordance with Article 6

e) undertaking tasks in accordance with the preventive arm of the SGP and the corrective arm of the SGP

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

g) upon invitation, participating in regular hearings and discussions at the national Parliament.

Does this clash of proposals (the EC and the Council) imply a setback for the activity of IFIs? Yes and no. On the one hand, one could say that having fewer tasks dents the capacity of IFIs to promote fiscal responsibility. On the other hand, actual effectiveness depends, fundamentally, on the quality of assessments, reputation, and the involvement of IFIs in public debate. In addition, national IFIs vary a lot when it comes to their mandates and resources – as Kopits (2023) rightly highlights. This situation, he argues, diminishes the relevance of data that cover IFIs and that are not comparable across countries, not amenable to quantification, and include entities that do not necessarily conform to minimum standards of good practice. And, as Thygesen et al. (2021) argue, “In a broad sense, national IFIs remain too heterogeneous in the EU to consistently shape the conduct of fiscal policy... Absent a conscious effort to harmonise the role and functions of these entities, the Commission and the Council roles in monitoring performance and formulating recommendations will remain essential”. IFIs have a significant role to play in this respect, but one should not exaggerate it.

The IFIs should do what they can deliver effectively

The EC communication's vision was that national IFIs would get involved in the design of fiscal-structural plans, while the proposal of 26 April 2023 alludes to it in vague terms (EC, 2022, 2023). The Council directive proposal of December 2023 drops such a task (Council of the European Union, 2023).

The vision in the communication on the role of IFIs in assessing fiscal-structural plans has a rationale, but it also raises significant questions. One could argue that it is not worthwhile to make comments after this idea was dismissed by the Council directive proposal. As a matter of fact, what the communication proposed is not something strange, and there are high-profile experts who support it

(Blanchard et al., 2022; Garicano, 2024). But how would reforms in various sectors, in education and healthcare, for instance, be evaluated? A few national IFIs may have expertise in such undertakings, but most do not. The outcome of structural reforms and investments may take years to show up, whereas national IFIs would be asked to provide assessments on a regular basis. And “the EFB doubts whether the proposed merge of fiscal and structural surveillance in relation to national plans is a realistic vision for the future when the one-off NGEU [NextGenerationEU], involving EU funding, fades out” (Thygesen, 2023, 2).

The concerns of the EC are fully justified in view of the enormous challenges that the Union is facing: the energy crisis, climate change, digitalisation, the impact of artificial intelligence, an overall productivity problem, security concerns, etc. There are also worries that the NGEU money could be misused. On the other hand, national IFIs have a validated niche in fiscal policy and tax regimes that impact budgets. They can also judge (and some of them do it) the overall macro policy mix.

Nonetheless, an analysis of structural reforms and public investment could become mission impossible – unless proper conditions exist. One can examine the impact of public investment, as an aggregate, on potential economic growth, but to get into an analysis of the composition of public investment is arguably very tricky. Spending reviews are done by only a few national IFIs, aside from what is required on the part of national governments. Nonetheless, having national IFIs involved in a detailed analysis of spending and investment is questionable.

The communication envisioned national IFIs to be involved in the design of policies: “Independent fiscal institutions could provide an *ex-ante* assessment of adequacy of the plans and their underlying forecasts, which would help national government in the design phase” (European Commission, 2022, 16). Examining underlying forecasts sounds sensible, but an involvement, albeit subtle, of national IFIs in the policymaking process is problematic. There are at least two relevant aspects involved in this matter.

One aspect pertains to substance, in view of a broader scope of assessments that would be asked of national IFIs. And here, national IFIs may not necessarily have the best views, although they are presumed to be an embodiment of “technocracy” and “independent thinking”. “Independence” does not automatically imply best judgement. For instance, public entities failed when they propounded a light-touch regulation of financial systems, which invited a calamity. The same happened with suboptimal fiscal

rules, as these were implemented during the sovereign debt crisis and austerity measures were enforced pro-cyclically, with neglect of spillover effects. The procrastination of regulatory agencies in dealing with shadow banking, as well as with the crypto activity, is also unfortunate. Similarly, the EU energy market has flaws that have been conspicuously highlighted by the energy crisis.

Macroeconomic models can hardly cope with radical uncertainty and non-linearities. In addition, economists themselves may have different theoretical propensities, which influence their policy recommendations. Inside the IFIs, there may also be opposing views, with a bearing on their public documents. Therefore, caution should accompany policy prescriptions. Rigor is needed to avoid major policy blunders, and national IFIs can help influence policy construction to this end and enhance good practices. But one should not take for granted that independence secures best policies by itself.

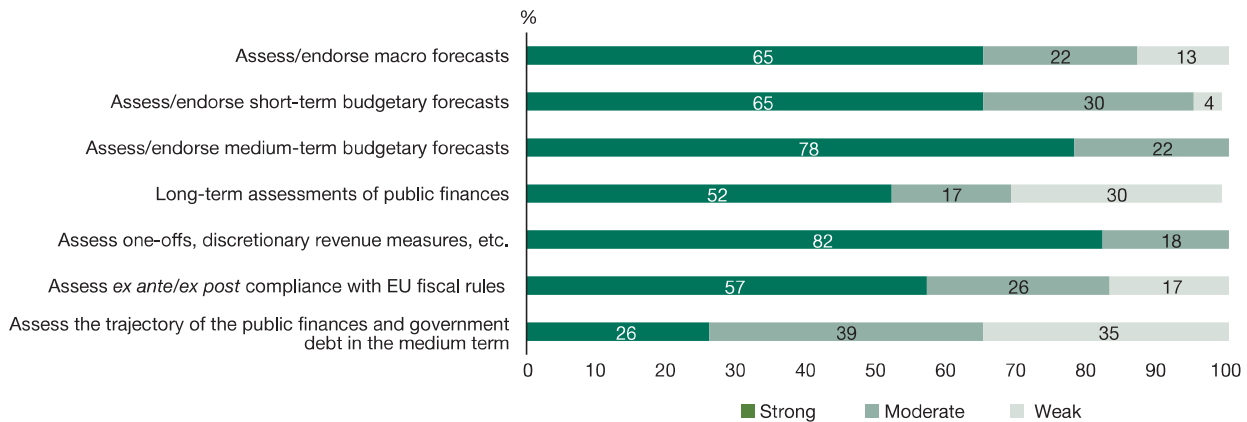
A second aspect of national IFIs’ direct or indirect involvement in policy design refers to an inescapable conflict of interest. If national IFIs are involved in the policy design process, then a third party would presumably have to come into the picture, as a genuinely neutral assessment entity. Moreover, national IFIs cannot turn into fiscal policy, or overall policy arbitrators; their function is essentially to operate as watchdogs of fiscal responsibility, and to advise. Beetsma (2023) is right when calling them “independent advisory fiscal institutions”.

It is easy to understand why the Commission would like to have independent assessments of the national recovery and resilience plan implementation. However, one needs to be careful in asking national IFIs to change their mandates in ways that may unnecessarily expose them publicly, since reputational risks could ensue. There is also the risk of reinforcing the perception that some people have that national IFIs are entities imposed by European authorities. This could be counterproductive. Some may even see it as a surreptitious “technocratic encroachment” on what are and should be democratic policymaking processes.

A baffling variety of national IFIs

What some people seem to underplay are implications of the large variety of national IFIs in terms of mandates and capabilities. There are national IFIs that operate as large think tanks (e.g. in Belgium, the Netherlands, Spain and Denmark), which undertake a wide range of analyses, including economic platforms of political parties – e.g. in the Netherlands. In Germany, there is a web of major economic research institutes that can perform the tasks

Figure 1
Independent Fiscal Institutions' capacity by type of task



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

Source: EU Network of Independent Fiscal Institutions (2022).

of IFIs. But such entities may be hard to replicate all over the EU.

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

However, national IFIs must be strengthened, and the Commission and the EFB are right to emphasise that common minimum standards have to exist to this end. But even common minimum standards need to be defined as what may appear uniform on the surface could hide big qualitative differences.

The Council directive proposal's dropping of national IFIs' involvement in the assessment of medium-term fiscal-structural plans is, arguably, realistic under the circumstances, but it should not have eliminated the IFIs' overall task of examining the impact of various policies on fiscal sustainability – e.g. changes in tax regimes and their influence on economic activity. IFIs are entitled to make judgements in this regard as such changes can heavily

affect tax revenues. The Council directive proposal goes arguably too far in dropping the task of producing debt sustainability analysis or endorsing those provided by the budgetary authorities. It is true, however, that many IFIs do not (yet) have the capacity to produce a debt sustainability analysis; and there is a difference between producing a forecast and assessing/endorsing a forecast, which is presumably related to individual institutional capacity, aside from what national mandates say. As a survey made by the national IFIs network notices, less than half of them have the capacity to provide long-term assessments of public finances (EU Network of Independent Fiscal Institutions, 2022).

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

National IFIs' resources should be seen in conjunction with the aim of establishing minimum standards of operation. But this goal has become a sort of a mantra and it needs a more concrete definition in order to help more IFIs overcome hurdles in their activity. For example, when a national IFI cannot hire more staff owing to austerity measures imposed by a government (as experts of the IFI are classified as public sector employees). The salary can also be a major stumbling block in hiring experts. And these are not hypothetical cases. How to translate the general statement and principle of ade-

quate resources into a concrete reality is a problem that regularly begs for solutions.

IFIs may also rely on resources (human and material) provided by other public entities, such as central banks, or governments. While this could be helpful in a transition phase, allowing IFIs to grow, it could also create a dependency, with advantages and disadvantages. The EFB itself relies on resources provided by the EC.

The Council proposal eliminated the task on debt sustainability analysis from the IFI mandates. But this should not impede IFIs from undertaking such assessments, provided they have analytical capacity. And, as Arnold et al. (2022) suggest, a common methodology for debt sustainability analysis should be used by the national IFIs.

In evaluating debt sustainability, it is necessary to consider the costs of the war in Ukraine and the probable significant rise in defence expenses in many EU member states in the years to come; the peace dividend has likely come to an end. Against the backdrop of the energy crisis and the war in Ukraine, some economies are becoming sort of *sui generis* “war economies” and resource allocation is heavily impacted. And AI, despite its benefits, could augment financial turbulences, make economies more fragile and entail hidden liabilities for public budgets.

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

National tax regimes should be considered in view of very low fiscal revenues in some member states; tax revenues in Romania, for example, including contributions, are around 27% of GDP, 31% in Bulgaria, and 35% in Hungary, Czechia and Poland, while the average in the EU is around 41%. This situation should be judged as against the huge pressure on public budgets in the coming years. National IFIs should take a firm stand against tax evasion and tax avoidance, particularly at a time of so much pressure on public budgets.

Fiscal rules and macroprudential rules: An overall macroprudential policy?

The EFB’s evaluation of the overall fiscal policy stance of the euro area does make sense, but it cannot be done without examining the macroprudential policy stance in the euro area, as private sector deficits can harm the euro area as much as public sector deficits. Such an evalua-

tion must consider the functioning of the global financial system as well, in which the Fed’s monetary policy plays a dominant role. It is justified for the EFB to consider overall systemic risks, which go beyond the remit of judging fiscal policies.

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

There should be instruments available to discourage excessive private debts, which should complement what central banks do with their macroprudential instruments.³ Would governments interfere with the functioning of markets? Yes, but this is not necessarily bad in an environment in which speculative behaviour is rampant and productive investment is insufficient. Rating agencies have always played a role in this regard, but, as the financial crisis and other episodes have shown, their judgement is not faultless and may be biased.

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

Final remarks

The EFB and national IFIs are asked to play a significant role in the architecture of the EU economic governance framework. The EC communication has advocated for a role for the national IFIs in the evaluation of fiscal-structural plans. The EC directive proposal scaled down that vision, which was further diminished by the Council directive proposal, which dropped any reference to national IFIs being involved in the assessment of policy impacts on fiscal sustainability. In January this year, the Council and the Parliament reached a provisional agreement on the proposed reform of the EU economic governance framework.

National IFIs have a niche of work that concerns fiscal and budget policies and tax regimes that impact budgets and compliance with fiscal rules. They also judge macroeco-

³ As banks are asked to have adequate capital and liquidity reserves, similar requirements could operate for companies. Then, the question is who should be in charge of formulating and enforcing such requirements.

conomic policy. Getting them involved in an assessment of structural reforms and public investment could backfire unless proper conditions exist. The involvement of national IFIs in the policy design process could be even more problematic. There are at least two aspects involved here. First, and related to a broader scope of assessments, national IFIs may not necessarily have the best views, be they presumed to be an embodiment of independent thinking. Second, national IFIs' involvement in policy design would entail an inescapable conflict of interest. It could be perceived as a technocratic encroachment on a democratic decision-making process, and there are cases in which "technocratic" governments have had modest results, or even failed.

The Council directive proposal may have gone too far in leaving out the tasks of producing debt sustainability assessments underlying the government medium-term planning and producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth completely, without qualifications, from the EC directive proposal.

The Council directive proposal does not make progress on addressing the fundamental weaknesses of the euro area design and of the EU economic governance. Neither does the EC proposal. A common fiscal capacity, EDIS and a safe asset, remain in the realm of wishful thinking due to seemingly intractable political constraints. It is therefore not surprising that the banking union and the capital markets union can hardly advance in the EU.

National IFIs should continue to strive for better access to good and timely information, safeguards to independence, the possibility to make their own assessments, the effective implementation of the "comply or explain" principle and, last but not least, the existence of a legal obligation at the EU level to consider national IFIs, assessments across a range of areas. Establishing minimum standards for IFIs at the EU level is still a distant goal, but it is a prerequisite for their effectiveness.

National IFIs can enhance their contributions to discouraging egregious populist temptations and demagoguery, help instil public governance with common sense and vision, enhance fiscal responsibility and consolidate good practices. They should try to imbue their activity framework with a macroprudential thrust as well.

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